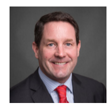
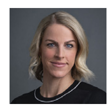
High Yield Bonds Could Prove Resilient as Inflation Surges

Shorter durations, higher yields could provide a buffer as rates rise.

April 2022



Kevin Loome, CFA
Portfolio Manager, US High Yield Bond Strategy



Ashley Wiersma
Portfolio Specialist

KEY INSIGHTS

- Below investment-grade bonds tend to be more resilient in rising rate environments because of their higher yields and shorter durations.
- High yield bonds have generated positive returns in periods of rising interest rates during the last 15 years.
- However, high yield bonds are not immune to the effects of inflation, so we actively try to manage inflation risk in the strategy.

Inflation and rising rates have left many investors wary of investing in bonds as traditional fixed income asset classes—which have relatively low yields and more sensitivity to interest rate risk—have historically not fared well in this type of climate. However, fixed income strategies that specialize in below investment-grade credit such as high yield bonds and bank loans tend to be more resilient in these environments. This stems, in part, from the higher yields and shorter durations[1] of these segments.

Inflation and the Fed

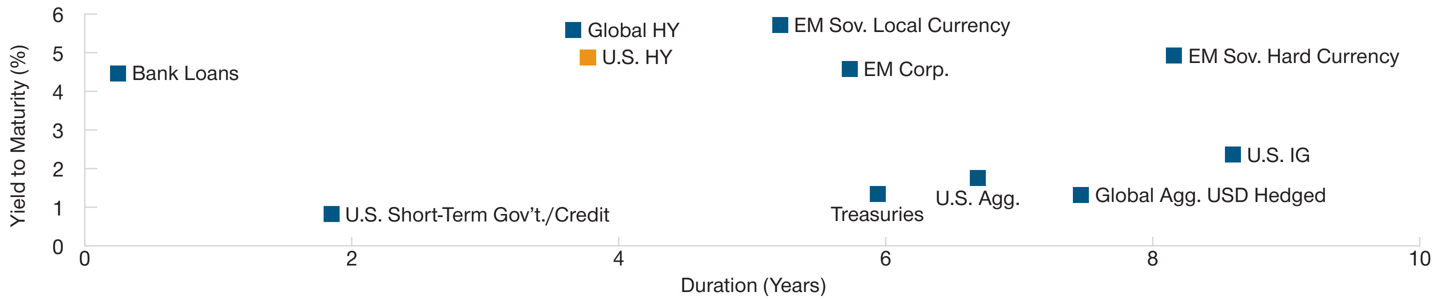
Broad-based supply disruptions stemming from pandemic-related shutdowns and more recently from the Russian invasion of Ukraine have affected everything from transportation to labor to raw materials, which has resulted in higher prices for many goods and services. This, coupled with pent-up demand as economies reopen and consumers are flush with savings and eager to spend after prolonged lockdowns, has brought inflation rates to levels not seen since the early 1980s.

The Federal Reserve has two primary tools for managing inflation—increasing rates and tightening monetary supply by reducing the size of its balance sheet. Keeping inflation near a 2% target and maintaining full employment form the central bank's mandate. After taking a patient approach throughout most of 2021, the Fed has recently pivoted to a much more hawkish tone, and markets now expect rate increases and balance sheet reductions to occur at a much quicker pace.

[1] Duration measures a bond's sensitivity to changes in interest rates.

