CIO Perspectives

14 September 2022

Hou Wey Fook, CFA
Chief Investment Officer

Daryl Ho, CFA
Strategist

Key points

- The highest inflation in 40 years beckons risk-adverse investors to seek a better strategy than relying on cash returns.
- The Liquid+ Strategy comprising a short-duration (1-3Y), Credit/ Treasuries portfolio construct is a better substitute for cash, providing the optimal mix of safety, liquidity, and yield.
- Impressively, this Credit/Treasuries portfolio had performed remarkably against inflation during the "Great Inflation" of the 1970s, eking out real returns of +0.4% through 1973-1983.
- With global short-duration IG credit now yielding c.4% – a level not reached even in the peak of the Covid crisis – investors are once again given the opportunity to get paid for going up in quality.
- The current confluence of (a) higher yields, (b) low default risk, (c) ample liquidity, (d) flat yield curves, and (e) flight-to-safety tailwinds suggests that the Liquid+ Strategy is a worthy cash alternative that has all the attributes of safety and liquidity, but with returns that could mitigate the effects of inflation in the longer run.

CREDIT STRATEGY

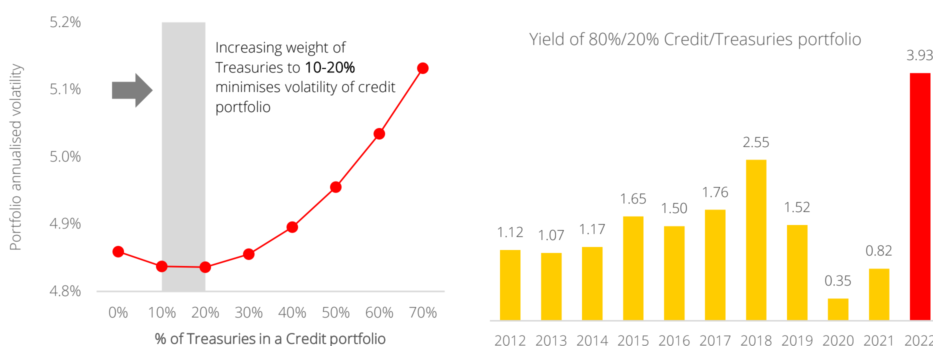
Liquid+ Strategy – The importance of yield and liquidity in an age of volatility

The false allure of cash. The investing world has found no shortage of risks in 2022, with the largest commodity moves in a decade, the threat of escalating conflict on the European continent, widespread volatility around risk assets, and the first 75 bps Fed hike in 28 years. Under such environments of profound uncertainty, it is natural for risk-averse investors to seek first the safety of cash to preserve both capital and liquidity. Yet the prospect of facing the highest inflation in 40 years leaves it difficult to imagine that cash would register positive real returns over the longer run.

Having the best of both worlds. Caught between a rock and a hard place, most income-seeking investors are forced to choose between (a) the higher yields in riskier pure credit funds to beat inflation, or (b) capital certainty and liquidity but lower returns of cash/deposits. We believe that there is yet a middle ground to be achieved – constructing a portfolio with a mix of both Investment Grade (IG) credit and risk-free Treasuries makes the whole greater than the sum of its parts. Analysing the risk/return spectrum of a two-asset portfolio of (i) Government Treasuries and (ii) IG corporate credit, we found that the addition of 10-20% of Treasuries to a credit portfolio is the sweet spot in minimising the overall volatility of the fixed income portfolio, giving an investor the best of both worlds when it comes to capital stability and income generation.

The Pareto principle for bonds. Moreover, the minor Treasury allocation enables a more robust portfolio by (a) benefitting from flight-to-safety flows under unexpected economic downturns, and (b) providing liquidity for the portfolio as Treasury bonds have vastly deep markets. Under the most adverse of circumstances, central banks would always act as buyers of last resort.

