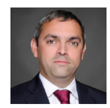
**T. ROWE PRICE INSIGHTS**
ON GLOBAL FIXED INCOME

# Three Critical Questions Facing Fixed Income Investors in 2021

Why a flexible approach is necessary in this challenging environment.

January 2021

**Arif Husain**
*Head of International Fixed Income, Lead Portfolio Manager of the Dynamic Global Bond Fund*


## KEY INSIGHTS

- The current bond market landscape raises serious questions for investors about fixed income diversification power, return potential, and liquidity profile.
- Potential for greater volatility in government bond prices, particularly at the long end of curves, is likely to require a more flexible approach.
- The T. Rowe Price Dynamic Global Bond Fund successfully navigated the volatility and large price swings witnessed in 2020 to deliver its goals of regular returns, downside control, and diversification.

While a new year may be underway, at least one thing remains the same: low bond yields. We believe that the challenges and risks this environment presents may not be fully understood by investors. For that reason, we have identified three questions that we believe investors should consider: focusing on the diversification power of bonds, their performance potential, and their liquidity profile for 2021.

## 1 Diversification—Do Bonds Still Deliver Diversification Benefits?

Traditionally, fixed income has been a diversifying asset class that typically performs well when risk markets such as equities sell off. This means that bonds have often been used by investors as risk mitigation to keep portfolios balanced. However, many are questioning whether this approach is still as effective with bond yields so low—and with good reason. In the first quarter of 2020, the main German stock index fell 25%,[1] but German bunds[2] only rose 2%, indicating that the diversification power of bonds may be much less potent in the current low interest rate environment. If this is the case, it follows that government bonds should no longer be the sole risk mitigation tool for investors and that finding new sources of diversification should be a priority in 2021.
We believe that this will require a portfolio construction that is more agile and uses relative value positioning, volatility trading-based instruments, and in-depth research to benefit from potential decorrelated opportunities.

> ...Finding new sources of diversification should be a priority in 2021.

[1] Source: Xetra DAX Index.
[2] Source: Bloomberg Barclays Euro-Aggregate Treasury Germany Index (See Additional Disclosures).

## Performance Table

(Fig. 1) Performance of the T. Rowe Price Dynamic Global Bond Fund (AUD) versus the Bloomberg AusBond Bank Bill Index

| | | | Annualized | | |
|---|---|---|---|---|---|
| | Three Months | One Year | Three Years | Five Years | Since Inception Feb. 18, 2014 |
| T. Rowe Price Dynamic Global Bond Fund—I Class (Net of Fees) (AUD) | 2.24% | 8.43% | 3.05% | 3.02% | 3.86% |
| Bloomberg AusBond Bank Bill Rate Index | 0.02 | 0.37 | 1.26 | 1.52 | 1.79 |
| **Value Added (Net of Fees[1])** | **2.22** | **8.06** | **1.79** | **1.50** | **2.07** |

As of December 31, 2020. Figures are calculated in Australian Dollars.
**Past performance is not a reliable indicator of future performance.**

[1] The Value Added is shown as the T. Rowe Price Dynamic Global Bond Fund (Net of Fees) minus the benchmark in the previous row. Net-of-fees performance is based on end-of-month redemption prices after the deduction of fees and expenses and the reinvestment of all distributions. Gross-of-fees performance is the net return with fees and expenses added back. Figures include changes in principal value. Investment return and principal value will vary, and an account may be worth more or less at termination than at inception.

Source: T. Rowe Price, Bloomberg and J.P. Morgan (See Additional Disclosures).

"...The March experience raises the question of which securities and sectors will be considered liquid in the future.

### 2 Yields—Where Next for Rock-Bottom Bond Yields?

The aggressive monetary policy actions of central banks have pushed bond yields down to historic low levels. Given ongoing uncertainties surrounding the pandemic, further moves lower in yields should not be ruled out. However, the biggest shifts are likely to be behind us now. The yield on the two-year U.S. Treasury bond, for example, ended 2020 at 0.12%—which is already within the fed fund's target rate range of between zero and 0.25%. It was a similar story in other core markets, such as Japan and Germany, at the end of 2020.

While central banks are unlikely to raise interest rates in the near future, the prospect of some sort of tapering should not be completely disregarded, especially if a rebound in economic conditions leads to inflation picking up. The pressure on yields could be exacerbated further should governments start to signal plans to loosen fiscal policy further after unprecedented spending during the pandemic. Against this backdrop, there is the potential for greater volatility in government bond prices, particularly at the long end of curves. We believe that active yield curve management will, therefore, be important in 2021, as will the ability to make dramatic shifts in duration posture. Inflation-linked bonds may also prove beneficial this year.

