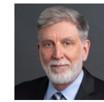
T. ROWE PRICE INSIGHTS
ON FIXED INCOME

Rates Volatility to Continue as Economic Outlook Evolves

We expect a relatively mild U.S. recession, not a steep downturn.

May 2023



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KEY INSIGHTS

- The rates market appears to be pricing in a "recessionary cliff" later this year, with the Fed responding by cutting rates before the end of 2023 in this scenario.
- While the odds of an abrupt downturn have risen since the sudden collapse of Silicon Valley Bank in March, we think that a recession will be relatively mild.
- We have been patiently positioning for a steeper 5- to 30-year segment of the Treasury yield curve.

Although the U.S. economy is withstanding the Federal Reserve's interest rate hikes and the recent banking system turmoil remarkably well as of late April, the rates market appears to be pricing in a "recessionary cliff" later this year. In this scenario, the economy would suddenly fall into a deep recession, with the Fed responding by cutting rates before the end of 2023.

Anticipating Mild Recession

Our outlook is not as dire. While the odds of an abrupt downturn have certainly increased since the sudden collapse of Silicon Valley Bank in March and the ensuing worries about other regional banks, we anticipate that the economic slowdown will be relatively mild. In this situation, the Fed would keep rates on hold through the end of the year with inflation remaining well above the central bank's 2% target, though an uptick in inflation data could cause another rate hike.

The system is still flush with cash, and demand for loans has been low and falling. However, credit conditions are tightening. If loan demand starts to inch upward, the more stringent credit conditions could limit firms' access to funding and lead to a modest recession.

Rapid Outlook Adjustments Causing Treasury Volatility

In March, the ICE BofA MOVE[1] Index, which measures implied volatility in U.S. Treasury yields, reached its highest level since the global financial crisis—even surpassing the elevated level at the onset of the pandemic in 2020. At the same time, the yield curve abruptly became less inverted, with the difference between 2- and 10-year Treasury yields moving from -106 basis points (bp)[2]

[1] See Additional Disclosures.
[2] A basis point is 0.01 percentage point.

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in early March to -39 bp later in the month. Plainly, market participants were rapidly adjusting their outlooks for the magnitude of recession and its effects on Fed policy.

While the MOVE Index has moderated since March, both the level of interest rates and the shape of the yield curve are likely to remain quite volatile as this process continues. We think that it could take as long as 12 months for the Treasury yield curve inversion to dissipate, returning the curve to a more "normal" slope where short-term rates are lower than longer-maturity yields.

Opportunities in Steepening Yield Curve

In terms of portfolio positioning implications, we are cautious about meaningfully adding to outright duration[3] as much of the near-term benefit of duration is already priced in to the rates market amid expectations for a deep recession. However, we believe that positioning for a steepening in the 5- to 30-year segment of the U.S. Treasury yield curve represents an attractive opportunity as the federal funds rate reaches its highest point in this economic cycle. With that said, we have been patient in implementing this positioning amid the interest rate volatility.

Negative Correlation Between Bonds and Stocks to Return

We think that most investors should have some exposure to longer-duration assets in their broad portfolios because we believe that the long-standing historical negative correlation[4] between bonds and equities will return over the course of this year. This would come as a relief to investors disappointed by the positive correlation between the asset classes in 2022, when both fixed income and stocks dropped sharply amid high inflation and rapid Fed tightening. Although the negative correlation may not be as strong as it has been in the past, it should help reinforce the value of maintaining a fixed income allocation in a diversified[5] portfolio.

WHAT WE'RE WATCHING NEXT

We believe the debt ceiling standoff will be resolved in the coming months. After a resolution is reached, Treasury bill issuance will increase at a rapid pace. Bank reserve levels, which have been falling as the Fed allows its balance sheet to run off, are likely to fall even faster as investors draw on reserves to buy the new Treasury issuance. A rapid tightening of liquidity conditions is likely to lead to bouts of market volatility toward the end of the third quarter.

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[3] Duration measures a bond's sensitivity to changes in interest rates.
[4] 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.
[5] Diversification cannot assure a profit or protect against loss in a declining market.

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