



# 2023 Midyear Market Outlook

Finding the Signal  
Through the Noise



# 2023 Midyear Market Outlook

## Economic Resilience Tested



The global economy avoided recession in the first half of 2023. The second half will bring further tests as the impacts of higher interest rates and tighter liquidity are fully felt.

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## Bonds Are Back?



An inverted yield curve means investors may want to think twice before aggressively jumping into longer-term U.S. bonds. Credit sectors and global ex-U.S. markets offer return potential.

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## A Focus on Earnings



Earnings growth estimates have come down but may need to fall even more in the second half. Still, there are opportunities in U.S. small-cap stocks, mega-cap technology, and global ex-U.S. markets.

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## Tactical Allocation Views



Our views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.

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## INTRODUCTION

# Reluctantly Bearish

“Skilled active management can help investors avoid riskier exposures.

— Sébastien Page

Head of Global Multi-Asset and CIO

Moving into the second half of 2023, the balance of economic forces still appears tilted against global capital markets. Sticky inflation, central bank tightening, and financial instability all pose clear risks.

Yet, through late May, economies and markets both showed surprising resilience. Growth remained positive in the major economies (Figure 1), and earnings results came in stronger than expected. Key equity markets posted gains.

These results appeared to validate the wisdom of a “reluctantly bearish” approach. Bearish, because the risks are substantial. Reluctant, because excessive pessimism can lead investors to overlook opportunities and miss market recoveries.

It’s an open question whether economies and markets can continue to defy the pessimists in the second half, says Sébastien Page, head of Global Multi-Asset and chief investment officer (CIO).

Many economic indicators, Page notes, are flashing red. But lingering distortions from the COVID pandemic make it hard to distinguish the signal from the noise—the useful information from the meaningless data points.

The strongest bear argument, Page says, is that the economic impact of 500 basis

points (bps) of interest rate hikes by the U.S. Federal Reserve has yet to be fully felt. “Every time the Fed has slammed on the brakes in the past, someone’s head has gone through the windshield,” he warns. “And we’ve already found out that some banks weren’t wearing their seat belts this time.”

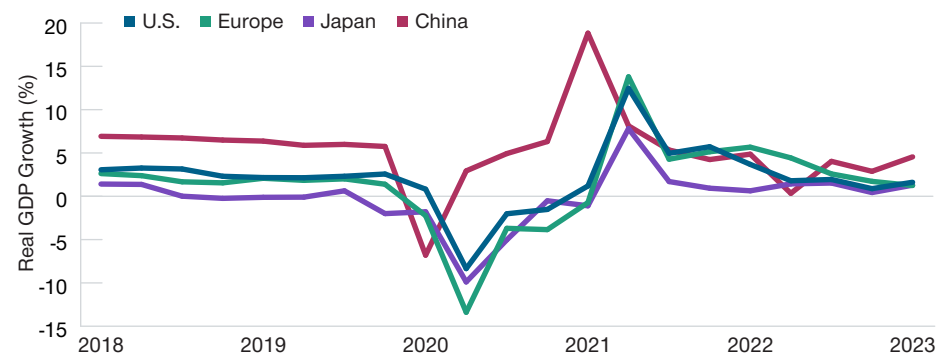
Although the banking crisis appears contained, its impact on credit conditions will be felt with a lag, notes Arif Husain, head of International Fixed Income and CIO. Resolution of the political dispute over the U.S. debt ceiling also could squeeze market liquidity in the second half, he says, as the U.S. Treasury rebuilds its depleted cash account at the Fed.

Yet, opportunities can be found in select sectors, including small-cap stocks and high yield bonds. Cheaper valuations and a weaker U.S. dollar also could make global ex-U.S. equity markets attractive, says Justin Thomson, head of International Equity and CIO. Positive yield curves could do the same for global ex-U.S. bond markets, Husain adds.

In an uncertain environment, careful security selection will be critical. “Skilled active management can help investors avoid riskier exposures,” Page argues.

