



Finding Opportunities in Evolving Fixed Income Markets

Flexible multi-sector approach is essential as markets shift.

September 2022

KEY INSIGHTS

- We think that the typical negative correlation between high-quality government bonds and stocks will return as the Fed likely shifts focus from inflation to growth.
- We seek to combine well-diversified sector allocation with tactical insights to pursue consistent risk-adjusted returns across different market environments.
- Seeking to capitalize on bond market inefficiencies and constructing a diversified, risk-balanced portfolio inform our strategic allocation and positioning.

Flexibility and a collaborative multi-sector approach, in our view, are essential components of fixed income portfolio management. These characteristics were particularly vital when navigating the historic sell-off in bonds that occurred in the first half of 2022 as the Federal Reserve (Fed) raised interest rates amid rapidly rising inflation.

The pressure on the bond market coincided with a bear market in stocks, moving against the historical tendency for higher-quality bonds to rally when equities decline. We anticipate that the typical negative correlation¹ between high-quality government bonds and stocks will reemerge as the Fed likely shifts its focus from taming inflation to

managing growth. This transition should relieve some of the upward pressure on interest rates that resulted from the Fed “expeditiously” removing monetary policy accommodation, allowing Treasuries to outperform if risk assets remain out of favor.

Credit spreads² widened meaningfully in the first half of the year as sentiment toward risk assets in general deteriorated. Although credit spreads narrowed over the summer, we remain cautious about adding exposure to credit risk as the Fed attempts to slow the economy without pushing it into recession to achieve a “soft landing.” Our flexible, active portfolio management approach should provide occasions to take advantage of opportunities in this



Christopher Brown, CFA

Co-portfolio manager, US Total Return Bond Strategy



Anna Dreyer, Ph.D., CFA

Co-portfolio manager, US Total Return Bond Strategy

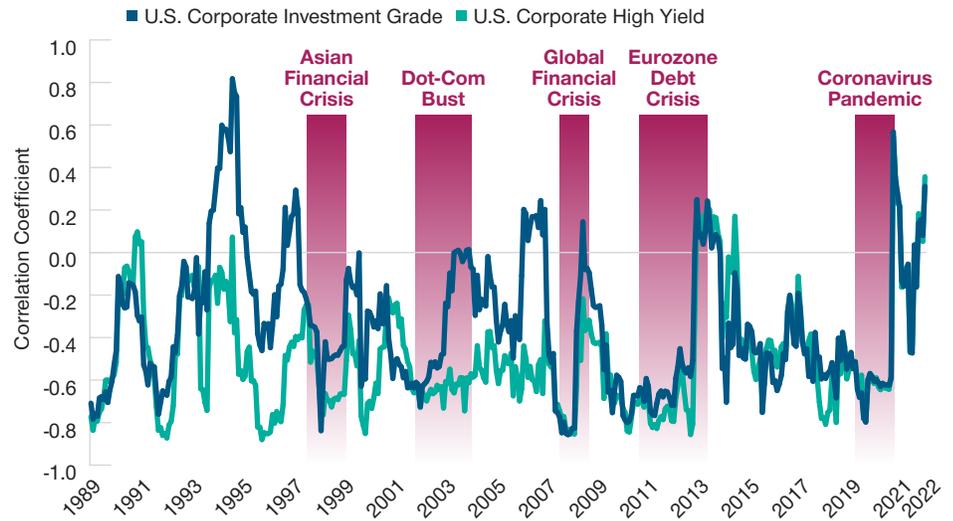
¹ Correlation measures how one asset class, style, or individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one security moves, either up or down, the other security moves in lockstep in the same direction.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

² Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

“...we still view the current environment as very uncertain.”

Treasuries Have Been Strong Diversifiers

(Fig. 1) Correlation of 10-year Treasury and credit indexes*



As of July 31, 2022.

Past performance is not a reliable indicator of future performance.

Source: Barclays Live/Haver Analytics.

*Rolling 12-month correlation of credit index excess returns. Excess return is calculated as the index's total return less the return of a duration-matched U.S. Treasury security. Investment-grade and high yield corporate excess returns are based on Bloomberg U.S. Corporate Investment Grade and U.S. Corporate High Yield indices.

unusual and volatile environment—as well as inefficiencies that tend to persist across varied macro backdrops—while managing risk in the US Total Return Bond Strategy.

Positioning Extremes, Limited Summer Liquidity Driving Risk Rally

A range of factors appears to have driven the recent rally in risk assets, such as credit and equities. Some of the most important may be related to defensive positioning and negative sentiment reaching an extreme—simply put, there were no sellers left—compounded by typically limited summer liquidity. Declining volatility in many markets also led some systematic investors that employ purely quantitative approaches to leverage up their exposure to those markets.

