A Challenging Environment for Stocks and Bonds

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Asset Allocation Insights

Tim Murray, CFA
Capital Markets Strategist, Multi-Asset Division

KEY INSIGHTS

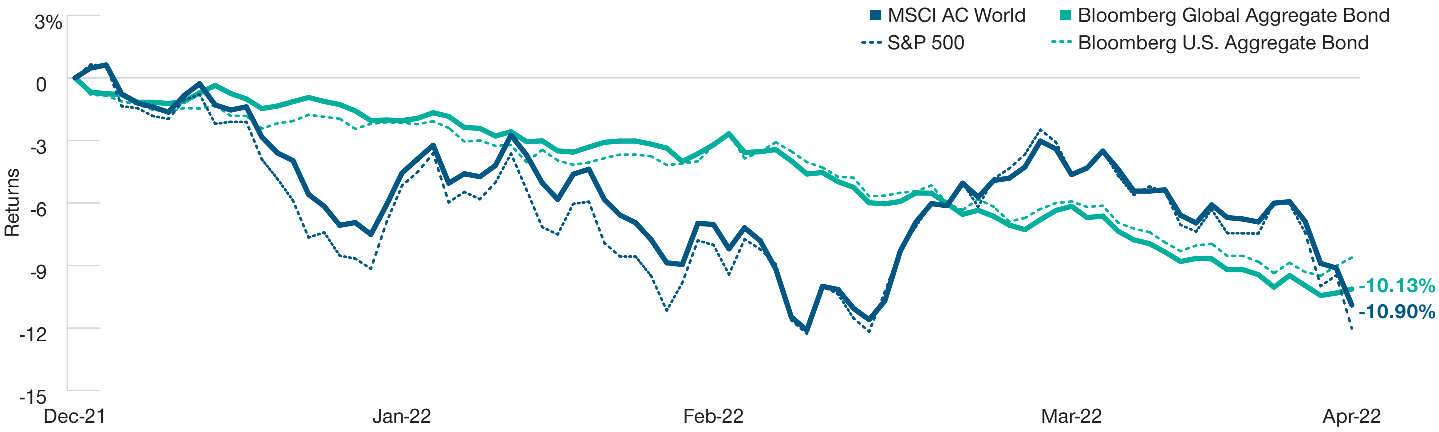
- Global stocks and bonds have both declined year-to-date, frustrating investors who typically rely on the diversifying benefits of fixed income allocations.
- We believe that expectations for interest rate hikes have largely been priced in; therefore, the positive correlation between stock and bond performance is, in our view, unlikely to be sustained.

During the first part of 2022, stocks declined sharply due to rising geopolitical uncertainty and accelerated inflation. Notably, bonds—which typically help to manage downside risk in a portfolio—pulled back almost as much as stocks (Fig. 1), frustrating investors who often rely on the diversifying benefits of fixed income securities during equity market sell-offs.

While stock and bond returns historically tend to have low or negative correlations over the long term, correlations have at

A Difficult Year So Far for Stocks and Bonds

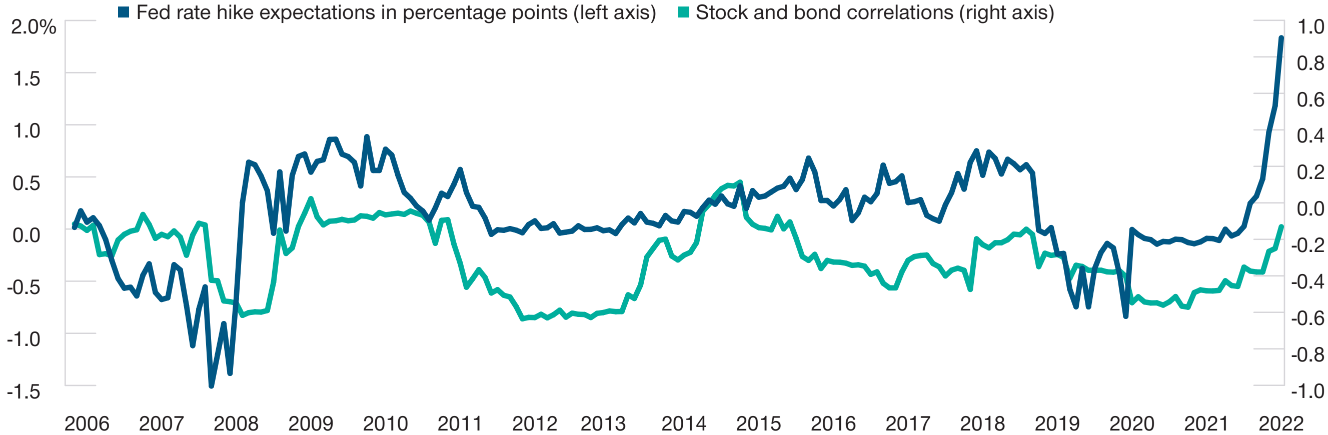
(Fig. 1) Both asset classes have declined meaningfully year-to-date



Past performance is not a reliable indicator of future performance.
December 31, 2021, to April 26, 2022
Sources: Standard & Poor's and MSCI (see Additional Disclosures). Bloomberg Finance L.P. T. Rowe Price analysis using data from FactSet Research Systems Inc.

Rate Hikes Have Presented Headwinds for Both Stocks and Bonds

(Fig. 2) Correlations were higher when rate hike expectations were rising*



Past performance is not a reliable indicator of future performance.

January 2006 to March 2022

Source: Bloomberg Finance L.P.

*Fed rate hike expectations calculated as the difference between the 2-year U.S. Treasury yield and the federal funds rate. Stock and bond correlation is the rolling 2-year correlation of monthly price changes for the S&P 500 Index and U.S. 10-Year Treasury futures.

times been positive over shorter periods. Environments where expectations for central bank tightening are increasing rapidly, in particular, can be challenging for both asset classes (Fig. 2). This is because rising interest rates typically push yields higher and bond prices lower. Meanwhile, stocks usually suffer in a rising rate environment because rate hikes often slow down economic growth, resulting in lower earnings.

Rate hike expectations have increased rapidly in early 2022. At the beginning of the year, markets generally expected the U.S. Federal Reserve to raise rates at a measured pace—despite already elevated inflation—and then pause with rates still at relatively low levels. However, this outlook shifted dramatically in the first quarter, as inflation concerns were exacerbated by Russia's invasion of Ukraine and a spike in oil prices.

Although a cautious approach is warranted amid growing economic headwinds, we believe that expectations for more hawkish central bank policies have largely been priced into asset valuations. If this view is correct, the strong positive correlation between stock and bond returns seen in early 2022 is unlikely to be sustained. As a result, the Asset Allocation Committee has further increased its allocation to long duration[1] U.S. Treasuries, which the committee believes are more likely to offer portfolio diversification potential now that yields have adjusted higher.

[1] Duration measures a bond or other debt instrument's price sensitivity to a change in interest rates.

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