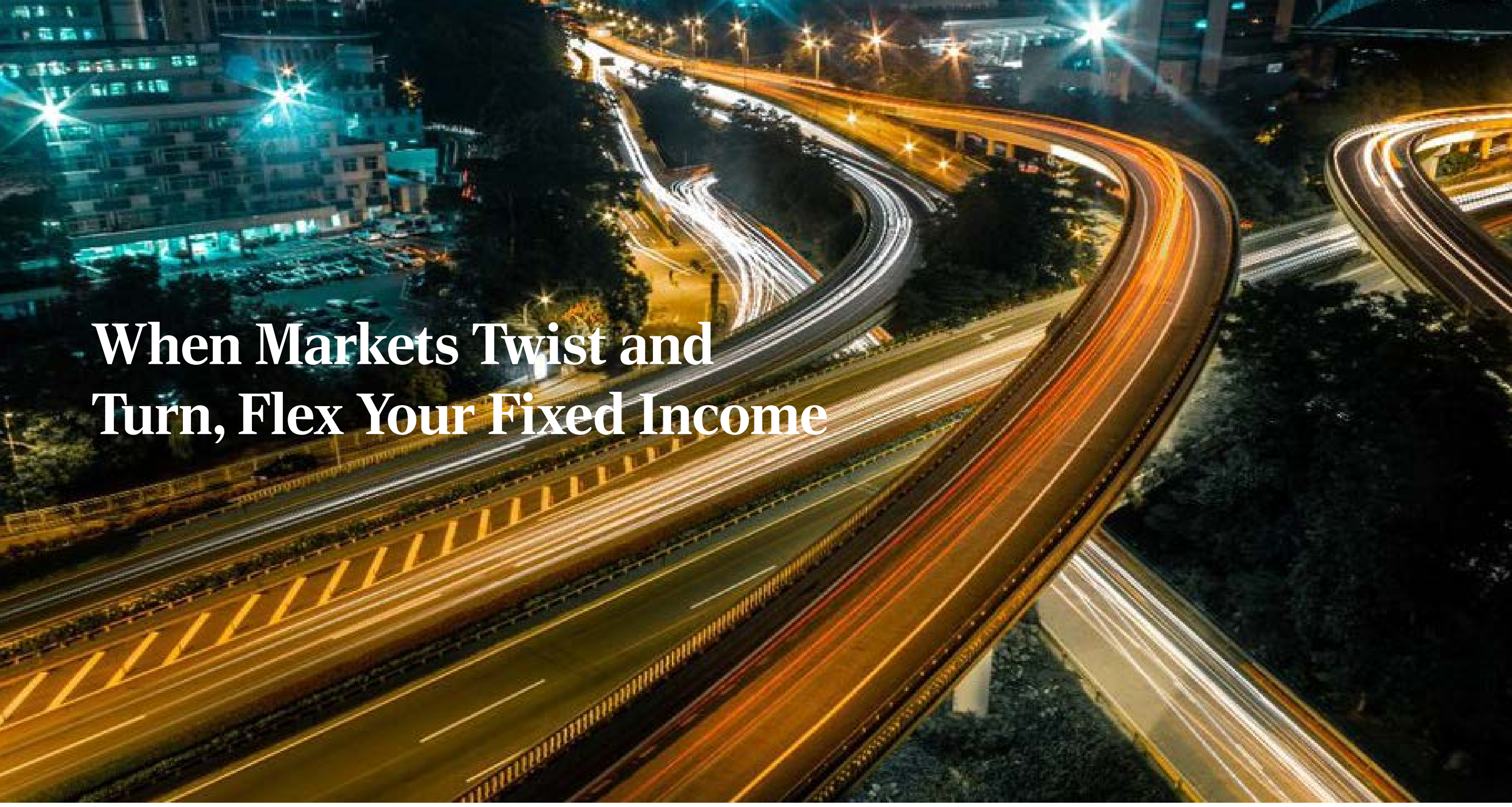

When Markets Twist and Turn, Flex Your Fixed Income

Leonard Kwan
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During the past two years, investors have had to contend with periods when bonds and equities sold off at the same time. This went against the traditional function of fixed income as a diversifying asset class that tends to perform well when stock markets decline. High and sticky inflation, along with the sheer number of interest rate hikes aimed at taming it, were the main drivers of this unusual correlation.

