

April 2021

Global Value and Income Dispatch

Should Credit Investors Panic About Rates?

Highlights

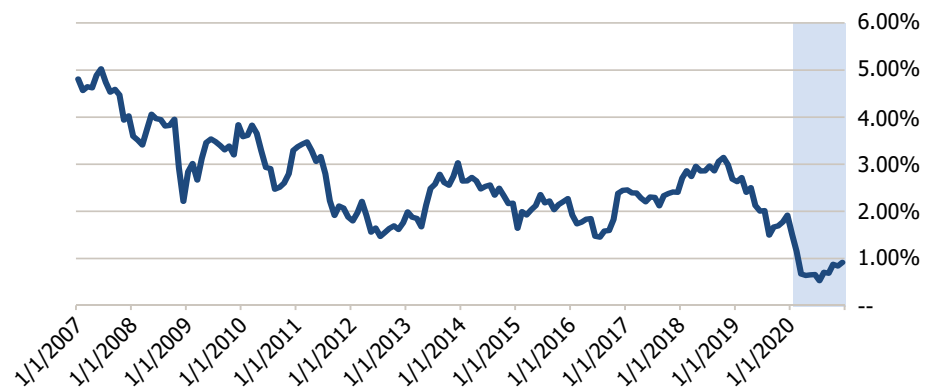
Credit investors need to be prepared for the potential of further rising rates

Don't panic! Rates are rising because the world is improving

There are still attractive returns available in credit

Rates! Panic! That's my impression of the markets so far this year. I get it - interest rates are an important piece of the investment landscape. Why invest in something risky when you can invest in something "riskless" for a similar return. Treasury yields are part of the comparison set against which all other investments must compete for capital. When treasury yields change quickly, it is important to adjust our expectations for everything else. Should we panic about an increase, though? Isn't this what we expected to happen?

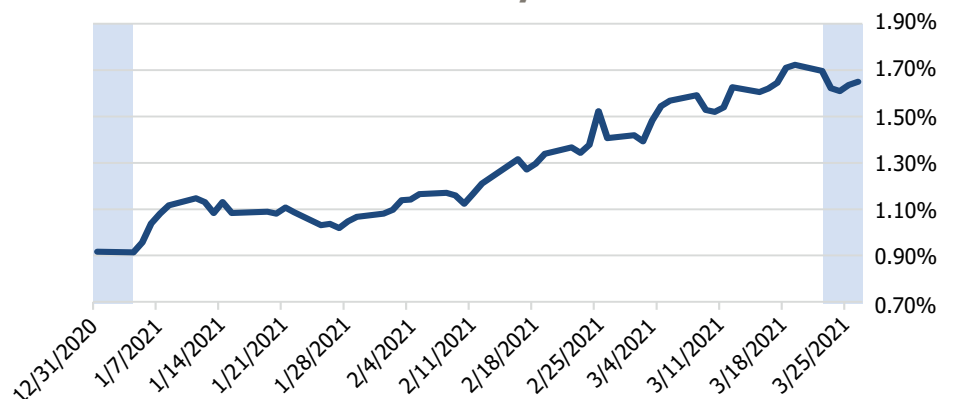
10-Year Treasury Yield – The Last 14 Years



Source: Bloomberg, as of December 31, 2020.

As you can see, looking back to before the 2008 recession, a 10-year Treasury yield as low as it was in 2020 is pretty strange, which is why more or less everybody thought rates were going up this year. Well, it turns out that just like with everything else over the last year, the interest rate cycle is playing out faster than usual. Just look at what the 10-year Treasury yield has done this year!

10-Year Treasury Yield- YTD



Source: Bloomberg, as of March 26, 2021.

How concerned should we be?

Well, unlike some other types of price shocks, this one seems to be largely driven by increasing expectations of a robust economic recovery and fiscal stimulus – resulting in businesses growing again and employment increasing. Perhaps the Federal Reserve will even be successful in generating inflation at or above their target rate for the first time in a long time. To be sure, different parts of the economy are likely to benefit more from the coming environment than others, and we are always mindful of who stands to gain and who stands to lose. That said, risk of permanent capital loss is likely decreasing when the economy is improving, so maybe panic is not quite called for.

Ok, no panicking – what should we do instead?

