FIXED INCOME

Why short duration now

For professional investors only | For promotional purposes

Members of the Janus Henderson Global Bonds Team explain why the return of positive real interest rates comes at a welcome time.

Daniel Siluk
Portfolio Manager

Jason England
Portfolio Manager

Alex Roitz, CFA
Product Specialist

Key takeaways

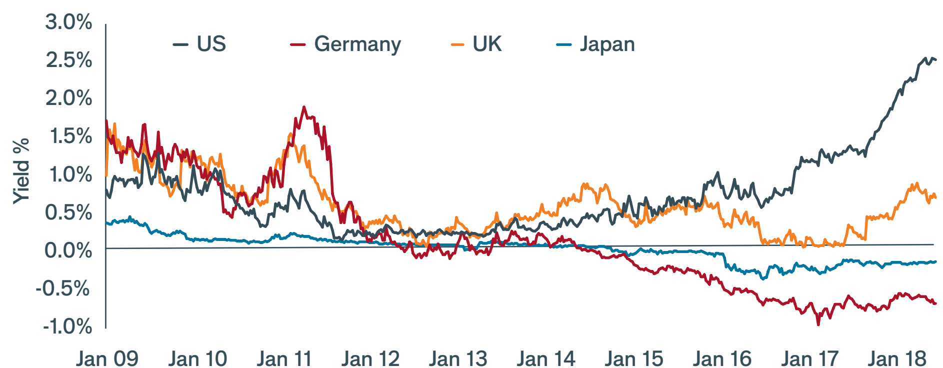
- For the first time since the Global Financial Crisis, real yields on shorter-dated Treasuries have turned positive.
- Fixed income investors seeking higher liquidity or a more conservative risk profile can now maintain shorter duration with considerably less risk of incurring negative returns.
- This development comes just in time, as longer-dated fixed income securities are largely failing to compensate investors for their near record-high interest rate risk.

For much of the post-financial-crisis era, fixed income investors have had to make do without a key component of their tool kit: attractively yielding short duration bonds. The culprit was the highly accommodative monetary policy undertaken by global central banks. Large-scale asset purchases pushed real interest rates into negative territory and forced yield-starved investors further out along the risk spectrum. At long last, the end of this period is in sight as real rates on short-term securities have once again turned positive. This development has elevated the attractiveness of short-term bonds, especially when compared to those of longer tenors. Investors preferring liquid instruments that provide higher yields than cash and those seeking to complement core bond portfolios stand to benefit. A return to positive real yields comes not a moment too soon as the forces that had suppressed volatility – a development that seemingly gave investors the green light to hold riskier assets – seem set to reverse, thus increasing the odds of more turbulent markets.

The 'extraordinary' background

In the wake of the Global Financial Crisis, many of the world's major central banks injected massive amounts of liquidity into financial markets and became aggressive purchasers of a wide range of fixed income instruments – and in some cases other asset classes. The scale in which central banks were willing to expand balance sheets resulted in them becoming the marginal buyer of government debt, and in the process, sending yields on shorter-dated – and in some cases, longer-tenored – securities into negative territory. Sub-zero returns along the front end of the yield curve took away a traditional liquid source of income from investors and forced them into riskier asset classes in order to generate sufficient carry, or yield above cash. Common destinations included longer-dated government debt, high yield corporate credit, emerging market debt and even equities.

Generic 2-year sovereign notes



Source: Bloomberg, as at 30 June 2018.

Janus Henderson INVESTORS

Why short duration now

In more recent years, many investors sought to generate income by taking on more esoteric exposure, including selling volatility – a strategy aimed to benefit from subdued market swings in bonds as well as other asset classes. The pervasiveness of this strategy resulted in suppressed volatility across markets and created a level of complacency as investors deduced that the historical risk profiles of high yield credit, emerging markets and stocks were not to be feared.

