The Strategic Advantage of Short Duration High Income Bonds

In an era of evolving political dynamics and shifting economic landscapes, investors are increasingly seeking asset classes that reduce volatility with attractive income. The US Federal Reserve's (Fed) ongoing rate-cutting cycle and the evolving policy priorities under a Trump presidency add layers of complexity to financial markets. Against this backdrop, short duration high income bonds stand out as a compelling choice, combining attractive income potential with lower interest rate sensitivity. This asset class offers a strategic edge through resilience against interest rate shifts and its role as a defensive block in navigating a dynamic market environment.

Implications of the US Presidential Election

The November 2024 US presidential election marked significant political shifts, with Donald Trump securing a decisive victory and the Republicans gaining control of Congress. A red sweep could pave the way for Trump to implement his policies. Trump's focus on reducing corporate taxes and further deregulation is expected to benefit US companies, enhancing their growth prospects and boosting earnings. These policies are likely to stimulate economic activity and support corporate profitability.

However, while these growth-friendly policies could drive economic expansion, they also carry inflationary risks. Tax cuts and deregulation may create upward pressure on demand, while Trump's proposed tariff hikes could pose substantial risks to global trade. In addition to economic policy, Trump's unpredictable foreign policy approach may introduce elevated geopolitical risks, which could affect investor sentiment and global capital flows. Given these complexities, investors must remain adaptable, balancing income-generating strategies with preparedness for increased market volatility.

US Federal Reserve's Rate-Cutting Trajectory

The Fed, having initiated a rate-cutting cycle in September 2024, continues its monetary easing to address inflationary pressures and slowing job growth in the economy. A 25-basis-point reduction in November underscored its renewed commitment to economic support, with additional cuts projected through 2025. Allianz Global Investors expects cumulative rate cuts of up to 125 basis points between December and 2025, reflecting a proactive approach to managing inflation expectations while supporting economic growth.

Notably, the Fed's approach signals an important shift, focusing on maximum employment — a core component of its dual mandate alongside price stability. This shift toward pre-emptive, front-loaded rate cuts suggests the Fed has learned lessons from previous economic cycles, where policy restraint typically stayed in place for too long, unnecessarily raising recession risks. The Fed's actions have, for now at least, increased the probability of a US soft landing in 2025, where economic growth moderates without triggering a downturn.

Beyond monetary policy, broader economic tailwinds underscore the resilience of the US economy. Steady consumption, continued government spending, improving productivity, increasing capital expenditures, and the proliferation of artificial intelligence, highlight its underlying strength. However, risks persist. Other potential headwinds, such as escalating geopolitical tensions, prolonged labor market softening, deteriorating consumer sentiment, and continued manufacturing contraction, could hinder this momentum. Against this backdrop, adopting investment strategies that balance income potential with risk management becomes critical. Leveraging the strategic advantages of short duration high income bonds can provide investors with a way to navigate volatility while pursuing attractive potential returns.

Enhanced Yield Potential Amid Declining Rates

The Fed's ongoing rate cuts have fostered a more accommodative interest rate climate, which in turn highlights the appeal of high-yield bonds. As of 31 October 2024, the yield on 10-year US Treasury bonds stood at 4.28%, while investment-grade corporate bonds offered a yield of 5.22%. The S&P 500's dividend yield was a modest 1.32%. By contrast, US high-yield bonds provided an average yield of 7.5%[1], highlighting their attractiveness to yield-seeking investors both domestically and internationally.

The continued growth of the US high-yield bond market strengthens its case as a compelling investment option. The market has expanded from USD 338 billion in 2000 to USD 1.38 trillion by December 2023[2]. Additionally, according to the ICE BofA US High Yield Index, US high-yield bonds account for approximately 62% of the global high-yield bond market. The market's diverse industry coverage broadens its investment potential, offering investors exposure to sectors that may perform differently under various economic conditions. The default rate for short duration high income bonds remains notably low at 0.55% as of October 2024, well below its long-term average of 3.5%[3]. With Allianz Global Investors' base-case scenario anticipating a US economic soft landing, short duration high income bonds are expected to maintain their resilience, offering attractive potential yields projected to range between 6% and 7% in 2025. Even in the event of a recession, the default rate for short duration high income bonds is unlikely to rise significantly, given that the yield curve inversion has persisted for over two years while the US economy has remained resilient. Both large and small businesses have already prepared for the possibility of a US recession, adopting conservative debt issuance practices, focusing on cash flow, and maintaining relatively low leverage ratios.

