



Long-Dated Credit Can Boost Returns in a Tightening Environment

Shorter-dated bonds are typically hit harder by rising inflation and low growth.

March 2022

Last month, the U.S. Federal Reserve reiterated its intention to begin raising interest rates this month. Since then, Russia has invaded Ukraine, injecting a heavy dose of uncertainty into the economic outlook. The ongoing war will have an inflationary consequence globally via, for example, reduced supply of energy and perishable commodities such as wheat. While the increased uncertainty complicates the economic picture, these inflationary developments are unlikely to derail the Fed's monetary tightening path. For investors, then, the challenge of how to position their portfolios for a rising rate environment remains a pressing one.

The Fed's announcement last month was hardly a surprise. Stubborn inflationary trends caused by post-pandemic easy monetary policy, supply chain disruptions, and rising energy prices have been a source of anxiety in markets for some time. Looming inflation puts pressure on central banks to tighten policy, which causes trouble for credit investors in two ways: first, rising bond yields have typically hit corporate bonds hard because of the duration embedded within them; and second, corporate bond spreads tend to be adversely affected by tighter financial conditions. In this article, we'll focus on the latter.

Kenneth Orchard

Portfolio Manager

Onur Uncu

Quantitative Analyst

Higher policy rates generally make corporate borrowing more expensive as investors demand a premium over the policy rate when they lend to corporates. Rising borrowing costs eat into corporate profits, which is negative for corporate bond spreads.

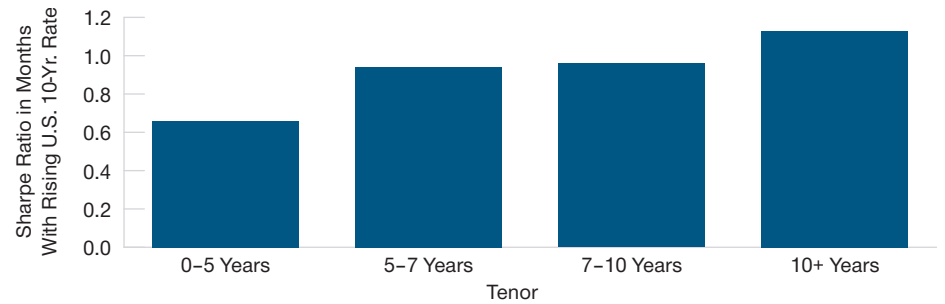
Not all corporate bonds are equal, though. Monetary policy tends to normalize in the long term as growth slows and/or inflation subsides. Aware of this, the markets tend to price in the fact that shorter-term bonds will be heavily exposed to short-term risks while longer-dated bonds will likely benefit from a normalization of conditions. This is evidenced by the fact that, historically, the Sharpe ratios (a measure of risk-adjusted returns) of longer-dated U.S. investment-grade (IG) corporate bonds have been higher than shorter-dated IG bonds when yields rose (Figure 1). This suggests that credit investors may be able to boost performance in the period ahead by allocating more to longer-dated credit.

Higher policy rates generally make corporate borrowing more expensive...

— Kenneth Orchard
Portfolio Manager

Longer-Dated U.S. IG Credit Has Outperformed During Periods of Rising Yields

(Fig. 1) Markets price in the normalization of policy in the long term



As of February 28, 2022.

Past performance is not a reliable indicator of future performance.

Based on monthly credit excess returns data between January 2000 and February 2022.

We take monthly credit excess returns for each of the four tenors above. For each month, we calculate the change in the U.S. 10-year rate. We then take the subset of the months where the U.S. 10-year rate has gone up. On that subset, we calculate the annualized excess returns and volatility for each tenor. Sharpe ratio is calculated as the ratio of annualized excess returns divided by annualized excess return volatility.

Sources: Bloomberg Indices, Bloomberg Finance L.P.

“...unless inflation falls back, the Fed is likely to continue tightening...”

— Onur Uncu
Quantitative Analyst

It's worth noting that the current tightening conditions differ from previous ones in a way that spells more risk for corporate bond spreads. Over the past 40 years, the Fed's main goal with tightening has been to slow growth and prevent economic overheating; this time, it is trying to control inflation. This means that unless inflation falls back, the Fed is likely to continue tightening, even if growth is weaker than during previous tightening periods, which would hit shorter-term credit harder than longer-dated credit. An extended war in Ukraine could exacerbate this still further given that wars are invariably inflationary.

Positioning at the long end of the credit curve has the additional benefit of being cash-efficient. Long-dated bonds tend to have higher “duration times spread” (a measure of the credit volatility of a corporate bond) per dollar invested. This means that a target risk level can typically be achieved with a smaller cash outlay. Allocating to longer-dated corporate bonds, therefore, should allow investors to unlock cash that may then be used in other ways to generate yields, such as purchasing Treasury inflation protected securities (TIPS).

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.

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—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.

Mainland 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 mainland of the People's Republic of China ("Mainland China", not including the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the Mainland China. 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 Mainland China. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the Mainland China that are expressly authorized under the laws and regulations of the Mainland China to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the Mainland China. Potential investors who are resident in the Mainland China are responsible for obtaining the required approvals from all relevant government authorities in the Mainland China, 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 Mainland China, or nationals with permanent residence in the Mainland China, or to any corporation, partnership, or other entity incorporated or established in the Mainland China.

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. (UEN: 201021137E), 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.

© 2022 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.