

INSIGHTS

INVESTMENT

The Long and Unwinding Road: Opportunities in Fixed Income Amidst the End of the QE Era



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The questions are coming up more frequently: Are we in a bear market in bonds? What will rising interest rates mean for fixed-income portfolios (not to mention equity portfolios)? In this Q&A, Mark Vaselkiv, chief investment officer of fixed income at T. Rowe Price Group, and Samy Muaddi, emerging markets portfolio manager, answer these questions and discuss where they are finding opportunities, as well as how fixed income can play an increasingly critical role in institutional asset owners' portfolios.

[Pensions & Investments] *What is your view of fixed-income markets, including investor misconceptions?*

[Mark Vaselkiv] For the last decade or so, particularly since the financial crisis, we have seen fixed income as a capital appreciation and wealth creation vehicle. Now the focus is shifting more toward capital preservation and reducing portfolio volatility.

For example, if you are managing a broad portfolio of stocks and bonds, your biggest dilemma would be the enormous increase in the value of risk assets, particularly equities. Investors are looking today for strategies in fixed income that are essentially uncorrelated with equities. That is really the big question. On the T. Rowe Price asset allocation committee, we've grown increasingly concerned about the valuations for stocks, and we believe this is a good time to add more balance in your portfolio.

[P&I] *You mentioned fixed income as an uncorrelated asset class. What about as a source of yield?*

[Vaselkiv] The whole dilemma of fixed income is that even in the riskier strategies, like high yield and emerging markets, the overall yields and spreads are near historic lows. We're finding it hard to generate meaningful sources of income given where yields are today.

We are enjoying a very low default rate in some credit strategies, and as a result, you don't have to completely give up on income in this environment; but if you're going to go into some below investment grade strategies, we would want to complement that with lower risk strategies.

One compelling area where we're focused on income

is looking for strategies that offer floating-rate interest. That would be asset classes like bank loans, where the spread is based off the LIBOR rate.

[P&I] *What are your views about portfolio construction today, particularly given the headwinds facing fixed income?*

[Vaselkiv] In our fixed-income strategy, we talk about the three S's of portfolio construction: One would be "safety," and by "safety" I mean seeking asset classes that are more defensive and can provide more capital preservation potential; the second would be short duration to help protect you against rising interest rates; finally, the third S we classify as spread, and that relates to your question about generating good income in a low-interest-rate environment. We've developed a barbell approach to fixed income, where on the "safety" side, we're looking at some risk-free assets in the U.S. and overseas.

[P&I] *Let's dive into the risk of rising interest rates. Given that rates are likely to continue moving higher, what is the impact on fixed-income investors?*

[Samy Muaddi] It really comes down to more of a portfolio-construction project and recognizing that while interest rates might be going higher in the United States, somewhere around the world interest rates are falling, and you can take advantage of that. (See exhibit) Diver-

gence in monetary policy is more evident than in recent years and the opportunity set has expanded with over 70 countries available in global emerging markets. That's why you go into emerging markets and some high-quality international fixed-income strategies. But you need a broader investment program and investment process.

As we get more concerned about Treasury yields rising above 3%, the European risk-free rates look better because the [European Central Bank] has committed to staying put for at least the next year and a half. We see less risk of losing principal from rising interest rates. While everyone is fixated on higher rates in the United States, you can find opportunities outside the U.S.

[P&I] *Where are some of the most interesting opportunities in emerging markets?*

