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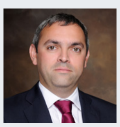
**POLICY INSIGHTS**

September 2018

*The view from our fixed income experts.*

**GLOBAL INVESTMENT TEAM**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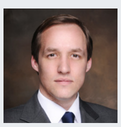
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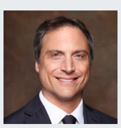
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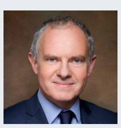
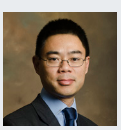

Quentin Fitzsimmons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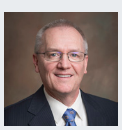
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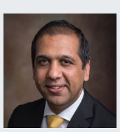
Saurabh Sud

*Once a month, our fixed income experts, helped by our analysts and traders, conduct an in-depth review of the full fixed income opportunity set. This article highlights a particular theme that dominates markets today.*

# Fixed Income Markets: The Domino Effect

From currency crises in Argentina and Turkey to extreme volatility in Italian government bonds, it has been an eventful few weeks and months in markets. Yet so far, we have not seen tangible signs of contagion leading to a wider risk aversion cycle. This was a key discussion point during our latest investment policy meetings in which the team analyzed the environment to identify where opportunities may arise.

It has been a summer to forget for some—but not all. While some countries and markets came under extreme selling pressure, others emerged relatively unscathed. The moves have been very specific and more reminiscent of dominoes falling than a systematic crisis, when everything is under stress. This has been most evident in emerging markets, where some countries—such as Romania—have been quite stable, while others have deteriorated rapidly, beginning with Argentina then moving to Turkey, Brazil, Indonesia, and, more recently, Russia and South Africa. Those coming under scrutiny have often been countries with either political uncertainty or a current account deficit that markets are worried could become more difficult to finance with U.S. interest rates rising.

"The market has been constantly hunting for the next big selling story, and any emerging market country showing signs of vulnerability has seen its currency in freefall and its domestic government bonds pressured," said Quentin Fitzsimmons, portfolio manager and member of the fixed income global investment team.

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>
> **–Quentin Fitzsimmons, Portfolio Manager**

Although its too early to call an end to the volatility—considering the risks associated with tariffs and upcoming political events such as the elections in Brazil and midterm elections in the U.S.—there may already be some attractive entry points as some countries have potentially been punished unfairly with valuations that have adjusted well beyond their associated risks. Mexico stands out in this regard. "Inflation is expected to ease, and it is possible that Mexico's central bank moves toward a rate-cutting cycle next year," said Mr. Fitzsimmons. "Attractive valuations are underlined by the historically wide spread of Mbonos [Mexico's local currency government bonds] to U.S. Treasury bonds."

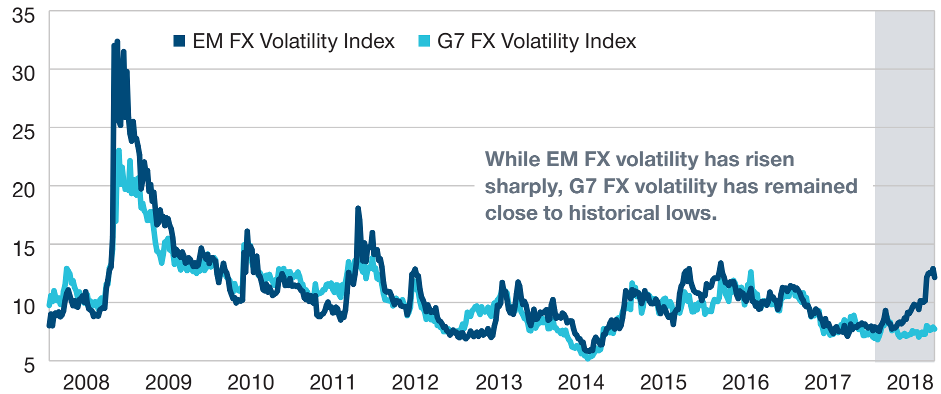
Another country whose fundamentals appeal to the investment team is Colombia. "Inflation is stable at a time when the economy is recovering. While the central bank is expected to raise interest rates next year, we believe that the market is pricing in too many hikes, which helps us to build a picture that the local government bond market is moderately attractive," said Mr. Fitzsimmons.

Turning attention to developed markets, the investment team noted that for the most part there has been much less volatility. However, not all countries have been immune. The Swedish krona, for example, has significantly underperformed other developed market currencies this year as markets became concerned about the state of the housing market and its potential vulnerability to slowing global growth. Repeated delays in interest rate rises by the Swedish central bank probably hasn't helped in this regard. However, with elections now out of the way, a key risk has been removed from the market, which may provide a good opportunity to go back into a currency whose volatility may have been excessive given its fundamentals.

On the bond front, one of the most extreme examples of volatility in developed markets this year has been Italy, where political concerns triggered significant outflows from international investors. "The correction witnessed in the short end of the Italian curve in May corresponded to a 20-standard deviation event," said Mr. Fitzsimmons. The investment team noted that while

**FIGURE 1:** **J.P. Morgan Currency Volatility Indicies: Emerging Markets vs. G7**

As of September 14, 2018




Source: J.P. Morgan. Analysis by T. Rowe Price.

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–Quentin Fitzsimmons, Portfolio Manager

long-term concerns remain, there could be a short-term tactical opportunity to benefit from Italy's attractive valuations, particularly in short-maturity government bonds.

Within corporate markets, where default rates remain at historic lows, there is also evidence of investors being much more selective and quick to punish companies at signs of any negative news. In some cases, this is suppressing secondary market liquidity. For example, credit spreads on pharmaceutical company Bayer widened significantly on concern that it could face litigation charges. Similarly, credit default swaps on Ford widened substantially after rating agency Moody's Investors Service, downgraded the U.S. automaker's credit rating to Baa3, the lowest investment-grade credit rating.

The investment team noted that the European auto sector could be vulnerable should the U.S. impose additional tariffs on European imported goods. This sector could, therefore, be a strong candidate to hold select short credit default swap positions should liquidity suddenly evaporate.

"As monetary conditions continue to tighten in the U.S. at a time when other major central banks dial back their easing programs, a key concern is whether this domino effect mutates into a more systematic environment for lower risk appetite," concluded Mr. Fitzsimmons.

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