

Opportunities in fixed income for investors moving out of cash



From the Field
May 2024

Key Insights

- With uncertainty around the path of cash rates, it is time for investors to consider stepping out of cash.
- We believe fixed income is an attractive place to redeploy cash, particularly for investors seeking to lock in income as bond yields are near historic highs.
- With diverse sectors, fixed income solutions can potentially help support investors with a range of goals and risk tolerances.



Kenneth Orchard, CFA
Head of International Fixed Income

With the path of cash rates somewhat uncertain, we think it is time for investors to consider redeploying into the market. But where? With bond yields close to historic highs, we believe that fixed income is an attractive asset class to put cash to work—especially for investors seeking to lock in income.

Why we believe it's time to step out of cash

Cash has been king these past few years. The combination of market uncertainty and high short-term interest rates has resulted in a record amount of money held in money market funds. But staying parked in cash over a medium- and long-term horizon could mean missing out on capital

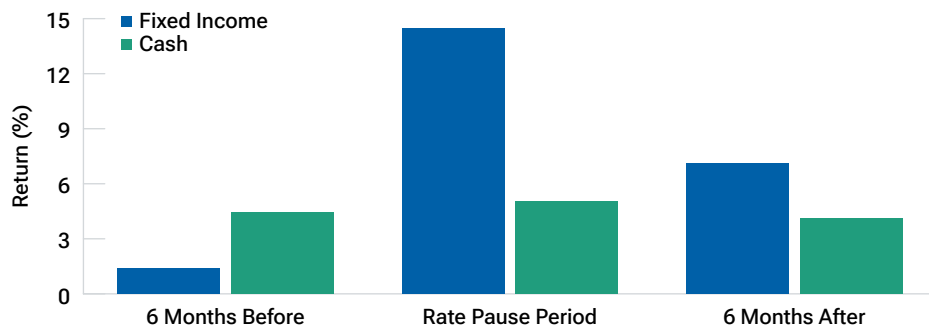
appreciation opportunities elsewhere. Furthermore, it's not certain where cash rates go from here. On the one hand, its possible cash rates stay high, especially if labor markets remain tight. On the other, there is a case to be made for cash rates to fall, especially in Europe and select emerging markets, where there has been more progress in bringing down inflation.

Against this backdrop, we believe it is a good time for investors to consider stepping out of cash and into the markets again. The current monetary policy pause may signal a good opportunity to do so—a review of past Federal Reserve policy cycles suggests it was typically beneficial for investors to deploy cash when rates peaked (see Fig. 1).

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A rate pause signals opportunity

(Fig. 1) Bonds have tended to outperform cash during rate pause periods



As of April 30, 2024.

Past performance is not a reliable indicator of future performance. For illustrative purposes only. This is not representative of actual investments and does not reflect any fees and expenses associated with investing. Indexes cannot be invested in directly.

Cash is represented by the Bloomberg U.S. Treasury Bills 1–3 Month Index, and bonds is represented by the Bloomberg U.S. Aggregate Bond Index. Historical average performance in the 6 months leading up to the last Federal Reserve rate hike, the rate pause period (between the last rate hike and first cut), and the 6 months after the first cut. Dates used for the last rate hike of a cycle are: 02/01/1995, 03/25/1997, 05/16/2000, 06/29/2006, 12/19/2018. Dates used for the first rate cut are: 07/06/1995, 09/29/1998, 01/03/2001, 09/18/2007, 08/01/2019.

Source: Bloomberg Finance L.P. Data analysis by T. Rowe Price.

Why move into fixed income?

With bond yields in several sectors near multiyear highs right now, we believe fixed income is an attractive place to deploy cash. Fixed income has diverse sector options that support a range of goals and risk tolerances. It offers opportunities for both defense and capital appreciation. The fragmented nature of the asset class means that what drives one sector of the market is different than another, so there's often a wide dispersion among sector returns. This provides flexibility to choose sectors that suit distinct needs—generating consistent income, capital appreciation, or defense against equity market volatility.

Fixed income and equity markets have tended to move in tandem in recent years. This understandably raises questions about whether bonds can still deliver the benefits of diversification seen historically. Correlations¹ between the asset classes

could continue to be volatile. However, if an extreme market event or significant downturn puts major selling pressure on risk assets such as equity, we expect high-quality government and corporate bonds to be an effective diversifier. At a minimum, they should provide longer-term investors with potential liquidity—therefore optionality—needed to make portfolio adjustments in times of stress.

