Global bond yields continue to climb, as generally positive data challenges the view that Federal Reserve officials will need to cut rates in the near future. We believe the Fed will keep interest rates elevated for longer in order to ensure inflation returns to the central bank’s 2% target, a view that Fed Chair Jerome Powell reinforced at the Jackson Hole Economic Symposium in August. As a result, we see potentially interesting opportunities in this environment of high but relatively stable interest rates, especially on the short end of the yield curve.

Cash-substitute investments may be a suboptimal strategy
When interest rates are going up, conservative investors often gravitate toward cash-substitute investments—such as money market funds and ultra-short-term Treasuries or certificates of deposit (CDs)—because these types of securities tend to outperform in a rising-rate environment. But cash substitutes also tend to underperform when rates are high but stable, and in our view this is the type of investing environment in which we currently find ourselves. In such an environment, we believe other short-duration investments—including new-issue callable notes, high-coupon mortgage-backed securities, and floating-rate preferred securities—have the potential to provide better risk-adjusted returns.

New-issue callable corporate and agency notes
Investors looking to maximize cash flow by focusing on short-term interest rates may find attractive alternatives in new-issue callable notes. Primarily issued by banks and agencies, these callable notes are generally characterized by shorter-term final maturities out to five years, with a callable feature in one to two years. These securities are issued at par and typically have larger coupons than comparable non-callable maturities to compensate investors for call risk. The larger coupons may, in turn, provide greater price protection due to the notes’ lower duration and price sensitivity, as well as greater cash flow compared to similar non-callable securities.

On the downside, new-issue callable notes generally underperform and introduce greater reinvestment risk in declining-interest-rate scenarios. Despite this potential risk, we favor new-issue callable notes above rolling T-bills or CDs in the current interest rate environment, because the latter securities may expose investors to more frequent reinvestment risk and usually produce lower yields.

To illustrate, the table below compares the one-year total return performance of two securities maturing in three years: one is an investment-grade (IG) rated corporate note with a 6% coupon and a call feature in one year, and the other is a Treasury note with a 4.375% coupon and no call provision. The total return of the Treasury exceeds the callable corporate note if interest rates are falling, but the corporate note outperforms in both stable and rising-rate environments. Absent a credit event, the corporate note pays a larger 6% coupon, resulting in greater interest income and helping offset marked-to-market price declines.

### Treasuries may underperform when interest rates are stable or rising
One-year total return performance of 3-year securities*

<table>
<thead>
<tr>
<th>Interest rate trend</th>
<th>Yield shift (basis points)</th>
<th>3-year Treasury note</th>
<th>3-year IG corporate note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rising</td>
<td>+150</td>
<td>2.07%</td>
<td>3.27%</td>
</tr>
<tr>
<td></td>
<td>+100</td>
<td>2.93%</td>
<td>4.12%</td>
</tr>
<tr>
<td>Stable</td>
<td>+50</td>
<td>3.81%</td>
<td>5.08%</td>
</tr>
<tr>
<td></td>
<td>0</td>
<td>4.69%</td>
<td>6.00%</td>
</tr>
<tr>
<td></td>
<td>-50</td>
<td>5.58%</td>
<td>6.00%</td>
</tr>
<tr>
<td>Falling</td>
<td>-100</td>
<td>6.47%</td>
<td>6.00%</td>
</tr>
<tr>
<td></td>
<td>-150</td>
<td>7.37%</td>
<td>6.00%</td>
</tr>
</tbody>
</table>

* U.S. Treasury note: 4.375% coupon, no call provision. Corporate note: investment-grade rating, 6% coupon, callable in one year.

Source - RBC Wealth Management

For author’s contact information and important disclosures see page 3.

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**Higher-coupon mortgage-backed securities**

Mortgage-backed securities (MBS) may be another option for investors to increase income while also potentially reducing interest rate risk. If investors decide to purchase MBS, we favor individual securities over mutual funds and exchange-traded funds (ETFs), which tend to be more sensitive to changes in prevailing interest rates due to the notable refinancing wave in 2020 and 2021 when interest rates were at record lows.

More recently issued MBS have coupons we view as attractive. For example, Ginnie Mae (GNMA) MBS have been issued with coupons in the 5.5%–7.5% range this year, allowing investors to generate high cash flows while potentially reducing reinvestment risk versus cash-substitute investments given the current interest rate environment.

Under normal circumstances, higher-coupon MBS are typically subject to significant prepayment risk that results in a faster return of principal to investors. However, we believe current mortgage rates would need to decline by an estimated 200 basis points before there would be meaningful economic incentives to prepay more recently issued mortgages. Even then, we think it’s highly unlikely that prepayments would reach 100% given the large number of loans that comprise a mortgage-backed security.

Ginnie Mae MBS are identical in credit quality to Treasuries and FDIC-insured CDs because all are backed by the full faith and credit of the United States. We think recently issued MBS have the potential to outperform these alternatives, unless mortgage rates drop significantly while Fed policy rates stay high—a scenario we believe to be extremely unlikely.

**Current floating-rate hybrid preferred securities**

Fixed-to-float hybrid preferreds in floating rate mode may be another attractive investment option for investors with higher risk tolerances. For background, fixed-to-float hybrid preferreds initially pay a fixed coupon until a predetermined date, at which point the issuer has the option to redeem the securities (usually at par) or to allow them to remain outstanding and pay a variable-rate coupon that is set over a predetermined benchmark such as Constant Maturity Treasury (CMT) or the Secured Overnight Financing Rate (SOFR).

Currently, many outstanding preferreds in floating-rate mode are paying distribution yields of at least 8%, depending on credit quality, while yields on cash-substitute investments are in the 5.00%–5.25% range. Preferred securities in floating-rate mode are subject to call risk, although we think current market conditions are likely to financially disincentivize companies from calling the securities, depending on prevailing coupons for newly issued preferred securities.

Most preferreds in floating-rate mode are trading near par because of the continual call risk, but investors can purchase these securities with dividend yields we view as attractive. At times such as this, investors receive variable-rate coupons that can move in sync with fluctuating interest rates. Nonetheless, investors should be aware that preferred securities involve a significantly higher degree of credit risk than cash-substitute investments. More conservative investors are therefore likely to find better risk-adjusted returns in the other two options discussed above.

**In conclusion**

We think the Federal Reserve will keep interest rates elevated for longer to ensure inflation returns to the 2% target, which in our view creates potentially interesting fixed income investment opportunities in an environment of high but relatively stable interest rates. In a higher-for-longer interest rate environment, we think new-issue callable notes, high-coupon mortgage-backed securities, and floating-rate preferreds may provide better risk-adjusted returns compared to traditional cash-substitute investments such as money market funds and ultra-short-term Treasuries or CDs.
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