

THEME THREE

Flexible Fixed Income

U.S. Treasuries and other developed sovereign bonds did an exceptionally poor job of offsetting equity volatility in the first half. This suggests that investors may need to expand their search for diversification across fixed income sectors and geographic regions.

A key question, Page says, is whether the spike in stock/bond correlations seen in early 2022 was just temporary or reflected a structural “regime change” that could keep correlations high for an extended period. If the latter explanation is correct, alternatives to the traditional 60/40 stock/bond allocation that include dynamic hedging and other defensive strategies could offer advantages to some investors.

Stock/bond correlations have switched from positive to negative several times in recent years, Page notes (Figure 4). T. Rowe Price research suggests that these shifts typically were caused by economic shocks—sudden spikes in unemployment, inflation, or interest rates.

“I think Treasuries still have a role to play in portfolio allocations—especially if

the next leg of the crisis is a recession,” Page says. “But I also think investors are going to want to consider other approaches to downside risk mitigation.”

Is It Time to Extend Duration?

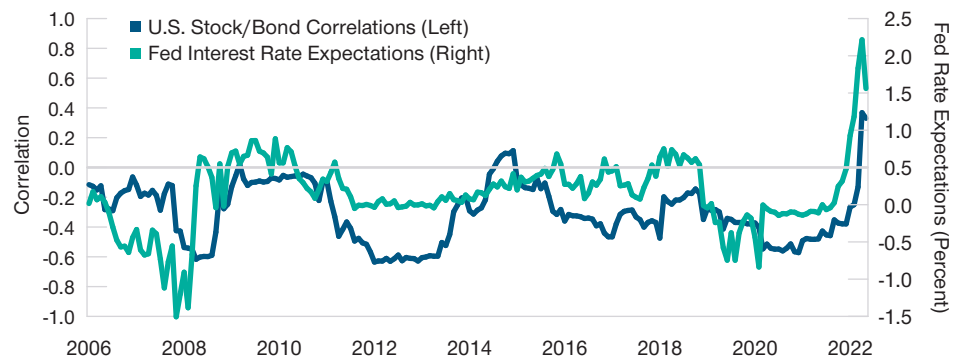
A more immediate issue for fixed income investors is whether bond yields have reached a near-term peak, creating a potential opportunity to lock in portfolio income.

“In our view, this is the most attractive point to buy bonds that we’ve seen for several years,” Husain says. “We think that over the next several quarters investors may want to consider adding duration.”

However, Husain also predicts that the Fed will continue tightening until it has pushed its key market rate, the federal funds rate, into positive territory in after-inflation terms. With the nominal fed funds rate still under 1% at the end of May, that would seem to leave considerable room for further rate hikes. As of early June, he adds, “I don’t think we’re quite at the peak for yields.”

In a Rising Rate Environment, Bond Investors May Need More Diversification

(Fig. 4) Fed rate expectations vs. U.S. stock/bond correlations*



Past performance is not a reliable indicator of future performance.

January 2006 through May 2022.

*Fed interest rate expectations = yield on two-year Treasury note minus federal funds target rate. U.S. stock/bond correlations = rolling two-year correlation of monthly price changes for the S&P 500 Index and the 10-year U.S. Treasury futures contract.

Sources: Standard & Poor’s, J.P. Morgan North America Credit Research (see Additional Disclosures), and Bloomberg Finance L.P. Data analysis by T. Rowe Price.

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— Arif Husain

Head of International Fixed Income and Chief Investment Officer

For U.S.-based investors worried about rising rates, global markets could offer diversification potential, Husain suggests. While the Fed is tightening, other countries are further along in their interest rate cycles. Some have stopped raising rates. Others have even started cutting them.

“By taking advantage of monetary policy divergence, investors can seek to diversify their interest rate exposures on a currency-hedged basis,” Husain explains. Recent valuation levels potentially make emerging markets (EM) U.S. dollar bonds particularly attractive, he adds, although both country selection and underlying security selection will be critical.

The Upside Potential of Higher Yields

If yields do continue to rise, Husain says, at some point they should reach levels that offer attractive income opportunities for investors who understand how to manage duration—or who can rely on skilled investment professionals to do it for them. “Over the medium term, I think yields will reach levels that will make clients happy with the income they’re getting from their bond portfolios,” he says.

Some credit sectors, such as high yield corporate bonds, may have reached that

point, Husain suggests. “Looking at the high yield universe, I’ve seen yields in the 7% to 8% range, in some cases,” he says. “I’ve seen some BB rated bonds priced at 80 cents on the dollar. Those are levels that historically have proven to be good buying points.”

The caveat to the bullish case for high yield is the uncertain economic outlook, Husain notes. As of May, high yield default rates remained near historical lows, and rating upgrades were more than twice as high as downgrades. But a growth shock could quickly change that picture.

“The threat of recession is real,” Husain cautions. “So investors need to do their homework.” For T. Rowe Price fixed income portfolio managers, he adds, this will mean relying on the firm’s extensive research capabilities and independent credit ratings to help navigate risks.

In volatile markets, duration management and yield curve positioning also could be important tools for managing risk, Husain suggests. “Fixed income is a relatively liquid asset class, so I would argue that investors could potentially benefit by using that liquidity to stay active,” he says.

FLEXIBLE FIXED INCOME

Investment Idea	Rationale	Examples
Globally Diversified Bonds	While the Fed and other major central banks are tightening, not all countries are at the same point in their monetary cycles. By taking advantage of divergence, investors may be able to diversify interest rate exposure.	<ul style="list-style-type: none"> Dynamic Bond Allocation Strategies
High Yield Income	Higher interest rates and wider credit spreads (the additional yield over comparable U.S. Treasuries for bonds with credit risk) potentially create income opportunities for investors with the appropriate time horizons.	<ul style="list-style-type: none"> Global High Yield Bonds

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