How Fixed Income May Help Navigate Evolving Markets

Five flexible bond opportunities to help lead clients through new market realities.

October 2022

KEY INSIGHTS

- It's been a challenging period for fixed income, but given how far the market has come, it could be a good time for investors to start adding duration back, particularly if growth is a concern.
- With diverse sectors, fixed income markets offer solutions that can potentially help support investors with a range of goals and risk tolerances.
- For investors seeking diversification, absolute return bond strategies may help, while those with a higher risk tolerance and longer time horizon could find attractive opportunities in corporate bonds at present.

For many investors, high inflation and rising interest rates may have seemed like vestiges of a bygone era, something they have neither experienced nor grappled with in their portfolios. Yet here they are, defining the current investing environment thanks to geopolitical turmoil and the lingering upheaval of the pandemic.

These new dynamics have created significant uncertainty, which, together with rising rates, has led to bond yields rising sharply to stand at levels not seen in years. Given that bonds and yields move inversely, this rise in yields means that bond prices have fallen.

Further complicating the picture is that the pressure in bond markets has coincided with stock markets selling off. This goes against the traditional tendency for fixed income to be a diversifying asset class that typically performed well when equity markets declined. Inflation has been the main driver of this, but if growth meaningfully slows, bonds are likely to reassert themselves as a useful diversification tool to riskier assets. Also, with Treasury bond yields now at meaningfully higher levels, they simply have more room to rally in the event that growth fears take over.

"Bond markets have been challenged this year by interest rate volatility and are now much better priced for the new market realities," said Franco Ditri, an investment specialist in Fixed Income at T. Rowe Price. "It could be a good time for investors to start adding duration[1] back into portfolios, particularly if they are concerned about the growth outlook."

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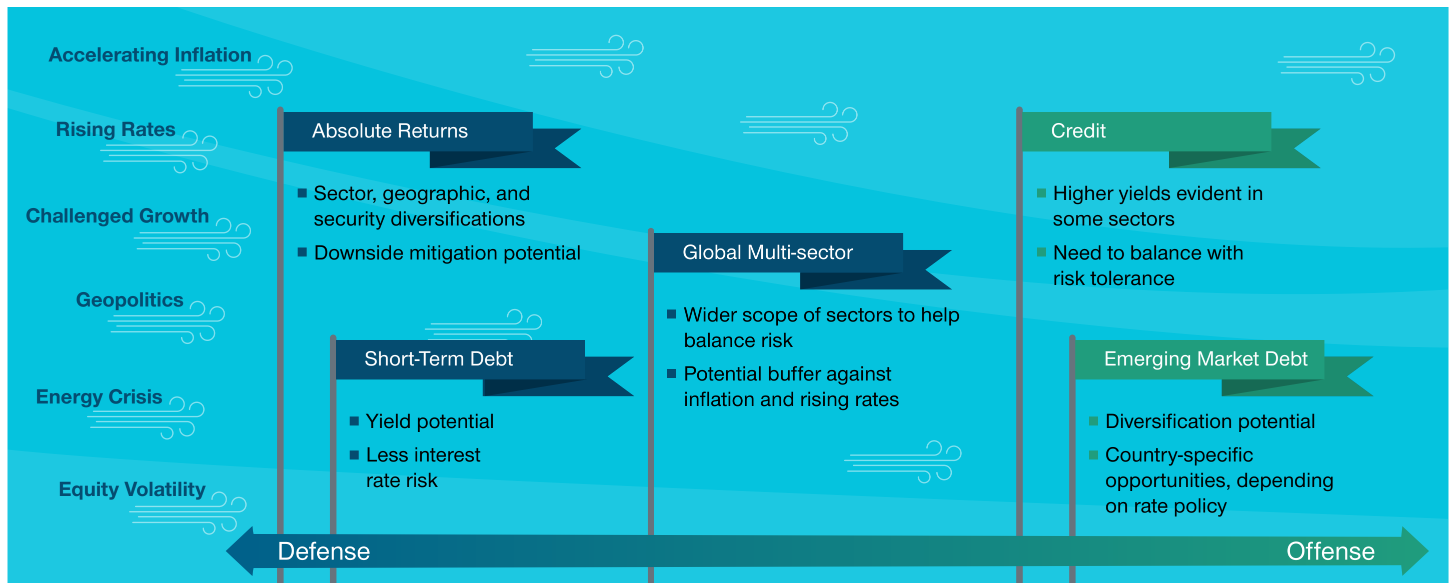
[1] Duration measures a bond's sensitivity to changes in interest rates.

