AEGON Asset Management

Asset Class Perspective
March 2024

AEGON **INSIGHTS**

Short duration: It's all relative

Six months ago, we wrote about the case for an allocation to short-duration strategies being as compelling as it has ever been. That argument centered around elevated yields, strong fundamentals and the potential for strong risk-adjusted returns.

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Norbert King is a senior portfolio manager responsible for the portfolio management of Investment Grade Credit strategies, Long Credit strategy, Intermediate Credit strategy and multi-sector portfolios. Prior to his current role, Norbert was an investment grade credit trader responsible for trading across all investment grade credit and multi-sector mandates. He has been in the industry since and started with the firm and its affiliates in 2011. Norbert received his BA in accounting from the University of Lynchburg and an MBA with a concentration in finance from Villanova University.

We still believe that to be the case. In fact, we believe short-dated credit currently offers a very compelling relative value opportunity in the market. Credit spreads have had a volatile couple of years, but that has created dislocations across the market that may provide opportunities to generate alpha through credit selection.

Today, we see strong opportunities in short-dated corporate and securitized credit spreads. In this piece, we'll look at where spreads are trading today compared to historical averages and relative to other parts of the market.

The case for short-duration strategies

First, let's revisit the thesis for allocating to high-quality corporate bonds in short-dated credit strategies. From a bottom-up perspective, investors have a much clearer look into the near-term runway of company fundamentals, which allows investors with strong research capabilities the opportunity to source more alpha through credit selection.

Second, the cushion built into short-dated bonds offers the potential to absorb volatility, while still generating positive excess returns. The metric we like to reference is the "breakeven," which is just the spread per unit of duration. You can also look at this on a total return basis, using yield instead of spread.

The current excess return breakeven for the ICE BofA 1-3 year Corporate Index is +39 basis points (bps). In other words, you would have to see spreads widen that much before underperforming a duration-matched Treasury over a 12-month period.

We believe spreads are priced attractively and are less likely to experience significant spread widening. The current total return breakeven is +303 bps before generating negative total returns over a 12-month horizon. If you look at annual total and excess returns for the ICE BofA 1-3 year Corporate Index going back 20 years, there were only two years where the index posted both a negative total and excess return. And each of those occurrences coincided with major macro-economic events.

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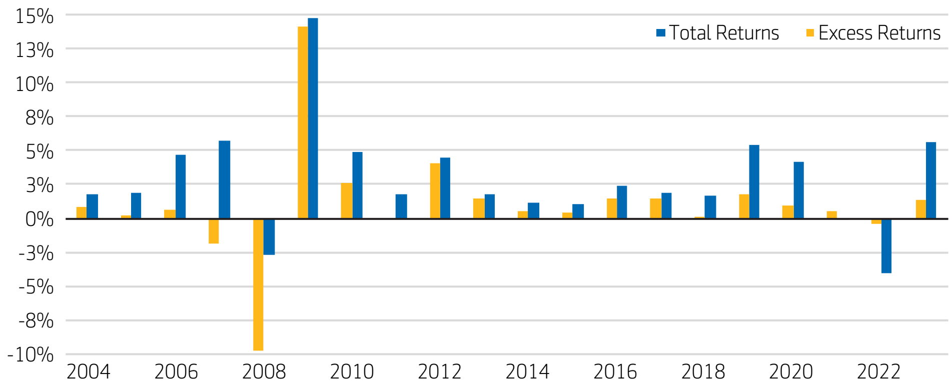
Exhibit 1: ICE BofA 1-3 year US Corporate Index: annual total and excess returns[1]

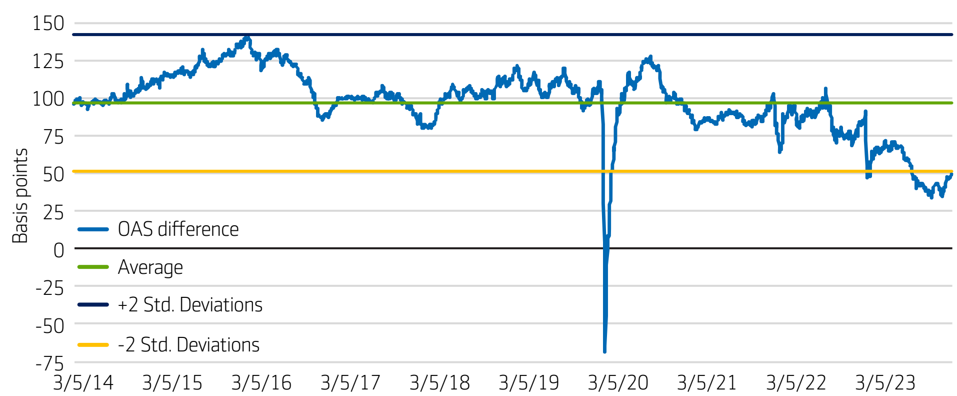


Source: ICE BofA. As of March 2024. Index data is from January 2004 to December 2023.

