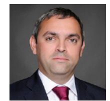
Duration Hideouts Offer Opportunities as Bond Sell-Off Continues

Five key themes for an uncertain period in fixed income markets.

May 2021

KEY INSIGHTS

- The acceleration in global growth is likely to keep pressure on developed market bond yields over the next few months.
- Investors are expected to ignore the widely anticipated rise in headline inflation and instead await signs of real price pressures emerging.
- There is a preference for "duration hideouts" in the current rising rate environment, while select emerging market local currency bonds also look appealing.



Arif Husain
Head of International Fixed Income, Lead Portfolio Manager of the Dynamic Global Bond Strategy

What's next for fixed income markets? A sharp rise in government bond yields since late 2020 has left many investors questioning how much further this trend has to run, if at all. At the same time, inflation fears are growing, and there are concerns about the diversification power of bonds. Given this uncertainty, we have assessed the current state of the global bond market and identified five key themes that we believe investors should be mindful of.

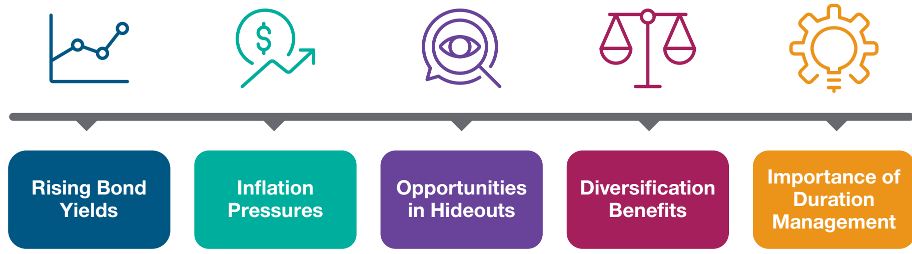
1. The Bond Sell-Off Is Likely to Continue

Bond yields are still too low and will likely continue to rise over the next few months (yields rise when bonds sell-off). There are four themes that currently underpin sentiment in financial markets: ultra-accommodative monetary policy, expansionary fiscal policy, significant pent-up demand for services, and expectations that vaccines will lead to the reopening of economies.

> "Bond yields are still too low and will likely continue to rise over the next few months....

Five Key Themes in Fixed Income Markets

(Fig. 1) Navigating the uncertain environment



> If price pressures do finally emerge, they are unlikely to be felt equally across the globe.

If these themes continue, developed market bond yields are likely to remain under pressure. Monitoring these themes closely will be critical over the coming weeks and months as signs that any of them are reversing could be the catalyst for change.

Looking into more detail at the themes, major central banks have vowed to keep monetary policy broadly accommodative in 2021. But if strong data are sustained and cause real inflationary pressures to build, central banks such as the U.S. Federal Reserve may be forced to change course and signal the start of tightening. Fiscal policy remains supportive for the time being thanks to new stimulus in the U.S., but some governments may look to tighten later in the year after unprecedented spending during the pandemic. We recognize that there is still a lot of uncertainty over the last two themes. For example, it is unknown how effective vaccines will be over a longer time horizon and whether they will be able to fight new variants of the coronavirus disease. There is also uncertainty about potential tax rises in places such as the U.S. and how that might impact the expected rebound in consumption.

2. Investors Need to See Evidence of Real Inflation Pressures

Market participants will probably look past the rise in the headline inflation rate over the next few months as it is widely expected and being driven by commodities and favorable base effects. Any sequential inflation caused by the easing of lockdowns and increased consumption will be harder to predict—investors will want to see evidence that it is actually happening before believing it, given the number of false dawns in the past. If price pressures do finally emerge, they are unlikely to be felt equally across the globe. For example, the U.S. stands out as potentially more exposed due to its procyclical monetary and fiscal policy.

A short duration stance and allocations to positions that aim to mitigate against higher inflation, such as U.S. inflation-linked bonds, should help manage the risks around price pressures. A short U.S. dollar bias could also prove beneficial.

3. Duration Hideouts Offer Opportunities as Rates Rise

From a bond perspective, we favor "duration hideouts"—markets that are potentially less correlated and sensitive to a sell-off in core rates—in the current market environment. Chinese local currency government bonds, in particular, stand out on this front. In contrast to the rest of the world, China is expected to slow this year as policymakers focus on deleveraging and rebalancing the economy. This could drive the central bank to shift toward easing monetary policy later this year while most other major central banks potentially start moving toward tightening and removing some accommodation. We believe that the policy divergences from major markets make China a good duration hideout.

There are also some good opportunities in select emerging market local currency government bonds. In some countries, we believe there are too many interest rate hikes priced in, which we believe makes the steepness of curves attractive.

4. Bonds Can Still Deliver Diversification Benefits

There have been doubts for some time about whether bonds can still deliver diversification benefits with bond yields so low. We believe that time horizon is an important consideration here. In the short term, there is a question mark over the diversification benefits, but we would not bet against investors continuing to use bonds as a diversification tool over the medium term. Let's not forget that bond yields are higher and curves steeper than where they were at the start of 2021, so the backdrop has improved.

> “…a risk that investors are not always aware of is the duration risk hidden in credit markets today….

Furthermore, if we were to face another extreme event that puts major selling pressure on risk assets such as equity and credit, we believe fixed income will deliver diversification benefits—the caveat being that this can only work if the cause of the sell-off is not related to bond yields.

Using the full toolkit that is available to help balance and mitigate risks in portfolios is therefore important, which has very much been our approach.

5. Managing Duration Is Becoming More Important

Fixed income can be used either for income-seeking or for diversification purposes. What's important is that investors know and understand the role they want their fixed income allocation to play. For example, investors seeking income may decide to allocate to credit sectors such as investment grade and high yield—however, although these may carry less risk than equity markets, they are still positively correlated and will likely suffer when there's a sell-off in risk assets. Investors also need to be mindful that credit sectors are typically less liquid than government bond markets.

Lastly, a risk that investors are not always aware of is the duration risk hidden in credit markets today—credit contains a duration component that exposes it to changes in the underlying risk-free rate. Over the past decade, duration has become a key driver of credit returns, highlighting the importance of active duration management for credit investors. The strong influence of duration has not been a problem while yields were trending lower, but the environment is changing. Going forward, there's likely to be more interest rate volatility, so managing duration is not only going to matter in government bonds, but also in credit portfolios.

Brighter Days Are Likely Ahead for Government Bonds

The next few months could be tough to navigate, but once we are through that period, the conditions are likely to be a lot brighter for investing in government bond markets. Any further sell-offs in the long end of curves should help valuations to improve, and at some point, these bonds will become attractive again because of their absolute level of yield and curve shape. Let's not forget that there's potential to earn greater income when curves are steeper. Identifying that key inflection point will likely be critical for future returns.

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

T. Rowe Price®

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2021 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc.

ID0004278 (05/2021)
202105-1647167