T. Rowe Price®
INVEST WITH CONFIDENCE

SECTOR PULSE

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Fixed Income Newsletter

Steven C. Huber, CFA, FSA
Portfolio manager for Global Multi-Sector Bond Strategies

Stephen L. Bartolini, CFA
Portfolio manager for US Inflation Protected Bond and US Limited Duration Inflation Focused Bond Strategies

FIRMING INFLATION GIVES TIPS SOME UPSIDE POTENTIAL DESPITE HAWKISH FED

KEY TAKEAWAYS

- We believe that the sub-2% annualized consumer price index readings we saw during the summer represented a low for the current inflation cycle, and we expect inflation rates will stabilize or run moderately higher in the near term, followed by 2%—or higher—inflation in 2018.
- U.S. Treasury inflation protected securities (TIPS) have yet to price in the potential uptick in inflation, providing some upside potential for TIPS investors if inflation does return to trend at 2% or higher over the next year.
- Increasing price pressure from the tightening employment market, the weaker U.S. dollar, and relatively stable oil prices are likely to contribute to rising inflation.
- The Federal Reserve, which has made it clear recently that its focus on the tightening labor market and easy financial conditions will take precedence over inflation readings that fall short of its 2% annual target, stands as the most prominent obstacle to higher inflation and will likely serve as a cap on TIPS performance in the medium term.

Expectations for higher inflation following the U.S. presidential election faltered in the first half of 2017 as declines in oil prices helped drive the overall consumer price index (CPI) lower. However, we believe that the sub-2% annualized CPI readings we saw during the summer represented a low for the current inflation cycle. As a result of continuing solid growth in the broader economy and a tightening labor market, we expect inflation rates will stabilize or run moderately higher in the near term, followed by 2%—or higher—inflation in 2018.

As of late October, U.S. Treasury inflation protected securities (TIPS) have yet to price in the potential uptick in inflation. The 10-year break-even rate, which represents the yield difference between 10-year nominal securities and TIPS and is a useful gauge of the market's inflation expectations, traded around 1.88% in late October. This provides some upside potential for TIPS investors if inflation does return to trend at 2% or higher over the next year.

CORE CPI LOOKS READY TO MOVE HIGHER

The most recent print for annualized CPI was 2.2% as of September, when the effects of Hurricane Harvey led to a spike in gasoline prices and ended a run of four months when headline inflation came in under 2%. The oil refinery disruptions caused by the hurricane led to a 13% increase in gas prices and a 6.1% jump for the energy sector overall. The weather had less impact on core CPI, which excludes food and energy. It held steady at 1.7% for the fifth straight month, but we believe macroeconomic factors could contribute to a firming of core prices in the near term. We expect 2% core readings by the second quarter of 2018, which will also support higher headline CPI.

We have already begun to see a move toward higher prices in some core sectors. After some weakness in the second quarter, shelter prices increased 3.5% in the third quarter on an annualized basis, which is only slightly slower than the 2016 pace. Moreover, the core services components most affected by the business cycle (core services ex-shelter, ex-health care) have also been firming, with prices increasing at an annualized 2.8% rate over the third quarter.

WAGES RISING AMID TIGHTER LABOR MARKET

Core services, which are more dependent on labor costs than other CPI sectors, will likely see increasing price pressure from the tightening employment market. Similar to the inflation numbers, the employment report for September was likely distorted by the recent hurricanes, but the tightening trend seems clear. The unemployment rate fell to 4.2%, the lowest level since early 2001. The unemployment rate was 4.9% a year earlier. Average hourly earnings rose 2.9% over the 12-month period ended in September.

Another factor that we believe will contribute to rising inflation is a weaker U.S. dollar, which will lead to higher prices of imported goods. Oil prices, meanwhile, have bounced back from the recent low of about U.S.$43 per barrel of West Texas Intermediate crude in June and have been trading in the U.S.$50 range—near where they started the year.

LESS ACCOMMODATIVE FED LIKELY TO CHECK RISING INFLATION

The Federal Reserve stands as the most prominent obstacle to higher inflation and will likely serve as a cap on TIPS performance in the medium term. The Fed has made it clear recently that its focus on the tightening labor market and easy financial conditions will take precedence over inflation readings that fall short of its 2% annual target. Communications from Federal Open Market Committee (FOMC) members have recently been moderately hawkish, with Fed Chair Janet Yellen saying “it would be imprudent to keep monetary policy on hold until inflation is back to 2%” and that the Fed should be “wary of moving too gradually” due to concerns about overheating the labor market or creating financial instability.