However, inflation is now cooling, and central banks have likely finished their hiking cycles. With growth also expected to slow, bonds may potentially reassert their role as an effective diversifier for riskier assets. Furthermore, with bond yields now meaningfully higher, we think there is room for bonds to rally should fears of a deeper economic slowdown or a market shock dampen investors' risk sentiment.

That said, uncertainty is likely to remain high in 2024. The potential for larger-than-anticipated government debt issuance to fund fiscal deficits may result in supply/demand imbalances, which could contribute to volatility. But with no more interest rate hikes expected, rate volatility could shift to the long end of yield curves. This backdrop, combined with weaker growth and ongoing geopolitical risks, highlights the need for an active and flexible approach to fixed income investing. We believe this environment will be conducive for more dynamic strategies that can tactically adapt to the shifting macro and policy landscape.

Here to discuss more are Leonard Kwan, who manages the Dynamic Emerging Markets Bond Strategy, and Saurabh Sud, who manages the Dynamic Credit Strategy.

What are the key features of your strategy and what role do you expect it to play in a global slowdown environment?

Leonard Kwan: The Dynamic Emerging Markets Bond Strategy seeks to capture the most attractive opportunities from the full spectrum of Emerging Markets (EM) debt, a broad opportunity set encompassing about 80 countries, more than 20 currencies, and over 800 corporate issuers. By focusing on the team's best ideas across sovereign, corporate, and local currency bonds, the strategy aims to capture EM's inherent growth potential while reducing drawdowns by actively managing the portfolio's volatility profile.

We take a forward-looking approach, underpinned by fundamental research and collaboration across asset classes and regions. Our process combines top-down macro analysis to inform asset allocation decisions among EM markets, corporates, interest rates, and currencies, with bottom-up country and issuer selection. We believe this approach is crucial to manage risk and mitigate losses in downturns.

In a weaker growth environment, we believe the strategy can be a useful source of income and diversification. All-in yields in EM are compelling, and the wide universe means there is potential to diversify by finding opportunities uncorrelated to global cycles. Although EM assets may come under pressure if broader risk appetite is impacted, our strategy has the tools to weather such a scenario by dynamically allocating to different sectors, countries, ratings, and companies. We can add duration to issuers we like, but in the same vein, we can choose to eschew segments we don't like even if it holds a weight in a traditional benchmark.