In addition to short-dated corporate bonds, we see significant value in asset-backed securities.

As of this writing, the ICE BofA 1-3 year US Corporate Index is trading at an option-adjusted spread (OAS) of +67 bps, which puts it in the 40th percentile over the past 10 years. While that may not scream cheap at first glance, it's important to put that into perspective. To do so, we look at longer-maturity corporate bonds using the ICE BofA 10+ Year US Corporate Index, which is trading at an OAS of +117 bps, putting it in the 1st percentile. So, while the 1-3 year index is trading just inside the historical averages, longer-dated corporate bonds are near their richest level in the last 10 years. Another way to look at the relative attractiveness of 1-3 year corporate bonds is to compare the spread pickup to extend duration from the 1-3 year index, with a duration of 1.79 years, to the 10+ year index, which has a duration of 12.7 years. As you can see in Exhibit 2, the spread pick up today is only 50 bps, which puts it in the 5th percentile, or said another way, it's 2 standard deviations rich. That suggests to us that there is significant scope for the front end to outperform, especially on a risk-adjusted basis.

Exhibit 2: OAS difference between the ICE BofA 10+ year US Corporate Index and the ICE BofA 1-3 year US Corporate Index[1]



Source: ICE BofA. As of March 2024.

Potential value play: Asset-backed securities

In addition to corporate bonds, we see significant value in asset-backed securities (ABS).The ICE BofA US Fixed Rate ABS Index OAS is sitting at +100 bps, which puts it in the 67th percentile over the last 10 years. The index is clearly skewed by periods

[1]Past performance is not indicative of future results. For illustrative purposes only. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs. Statements concerning financial market trends are based on current market conditions which will fluctuate. All investments contain risk and may lose value.

of severe distress such as the Covid-related sell-off, but as Exhibit 3 shows, it's rare for the ABS sector to trade this wide. From a fundamental perspective, while we have broadly seen credit normalization back to pre-Covid levels, signs suggest we are getting close to a plateau. Even so, deal structures can provide strong protections for investors.

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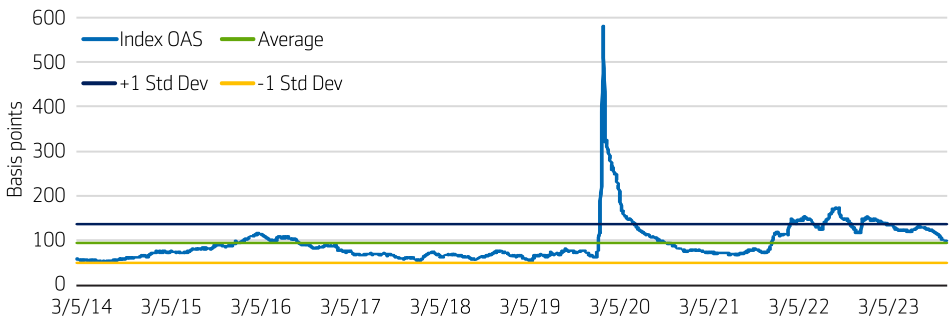
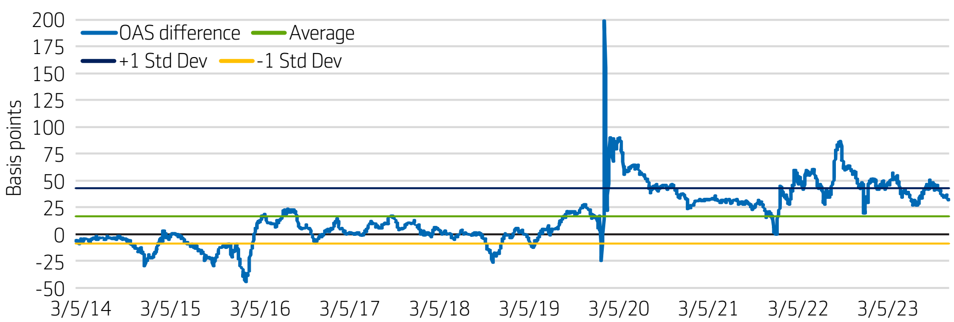
Exhibit 3: ICE BofA US Fixed Rate Asset Backed Securities Index OAS[1]



Source: ICE BofA. As of March 2024.

As we evaluate the current landscape, the ABS sector screens as the most attractive. Exhibit 4 puts more context around how we think about the relative value between short-dated corporate bonds and ABS.

