Fixed Income | Perspectives

Understanding the New Interest Rate Regime

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INTRODUCTION

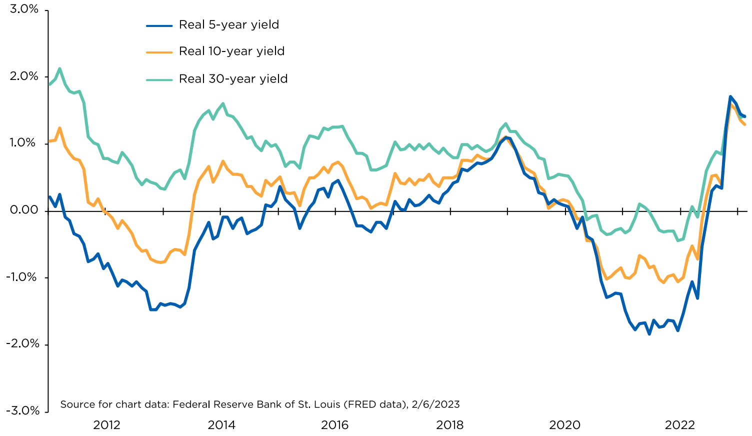
A worldwide pandemic, the supply chain challenges that still linger and geopolitical events like Russia's invasion of Ukraine have brought a significantly changed macroeconomic environment for the decade of the '20s. The conditions that characterized the previous decade—moderate to strong growth around the world, a prolonged bull market for stocks, low inflation and low interest rates—are no longer present.

In the United States, the steps the Federal Reserve (Fed) has taken to aggressively address persistently high inflation have brought much higher interest rates. We consider this shift to be an interest rate regime change. Its significance goes far beyond a discussion point for economists and market observers. For advisors and investors, this change has major implications. The factors that had been influencing investment decisions for so long have gone away, including the "easy money" provided by accommodative Fed policies, which have been present for decades, and the "thirst for yield" amid historically low interest rates.

This new interest rate regime requires advisors and investors to reconsider how they have been viewing the two major asset classes, the role each plays in portfolios, and the diversification strategies that can deliver the best balance of risk and returns.

Looking at fixed income yields demonstrates the degree to which conditions have changed. Even amid a period of high inflation, the real yields on 5-year, 10-year and 30-year Treasuries are now much higher. The search for higher yields from other, higher-risk asset classes may not be as necessary.

Real yields on 5-, 10- and 30-year Treasuries 2011 to 2022



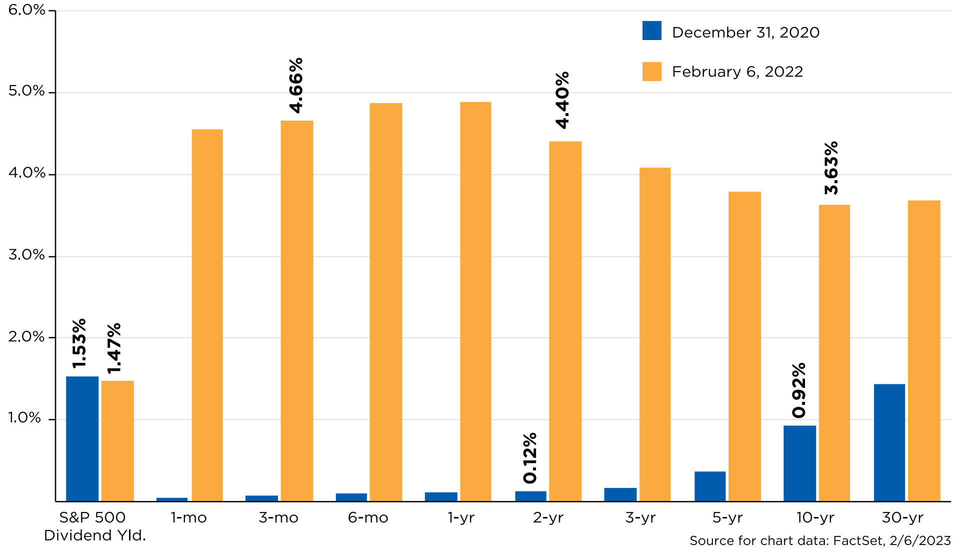
Source for chart data: Federal Reserve Bank of St. Louis (FRED data), 2/6/2023

KEY TAKEAWAYS

- The rapid increase in the benchmark federal funds rate last year, as the Fed worked to combat high inflation, brought a new interest rate regime. It stands in stark contrast to the low rate, low inflation environment of the previous decade.
- The fundamentals of the credit markets appear to be solid, as earnings among companies in the high-yield and investment-grade sectors have been high enough to suggest they can continue meeting debt obligations even in the advent of a recession.
- With the possibility for continued bond market volatility, fixed income investors may be best served this year by focusing on short-duration and high-quality bonds in the investment-grade universe.

