Navigating market turbulence: the impact of higher rates on bonds and investment opportunities

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Key Takeaways

- Rising bond yields across major economies signal a 'higher for longer' rate environment, with US 10-year Treasury yields nearing critical thresholds, creating opportunities for yield-focused investors to manage rate volatility.
- The WisdomTree USD Floating Rate Treasury Bond UCITS ETF (TFRN) offers a low-duration, high-yield solution in the current environment, outperforming European counterparts and benefiting from the resilient US dollar.
- Contingent convertible bonds (CoCos) demonstrate resilience amid high rates, benefiting from stronger banking sector fundamentals, offering investors a compelling alternative to vulnerable high-yield corporate bonds.

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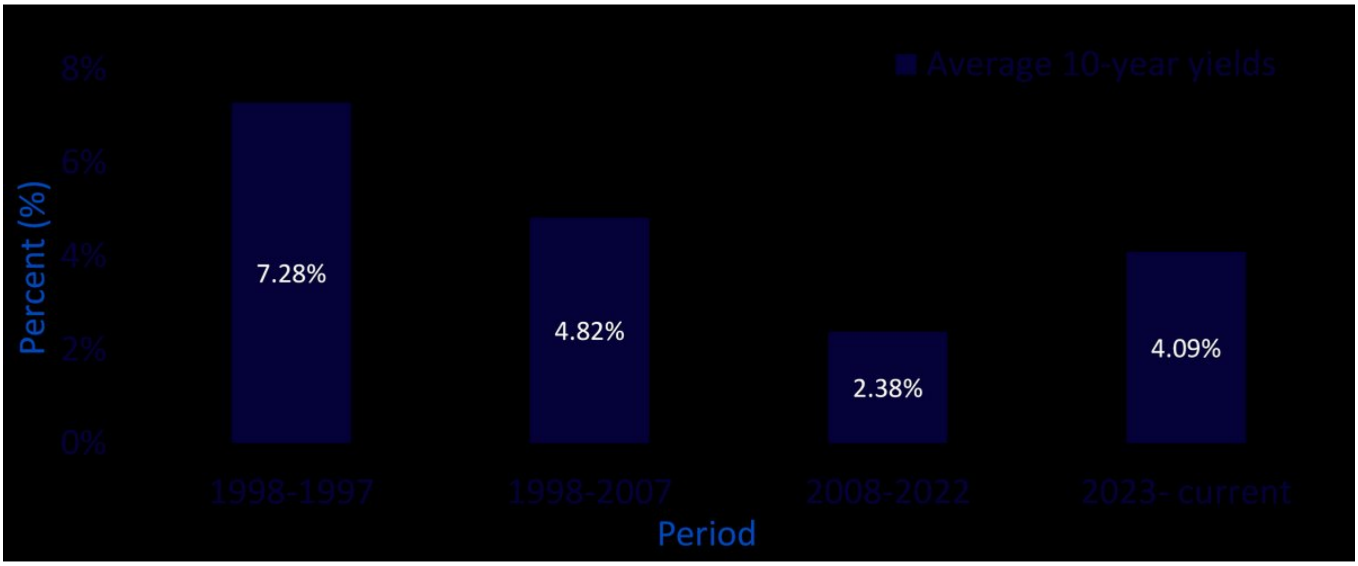
The recurring selloffs in global bond markets are driving yields closer to critical thresholds, fuelled by growing concerns over persistent inflation, political instability, and rising government debt levels. The shifting narrative since mid-September regarding continued moderate growth and a "bumpy" inflation path for the U.S. economy has led the markets to visibly reduce the pace of expected Fed rate cuts in 2025.President-elect Donald Trump's victory has also created uncertainty surrounding tariffs and the potential for a more stimulative fiscal policy that could potentially swell U.S. budget deficits.

In the US, the 10-year Treasury yield rose as high as 4.80%, pushing it toward the 5% peak hit in October 20231. The higher-rates-for-longer phenomenon looks to be rooted in changes to the US outlook but is sending ripples across major economies, resulting in higher borrowing costs. In the UK, that yield hit as much as 4.89%, the highest since August 20082. Myriad factors contributed to the higher, including the

Labour government's spending ambitions, sticky inflation, higher US rates and supply pressures. Even in Japan, the 10-year rate on government bonds has pushed over 1% to the highest in over a decade1.

