THEME TWO

# Bonds Are Back?

The sharp rise in bond yields since early 2022 has improved return potential in many fixed income sectors. But an aggressive portfolio shift into longer-term bonds still appears premature.

"Anyone who universally says that 'bonds are back' is being a little too optimistic," Husain says. "Some bond markets are back. Others may be back in the near future. But I think it's too sweeping to just say, 'go out and buy fixed income.'"

Yields on most sovereign bonds and investment-grade credits still aren't positive in real (after inflation) terms, Husain notes. And with the U.S. Treasury yield curve close to a record inversion as of late May (Figure 4), investors who trade money market holdings for longer-term bonds could pay a heavy return penalty.

Negative yield curves make it expensive to extend duration[2]—especially for investors using borrowed short-term money to finance their long bond positions, Husain notes. "You end up sacrificing yield on a daily basis."

Under these conditions, aggressively extending duration in the U.S. fixed income market amounts to a bet that a recession is near, Husain argues. "You're saying, 'I think the Fed will cut rates soon, and probably in a very quick way.' I'm not sure we can say that, at least not yet."

But Page thinks a modest increase in duration could be prudent for investors seeking to hedge against that very scenario—the sudden onset of a U.S. recession followed by rapid Fed rate cuts.

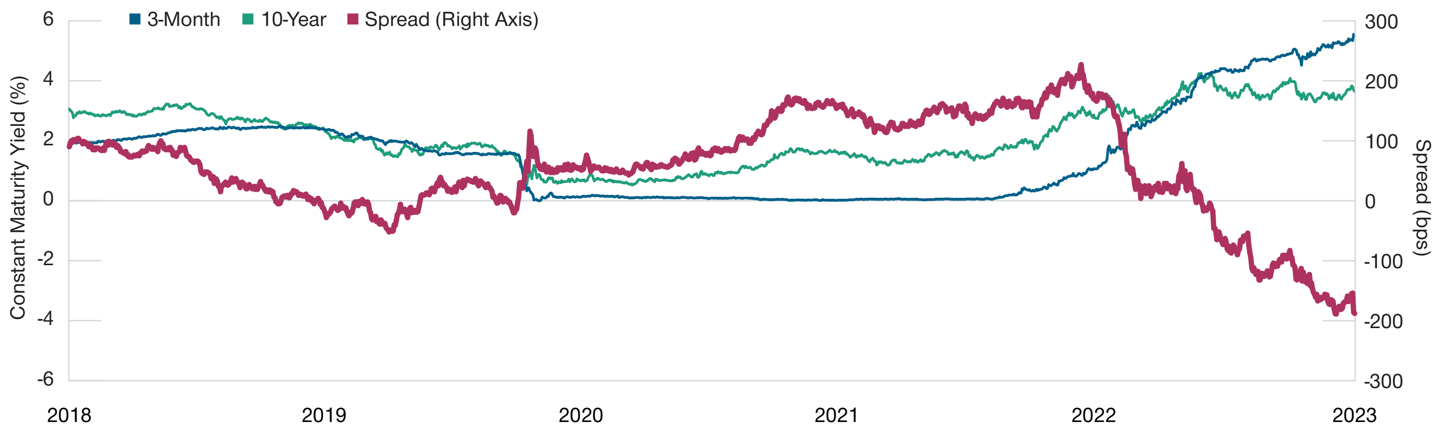
T. Rowe Price's Asset Allocation Committee, Page notes, has modestly extended duration in its multi-asset portfolios—both to guard against a growth shock and to potentially enhance returns if one does push yields sharply lower. "When you look at our tactical positions, we're playing both defense and offense."

### High on High Yield

The rise in yields may have created more significant opportunities in corporate credit, Husain says. Yields in the 8%–10% range and credit spreads close to their 10-year average (Figure 5) make the global high yield market attractive in any scenario short of a deep global recession, he argues.

## Inverted Yield Curve Makes Buying Longer-Term Bonds Expensive

(Fig. 4) Treasury yield curve (10-year minus 3-month constant maturity)




As of May 31, 2023.
Source: Federal Reserve Bank of St. Louis.

[2] Duration is a measure of the interest rate risk on fixed income securities. Generally, bonds with longer maturities also have longer duration.

Slower economic growth and higher rates are likely to push default rates up gradually over the balance of 2023 and into 2024, Husain says. But with corporate balance sheets, on average, still featuring low leverage and ample debt service coverage, default risks appear moderate, he argues.

Based on their credit research, Page adds, T. Rowe Price analysts as of late May were forecasting a U.S. high yield default rate of about 3% over the next 12 months, roughly in line with the longer-term historical average.

"We don't see default rates getting anywhere close to eroding the extra yield premium, relative to investment-grade bonds, that you can get in high yield right now," Husain says.

