



# Turmoil Creates Opportunity for Short Duration Bonds

Fed hikes have pushed up yields on lower-risk bond allocations.

August 2022

## KEY INSIGHTS

- This year's bond market volatility has led to higher yields and a flatter curve that creates a particularly compelling case for shorter-maturity securities.
- The combination of increased yield cushion and lower interest rate risk in short-term bonds provides a buffer against further rate volatility.
- We believe that our multi-sector approach to managing low-duration portfolios can tap in to parts of the market that historically offered one of the best returns per unit of risk.

Stubbornly high inflation and hawkish central banks around the globe have pressured fixed income asset classes, with many posting meaningful losses in the first half of 2022. However, this year's significant shift higher in bond yields,

particularly in shorter-maturity securities, can offer investors compelling yield with less interest rate risk. We believe that our multi-sector approach to managing low-duration<sup>1</sup> portfolios can help diversify risk while tapping in to parts of the market that historically offered one of the best returns per unit of risk.

## Rapid Move in Two-Year Treasury Yield

(Fig. 1) Yields have risen faster than in previous cycles



**Past performance is not a reliable indicator of future performance.**

As of June 30, 2022.

Source: Bloomberg Finance L.P., analysis by T. Rowe Price.

<sup>1</sup> Duration measures a bond's sensitivity to changes in interest rates.



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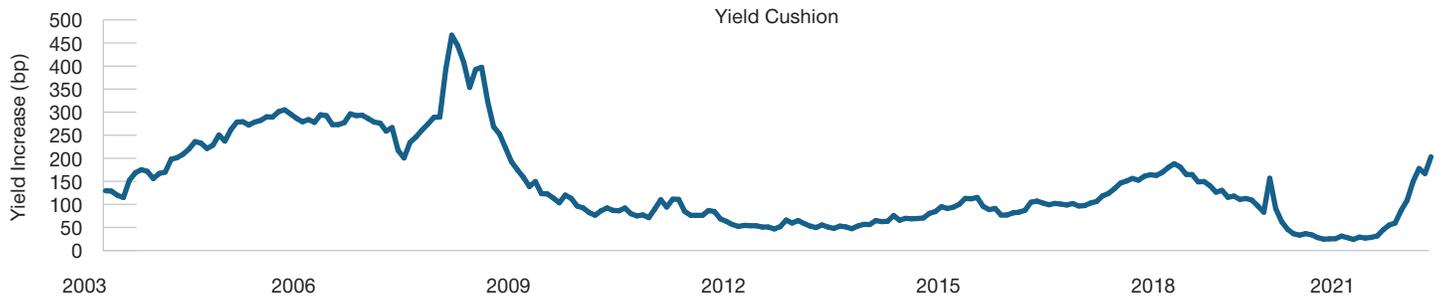


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## Yield Cushion Has Expanded in 2022

(Fig. 2) Yield move that would generate negative return\*



As of June 30, 2022.

**For illustrative purposes only. Actual results may differ materially from estimates.**

Source: Bloomberg Finance L.P., analysis by T. Rowe Price.

\*For the Bloomberg U.S. Corporate 1–3 Year Index.

### Fed Tightening Has Triggered Volatility

After more than a decade of heightened stimulus measures that sent yields to multi-decade lows and suppressed volatility, the Federal Reserve is withdrawing liquidity and hiking interest rates in response to multi-decade-high inflation.

Unsurprisingly, the central bank's moves have been highly disruptive, as evidenced by performance across asset classes this year. In the U.S., the two-year Treasury yield ratcheted up to reach a two-year high of 3.43% in mid-June after the Fed sprang into action to stamp out inflation, a significantly sharper move than in previous tightening cycles.

The volatility in Treasury yields has also pressured credit spreads<sup>2</sup> wider across fixed income sectors with credit risk. Historically, returns on Treasuries and credit sector performance have been negatively correlated,<sup>3</sup> but that has not been the case for much of this year. As a result, losses on short duration corporate credit in the first half of 2022 exceeded those experienced in late

2008 when credit spreads widened out to over 700 basis points (bp).<sup>4</sup> The downturn also shows how vulnerable short-term credit was in mid-2021 when credit spreads and Treasury yields were at historically low levels, offering little cushion when both started moving higher.

### Flatter Yield Curve Benefits Short-Term Bonds

The repricing of yields has led to a significantly flatter yield curve, so investors can receive nearly the same yield in short-term bonds as they would from longer-maturity credits—at a fraction of the interest rate risk. Furthermore, these increased yields can buffer the impact of rising rates and offer significantly more cushion than a year ago.

