BEA Union Investment

Short-term quality bonds offer both offense and defense amid choppy markets

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In the face of market volatility, an uncertain interest rate trajectory in the second-half of the year, and the potential economic impact of evolving US tariff policies, BEA Union Investment believes investment-grade short-term dollar bonds are worth exploring at this juncture. This asset class offers compelling yields, while exhibiting low sensitivity to interest rate movements, making them relatively immune from market fluctuations.

Undaunted by widening credit spreads: investment-grade corporate short-term bonds for yields and capital gains

Since last year, credit spreads of many investment-grade dollar bonds have continued to tighten. However, in April, the implementation of US reciprocal tariffs triggered a brief market correction, opening up entry points for select high-quality short-term bonds with appealing yields.

Among them, a major UK bank with robust fundamentals experienced a 140-basis point widening in its credit spread at the height of the correction in April. But the spread quickly narrowed, ultimately ending just 20 basis points wider.

Highlights

- **Investment-grade short-term bonds are less sensitive to interest rates and less affected by market fluctuations**
- **Investment-grade short-term bond yields continue to be attractive**
- **Demand for Asian investment-grade bonds continues to outstrip supply, providing technical support for the asset class**

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Based on mark-to-market calculations, a 20-basis point widening would translate into an annual price decline of only 20 cents — underscoring the minimal impact that market volatility has on short-duration bonds. Since short-term bonds have short maturities, in the event of credit spread widening, investors holding a one-year bond need only wait one year until maturity to recover their principal. Conversely, should credit spreads narrow, investors have the option to sell and realise capital gains. Together, these two strategies represent both offensive and defensive approaches. Additionally, the strong fundamentals and relatively low default probabilities of investment-grade bonds help keep overall risk manageable. Hence, widening in credit spreads could represent timely opportunities to allocate to investment-grade corporate short-term bonds.

Compelling yields; Resilient Asian Credit Fundamentals

Yields of investment-grade short-term bonds remain appealing. Currently, the one-year US Treasury yield hovers around 4%, compared to yields of approximately 4.7% and 4.6% for US and global 1-3 year investment-grade corporate dollar bonds, respectively. Notably, Asian investment-grade bonds offer even more attractive yields of about 4.9%.

Some investors may worry about the potential impact of tariff tensions on Asian issuers. However, we believe that Asia's investment-grade short-term bond market is both broad and diverse. Issuers span across multiple markets and sectors, including financials, banking, consumer, technology, and sovereigns. Moreover, very few are export-driven, and only a low-single digit percentage of these issuers derive more than 10% of their revenue from the US.

At the same time, Asian dollar bonds benefit from both resilient credit fundamentals and favourable technical factors. Many Asian corporates hold higher credit ratings than their counterparts in other markets such as the US, but their net leverage ratios also stand at about 1.6-1.7x, well below their US peers, which hover near the 3x level.

Over the past two years, with interest rates in Asia generally lower than those in Europe and the US, Asian companies have enjoyed an array of financing options. In China, for instance, companies can issue RMB bonds at rates of approximately 2%, cheaper than about 4% for dollar bonds. But some firms still prefer issuing in US dollars despite the higher cost due to the market's deep liquidity and strong investor base. Also, for companies generating a lion's share of revenue in US dollars, issuing bonds in the same currency helps reduce the currency mismatch risk. Since relatively few are taking this route, demand for dollar bonds continues to outstrip supply, providing technical support to the asset class.

Market is bracing for more short-term volatility as tariff negotiations continue. Investors who do not have the risk appetite for equities, or prefer to wait for clearer visibility without leaving funds idle, may look into investment-grade short-term bond strategies. The asset class presents a way to secure income with relatively low risk, while retaining the flexibility to capture capital gains as opportunities emerge.