Manulife Investment Management

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Asian short duration bonds: Navigating interest rate volatility

Rising interest rates generally create a more challenging environment for bonds. However, short duration bonds are a notable exception. Being less sensitive to interest rate fluctuations, they may be an ideal vehicle for navigating volatile interest rate cycles. Within the fixed income universe, Asian short duration bonds (typically characterised with 3 years duration or lower) are a particular standout thanks to the region's solid fundamentals and growth prospects.

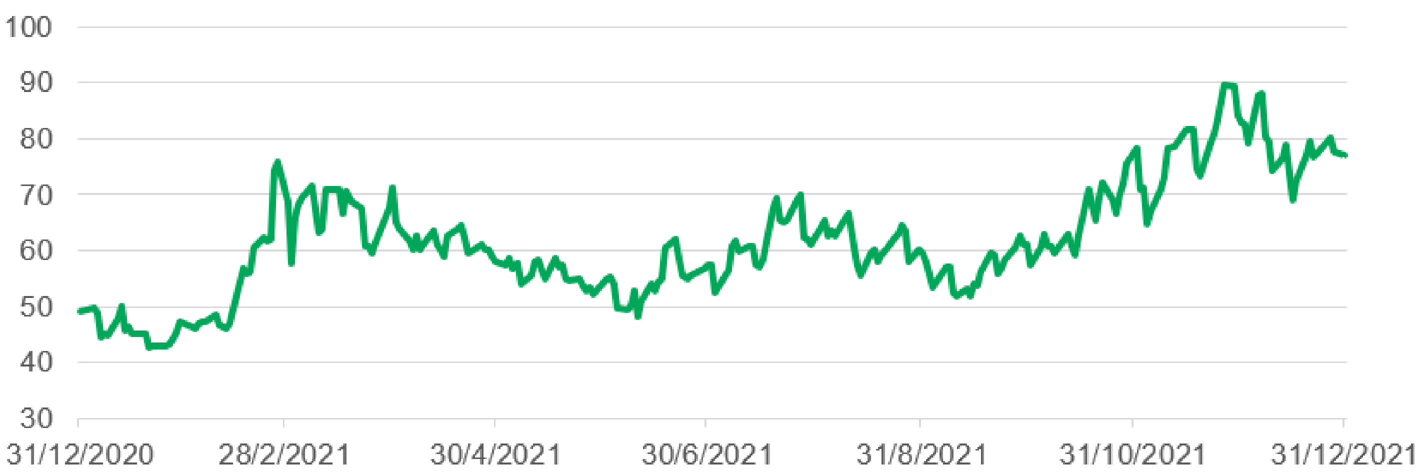
After an extended period of zero interest rates, the US Federal Reserve (Fed) has begun to signal its economy gathering momentum, while persistent inflation could prompt the Fed to tighten monetary policy and raise interest rates[1]. Interest rate volatility is spiking as the Fed's tapering of its monthly bond purchase programme removes liquidity from financial markets, pushing US Treasury yields higher[2]. Meanwhile, concerns about continued supply-chain disruptions and the direction of the global recovery – especially considering new COVID variants – are adding to the overall sense of uncertainty.

It all adds up to rising interest rate volatility since the beginning of 2021 and is reflected in the fixed-income-focused MOVE volatility index[3], which tracks movements in US Treasury yields (Chart 1).

Across the world, central banks in both developed and emerging markets appear poised to increase interest rates further in 2022. We have already seen a total of 59 rate hikes across global central banks in 2021[4]; with more likely on the way, bond investors look set for a challenging ride.

Yet, one strategy stands out that can help market participants navigate a volatile environment – and that is to focus on short duration bonds.

Chart 1: "VIX for Bonds" showed increasing volatility in US Treasury yields



Source: Bloomberg, as of 31 December 2021. US Treasury yield volatility represented by ICE BofA MOVE Index.

Understanding the relationship between bond duration and interest rates

Rising interest rates are one of the biggest concerns for fixed income investors. As interest rates rise, the yields offered by bonds will also increase, in order to compensate. And when yields move higher, bond prices fall (since yields are a function of the underlying price). Therefore, bond prices and interest rates can be considered inversely related.

Interest rates are also commonly used as a policy tool. Monetary authorities, such as central banks, raise interest rates to “cool” the economy and fight inflation. Conversely, they lower them to stimulate economic activity, as shown by the rate cuts seen during the pandemic. Now, with economic activity recovering as economies reopen, inflationary pressures are back. Therefore, we are likely entering a rate hike cycle, which would negatively impact bond prices.

