



# Rising rates

What you need to know



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# Understanding the impact of rising rates

**“An investment in knowledge pays the best interest.”**

**Benjamin Franklin**

It's important to know that the primary reasons for owning fixed income investments don't change when market conditions, including interest rates, change. In addition to providing income, fixed income strategies are an important component of a well-diversified portfolio, often serving as a potentially less volatile option to offset equity market volatility.

The following pages will review how interest rate movements affect fixed income investments, the factors that can impact interest rates, and why certain fixed income strategies are typically less interest rate sensitive than others.

## What drives interest rates?

To better understand the impact rising interest rates can have on your investments, you need to know the relationship between bond prices and interest rates, and the different factors that can influence short- and long-term rates. It is also worth noting that short- and long-term rates don't necessarily move in tandem.

## When interest rates go up, prices go down (and vice versa)

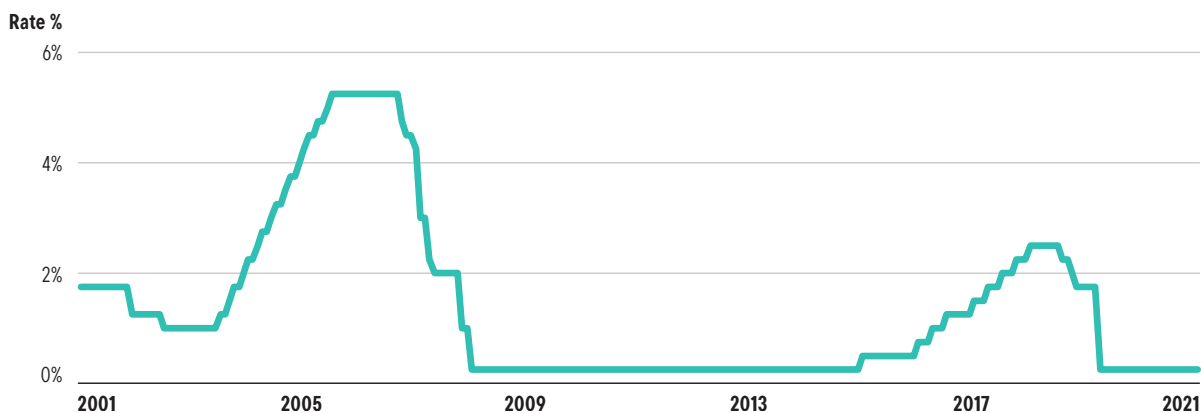
Typically, bond prices and interest rates move in opposite directions. That means when interest rates rise, bond prices tend to fall, and conversely, when interest rates decline, bond prices tend to increase. Likewise, the share price of a fixed income mutual fund or ETF may move up or down, depending on movements in interest rates and their effect on the value of the bonds held in the fund's portfolio.

## What is the federal funds rate, and why is it important?

The central bank for the US, the Federal Reserve (Fed), controls the federal funds target rate. This is the rate commercial banks charge other banks for overnight loans, but it also strongly influences the rates of other short-term investments. Generally, the Fed reduces the federal funds target rate to try and stimulate a sluggish economy, and may raise rates when the economy is thriving to prevent inflation from getting too high.

