The first five months of 2022 have not been easy for investors. A powerful cocktail of difficult economic conditions and rising geopolitical concerns have made their mark: The S&P 500 Index was down by more than 12% from January 1 to May 31—its worst record over that period since 1970 (Figure 1).1

In recent years, multi-asset investors have generally been able to rely on their fixed income holdings to cushion the blow if equity markets fell. However, these diversification benefits were notable for their absence over the first four months of this year. As equities plummeted, U.S. fixed income was hit by its worst drawdown since 1980—in fact, it was the first time since at least the mid-1970s that the U.S. equity and fixed income markets both experienced a drawdown more severe than 10% at the same time (Figure 2). These losses were especially painful in inflation-adjusted terms, as rapid price increases across many major economies led to the purchasing power of investments falling even more.

There seem to be five main reasons for the continued declines of global equity and fixed income markets so far this year: (1) the accelerated pace of monetary tightening by central banks such as the U.S. Federal Reserve, (2) persistently high inflation, (3) concerns over slowing economic growth, (4) disruptions caused by China’s strict zero-COVID policy, and (5) Russia’s invasion of Ukraine.

KEY INSIGHTS

- Challenging market conditions and deeper structural shifts are demanding fresh thinking from investors.
- Such thinking may include new ways to help mitigate the impact of volatility on equity portfolios, adapt the role of government bonds, and use active management to potentially benefit from market volatility.
- We believe that ideas such as these will help investors to manage losses while potentially generating inflation-beating returns.

Winning by Not Losing: Building Portfolios for a More Challenging World

Generating positive returns in tougher conditions requires new thinking.

1 Past performance is not a reliable indicator of future performance. The 10 years since 1928 with the lowest total return for the S&P 500 Index from the beginning of each year through May 31: 1932 -45.0%, 1940 -25.2%, 1962 -15.8%, 1970 -15.5%, 1931 -15.1%, 2022 -14.1%, 1939 -11.2%, 1938 -10.7%, 1941 -10.6%, 1973 -10.5%. The 10 years with the higher total returns: 1933 42.0%, 1975 35.4%, 1943 23.4%, 1987, 21.3%, 1991 20.8%, 1983 19.9%, 1954 19.3%, 1986 18.8%, 1995 17.1%, 1985 16.7%.

2 Past performance is not a reliable indicator of future performance. Fixed income is represented by the Bloomberg U.S. Aggregate Index.
Another factor behind the uncertainty is that markets are simultaneously undergoing several structural shifts: from pandemic lockdowns to reopening, from low and stable to high and volatile inflation, from super-accommodative monetary policy to tightening, from globalization to a focus on local supply chains, and from U.S. hegemony to a realignment of powers. Still recovering from the shock of COVID, the world must now contemplate a slew of new challenges. During structural shifts, investors and markets need to adapt—and adaptation typically involves uncertainty and volatility.

What can investors do to generate positive inflation-adjusted returns in this market environment? Or, to put it another way, where can they lose the least money? To help achieve these objectives, we have identified three investment ideas, each of which is shaped around one of the possible regimes that lie ahead.

"During structural shifts, investors and markets need to adapt...."

— Yoram Lustig
Head of EMEA
Multi-Asset Solutions

The S&P 500’s Start to 2022 Was Its Worst in 50 Years
(Fig. 1) It was down by 14% from January to May 31, 2022

Equities and Bonds Fell in Tandem Over the First Four Months of the Year
(Fig. 2) It was their worst parallel drop since the mid-1970s

As of May 31, 2022.
Past performance is not a reliable indicator of future performance.
1. Managing Equities in a Time of Volatility

Major equity market indices have fallen by between 13% and 23% from their peaks in 2022, bringing previously elevated valuations into “reasonably priced” territory. Over the long term, valuations—measured by price to earnings (P/E) ratio—are a significant driver of equity market performance (Figure 4).

At the end of December 2020, the S&P 500’s valuation implied a potential near zero total return for the index over the next decade based on historical experience. Following the sell-off in equity markets seen so far in 2022, the relative valuation now implies about a 7% total return per annum over the next decade. In other words, the equity risk premium may have staged a comeback.

Equity exposure is the strategic cornerstone of most multi-asset portfolios, and we are currently modestly underweight equities. However, gradually building exposure using dollar cost averaging to avoid betting on a single buying price, with a focus on more beaten-down areas, could generate long-term inflation-beating returns. The market is already pricing in a much higher probability of negative events playing out than it did at the beginning of the year. This will soften the blow if such events materialize.

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The market is already pricing in a much higher probability of negative events....

— Michael Walsh
Multi-Asset Solutions Strategist

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Valuations Are a Key Driver of Equity Market Performance

(Fig. 4) Low P/E ratios typically lead to stronger subsequent returns

As of May 31, 2022.
Sources: S&P 500 Index (see Additional Disclosures), Analysis T. Rowe Price. Based on monthly total returns measured in U.S. dollars. The orange dots represent values of P/E ratio as of December 2020 and May 2022. For the period January 1954 through May 2022.

Past performance is not a reliable indicator of future performance. MSCI All Country World Index (ACWI) has declined about 13.0% from its peak on November 16, 2021, through May 31, 2022. The NASDAQ Composite has declined about 22.5% from its peak on November 19, 2021, through May 31, 2022.
Conversely, some cyclical areas may rerate higher if worst-case scenarios can be averted.

