



Leveraging a Diversity of Perspectives on Rising Rates

An unusual rebound may provide opportunities even as rates rise.

April 2021

KEY INSIGHTS

- T. Rowe Price investment professionals have varying views on the recent increase in Treasury yields but expect an atypical economic rebound later in 2021.
- We highlight viewpoints related to inflation protected securities, the Treasury yield curve, dividend-paying stocks, emerging markets, and the Federal Reserve.
- We believe that our diversity of views on the implications of rising rates can give our investment professionals an advantage in this unusual environment.

Just as the sudden shutdown of much of the global economy at the onset of the coronavirus pandemic in 2020 was unprecedented, the expected recovery in 2021 is likely to be unique. Developed market central banks seem determined to maintain their extremely accommodative monetary policies, and fiscal stimulus in many countries—as evidenced most recently by the USD 1.9 trillion spending package in the U.S.—should make the economic rebound much more robust than previous recoveries. With the consumer saving rate at record highs in the U.S., pent-up demand could also help drive growth as accelerating vaccinations support economic reopening.

But what does this mean for financial markets? U.S. Treasury yields have increased markedly in early 2021, with the yield on the benchmark 10-year Treasury note climbing from 0.93% at the end of December 2020 to around 1.70% in mid-March 2021. By placing

a greater discount on future earnings, higher yields have helped accelerate the rotation away from higher-valuation tech stocks and toward value stocks.

Some T. Rowe Price investment professionals see the rising rates as an indicator of meaningfully higher longer-term inflation expectations, while others view the move as simply a healthy reflection of the expected increase in growth as global economies recover. This range of perspectives can help portfolio managers evaluate the potential for scenarios that may not exactly align with their own outlook. Here's what our investment professionals are saying.

Potential for Inflation to Exceed Anticipated Increase

Economists widely expect inflation data to show relatively large price increases beginning in the second quarter in comparison with the year-earlier period, when consumer prices broadly fell.

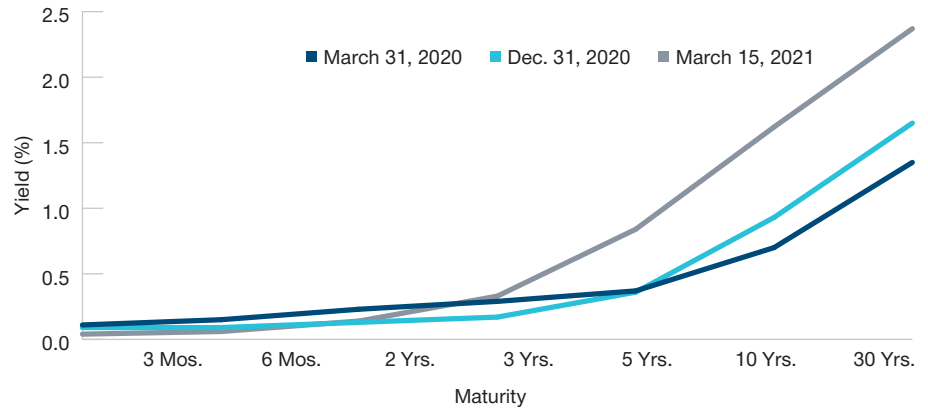


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Increasing Longer-Term Treasury Yields

(Fig. 1) U.S. Treasury yield curves have steepened



Yields are subject to change.
As of March 15, 2021.
Source: Federal Reserve Board.

However, most see inflation settling at lower levels in the longer term.

Michael Sewell, portfolio manager of the Inflation Protected Bond and Limited Duration Inflation Focused Bond Funds, sees the potential for inflation to exceed even the broadly anticipated increase in 2021. This could cause consumers to adjust their expectations for inflation going forward, potentially leading to structurally higher longer-term inflation levels.

Mike says that Treasury inflation protected securities (TIPS) would likely perform well in an environment where actual inflation exceeds market expectations. In terms of investors' broad asset allocations, he believes that TIPS are an effective hedge against interest rate risk because they should be poised to outperform nominal (not inflation-adjusted) Treasuries in an environment where stronger growth and inflation concerns pressure nominal rates higher. In addition, in his view, inflation protected bonds can potentially also act as a hedge against downturns in risk assets if inflation exceeds expectations and begins to pressure corporate profits.

Portfolio Allocations That Benefit From Inflation

Similarly, Tim Murray, capital markets strategist in our Multi-Asset Division, sees consumers exiting the pandemic with a remarkable savings glut, likely leading to a sudden increase in spending that could lead to rising prices. He anticipates that longer-term inflation will rise above the abnormally low levels seen over the past decade.