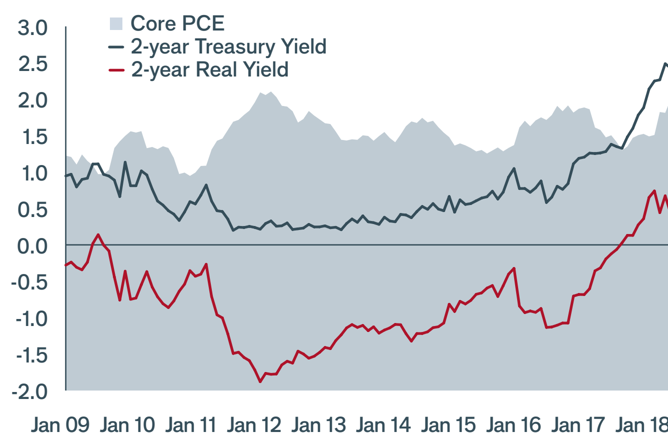
2016: the pivotal year

For many years, low real yields reflected, in part, sluggish global economic growth and the distortive effects of central bank asset purchases. That changed in the wake of the 2016 US election. Risk assets rallied and Treasuries sold off as investors priced in the prospect of a pro-growth agenda from the incoming Trump administration. The exit from safer securities was further propelled by a distinct shift in monetary policy. Investors forecasted that, after years of failing to meet its own projections, the US Federal Reserve (Fed) would raise the benchmark overnight lending rate multiple times in 2017. The expectation of higher rates nudged yields among shorter- and intermediate-dated Treasuries into a higher band than had existed during the preceding years. Yields on longer-dated Treasuries proved stickier as their relative value stacked up well against foreign alternatives and domestic inflation remained muted.

Where are we now?

The Fed indeed altered its rate path, hiking three times in 2017 and twice so far this year. This has pushed the yield on 2-year Treasuries up roughly 200 basis points (bp) over the past two years, to over 2.50%. Inflation – after a 2017 soft patch – has resumed an upward trajectory as well, but at a slower rate than that of shorter-dated bonds. The Fed's preferred gauge of core inflation[1] has risen from 1.3% in August 2017 year-over-year to 1.8% in April 2018. That is the same level that TIPS Breakevens[2] infer inflation will average over the next two years. The result has been real yields on 2-year Treasuries turning positive in late 2017 for the first time in eight years. Consequently, investors have less incentive to venture into riskier asset classes to generate income.

Real yields on 2-year Treasuries turn positive



Source: Bloomberg, as at 30 June 2018.

Just in time

The return of positive carry on the short end of the yield curve goes hand-in-hand with the rising likelihood of higher volatility across a range of asset classes. Both short-term bonds and selling volatility are sources of carry, and as the former starts to offer attractive yields, the impetus to sell volatility will likely diminish. With that dampener on market gyrations weakened, one can expect volatility across a range of asset classes to reset to higher levels.

By many measures, longer-dated Treasuries, high yield corporates and emerging market debt are richly valued. Should volatility return to historical levels, current valuations may not be sufficient to adequately compensate investors for the amount of risk they are incurring.

Perhaps the most telling example is Treasuries, as illustrated by a rapidly flattening yield curve. The spread between the 10-year and 2-year notes narrowed from 136 bp in the post-2016 election sell-off to 33 bp by the end of June 2018. Spreads between 10-year and 30-year Treasuries were an even tighter 13 bp. In both cases, investors choosing to invest in the longer-dated maturities would take on significantly higher duration risk for only a marginal bump in yield.

Adding more arrows to the quiver

Shorter-dated fixed income securities have traditionally offered investors numerous favorable characteristics. Among them are liquidity, visible income streams and lower volatility. As central banks continue along their path toward policy normalisation, bond investors can once again leverage these characteristics by incorporating short-term bonds into a broader fixed income portfolio in order to create their preferred risk/return profile.

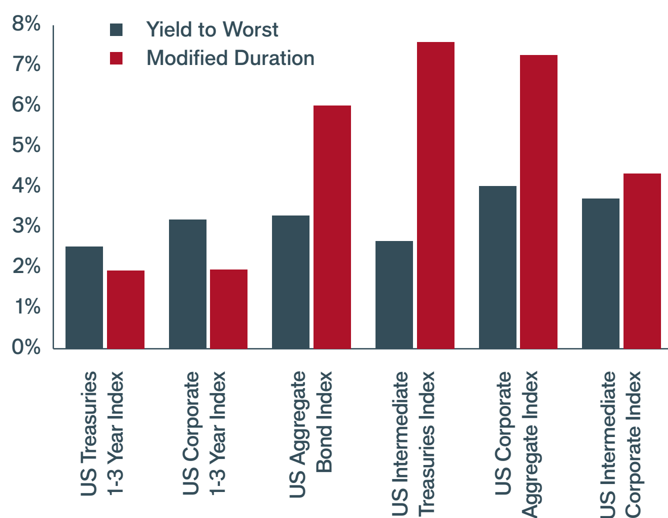
[1] The Personal Consumption Expenditure (PCE) Price Index, ex Food and Energy, a gauge of core inflation.

