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May 2018

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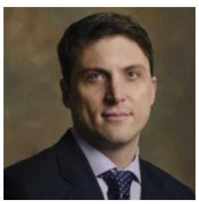

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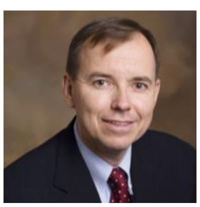

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Fixed Income

THE LONG UNWINDING ROAD—NAVIGATING REGIME SHIFT

KEY POINTS

- Global markets are approaching the end of a prolonged period of accommodative global monetary policies as major central banks move toward tighter monetary conditions.
- While markets will likely see increased volatility and higher rates, divergence in the pace of monetary tightening will open up potential opportunities on a global basis.
- With valuations stretched, casting a wide geographic net will become increasingly important with select emerging markets often showing better relative value than developed markets.
- Temporary market dislocations may open up additional opportunities identified through a disciplined, active investment approach.

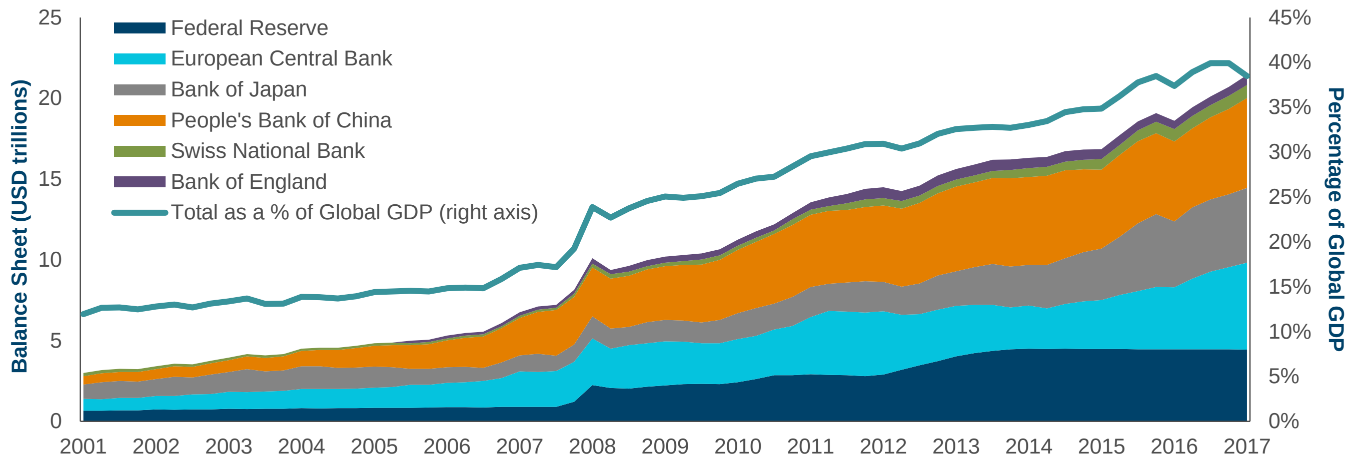
END OF AN ERA FOR FIXED INCOME

Although the global economy displayed sustained growth momentum in recent years, major developed market central banks maintained their respective loose monetary policies amid persistent subdued inflation. This widespread liquidity support helped keep wider market volatility well below long-term averages for much of the past two years and into the early weeks of 2018. However, a pronounced spike in volatility in early February and again in March reminded markets that the “Goldilocks” environment of excess liquidity, low rates, and strong economic growth cannot be counted on to last forever. While geopolitical concerns were partly behind the spikes in risk-off sentiment, the steady withdrawal of global liquidity and the move back into a higher rate environment stand as key risks to the fixed income markets going forward.

The Federal Reserve in the U.S. ended its quantitative easing (QE) bond buying back in 2014 but last year began reducing the size of its outstanding balance sheet as well as proceeding with steady interest rate hikes as the country’s economic growth has recently been around 2.5% alongside rising inflation. We maintain our expectations of three to four rate hikes in 2018 with more anticipated for 2019. Since 2013, the European Central Bank (ECB) has flooded the market with liquidity through successive rounds of QE bond purchases. However, the eurozone has enjoyed a broad-based economic recovery over the past year, allowing the central bank to taper its monthly purchases from €60 billion to €30 billion in January of this year. Attention has now turned to a potential further taper or end to asset purchases altogether in late 2018. Elsewhere, the central banks of Canada and the UK implemented rate hikes over the past year with the potential for additional rises in the year ahead.