In addition, many market participants interpreted Fed Chair Jerome Powell's press conference following the central bank's July policy meeting as dovish as

he acknowledged that growth is slowing and that monetary policy works with a lag, raising hopes that the Fed might not raise rates as much as anticipated. At the same time, some economic data—particularly related to the labor market—began to surprise to the upside, helping to assuage fears that the U.S. is quickly falling into a recession. Falling commodity prices and signs of easing inflation also supported risk sentiment.

Caution Warranted in Uncertain Environment

However, we still view the current environment as very uncertain. We have already experienced a large amount of policy tightening with more to come, which in turn has led to a tightening of financial conditions through higher Treasury yields, wider credit spreads, lower equity prices, and a stronger dollar. Additionally, while market-based indicators of inflation are moving in the right direction, realized inflation data have thus far failed to convincingly turn. This

probably needs to happen soon for the Fed to achieve the soft landing outcome.

By many measures, it appears that the market is pricing in something quite close to a soft landing. In our view, if this outcome comes to fruition, it will be difficult for credit spreads to tighten meaningfully from their late-August levels. If not, and we experience a more severe downturn, spreads could easily widen. A wide range of potential outcomes and this asymmetrical risk/return profile lead us to remain cautious on adding credit risk to the strategy. To turn more optimistic on credit, we would need to see an upturn in economic growth data, a convincing move lower in inflation that allows central banks to unequivocally act less hawkish, or spreads providing meaningfully more compensation for the uncertain environment.

Relative Value Opportunities Across Sectors

We utilize a collaborative approach across fundamental, quantitative, and macro disciplines to identify structural advantages and relative value among fixed income sectors. A flexible multi-sector portfolio management approach allows the freedom to make these comparisons across sectors. An investment-grade corporate bond, for example, often trades differently from a similarly rated municipal bond or asset-backed security (ABS). Performance for fixed income sectors varies in different environments, and certain sectors have tended to more consistently outperform others on a risk-adjusted excess return³ basis.

To a larger extent than equity markets, fixed income markets are fragmented and tend to have investors that are narrowly focused on a sector or asset class niche. This can lead to technical pressure where some dedicated funds receiving inflows will buy because they

have to put cash to work, resulting in disparate cross-sector relative value. More-diversified portfolios that employ a multi-sector approach can capitalize on these relative value dislocations.

Along with building portfolios that diversify credit risk across sectors, we can also make tactical allocation adjustments when we identify possible relative value opportunities. These dislocations can also occur within credit sectors when our internal credit analyst teams have a meaningfully different view of the credit quality of an issuer, subsector, or industry compared with market consensus.

As an example, the strategy can have impactful out-of-benchmark allocations to high yield bonds and bank loans, where we rely heavily on the work of our high yield credit analysts. The team uses extensive proprietary fundamental research to expose and exploit value dislocations in these markets where liquidity constraints can create opportunities for active, long-term investors.

Flexibility to Tactically Adjust Duration

Another key part of our active portfolio management approach, the flexibility to adjust duration⁴ in the strategy, is essential in this volatile environment. This year, we have moved from a shorter-duration bias in the first quarter to a neutral-to-long bias in the second quarter as the market's focus began to shift from alarmingly high inflation to concerns about the Fed's tightening efforts possibly steering the economy into recession.

More recently, we shortened duration again, focusing on shorter maturities in the wake of the summer rally in Treasuries. While duration has become more attractive with policy rates entering restrictive territory, we felt that the

³ Excess returns are returns in excess of high-quality government securities with a similar maturity.

⁴ Duration measures a bond's sensitivity to changes in interest rates.

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market may have gotten ahead of itself in pricing in rate cuts in 2023 before inflation has yet to meaningfully decline.

Because high-quality government debt tends to rally in periods of deteriorating risk sentiment, duration can also serve as a hedge against credit risk. Given the positive correlation between Treasuries and risk assets during the downturn in the first half of 2022, some observers have questioned the effectiveness of duration as a hedge for credit risk.

We think that the prevailing market narrative will ultimately shift focus from inflation to economic growth, making it easier for Treasuries to reassert their place as a useful hedge against a steep sell-off in credit and other riskier assets, like equities. Also, with Treasury yields now at meaningfully higher levels, they simply have more room to rally in a risk-off environment. As a result, adding duration can allow investors to have more exposure to credit risk, with all else equal.

Exploiting Persistent Inefficiencies

Fixed income markets also feature some durable inefficiencies that persist despite being well understood by many market participants. Most of these inefficiencies result from imbalances between supply and demand or from investor constraints. There are also market participants with objectives other than maximizing total return, such as institutions constrained by tax considerations and those that have yield-driven performance targets. Finally, some sectors require specialization to understand the investment structures, so investors lacking this specialization may avoid them, creating opportunities for others.