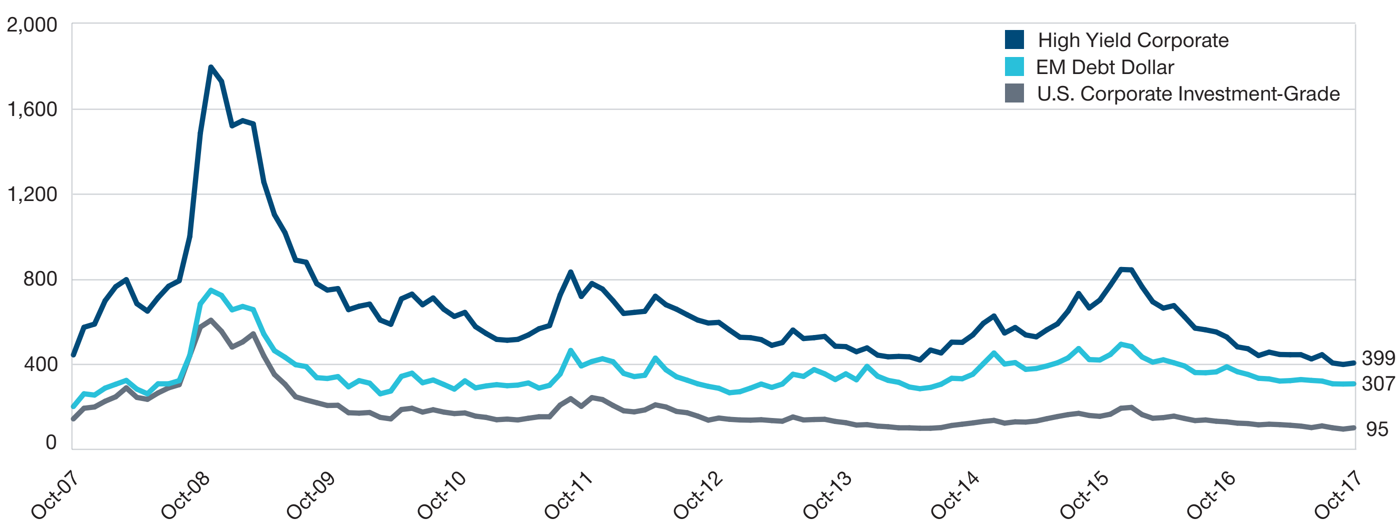
The median rate projections that the FOMC released at its September meeting indicated that the central bank intends to hike rates in December, followed by three more increases in 2018. These moves could tamp down nascent inflation. The economic projections also showed that the Fed now expects to hit its 2% inflation (measured in terms of the personal consumption expenditure price index) target in 2019 rather than 2018 as it had previously forecast.

NEW CENTRAL BANK LEADERSHIP WILL PROBABLY HAVE SIMILAR APPROACH TO INFLATION

With Yellen’s four-year term as Fed chair ending in February 2018, there is some uncertainty about the future of monetary policy (although there is a possibility that President Trump will nominate her to a second term). In our view as of late October, the leading candidates to replace her seem likely to continue her approach to inflation or perhaps move in a slightly more hawkish direction.

Yield Spreads Over Treasuries (basis points)

October 31, 2007–October 31, 2017



Sources: High Yield Corporate—J.P. Morgan Global High Yield Index, EM Debt Dollar—J.P. Morgan Emerging Markets Bond Index Global, U.S. Corporate Investment-Grade—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index.*

Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright 2017, Bloomberg Index Services Ltd. Used with permission.

Yield spreads over treasuries are the calculated spreads between a computed option-adjusted spread index of all bonds in a given rating category and a spot Treasury curve.

*Option-adjusted spread for the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index as of October 31, 2017. Spread-to-worst for the J.P. Morgan Global High Yield Index as of October 31, 2017.

