T. Rowe Price

The benefits of hedged diversification

From the Field

May 2024

Key Insights

- Higher yields on hedged non-U.S. dollar bonds and better expectations for rate cuts by non-U.S. developed central banks have created diversification opportunities for U.S. dollar-based investors.
- Our Asset Allocation Committee recently raised exposure to hedged non-U.S. bonds in our U.S.-based multi-asset portfolios.

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Investment-grade (IG) bond returns for U.S. investors have been subpar over the past year, as stubborn inflation and a more hawkish U.S. Federal Reserve have pushed yields higher. The Bloomberg U.S. Aggregate Bond Index returned -0.83% over the year ended April 23, 2024.

Non-U.S. IG bonds also have suffered, with the Bloomberg Global Aggregate ex-USD Bond Index (Global Agg ex-USD) returning -2.82% over the year ended April 23, 2024. However, this loss was primarily due to a strong U.S. dollar. On a U.S. dollar-hedged basis, the Global Agg ex-USD posted a positive 5.59% return.

There are reasons to believe these relative performance trends could continue.

- Although U.S. bond yields generally are higher than yields in other developed markets currently, by hedging their foreign currency exposure, U.S. dollar-based investors can increase the effective yields on nondollar bonds—giving sovereign bonds in many non-U.S. developed markets a yield advantage over U.S. bonds (Figure 1).
- Non-U.S. bonds also may offer better duration[1] exposure if interest rates fall more rapidly in other developed markets.

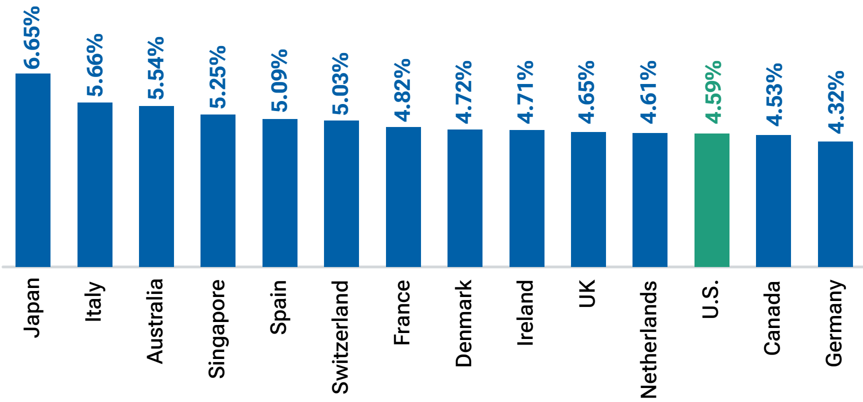
U.S. inflation expectations have risen since the start of 2024, which could force the Fed to hold rates "higher for longer" (Figure 2). But expectations for eurozone inflation have declined modestly. This means the European Central Bank (ECB) may have less reason to keep rates at current levels.

[1] Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice versa.

Past performance is not a reliable indicator of future performance.

Non-U.S. bond yields are higher on a hedged basis

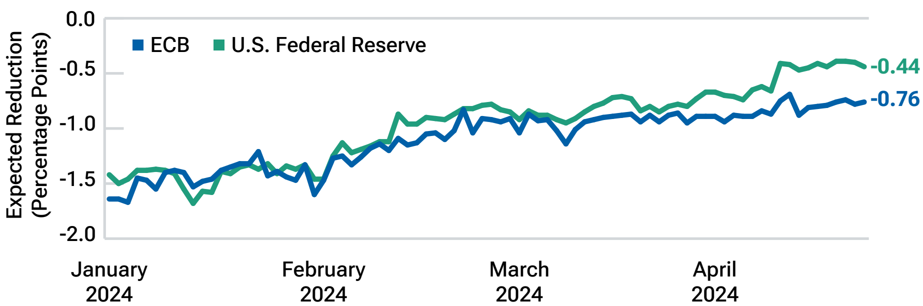
(Fig. 1) USD-hedged 10-year sovereign yields in key developed markets



As of April 23, 2024.
Past performance is not a reliable indicator of future performance.
Source: Bloomberg Finance L.P.

Other central banks appear more likely to cut rates

(Fig. 2) Expected 2024 rate reductions priced in to futures markets



December 31, 2023, through April 23, 2024.
Actual outcomes may differ materially from forward estimates.
Source: Bloomberg Finance L.P.

As of early January, futures markets were pricing in a 1.68 percentage point reduction in the Fed's key policy rate—the federal funds rate—by the end of 2024 (Figure 2). The ECB was only expected to cut rates by 1.53 percentage points.

By April 23, however, markets only expected the Fed to cut rates by 0.44 percentage points before the end of 2024. The ECB, meanwhile, was expected to cut rates by 0.76 percentage points.

Given the currently superior yields on hedged nondollar bonds, and more promising expectations for rate cuts in other developed markets, T. Rowe Price's Asset Allocation Committee recently raised exposure to hedged non-U.S. bonds in our U.S.-based multi-asset portfolios.

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All charts and tables are shown for illustrative purposes only.

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