

Uncertainty heightens the need for active fixed income management

From the Field



Key Insights

- While passive fixed income investing has grown, active fixed income remains as a key part of the space. This is for good reason as average performance from active fixed income alternatives (active intermediate core-plus managers) continued to surpass that of passive alternatives (passive intermediate core managers) over most periods.
- Today's investing environment of increased global protectionism, higher trend inflation, and higher interest rates creates distinct opportunities in global fixed income for active managers.
- We believe it will be critically important to manage duration actively as diverging global monetary policy and high developed world fiscal deficits are likely to stoke volatility.

Despite the growth of passive investing in the fixed income space in recent years, active management continues to dominate the multi-trillion-dollar bond market. With there being inherent challenges of replicating a bond index, active managers have taken advantage of ample opportunity to navigate around what has been a secular rising interest rate trend in recent years. As can be seen in Figure 1, since the global financial crisis of 2008/2009, the average trailing three-year Intermediate Core Bond Plus active manager outperformance of the Bloomberg US Aggregate Bond Index

has only trailed that of the Intermediate Core Bond passive managers for a few brief periods in 2015 and 2019.¹

Looking ahead, we expect this phenomenon to continue as we believe that a less globalized world is likely to lead to higher trend inflation and interest rates, which would drive greater dispersion and heightened volatility in global bond markets overall. An active approach could be key to not only help navigate such conditions, but also benefit from them through potential alpha generation.²



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Opportunities to benefit from diverging monetary policy

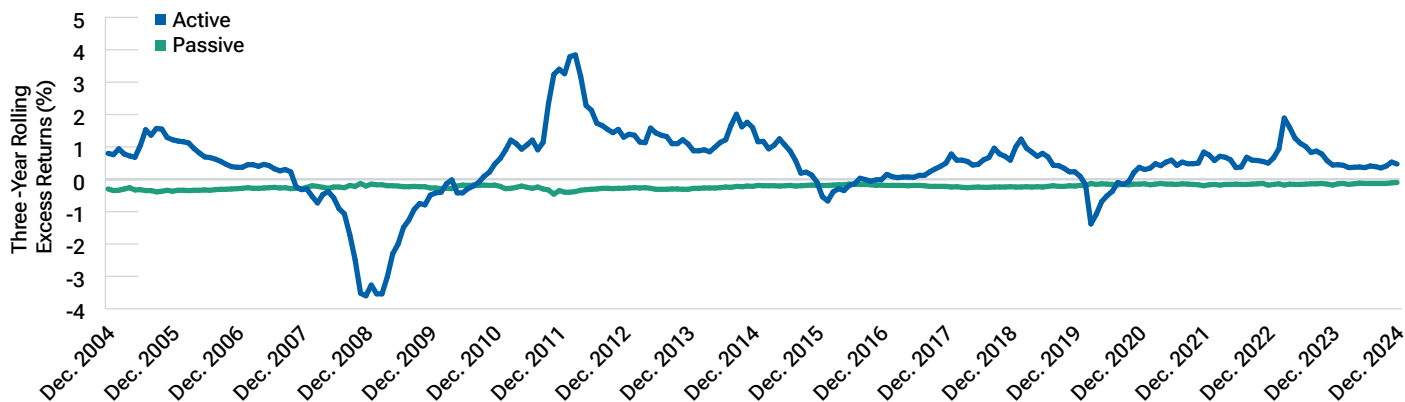
Today's investing climate is unique relative to the highly globalized environment that preceded and then followed the global financial crisis. That era of geopolitical quiet, ever cheaper consumer goods, low inflation and interest rates, and low volatility was the experience in the U.S. Away from the U.S., there was an element of predictability from a global fixed income perspective as the Federal Reserve arguably not only served as the U.S. central bank, but also as a de facto central banker

¹ As of December 31, 2024. **Past performance is not a guarantee of future results.**

² Alpha is the excess return of an investment relative to its benchmark.

Active core plus bond managers have delivered more excess return

(Fig. 1) Average active excess return versus average passive excess return.



As of December 31, 2024.

Past performance is no guarantee or a reliable indicator of future results. Chart shows average active managers' and average passive managers' three-year rolling excess returns net of fees, calculated monthly. The active manager group consists of all actively managed mutual funds and ETFs (exchange traded funds) in the Morningstar Intermediate Core Plus Bond category which is made up of funds which invest primarily in investment-grade U.S. fixed-income, but have greater flexibility than core funds to hold non-core or "spread" sectors like high-yield, bank loans, and emerging market debt. The Bloomberg U.S. Aggregate Bond Index is listed as the primary prospectus benchmark. The passive manager group consists of all passive funds in the Morningstar Intermediate Core Bond category with the Bloomberg U.S. Aggregate Bond Index listed as the primary prospectus benchmark. Passive funds are those that the Morningstar Direct database identifies as index funds.³ Source: Morningstar and analysis by T. Rowe Price. See Additional Disclosures.

to the rest of the world, with the U.S. dollar remaining as the primary reserve currency. When the Fed acted in that world, many central banks followed. Today, the world is on a path of deglobalization where the Fed no longer leads in such a capacity. What exists now are divergent economic outcomes and monetary policy—clear opportunities through an active global fixed income lens.

