T.RowePrice
INVEST WITH CONFIDENCE

FIXED INCOME SECTOR PULSE

FEBRUARY 2015

SUMMARY:

10-year Treasury yields have rebounded from January lows amid more stable oil prices and another strong US labour report. The Treasury market still appears unprepared for a midyear start to Fed rate hikes. However, tepid global growth and ultralow yields in other major sovereign markets should continue to constrain longer-term US rates.

The forthcoming quantitative easing (QE) programme from the European Central Bank's (ECB) should keep yields in Europe at low levels, driving investors into higher-risk assets. A pickup in European growth could begin to push longer-term yields higher later in the year. In Japan, government bonds have recently sold off in increasingly illiquid market conditions. But the Bank of Japan's (BoJ) large-scale asset purchases should continue to provide support, overshadowing fiscal concerns for now.

Valuations across credit markets are generally neutral, though there are a variety of interesting bottom-up stories within sectors. Leverage is slowly increasing within investment-grade corporates, but technical conditions remain solid. High yield has benefited from steadier energy prices, and value can be found in the new issue and secondary markets. Securitised credit has been remarkably stable amid commodity-driven market turbulence. Agency mortgage-backed securities (MBS) have been more volatile due to vacillating Treasury rates, increased housing policy risks, and an uncertain prepayment outlook.

Emerging markets (EM) credit looks attractive versus other opportunities, but numerous idiosyncratic risks and poor liquidity warrant caution. EM local valuations are less compelling on the rates side following a bond rally, while currencies have continued to broadly cheapen.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Higher-beta commodity-related sectors and a steeper credit curve following a collapse in risk-free rates have contributed to increased volatility and wider spreads year-to-date. T. Rowe Price credit analysts continue to find opportunities in select financials and lower-beta sectors.

EUROPEAN CORPORATES: Spreads have drifted lower, responding positively to the ECB's QE package. Although modestly rich to fundamentals and to US investment-grade corporates, negative yields on core government bonds are leading to strong demand for high-quality corporate bonds.

US HIGH YIELD: Overall valuations and market yields are still interesting but are not as attractive as in January. Volatility remains likely given the energy sector's impact. Spread levels are still implying a higher default rate than we are currently expecting. If oil prices remain low for a more extended period of time, we will need to evaluate the impact to our 2016 default outlook.

EURO HIGH YIELD: In relative valuation terms, European high yield spreads are well inside the US post the energy-driven US sell-off. Despite appearing less attractive, the European sector outperformed both US and global high yield in January. With QE, inflows and positive tone is expected to continue despite the sector looking less compelling on both a spread and yield basis.

BANK LOANS: Loans still appear to offer a more defensive way to play solid high yield fundamentals with lower volatility, although valuations are not quite as cheap as in January. Loans performed more defensively than high yield in the recent sell-off but were not immune. There are now discounts to be found, with 80% or more of the sector trading below par. Importantly, loans have a materially lower exposure to the commodities sectors than high yield bonds. The market remains supported by collateralised loan obligation issuance.

AGENCY MBS: Spreads cheapened considerably in January. Elevated levels of market volatility in the US Treasury market and mortgage borrowing rates at 18-month lows have led to a higher degree of directionality in spread movement. Cheaper valuations versus Treasuries and other spread sectors reflect a weaker fundamental backdrop for mortgages, as investors revise expectations for faster prepayments in the current low rate environment, and net supply numbers for the year are adjusted higher.

EM DOLLAR SOVEREIGN: The sector is attractive versus US credit—both high yield and investment grade—but is increasingly idiosyncratic (Russia, Petrobras, Venezuela, and other oil-related names, in particular). Commodity and currency moves will claim victims, and Fed liftoff may challenge less-liquid asset markets.

EM CORPORATES: Valuations are still attractive versus similarly rated US credit. Within the EM asset class, sovereign versus corporate valuations are more neutral and nuanced at a bottom-up intra-country level. Our enthusiasm is tempered by poor liquidity, particularly in the high yield segment of the asset class.

