THEME THREE

The Return of Yield

A brutal year for bond markets in 2022 ended with a silver lining for investors: It raised fixed income yields to some of the most attractive levels seen since the global financial crisis.

Higher yields (Figure 4, left) were mirrored in greatly improved valuations for both sovereigns and private credits, with many sectors selling close to or below their 15-year historical medians as of late November (Figure 4, right).

Higher-quality credits in the mortgage-backed and asset-backed sectors also are attracting inflows from investors looking to put cash to work or extend duration (a measure of interest rate sensitivity), McCormick adds.

"This is the first opportunity try to lock in high-single-digit yields in over a decade," McCormick says. "Anytime there's been a glimmer that the Fed might be ready to slow its pace, or that inflation might have peaked, we've seen money find its way into the market."

High yield bonds could offer particularly attractive return opportunities in 2023, McCormick and Page both say. Page cites three potential positives:

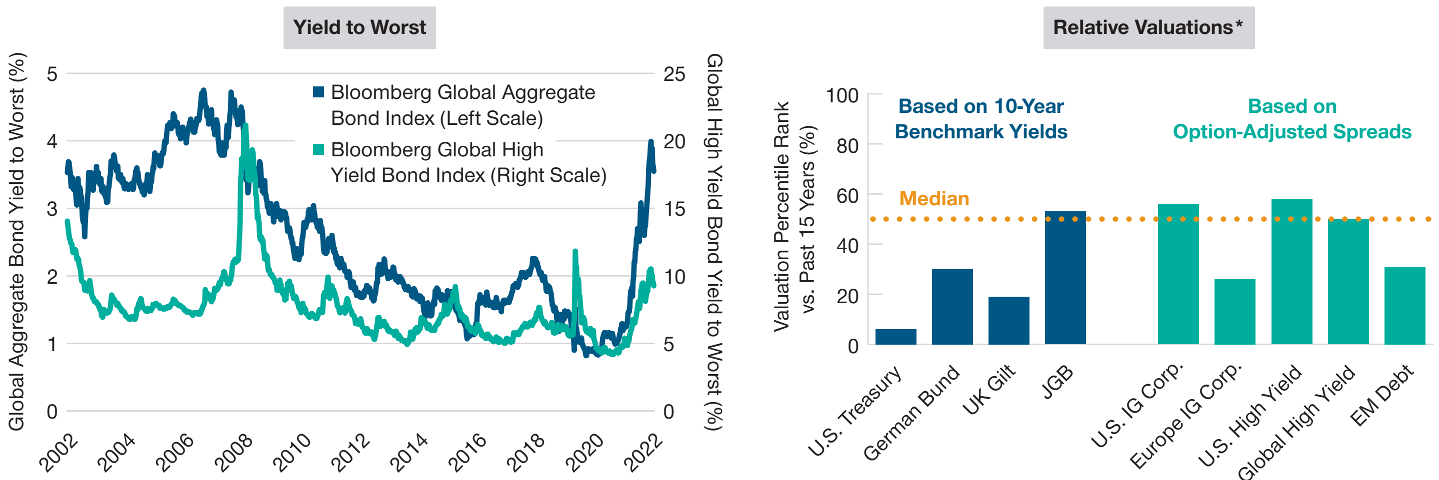
- Credit spreads—the yield difference between private credits and comparable U.S. Treasury maturities—have widened while default rates have remained relatively low.
- Corporate balance sheets generally are in strong shape.
- Energy accounts for a smaller share of U.S. high yield debt than in the past, helping reduce default sensitivity.

Default rates almost certainly will rise if the U.S. economy slips into recession, Page acknowledges. But it would take a substantial leap to offset the return advantage built into current spreads. "If we get anything outside of a deep recession, the valuation case for U.S. high yield appears pretty strong," he argues.

As of late November, McCormick adds, T. Rowe Price credit analysts estimated that U.S. default rates could rise to slightly under 3% for high yield bonds and just over 3% for floating rate bank loans in

The Bond Bear Market Has Improved Both Yields and Relative Valuations

(Fig. 4) Yields on Aggregate Bond and High Yield Indexes; Fixed Income Valuations vs. Historical Averages



Past performance is not a reliable indicator of future performance.

Yields as of November 25, 2022. Valuations as of November 30, 2022. Subject to change.

*U.S. Treasury = 10-Year Note, German Bund = 10-Year Bund, UK = 10-Year Gilt, JGB = 10-Year Japanese Government Bond, U.S. IG Corp.= Bloomberg U.S. Investment Grade Corporate Index, Europe IG Corp. = Bloomberg EuroAggregate Credit Index, U.S. High Yield = Bloomberg U.S. Aggregate Credit–Corporate High Yield Index, Global High Yield = Bloomberg Global High Yield Index, Emerging Markets Debt = Bloomberg Emerging Markets USD Aggregate Index.

