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Markets

FOCUS

26 October 2021

Within ***Focus*** we comment on extraordinary market events and analyse capital market-related special topics.

Short-term bonds - more (value) than liquidity substitute

Market expectation does not point to an end of the negative interest rate environment any time soon

The negative interest rate environment will probably accompany us for around a decade in total. Current market expectations show that positive Euro money market interest rates are not to be expected before end of 2024 (Fig. 1). Even the current discussion as to whether the rise in the inflation rate is only temporary or whether a sustained higher price level increase will materialise has not changed the interest rate outlook so far. Following the change in strategy by the European Central Bank (ECB), it will in future tolerate a temporary overshooting of inflation above the target of 2%, which argues in favour of a lower key interest rate level in the Eurozone for longer.

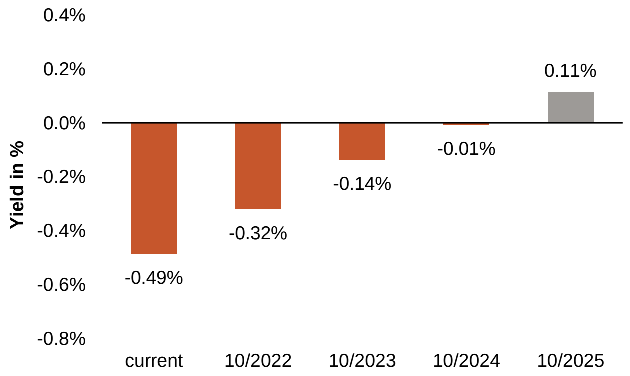
Yield optimisation or risk management - the motive counts

Many investors who hold liquidity in the medium term for strategic or regulatory reasons are therefore looking for alternatives and have increasingly turned to short-term bonds and fund investments in recent years. This group of investors accepts a higher risk compared to overnight or time deposits if this is rewarded by a higher expected performance. Multi-asset investors are also increasingly focusing on this market segment. The main argument here is the currently prevailing stronger synchronisation of equities and long-term bonds and the above-average duration risks without corresponding current income in defensive bond segments with longer residual maturities (Fig. 2)[1].

Flexibility is the key

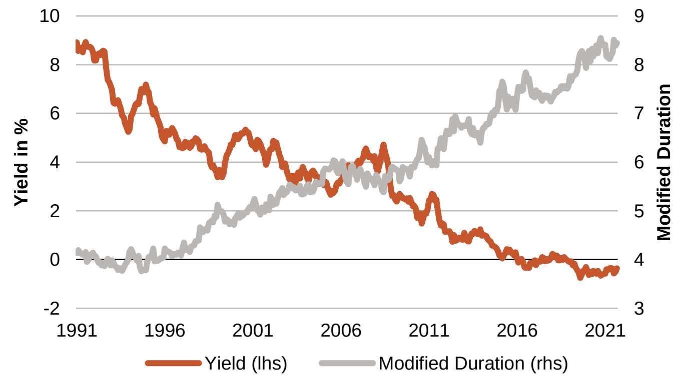
For both investor groups, a performance above that of money market investments is crucial. This can only be achieved through the right choice of instruments, the targeted use of risk premiums and appropriate portfolio positioning. We analyse the market structure and illustrate which alternatives are available. We also discuss when the use of individual alternatives is sensible, especially in the current market environment, and why it is important to take ESG risks into account.

Fig. 1: Positive overnight rates expected from end of 2024 onwards
EONIA forward curve



Data as of: 20/10/2021
Source: Bloomberg Finance LLP, own calculations

Fig. 2: A lot of duration risk and no return
Development of the average yield of all outstanding German government bonds compared to their modified duration



Time Period: 31/12/1991 - 30/09/2021, monthly data
Source: ICE, own calculations

[1] See also Berenberg Markets Focus "Stronger equity and government bond synchronization likely to continue to shape coming years", 30 August 2021.

A diverse market segment

USD and EUR-denominated bonds most important components in the portfolio

The global market structure in the space of short-dated bonds is characterised by immense diversity and offers potential investors a wide range of options. This segment includes bonds with a remaining term of up to five years and floating rate notes (FRNs)[2]. The latter are characterized by a significantly lower interest rate risk due to the usually quarterly adjusment of the coupon to a money market interest rate.

