Time for a Fresh Look at Short and Ultra-Short Credit

We think a closer look at how certain areas of the equity market performed during the recovery from the March lows may provide insights on the winners and losers of the post-shutdown era.

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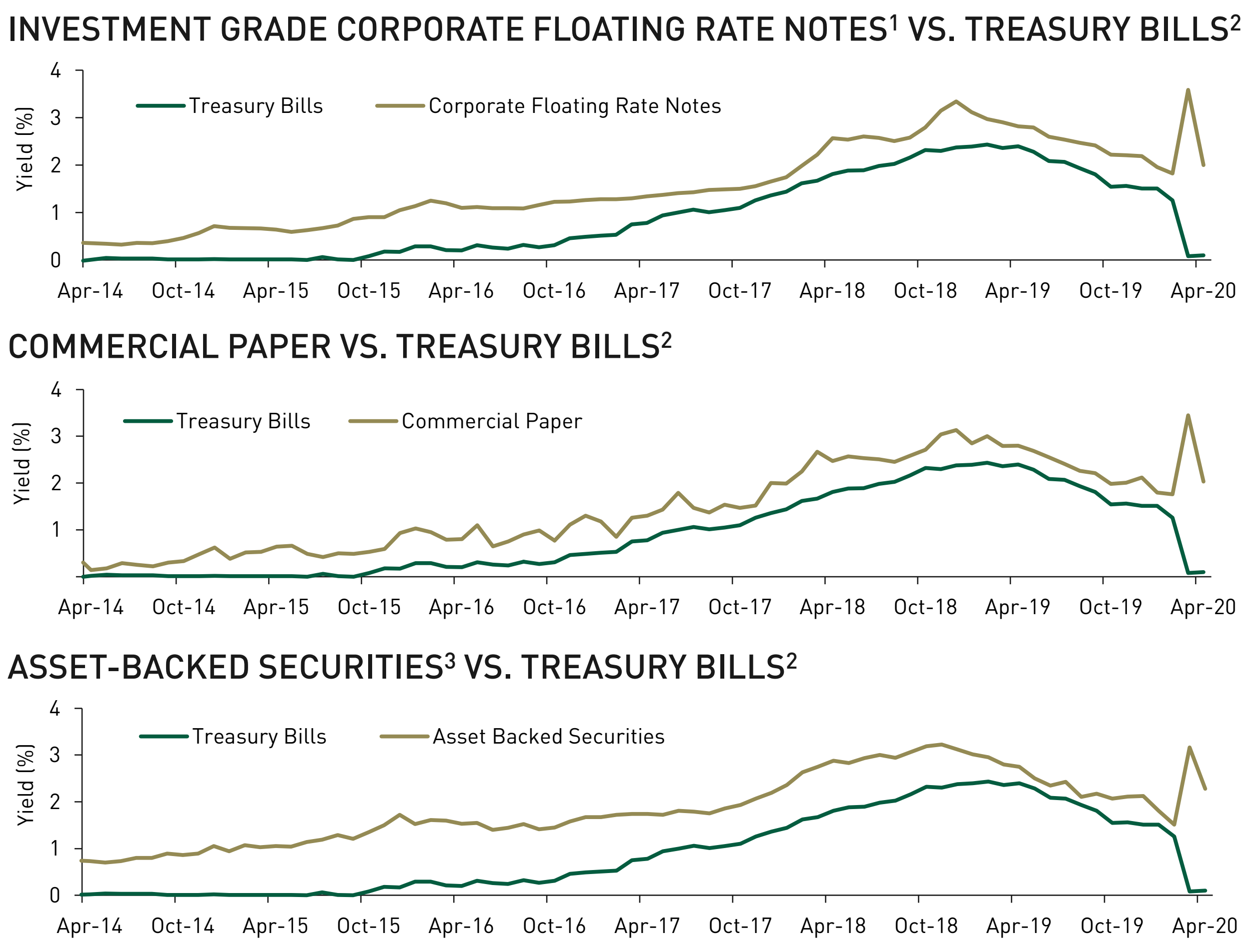
Figure 1. Ultra Short Bonds Have Been Offering Unusually High Excess Yield with Limited Credit Risk



Source: Bloomberg Barclays & ICE Data Indices, LLC. Data from April 1, 2014-April 30, 2020.
[1]Bloomberg Barclays USFRN <18mos. [2]Bloomberg Barclays 3 Month U.S. T-Bill Index. [3]ICE BofA ABS 0-3 yr Fixed Rate.
Past performance is not a reliable indicator or guarantee of future results. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Amid the historic volatility the markets experienced in March, there were some unusual price movements in the short-term credit markets. At the time, we tried to reassure investors that much of the price action was not an indication of significant credit issues but rather was being driven by supply/demand imbalances in short-term lending markets.

