T. Rowe Price
INVEST WITH CONFIDENCE

SECTOR PULSE
April 2018 | Volume 8: Number 4

T. Rowe Price
Fixed Income Newsletter

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RISING RATES REINFORCE CONVICTION IN LEVERAGED LOANS

KEY TAKEAWAYS

- Loan funds experienced positive flows in 2017, and this trend is likely to continue as investors gravitate toward the protection from higher rates offered by the floating rate feature of bank loans.
- Although resilient demand has allowed companies to lower their borrowing costs on existing loans, the rise of LIBOR has outpaced the growth of refinancing transactions, meaning that the rate reset feature of the asset class helped mitigate the loss of coupon for investors.
- Bank loans are a true floating rate asset again because the benefits of resetting bank loan coupons have come to fruition as LIBOR has risen above floor levels.
- Although troubled market segments such as retail are likely to experience more bankruptcies in 2018, we believe the default rate will remain comfortably below the long-term average, as earnings growth and mostly favorable macro conditions should be supportive for borrowers.

Leveraged loans are a compelling option for fixed income investors seeking a low-duration, higher-yielding asset class and who are willing to accept the credit risk associated with owning below investment-grade issuers. In the current environment, many fixed income sectors have come under pressure due to growing concerns about rising rates and inflation. Unlike most other fixed income alternatives where prices fall as rates rise, the floating rate feature of bank loans results in a low-duration profile because their coupons reset higher as rates rise. Additionally, the senior secured status of loans typically results in less volatile performance relative to high yield bonds.

The Federal Reserve's decision to reduce its balance sheet and continue gradually raising interest rates has led to higher Treasury yields. The passage of U.S. tax reform and a federal budget agreement that is expected to increase deficit spending have also placed upward pressure on rates. In February, the yield on the 10-year Treasury note climbed to its highest level since early 2014, peaking mid-month at 2.94%. After having raised rates three times in 2017, the Fed is projecting up to four rate hikes this year. Leveraged loans have historically outperformed other fixed income asset classes during periods of rising Treasury rates and monetary policy tightening. Notably, leveraged loans advanced in the first two months of 2018, while most other fixed income segments posted losses.

SUPPORTIVE TECHNICAL ENVIRONMENT

Steady demand and a dearth of new supply have created favorable technical conditions for the asset class. Demand for loans exceeded supply over the last 12 months, with a significant portion of total issuance consisting of repricing/refinancing transactions rather than new loans coming to the market. Collateralized loan obligations (CLOs) have been a key source of demand. According to J.P. Morgan, CLO volume for calendar year 2017 reached the highest annual total on record. Loan funds also experienced positive flows last year versus outflows from high yield bond funds. This trend is likely to continue as investors gravitate toward the protection from higher rates offered by the floating rate feature of bank loans. It must be noted, however, that robust demand has led to elevated valuations in the loan market. The percentage of loans trading above par has risen steadily, and we have modest expectations for capital appreciation in the year ahead.

STRONG DEMAND DRIVES REPRICING TRANSACTIONS

While resilient demand has supported the asset class, it has also fostered a surge in repricing activity. This occurs when companies return to the market to take advantage of benign credit conditions to lower their borrowing costs on existing loans. According to J.P. Morgan, repricing activity accounted for nearly half of all issuance over the previous 12 months through February. However, the rise of LIBOR has outpaced the growth of repricing transactions, meaning that the floating rate feature of the asset class helped mitigate the loss of coupon for investors.