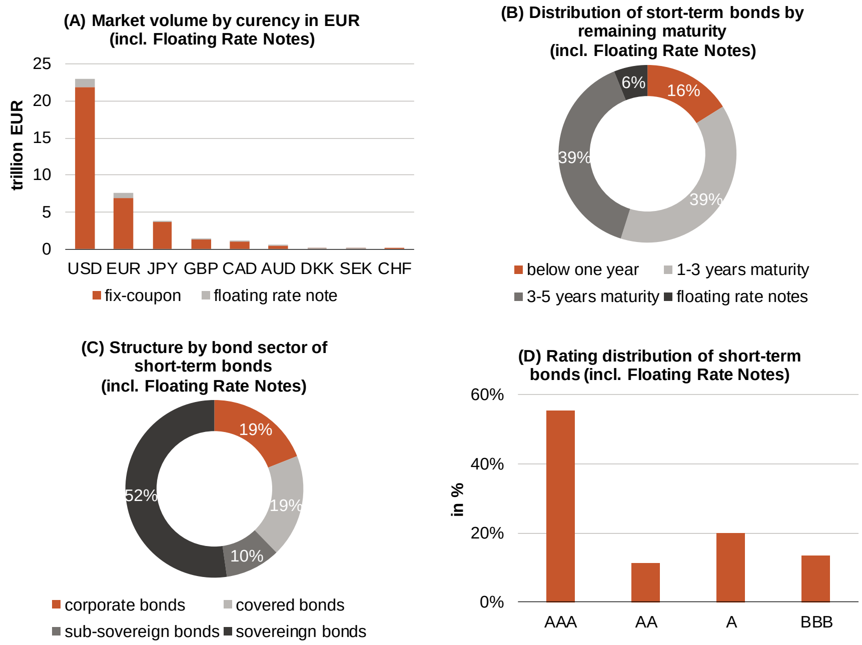
The market volume as per end of September 2021 is around EUR 32 trillion. This corresponds to a market share of 47% measured by the ICE All Maturity Global Broad Market Index, supplemented by floating rate notes[3]. Thereof, USD-denominated instruments account for EUR 18.1 trillion, while their EUR-denominated counterparts come to EUR 7.5 trillion (Fig. 3 A).

A further breakdown can be made using maturity bands. Here, bonds with residual maturities of less than one year account for EUR 5 trillion, bonds with residual maturities of between 1-3 years for EUR 12.1 trillion and bonds with residual maturities of between 3-5 years for EUR 12.7 trillion (Fig. 3 B).

High concentration in government bonds

At sectoral level, the area of government bonds and government-related issues represents the largest share of this universe at 64% (Fig. 3 C). The remainder is distributed almost equally between corporate and collateralised bonds. Due to the high share of government bonds, this segment is characterised by ratings of AA- or better with almost 65% (Fig. 3 D).

Fig. 3: Market overview of short-dated bonds



Data as of: 30/09/2021
Source: ICE, own calculations

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[2] Floating rate notes are bonds with variable interest rates. The coupon is fixed regularly, usually quarterly, depending on a selected money market interest rate (reference interest rate). In addition, a premium (discount margin) is added depending on the creditworthiness of the bond debtor.
[3] Floating Rate Notes with at least EUR 250 million outstanding, investment grade, currencies: USD, EUR, CAD, DKK, SEK, JPY, AUD, CHF, data as of 30/09/2021

Depending on risk appetite and investment preferences, there are attractive opportunities in FRN space. Due to the special duration characteristics of these instruments, they are particularly suitable for investors who expect interest rates to rise. It should be noted, however, that FRNs are subject to a spread change risk similar to that of fixed-coupon bonds. Compared to the broad market average, the FRN universe is characterised by a relatively high proportion of issuers from the financial sector and smaller issue volume (Table 1).

Floating rate notes protect against rising interest rates

Table 1: Comparison of floating-rate notes (FRN) versus fixed-rate bonds

	Floating-rate notes (FRN)	Fixed-rate bonds
Interest rate risk (interest rate duration)	Coupon adjustment date (mostly 3 or 6 months)	Final maturity
Credit risk (Spread-Duration)	Final maturity	Final maturity
Liquidity risk	Slightly elevated	Medium
Ø Issue volume	Predominantly <EUR 500 million	Predominantly >EUR 500 million
Investors	Predominantly money market funds, treasury departments	Widely diversified
Issuers	Mostly banks	Widely diversified

Source: Berenberg, own presentation

Even for more conservative investor groups with more restrictive guidelines, such as investors who have to comply with the regulations of the fourth German Social Security Code (SGB IV), the market for short-term bonds offers a selection of attractive opportunities. This applies to both fixed-rate and floating-rate bonds. The same applies to investors who are subject to stricter requirements in certain areas, primarily for regulatory reasons, such as banks and insurance companies.

