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Time to rethink fixed income portfolio

The Rising Cost of Capital: Bond Implication

After languishing near zero for over a decade, US interest rates have risen at the fastest pace in modern history. It's a tightening policy that's been mirrored by central banks around the world.

For now, financial markets appear remarkably unaffected. Labour markets remain buoyant, economies are still growing and equity markets have rebounded strongly from their October 2022 lows.

T. Rowe Price's fixed income investment professionals believe things are set to change. During Free Talk, a biannual Fixed Income Webinar, they believed we are likely witnessing a classic lag between central bank policy action and its after-effects.

And as signs of recession begin to appear, they went on, it's time to add duration to a fixed income portfolio.

We are firmly in the neighbourhood of policy errors

According to Arif Husain, Head of International Fixed Income and Chief Investment Officer, Fixed Income at T. Rowe Price, central banks may already have raised rates too far in their quest to quell inflation.

"We are now firmly in the neighbourhood of policy errors," Husain shared.

"Central banks are looking backwards: their models for forecasting inflation haven't worked. I worry that they are now likely to overtighten policy," he said.

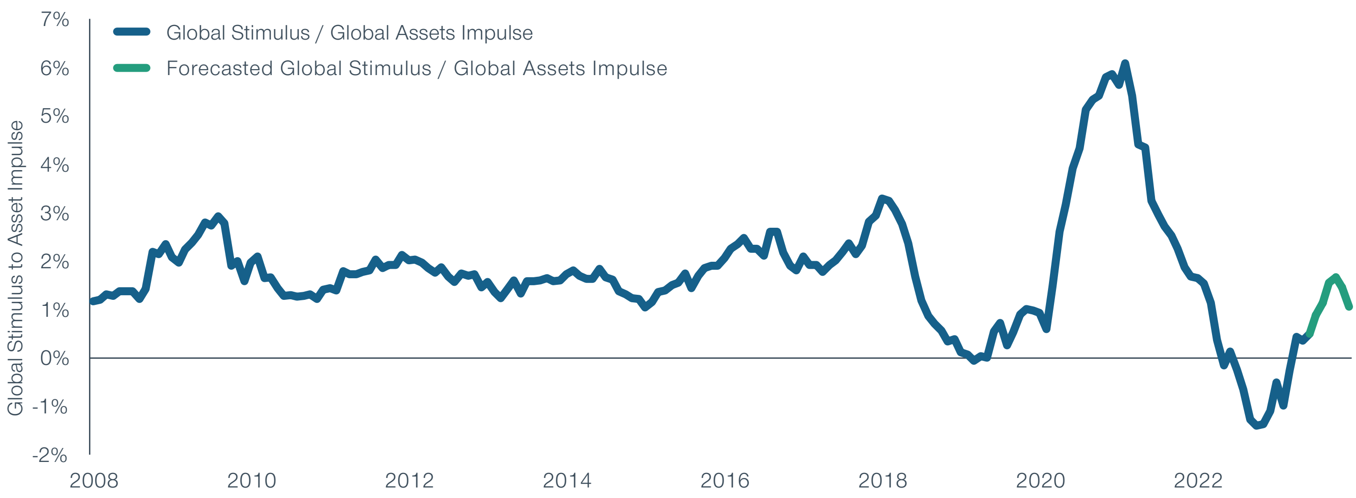
There are other factors adding to the risk of a market accident, said Husain.

First, investors are too complacent about the possibility of rising defaults. Second, the energy supply outlook is still uncertain as a result of the Russia/Ukraine war. Third, since the global financial crisis a lot of leverage has shifted from bank balance sheets into the shadow banking system, where it's harder to monitor and control.

Meanwhile, said Husain, the monetary stimulus that was added by central banks in late 2022 and early 2023—in response to the UK pension fund crisis and the failure of several US regional banks—is beginning to wear off.