Our quantitative research team has identified some of these anomalies and tested their robustness in various macro scenarios. As long as we have a relatively high degree of confidence that these inefficiencies will persist in the longer term and that they are appropriate for our investor base,

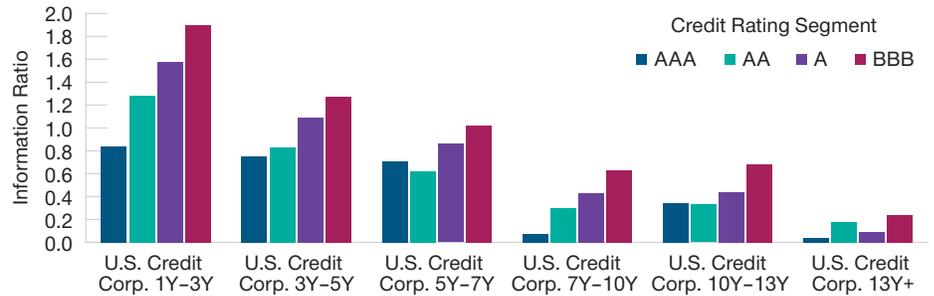
we aim to take advantage of them. Capitalizing on these inefficiencies while constructing a diversified, risk-balanced portfolio forms the basis of our strategic asset allocation and portfolio positioning. At the same time, we are aware that there are certain transient environments where positioning to exploit these anomalies could weigh on performance, and we strive to anticipate these shorter-term shifts and tactically adjust exposures appropriately.

Areas of Structural Inefficiency

- **Shorter-maturity corporate bonds** historically have exhibited higher risk-adjusted returns than longer-term corporates. Portfolios can hold a credit curve steepener—overweights to shorter-duration corporate credit and underweights to longer-duration corporates in seeking to capitalize on this structural inefficiency.
- We have also observed that **credit derivatives** tend to perform better in credit sell-offs than cash bonds, and it can be advantageous to replace some cash bond exposure with credit derivatives when the “basis”—the difference in spread between cash bonds and derivatives—is especially tight.
- In another example, credit quality constraints prevent some investors from holding non-investment-grade securities. When a bond is downgraded from investment grade into the high yield universe, forced selling from these investors can push prices lower than what the bond’s fundamentals would dictate. We try to capitalize on the relative value that can often be found in these “fallen angels.”
- **Securitized credit** is another area of structural inefficiency. Some investors were restricted from owning securitized debt after the global financial crisis, and some lack the ability to analyze the often-complex cash flow structures of the securities. T. Rowe Price’s team of securitized

Shorter-Term Corporates Outperformed

(Fig. 2) Information ratio on excess return by maturity and credit rating*



March 31, 1998, through July 31, 2022.

Past performance is not a reliable indicator of future performance.

Source: Bloomberg Index Services Limited (see Additional Disclosure). Calculations by T. Rowe Price.

*The information ratio measures returns beyond the returns of the broad index compared with the volatility of those returns. The broad index is the Bloomberg U.S. Corporate Investment Grade Index.

“...the income and relatively low volatility of a fixed income allocation make it an important part of a broader portfolio’s asset allocation.”

credit analysts has the capability to value these bonds, allowing us to locate attractive securities and segments that other investors may overlook.

Flexible Multi-Sector Approach

On a broader level, the income and relatively low volatility of a fixed income allocation make it an important part of a broader portfolio’s asset allocation. In the US Total Return Bond Strategy, we seek to combine well-diversified sector allocation with tactical insights to pursue superior, consistent risk-adjusted returns across different types of market environments. Our flexible multi-sector approach to managing the portfolio allows us to actively manage relative

duration and try to take advantage of relative value among sectors.

It must be mentioned that having the platform at hand that we do at T. Rowe Price is invaluable when facing challenging market conditions. As a firm, we have tremendous expertise across the globe, reaching across the capital structure from investment-grade debt to equity, across all sectors, across macro and micro, and across fundamental and quantitative. In our view, these resources are an advantage in managing a multi-sector fixed income portfolio when it comes to everything from navigating changing market dynamics to constructing durable portfolios to fundamental security selection.

WHAT WE’RE WATCHING NEXT

Environmental, social, and governance (ESG) analysis is an integral part of our fundamental credit research process. T. Rowe Price’s proprietary ESG research tools identify credits with potential ESG-related issues, which our analysts and portfolio managers incorporate, as appropriate to their strategy, into investment theses, internal credit ratings, price targets, and position sizing.

Additional Disclosure

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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.

ESG and Sustainability risk—May result in a material negative impact on the value of an investment and performance of the portfolio.

Counterparty risk—An entity with which the portfolio transacts may not meet its obligations to 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—A portfolio’s attempts to reduce or eliminate certain risks through hedging may not work as intended.

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.

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