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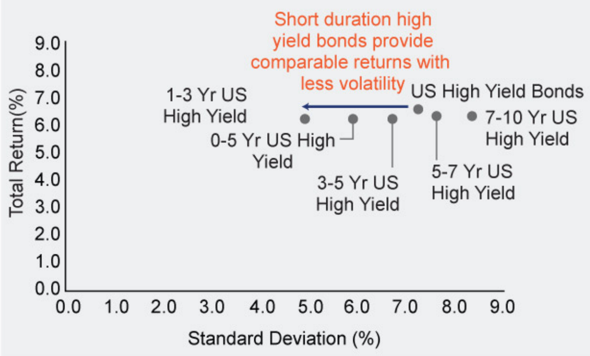
Short Duration: Better Risk/Return Ratio

There are key primary benefits to investing in the short-duration segment (referring to the short end) of the US high-yield market, particularly as represented by the 1-3 Year US High Yield Index. First, this segment offers a better risk/return ratio. The short end of the US high-yield market has provided comparable returns to the broader US high-yield market, but with significantly lower volatility, making it an attractive option for income-focused investors.

Chart 1: US high yield market exhibits risk / return variability by maturity



Source: Voya Investment Management, FactSet, ICE Data Services, data from November 2009 to September 2024. This statement reflects performance and characteristics for the time period shown, results over a different time period may have been more or less favorable. The performance shown above is gross and does not reflect the deduction of investment advisory fees. 1-3 YR: ICE BofA 1-3 Year US Cash Pay High Yield Index , 3-5YR: ICE BofA 3-5 Year US Cash Pay High Yield Index, 5-7YR: ICE BofA 5-7 Year US Cash Pay High Yield Index, 7-10YR: ICE BofA 7-10 Year US Cash Pay High Yield Index, US High Yield Bonds: ICE BofA US High Yield Index; 0-5Yr: ICE BofA 0-5 Year US High Yield Constrained Index.

Second, short duration high income bonds offer a compelling yield-to-duration ratio. Yield-to-duration measures how much a bond's price would need to decline to offset its yield, resulting in a capital loss. This is often referred to as the “break-even point”. In the current environment, elevated yields act as a cushion against potential price declines in US high yield, particularly if recession fears re-emerge. The record-high new issuance and refinancing activity in 2020 and 2021 pushed coupons and interest expense down and maturities further out, creating an even more compelling yield-to-duration trade-off in the short end of the US high yield market.

Another significant advantage of short duration high income bonds is their attractive risk-adjusted return. Short duration high income bonds have been overlooked by many investors despite their consistent income potential and strong risk-adjusted performance. It has outperformed core bonds with similar volatility while delivering the returns of the broad high-yield bond market with lower volatility. As the Fed embarks on its easing cycle with few signs of a recession, short duration strategies tend to outperform longer-duration bonds during rate-cutting cycles that coincide with a soft landing.

Conclusion

The Fed's rate cuts, combined with the policies of a Trump presidency, have shaped a distinct investment landscape. In this evolving landscape, short duration high income bonds offer a compelling solution for income-focused investors. These bonds combine reduced sensitivity to interest rate fluctuations, lower default rates, and attractive risk-adjusted returns, making them resilient in uncertain times. Actively managed short duration high income strategies further strengthen this case by reducing price volatility, which is often amplified in passively managed strategies. Their shorter maturities put securities first in line to repayment at par, minimizing excessive credit risk. Their ability to navigate economic uncertainties while delivering attractive potential returns underscores their potential as a valuable complement to a core fixed-income allocation.

