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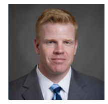
ASSET ALLOCATION INSIGHTS

The Challenge of Rising Inflation

June 2021



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KEY INSIGHTS

- In a highly inflationary environment, bonds could lose their typical hedging characteristics, posing a challenge for asset allocators.
- Bank loans may potentially benefit investors seeking a fixed income option with less sensitivity to rising interest rates.

Asset allocators face a challenging environment as inflation expectations continue to rise amid sharply higher commodity prices and rapidly rising wages. While bonds typically help to provide some downside risk mitigation to a portfolio when stocks decline, stock and bond returns tend to become more correlated in a highly inflationary environment.

To account for this dynamic, the Asset Allocation Committee is overweight to bank loans, as their interest rate reset feature makes them less sensitive to rising rates than traditional bonds. As shown in Figure 1, during the last four periods where the 10-year U.S. Treasury yield increased by more than 1% in less than a year, bank loans posted positive returns and meaningfully outperformed the broader fixed income market.

Investors should note that although these loans offer an appealing alternative, they are vulnerable to credit risk and generally have high yield credit ratings. Fortunately, the current strong economic environment has driven down default rates (see Figure 2). Further, the fundamental outlook for bank loans appears attractive given the anticipated acceleration in growth as economies reopen globally.

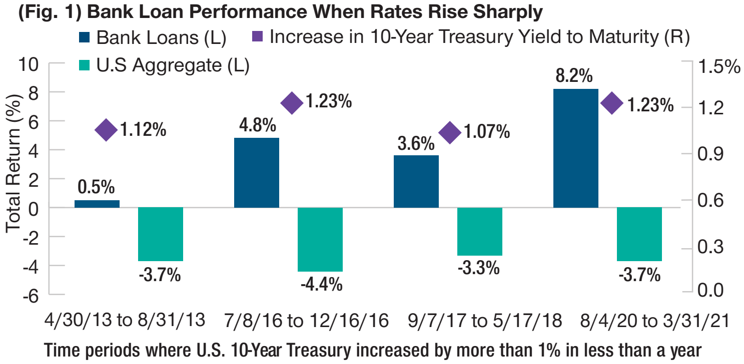
Notably, these supportive expectations have—to some extent—already been priced into bank loan valuations, driving yields to below-average levels. However, bank loans still remain relatively attractive compared with other fixed income segments.

While sharply rising inflation may pose challenges for asset allocators, an allocation to bank loans could, in our view, potentially benefit investors seeking a fixed income option with less sensitivity to rising interest rates.

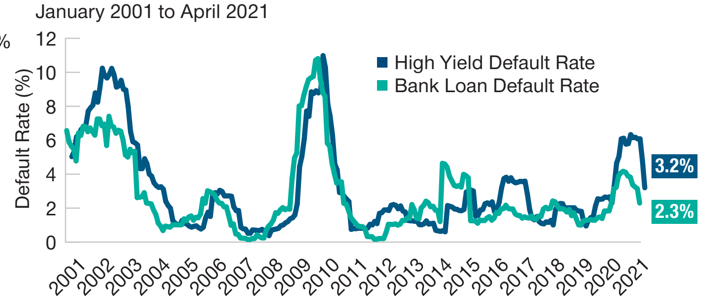
The Case for Bank Loans

The fundamental outlook for bank loans is attractive

(Fig. 1) Bank Loan Performance When Rates Rise Sharply



(Fig. 2) High Yield Versus Bank Loans, Default Rates
January 2001 to April 2021



Past performance is not a reliable indicator of future performance.
Sources: S&P/LSTA, Bloomberg Barclays. T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. See Additional Disclosures. Bank Loans represented by the S&P/LSTA Performing Loan Index, U.S. Aggregate represented by the Bloomberg Barclays U.S. Aggregate Bond Index. (L)=Left-side axis, (R)= Right-side axis. High yield default rate source: J.P. Morgan Global High Yield Index. Bank loans default rate source: J.P. Morgan Leveraged Loan Index. See Additional Disclosures.

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