



# Finding Opportunities Amid Fixed Income Turbulence

Flexible multi-sector approach is essential as markets shift.

January 2022

## KEY INSIGHTS

- Flexibility and a collaborative multi-sector approach, in our view, are particularly important in navigating today's dynamic market environment.
- We seek to combine well-diversified sector allocation with tactical insights to pursue consistent risk-adjusted returns across different market environments.
- Seeking to capitalize on bond market inefficiencies and constructing a diversified, risk-balanced portfolio informs our strategic allocation and positioning.

Flexibility and a collaborative multi-sector approach, in our view, are essential components of fixed income portfolio management. These are particularly important in navigating the crosscurrents of today's dynamic market environment. The emergence of the omicron variant of the coronavirus has unsettled markets, with sentiment shifting between alarmist and complacent since late November. At the same time, investors are still digesting the Federal Reserve's abrupt policy shift in December from dovish to hawkish. In addition, the economy is now facing both monetary and fiscal tightening in 2022.

The simultaneous presence of these risks at a time when Treasury yields are low and credit spreads<sup>1</sup> are narrow by historical standards suggest that the first half of 2022 could be increasingly turbulent. Despite this cloudy backdrop, credit fundamentals are still strong and

market technicals are supportive. Our flexible, active portfolio management approach should give us opportunities to take advantage of anomalies that are present in this unusual environment—as well as inefficiencies that tend to persist regardless of the macro backdrop—while managing risk in the Total Return Fund.

## Odds of Fed Policy Error Increasing

In our view, the chances of a Fed policy error, such as over-tightening policy to tame inflation, are increasing. The current environment has some parallels to the 2017–2018 period, when the market transitioned from tranquil to a higher-volatility regime as the Fed engaged in quantitative tightening and the global growth outlook dimmed. The central bank eventually relented as markets reacted poorly to the perceived policy error.



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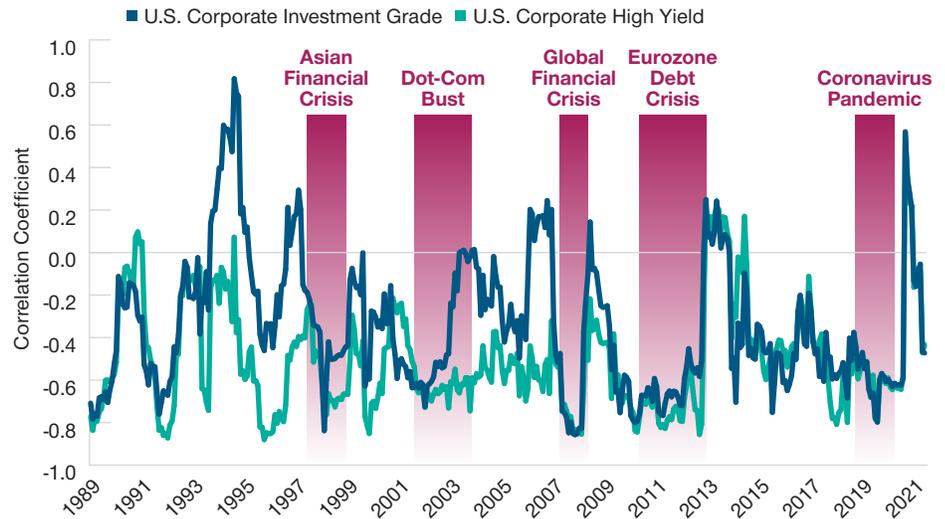
<sup>1</sup> Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.



A multi-sector portfolio management approach allows the freedom for relative value comparisons across fixed income sectors.

## Treasuries Have Been Strong Diversifiers

(Fig. 1) Correlation of 10-year Treasury and credit indexes\*



As of December 31, 2021.

**Past performance is not a reliable indicator of future performance.**

Source: Barclays Live/Haver Analytics

\*Rolling 12-month correlation of credit index excess returns. 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 0 correlation implies no relationship at all. Excess return is calculated as the index's total return less the return of a duration-matched U.S. Treasury security. Investment-grade and high yield corporate excess returns are based on the Bloomberg U.S. Corporate Investment Grade and U.S. Corporate High Yield indices.