### The federal funds target rate<sup>1</sup>

20-year period ended December 31, 2021



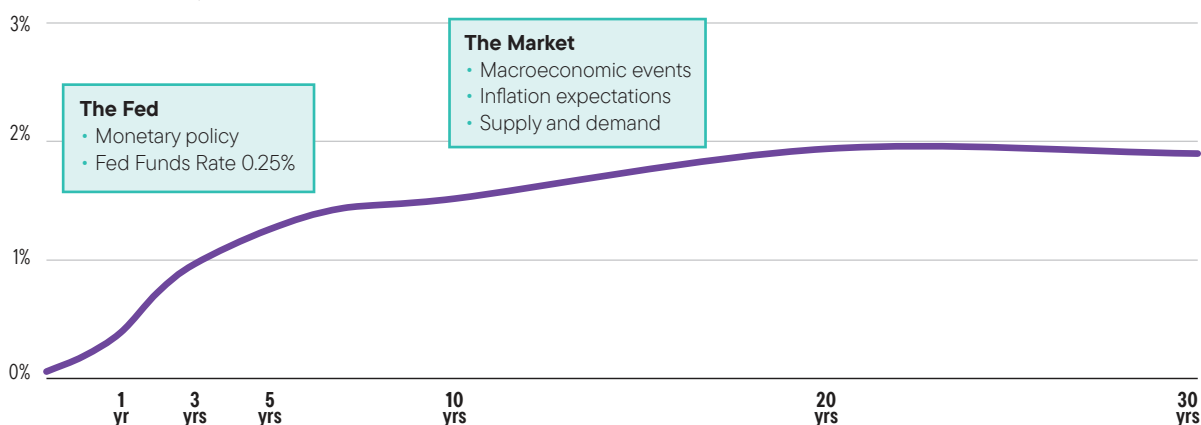
1. Source: © 2022 [www.fedprimerate.com](http://www.fedprimerate.com)

## Factors that influence long-term rates

The illustration below shows the yields associated with bonds of different maturity lengths. While short-term rates are largely influenced by the Fed, long-term rates, as represented by yields of 10-year and 30-year Treasury bonds, are typically market-driven. Macroeconomic events influence long-term rates (such as economic expansions or contractions), inflation expectations, and supply and demand factors (including demand from foreign central banks).

### Treasury yield curve

As of December 31, 2021<sup>2</sup>



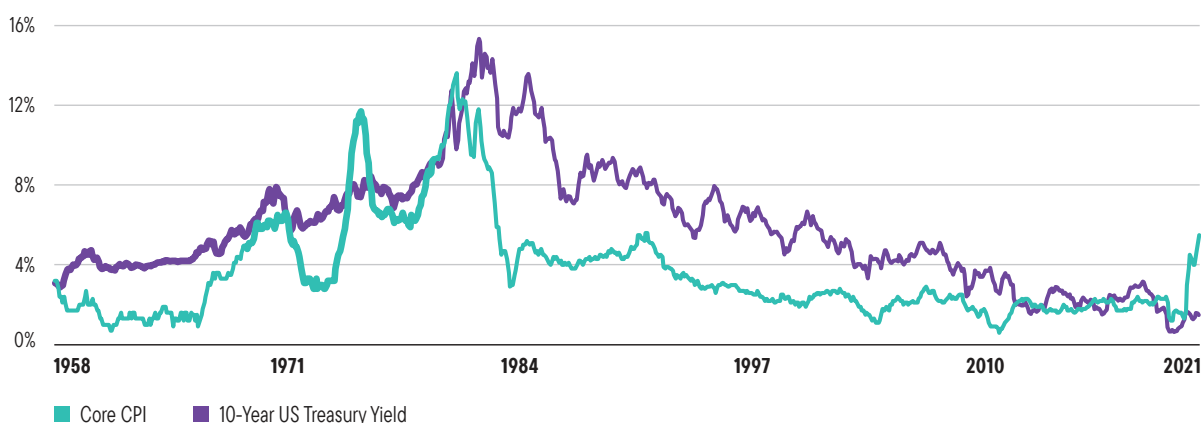
*This chart is for illustrative purposes only and does not reflect the performance of any Franklin Templeton fund. **Past performance does not guarantee future results.***

## Inflation has historically influenced long-term rates

While different factors may affect interest rates at any given time, over the long term, inflation (or the rate at which the prices of goods and services are rising) has been a key driver. Inflation is often a sign that the economy is expanding, and expectations of growing inflation by the market may cause long-term rates to move higher.

### 10-year US Treasury yield vs. Core CPI (inflation) year-over-year<sup>3</sup>

January 31, 1958–December 31, 2021



2. Source: Bloomberg, Federal Reserve. Important data provider notices and terms available at [www.franklintempletondatasources.com](http://www.franklintempletondatasources.com).