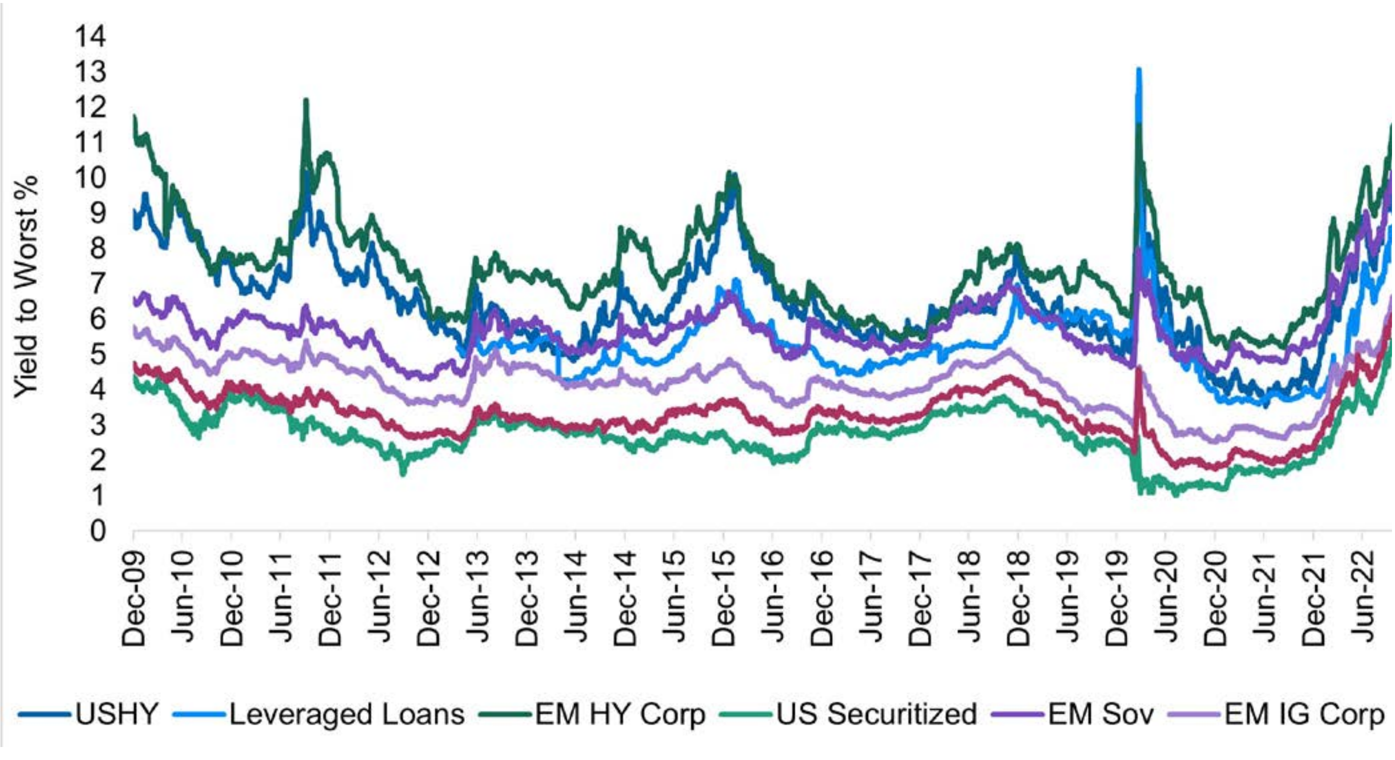
Overall, we believe that maintaining liquidity, with a focus on better-anchored countries and more defensive corporate ratings and sectors, is critical if a recession materializes. At the same time, we will look to leverage our deep EM expertise and extensive research capabilities to identify promising long-term opportunities. Ultimately, we believe our emphasis on fundamental research and active security selection will drive meaningful portfolio outcomes across cycles.

Saurabh Sud: The Dynamic Credit Strategy seeks to offer investors a "smoother ride" in credit investing by finding diverse alpha sources across the broad credit market (Fig.1). The strategy focuses on credit selection and sector rotation across the credit spectrum, including investment grade, high yield, emerging markets, securitized, distressed, municipals, convertibles, and bank loans. We have a long bias but employ active credit shorting and duration management to pursue alpha and dampen volatility during periods of weakness in credit markets.

The strategy aims to deliver attractive returns, source credit alpha flexibly, and diversify risk-asset returns. What we mean by the latter is targeting a lower beta to riskier asset classes, such as high yield credit and equities. To achieve these goals, the strategy harnesses expertise across T. Rowe Price's global research platform.

FIGURE 1: Global Credit Market Fluctuations

Opportunities consistently around in global credit markets



Past performance is not a reliable indicator of future performance.