Attractive Yield Relative to Duration

(Fig. 1) Yield versus duration



Past performance is not a reliable indicator of future performance.
As of December 31, 2021.
Source: Data analysis by T. Rowe Price.
U.S. High Yield represented by ICE BofA U.S. High Yield Constrained Index; Bank Loans by S&P/LSTA Performing Loan Index; U.S. Short-Term Gov't./Credit by Bloomberg 1–3 Year Government/Credit Index; Global High Yield by J.P. Morgan Global High Yield Index; EM Corporate by J.P. Morgan Corporate Emerging Market Bond Index Broad Diversified; EM Sovereign Local Currency by J.P. Morgan Global Bond Index–Emerging Markets Global Diversified; EM Sovereign Hard Currency by J.P. Morgan Emerging Markets Bond Global Index; U.S. Agg. by Bloomberg U.S. Aggregate Bond Index; Treasuries by Bloomberg U.S. Treasuries 4–10 Year Index; Global Agg. USD Hedged by Bloomberg Global Aggregate USD Hedged Index; U.S. Investment Grade by Bloomberg U.S. Corporate Investment Grade Index. Bloomberg Index Services Limited. See Additional Disclosures.

High Yield Bonds Tend to Be Less Affected by Rising Rates

In an environment of rising rates, a shorter duration means less downside risk because money can more quickly be reinvested into newer bonds at higher rates. Meanwhile, higher yields (coupons) provide an added level of income return potential, which can provide a meaningful cushion to help offset any price declines. Additionally, rising rates are typically the product of strong economic growth, and a robust economy tends to boost corporate earnings and revenues. This can make it easier for high yield issuers to service their debt, thereby reducing overall default risk.

As a result, returns of high yield bonds tend to be negatively correlated with U.S. Treasury returns. In fact, over the 15 years ended December 31, 2021, high yield bonds exhibited a -0.3 correlation[2] with 10-year Treasuries. A negative correlation means that if U.S. Treasuries are expected to lose value when rates rise, then high yield bonds should actually increase in value.

Looking back at historical periods of rising rates, this has indeed been the case. As Figure 2 shows, there have been six time periods where interest rates rose by 100 basis points[3] or more over the last 15 years. High yield bonds produced positive performance results in each of those periods, with an average cumulative return of 9.39% (second only to their close relative, bank loans). It is worth noting that yields today are starting from a lower point than they have in the past; therefore, it may be important for investors to temper expectations for future returns.

[2] Correlation measures how one asset class, style, or individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one security moves, either up or down, the other security moves in lockstep, in the same direction. A perfect negative correlation means that two assets move in opposite directions, while a 0 correlation implies no relationship at all.
[3] A basis point is 0.01 percentage point.

High Yield Has Been Resilient in Rising Rates

(Fig. 2) Cumulative high yield returns when 10-year Treasury yield rose more than 100 bps

Period	Beginning Date	End Date	10-Year Treasury Move	U.S. High Yield	Loans	U.S. Agg.	10-Year Treasuries	U.S. Short-Term Gov't./Credit
1	12/31/08	06/10/09	189 bps	29.88%	32.50%	-0.20%	-11.99%	1.28%
2	10/08/10	12/28/10	110 bps	1.52	2.50	-2.82	-8.14	-0.54
3	07/24/12	09/05/13	161 bps	9.62	7.54	-3.57	-10.13	0.36
4	07/08/16	12/15/16	124 bps	5.23	4.78	-4.28	-9.87	-0.66
5	09/08/17	11/08/18	119 bps	2.68	5.81	-2.93	-7.17	-0.03
6	07/31/20	03/31/21	120 bps	7.39	8.38	-3.56	-9.79	0.21
Average				9.39	10.25	-2.89	-9.52	0.10
Median				6.31	6.68	-3.25	-9.83	0.09

Past performance is not a reliable indicator of future performance.
As of December 31, 2021.
Source: T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.
U.S. High Yield represented by ICE BofA U.S. High Yield Constrained Index; Loans by S&P/LSTA Performing Loan Index; U.S. Agg. by Bloomberg U.S. Aggregate Bond Index; U.S. Short-Term Gov't./Credit by Bloomberg 1–3 Year Government/Credit Index. Bloomberg Index Services Limited. See Additional Disclosures.

"...returns of high yield bonds tend to be negatively correlated with U.S. Treasury returns.

