Santander
Private Banking

A new yield environment for short-term fixed-income

+3.7%
Short-term € government bond yields[1]

+0.5%
Expected Euro area GDP growth in 2023[2]

1.20%
Credit spread: high-quality corporate bonds vs. govies curve[3]

1 Source: Bloomberg (Bloomberg Pan-European Aggregate Treasuries 1-3 Years Index). Data as of 8 March 2023.
2 Source: Bloomberg economists' consensus. Survey on 8 March 2023.
3 Source: Bloomberg. Credit spreads: short-term corporate bonds (1-3 years). Data as of 8 March 2023.

Interest rate adjustment offers a new yield outlook for the conservative short-term fixed-income investor

A favourable environment for a conservative approach

European investors with a conservative profile have been heavily penalized over the last decade as a result of the ultra-expansionary monetary policy that kept interest rates in negative territory until just over a year ago.

Low-risk investment options to generate returns have changed significantly in recent quarters thanks to the interest rate readjustment that the European Central Bank has had to implement to combat inflation. The final phase of this rate adjustment is approaching and this provides a **clearer outlook for fixed-income investment.**

Managers of mandates for this asset class **can capture the value of the interest rate curve, which is already discounting the ECB raising rates to around 4%.**

Additionally, **the economic growth outlook for 2023 has improved, creating a more favourable environment for investing in high-quality corporate bonds.**

The combined increase in yields from the government debt curve and the credit risk premium creates a favourable environment for investing in low-risk fixed-income strategies: short-term high-credit quality.

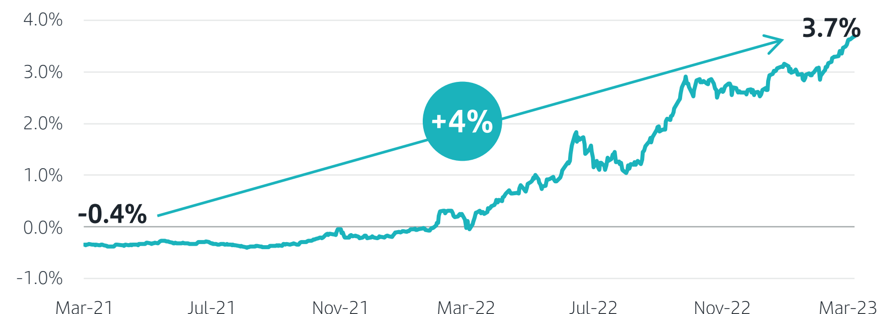
Changing environment for returns on low-risk investments

The yields offered by the Euro area yield curve have experienced an additional rally in recent weeks. This movement implies a **cumulative change of 4% in yields** to maturity on short-term government securities since March 2021. **Conservative fund managers can now obtain returns in excess of 3.5% with high-quality, liquid securities.**

We believe that the negative impact of additional interest rate hikes is more limited, given the high level already attained. Moreover, economists' consensus expects inflation to gradually decline in the coming months. We are in the final phase of calibrating monetary tightening and it is a good time to invest in the short end of the curve by capitalizing on the terminal rate of this phase of rising interest rates.

A new yield environment for short-term fixed-income

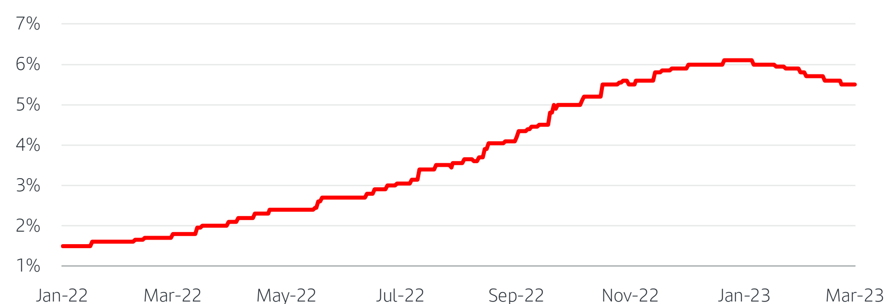
Source: Bloomberg Pan-european Aggregate Treasuries 1-3 Year index



Average annual Euro area inflation 2023

Expectations of an upswing in inflation appear to have peaked

Source: Bloomberg. Economists' estimates of Euro area average inflation in 2023



Quality corporate bonds also offer value

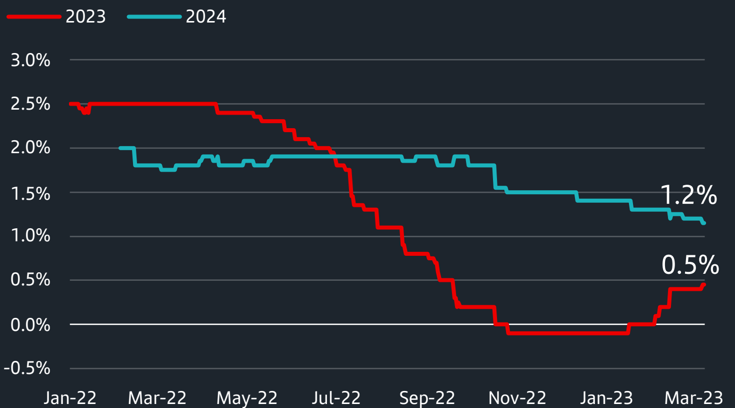
The recent improvement in economic growth prospects for the Euro area in 2023 enables managers to invest in low-risk corporate bonds.