Sources: Bloomberg Financial L.P. and Bloomberg Index Services Limited (see Additional Disclosures). T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

We've already seen bouts of illiquidity in some high-quality markets....We believe the risk of further episodes remains elevated.

— **Andrew McCormick**
Head of Global Fixed Income and Chief Investment Officer

2023, significantly less than current credit spreads. This forecast assumes that the U.S. economy passes through a mild recession, McCormick adds.

The outlook for European high yield is more guarded, McCormick cautions. While yields also have improved in those markets, the value proposition is less compelling because of the economic backdrop, he says.

Illiquid Markets Could Be Volatile

Market liquidity deteriorated in 2022 as monetary tightening accelerated, McCormick notes. As central banks shrink their balance sheets in 2023, new buyers will be needed. But stricter capital rules put in place after the global financial crisis have made it harder for bond dealers to function as liquidity providers.

"We've already seen bouts of illiquidity in some high-quality markets, like UK gilts and U.S. Treasuries," McCormick notes. "We believe the risk of further episodes remains elevated."

But poor liquidity and price volatility also can create opportunities for longer-term investors, McCormick notes. The U.S. municipal bond market, for example, experienced several months of outflows in late 2022 as investors harvested tax losses and repositioned for higher rates.

Credit conditions in the muni market appear strong, McCormick says. State and city governments received federal support during the pandemic shutdown, he notes, and saw tax revenues rise when businesses reopened. Given these fundamentals, muni yields and spreads remained attractive by most historical standards as of late November, which was attracting buyers back to the market.

Diversification in an Inflationary World

Higher volatility also has big implications for portfolio construction, Page says. But the key issue is the source of that volatility and its impact on asset correlations.

Historically, Page says, returns on stocks and on U.S. Treasuries have tended to move in the same direction when worries about inflation and interest rates have been high—as they were in 2022. This can destroy the diversification benefits of Treasuries. But, when concerns about economic growth are uppermost, returns can move in opposite directions, increasing the diversification benefits of Treasuries.

If 2023 is dominated by concerns about growth, Treasuries could resume their traditional role as portfolio diversifiers, Page predicts. But, over the longer run, he says, different tools may be needed. These could include:

- "Barbell" structures that divide bond allocations between long Treasuries and fixed income diversifiers such as high yield, floating rate, and EM debt.
- Alternative strategies that seek to deliver positive absolute returns.
- Real assets equities, such as energy, real estate, and metals and mining stocks.
- Equity strategies that potentially offer downside risk mitigation in inflationary environments when Treasuries fail.

THE RETURN OF YIELD

Investment Idea	Rationale	Examples
Bond Yields Are More Attractive	Higher interest rates and wider credit spreads have lifted yields in many fixed income sectors. While a slowing economy could further widen spreads, current yield levels can help provide a buffer against a rise in default rates.	▪ High Yield Bonds ▪ Municipal Bonds

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

Additional Disclosures

Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright © 2022, J.P. Morgan Chase & Co. All rights reserved.

Copyright © 2022, Markit Economics Limited now part of S&P Global. All rights reserved and all intellectual property rights retained by S&P Global.

"Bloomberg®" and Bloomberg U.S. Investment Grade Corporate Index, Bloomberg EuroAggregate Credit Index, Bloomberg U.S. Aggregate Credit–Corporate High Yield Index, Bloomberg Global High Yield Index, and Bloomberg Emerging Markets USD Aggregate Index are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by T. Rowe Price. Bloomberg is not affiliated with T. Rowe Price, and Bloomberg does not approve, endorse, review, or recommend T. Rowe Price products. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to T. Rowe Price products.

The "S&P 500 Index" is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates ("SPDJI"), and has been licensed for use by T. Rowe Price. Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); and these trademarks have been licensed for use by SPDJI and sublicensed for certain purposes by T. Rowe Price. T. Rowe Price products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the S&P 500 Index.

MSCI and its affiliates and third party sources and providers (collectively, "MSCI") makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. Historical MSCI data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

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.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose only. Any strategy and/or any products associated with the strategy discussed herein 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 which is regulated by the Dubai Financial Services Authority as a Representative Office. 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. Not for further distribution.

Mainland China—This material is provided to qualified investors only. 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. 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—ANY STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING DISCUSSED 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 by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 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—Issued in South Africa by T. Rowe Price International Ltd (TRPIL), 60 Queen Victoria Street, London, EC4N 4TZ, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: www.faisombud.co.za, Email: info@faisombud.co.za

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.

ID0005533 (12/2022)
202212-2620300