However, not all bonds have the same sensitivity to interest rate increases. Whereas one bond may fall by 1% for every 1% increase in interest rates, another may fall by 10%. This degree of sensitivity can be measured by a bond’s duration. A bond’s duration in simplistic terms acts as the “multiplier” to reflect how much a bond’s price would change in relation to interest rates.

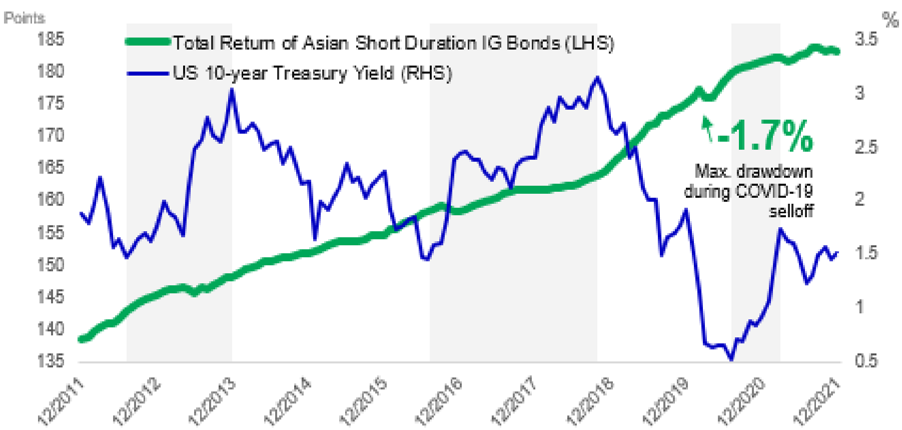
In sum, the shorter the bond duration, generally, the less sensitive it is to interest rate fluctuations. With interest rates not only being volatile – but set to rise – short duration bonds are a powerful tool for adding resiliency to an investor’s portfolio.

The value of Asian short duration bonds in a volatile interest rate environment

While short duration bonds tend to demonstrate greater resiliency in the face of rising interest rates, the data indicates that Asian short duration bonds have also shown particularly strong resilience in periods of global risk-off environment. During the global COVID-19 selloff in March 2020, their maximum drawdown was as low as 1.7% (Chart 2).

Asian bonds and Asian short duration investment-grade (IG) bonds also generally have a shorter duration (around 80% lower) than their global counterparts (Chart 3).

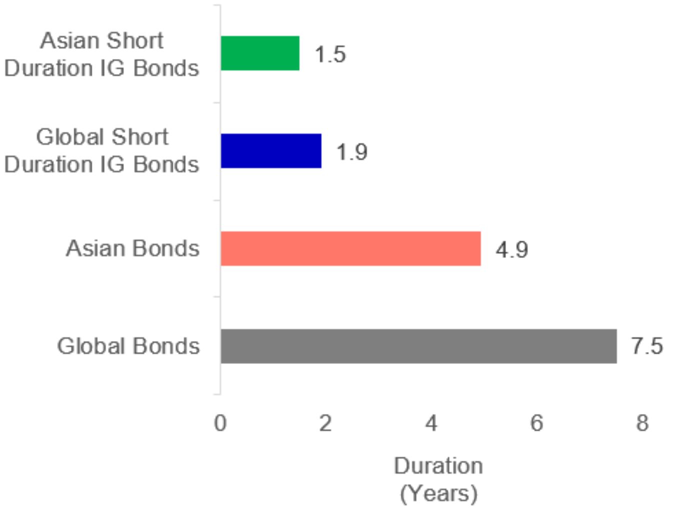
Chart 2: Asian short duration IG bonds outperformed during period of rising yields



(monthly change)	US 10-year Treasury Yields	Total Return of Asian Short Duration IG Bonds	Total Return of Asian IG Bonds
Jul 2012 – Dec 2013	+156 bps	+3.9%	+0.9%
Jul 2016 – Oct 2018	+169 bps	+3.5%	+0.5%
Jul 2020 – Mar 2021	+121 bps	+1.4%	-0.6%