The path of inflation—and the Fed's response—will be a key indicator to watch in the coming months. While we acknowledge that there are still upside risks for inflation, we believe that supply chain bottlenecks and labor market tightness will gradually ease. This disinflationary dynamic would help sustain economic growth.

### Outlook for Volatility in Rates and Credit

This ongoing uncertainty about the interaction of COVID-19 trends, inflation and other economic data, and global central banks removing monetary accommodation should create volatility in rates and credit markets. We are likely to keep the portfolio defensively positioned in this environment, keeping

risk exposure well balanced and toward the lower end of its historical range in the Fund. At the same time, we have been selectively adding exposure to fixed income sectors that provide relatively attractive valuations. These include some areas of securitized credit<sup>2</sup> as well as bank loans, which have floating coupons that would adjust upward as the Fed raises rates.

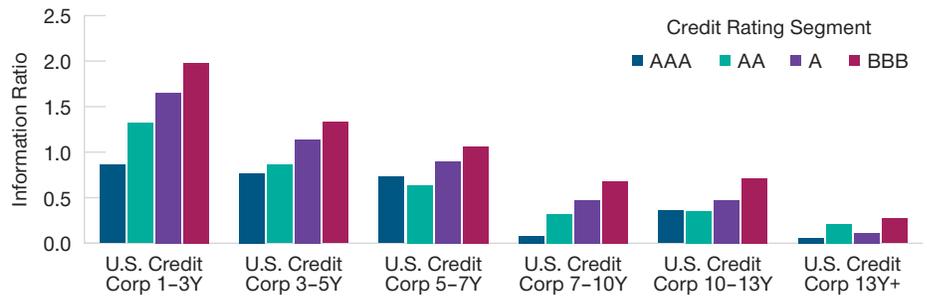
### Relative Value Opportunities Across Sectors

A multi-sector portfolio management approach allows the freedom for relative value comparisons across fixed income sectors. An investment-grade corporate bond and a similarly rated municipal bond or asset-backed security (ABS) often trade differently.

<sup>2</sup>Securitized credit includes commercial and non-agency residential mortgage-backed securities, asset-backed securities, and collateralized loan obligations.

## Shorter-Term Corporates Outperformed

(Fig. 2) Information ratio on excess return by maturity and credit rating\*



March 31, 1998, through December 31, 2021.

**Past performance is not a reliable indicator of future performance.**

Source: Bloomberg Index Services Limited (see Additional Disclosure). Calculations by T. Rowe Price.

\*The information ratio measures returns beyond the returns of the broad index compared with the volatility of those returns. The broad index is the Bloomberg U.S. Corporate Investment Grade Index.

To a larger extent than equity markets, fixed income markets are fragmented and tend to have investors that are narrowly focused on a sector or asset class niche. This can lead to technical pressure where some dedicated funds receiving inflows will buy because they have to put cash to work, resulting in disparate cross-sector relative value. More diversified portfolios that employ a multi-sector approach can capitalize on these relative value dislocations.

Along with building portfolios that diversify credit risk across sectors, we can also make tactical allocation adjustments when we identify possible relative value opportunities. These dislocations can also occur within credit sectors when our internal credit analyst teams have a meaningfully different view of the credit quality of an issuer, subsector, or industry compared with external research.

As an example, the Total Return Fund can have impactful out-of-benchmark allocations to high yield bonds and bank loans, where we rely heavily on the work of our high yield credit analysts. The team uses extensive proprietary fundamental research in aiming to expose and exploit value dislocations in these markets.

### Flexibility to Tactically Adjust Duration

A key part of our active portfolio management approach, the flexibility to adjust duration<sup>3</sup> in the Fund is essential in this volatile environment. At the end of 2021, overall duration was close to the benchmark with a slight bias toward a short relative duration position, in keeping with our defensive posture in the portfolio. When U.S. economic growth was still accelerating in early 2021, we maintained a meaningfully shorter-than-benchmark duration position, which helped dull the negative price effects of increasing yields.

