Fixed Income.

SEEKING GLOBAL FIXED INCOME VALUE AMID FED UNCERTAINTY.

EXECUTIVE SUMMARY

Following several years of strong performance, fixed income sectors have generally produced middling returns over the past year amid elevated volatility in interest rates, credit spreads, and currencies. Treasury yields have followed a choppy path, occasionally pushing higher as solid U.S. labor market data suggested that the Federal Reserve would begin raising rates from near zero. But persistently low inflation and concerns about the health of the global economy have postponed a rate “liftoff” and sustained demand for Treasuries. Meanwhile, risk premiums have climbed to multiyear highs in many credit markets as investors have grown increasingly cautious heading into the first Fed tightening cycle in nearly a decade. Tumbling commodity prices and a decelerating Chinese economy have added to concerns for high yield and emerging markets bonds.

In a recent roundtable discussion, a trio of T. Rowe Price fixed income investment professionals shared their views on the uncertain, increasingly volatile environment and what it entails for their portfolio positioning.

ON SEPTEMBER 17, THE FED ELECTED TO DELAY ITS FIRST RATE HIKE IN NEARLY A DECADE. DO YOU EXPECT TIGHTENING TO BEGIN THIS YEAR? AND HOW BIG OF A RISK DOES A RATE HIKE POSE TO BOND MARKETS?

Steve Huber: I think the Fed wants to get rates off zero and is comfortable with labor market conditions. If the Fed decides not to raise rates this year, it’ll largely be due to inflation. Officials may want to see more wage pressures to make them comfortable that inflation will get to their 2% target over the next couple of years. However, it wouldn’t surprise me if they decide to hike once and then wait to see how the market digests it. Raising rates from 0% has never happened before, and there are a lot of questions as to how markets will react. From an investment standpoint, a critical piece will be how the Fed telegraphs what it’s going to do in the future. I see tightening potentially causing a risk-off event in the markets, and I am looking for the Fed to balance that by communicating that it will be in wait-and-see mode after the first rate hike.
Hugh McGuirk: Whether it happens in October, December, or early 2016, it’s almost immaterial when the Fed decides to begin raising rates. We think it will be a long, slow path to a very modest terminal rate somewhere around 2%, or maybe a little higher. As long as the market holds the same view—and the Fed doesn’t say anything to change it—Treasuries shouldn’t react too negatively. There’s a high correlation between Treasury rates and municipal rates over long time periods. Therefore, we wouldn’t expect munis to react too negatively, either.

Mike Conelius: Clearly the U.S. economy doesn’t justify 0% interest rates. I think the Fed ought to get it over with and see how the dust settles. Twenty-five basis points more yield in short-dated U.S. assets isn’t much of a move in risk premiums. I’m more concerned about market infrastructure and banks’ ability to warehouse and move risk around the market. Within emerging markets (EM), we’ve adopted a bit more cautious positioning in terms of liquidity and being a little more defensive. It pays to be more defensive in a more vulnerable asset class. If there’s a market dislocation, it’s likely to be in emerging markets. But we think fundamentals are starting to heal, and next year could present a decent opportunity for investors. The Fed rate hike will probably be the last shoe to drop.

THERE HAVE BEEN THREE TIGHTENING CYCLES IN RECENT DECADES. HOW MIGHT THIS CYCLE DIFFER FROM THOSE, AND HOW WORRIED SHOULD INVESTORS BE ABOUT BOND PERFORMANCE?

Steve Huber: The 1994—1995 and 1999—2000 tightening cycles were driven by inflation fears. In 2004—2006, there were concerns about real estate and energy prices. In that cycle, we saw 17 consecutive 25 basis point moves by the Fed as it increased the fed funds rate from 1.00% to 5.25%. This cycle is likely going to be different than all three of those. The Fed is not going to be tightening because of inflation, but because it wants to get off

Figure 1: The Importance of the Coupon Component to Total Returns
December 1993—December 2014

**Fixed Income Market Calendar Year Returns**

![Graph showing total return, coupon component, and price return over calendar years 1994 to 2014 with indicators for Fed tightening.]

Sources: Barclays and T. Rowe Price.
Market represented by the Barclays U.S. Aggregate Bond Index.
^Includes prepayment factor on securitized products.
zero and start to normalize policy given some of the strength we’re seeing in the U.S. economy. We may not even get two consecutive tightening moves in this cycle. So my expectation is that long-term rates will stay relatively low and will be driven by global risk aversion and how the economic picture plays out.

In past tightening cycles, there were some pretty large negative price returns. But they tended to be largely offset by coupon returns, which is a very important contributor to total return (see Figure 1). Total returns were slightly negative in 1994 and 1999; returns were actually positive from 2004 to 2006 as long-term rates barely budged. I think we’re in for a long period of lower long-term rates, at least until inflation starts to show signs of increasing.