Bloomberg: USHY: Bloomberg US Corporate High Yield Total Return Index Value Unhedged USD - Index Yield to Worst, Leveraged Loans: Morningstar/LSTA U.S. Leveraged Loan 100 Index (Wtd Average Yield) - Last Price, EM HY Corp: J.P. Morgan CEMBI Broad Div High Yield Yield to Worst - Last Price, US Securitized: Bloomberg U.S. Securitized: MBS/ABS/CMBS and Covered TR Index Value Unh - Index Yield to Worst, EM Sov: J.P. Morgan - EMBIG Diversified Yield to Worst - Last Price, EM IG Corp: J.P. Morgan CEMBI Broad Div High Grade Yield to Worst - Last Price, USIG: Bloomberg US Corporate Total Return Value Unhedged USD - Index Yield to Worst.
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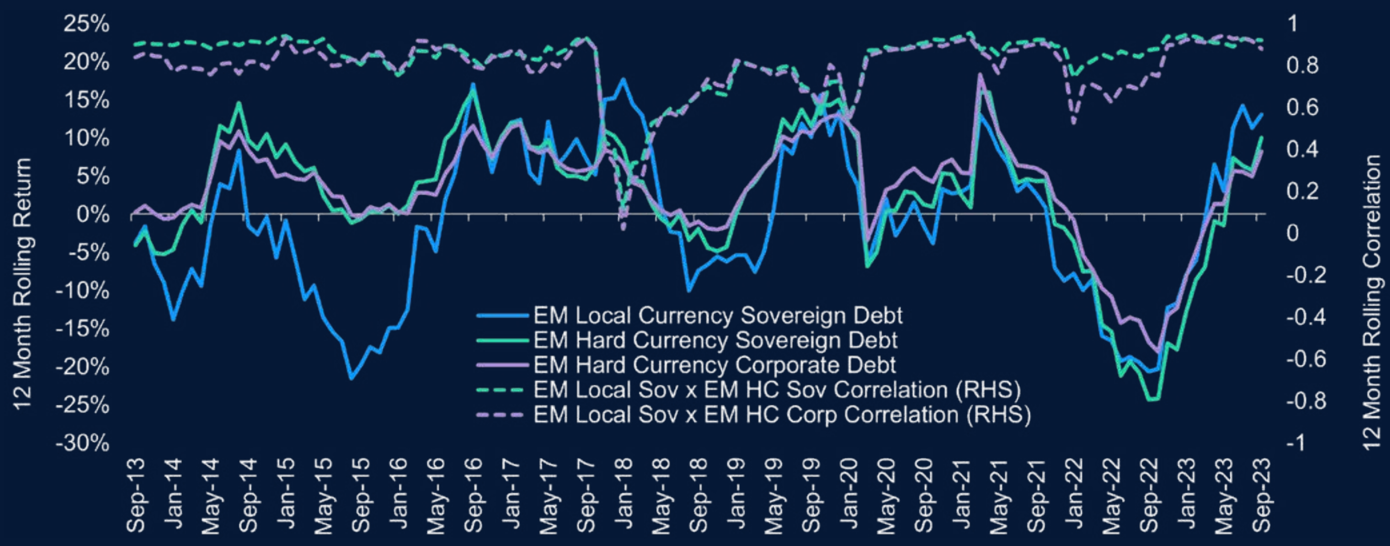
FIGURE 2: Emerging Markets Debt Sectors Returns and Correlations
12-months rolling returns and correlations



As of 30 September 2023. Figures are Calculated in U.S. Dollars.
Past performance is not a reliable indicator of future performance.
Indices: J.P. Morgan EMBI Global Diversified, J.P. Morgan CEMBI Broad Diversified, J.P. Morgan GBI-EM Global Diversified.
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We believe the strategy's alpha-seeking but risk aware approach is suitable for a range of market conditions, but may be more valuable in a slowing growth and uncertain credit environment. We believe that our fundamental credit analysis process, which generates forward-looking insights from a global research platform with broad sector expertise, can help the strategy identify and capitalize on inefficiencies ahead of the market.

How is your strategy different from traditional fixed income strategies? What solution does it aim to provide investors?

Leonard: Unlike traditional EM bond strategies, the Dynamic Emerging Markets Bond Strategy is a highly flexible solution offering unconstrained and diversified exposure to EM debt. Crucially, the team dynamically allocates across EM sovereign, corporate, and local currency debt sectors, investing in where we see the best opportunities (Fig.2).

