



SECTOR PULSE

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T. Rowe Price
Fixed Income Newsletter

Steven C. Huber, CFA, FSA

*Co-portfolio Manager for Global
Multi-Sector Bond Strategy*

Kenneth Orchard, CFA

*Co-portfolio Manager for Global
Multi-Sector Bond and International
Bond Strategies*

Keir Joyce, CFA

*Associate Portfolio Manager for
Agency MBS Strategies*

After recently generating weak returns relative to Treasuries, agency MBS now appear to offer more attractive valuations. The sector underperformed in May as political uncertainty in Europe led investors to seek out high-quality sovereign debt. More broadly, agency MBS have faced headwinds since the Federal Reserve began reducing its balance sheet reinvestment in October 2017. However, demand for MBS has been resilient, and fundamentals appear solid. Additionally, higher interest rates have reduced prepayment risk, which can reduce returns as homeowners refinance mortgages at lower rates.

BUYERS STEP IN AS FED WINDS DOWN BALANCE SHEET

Investors have been concerned about how MBS demand would hold up after the Fed started to reduce its support for the sector as part of its plan to slowly shrink its USD \$4.5 trillion balance sheet, which was a legacy of its massive

AGENCY MBS COULD OFFER MORE ATTRACTIVE VALUATIONS AMID RESILIENT DEMAND

KEY TAKEAWAYS

- Although agency mortgage-backed securities (MBS) have faced headwinds since the Federal Reserve began reducing its balance sheet reinvestment in October 2017, we now see some relative value in the sector amid resilient demand.
- Expectations for increased MBS issuance in 2018 also contributed to investor worries about weakening technical conditions, but issuance has been lower than expected so far, and other buyers have stepped in as the Fed has reduced its role.
- Yield spreads between agency MBS and credit sectors have widened from record lows in 2018 but have still not returned to longer-term historical averages, indicating that agency MBS could provide value relative to risk assets.
- Within the agency MBS sector, we believe shorter-duration MBS with higher coupons could offer the best relative value.

purchases of Treasury bonds and MBS in the aftermath of the 2008 financial crisis.

According to the plan that the central bank decided on last summer, the Fed is reinvesting only the amount that exceeds a monthly cap. This cap started at USD \$4 billion for agency MBS and is increasing by USD \$4 billion every three months until it reaches USD \$20 billion. Reducing reinvestment at this pace will almost entirely remove the Fed as a buyer of agency MBS by the end of 2018.

In addition to the Fed's efforts at balance sheet normalization, expectations for increased MBS issuance in 2018 contributed to investor worries about weakening technical conditions. However, issuance has been lower than expected so far, and other buyers have stepped in as the Fed has reduced its role. As yields have become more attractive, banks have been adding MBS to their balance sheets, and large asset managers have also been purchasing MBS at an increasing rate.

LIQUIDITY, SOLID FUNDAMENTALS ATTRACT DEMAND

There was uncertainty about the level of interest money managers would show for MBS this year, but we believe there are several factors that have made the sector appealing, including its liquidity. Concerns may also be growing about how higher-risk, less liquid fixed income segments will hold up as central banks reduce the quantitative easing (QE) programs they put in place after the global financial crisis.

In addition to holding interest rates at historically low levels to help stimulate economic activity, another goal of the Fed's QE was pushing investors into riskier asset classes in search of yield, helping to keep credit flowing. This supported a lengthy rally in corporate credit that pushed credit spreads to near historically narrow levels. Yield spreads between agency MBS and credit sectors have widened from record lows in 2018 but have still not returned to longer-term historical averages, indicating that agency

MBS could provide value relative to risk assets (Figure 1). Furthermore, MBS could hold up well on a relative basis if corporate bonds face headwinds from increasing merger activity and a subsequent spike in issuance to finance deals.

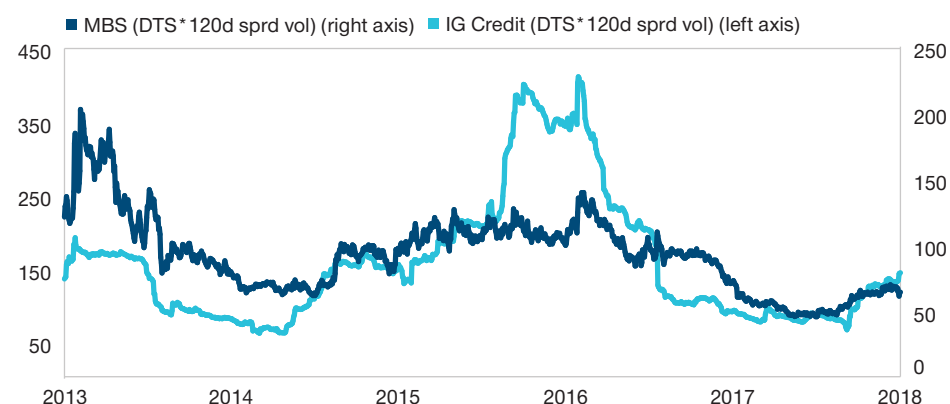
Fundamentals in the mortgage-backed sector also appear strong. Against a backdrop of near record-low unemployment and slowly rising wages that has bolstered consumer strength, the housing market appears to be on a solid foundation as demand for houses is exceeding supply.