EMERGING MARKETS CURRENCIES HAVE DEPRECIATED SHARPLY OVER THE PAST YEAR AMID CONCERNS ABOUT FALLING COMMODITY PRICES, THE SLOWDOWN IN CHINA, AND CAPITAL FLIGHT IF U.S. RATES RISE TO MORE ENTICING LEVELS. ARE WE IN FOR A REPRISE OF THE CURRENCY CRISIS THAT ROCKED EMERGING MARKETS IN THE 1990S?

Mike Conelius: The 1997—1998 crisis involved the breaking of unsustainable currency regimes, with currency pegs contributing to a credit crisis and widespread defaults. Today, most countries have floating currencies, and they’re letting their currencies adjust. They needed to adjust because they’re no longer enjoying commodity windfalls or easy money from foreign investors flowing into their local bond and equity markets. You now have meaningfully cheap currencies in many countries (see Figure 2). This will support a recovery, whether it’s in 2016 or 2017.

We’re seeing improvement in fundamentals. In some cases it’s being forced on countries in terms of current account adjustments and import compression now that their currencies have weakened. Other countries are incrementally adding to reforms. Emerging markets are universally unloved, with a lot of pessimism already priced in. Credit spreads are at five-year wides. Clearly there’s volatility in emerging markets, but you can earn a decent yield without having to take below investment-grade credit risk. However, it might be a little too soon for this to be a buying opportunity.

THE NORMALLY PLACID MUNICIPAL MARKET HAS GARNERED A LOT OF HEADLINES DUE TO TROUBLE SPOTS SUCH AS CHICAGO, DETROIT, AND PUERTO RICO. HOW LARGE ARE THE MARKET’S PENSION PROBLEMS, AND WILL WE SEE CREDIT STRESS WHEN RATES START TO RISE?

Hugh McGuirk: The pension issues are a big deal for our market. But they’re a longer-term issue, and I think we still have time to address them. However, if nothing is done, it could evolve into a crisis. It really comes down to ability and willingness to deal with the problems. A case in point is Chicago and the state of Illinois, where we think they have the ability, but the willingness has not yet emerged. In contrast, the government in Puerto Rico is demonstrating willingness to fix problems, but it may lack the ability. A lot has to go right for Puerto Rico’s recovery plan to work out for bond investors.

The narrative in the muni market has been dominated by the troubled credits, but the overall market is very large and high quality. There are over 50,000 different issuers, and over 60% of our market is either AA or AAA rated. For the most part, state and local governments are doing the right thing by raising revenues and reducing expenses. Debt is still a four-letter word for many state and local governments. While we have averaged close to
$400 billion in issuance on an annual basis, much of that has been for refinancing purposes. Issuers have been delivering, and I think that trend will persist. I don’t foresee much credit stress from rising rates alone.

WHAT ARE THE IMPLICATIONS OF THE COLLAPSE IN THE PRICES OF OIL AND OTHER COMMODITIES FOR INVESTORS IN HIGH YIELD AND EMERGING MARKETS BONDS?

Steve Huber: The energy sector makes up about 20% of the U.S. high yield market, and if you include metals and mining, it’s close to 25% in commodity-related sectors. The commodity price decline has been the primary reason for the spread widening we’ve seen in high yield. The energy sector in high yield has declined by about 20% over the past year. Excluding energy, returns have actually been slightly positive. We’ve been underweight the high yield energy sector, but some names are starting to look interesting. A lot depends on oil prices going forward, which are very difficult to predict. Depending on how that plays out, we could see a modest uptick in defaults next year due to some of the distressed energy companies.

Mike Conelius: Certainly weaker commodity prices have been negative for developing countries that are very dependent on commodity exports. Venezuela’s spreads have widened over 2,000 basis points. Most of their bonds are trading at recovery levels of 30 cents on the dollar, and bonds maturing in the next year or two are offering 40% or 50% yields. But on a GDP-weighted basis, there are clearly winners in important countries. India and China are two key beneficiaries of lower oil prices. The market has been able to discern which countries are more vulnerable. Lower gasoline prices have been a windfall for middle-class consumers, and on the corporate side, we tend to focus more on consumer-facing companies. Investors need to parse out the winners from the losers. We were pretty bearish on commodity prices based on research from our Equity Division’s natural resources team and have been positioned fairly well in our portfolios.

LIQUIDITY HAS BEEN A PARTICULAR AREA OF CONCERN FOR BOND INVESTORS, AS NEW REGULATIONS HAVE CONSTRAINED WALL STREET BANKS’ TRADING ACTIVITIES AT THE SAME TIME THAT THE SIZE OF BOND MARKETS HAS SWELLED. WHAT ARE YOU DOING IN YOUR PORTFOLIOS TO ADDRESS LIQUIDITY CHALLENGES?

Steve Huber: I think liquidity in general is undervalued. It’s even more important in the current uncertain environment, because having liquidity in portfolios allows you to tactically allocate as conditions and risks change. The combination of credit concerns and illiquidity in a portfolio can be fairly lethal if you want to get out of a security and can’t—at least at a fair price. I expect a high-volatility environment going forward, where balancing illiquid positions with very liquid positions will be essential: not only for protection, but also for tactical allocation. Credit dislocations tend to be really good opportunities to provide liquidity to the market. If you can be a buyer in those periods, you can really reap some good long-term opportunities.