This results in a concentrated portfolio that expresses our ideas via a mix of long-term core positions, high-conviction opportunities, and tactical hedges, with the flexibility to adjust exposures as market cycles shift.

The primary value proposition of the strategy is to provide a smoother EM experience by seeking to capture the bulk of the upside potential while limiting downside. This is particularly important as emerging markets and economies are less mature and typically involve higher risks. By focusing on our highest-conviction ideas, the strategy is designed to capitalize on sovereign and corporate growth in fast-expanding economies and capture emerging bonds' yield premium over their developed peers. This, combined with thoughtful diversification and tactical hedges, helps limit drawdowns, seeking for a more consistent return profile. Such an approach also alleviates the burden of investors having to make frequent reallocation decisions in response to changing market conditions and the evolving opportunity set.

Saurabh: What makes the Dynamic Credit Strategy unique is not just that it tactically invests across various credit sectors, but also our ability to flexibly manage duration and credit beta, as well as short individual credits. We believe our approach to portfolio construction makes the strategy a compelling and consistent credit allocation. The strategy's lower-beta profile helps it to weather conditions of widening credit spread, while actively managing duration positions it to adapt to different rate environments.

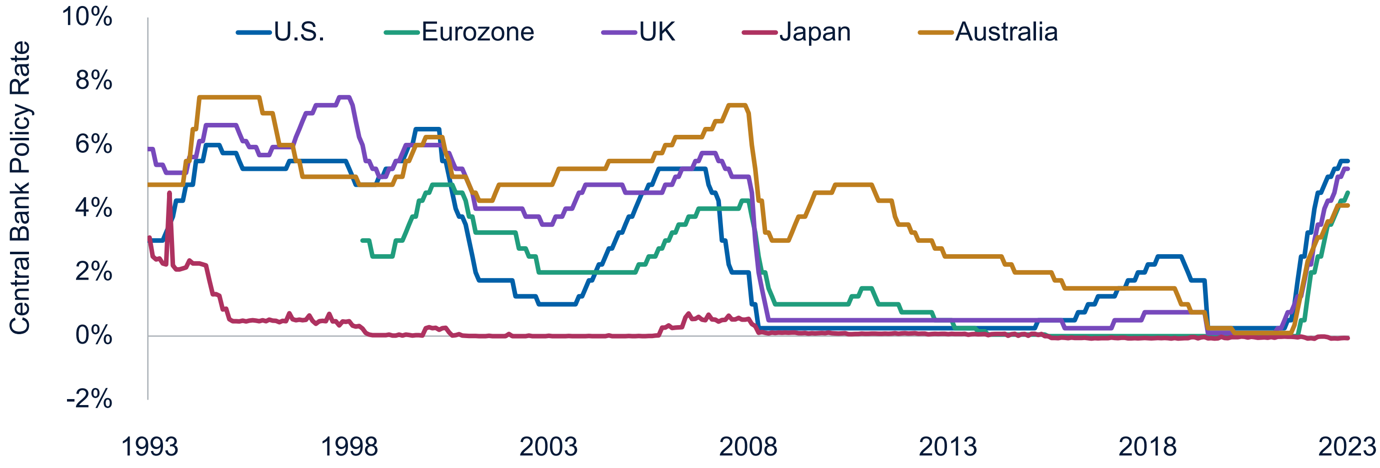
The strategy may suit investors who want to take advantage of credit opportunities while also managing drawdowns in volatile environments. It meets investors' search for yield, while managing undue credit beta and duration risk by using the full toolkit and capabilities on offer.

What is the outlook for bond markets for 2024?

Leonard: We believe we are at "peak everything" in terms of rates, inflation, liquidity, fiscal support, and credit. These factors supported the world economy's post-pandemic resilience but appear to be weakening toward longer-term trend levels. Our base case is for global growth to soften as governments taper fiscal

FIGURE 3: Short-term interest rates appear close to cyclical peaks

Central bank policy rates



As of September 30, 2023.