The magnitude of change in the environment over the past two years is also evident when comparing the yield on U.S. Treasuries to the dividend yield for the S&P 500® Index. At the end of 2020, equity dividends provided, on average, a higher yield than Treasuries across the full maturity spectrum. By the early months of 2023, the comparison looked entirely different, with Treasuries of all maturities offering significantly higher yields than equity dividends.

S&P 500 dividend yield vs. U.S. Treasury yields



Source for chart data: FactSet, 2/6/2023

A SHIFT FROM QE TO QT

In the early days of the pandemic, the Fed began a zero interest-rate policy (ZIRP) by lowering the federal funds rate to 0.25%—effectively zero. The ZIRP helped the U.S. economy recover from the pandemic-induced slowdown, but high inflation set in as consumer spending rebounded and global supply chains couldn't keep pace with the rising demand. The Fed responded by aggressively raising interest rates, often at 75-basis-point intervals. By the end of 2022, the once near-zero fed funds rate had risen to 4.25%. The great "reset" of interest rate regimes was firmly in place.

The shift to a tighter monetary policy was also facilitated by the Fed's decisions to stop purchasing bonds, which had been part of its quantitative easing (QE) efforts to ensure liquidity in the system during the economic slowdown that occurred at the outset of the pandemic. With the transition to quantitative tightening (QT), the Fed is working to reduce its balance sheet.

The change in Fed policy has had a direct and major impact on the fixed income markets. With tighter monetary conditions, the supply of securities such as Treasury bonds has been reduced, and, with higher rates, the use of bonds to raise financing has become more expensive for all issuers, including governments and companies.

The rapid increase in rates brought a swift decline in prices across all sectors of the fixed income market, especially in long-duration assets. A broad measure of the market, the 50/50 mix of government and corporate intermediate-term, investment-grade bonds represented by the Bloomberg U.S. Aggregate Bond Index, was down 13% in 2022. It was the broad bond market's worst year on record, dating back to 1928.[1] The drop last year surpassed the previous worst annual decline of 9% in 1931.

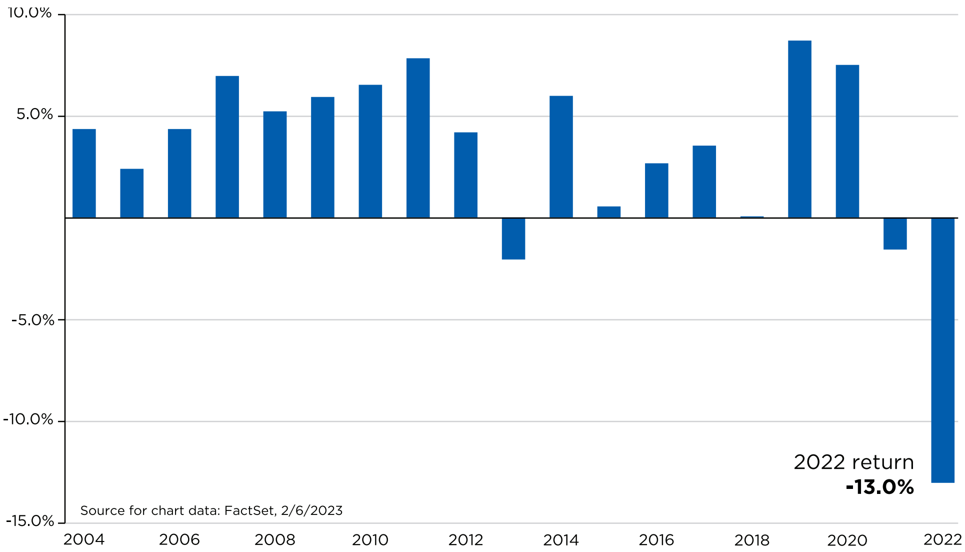
To keep 2022 in perspective, though, it's important to remember that this difficult year was the exception, not the rule. Over the past 20 years, the bond market has typically delivered positive, and often strong, returns. With 2022 as the notable exception, in the few prior years it was down, the declines were relatively modest. In past periods of rising interest rates, the availability of higher yields often offset the impact of declining bond prices. But the magnitude and pace of rate increases in 2022, coupled with the challenging economic climate, delivered a perfect storm that brought a high-magnitude market decline.