Figure 1: New normal – US bond yields approaching pre-financial crisis

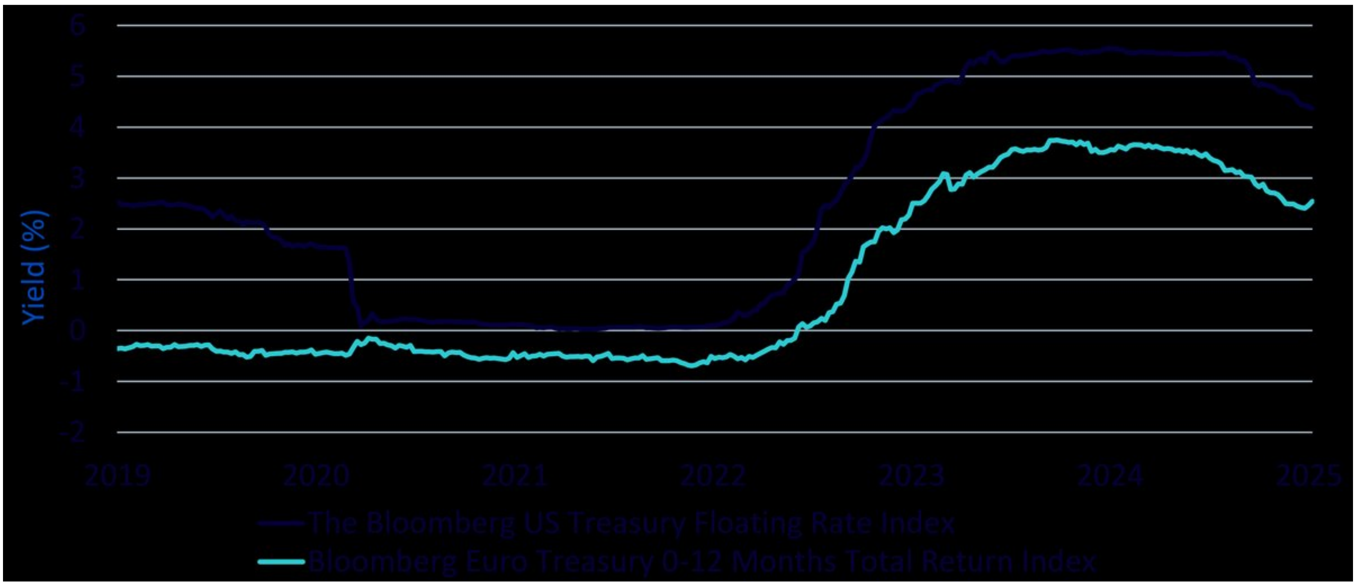


Source: Bloomberg, WisdomTree from 1 January 1998 to 10 January 2025. **Historical performance is not an indication of future performance and any investments may go down in value.**

Opportunity for a yield seeking investor

Amid the turbulence, floating-rate Treasury funds such as the WisdomTree USD Floating Rate Treasury Bond UCITS ETF (TFRN) offers investors a low-duration, high yield solution for managing rate volatility and duration. These securities seek to track the price and yield performance of the Bloomberg US Treasury Floating Rate Bond Index. With the monetary cycle still in, 'higher for longer' mode, this strategy provides investors with a means of income whilst lowering their duration. Additionally, the WisdomTree USD Floating Rate Treasury Bond UCITS ETF (TFRN) offers a higher yield that is 1.82%3 above the Bloomberg Euro Treasury Index (0-12 months), enabling investors to benefit from the additional yield.

