



Fresh Hope For the Global Economy?

How looser financial conditions could impact fixed income markets.

February 2019

KEY INSIGHTS

- Major central banks that tightened liquidity conditions in 2018 are now signaling a pause.
- Potential for high-quality countries with rate hikes priced in to perform well.
- Emerging market local bonds could benefit from looser global financial conditions.

Major central banks have put the brakes on their quantitative tightening efforts. This marks a sharp turnaround from last year, when interest rate hikes were plentiful and central banks made significant steps to shrink bloated balance sheets. During our latest policy meetings, the investment team discussed whether the shift to a more cautious stance offers fresh hope for investors concerned about slowing growth, especially if it leads to a new supply of liquidity.

The change of tone from the Federal Reserve in particular, which said it has become more “data-dependent,” has been a key driver of the rally seen in risk assets so far in 2019. In addition, the European Central Bank (ECB) has raised the possibility of a new round of financing for banks, and, more recently, Australia’s central bank has put the option of a rate cut back on the table. “The dovish rhetoric among some of the major central banks has

fueled investor optimism that we might get looser financial conditions in 2019,” said Andrew Keirle, a portfolio manager and member of the fixed income investor team.

For credit markets, the developments have been a welcome reprieve, with the environment much more supportive for investment-grade companies issuing bonds than during the second half of 2018. “The Fed has effectively supported the issuance of corporate bonds,” said Mr. Keirle.

If major central banks follow through with their dovishness and more liquidity is supplied to the markets, the short end of the curve in most traditional bond markets could perform well, the investment team noted. High-quality countries where interest rate hikes have already been priced in are particularly attractive as there is potential for these hikes to be pushed back indefinitely. Countries such as Israel, where growth has softened and inflation has fallen

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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.

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— Andrew Keirle

Portfolio Manager and Member of the Fixed Income Investor Team

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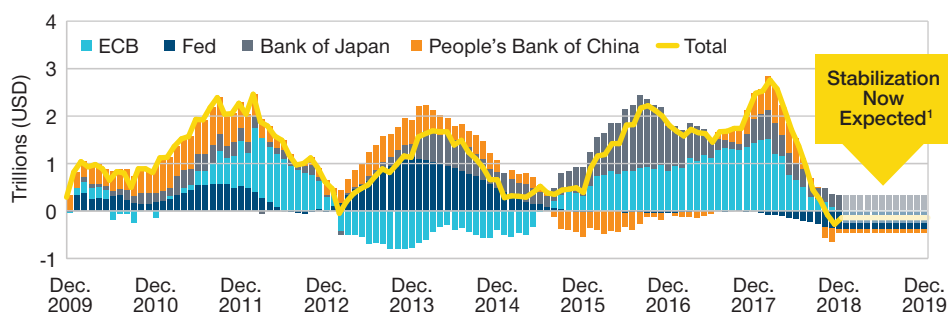
— Andrew Keirle

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(Fig 1) Central Bank Liquidity Strongly Reduced in 2018

Major central banks' balance sheets, year-on-year change

As of December 31, 2018



Sources: Federal Reserve Bank, European Central Bank, Bank of Japan, Bank of China.

Analysis by T. Rowe Price.

¹ T. Rowe Price estimates.

to the lower end of the central bank's target range, are prime candidates in this regard.

For some higher-carry markets, a more accommodative Fed stance may even open the door for interest rate cuts. India has already taken advantage of this, but there is the potential for others—such as Mexico—to follow. “The short end of the local bond market in Mexico currently stands out as a potential beneficiary should we see further evidence of a growth slowdown in the U.S.,” said Mr. Keirle.

Emerging market local currency bonds as an asset class could be supported by looser financial conditions. “The first wave of flows has gone into emerging market equities and hard currency

debt, but local emerging market bonds could be next to benefit from increased investor appetite for risk,” Mr. Keirle said.

The local debt of countries such as Indonesia and Romania stand out because valuations are attractive. However, momentum will only be sustained if growth outside the U.S., notably in China and the eurozone, can show clear signs of improvement longer term. Frontier emerging markets may also start to appeal to some investors as they offer attractive income profiles. “Investing in currencies like the Argentine peso and the Turkish lira makes sense as long as the global liquidity theme continues to dominate markets,” said Mr. Keirle.

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