



Confronting the Challenges of Persistent Transitory Inflation

How to position against potential inflation risks in fixed income.

September 2021

KEY INSIGHTS

- Investors should factor in a higher premium for inflation as it continues to remain stubbornly high.
- Select developed market central banks could use the rise in prices as an opportunity to reset inflation expectations higher after years of missed targets.
- We believe astute active management is key to navigating the ripple effects created by inflation.

The peak in global inflation keeps being pushed higher, challenging the view that the current wave of price pressures is transitory (temporary). During our latest policy meetings, the investment team discussed the current inflation dynamics, how central banks are responding to them, and, in particular, how bond investors might seek to navigate the period ahead.

Time for a Higher Inflation Premium

Across developed markets, inflation has soared higher in recent months, driven by a combination of economies reopening, higher energy prices, and supply chain bottlenecks. In the eurozone and the UK, price pressures are close to decade highs, while in the U.S., annual consumer prices have risen above 5% for the first time since 2008.

“Almost everyone has been wrong about inflation this year—it continues to remain stubbornly high and reach new peaks,”

said Arif Husain, portfolio manager and head of International Fixed Income. “Given the conditions, it may be prudent for fixed income investors to factor a higher premium for the inflation risk,” added Mr. Husain.

So far, there are limited signs of this taking place in bond markets, where interest rates remain close to record lows. “The bond market appears to be firmly of the belief that the inflation spike is transitory, but this perspective is looking increasingly risky the longer prices stay elevated,” warns Mr. Husain.

Developed market central banks have hardly reacted to the rise in inflation because, as shown by their forecasts, they expect the pressures to be temporary and cool by next year. For example, the European Central Bank (ECB) expects headline inflation to fall from an average of 2.2% this year to 1.7% in 2022.

Global Fixed Income Team



Arif
Husain



Andrew
Keirle



Kenneth
Orchard



Quentin
Fitzsimmons



Ju Yen
Tan



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.

“The bond market appears to be firmly of the belief that the inflation spike is transitory, but this perspective is looking increasingly risky...”

— Arif Husain
Portfolio Manager,
Head of International Fixed Income

“I believe this theme of persistent transitory inflation will manifest itself at different times in various geographical locations...”

— Arif Husain
Portfolio Manager,
Head of International Fixed Income

Opportunity for Central Banks to Reset Inflation Expectations

At present, central banks are merely signaling the start of dialing back crisis-era support—they are not proposing to remove accommodative policies or tighten monetary policy yet.

There is a risk that central banks may fall behind the curve in tackling inflation—though in some cases this might be deliberate. For the past decade, many developed countries have been stuck in a low inflation environment despite the best efforts of central banks to engineer pressure on prices. “The current price spike could act as a potential opportunity for select developed central banks to reset inflation expectations higher after years of failing to meet their price target,” noted Mr. Husain.

The ECB may be one of those banks, as the recent sharp rise in European energy prices is expected to drive inflation temporarily above target. “The ECB will likely not lean against temporary inflation pressures generated by the energy price rise but instead keep policy easy to help generate second-round effects,” said Mr. Husain.

The potential for political change in Europe could also tilt inflation to the upside, which we believe bolsters the compelling case for inflation-linked bonds in the region. For example, Germany’s next coalition government is likely to increase spending, which could potentially stimulate greater inflation.

Exploiting Potential Inflation Risk in Bond Portfolios

Flexibility has been key to navigating inflation so far in 2021, and we expect this trend to continue. It has become apparent over the course of the year that not all inflation-mitigating instruments

work at the same time, and this served as a reminder that dynamism is required to access the full opportunity set.

In the first three months of the year, for example, underweight duration positions in developed countries such as the UK and the U.S. typically performed well as yield curves steepened on the back of rising inflation expectations. When yields began to fall in the second quarter, however, these positions no longer worked. Then in June, after the Federal Reserve had finally acknowledged the risk of inflation, short-dated U.S. inflation-linked bonds appeared to work well.

Looking beyond developed markets has also been important this year. For example, being underweight duration in select Eastern European countries, such as Poland and Hungary, where inflation pressures were rising also proved beneficial at times.

At present, we believe that inflation risk may be managed through exposure to eurozone inflation-linked bonds, as inflation expectations remain largely underpriced in Europe compared with the U.S. Another way of managing the inflation threat could be to adopt short-duration positions in countries where price rises could potentially be more structural. This includes the UK, where shortages in global goods and labor supply problems should drive further price rises later this year.

“I believe this theme of persistent transitory inflation will manifest itself at different times in various geographical locations, so while pressure may subside in one region, it could rise in another. It is, therefore, important to keep monitoring the conditions and adapting to them as they change,” said Mr. Husain.

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

T. Rowe Price[®]

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2021 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.