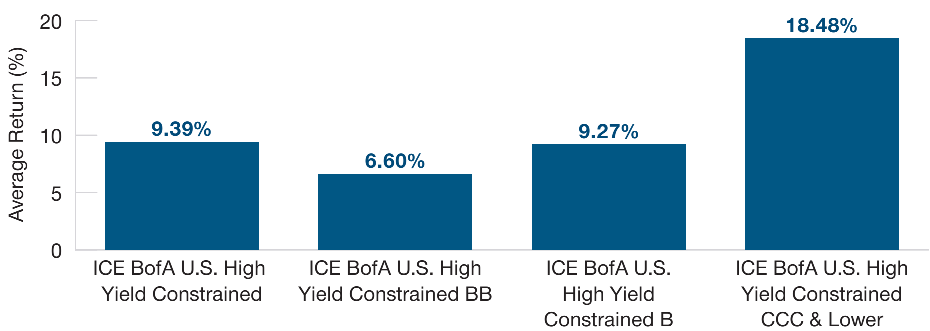
Taking a deeper look and breaking out these high yield bond returns by credit rating, it is evident that the lower quality tiers within the high yield market have tended to generate the strongest returns in these past rising rate environments. Though our portfolio is well positioned to benefit from this trend given our overweight to the lower quality tiers of the market, we are cognizant of the fact that this will reverse at some point in the credit cycle.

Yet Not Immune to the Effects of Inflation

Though high yield bonds tend to be somewhat insulated from the effects of inflation and rising rates relative to many other fixed income asset classes, they certainly are not immune. There are three primary ways that we seek to manage inflation and interest rate risk in the US High Yield Bond Strategy. First, we have maintained an underweight to BB rated bonds (the highest credit

Lower-Rated High Yield Has Outperformed in Rising Rates

(Fig. 3) Returns by credit rating when 10-year Treasury yield rose more than 100 bps



Past performance is not a reliable indicator of future performance.
As of December 31, 2021.
Source: T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

> "...we naturally look to avoid areas of the market where we expect that inflation will serve as a greater headwind..."

rating rung of the non-investment-grade universe), which tend to have the highest interest rate sensitivity in the high yield market. Second, the strategy typically has meaningful allocations to bank loans, which currently offer similar yield to below investment-grade bonds but with shorter duration given their floating rate coupons. The third way that we manage inflation risk is through sector allocation and security selection, which we discuss further below.

Analyzing the Impact of Inflation on Issuers and Sectors

Inflation has become so rampant and widespread that it is virtually impossible to name an industry or sector that has been untouched by its effects. As part of our bottom-up fundamental credit analysis, we assess the impacts of inflation as we evaluate both current and new investment opportunities. As part of this process, we find ourselves asking questions like:

1. Has inflation driven up the cost of key inputs (e.g., raw materials, transportation, labor, etc.) within this sector or for this issuer?
2. Are the effects of inflation transitory, or are they likely to be felt over the longer term? Why?
3. Does the issuer have the ability to pass higher input costs through to customers via higher prices? To what extent is customer demand for the issuer's goods or services elastic or inelastic?
4. What supply chain issues exist? When and how do we expect those issues to be resolved?
5. What net impact will inflation have on the profitability of the issuer's overall business?

Examining the Impact of Inflation

	Inflation Assessment
Industry: Restaurant **Description:** Fast Food Franchise **Outcome:** Exited Position	▪ Inflation led to significantly higher input costs for food and labor. ▪ Viewed higher food costs as transitory but expected more persistent labor inflation. Issuer did not have the ability to meaningfully pass higher costs through to customers via higher prices due to highly elastic customer demand.
Industry: Energy **Description:** Natural Gas-Oriented Exploration and Production Company **Outcome:** Increased Position	▪ Constructive view on commodity prices should benefit company earnings and revenues. ▪ Necessity travel, in addition to pent-up demand for both ground and air travel for leisure, should continue to drive demand and allow for some degree of price elasticity. ▪ Attractive relative value, room for further spread compression, potential for merger and acquisition activity.
Industry: Automotive **Description:** Designer, Manufacturer, and Distributor of Aftermarket Vehicle Enhancements **Outcome:** Reduced Position; Held	▪ Impressive pricing power, supportive enterprise value† multiples, sensible corporate strategy, sizable market share. ▪ Positive industry backdrop for sales of both new and used vehicles given pent-up demand. ▪ Rising price of key input (aluminum) served as sizable headwind that could impact performance.
Industry: Metals and Mining **Description:** Copper Producer **Outcome:** Initiated Position	▪ Attractive low-cost profile relative to peers, prudent management team, mining permits on hand and ready to execute versus competitors more dependent on approvals from regulators. ▪ Constructive view on copper prices over medium term. ▪ Attractive pricing given it was a first-time issuer in the high yield market.

