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U.S. Fixed Income

OPPOSITE ENDS OF CREDIT SPECTRUM ENHANCE PORTFOLIO POSITIONING

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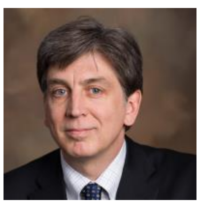

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KEY POINTS

- While the Fed will probably raise rates at least twice more this year, pushing short-term rates higher, the pace is likely to remain gradual.
- However, crosscurrents in the fixed income markets may help limit further yield increases on longer-term bonds even as the Fed hikes rates.
- In this uncertain rate environment, a sound strategy involves overweight allocations to sectors with high credit quality as well as noninvestment-grade segments.
- We believe this positioning can provide relatively low sensitivity to rate increases as well as the ability to benefit from rallies in sectors with credit risk.

Although the Federal Reserve has signaled that it will continue to gradually raise interest rates as 2017 progresses, longer-term yields appeared to reach a temporary equilibrium following the central bank's March rate hike. The ongoing uncertainty about the ability of the Trump administration to implement tax cuts and fiscal expansion has created crosscurrents in the fixed income markets that may help limit further yield increases on longer-term bonds even as the Fed normalizes monetary policy.

While the Fed will probably raise rates at least twice more this year, pushing short-term rates incrementally higher, the pace of increases is likely to be far more gradual than in historical cycles of monetary policy tightening. In addition, the terminal rate—the highest level of the central bank's target federal funds short-term benchmark in a tightening cycle—is considerably lower than in past cycles because of lower growth expectations. Investors fearful of rapidly rising rates might be tempted to abandon their fixed income allocations, but we think that this worry will prove to be unfounded. At the same time, from our point of view, investors should consider bond strategies with overweight allocations to opposite ends of the credit spectrum.

Figure 1: **ABS, high yield bonds, and bank loans have generally fared well in past periods of rising rates.**

Total returns when 10-year Treasury yields increased by more than 100 basis points (bps) over 12 months					
12 Months Ended	**10-Year Treasury Yield Move**	**Bloomberg Barclays U.S. Agg. Bond Index**	**ABS**	**High Yield**	**Bank Loans**
May 31, 2004	+130 bps	-0.44%	1.06%	13.23%	7.50%
Jun. 30, 2006	120	-0.81	1.19	5.06	6.15
Dec. 31, 2009	162	5.93	24.72	58.90	52.53
Sep. 30, 2013	140	-1.68	-0.38	7.08	5.07
Total returns during the 2016 Treasury market sell-off					
	10-Year Treasury Yield Move	**Bloomberg Barclays U.S. Agg. Bond Index**	**ABS**	**High Yield**	**Bank Loans**
Jul. 8, 2016–Dec. 16, 2016	+123 bps	-4.38%	-0.83%	5.82%	4.82%

Past performance cannot guarantee future results.
Sources: J.P. Morgan Chase & Co., S&P/LSTA, and T. Rowe Price.

MANY CROSSCURRENTS AFFECTING U.S. RATES

Accurately forecasting interest rate changes over longer time horizons is difficult. In addition to the Fed's actions, many other factors influence U.S. yields. The policy stances of central banks outside the U.S. affect yields on other high-quality sovereign debt, which influences U.S. rates. For example, if Treasuries offer meaningfully higher currency-adjusted yields than German bunds, incremental investor demand can drive a decrease in Treasury rates.

A strengthening economy can push inflation expectations—and yields—higher. However, we think U.S. economic data may have reached a plateau, which may stabilize longer-term yields. Also, if the Trump administration is unable to enact the tax cuts and fiscal stimulus policies that many investors seem to anticipate, a reversal in sentiment toward risk could boost demand for intermediate- and long-maturity Treasuries and push their rates lower.

OVERWEIGHTS TO OPPOSITE ENDS OF THE CREDIT QUALITY SPECTRUM

In terms of positioning in this uncertain rate environment, we think that a sound fixed income investment strategy involves combining overweight allocations to sectors with high credit quality, such as short-maturity asset-backed securities (ABS), with overweights to noninvestment-grade sectors, including both global high yield bonds and bank loans. ABS are backed by the cash flows from credit card receivables, auto loans, or other types of assets. We believe using opposite ends of the credit quality spectrum for portfolio positioning can provide an ideal combination of relatively low sensitivity to interest rate increases as well as the ability to benefit from rallies in sectors with credit risk.

The recent increase in short-term Treasury rates has actually made ABS more attractive by raising their yields, making them useful for a high-quality, relatively stable exposure in a taxable fixed income portfolio. Technical factors related to the Securities and Exchange Commission's October 2016 reforms of the money market industry have also helped make ABS attractive. ABS generally have high credit ratings and are significantly more liquid than many other fixed income sectors, allowing us to quickly move into or out of individual positions at efficient prices.

Most ABS have short maturities, which is a valuable characteristic despite the likelihood that short-term rates will trend higher with the fed funds rate. Portfolio managers can reinvest the principal payments from maturing notes into new bonds issued at higher rates that pay more attractive coupons.

HIGH YIELD DEBT PROVIDES SOME INSULATION AGAINST RISING RATES

At the opposite end of the credit spectrum, bank loans and global high yield bonds have relatively low sensitivity to rising rates and provide significant additional yield—albeit with elevated credit risk and lower liquidity. Floating rate bank loans are noninvestment-grade debt instruments that generally are less sensitive to changes in the market's pricing of broad credit risk than bonds given loans' higher positioning in a company's capital structure. Loans feature coupon rates that adjust periodically based on the level of a benchmark interest rate, typically the three-month London interbank offered rate (LIBOR). As a result, bank loan holders enjoy higher coupon payments when short-term rates increase.

High yield bonds are also less sensitive to the negative price effects of rising rates. Noninvestment-grade bonds from issuers outside the U.S., where many central banks are maintaining their accommodative monetary policies, may be even more insulated from any increases in U.S. rates. In addition, the fundamental condition of many high yield issuers remains solid, with default rates expected to tick lower in 2017.

STRONG HISTORICAL PERFORMANCE WHEN RATES INCREASED

As shown in Figure 1, all three of these sectors—ABS, global high yield, and bank loans—performed consistently in four separate 12-month time periods of rising interest rates over the last 15 years as well as during a period of about five months in mid- to late 2016. Bank loans and high yield bonds generated solidly positive returns in all time periods, while ABS consistently held up better than most other bond sectors. In today's uncertain environment, adopting a credit barbell strategy using these components may provide some insulation from rising rates as well as the ability to benefit from improvements in sectors with higher credit risk.

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