## Growth Has Slowed but Major Economies Are Not in Recession—Yet

(Fig. 1) Growth in real gross domestic product (GDP), year over year



As of March 31, 2023.

Sources: Haver Analytics/U.S. Bureau of Economic Analysis, Statistical Office of the European Communities, Cabinet Office of Japan, Japan Ministry of Internal Affairs and Communications, International Monetary Fund.

THEME ONE

# Economic Resilience Tested

Economic reports in the first half of 2023 generally painted a grim picture, with many indicators posting declines similar to those seen heading into past U.S. recessions.

An inverted U.S. Treasury yield curve—with shorter-term yields higher than longer-term yields—is one of the warning signs that historically has signaled a downturn, Page notes. At the end of May, the yield on the three-month Treasury bill was 188 bps higher than the yield on the 10-year Treasury note—just below the all-time record set earlier in the month.

But those recession warnings could be misleading, or at least incomplete, Page argues. In many cases, the sharp declines seen in such measures as purchasing managers' indexes, consumer confidence, and the U.S. money supply have been from the inflated levels reached during the pandemic and its aftermath. "A lot of these indicators are flashing red because we're still unwinding COVID distortions," he says.

During the pandemic, Page notes, household savings soared as stimulus measures poured money into consumers' bank accounts faster than they spent

it. Now those balances are coming down. But they remain extremely high by historical standards, and debt service ratios are still low.

In the Fed's most recent survey of senior bank loan officers, nearly half said they've tightened lending standards in the wake of the banking crisis—a level also historically associated with recessions, Page notes. But healthy consumer and corporate finances could mitigate the economic impact of tighter credit. "The most important difference now is that the balance sheets are in better shape," he says.

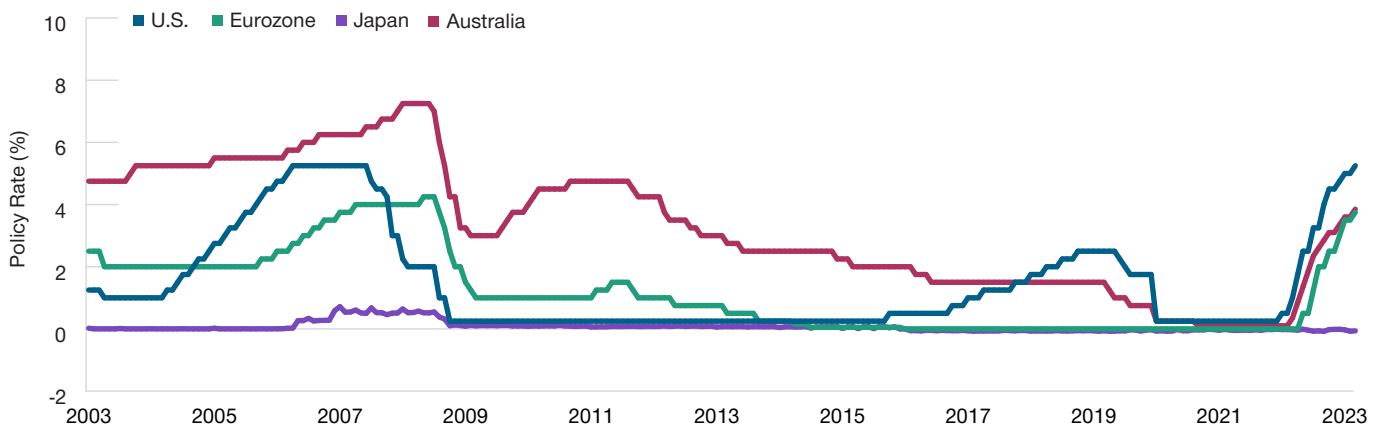
Husain suspects that some financial indicators also could be sending misleading signals about the near-term direction of central bank policy rates (Figure 2).

As of late May, Husain notes, interest rate futures markets were forecasting several Fed rate cuts before the end of 2023. He sees that as unlikely, barring a major liquidity crisis and/or an abrupt U.S. plunge into recession.

