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# NAVIGATING THE NEW VOLATILITY IN FIXED INCOME MARKETS.


## EXECUTIVE SUMMARY

Having been relatively calm for most of the summer, markets were hit by a surge of volatility in August. While the proximate cause of this was slowing growth in China—and the policy responses to this—the ramifications were felt across the globe.

In this Price Point Q&A, Arif Husain shares his views on events in China and elsewhere and discusses how fixed income investors can navigate the current volatility.


## IT'S BEEN AN EVENTFUL SUMMER. WHERE DO RECENT DEVELOPMENTS LEAVE FIXED INCOME INVESTORS?

For the past few months, I've been preaching a sermon of caution in fixed income, and that continues to be my sermon. I expect higher bond yields, wider credit spreads, and increased volatility. Caution is key.

## CHINA HAS BEEN AT THE EPICENTRE OF RECENT EVENTS. WHAT'S YOUR TAKE ON THE SITUATION IN CHINA AT THE MOMENT?

I'd break it down into three broad themes. First, China is going through a structural long-term change—it is trying to become more international, liberalise its capital account and become more open, generally, toward the world.

Second, most experts believe that China's growth is probably slowing from the official figure of 7% to something more like 5% or 6%1— a modest decline but an important one nonetheless. At T. Rowe Price, we believe that any talk of a "hard" or "soft" landing for the Chinese economy is misleading because it implies an ending, whereas China's deceleration has no clear endpoint.

Third, there is a certain apathy toward the situation. People invested in different asset classes understand that China is having an impact on their portfolios, but they don't really know why or how to respond to it.

[1] Source: ft.com.

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### WAS CHINA THE SOLE CAUSE OF THE RECENT VOLATILITY, OR WERE THERE OTHER FACTORS AT WORK?

China is just one element of a number of things happening in the world—it is unfair to blame it for everybody else’s troubles. We’ve gone from a period of almost perfect certainty to a number of very large changes. The Fed has rates at zero, and that’s going to change at some point; China used to have a fixed currency regime, and that’s changed; Iran used to be completely isolated, and now it is potentially coming back into the global community.

A lot of things are changing, which is having ramifications in financial markets. In summary, when there is change, uncertainty arises, and that leads to volatility. We’re just living through that. The market, however, finds it difficult to focus on more than one thing at once. Recently, that has been China, but the market will soon get bored of that and focus on something else. There are other issues in the world that are equally important.

### MOVING BEYOND CHINA, ARE FUNDAMENTALS IN OTHER EMERGING MARKETS AS BAD AS THE RECENT DATA SUGGEST?

Emerging markets have become a group of disparate countries. Yes, the fundamentals in some emerging market countries are pretty bad at the moment—they’re facing political, economic, and structural issues all at the same time. So some countries—Brazil, for example—are definitely having a tough time. Other emerging market countries are in better positions, having gone into the financial crisis in much better shape than they did in previous crises.

There has been some talk of the possibility of another Asian financial crisis like that of 1997, but we don’t think that will happen. The main reason for this is that a lot of Asian countries have worked very hard since 1997 to make sure that they have stronger buffers in place to defend themselves against another crisis. For example, current accounts are in surplus rather than deficit, and new regulations have ensured that banks and other companies don’t have foreign exchange mismatches.

### WHAT EFFECT WILL THE FED’S DECISION TO DELAY RAISING RATES HAVE ON VOLATILITY LEVELS?

It means things will probably continue as they have been for a while yet. The hike will probably now come in December or early next year, but the exact timing will depend on circumstances and therefore can’t be predicted with certainty. So the markets will continue to speculate about the timing of the rise just as it did ahead of the September decision, which will lead to further volatility. For fixed income investors, this means positioning our portfolios for volatility and being alert in order to take advantage of any potential mispricings we identify.

### WHAT OPPORTUNITIES ARE YOU SEEING AT THE MOMENT?

An important recent development is the divergence—or desynchronisation, if you prefer—of monetary policy. Over the course of 2015, almost as many central banks have cut rates as have hiked them, which is creating opportunities at the interest rate and government bond level. At the same time, differentiation is occurring within credit markets. The obvious examples are the oil and mining industries, which have suffered as the oil price has slumped.

There are also changes taking place in other credit markets—for example, the cable market in the U.S.—which are also creating dispersion and opportunities. We’ve also spotted some good opportunities in Europe, particularly in hybrid debt, and in emerging markets too, in both hard and local currency terms. Active investors need to be on the lookout for these.

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