Figure 1: A balanced mix of lower risk and higher returns



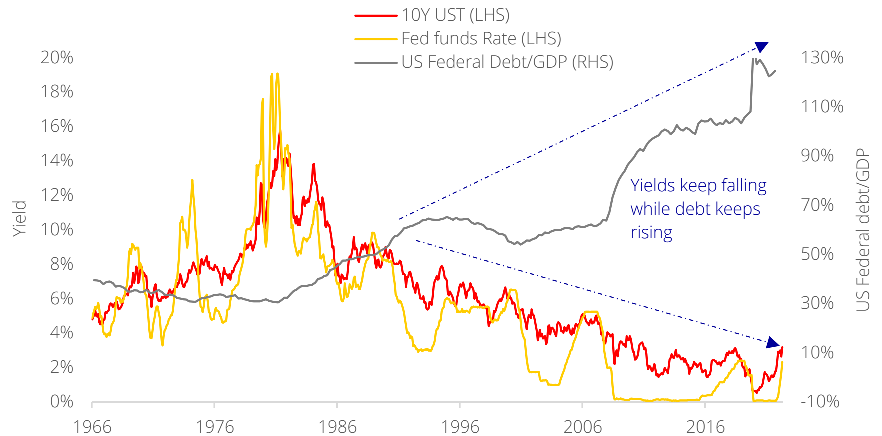
Source: Bloomberg, DBS

Be rewarded for safety. The best part? Investors are, for the first time in a long while, well-compensated for taking less risk. Given the hawkish pivot of global central banks in 2022, the yield on the 80/20 mix of a Credit/Treasuries portfolio is now close to 4%, dwarfing the returns of the same fixed income portfolio mix over the last 10 years (Figure 1). This bucks the trend of lower-for-longer yields under a decade of quantitative easing – investors now have a worthy alternative to cash that offers superior returns without needing to take excessive risks. Notably, the default rates of IG credit had never exceeded 0.5% in any one year, even through periods of significant economic downturns such as the 2001 dot-com collapse, the 2008 Global Financial Crisis, and the 2020 Covid crisis. With the interest rate curve being historically flat, investors can also keep to the 1-3 year maturity segment – not needing to take excessive duration risk for that extra bit of yield.

Stay nimble with the Liquid+ Strategy. We therefore believe that the time is ripe for risk-adverse income-seekers, achieving the optimal mix of safety, liquidity, and yield through a short-duration, Credit/Treasuries portfolio construct as a substitute for cash. We term this the Liquid+ Strategy – in an environment fraught with uncertainty, investors need to be nimble with a high-quality fixed income portfolio that they can easily liquidate for opportunities that present themselves in volatile markets, while high income-generation is always a plus.

What about risks in the rate-hiking cycle? Despite the aggressiveness by which interest rates had risen of late, we believe that a quick reversion to the high-rates environment of the pre-1990s remains a difficult transition. History has shown that each subsequent peak in the hiking cycle had always been lower than the last since the 1980s (Figure 2), owing to the secular decline of the long-term neutral rate of interest from (a) ageing demographics, (b) high global debt burdens, and (c) technological disruption leading to a productivity boom. This time may not be different.

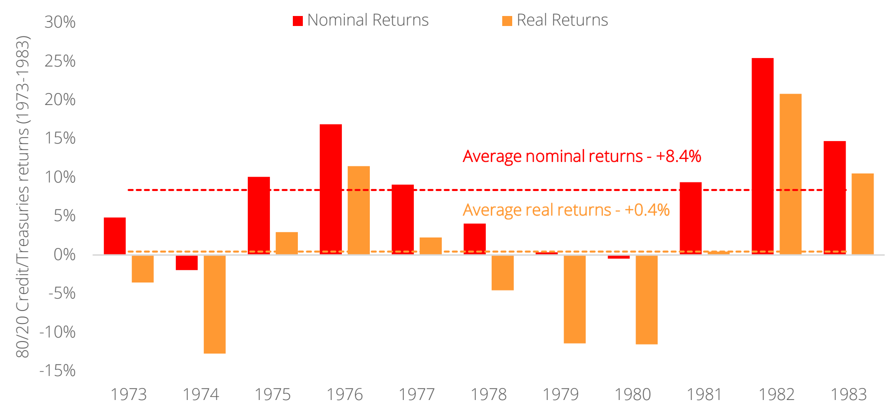
Figure 2: High debt burdens act as a lid on interest rates



Source: Bloomberg, DBS

Assuming the worst-case scenario. Supposing however, our high debt-low rates hypothesis is wrong, and the world reverts to the high inflation-high rates paradigm of the 1970s – would the Liquid+ Strategy weather the storm as a cash substitute? To answer this question, we looked back in history towards the decade starting in the mid-1970s – where y/y consumer price index (CPI) first exceeded 5% in 1973 until a series of aggressive rate hikes eventually brought it back down below 5% again in 1983. While an 80/20 Credit/Treasuries portfolio saw significant volatility during this period, it is noteworthy that this same portfolio ultimately saw returns that beat the "Great inflation" – real returns averaged +0.4% over the same decade.