"Our proprietary indicator shows all the stimulus in the system," said Husain. "It combines monetary policy, fiscal policy and what banks are doing. In the early part of this year, we saw a big upturn in stimulus. But now our stimulus indicator is starting to roll over due to the lagged effect of interest rate rises. We now have all the conditions for a rising default cycle."

Global stimulus is rolling over
As of 31 May 2023



Source: Bloomberg Finance L.P.
Analysis done by T. Rowe Price.

Dollar rates won't fall as fast

According to Blerina Uruçi, Chief US Economist at T. Rowe Price, markets have got it right when it comes to the point at which the Federal Reserve stops tightening—but not when it comes to the aftermath.

"Market pricing with regards to the peak in interest rates makes sense," Uruçi said.

"But what's different in this business cycle is that once the Federal Reserve finds its peak, it's not going to cut interest rates as fast as it's done in the past. It needs to really make sure it has pushed down second-round effects and prevented a wage spiral from occurring."

The likely reticence to cut rates will reflect lingering tightness in the US labour market, said Uruçi, which in turn reflects a structural deterioration in the US economy. "One of the key findings of our research was that the chronic shortage of workers in the US is going to play out over a long period of time," said Uruçi.

"Some of the factors driving the shortage of labour are long-term, like demographics. But there are also new ones keeping workers outside of the labour force, such as long COVID. There was also a collapse in immigration flows last year," she said.

A storm is coming, but it won't sink all boats

Mike Della Vedova, Portfolio Manager of Global High Yield Bond strategy, believes that yields in some areas of the fixed income market have already risen far enough to represent good value for investors.

"Default rates will go up and they're probably going to keep going up at least for the next year," Della Vedova said in the webinar.

"But I don't think we're going to see the kind of double-digit default rates we saw during the global financial crisis," he went on, "And to some extent, higher interest rates are already compensating for those risks."

"A storm is coming over the ocean, is it going to sink all boats? We don't think so. You want those boats that have more ballast, those that are built for heavier weather, those companies that have a better capital structure and business plan."

Della Vedova believed sectors like utilities and healthcare were throwing up some good high yield opportunities. And he cited past performance data showing that once yields in the global high yield market hit 9 percent or more, the median return for the following 12-month period was well into double figures.

"If you're in the right boat, you can catch some decent returns," he added.

High yield debt is already attractive

From 1 January 2012 through 31 March 2023

Past performance is not a reliable indicator of future performance.

Returns since 1 January 2012. Performance periods shown once index yields moved through the yield threshold and had not been at that level for the preceding 30 business days. Global High Yield Market represented by the JP Morgan Global High Yield Index. 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.

The emerging market growth premium

Despite worries of a global recession, emerging market debt markets offer attractive investment opportunities, said Sheldon Chan, Portfolio Manager of Asia Credit Bond strategy.

"In China, in recent months we have been seeing stress within the real estate and housing sectors and in the labour market. Meanwhile, consumer confidence amongst households is still low," said Chan.