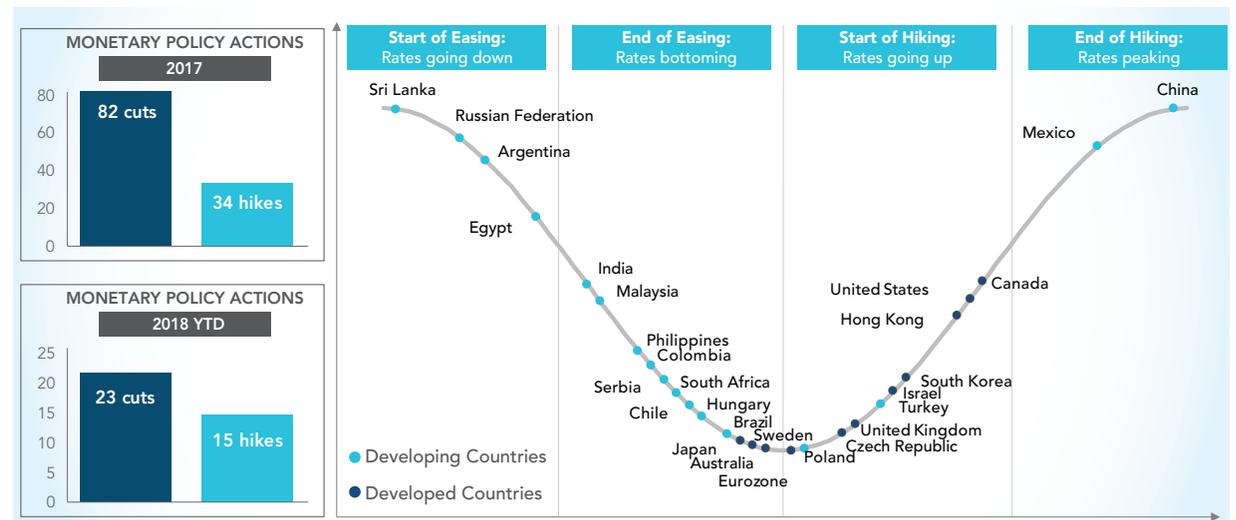
[Muaddi] Two years ago the best opportunities were investing in Brazil. Last year Argentina offered a tremendous inflection point. Both countries delivered 20%-plus returns per calendar year, which was remarkable. You're looking for countries that are experiencing some transformational change and a better political situation, potentially falling interest rates, strengthening economies.

If I were to pick one country this year that fits into that category where we're starting to invest a little bit more, it would be South Africa. They had a presidential election

DIVERGENCE BETWEEN COUNTRIES CREATES OPPORTUNITY

as of March 31, 2018

Illustrative Interest Rate Cycle



The 'Monetary Policy Actions' charts show the number of rate cuts and rate hikes made by all central banks globally. Country classifications in the chart are in line with IMF groupings as of reporting date. Sources: IMF, CB Rates. Analysis by T. Rowe Price.

that went really well. It's not for the faint of heart to invest in a place like South Africa, but there's hope, and things can turn around. That's one of the great things about emerging markets. You can invest in blue-chip companies operating in very difficult environments.

Generally speaking, national champions, whether they're banks or energy companies, utilities or telecommunications companies, can make for good long-term investments if you successfully underwrite both the corporate and macro risk. It is a value-driven process and philosophy, and it's proven to be rewarding.

|P&I| How concerned are you about U.S. tax and fiscal policy and budget deficits?

|Vaselkiv| I'm very concerned. In the U.S., we've created a situation where we're going to experience trillion-dollar deficits for the foreseeable future because of the tax cuts and spending increases. The dynamic that I just described about the advantage of buying European government bonds vs. U.S. government bonds is the mere flip side of that argument. As you know, the dollar has been declining significantly in the last year vs. other major currencies. We tend to hedge currencies on our foreign trades.

|P&I| Given this backdrop, are active strategies the only way to go?

|Vaselkiv| I shy away from either/or discussions and suggest that both/and is a better way of thinking about the issue. Exchange-traded fund strategies work very well for plain vanilla fixed-income markets and asset classes like Treasuries. In the more sophisticated and esoteric areas of the world, a strategic approach is more relevant. In some areas like high yield, dynamic global bond strategies and emerging markets corporates — all emerging markets for that matter — strategic investing really can add a tremendous amount of value.

That speaks to the importance of fundamental research.

At T. Rowe, for example, we have credit analysts working around the world. Those boots on the ground really help us follow our companies more closely and understand major geopolitical developments.

|P&I| What are the implications of rising interest rates in terms of asset allocation moves by pension funds?

|Vaselkiv| If rates move much past 3%, it's going to take a big bite out of the stock market. The yield on bonds is approaching the earnings yield on stocks, and that could lead to some derisking by pensions over the next couple of years. Some pension funds will lock in gains and shift into safer assets with a higher certainty of return — such as fixed income — than you might have in equities.

|P&I| What are your thoughts on the yield curve, and what are the implications for fixed-income investors?

|Vaselkiv| The yield curve has everybody focusing on whether it will ultimately invert, and if it does, the general theory is that we're heading toward a recession. We don't necessarily see that in today's environment. We think we still have a little bit of flattening to go.

