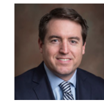
Global Economy Appears Poised to Rebound

Rising confidence in ongoing reflation informs our positioning.

October 2019



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KEY INSIGHTS

- We are positioning the Total Return Strategy for a continuation of the recent reflationary trend as we are gaining confidence in the global economy.
- However, uncertainties still abound in trade and monetary policy, so we are using relatively liquid tools to implement our portfolio positioning for reflation.
- We are managing duration with U.S. Treasuries or Treasury futures and added TIPS as a contrarian position that would benefit from reflation.

Despite ongoing uncertainty about trade policy, we are gaining confidence that the global economy will recover from its slowdown, avoiding a near-term recession. As a result, we are positioning the Total Return Strategy for a continuation of the recent reflationary trend in the markets, evidenced in higher U.S. Treasury yields, a steeper yield curve, and a rally in risk assets. However, the meaningful uncertainties that still abound in trade and monetary policy could disrupt an economic recovery. Chief among these are the ongoing U.S.-China trade conflict and the Federal Reserve's (Fed) ability to convince markets that its recent rate moves have been "insurance cuts" that will stave off recession. This lack of clarity has prompted us to use relatively liquid tools to implement our portfolio positioning for reflation.

High Conviction in Global Growth Rebound

In a recent policy discussion involving T. Rowe Price's global economics team and fixed income portfolio managers, the economists expressed high conviction that global economic growth will rebound over the next few quarters. This forecast appears to run counter to the current market consensus outlook, which is still quite negative.

After some miscommunications about its level of commitment earlier in the year, the Fed's recent rate cuts and communications show that policymakers are now willing to ease enough to avoid a recession, at least in the near term. In another measure that reassured markets, the central bank has taken steps to deal with the recent unusual overnight lending rate spikes, buying USD 60 billion of Treasury bills per month into the second quarter of 2020 to bolster reserves and offering

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overnight and term repo[1] through at least January 2020. Global financial conditions have eased, and some leading economic indicators have turned positive.

The volatile U.S.-China trade conflict has been weighing on corporate capital expenditure for about the last 12 months, dampening economic growth. The recent de-escalation in tensions, though possibly temporary, follows conciliatory measures from both countries in mid-October. This has given markets some confidence that the U.S. and China can avoid the worst-case scenario of an all-out, extended trade war.

Meaningful Uncertainties Remain

Indeed, major uncertainties remain that could meaningfully change our more positive outlook for the global economy. In addition to the uncertainty surrounding the U.S.-China trade negotiations, the Fed could again fall behind the curve, causing investors to lose confidence in its ability to sufficiently support the U.S. economy and triggering a renewed flight to quality. Also, we do not think that China is willing or, more importantly, able to provide the high levels of fiscal and monetary stimulus that it has implemented in the past in order to boost its own economy—and, in turn, global growth.

Stressing Liquidity in Positioning for Reflation

As a result of the still-elevated global uncertainty, we are stressing liquidity as we implement portfolio positioning in the Total Return Strategy to benefit from ongoing reflation. Doing so may permit us to nimbly adapt to a major deterioration in U.S.-China trade sentiment or other events that negatively impact our more constructive outlook for the global economy and credit markets.

One of these portfolio positioning tools is managing duration[2] through buying or selling U.S. Treasuries or Treasury futures contracts. With Treasury yields still quite low—in mid-October, the 10-year Treasury yield was close to levels last seen in 2016 after the UK's Brexit vote and before the U.S. presidential election—we've shortened duration with the expectation that longer-term yields will increase as reflation takes hold. Because U.S. Treasuries and Treasury futures are among the most liquid financial instruments, we should be able to quickly adjust this positioning if needed.

We added Treasury inflation protected securities (TIPS) to the Total Return Strategy as a contrarian position that would benefit from meaningful reflation. Current market expectations for inflation are quite low, giving TIPS an asymmetrical return profile that has more potential upside than downside. However, it should be noted that TIPS are less liquid than nominal (not inflation-adjusted) U.S. Treasuries.

Tools for Expressing a More Optimistic View on Credit

Although credit spreads[3] are relatively narrow, implying that credit sectors don't have much room to rally, there are ways to selectively express a more optimistic view on credit while maintaining liquidity. In the credit derivatives market, we can sell default protection on investment-grade credit indices. These positions tend to benefit when credit spreads decrease as credit rallies and can be more easily exited than cash bonds.

Also, because some credit default swaps[4] (CDS) on credit indices appear expensive relative to the underlying cash bonds, we added positions in total return swaps[5] (TRS) to benefit from spread tightening on the credit indices.

[1] Repurchase agreements (repo) are short-term loans collateralized by U.S. government securities.
[2] Duration measures a bond's sensitivity to changes in interest rates.
[3] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
[4] A credit default swap involves regular payments from the buyer to the seller in exchange for repayment of principal value to the buyer if the issuer experiences a credit event such as default.
[5] A total return swap involves paying a floating interest rate in exchange for payments based on the return of a reference asset, such as a corporate bond.

In recent years, TRS have gained wider acceptance among the investor community and are an efficient way to express a broad view on credit markets. Finally, as geopolitical uncertainty drives volatility higher amid demand for defensive positions in some credit segments, we sold payer options[6] on CDS indices that help protect the holder against credit spreads widening in order to generate income.

The above-mentioned instruments are ideas that would allow us to express a more constructive view on the investing environment while maintaining the ability to quickly adjust positioning if events change our outlook for recovering global growth.

WHAT WE'RE WATCHING NEXT

The U.S. dollar has stayed surprisingly strong so far in 2019 despite the Fed's rate cuts. A weaker dollar would make imported goods more expensive for domestic consumers, lifting inflation and supporting our reflation thesis. We are closely monitoring economies outside the U.S., which would need to improve for their currencies to strengthen against the dollar.

[6] A payer option gives the holder the right to buy protection in a CDS on a specified date and price.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

General Portfolio Risks

Capital risk—the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

Counterparty risk—an entity with which the portfolio transacts may not meet its obligations to the portfolio.

Geographic concentration risk—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk—the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk—operational failures could lead to disruptions of portfolio operations or financial losses.

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