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Three Reasons Why "Higher for Longer" May Benefit Bond Investors

Elevated yields could prove advantageous for long-term bondholders.

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If you Google "higher for longer," you'll get the impression that higher interest rates that stick around for a while are a bad thing. Many articles state that corporations won't be able to withstand the higher costs associated with higher rates. Other articles say that a federal funds rate[2] that stays at 5% or higher portends trouble for the equity markets and equity funds. Perhaps these prognostications will prove to be accurate, but what could higher for longer mean for bonds and bond funds?

I think higher for longer could be advantageous for bond-fund investors, especially for those who invest in higher-quality bonds. I see three main advantages of higher-for-longer rates:

1. It allows for issuance of new debt at higher income levels;
2. It provides additional recovery time for capital appreciation opportunities created from the damage in 2022; and
3. It may act as a bigger buffer against interest-rate volatility in the future.

Key Points

- The Federal Reserve's current "higher-for-longer" stance on interest rates could work to the advantage of bond-fund investors, especially for those who favor investment-grade issues.
- There's a large cohort of bonds issued before 2022 that now trade at a discount, offering the potential to increase total return as the bonds move closer to par.[1]
- Historically low interest rates hindered bonds from fulfilling their primary role of providing adequate income and offsetting equity losses. Higher rates could change this.

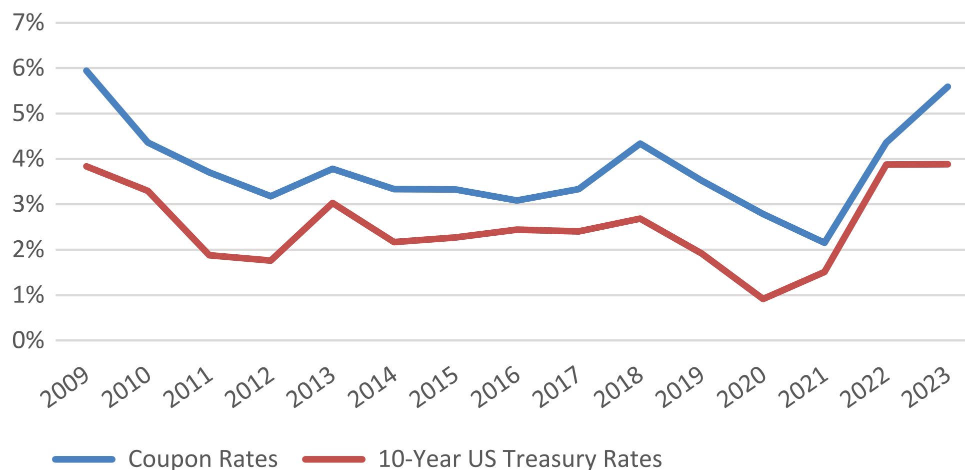
Issuance of Debt at Higher Levels

For many years, fixed income was deemed unattractive as the level of coupon income was de minimis.[3] In the aftermath of the Global Financial Crisis (GFC), the trend for investment-grade (IG) corporate bonds[4] and fixed-rate coupons was generally downward. The average had dropped from almost 6% in 2009 to a low of just a meager 2.15% in 2021. Ten-year US Treasury rates had averaged almost 4.50% from the start of 2000 up through the end 2009 but were 225 basis points (bps)[5] lower on average from the start of 2010 to the end of 2021.

FIGURE 1

The Flat Fixed-Income Rates of the Post-GFC World Have Staged a Rebound

Corporate Coupon Rates and 10-Year Treasury Yields (2009-2023)



As of 12/31/23. Source: Bloomberg.

However, as interest rates rose from historic lows in 2021, and as the Federal Reserve (Fed) took its target rate from 0% in March 2022 to the 5.50% upper bound as of January 2024, IG corporate coupons in 2022 and 2023 began to rise and approach their pre-GFC levels (**FIGURE 1**). The combined average for both 2022 and 2023 IG corporate debt was a just basis point under 5% for more than 2,500 different fixed-rate securities. Issuance in 2024 has yet to show any signs of slowing down: January set a record with $188 billion of issuance, with the fixed-rate portion averaging 5.31%. This issuance is feeding bond funds as money moves back to taxable bonds ($221 billion in 2023 per Morningstar) and as mutual-fund dividends get reinvested.

