

Why investors should not fear rising interest rates

BY JOHN LAGOWSKI, CFA¹

The bond market's 2021-22 drawdown during the great interest rate reset left many investors with a simple takeaway: Rising rates are bad for bonds. Over short horizons, that instinct is correct in one sense: When rates rise, bond prices fall.

That simple thinking, however, misses the other half of the fixed income return equation: income. For long-term investors, the starting yield and the ability to reinvest at higher yields can matter as much as the initial price decline. In 2026, higher starting yields make for a different investment environment than in 2021-22.

What happened in 2021-22

The 2021-22 bear market in bonds began from an extreme starting point with the 10-year US Treasury yield falling to an all-time low of 0.51% in August 2020. But the vulnerability had been building for more than a decade. Following the Global Financial Crisis (GFC), global central banks held policy rates at unusually low levels for years. That prolonged low-rate environment mattered because bond markets continually refinance, allowing companies, governments, agencies, and households to issue or refinance debt at progressively lower coupons (i.e., yields). With the time between the GFC and the rate reset comparable to the maturity profile of much of the investment-grade bond market, low yields were not merely a spot-market condition. Instead, they became embedded in the outstanding stock of bonds.

Key points

- The bond market drawdown in 2021-22 – a period we call the “great interest rate reset” – was unusually severe. When interest rates shifted higher investors entered the reset with near-zero starting yields and more than a decade of low coupons embedded across the bond market. That left little income to cushion falling prices.
- Today's higher starting yields improve the “bond math.” Rising rates still push prices down immediately, but higher starting yields increase portfolio income, and ongoing increases in rates help create reinvestment opportunities over time. That allows a portfolio's income stream to increasingly offset, and potentially exceed, the price impact of further rate increases. In short, the potential benefit of higher income compounds over time.
- Three scenarios show why rising rates need not hurt long-term bond investors: Moderate and extreme rate increases ultimately produce higher 10-year annualized returns compared to a baseline scenario with unchanged rates. Still, sharper increases can cause meaningful short-term drawdowns, reinforcing the need to manage duration.

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When rates began to rise in 2021, investors faced two historic headwinds: near-zero starting yields and a portfolio of outstanding securities carrying coupons set during years of suppressed rates. The rapid repricing of rates amid surging inflation and monetary policy tightening made the near-term experience more painful, but the combination of a very low starting point and a decade-long erosion of coupon income made the drawdown especially severe.

That said, the lesson is not that bonds cannot withstand rising rates. The lesson is that starting yield matters. Today, fixed income begins from a much healthier level of income, giving investors a cushion against additional rate volatility and a higher reinvestment rate if yields rise further.

What made the reset different

- Near-zero starting yields: When the reset began, yields were close to historic lows. That left investors with very little current income to cushion the negative price effect of rising rates.
- A decade of low coupons embedded in the market: The post-GFC low-rate regime lasted long enough for a large share of outstanding debt to be issued or refinanced at low coupons. By 2021, low yields had permeated the bond market, leaving investors with limited carry when rates began to rise.
- The price reset came before the income reset: Bond prices adjusted immediately to higher market yields, while the portfolio's coupon base could improve only as cash flows were reinvested and securities matured or turned over. Investors experienced mark-to-market losses first. The benefit of higher income arrived later and gradually.

How today's bond math alters the picture

This is what we mean by “bond math.” As interest rates initially rise, the negative price return on bonds can outweigh the income the portfolio is generating, pushing total returns lower. But as rates move higher, the portfolio's income generation also rises. Eventually, there is a threshold at which that higher income is enough to offset the price drag from further rate increases.

The key is how bond portfolios behave when managed to a constant duration. (Duration is a measure of a bond portfolio's sensitivity to changes in interest rates.) If duration remains constant, the first-order price impact of a similar increase in rates remains roughly

equal. For example, with a constant duration of 4.0 years, each 100-basis point increase in rates still creates the same 4.0% price decline. The income side, however, continues to grow. As coupons are received, bonds mature, and the portfolio turns over, proceeds are reinvested at progressively higher yields over time.

From a total return perspective, the price drag from the same rate increase can remain roughly constant while the income available to offset can be expected to grow progressively. That is the threshold effect at the heart of bond math: Eventually, higher income could more than offset the negative price return from still-rising rates.

What our 3 rising-rate scenarios show

We modeled three interest-rate paths for an intermediate bond portfolio with characteristics based on the Bloomberg Intermediate US Government/Credit Bond Index.

In each chart, the gray bars represent hypothetical future interest rate levels, and the navy line represents the value of \$1,000 invested in the portfolio over the next 10 years. The key assumptions are:

- The investment horizon is 10 years to reflect the experience of long-term-focused investors.
- The starting yield of the portfolio equals the starting interest rate, which is very close to prevailing market levels: The 10-year yield was 4.75% as of August 31, 2026, and the yield-to-maturity for the Bloomberg Intermediate Government/Credit Index was 4.69%. For simplicity, we set both at 4.75% at the start of each scenario.
- The portfolio is managed with a constant duration of 4.0 years and a 20% annual portfolio turnover rate, so the entire portfolio turns over every five years.
- Income is reinvested.
- Changes in interest rates are referenced by the yield on the 10-year US Treasury note, but the model assumes a parallel shift in interest rates across the yield curve.