Fixed Income Approaches in a Changing Market Climate

With a range of market headwinds, investors can flex between defensive and offensive approaches



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Why Fixed Income?

With diverse sectors, fixed income markets offer solutions that can help support investors with a range of goals and risk tolerances. A key appeal of fixed income investing is that there are opportunities for both defense and offense—often in the same strategy. The asset class is more fragmented than others. What drives one sector of the market is different than what drives another, so there's often been a wide dispersion among sector returns. This provides investors with the flexibility to find a sector and/or combination of sectors that can suit their particular needs—whether those needs are generating consistent income; defending against equity market volatility; or, in some instances, increasing capital appreciation.

Five Bond Opportunities for the Current Landscape:

1. Short duration debt offers compelling opportunity

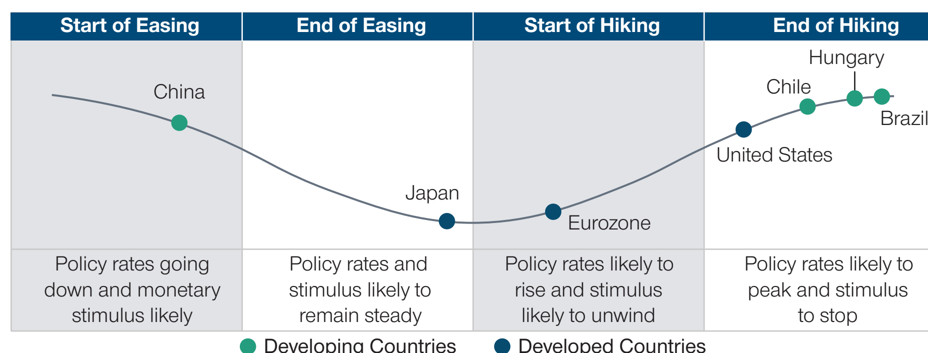
The repricing of Treasury yields this year has led to an inverted yield curve—a scenario in which short-term yields are higher than those of longer-maturity bonds. This means that investors can potentially receive a higher yield in shorter-maturity bonds while taking on less interest rate risk. This is a compelling opportunity amid today's conditions.

2. Multi-sector strategies broaden the opportunity set

Multi-sector strategies have greater flexibility to pursue opportunities across an expanded set of credit sectors. Whereas strategies that seek to mirror a broad-based index, such as the Bloomberg U.S. Aggregate Bond Index, are typically limited in the types of bonds they can own, multi-sector strategies have the ability to invest in a wider opportunity set. This may include high yield corporate bonds, securitized credit, Treasury inflation protected securities (TIPS), and bank loans, with the latter two able to help with mitigating the impacts of inflation and rising rates. This greater choice can bring potential opportunities to be strategic and help to balance and distribute risk more evenly across a larger number of sectors.

Hiking Cycle Across the Globe

(Fig. 1) Illustrative interest rate cycle



As of September 30, 2022.
These represent estimates of where the stated countries are in the hiking cycle. Actual future outcomes may differ materially.
Sources: IMF, CB Rates, and T. Rowe Price.

3. Absolute return bond strategies can help with portfolio diversification

Absolute return bond strategies can tactically adjust in response to shifting market conditions, making them an appealing choice in a range of different environments, including tumultuous periods. These nontraditional fixed income strategies are typically benchmark-agnostic and can cast a broader net, with the potential to invest in a wide range of geographies, sectors, and security types. However, investors should be aware that strategies within this category can vary significantly.