Figure 1: **Central Bank Balance Sheets as Percentage of Global Gross Domestic Product (GDP)**

As of December 2017



Sources: U.S. Treasury Department, and Bank of International Settlements/Haver Analytics; analysis by T. Rowe Price. Based on the moving sum of the last four quarters' GDP figures.

The net result of this trend in developed market monetary policy is that peak liquidity is now in the rearview mirror and the technical environment going forward will likely be less supportive. With valuations having become increasingly stretched over a prolonged period of low rates and excess liquidity, there is little cushion in most sectors for fixed income to absorb the shift to higher rates and heightened volatility.

GOING GLOBAL KEY IN NEW LANDSCAPE

Looking at this new, more challenging regime can easily lead one to a bearish stance on fixed income. However, a closer look at the shift in monetary policy reveals an increasing divergence between different central banks on the speed and degree of tightening in the year ahead. It is our view that this divergence in the pace of travel on the road to normalization holds the potential to open up opportunities for fixed income investing when viewed from a global scale.

Looking at Europe, the central bank remains behind its U.S. counterpart in the stage of its path to normalization. Even if less so than in 2017, the ECB will remain in expansionary mode until at least September. It has also assured markets that it will maintain its balance sheet through reinvestments of maturing bonds while also keeping rates on hold for the near term. We expect that the ECB will continue to proceed cautiously with monetary normalization to entrench the economic recovery, which has, so far, shown signs of moderating in 2018.

The Bank of England, too, may tread more slowly on its path to rate hikes than its U.S. counterpart, with inflation slowing in early 2018 alongside potential Brexit economic headwinds. The Bank of Japan, meanwhile, has repeatedly indicated it is still too early to begin unwinding its long-held stimulus program, with inflation in Japan remaining some ways off its 2% target.

Taking this global perspective further to include emerging markets reveals that in 2017 we saw far more rate cuts (82) than rate hikes (34), and this trend is likely to follow a similar path in the year ahead.[1] On the whole, many emerging market economies have displayed meaningful economic growth in recent years with domestic consumption forming a larger driver of economic growth than in the past. As a result, much of emerging markets is less directly tied to U.S. Federal Reserve policy, which can create opportunities with increased policy divergence. Furthermore, many emerging market countries have implemented structural reforms and improved current account balances and currency reserves in recent years, meaning they are better positioned to weather a tightening of U.S. dollar liquidity than the period of the "taper tantrum" five years ago.

VOLATILITY CAN OPEN UP SELECT OPPORTUNITIES

We believe the strong and broad-based economic growth backdrop should remain in place over the year ahead. Despite some fissures in the synchronized global growth story appearing in the first quarter of 2018, we view the recent modest slowdown in Purchasing Managers' Index figures globally as temporary "normalization" following peak growth levels in the latter stages of 2017. This means that while the technical backdrop will likely become less accommodating, corporate fundamentals should remain largely favorable.

Even if stretched relative to their own history, emerging market bonds and credit indices can still trade with attractive premiums relative to developed markets when compared with levels from five years ago. With the global growth outlook still favorable, we see a number of compelling relative value opportunities within emerging market investment-grade corporates.

However, the U.S. investment-grade credit market in particular has been a crowded trade in recent years as investors have sought shelter from ultralow and often negative interest rates in the government sector. Therefore, U.S. credit remains susceptible to even temporary periods of heightened volatility and rising rates.

Strategies to adapt to the changing environment can be as straightforward as rolling down the curve and reducing duration. Also, we believe actively employing market-neutral strategies, such as pairs trades and barbell allocations, may further protect against the shifting inflation backdrop. Investment strategies that are less highly correlated may also benefit as times of heightened volatility can see breakdowns in expected correlations.

With valuations across fixed income stretched relative to both history and fundamentals, casting a wide geographic net becomes increasingly important. Even if stretched relative to their own history, emerging market bonds and credit indices can still trade with attractive premiums relative to developed markets when compared with levels from five years ago. With the global growth outlook still favorable, we see a number of compelling relative value opportunities within emerging market investment-grade corporates.

