



Time to rethink fixed income portfolio

The Rising Cost of Capital: Bond Implication

FreeTalk

The definitive word in Fixed Income



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.

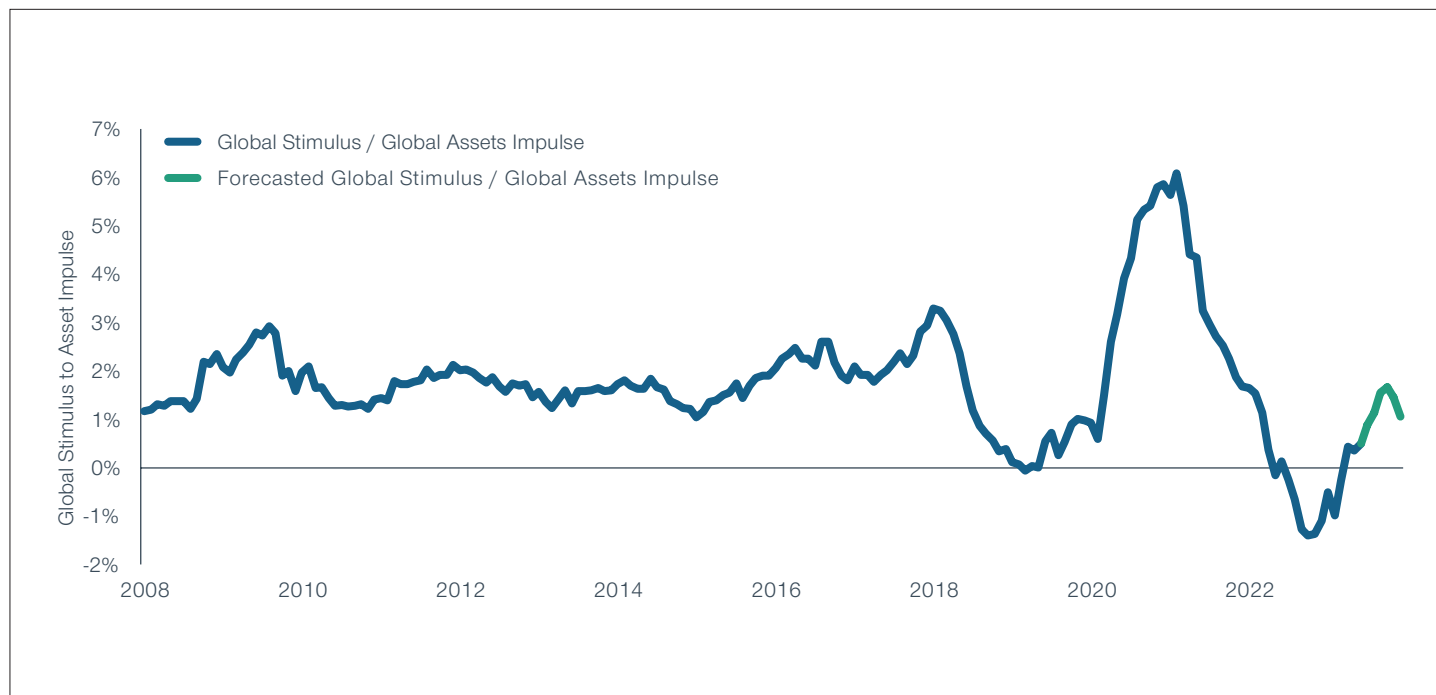
First, investors are too complacent about the possibility of rising defaults. Second, the energy supply outlook is still uncertain as a result of the Russia/Ukraine war. Third, since the global financial crisis a lot of leverage has shifted from bank balance sheets into the shadow banking system, where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

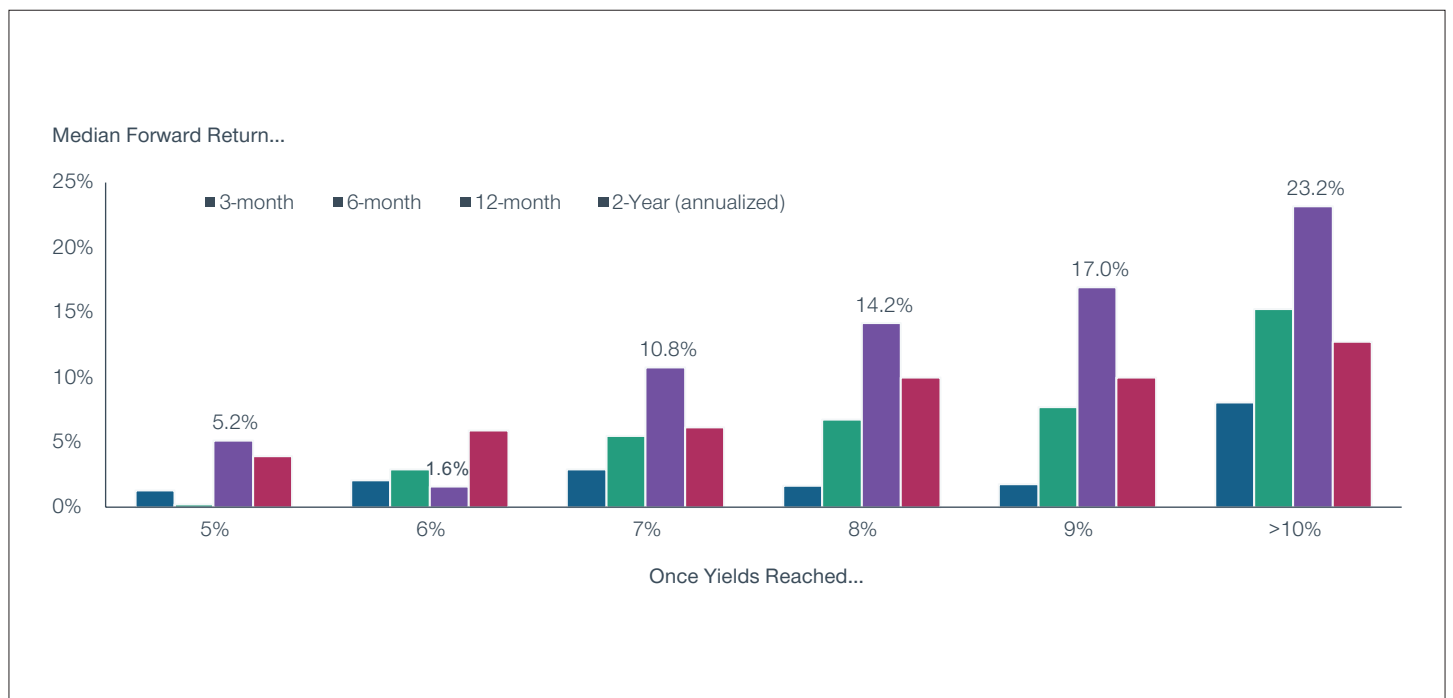
“A storm is coming over the ocean, is it going to sink all boats? We don’t think so. You want those boats that have more ballast, those that are built for heavier weather, those companies that have a better capital structure and business plan.”

