



## Quarterly Outlook – Fixed Income

# REFLATION THEME GAINS MOMENTUM

JANUARY 2020

Arif Husain

*Portfolio Manager, Dynamic Global Bond Strategy*



---

### KEY INSIGHTS

- Our base case is that the trends of major central banks staying on hold and global growth improving will continue in early 2020.
- Geopolitical risk needs to be factored back in. While trade tensions between the U.S. and China appear to have receded, geopolitical risk in the Middle East and Asia has picked up recently.
- Overall, we believe the current environment calls for a tactical approach, which should provide a tailwind for our strategy, as we have the flexibility to adapt quickly to changes in market conditions.

---

The reflation theme gained momentum during the fourth quarter of 2019 as the global macroeconomic environment showed signs of recovery. This led investors to add risk back into their portfolios, which resulted in gains for risk assets, such as equity and corporate bonds. At the same time, developed government bonds struggled as the stabilization in growth reduced the prospect of major central banks delivering further interest rate cuts.

#### BASE CASE FOR 2020

Our base case is that the trends of major central banks staying on hold and global growth improving will continue in early 2020. To reflect these views, we express short duration stances in high-quality countries. We have also built up our long positioning in currencies and local bond markets of select emerging market countries that we feel could benefit from a stronger global growth environment.

#### DISPERSION OF RETURNS IN THE CREDIT SPHERE

In the credit sphere, we are seeing signs of instability in some pockets of the market. For example, in U.S. high yield, the overall positive performance during the final quarter of the year masked the dispersion of returns, with spreads on the riskier CCC-rated segment of the market significantly lagging performance of higher-rated bonds in the BB and B categories. It's possible this trend will continue in 2020 with investors more mindful of where they place risk this late in the economic cycle.

Liquidity can also be issue for the more distressed parts of the high yield market. Against this backdrop, we marginally added back to credit hedges in December. At the same time, we took profit on some of corporate bond exposures, which brought our overall credit stance in the portfolio back to around neutral.

“Our base case is that the trends of major central banks staying on hold and global growth improving will continue in early 2020.”

#### **CAUTION AMID HEIGHTENED GEOPOLITICAL RISK**

Geopolitical risk needs to be factored back in. While trade tensions between the U.S. and China appear to have receded, geopolitical risk in the Middle East and Asia has picked up recently. Further escalation could easily dent investor sentiment and halt the rally in risk assets. Against this backdrop, we believe it's important to stay cautious, particularly as the economic recovery remains in the early stages.

#### **ADAPTING TO CHANGES IN MARKET CONDITIONS**

Monitoring economic data will be important going forward as we look for signs of further improvement in the global economy. Overall, we believe the current environment calls for a tactical approach, which should provide a tailwind for our strategy, as we have the flexibility to adapt quickly to changes in market conditions. We will continue to follow our trusted investment process and strive to maintain a portfolio that strikes a balance between country, duration, and yield curve positioning to take advantage of relative value opportunities globally while also managing downside risks.

---

---

## RISKS

The following risks are materially relevant to the portfolio.

**ABS/MBS risk** – These securities may be subject to greater liquidity, credit, default and interest rate risk compared to other bonds. They are often exposed to extension and prepayment risk

**Contingent convertible bond risk** – contingent convertible bonds have similar characteristics to convertible bonds with the main exception that their conversion is subject to predetermined conditions referred to as trigger events usually set to capital ratio and which vary from one issue to the other.

**China Interbank Bond Market risk** – market volatility and potential lack of liquidity due to low trading volume of certain debt securities in the China Interbank Bond Market may result in prices of certain debt securities traded on such market fluctuating significantly.

**Country risk (China)** – All investments in China are subject to risks similar to those for other emerging markets investments. In addition, investments that are purchased or held in connection with a QFII licence or the Stock Connect program may be subject to additional risks.

**Country risk (Russia and Ukraine)** – In these countries, risks associated with custody, counterparties and market volatility are higher than in developed countries.

**Credit risk** – A bond or money market security could lose value if the issuer's financial health deteriorates.

**Currency risk** – Changes in currency exchange rates could reduce investment gains or increase investment losses.

**Default risk** – The issuers of certain bonds could become unable to make payments on their bonds.

**Derivatives risk** – Derivatives may result in losses that are significantly greater than the cost of the derivative.

**Emerging markets risk** – Emerging markets are less established than developed markets and therefore involve higher risks.

**High yield bond risk** – a bond or debt security rated below BBB- by Standard & Poor's or an equivalent rating, also termed 'below investment grade', is generally subject to higher yields but to greater risks too.

**Interest rate risk** – When interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.

**Issuer concentration risk** – To the extent that a portfolio invests a large portion of its assets in securities from a relatively small number of issuers, its performance will be more strongly affected by events affecting those issuers.

**Liquidity risk** – Any security could become hard to value or to sell at a desired time and price.

**Prepayment and extension risk** – With mortgage- and asset-backed securities, or any other securities whose market prices typically reflect the assumption that the securities will be paid off before maturity, any unexpected behaviour in interest rates could impact fund performance.

**Sector concentration risk** – The performance of a portfolio that invests a large portion of its assets in a particular economic sector (or, for bond funds, a particular market segment), will be more strongly affected by events affecting that sector or segment of the fixed income market

### 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.

---

---

### Important Information

**This material is being furnished for general informational and/or marketing purposes only.** The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. 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.

**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.

**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.

**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.

© 2020 T. Rowe Price. All rights reserved. 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.