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PRICE POINT

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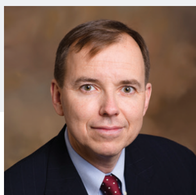
Global Fixed Income

FIXED INCOME ENTERS A NEW ERA

KEY POINTS

- Developed market central bank tightening is set to begin in earnest in 2018, ending an almost-decade-long period of monetary stimulus.
- Monetary tightening will take place against a background of low yields, tight valuations, the possibility of inflation, and a number of ongoing geopolitical risks.
- However, we believe growth will remain firm in many parts of the world, creating compelling opportunities in select credit sectors.
- In this environment, it may pay to employ barbell strategies that combine higher-yield assets with assets that have lower correlation to equities.



Mark Vaselkiv
Chief Investment Officer, Fixed Income

We expect 2018 to mark the beginning of a new era in bond investing as central banks begin the long process of withdrawing the quantitative easing (QE) measures introduced in the wake of the global financial crisis, with some monetary policymakers also set to hike interest rates. These tightening measures will be implemented at a time when sovereign yields in the developed markets are very low and credit spreads are tight, and while the global economy faces trade uncertainty, the potential return of inflation, and a number of geopolitical risks. However, we believe growth will remain firm in many parts of the world, creating compelling opportunities in select credit sectors.

In this environment, bond investors might consider casting a wider net and diversifying their fixed income portfolios to meet their desired risk and return objectives, with an emphasis on detailed research, active security selection, and sector rotation.

CENTRAL BANKS TAKE CENTER STAGE

The year 2017 arrived amid high expectations that newly elected U.S. President Donald Trump's proposed infrastructure spending, tax cuts, and regulatory reforms would result in higher U.S. growth and inflation. It did not take long for these expectations to fade. When it became clear that Trump's policies would prove much harder than anticipated to put into practice, yields fell back down to levels last seen before the presidential election, interest rates declined, and the dollar slumped against the euro. Since then, interest rates have modestly picked up and the dollar has rallied slightly, but uncertainty persists over the extent to which Trump can deliver on his original mandate.

A potentially bigger influence on markets in 2018 than President Trump's political fortunes, however, will be the extent and speed of central bank tightening. Following almost a decade of unprecedented monetary stimulus, central

bank-owned assets equaled around 40% of global gross domestic product (GDP) at the end of September, compared with around 20% immediately prior to the 2008 financial crisis (Figure 1). This figure will fall again as central banks begin the long process of retrenching their balance sheets, but it is not yet clear how quickly they will seek to do this, nor what the cumulative impact on markets will be.

We expect that some central banks will also hike interest rates in 2018—possibly more aggressively than currently priced in by the markets. The Fed has signalled it will hike rates three times next year, which would take the federal funds rate to 2.25% and—if long-term rates remain stable—flatten the U.S. Treasury yield curve. If the Fed hikes more than that, or seeks to reduce its balance sheet more quickly than anticipated, the U.S. yield curve could even become inverted. Based on past experience, this would imply a negative outlook for the U.S. economy. When longer-dated assets generate less income than shorter-dated ones, the incentive to make new loans dries up, depriving the economy of a vital source of funds. If the Fed proceeds more cautiously, however, a reasonable rate of economic growth should be achievable.

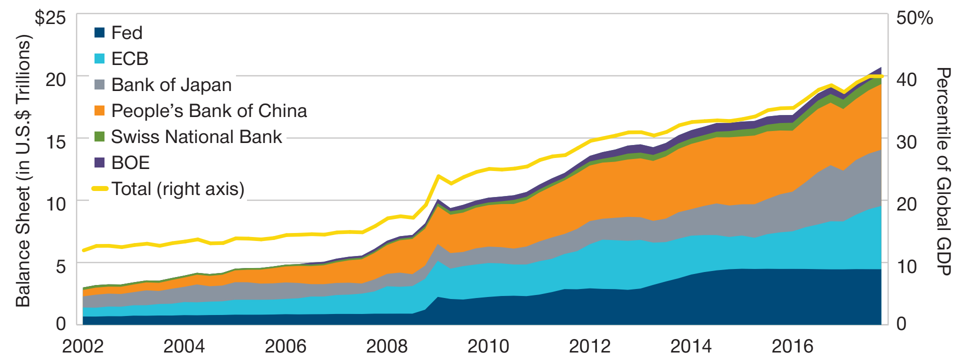
Europe remains at an earlier stage in the credit cycle than the U.S., with reasonable growth prospects for 2018. The European Central Bank (ECB) has signaled its intention to begin tapering its bond purchase program next year, but it is unlikely to begin raising interest rates until 2019. Although the eurozone yield curve is also likely to flatten, it is unlikely to invert. Elsewhere, however, there are growing expectations that the Bank of England (BOE) will raise rates more quickly than previously thought to curb inflation, and the Bank of Canada appears likely to move into an aggressive cycle of rate hikes.

