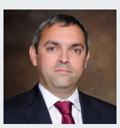
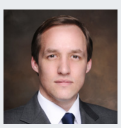
POLICY INSIGHTS

July 2018

The view from our fixed income experts.

GLOBAL INVESTMENT TEAM


Arif Husain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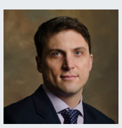
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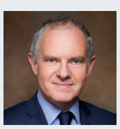
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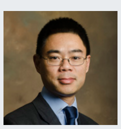
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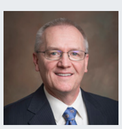
Steve Huber

Once a month, our fixed income experts, helped by our analysts and traders, conduct an in-depth review of the full fixed income opportunity set. This article highlights a particular theme that dominates markets today.

Are Fixed Income Markets At Risk Of Overheating?

While the past few years have been dominated by central bank interest rate cuts, 2018 has been much more even, with an almost identical number of hikes and cuts. In our latest round of policy meetings, the investment team discussed whether this may cause a correction in parts of the fixed income market—and the potential opportunities that might follow.

"The era of ultra-accommodative polices is over," said Arif Husain, portfolio manager and head of International Fixed Income. "The trend now is for higher global interest rates, with further monetary tightening expected in the second half of the year."

In developed markets, this includes the Federal Reserve, which is expected to deliver two more interest rate increases in 2018. It is also possible that the Bank of Canada will hike for the third time this year and that the Bank of England will resume its tightening cycle after taking time to assess the impact of last November's hike—its first in more than a decade. Sweden, where inflation pressures are rising, has emerged as another potential candidate for raising rates lately.

This overall tightening of financial conditions has had a knock-on effect on emerging markets (EM), where several central banks have taken action in response to the combination of depreciating currencies and domestic inflation pressure. In June, Mexico, Turkey, India, the Philippines, the Czech Republic, and Indonesia all raised interest rates, and it is likely that more EM countries will follow in the second half of the year. "This is a challenging environment for fixed income investors," said Mr. Husain. "But opportunities can still be found even when central banks are hiking."

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> –Arif Husain, Global Fixed Income Portfolio Manager

Romania stands out in this regard, the investment team noted. Since January, Romania's central bank has hiked interest rates by 75 basis points, and with further increases already priced in by the market, the country's five-year domestic bond looks appealing at a current yield of around 5%. Other countries are at different stages of the interest rate cycle—in Eastern Europe, for example, the Czech Republic kicked off its tightening cycle mid-last year, while Hungary and Poland have been reluctant to follow suit so far despite robust growth and rising inflation.

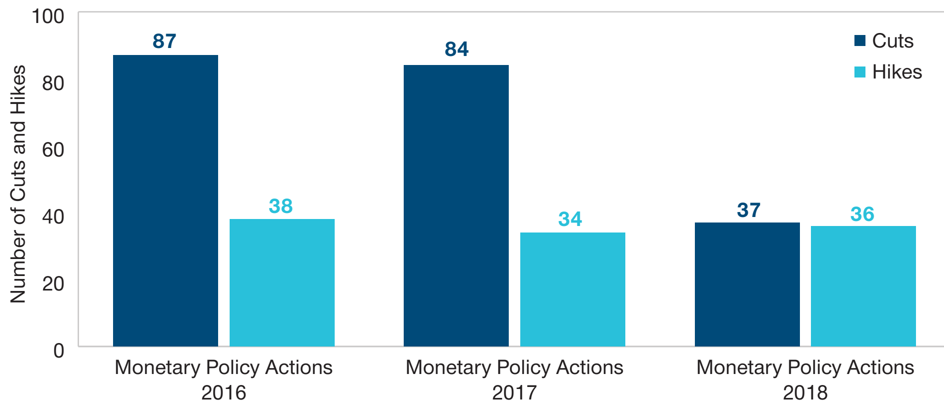
China was one of the first to raise rates earlier this year, but since then its central bank has shifted toward a softer stance amid signs the economy is slowing. These developments have helped the Shibor, the Shanghai interbank offered rate, come down by almost 1% from its January highs. "The combination of softer inflation and infrastructure deceleration should be supportive for local Chinese bonds in the second half of this year," Mr. Husain said.

Signs of overheating in credit markets are also apparent, the investment team observed. Merger and acquisition activity has been picking up again, and 2018 looks set to be a record year in the U.S. for acquisitions. This has occurred at a time when fears of an overhang from issuance and excessive valuations have weighed on prices in investment-grade corporate bonds. "Investors' appetite for corporate bonds has clearly waned lately, as shown by the concessions given on new issues," said Mr. Husain.

More surprising has been the underperformance of A rated bonds versus BBB rated securities this year, which the investment team noted has

FIGURE 1: **Interest Rate Cuts vs. Interest Rate Hikes by Central Banks**

As of June 30, 2018



The "Monetary Policy Actions" charts show the number of rate cuts and rate hikes made by all central banks globally.
Source: CB Rates. Analysis by T. Rowe Price.

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> **–Arif Husain, Global Fixed Income Portfolio Manager**

created opportunities to rotate into higher-quality names at more attractive premiums. There may also be an opportunity to switch some credit risk out of corporate bonds into agency mortgages, where signs of overheating have been far more subdued. Although home prices in the U.S. have steadily outpaced income growth for the past two years, the situation remains relatively healthy, with data indicating that the average household debt service ratio is at its lowest since the financial crisis. "The shape of the interest rate swap curve makes owning a combination of agency mortgages with higher coupons and lower durations a very attractive proposition offering better risk/reward compared with investment-grade corporate bonds," concluded Mr. Husain.

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