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Income Investors – Beware of Falling Short-Term Interest Rates!

by Larry Eiben
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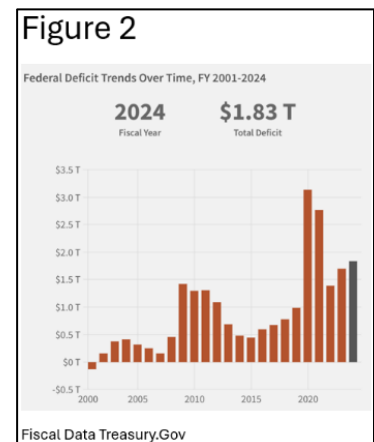
It's been an interesting time for income investors over the last 10-15 years. Coming out of the Great Recession, we saw an unprecedented period of zero-interest rate policy ("ZIRP") which made it challenging to find "income" investments with attractive yields.[1] The COVID epidemic closed out that period with record budget deficits in the United States and fiscal policy (e.g., government spending) becoming a major driver of economic outcomes. Inflation exploded coming out of COVID leading to one of the most aggressive tightening campaigns that we've ever seen by the Federal Reserve Bank of the United States (the "Fed").[2] The exact path of rates from here is anyone's guess but the Fed has indicated a desire to lower the Federal Funds Rate ("FFR") and will do so if inflation permits (i.e., continues to drop). So, it's a good time to check your interest rate exposures as many income investors are experiencing dividend cuts.

Let's first take a quick tour back through history to see how we arrived at where we are today. As can be seen in the chart below (Figure 1), interest rates (in this case the yield on the 10-Year U.S. Treasury Bond), peaked in the early 1980s and proceeded to fall for the next 40 years.

This period was great for fixed income investors who enjoyed predictable income and, generally, capital gains on bonds that rose with falling rates. The period ended with COVID as the 10-Year U.S. Treasury Bond bottomed around 50 basis points leading some to describe recent bond investing as "yield free risk" - a pun on "risk free yield" which is a phrase used to describe short-term treasury bonds.



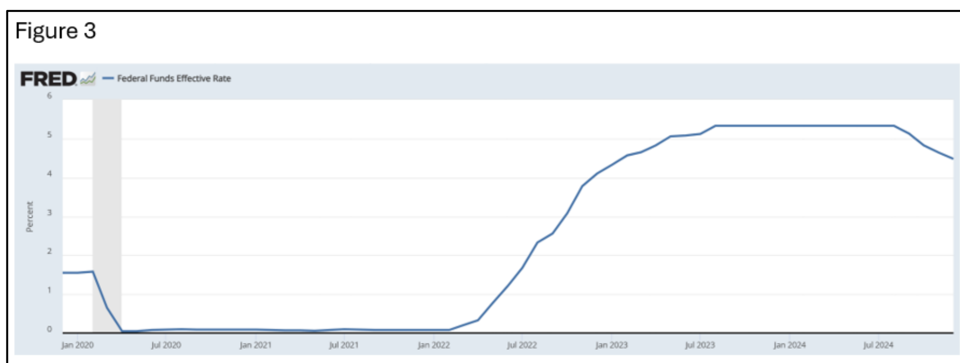
Coming out of COVID, we saw unprecedented government spending as evidenced by Figure 2 which shows the U.S. Federal Budget deficit by year since 2000.

As observed in Figure 2, we have not had a surplus in over 20 years, and the spike during and after COVID is particularly noteworthy (with the Federal Debt growing around $10 trillion in less than five years). While there are many factors that affected inflation coming out of COVID, government spending, which included checks mailed directly to citizens, and payroll subsidies (i.e., via the Paycheck Protection Program) likely played a significant role.[3]

Given the rise in inflation, the Fed acted by aggressively raising the Federal Funds Rate over 500 basis points in less than 18 months as can be seen in Figure 3 below. These increases pushed the FFR target up to a recent peak of 5.25-5.50%.

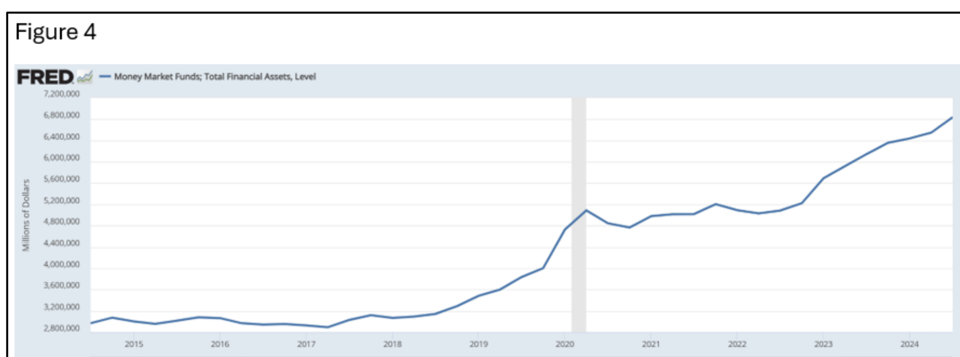
When the Fed raised the FFR, it caused short-term rates to exceed long-term rates - a phenomenon known as an "inverted yield curve." An inverted yield curve is an abnormal, restrictive and temporary condition.[4] It can be beneficial to investors, while the inversion persists, as abnormal (outsized) yields are realized on many types of variable-rate credit investments. The recent period is no exception as investors took notice of the inversion by parking money in "risk free" Treasury-bills and money markets. The surge in dollars in money market accounts is particularly noteworthy and has been well documented. Figure 4 below shows the unprecedented surge of dollars into money market accounts spurred by COVID stimulus policies coupled with the sharp rise in short-term interest rates.