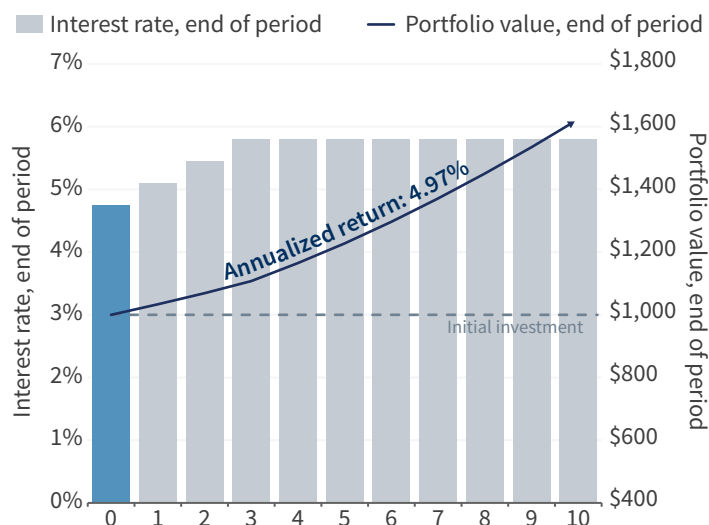
We compare each scenario with a baseline in which interest rates and the portfolio yield remain unchanged at 4.75% for the entire 10-year period. Under that baseline, the annualized return is 4.75% and the ending portfolio value is \$1,590.52.

Scenario 1: Steady rise to long-term average

The chart to the right tracks the value of \$1,000 invested in an intermediate bond portfolio over 10 years if rates rise and the 10-year Treasury yield moves from its current 4.75% to its long-term average of 5.80%. This scenario assumes an even, annual 0.35% rise for the first three years before rates level off.

Under this scenario, the annualized return over the 10-year investment horizon is 4.97%, or 0.22% higher per year than under the baseline return. If rates increase in this manner, holding all else equal, the portfolio achieves a higher return than it would have if rates had remained the same, with its ending value rising to \$1,623.85 versus \$1,590.52 in our baseline scenario.

Steady rise to long-term average
Value of \$1,000 invested in intermediate bond portfolio with starting yield of 4.75% during steady parallel rate shift of 0.35% per year for the first three years of a 10-year period.



Note: Analysis assumes a constant portfolio duration of 4.0 years with 20% annual portfolio turnover so that the entire portfolio turns over about every five years. Starting portfolio yield equals starting long-term interest rate. For illustrative and discussion purposes only. Intended to illustrate a mathematical principle, and not representative of any product or service.

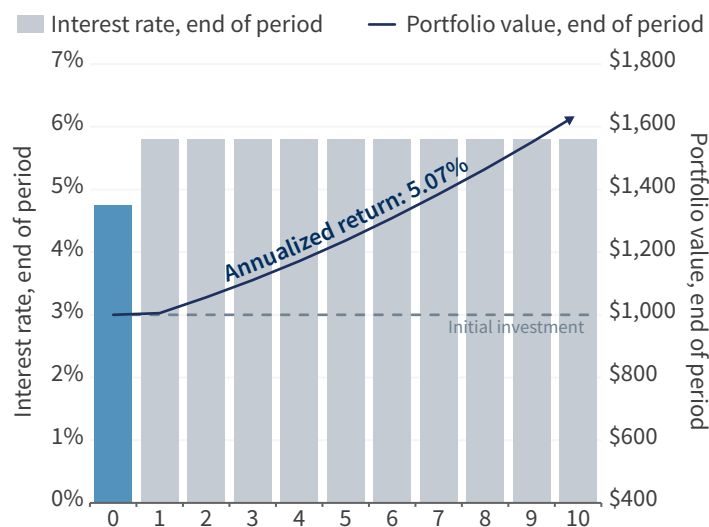
Scenario 2: Quick rise to long-term average

Next, consider a more concerning scenario in which long-term rates spike immediately, rising the full 105 basis points from 4.75% to 5.80% in the first year and then stay there.

This scenario produces an even higher 10-year annualized return. The portfolio initially produces only a modest 0.55% total return in the first year, but the portfolio never falls below its initial value. More importantly, the portfolio's income generation improves more quickly, helping to propel the total annualized return over the full 10-year period to 5.07%, higher than both the baseline return of 4.75% and the Scenario 1 return of 4.97%.

Instead of being a scenario to fear, this rising-rate scenario is more advantageous for long term-focused investors.