Figure 3: Credit/Treasuries fared well through the "Great Inflation" of the 1970s



Source: NYU Stern, St. Louis Fed, Moody's Investors Service, DBS

Shortening duration is key. These results may come as a surprise to investors who are familiar with the inverse relationship between interest rates and bond prices. The key is in keeping the overall portfolio duration short – as bond holdings mature more quickly, they could be reinvested towards instruments of higher yields during a rate hiking cycle, ensuring that portfolio returns remain commensurate with the prevailing interest rate environment.

In our current environment, a quick sensitivity analysis gives additional comfort – IG credit of 1-3Y duration can withstand up to another 200 bps widening in yields without running into losses in the next 12 months (Figure 4).

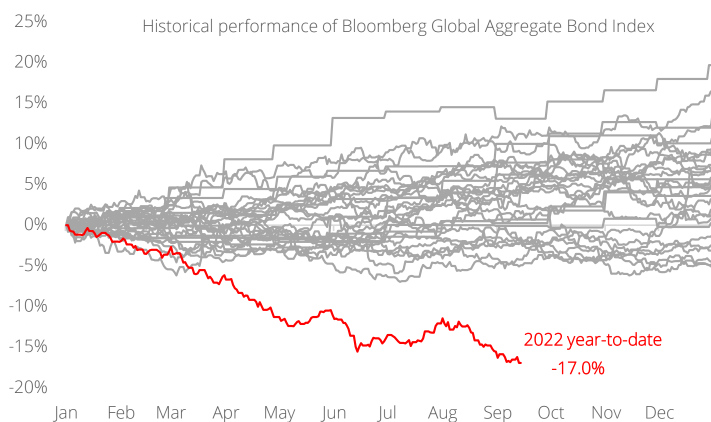
Figure 4: Short duration credit can endure aggressive hikes without running into losses

	Change in yields											
Duration	-20bp	0bp	+20bp	+40bp	+60bp	+80bp	+100bp	+120bp	+140bp	+160bp	+180bp	+200bp
1-3Y	4.7%	4.3%	3.9%	3.5%	3.1%	2.7%	2.3%	1.9%	1.5%	1.1%	0.7%	0.3%
3-5Y	5.4%	4.6%	3.9%	3.1%	2.4%	1.6%	0.8%	0.1%	-0.7%	-1.4%	-2.2%	-2.9%
5-7Y	5.9%	4.8%	3.7%	2.6%	1.6%	0.5%	-0.6%	-1.7%	-2.7%	-3.8%	-4.9%	-6.0%
7-10Y	6.5%	5.1%	3.6%	2.1%	0.6%	-0.8%	-2.3%	-3.8%	-5.2%	-6.7%	-8.2%	-9.7%
>10Y	8.1%	5.4%	2.8%	0.1%	-2.5%	-5.2%	-7.8%	-10.5%	-13.1%	-15.8%	-18.5%	-21.1%

Source: Bloomberg, DBS

The largest interest rate moves may be behind us. In a bull case scenario, markets may already be close to peak rates, given that recessionary outcomes have gained prominence in consensus expectations. Should rate expectations reprice downwards due to an economic downturn, high quality credit investors may receive capital gains, as opposed to just holding cash which retains no upside. Much of the inflationary fears may have also been priced into the bond markets – based on over 30 years of history of the Bloomberg Global Aggregate Bond Index, 2022 marks the worst year-to-date performance on record (Figure 5). As such, some mean reversion from a flow and performance perspective could prove to be strong tailwinds for those who are positioned in bonds.

Figure 5: Being "greedy when others are fearful" could also apply to bonds

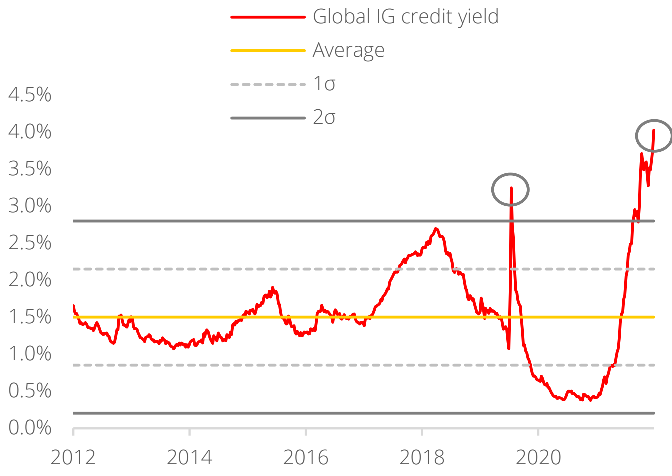


Source: Bloomberg, DBS

Credit is king, not cash. With global short-duration IG credit yielding c.4% (Figure 6) – a level not reached in the last 10 years (even in the peak of the Covid crisis) – investors are once again given the opportunity to get paid for going up in quality. Credit is also expected to outperform cash in the medium term, given that deposit rates have always lagged the upward moves in the interest rate environment, and even if they did adjust, the higher rates would often only be applicable to a limited quantum of funds. Taking a step back and seeing the larger picture also gives bond investors the confidence to beat inflation for the long run. Looking at cumulative returns since 2003, it is short-duration IG credit that has meaningfully surpassed the cumulative increases in CPI, while the same cannot be said of cash returns (Figure 7).