Figure 2 shows the increase in yield that would be required to fully offset the current yield, turning total return negative. For context, in late July, the Bloomberg U.S. Corporate 1–3 Year Index could handle a yield increase of 200 bp before producing a negative return, compared

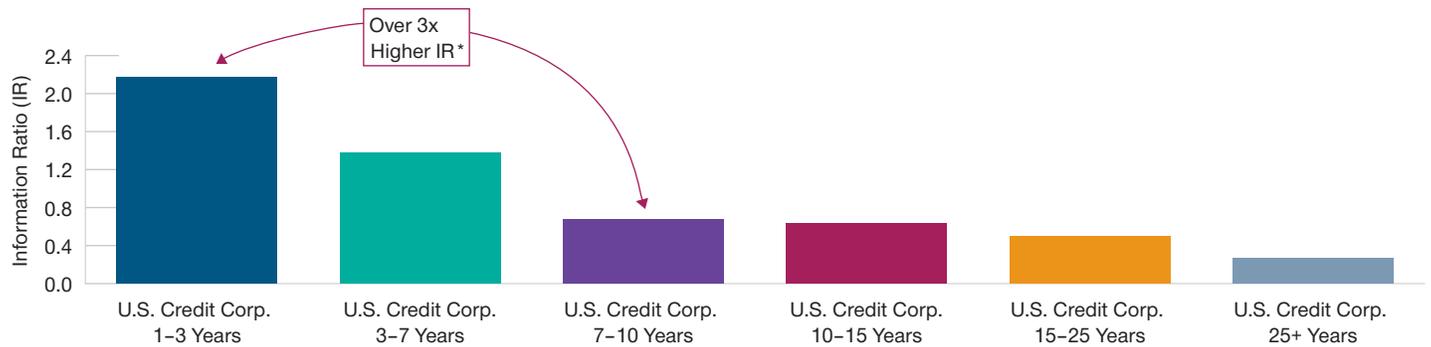
<sup>2</sup> Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

<sup>3</sup> 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.

<sup>4</sup> A basis point is 0.01 percentage point.

## Higher Risk-Adjusted Return Historically

(Fig. 3) Information ratio of rolling excess return\*



**Past performance is not a reliable indicator of future performance.**

As of June 30, 2022.

Source: T. Rowe Price analysis of Bloomberg indexes.

\*Average 1-year rolling return since December 2002.

with only 60 bp at the beginning of the year. This could serve as a tailwind to total returns going forward.

### Multi-Sector Approach Adds Flexibility

A broad multi-sector approach to managing a low-duration portfolio that also incorporates an actively managed liquidity sleeve can help to limit risk by diversifying across sectors and maintaining ample liquidity even when historical correlations break down. Our multi-sector capability gives us the flexibility to add exposure to the fixed income sectors where we identify securities with higher risk-adjusted yield potential.

For example, in investment-grade corporate credit, short-maturity debt has provided meaningfully higher risk-adjusted returns than longer-term bonds. This theme is consistent across other short-maturity bonds with credit risk. From December 2002 through

June 2022, the information ratio<sup>5</sup> of the average one-year rolling excess return<sup>6</sup> of investment-grade corporates in the one- to three-year maturity range was more than three times higher than the same measure for 7- to 10-year investment-grade corporate bonds.

### Liquidity to Navigate Market Uncertainties

Across our low-duration strategies, we balance our diversified multi-sector portfolios with an actively managed liquidity sleeve consisting of very short-term debt instruments and principal paydowns from securitized products such as mortgage- and asset-backed securities. Our thoughtful approach to liquidity management can afford the portfolios with incremental yield while maintaining an ample source of organic liquidity to navigate market uncertainties—a key consideration in an environment of rapid central bank tightening and volatility.

<sup>5</sup> The information ratio is a measure of risk-adjusted return calculated as the difference between the segment return and the broad index return, divided by the tracking error (the standard deviation of the difference).

<sup>6</sup> Return above that of a comparable-maturity Treasury security.



## WHAT WE'RE WATCHING NEXT

In light of the public attention on high gasoline prices, the Fed's focus seems to have shifted from its traditional core inflation target toward lowering headline inflation, which includes prices of food and energy. We are closely monitoring how crude oil prices, which moderated somewhat in July, might affect the central bank's path of monetary policy tightening.

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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**—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.

## INVEST WITH CONFIDENCE<sup>SM</sup>

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