ASYMMETRICAL RATE SENSITIVITIES CAN CREATE POTENTIAL OPPORTUNITIES IN FIXED INCOME

by Henry Pasts, Executive Vice President and Analyst, BTS Asset Management, Inc.

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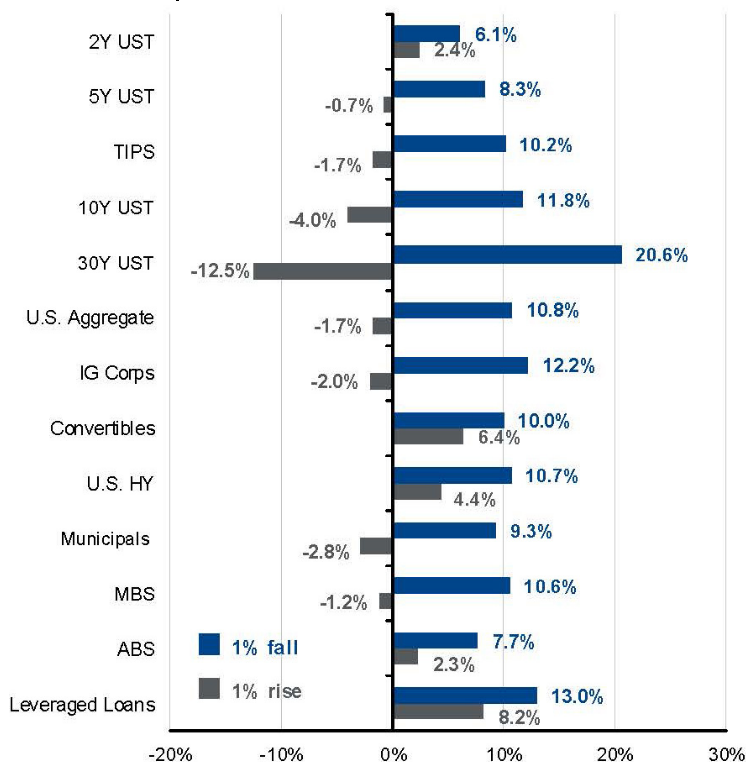
Its well known that bond prices tend to move in the opposite direction of interest rates, as we saw when many areas of the fixed income universe suffered drawdowns during the recent rate hike cycle. But bonds are not a homogenous asset class, as they can vary by their type of issuer, credit quality, length to maturity, coupon rate, callability, and other key features, all of which may affect the interest rate sensitivity of the bond. Furthermore, the effect of rising rates on the total return of a bond is not necessarily an equal and opposite reaction to that of falling rates. In other words, many bonds exhibit asymmetrical sensitivity to changes in rates, creating interesting opportunities in the space for those investors who understand the changing dynamics of rate sensitivities and how to potentially take advantage of them.

The chart below shows the impact that a 1% rise or fall in rates can have on the total returns of several varieties of fixed income vehicles. Total returns here reflect the sum of the price impact of a rate change, plus the current yield level. Given the level of uncertainty with the Fed's terminal rate, bond yields now have the potential to move in any direction. However, with most of the rise in rates likely already done, higher current yields now may provide an important hedge if we were to see any additional rate hikes, potentially limiting downside. Moreover, with the Fed expected to eventually lower rates, total returns for fixed income may look favorable at these entry points, with potential for both high yields and high price returns. All of this suggests conceivable opportunities in several fixed income sectors, such as shorter duration bonds given their current yields and risk profile, high-quality longer-dated bonds that may add a buffer to portfolios in case yields collapse, and bonds with hybrid characteristics such as convertibles, high yields, and leveraged loans that may offer attractive total returns whether rates rise or fall. ■

Impact of a 1% Rise in Interest Rates[1]



Source: Bloomberg, FactSet, Standard & Poor's, U.S. Treasury, J.P. Morgan Asset Management. Sectors shown above are provided by Bloomberg unless otherwise noted and are represented by – U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; ABS: J.P. Morgan ABS Index; Corporates: U.S. Corporates; Municipals: Muni Bond; High Yield: Corporate High Yield; Leveraged Loans: J.P. Morgan Leveraged Loan Index; TIPS: Treasury Inflation-Protected Securities; Convertibles: U.S. Convertibles Composite. Past performance is not indicative of future results.