Bond solutions for different market environments

Given the volatility and uncertainty in markets in recent years, investors may be feeling apprehensive about stepping out of cash. But regardless of how they expect the market environment to evolve, we believe that investors can find a solution in fixed income to mitigate risks and address their objectives. Below, we explore three economic scenarios and the bond strategies potentially conducive to each.

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Scenario 1: Growth

Investment solution: High Income.

A scenario of moderate economic growth is our base case scenario. Investors anticipating this should consider high yield strategies as the healthy macro environment will likely be supportive. The risk of a significant credit spread² widening is less of a concern in this environment, which should allow for potential comfortable income accumulation. Current all-in yields available in high yield are attractive, so it's a good time to potentially lock in high income. As of the end of March 2024, the average yield in global high yield corporate bonds was around 7.63%, much higher than the average yield of 6.39% observed in the last 10 years.³

A higher-quality global multi-sector bond approach is another appealing option. It can offer attractive income potential and diversified return sources. These types of solutions provide exposure to a variety of sectors, including governments and securitized, investment-grade, and high yield corporate bonds. The broad range of sectors offers the potential to diversify sources of return and lower volatility.

¹ Correlation measures how one asset class, style or individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one security moves, either up or down, the other security moves in lockstep, in the same direction. A perfect negative correlation means that two assets move in opposite directions, while a zero correlation implies no relationship at all.

² Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

³ As of March 31, 2024. Yield to worst of the ICE BofA Global High Yield Index. **Performance is not a reliable indicator of future performance.** Source: ICE BofA. See Additional Disclosures.

Bond solutions for a range of economic environments

(Fig. 2) Strategies conducive to a growth, deterioration, or stagflation scenario



As of April 30, 2024.

For illustrative purposes only. This is not to be construed to be investment advice or a recommendation to take any particular investment action.

Investments involve risks, including possible loss of principal. **Diversification cannot assure a profit or protect against loss in a declining market.**

Source: T. Rowe Price.



Scenario 2: Deterioration

Investment solution: High quality.

A deterioration scenario would involve a decline in economic activity and deceleration of inflation, leading to interest rate cuts. For investors worried about this scenario, investment solutions that are higher quality can be useful, such as developed government bonds where there's typically better liquidity than other fixed income segments. Furthermore, the significant repricing of bond yields these past few years has led to improved valuations in government bonds with yields at some of their highest levels since the global financial crisis.

Investment-grade corporate bond strategies also offer a potential combination of high quality and consistent income. For example, the average yield in European investment-grade corporate bonds stood at around 3.66% at the end of March—which is well above the average level of 1.46% observed in the last decade.⁴



Scenario 3: Stagflation

Investment solution: Diversification.

A stagflation scenario would involve inflation reaccelerating and economic growth slowing. This could lead to further interest rate rises and weakness in risk markets, such as equity. Such an environment can be challenging for investors. But a good way to navigate is through utilizing alternative and very active management strategies that can potentially benefit from higher volatility. In particular, investors should consider solutions that can generate income while seeking to minimize interest rate risk and mitigate against severe risk-off events. These include flexible strategies, such as absolute return. These are typically benchmark agnostic and can cast a broader net, with the potential to invest in a wide range of geographies, sectors, and security types. However, strategies within this category can vary significantly. If an investor is seeking diversification, it's important to choose an approach that has either low or negative correlation with key market indexes, such as the S&P 500.

Lower-beta multi-asset credit strategies can also work in this scenario. These offer the ability to find diverse sources of return across the broad credit market. In particular, approaches that actively manage credit and interest rate risk can help to navigate volatile environments.

The combination of election risks, the soft global growth environment, sticky inflation, and lingering geopolitical issues may be unsettling for some investors—keeping many parked in cash. But with bond yields near historic highs, it is time to consider redeploying those cash assets to potentially lock in income at these attractive levels. In today's ever-evolving landscape, fixed income offers a wide range of opportunities, including strategies for income, defense, or capital appreciation purposes. Choosing an approach that prioritizes quality active research is essential. This can give investors greater confidence about shifting their cash holdings to take potential advantage of the attractive all-in yields that are available.

⁴ As of March 31, 2024. Yield to worst of the Bloomberg Euro Aggregate—Corporate Bond Index. **Past performance is not a reliable indicator of future performance.** Source: Bloomberg Finance L.P.

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