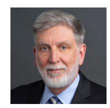
Rates Volatility to Continue as Economic Outlook Evolves

We expect a relatively mild U.S. recession, not a steep downturn.

May 2023



Andrew McCormick
Head of Global Fixed Income and Chief Investment Officer, Fixed Income

KEY INSIGHTS

- The rates market appears to be pricing in a "recessionary cliff" later this year, with the Fed responding by cutting rates before the end of 2023 in this scenario.
- While the odds of an abrupt downturn have risen since the sudden collapse of Silicon Valley Bank in March, we think that a recession will be relatively mild.
- We have been patiently positioning for a steeper 5- to 30-year segment of the Treasury yield curve.

Although the U.S. economy is withstanding the Federal Reserve's interest rate hikes and the recent banking system turmoil remarkably well as of late April, the rates market appears to be pricing in a "recessionary cliff" later this year. In this scenario, the economy would suddenly fall into a deep recession, with the Fed responding by cutting rates before the end of 2023.

Anticipating Mild Recession

Our outlook is not as dire. While the odds of an abrupt downturn have certainly increased since the sudden collapse of Silicon Valley Bank in March and the ensuing worries about other regional banks, we anticipate that the economic slowdown will be relatively mild. In this situation, the Fed would keep rates on hold through the end of the year with inflation remaining well above the central bank's 2% target, though an uptick in inflation data could cause another rate hike.

The system is still flush with cash, and demand for loans has been low and falling. However, credit conditions are tightening. If loan demand starts to inch upward, the more stringent credit conditions could limit firms' access to funding and lead to a modest recession.

Rapid Outlook Adjustments Causing Treasury Volatility

In March, the ICE BofA MOVE[1] Index, which measures implied volatility in U.S. Treasury yields, reached its highest level since the global financial crisis—even surpassing the elevated level at the onset of the pandemic in 2020. At the same time, the yield curve abruptly became less inverted, with the difference between 2- and 10-year Treasury yields moving from -106 basis points (bp)[2]

[1] See Additional Disclosures.
[2] A basis point is 0.01 percentage point.

> ...both the level of interest rates and the shape of the yield curve are likely to remain quite volatile....

in early March to -39 bp later in the month. Plainly, market participants were rapidly adjusting their outlooks for the magnitude of recession and its effects on Fed policy.

While the MOVE Index has moderated since March, both the level of interest rates and the shape of the yield curve are likely to remain quite volatile as this process continues. We think that it could take as long as 12 months for the Treasury yield curve inversion to dissipate, returning the curve to a more "normal" slope where short-term rates are lower than longer-maturity yields.

Opportunities in Steepening Yield Curve

In terms of portfolio positioning implications, we are cautious about meaningfully adding to outright duration[3] as much of the near-term benefit of duration is already priced in to the rates market amid expectations for a deep recession. However, we believe that positioning for a steepening in the 5- to 30-year segment of the U.S. Treasury yield curve represents an attractive opportunity as the federal funds rate reaches its highest point in this economic cycle. With that said, we have been patient in implementing this positioning amid the interest rate volatility.

Negative Correlation Between Bonds and Stocks to Return

We think that most investors should have some exposure to longer-duration assets in their broad portfolios because we believe that the long-standing historical negative correlation[4] between bonds and equities will return over the course of this year. This would come as a relief to investors disappointed by the positive correlation between the asset classes in 2022, when both fixed income and stocks dropped sharply amid high inflation and rapid Fed tightening. Although the negative correlation may not be as strong as it has been in the past, it should help reinforce the value of maintaining a fixed income allocation in a diversified[5] portfolio.

WHAT WE'RE WATCHING NEXT

We believe the debt ceiling standoff will be resolved in the coming months. After a resolution is reached, Treasury bill issuance will increase at a rapid pace. Bank reserve levels, which have been falling as the Fed allows its balance sheet to run off, are likely to fall even faster as investors draw on reserves to buy the new Treasury issuance. A rapid tightening of liquidity conditions is likely to lead to bouts of market volatility toward the end of the third quarter.

T. Rowe Price cautions that economic estimates and forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual outcomes could differ materially from those anticipated in estimates and forward-looking statements, and future results could differ materially from historical performance. The information presented herein is shown for illustrative, informational purposes only. Forecasts are based on subjective estimates about market environments that may never occur. The historical data used as a basis for this analysis are based on information gathered by T. Rowe Price and from third-party sources and have not been independently verified. Forward-looking statements speak only as of the date they are made, and T. Rowe Price assumes no duty to and does not undertake to update forward-looking statements.

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

[4] 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 means that two assets move in opposite directions, while a zero correlation implies no relationship at all.

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

INVEST WITH CONFIDENCE®

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

To learn more, please visit troweprice.com.

T. Rowe Price®

Additional Disclosures

ICE BofA indexes—ICE Data Indices, LLC ("ICE DATA"), is used with permission. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD-PARTY SUPPLIERS DISCLAIM ANY AND ALL WARRANTIES AND REPRESENTATIONS, EXPRESS AND/OR IMPLIED, INCLUDING ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, INCLUDING THE INDICES, INDEX DATA AND ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM. NEITHER ICE DATA, ITS AFFILIATES NOR THEIR RESPECTIVE THIRD-PARTY SUPPLIERS SHALL BE SUBJECT TO ANY DAMAGES OR LIABILITY WITH RESPECT TO THE ADEQUACY, ACCURACY, TIMELINESS OR COMPLETENESS OF THE INDICES OR THE INDEX DATA OR ANY COMPONENT THEREOF, AND THE INDICES AND INDEX DATA AND ALL COMPONENTS THEREOF ARE PROVIDED ON AN "AS IS" BASIS AND YOUR USE IS AT YOUR OWN RISK. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD-PARTY SUPPLIERS DO NOT SPONSOR, ENDORSE, OR RECOMMEND T. ROWE PRICE OR ANY OF ITS PRODUCTS OR SERVICES.

Important Information

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action.

The views contained herein are those of the authors as of April 30, 2023 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation concerning investments, investment strategies, or account types, advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Please consider your own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. **Fixed-income securities are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall.** All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

© 2023 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.

ID0005859 (05/2023)
202305-2879303