3. Source: Bloomberg, Federal Reserve H.15 Report, Bureau of Labor Statistics.

# Rising rates don't impact all fixed income sectors equally

The size and scope of the fixed income market is much larger than the stock market. Within this large marketplace, different fixed income asset classes have their own unique characteristics and risks, including interest rate sensitivity.

This table shows the annual returns of key fixed income sectors from 1992–2021, ordered from high to low. The outlined columns denote years when the federal funds target rate and/or the 10-year Treasury bond yield increased.

Annual total returns of key fixed income sectors (1992–2021)<sup>4</sup>

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This table shows the annual returns of key fixed income sectors from 1992–2021, ordered from high to low. The outlined columns denote years when the federal funds target rate and/or the 10-year Treasury bond yield increased.

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
High-Yield Bonds	High-Yield Bonds	High-Yield Bonds	Floating-Rate Loans	Emerging Markets Debt	Emerging Markets Debt	High-Yield Bonds	International Bonds	Emerging Markets Debt	Preferreds	Investment-Grade Corp. Bonds	International Bonds	High-Yield Bonds	International Bonds
17.44%	18.86%	10.32%	26.38%	35.23%	12.21%	17.79%	24.18%	16.20%	10.31%	21.99%	27.94%	12.14%	
Preferreds	International Bonds	International Bonds	10-Year US Treasury Bonds	High-Yield Bonds	Emerging Markets Debt	Global Bonds	Floating-Rate Loans	10-Year US Treasury Bonds	Preferreds	Global Bonds	Emerging Markets Debt	High-Yield Bonds	
12.75%	15.12%	5.99%	23.73%	13.03%	11.95%	15.30%	4.69%	14.45%	9.84%	19.49%	25.66%	11.95%	
Municipal Bonds	Global Bonds	Global Bonds	Investment-Grade Corp. Bonds	Floating-Rate Loans	10-Year US Treasury Bonds	10-Year US Treasury Bonds	High-Yield Bonds	Emerging Markets Debt	Asset-Backed Securities	TIPS	International Bonds	Emerging Markets Debt	
8.81%	13.27%	2.34%	22.25%	7.48%	11.27%	12.88%	3.59%	14.41%	9.81%	16.57%	18.52%	11.73%	
Investment-Grade Corp. Bonds	Municipal Bonds	Short-Term Government Bonds	Preferreds	Preferreds	Investment-Grade Corp. Bonds	Agencies	Short-Term Government Bonds	TIPS	Agencies	10-Year US Treasury Bonds	Global Bonds	Global Bonds	
8.69%	12.29%	1.39%	20.41%	7.44%	10.23%	8.85%	3.41%	13.18%	8.31%	14.66%	14.91%	10.35%	
Asset-Backed Securities	Investment-Grade Corp. Bonds	Asset-Backed Securities	High-Yield Bonds	Mortgage-Backed Securities	Preferreds	Investment-Grade Corp. Bonds	TIPS	Agencies	Short-Term Government Bonds	Emerging Markets Debt	Floating-Rate Loans	TIPS	
7.35%	12.16%	0.13%	19.68%	5.35%	9.99%	8.57%	2.39%	12.18%	8.23%	13.11%	11.01%	8.46%	
Agencies	10-Year US Treasury Bonds	Mortgage-Backed Securities	International Bonds	Short-Term Government Bonds	Agencies	Asset-Backed Securities	Mortgage-Backed Securities	Municipal Bonds	Mortgage-Backed Securities	Agencies	Preferreds	Floating-Rate Loans	
7.31%	11.84%	-1.61%	19.55%	5.32%	9.70%	7.76%	1.86%	11.68%	8.22%	11.01%	9.43%	5.60%	