Short-term bonds also attractive for conservative investors

The area of non-listed securities - be it in the form of commercial papers, time deposits or with the help of so-called private placements - may also offer interesting opportunities to cover niche interests. It should be noted, however, that generally lower liquidity and the lack of an exchange listing or bond rating limit the potential investor base.

Using risk premiums profitably

Investors can choose from a variety of interesting risk premiums

The current interest rate environment makes it necessary to act flexibly and to use risk premiums profitably. In addition to the classic duration risks and the associated maturity premiums, the bond market also offers further scope for positioning and selecting individual securities in the short-term segment.

The addition of credit risks increases the return and portfolio diversification

Credit risks are a central component and thus represent the main risk premium in the short-term segment. The credit spread of a bond is the part of the yield that serves to compensate for default, migration[4] and liquidity risks. The low and negative interest rate environment that has prevailed since the end of the financial market crisis has meant that the relative share of the credit spread now significantly exceeds the total yield on short-term bonds (Figs. 4 and 5). This makes it all the more crucial to manage and use credit risks actively, flexibly and opportunistically in the portfolio context. Various strategies and structuring options are available for this purpose.

Profiting from increasing spread differences between the rating categories without increasing the overall risk

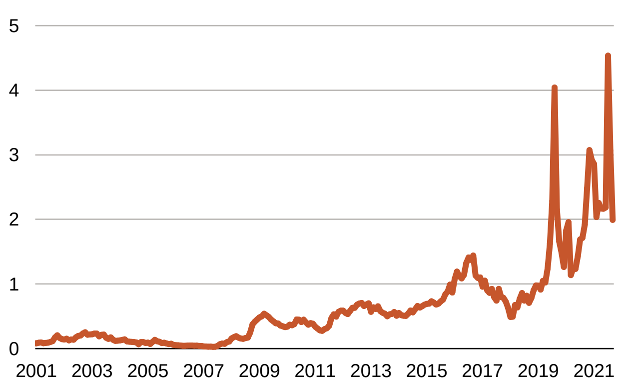
Among the **risk-neutral strategies** is the credit-barbell structure (Fig. 6 A). Here, high and low credit risks are combined in the portfolio in such a way that the overall risk remains unchanged at the portfolio level. The positioning is at the expense of medium credit risks. Segments with high credit risks include, for example, the BBB segment, high-yield or subordinated bonds[5]. This strategy is suitable for bond market investors who are not allowed to take on any additional risks at portfolio level compared to their benchmark index and are regulated by investment restrictions and rating specifications at portfolio level. It is particularly suitable in an environment of high and exponentially rising spread differences between individual rating categories.

Increasing the overall risk

By means of **risk-increasing strategies**, the credit risk is increased in the portfolio under tactical or strategic considerations. The overweighting of credit risk is achieved by adding or increasing certain bond sectors or rating categories within the benchmark-universe (Fig. 6 B).

Fig. 4: Credit spread exceeds yield many times over...

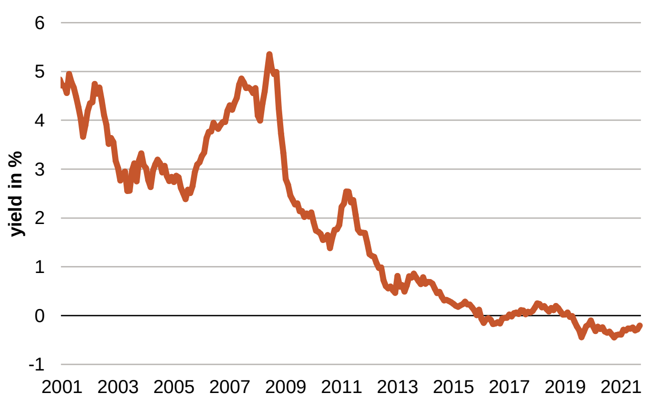
Ratio between credit spread and total return of 1-5-year € corporate and financial bonds in the investment grade range



Time Period: 31/12/2000 – 30/09/2021
Source: ICE, own calculations

Fig. 5: ... due to the decline in risk-free interest rates

Risk-free share (after deduction of the credit spread) of the yield of 1-5 year EUR corporate and financial bonds



