



# Opportunities and Risks in a Low-Yield World

Why fixed income investors should look beyond current yield levels.

September 2020

## KEY INSIGHTS

- Value remains in government bonds while central banks provide support through bond-buying programs.
- Opportunities exist in high yield and securitized credit, while investment-grade corporates look fairly valued.
- Security selection and an ability to remain flexible are likely to be key drivers for future performance.



**Arif Husain**

*Lead Portfolio Manager,  
Dynamic Global Bond Fund*

What's next for fixed income markets? Government bond yields have plunged to extremely low levels, while most credit spreads<sup>1</sup> have tightened back to pre-coronavirus levels. These developments have left some investors questioning how much value is left in fixed income. In this Q&A, Arif Husain, lead portfolio manager for the Dynamic Global Bond Fund, explains where he expects to find some of the best opportunities over the next six months.

**Q: Arif, first of all, is it fair to say there is little value left in fixed income markets?**

**A:** There is a common misconception that generating alpha (excess returns) is just about the outright level of yield, but the current environment offers lots of opportunities through dispersion,

volatility, and the shapes of yield curves. If you ignore these elements and choose to disregard fixed income simply because interest rates are low, you risk missing out.

I want to make it clear that there is still value in government bonds. Don't fight the central banks—their accommodative policies, such as large-scale bond-buying programs, provide an anchor for the short end of most developed government bonds markets. There are also some great opportunities for skilled security selection within credit markets. It appears that we are transitioning from a beta market—in which credit markets rose sharply irrespective of a company's underlying fundamentals—to an alpha market where there's greater performance dispersion among companies. I believe further dispersion lies ahead, creating

<sup>1</sup> Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

“The opportunities are there—you just have to search a bit harder to find them.”

opportunities for active managers to potentially generate alpha by seeking to identify the stronger companies and avoiding those with weaker fundamentals that will probably lag or potentially even face default.

Currency markets also deserve a close look as the U.S. dollar's multiyear run of strength could be about to end. Several indicators, including an ultra-easy Federal Reserve and the likelihood of a slower economic recovery in the U.S. than its peers, point to potential dollar weakness ahead. This could be an important inflection point that opens up the door for lots of other currencies to shine, such as the euro.

**Q: Are you still a strong advocate of keeping duration<sup>2</sup> elevated in portfolios?**

**A:** Yes, duration remains a powerful tool. The environment is highly uncertain, with lots of potential risk events ahead that could trigger bouts of volatility and a flight into high-quality government bonds. The upcoming U.S. presidential election, for example, is a big unknown for financial markets.

Developed government bond yields are low, but they could go even lower. The German 10-year government bond, for example, is only in the middle of its 2019 range, so there is room for bund yields to fall further. In the U.S., it is also entirely possible for Treasury yields to decline even further and settle into a new lower trading range as long as a vaccine for the coronavirus remains unavailable. Furthermore, a move into negative yields in some parts of the Treasury market should not be ruled out even though it is unlikely that the Fed will cut interest rates below zero. In the UK, for example, the country's debt management office started to issue some government bonds at negative yields in May this year, despite positive key lending rates.

**Q: Where do you see value in credit markets?**

**A:** The opportunities are there—you just have to search a bit harder to find them.

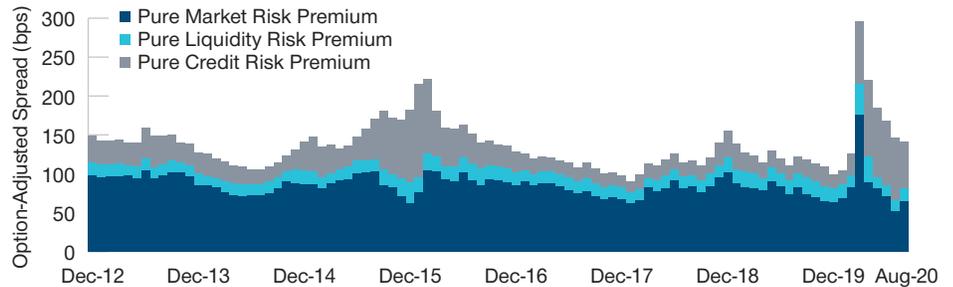
Credit has come a long way since March's lows. This is particularly true for investment-grade credit, where credit spreads have tightened significantly. Let's remind ourselves that the premium that investors demand to hold corporate bonds and to take on the risks associated with them can be divided into three parts: a pure credit quality component (which is linked to the risk of default), a pure liquidity component, and a pure market risk component. A recent study by our quantitative analyst team shows that the premiums for both the pure liquidity and the pure market risk have already reverted back to their long-term averages. To make additional gains in the investment-grade space, a further tightening of the pure credit quality component would therefore be required. This could only happen if we see default expectations fall and the global economic recovery pick up pace and exceed expectations.

In high yield, it is interesting to note that the premiums are still wide relative to investment-grade bonds. We have been finding particularly interesting opportunities among fallen angels—bonds that have been downgraded from investment grade into the BB category—in select energy-related and property issuers. But we are aware of rising default risk and low recovery rates: According to a J.P. Morgan note published at the end of June, the recovery rate on defaulted high yield bonds averaged 17 cents on the dollar over the last 12 months, well below the 25-year annual average of around 40 cents on the dollar. This highlights why security selection is imperative. We are confident that our global team of credit analysts can help us find companies

<sup>2</sup>Duration measures a bond's sensitivity to changes in interest rates.