Uncertainty regarding the impact of COVID-19 prompted many companies to build additional liquidity in March in order to have a war chest of cash on their balance sheets. As they went to borrow through commercial paper and other markets, traditional buyers of short-term securities took a step back from those markets to build their own cash reserves. These imbalances created sharp spikes in credit spreads, resulting in lower prices and higher yields even for very short-term, investment-grade securities.

Additional Yield and Return Potential

As markets have calmed down and the U.S. Federal Reserve has intervened with multiple programs to supply adequate liquidity to ensure that markets function properly, yields and spreads have receded, but still remain elevated relative to pre-COVID crisis levels. We recently wrote about how this has played out in the short-term corporate bond market. This has also created interesting opportunities in the ultra-short bond markets.

Figure 1 illustrates yields on select asset classes which are often included in ultra-short strategies (such as short-term investment-grade corporate bonds, commercial paper, and asset-backed securities) relative to three-month U.S. Treasury bills. Historically, these sectors have offered modest spread over Treasury bills with limited duration and credit risk, providing an option for additional yield and return potential over cash and money market securities, with lower volatility than short- or intermediate-term bond strategies.

Figure 1 shows how yields spiked amid the grab for liquidity in March and have since partially recovered. However, yields on alternative so-called "risk-free" options, such as Treasury bills, have collapsed to nearly 0% (and briefly dipped into negative territory). Relative to Treasury bills and cash, short-maturity investment-grade bonds recently offered unusually high spreads with very low duration and little credit risk.

Low Historical Default Rates

Historical default rates for short-maturity investment-grade bonds have been extremely low, as Figure 2 makes clear.

Figure 2. Historically, Default Rates for Short-Maturity Investment-Grade Bonds Have Been Extremely Low.

INVESTMENT GRADE CORPORATE DEFAULT RATES

S&P STUDY OF DEFAULTS
1981-2016
ONE YEAR DEFAULT RATES

Rating	Default Rate
AAA	0.00%
AA	0.02%
A	0.06%
BBB	0.18%

NON-FINANCIAL COMMERCIAL PAPER DEFAULT RATES

MOODY'S STUDY OF DEFAULTS
1972-2017
90 DAY HORIZON

Rating	Default Rate
P-1	0.004%
P-2	0.01%
P-3	0.05%

ASSET-BACKED SECURITIES DEFAULT RATES

S&P STUDY OF DEFAULTS
1983-2016
ONE YEAR DEFAULT RATES

Rating	Default Rate
AAA	0.00%
AA*	0.01%
A	0.10%

Sources: Moody's, Standard & Poor's. *Default rate on "AA"-rated ABS was 0% every year except 2002. Data provided in the charts above are latest available data. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

The recent experience illustrates one of the characteristics of short-term investment-grade credit; during periods of extreme moves in credit spreads or interest rates, such securities can experience some price volatility. (There is no question March was a period of extreme volatility; high-yield spreads increased by 750 basis points [bps] off January lows, while spreads on short-term "BBB"-rated bonds rose by almost 500 bps. In such an environment one would expect some price declines, even in very short-term investment-grade securities.) However, if you have true short-maturity bonds, and can avoid credit issues, prices ultimately recover as there is a "pull to par" as these securities approach their maturity date.

Going Forward

During the recent period of volatility, there was a large flight to safety: over $1 trillion in assets have flocked to U.S. government money market funds since mid-February, with total assets now approaching $4 trillion. With the drop in Treasury bill yields, that large pile of assets is now yielding close to 0%.

For many investors, a portion of that "cash" needs to be in true cash despite the lack of yield for short-term liquidity needs and unexpected expenses. But there may be a portion of that cash that is not likely to be needed in the near term—say, for at least three months or more —that can take advantage of the unusual spread opportunity in ultra-short bonds.

We believe that the recent market environment is creating attractive long-term opportunities in certain segments of the equity and credit markets. For investors who are holding excess cash on the sidelines before committing funds to these markets, they may want to consider allocating a portion of their "long-term cash" to short- and ultra-short bond strategies that can provide additional income and total return potential with little additional volatility.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds.

No investing strategy can overcome all market volatility or guarantee future results.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

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Glossary of Terms

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

A **basis point** is one one-hundredth of a percentage point.

Pull to Par is the effect in which the price of a bond converges to par (or face value) as the bond approaches maturity.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point).

The **Bloomberg Barclays Capital US FRN < 18 months Index** is a subset of the US Floating-Rate Note (FRN) Index, which measures the performance of USD denominated, investment-grade, floating-rate notes across corporate and government-related sectors.

The **Bloomberg Barclays 1-3 Month U.S. Treasury Bill Index** measures the performance of public obligations of the U.S. Treasury that have a remaining maturity of greater than or equal to 1 month and less than 3 months.

The ICE BofA/Merrill Lynch ABS Fixed Rate 0-3 Year Index, is a rate- and maturity-specific subset of the ICE BofA/ML U.S. Fixed and Floating Rate Asset Backed Securities Index

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