We believe the biggest near-term risk for the sector would be if the Fed were to take a more aggressive approach to tightening monetary policy than the market currently expects. A faster pace of rate hikes, tighter financial conditions, and increased rate volatility could hurt the MBS market.

SHORTER-DURATION AGENCY MBS AND GNMAS APPEAR ATTRACTIVE

Within the sector, we generally see less value in longer-term bonds as a result of the flattening yield curve. We believe shorter-duration MBS with higher coupons

FIGURE 1: Risk-Adjusted Spreads Show Value in Agency MBS



Source: Barclays Live.

*Zero-volatility spread levels adjusted for duration and 120-day trailing spread volatility. Based on current-coupon 30-year Fannie Mae MBS and Bloomberg Barclays U.S. Investment-Grade Corporate Index spreads.

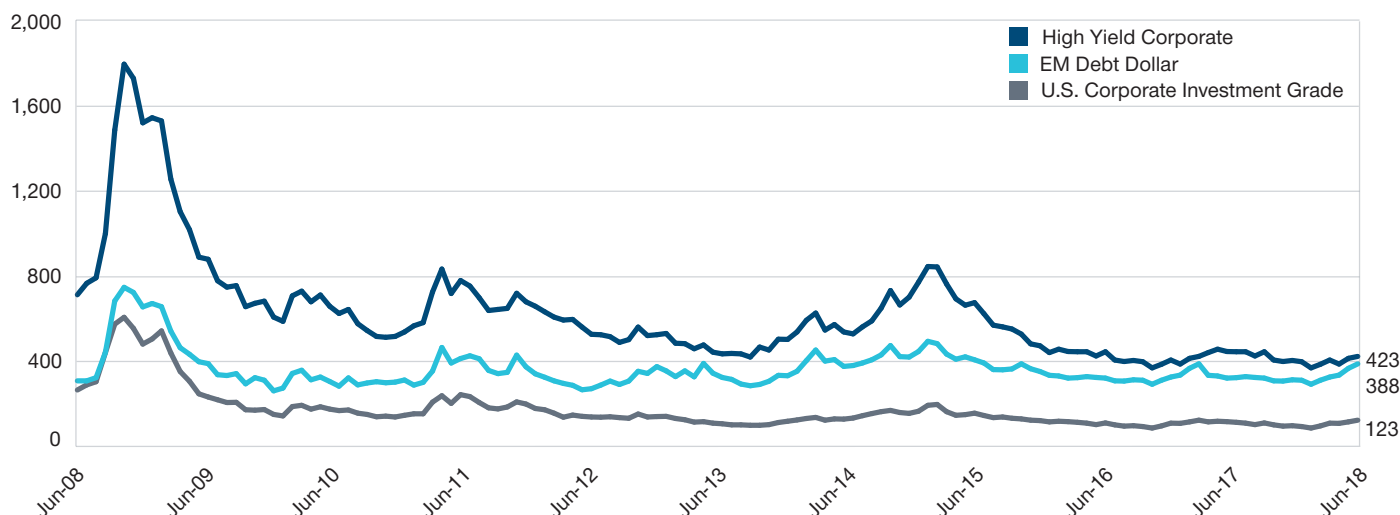
could offer the best relative value. The higher yields these securities offer can provide some cushion against the possibility of short-term volatility.

Besides agency MBS, which are issued by Fannie Mae and Freddie Mac, we are also seeing more attractive relative values in Ginnie Mae (GNMA) MBS. GNMA's faced headwinds in 2017 amid reports that some lenders participating in a Department of Veterans Affairs loan

program had been "churning" borrowers, or lending at a rate they knew could be refinanced lower within a short time to capture more commissions. This activity artificially elevated prepayments and weighed on the segment. However, we have become more constructive on these securities following federal investigations of these practices, and the recent passage of revisions to the Dodd-Frank law provides consumer protections that should help slow prepayments.