> While today's issuance generally starts off at par, there's a whole cohort of bonds issued before 2022 that now trade at a discount.

Capital Appreciation Opportunities

2022 was a year of reckoning for fixed income with the Bloomberg US Aggregate Bond Index (the "Agg")[6] losing more than 13%. High-quality bonds, which for years had been at par or better, saw the most significant price declines since the mid-1980s. However, most of these losses can be traced back to the steep back-up in interest rates and weren't tied to credit or default issues.

While today's issuance at higher rates generally starts off at par, there's a whole cohort of bonds issued before 2022 that now trade at a discount. The Bloomberg US Corporate Index[7] shows more than 5,300 bonds issued between 2010 and 2021 trading at an average price of 89 cents on the dollar as of 1/31/24. The average coupon of those securities is only 3.58%, but the discount on the bonds has the potential to increase total return as the bonds move closer to par.

Yield-to-worst[8] is a measure that combines both current coupon levels and price appreciation to reflect total-return potential in a given year. As of 1/31/24, the measure was 5.11% for the Bloomberg US Corporate Index vs. 2.33% at the end of 2021.

As rates remain higher for longer, the natural progression would be for new bonds to roll on at higher rates and old bonds to accrete[9] back to par. A meaningful back-up in rates from here would delay this accretion. A significant decline would accelerate the accretion but also potentially lower the coupons of the new issuance moving forward. Ideally, an extended time period in which rates remain higher for longer could reset a significant amount of bonds in funds and ETFs where coupon would be the main driver of return rather than appreciation. That scenario brings bond funds back to the role they're meant to play: to seek to provide consistent income and a potential offset to equity risk.

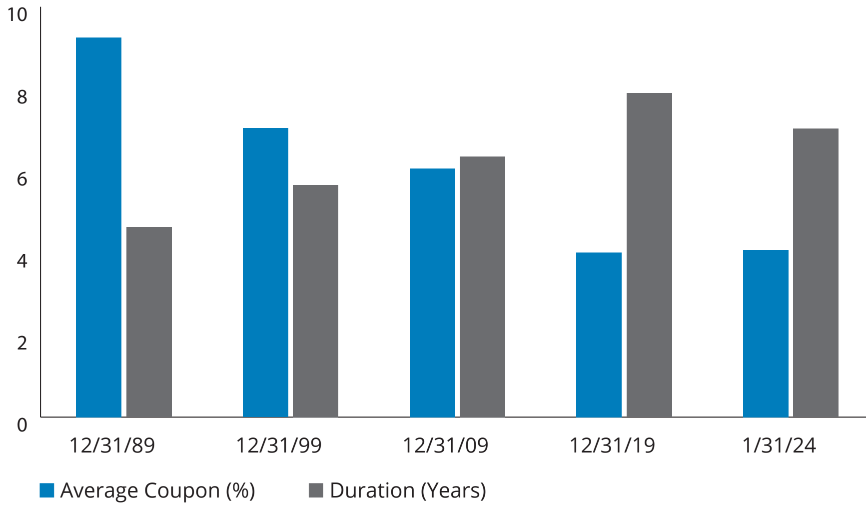
Higher Rates–Bigger Potential Buffer

It's also important to remember that, within a bond fund, bonds with higher rates have less interest-rate risk. In general, the higher a fund's duration,[10] the more sensitive it is to up-or-down interest-rate moves. Duration is directly impacted by the level of coupons in the fund, among other things. The higher a bond's coupon, the shorter its duration, because the investor receives more of its total return in the form of interest payments before final maturity. The opposite is true with lower coupons as the investor is getting less in the form of interest payments. The impact of higher coupons in a bond fund may help provide some ballast in volatile rate markets—all else being equal (**FIGURE 2**).

FIGURE 2

The Smaller the Coupon, the Bigger the Risk

Historical Average Coupon Rates and Associated Duration



As of 1/31/24. Based on the Bloomberg US Corporate Index. Source: Bloomberg.

There comes a point at which high rates create more credit risk. However, bonds with higher coupons provide an added benefit of potentially reducing interest-rate volatility.

There's a balance to be struck because, potentially, there comes a point at which high rates create more credit risk. However, bonds with higher coupons provide an added benefit of potentially reducing interest-rate volatility.