For illustrative purposes only. This is not intended to be investment advice or a recommendation to take any particular investment action.

† Enterprise value is a company's equity market capitalization plus its total debt minus its cash and cash equivalents.

As we develop answers to these questions, we naturally look to avoid areas of the market where we expect that inflation will serve as a greater headwind and add exposure to parts of the market that we believe will fare better, unless our broader fundamental and relative value analysis of the opportunity directs us otherwise. We show a few recent examples in the Examining the Impact of Inflation section.

Defaults Expected to Stay Low Through 2023

Overall, our outlook for high yield bonds remains constructive. Though credit spreads[4] are tight, default rates remain near historic lows as many companies have taken advantage of low rates over the last 12 to 24 months to refinance and extend their debt. With no meaningful waves of maturing bonds on the near-term horizon, we expect defaults to remain low through 2023. Given that credit risk is the primary risk associated with high yield, we believe this backdrop should bode well for the asset class in the near to intermediate term.

Additionally, high yield bonds can offer an attractive risk/reward profile that combines much of the upside potential associated with equities with some of the downside protection and income associated with fixed income. We think this should be a compelling combination in the current environment of low but rising yields and equity valuations that started the year appearing stretched before encountering selling pressure.

Credit Selection to Remain Important Driver of Returns

As an active and concentrated U.S. high yield manager, we do not seek to make big macro calls on the direction of interest rates, nor do we seek to fully hedge out interest rate risk in our portfolio. With that said, we do strive to understand the impact that inflation and rising rates could have on the investment performance that we seek to deliver to clients and to position the portfolio accordingly. In doing this, we rely heavily on proprietary, bottom-up fundamental credit research, which we view as our competitive advantage.

Given the relatively tight credit spreads in the high yield market today, we believe credit selection will be an even more important driver of returns in the year ahead. We anticipate that periods of volatility could provide some windows of opportunity for active investors like ourselves to take advantage of temporary price dislocations in certain areas of the market.

WHAT WE'RE WATCHING NEXT

Aside from inflation and rising rates, the biggest risk that we see in the market today is a Fed policy mistake, such as hiking too quickly or too slowly or somehow surprising the market, as we enter a tightening cycle. Recent geopolitical tensions involving Russia and Ukraine have added another layer of complexity to markets and for the Fed. At the end of the day, high yield is considered a risk asset and, as such, could continue to experience bouts of volatility throughout the year as markets react to and digest the timing, pace, and scale of Fed communications and actions. We are also keeping a close watch on future maturity walls, which could force companies to refinance their debt at meaningfully higher rates, as well as on risks around the potential for stagflation (the combination of slow growth and high inflation).

[4] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

General Fixed Income Risks

Capital risk—the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

Counterparty risk—an entity with which the portfolio transacts may not meet its obligations to the portfolio.

Environmental, social, and governance and sustainability risk—may result in a material negative impact on the value of an investment and performance of the portfolio.

Geographic concentration risk—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk—the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk—operational failures could lead to disruptions of portfolio operations or financial losses.

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.RowePrice®

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.

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 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.

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.

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.

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

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 Investment Management, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

ID0004889 (04/2022)
202203-2083959