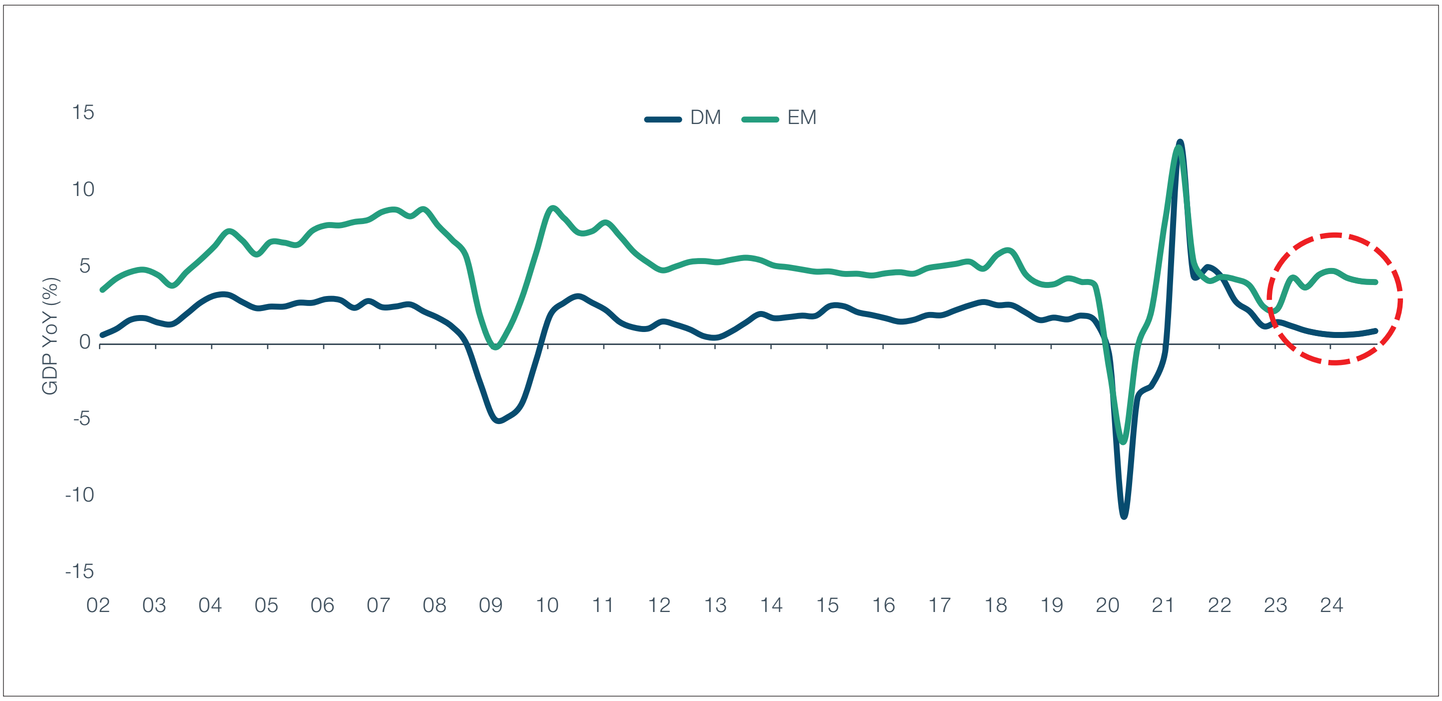
But China's economy is still expected to grow by 5 percent in 2023, added Chan, reminding us that emerging markets continue to enjoy a substantial economic growth premium over developed economies.

"That is typically an environment that is supportive for emerging market assets," said Chan. He said that structural demand from the global green energy transition is a key factor supporting economic growth in many commodity-rich emerging economies.

Emerging market financial systems could also be relatively resilient to global strains, added Chan. "When we saw pressure on the US regional banking system in the first quarter of 2023, that had fairly limited impact on emerging market banks."

"They just don't have the same type of securities exposure or duration exposure. We see a lot more diversification in funding models, as well as stronger capital positions and healthy liquidity. Resilience is really prevalent across the entire emerging market debt space."

Relative growth in emerging markets (EM) and developed markets (DM)
As of 31 March 2023



Source: HSBC. Figures beyond 2022 are IMF estimates. There is no guarantee that any forecasts made will come to pass.

Time to rethink fixed income portfolio

There's a lull before a storm—the uneasy period where the needle on the barometer has already dropped but the strong winds of a low-pressure system have yet to arrive. Interest rates have risen sharply but signs of an impending recession are still faint.

But it's not too early to be thinking about adding to fixed income exposure and extending duration, said T. Rowe Price's investment professionals, even if cash is a safe haven and deposit rates are tempting.

"Currently, you get paid a lot for owning cash and less for extending your duration and owning bonds," said Husain.

"Negative carry is a horrible way of making a living. But when that recession comes, when everyone opens their eyes and sees it, rates are going to collapse. We're getting to that window where I think we should all be adding a little bit of duration."

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