Time Period: 31/12/2000- 30/09/2021
Source: ICE, own calculations

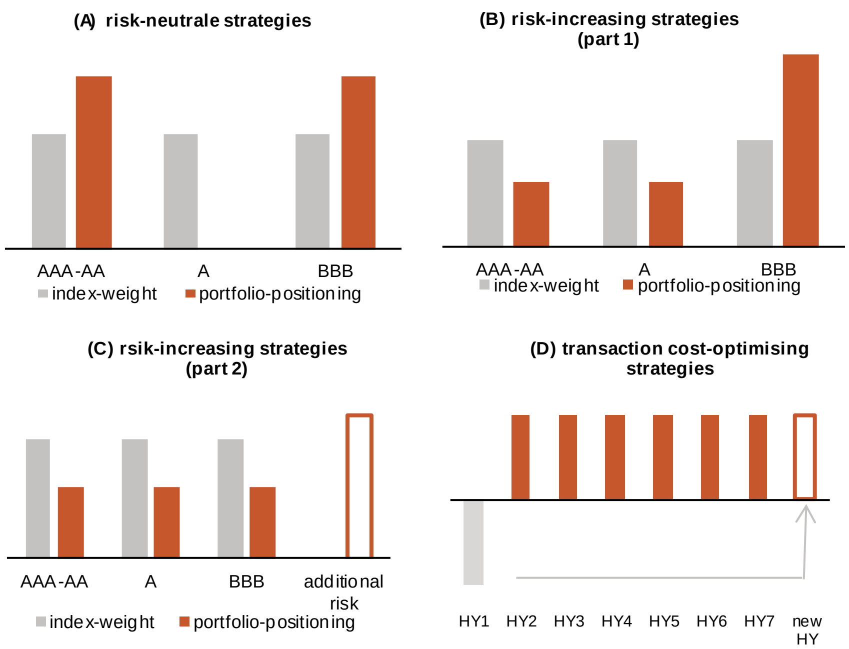
[4] Migration risk comprises the risk that the credit rating of the issuer changes over time.
[5] Subordination means that in the event of insolvency, investors in such instruments are only serviced after all non-subordinated debt instruments (e.g. Pfandbriefe, senior unsecured bonds) have been serviced

Also investments outside a specific benchmark universe, like high-yield bonds, emerging markets or the subordinated segment, are also conceivable (Fig. 6 C). One other variant is to add long-dated credit risks outside the short-dated investment spectrum in order to benefit from steep credit spread curves and to collect attractive term premiums on the credit spreads. The additional interest rate risk above a benchmark index can be reduced to index level via interest rate derivatives. Alternatively, long-dated FRNs exposed to credit risk can be used to increase the credit risk. Their spread duration is comparable to that of fixed-coupon bonds. However, they are only subject to marginal interest rate risks.

Keeping the transaction costs in view

The last block is made up of **transaction cost-optimising strategies** (Fig. 6 D). These are suitable for investors for whom a limited turnover rate and low transaction costs of their portfolio are important and who therefore rely on reduced active management. The classic ladder structure lends itself to this. Here, the portfolio is invested in an equally distributed manner over the term of quarters or half-years. Each of these sub-segments within the portfolio can now be stocked with the appropriate bonds, taking into account the overall portfolio risk and under consideration of the individual investment guidelines. Management remains limited to the reinvestment of maturing bonds within one year. The maturing bonds are reinvested on a revolving basis at the prevailing interest rate and spread level at the time. The duration risk remains constant and is not actively managed.

Fig. 6: Schematic illustration of the different strategies



Source: Berenberg, schematic illustration

The decision itself to increase credit risk in the portfolio can be made under many aspects. Flexible and opportunistic approaches often take into account the relative attractiveness compared to other market segments, one's own history and fundamental considerations in the decision-making process. This is in contrast to momentum strategies, among others, which pursue trend-following approaches.