Consider some features of today's investment environment as an example. While the Fed is on "hold" for the foreseeable future, the Bank of Japan is currently tightening monetary policy. In contrast, the European Central Bank is easing policy, as is the Bank of England. Interestingly, even the U.S. and Canada have diverged as their historically connected policy rates are now materially different. Meanwhile, everything just described is occurring before the prospect of higher tariffs likely exacerbates this general deglobalization phenomena.

These dynamics represent not only a total return opportunity for active fixed income managers, but also diversification⁴ potential at a time when valuations in certain areas of U.S. equity markets appear unduly stretched.

Active duration management will be critical

Beyond global economic and monetary policy divergence, excessive global debt funding is another factor to watch this year and beyond. Consider the U.S., for example: Despite a strong economy, there is also a budget deficit running in the range of 7% of gross domestic product. This unsustainable profile exists at the same time that the Trump administration is seeking tax cuts, which is setting off a maelstrom of activity in Washington DC as spring approaches. Amid the flux, controversial ideas such as replacing certain parts of existing U.S. Treasury obligations with long maturity

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³ Morningstar is an independent provider of fund data. The fund data used in this analysis were obtained from Morningstar Direct, a database containing comprehensive information about mutual funds and other investment products, including performance, holdings, analytics, investment characteristics, and whether a fund is actively managed or passive (Index fund). A passive fund aims to mirror the performance of a target index. Actively managed funds strive to generate differentiated returns relative to their benchmark by making purposeful investment decisions.

⁴ Diversification cannot assure a profit or protect against loss in a declining market.

Transition to a new investing paradigm

(Fig. 2) More volatility and greater dispersion expected in the new environment



Post-Global Financial Crisis Era

- Benign disinflation
- Low interest rates
- Peak globalized construct

Level of predictability
Low volatility



Post-Pandemic Era

- Higher trend inflation
- Higher interest rates
- Rising protectionism

Greater dispersion
More volatility

As of February 2025.

For illustrative purposes only. This is not to be construed to be investment advice or a recommendation to take any particular investment action. Investments involve risks, including possible loss of principal.

Source: T Rowe Price.

“perpetual” debt are being reported in the financial press. Meanwhile, the Treasury Department continues funding the sizable U.S. budget deficit largely with T-Bill issuance which will need, at some point, to pivot to more “coupon” supply at a time of diminished foreign demand for such issuance. And while the current efforts of the fledgling Department of Government Efficiency seek to combat these deficit spending dynamics, much uncertainty remains. Deficit spending is not just a U.S. problem as many other developed market governments have bloated balance sheets that will also need to be funded with new debt supply.

It is against this backdrop that we expect heightened volatility to be persistent, which raises the importance of active duration⁵ management in 2025. Careful monitoring of corporate and emerging market debt borrowers will also be vital as global macroeconomic conditions change. While

challenging, opportunity awaits active global fixed income managers in the months ahead.

Why now is the time to consider an active allocation to fixed income

Beyond the importance of active management within fixed income, there is also a compelling case for allocations to lean more to fixed income generally. “Starting points” matter. In 2011, the S&P 500 had a historically low (cheap) price-to-earnings ratio of 11 times, which contrasted with the (expensive) 10-year U.S. Treasury yield of around 1.5%. These valuations were powerful indicators of what was to come—stellar equity returns that dwarfed lackluster fixed income results. Today’s environment represents the reverse—the multiple for the S&P 500 remains materially elevated relative to long term historical averages, while the 10-year Treasury yield is around

4.35% currently.⁶ Today’s “starting point” does indeed appear to indicate a break from the past as it points to a future where active fixed income will matter more.

Overall, we believe there is a compelling case for taking an active approach to investing in fixed income markets. We have moved from an environment of low interest rates, disinflation, and a peak globalized construct to one that is marked by higher trend inflation, elevated interest rates, and increased protectionism. The new investing paradigm is likely to lead to greater dispersion and more volatility in bond markets. To navigate such conditions, we believe it will be critically important to actively manage duration, security, and sector selection while maintaining flexibility to quickly adapt as market conditions change in what is likely to be a volatile 2025 investment environment.

⁵ Duration measures a bond price’s sensitivity to changes in interest rates. The longer a bond’s duration, the higher its sensitivity to changes in interest rates and vice versa.

⁶ Data as of March 7th, 2025. The multiple is the price earnings ratio.

For financial definitions refer to: <https://www.troweprice.com/en/us/glossary>

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