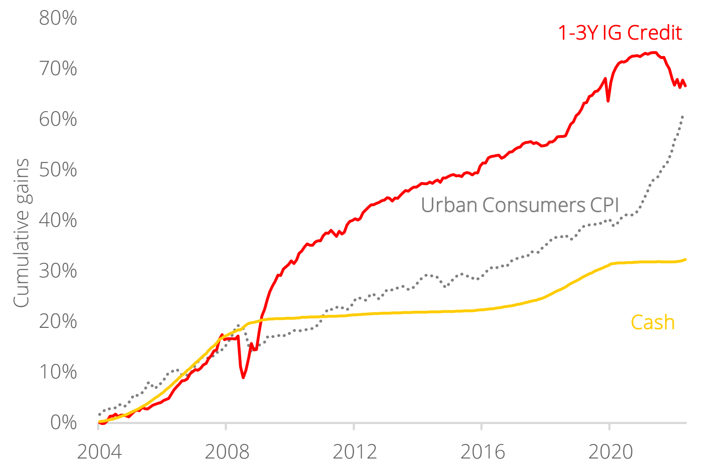
When stars align. The confluence of (a) higher yields, (b) low default risk, (c) ample liquidity, (d) flat yield curves, and (e) flight-to-safety tailwinds for IG credit beckons investors to not be satisfied with just holding cash alone, but an alternative that provides all the attributes of safety and liquidity with returns that could stand a chance against inflation. The Liquid+ construct of a short-duration, Credit/Treasuries composite portfolio is a solution that checks all the boxes. While cash might have been known to be king in times of uncertainty, one would find that this strategy is a more than worthy contender for the throne.

Figure 6: Short-dated IG yields exceed the Covid crisis peak



Source: Bloomberg, DBS

Figure 7: Inflation-beating credit returns over the long run



Source: Bloomberg, DBS

Disclaimers and Important Notes

This information herein is published by DBS Bank Ltd. ("DBS Bank") and is for information only. This publication is intended for DBS Bank and its subsidiaries or affiliates (collectively "DBS") and clients to whom it has been delivered and may not be reproduced, transmitted or communicated to any other person without the prior written permission of DBS Bank.

This publication is not and does not constitute or form part of any offer, recommendation, invitation or solicitation to you to subscribe to or to enter into any transaction as described, nor is it calculated to invite or permit the making of offers to the public to subscribe to or enter into any transaction for cash or other consideration and should not be viewed as such.

The information herein may be incomplete or condensed and it may not include a number of terms and provisions nor does it identify or define all or any of the risks associated to any actual transaction. Any terms, conditions and opinions contained herein may have been obtained from various sources and neither DBS nor any of their respective directors or employees (collectively the "DBS Group") make any warranty, expressed or implied, as to its accuracy or completeness and thus assume no responsibility of it. The information herein may be subject to further revision, verification and updating and DBS Group undertakes no responsibility thereof.

All figures and amounts stated are for illustration purposes only and shall not bind DBS Group. This publication does not have regard to the specific investment objectives, financial situation or particular needs of any specific person. Before entering into any transaction to purchase any product mentioned in this publication, you should take steps to ensure that you understand the transaction and has made an independent assessment of the appropriateness of the transaction in light of your own objectives and circumstances. In particular, you should read all the relevant documentation pertaining to the product and may wish to seek advice from a financial or other professional adviser or make such independent investigations as you consider necessary or appropriate for such purposes. If you choose not to do so, you should consider carefully whether any product mentioned in this publication is suitable for you. DBS Group does not act as an adviser and assumes no fiduciary responsibility or liability for any consequences, financial or otherwise, arising from any arrangement or entrance into any transaction in reliance on the information contained herein. In order to build your own independent analysis of any transaction and its consequences, you should consult your own independent financial, accounting, tax, legal or other competent professional advisors as you deem appropriate to ensure that any assessment you make is suitable for you in light of your own financial, accounting, tax, and legal constraints and objectives without relying in any way on DBS Group or any position which DBS Group might have expressed in this document or orally to you in the discussion.

