



A New Fixed Income Regime—Three Active Portfolio Responses

What to expect as monetary policy tightening moves closer to ending.

July 2023

KEY INSIGHTS

- Volatility is likely to remain high during the transition from a hiking rate environment to a pausing environment, creating potential interest rate and curve management opportunities for active managers.
- With escalating debt-to-gross domestic product levels, investors should expect structurally higher rates going forward in certain countries.
- There is potential for the negative stock/bond correlation to return, but it is unlikely to be as stable as during the post-financial crisis era because central banks are no longer supporting markets.

The period of aggressive monetary policy tightening is moving closer to the finish line, with a new regime in fixed income markets set to begin. These transitions can often be

challenging for investors, so we have identified three key themes to consider and share our ideas for how to navigate this new market paradigm.



Scott Solomon, CFA

*Co-portfolio Manager,
Dynamic Global Bond Strategy*



Quentin Fitzsimmons

*Co-portfolio Manager,
Dynamic Global Bond Strategy*

What to Expect as Tightening Nears the Peak

Three key themes and active portfolio approaches

1. Volatility



The transition to a pause environment is unlikely to be smooth, so expect volatility.

Active duration management and curve positioning.

2. Higher Rates



With higher debt-to-GDP levels, brace for structurally higher rates.

Active country selection and curve positioning.

3. Stock/Bond Correlations



There is potential for the negative correlation to return, but it is unlikely to be as stable as before.

Active approach that adapts to the market environment.

As of June 30, 2023.

For illustrative purposes only. This is not to be construed as investment advice or a recommendation to buy or sell any security. Investments involve risks, including possible loss of principal.

Source: T. Rowe Price analysis.

We expect heightened volatility in bond markets before central banks pause rate hikes, especially as the market continues to flip-flop from worrying about sticky inflation to worrying about a recession.

— Scott Solomon, CFA
Co-portfolio Manager,
Dynamic Global Bond Strategy

Debt-to-gross domestic product (GDP) levels have risen, and greater government debt issuance will be needed to help finance the higher deficits.

— Quentin Fitzsimmons
Co-portfolio Manager,
Dynamic Global Bond Strategy

1 Smooth Transition to a Pause Environment Unlikely

Defensive interest rate strategies have worked well for more than a year, but the need to continue with such an approach is receding. Central banks are moving closer to the end of their hiking cycles, and most are expected to finish in the second half of this year. At the same time, inflation is easing—albeit slowly—and growth is showing signs of weakening, particularly on the manufacturing side. Against this backdrop, we have become more favorable on duration; however, we believe this stance needs to be kept under constant review.

Transitioning from a hiking environment to a pause environment is never just a simple case of moving from a short duration posture to a long bias and remaining there. A lot happens along the way—and this regime change will be no different. We expect heightened volatility in bond markets before central banks pause rate hikes, especially as the market continues to flip-flop from worrying about sticky inflation to worrying about a recession. Uncertainty remains high, and it only takes one data print or central bank surprise to change market sentiment around the pricing of rate hikes or when cuts might start.

Portfolio approach—Active duration management and curve positioning

We believe that managing duration actively will be critical to navigating this transition. An active approach facilitates tactical responses to different market climates and regime changes while also providing the flexibility to take advantage of pricing anomalies and dislocations that might occur in a volatile environment.

It may also be beneficial to consider curve positioning. We believe that positioning for a steepening in select curves, such as the U.S. Treasury market, is an attractive opportunity as interest rates reach their peaks in this

economic cycle. The normalization could take several quarters to play out, however, so patience is required.

Taking advantage of the broad investment universe is also important. It offers opportunities to capture value resulting from monetary policy dispersion. Central banks are approaching the end of the cycle at varying speeds—emerging markets are the furthest ahead and bond yields are starting to fall there now, particularly in Latin America. In developed markets, there is considerable disparity among countries. New Zealand's central bank, for example, has signaled the end of hiking, while the Bank of England has indicated that it still needs to deliver more rate rises to combat sticky inflation. The Bank of Japan remains something of an outlier with its accommodative monetary policy stance, but we believe it may alter its yield curve control policy at some point this year.