Figure 3



Money markets are not the only beneficiaries during a yield curve inversion. For example, below are a few of the many types of assets that, generally, price off short-term interest rates. As investors saw rising yields but did not perceive an increase in risk, several of these sectors saw big asset inflows in 2024.[5]

Figure 4



Categories of Variable-Rate Credit Investments

- Ultra Short-Term Treasury Bond ETFs (e.g., T-Bill conduits)
- Mortgage-Backed Securities ("MBS" and "CMBS")
- Private Real Estate Credit (Senior)
- Collateralized Loan Obligations ("CLOs")
- Bank Loans/Leveraged Loans
- Private Corporate Credit
- Private Infrastructure Credit (Senior)
- Variable-Rate Preferred Shares

Most of these sectors have been enjoying abnormally high yields over the last several years. For example, if one believes that "neutral" short term rates (i.e., the level at which rates are neither stimulative nor restrictive) is around 3.0%-4.0% as the Fed suggests[6], then these investments have recently been enjoying a temporary boost in yield of 150-250 basis points (annualized) above their expected longer-term run rates. In fact, most have been losing yield since the third quarter of 2024 as the Fed brought the FFR target from 5.25-5.5% to 4.25-4.50% (a full 100 basis point drop). Given that there is often a lag before these cuts affect dividends, variable-rate income tools are likely to continue to experience yield reductions in the coming months.

We believe it is time to check your portfolio for falling interest rate exposure. We looked at the largest ETFs in each category that we believe are likely to be immediately and materially affected by falling rates and found well over $200B in investor ETF exposure (Figure 5). The actual exposure is considerably higher as Figure 5 excludes variable-rate credit exposure that investors have obtained through continuous offered closed end funds (i.e., "interval funds"), mutual funds, private funds and directly held security portfolios.

Figure 5

Variable-Rate Credit ETF Category	Rank of ETF by Size (in Category)	Assets ($B)
US T-Bill	1	$36.8
US T-Bill	2	$32.1
US T-Bill	3	$19.1
Bank Loans	1	$9.9
Bank Loans	2	$8.7
Floating-Rate Corporate (CLOs)	1	$18.8
Floating-Rate Corporate (CLOs)	2	$1.8
Mortgage-Backed	1	$36.3
Mortgage-Backed	2	$19.7
Floating-Rate Treasury & Corporate	1	$17.6
Floating-Rate Treasury & Corporate	2	$8.2

Asset totals from VettaFi as of January 29, 2024

One should consider balancing variable-rate income investments with investment managers that seek to add alpha by actively managing interest rate exposures. One may find better overall performance and lower volatility by diversifying exposure in this way. At Thirdline Capital Management, we attempt to take advantage of opportunities along the yield curve – always seeking the highest risk-adjusted performance. Our specialty is investing in real estate for income. We presently believe that the best risk-adjusted returns in income investing can be found in the middle portion of the real estate "capital stack" (e.g., B-tranche of senior loans, mezzanine loans and preferred equity). Many of these investments are "fixed rate" exposures where yields are not a function of short-term rates and will not be adversely affected by a falling FFR. By adjusting exposures as opportunities permit, portfolio managers may be able to greatly improve the consistency of dividend yield which, in turn, may help investment advisors better target desired outcomes and achieve client objectives.

About the author

Mr. Eiben is Co-Founder and Co-Portfolio Manager at Thirdline Capital, an investment advisor and manager of a real estate credit interval fund and other private real estate investments. Prior to Thirdline, Mr. Eiben spent over 15 years at TFS Capital, a firm that specialized in developing liquid alternative investment strategies, where he served as a Portfolio Manager and Chief Operating Officer.

Notes

1. *Federal Reserve Bank of St. Louis, The Origins of Unconventional Monetary Policy in the U.S (Annual Report 2015)*
2. *Brighthouse Financial, Phil Melville, Federal Reserve Tightening Cycles – A Brief History (2022)*
3. *MIT Sloan School of Management, Betsy Verecky, Federal Spending was Responsible for the 2022 Spike in Inflation (2024)*
4. *Federal Reserve Bank of Chicago, Luca Benzoni , Olena Chyruk , David Kelley, Why Does the Yield-Curve Slope Predict Recessions? (2018) and FRED (Federal Reserve Economic Data), Federal Reserve Bank of St. Louis, 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant*
5. *Factset, Elisabeth Kashner, ETFs Went Bananas in 2024 (2025)*
6. *Board of Governors of the Federal Reserve System, Summary of Economic Projections and Minutes of Federal Open Market Committee (2024)*

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