Source:
1. Data from the ICE Data Service, Bank of America, FactSet. Past performance is not a reliable indicator of future performance. Data as of 31 October 2024. US High-Yield Bonds = ICE BofA US High Yield Index; US 10-Year Treasury Bonds = ICE BofA Current 10-Year US Treasury Index; US Investment-Grade Corporate Bonds = ICE BofA US Investment-Grade Corporate Bond Index.
2. ICE Data Services, ICE BofA US High Yield Bond Index, as of 31 December 2023.
3. Bank of America, JPMorgan Chase; as of 31 October 2024. US high yield bonds are represented by the ICE BofA US High Yield Bond Index.

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2025 Global Financials Outlook

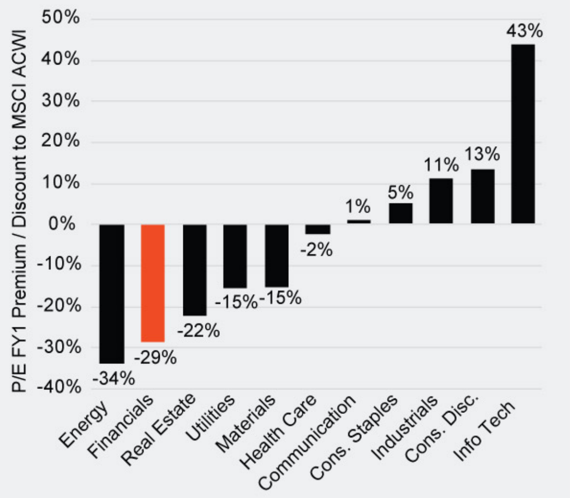
The Financials sector has demonstrated robust performance in 2024, returning 29% by the end of November, which is 9% higher than the broader global equities market. This makes it the second best-performing sector after Information Technology. The surge in performance is largely attributed to heightened optimism following the recent U.S. Presidential Election, which has ushered in a wave of optimism for the sector.

With Donald Trump set to take office for a second term, investors believe financial markets are poised to benefit from a more favorable regulatory environment and potential tax reforms. This anticipated shift could stimulate lending and investment activities, further enhancing market confidence. While this is exciting, the conviction in the financial sector is not confined to the US. Investors continue to see attractive opportunities among cheap European Banks, fast-growing FinTech companies, and opportunist investments in Emerging Markets which trade at attractive valuations.

From a valuation standpoint, the Financials sector still trades at a 29% discount relative to the broader global equity index (as of Nov 30th, 2024) and remains the 2nd cheapest sector in the global equity market. This is despite the very strong performance YTD following the US election.

Chart 1

The Financials sector trades at a 29% discount relative to the MSCI ACWI despite being the 2nd best performing sector in 2024



Source: Bloomberg as of November 30, 2024

US Financials

Investors see significant opportunities in US Financials following the US election due to:

1. Improved regulatory backdrop for Banks: The recent election results are, in the investors' view, decidedly positive for United States banks, particularly with the re-election of former President Donald Trump and a Republican-controlled Congress. This outcome is expected to facilitate a period of deregulation, easing capital requirements imposed by frameworks such as Basel III, thereby enhancing profitability and shareholder returns. For example, the proposed U.S. implementation of Basel III standards would increase banks' measured risk-weighted assets by roughly 19% without changing the underlying holdings. It's estimated that this rise in RWAs would reduce the average Common Equity Tier 1 capital ratio of US Banks from about 11.4% to 9.7%, meaning there would be limited excess capital in the industry. However, this should go away under a Trump administration which would then open the door for >$100bn in buybacks from US Banks.

Chart 2：Effect of Basel III Implementation in the US

Source: Barclays US Large Cap Banks Research, December 3, 2024

Additionally, anticipated leadership changes at the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) may lead to a regulatory framework that is less stringent for banks. As a result, US Regional Banks could find themselves with increased capital for stock buybacks and growth initiatives, fostering a more favorable environment for expansion within the segment.

2. Improved regulatory backdrop for Consumer Credit: The reorganization of consumer protection agencies like the Consumer Financial Protection Bureau (CFPB) could create a more favorable regulatory environment for credit card companies, potentially eliminating the "late fee rule." Additionally, Donald Trump is expected to provide a clearer regulatory framework for crypto, benefiting players in that space.