Yield Spreads Over Treasuries (basis points)

June 30, 2008–June 30, 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 June 30, 2018. Spread-to-worst for the J.P. Morgan Global High Yield Index as of June 30, 2018.

Relative Value Short-Term Outlook

Sector Returns

(As of June 30, 2018)**

Sector	Driver	One-Mo. Return	Three-Mo. Return	YTD Return	One-Yr. Return
U.S. Treasuries	The U.S. yield curve continues to flatten as growth remains on track, inflation expectations have increased, and the Fed remains seemingly more confident in the tightening cycle. However, the market is digesting a moderation in growth, impacts from tighter financial conditions, increasing pressure on corporate profit margins, and trade policy uncertainty, which could keep yields contained.	0.02%	0.10%	-1.08%	-0.65%
U.S. Treasury Inflation Protected Securities (TIPS)	Inflation expectations increased as oil prices rose following the OPEC meeting, placing upward pressure on breakevens. However, a reversal in oil prices or continued Fed tightening could cap break-even spreads and TIPS performance.	0.40	0.77	-0.02	2.11
Global Sovereign ex-U.S. [†]	German bund yields have remained low as the market continues to digest a deceleration in European economic activity from lofty levels. Also, fears about Italian politics have eased somewhat. The European Central Bank (ECB) has communicated its desire to end QE by year-end, which could put upward pressure on yields. Meanwhile, the Bank of Japan remains highly accommodative amid recent softer growth and inflation data, and in the UK, the Bank of England signaled a diluted commitment to raising interest rates and Brexit uncertainty remains a risk.	-0.70	-4.76	-1.31	2.78
U.S. Municipals	Municipal yield ratios versus Treasuries are at fair value across the curve. Favorable supply/demand dynamics in the sector are expected to continue and credit conditions remain broadly stable.	0.09	0.87	-0.25	1.56
Mortgage-Backed Securities (MBS)	Despite solid fundamentals, there is uncertainty in the sector due to the move higher in U.S. interest rates, a potential shift to a higher range in volatility, as well as technical challenges from increased seasonal supply and reduced Fed reinvestments.	0.05	0.24	-0.95	0.15
Commercial Mortgage-Backed Securities (CMBS)	Despite being in the later stages of the current credit cycle, credit fundamentals in the CMBS sector have remained largely healthy, and from a technical perspective, higher yields should increase investor demand and a light new issue calendar should be supportive.	-0.17	-0.06	-1.38	-0.25
Asset-Backed Securities (ABS)	The ABS sector continues to benefit from strong consumer fundamentals, but spreads are more likely to be influenced by macro shocks outside the market rather than by internal credit issues.	0.05	0.42	0.03	0.44
Global Investment-Grade Corporate	Elevated volatility, a flatter credit curve, weaker technicals, and EM and European political fears have 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, and fading overseas demand could weigh on the asset class.	-0.58	-0.98	-3.27	-0.83
Global High Yield Corporate	Spreads have retraced after widening earlier in the year due to equity volatility and rising Treasury yields, but valuations remain stretched. Fundamentals remain solid amid a supportive backdrop for employment and stable oil prices. Potential risks include volatility in commodity prices, outflows, weakness in equities, and corporate credit being late in the cycle.	0.12	0.17	-0.53	2.58
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.	0.16	0.74	2.28	4.57
Emerging Markets (EM) Dollar Sovereigns	Valuations have improved for emerging markets (EM) credit as rising U.S. rates, a stronger U.S. dollar, and concerns around specific countries have weighed on performance. Continued volatility in risk assets leave EM markets vulnerable to additional spread widening, but encouragingly, underlying fundamentals look better than in past periods of market stress.	-1.00	-3.51	-5.23	-2.45
EM Corporates	Some value has been restored to the sector after a 25% correction in spreads. Although recovering fundamentals and resilient oil prices provide tailwinds for the sector, we are cautious in the near term given the recent weakness in the sector, less favorable liquidity profile, and little buffer for idiosyncratic shocks.	-0.42	-1.77	-2.87	-0.14
EM Local	A stronger dollar has weighed on EM local markets, but this trend may be reversing. We continue to favor countries with less tightening pressure that offer high real yields or are showing progress on reforms. However, we are cautious as the sector has seen much higher rates in some countries and is feeling pressure that we haven't seen over the recent past.	-2.86	-10.42	-6.44	-2.33

Past performance is not a reliable indicator of future performance.

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 Dollar 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.

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