Looming Volatility Calls for Caution and Selectivity

Turbulent conditions can create opportunities to invest in mispriced securities.

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Arif Husain
Head of International Fixed Income

KEY INSIGHTS

- Volatility is set to continue this year amid increased uncertainty over the ability of major developed markets to grow at a steady pace, leading to greater dispersion of returns across asset classes.
- We expect opportunities to arise in select local emerging market markets such as Mexico, while there may also be carry opportunities in the short end of the investment grade curve.
- Owning duration is unlikely to be a successful defensive strategy this year. A better approach may be to identify high quality relative value opportunities away from traditional markets.

Continued volatility across markets is likely this year amid increased uncertainty over the ability of major developed market countries to grow at a steady pace, leading to greater dispersion of returns between regions and asset classes. We believe this environment will be suited to our Dynamic Global Bond (DGB) Fund, with its emphasis on defensive hedging and on moving quickly to identify sectors and securities that have become mispriced through temporary market dislocations.

Volatility returned to markets with a vengeance in the second half of last year. Equity markets sold off aggressively, with a number of major stock indexes entering or flirting with bear market territory in December. In bond markets, credit bore the brunt of the selloff, while government bonds benefited from a flight to quality. During this time, the DGB Fund demonstrated its ability to perform during abrupt equity corrections, providing a reminder of the diversification power it can play within a client's broader asset allocation.

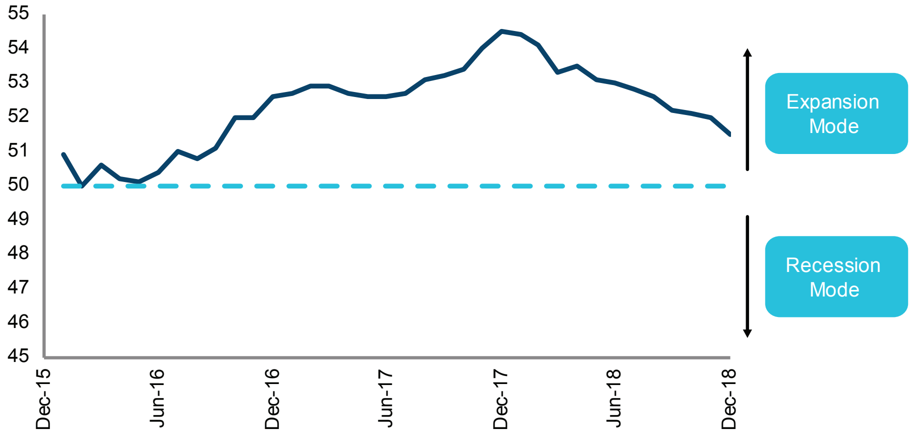
The Fund is designed so that defensive hedging positions are implemented at all times, a feature that lends itself to volatile markets. Our approach worked well during the recent market turbulence, particularly the put options we held on U.S. equities. We also benefited from our short exposition in credit markets expressed through short positioning in U.S. and European investment grade credit indexes, even if credit derivative instruments proved more resilient than cash bonds by not correcting as much in the general corporate bond sell-off. Meanwhile, the defensive position we held in the Japanese yen did not begin working until December.

Global Growth Slowing

Looking ahead, there are a number of uncertainties facing markets, most

Receding expectations

Global Manufacturing PMI Has Been Decelerating Since Beginning 2018



Sources: Bloomberg Barclays U.S. Aggregate 3-5 Year Bond Index - Yield To Worst and Federal Reserve.
Analysis by T. Rowe Price.

notably the path of global growth. The global purchasing managers' index (PMI) has been decelerating since the beginning of 2018 and this is expected to continue this year (see chart). Most eyes will be on the US in this regard: after outperforming most developed market peers in 2018, the U.S. economy looks set to moderate this year as the effect of stimulus measures diminish. If this occurs, the Federal Reserve is likely to slow the pace of interest rate hikes, which would probably result in U.S. Treasury yields narrowing versus other high-quality countries. Germany in particular stands out in this regard as a potential place to express a short duration, with bund valuations looking expensive at a time when the European Central Bank (ECB) has ceased its monthly bond-buying program. After reaching historic wides, we believe the spread differential between U.S. and German rates may soon narrow.