Quick rise to long-term average
Value of \$1,000 invested in intermediate bond portfolio with starting yield of 4.75% during quick parallel interest rate shift of 1.05% in the first year of a 10-year period.



Note: Analysis assumes a constant portfolio duration of 4.0 years with 20% annual portfolio turnover so that the entire portfolio changes about every five years; starting portfolio yield equals starting long-term interest rate. For illustrative and discussion purposes only. Intended to illustrate a mathematical principle, and not representative of any product or service.

Scenario 3: Steady rise to all-time high

So far, we have assumed that the 10-year yield rises only to its long-term average. But what if rates moved dramatically higher? Our third scenario raises the 10-year yield from its current level of 4.75% to a new all-time high of 16% within five years – an increase of 2.25% per year for the first five years, after which rates level off.

This extreme scenario turns out to produce the highest of the three scenarios' annualized returns, assuming an investment time horizon of 10 years. That's not to say the first several years wouldn't be difficult. The portfolio value would fall immediately and stay below its initial value until the end of year 6. The maximum cumulative loss (or maximum drawdown) would be around -11.4% at the end of year 4, which would start to approach the fixed income losses experienced during the great interest rate reset of 2021-22.

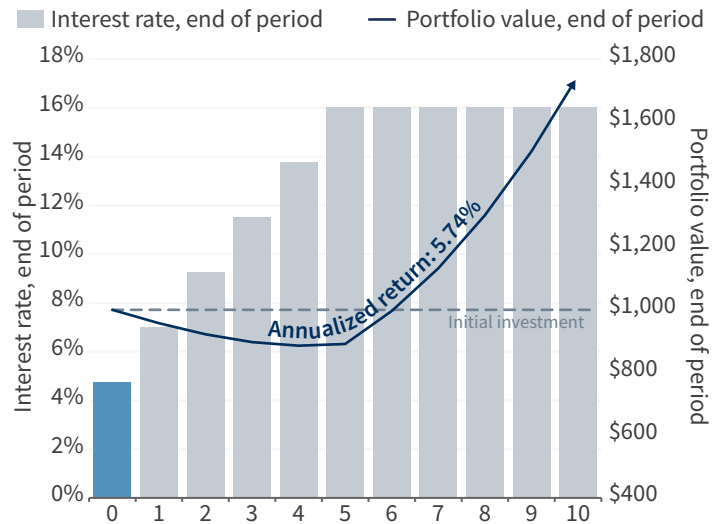
However, as with the previous rising-rate scenarios, higher interest rates eventually translate into higher income generation, and the bond portfolio's value starts to recover and then improves. The total annualized return over the full 10-year period is 5.74%, well above scenarios 1 and 2, and almost a full percentage point higher per year than the baseline 4.75% return.

The reset changed the risk/reward

Rising rates are not painless. A sharp increase in yields can still create near-term losses, particularly for investors with longer duration or shorter time horizons. But because of the great interest rate reset, investors now are not entering a potential rising-rate environment after a decade when low yields became embedded across much of the outstanding bond market. Today's higher starting income provides a more meaningful cushion against price declines and allows portfolio cash flows to be reinvested at even higher yields if rates rise further.

Dramatically higher rates

Value of \$1,000 invested in intermediate bond portfolio with starting yield of 4.75% during steady parallel interest rate shift of 2.25% per year for the first five years of a 10-year period.



Note: Analysis assumes a constant portfolio duration of 4.0 years with 20% annual portfolio turnover so that the entire portfolio changes about every five years; starting portfolio yield equals starting long-term interest rate. For illustrative and discussion purposes only. Intended to illustrate a mathematical principle, and not representative of any product or service.

That is the central message of the three scenarios. The initial price effect of higher rates is visible immediately, but the potential benefit of higher income compounds over time. This does not eliminate interest-rate risk, and it does not mean investors should ignore duration. Given our view that long-term rates may remain elevated with a bias higher, we continue to favor a shorter-to-intermediate duration approach.

And with that approach, as portfolio turnover and reinvestment occur, higher yields increasingly can work for investors – not against them.



John Lagowski, CFA, is a Portfolio Manager and Senior Research Analyst on Eagle's Fixed Income team, as well as Head of Asset Allocation on the broader Eagle Income franchise. He co-manages several of the team's taxable fixed income portfolios as well as the multi-asset Eagle Strategic Income and Eagle Vertical Income strategies. As Head of Asset Allocation, he oversees the team's macroeconomic processes and is involved with the strategic and tactical allocation decisions across the team's suite of investment portfolios.

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Definitions

Bear market – A capital market characterized by investors tending to avoid risk more than they seek risk. A common metric for determining a bear market is a drop in asset prices of more than 20% from previous highs.

Index

Bloomberg Intermediate US Government/Credit Bond Index – Measures the performance of US dollar-denominated US Treasuries, government-related, and investment-grade US corporate securities that have a remaining maturity of greater than 1 year and less than 10 years.

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