



# 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 Strategy*

What's next for fixed income markets? Government bond yields have plunged to extremely low levels, while most credit spreads 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 Strategy, explains where he expects to find 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 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

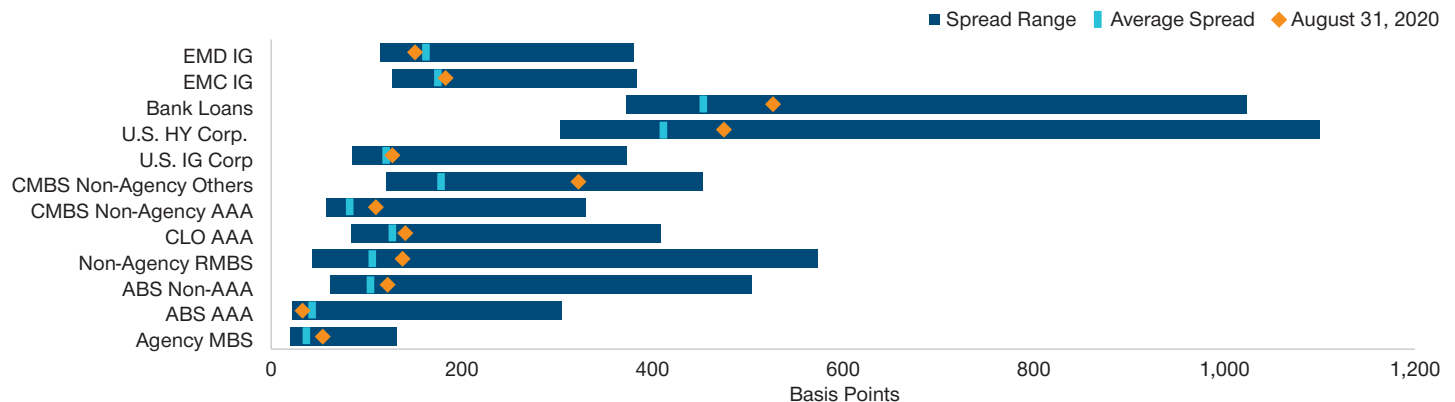
income simply because interest rates are low, you risk missing out.

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. I believe further dispersion lies ahead, creating opportunities for active managers to 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

## Performance of Credit Sectors

(Fig. 1) Credit premiums over the last three years



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

As of August 31, 2020.

Sources: Bloomberg Index Services Limited (see Additional Disclosure), and J.P. Morgan Chase & Co. All rights reserved.

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

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 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 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.

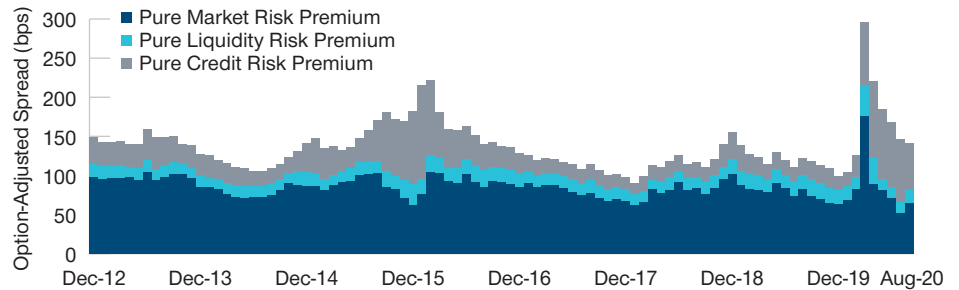
#### Q: Where do you see value in credit markets?

**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 the beta has now largely evaporated. Let's remind ourselves that the premium that investors demand to hold corporate bonds 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

## Decomposition of Credit Premium

(Fig. 2) Breakdown of U.S. investment-grade credit premium



As of August 31, 2020.

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

“We need to be prepared to make strategic changes quickly when faced with new information.”

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 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 selecting securities with high upside potential in a recovery scenario and more limited downside if the recovery is more protracted than expected.

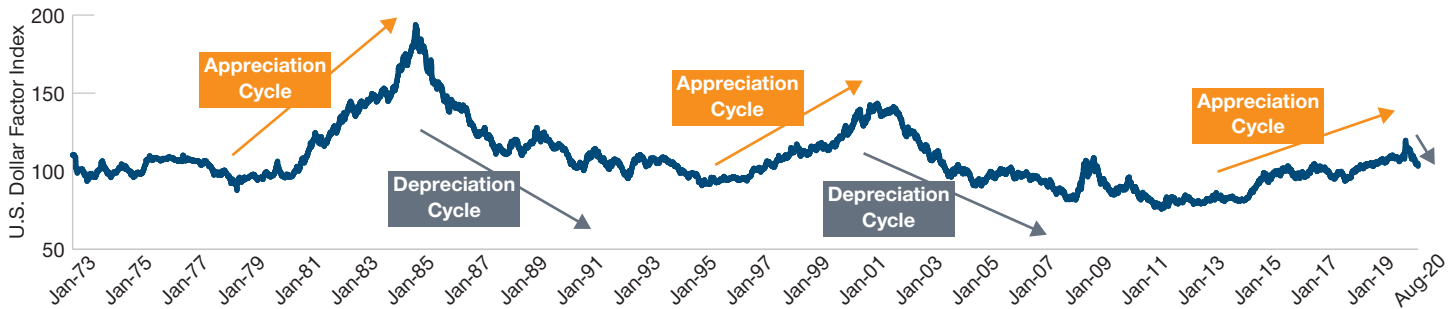
**Q: What skills do you think are necessary to navigate the current market environment?**

**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.

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

(Fig. 3) USD Factor Index<sup>1</sup> since 1973



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

As of August 31, 2020.

<sup>1</sup> USD Factor Index: Total return (in percent) of an equally weighted basket of LONG USD versus EUR, GBP, CHF, SEK, NOK, JPY, AUD, NZD, and CAD currencies. Sources: Bloomberg Finance L.P. Analysis by T. Rowe Price.

“...successful security selection is going to become a dominant factor as credit alpha is likely to drive the next phase of the market gains.”

Third, I believe successful security selection is going to become a dominant factor as credit alpha is likely to drive the next phase of the market gains. It's not just about picking the winners; avoiding 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.

#### **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 taper 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, affecting 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**

Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright © 2020, Bloomberg Index Services Ltd. Used with permission. Sector indexes are represented by Bloomberg Barclays indexes of the same name except Bank Loans and CLOs where data is from JPMorgan and RMBS from Bank of America. Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright © 2020, J.P. Morgan Chase & Co. All rights reserved.

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

**T.RowePrice®**

**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.

© 2020 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.