Central Banks Diverge in Response to Inflation

How differences are creating opportunities in fixed income.

November 2021

KEY INSIGHTS

- Although some central banks are responding to price rises with aggressive interest rate hikes, others remain resolutely dovish despite consistently high inflation prints.
- Such divergences create attractive opportunities for relative value positions between countries, in our view.
- We see attractive value in countries that have progressed further in their hiking cycles versus those that are reluctant to act on inflation.

Inflation is a dominant theme across financial markets, yet central banks have responded in different ways. This variation is creating attractive opportunities, which the investment team discussed in detail during its latest policy meetings.

"Advanced Hikers" vs. "Reluctant Hikers"

Rising prices are evident across almost all countries, but this has not prompted a standard reaction from central banks. Effectively, two camps have emerged. The first are "advanced hikers"—central banks that have already responded to inflation by tightening monetary policy and raising rates. This group includes Norway and emerging market countries that have hiked multiple times this year, such as Russia, Brazil, and Chile.

The second group are what we refer to as "reluctant hikers"—central banks that have taken little or no action so far and remain resolutely dovish because they expect price pressures to be temporary. In this category, we include the European Central Bank, the Bank of Japan, Sweden's Riksbank, and the U.S. Federal Reserve.

"The bond market has been increasingly discriminating between how central banks are responding to inflation, and we expect this trend to continue," said Quentin Fitzsimmons, a portfolio manager and member of the fixed income investment team. This type of environment is likely to create a dispersion in relative value opportunities that should benefit active managers such as T. Rowe Price, he added.

Finding Attractive Opportunities in "Advanced Hikers"

Across most "reluctant hiker" markets, bonds have outperformed of late. However, with yields remaining low, we believe valuations are expensive.

Global Fixed Income Team

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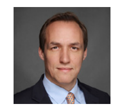

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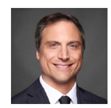

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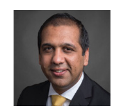

Saurabh Sud

Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

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> *Portfolio Manager*

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> *Portfolio Manager*

Furthermore, curves in these markets are typically flat, which leaves them potentially more vulnerable to long-end repricing.

By contrast, the bond markets of advanced hikers, particularly those in emerging markets, have been under heavy selling pressure. This is creating a situation in which pockets of attractive value are beginning to emerge in some local currency government bond markets.

"Select emerging markets bonds are starting to look appealing both from the absolute level of yield and from the curve shape," said Mr. Fitzsimmons, who cited Russia and Mexico as examples. "Let's not forget that there is the potential to earn greater income when curves are steeper," he said.

It is also important to remember that a period of tightening in emerging markets is typically followed by easing, which means that the advanced hikers of today could shift to cutting interest rates later down the line should growth slow and inflation concerns dissipate. If this happens, an opportunity to benefit from capital gains may arise. It is difficult to predict when the inflection point in emerging markets might occur, but we are monitoring developments closely.

The Conundrum of Slowing Growth

In developed markets, New Zealand, stands out as a potentially attractive advanced hiker because we believe sufficient tightening is priced into the curve and find the long end most appealing. Broadly speaking, though, there are fewer so-called advanced hikers in the developed market space as central banks are concerned that hiking or tapering too quickly could choke the recovery.

"The paradox of growth slowing at a time when inflation is rising is complicating central bank behavior in developed markets," said Mr. Fitzsimmons. He added that the Bank of England (BoE), for example, is "stuck between a rock and a hard place" as UK growth is slowing while wages and inflation more broadly are rising rapidly. At present, it seems likely that the BoE will hike before the end of the year. Whether this proves to be a wise decision given the slowing growth picture remains to be seen.

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