T.RowePrice®
INVEST WITH CONFIDENCE

March 2016

FIXED INCOME VIEWPOINTS

SUMMARY:

US Treasuries performed strongly in early February, with the 10-year yield falling to its lowest level since August 2012, as the market priced in fewer Federal Reserve rate hikes amid heightened global growth concerns. However, Treasury yields later retraced much of the move as risk appetite returned, oil prices rebounded, and U.S. economic data generally exceeded low expectations.

European sovereign debt rallied, with the 10-year German bund yield ending February at 0.11%, as expectations built for aggressive monetary easing measures by the ECB when it meets on 10 March. Japanese government bond yields declined to new lows as the Bank of Japan implemented its new negative interest rate policy. 10-year JGB yields fell below 0%, while 40-year yields slipped below 1% for the first time. Additional deposit rate cuts by the BoJ may be forthcoming, as the central bank desires to weaken the yen and stimulate inflation.

Corporate credit spreads widened sharply in early February before snapping back as risk sentiment suddenly improved. Within investment grade, certain out-of-favor industrial and commodity-related names offer attractive relative value. The wave of "fallen angels" entering the U.S. high yield market provides opportunities to buy higher-quality credits at discounted prices. European high yield should continue to benefit from accommodative ECB policy and fundamental strength.

Dollar-denominated emerging market sovereigns continue to be favored over EM corporates due to the latter's liquidity challenges. EM local bonds have recently performed well following a long stretch of underperformance, but uncertainty about the path of Fed tightening and Chinese policy remain key risks—particularly on the currency side.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Financials notably underperformed in February as investors unwound long positions amid concerns about the health of the European banking system and the impact of low interest rates on banks' net interest margins. In contrast, energy and metals and mining names rebounded strongly from distressed valuation levels as commodity prices moved higher. Real estate investment trusts and higher-quality metals credits are areas of interest, along with midstream energy companies whose managements are proactively addressing balance sheet concerns by cutting dividends, reducing capital expenditures, and raising equity.

EURO CORPORATES: Credit spreads are marginally tighter, having recovered from the sell-off in the first half of February. Valuations currently represent fair medium-term value. European banks have materially underperformed, with significant recovery seen in distressed metals and mining names. Expectations have grown for increased monetary policy accommodation at the ECB meeting on 10 March. Expanding quantitative easing (QE) to corporate bonds is an upside scenario.

US HIGH YIELD: February began with significant spread widening and a continuation of the energy and metals sell-off. But in the second half of the month, spreads retraced all of the widening, with investors reaching for low dollar priced bonds and some stability in energy prices. We have experienced a very large amount of "fallen angel" supply over the last month as investment-grade issuers were downgraded to high yield, and the market is absorbing this paper. Overall valuations and market yields are still heavily skewed by the distressed energy and metals and mining industries, but we continue to find interesting ideas away from commodities and even within the highest-quality segment of the energy universe.

EURO HIGH YIELD: Market technicals remain positive, with mutual fund inflows returning across the industry as higher yields brought investors back to the asset class. A lack of a decent primary calendar for several months has led to a build-up of market demand. Sound fundamentals and expectations for active ECB support also remain in place. We look to both the reopening of the primary market and ECB action on 10 March to help the market find direction. European high yield has lagged the U.S. high yield market but is likely to receive a boost when the new issuance market finally starts up.

BANK LOANS: Loans still appear to offer a more defensive way to play decent high yield fundamentals with lower volatility. The sector has benefited from a materially lower exposure to commodities and CCC rated debt than the U.S. high yield market. It also still provides some measure of protection against rising interest rates. Spreads have widened in recent months in response to the move in high yield spreads, as well as weaker technical conditions. The vast majority of loans are now trading below par. Technical factors, including collateralized loan obligation performance and issuance will be key drivers of the market.

AGENCY MORTGAGE-BACKED SECURITIES: Spreads on agency MBS recovered from their mid-February wides as risk sentiment improved, Treasury rates retraced higher, and prepayment concerns eased. We maintain a neutral view on the sector. Spreads are historically cheap versus Treasuries, though arguably more fairly valued in the context of broader market risk factors. However, MBS still appear attractively valued on a risk-adjusted-basis versus credit sectors

For investment professionals only. Not for further distribution.

EM DOLLAR SOVEREIGN: Stabilization of commodity prices has supported a risk rally in the sector. With the U.S. high yield market also rallying on higher oil prices, relative value for BB rated EM sovereigns is now fair rather than rich. Investment-grade EM sovereigns have outpaced the U.S. investment-grade credit market, so a pause in the rally is likely—potentially caused by increased supply. Idiosyncratic noise from Brazil has turned positive; the probability of regime change has increased, and improvements in Brazil's external accounts are promising. Greater clarity around Chinese policy will be a barometer for adding risk.

EM CORPORATES: Despite recent strong performance, we maintain a somewhat cautious outlook for EM corporates. The sector's illiquidity relative to other fixed income alternatives puts a higher bar on a valuation or fundamental-centered thesis for adding to exposures. From a country perspective, some of our highest-conviction names are found in Mexico, China, Indonesia, the Philippines, and—increasingly—Brazil. BBB and BB rated credits still offer the best risk/reward profile.