"I think the market is trying to reconcile two very different scenarios—one where the U.S. economy remains fairly strong

## Interest Rates May Have to Stay Higher for Longer

(Fig. 2) Central bank policy rates



As of May 31, 2023.

U.S. = Federal Reserve fed funds upper limit. Eurozone = European Central Bank main refinancing rate. Japan = Bank of Japan overnight call rate. Australia = Reserve Bank of Australia official cash rate.

Sources: U.S. Federal Reserve, Statistical Office of the European Communities, Cabinet Office of Japan, Reserve Bank of Australia.

I do think the Fed and other central banks will cut rates eventually. But the timing is tricky.

— Arif Husain  
Head of International Fixed Income and CIO

and the Fed doesn't cut rates, and one where things go terribly wrong and the Fed has to cut by several hundred basis points," Husain explains. "That averages out as what's priced into the market."

Near-term rate cuts are even more unlikely in Europe, Husain adds. In fact, he expects both the European Central Bank (ECB) and the Bank of England to raise rates several times more, despite the economic risks. "I do think the Fed and other central banks will cut rates eventually," Husain says. "But the timing is tricky. Rates are going to remain higher for longer."

The Bank of Japan (BoJ) remains an outlier among the key developed central banks, Husain notes, as it still is in quantitative easing mode—including its policy of capping yields on long-term Japanese government bonds. But this could soon change, he warns.

"If the BoJ lifts its yield curve controls, it could end up being a lot more important for markets than whether the Fed hikes or cuts rates at its next meeting."

### Inflation Remains a Sticking Point

Persistent inflationary pressures remain the primary global obstacle to monetary easing, Page and Husain both say.

Core inflation readings—which exclude volatile food and energy prices—remain stubbornly high (Figure 3). Service sector inflation is actually trending up, Page adds. Another energy price shock remains a risk, especially for Europe.

"U.S. inflation is probably going to get stuck at around 3%, maybe even 4%, for awhile," Page predicts. "A 4% rate would be double the Fed's target."

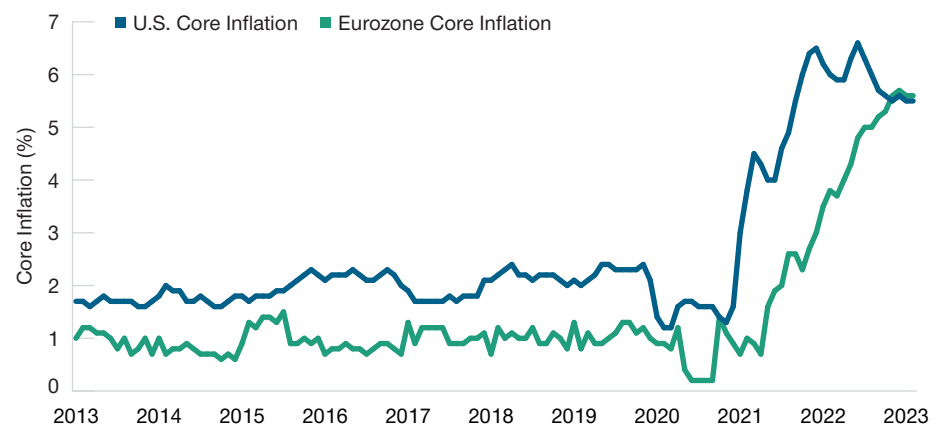
However, a convergence of factors could choke U.S. financial liquidity in the second half, Husain suggests, perhaps leading to a shift in the Fed's policy course.

Just as the Fed's rate hikes have not fully worked their way through the economy, the impact of the banking crisis on credit availability also will be felt with a lag—perhaps as long as two or three quarters, Husain argues.

Meanwhile, the U.S. Treasury will need to issue an estimated USD 1.4 trillion in debt in the second half to cover deferred payments and restore cash reserves. Those reserves are held in a special account at the Fed, and cash transfers into that account must be offset elsewhere on the Fed's balance sheet—in essence, shrinking the U.S. money supply.