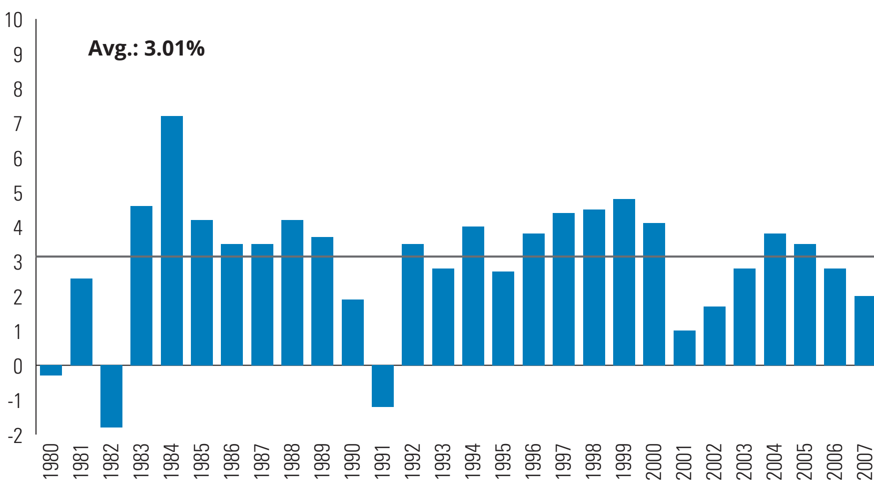
How Long Is Too Long?

This is the question much of the market is grappling with. The fear is that rates at these levels will slow economic growth. But slower growth doesn't mean no growth. The US 10-year Treasury rate was approximately 4.24% as of 2/29/24. Prior to 2008, going back to 1980, borrowing at levels above 4% was the rule, not the exception. During this period, GDP grew at an average rate of 3.01% per year with only three negative years (**FIGURE 3**). In addition, the S&P 500 Index[11] returned 14% per year on average from 1980 to the end of 2007. Many other factors outside of rates (technology, innovation, productivity, etc.) can impact growth. It's been shown that rates at these levels don't have to bring growth to a screeching halt, and the economy has historically figured out a way to function regardless of where the 10-year note trades.

FIGURE 3

Economic Growth Can Be Positive Even When Treasury Rates Are Above 4%

Annual US GDP Growth (%) 1980-2007



Source: Bloomberg.

Conclusion

The term higher-for-longer has often taken on a negative connotation. However, it actually appears rates are returning back to pre-GFC norms. The goal of many bond funds has been to earn income while preserving capital and helping to reduce drawdowns within a portfolio. However, at a low level of interest rates, bonds funds haven't been providing enough income for some and have lost some of that ability to offset equity losses.

These days, more high-quality debt is being issued at levels above 5%. In addition, the rate back-up from 2022 pushed many bonds into a discount despite the likelihood of defaults being remote. That's created capital-appreciation opportunities on top of more income being added via new issuance. These higher levels can provide more stability in a volatile rate environment without necessarily damaging the whole economy.

Talk to your financial professional to help you construct a bond portfolio that's right for you.

Past performance does not guarantee future results. Investors cannot directly invest in indices.

[1] The term "at par" means at face value. A bond, preferred stock, or other debt instrument may trade at par, below par, or above par. Par value is static, unlike market value, which fluctuates with credit ratings, time to maturity, and interest rate fluctuations.

[2] The federal funds rate is the target interest rate set by the Federal Open Market Committee. This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

[3] De minimis is Latin for "about minimal things."

[4] Investment-grade (IG) bonds are believed to have a lower risk of default and receive higher ratings by the credit rating agencies, namely bonds rated Baa (by Moody's) or BBB (by S&P and Fitch) or above. These bonds tend to be issued at lower yields than less creditworthy bonds.

[5] A basis point (bps) is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

[6] Bloomberg US Aggregate Bond Index is composed of securities that cover the US investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

[7] The Bloomberg US Corporate Index measures the investment grade, fixed-rate, taxable corporate bond market.

[8] Yield-to-worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.

[9] In finance, accretion refers to the accumulation of the additional income an investor expects to receive after purchasing a bond at a discount and holding it until maturity. Par is the face value of a bond, which defines its maturity value and the dollar value of coupon payments.

[10] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[11] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

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