



Economic Risks Are Rising

April 2022



KEY INSIGHTS

- Investors have become concerned about stagflation, an environment characterized by high inflation and economic weakness.
- Given heightened economic risks, we believe investors should consider adding exposure to assets that may benefit from higher inflation or potentially hedge against recession.



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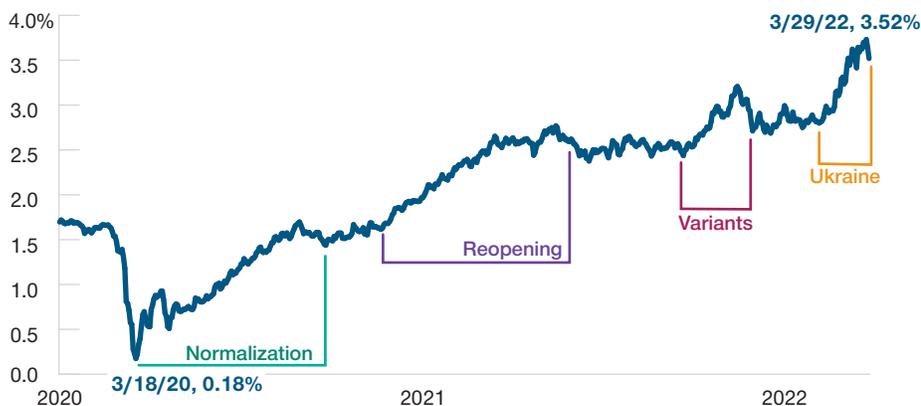
Following a very volatile first quarter, investors have become increasingly concerned about a potential “stagflationary” environment, which is typically characterized by very high inflation and economic weakness.

For most of the past 15 years, inflation has been a nonissue, but this is no

longer the case. At the height of the pandemic in March 2020, the five-year forward inflation expectation—derived from the five-year Treasury inflation protected securities’ break-even yield—was close to zero (Fig. 1) amid fears that the coronavirus would cause a severe global recession. However, by the end

Rising Inflation Has Defied Expectations

(Fig. 1) The inflation outlook, from afterthought to major concern



January 1, 2020, to March 29, 2022.

Source: Bloomberg Finance L.P.

Five-year forward inflation expectation is derived from the five-year Treasury inflation protected securities’ (TIPS) break-even yield, calculated as the difference between the five-year U.S. Treasury yield and the five-year TIPS yield.

Higher Oil Prices and Rising Rates Present Economic Headwinds

(Fig. 2) Oil prices at multiyear highs and a hawkish Fed may stifle growth

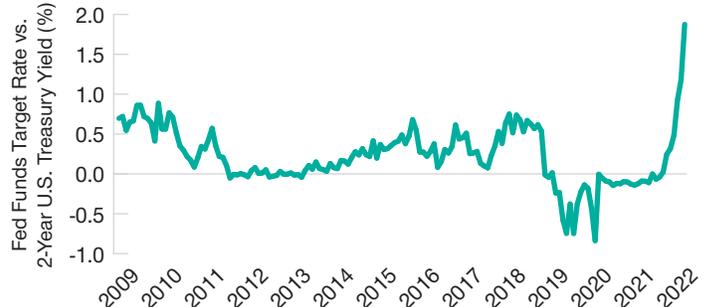
Oil Price (West Texas Intermediate)

January 2009 to March 2022



Fed Hiking Expectations

January 2009 to March 2022



Past performance is not a reliable indicator of future performance.

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

Fed hiking expectations calculated as the difference between the two-year U.S. Treasury yield and the Fed funds rate.

of August 2020, inflation expectations had rebounded to pre-pandemic levels.

Since then, the inflation outlook has progressively worsened. As economies reopened in 2021, labor shortages and a mismatch in timing between the sharp recovery in demand and a more gradual ramp-up in supply caused shortages and drove up prices. The emergence of COVID variants and Russia's recent invasion of Ukraine have further exacerbated supply chain disruptions and accelerated inflationary pressures.

Meanwhile, the global economy faces near-term headwinds from rising interest rates and higher oil prices (Fig. 2). Determined to curb inflation, many central banks have communicated their intentions to raise interest rates over the

coming two years. Rate hikes typically increase borrowing costs and dampen economic growth. Moreover, oil prices have surged more than 450% from April 30, 2020, to March 29, 2022, imposing a significant tax on consumers and economic activity.

We believe that economic activity is likely to slow down considerably in the near term due to elevated inflation and economic weakness. Given this expected shift, investors should, in our view, consider increasing their exposure to asset classes that could benefit from higher inflation—including “real assets” like energy, materials, and real estate equities—and to longer-duration¹ fixed income assets, such as U.S. Treasury bonds, that could potentially provide a hedge against recession.

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

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