*U.S. = Federal Funds Rate Upper Limit, Eurozone = ECB Main Refinancing Rate, UK = Bank of England Official Bank Rate, Japan = BoJ Overnight Call Rate, Australia = Official Cash Rate, end of period.

Sources: Haver Analytics / Federal Reserve Board, European Central Bank, Bank of England, Bank of Japan, Reserve Bank of Australia. T. Rowe Price calculations using data from FactSet Research Systems Inc.

accommodation and cumulative monetary policy tightening worldwide takes effect. Most economies are at a late stage of the economic cycle, though the prospect, timing, and depth of the slowdown remains difficult to forecast.

For EM, inflation is cooling in most countries, so central banks are expected to gradually ease policy. At the same time, the Federal Reserve (Fed) is likely at the end of its hiking cycle, which should reduce broader market uncertainty. Against this backdrop, our bias is for broadly lower yields and moderately wider spreads across the EM landscape in 2024. Nonetheless, we think all-in yields remain attractive, which should support above-trend returns and cushion against adverse macroeconomic events. We continue to expect attractive bottom-up opportunities due to the intrinsic differentiation and idiosyncratic nature of the EM asset class.

Saurabh: Most developed market central banks appear to have reached peak interest rates (Fig.3). The focus now is on sequencing—i.e., how long policymakers pause on rates before cutting. This will vary from country to country and depend on how economic growth and inflation evolves.

In the U.S., the economy is yet to show signs of significant weakness, but the Fed's recent dovish rhetoric points to likely easing in 2024. However, our economics team expects a sequential re-acceleration in growth data in the immediate term before moderating again, which may upset a market that has priced in aggressive interest rate cuts. Elsewhere, the BoJ is getting closer to achieving its price stability target. This combined with tight labor market conditions point to the potential removal of negative rates.

Broadly, the global economy is expected to weaken in 2024. While this could pose headwinds for credit markets, we continue to find appealing areas, such as secured parts of the U.S. high yield market. Overall, the asset class is supported by attractive yields, even though credit spreads—the yield differences between bonds with credit risk and high quality government bonds with similar maturities—appear less compelling at present. The overall improvement in quality of the high yield universe overall is another supportive factor, but selectivity remains key amid this tricky environment.

How will these market conditions suit the strategy that you manage?

Leonard: The multi-trillion-dollar EM bond market covers a multitude of companies and countries with distinct geopolitical and economic profiles. It is vast with plenty of differentiation and divergence, which is conducive for us as we can invest across the EM debt sphere. At present, we are watching Asian markets for signs of an activity upswing as China's economy stabilizes. Elsewhere, we see Latin America as potential beneficiaries of U.S. economic resilience. All these present potentially interesting alpha opportunities for astute investors to exploit.

In all, we believe our strategy is well suited for investors looking to stay invested in EM through the economic cycle. As mentioned, EM's diversity means there are likely always idiosyncratic opportunities to be found. Our flexible approach should not only enable us to find a range of less correlated exposures across sectors, but also supports diversification. The strategy's ability to tactically adjust duration and market beta is advantageous, relative to benchmark-aware strategies in periods characterized by volatility and uncertainty.

These features position it well to navigate through most economic environments.

Saurabh: Credit markets are currently priced for a soft economic landing. But a hard landing, or a tougher economic environment, is not out of the question, particularly if unemployment continue to rise. Even if a recession is avoided, we are likely to see economic growth concerns intermittently elevated. Therefore, we believe it’s important to have a strategy that can flexibly navigate global credit markets. We can tactically shift allocations across sectors, which gives us the ability to streamline overall allocations. This should help improve overall diversification.

In an environment where growth is weakening, skilled security selection and sector allocation, informed by in-depth fundamental research, is vital. Harnessing the full breadth and depth of our global platform enables us to uncover great opportunities where prices have become dislocated from fundamentals, but also helps us to avoid issuers that might struggle in the more challenging macro conditions.

Additional Disclosures

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