Bottom-up research and skilled security selection will be critical to managing default risk, Page cautions. "Skilled active managers know how to differentiate between healthy versus true junk balance sheets." This, he contends, can help investors avoid "zombies"—companies that are still technically in business but almost certainly are headed toward bankruptcy.

### Going Global

For investors in markets with inverted yield curves (like the U.S.), other global bond markets may offer attractive diversification and potential return opportunities, Husain says. "As I look around the world, I see some markets that actually have very steep, positive yield curves," Husain observes. "So, investors are getting paid, in a sense, to own them."

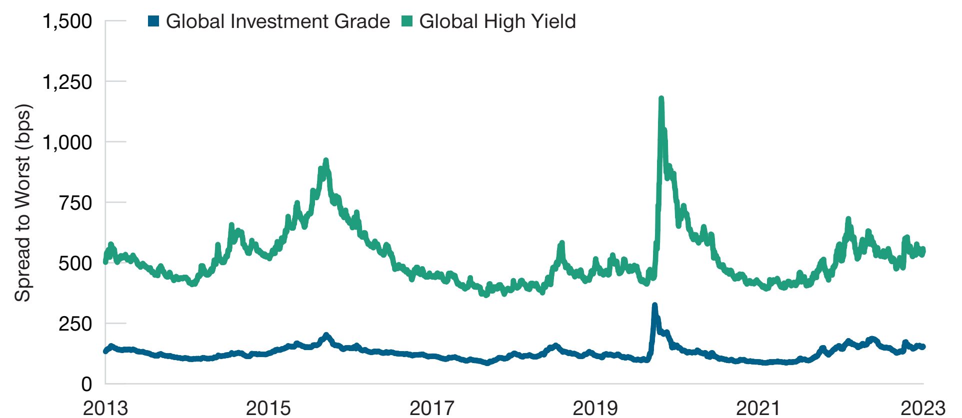
Some central banks, especially in the emerging markets, may be on the verge of cutting policy rates, Husain adds, creating a potential for capital appreciation in those markets. However, EM debt markets are only attractive on a very selective basis, he says.

Global investors also need to be mindful of several "black swan" risks—potentially high-impact events with probabilities that are difficult to estimate, Husain cautions. Key among these, he says, is the possibility of a change in monetary policy by the BoJ.

Japan's version of quantitative easing, Husain notes, includes capping yields on longer-term Japanese government bonds. The BoJ has kept these controls

## Global Credit Sectors Offer Opportunities

(Fig. 5) Investment-grade and high yield spreads, in basis points




As of May 31, 2023. **Past performance is not a reliable indicator of future performance.**
Global high yield = J.P. Morgan Global High Yield Index. Global investment grade = Bloomberg Global Aggregate Corporate Index. Spreads versus sovereign bonds with similar duration.
Sources: J.P. Morgan Chase (see Additional Disclosures), Bloomberg Finance L.P. T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

> Japanese monetary policy could be the San Andreas fault of global finance.
>
> **— Arif Husain**
> *Head of International Fixed Income and CIO*

in place even as the Fed and other major central banks have shifted to monetary tightening. "I would describe Japan as a last anchor of quantitative easing."

But that anchor may be about to give way, which could have major implications for other global bond markets.

Japanese investors, Husain notes, control the world's largest pool of financial wealth. But much of that wealth is invested outside Japan—a legacy, in part, of the years of negligible returns on Japanese bonds. However, if the BoJ allows yields to rise, Japanese investors could start bringing their wealth back home—delivering a significant shock to markets outside Japan.

"Japanese monetary policy could be the San Andreas fault of global finance," Husain warns. "I know the BoJ is conscious of the effect it could have on global markets, but it's a real and present danger, in my view. I certainly think it's something that should be on our radar as investors."

The threat of a broader systemic market event—perhaps triggered by a U.S. liquidity crunch—is another potentially dramatic but hard-to-quantify risk, Husain says.

Notwithstanding the recent depositor runs from several U.S. regional banks, the global banking system isn't the most likely candidate for such an event, Husain suggests. A depressed U.S. commercial real estate sector also poses risks, but bank lending in the sector also is unlikely to be the epicenter of the next crisis, he adds.

"The playbook the authorities have for a banking crisis is pretty much set," Husain argues. "They know how to deal with it."

A more likely venue, Husain says, is the so-called shadow banking system—lenders that are less regulated, less liquid, and more opaque than commercial banks. Many of these lenders, and the complex financial instruments they've created, have not yet endured a full economic cycle, Husain notes. "If we're looking for potential trouble spots, I think that's where we might find them."

**BONDS ARE BACK?**

| Investment Idea | Rationale | Examples |
|---|---|---|
| Take Advantage of Attractive Yields | Bonds may not be a good source of capital appreciation in 2023, but do provide yield. Equity upside may be limited by an uncertain economic landscape, so high yield bonds may offer better return opportunities. | ▪ Global high yield<br>▪ EM local currency bonds |

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