Exhibit 4: OAS difference between the ICE BofA US Fixed Rate Asset Backed Securities Index and the ICE BofA 1-3 year US Corporate Index[1]



Source: ICE BofA. As of March 2024.

The ABS index typically trades 17 bps cheap compared to corporate bonds. But following the outperformance of corporate bonds, the basis is nearly 1 standard deviation wide, sitting at +33 bps as of this writing. It's not unusual to see corporate credit outperform ABS following periods of volatility. Given both the absolute level of spreads and the relative attractiveness compared to the entire opportunity set, these two sectors are particularly attractive. For many investors, incremental investments in ABS may provide the most return potential, but investing in both sectors continues to make sense.[2]

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[2]There is no guarantee any investment will work under all market conditions or is suitable for all investors. Each investor should evaluate their ability to invest over the long-term, especially during periods of increased market volatility.

AEGON Asset Management

The fixed income sweet spot

Shifting our attention to monetary policy and the rate market, our expectation is that the Fed will begin cutting rates this summer. We will likely see three or four cuts by year end, which in our view, should result in the Treasury curve bull steepening.

As we discussed in our previous paper, this presents a sweet spot for fixed income. A short-dated credit strategy can capture elevated yields and attractive credit spreads, as discussed above, with the potential for higher returns driven by lower Treasury yields by the end of the year.

If our forecast is wrong as it relates to Fed cuts and interest rates stay elevated for longer, a short-dated credit strategy can provide a cushion against volatility, potentially reducing downside risk. Lastly, as you can see in the final two charts, historically the months and years immediately after a Fed pause have been followed by positive total returns and the starting point of yields is a good indicator of returns.

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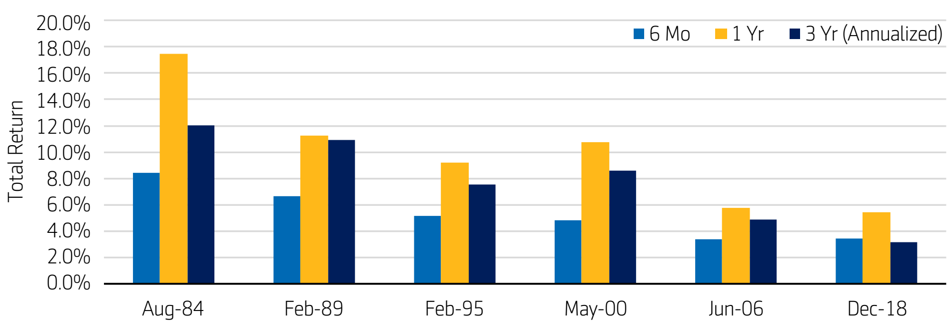
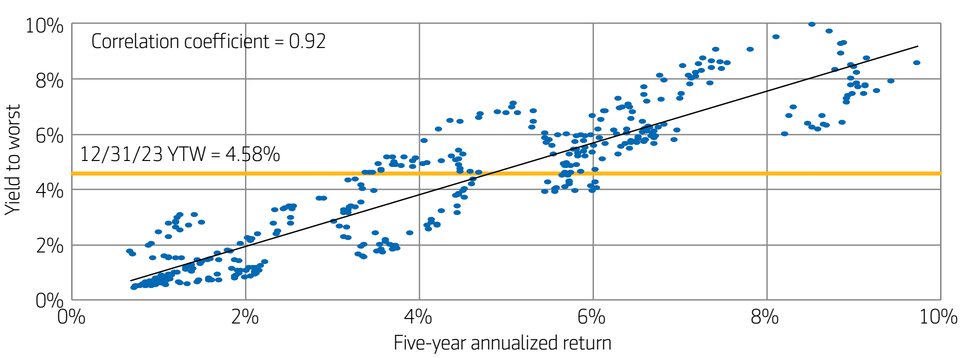
Exhibit 6: Short-duration corporate returns following a Fed pause[1]



Source: Bank of America, Fed Funds, Bloomberg. As of March 2024. Short-duration corporate returns are represented by the ICE BofA US Corporate 1 - 3 Year Index. Index data is from January 1984 to December 2021. The 6-month, 1-year and 3-year returns start at the end of month following the last hike in a cycle.

Exhibit 7: ICE BofA 1-3 Year Government Credit Index Starting yields and subsequent annualized 5-year returns, July 1986 - Dec 2018[1]



Source: ICE BofA. As of March 2024. The correlation coefficient is a measure of the relationship between two variables. The correlation coefficient can range from -1 to +1, with -1 meaning the values are perfectly negatively related and +1 indicating they are perfectly positively related.

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