[1] Source: FactSet, Using the performance of a portfolio, developed by New York University, that was 50% invested in U.S. Treasuries and 50% invested in investment-grade bonds (rated Baa or better), for 1928 to 1975. Using the performance of the Bloomberg U.S. Aggregate Bond Index for data from 1976 to year-end 2022.

The year was difficult for stocks as well, as equities were buffeted in the first half of 2022 by two consecutive quarters of negative growth, the impact of the war in Ukraine, soaring inflation and expectations that a prolonged recession might be imminent. The S&P 500 dropped 18% for the year.[2]

The simultaneous steep decline for bond and equities caused the 60/40 portfolio to lose 16%, its third worst year on record since 1950. Worse annual returns for this traditional diversification strategy were posted only during the Global Financial Crisis of 2008 (-20%) and in 1974 (-17%), amid a recession with the stagflation conditions of high unemployment and high inflation.

Bloomberg U.S. Aggregate Bond Index total returns 2004 to 2022



Source for chart data: FactSet, 2/6/2023

DUELING NARRATIVES

Advisors and investors now want to know what they can expect from the economy and financial markets in 2023. Through the end of 2022 and into the early weeks of the new year, bond market traders and the Fed seemed to have had decidedly different views about how the year will play out. The markets responded to signs at the end of 2022 that the pace of inflation might be slowing enough to give the Fed reason to begin cutting rates in the second half of 2023. That belief was reflected in the pricing of Fed Funds futures in February, after the first Federal Open Market Committee (FOMC) meeting of the year.[2]

The Fed, however, appears to be charting a different course. On February 1, 2023, it raised rates again, at the relatively modest increment of 25 basis points. The Fed also gave no indication that the February hike would constitute the end of its current cycle of rate increases. Guidance from the Fed even suggested it may hike rates further to bring the federal funds rate into the low 5% range—and keep it there for the rest of the year.

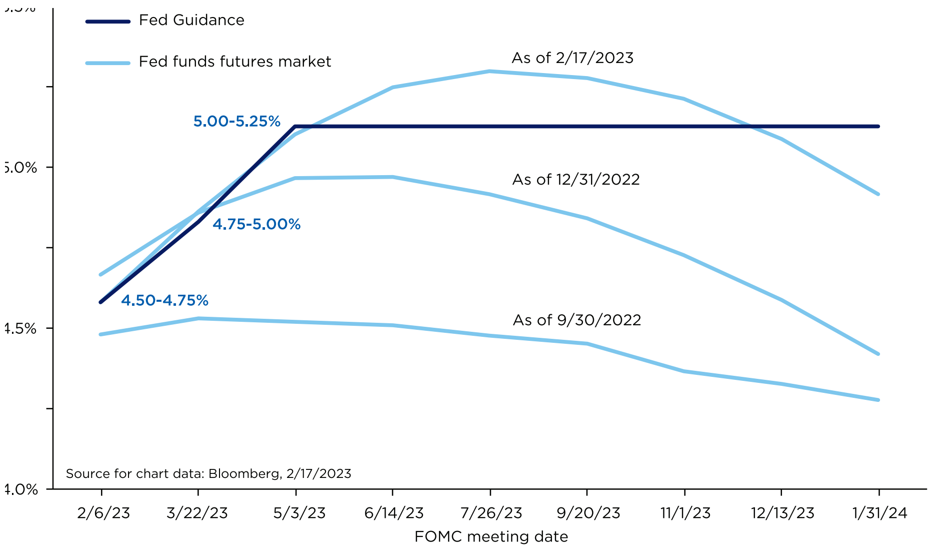
The markets' contrary view began to change as reports on the state of the economy in January were issued. The prices that wholesalers pay for goods and services, as measured by the Producer Price Index, increased by 0.7% in January.[3] Similarly, the amounts consumers pay, as tracked by the Consumer Price Index, increased 0.5% for the month.[4] If consumers had responded to high prices by purchasing less, that might have caused prices to come down, but January didn't offer signs that demand was weakening. Instead, retail sales for the month rose above December levels by 2.3%.[5]

If high inflation persists, interest rates are likely to remain higher for longer. The markets now appear to be catching up to the Fed's view that there are still considerable inflationary pressures in the economy.