2 Brace for Structurally Higher Interest Rates and Potential Risk Volatility

Across the globe, government spending has increased materially in recent years due to the pandemic and various schemes to help citizens with the higher cost of living. Debt-to-gross domestic product (GDP) levels have risen, and greater government debt issuance will be needed to help finance the higher deficits. However, this comes at a time when central banks are no longer supporting markets with quantitative easing, which means they will not be mopping up the increased supply as they have done previously. Demand will need to be met entirely by the private sector, which could anchor rates at higher levels than past cycles. It is important to note that this is on a country-by-country basis, with some more impacted than others. The UK, for example, is one country that stands out as it needs to sell more than GBP 240 billion worth of gilts in the 2023 fiscal year,¹ the second largest on record.

¹ Source: UK Debt Management Office.

...we believe that the negative stock/bond correlation will make a return. However, it is unlikely to be as stable as the post-financial crisis era...

— Quentin Fitzsimmons
Co-portfolio Manager,
Dynamic Global Bond Strategy

Debt issuance also needs to rise in the U.S. The agreement reached in the U.S. Senate to suspend the debt ceiling until after the presidential election in 2024 means that the Treasury needs to replenish the Treasury General Account. As a result, net Treasury bill issuance of more than USD1.03 trillion is expected in the second and third quarters of this year.² We believe this will drain liquidity from financial markets and ignite volatility in risk markets such as credit and equity. This backdrop adds to our already cautious view on the outlook for risk markets, where we believe there is potential for corporate fundamentals to deteriorate amid the challenges of slowing growth and higher debt servicing costs.

Portfolio approach—Active country selection and defensive positioning

An active approach to country selection is important in this environment, as is curve positioning, especially as the countries that need to raise more debt may target different maturities. For example, the U.S. is selling shorter-dated maturities, which is an important factor to consider when looking at this part of the Treasury curve. By contrast, in the UK, the long end is likely to be more impacted by greater gilt issuance.

Given the concerns around the risk environment, a defensive approach may also be warranted as hedging strategies can help to navigate volatility.

3 Potential for Stock/Bond Correlation to Return

A key pressure point for investors last year was the fact that bond yields rose while stock markets were selling off. This went against the traditional tendency

for fixed income to be a diversifying asset class that should perform well when equity markets decline. Inflation, and the sheer number of hikes aimed at taming it, were the main drivers of this positive correlation. But with inflation easing, albeit from a high base, and the end in sight for central bank tightening, we believe that the negative stock/bond correlation will make a return. However, it is unlikely to be as stable as the post-financial crisis era given that central banks are no longer supporting markets with accommodative monetary policies, such as quantitative easing.

Portfolio approach—Active approach that adapts to the market environment

We believe it is important to be able to adapt to the risk environment and not to assume that the stock/bond correlation will always work. For example, if there is an extreme market event that puts major selling pressure on risk assets such as equity and credit, we expect duration to be an effective diversifier. However, this will likely not work if the cause of the sell-offs is bond yields themselves. Against this backdrop, it is important to be agile and choose hedging tools that are appropriate for the environment. In some instances, this may mean using currency and derivatives markets instead of duration to help to balance and mitigate risk.

In all, the next few months look set to be fraught with volatility in bond markets as we approach these turning points in interest rate cycles around the world. Although this may present challenges, we believe the conditions will create great opportunities for active management within fixed income portfolios.

² Source: U.S. Treasury, as of July 12.

INVEST WITH CONFIDENCESM

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T. Rowe Price[®]

Additional Disclosure

CFA[®] and Chartered Financial Analyst[®] are registered trademarks owned by CFA Institute.

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.

DISCLOSURE CONTINUES ON THE FOLLOWING PAGE.

Important Information (cont.)

Australia—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, 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 by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, 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.

© 2023 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.