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. Copyright © 2023, J.P. Morgan Chase & Co. All rights reserved.

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.

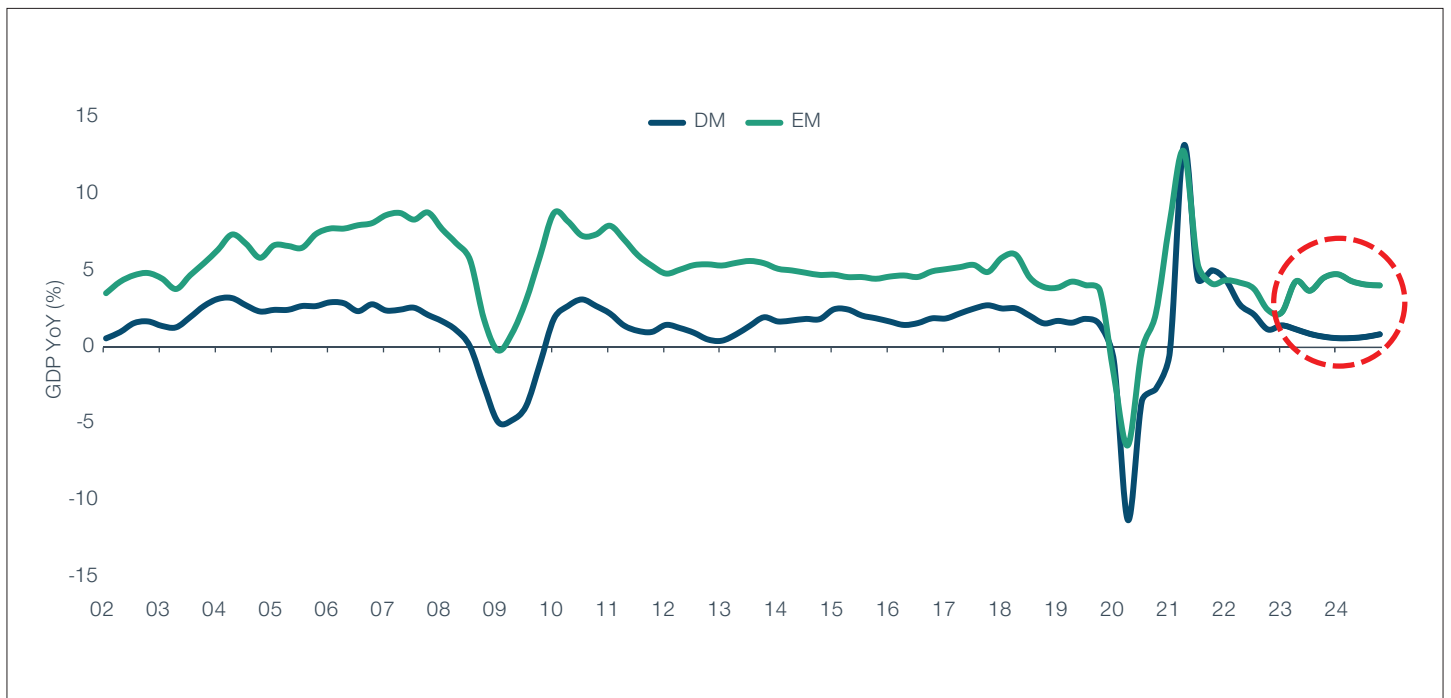
“That is typically an environment that is supportive for emerging market assets,” said Chan. He said that structural demand from the global green energy transition is a key factor supporting economic growth in many commodity-rich emerging economies.

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.”

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 noted on the material 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.

All investments are subject to market risk, including the possible loss of principal. Fixed-income securities are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall. Investments in high-yield bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. International investments can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. These risks are generally greater for investments in emerging markets.

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., and T. Rowe Price Investment Services, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which are regulated by the US Securities and Exchange Commission and Financial Industry Regulatory Authority, Inc., respectively. 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.

CCON0156603 | 202307-3028561

For more information on T. Rowe Price and our investment capabilities, please visit our website:

troweprice.com

T. Rowe Price[®]
INVEST WITH CONFIDENCE