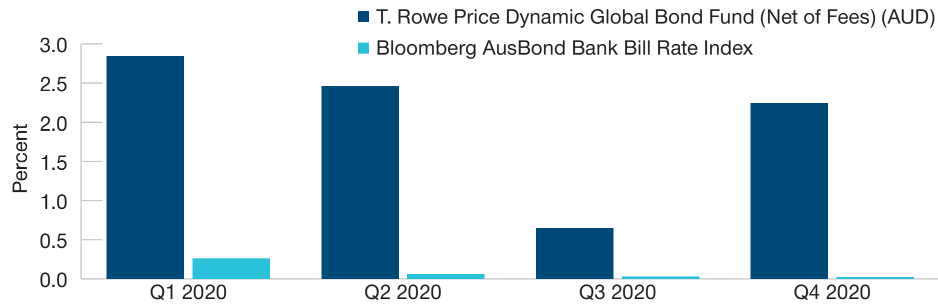
### 3 Liquidity—What Is Liquid in Your Portfolio?

In March 2020, we witnessed the first real collapse in liquidity conditions since the global financial crisis. It started with credit markets, and eventually, every segment of the bond market was affected, with price dislocation even occurring in some parts of the U.S. Treasury market at the height of the crunch. This episode provided a stark reminder that liquidity is rarely present when it is needed and that it is always important to undertake a forensic analysis of the liquidity profile of fixed income under different market environments.

Furthermore, the March experience raises the question of which securities and sectors will be considered liquid in the future. In our view, liquidity currently needs to be found elsewhere—for example, from currency markets and derivative instruments such as synthetic credit indices, which both provided liquidity while other assets

## Quarterly Performance Breakdown

(Fig. 2) Quarterly performance of the T. Rowe Price Dynamic Global Bond Fund—I Class (Net of Fees) (AUD)




As of December 31, 2020. Figures are calculated in Australian Dollars.
**Past performance is not a reliable indicator of future performance.**
Net-of-fees performance is based on end-of-month redemption prices after the deduction of fees and expenses and the reinvestment of all distributions. Gross-of-fees performance is the net return with fees and expenses added back. Figures include changes in principal value. Investment return and principal value will vary, and an account may be worth more or less at termination than at inception.
Source: T. Rowe Price, Bloomberg and J.P. Morgan (See Additional Disclosures).

struggled during 2020. Accordingly, we have increased our exposure to both. Increasing the use of option positions could also offer an opportunity to exploit sudden moves in volatility in 2021.

### How Our Absolute Return Approach May Help in This Environment

To navigate some of the challenges highlighted by the three questions listed above, we believe that a flexible approach could help. In the T. Rowe Price Dynamic Global Bond Fund ("the fund"), we have three clear goals that we seek to achieve:

#### 1. Regular Return

Aims to generate consistent and sustainable performance from coupon income and capital gains. Diversification across geography and markets is important—we benefit from a large global research platform that is the engine powering our investment ideas. Covering more than 80 countries, 40 currencies, and 15 sectors, our deep research capabilities enable us to uncover inefficiencies and exploit opportunities across the full fixed income investable base. But we do so in a disciplined way—managing risk is very important to us. We devote significant efforts to the analysis and monitoring of risk of each individual investment position, as well as the overall level of risk borne by the portfolio.

#### 2. Capital Preservation and Downside Risk Management

Aims to minimize losses and preserve capital through managing downside risks, such as a potential rise in interest rates. We have wide latitude to manage overall duration, which gives us the flexibility to adapt rapidly to different market environments and cycles, especially since our approach displays a high-quality profile. When interest rates are rising, for example, we can quickly cut duration to as low as zero in order to minimize potential losses, using instruments such as fixed income futures and interest rate swaps. By contrast, when rates are falling, we can increase duration to as high as six years to maximize gains. A good example of our tactical duration management was 2020. After kicking off the year with the portfolio's overall duration around zero, we quickly pivoted in February and significantly increased duration as the coronavirus situation escalated. The changes made, particularly moving from a short duration to a long position in U.S. duration, helped the fund deliver a positive performance in the first quarter at a time when many other bond investors struggled.