Because high-quality government debt tends to rally in periods of deteriorating risk sentiment, duration can also serve as a hedge against credit risk. Some observers have questioned the effectiveness of duration as a hedge for credit risk with Treasury yields at levels that are low by historical standards, reasoning that Treasuries have limited room to rally. We think that Treasuries will continue to be useful as a hedge against a steep sell-off in credit and other riskier assets, such as equities. As a result, adding duration can allow investors to have more exposure to credit risk, with all else equal.

<sup>3</sup> Duration measures a bond's sensitivity to changes in interest rates.

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### Seeking to Exploit Persistent Inefficiencies

Fixed income markets also feature some long-lasting inefficiencies that persist despite being well understood by many market participants. Most of these inefficiencies result from imbalances between supply and demand or from investor constraints. There are also market participants with objectives other than maximizing total return, such as institutions constrained by tax considerations and those that have yield-driven performance targets.

Our quantitative research team has identified some of these anomalies and tested their robustness in various macro scenarios. As long as we have a relatively high degree of confidence that these inefficiencies will persist in the longer term and that they are appropriate for our investor base, we try to take advantage of them. Seeking to capitalize on these inefficiencies while constructing a diversified, risk-balanced portfolio forms the basis of our strategic asset allocation and portfolio positioning. At the same time, we are aware that there are certain transient environments where positioning to exploit these anomalies could weigh on performance, and we strive to anticipate these shorter-term shifts and tactically adjust exposures appropriately.

### Areas of Structural Inefficiency

- **Shorter-maturity investment-grade corporate bonds** historically have exhibited much higher risk-adjusted returns than longer-term corporates. Portfolios can hold a credit curve steepener—overweights to shorter-duration corporate credit and underweights to longer-duration corporates—to try to capitalize on this structural inefficiency.
- We have also observed that **credit derivatives** tend to perform better in credit sell-offs than cash bonds, and it can be advantageous to replace some cash bond exposure with credit derivatives when the “basis”—the difference in spread between

cash bonds and derivatives—is especially tight.

- In another example, credit quality constraints prevent some investors from holding non-investment-grade securities. When a bond is downgraded from investment grade into the high yield universe, forced selling from these investors can push prices lower than what the bond’s fundamentals would dictate. We try to capitalize on the relative value that can often be found in these **fallen angels**.
- **Securitized credit** is another area of structural inefficiency. Some investors were restricted from owning securitized debt after the global financial crisis, and some lack the ability to analyze the often-complex cash flow structures of the securities. T. Rowe Price’s team of securitized credit analysts have the capability to value these bonds, allowing us to locate attractive securities and segments that other investors may overlook.

### Flexible Multi-Sector Approach

On a broader level, the income and relatively low volatility of a fixed income allocation make it an important part of a broader portfolio’s asset allocation. In the Total Return Fund, we seek to combine well-diversified sector allocation with tactical insights to pursue strong, consistent risk-adjusted returns across different types of market environments. Our flexible multi-sector approach to managing the portfolio allows us to actively manage relative duration and try to take advantage of relative value among sectors.

It must be mentioned that having the platform at hand that we do at T. Rowe Price is invaluable when facing challenging market conditions. As a firm, we have tremendous expertise across the globe, reaching across the capital structure from investment-grade debt to equity, across all sectors, across macro and micro, and across fundamental and quantitative. In our view, these resources are an advantage in managing

a multi-sector fixed income portfolio  
when it comes to everything from  
navigating changing market dynamics to

constructing portfolios to just plain old  
fundamental security selection.



#### **WHAT WE'RE WATCHING NEXT**

Environmental, social, and governance (ESG) analysis is an integral part of our fundamental credit research process. T. Rowe Price's proprietary ESG research tools identify credits with potential ESG-related issues, which our analysts and portfolio managers, as appropriate to their strategy, incorporate into investment theses, internal credit ratings, price targets, and position sizing.

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#### **Additional Disclosure**

Bloomberg®, Bloomberg U.S. Corporate Investment Grade, and Bloomberg U.S. Corporate High Yield are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by T. Rowe Price. Bloomberg is not affiliated with T. Rowe Price, and Bloomberg does not approve, endorse, review, or recommend US Total Return Bond Strategy. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to US Total Return Bond Strategy.

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The fund is subject to market risk, as well as risks associated with unfavorable currency exchange rates and political economic uncertainty abroad.

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