Should Investors Continue to Ignore Inflation?

How the path of inflation will impact fixed income markets.

October 2019

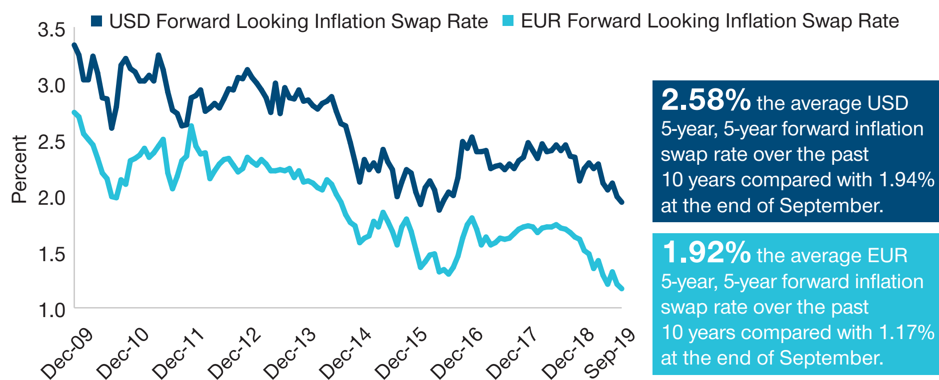
KEY INSIGHTS

- With central banks close to exhausting all their options, it's time for governments to step up fiscal policy to revive economies and support inflation.
- A material boost in government spending could be conducive for the reflation trade in the coming quarters.
- In the short term, inflation risk is likely to remain low.

Global growth is approaching an inflection point; either the slowdown becomes entrenched and leads to a recession, or the cycle gets extended as interest rate cuts and fiscal stimulus start to take effect. What does this mean for the inflation outlook? This was a key discussion point during our latest policy meetings with the investment team debating the risk that price pressures may start to rise.

(Fig. 1) Inflation Expectations Continue to Fall Despite Central Banks Easing

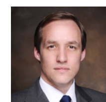
U.S. and eurozone 5-year, 5-year forward inflation swap rates
As of September 30, 2019



Sources: Bloomberg Finance L.P. Used with permission of Bloomberg Finance L.P. Analysis by T. Rowe Price.

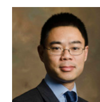
Global Fixed Income Team

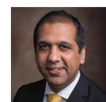
Arif Husain


Andrew Keirle

Kenneth Orchard

Quentin Fitzsimmons


Ju Yen Tan


Saurabh Sud

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 that was discussed.

> The risk for central banks is that they are perceived as being in constant failure of their inflation target.
>
> — **Arif Husain**
> *Portfolio Manager and Head of International Fixed Income*

> If governments commit to materially boosting fiscal spending, there could be some growth and inflation pickup in the next few months.
>
> — **Arif Husain**
> *Portfolio Manager and Head of International Fixed Income*

For more than a decade, developed countries have been stuck in a low-inflation environment despite the best efforts of central banks to engineer pressure on prices. This setting has been a significant driver of the sharp decline in rates that has pushed a large number of government bond yields to historic lows and a record amount into negative-yield territory.

"The risk for central banks is that they are perceived as being in constant failure of their inflation target," said Arif Husain, portfolio manager and head of International Fixed Income.

Indeed, major central banks have resumed monetary policy easing this year, yet inflation expectations have continued to fall. For example, the five-year, five-year forward—a key gauge of future inflation expectations followed by central banks—has declined below 2% in the U.S., while a similar measure for the eurozone has fallen to an all-time low.

"Markets are painting a bleak picture for the inflation outlook, which is worrying central banks as they already used an arsenal of tools over the years attempting to revive it," said Mr. Husain. "From interest rate cuts to bond buying and cheap lending to banks, central banks have done as much as they can. It's now time for governments to step up to help stimulate the economy."

On that note, there has been a noticeable change in the political tone around the use of fiscal policy to boost growth. In the U.S., the Republicans and the Democrats have both set out fiscal stimulus agendas ahead of the presidential election next year. Meanwhile, in Europe, Italy is pushing for fiscal latitude, while both France and, more recently, Germany are warming to the idea of loosening fiscal discipline.

Turning attention to China, expectations were high at the start of the year that there would be a repeat of the massive stimulus program launched in 2015. This proved to be a strong catalyst for a revival in the global economy that year. So far, stimulus measures have not materialized to the same degree, with spending much smaller and more targeted this time around.

"If governments commit to materially boosting fiscal spending, there could be some growth and inflation pickup in the next few months," said Mr. Husain.

Such an environment could be conducive for the reflation trade, a scenario whereby bond yields and risk assets rise at the same time. In that scenario, U.S. inflation-linked bonds offer a good way to support a fixed income portfolio, the team noted. "Buying U.S. inflation linked bonds right now is effectively a call option on the reflation scenario."

Over the short term, however, a material pickup in inflation seems unlikely. For bond markets, the absence of price pressures should continue to be supportive as central banks will be encouraged to keep monetary policy accommodative. Local debt of emerging market countries, in particular, stands to benefit in this environment. "Countries like Indonesia continue to offer attractive returns as local inflation should remain contained," Mr. Husain concluded.

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T. Rowe Price®

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

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

South Africa—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

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

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

© 2019 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.

ID0002749 (10/2019)
201910-986616