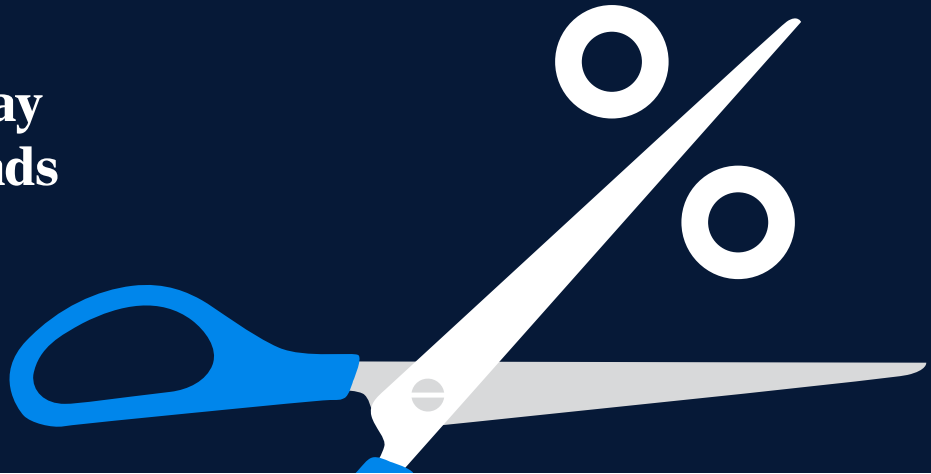


The Fed's big cut may favor high yield bonds



From the Field
October 2024

Key Insights

- Historically, high yield bonds performed well after the first rate cut in a Federal Reserve easing cycle if that move was not followed by a recession.
- The Fed's large September cut improved the odds of avoiding a U.S. recession. Strong credit fundamentals and attractive yields are also supportive.



Tim Murray, CFA
Capital Markets Strategist
Multi-Asset Division

After a lengthy wait, the U.S. Federal Reserve began cutting interest rates in September. Many investors may be wondering how this could affect their fixed income allocations.

Initially, at least, markets viewed the Fed's first cut of 50 basis points (0.5 percentage point) as positive for the U.S. economic outlook. Longer-term yields, which are sensitive to changes in economic expectations, rose over the week following the Fed's move.

Historically, long-term investment-grade (IG) bonds have tended to be an excellent hedge against economic weakness but less attractive when the economy strengthens. High yield bonds, on the other hand, have tended to benefit from economic strength. This being the case, bond investors may want to consider the

mix between IG and high yield bonds in their portfolios.

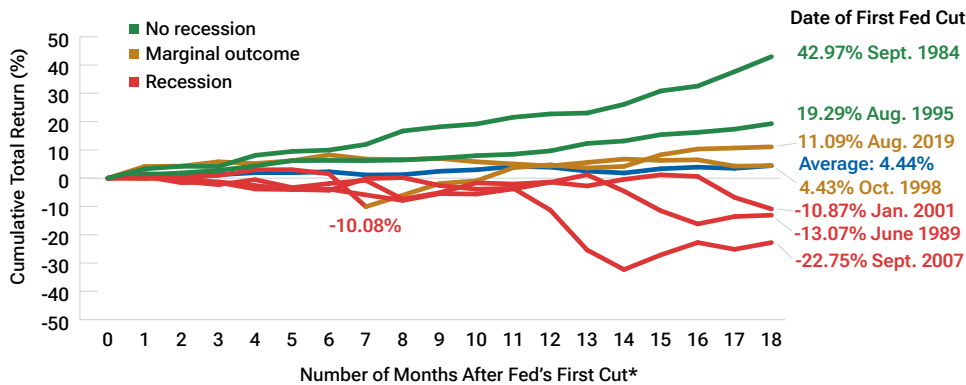
High yield performance after Fed cuts

On average, the Bloomberg U.S. High Yield Index has returned 4.44% in the 18 months after the Fed has embarked on a rate-cutting cycle. But the range of outcomes has been very wide (Figure 1).

These results depended heavily on whether a recession occurred after the Fed's initial cut. In three out of the four cases where a recession did occur in the next 18 months, high yield bonds produced negative double-digit returns. In the fourth case, after the Fed cut rates in August 2019, high yield bonds fell sharply once the COVID pandemic hit the U.S. economy six

High yield performance after the Fed's first cut

(Fig. 1) Performance of Bloomberg U.S. High Yield Index over following 18 months



Past performance is not a reliable indicator of future performance.

*First Fed cut is defined as the first month in which the federal funds effective rate fell 0.25% below the trailing 12-month peak.

Sources: Bloomberg Finance L.P. T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

months later, but bounced back when that recession proved to be deep but very short.

