

Interest Rate Environment and Asset Allocation Choices

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Abstract. Since the dawn of the 21st century, major global economies have maintained prolonged periods of low interest rates to stimulate economic growth, establishing a stable low-interest-rate macroenvironment. However, in recent years, driven by factors such as elevated inflation and tightening monetary policies, the global interest rate landscape has embarked upon a structural transition from prolonged low rates towards higher rates. This shift has profoundly impacted the pricing logic of financial markets and investors' asset allocation frameworks. Traditional allocation strategies now face the risk of becoming obsolete, creating an urgent need for systematic research to provide theoretical and practical support. Focusing on the impact of evolving interest rate environments on investors' asset allocation decisions, this analysis examines asset performance across different interest rate cycles, with a specific emphasis on transition periods. By examining representative cases of high and low interest rates, it traces the historical performance of various asset classes during distinct interest rate phases and presents data analysis. Research findings indicate that bonds and growth equities demonstrate superior performance during low-interest-rate periods, while value equities, commodities, and cash-like assets yield more stable returns during high-interest-rate phases. Key signals identifying interest rate transition periods—such as unexpected inflation surges and central bank policy shifts—are identified. Risk management strategies proposed include diversified allocation, dynamic duration adjustment, and increased allocation to inflation-hedging assets, offering practical guidance for investors to navigate interest rate cycles and optimise asset allocation.

Keywords: Global interest rate environment, Asset allocation, Interest rate cycle transition, Market signals, Risk management

1. Introduction

Since the 2008 financial crisis, the world has entered an era of prolonged low and negative interest rates, characterised by elevated asset valuations alongside accumulating credit risks. From 2022 onwards, synchronised interest rate hikes by central banks have heightened risks of global economic slowdown and recession, while amplifying financial market volatility and capital flows [1]. Existing research predominantly focuses on either low-rate or high-rate phases, with limited systematic analysis comparing transition signals and dynamic allocation strategies between these phases. This paper undertakes an empirical investigation into the impact of the global transition from prolonged low interest rates to elevated levels on asset allocation decisions [2]. It examines the risk-return

characteristics of different asset classes during low-rate, high-rate, and transitional phases; identifies signals of interest rate shifts; and explores volatility patterns and expectation management. This analysis employs multiple research methodologies: Firstly, a literature review method systematically synthesises domestic and international research on interest rate cycle theory, asset pricing logic, and the correlation between interest rate environments and asset performance. This clarifies the academic definitions of low-rate, high-rate, and transition periods, summarises existing research consensus and gaps in cycle classification and impact mechanism analysis, thereby laying a theoretical foundation for the research framework. Second, case studies will examine globally significant interest rate cycle phases, including prolonged low-rate periods and high-rate transition phases [3]. These analyses will dissect core drivers of rate adjustments, policy implementation pathways, and the practical impacts on equity, bond, and commodity markets across different stages. Thirdly, the descriptive analysis method combines market characteristics across different interest rate cycles to examine the risk profiles and return patterns of various assets during low-rate, high-rate, and transition periods. This approach identifies commonalities and distinctions in asset allocation strategies across these phases, effectively helping investors recognise interest rate inflection points. It facilitates the development of dynamic allocation strategies to enhance risk-adjusted returns, thus providing valuable insights for practice in asset management.

2. Case study on asset allocation in a low-interest rate environment

2.1. Case studies of typical low-interest-rate economies

Following the financial crisis, central banks worldwide adopted ultra-low and negative interest rate policies in an effort to counter recession and deflation through monetary easing, with the goal of restoring economic growth. This paper analyses the period of ultra-low interest rates in the United States after the 2008 financial crisis and the European Central Bank's negative interest rate period from 2014 to 2022 as case studies. During 2007-2008, the United States experienced a sharp decline in GDP and unemployment rates exceeding 10%, triggered by the subprime mortgage crisis and the collapse of Lehman Brothers. Throughout this period, the US federal funds rate was progressively reduced from 4.75% to 0.25% by December 2008 [2]. Between 2008 and 2014, the US implemented three rounds of quantitative easing, signalling its intent to maintain low interest rates for an extended period [4,5]. By lowering rates, it stimulated economic growth and stabilised financial markets. Reduced corporate financing costs boosted corporate borrowing and consumer spending. At that time, low long-term sovereign bond yields highlighted the value of bond duration. Purchasing commodities provided a hedge against resurgent inflation. Within this low-cost financing environment, investing in real estate with leverage amplified total returns [6]. In 2014, the European Central Bank introduced negative interest rates [7]. This occurred against a backdrop of persistent economic stagnation in the Eurozone, where inflation remained below 2%, leading to rising unemployment, depressed corporate profits, and increased real debt burdens. Negative rates prompted banks to increase lending, lowering financing costs and supporting investment and credit expansion. The policy also depreciated the euro, enhancing foreign exchange competitiveness and boosting export volumes. In this context, the decline in risk-free rates facilitated purchases of medium-to-long-term sovereign bonds. Widening credit spreads encouraged investments in corporate bonds. Commodity purchases and real estate investments followed, as illustrated in Figure 1 [8].

