T.RowePrice
INVEST WITH CONFIDENCE

# FIXED INCOME SECTOR PULSE

JANUARY 2015

## SUMMARY:

A continued decline in commodity prices, falling inflation expectations, and the attractiveness of US rates relative to most other developed sovereign markets have driven 10-year Treasury yields back below 2%. With the domestic economy maintaining strong momentum, a Federal Reserve rate hike remains on track around mid-year. But given a weak global backdrop, the Fed will be patient with the pace of tightening.

Amid weak economic growth and sub-zero inflation, the European Central Bank (ECB) is widely expected to soon launch sovereign bond purchases. Although the outlook for euro area growth has brightened this year, ECB policy will remain highly accommodative for the foreseeable future. Meanwhile, the Bank of Japan's (BoJ) recently expanded quantitative and qualitative easing programme has further compressed an already flat Japanese yield curve despite concerns about the country's long-term debt sustainability.

Plummeting commodities have pressured corporate credit spreads wider, with US high yield bearing the brunt. High yield defaults are expected to remain low in 2015 but could rise next year if oil prices persist at depressed levels. With a growing percentage of bonds trading at distressed prices, high yield valuations are increasingly compelling.

Less exposed to energy, securitised credit has been resilient to market volatility. Agency mortgage-backed securities (MBS) valuations have improved, but increased prepayment risk and new government housing initiatives are generating uncertainty.

In emerging markets (EM), external sovereigns and corporates remain attractive versus similarly rated developed market credit, though low liquidity and weak commodity prices remain risks. Local EM rates have rallied with global rates, while the strong dollar trend has weighed on currency performance; at current valuations, certain currencies look enticing.

## SPREAD SECTORS:

**US INVESTMENT-GRADE CORPORATES:** As in recent months, the market's focus continues to be higher-beta commodity and energy-related sectors, which have contributed to increased volatility and wider spreads. T. Rowe Price credit analysts continue to find opportunity in select financials and lower-beta sectors.

**EUROPEAN CORPORATES:** Speculation of ECB bond buying dominates the medium-term outlook. Direct corporate bond purchases could further squeeze spreads. However, it's not all about the ECB, as the European economic environment of low growth, low inflation, and low rates remain supportive of credit even if valuations are stretched.

**US HIGH YIELD:** The overall fundamental picture remains intact—outside of the commodities space. We continue to see a relatively muted default outlook through 2015. If oil prices remain low for an extended period of time, we will evaluate the impact to our 2016 default outlook. Overall valuations and market yields are getting more interesting now as they start to approach 7.5%, albeit likely with some volatility still to come from the energy sector. Spread levels are starting to imply a higher default rate than we are currently expecting.

**EURO HIGH YIELD:** Fundamentally, little has changed over the quiet year-end period. New issuance is yet to get underway and market cash balances are reported as high. Risk appetite is expected to be driven by the extent of ECB accommodative action but may be tempered by concerns over potential volatility. The Greek elections are an example of a possible trigger. While valuations are less attractive, Euro high yield has been less volatile than US high yield.

**BANK LOANS:** The fundamental backdrop remains intact with low forward default expectations and a minimal near-term maturity profile. Loans still appear to offer a more defensive way to play solid high yield fundamentals with lower volatility. The market remains supported by a strong collateralised loan obligation bid, which is currently more than making up for retail outflows. And importantly, the sector has a materially lower exposure to the commodities sectors than US high yield.

**AGENCY MBS:** Spreads across the sector have cheapened considerably, but the moves appear warranted given the greater uncertainty in the market. The fundamental backdrop for MBS is becoming more challenged with increasing prepayment concerns, as well as new policy efforts to ease credit standards to support housing.

**EM DOLLAR SOVEREIGN:** Both investment-grade and high yield sovereigns are attractive versus US credit, but the market is increasingly idiosyncratic (Russia, Venezuela, and other oil-related names, in particular).

**EM CORPORATES:** Valuations are attractive relative to the US credit across the ratings spectrum. Commodity price weakness has a mixed impact on performance but is generally a headwind to spread compression. Our enthusiasm is tempered by poor liquidity, particularly in the high yield segment of the asset class.

**EM LOCAL:** Bonds have been performing well, but currencies remain weak. Both trends appear more extended. Yield spreads are near their tights versus US Treasuries, but local currency bonds look relatively cheap to other global sovereign bonds. However, local bonds are looking expensive compared with EM sovereigns issued in dollars.

## DEVELOPED SOVEREIGN MARKETS:

**US:** The labour market continues to maintain strong momentum, and the Fed's communications indicate a mid-2015 liftoff to the hiking cycle. The Fed continues to look through energy-related headline inflation weakness, keeping the liftoff in rates on track. Relatively strong growth conditions would suggest higher yields, but the market's focus on inflation expectations and global weakness continues to hold yields down. Until those conditions change, any rise in yields will be limited.

**EUROZONE:** The growth and inflation outlook is expected to improve later this year, but monetary policy is likely to remain accommodative for the foreseeable future. Negative yields in the front end of the German curve are pushing demand further out the term structure. Sovereign bond quantitative easing should constrain yields at low levels. However, valuations are extremely expensive.

**JAPAN:** Core inflation continues to undershoot, dragged lower by energy prices. Fourth-quarter growth signs have been more encouraging after a very weak third quarter. 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 market pricing push out the timing of rate hikes; the Bank of England has validated the first move coming only later in 2015. We continue to expect only a modest hiking cycle given the interest rate sensitivity of the economy.

**CANADA:** Growth data remains relatively resilient, and we expect Canada to benefit from the US recovery and stronger export growth. Inflation has returned close to target. Downside growth risks have grown recently with the sharp decline in oil prices. The market is under-priced for a resumption of rate hikes from the Bank of Canada later this year, though it could lag the Fed and have a shorter hiking cycle given the higher starting point.

**AUSTRALIA:** The Reserve Bank of Australia (RBA) is content to stay on hold for now but has been disappointed by the recovery in non-mining sectors of the economy. There are downside growth risks given the ongoing decline in commodity prices and terms of trade. On balance, we expect the RBA to remain on hold for an extended period but acknowledge the door for further easing is open.


### 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 12 January 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-1360