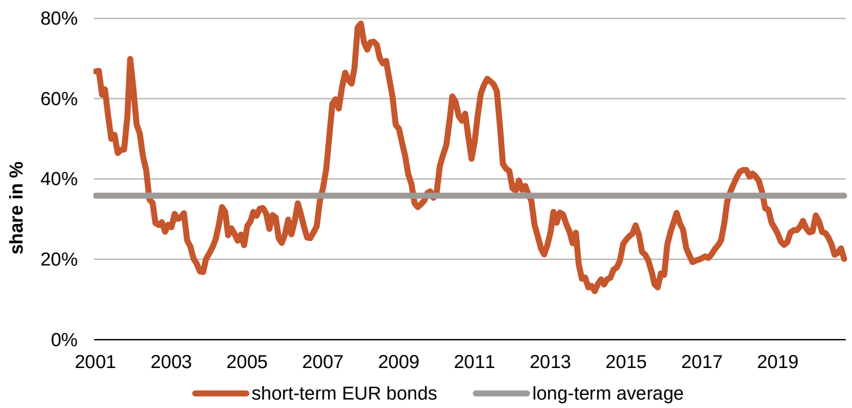
The new issue premium collected supports performance

New issues open up opportunities to earn additional returns

New issues are an important instrument in the management of short-dated bond portfolios. Since the end of 2001, slightly more than one-third of new issues in EUR of corporate and financial bonds have been in the short-dated bond segment. However, the trend in short-dated bond issuance has recently been declining relative to the overall market (Fig. 7). Many financial market players are taking advantage of the favourable conditions in the current market environment to refinance themselves on a longer-term basis. The total volume of new issues is also down slightly this year after the record year of 2020.

Fig. 7: Share of short-dated bonds in the primary market

Share of short-dated bonds (residual maturity <= 5.5 years) in the primary market in EUR and USD rolling over 6 months compared to the historical mean



Period: 31/12/2001 - 30/09/2021
Source: Bloomberg Finance LLP, own calculations

Investors' risk behaviour also influences the new issue premium

The supply of new issues opens up the possibility for bond market investors to generate additional returns. In order to create an incentive to subscribe to the new issue, it often comes with a premium. This new issue premium is orientated to the valuation of comparable bonds already outstanding from the issuer. In the case of first-time issuers, the basis, i.e. the fair level of the credit risk premium, is based on comparable issuers from their sector in terms of credit quality and maturity. The premium itself is influenced by the general risk appetite and investor feedback. In a risk-averse bond market environment, investors demand a higher risk premium. In a risk-seeking market environment, investors also accept lower new issue premiums. In addition, the format of the bond, such as issue size or rank, plays an important role in determining the basis and new issue premium.

Spread curves react quickly

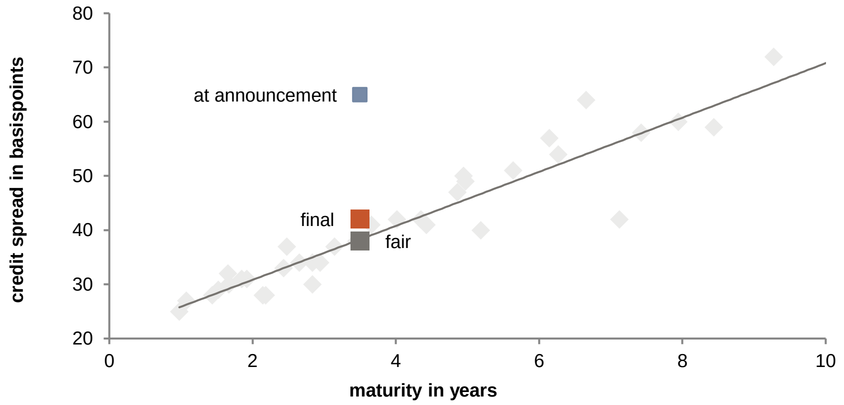
Due to the risk premium of the new issue, the issuer's spread curve is no longer fairly valued and thus opens up arbitrage opportunities. To compensate for the mispricing, either the risk premium of the new issue adjusts to the credit curve of the already outstanding bonds after the initial listing or the risk premiums of the old bonds adjust to the level of the new issue. In practice, there is often a combination of both effects.

Case study of an issuance process

Figure 8 shows an example of the marketing process for a new issue by a subsidiary of Volkswagen AG. At the time of announcement and opening of the subscription books (blue) at Mid Swap + 65/70 basis points.

Fig. 8: Relative attractiveness of new issues

Example: 0% Volkswagen 12.02.2025 (XS2374595127)



Dates as of: 05/08/2021

Source: ICE, Bloomberg Finance LLP, own calculations

Due to the excess demand, the issuer was able to reduce the credit spread to 42 basis points (brown) by the time the books closed. The fair value (dark grey), derived from the distribution of the risk premiums of the outstanding bonds, was around 35 basis points. The final new issue premium was thus 7 basis points above the level of the outstanding bonds.

