The U.S. Economy: No Longer Exceptional

How slower U.S. growth could impact fixed income markets

January 2019

KEY INSIGHTS

- A slowdown in U.S. growth has implications for global fixed income markets.
- Potential for U.S. dollar to depreciate.
- Local debt of emerging market countries could become more attractive.

Following a spectacular year in which the U.S. economy outpaced most other developed market countries, 2019 looks set to be dominated by a deceleration that drives growth in the world's largest economy down toward its long-term average potential. During our latest policy meetings, the investment team discussed how the end of U.S. economic exceptionalism could affect markets.

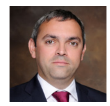
As the effect of fiscal stimulus diminishes and uncertainty over trade tariffs continues, U.S. growth is expected to slow in 2019. "The growth gap between the U.S. and other developed markets should narrow in 2019, with significant implications for global markets," said Arif Husain, portfolio manager and head of International Fixed Income.

One consequence of softer U.S. growth is likely to be a slowing in the pace of Federal Reserve monetary policy tightening. This is already anticipated by the markets, which are pricing only one hike in 2019 compared with the two hikes signaled by the most recent Fed dot plots, published in December. "The Fed has so far been the furthest ahead amongst its developed market peers in terms of normalizing monetary policy," noted Mr. Husain.

The impact of fewer Fed hikes is likely to be reflected in the narrowing of U.S. yields against other countries where central banks have been slow to remove accommodative policies, such as the European Central Bank. "Going long U.S. bonds and short German bonds has been a popular but unsuccessful trade for some time, but we may finally be in a position where we see U.S. Treasuries outperforming," said Mr. Husain.

Turning its attention to other markets, the investment team pointed out there is potential for large impacts in the currency sphere from an end to U.S. exceptionalism. "One of the casualties of slower U.S. growth could be the U.S. dollar," said Mr. Husain, pointing out that in 2018 the U.S. dollar performed the unusual role of acting as both a safe-haven currency at times of market stress and as a proxy risky currency during periods of low volatility, thanks to

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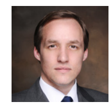
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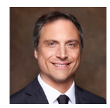
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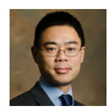
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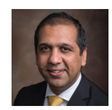
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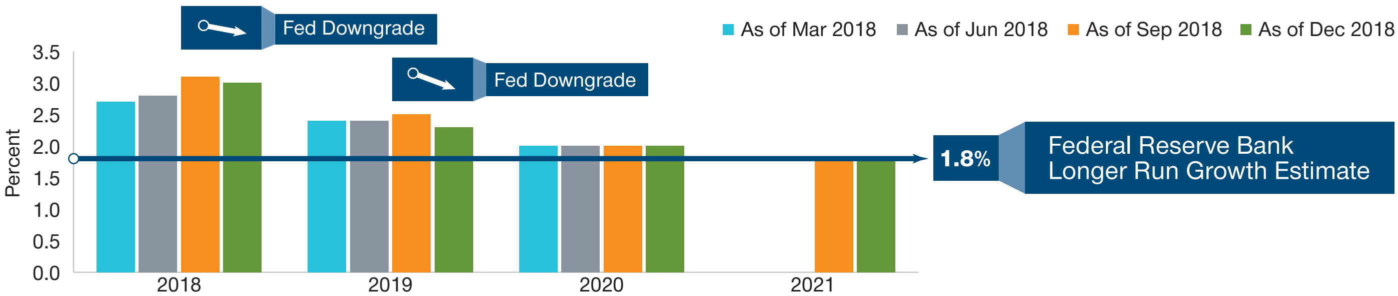
Each month our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

(Fig. 1) Future U.S. Growth Has Been Revised Down By The Fed

As of December 20, 2018



Source: Federal Reserve Bank Economic Projections. Analysis by T. Rowe Price.

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its attractive carry profile. This dual role resulted in appreciation against almost all major and emerging market currencies. "A lot of good news seems to be priced into the U.S. dollar and that leaves it vulnerable in my view," concluded Mr. Husain.

In developed market currencies, valuations are now more conducive to adopting long positions against the U.S. dollar—however, this might not necessarily be enough to persuade investors to act accordingly. "While the euro is technically a prime candidate for appreciation, the recent slowdown in Germany and political uncertainty in Italy and France are warning signs for some international investors," said Mr. Husain. "Only a steady improvement in European economic conditions is likely to lead to significant euro appreciation."

The investment team pointed out that emerging market currencies could turn out to be the real winners in 2019, supported by a softer monetary policy stance from the Federal Reserve. In particular, the currencies of countries with large external imbalances and/or high funding costs should benefit, such as the South African rand, the Turkish lira, and the Indonesian rupiah. A less hawkish Fed could also be supportive for some Eastern European currencies, including the Polish zloty and the Czech koruna, which have attractive valuations and positive growth outlooks. "However, there is a big caveat to this scenario," warned Mr. Husain. "The U.S. needs to grow at around its long-term potential level. Any sign of a more severe U.S. growth slowdown could send emerging market currencies into free-fall."

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Given this backdrop, the investment team noted that a potentially better way to invest in the current environment would be to own local emerging market bonds. A more accommodative Fed, together with a stabilization in the U.S. dollar, would give emerging market central banks some breathing space with their current high interest rates profiles and possibly give some the room to ease monetary policy. China in particular stands out in this regard—the Chinese economy continues to slow at a time when inflation pressures have receded, yet the central bank has so far been reluctant to cut interest rates due to the pressure on the currency from the U.S. dollar. "A more stable Chinese renminbi could drive the central bank into action. An easier monetary policy stance, combined with the introduction of China into global fixed income indices, makes investing in Chinese local bonds an attractive proposition," added Mr. Husain.

2019 is shaping up to be another year where fundamentals and valuations are the primary drivers for global fixed income markets. In addition, investors' appetite for risk and protection is expected to play a key role in markets. How all this plays out will be highly dependent on the path of U.S. growth.

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