Mortgage-Backed Securities	Floating-Rate Loans	High-Yield Bonds	Global Bonds	Asset-Backed Securities	Mortgage-Backed Securities	Mortgage-Backed Securities	Asset-Backed Securities	Mortgage-Backed Securities	TIPS	Investment-Grade Corp. Bonds	TIPS	Investment-Grade Corp. Bonds	
6.96%	11.17%	-2.04%	19.04%	5.05%	9.49%	6.96%	1.82%	11.16%	7.90%	10.12%	8.40%	5.39%	
10-Year US Treasury Bonds	Agencies	Agencies	Agencies	Municipal Bonds	Municipal Bonds	Preferreds	Agencies	Asset-Backed Securities	High-Yield Bonds	Municipal Bonds	Investment-Grade Corp. Bonds	Preferreds	
6.50%	10.51%	-3.32%	18.27%	4.43%	9.19%	6.72%	-0.94%	10.84%	6.16%	9.60%	8.24%	5.11%	
Global Bonds	Preferreds	Investment-Grade Corp. Bonds	Municipal Bonds	International Bonds	Floating-Rate Loans	Short-Term Government Bonds	Investment-Grade Corp. Bonds	Investment-Grade Corp. Bonds	Municipal Bonds	Mortgage-Backed Securities	Municipal Bonds	10-Year US Treasury Bonds	
5.53%	9.76%	-3.93%	17.45%	4.08%	8.30%	6.59%	-1.96%	9.08%	5.13%	8.75%	5.31%	4.87%	
International Bonds	Asset-Backed Securities	Municipal Bonds	Mortgage-Backed Securities	Global Bonds	Asset-Backed Securities	Municipal Bonds	Municipal Bonds	Short-Term Government Bonds	10-Year US Treasury Bonds	Asset-Backed Securities	Asset-Backed Securities	Mortgage-Backed Securities	
4.77%	7.95%	-5.17%	16.80%	3.62%	7.41%	6.48%	-2.06%	7.66%	4.01%	8.55%	4.01%	4.70%	
Emerging Markets Debt	Mortgage-Backed Securities	Preferreds	Asset-Backed Securities	Agencies	Short-Term Government Bonds	Floating-Rate Loans	Global Bonds	Floating-Rate Loans	Floating-Rate Loans	Preferreds	Mortgage-Backed Securities	Municipal Bonds	
NA	6.84%	-5.69%	13.43%	3.29%	6.40%	5.31%	-4.27%	4.94%	2.65%	7.66%	3.07%	4.48%	
Floating-Rate Loans	Short-Term Government Bonds	10-Year US Treasury Bonds	Short-Term Government Bonds	Investment-Grade Corp. Bonds	Global Bonds	TIPS	Preferreds	Global Bonds	Emerging Markets Debt	Short-Term Government Bonds	Agencies	Agencies	
NA	4.88%	-7.85%	9.77%	3.28%	0.23%	3.95%	-4.43%	1.59%	1.36%	5.13%	2.59%	3.33%	
Short-Term Government Bonds	Emerging Markets Debt	Emerging Markets Debt	Floating-Rate Loans	10-Year US Treasury Bonds	International Bonds	High-Yield Bonds	International Bonds	International Bonds	Global Bonds	High-Yield Bonds	Short-Term Government Bonds	Asset-Backed Securities	
N/A	N/A	-18.35%	8.91%	0.07%	-4.26%	0.55%	-5.07%	-2.63%	-0.99%	3.10%	1.89%	3.01%	
TIPS	TIPS	TIPS	TIPS	TIPS	TIPS	Emerging Markets Debt	10-Year US Treasury Bonds	High-Yield Bonds	International Bonds	Floating-Rate Loans	10-Year US Treasury Bonds	Short-Term Government Bonds	
N/A	N/A	N/A	N/A	N/A	N/A	-11.54%	-8.41%	-5.66%	-3.54%	1.12%	1.25%	0.92%	
Year-End Federal Funds Target Rate:	3.00%	3.00%	5.50%	5.50%	5.25%	5.50%	4.75%	5.50%	6.50%	1.75%	1.25%	1.00%	2.25%
Year-End 10-Year Treasury Bond Yield:	6.70%	5.83%	7.84%	5.58%	6.43%	5.75%	4.65%	6.45%	5.12%	5.07%	3.83%	4.27%	4.24%
Year-End 6-Month CD Yield:	3.46%	3.36%	6.89%	5.37%	5.46%	5.74%	4.97%	6.08%	6.10%	1.92%	1.32%	1.16%	2.72%