Any information relating to past performance, or any future forecast based on past performance or other assumptions, is not necessarily a reliable indicator of future results.

If this publication has been distributed by electronic transmission, such as e-mail, then such transmission cannot be guaranteed to be secure or error-free as information could be intercepted, corrupted, lost, destroyed, arrive late or incomplete, or contain viruses. The sender therefore does not accept liability for any errors or omissions in the contents of the Information, which may arise as a result of electronic transmission. If verification is required, please request for a hard-copy version.

This publication is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation.

If you have received this communication by email, please do not distribute or copy this email. If you believe that you have received this e-mail in error, please inform the sender or contact us immediately. DBS Group reserves the right to monitor and record electronic and telephone communications made by or to its personnel for regulatory or operational purposes. The security, accuracy and timeliness of electronic communications cannot be assured.

Dubai International Financial Centre

This communication is provided to you as a Professional Client or Market Counterparty as defined in the DFSA Rulebook Conduct of Business Module (the "COB Module"), and should not be relied upon or acted on by any person which does not meet the criteria to be classified as a Professional Client or Market Counterparty under the DFSA rules.

This communication is from the branch of DBS Bank Ltd operating in the Dubai International Financial Centre (the "DIFC") under the trading name "DBS Bank Ltd. (DIFC Branch)" ("DBS DIFC"), registered with the DIFC Registrar of Companies under number 156 and having its registered office at units 608 - 610, 6th Floor, Gate Precinct Building 5, PO Box 506538, DIFC, Dubai, United Arab Emirates.

DBS DIFC is regulated by the Dubai Financial Services Authority (the "DFSA") with a DFSA reference number F000164. For more information on DBS DIFC and its affiliates, please see http://www.dbs.com/ae/our--network/default.page.

Where this communication contains a research report, this research report is prepared by the entity referred to therein, which may be DBS Bank Ltd or a third party, and is provided to you by DBS DIFC. The research report has not been reviewed or authorised by the DFSA. Such research report is distributed on the express understanding that, whilst the information contained within is believed to be reliable, the information has not been independently verified by DBS DIFC.

Unless otherwise indicated, this communication does not constitute an "Offer of Securities to the Public" as defined under Article 12 of the Markets Law (DIFC Law No.1 of 2012) or an "Offer of a Unit of a Fund" as defined under Article 19(2) of the Collective Investment Law (DIFC Law No.2 of 2010).

The DFSA has no responsibility for reviewing or verifying this communication or any associated documents in connection with this investment and it is not subject to any form of regulation or approval by the DFSA. Accordingly, the DFSA has not approved this communication or any other associated documents in connection with this investment nor taken any steps to verify the information set out in this communication or any associated documents, and has no responsibility for them. The DFSA has not assessed the suitability of any investments to which the communication relates and, in respect of any Islamic investments (or other investments identified to be Shari'a compliant), neither we nor the DFSA has determined whether they are Shari'a compliant in any way.

Any investments which this communication relates to may be illiquid and/or subject to restrictions on their resale. Prospective purchasers should conduct their own due diligence on any investments. If you do not understand the contents of this document you should consult an authorised financial adviser.

Hong Kong

This publication is distributed by DBS Bank (Hong Kong) Limited (CE Number: AAL664) ("DBSHK") which is regulated by the Hong Kong Monetary Authority (the "HKMA") and the Securities and Futures Commission. In Hong Kong, DBS Private Bank is the private banking division of DBS Bank (Hong Kong) Limited.

DBSHK is not the issuer of the research report unless otherwise stated therein. Such research report is distributed on the express understanding that, whilst the information contained within is believed to be reliable, the information has not been independently verified by DBSHK.

Singapore

This publication is distributed by DBS Bank Ltd (Company Regn. No. 196800306E) ("DBS") which is an Exempt Financial Adviser as defined in the Financial Advisers Act and regulated by the Monetary Authority of Singapore (the "MAS").

Thailand

This publication is distributed by DBS Vickers Securities (Thailand) Co., Ltd. ("DBSVT").

United Kingdom

This communication is from DBS Bank Ltd., London Branch located at 9th Floor, One London Wall, London EC2Y 5EA. DBS Bank Ltd. is regulated by the Monetary Authority of Singapore and is authorised and regulated by the Prudential Regulation Authority. DBS Bank Ltd. is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of DBS Bank Ltd., London Branch's regulation by the Prudential Regulation Authority are available upon request.

DBS