For truly long-term investors, investing in equities has been, and remains, one of the best ways to help generate attractive returns. However, to get to the long term, investors need to survive the short term. Until some of the imbalances affecting markets recede, volatility is likely to persist. To help smooth the ride, investors should consider the following ideas:

- **Mitigating downside risk.** Consider techniques and listed derivative overlays to help mitigate volatility and downside risks, focused on minimizing the drag on performance. Our diversified tail-risk mitigation program is an example of this.

- **Using diversified diversifiers.** Consider diversifying across global equity markets. This may include more esoteric areas such as frontier markets and involve different equity style blends, thereby ensuring exposure to areas such as growth, value, and small-caps.

- **Dynamically managing portfolios.** Consider making portfolios more dynamic; for example, by actively controlling the volatility of the overall equity portfolio within a desired range.

### 2. Rethinking the Role of Government Bonds

One of the challenges so far in 2022 has been that both equity and bond markets have fallen at the same time, making diversification difficult. In recent years, many investors have moved away from high-quality government bonds as long-term yields around zero meant little prospect of positive returns from such holdings. However, after the recent rise in yields, there may be more scope for government bonds to resume their traditional role of safe havens in the event of a very negative economic or geopolitical outcome. In addition, inflation-linked bonds are one of the few assets offering cash flows that increase in line with inflation.

With higher yields, the “price” of safety has come down. Indeed, one reason for the weakness in equity markets in 2022 has been that government bonds have become more attractive. Some investors, satisfied with a modest but predictable nominal return, have rotated from riskier equities to bonds.

If inflation persists, economic growth remains solid, and central banks continue to tighten their policies, government bond yields may keep rising and government bonds may deliver negative total returns. Nevertheless, portfolios balancing equities and bonds should perform well because equity gains are likely to outweigh bond losses under these circumstances.4

On the other hand, if inflation recedes, growth slows, and central banks discontinue tightening policy, bonds may generate positive returns and diversify equity risk.

To mitigate the risk of bond losses, the following may help:

- **Adopting a global approach.** Tapping the global government bond market, instead of the local one, while systematically hedging overseas currency exposure offers diversification and a wider investment opportunity set.

- **Adding selective currency exposure.** Allocations to safe-haven currencies, such as the U.S. dollar and Japanese yen, may add to equity diversification at times of stress.

- **Allocating to inflation-linked bonds.** A strategic allocation to inflation-linked bonds is one way to add some protection against inflation.

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4 Our paper “Putting the Fed’s Planned Rate Hikes into Context” from February 2022 found that the U.S. equity market delivered a positive total return 17 times out of 21 hiking cycles in the 12 months after the first hike over the period from January 1974 to December 2021.
Equity Market Volatility Has Increased Over the Past Two Years

(Fig. 5) It was low between 2013 to 2020

3. Balancing Market and Active Risk

Equity and fixed income markets have rallied strongly over the past two decades, which has meant that index exposure has often been sufficient to generate the returns required by investors. Beating inflation at the current level of around 8% is a much bigger hurdle. Even if current supply issues unwind and geopolitical tensions abate, inflation expectations have moved sharply upward—market expectations for U.S. inflation are about 3% per annum over the next five years. An extra boost may be needed to deliver positive after-inflation returns in this environment.

While equity volatility was low between 2013 to 2020, it has subsequently increased, offering more opportunities for active management to add value.

For skillful active managers, volatility is a friend. It creates opportunities, especially when widening the dispersion of prices across investments and sending prices away from intrinsic values. The following ideas may help investors capitalize on these.

- Actively managing traditional asset classes. An increased level of market volatility and an uncertain macro environment create winners and losers, rewarding skilled equity and fixed income managers.

- Using liquid alternatives. With uncertain returns forecast for equity and fixed income markets, alternatives may prove their worth within a diversified portfolio. Investors need to treat each alternative on a case-by-case basis, ensuring clarity on why an alternative strategy is included within their portfolio and what to expect in different market conditions.

- Embracing multi-asset investing. Large-scale adjustments to portfolios against a turbulent market backdrop can be challenging. Multi-asset investing can bring these ideas together, dynamically blending different sources of returns and adjusting portfolios as markets adapt to new regimes and as new strategies or risk management techniques become available.

As of May 31, 2022.

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

Sources: S&P 500 Index, Bloomberg U.S. Treasury Index (see Additional Disclosures). Analysis T. Rowe Price. Based on monthly total returns measured in U.S. dollars. Volatility (annualized standard deviation) is calculated using rolling 36 months. For the period January 1979 through May 2022.

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For skillful active managers, volatility is a friend.

— Eva Wu
Multi-Asset Solutions Analyst

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* April 2022 readings of the consumer price index (CPI) year-on-year change were 8.3% in the U.S., 7.4% in the eurozone, 9.0% in the UK, and 2.5% in Japan.
* U.S. 5-year break-even inflation of 2.96% per annum as of May 31, 2022.
Adjusting to a Tougher Environment

The investment environment has become more challenging. New market conditions under new regimes require new thinking. We believe investors face a period of lower market returns, less predictable inflation, and higher volatility. We have listed three investment ideas for consideration to help investors manage losses while potentially generating inflation-beating returns. The old ways of investing may give way to new ones.

Active management does not ensure a favorable outcome, and there is no assurance that any investment objective will be achieved. Diversification does not assure a profit or protect against loss in a declining market.

Additional Disclosures

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