## Decomposition of Credit Premium\*

(Fig. 1) Breakdown of U.S. investment-grade credit premium



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

As of August 31, 2020.

\* Credit premiums measure the additional yield investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

Source: Bloomberg Finance L.P. Analysis by T. Rowe Price.

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that are fundamentally solid and likely to thrive over the long-term.

Attractive value can also be found in securitized credit as certain parts of this market remain dislocated from fundamentals, especially in the industries that were hit hardest by the virus. Non-agency mortgage-backed securities and commercial mortgage backed securities look particularly interesting. As with high yield bonds, distinguishing the performers from those that could struggle is crucial. Our dedicated team of securitized credit analysts are focused on seeking securities with high upside potential in a recovery scenario.

### **Q: What skills do you think are necessary to navigate the current market environment?**

**A:** First, flexibility—the ability to extract value from different markets at different times. So far this year, duration dominated performance in the first quarter, credit dominated during the second quarter, and currency markets have dominated more recently. Having the flexibility to reallocate risk within

the global fixed income universe has been crucial, and I expect this to remain the case.

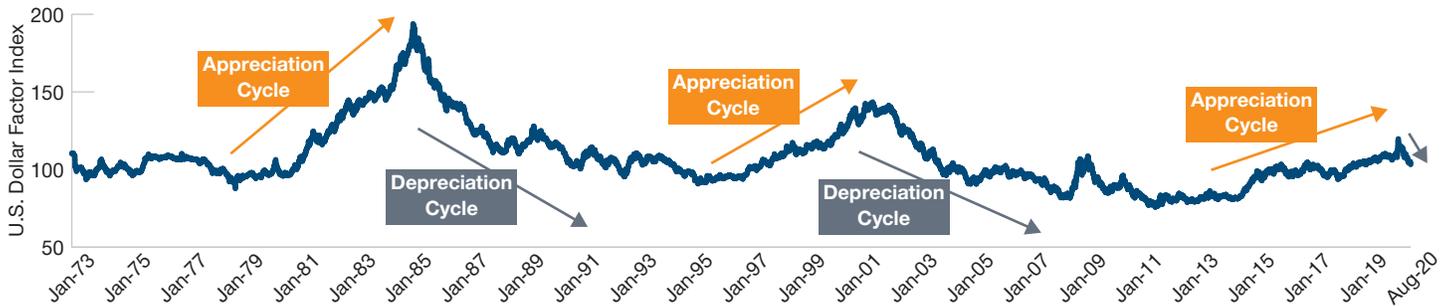
Second, we need to be prepared to make strategic changes quickly when faced with new information. For example, on the duration front, a vaccination or change in stance by a major central bank such as the Fed could potentially be game changing, with significant implications for government bond yields. Being able to act quickly to changes in market conditions will therefore be important.

Third, I believe successful security selection is going to become a dominant factor as alpha<sup>3</sup> is likely to drive the next phase of the market gains. It's not just about picking the winners; striving to avoid the losers is just as important, particularly in an environment where defaults are expected to pick up meaningfully over the next few months. To do this, we focus on bottom-up research. We have continued to add talent to our already vast platform of dedicated analysts that spans the globe, covering every major sector within fixed income.

<sup>3</sup> Alpha measures the returns generated over and above the returns of the broad market for specific sectors or securities within that market.

## Turn in the U.S. Dollar Cycle?

(Fig. 2) USD Factor Index\* since 1973



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As of August 31, 2020.

\* USD Factor Index: Total return (in percent) of an equally weighted basket of USD versus EUR, GBP, CHF, SEK, NOK, JPY, AUD, NZD, and CAD currencies. The USD Factor Index represents the performance of the U.S. dollar relative to a basket of foreign currencies. When the Index goes up this shows the dollar is strong compared to the other currencies.

Sources: Bloomberg Finance L.P. Analysis by T. Rowe Price.

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### Q: What could be the catalyst for a change in fixed income markets?

**A:** The closest big unknown is November's U.S. presidential election. It's hard to predict an outcome—anything, from an outright win by either party to a protracted legal battle, is possible. It may take several weeks before a result is validated, creating uncertainty and possibly volatility. We need to be prepared to quickly assess different potential scenarios, look beyond any short-term volatility to evaluate the long-term implications and what opportunities might arise as a result.

Any signs that central banks are showing less commitment to supporting markets could potentially be another game changer. Historically, major central banks such as the Fed have been keen to lift rates away from zero and reduce the size of their balance sheet as soon as they can. If we see any indications of this, we will need to act quickly as

there's a real possibility of a repeat of the 2013 taper tantrum, when U.S. Treasury yields rose sharply. This could affect not only core government bonds, but also credit.

Inflation surprising to the upside could also be a catalyst for change. Everybody thinks it's dead, but it might not be dead everywhere. Countries in Central and Eastern Europe, for example, could see price pressures rise. The outcome of the U.S. elections could also impact long-term inflation expectations.

Finally, we are still in unknown territory with respect to the coronavirus. Second waves and further shutdowns are a real risk to the global economic recovery. We have observed that economic data appear to follow the developments of COVID-19, the disease caused by the coronavirus, with a six-week lag. It was, therefore, no surprise to see economic data in the U.S. beginning to deteriorate recently after an initial strong jump.

### Additional Disclosure

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