EM LOCAL: Yield spreads versus U.S. Treasuries have tightened over the past month. As Treasury yields stabilized, large EM markets—most notably Brazil, Russia, and Turkey—drove strong performance in local rates. At the headline level, valuations are less attractive. However, sector-level yields are still somewhat wide relative to Treasuries. EM currencies also performed well over the past month. Recent price action has been supportive of a bottoming in commodity prices. Going forward, currencies are likely to trade in a more volatile range, which supports adding selectively to exposures over time. The potential for resumption of Fed tightening and China-related concerns remain the central risks.

DEVELOPED SOVEREIGN MARKETS:

US: Treasury yields have lagged the sharp move higher in risk assets, oil, and inflation expectations into early March. The hesitant move higher in yields reflects some uncertainty as the Fed, ECB, and BoJ are all scheduled to meet in mid-March. However, domestic economic data has surprised to the upside recently, increasing the probability of higher U.S. interest rates. Assuming risk appetites do not reverse yet again, a strategy of selling U.S. Treasuries on strength appears prudent in the near term.

EUROZONE: The ECB remains engaged in an aggressive program of sovereign QE and may decide to extend the program beyond the current March 2017 end date. The ECB is likely to cut its deposit rate again on 10 March, but the market has fully priced in this possibility, expecting a 20 bps cut this month and another 10 bps reduction next quarter. Consensus growth expectations have been stable over the past month at about 1.6% per annum, but recent economic data has been softer than expected. A lack of inflation implies that rate hikes will not happen for at least three years.

JAPAN: A loss of economic momentum continues with some divergence across the manufacturing and services sectors. Into 2016, growth will likely be supported by additional fiscal initiatives prior to the midyear upper house elections. The BoJ's negative deposit rate hit a snag as administrative inability to manage negative deposit rates caused a substantial decrease in activity in the interbank market. We expect additional easing by the BoJ through an additional reduction of the interest rate paid on commercial banks' deposits at the central bank, and possibly through expansion of the qualitative easing programme (e.g., ETF purchases).

UK: Market expectations for the first Bank of England (BoE) interest rate hike continue to be moved back from 2018 last month to 2020 currently by some measures. The profound change has been driven by a combination of softer data, an increase in global risk aversion, and a view that "Brexit" risk will keep the BoE not only on hold but also poised to cut interest rates should the realization of Brexit occur—actual or even anticipated. Exiting the European Union has the potential to disrupt UK economic growth, which has helped support gilts at objectively very rich levels. Meanwhile, Moody's has highlighted the downside risk to the UK's sovereign rating should Brexit become a reality.

CANADA: Fourth-quarter growth was weak, as expected, with capital expenditures detracting significantly. Recent stability in oil prices has made the outlook less gloomy, but a period of below-trend growth still looks likely. Inflation has remained contained, giving the Bank of Canada some welcome monetary policy flexibility. While we expect policy rates to remain on hold for an extended period, further easing could be delivered if growth disappoints. Canadian government bonds lagged the rally in U.S. Treasuries through mid-February and are likely to outperform in a rising U.S. yield environment.

AUSTRALIA: Recent domestic data has been more encouraging, with consumption and housing activity offsetting the still-significant mining investment drop-off. With inflation close to the lower end of its target band, the Reserve Bank of Australia has indicated that there is scope for further easing should inflation remain low—the first-quarter CPI print in April will be critical for making this decision.

IMPORTANT INFORMATION

This material, including any statements, information, data and content contained within it and any materials, information, images, links, graphics or recording provided in conjunction with this material are being furnished by T. Rowe Price for general informational purposes only. The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price. The material does not constitute a distribution, an offer, an invitation, recommendation or solicitation to sell or buy any securities in any jurisdiction. The material has not been reviewed by any regulatory authority in any jurisdiction. The material does not constitute advice of any nature and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The views contained herein are as of 3 March 2016 and may have changed since that time. Unless indicated otherwise the source of all market data is Thomson Datastream.

Australia - Issued in Australia by T. Rowe Price International Ltd (ABN 84 104 852 191), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. T. Rowe Price International Ltd is exempt from the requirement to hold an Australian financial services licence in respect of the financial services it provides in Australia. T. Rowe Price International Ltd is authorised and regulated by the UK Financial Conduct Authority under UK laws, which differ from Australian laws. For Wholesale Clients only.

Canada - Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services. T. Rowe Price (Canada), Inc. is not registered to provide investment management business in all Canadian provinces. The investment management services provided by T. Rowe Price (Canada), Inc. are only available for use by Accredited Investors as defined under National Instrument 45-106 in those provinces where it is able to provide such services.

DIFC - Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA - Issued in the European Economic Area by T. Rowe Price International Limited, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong - Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Japan - Issued in Japan by T. Rowe Price International Ltd, Tokyo Branch (KLFB Registration No. 445 (Financial Instruments Service Provider), JIAA Membership No. 011-01162), located at GranTokyo South Tower 7F, 9-2, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100-6607. This material is intended for use by Professional Investors only and may not be disseminated without the prior approval of T. Rowe Price International Ltd, Tokyo Branch.

Singapore - Issued in Singapore by T. Rowe Price Singapore Private Limited, No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Limited is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland - Issued in Switzerland by T. Rowe Price (Switzerland) GmbH ("TRPSWISS"), Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA - Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE and the Bighorn Sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc. in the United States, European Union, and other countries. This material is intended for use only in select countries.