LIBOR RISES ABOVE FLOOR LEVELS

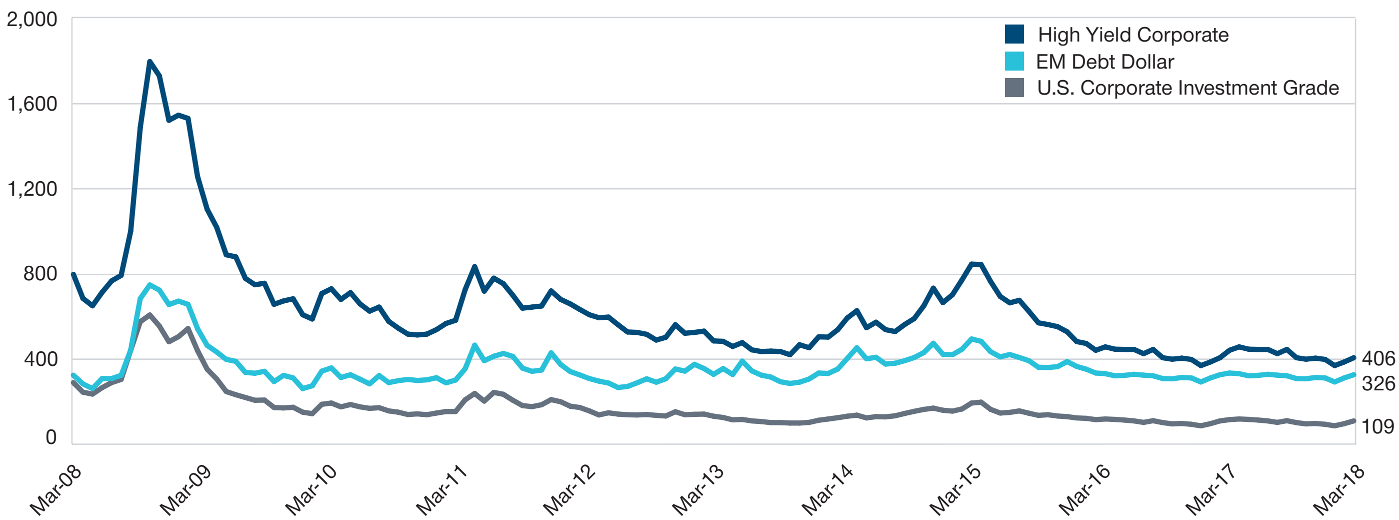
A loan's coupon equals the credit spread plus LIBOR, the interest rate at which banks lend money to each other in the London wholesale market. The total coupon typically resets every 90 days based on the LIBOR level, while the spread remains unchanged. Importantly, the benefits of resetting bank loan coupons do not come to fruition until LIBOR increases above floor levels. Three-month LIBOR ended February at 2.02%, making floors largely unnecessary. LIBOR floors today typically range from 0.75% to 1.50%. With LIBOR above these levels, bank loans are a true floating rate asset again. Still, a development of note for the asset class is that the percentage of loans in our index with LIBOR floors has declined, as a growing number of loans are coming to the market without floors.

FAVORABLE LONG-TERM OUTLOOK

We remain constructive on the long-term prospects for the loan market. Steady economic growth, favorable employment trends, healthy corporate fundamentals, and modest default levels should bolster the performance of the asset class. According to J.P. Morgan, the 2017 default volume was the lowest annual total since 2013. The number of defaults is likely to increase in 2018 due to more bankruptcies in troubled market segments such as retail. However, we believe the default rate will remain comfortably below the long-term average, as earnings growth and mostly favorable macro conditions should be supportive for borrowers. Moreover, the defaults we are likely to see this year have been well telegraphed or are widely expected by the market, thus the impact on the broader asset class should be contained.

Yield Spreads Over Treasuries (basis points)

March 31, 2008–March 31, 2018



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 2018, 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 March 31, 2018. Spread-to-worst for the J.P. Morgan Global High Yield Index as of March 31, 2018.