[2] Source: Source: "US stocks finish 2022 with another loss, ending the year down 20% in their worst performance since 2008," MarketsInsider.com, 12/30/22
[3] Source: "Wholesale prices 0.7% in January, more than expected, fueling inflation increase," CNBC.com, 2/16/23
[4] Source: "Inflation rose 0.5% in January, more than expected and up 6.4% from a year ago," CNBC.com, 2/14/23
[5] Source: "January retail sales are strong to start 2023," Supply Chain Management Review, 2/15/23

Investors hoping for more price stability with their fixed income investments may have to wait. Amid this heightened concern from both the Fed and the markets about the high level of inflation, each month's economic indicators and the markets' interpretation of their relevance will likely cause continued volatility throughout 2023.

Federal Reserve rate guidance vs. market expectations



Source for chart data: Bloomberg, 2/17/2023

STRONGER FUNDAMENTALS FOR HIGH YIELDS IN A WEAKENING MACRO ENVIRONMENT

Even in the midst of weak macroeconomic conditions, the high-yield bond market seems to be healthier and more stable than it has been for some period. History offers an additional rationale for investors to be hopeful about the prospects for high-yield bond returns this year. Since 1987, high-yield bonds, as measured by the ICE BofA US High-Yield Index, have posted negative annual returns in only 7 of those 36 years (1994, 2000, 2002, 2008, 2015, 2018 and 2022). After each of the previous down years, high-yield bonds always rebounded and delivered positive, and often double-digit, returns in the following year. To gauge how high-yield bonds might fare this year, there are several key market indicators and trends advisors will want to monitor.

Net leverage ratios reveal how much earnings companies have to cover their debt. In 2021, companies took advantage of the low interest rates available at the time and refinanced much of their debt. As a result, many companies' balance sheets are looking healthy and strong. The volume of refinancings at exceptionally low yields, especially in 2021, enabled companies to push out the maturity dates when they would have to pay back principal or look to refinance their debt, perhaps at less favorable rates. Collectively, for the sector, the "maturity wall," when a large volume of current debt will reach maturity, has been pushed out to the final years of this decade.

A low level of new bond issuance, along with the number of companies whose bonds have been upgraded out of high-yield and into the investment-grade universe, has created a negative net supply for this market in 2022. That short supply could provide more support for high-yield bond valuations.

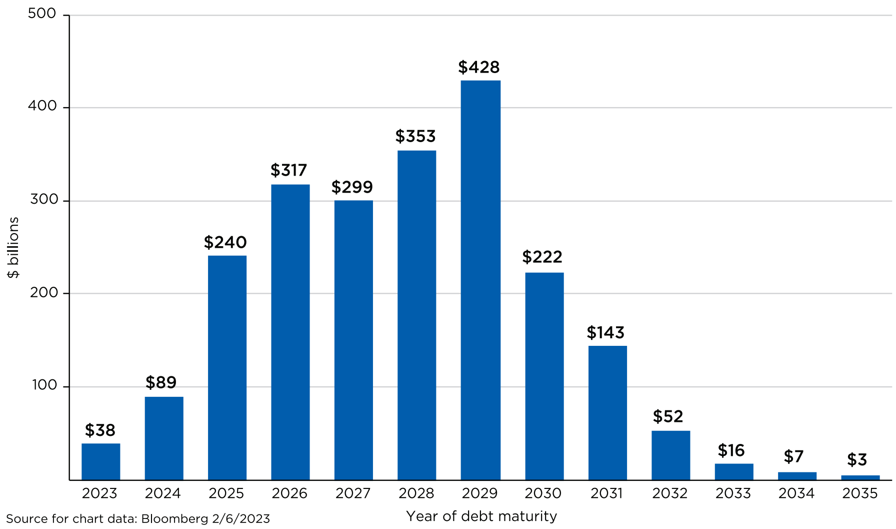
If the economy enters a recession or simply slows down to a degree that delivers paltry growth, many high-yield issuers could be well prepared to handle a period of difficulty. They have enough capital on hand to cover their interest expenditures at least four times over, as evidenced by how high interest coverage ratios have climbed since 2020. Still, there could be some diversion of performance across the high-yield sector. Monitoring credits and selective investing will be critical to ensure that portfolios avoid or exit positions in companies that are showing any signs of distress, like weakening earnings.

The prospect of recession always raises concerns among investors that the default rate in the high-yield sector could significantly increase. With these levels of interest coverage ratios, though, we don't foresee that as a likelihood. Still, advisors may want to keep an eye on two additional key indicators that could suggest whether risks are increasing for the sector.

The first is refinancing rates, particularly as we reach the end of 2023 and enter 2024. The first large wave of refinancings are scheduled to occur in 2024, and higher refi rates would make borrowing more expensive for high-yield issuers.