So, for those seeking potential portfolio diversification, it's important to look under the hood for an absolute bond fund manager that has either a low or negative correlation[2] with key market indexes, such as the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index. Together with the ability to tactically respond to shifting market dynamics, strategies with these correlation characteristics give investors the potential to realize returns in a variety of different market environments.

4. Corporate bonds offer attractive long-term income opportunities

Many investors come to the fixed income market seeking a consistent income stream. And, while there are significant headwinds, this year's extreme volatility has propelled corporate bond yields significantly higher. Indeed, they're now at levels that offer potential attractive income opportunities for investors with a longer time horizon.

Some credit sectors, such as U.S. investment-grade corporate bonds, offer yields above 5%[3]—levels not seen since 2009. Global high yield is also very appealing with average yields in excess of the 10%[4] level. Even if the economic picture worsens, companies may be better placed to withstand it than in previous downturns

[2] Correlation measures how one asset class, style, or individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one security moves, either up or down, the other security moves in lockstep in the same direction. A perfect negative correlation of -1 means that two assets move in opposite directions, while a zero correlation implies no relationship at all.

[3] Yield to maturity as of September 30, 2022, for the Bloomberg U.S. Corporate Investment Grade Index.

[4] Yield to maturity as of September 30, 2022, for the Bloomberg Global High Yield Index.

Yield data subject to change, is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.

“In today’s fast-paced, ever-evolving landscape, fixed income offers investors a wide range of potential opportunities....

as corporate balance sheets have strengthened since 2020. Importantly, the current slowdown differs from previous downturns in some distinct ways. Namely, it’s the result of inflation and the sheer number and pace of interest rate hikes aimed at taming it. By contrast, the market declines that accompanied the tech bubble and global financial crisis stemmed from investors’ concerns over the creditworthiness of certain assets, including overvalued tech stocks and excesses in the U.S. housing market.

But investing in credit markets comes with greater risk than government bond markets, and the lower down the credit scale the investor goes, the higher the risk. So, while corporate bonds offer compelling opportunities, it’s important that rigorous fundamental credit research takes place. This helps to identify top opportunities and prudently manage risks.

5. Emerging markets offer income potential and diversification benefit

Emerging market debt is also a potential offensive strategy opportunity for investors with an appropriate time horizon. Similar to corporate bonds, yields on emerging market bonds have reached levels that offer potential attractive income opportunities for investors. There’s also a wider opportunity set and potential to diversify interest rate exposures. While the Federal Reserve and other major central banks are tightening, not all countries are at the same point in their monetary policy cycles. In fact, some emerging market countries started hiking interest rates earlier, so they are further down the path. For example, Brazil appears to be nearing the end of the cycle while Hungary is also nearing the end point. This could mark a good potential entry point for investors concerned about interest rate risk.

Again, it’s important to note that emerging markets are subject to more credit risk than developed markets, so bottom-up research is essential. This helps to not only gain exposures to countries that offer different interest rate profiles, but also to identify potential opportunities where prices have become dislocated from fundamentals.

Market Dynamics Demand Deep Research

Market dynamics have changed, and this may be unsettling for investors. But while the landscape is different, we believe the need for fixed income as part of a diversified investment portfolio remains the same. Investors continue to seek ways to balance the need for both income and volatility management during these more uncertain times.

In today’s fast-paced, ever-evolving landscape, fixed income offers investors a wide range of potential opportunities, whether they are seeking strategies for offense or defense purposes, or a combination of both. To tap into this, choosing a global manager that prioritizes research is important and should help investors not only uncover potential opportunities, but also manage risks.

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Fixed-income securities are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall. Investments in **high-yield bonds** involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities.

Investments in **bank loans** may at times become difficult to value and highly illiquid; they are subject to credit risk such as nonpayment of principal or interest, and risks of bankruptcy and insolvency. In periods of no or low inflation, other types of bonds, such as US Treasury Bonds, may perform better than **Treasury Inflation Protected Securities**.

International investments can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. These risks are generally greater for investments in **emerging markets**.

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

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