



Positioning for a Pause in Fed Rate Hikes

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

January 2019

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 duration¹ positioning in our domestic core bond portfolios. An analysis of historical periods when corporate credit spreads² 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



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¹Duration measures a bond's sensitivity to changes in interest rates.

²Credit spreads measure the additional yield that investors demand to hold a bond with credit risk relative to a comparable-maturity Treasury security.

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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 versus Treasuries of -2.00% or lower since 1989 and the reaction of credit spreads and Treasury yields in the subsequent two-month periods.³ 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.

Based on T. Rowe Price analysis using Bloomberg Barclays data.

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³ Time period represented is from January 1989 to December 2018. Investment grade corporate debt is represented by Bloomberg Barclays U.S. Corporate Investment Grade Index. Treasuries is represented by the 10-year U.S. Treasury note.

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