Hugh McGuirk: A couple of decades ago, we might have had 100% turnover in our portfolios. Today, turnover is often less than 20%. It used to be that you could buy a bond that was a little cheaper than average and then trade it for another bond when relative valuations reversed. Today, it’s much more about long-term investing and doing the credit work up front. That’s one of our defense mechanisms—making sure via fundamental research that we’re picking the securities that we want to own for a long time. We also want to make sure that we have a store of liquidity in our portfolios so that we can be liquidity providers when the muni market experiences bouts of illiquidity. Intermediate-term AA rated municipal bonds are extremely liquid.

Mike Conelius: EM bonds are probably the most liquidity-challenged asset class overall. On the corporate side, you have to take a longer-term view and size your positions accordingly based on analyst conviction. And you want to have some dry powder to add to a name if there’s distressed pricing. Dollar-denominated sovereign debt is fairly liquid, but not for every country: Sub-Saharan African sovereigns are not so liquid, while Brazil and Russia are very liquid. Although foreign investors can aggressively sell EM local currency debt, it’s the deepest and most liquid part of our market, with a dedicated domestic buyer base. We have been investing in local currency debt partly for high real yield, but also as a store of liquidity.
Based on your outlook, how are you positioning your portfolios to take advantage of opportunities and mitigate risks?

Steve Huber: The levers we use are sector, duration, currency, and security selection. The credit cycle has largely run its course. But going into Fed tightening, I think credit will still do fairly well. I don’t think we’re going to see a lot of spread compression, but the downside appears fairly limited. Absent a more severe tightening cycle than I expect, I still like high yield for now. I think there are some longer-term issues facing high yield as we get into late 2016, but the higher coupons that high yield currently offers are pretty attractive.

On the duration side, I’m looking globally for opportunities. I don’t think duration will be as onerous as it was in past tightening cycles, but I still think it’s valuable to diversify duration risk globally. Global rates markets tend to be more liquid than credit markets, so that’s a good area to extract value as different policy cycles play out and volatility creates tactical opportunities. In currencies, the opportunities are in emerging markets. It’s probably a little early to jump into EM currencies until countries have worked through a few more of their problems, but this is an area that stands out to me longer term. We are staying focused on reform-oriented governments, such as Mexico’s, and have high conviction in the peso. Security selection is ultra-important in this environment. At the end of the credit cycle, the most important thing is avoiding the losers. That’s where strong credit research comes in.

Mike Conelius: Emerging markets valuations are favorable and justify being somewhat optimistic. With recent underperformance, EM is the cheapest asset class. Fundamentals clearly deteriorated but have probably bottomed. Some of the more important countries became a bit relaxed in terms of reforms as they enjoyed commodity windfalls and massive capital inflows, some of which they didn’t deserve. Now they’re going to have to earn that incremental foreign inflow or else adjust, and we’re seeing that now. Historically, emerging countries have responded; they don’t have the luxury of kicking the can down the road with easy monetary policy.

It might be contrarian, but I think Brazil could be rewarding; it’s a longer-term trade, but I think these are good prices to be accumulating positions. Mexico is by far our favored market; energy reform was maybe two years too late, but other reforms are paying dividends. In Eastern Europe, Serbia has been a long-term overweight as it moves toward joining the European Union, and Ukraine has a reformist government in place. I’m relatively bearish on Russia due to the long-term implications of Iran being a gas exporter to Europe, which will undermine Gazprom. In Asia, we like select corporates in China. Indonesia hasn’t made the progress with reforms that we had hoped, but valuations are interesting in both the dollar and local currency markets, and longer term it’s an interesting story to stay focused on.

Hugh McGuirk: Our base case is that the Fed is going to be on a fairly benign path of raising rates over a long period of time. With the Fed’s rate hikes having a greater effect on the front of the curve, we feel like the municipal curve is steeper than it will end up eventually. As such, we like the yield offered at the long end. Even if there is some mild principal loss from rising rates, we think the yield will help offset that. Longer-term munis are also cheap relative to Treasuries, providing a good alternative for taxable investors looking to get involved in fixed income.

The number one thing for me is security selection based on strong and detailed fundamental credit research. There’s no substitute for having a strong credit team, which we’re very proud of at T. Rowe Price. If you look at the muni market overall, it consists of about two-thirds revenue bonds and one-third general obligation bonds. We have a strong emphasis on revenue bonds. The very large unfunded pension liability issues affecting the general obligation space doesn’t really exist in the revenue bond space. Given that, you would think that revenue bonds would yield less than general obligation bonds, but that’s actually not the case. We keep much lower allocations to general obligation bonds and use credit research to pick issuers with the ability and willingness to address long-term challenges.
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