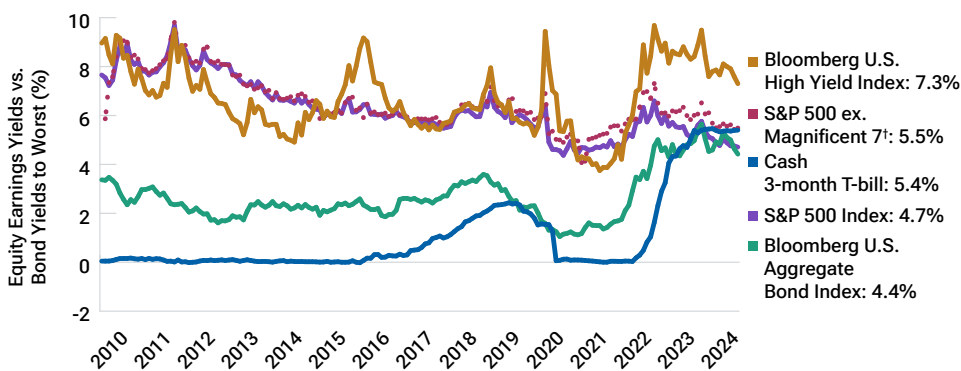
Results were much more encouraging when an initial Fed cut was not followed by a recession. In all three cases, high yield bonds provided positive returns. But those gains were relatively modest after the Fed starting cutting rates in 1998, and a U.S. recession eventually hit in 2001.

High yield fundamentals appear quite strong

On the bright side, several key metrics used to gauge the health of the high yield market remain high by historical standards. This is typically not the case before the onset of a recession.

Yields are attractive on a relative basis

(Fig. 2) Equity, fixed income, and cash yields*



January 2010 to August 2024.

Past performance is not a reliable indicator of future performance.

*Yields for the Bloomberg U.S. High Yield Index, the Bloomberg U.S. Aggregate Bond Index, and Cash are yield to worst. Yields for the S&P 500 Index and the S&P 500 ex. Magnificent 7 are earnings yields.

†The "Magnificent 7" are Apple, Alphabet, Amazon, Meta, Microsoft, NVIDIA, and Tesla. The specific securities identified and described are for informational purposes only and do not represent recommendations.

Sources: Bloomberg Finance L.P. and Standard & Poor's (see Additional Disclosure).

As of June, earnings before interest, taxes, depreciation, and amortization (EBITDA) were almost five times interest expense in the high yield universe—below the recent peak of 5.77 but above the highest level reached from 2008 through 2020.¹

This was true even after we adjusted EBITDA for capital expenditures.

Attractive yields versus equities

Lastly, high yield bonds now offer attractive yields—not only relative to other fixed income assets but to equities as well (Figure 2). At the end of August, the Bloomberg U.S. High Yield Bond Index had a yield to worst² of 7.3%, while the earnings yield for the S&P 500 Index was only 4.7%.

Even if we ignore the impact of the so-called Magnificent Seven technology stocks (which pull the S&P 500 earnings yield lower), high yield bonds still offer considerably more attractive levels of yield.

Conclusion

We believe the Fed's recent dovish shift has increased the likelihood that a recession will be avoided over the near to medium term. If so, high yield bonds could prove more attractive than longer-term IG bonds over the next 18 months. As a result, our Asset Allocation Committee is maintaining an overweight position in high yield bonds.

¹ J.P. Morgan Chase North America Credit Research

² Yield to worst is the lowest possible yield on a bond if it is called before maturity.

INVEST WITH CONFIDENCE™

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

Additional Disclosure

Bloomberg® and Bloomberg Indices are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited (“BISL”), the administrator of the index (collectively, “Bloomberg”) and have been licensed for use for certain purposes by T. Rowe Price. Bloomberg is not affiliated with T. Rowe Price, and Bloomberg does not approve, endorse, review, or recommend its products. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to its products.

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 © 2023, J.P. Morgan Chase & Co. All rights reserved.

The S&P 500 Index is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates (“SPDJ”), and have been licensed for use by T. Rowe Price. Standard & Poor’s® and S&P® are registered trademarks of Standard & Poor’s Financial Services LLC, a division of S&P Global (“S&P”); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC (“Dow Jones”). T. Rowe Price’s product is not sponsored, endorsed, sold or promoted by SPDJ, Dow Jones, S&P or their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product nor do they have any liability for any errors, omissions, or interruptions of the S&P 500 Index.

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. 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.

DISCLOSURE CONTINUES ON THE FOLLOWING PAGE.

Important Information (cont.)

Australia—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose only. Any strategy and/or any products associated with the strategy discussed herein 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.

Colombia, Chile, Mexico, Perú, Uruguay—This material is prepared by T. Rowe Price International Ltd - Warwick Court, 5 Paternoster Square, London, EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority - and issued and distributed by locally authorized distributors only. For professional investors only.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd which is regulated by the Dubai Financial Services Authority as a Representative Office. For Professional Clients only.

EEA—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. Not for further distribution.

Mainland China—This material is provided to qualified investors only. No invitation to offer, or offer for, or sale of, the shares will be made in the mainland of the People's Republic of China ("Mainland China", not including the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the Mainland China. 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 Mainland China. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the Mainland China that are expressly authorized under the laws and regulations of the Mainland China to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the Mainland China. Potential investors who are resident in the Mainland China are responsible for obtaining the required approvals from all relevant government authorities in the Mainland China, 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 Mainland China, or nationals with permanent residence in the Mainland China, or to any corporation, partnership, or other entity incorporated or established in the Mainland China.

Malaysia—This material can only be delivered to specific institutional investor. 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 by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, 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—ANY STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING DISCUSSED 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 by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 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—Issued in South Africa by T. Rowe Price International Ltd (TRPIL), Warwick Court, 5 Paternoster Square, London EC4M 7DX, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: www.faisombud.co.za, Email: info@faisombud.co.za

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, Warwick Court, 5 Paternoster Square, London EC4M 7DX 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.

© 2024 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.