INCREASING YIELD WITH US CORPORATE BONDS

For 2021, with interest rates very low and spreads tight, investors are wondering where to turn in order to generate returns in the liquid fixed income universe. We will show that US credit investments offer attractive returns even after currency hedging. Due to a steep US yield curve, the expected return is higher than the current yield.

Average returns for safe-haven securities such as government and covered bonds are negative, whereas euro-denominated investment grade (IG) corporate bonds generate yields of less than 0.5%. In this environment, US dollar-denominated corporate bonds are an exception, offering yields of 2.2% – and a current yield of 1.35% including FX hedging. These numbers have increased recently after the considerable interest rate movements in the US in Q1/2021 when the 10-year rate moved sharply higher from a level of 0.91% at the turn of the year to above 1.6% in mid-March.

In addition to this yield pick-up, investors in US dollar corporate bonds benefit from a diversifying effect. The ICE BofA US Corporate Index is even more diversified than its European counterpart; it includes more than 8,800 bonds issued by nearly 1,100 corporates, compared to 3,600 bonds issued by over 600 companies in the Euro IG index. Moreover, sector concentration in the ICE BofA US Corporate Index is lower than in a comparable Euro index. For example, financial bonds account for only about 30% of the US index compared to 40% in Euro. Investors also gain access to the US yield curve which does not always correlate with the European yield curve.

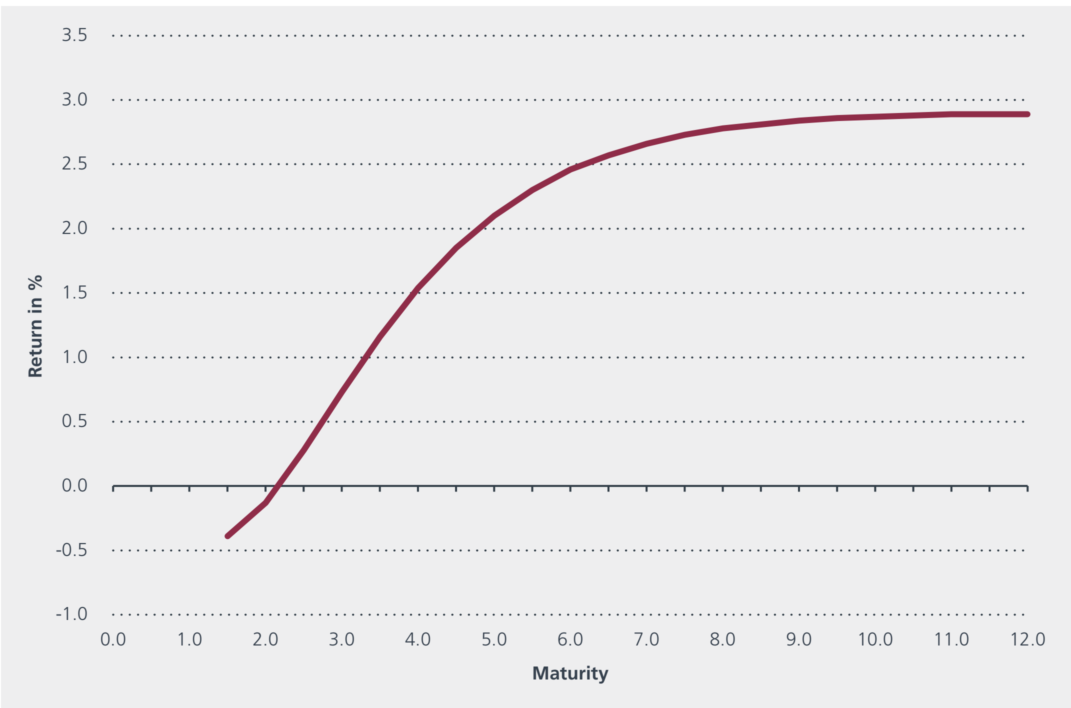
When investing in US bonds, investors should hedge their currency risks, since FX volatility is significantly higher than corporate bond volatility and thus has a dominant impact on returns. For efficiency reasons, this hedge is often set up for a month and then rolled over monthly, a methodology also applied by benchmark providers when calculating currency-hedged benchmark returns. However, hedge costs are subject to strong fluctuations: whilst in November 2020 they had amounted to 0.85%, costs rose to 1.86% by mid-December 2020 before returning to their previous level in 2021.

Roll-down as an additional yield factor

However, the current interest return on the bonds minus the hedge costs is not the total return an investor can expect on an annual basis, since this number does not include the roll-down return, i. e. the additional return resulting from the decrease in the residual maturity of invested bonds over time. Provided that the yield and spread curves have a certain degree of steepness, a decrease in the remaining term of a bond lowers its yield to maturity, which in turn increases the bond price and thus generates an extra return. With the US yield curve currently being steeper than the European curve – after the interest rate increases of the first quarter 2021, the yield pick-up of 10Y versus 2Y US Treasuries amounts to 1.48% in mid-March, whilst the difference in Europe is only 0.38% – this is another source of excess return offered by US bonds compared to their European counterparts. Adding this roll-down return to the current yield results in the expected total return on investment, assuming interest rates and spreads remain unchanged. Figure 2 shows that a US dollar IG bond index with a duration of around 9 can be expected to generate a total return of approximately 2.8%.

> 'After recent interest rate increases, US corporate bonds should be on investors' radar in 2021.'

USD investment grade credit total returns (hedged in Euro)



Carry and roll-down return by maturity for USD IG credit. Source: Quoniam Asset Management GmbH

Yield pick-up and diversification potential

In the current low-yield environment (with negative yields or yields close to zero), US dollar-denominated corporate bonds offer potentially attractive yields – even when hedging FX risks. In addition to this yield pick-up, these investment vehicles also provide diversification benefits. As a result, investors analysing liquid fixed income investments for 2021 should keep US bonds on their radar.

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