

Three Years Since Tapering: Re-examining the Rising Rates Toolkit

Published November 29, 2016

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Nearly three years ago, the U.S. Federal Reserve started the process of reducing monetary accommodation by “tapering” the pace of its asset purchases. On the same day,¹ WisdomTree launched a suite of [rising rates bond strategies](#) that sought to maintain exposure to the bond market but manage the risk of rising rates. While these strategies are based on commonly followed bond indexes, they also provide the opportunity to manage interest rate risk the same way many institutions do, by hedging or even going short (e.g., negative) duration. Since that time, interest rates have declined for maturities greater than five years, while rising at shorter maturities. Below, we highlight the potential risks for bond portfolios during sustained periods of rising rates.

Quantifying Bond Market Performance

In our analysis, we show the impact on three variants of the Bloomberg Barclays U.S. Aggregate Index (Agg) and the Bank of America Merrill Lynch 0-5 Year U.S. High Yield Constrained Index (High Yield in table and graphic): unhedged, zero duration² and negative duration.³ In the chart below, we highlight the impact on returns since tapering began, a period when interest rates fell and periods when interest rates have increased.

[\[Image unavailable\]](#)

Rising Rates– Aggregate and High Yield Performance

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Since Tapering: High Yield and Agg Produce Similar Results

Interestingly, the performance of the unhedged Agg and Bank of America Merrill Lynch 0-5 Year U.S. High Yield Constrained Index since tapering began are essentially the same. Over the past three years, the decline in longer-term interest rates has boosted returns of the lower yielding aggregate strategy. Over the same period, credit spreads widened, causing a drag on high-yield performance. While spreads have come in since February (boosting high-yield bond returns), they still remain wider than at the end of December 2013. The key question for investors now is which risk they should assume going forward?

Duration vs. Credit

In our view, positive total returns of the Agg over the next 12 months will be solely predicated on stable or falling interest rates. As a result, investors should consider hedging their aggregate positions or increasing exposure to credit (or both).

In general, interest rate and credit risk are the primary levers that a bond investor can pull to generate performance. In the two most recent periods of rising rates, credit has added value while interest rate risk has detracted.

Through a zero duration strategy, investors can now separate their bets on credit from their view of nominal interest rates. In both periods, hedged strategies predictably outperformed unhedged strategies.

However, high-yield strategies outperformed investment grade strategies because of their higher income potential and the perception that rates were rising in response to a stronger U.S. economy.

The other interesting element is that explicit bets on rising rates (negative duration) outperformed hedged high-yield positions. Over both periods, nominal interest rates were the primary driver of total returns.

Therefore, investors seeking to make a tactical play that rates are going to rise should determine whether they favor rates or credit or some combination of the two.

The Other “Duration” of Rising Rates

While we have previously highlighted the efficacy of rising rates strategies over shorter periods, we believe investors should also prepare for a scenario in which rates rise over many months or even years. Recently, there has been much debate about the prospect of a generational low in the U.S. 10-Year yield in July 2016.⁴ Generally speaking, previous periods of rising rates were palatable because coupon rates (and yields) were much higher than they are today.

While investors may have lost value during a period of rising rates, eventually, they could “earn” their way out of it. This is precisely the reason why over the last 30 years, the Bloomberg Barclays U.S. Aggregate Index has experienced negative returns in only three calendar years: 1994, 1999 and 2013.⁵ Because of current interest rates, it is far more likely that investors will experience periods of negative total returns even when rates rise by modest amounts. In our view, this is precisely why investors should consider to be over-weight in credit risk at the expense of interest rate risk.

In our view, the Bloomberg Barclays U.S. Aggregate Index is ill-suited to deal with a rise in U.S. interest rates. As an alternative, investors now have a greater number of tools at their disposal to potentially hedge or profit from a rise in U.S. interest rates. Given that many of these alternative approaches now have real-time track records, we believe more investors should consider how they can best protect their portfolios from a potential generational shift in the bond market.

¹December 18, 2013.

²Bloomberg Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration and BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, Zero Duration Index.

³Bloomberg Barclays Rate Hedged U.S. Aggregate Bond Index, -5 Duration and BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, Negative Seven Duration Index.

⁴Source: Bloomberg, as of 11/18/16.

⁵Source: Bloomberg, as of 11/18/16.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.