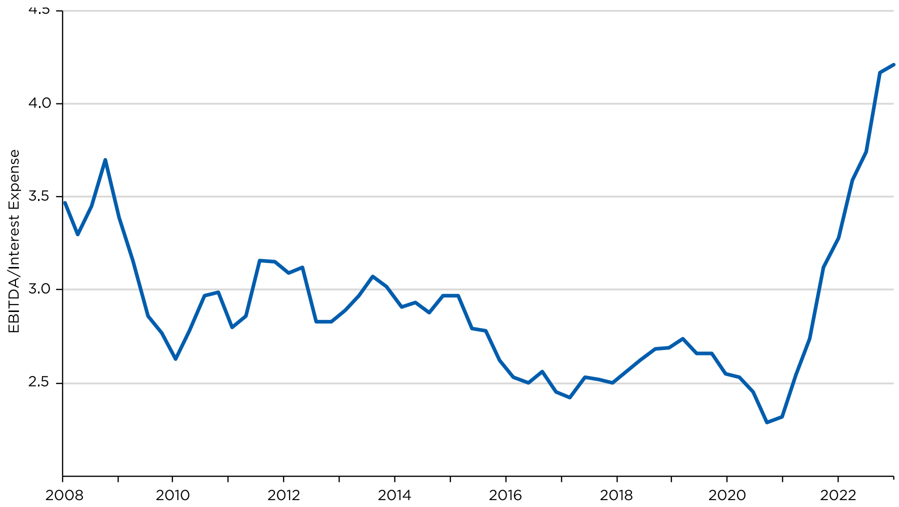
The second important factor is earnings. As healthy as the high-yield market appears to be currently, there could be cause for concern if a number of companies begin to make downward earnings revisions, especially as we approach 2025 and 2026 and the maturity wall begins to rise. Weaker earnings would bring a decline in interest coverage ratios and perhaps signal that more companies might have trouble meeting their interest and principal payment obligations.

High yield maturity "wall," outstanding debt by year of bond maturity



Source for chart data: Bloomberg 2/6/2023

Interest coverage ratios for high yield bonds (BB-CCC rated)



Source for chart data: Bloomberg, 2/6/2023

FOCUS ON SHORT DURATION INVESTMENT-GRADE CREDIT

While inflation may have spiked in January, it remains well below the 9.1% level seen in June of 2022. Further, the persistence of low (below 50) readings from the PMI, which registered at 46.9 for January, suggests some weakness in the economy.[6]

Risks in the credit markets could increase if the Fed fails to execute a soft landing for the economy and the resulting recession proves to be even worse than expected. If the Fed's response to those conditions continues to flatten the yield curve, it's likely that credit spreads will widen.

Even if the higher for longer environment continues for interest rates, it's important to keep in mind that short-term yields are now the most attractive they have been since 2006 and 2007.

With a flat credit yield curve, there is little reason for investors to go out further on the curve, as they would in other circumstances, to pursue additional income. Longer-maturity credits have greater risks, given their increased sensitivity to interest rate changes. Those risks may be highlighted if the economy worsens, and credit spreads widen.

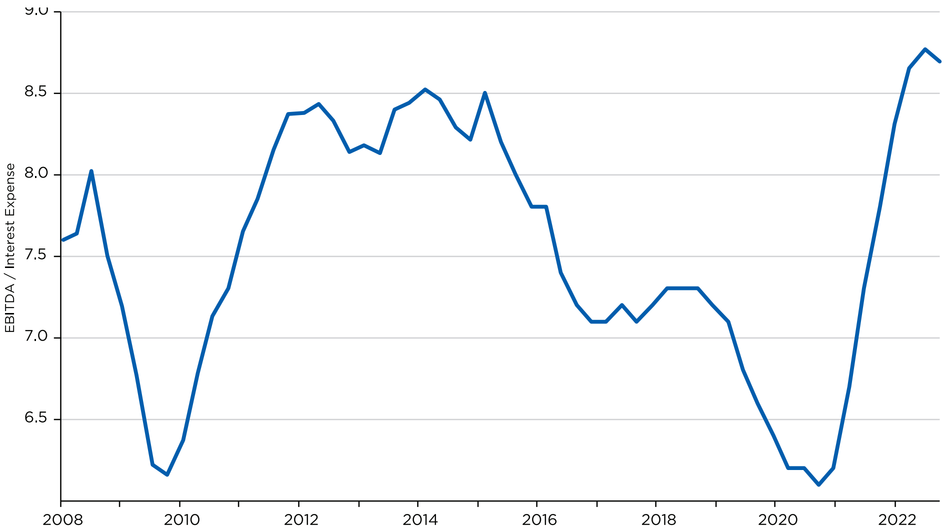
Short-term bonds involve considerably less risk, given that their prices are much less sensitive to interest rate fluctuations. In contrast to the usual risk/reward tradeoff, short-term bonds are now delivering the reward of high income with less risk than their long-term counterparts.

