



When Inflation Offers Relative Value Opportunities

How global inflation trends could impact fixed income markets.

March 2019

KEY INSIGHTS

- The concept of allowing inflation to overshoot in the future to make up for past misses has surfaced recently in the U.S.
- Higher U.S. price pressures could impact long-dated bonds and cause the curve to steepen.
- By contrast, low inflation in the Asia region remains supportive for local bond markets.

After more than a decade of low inflation in most developed market economies, it has been suggested in the U.S. that price rises should be allowed to overshoot in the future to make up for missing past targets. During our latest policy week meetings, the investment team

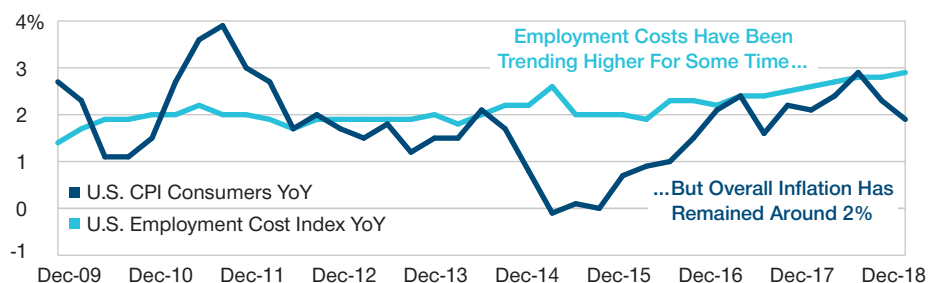
discussed the potential implications of this for fixed income markets.

Allowing inflation to drift higher has been a dangerous approach for central banks in the past and has sometimes been associated with an exodus of foreign capital, particularly

(Fig. 1) U.S. Inflation: A Tale Of Two Stories

U.S. employment cost vs. U.S. consumer price index, year on year change

As of February 28, 2019



Source: Bureau of Labor Statistics. Analysis by T. Rowe Price.

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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

History shows that central banks can quickly lose credibility when they let inflation run above target.

— Quentin Fitzsimmons
Portfolio Manager

While inflation risk appears to be skewed to the upside in the U.S., Asia and Europe face the opposite side of the story with a lot of deflationary trends in place.

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Portfolio Manager

for emerging market countries. “History shows that central banks can quickly lose credibility when they let inflation run above target,” said Quentin Fitzsimmons, a portfolio manager and member of the global fixed income investment team.

U.S. policymakers are concerned about the implications of persistent low inflation expectations, leading to speculation that the Federal Reserve could make changes to the way it targets inflation. It could, for example, shift to an “average rate” target through which periods of above-target price rises are tolerated in order to counterbalance below-target periods.

In bond markets, long-maturity bonds typically lose value, and the curve steepens when central banks are more lenient with their price targets. “In the scenario of higher U.S. inflation and an accommodative Fed, the front end of the curve is likely to remain anchored while long-dated securities could come under pressure,” noted Mr. Fitzsimmons. Greater price pressures could provide a further boost to the U.S. inflation-linked bond market, which has already been performing strongly, thanks to supportive seasonality factors and expectations that the Fed will remain on hold for at least the first half of 2019.

Discussions about the future inflation target come at a time when price pressures in the U.S. are expected to moderately grind higher as the output gap narrows. In credit markets, security selection will be important if U.S. inflation picks up steam, because margins could face pressure from higher production costs and lower capital spending—factors that could also lead to rating downgrades.

The investment team noted that industrial companies are most at risk, but theirs is not the only vulnerable sector. Service industries, for example, could also suffer, particularly as companies already face pressure from rising wage costs, as highlighted by the biggest annual increase in average hourly earnings since 2009 in February. “It makes sense to concentrate credit risk in the short end of the curve currently, and to shift some of the credit risk out of the U.S. back into the eurozone,” said Mr. Fitzsimmons.

Inflation remains subdued in the eurozone, supporting the European Central Bank’s decision to provide another round of cheap funding for banks. A lack of price pressures is also evident in other countries, most notably in Asia. “While inflation risk appears to be skewed to the upside in the U.S., Asia and Europe face the opposite side of the story with a lot of deflationary trends in place,” noted Mr. Fitzsimmons.

In terms of investment opportunities, local bond markets in Asia look attractive on a currency-hedged basis. The combination of subdued inflation and a softer Fed policy potentially open the door for some countries to deliver interest rate cuts later this year. Indonesia, in particular, stands out in this regard as the prospect of lower food prices and contained oil prices should drive inflation lower there. In other emerging countries, the investment team noted that Mexico is an appealing local bond story as headline inflation is finally starting to break below 4% on the back of lower energy and agricultural prices. “It’s possible that Mexico’s central bank kicks off a rate-cutting cycle that results in the key rate falling by as much as 150 basis points from the current 8.25% level,” said Mr. Fitzsimmons.

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