[2] TIPS, Treasury Inflation-Protected Securities, are government bonds that are periodically adjusted to account for inflation. Breakevens are the inflation levels implied by TIPS prices.

For years there had been scant benefit for investors who prefer a relatively high allocation to cash and other liquid instruments to hold short-term bonds, as rates were often mired below 0%. A return to positive real yields now means that conservative investors no longer must choose between liquidity and earning a suitable level of carry.

Investors with a more traditional fixed income allocation would be well served to consider positioning along the front end of the curve as a complement to core bond portfolios. Driving home this point is the historic mismatch between risk and return in the Bloomberg Barclays US Aggregate Bond Index (Agg), a popular benchmark for core bond portfolios. Although the yield-to-worst on the Agg climbed above 3% in 2018 for the first time since 2011, the index's duration remains just beneath its record high of 6.2 years, set earlier this year.

Shorter-dated bonds exhibit more favourable risk profiles



Source: Bloomberg, as at 30 June 2018.

Bloomberg Barclays indices shown represent investment grade, fixed rate debt of the US bond markets described by their names.

Yield to Worst: The lowest potential yield an investor would earn - accounting for all provisions - short of a security defaulting.

Modified Duration: A measurement of a bond's sensitivity to interest rates, with a higher number, measured in years, being more sensitive.

Rich valuations on longer-dated bonds expose investors to an elevated risk of capital loss. For example, the annual income on the generic 10-year Treasury note with a coupon of 2.875% would be wiped out if rates rose just 34 bp. On the 2-year note with a 2.5% coupon, it would take a much more pronounced 131 bp upward move in rates to render the investment flat for the year. Investors would be mindful to heed these disparate risk profiles as bond markets face visible headwinds, including an elongated credit cycle, tight spreads on corporate credit, still-manageable but rising inflation and the expectation of higher market volatility.

Prudence required

While the argument can be made that conditions merit an increased allocation to short duration bonds, investors should still act judiciously when choosing how to optimally gain exposure to these maturities. Despite their shorter durations and higher liquidity, risks still remain in the front end of the curve. Given rich valuations across all tenors, active management may help investors avoid securities whose prices have outrun fundamentals. Strategies that place an emphasis on lowering correlations to core bond strategies would likely prove advantageous in the event of market upheaval.

Rather than tethering oneself to a benchmark, an absolute return strategy can enable investors to identify securities that meet their preferred risk/return profile from a wider opportunity set, regardless of geography. Individual countries are at different stages of credit and monetary cycles. Advanced economies that maintain accommodative monetary policy relative to their peers and foreign investment grade companies benefiting from secular tailwinds may offer investors attractive risk-adjusted returns without forcing them to descend the capital structure or increase exposure to emerging markets.

Perhaps most importantly, we believe investors need to alter the mindset that has governed them for much of the post-crisis era. The days of distorted markets that enabled investors to pursue returns with only secondary consideration of the historical risk levels associated with many asset classes are likely in the past. The return of positive carry along the front end of the yield curve likely harkens elevated volatility across a range of riskier asset classes. Fortunately, the return of positive real yields on short-term bonds means such strategies are now less enticing. Instead, short-term bonds can be looked upon to do what they have historically provided investors: income generation and a potential dampener to overall portfolio volatility.

These are the views of the authors at the time of publication and may differ from the views of other individuals/teams at Janus Henderson Investors. Any sectors, indices, funds, and securities mentioned within this article do not constitute or form part of any offer or solicitation to buy or sell them.

Past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise and investors may not get back the amount originally invested.

The information in this article does not qualify as an investment recommendation.

