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ASSET ALLOCATION INSIGHTS

March 2018

The T. Rowe Price Asset Allocation Committee meets regularly to assess market conditions and the relative values of major asset classes over a 6- to 18-month time horizon. This series of *Asset Allocation Insights* offers a look at specific topics of interest from the committee's recent discussions.

ASSET ALLOCATION COMMITTEE

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Rising Inflation: Regime Change or Overreaction?

KEY POINTS

- Surprisingly strong wage growth in January led to concerns about rising inflation and contributed to a slump in stock markets that had been priced for perfection.
- Deficit spending, Treasury supply, and a tighter labor market are likely to ratchet up inflationary pressures in 2018, with uncertainty about U.S. trade policies looming as another consideration.
- However, inflation gains should be limited as higher interest rates constrain economic growth, with a renewed slide in energy prices, reduced contributions from the housing sector, and a stabilizing U.S. dollar further dampening inflationary pressures.
- Against this backdrop, we increased our allocation to bonds and cash as the yield on the 10-year Treasury note approached 3% and money market rates hit 1.5%, while equities could be pressured as rising input costs, wage growth, and higher interest rates weigh on corporate profit margins.

WAGE GROWTH SURPRISE LEADS TO INFLATION CONCERNS...

An upside surprise to wage growth in January's employment report seemed to catch markets off guard, and inflation expectations jumped. Stock markets, which had been priced for perfection leading into the start of 2018 against a backdrop of low interest rates, low inflation, low volatility, and positive earnings momentum, slumped and have now experienced a full correction for the first time in two years.

At our most recent Asset Allocation Committee meeting, however, we expressed little surprise that inflation may finally be on the rise. After all, we've witnessed a decade of unprecedented policy accommodation from global central banks, including negative policy rates and trillions of dollars in bond purchases, to combat low inflation. Synchronized global economic growth is finally occurring, while a tight labor market has been accompanied by record non-recessionary fiscal stimulus in the U.S.

The key questions for the markets now are: Where does inflation go from here, and how does the Federal Reserve react? These are important because the answers will influence our asset allocation decisions.

...BUT COMPETING FACTORS SHOULD LIMIT NEAR-TERM PRESSURES.

On one hand, increased deficit spending in Washington nine years into the economic cycle is likely to support

upward trends in both economic growth and inflation expectations. This will serve as a source of increased Treasury issuance just as the Fed is selling securities to unwind its massive balance sheet. These factors could combine to push longer-term bond yields higher. A tighter labor market and higher wages are also likely to ratchet up inflationary pressures in 2018. We are also keeping a watchful eye on recent developments with U.S. trade policy as increased tariffs may add to inflationary forces.

Yet, there are several near-term factors that should limit the extent of a further acceleration in inflation. As the Fed advances further into its hiking cycle, a rising fed funds rate will serve increasingly as a constraint on growth and inflation. Oil prices, which stabilized at higher levels in 2017, are showing signs of renewed weakness in 2018. The contribution to inflation from housing—the largest component of core inflation—appears to be tapering off. Since a weaker currency is often inflationary as it increases the costs of imports, stabilization of the U.S. dollar in 2018 could dampen inflationary pressures following a period of U.S. dollar weakness in 2017.

Other factors that could limit inflation include long-term secular trends toward increased automation and e-commerce, which limits the pricing power of companies in a highly competitive and increasingly global marketplace. In addition, lower growth rates in an environment of high government and consumer debt levels and an aging population should constrain inflationary pressures.

As we weigh all of these factors over the near term, we do not see inflation breaking out much above the Fed's 2% target level. As summarized by Dan Shackelford, portfolio manager of the New Income Fund and member of the Asset Allocation Committee: "We are likely closer to the end of the inflation surge than building the base for a future leg higher."

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>
> —Dan Shackleford, portfolio manager of the New Income Fund and member of the Asset Allocation Committee

Modestly higher inflation is likely to keep the Fed on a path toward higher short-term interest rates, and 2% inflation may not be perceived as problematic. However, there is a risk that it contributes to an overreaction by the Fed.

INCREASED ALLOCATIONS TO BONDS AND CASH VS. EQUITIES

So how do these factors influence our investment thinking? We recently increased our allocation to bonds and cash as the yield on the 10-year Treasury note approached 3% in the wake of rising inflation and interest rate expectations, and with cash finally becoming a source of yield and potential safety as money market rates hit 1.5%, with the potential to move higher. Within bonds, we increased our allocation to floating rate bank loans as their shorter duration profiles and rate reset features are particularly attractive if the Fed continues to raise interest rates in 2018, as expected.

While higher interest rates and inflation are not yet at problematic levels, they do represent headwinds for an equity market characterized by elevated valuations. Increased input costs, wage growth, and higher interest rates could combine to pressure corporate profit margins against a backdrop of limited pricing power. As we look further into 2018, earnings growth will play a larger role in driving the direction of stock market returns over the coming months as equity multiples typically compress during periods of tightening Fed policy.

Real assets-related equities—stocks in companies that own or develop physical assets such as commodities, real estate, and energy—are included in many of our multi-asset portfolios as a hedge against unexpected inflation. However, we are underweight this area due to the potential for higher real interest rates, ongoing concerns about long-term oversupply in the energy sector, and higher rates weighing on "yield proxies," such as real estate investment trusts.

A LOOK AHEAD

Changing market conditions demand a flexible investment approach. We believe our ability to make tactical adjustments in our underlying investment mix helps to find an appropriate balance of risks and opportunities in our multi-asset portfolios. In future issues of Asset Allocation Insights, we will explore further how the Asset Allocation Committee works to keep our investors on the right side of change.

The T. Rowe Price Asset Allocation Committee comprises some of our firm's most senior investment professionals. The committee's decisions are reflected across our multi-asset portfolios, which accounted for USD $292 billion in assets under management as of December 31, 2017. For a broader perspective on asset allocation positioning in our multi-asset portfolios, please see our Asset Allocation Viewpoints.

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