Active participation optimises the allocation rate

The excess demand also leads to allotment ratios of usually less than 100%. Therefore, qualitative factors are increasingly influencing the allocated volume and thus also the overall investment success. For example, the allotment ratio can often be increased through active participation in roadshows, the provision of feedback on the new issue, the credit quality of the issuer and the expression of interest in purchasing a certain volume of the new issue. However, this possibility is usually only available to institutional investors, such as fund management companies, insurance companies or other capital collection agencies.

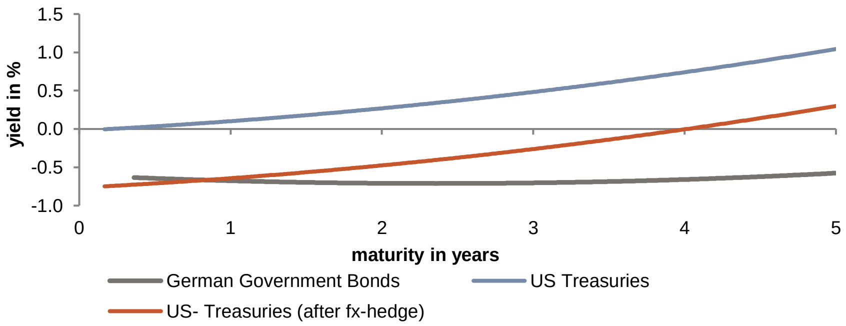
Currency-hedged foreign currency bonds

Foreign currency bonds (currency hedged) can offer attractive returns

The use of foreign currency bonds can provide additional returns for euro investors even after hedging foreign currency risk. Investors can look at this from different angles. For example, the addition may appear attractive due to differences in the interest rate structure between foreign currency bonds and EUR bonds (Fig. 9).

Fig. 9: Comparison of yield curves

Yield curves of Bunds versus US Treasuries before and after annualised foreign currency hedging costs for three months from the perspective of a euro investor



Data as of: 30/09/2021

Source: ICE, own calculations

There are also opportunities in the credit segment. It is particularly interesting to look at individual issuers. Local investors usually have a more differentiated view of the credit quality of local bond issuers than international investors and accordingly assess the credit risk of these issuers differently. For foreign investors, on the other hand, bonds from these issuers usually only represent an admixture in the portfolio context. Here, too, the approach to the analysis is similar. Instead of the government bond curve, however, the curve of the issuer in the corresponding currencies under consideration of hedging costs is observed (Fig. 10).

The credit segment also offers attractive investment opportunities

In both cases, the hedging costs for the foreign currency risk must be taken into account in the investment decision as they have a significant influence on the attractiveness of foreign currency bonds. This applies both to the initial investment and to the prolongation of the hedge.

After a prolonged period of rising hedging costs for EURUSD exchange rate risks, the expansionary monetary policy measures taken by the Fed and the ECB in the wake of the Corona crisis have led to a marked fall in hedging costs. Currently, the hedging costs for three months amount to approx. 0.8% on an annual basis (Fig. 11).

EURUSD hedging costs currently favourable

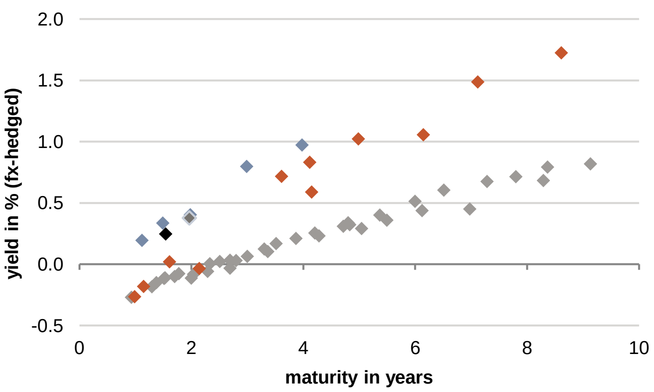
Consider sustainability risks

ESG integration is an important component of many investment strategies, particularly in the context of risk management. It is becoming increasingly clear that neglecting ESG risks in decision-making can have a negative impact on the performance of investments, especially in the case of short-term investment strategies. For example, the current negative interest rate environment makes it difficult to cover ESG-related losses (e.g. due to a governance scandal) with positive returns in other parts of the bond portfolio. Also, due to the tendency of these investment strategies to have a short- to medium-term holding period, there is often not enough time available to offset losses. It is therefore all the more crucial to combine a comprehensive and ESG-integrated analysis of companies and sectors with a broad diversification of idiosyncratic risks at portfolio level.