With regard to the U.S. yield curve itself, while we believe there is some value in short-dated Treasuries, the long-end of the curve is vulnerable to broader fiscal conditions. The U.S. government has turned on the fiscal taps via tax cuts and a range of spending measures, leading to a near-17% increase in the budget deficit for the fiscal year ending in September 2018. According to the Congressional Budget Office, the annual budget deficit could exceed $1.2 trillion by 2022, which would represent a fiscal deficit of 5.3% of GDP. The fiscal situation in the U.S. has clearly deteriorated and when the market eventually come to grips with the implication of this for future generations, longer-dated Treasuries look most at risk.

In currency markets, the U.S. dollar strengthened against almost all major and emerging market currencies in 2018. Essentially, a lot of good news has been priced in but with growth expected to slow and potentially fewer interest rate hikes ahead, the U.S. dollar looks vulnerable to a correction. As a result, we have a negative view on the currency although we recognize we might need to see improvements in sentiment toward other key markets, such as the eurozone or China, before meaningful U.S. dollar weakness materializes.

Opportunities Available in EM Debt and Credit

After a volatile fourth quarter, sentiment toward risk assets has favoured EM assets as market concerns over trade wars have receded following the 90-day truce agreed by China and the U.S. in early December. Both sides now have until March 2 to strike a deal. However, while an agreement by that date would be a positive development, to some extent this may have already been priced in by markets so the reaction to a deal could potentially be muted. As such, we have not aggressively added to risk markets, particularly given the backdrop of slowing global growth and other uncertainties such as Brexit and the U.S. debt ceiling. Instead, we have kept our exposures in places where we have the highest convictions. This includes select local currency emerging market bonds such as Mexico, where inflation pressures are easing and where there is potential for the central bank to revert to cutting interest rates over the medium-term horizon.

Turning to credit markets, we feel the best opportunities for attractive carry can be found in the front-end of the investment-grade curve. Not only can investors earn favourable yields there, but by concentrating risk in the short-end of the curve they can also benefit from less volatility. Sector specialists who we collaborate with have also highlighted the attractiveness of low duration/high coupon AAA agency mortgages backed by the U.S. government. Additionally, we expect to cherry pick specific corporate bond names in the Fund where we can see price dislocation and where our analysts have strong conviction. In this case, security selection will be the main driver of our allocation and is likely to be idiosyncratic in nature.

Where is Safety?

Given the risks prevalent in the market, it is important to find areas of safety – however, we do not believe that owning duration is one of them. Concerns around the global economy have driven a significant rally in government bonds and curves have flattened considerably, reducing the potential for high-quality government bonds to perform during another bout of volatility. Moreover, very little is being priced in for the future. In the eurozone, for example, the ECB has finished its monthly bond-buying program and although interest rates rises are not imminent, the central bank has taken a significant step toward monetary policy normalization – so far, largely ignored by markets. As such, we believe that identifying high quality relative value opportunities away from traditional markets and across the full opportunity is the best strategy in the current environment.

From a risk perspective, the world appears more nuanced, with greater differentiations now between asset classes and geographies. Among asset classes, we believe that credit is one of the most vulnerable to global growth slowing. Given this, we continue to favour expressing a short exposure in credit markets. However, we have started to notice more dispersion of returns between U.S. and European corporate bonds, so tactical rotations across geographies will be required.

Defensive Positioning Fundamental to Our Approach

We believe volatility will remain a key theme in 2019. Global growth has slowed and political uncertainty has the potential to undermine a number of developed countries, such as the UK, which is set to leave the European Union at the end of March. At the same time, global liquidity conditions continue to tighten. Combined, these factors are likely to cause turbulence, with swings possible in both directions, meaning that tactical allocations will come into their own. We believe this environment will provide a tailwind for the Dynamic Global Bond Fund as we seek to identify sectors and individual securities that are mispriced because of temporary market dislocations.

Our role is to offer a diversification alternative to our clients while generating sustainable income and to minimize capital losses for our clients. We seek to achieve these objectives through genuine diversification, dynamic active management through flexibility and a 'go-anywhere' approach, together with rigorous risk management. We will maintain this approach in the period ahead and beyond.

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