The ratio of upgrades to downgrades from the three major bond rating agencies—Standard & Poor's, Moody's and Fitch—did trend lower in 2022. A continuation of that trend in 2023, with an increase in downgrades, could cause further credit spread widening. While the downgrades mostly affected the high-yield sector, advisors will want to monitor whether any deterioration of economic conditions causes that trend to spread into the investment-grade universe.

In all these possible scenarios, we think advisors may be well-served by suggesting that their clients stick with short-duration bonds and focus on quality. We believe there will likely be little incentive, and considerably more risk, for investors to venture outside the investment-grade universe of bonds rated BBB to AAA.

The strength of the investment-grade market is evident from how high interest coverage ratios are. They have climbed close to 9, the highest level seen over the past 16 years. With high earnings in relation to their debt, the companies in the quality corner of the credit markets seem well-prepared to keep meeting their obligations to fixed income investors, even if the economy enters a deep or prolonged recession.

Interest coverage ratios for investment-grade bonds
(AAA-BBB rated)



Source for chart data: Bloomberg, 2/6/2023

[6] Source: "US Purchasing Managers Index (PMI)," Investing.com, 2/1/23

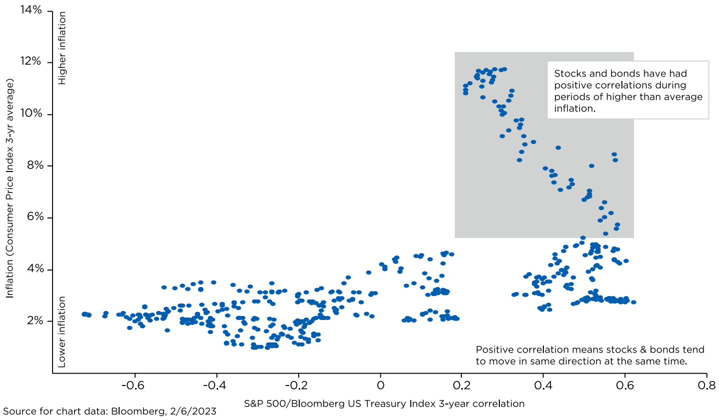
FOUR REASONS WHY THE 60/40 PORTFOLIO IS NOT DEAD

Count us among those who think reports of the death of the 60% stocks/40% bonds diversification strategy have been greatly exaggerated. Last year did provide evidence for those who have become skeptical about the value of this traditional approach. But 2022 may have been more of an aberration than a proof point. Historically, stock and bond returns have always become closely correlated during periods of high inflation.

Absent those conditions, though, the two major asset classes have been negatively correlated. That has provided the key diversification benefits that have enabled the 60/40 portfolio to deliver solid returns over long periods.

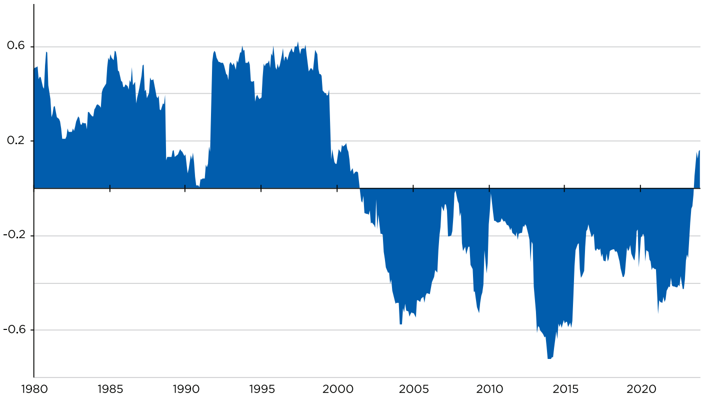
Still, if high inflation persists, investors will likely have to expect continued volatility from their 60/40 portfolios. Before giving up on this traditional approach to diversification, though, investors may want to keep several important considerations in mind.

