



ASSET ALLOCATION INSIGHTS

The Challenge of Low but Rising Rates

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KEY INSIGHTS

- With the 10-year U.S. Treasury yield increasing, government bond investors face the dilemma of low but rising interest rates.
- High yield bonds are typically less sensitive to rising interest rates and may offer investors higher current income.

The 10-year U.S. Treasury yield has been on a downward trend for the last decade, reaching a remarkable low of 0.50% on August 4, 2020. However, the yield has been steadily increasing since then. Going forward, government bond investors may be facing the worst of both worlds—the dilemma of low but rising interest rates.

For investors, low rates mean the current expected income from government bonds is limited, while rising rates mean the market value of their investment is decreasing. From an asset allocation perspective, this is particularly troublesome as bonds

are important portfolio building blocks for two reasons—income and stability.

To cope with this challenging dynamic, investors could increase their allocation to higher-yielding corporate bonds. The right chart below compares the yield and duration (price sensitivity to rate changes) for both the Bloomberg Barclays U.S. Aggregate Bond Index and the Bloomberg Barclays U.S. High Yield Index. As illustrated, the high yield bonds typically offer higher current income and are also less sensitive to rising rates.

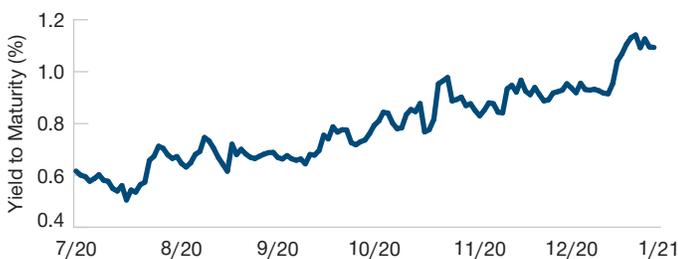
The primary downside to high yield bonds, however, is their higher credit or default risk during times of economic stress relative to investment-grade bonds. While this is a valid concern, the current environment appears favorable for credit risk for the same reason that interest rates are rising—i.e., improving economic growth expectations.

A low but rising interest rate environment can be challenging for bonds, but, fortunately, it typically benefits higher-yielding bonds. For this reason, the T. Rowe Price Asset Allocation Committee favors high yield bonds over investment-grade bonds.

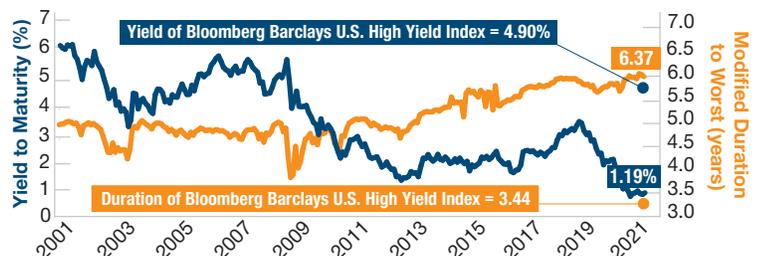
Searching for Yield Amid Rising Rates

High yield versus investment-grade bonds

10-Year U.S. Treasury Yield, 6 months ended 1/20/21



Bloomberg Barclays U.S. Aggregate Bond Index Yield and Duration 20 Years ended 1/20/21



Past performance is not a reliable indicator of future performance.

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