This chart is for illustrative purposes only and does not reflect the performance of any Franklin Templeton fund. **Past performance does not guarantee future results.** Fund performance can be obtained at [franklintempleton.com](https://franklintempleton.com).

Diversification does not guarantee a profit or protect against a loss. It's important to note that CDs are insured by the Federal Deposit Insurance Corporation (FDIC) for up to \$250,000 and offer a fixed rate of return. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed.

4. Sources: Bloomberg, Credit Suisse, Federal Reserve H.15 Report and © 2022 Morningstar.

**Past performance is no guarantee of future results.** Indexes are unmanaged and one cannot invest directly in an index. Index returns do not reflect any fees, expenses or sales charges. Please see page 8 for definitions of indexes shown here.



# Strategies to consider during a rising rate environment

Interest rate sensitivity can vary across sectors within the fixed income universe. Generally speaking, higher quality sectors (such as US government bonds) and longer duration bonds have tended to be the most vulnerable to interest rate volatility. The following strategies have historically been less interest-rate sensitive though they may be subject to additional risks.

Consider credit-oriented strategies	Keep it short	Go global
<ul style="list-style-type: none"><li>• <b>High-Yield Bonds</b></li><li>• <b>Floating-Rate Loans</b></li></ul> <p>Credit-oriented sectors and, in particular, non-investment grade sectors such as high-yield corporate bonds and floating-rate bank loans, have historically been less correlated to US Treasuries as their performance is typically tied more to the overall economic outlook and corporate earnings landscape than interest rates.</p>	<ul style="list-style-type: none"><li>• <b>Adjustable-Rate Mortgages</b></li><li>• <b>Short-Term Government Bonds</b></li><li>• <b>Floating-Rate Loans</b></li></ul> <p>Shorter duration securities are generally not as sensitive to long-term rate movements and can offer an attractive alternative to longer duration securities where rising rates typically have a greater effect on price and valuations.</p>	<ul style="list-style-type: none"><li>• <b>Global Bonds</b></li><li>• <b>International Bonds</b></li></ul> <p>International and global strategies can seek to capitalize on the differing business cycles and economic conditions present around the world, and thus are typically less impacted by rate changes in the US.</p>

## The upside of rising rates

While there is often apprehension at the prospect of rates increasing, it's important to remember the potential upside as well. Rising rates may indicate economic expansion, which can lead to increased interest payments over time.

## What about stocks?

Most people associate rising interest rates with bonds, but many investors may not consider the impact on equities. When rates are rising due to economic growth, it also tends to mean businesses and consumers are increasing their spending on goods and services—all of which can be good for the stock market.

## And alternatives?

Alternative hedge strategies can offer additional diversification to traditional stock and bond portfolios. Hedge strategies have historically shown a negative correlation to 10-year Treasuries.<sup>5</sup>

## How to prepare for rising rates

It's impossible to predict the exact timing and direction of interest rates changes. And, while rising interest rates will likely generate news headlines, investors should avoid overreacting. Instead, work with your financial professional to determine the best plan to keep your long-term investment strategy on track.

To learn more about Franklin Templeton products that might benefit your investment strategy, talk to your financial professional. They offer market knowledge, planning expertise and will consider your investment needs to create an investment strategy tailored to your specific goals and risk tolerance.