However, locating global relative value opportunities is insufficient, in our view, as spikes in volatility will bring increased pressure on regional markets and specific names. We maintain that sustained performance will largely depend on actively identifying which countries and credits are best positioned for long-term performance. Amid the shifting global backdrop, higher-quality, more stable markets such as Chile or Thailand offer potential investments that can withstand temporary bouts of volatility. Elsewhere, countries emerging from recessions, such as Brazil, will likely benefit from a noninflationary expansion of economic growth, which will improve government and corporate fundamentals, even as global rates become less favorable.

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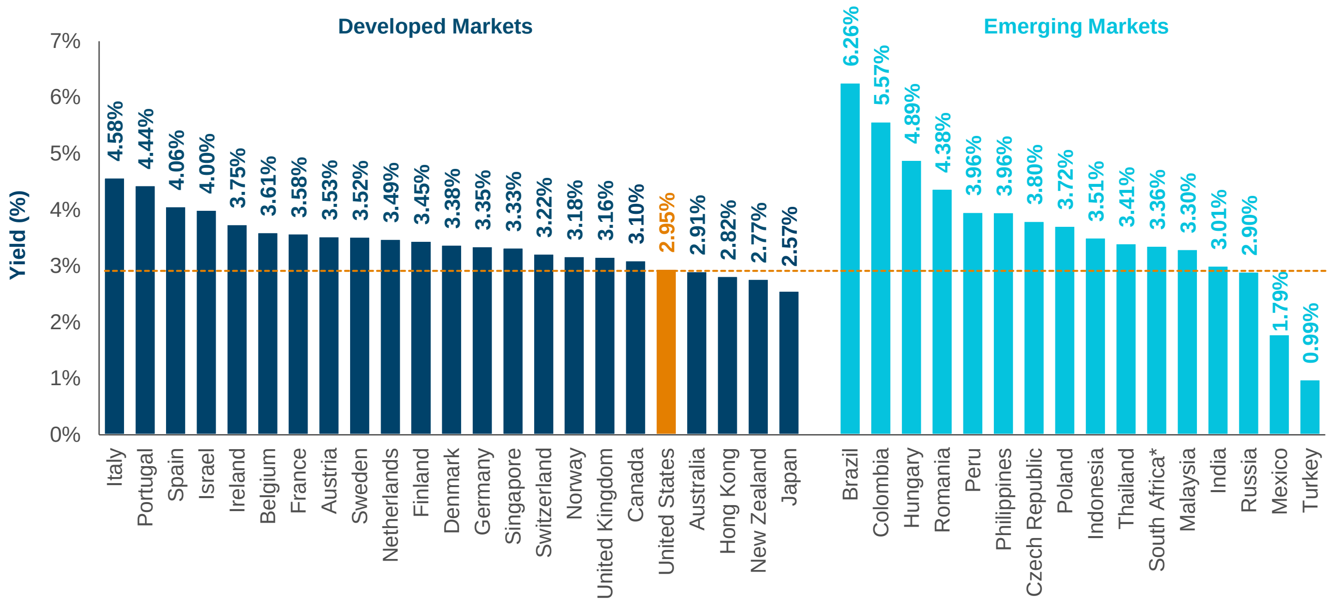
[1]Sources: IMF and CB Rates. Analysis by T. Rowe Price. As of December 31, 2017.

As well as becoming less directly tied to U.S. policy, we recognize that emerging markets also exhibit increased diversity between countries and regions. We continue to favor those countries implementing positive political and economic reforms, such as South Africa and Argentina. While we acknowledge there will inevitably be bumps in the road, especially in a higher-volatility backdrop, a commitment to market-friendly reforms will potentially enhance the long-term value of strong names with these regions.

Figure 2: **10-Year U.S. Dollar-Hedged Sovereign Bond Yields**

As of April 30, 2018



*South African yield calculated using 9-year yield.
Source: Bloomberg Finance L.P.

Furthermore, global yields in both emerging and developed markets appear attractive on a relative basis when hedged back to U.S. dollars. With this in mind, even if money flows from other regions back into the U.S. as the dollar strengthens against global currencies, we maintain that certain regions and individual names will still offer compelling relative value due to the excess yield.

By definition, a higher-volatility environment will mean market swings will be in both negative and positive directions, which means upside as well as downside risk. An active management approach can identify issuers poised for long-term performance by providing capital to fundamentally strong names during temporary periods of risk aversion and benefit from the upside potential when markets stabilize. Markets are likely to become less directional and prone to swings in volatility. We believe that a disciplined approach will allow for increased flexibility to look globally and move between regions to take advantage of diverging monetary cycles and identify the best opportunities across the fixed income landscape.

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