Relative Value Short-Term Outlook

Sector Returns
(As of October 31, 2017)**

Sector	Driver	One-Mo. Return	YTD Return	One-Yr. Return
U.S. Treasuries	Decent strength to the economy, tax reform momentum and the Fed indicating that another rate hike is likely this year point to higher yields, but a potential change in leadership at the Fed adds uncertainty to the outlook. The market will be closely watching the FOMC's policy response to employment and inflation data and the resulting impact on financial conditions.	-0.12%	2.14%	-0.69%
U.S. Treasury Inflation-Protected Securities (TIPS)	We may see higher breakevens as inflation data has firmed. However, fed tightening, a stronger U.S. dollar and weakness in commodity prices could keep inflation in check, limiting the upside from current levels.	0.21	1.94	-0.11
Global Sovereign ex-U.S.†	Global monetary policy is shifting from easy to mixed. The improving European economy and gradually rising inflation are convincing the ECB to slowly normalize monetary policy. Meanwhile, the BOJ remains highly accomodative despite positive economic data and the UK could raise interest rates as long as volatility surrounding Brexit remains under control.	-0.75	7.93	1.26
U.S. Municipals	Municipal yield ratios versus Treasuries have widened slightly over the past month but remain rich in the intermediate section of the curve. Moderate supply and solid cash flows have kept the market technically supported, but tax policy reform remains a risk.	0.24	4.92	2.19
Mortgage-Back Securities (MBS)	The move to higher rates and tighter spreads in competing sectors has been supportive for MBS and the Fed's tapering of reinvestments was well-received, with stability in spreads. The carry profile of the sector remains attractive if volatility remains low.	-0.03	2.29	0.53
Commercial Mortgage-Backed Securities (CMBS)	CMBS spreads have held tight through a recent supply wave and look fairly valued versus corporate debt, but rising macro uncertainty could pressure spreads wider.	0.39	3.39	1.06
Asset-Backed Securities	The ABS sector continues to benefit from strong consumer fundamentals and should continue to provide a relative safe haven if volatility increases in other markets.	0.06	1.63	0.95
Global Investment-Grade Corporate	Although valuations screen rich in U.S. and European investment grade corporate markets and credit and profit cycles are somewhat extended, credit continues to benefit from supportive fundamentals and technicals. ECB tapering could potentially weigh on European corporate bonds by removing some of the technical support for the sector.	0.40	5.61	3.46
Global High Yield Corporate	The high yield market continues to be supported by low default rate expectations, solid corporate earnings and investor demand for yield. However, volatile commodity prices, outflows, weakness in equities, and corporate credit being late in the cycle are potential risks. Corporate tax reform could provide further fundamental support.	0.51	7.89	9.80
Bank Loans	Bank loans, with their floating-rate feature, appeal to investors seeking shelter from rising interest rates. Solid fundamentals, low commodity exposure, low default rate expectations and continued strong demand lead us to be constructive on the sector, but a reversal in technicals is a key risk.	0.63	3.72	5.25
Emerging Markets (EM) Dollar Sovereigns	Flows into the sector have remained supportive as the reach for yield continues. Risks in the sector include negative geopolitical developments, Fed tightening, ECB tapering, U.S. fiscal and trade policy uncertainty, falling oil prices and slowing Chinese growth data.	0.18	8.92	5.89
EM Corporates	Despite a supportive technical backdrop, we are cautious in the near-term given the extent of the sector's rally, weaker liquidity profile, and the sector's heightened exposure to global risk aversion.	0.34	7.59	6.18
EM Local	Broad-based and resolute global growth has provided a tailwind for EM local bonds. The environment remains tentative due to the risks of more than expected Fed tightening, higher global interest rates, USD-supportive U.S. policy changes, slower Chinese growth and a decline in commodity prices.	-2.82	11.06	5.18

Sources: T. Rowe Price, Bloomberg Barclays, J.P. Morgan, and S&P/LSTA.

**U.S. Treasuries—Bloomberg Barclays U.S. Treasury Index, U.S. TIPS—Bloomberg Barclays U.S. TIPS Index, Global Sovereign ex-U.S.—Bloomberg Barclays Global Aggregate ex-U.S. Index, U.S. Municipals—Bloomberg Barclays Municipal Bond Index, MBS—Bloomberg Barclays U.S. MBS Index, CMBS—Bloomberg Barclays U.S. CMBS Index: ERISA Eligible, ABS—Bloomberg Barclays Asset Backed Index, Global Investment-Grade Corporate—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index, Global High Yield Corporate—J.P. Morgan Global High Yield Index, Bank Loans—S&P/LSTA Performing Loans Index, EM Debt Sovereigns—J.P. Morgan Emerging Markets Bond Index Global, EM Corporates—J.P. Morgan CEMBI Broad Diversified, EM Local—J.P. Morgan Global Bond Index—Emerging Market Global Diversified.

†European corporates are included in this sector.

Past performance is not a reliable indicator of future performance.

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