That's another reason why you might want to own bank loans right now, because you're getting more yield on the bank loans, which reset every 90 days, then you might on some 10-year bonds.

|P&I| Volatility is up. Is this good?

|Muaddi| Yes, absolutely. Our markets were affected up until February with a tremendous amount of complacency, and valuations had gotten to extreme levels. The best way to manage portfolios strategically is during periods of volatility. When securities trade down substantially, we can often buy bonds below par and generate some appreciation. When markets are turbulent, we continually cast a wider net for sound investment opportunities.

|P&I| Do you worry about the decreasing liquidity in some fixed-income markets and the potential fallout from another liquidity crisis?

|Vaselkiv| I think part of the solution is in your portfolio-construction process. You need to own enough liquid assets in your funds so that in the event of a major outflow of funds you have the reserves necessary. In some of our strategies, we keep at least a 5% cash position in our portfolios. It takes some creativity and some innovation. We're fortunate because most of our money is institutional, not retail. As a result of that, we don't have the same problems as ETFs with that hot money issue.

|P&I| How do you find uncorrelated assets?

|Vaselkiv| As part of our platform we partner with dissimilar strategies such as global multi-sector strategies, which survey the market landscape with a long/short focus. Speaking with different marginal buyers of risk on our platform provides a more informed view of which correlations are likely to hold or breakdown as market conditions change.

|P&I| So ultimately, is the party over in fixed income?

|Vaselkiv| No. While there definitely is risk from higher rates in the U.S., it's not all terrible news in terms of the outlook for fixed income in general, if you can develop broader strategies. Really, it is an amazing time when you have pretty much all the regions of the world experiencing economic expansion and almost no large country is in a recession.

This year, we believe growth will accelerate relative to 2017 in the majority of the developed world. We should be able to find good opportunities to invest in generating income. Though we're at least mid-cycle and drifting toward late cycle in the U.S., there are many other parties around the world. ■

www.pionline.com/TRP_fixedincome

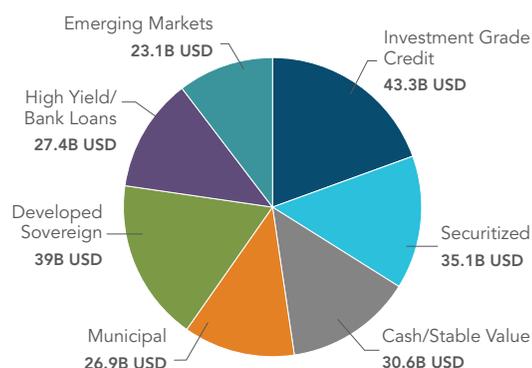
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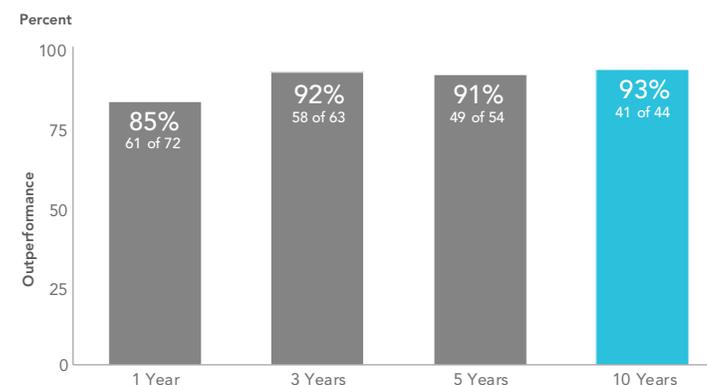
as of March 31, 2018



OUR ACTIVE APPROACH HAS LED TO ROBUST LONG-TERM RESULTS

as of March 31, 2018

93% of our fixed income composites beat their benchmarks over 10 years¹



Past performance cannot guarantee future results

¹ Performance as of 31 March 2018; All composites available at time of reporting, compared to official composite primary benchmark. (Performance based on gross annualized total returns and would have been lower as the result of the deduction of applicable fees.)

¹ The total fixed income assets under management of the T. Rowe Price group of companies. The T. Rowe Price group of companies includes T. Rowe Price Associates, Inc., T. Rowe Price International Ltd, T. Rowe Price Hong Kong Limited, T. Rowe Price Singapore Private Ltd., and T. Rowe Price (Canada), Inc. Total fixed income assets include all fixed income separate accounts and funds, along with a portion of certain T. Rowe Price U.S.- registered asset allocation funds.

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