EM LOCAL: Yield spreads are near their tightest levels of the past three years versus US Treasuries, but local bond valuations still look relatively cheap versus other global sovereigns. EM local market performance remains unusually bifurcated: Bonds have performed well, but currencies remain weak. Both trends appear increasingly extended. But until global growth picks up, EM currencies will remain under a cloud.

DEVELOPED SOVEREIGN MARKETS:

US: Inflation expectations have stabilised, but global growth conditions are holding term premiums low and capping yields. Yields have moved higher from their recent lows in the past month, however. The move higher in inflation expectations and stronger labour data has allowed the Fed to win back the market narrative for the time being. How risk assets perform with a mid-2015 rate liftoff on the table will be crucial in determining the near-term direction of yields.

EUROZONE: Negative yields toward the front end are pushing demand further out the curve. Sovereign bond QE should constrain yields at low levels. However, valuations are extremely expensive. Growth and inflation outlooks are expected to improve later this year, but monetary policy is likely to remain accommodative for the foreseeable future.

JAPAN: Core inflation continues to undershoot, dragged lower by energy prices, but growth has picked up following weakness in the second and third quarters of 2014. While longer-term debt dynamics look unsustainable and Government Pension Investment Fund rebalancing will be an offsetting outflow, the BoJ's bond purchase programme is expected to dominate and support low yields.

UK: Benign inflation and concern about the drag from a weak eurozone has seen the market pricing push out the timing of rate hikes; the Bank of England has validated the first move coming only later in 2015. The general election in May could see a potentially messy result.

CANADA: Although current growth has been reasonable and inflation close to target, the Bank of Canada (BoC) has shown itself to be more concerned about downside growth risks following the sharp decline in oil prices. The BoC delivered a surprise rate cut and looks likely to maintain a dovish bias. The market is very expensive by any historical measure, but an easing bias and threat of a further rate cut could keep the market better supported even in the face of rising US yields.

AUSTRALIA: The Reserve Bank of Australia (RBA) has also opportunistically cut rates, taking advantage of the benign inflation environment and trend of easing monetary policy globally. There are downside growth risks given the ongoing decline in commodity prices and terms of trade. A further rate cut is possible, and the RBA is likely to remain accommodative for a considerable period.

IMPORTANT INFORMATION

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are as of 10 February 2015, and may have changed since then.

This document, including any statements, information, data and content contained therein and any materials, information, images, links, sounds, graphics or video provided in conjunction with this document (collectively "Materials") are being furnished by T. Rowe Price for your general informational purposes only. The Materials are not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the Materials and in certain countries these Materials are only provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction. Under no circumstances should the Materials, in whole or in part, be copied, redistributed or shown to any person without consent from T. Rowe Price. The Materials do not constitute a distribution, an offer, an invitation, recommendation or solicitation to sell or buy any securities in any jurisdiction. The Materials have not been reviewed by any regulatory authority in any jurisdiction. The Materials do not constitute investment advice and should not be relied upon. Investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

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.

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

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. Our investment management services are only available for use by Accredited Investors as defined under National Instrument 45-106 in those provinces where we are able to provide such services.

Issued in the Dubai International Financial Centre by TRPIL. This material is communicated on behalf of TRPIL by the TRPIL Representative Office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

Issued in the EEA by T. Rowe Price International Limited ("TRPIL"), 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the Financial Conduct Authority. For Qualified Investors only.

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

Issued in Japan by T. Rowe Price International Ltd, Tokyo Branch ("TRPILTB") (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 TRPILTB.

Issued in New Zealand by T. Rowe Price International Ltd ("TRPIL"). TRPIL is authorised and regulated by the UK Financial Conduct Authority under UK laws, which differ from New Zealand laws. This material is intended only for use by persons who are not members of the public, by virtue of section 3(2)(a)(ii) of the Securities Act 1978.

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

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

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

The-Long-View_FI_overview
2015-GL-1505