Guide to the Markets – U.S. Data are as of December 31, 2023

DISCLOSURES

[1] Projected returns reflect an investment adviser's performance estimates, which is often based on historical data and assumptions. Projected returns are being used to predict a likely return. Projected returns do not take into consideration general market performance or economic conditions. All investors must consider their specific risk tolerances before any financial strategies are chosen for investment purposes.

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Treasuries - Treasury securities are divided into three categories according to their lengths of maturities. These three types of bonds share many common characteristics, but also have some key differences. The categories and key features of treasury securities include: T-Bills – These have the shortest range of maturities of all government bonds. Among bills auctioned on a regular schedule, there are five terms: 4 weeks, 8 weeks, 13 weeks, 26 weeks, and 52 weeks. Another bill, the cash management bill, isn't auctioned on a regular schedule. It is issued in variable terms, usually of only a matter of days. These are the only type of treasury security found in both the capital and money markets, as three of the maturity terms fall under the 270-day dividing line between them. T-Bills are issued at a discount and mature at par value, with the difference between the purchase and sale prices constituting the interest paid on the bill. T-Notes – These notes represent the middle range of maturities in the treasury family, with maturity terms of 2, 3, 5, 7 and 10 years currently available. The Treasury auctions 2-year notes, 3-year notes, 5-year notes, and 7-year notes every month. The agency auctions 10-year notes at original issue in February, May, August, and November, and as reopening's in the other eight months. Treasury notes are issued at a $1,000 par value and mature at the same price. They pay interest semiannually. T-Bonds – Commonly referred to in the investment community as the "long bond", T-Bonds are essentially identical to T-Notes except that they mature in 30 years. T-Bonds are also issued at and mature at a $1,000 par value and pay interest semiannually. Treasury bonds are auctioned monthly. Bonds are auctioned at original issue in February, May, August, and November, and then as reopening's in the other eight months. TIPS - Treasury Inflation-Protected Security (TIPS) is a Treasury bond that is indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money. Bloomberg Aggregate Bond Index, which is comprised of government securities, mortgage-backed securities, asset-backed securities and corporate securities with maturities of one year or more to simulate the universe of bonds in the market. Investment Grade Corporate - An investment grade is a rating that signifies a corporate bond presents a relatively low risk of default. Bond rating firms like Standard & Poor's and Moody's use different designations, consisting of the upper- and lowercase letters "A" and "B," to identify a bond's credit quality rating. "AAA" and "AA" (high credit quality) and "A" and "BBB" (medium credit quality) are considered investment grade. Convertible Bonds - A convertible bond is a fixed income debt security that yields interest payments but can be converted into a predetermined number of common stock or equity shares. The conversion from the bond to stock can be done at certain times during the bond's life and is usually at the discretion of the bondholder. High Yield - High-yield bonds are bonds that pay higher interest rates because they have lower credit ratings than investment-grade bonds. High-yield bonds are more likely to default, so they must pay a higher yield than investment-grade bonds to compensate investors. Munis -A municipal bond is a debt security issued by a state, municipality or county to finance its capital expenditures. Municipal bonds are exempt from federal taxes and most state and local taxes. ABS - An asset-backed security (ABS) is a financial security such as a bond or note which is collateralized by a pool of assets such as loans, leases, credit card debt, royalties, or receivables. MBS -A mortgage-backed security (MBS) is an investment similar to

a bond that is made up of a bundle of home loans bought from the banks that issued them. Leveraged Loan is a type of loan that is extended to companies or individuals that already have considerable amounts of debt or poor credit history. Lenders consider leveraged loans to carry a higher risk of default, and as a result, a leveraged loan is more costly to the borrower.

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