ECB Agenda

Eurozone - ECB Benchmark Interest Rate Eurozone - ECB Total Assets
EU - MM AI ECB Statement Hawkish-Dovish Index

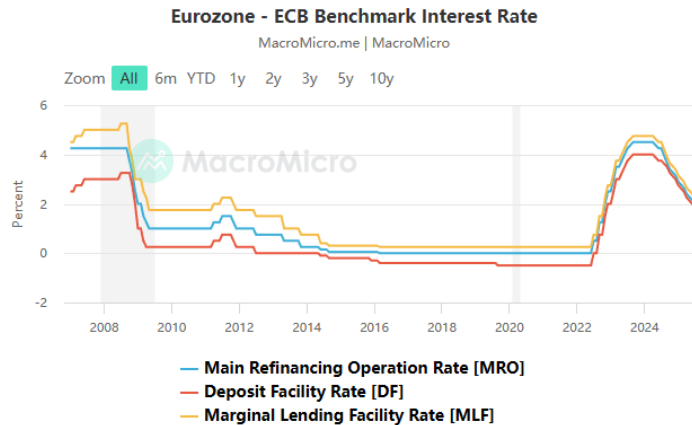


Figure 1. Eurozone-ECB benchmark interest rate [6]

2.2. Redefining asset allocation in a low-interest rate environment: institutional and individual perspectives

Amidst a global economic slowdown and accelerating population ageing, many major economies have entered an era of prolonged low and negative interest rates. These factors have reshaped the risk-return structure of financial assets. In September 2016, the Bank of Japan implemented an ultra-loose monetary policy featuring negative interest rates and yield curve control. The Japanese government sought to channel more capital into the real economy to stimulate growth and combat deflation. Prolonged negative rates rendered deposits and government bonds unprofitable, prompting individuals to shift holdings towards foreign equities and bonds. Meanwhile, reduced borrowing costs encouraged businesses to expand production and investment. This indirectly incentivised cross-border financing, enabling enterprises to secure overseas fixed-income streams that offset domestic yield shortfalls. Concurrently, the Swiss National Bank introduced negative deposit rates in 2015, similarly incentivising banks to lend funds to the market. Within this negative interest rate environment, individuals increased holdings of foreign sovereign bonds, commodities, insurance products, and tangible assets to preserve and enhance capital value. Businesses also expanded overseas operations at low cost during this period, shifting towards global high-yield bonds to secure stable cash flows. Thus, the negative interest rate era saw individuals turning to financial assets, driving up demand for secure and highly liquid holdings, while enterprises pivoted towards overseas investments [9].

3. Case studies in asset allocation under high-interest rate environments

3.1. Typical examples of global high-interest rate cycles

During periods of high inflation in the global economy, central banks will rapidly raise interest rates to increase borrowing costs and reduce money supply, thereby curbing excessive consumption and investment. This article analyses the Volcker Shock of the 1980s in the United States and the 2022 global wave of interest rate hikes. To tackle persistent US inflation, Paul Volcker raised the federal funds rate to 20% in 1980. This policy triggered a sharp decline in long-term bond prices, prompting

investors to purchase short-term bonds to reduce portfolio duration. Value stocks also emerged as a preferred choice during high inflation. Commodity prices, including gold and oil, surged, solidifying their role as effective inflation hedges [10,11]. In 2022, multiple central banks raised interest rates repeatedly to combat high inflation. Global government bond yields rose, bond prices fell, and market capitalisation evaporated. Capital flowed out of high-risk assets towards safer investments, intensifying volatility in both equity and bond markets. Inflation-linked bonds and commodity futures remained key inflation hedges, with investors turning to gold and energy stocks offering stable cash flows [12].

3.2. Price impacts and transmission mechanisms of high interest rates on core asset classes (bonds, equities, commodities)

When benchmark interest rates rise, the coupon rates of existing bonds become relatively less attractive, leading to a fall in market prices. Moreover, short-term interest rates are directly affected by rate hikes. In 2022, the Federal Reserve implemented substantial rate hikes, pushing the yield on 10-year US Treasuries to approximately 4% by year-end – an increase of around 238 basis points. Treasury prices and yields maintain a stable inverse relationship. In a high-interest-rate environment, capital flows shift from high-risk equities towards lower-risk bonds. Rising rates directly increase the discount rate applied to future cash flows, causing greater declines in highly valued sectors. In 2022, once the 10-year US Treasury yield exceeded 3%, investors redirected substantial capital from equities to bonds. The S&P 500 index declined by approximately 18% during the year, with highly leveraged growth stocks suffering even steeper losses. Rising interest rates directly increase storage and financing costs, thereby reducing market demand and depressing both spot and futures prices. Interest rate hikes are typically accompanied by a strengthening US dollar, which depresses dollar-denominated commodities and further curbs demand. In 2023, as central banks led by the Federal Reserve continued raising rates amid high inflation, copper prices declined rapidly [13,14].