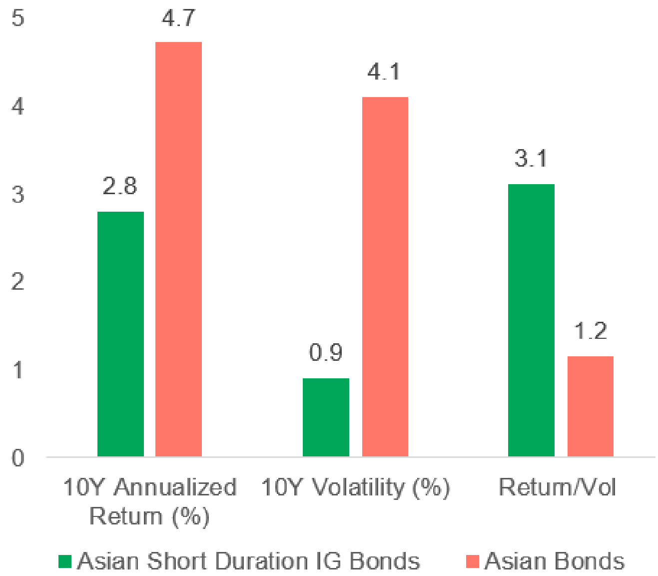
Source: Bloomberg, as of 31 December 2021. Asian Short Duration IG Bonds represented by JACI Investment Grade 1-3 Year Total Return Index; Asian IG Bonds represented by JACI Investment Grade Total Return Index. The chart is based on monthly data and the maximum drawdown is based on daily data.

Chart 3: Asian short duration IG bonds show less interest rate sensitivity



Source: Bloomberg, as of 31 December 2021. Asian Short Duration IG bonds represented by JACI Investment Grade 1-3 Year Total Return Index; Global bonds represented by Bloomberg Global Aggregate Bond Index; Asian bonds represented by JACI Composite Total Return Index; Global Short Duration IG bonds represented by Bloomberg Global Aggregate 1-3 Year Bond Index.

Chart 4: Attractive risk-adjusted returns from Asian short duration IG bonds



Source: Bloomberg, 31 December 2011 to 31 December 2021. Asian Short Duration IG bonds represented by JACI Investment Grade 1-3 Year Total Return Index; Asian bonds represented by JACI Composite Total Return Index.

This means Asian short duration bonds are less interest-rate sensitive than global short duration bonds, providing a buffer for downside cushion during a rising interest rate environment.

A common misconception – prioritising income above risk-adjusted returns

It is natural for investors to assess fixed-income holdings by the income received from coupon payments or yield when considering the income stream in relation to the bond price. While this is undoubtedly an essential factor, investors should also evaluate a bond's total risk-adjusted return. For instance, longer duration bonds generally have higher yields and thus higher income. However, they are also much more sensitive to interest rate volatility – a factor many investors neglect in calmer times.

Instead, a more holistic risk-adjusted total return may be more appropriate. The data shows that Asian short duration bonds have delivered 58% of the total returns in the broad USD Asian bond universe – but with one-fifth of the volatility over the past 10 years (Chart 4). This favourable risk-return profile makes them a resilient vehicle in a turbulent interest-rate environment.

Manulife Global Fund – Asian Short Duration Bond Fund (the "Fund"). A focus on risk-adjusted returns.

When investing in bonds, investors should consider duration/interest-rate sensitivity, credit quality and other risk factors that affect a bond's price. The Fund focuses on Asia Pacific credits with low duration and aims to provide investors with income as well as long-term capital appreciation in various market cycles.

The Fund is managed by an experienced investment team with an average of 19 years' investment experience, using its time-tested investment process (in place for more than ten years), which leverages the firm's strong Asian footprint with presence in 10 Asian markets[5] and extensive on-the-ground research capabilities across Asia to facilitate robust credit selection[6]. The team focuses on selecting credits based on both risk-adjusted returns as well as superior yields. For example, the team avoided a Sri Lankan sovereign bond issuance in 2021, despite its attractive yield of 6%[7] at the time. This was later proven right as the country's sovereign rating was subsequently downgraded[8]. We believe in balancing notable and sustainable income returns with credit quality and interest rate sensitivity of bond issues.

To find out more about the Manulife Global Fund – Asian Short Duration Bond Fund, contact us.

[1] WSJ, 10 December 2021.
[2] Bloomberg, 6 December 2021.
[3] Bloomberg, Merrill Lynch Option Volatility Estimate, 29 December 2021.
[4] Reuters, 13 December 2021.
[5] Comprising of investment professionals of Manulife Investment Management, Manulife-TEDA Fund Management Co. Ltd., a 49% joint venture is a joint venture between Manulife Financial and Northern International Trust, part of the Tianjin TEDA Investment Holding Co. Ltd. (TEDA), and Mahindra Manulife Investment Management Private Limited, a 49% joint venture of Manulife and Mahindra AMC.
[6] Source: Manulife Investment Management, as of 31 December 2021.
[7] CEIC data, as of 29 December 2021.
[8] EconomyNext, 28 October 2021.