5. Source: © 2022 Morningstar Direct. Based on the 15-year period ended 12/31/21. Hedge strategies are represented by the HFRI Fund Weighted Composite Index, 10-Year US Treasuries are represented by the FTSE 10-Yr US Treasury Index. Indexes are unmanaged and one cannot invest directly in an index. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are backed by the full faith and credit of the US government. Past performance does not guarantee future results.

# Franklin Templeton

Offering boutique specialization with global scale

Franklin Templeton brings together an unmatched collection of independent specialist investment managers to provide our clients deep expertise and specialization within and across asset classes, investment styles, and geographies. This combination of multiple investment groups in one company provides boutique specialization with global scale. With roots that date back more than 70 years and \$1.5 trillion in assets under management, Franklin Templeton today is one of the largest global asset managers.<sup>6</sup>

## Franklin Templeton's Specialist Investment Managers



<sup>6</sup>. As of 12/31/2021.

## WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. As interest rates rise, bond prices typically fall. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. Floating-rate loans and high-yield corporate bonds are generally rated below investment grade and are subject to greater risk of default, which could result in loss of principal, a risk that may be heightened in a slowing economy. The risks of foreign securities include currency fluctuations and political uncertainty. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity.

Alternatives: Hedge strategies are actively managed and could experience losses if an investment manager's judgment about markets, future volatility, interest rates, industries, sectors, and regions, or the attractiveness or the potential appreciation of particular investments prove to be incorrect. Short sales of securities involve the risk that losses may exceed the original amount invested. Merger arbitrage investments risk loss if a proposed organization in which the fund invests is renegotiated or terminated.

**This communication is general in nature and intended for educational purposes only; it should not be considered tax, legal or investment advice, or an investment recommendation. Consult your financial professional for personalized advice that is tailored to your specific goals, individual situation and risk tolerance.**

### Index Definitions

Credit Suisse High-Yield Index is designed to mirror the investible universe of the US dollar denominated high-yield debt market.

J.P. Morgan Emerging Markets Bond Index Global tracks total returns for US dollar denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities.

Credit Suisse Leveraged Loan Index is designed to mirror the investible universe of the US dollar denominated leveraged loan market.

FTSE World Government Bond Index Non-US is a market capitalization weighted index consisting of investment-grade world government bonds (apart from US).

FTSE World Government Bond Index is a market capitalization weighted index consisting of investment-grade world government bonds.

Bloomberg Barclays US TIPS Index covers the universe of inflation-protected notes issued by the US Treasury that have at least one year to final maturity.

Bloomberg Barclays Municipal Bond Index is a market-value-weighted index engineered for the long-term tax-exempt bond market.

Bloomberg Barclays US MBS Index is the MBS component of the Bloomberg Barclays US Aggregate Index and covers agency mortgage-backed pass-through securities (both fixed rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bloomberg Barclays Asset-Backed Securities (ABS) Index is the ABS component of the Bloomberg Barclays US Aggregate Index and includes credit and charge card, auto, and utility loans.

Bloomberg Barclays US Corporate Investment Grade Index is the US corporate component of the Bloomberg Barclays US Credit Index and covers USD-denominated, investment-grade, fixed-rate, taxable securities sold by industrial, utility, and financial institution issuers.

Bloomberg Barclays US Government Index: 1-2 Year Component is the 1-2 year component of the Bloomberg Barclays US Government Index.

Bloomberg Barclays US Government Index is the US Government component of the Barclays US Government/Credit index and includes public obligations of the US Treasury with at least one year to final maturity and publicly issued debt of US Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US Government.

Bloomberg Barclays US Agency Index is the US agency component of the Bloomberg Barclays US Government/Credit Index and includes publicly issued debt of US Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US Government.

FTSE 10-Year US Treasury Index is a total return index based on a constant maturity instrument.

BofAML Preferred Stock Fixed Rate Index tracks the performance of fixed rate US dollar-denominated preferred securities issued in the US domestic market.

US Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the US government. The US government guarantees the principal and interest payments on US Treasuries when the securities are held to maturity. Unlike US Treasuries, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the US government. Even when the US government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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