Figure 2: Comparison of US and European yields

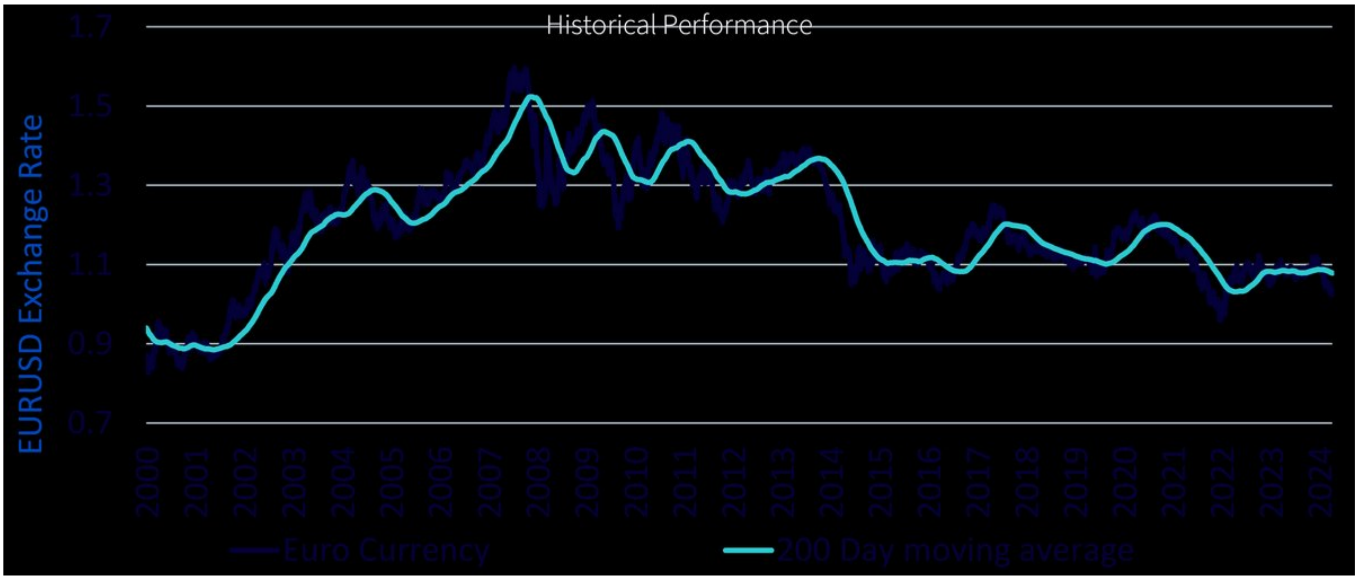


Source: Bloomberg, WisdomTree from 4 January 2019 to 10 January 2025. **Historical performance is not an indication of future performance and any investments may go down in value.**

Resilient dollar and European challenges

Adjusted for inflation, the Federal Reserve's (Fed) measure of the broad, trade-weighted dollar is now at the highest level since 1985. Europe remains mired in weak growth and unstable leadership. The European Central Bank (ECB) looks prepared to take the policy rate sub-neutral, perhaps as early as Q2 2025, aiding the EUR/USD's move towards parity. In comparison, the US economy appears set to continue a modest growth path, with further improvements on the inflation front proving to be 'bumpy', in line with Fed Chair Powell's description.

Figure 3: EUR/USD currency pair remains below the 200-day moving average



Source: Bloomberg, WisdomTree from 3 January 2000 to 10 January 2025. **Historical performance is not an indication of future performance and any investments may go down in value.**

Several Fed policymakers recently signalled they support keeping rates on hold for an extended period. A similar view is being reflected in the swaps market, with the next quarter-point rate cut not fully priced in until H2 20254. These factors are likely to exert downward pressure on the euro relative to the dollar, potentially benefiting EUR-based investors in the WisdomTree USD Floating Rate Treasury Bond UCITS ETF (TFRN).

CoCos: resilience amid high rates

Higher interest rates create a challenging environment for high-yield corporate bonds, while highlighting the relative resilience of contingent convertible bonds (CoCos). High-yield corporate bonds are particularly sensitive to high interest rates due to increased vulnerability to default risks during periods of tighter financial conditions. As borrowing costs rise, companies with weaker credit profiles face greater difficulty refinancing debt or meeting obligations, leading to wider spreads and heightened risk premiums. Additionally, the inherent volatility of high-yield corporate bonds often results in diminished investor appetite during such periods, further pressuring their valuations.

In contrast, contingent convertible bonds (CoCos) are uniquely positioned and continue to navigate this high-rate environment more effectively. Unlike high-yield corporate bonds, CoCos benefit indirectly from the improved financial health of the banking sector, as higher rates bolster banks' profitability by expanding net interest margins. This strengthened profitability reduces the likelihood of CoCo conversions or write-downs, fostering greater investor confidence. Furthermore, CoCos typically exhibit lower sensitivity to adverse rate movements, offering an added layer of resilience.

A compelling alternative for investors

This contrast underscores a key distinction: while high-yield corporate bonds tend to struggle with higher interest rates and the associated credit risks, CoCos have historically thrived on the strengthened balance sheets of their issuers. For investors seeking returns in a high-rate environment, CoCos could present a potential alternative to the heightened vulnerabilities of high-yield corporate bonds, and offer a combination of stability, robust fundamentals, and potential for capital gains.

1 Bloomberg as of 15 January 2025
2 Bloomberg as of 14 January 2025
3 Difference in yields 1.82% between WisdomTree USD Floating Rate Treasury Bond UCITS ETF (4.37%) and Bloomberg Euro Treasury Index (2.54%) as of 10 January 2025.
4 Bloomberg as of 13 January 2025.

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WisdomTree USD Floating Rate Treasury Bond UCITS ETF

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