Rising Rates’ Silver Linings

Over the last six decades, the trajectory of U.S. interest rates has been quite dramatic (see Exhibit 1). It’s not hard to imagine why all eyes are on the Federal Reserve’s next move. Beginning in the mid-1950s, interest rates increased steadily until they reached a pinnacle in the early 1980s. Since then, bonds have been having an impressive bull run.

Exhibit 1: 10-Year U.S. Treasury Bond Rate

Source: U.S. Federal Reserve. Data from April 1953 through September 2015. Chart is provided for illustrative purposes.

This preoccupation arises in large part because interest rates are, as Exhibit 1 indicates, hovering near their lowest levels in history and, more importantly, they are near zero, leading to the natural conclusion that there’s only one direction for interest rates to go. When anticipating rising rates, perhaps the last thing to think about is bond investments. But, for a number of reasons, some circumstances necessitate an allocation to fixed income, whether for diversification or risk reduction.

INTEREST RATE MATTERS

Though bond values will, definitionally, fall when interest rates rise, different types of bonds have differing characteristics. What type of bond is the right fit depends heavily on individual circumstances. Exhibit 2 charts the performance of the S&P 500®, the S&P 500 Bond Index², and the S&P/BGCantor 7-10 Year U.S. Treasury Bond Index.³ The chart not only highlights the remarkably different risk profiles of stocks and bonds, but also the performance divergence between the performance of corporate debt and U.S. Treasuries in the 2008 financial crisis.

Exhibit 2: Relative Performance of the S&P 500, S&P 500 Bond Index, and S&P/BGCantor 7-10 Year U.S. Treasury Bond Index

During the recovery from crisis mode in 2009, the S&P 500 Bond Index far outperformed the S&P/BGCantor 7-10 Year U.S. Treasury Bond Index.

The chart of annual returns provides a better picture of the difference in performance for the two bond indices during times of turmoil (such as in 2008), as well as in the recovery from crisis mode in 2009, when the S&P 500 Bond Index far outperformed the S&P/BGCantor 7-10 Year U.S. Treasury Bond Index (see Exhibit 3).


³ As of Sept. 30, 2015, the S&P/BG Cantor 7-10 Year U.S. Treasury Bond Index has a weighted duration of 7.67 and yield of 1.94%, which is the closest treasury index to the S&P 500 Bond Index’s weighted duration of 6.67 and yield of 3.34%.
Under certain circumstances, investors may prefer corporate bonds to U.S. Treasury bonds. Inexorably, corporate debt comes with greater risk. But, relative to U.S. Treasuries, corporate bonds also have higher return potential.4

Between the S&P 500 Bond Index and the S&P/BGCantor 7-10 Year U.S. Treasury Bond Index, the former is much more correlated with the S&P 500 (see Exhibit 4). This is not surprising, since corporate debt is riskier than U.S. Treasuries. When a crisis is such a threat that corporations’ survival is in peril, then naturally debt issued by corporations will also be in danger of default.

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This dynamic is manifested in the performance history of the S&P 500 Bond Index and the S&P/BCantor 7-10 Year U.S. Treasury Bond Index. In periods of good equity performance, the S&P 500 Bond Index has underperformed stocks but outperformed U.S. Treasuries. In periods of poor equity performance, the S&P 500 Bond Index outperformed stocks, but was itself outperformed by U.S. Treasury bonds. Exhibit 5 highlights the performance of stocks, corporate bonds, and U.S. Treasuries in various stock market environments.

Exhibit 5: Comparative Performance of the S&P 500, S&P 500 Bond Index, and S&P/BCantor 7-10 Year U.S. Treasury Bond Index

Source: S&P Dow Jones Indices LLC. Data from Dec. 30, 1994, through Sept. 30, 2015. Past performance is no guarantee of future results. It is not possible to invest directly in an index, and index returns do not reflect expenses an investor would pay. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosures at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

THE WORST OF TIMES FOR U.S. TREASURIES

Between 1995 and 2015, in the months when U.S. Treasuries delivered their worst performance, corporate bonds outperformed U.S. Treasuries by the largest margin (see Exhibit 6). We divided the 249 months in this period into modified quartiles based on whether the S&P/BCantor 7-10 Year U.S. Treasury Bond Index was positive or negative, and then further divided those months equally into the biggest and more moderate changes in each direction. In the worst quartile, U.S. Treasury bonds showed an average monthly decline of 2.04%, while the S&P 500 Bond Index’s average decline was only 0.79%, an outperformance of 1.25%. In those same months, an archetypal 60/40 allocation with corporate bonds yielded an outperformance of 0.49% versus the same allocation with U.S. Treasuries.
Exhibit 6: Performance in Various Interest Rate Environments

<table>
<thead>
<tr>
<th>Treasury Performance</th>
<th>Number of Months</th>
<th>S&amp;P/BGCantor 7-10 Year U.S. Treasury Bond Index (%)</th>
<th>S&amp;P 500 (%)</th>
<th>S&amp;P 500 Bond Index (%)</th>
<th>S&amp;P 500 (60%)/S&amp;P/BGCantor 7-10 Year U.S. Treasury Bond Index (40%) (%)</th>
<th>S&amp;P 500 (60%)/S&amp;P/BGCantor 7-10 Year U.S. Treasury Bond Index (40%) (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Biggest Declines</td>
<td>46</td>
<td>-2.04</td>
<td>1.49</td>
<td>-0.79</td>
<td>0.60</td>
<td>0.11</td>
</tr>
<tr>
<td>Moderate Declines</td>
<td>46</td>
<td>-0.43</td>
<td>1.25</td>
<td>-0.02</td>
<td>0.75</td>
<td>0.59</td>
</tr>
<tr>
<td>Moderate Increases</td>
<td>79</td>
<td>0.71</td>
<td>1.06</td>
<td>0.69</td>
<td>0.92</td>
<td>0.93</td>
</tr>
<tr>
<td>Biggest Increases</td>
<td>78</td>
<td>2.55</td>
<td>-0.32</td>
<td>1.55</td>
<td>0.45</td>
<td>0.86</td>
</tr>
</tbody>
</table>

Source: S&P Dow Jones Indices LLC. Data from Dec. 31, 1994, through Sept. 30, 2015. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosures at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

Historically, when interest rates have risen, their effect on corporate bonds has been muted compared with their effect on U.S. Treasuries. Similarly, a balanced allocation incorporating corporate bonds has offered more protection relative to U.S. Treasury bonds during these times.

**ADDITIONAL RESOURCES**

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Rising Rates’ Silver Linings

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