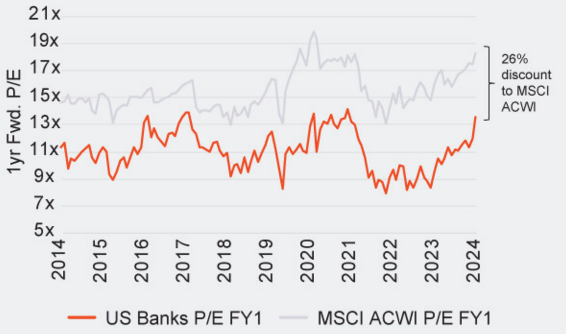
3. Improved domestic investment and M&A Outlook: Early feedback on the election from US corporates is overwhelmingly positive, and investors see this as a positive for banks via improved loan growth. Under Trump, M&A activity could increase, especially among US Regional Banks. This could include the potential completion of the Capital One - Discover merger, which would have positive effects for investment banking firms.

US Banks

As mentioned above, investors see the operating environment for US Banks as very supportive into 2025. Investors see an environment characterised by 1) US deregulation, 2) higher US Tariffs, 3) lower US immigration, 4) stable to lower US taxes, and 5) an end to the Ukraine and Middle East conflicts. The negative supply shocks of higher import prices and lower immigration should be more than offset by a boost to demand from anticipated fiscal and regulatory policy shifts as well as better corporate sentiment. Despite the strong gain by US Banks in 2024, US Banks trade at a 26% discount to global equities.

Chart 3

Despite strong post-election returns, US Banks trade at a 26% discount to the MSCI ACWI



Source: Bloomberg as of November 30, 2024

US Large Cap Banks are particularly cheap, trading at 50% discount relative to the S&P 500 Index. While concerns of rate cuts may be a concern to investors, it's important to note that in 4 out of the prior 5 tightening cycles, US Banks (as represented by the BKX Index) outperformed the S&P 500 Index over the 1-year period after the final hike (source: Barclays November 2024). Banks have been reducing asset sensitivity as Fed is expected to ease on monetary policy. At the same time, US Banks earnings continue to be strong as more than 80% of Banks beat quarterly earnings expectations in the first half of 2024.

As investors look ahead, this favorable backdrop suggests that Banks will not only maintain profitability but could also experience a resurgence in lending activities as consumer confidence grows. Moreover, with technological advancements reshaping customer interactions and operational efficiencies, Banks are well positioned to capitalize on emerging opportunities in a rapidly evolving financial landscape.

US Consumer Finance

Investors see opportunities among US Consumer Finance names as they trade at attractive valuations with healthy EPS growth driven by US deregulation, improved credit quality and increased loan growth.

In 2024, this was one of the top performing industries within the financial sector primarily driven by confidence that the reorganization of consumer protection agencies like the Consumer Financial Protection Bureau (CFPB) could create a more favorable regulatory environment for credit card companies. Most notably, eliminating the "late fee rule" in the US would be additive to earnings for these companies. The lost revenues due to the implementation of this late fee rule exceeds over $3bn aggregated among the five largest US card issuers. If reversed, it could potentially reinstate this revenue for these companies.

US Capital Markets

Within Capital Markets, valuations remain attractive especially at investment banks where deal-making for investment banks hit a 10-year low at the end of 2023 and haven't yet recovered. Investors believe to see an acceleration in capital markets activity during the Trump presidency as IPO/M&A activity is running at just 50% of history.

