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Monthly Market Review

FIXED INCOME MARKETS

MAY 2018

GEOPOLITICAL WORRIES HELP DRIVE TREASURY YIELDS LOWER IN MAY

Although the yield of the benchmark 10-year Treasury note briefly reached a seven-year high, Treasury yields finished May generally lower in a volatile month. (Bond yields and prices move in opposite directions.) In a continuation of April's trends, strong economic data and concerns about increasing inflation pressures reduced demand for Treasury debt in the first half of the month. But rising geopolitical worries—highlighted by Italy's troubles in forming a new government—led to a rally in Treasuries and other lower-risk assets. The 10-year Treasury note's yield reached a closing high of 3.11% on May 17 before dipping to 2.83% at month-end, and the 30-year Treasury bond's yield followed a similar path, reaching a nearly three-year high of 3.25% before finishing May at 3.00%.

The drop in yields at the end of the month appeared largely due to a risk-averse environment following political turmoil in Italy. The League and Five Star Movement parties succeeded in forming a government on the last day of the month, but investors worried that the country might violate eurozone fiscal rules or even abandon the common currency. The Italian drama added to investor concerns caused by the China-U.S. trade dispute and uncertainties regarding the U.S.-North Korea summit; as a result, on May 29, the 10-year Treasury note had its largest one-day yield decrease since the UK voted to leave the European Union in June 2016.

The Federal Reserve's policymaking committee met at the beginning of the month and kept the federal funds rate unchanged, as expected. In the minutes from the meeting, released later in May, Fed officials explicitly signaled a high likelihood of another hike at the June meeting. But policymakers also indicated that a modest overshoot of the 2% inflation target "could be helpful in anchoring long-run inflation expectations," implying that the Fed doesn't intend to hasten the pace of rate hikes. Ten-year break-even spreads, a measure of investors' inflation expectations, decreased somewhat in May after reaching a three-year high in April.

Total Returns

Index	May	Year-to-Date
Bloomberg Barclays U.S. Aggregate Bond Index	0.71%	-1.50%
J.P. Morgan Global High Yield Index	-0.35	-0.65
Bloomberg Barclays Municipal Bond Index	1.15	-0.33
Bloomberg Barclays Global Aggregate Ex-U.S. Dollar Bond Index	-1.87	-0.62
J.P. Morgan Emerging Markets Bond Index Global Diversified	-0.94	-4.08
Bloomberg Barclays U.S. Mortgage Backed Securities Index	0.70	-1.00

Figures as of May 31, 2018. **Past performance cannot guarantee future results.** This chart is shown for illustrative purposes only and does not represent the performance of any specific security.

Source: Third-party vendor RIMES.

MUNIS CONTINUE TO BENEFIT FROM LIMITED ISSUANCE

The risk-averse environment seemed to benefit municipal bonds, which outperformed most other fixed income segments for the month. However, within the asset class, investors favored lower-rated, higher-yielding securities, such as tobacco bonds. New issuance remained constrained—through the first five months of the year, muni issuance trailed the same period in 2017 by 20%, which supported muni prices. In issuer-specific news, Kentucky had its rating cut from A+ to A by S&P Global Ratings due to underfunded pensions and a lackluster state economy.

U.S. Treasury Yields

Maturity	April 30	May 31
3-Month	1.87%	1.93%
6-Month	2.04	2.08
2-Year	2.49	2.40
5-Year	2.79	2.68
10-Year	2.95	2.83
30-Year	3.11	3.00

Source: Federal Reserve Board.

TREASURIES AND MORTGAGE-BACKED SECURITIES OUTPERFORM CORPORATE BONDS

Within the Bloomberg Barclays U.S. Aggregate Bond Index, Treasuries and mortgage-backed securities (MBS) produced the strongest results as investors sought out safe havens. MBS also received support from lower-than-expected supply and a rebound in demand from banks and money managers. Investment-grade corporate bonds generated positive results but lagged the broader investment-grade bond market in the risk-off environment. Lack of demand from Asian investors and concerns about a potential increase in new issuance also weighed on the asset class.

Geopolitical concerns had a negative impact on high yield bonds overall, but similar to munis, lower-quality segments, including health care, metals and mining, and energy, rallied within the below investment-grade bond asset class. Earnings reports from high yield issuers generally met or exceeded expectations, and limited issuance provided technical support. Bank loans outperformed their high yield bond counterparts for the month.

ITALIAN BONDS SELL OFF AMID POLITICAL VOLATILITY

Yields of 10-year government notes moved lower in Germany, the UK, and Japan; however, Italian government bonds sold off amid concerns about the new government's anti-European Union agenda and plans to reverse austerity measures. The Bank of England voted to keep its benchmark interest rate unchanged after recent economic data showed weakening growth, supporting UK government bonds. The euro and the British pound lost ground against the U.S. dollar for the month, while the yen strengthened.

EMERGING MARKETS: ARGENTINA, TURKEY HIKE RATES AS THEIR CURRENCIES WEAKEN

Emerging markets bonds produced negative results, hampered by faltering investor sentiment, a stronger dollar, and some country-specific issues. Argentina and Turkey dominated headlines as they struggled to support their currencies. Argentina's central bank hiked rates 12.75 percentage points over an eight-day period starting on April 27. The moves lifted the country's benchmark lending rate to 40% as the bank sought to halt a precipitous drop in the peso.

Meanwhile, the Turkish lira plunged to an all-time low after President Recep Tayyip Erdogan vowed to take greater control of monetary policy if he wins the June election. Turkey's central bank responded to the currency instability with a surprise three-percentage-point rate hike. It also simplified the country's complex monetary policy framework by establishing a single key policy rate, which it set at 16.5%.

OUTLOOK: THREE-MONTH T-BILLS AN INTERESTING OPTION AFTER RISE IN YIELDS

The T. Rowe Price asset allocation committee believes that higher short-term U.S. rates are increasing the appeal of cash investments. After years of money market rates at essentially zero, the three-month U.S. Treasury bill yield has climbed steadily in 2018 and finished May at 1.93%. As a result, these securities have suddenly become interesting as a nearly risk-free allocation option. Bank loans have also benefited from the increase in short-term rates because their coupon payments have adjusted upward with increases in their London Interbank Offered Rate (LIBOR) benchmark reference rate.

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