### 3. Diversification Away From Risky Markets

Aims to be a performance anchor during times of equity and risk market corrections. To help do this, we implement a number of defensive hedging positions, such as short positions on emerging market currencies, allocation to markets displaying defensive characteristics, or going long volatility through options, so that during periods of market turbulence, we could benefit from price falls of risky assets. We also have a high-quality bias—investing a large portion of our portfolio in high-quality and less volatile government bond markets where liquidity is better. This helps us to be dynamic and adapt quickly to changes in market conditions. It also gives us latitude to take advantage of possible pricing anomalies and dislocations that might occur, as in March 2020, when a huge sell-off in credit opened up a good opportunity to add select exposure at cheap prices. When it comes to credit, it's important to understand that we don't just buy and hold—exposures are managed actively. The best ideas are selected from our global research platform; then to help remove some of the credit beta, we typically utilize derivative instruments. This allows us to invest specifically in the position's alpha potential.

## 2020 at a Glance

| | Key Market Dynamics | Main Fund Responses |
|---|---|---|
| Q1 | ▪ Sudden rise in volatility with significant underperformance of credit markets.<br>▪ Flight to quality benefiting government bonds and the U.S. dollar.<br>▪ Liquidity challenged in most parts of the fixed income markets. | ▪ Rapid increase in total duration profile from early February.<br>▪ Implementation of specific short credit positions.<br>▪ Use of options to benefit from a rapid increase in volatility.<br>▪ Profits taken on most option-related positions at the end of March. |
| Q2 | ▪ Central bank inspired rally with ample supply of liquidity.<br>▪ Reopening of primary market in investment-grade corporate bonds.<br>▪ Upward revision in default expectations. | ▪ Duration profile maintained toward maximum of allowed range.<br>▪ Allocation to periphery debt within eurozone.<br>▪ Implementation of short U.S. dollar position vs. European currencies.<br>▪ Credit beta profile moved to small positive via participation in the investment-grade corporate bond new issuance and adding securitized debt. |
| Q3 | ▪ Developed market government bonds relatively stable.<br>▪ Search for yield pushed credit spreads tighter.<br>▪ Reopening of primary market in high yield. | ▪ Duration profile maintained toward maximum of allowed range before being reduced at quarter-end.<br>▪ Allocation to eurozone periphery debt increased and then reduced.<br>▪ Short U.S. dollar position maintained against developed market currencies.<br>▪ Within sectors, rotation into lower-rated securities and reduction of credit beta profile to neutral ahead of U.S. election.<br>▪ Cost-effective defensive hedging in place against potential new market dislocation. |
| Q4 | ▪ U.S. presidential election followed by COVID vaccine news pushed risky markets higher.<br>▪ Potential peak in high yield defaults.<br>▪ Inflation risk looming. | ▪ Duration profile moved to near zero.<br>▪ Rotation from developed market into emerging market local bonds.<br>▪ Allocation to inflation-linked bonds.<br>▪ Short U.S. dollar position recalibrated against European currencies and higher-yielding emerging market currencies.<br>▪ Credit beta profile moved into positive territory via long synthetic credit positions.<br>▪ Cost-effective defensive hedging in place against potential new market dislocation. |

> The year was an important test of our approach and we delivered for our clients what we set out to do…

### 2020—An Important Test of Our Approach

Through all the volatility and different market environments of 2020, the T. Rowe Price Dynamic Global Bond Fund—I Class (Net of Fees) (AUD) delivered a strong positive return compared to the Bloomberg AusBond Bank Bill Rate Index during every single quarter. The year was an important test of our approach, and we delivered for our clients what we set out to do—provide stable returns, capital preservation, and diversification away from risk markets.

Looking ahead to this year, there are four themes that currently underpin the bullish tone in financial markets: ultra-accommodative monetary policy, expansionary fiscal policy, significant pent-up demand for services, and expectations that vaccines introduce a return to a more normal life.

As long as these themes continue, the positive tone underpinning markets is likely to remain in place. On our side, we will continue to follow our trusted investment process and strive to maintain a portfolio that strikes a balance between country, duration, and yield curve positioning to take advantage of relative value opportunities globally while also managing downside risks. We believe that flexibility will be key in 2021, which is conducive to our fund as we have the ability to be nimble and adapt quickly to changes in market conditions.

**Additional Disclosures**

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T. Rowe Price®



ID0003984 (01/2021)
202101-1493891