Looking Beyond Negative Yields

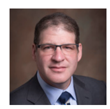
Globally diversified bonds still play a key role in portfolios.

December 2019

KEY INSIGHTS

- We believe that bonds will continue to provide benefits in terms of both portfolio diversification and return in the years ahead.
- However, with absolute bond yields at low or even negative levels in some markets, these benefits may be muted relative to historical patterns.
- These dynamics heighten the need to take an active, global approach to a fixed income allocation that can provide opportunities to gain additional yield.

Steven Boothe, CFA
Head of Investment-Grade Credit and Portfolio Manager



Lowell Yura, CFA
Head of Multi-Asset Solutions, North America

Bonds will continue to provide benefits in terms of both portfolio diversification and return in the years ahead, in our opinion. However, with absolute bond yields at low or even negative levels in some markets, we acknowledge that these benefits may be muted relative to historical patterns. These dynamics heighten the need to take an active, global approach to a fixed income allocation. Investors can diversify their bond allocations across regions and segments that provide opportunities to benefit from the total return potential of international or emerging markets or from the additional yield from currency hedges. From a broader asset allocation perspective, we believe bonds still provide an attractive source of diversification against equity market downturns.

Accommodative Monetary Policies Likely to Continue

Years of negative benchmark lending rates and aggressive quantitative easing policies from the Bank of Japan and the European Central Bank have driven yields on high-quality Japanese and eurozone government debt—and some corporate bonds—well into negative territory. We see little sign that these accommodative monetary policies will change in the foreseeable future, making it increasingly difficult for fixed income investors to generate income. However, we do not anticipate that the U.S. Federal Reserve would implement negative rates.

Of course, a negative return on a bond with a negative yield is only guaranteed if an investor holds the bond to maturity. While it is possible that yields could become even more negative, providing opportunities for price appreciation by selling a bond before it matures, we believe it is more prudent to seek to generate total return in more efficient ways.

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> ...we expect a fixed income allocation to provide a useful hedge against a future downturn in stocks.

Opportunities to Diversify Outside Government Bonds

One potential source of return from bonds is carry,[1] which measures incremental yield. From a broad asset allocation perspective, carry becomes particularly important when equity markets are not following clear upward or downward trends. To find bonds with more potential for carry, investors can look to securitized debt such as mortgage- and asset-backed securities, which typically offer higher coupons than Treasuries. Corporate bonds provide attractive coupons and carry along with higher credit risk, making fundamental credit analysis vital. Bank loans, which have noninvestment-grade credit ratings but receive repayment priority over bonds in the event of issuer default, are a market that has expanded meaningfully in recent years and can generate attractive carry.

Corporate bonds from issuers in developed international and emerging markets can also offer beneficial carry. Issuance of emerging markets bonds has grown meaningfully in recent years, providing more potential opportunities in a market that has also become higher quality. In addition, hedging the currency exposure in non-U.S. dollar-denominated bonds back to dollars can generate additional yield. This hedged yield results from the difference in short-term yields between non-U.S. currencies—short-term rates are very low in euros, for example—and U.S. dollar short-term rates.

Bond Allocations Continue to Provide Diversification

While the income available from bonds has fallen with global yields, we believe that a core bond allocation will continue to be an attractive source of diversification against a bear market in equities. The rolling 12-month returns for the Bloomberg Barclays U.S. Aggregate Bond Index were negatively correlated with the returns of the S&P 500 Index during the eurozone debt crisis in 2012 and 2013, during the global financial crisis in 2007 and 2008, and in the early 2000s after the bursting of the dot-com stock bubble.[2]

Bonds continue to benefit during periods of risk aversion, so we expect a fixed income allocation to provide a useful hedge against a future downturn in stocks. With equity valuations at elevated levels relative to historical averages, our expectations for stock returns are muted, potentially making this diversification even more valuable.

Active Management Essential on Many Levels

Active portfolio management is an essential component of an effective fixed income allocation. This can take the form of fundamental credit analysis to inform security selection, which is particularly important in segments that provide higher carry. Another form of active portfolio management involves tactical allocation to bonds in non-core segments such as emerging markets. At the broadest level, multi-asset portfolio managers can help optimize an investor's allocations across asset classes based on an economic outlook and tolerance for risk.

[1] Carry is a bond's coupon minus the cost of cash financing.
[2] Sources: Bloomberg Index Services Limited and S&P/Haver Analytics (see Additional Disclosures).

WHAT WE'RE WATCHING NEXT

Heathy consumer spending has underpinned the U.S. economy in 2019 as manufacturing has shown continuing signs of weakness, weighing on corporate capital expenditures. With the Fed seeming unlikely to cut rates further in the near term, we are closely monitoring consumer sentiment surveys to evaluate whether consumers will maintain their spending pace and support the economy.

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