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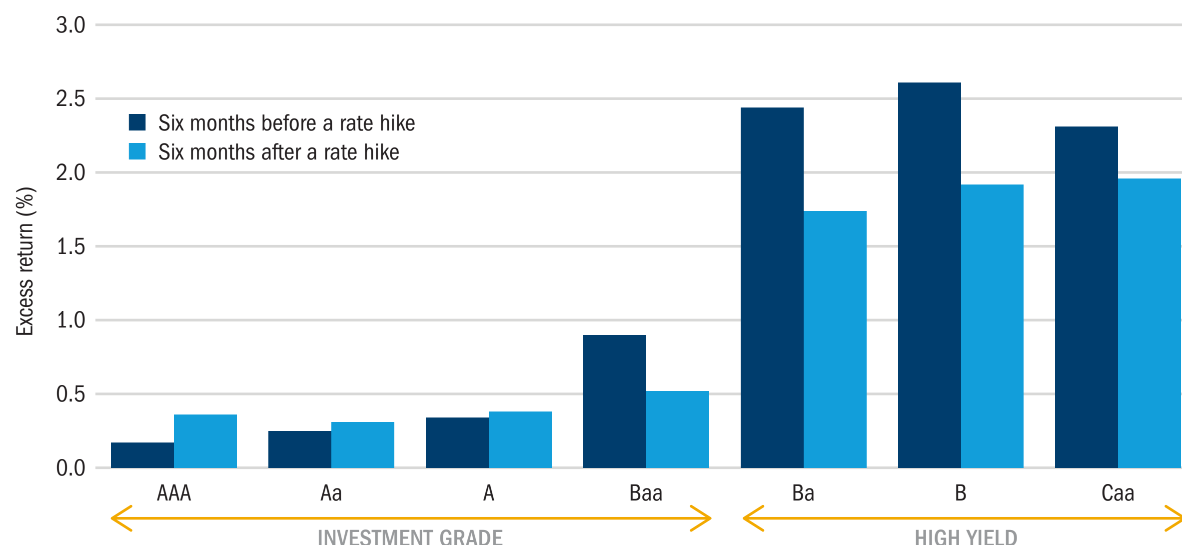
After a rate hike, bonds with higher credit risk become less attractive

Average excess returns before and after Fed rate hike



Past performance is not a guarantee of future results.

Source: Bloomberg. Excess return is the additional return over Treasury securities with comparable duration. The returns are based on the following indices: Bloomberg U.S. Corporate Index (Aaa–Baa) and Bloomberg U.S. High Yield Index (Bb–Caa). The time periods the data is based on are five episodes of interest hikes from 1994 to today (01/31/94, 02/28/97, 06/30/99, 06/30/04, and 11/30/15). The Bloomberg U.S. Corporate Bond Index consists of publicly issued, fixed rate, non-convertible, investment grade debt securities. The Bloomberg U.S. Corporate High Yield Bond Index is a market value-weighted index which covers the U.S. non-investment grade fixed-rate debt market. It is not possible to invest directly in an index.

How should fixed-income investors position themselves for a rising rate environment? Looking back at previous tightening cycles, we see that early in a cycle — six months *before* an interest rate hike — financial conditions often haven't tightened to an extent that slows economic growth. This has been favorable for credit risk, which posted positive returns.

Further into the cycle — six months *after* an interest rate hike — tighter financial conditions begin to slow growth, and higher valuations cause returns from riskier assets to moderate. While credit risk still outperforms, the lowest quality tiers of the market start to look less attractive as risk compensation falls.

In the current environment, we think that investors can benefit from owning credit exposure, but they need to be selective, applying a research-based approach. We recommend staying flexible and ready to adjust positioning as the environment continues to change.

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