Tim believes that investors might want to consider increasing their portfolio allocations to asset classes that could benefit from higher inflation, including TIPS and value, small-cap, and emerging market equities. He also believes that "real assets"—which include natural resources and real estate equities—have the potential to maintain or gain value during periods of high inflation, making them potentially useful hedges in an inflationary environment.

Yield Curve Could Steepen Further

Although longer-term Treasury yields have increased this year, shorter-maturity yields have stayed relatively steady. As a result, the Treasury yield curve, which measures the difference between short- and long-term yields, has steepened.

Alex Obaza, portfolio manager of the Ultra-Short Term Bond Fund, observes that the dynamics of yield curve steepening have changed since the global financial crisis (GFC). Prior to the GFC, the yield curve typically steepened when the Federal Reserve cut interest rates and short-term yields decreased in line with the federal funds rate. But the Fed slashed rates to near zero during the GFC, where they have generally stayed. The near-zero federal funds rate now tends to hold short-term Treasury yields nearly steady as longer-maturity yields fluctuate in response to market expectations for economic growth and inflation.

Alex also analyzed post-GFC periods when the yield curve steepened and compared the size of those moves with the current trend. Although segments of the yield curve have steepened more than post-GFC averages (as of mid-March), Alex and New Income Fund Portfolio Manager Steve Bartolini see room for the steepening to continue. They note that the economic backdrop is stronger than it was following the GFC and during other post-GFC periods of yield curve steepening, with a variety of metrics measuring employment, manufacturing, and inflation expectations increasing at a greater pace.

Focus on Stocks Increasing Their Dividends

Dividend Growth Fund Portfolio Manager Tom Huber acknowledges that inflationary pressure and higher interest rates could lure some income-seeking investors away from stocks where an above-average dividend yield has typically accounted for the bulk of total returns. However, he concentrates on finding companies that he believes are increasing their dividends, not just those with high dividends.

Tom says that, in fact, higher rates could boost some sectors, such as financials. Banks stand to benefit from an expected increase in lending activity

as the economy recovers as well as from healthier net interest margins stemming from higher longer-term rates and a steeper yield curve. While these factors could temporarily boost most bank stocks, Tom tends to focus on company-specific drivers and characteristics that he believes can help position a financial institution for an extended period of sustained growth.

Higher Inflation Could Pressure Some EM Central Banks to Raise Rates

Inflation could also affect emerging markets (EMs). Andrew Keirle, Emerging Markets Local Currency Bond Fund portfolio manager, expects the recovery in oil prices to push headline inflation rates moderately higher in EMs over the next few months. However, in his view, core inflation—which excludes food and energy—is likely to lag because it will take time for output gaps to close and activity to normalize.

Andy says that higher headline inflation data could spark a debate about whether EM central banks need to raise rates to help stem inflation, which has historically been a problem in many EMs. On balance, he thinks that most EM central banks will keep rates on hold this year unless they experience a substantial increase in longer-run core inflation. He notes that Brazil and the Czech Republic, which are already experiencing meaningful inflationary pressure, are potential exceptions where central banks could begin rate hiking cycles.

Higher Yields Reflect Supportive Economic Backdrop

So far, the Fed has been willing to look through the rising Treasury yields. Policymakers have not chosen to put downward pressure on long-term yields by changing the composition of the Fed's quantitative easing purchases to focus on longer-maturity bonds. Chief International Economist Nikolaj Schmidt makes the case that the Fed is standing pat because the steepening yield curve simply reflects the supportive backdrop

of economic reopening and aggressively expansionary fiscal stimulus.

Nikolaj also thinks that there may be a more subtle reason for the Fed's inaction: Fed policymakers may be wary of creating a bond market bubble if they move to keep longer-term yields from reflecting the improving growth outlook. (Bond prices and yields move in opposite directions.) This would increase the risk of a disorderly sell-off in bonds when the central bank eventually moves to taper its accommodative policies.

Diversity of Views

I believe that this diversity of perspectives on the implications of rising rates can give our active management approach

an advantage in this highly unusual environment. The modern global economy had never experienced a downturn like that of 2020, and the extreme levels of fiscal and monetary stimulus provide the potential for an atypically fast recovery later in 2021. In my view, with this uncertain backdrop, this range of perspectives within T. Rowe Price should allow us to better navigate the possible market scenarios as the economic rebound evolves.

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