Successful energy procurement by the European Union and fiscal stimulus programs have contributed to lowering the perceived risk of a recession in 2023, as shown in the right-hand chart. The economists' consensus foresees a low growth environment in which the process of taming inflation will take some time. This combination of high interest rates with a low probability of a hard landing is a good environment for investing in high-quality corporate bonds (issuers less likely to default in times of economic slowdown).

Growth expectations for 2023 and 2024

The economists' consensus perceives a lower risk of recession in the Euro area

Source: Bloomberg Economic Forecasts. Data as of 08/03/2023



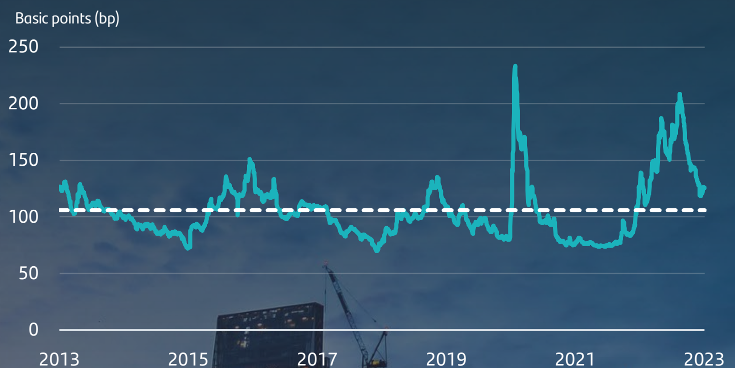
Improved prospects for yields by combining short-term government bonds and quality corporate bonds

In our baseline scenario, central banks keep interest rates high for longer than the market expects and economic growth will be very moderate, but will not collapse. This combination is favourable for short-term fixed-income investment strategies. Managers of this type of vehicles can capture the value of the curve (ahead of the rate hikes discounted by the market) and achieve extra yields through moderate exposure to bonds with high credit quality. Investors with a conservative profile finally have profitable low-risk options.

Credit spread of A-rated corporate bonds

Credit risk remuneration above historical average in corporate bonds with high credit quality

Source: Bloomberg. Credit spread: A-rated short-term corporate bonds (1-3 years). Data as of 03/03/2023



High yields with low-risk strategies

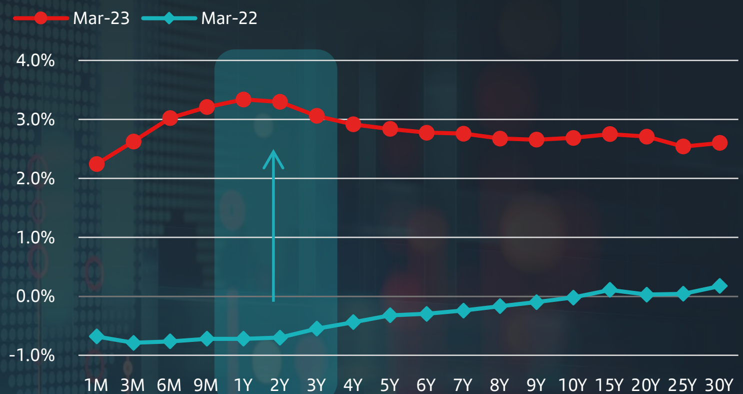
It is not necessary to adopt long-term positions to obtain positive yields

The yield curve has moved from negative territory in March 2022 to positive yields today. In addition, the slope has inverted, with long maturities anchored in the 2.5%-3% range while yields are close to 3.5% in the 1-3 year range.
Mutual funds focused on the short end of the curve enable investors to obtain better returns than are available in the money markets. The inverted curve provides additional yields without having to invest for the long term.

European government bond yield curve

Positive yields in the 1-3 year space

Source: Bloomberg EUR German SovereignCurve. Data as of 07/03/2023



It is not necessary assume high risk to achieve yields above 4%.

The current environment provides a positive situation for short-term fixed-income strategies that allows investors to obtain returns not seen in the last decade without assuming high risk (both interest rate and credit risk).
The result is that it is not necessary to lower credit quality or extend maturities to obtain yields of around 3.5%-4.0%. These levels of yield make it possible to offset adverse headlines (inflation, interest rates or growth).
The return/risk profile is significantly different than it was just twelve months ago (see table).

Credit quality	Yield	
	mar-23	mar-22
AAA[(1)]	3.3%	0.2%
AA[(2)]	3.6%	0.7%
A[(3)]	4.0%	1.0%
BBB[(4)]	4.6%	1.5%

Source: (1) Bloomberg Pan-European Aggregate: Corporate Aaa Total Return Index Unhedged EUR. (2) Bloomberg Pan-European Aggregate: Corporate Aa Total Return Index Unhedged EUR (3) Bloomberg Pan-European Aggregate: Corporate A Total Return Index Unhedged EUR (4) Bloomberg Pan-European Aggregate: Corporate Baa Total Return Index Unhedged EUR. Datos a 7/3/2023

How to position in this rate environment?

Seek collective investment vehicles that have a well-diversified portfolio of conservative fixed-income instruments, with extensive experience in managing and selecting high quality credit and curve positioning. The risk/return trade-off at this point in the cycle has improved significantly in the short end of the curve and in issuers with high financial strength.

To summarize, the sort of product to look for would be:

01 Actively managed through a mutual fund

02 A portfolio of high credit quality — both government bonds and corporates

03 Maturities in the 1-3 year range

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