4. Interest rate transition period: signal capture and market volatility management

4.1. Identifying market signals during interest rate transition

During interest rate transitions, markets emit pertinent signals whilst central bank announcements exhibit inherent lag. This analysis examines three signal categories: policy rate expectations, inflation expectations, and 2-year versus 10-year US Treasury yields. Should Fed Funds Futures indicate short-term rates commencing downward adjustment, this suggests rate hikes may be nearing conclusion. Taking September 2024 as an example: from 3rd to 16th September, the futures curve flattened from an upward trajectory, with the Fed announcing a rate cut on 19th September. The 5Y5Y Breakeven Rate measures market expectations for inflation over the next five years; a sharp decline of over 20 basis points within a short period suggests potential rate cuts. In early September 2024, yields dropped by 80 basis points over the two days of 3rd to 5th September. Prior to rate cuts, the yield curve between 2-year and 10-year US Treasuries typically shifts from inversion to steepening. For instance, on 10th September 2024, the 2-year yield stood at 3.59% while the 10-year yield was 3.65%.



Figure 2. 30-day federal funds interest rate futures [15]

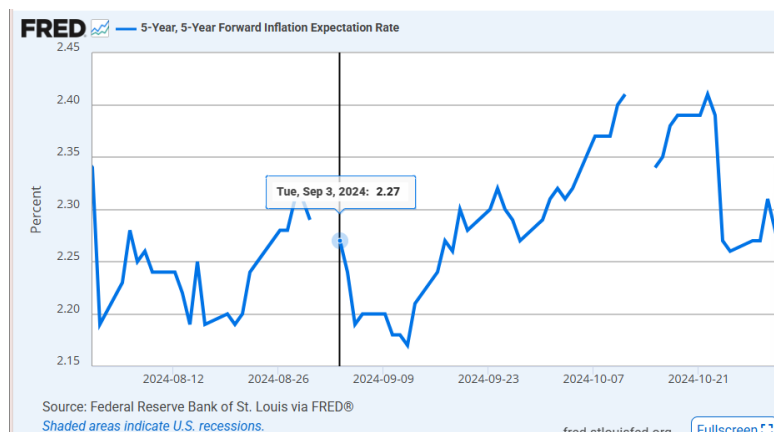


Figure 3. 5-year forward inflation expectation rate [16]

4.2. Volatility characteristics and expectations management during interest rate transition periods

Near interest rate inflection points, heightened market uncertainty regarding future policy can trigger significant fluctuations across various interest rate products, leading to increased volatility. Central banks' communication strategies can either amplify or stabilise such volatility in uncertain environments. Typically, implied volatility in 2-year interest rate swaps rises most rapidly, followed by products with maturities exceeding 10 years. This occurs because traders are more sensitive to short-term policy shifts, often expressing their expectations of rate hikes or cuts through derivatives first. Adjustments to long-term rates, however, require the combined influence of economic fundamentals and market inflation expectations, resulting in lagging volatility. After rates peak, market volatility first declines as more data and policies emerge, subsequently stabilising at a normalised level. This rhythm assists investors in managing position sizes at elevated levels and acquiring positions during lows. During transitional periods, central banks signal potential rate adjustments through statements, reducing market speculation and curbing excessive short-term volatility. Consistent and coherent statements bolster market confidence, suppressing volatility. Conversely, contradictory messaging heightens uncertainty and fuels increased volatility.

5. Conclusion

This paper examines the historical performance of various asset classes under high and low interest rate environments, alongside market signals and risk management during transition periods, focusing on the global interest rate transformation process. The case studies primarily cover

developed markets, with inadequate analysis of interest rate cycles and asset class performance in emerging economies. The quantitative models rely predominantly on historical data and descriptive statistics, omitting extreme events and multiple factors such as sudden policy shifts, investor sentiment, and preferences. This paper also suffers from limitations in data and literature. Future research will expand the sample analysis to incorporate data from BRICS nations and other emerging markets, comparing the performance of various asset classes across developed and emerging markets. During interest rate transition periods, research will also examine the valuation of financial sector equities and the correlation between social media sentiment and interest rate expectation signals.

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