

Performance in a Higher Rate Environment

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The Rate Reset: Assessing YTD Investment Performance

The investment landscape in 2026 has been defined by a surprise many investors did not expect: interest rates have moved higher rather than lower. Entering the year, markets broadly anticipated that moderating inflation and slower growth would allow Treasury yields to decline. Instead, long term rates continued to rise. By the end of August, the 10 year Treasury yield had approached 4.8%, its highest level since early 2025, while the 30 year yield had moved above 5.2%.

The rise in rates has produced very different outcomes across asset classes. Equities have continued to generate strong returns, supported by corporate earnings and sustained investment in artificial intelligence. Traditional fixed income has struggled as higher Treasury yields offset much of the income generated by bonds. Floating rate assets, high yield bonds, and convertibles have been more resilient because income, credit exposure, and equity participation have outweighed the effect of higher rates.

Why Have Interest Rates Moved Higher?

The increase in long term rates reflects persistent inflation pressure, growing fiscal concerns, and unprecedented demand for capital across public and private markets. Inflation has remained resilient enough to reduce expectations for aggressive monetary easing, while higher energy prices tied to the conflict involving Iran have added another source of uncertainty. At the same time, federal debt has surpassed \$40 trillion, persistent deficits require substantial Treasury issuance, and interest expense on the debt has become a more visible budgetary pressure, including comparisons to major federal spending categories such as defense.

Corporate borrowing has also stayed elevated as companies fund investment in artificial intelligence, data centers, power generation, and digital infrastructure (For additional perspective on the scale and credit implications of AI-related borrowing, see AAM's July paper, [Corporate Fundamentals 2Q26](#);

[AI Debt Issuance Can't Stop Won't Stop](#)). Investors are therefore being asked to absorb significant issuance from both the federal government and corporations. This matters because long term yields have risen even as parts of the economy have slowed, suggesting investors are demanding additional compensation for inflation uncertainty, fiscal risk, debt supply, and the opportunity cost of committing capital to longer duration assets.

Equities: Higher Rates Have Not Stopped the Rally

Equities have been the strongest major asset class in 2026 despite higher long term rates. Through August 31, the S&P 500 had gained approximately 12.3%, the Nasdaq had risen approximately 13.5%, and the Russell 2000 had advanced approximately 19.1%. The rally has been supported by strong earnings, especially among technology companies benefiting from artificial intelligence investment.

That balance may become more difficult to maintain if yields continue rising. Equity valuations remain above long term averages, leaving less room for disappointment. Higher Treasury yields raise the discount rate applied to future cash flows and can pressure valuation multiples, particularly for growth companies whose earnings are expected further in the future.

Investment Grade Fixed Income: Duration Remains the Challenge

Investment grade bonds have been among the clearest casualties of rising rates. Through August 31, the Bloomberg U.S. Aggregate Bond Index had declined approximately 0.3%, the Bloomberg U.S. Corporate Bond Index was down approximately 0.4%, and the Bloomberg U.S. Treasury Index had declined approximately 0.5%. The challenge has been duration. While yields today are significantly more attractive than they were several years ago, the income generated by investment-grade bonds has not been sufficient to offset the decline in bond prices caused by rising Treasury yields. Not all segments of the investment grade market have experienced the same outcome. Shorter duration securities have generally held up much better. The Bloomberg U.S. Government/Credit 1-5 Year Index gained approximately 0.7% through August 31, illustrating the benefits of lower interest rate sensitivity in a rising-rate environment.

High Yield Bonds: Income Matters

High yield bonds have significantly outperformed investment grade fixed income. The Bloomberg U.S. Corporate High Yield Index generated a total return of approximately 2.7% through August 31, as higher coupon income and credit spread created a cushion against rising Treasury yields. The shorter duration profile of the high yield market has also helped, because high yield returns are typically driven more by income and credit spreads than by changes in long term Treasury rates. Credit fundamentals have remained relatively stable, keeping spreads near historically tight levels. That supports current returns, but also means investors are receiving less compensation for future credit deterioration than they would during periods of wider spreads.