Relative Value Short-Term Outlook

Sector Returns
(As of March 31, 2018)**

Sector	Driver	One-Mo. Return	YTD Return	One-Yr. Return
U.S. Treasuries	U.S. Treasury yields could stabilize following their recent rapid ascent as the market has priced in loftier growth expectations and a dramatic shift from deflation fears to inflation fears. Economic data will need to surprise to the upside to sustain these trends. A higher Federal Reserve rate hike path is the main risk given that new Fed Chair Jerome Powell appears to have more confidence in the tightening cycle.	0.94%	-1.18%	0.43%
U.S. Treasury Inflation Protected Securities (TIPS)	Inflation data have been firming, placing modest upward pressure on breakevens; however, a negative move in energy prices or continued Fed tightening could cap breakeven spreads and TIPS performance.	1.05	-0.79	0.92
Global Sovereign ex-U.S.†	We expect developed market yields to increase through time as global growth momentum continues. The improving European economy and gradually rising inflation are convincing the European Central Bank to slowly normalize monetary policy. Meanwhile, the Bank of Japan remains highly accommodative despite positive economic data, and the UK will need to raise interest rates, albeit gradually, as long as political uncertainty associated with Brexit remains under control.	1.43	3.62	11.75
U.S. Municipals	Municipal yield ratios versus Treasuries have moved closer to fair value as new issue supply has been light year-to-date. Favorable supply/demand dynamics in the sector are expected to continue, and the impact of tax reform does not appear particularly onerous.	0.37	-1.11	2.66
Mortgage-Backed Securities (MBS)	Despite solid fundamentals, there is uncertainty in the sector due to the move higher in U.S. interest rates and a potential shift to a higher range in volatility, as well as technical challenges from increased seasonal supply and reduced Fed reinvestments. Offsetting demand from money managers and banks has also yet to materialize amid increased rate volatility.	0.64	-1.19	0.77
Commercial Mortgage-Backed Securities (CMBS)	Credit fundamentals in the CMBS sector are largely benign, and from a technical perspective, higher volatility is beginning to put pressure on new issue spreads.	0.39	-1.32	1.12
Asset-Backed Securities (ABS)	The ABS sector continues to benefit from strong consumer fundamentals and should continue to provide a relative safe haven if interest rate volatility were to increase; however, near-term technicals could be challenging with heavy supply coming to market.	0.18	-0.39	0.62
Global Investment-Grade Corporate	Elevated volatility has caused spreads to reprice wider. Fundamentals remain supportive in the near term, but the potential for earnings to become more challenging in the second half of the year, an increase in mergers and acquisitions that may lead to higher issuance, and fading overseas demand could weigh on the asset class.	0.25	-2.32	2.70
Global High Yield Corporate	Spreads have retraced after widening in February due to equity volatility and rising Treasury yields. Fundamentals remain solid amid a supportive backdrop for employment, corporate earnings growth, and stable oil prices. Potential risks include volatility in commodity prices, outflows, weakness in equities, and corporate credit being late in the cycle.	-0.54	-0.69	4.53
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.	0.31	1.53	4.63
Emerging Markets (EM) Dollar Sovereigns	Although the sector continues to see strong inflows, we are cautious on emerging markets given concerns around liquidity and as the Fed may need to tighten further amid higher inflation and tight labor markets. In addition, we are selective in the sector due to continued idiosyncratic political risks (e.g., Mexico, Brazil, and Turkey) and as risk assets may be challenged in the near term from risk off in global equity markets.	0.38	-1.78	3.34
EM Corporates	Despite a supportive technical backdrop, recovering fundamentals, and resilient oil prices, we are cautious in the near term given the recent weakness in the sector, less favorable liquidity profile, and little buffer for idiosyncratic shocks.	-0.19	-1.12	3.66
EM Local	Although we continue to favor countries in interest rate cutting cycles or that offer high real yields, idiosyncratic risks in the sector and the potential for additional Fed tightening lead us to be cautious. Broad-based and resolute global growth, strong inflows, stability in China, and rising oil prices have also supported the sector but provide uncertainty should these factors reverse.	1.02	4.44	12.99

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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T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

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Key Risks—The following risks are materially relevant to the strategies highlighted in this material: Transactions in securities denominated in foreign currencies are subject to fluctuations in exchange rates, which may affect the value of an investment. Returns can be more volatile than other, more developed markets due to changes in market, political, and economic conditions. Debt securities could suffer an adverse change in financial condition due to a ratings downgrade or default, which may affect the value of an investment. Investments in high yield securities involve a higher element of risk. Companies issuing leveraged loans typically have a below investment-grade credit rating and the loans could have greater price declines than higher-rated bonds.

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