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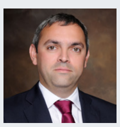
POLICY INSIGHTS

October 2018

The view from our fixed income experts.

TIME TO LOOK AGAIN AT SHORT-DATED BONDS

GLOBAL INVESTMENT TEAM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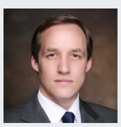
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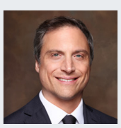
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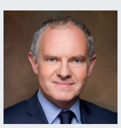
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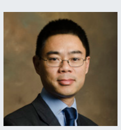
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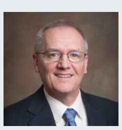
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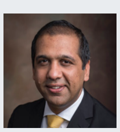

Saurabh Sud

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.

A key theme that has dominated global fixed income markets over the past year has been the flattening of yield curves, the most extreme of which has occurred in the U.S. During our latest policy meetings, the investment team took the opportunity to revisit the global opportunity set and discuss the markets and sectors where the sell-off in shorter-maturity bonds has created value.

With several major central banks moving toward tightening monetary policy, it is not surprising that short-dated bonds have been under pressure. At the same time, a lack of meaningful inflation has kept the long end in check, resulting in an overall flattening of yield curves. In some places, these moves may have gone too far and present an attractive entry point to buy shorter-maturity bonds. "We should not overlook short-dated bonds in the current environment," said Saurabh Sud, a portfolio manager and member of the global fixed income investment team. "There are lots of opportunities across markets and sectors."

The U.S. Treasury market in particular stands out as a potential area of opportunity as the sell-off in short-dated bonds has created appealing valuations, while short-dated dollar-denominated credit also looks attractive. In the U.S., the gap between two-year Treasury yields and the Federal Reserve's benchmark overnight lending rate has become extremely steep, and the investment team noted that concentrating risk in the short end of the curve could therefore be a defensive way of taking credit risk in an environment where the Fed is expected to raise interest rates "gradually."

> "Investing in short-dated corporate bonds has been out of fashion for a while due to the low-rate environment, yet it has many defensive qualities for investors."
>
> –Saurabh Sud, Portfolio Manager

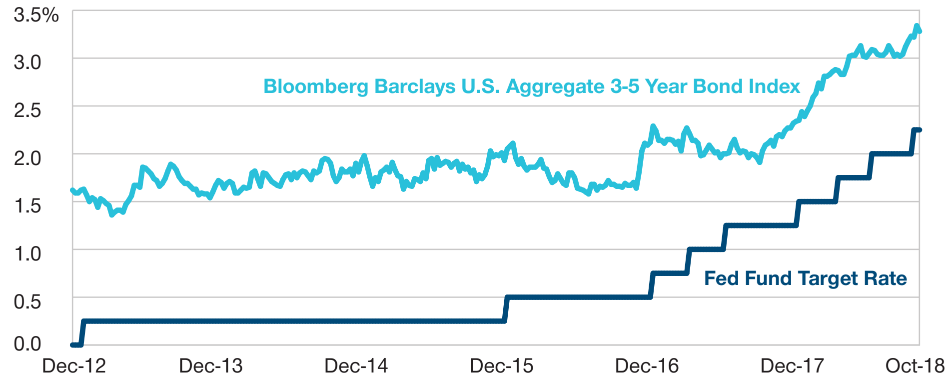
Three main reasons were highlighted: First, a number of interest rate hikes are already priced in by the market, so there are attractive roll-down opportunities; second, the backup in short-term yields means this area is also likely to be less sensitive to the overall direction of interest rates than the long end, which is looking expensive given the flattening move; and third, recession is still a distant enough prospect to mean that the risk of rising corporate defaults does not necessarily have to be factored into the price. "Investing in short-dated corporate bonds has been out of fashion for a while due to the low-rate environment, yet it has many defensive qualities for investors," said Mr. Sud.

Within credit markets, it is not just a story of traditional investment-grade corporate debt that can benefit from the shape of the curve—the team believes there are also many areas that can benefit from investing in shorter-maturity bonds. This includes Asia corporate bonds denominated in U.S. dollars, an asset class with an attractive risk premium due to its defensive characteristics relative to other emerging market sectors. Sector specialists also highlighted the attractiveness of highly rated securitizations backed by pools of nonqualifying mortgages and shorter-duration AAA collateralized loan obligation (CLO) refinancing transactions with two- to three-year reinvestment periods.

Turning attention to global government bond markets, the investment team assessed whether recent action by central banks has created potential opportunities in short-maturity bonds. In emerging markets, there have been a flurry of interest rate hikes as central banks respond to a combination of their currencies depreciating and domestic inflation pressures rising. In some instances, countries are nearing the peak of their tightening cycles, providing a potentially attractive entry point to invest in short-maturity bonds. "Countries like Romania and Mexico are near the top of their hiking cycles and are prime candidates for potentially reverting to cutting interest rates over the medium-term horizon," said Mr. Sud.

FIGURE 1: **The Yield On Short-Dated Bonds Has Risen**

As of October 12, 2018



Sources: Bloomberg Barclays U.S. Aggregate 3-5 Year Bond Index—Yield To Worst and Federal Reserve. Analysis by T. Rowe Price.

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> –Saurabh Sud, Portfolio Manager

Another point that came out of the discussions was the importance of earning defensive carry in the current climate when there are limited opportunities for capital gains and volatility may begin to increase. "We are at a point in the cycle where we need to look for attractive carry and roll-down opportunities rather than take more risk for potential price appreciation when many asset prices are priced to perfection," Mr. Sud said.

This is true for high yield, where short-dated securities remain attractive from a carry perspective but might offer limited appreciation potential due to the potential of being called early. More importantly, however, the team identified specific opportunities in hard currency bonds, where our bottom-up research analysis highlighted several quasi-sovereign bonds with a low-duration profile and robust fundamentals that currently stand out for their attractive income features. "The search for carry is influenced heavily by our bottom-up research analysis to find the best risk-adjusted ideas, rather than by the temptation induced by income alone," Mr. Sud concluded.

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