Relationship between inflation and stock/bond correlations



Source for chart data: Bloomberg, 2/6/2023

Stock-bond correlations turned flipped in 2022



Source for chart data: Bloomberg, 2/6/2023

1. **The performance of any strategy shouldn't be evaluated on the basis of a single year's returns.** It's the long-term average that matters most for long-term investors. On that score, the 60/40 portfolio has delivered remarkably well, generating a 7% average annual return for investors over the past 95 years. It's also important to remember that the average is achieved over time. Markets are volatile and down years, with returns well below the long-term average, will inevitably occur. Generally, they have been compensated for with strong rebounds in subsequent years.

2. **The performance in 2022 needs to be viewed in a historical context.** Before 2022, fixed-income investors had enjoyed a 40-year bull market for bonds, as rates steadily declined from their peak in 1980, when the fed funds rate was a staggering 20%. After getting close to zero during the pandemic, the fed funds rate rose 450 basis points within a single year. That scenario seems more of an anomaly than a trend.

3. **The 60/40 portfolio has a good track record for delivering sustained rebounds.** In the past, the 60/40 portfolio has solidly recovered after a down year, and those rebounds were not merely short and quick. Since 1928, the forward 1-, 3-, 5- and 7-year total returns for the 60/40 portfolio following a down year, on average, were 4.2%, 28%, 48% and 65%, respectively.[7]

4. **A long-term lens is critical.** Viewing the 60/40 portfolio only through the lens of 2022 would be needlessly shortsighted. From 1920 to 2022, the 60/40 portfolio delivered an average return of about 9%. That is an impressively consistent track record for a diversification strategy that has proven its merits for investors with a long-term horizon.

[7] Source: "Historical Returns on Stocks, Bonds and Bills: 1928-2022," New York University, 1/1/23

CONCLUSION: PRUDENCE WITH A FOCUS ON QUALITY

With a slowing economy and the possibilities of a recession, we think investors should be wary of assuming excessive credit risk. In other words, sticking with quality may be the best option for the foreseeable future.

After an extremely challenging 2022, investors are naturally hoping for a quick reprieve. But we think volatility may persist as the markets adjust to a new era of high real rates and increased geopolitical uncertainty.

Still, we believe there are plenty of reasons for bond investors to remain hopeful about the market's long-term prospects. A focus on quality and the support of investment teams that exercise prudent credit selection can help investors navigate the challenges of slow or negative economic growth and a Fed that may continue to tighten financial conditions.

The search for yield that characterized the low-rate environment of the previous decade is no longer necessary. The higher yields available now across the fixed income universe may enable bonds to return to their historical role as a low-risk and stable source of income for investors. The losses experienced by the bond market in 2022 could even set the stage for significant gains this year.

Credit markets may be under some pressure if economic conditions deteriorate in 2023. Still, we believe the default rate could be less than it has been in previous recessions because so many companies are benefiting from strong balance sheets.

The fact that inflation has come down from its peak, mid-2022 levels, along with the possibility that the Fed might stop raising rates after the first half of this year, provide reasons for bond investors to have cautious optimism. Even the bad news of a recession could cause more investors who have heavily focused on equities to return to the relative safety of the bond market, especially with the high yields now available from bonds. That increased demand could provide an additional boost for the market and benefit investors who recognize the value of maintaining a significant allocation to fixed income in all environments.

ABOUT THE AUTHOR

Mark Hackett serves as Chief of Investment Research. As a leader for Nationwide's capital markets analysis, Mark develops content to educate financial advisors and their clients on financial markets and implications for investors. In this role he is responsible for asset class research, market commentary, white papers and topical market pieces.

Mark brings more than 20 years of experience in the asset management industry, including roles in research for both Nuveen and Vanguard Group and as a portfolio manager for Nuveen. He began his investment career at the Vanguard Group as a research associate in the fixed income group.

Mark has been interviewed by and quoted in numerous media outlets, including The Wall Street Journal, CNBC.com, CNN Money, The Associated Press Money and several others. He also contributes weekly market commentary to the Nationwide Advisor Advocate Blog.

He earned his Bachelor of Science in Business Administration with concentrations in Finance and Economics at the University of Richmond, holds Chartered Financial Analyst (CFA) and Chartered Market Technician (CMT) designations and is a member of the CFA Institute.

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Bloomberg US Aggregate Bond Index: An unmanaged, market value-weighted index of U.S. dollar-denominated, investment-grade, fixed-rate, taxable debt issues, which includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities and commercial mortgage-backed securities (agency and non-agency).

