



# Volatility Brings Opportunity in Fixed Income

Interest rate markets offer alpha opportunities, dollar at risk of depreciation.

May 2023

## KEY INSIGHTS

- The combination of heightened volatility and increased dispersion should create some great potential alpha opportunities in rates markets.
- The U.S. dollar is at risk of weakening as the U.S. economy is hitting late cycle and the Federal Reserve looks set to pause hiking before most peers.
- Given the uncertain backdrop of sticky inflation and slowing growth, volatility is likely to remain high, so a flexible approach to bond investing will be important.

Bond volatility is likely to persist as concerns continue over sticky inflation, slowing growth, the banking sector, and the U.S. debt ceiling standoff. Through this volatility, we are finding potential attractive alpha (excess returns) opportunities in the interest rate space amid increased dispersion in central bank policy. In risk markets, the window of opportunity to add credit may have passed for now. While fundamentals continue to be supportive, we feel that risk markets may face challenges ahead from slowing growth or further market stresses, which is a possibility given the sheer number and pace of interest rate hikes since 2022.

Overall, we believe this environment will suit the T. Rowe Price Dynamic Global Bond Fund (“the fund”), which has a strong emphasis on active duration<sup>1</sup> management and is flexible with the

ability to tactically respond to different market environments.

## Conditions Ripe for Potential Alpha Opportunities in Rates

In rates, we believe that the current landscape is more conducive for generating alpha as heightened volatility creates dislocations that we can potentially take advantage of. One example here is the U.S., where banking turmoil led to markets pricing in multiple interest rate cuts later this year. While the Federal Reserve may pause rate hikes soon, we believe it is unlikely that it will then switch to cutting interest rates so quickly given the current U.S. inflation and labor market dynamics.

Our base case is for U.S. interest rates to stay higher for longer than markets currently anticipate. Why? Price pressures are cooling, but only moderately and not likely fast enough to force the Fed into



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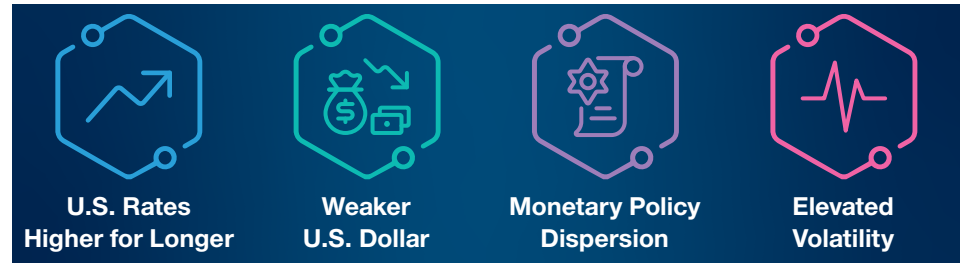
— **Scott Solomon, CFA**

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<sup>1</sup> Duration measures a bond's sensitivity to changes in interest rates.

## Tactical Themes in Bond Markets

(Fig. 1) Four key themes to monitor



As of April 30, 2023.

For illustrative purposes only. Not to be construed as a recommendation or investment advice.

Source: T. Rowe Price.

an early cutting cycle given that inflation remains materially above its 2% target. It is a similar story in the labor market, which may be loosening, but only gradually and from a position of extreme tightness. With this backdrop, U.S. interest rate cuts are probably off the table for 2023, so we expect the two-year U.S. Treasury yield to reprice higher. Eventually, the Treasury curve is likely to steepen or normalize as the current hiking cycle comes to an end. This is a long-term view that we believe will play out over several quarters.

### Dispersion in the Monetary Policy Cycle

Another key trend that we believe is conducive for potential alpha generation in rates is dispersion in the monetary policy cycle. Not all countries are at the same point—emerging market central banks, for example, started raising interest rates earlier and are therefore either close to the peak or finished their hiking cycles. The focus in emerging markets is now on the sequencing—i.e., how long central banks keep rates on hold before moving to cutting cycles. Broadly, we feel that a select few countries may be able to start easing later this year.

In developed markets, we are seeing some central banks, such as Australia, soften their guidance around future tightening, while others, such as the European Central Bank, remain hawkish in their battle to bring down inflation. Then there's the Bank of Japan (BoJ), which remains something of an outlier in its accommodative monetary policy stance. However, we do feel that at some point this year the BoJ may adjust its yield curve control policy and believe this is most likely to happen when market conditions are calmer and there's downward pressure on global yields.