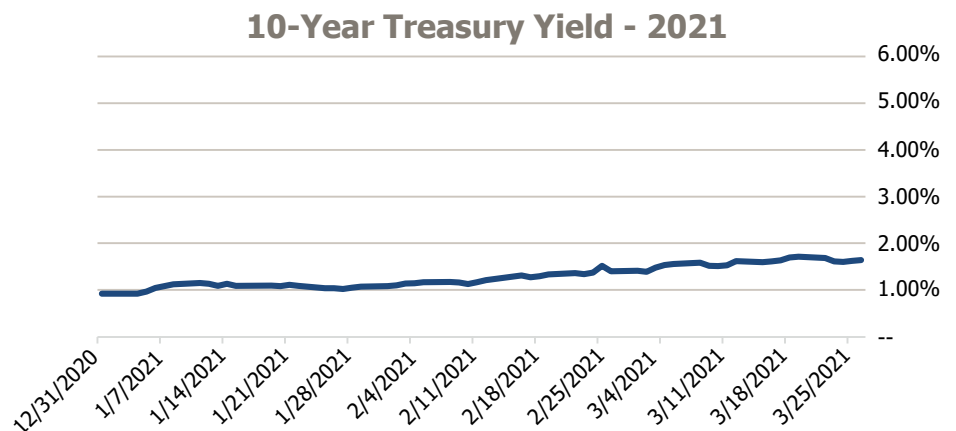
There are some relatively simple things we think make sense:

1. Duration is a risk over the next 12-24 months - expose yourself to duration carefully. Rates are likely going to normalize over the coming year or two (or three?). Nobody knows if that means 2% or 6% on the 10-year Treasury, but it most likely means that long dated fixed cash flow streams are going to be worth less tomorrow than they are today. The short end of the curve is not going anywhere for a while – everyone from the Federal Reserve has gone out of his or her way to make that abundantly clear. Shorter dated fixed income securities will be less exposed to interest rate risk. If you want to own a longer duration asset, just make sure the “juice is worth the squeeze.”
2. Make the credit-specific events work for you. A preponderance of the high yield market is call constrained – meaning bonds are trading like the company is likely to redeem the bonds the first chance they get. Usually this is because the company can issue much less expensive bonds in the current rate environment than when the existing bonds were sold. If rates rise quickly, that may no longer be the case. Bonds that currently trade based on a yield to their early call price may start to trade based on the yield to their maturity date several years later. This transition likely means that certain bonds the market used to treat as short-term instruments now have a lot more interest rate sensitivity – duration on some portfolios will expand without any changes to the security pool at all. Try to avoid those situations if you can, and look for company-specific catalysts to drive returns. Credit market beta was certainly your friend in 2020; we are not sure that will be the case in 2021.

When all else fails, a little perspective:

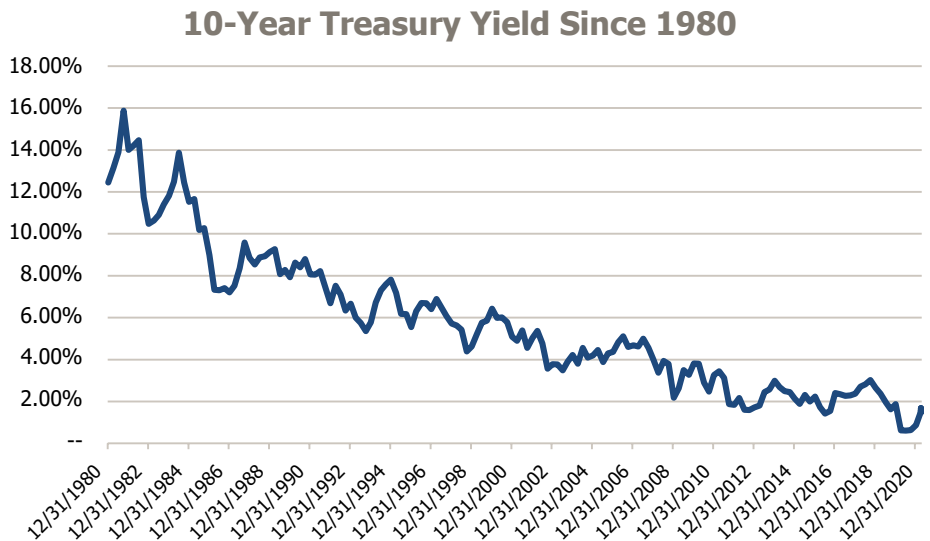
We probably shouldn't be surprised by a pretty wide range of outcomes for the 10-year Treasury yield at year end. Coming into the year, expectations ranged from 1.25% to 1.6% for the most part. Now, expectations seem to lean more towards 2%.

The yield has moved up pretty quickly this year, but just for fun, let's look at the year-to-date graph once again. This time, we'll make one change: we'll put it on the same y-axis scale as the 14-year chart from earlier.



Source: Bloomberg, as of March 26, 2021

Viewed this way, it seems like what we have seen so far really was not such a violent correction in the scheme of things. Rates have been trending lower for a very long time with periodic bouts of temporary increases. Here's a chart going back to the 1980's:



Source: Bloomberg, as of March 26, 2021.

Maybe that trend is over forever and we have moved into a new regime of inflation and rate increases? Or maybe the 10-year Treasury yield will move into the 2-3% range and be relatively stable until the next economic cycle turns. Both of those predictions must come with pretty wide error bars indicative of the high degree of uncertainty involved. In either case, the prescription above holds – be careful with duration and look for credit-specific catalysts. No matter what, though, do not freak out.

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