A tightening move by one central bank in isolation would probably not cause too much concern; a number of banks doing so at the same time is a different proposition. Developed market yields remain close to record lows, while credit spreads are tight on the back of years of accommodative monetary policies and benign economic conditions. Synchronized tightening in this environment could be disruptive; although, given that banks are likely to adopt a cautious approach, liquidity will likely remain ample for an extended period. The key question, therefore, is: Which factor is more important—the flow of QE (which will be negative) or the remaining stock of QE (which should still be very substantial)? How the markets answer this question will play a major part in determining whether 2018 sees a return to volatility or a continuation of stability, in our view.

In this environment, bond investors might consider casting a wider net and diversifying their fixed income portfolios to meet their desired risk and return objectives, with an emphasis on detailed research, active security selection, and sector rotation.

FIGURE 1: Central Bank Support Is Set to Wind Down

Central Banks Balance Sheet Versus Percent GDP, as of September 30, 2017



Sources: Haver Analytics and T. Rowe Price. Based on moving sum of last four quarters' GDP figures.

TRADE UNCERTAINTY AND GEOPOLITICAL RISKS CHALLENGE GROWTH

Uncertainties over trading relationships and Chinese growth pose further challenges. If the negotiations between the UK and EU over Brexit collapse, or if U.S. President Donald Trump delivers on his threat to scrap the North American Free Trade Agreement, the restrictions on trade that would likely ensue could negatively impact global growth. Following the 19th National People's Congress in October, the Chinese authorities are expected to ramp up their efforts to reform China's state-owned enterprises and reduce corporate debt, which could slow the Chinese economy in 2018. China's growth is still expected to come in above 6%, but a downside surprise could cause significant disruption given China's importance as the world's second-biggest economy.

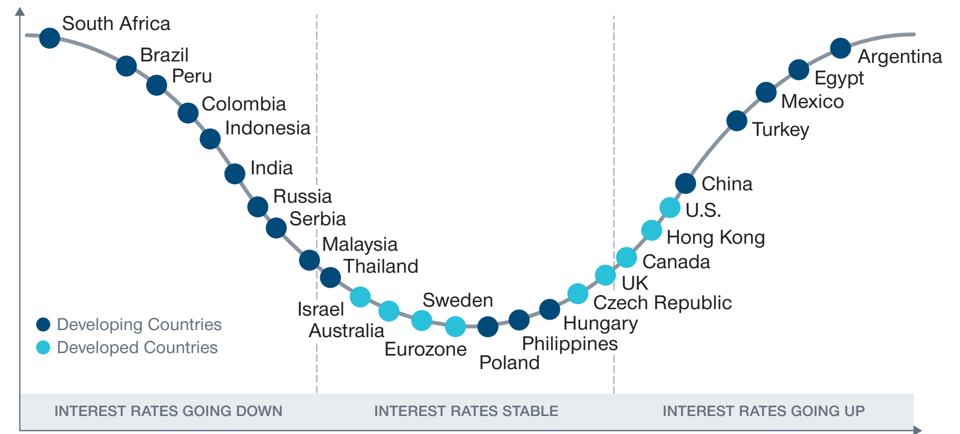
Geopolitical risks persist, too. Tensions between the U.S. and North Korea show no sign of abating. While full-scale war seems unlikely given the costs on both sides, the potential impact of the diplomatic standoff on U.S.-China relations is a concern. Elsewhere, the threat to European unity has receded following the failure of populist, anti-immigration parties to make major inroads in the Dutch, French,

and German elections, but the Catalan independence movement and ongoing negotiations over Brexit have the potential to unleash further volatility, as does the forthcoming Italian general election.

In addition, while under control for a number of years, inflation may make a comeback in 2018. The broader economic environment continues to show improvement, and there is a possibility that central banks may misinterpret underlying inflation signals and stresses.

FIGURE 2: **Illustrative Interest Rate Cycle**

As of October 31, 2017



Sources: CRB Rates and T. Rowe Price.

THE IMPORTANCE OF BEING UNCORRELATED

The past year was notable for the tranquility of the markets—bad news came and went without causing too much disruption. Efforts to hedge portfolios against risk generally did not pay off, hampering the returns of investors who opted to tread carefully. As noted above, whether the markets remain as nonchalant in 2018 will depend largely on how investors respond to the beginning of the withdrawal of monetary stimulus. We believe it is possible that a risk event, or combination of events, could result in volatility. It may therefore be prudent to consider diversifying and managing risk exposure, for example through selective underweight positions or risk-free assets such as US Treasuries. While sovereign yields in the developed markets are low, a number of emerging markets are at different stages in their interest rate cycles and offer higher sovereign yields. High yield bonds and bank loans appear to offer better return potential and lower duration than developed sovereigns, but they do not appear cheap in the current environment and also are highly correlated to equities—meaning they could be vulnerable in the event of a market correction.

We believe a barbell strategy—one that pairs credit instruments on one side with asset-backed securities or sovereigns (which historically have been less correlated with equities) on the other—may offer advantages in 2018. Another potentially promising approach could be to invest in countries undergoing positive transformational change. We believe Argentina, India, and Indonesia fall into this category, while prospects for Turkey and South Africa are less favorable, in our view.

More generally, given the potentially volatile nature of markets, a willingness to adopt an active approach to security selection and rotate between sectors where necessary could be advantageous for bond investors in 2018.

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