Positioning for a Pause in Fed Rate Hikes

Hold longer-than-benchmark duration positioning until credit spreads meaningfully recover.

January 2019

Stephen Bartolini, CFA
Lead Portfolio Manager for U.S. Core Bond Strategies

With 2018 behind us, financial conditions have tightened meaningfully and the Federal Reserve has set the stage for a potential pause in rate hikes. Volatility in riskier assets such as corporate bonds and equities also remains elevated as investors question how much longer the economic expansion can last. In this environment, we favor long duration[1] positioning in our domestic core bond portfolios. An analysis of historical periods when corporate credit spreads[2] meaningfully widened shows that Treasury yields often continue to decrease even after the selling pressure on corporates abates. We are likely to maintain a long duration posture until a recovery in corporate credit is well under way.

Significant Change in Fixed Income Environment in Late 2018

The U.S. fixed income environment looked very different early in 2018. Economic data pointed to a healthy U.S. expansion, and there were tentative signs of inflationary pressure. With rates poised to increase, a shorter-than-benchmark duration positioning was warranted. Ten-year Treasury note yields climbed from 2.40% at the beginning of 2018 to just above 3.20% in early October amid steady but gradual rate hikes from the Fed and fiscal stimulus-fueled growth. Riskier asset classes, including equities and high yield corporate bonds, outperformed.

However, when the yield on the 10-year Treasury breached 3.20%, risk assets were pressured lower as markets indicated that rates had increased enough to slow economic outcomes. Treasury yields then decreased in response to risk asset weakness, a process that continued throughout the fourth quarter of 2018.

Financial Conditions Tighten Amid Signs of Slowing Growth

As we enter 2019, increasing evidence suggests that U.S. growth is slowing. Inflation expectations have fallen rapidly alongside oil prices. Credit spreads have moved meaningfully wider, tightening financial conditions.

Now near 2.50%, the federal funds rate appears to be close to or at the neutral rate, which is the level that neither boosts nor reins in economic growth. The Fed's communications are signaling that rate increases may pause and that additional policy tightening will depend on the strength of economic data. All of these factors support Treasuries and favor maintaining a longer-than-benchmark

[1] Duration measures a bond's sensitivity to changes in interest rates.
[2] Credit spreads measure the additional yield that investors demand to hold a bond with credit risk relative to a comparable-maturity Treasury security.

> ...it's prudent to maintain a long duration posture even if corporate credit begins to recover and to remain in that positioning until the credit recovery firmly takes hold.

duration posture in our domestic core bond strategies.

Remain Long Duration Until Credit Risk Meaningfully Recovers

With sentiment in risk assets especially poor at the end of 2018, any bounce in risk appetite presents a risk to this positioning. Traditionally, Treasury yields rise as risk appetite improves. However, our research shows that after instances of particularly poor credit spread performance, Treasury yields tend to remain stable or decline further over the near term.

We examined the 14 instances of two-month periods when investment-grade corporate debt posted excess returns of -2.00% or lower since 1989 and the reaction of credit spreads and Treasury yields in the subsequent two-month periods. This analysis showed that, in 11 cases, Treasury yields continued to decline, even if credit spreads recovered. In all cases where credit spreads continued to widen, Treasury yields decreased, which is not surprising. Additionally, in the four post-financial-crisis periods when credit spreads materially weakened, Treasury yields declined even as credit spreads subsequently recovered. We believe this shows that it's prudent to maintain a long duration posture even if corporate credit begins to recover and to remain in that positioning until the credit recovery firmly takes hold.

High Conviction In Long Duration Posture

A pause in the Fed's rate hikes could revive appetite for credit risk but also keep Treasury yields well below recent highs. On the other hand, if the Fed presses ahead with further rate hikes, the market would increasingly price in a policy error. This would likely trigger a broad sell-off in risk markets and drive longer-term Treasury yields meaningfully lower, inverting the yield curve. Given these possibilities, we have high conviction in our longer-than-benchmark duration positioning.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:
Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates which may affect the value of an investment. Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default which may affect the value of an investment.

INVEST WITH CONFIDENCE®

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

To learn more, please visit troweprice.com.

T.RowePrice®

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

ID0001925 (01/2019)
201901-705490