For more information, please visit **janushenderson.com.**

Janus Henderson
INVESTORS

The views presented are as of the date published. They are for information purposes only and should not be used or construed as investment, legal or tax advice or as an offer to sell, a solicitation of an offer to buy, or a recommendation to buy, sell or hold any security, investment strategy or market sector. Nothing in this material shall be deemed to be a direct or indirect provision of investment management services specific to any client requirements. Opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent, and are subject to change at any time due to changes in market or economic conditions. It is not intended to indicate or imply that any illustration/example mentioned is now or was ever held in any portfolio. No forecasts can be guaranteed and there is no guarantee that the information supplied is complete or timely, nor are there any warranties with regard to the results obtained from its use. In preparing this document, Janus Henderson Investors has reasonable belief to rely upon the accuracy and completeness of all information available from public sources. Past performance is no guarantee of future results. Investing involves risk, including the possible loss of principal and fluctuation of value.

Not all products or services are available in all jurisdictions. The distribution of this material or the information contained in it may be restricted by law and may not be used in any jurisdiction or any circumstances in which its use would be unlawful. The contents of this material have not been approved or endorsed by any regulatory agency. Janus Henderson is not responsible for any unlawful distribution of this material to any third parties, in whole or in part, or for information reconstructed from this material.

This material may not be reproduced in whole or in part in any form, or referred to in any other publication, without express written permission.

Issued in **Europe** by Janus Henderson Investors. Janus Henderson Investors is the name under which Janus Capital International Limited (reg no. 3594615), Henderson Global Investors Limited (reg. no. 906355), Henderson Investment Funds Limited (reg. no. 2678531), Henderson Investment Management Limited (reg. no. 1795354), AlphaGen Capital Limited (reg. no. 962757), Henderson Equity Partners Limited (reg. no.2606646), Gartmore Investment Limited (reg. no. 1508030), (each incorporated and registered in England and Wales with registered office at 201 Bishopsgate, London EC2M 3AE) are authorised and regulated by the Financial Conduct Authority to provide investment products and services. Advisory services in the **U.S.** are provided by SEC registered investment advisers that are subsidiaries of Janus Henderson Group plc. In **Canada**, products and services are offered through Janus Capital Management LLC only to institutional investors in certain jurisdictions.

Issued in (a) **Singapore** by Henderson Global Investors (Singapore) Limited, licensed and regulated by the Monetary Authority of Singapore. Henderson Global Investors (Singapore) Limited Company Registration No. 199700782N, (b) **Hong Kong** by Janus Henderson Investors Hong Kong Limited, licensed and regulated by the Securities and Futures Commission, (c) **Taiwan** R.O.C by Janus Henderson Investors Taiwan Limited, licensed and regulated by the Financial Supervisory Commission R.O.C., (d) **South Korea** by Janus Capital International Limited, (e) **Australia and New Zealand** by Janus Henderson Investors (Australia) Institutional Funds Management Limited (ABN 16 165 119 561, AFSL 444266) and (f) the **Middle East** by Janus Capital International Limited, regulated by the Dubai Financial Services Authority as a Representative Office. No transactions will be concluded in the Middle East and any enquiries should be made to Janus Henderson.

Note to China (PRC), Africa and Colombia Readers: Janus Henderson is (a) not licensed, authorised or registered with the China Securities Regulatory Commission for investment management business or otherwise approved by any PRC regulatory authorities to provide investment management services in the PRC. Janus Henderson Investors makes no representation and warranties that it is, and will be, in compliance with PRC laws. (b) not authorised in South Africa for marketing and (c) not authorised to market its products and/or services in Colombia or to Colombian residents unless such promotion and marketing is made in compliance with applicable rules and regulations.

Outside of the U.S.: For use only by institutional and sophisticated investors, qualified distributors, wholesale investors and wholesale clients as defined by the applicable jurisdiction. **Not for public viewing or distribution.**

Janus Henderson, Janus and Henderson are trademarks of Janus Henderson Investors. © Janus Henderson Investors. The name Janus Henderson Investors includes HGI Group Limited, Henderson Global Investors (Brand Management) Sarl and Janus International Holding LLC.

H036969/0718