Integrating ESG into decision-making and reducing risks

Fig. 10: Identifying opportunities in foreign currencies

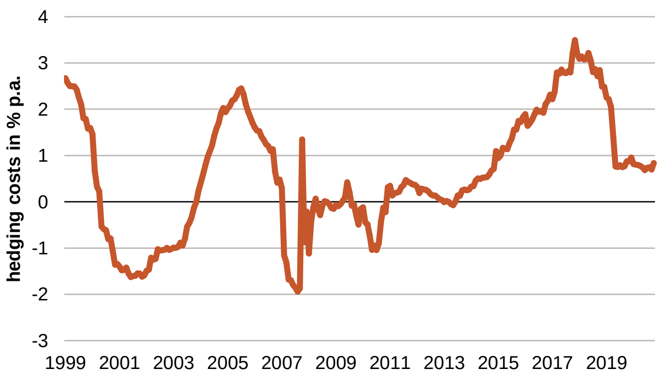
Yield comparison between Volkswagen's EUR bonds and its foreign currency bonds, taking into account foreign currency hedging costs



Data as of: 30/09/2021
Source: ICE, Bloomberg, own calculations

Fig. 11: EURUSD hedging costs currently low

EURUSD annualized hedging costs for three months from the perspective of a euro investor



Time Periode: 31/12/1999 – 30/09/2021
Source: Bloomberg

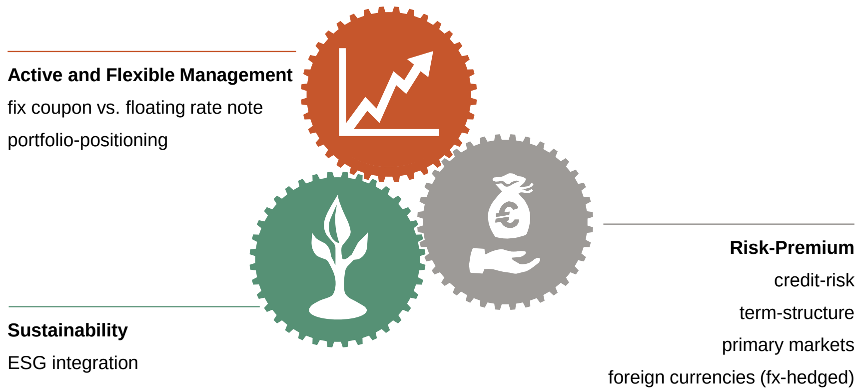
Inclusion also appears promising with a view to the coming years. Demand for bond ETFs and traditional mutual funds that take ESG risks into account has risen sharply in recent years. This trend should continue, which should continue to positively influence the performance of bonds from this segment.

Conclusion

The negative interest rate environment is likely to persist for some time and investors will probably continue to be burdened with penalty interest or custody fees for several years. There is also an asymmetry between the duration risks of longer-dated bonds and their earnings potential in a rising interest rate environment, which argues in favour of shorter duration in the portfolio context in the medium term.

We have shown that there are a number of interesting instruments and investment opportunities available in the short-dated bond segment to escape this dilemma (Fig. 12). For example, new issue markets and foreign currency bonds offer opportunities after foreign currency hedging and can thus contribute positively to investment success.

Fig. 12: A wide-ranging construction kit



Source: Berenberg

A detailed analysis and decomposition of the risk drivers, taking ESG risks into account, enables a precise match to be made to a predefined requirements and risk profile.

If risk budgeting also plays an important role in the liquidity investment, a customised selection of defensive and offensive mutual funds in combination with an overriding risk management[6] is advisable.

We at Berenberg use this wide range of opportunities in our strategies and mutual funds in this segment in order to achieve the best possible performance tailored to individual risk.

In conclusion, it should be noted that this market segment is not only justified by the current avoidance of negative interest rates in liquidity investment. Even in times of a positive interest rate environment, added value can be achieved through the use of diverse risk premiums and investment opportunities.

[6] See also Berenberg Insights "Liquidity Investments in the Negative Interest Rate Environment - The New Reality for Companies", February 2021

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