



ASSET ALLOCATION INSIGHTS

A Moderating Outlook for Equities

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KEY INSIGHTS

- Our Asset Allocation Committee modestly decreased the allocation to equities recently, given elevated stock valuations and a moderating economic outlook.
- In our view, key performance drivers may peak in the near term, which could temper potential equity returns going forward.

In March and April, our Asset Allocation Committee moderated the allocation to stocks relative to bonds, which was surprising given the very strong economic environment and improving earnings expectations.

The decision to underweight stocks was driven, in part, by elevated stock valuations after a period of very strong appreciation. In the 12 months ended March 31, 2021, both the S&P 500 Index and the MSCI All Country World Index rallied by more than 50%. As a result, overly optimistic expectations

pushed forward price-to-earnings (P/E) ratios higher (see Figure 1), and a lot of good news was already incorporated in stock prices. Further, despite an appealing macroeconomic environment, evidence was emerging that some of the tailwinds for stocks—such as accommodative monetary and fiscal policies and strong economic growth—might peak soon.

While stocks have continued to advance in recent months, the positive impact from these key drivers has started to diminish. In June, Fed policymakers appeared more concerned about the pace of inflation, highlighting the likelihood that global central banks have probably surpassed the point of peak dovishness. Notably, the rate of change in asset purchases by the world's four largest central banks is already slowing (see Figure 2)—typically a headwind for stocks. Also, fiscal stimulus is likely to peak soon with lower government spending expected in 2022 as coronavirus relief measures fade, and an increase in U.S. corporate taxes to fund recovery costs is likely.

In our view, the changing economic environment could temper potential equity returns. As a result, we believe a more moderate allocation to equities may be appropriate going forward.

A Changing Macro Environment

Stock returns may be subdued going forward

(Fig. 1) 12-Month Forward P/E Ratios, Past 5 Years



As of May 31, 2021.

Past performance is not a reliable indicator of future performance.

Sources: Standard & Poor's. MSCI. T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. See Additional Disclosures.

*The Four Largest Central Banks are U.S. Federal Reserve, European Central Bank, Bank of Japan, Central Bank of China

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(Fig. 2) Change in Assets of the Four Largest Central Banks* vs. Equity Market Performance



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