

THEME ONE

Navigating Challenging Currents

Inflation expectations are likely to dominate financial market performance in the second half of the year, just as they did in the first, the T. Rowe Price CIOs predict.

Although investors must contend with other economic headwinds—the war in Ukraine, COVID-19 lockdowns in China, and central bank tightening—inflation is the risk that channels those pressures into financial asset prices, Page argues.

- Higher energy and food prices in effect are a tax on the consumer, the main engine of global economic growth.
- With interest rates rising, continued earnings gains will be needed to support positive equity returns. But higher wage and input costs could cut into profit margins.
- Inflation raises the risk that the Fed will hike rates too aggressively, increasing the cost of capital and causing a recession.

“Those are three ways in which inflation can trigger a growth shock,” Page says.

The key questions investors face now are whether inflation has already peaked, and, if so, whether it will decelerate quickly enough to limit the need for

a prolonged monetary tightening campaign by the Fed.

While there have been some anecdotal signs in some markets that price pressures are easing—such as a slowdown in home price appreciation and cooling demand for labor—clearer evidence is needed, Husain argues. “Until we see a meaningful decline in inflation toward the targets that central banks have set, the burden of proof hasn’t been met,” he says.

How Will Central Banks Respond?

Even if inflation has peaked, fixed income investors appear unconvinced it will quickly return to the Fed’s long-run target.

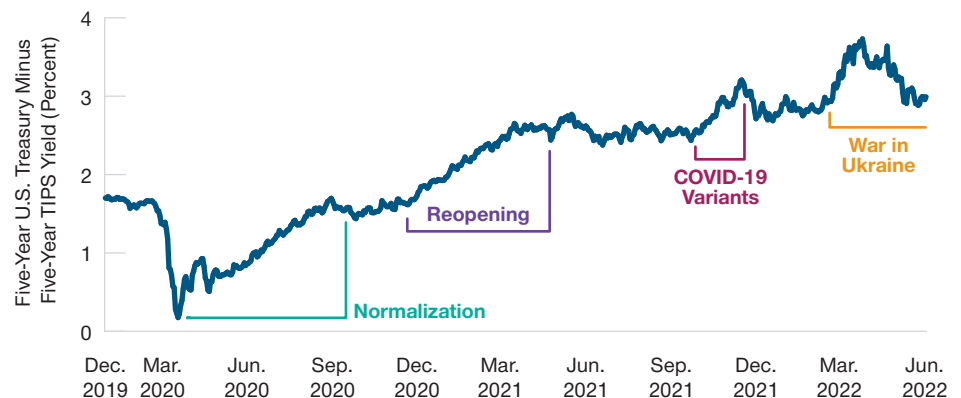
Figure 2 shows the spread, or breakeven, between yields on the nominal five-year U.S. Treasury note and on the five-year Treasury inflation protected security (TIPS). The breakeven is widely viewed as an estimate of investors’ inflation expectations.

Although inflation expectations eased somewhat after surging in the wake of Russia’s invasion of Ukraine, the breakeven remained close to 3% as of the end of May—almost a percentage point higher than the Fed’s long-term target for the U.S. consumer price index (CPI).

“The market has already priced in a number of future Fed rate hikes, yet it still

Inflation Is Still the Key Issue for Global Investors

(Fig. 2) Five-year U.S. inflation expectations based on TIPS breakeven yields



December 31, 2019, through June 1, 2022.

Source: Bloomberg Finance L.P. Data analysis by T. Rowe Price.

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— Sébastien Page, CFA
 Head of Global Multi-Asset
 and Chief Investment Officer

expects inflation to overshoot the Fed’s target by a full percentage point per year over the next five years,” Page comments.

With the CPI up more than 8.5% year over year through May, the market consensus also could prove too optimistic, Page says. “What if the CPI gets stuck on the way down at 4% or 5%?” he asks. “How committed is the Fed to its 2% target?”

The answers could be critical, and not just for the bond markets, Thomson says. “For global equity markets, the inflation outcome is absolutely key.”

“If inflation settles around 3%, that could be a reasonable backdrop for equities,” Thomson argues. “If it’s between 3% and 4%, things could get a bit more difficult. But, if it’s over 4% it could be [Paul] Volcker time”—a reference to the Fed chairman of the early 1980s who hiked rates to double-digit levels to break an inflationary spiral, pushing U.S. equities into a deep bear market.

The Supply Chain Factor

Inflation pressures are coming from both supply and demand and are being driven by both cyclical and structural factors, which makes the forecast exceptionally cloudy, Husain notes.

“I think what that means is that the Fed is going to keep raising rates,” Husain says. “There will come a point where they’ll want to pause and see what effect they are having. But my view is that we should be prepared for much higher rates going forward over the next few months.”

Page suggests a possible silver lining to those clouds. There is plenty of potential “pent up” supply in the global economy, he argues, which could help bring inflation down if supply chain bottlenecks can be unclogged.

“The question is whether fixing supply chains could do part of the Fed’s job for it,” Page says. “If it happens soon enough, maybe they won’t have to push demand off the cliff.”

NAVIGATING CHALLENGING CURRENTS

Investment Idea	Rationale	Examples
Defensive Positioning in Equities	Market declines in the first half of 2022 modestly improved equity valuations. However, earnings growth in the second half could be challenged by slowing economies. Higher input costs also could cut into profit margins.	<ul style="list-style-type: none"> Modest Equity Underweight
Inflation-Sensitive Equities	While inflation rates are expected to slow from recent peaks, lingering supply chain bottlenecks and strong demand for goods, services, labor, and housing could keep upward pressure on prices.	<ul style="list-style-type: none"> Real Assets Equities Natural Resource Equities

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