Interest Rates Continue to Fall: Charting a Course in Uncharted Territory

Commentary provided by Newfleet Asset Management

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The U.S. 10-year Treasury yield has fallen to historic lows in 2020, pushing bond markets into unchartered territory. The 10-year yield has steadily lost ground since starting the year at roughly 1.90%, plummeting in March and closing at 0.50% on March 9 after touching a low of 0.32%. Fears over the coronavirus, now formally declared a pandemic, and its impact on the global economy have resulted in a swelling flight to quality and two emergency off-meeting Fed Funds rate cuts by the Federal Reserve (50 bps on March 3 to a range of 1%-1.25%, followed by 100 bps on March 15 to a range of 0%-0.25%). The oil price war between Russia and Saudi Arabia has further heightened market volatility and the demand for safe havens.

Understanding the Situation

This unprecedented situation has lowered investor expectations across the board and has left few attractive options for income and risk-adjusted total return. Yields in traditional core fixed income are very low right now. For example, the U.S. Bloomberg Barclays Aggregate Bond Index has a yield to maturity of approximately 1.40% with a duration of six years as of March 16. Investors need to be aware that there is limited yield cushion when interest rates eventually move higher and long duration/ low yielding assets can experience meaningful price declines.

So where are we going from here? While we cannot predict with any accuracy the course of the coronavirus and when conditions will subside, the residual effects on the economy, may be longer lasting with the possibility of a recession.

Investment Approaches to Consider

In a scenario of a continued low-rate environment, investors may wish to consider fixed income opportunities in both traditional core fixed income, as well as outside core areas of the bond market. The latter include higher-yielding corporate high yield, floating rate bank loans, and emerging markets debt, as well as high quality securitized sectors such as asset-backed securities (ABS) and non-agency residential mortgage-backed securities (RMBS) that may offer a spread pickup to comparable quality and duration corporates.

Prudent asset management in environments such as this is critical. Credit research and issue selection is broadly important, but especially so in the non-core sectors, like corporate high-yield and floating rate bank loans, where the credit risk is higher and picking the wrong credit has more potential downside. Equally important is the ability to rotate between these sectors, overweighting the sector with the best relative value. Asset managers must ensure a research-driven infrastructure and multi-sector perspective to navigate volatile markets and capture opportunities outside of core fixed income.

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Interest rates and bond prices typically move inversely to each other. As interest rates rise, credit instruments typically fall, and as interest rates fall, credit instruments typically rise. Longer term and lower coupon bonds tend to be more sensitive to interest rate changes. Investments in loans and other floating-rate securities reduce interest rate risk. While interest rates on loans adjust periodically, these rates may not correlate to prevailing interest rates during the periods between rate adjustments. The Fund may be subject to a greater risk of rising interest rates due to the current period of historically low rates and the effect of potential government fiscal policy initiatives and resulting market reaction to those initiatives.

Investments in floating rate loans involve certain risks, including, among others, risks of nonpayment of principal and interest; collateral impairment; non-diversification and borrower industry concentration; and lack of full liquidity. Investments in non-investment-grade debt securities ("high-yield" or "junk" bonds) tend to have lower interest rate risk but may be subject to greater market fluctuations and risk of default or loss of income and principal than securities in higher rating categories. High-yield debt instruments carry a greater default risk, may be more volatile, less liquid, more difficult to value and more susceptible to adverse economic conditions or investor perceptions than other debt instruments.

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