Bank Loans: A Direct Beneficiary of Higher Rates

Bank loans have benefited directly from elevated rates. Floating rate loans generated approximately 3.0% through August 31, while the broader loan market offered yields approaching 8.5%. Because loan coupons generally reset with short term rates, investors have earned elevated income without taking the same duration risk as traditional fixed rate bonds. The primary risk has shifted from interest rates to credit quality. Loan markets generally include a larger share of lower rated issuers than the fixed rate high yield market, so the yield advantage should be evaluated against differences in borrower quality, documentation, liquidity, and downside protection. This does not mean bank loans should be avoided; rather, it reinforces the importance of sizing the allocation appropriately and relying on underwriting discipline. For investors willing to accept the added credit and liquidity risk, bank loans remain one of the most direct ways to benefit from a higher-rate environment.

Convertibles: Participating in Equity Strength

Convertible bonds have been among the strongest income oriented asset classes in 2026. The iShares Convertible Bond ETF generated a total return of approximately 16.5% through August 31, benefiting from equity market strength and the performance of technology and artificial intelligence related companies. Strong returns have also been accompanied by strong issuance. Convertible securities have become an increasingly popular source of financing, particularly among growth-oriented companies seeking to raise capital while limiting borrowing costs. Their hybrid structure has allowed investors to participate in equity gains while retaining some fixed income characteristics. Balanced convertible strategies can be especially useful when equity valuations are elevated, because they may preserve upside participation while providing more downside protection than a pure equity allocation if the equity market weakens.

Private Credit: Attractive Income, Growing Differentiation

Private credit continues to offer compelling income opportunities, but results increasingly depend on manager selection and underwriting discipline. Much of the sector remains floating rate, allowing investors to benefit from elevated short term rates. However, higher borrowing costs are exposing differences in borrower quality. Current income remains attractive, but valuation adjustments, credit marks, rising nonaccruals, and stress among weaker borrowers show that private credit is becoming more about credit selection than yield generation alone.

Investment Implications

The experience of 2026 shows that the impact of higher rates is more nuanced than the assumption that rising rates are simply negative for investors. The year has separated duration risk, credit risk, and equity exposure. Long duration bonds have struggled as higher Treasury yields offset coupon income, while high yield bonds, bank loans, convertibles, and other income oriented assets have

generated positive returns because their sources of return extend beyond interest rates alone. For investors, income levels are now the most attractive they have been in years, but the key question is whether that income adequately compensates for duration, credit, liquidity, and valuation risk. This environment reinforces the value of diversification and disciplined asset allocation work, because no single asset class solves every objective. For insurance companies, portfolio duration should continue to be driven primarily by liability characteristics, surplus position, liquidity needs, and risk tolerance rather than by a short term view on rates. The central lesson is that higher rates have reshaped the opportunity set, rewarded selectivity, and restored income as a meaningful contributor to expected returns.

Sources for Quoted Index Performance

- S&P 500 Total Return: ChartRow, S&P 500 YTD return.
- Nasdaq Composite Total Return: FRED, NASDAQ Composite Total Return; Nasdaq Global Indexes, XCMP overview.
- Russell 2000 Total Return: Yahoo Finance, Russell 2000 Total Return historical data; YCharts, Russell 2000 Total Return.
- Bloomberg U.S. Aggregate Bond Index: Bloomberg Professional Services, Bloomberg US Aggregate Index; BlackRock iShares U.S. Aggregate Bond Index Fund performance.
- Bloomberg U.S. Corporate Bond Index: YCharts, Bloomberg US Corporate Index.
- Bloomberg U.S. Treasury Index: YCharts, Bloomberg US Treasury Index.
- Bloomberg U.S. Government/Credit 1-5 Year Index: YCharts, Bloomberg US Government/Credit 1-5 Year Index.
- Bloomberg U.S. Corporate High Yield Index: Bloomberg Professional Services, Bloomberg US Corporate High Yield Index; YCharts, Bloomberg US Corporate High Yield Index.
- Bloomberg Leveraged Loan Index: Bloomberg Leveraged Loan Index.
- iShares Convertible Bond ETF: Yahoo Finance, ICVT performance history; iShares, ICVT fund data.

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