Overall, we feel these divergences in monetary policy are conducive for us as we can implement both long and short duration stances in the portfolio. At the end of April, our preferred long positions were expressed in New Zealand, Australia, Canada, and select emerging market local currency bonds.<sup>2</sup> By contrast, our preferred short positions at the end of April were predominately expressed in the eurozone and the short end of the U.S. curve as we believe that interest rate cuts are unlikely in 2023.

<sup>2</sup> 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. The risks of international investing are heightened for investments in emerging market and frontier market countries. Emerging and frontier market countries tend to have economic structures that are less diverse and mature, and political systems that are less stable, than those of developed market countries.

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the portfolio, and no assumptions should be made that the securities identified and discussed were or will be profitable.

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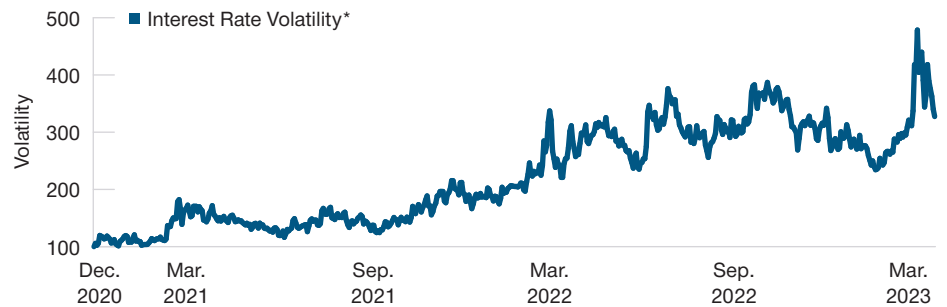
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## Heightened Volatility in Bond Markets

(Fig. 2) Levels of the MOVE Index since December 2020



As of March 31, 2023.

**Past performance is not a reliable indicator of future performance.**

\*Rebased to 100 as of December 1, 2020. Interest Rate Volatility = ICE BofA MOVE Index represents implied volatility on 1-month Treasury options.

Source: Bloomberg Finance L.P.

### U.S. Dollar at Risk of Weakening

After a period of multiyear strength, we believe that the U.S. dollar is at risk of weakening. There have been a few signs this year that the currency has hit a natural resistance after it failed to appreciate at times of heightened volatility in markets, such as the recent banking turmoil. Going forward, several indicators, including the U.S. economy moving into the late cycle before other countries and the likelihood that the Federal Reserve pauses hiking sooner than most peers, point to a period of dollar weakness. Accordingly at the end of April, we expressed an overall short bias in the U.S. dollar against a range of developed and emerging market currencies, including the euro and the Brazilian real.

### Importance of Flexibility

Going forward, we expect volatility to remain elevated in the fixed income market amid sticky inflation, slowing growth, ongoing geopolitical risks, and worries over the financials sector. There is also the political standoff over the U.S. debt ceiling—the longer this persists, the higher the risks. While this environment is likely to be challenging, volatility can often result in dislocations that we can potentially take advantage of thanks to our portfolio flexibility and active

management approach. For example, the dislocations created by volatility in March opened up a window to add select credit positions driven by our bottom-up research process.

With heightened volatility likely to persist, we anticipate that more opportunities will emerge in the future to add credit, but for now we feel the window has passed. Although robust credit fundamentals continue to be supportive, risk markets could face some challenges later this year. The impact of monetary policy tightening usually comes with a lag, so it is possible that other stresses could emerge at some point, particularly given the aggressive pace of rate hikes since 2022. Furthermore, we are conscious that recent banking sector turmoil may lead to tighter credit conditions in the future, adding another headwind to the global economy.

Overall, we believe that the current environment of elevated volatility, economic uncertainty, and the approaching turning points in interest cycles around the world lend themselves well to our actively managed global bond fund, which is flexible and has a strong emphasis on managing duration dynamically.

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Investments in foreign bonds are subject to special risks, including potentially adverse overseas political and economic developments, greater volatility, lower liquidity, and the possibility that foreign currencies will decline against the dollar. Investments in emerging markets are subject to the risk of abrupt and severe price declines. High-yield bonds carry higher credit and liquidity risks than higher-rated bonds, meaning there is a greater chance they will have their credit ratings downgraded or default.

**The fund’s use of derivatives may expose it to additional volatility in comparison to investing directly in bonds and other debt securities.** Derivatives can be illiquid and difficult to value, may involve leverage so that small changes produce disproportionate losses for the fund, and any instruments not traded on an exchange are subject to counterparty risk. The fund’s principal use of derivatives involves the risk that interest rate movements, changes in currency values and exchange rates, or the creditworthiness of an issuer will not be accurately predicted, which could significantly harm performance and impair efforts to reduce overall volatility.

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