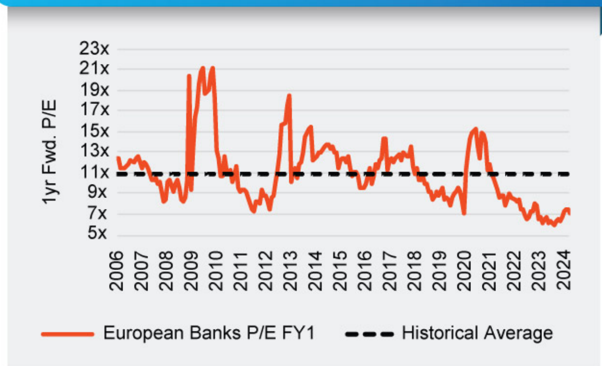
European Banks

US Banks significantly outperformed in 2024, European Banks also performed strongly in 2024. Despite this, valuations of both US and European Banks remain significantly discounted relative to the global equity market. European banks trade at a 62% discount to global equities, nearly 20% cheaper than the 10-year average relative valuation.

Chart 4: Financials valuation versus MSCI ACWI

Source: Bloomberg as of November 30, 2024

Chart 5



Source: Bloomberg as of November 30, 2024

This is also despite having a forecast forward EPS growth rate more than double the MSCI Europe Index, as well as a forecast dividend yield more than double the MSCI Europe Index.

European banks have significantly improved their capital positions over the past decade, leading to higher returns on equity (ROE). As profitability and net interest margins expanded due to the recent higher rate environment, European Banks are very well positioned to increase payouts back to shareholders. When combining dividends and share buybacks, several European Banks offer double-digit payout yields. Investors see particularly attractive opportunities Banks in the UK, Austria, Germany and Portugal. This is where investors find the cheapest and highest capital return banks in the world.

Investors also see plenty of idiosyncratic asymmetric return opportunities in these countries. For example, the European banking landscape is ripe for consolidation, with expectations of increased M&A activity. As larger banks look to build scale via acquisitions, this could create additional value for shareholders through enhanced market positions and operational efficiencies. The anticipated resurgence in M&A activity further underscores the attractiveness of investing in this sector at present.

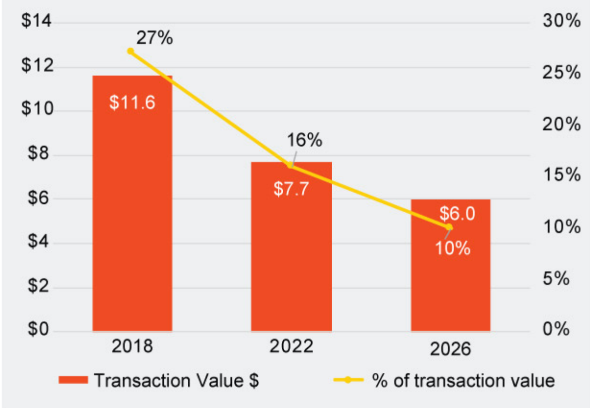
FinTech

FinTech valuations continue to look attractive as the segment trades at a 35% discount relative to the MSCI ACWI. Over the longer term, it's believed the segment is attractive due to 1) valuations which should benefit from lower interest rates while 2) the structural attractiveness of the industry remains a powerful long-term theme.

Investors continue to believe that consumer behavior changes that favor innovative digital financial solutions over traditional methods should drive top-line growth for FinTech companies over the long term. One of the main themes on which investors have continued conviction is the growth of digital payments relative to cash. While digital payments have already taken significant share from cash over the past 5 years, cash transactions still represent ~16% market share of transactions representing $7.7tn (USD) in value. This is expected to decline to less than 10% market share by 2026 as many cash-centric emerging economies adopt digital payments.

Chart 6

The declining usage of cash is expected to continue.
However, cash transactions remain prominent in many regions



Source: FIS Global Payments Report, May 2023. There is no guarantee that any forecasts made will come to pass.

According to McKinsey & Company, fintech revenues are anticipated to grow almost three times faster than traditional banking revenues between 2023 and 2028. Fintechs currently account for about 5% of global banking sector net revenue, with projections suggesting this could increase to over $400 billion by 2028, representing a 15% annual growth rate. Around 73 percent of the world's interactions with banks now take place through digital channels, providing further support for the digital banking segment.

High Opportunity EM

Investors currently see opportunities in Argentina, Turkey and Kazakhstan. Cheap valuations, faster top line and bottom-line growth and long-term structural growth associated with better demographics and increased financial penetration/inclusion.