



POLICY INSIGHTS

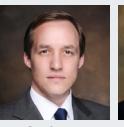
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The view from our global fixed income portfolio managers.

GLOBAL INVESTMENT TEAM



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Looking for hideouts in fixed income

With global growth on a firmer footing, several major central banks are moving toward tightening their monetary policies. The potential impact of such a synchronized move by central banks remains relatively unknown for bond markets and raises the question of whether there is currently any value in holding fixed income. This was a key discussion point during our latest investment policy meetings.

After years of ultra-accommodative monetary policies, the tide seems to be turning. The Federal Reserve is due to begin unwinding its US\$4.5 trillion balance sheet from October and looks on course to deliver its third rate hike of the year in December. Among the other major central banks, the Bank of Canada has already raised rates twice since July, and the Bank of England is inching closer toward hiking rates for the first time in a decade in order to cool inflation pressures. It is also likely that the European Central Bank will soon confirm a tapering of its bond-buying program, expected to begin next year.

“A synchronized tightening move among the major central banks could give developed market government bonds a volatile ride,” said Quentin Fitzsimmons, portfolio manager and member of the global fixed income investment team. “Navigating this uncertain environment will require a smart approach,” he added.

Specific positioning on the yield curve is likely to take center stage within portfolio construction, and the team agreed that U.S. long-dated bonds should remain well anchored despite pressure increasing on the short-end of the curve. Indeed, while the Fed clarified its rate hike cycle for the next 12 months at its latest monetary policy meeting, it also lowered its projections for the terminal rate—the rate at which the economy neither expands nor contracts—to 2.75% from 3%.

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—Quentin Fitzsimmons, portfolio manager and member of the global fixed income investment team

The opposite may be true for Japan, where there is speculation that the Bank of Japan may reduce its buying of longer-maturity bonds, which could result in a

Once a month, our fixed income portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This monthly article series examines one of the predominant themes highlighted during their discussions.

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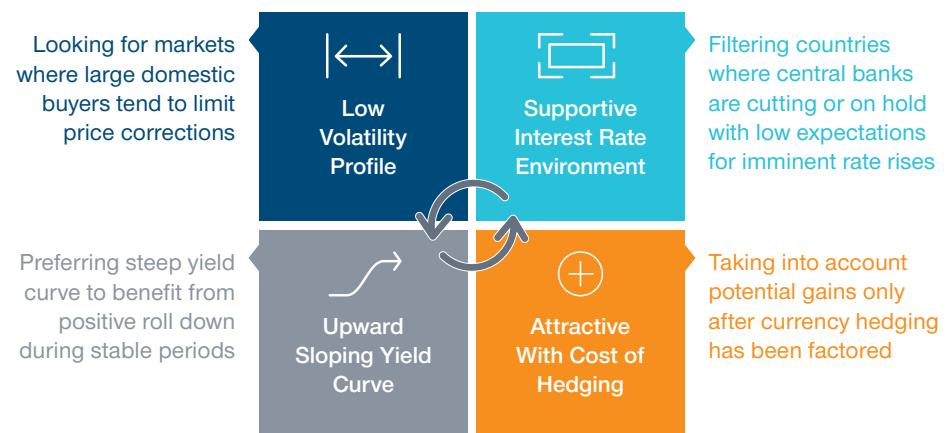
—Quentin Fitzsimmons, portfolio manager and member of the global fixed income investment team

steeper curve. In other markets, technical factors such as demand from domestic investors will also matter. “While the short and belly of the UK curve look vulnerable in the current environment, potential support exists from technical factors for 50-year gilts,” said Mr. Fitzsimmons, noting possible demand for this part of the curve from UK pension and insurance companies needing to meet future liabilities.

In addition to yield curve positioning, another way of navigating the current environment is to identify countries that are potentially less sensitive to a rising rate environment. Australia stands out in this regard, as although its domestic bond market is likely to react to a sell-off in U.S. Treasuries, it should quickly revert to being driven by domestic fundamentals once the market settles, according to Mr. Fitzsimmons. “The on-hold Reserve Bank of Australia keeps the domestic government curve well anchored,” he said.

FIGURE 1: What Makes a Good Hideout Market in Fixed Income?

As of October 19, 2017



Source: T. Rowe Price.

Israel also offers a potential refuge from interest rate volatility. With little sign of inflation in the country’s economy, the Bank of Israel is likely to remain on hold for the foreseeable future. However, the yield curve seems to be pricing an interest rate path similar to the one likely to be followed by the U.S. As a result, the implied steepness of the curve makes it a compelling opportunity in the current climate. Another market that has the potential to be less correlated with the major markets is Malaysia, according to the team. “The strong domestic investor base in Malaysia should help to put a cap on rising yields,” said Mr. Fitzsimmons, adding that interest rate volatility is generally lower for Malaysian government bonds.

However, should low-interest countries be dismissed? The team spent some time discussing the merits of investing in low-yielding markets where financing is cheap, which can, therefore, offer attractive relative value on a currency-hedged basis despite accommodative

monetary policy by the local central bank. “Sweden is a perfect example of a country where we continue to find value despite bonds trading at expensive levels,” said Mr. Fitzsimmons. “The positive currency-hedging effect makes it attractive for U.S. dollar, UK sterling, and euro-based investors,” he added.

In all, the environment is shifting away from outright duration views toward relative country positioning and yield curve positioning as central banks try to navigate the tricky path of prudent monetary tightening. Looking for hideout places in fixed income feels very much like an active position at present.

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