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Pg 1. Chart 1, titled: Real yields on 5-, 10- and 30-year Treasuries 2011 to 2022. This chart compares the real yields on 5-year, 10-year and 30-year Treasury yields from 2011 to 2022. In 2011, the 30-year yield started around 1.9% and trends downward until 2013 at a figure of around 0.4%. From there it climbs to 1.6% in 2014 and bounces between 0.75% and 1.2% until 2019 where it begins trending downward. It falls to -0.75% at the end of 2020. It recovered in 2021 to 0.1% before falling to -0.6%. In 2022, it trends upward, reaching a peak of 1.5%. In 2011, the 10-year yield started around 1.1% and climbed to 1.3% before trending downward. In 2012, it continued its decline from 0% at the beginning of the year down to -0.8% in 2013. From this point, it climbed to 0.6% at the end of 2013 and continued to fluctuate between 0.6% and 0.1% until 2019 where it climbed to 0.9%. It then dove to a pattern of fluctuation between -0.9% and -0.6% until, in 2022, it jumped to a high of 1.4%. In 2011, the 5-year yield started around 0.1% and followed similar patterns as the 10- and 30-year yields. It fell to -1.6% in late 2012 and early 2013 before rising to .3% in 2015. Between 2015 and 2018 it bounced between .3% and -0.8% until, in 2019, rising to .9%. After 2019, it falls sharply to a low of -1.9% and throughout 2022 jumping to a high of around 1.8%.

Pg 2. Chart 2, titled S&P 500 dividend yield vs. U.S. Treasury yields: This chart compares the S&P 500 dividend yields with the U.S. Treasury yields over 1-month, 3-month, 6-month, 1-year, 3-year, 5-year, 10-year and 30-year time periods. The figures in the chart were taken on December 31, 2020 and February 6, 2022. It shows a drastic rise in yields from the February, 2020 date to the December, 2022 date.

Pg 3. Chart 3, titled Bloomberg U.S. Aggregate Bond Index total returns 2004 to 2022: This chart shows the Bloomberg U.S. Aggregate Bond Index total returns from 2004 to 2022. Returns are primarily positive during the 18-year span shown, with 8 years showing returns between 1-5%. There is another 8 years with returns between 5-10%. 2015 and 2018 show returns well under 1%. Negative return figures occur in 2013, 2021 and, in 2022, it shows a negative return of -13%.

Pg 4. Chart 4, titled Federal Reserve rate guidance vs. market expectations: This chart shows the Fed Guidance as it rose to 5-5.25% and the Fed funds futures market as it trended downward in 2022. Note, on 2/23/23 the Fed fund is above the Fed guidelines, but it projects a downward turn.

Pg 5. Chart 5: This chart illustrates high yield maturity "wall," outstanding debt by year of bond maturity. Note, in 2023, debt maturity is $38 billion and climbs year over year to a peak of $428 billion in 2029. Then, it drops to $222 billion in 2030 and by 2035, it will be $3 billion.

Pg 5. Chart 6: This chat illustrates interest coverage ratios for high-yield bonds from through 2022. In 2008, the interest cost was just below 3.5% and dropped to about 2.7% in 2010. It experienced mild fluctuations between 2011 and 2017, where it dropped to around 2.4%. It then rose to 2.7% in 2017 before a steady drop that continued well into 2020 where it landed below 2.3%. Then, starting in late 2020 the rate begins a drastic climb all the way up to 4.2% in 2022.

Pg 6. Chart 7: This chart shows interest coverage ratios for investment-grade bonds. Starting in 2008, the interest expense figure is about 7.6% and rises to a tick above 8% at the end of the year. It then drops dramatically in 2009 to a low of about 6.25% at the end of 2009 before it begins a sharp rise and peaks in 2012 at 8.4%. Between 2012 and 2015, the interest expense undulates between 8.5 and 8.2% before a downward trend that starts in late 2015. In late 2016, the interest expense stood at around 7.2% and rose to above 7.3% in late 2018 before it fell. The interest expense reaches its low in late 2020 at just above 6.15%. From there, it rises steeply throughout late 2020 and 2021 to a peak figure of 8.7%.

Pg 7. Chart 8: The relationship between inflation and stock/bond correlations chart. The y-axis features inflation (Consumer Price Index 3-year average) and the x-axis features S&P 500/Bloomberg U.S. Treasury Index 3-year correlation. The chart highlights a predicted correlation that stocks and bonds have had positive correlations during periods of higher than average inflation.

Pg 7. Chart 9: Chart titled stock-bond correlations turned flipped in 2022. This chart plots stock-bond correlations from 1980 through 2022. Note, from 1980 to 2000 the stock-bond correlation ranged between 1-6%. Then, from 2001 to 2021 the stock-bond correlation flipped and ranged from 0 to -0.6%. As of 2022 the stock-bond correlation flipped again and is trending in the positive.