



The Bond Market Has Woken Up From a Deep Slumber

Heightened volatility reflects a changed reality.

November 2021

KEY INSIGHTS

- Bond market volatility has surged recently as central banks try to strike a balance between easing fears over inflation and continuing to encourage growth.
- Inflation is rising as the release of post-lockdown pent-up demand meets supply constraints and rising energy prices.
- The likelihood of continued inflation-related market volatility strengthens the case for an active approach to bond investing.

Bond market volatility has surged recently as central banks try to strike a balance between easing fears over inflation and continuing to encourage growth. This follows a long period in which bond volatility was artificially suppressed by the huge injections of central bank liquidity that followed the global financial crisis. In our latest policy meetings, the investment team discussed the reasons behind the latest volatility and its implications for bond investors.

How Long Is “Transitory”?

Inflation is causing alarm across the world as the release of pent-up demand following the easing of COVID lockdowns is being met with supply constraints and rising energy prices. Markets have reacted to this by speculating on how quickly central banks are likely to taper asset purchases and raise interest rates—hence the volatility in fixed income markets, particularly at the front end of the curve.

So far, the leading central banks have responded by insisting that they will “look through” the surge in inflation because it is likely to be transitory in nature.

This claim is becoming harder to sustain, however—and central banks are feeling the pressure. “The reality is that central banks in smaller countries, whose credibility is more fragile than the Fed or the European Central Bank, are already buckling,” said Quentin Fitzsimmons, a portfolio manager and member of the fixed income investment team. “The Brazilian and Russian central banks, for example, have both raised rates quickly. But the more mainstream, orthodox central banks are slowly getting dragged in, too. We saw this in early November, when the Reserve Bank of Australia announced it is going to abandon its yield curve control policy.”

It’s hard not to feel some sympathy for central banks—the dilemma they face is a tricky one. If they’re too slow to react

Global Fixed Income Team



Arif
Husain



Andrew
Keirle



Kenneth
Orchard



Quentin
Fitzsimmons



Ju Yen
Tan



Saurabh
Sud

Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

“...the more mainstream, orthodox central banks are slowly getting dragged in, too.

— Quentin Fitzsimmons
Portfolio Manager

“Countries that issue inflation-linked debt face a contingent liability problem...

— Quentin Fitzsimmons
Portfolio Manager

to the threat of inflation, it could spiral out of control; if they act too quickly, they risk spooking the markets and strangling the recovery. “They have to tread so carefully,” said Mr. Fitzsimmons. “However cautiously it’s communicated, if a bank says, ‘We might have to raise rates next year,’ the markets will immediately adjust their expectations and that will cause volatility.”

Indeed, this exact scenario occurred recently when the Bank of Canada (BoC) issued a statement in which it said that it will consider raising rates “in the middle quarters of next year” in response to rising inflation. While a vague commitment to thinking about raising rates in the middle of 2022 might sound like a dovish stance to many investors, the markets reacted as if the BoC had adopted a hawkish stance—the Canadian dollar soared and bonds were hit hard.

Investors Seek Strategies to Manage Volatility

As long as uncertainty remains over the path of inflation and the responses of central banks, volatility in fixed income markets is likely to persist. Worried bond investors are now scrambling to buy inflation-linked securities as a form of insurance against continued rising prices—only to find that there is not enough of it to go around. “Countries that issue inflation-linked debt face a contingent liability problem in that if inflation continues to rise, the cost of servicing that debt will rise too,” Mr. Fitzsimmons said. “That’s why some countries, notably the UK, seem reluctant to issue more inflation bonds, even though there is clearly a market for them.”

Another way to mitigate risk would be to reduce interest rate exposure by lowering the amount of duration in the portfolio—or even running a negative duration strategy. Alternatively, investors may consider structural curve positioning strategies, which seek to benefit from changes in the shape of the yield curve, not just overall level of duration.

Attempting the latter may be complicated at present because there is disagreement over whether the yield curve should be flatter or steeper. “Yields steepen if a recovery is expected, but also if inflation is anticipated because people want to be compensated for inflation risk,” said Mr. Fitzsimmons. “Recently, though, the curve has been flattening. This is a common phenomenon at the beginning of a hiking cycle as the front end of the curve shifts up and the back end remains anchored or shifts down because of concerns over future growth. A flattening curve implies the markets believe that the mainstream central banks will hike soon.”

The likelihood of continued volatility strengthens the case for adopting an active approach to bond investing—particularly given the Bloomberg Global Aggregate Total Return Index was down by more than 4.5% year-to-date on November 29. “There’s such a variety of potential outcomes depending on the speed, timing, and levels of central bank hikes,” said Mr. Fitzsimmons. “There’s also an asset class choice—how much inflation protection you want and how much it will cost you—as well as your yield curve positioning. It’s very much an environment for active management.”

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

T.RowePrice[®]

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. 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.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

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.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

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—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à.r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

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.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 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.

South Africa—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

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

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved 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.

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.

© 2021 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.