## Core Inflation Is Still Sticky

(Fig. 3) Consumer prices less food and energy, year-over-year change



As of April 30, 2023.  
Source: Bloomberg Finance L.P.

Heavy Treasury issuance, a shrinking money supply, and the lagged impact of credit tightening could deliver a triple punch to liquidity in the second half, Husain warns, potentially destabilizing markets and spilling over into the real economy.

### China’s Momentum Fades While Japan Accelerates

Other major economies delivered a welcome boost to global growth in the first half, Thomson notes. Falling energy prices helped eurozone economies avoid recession, while China lifted COVID restrictions faster than expected. A weak yen helped boost Japan’s export sector.

However, much of that momentum has faded, Thomson notes. China’s economy, he says, has remained stuck in “second and third gear,” reflecting a sluggish recovery in consumer demand and oversupply in the property sector. “China needs a new growth model,” he argues.

Japan’s economic outlook, on the other hand, appears more positive. “Corporate Japan is doing rather well,” he says. “There’s been a return of pricing power.”

### A Less-Than-Almighty U.S. Dollar

U.S. dollar strength has been a headwind for U.S. investors in global ex-U.S. markets in recent years. But structural and cyclical factors both appear likely to curb U.S. dollar strength over the intermediate term, Thomson argues.

Cyclically, narrower interest rate differentials and tepid global economic growth should support other currencies—emerging market (EM) currencies in particular, Thomson says. “Historically, the dollar has tended to be strongest in ‘risk off’ environments and when the U.S. economy was growing very strongly,” he argues. “In a more mixed scenario, you’d expect the dollar to weaken.”

Structurally, relative valuations also favor other currencies, Thomson adds. As of the end of May, the U.S. dollar was at the 96th percentile of its 15-year valuation range against major developed currencies,<sup>1</sup> he notes.

## ECONOMIC RESILIENCE TESTED

Investment Idea	Rationale	Examples
Maintain Flexibility and Keep “Dry Powder”	Global economies have been surprisingly resilient so far in 2023 but aren’t out of the woods yet. With short-term yields at attractive levels and economic uncertainty high, it makes sense to consider maintaining healthy cash balances and allocations to very short duration bonds.	<ul style="list-style-type: none"> <li>■ Cash</li> <li>■ Very short duration fixed income</li> <li>■ Dynamic global bond strategies</li> </ul>

**For illustrative purposes only. This is not intended to be investment advice or a recommendation to take any particular investment action.**

<sup>1</sup>Based on the U.S. Dollar Index, which measures the value of the dollar against a basket of six major currencies: the euro, the Japanese yen, the Canadian dollar, the British pound, the Swiss franc, and the Swedish krona. Monthly observations for the 15 years ended May 31, 2023.

## THEME TWO

# Bonds Are Back?

The sharp rise in bond yields since early 2022 has improved return potential in many fixed income sectors. But an aggressive portfolio shift into longer-term bonds still appears premature.

“Anyone who universally says that ‘bonds are back’ is being a little too optimistic,” Husain says. “Some bond markets are back. Others may be back in the near future. But I think it’s too sweeping to just say, ‘go out and buy fixed income.’”

Yields on most sovereign bonds and investment-grade credits still aren’t positive in real (after inflation) terms, Husain notes. And with the U.S. Treasury yield curve close to a record inversion as of late May (Figure 4), investors who trade money market holdings for longer-term bonds could pay a heavy return penalty.

Negative yield curves make it expensive to extend duration<sup>2</sup>—especially for investors using borrowed short-term money to finance their long bond positions, Husain notes. “You end up sacrificing yield on a daily basis.”

Under these conditions, aggressively extending duration in the U.S. fixed

income market amounts to a bet that a recession is near, Husain argues. “You’re saying, ‘I think the Fed will cut rates soon, and probably in a very quick way.’ I’m not sure we can say that, at least not yet.”

But Page thinks a modest increase in duration could be prudent for investors seeking to hedge against that very scenario—the sudden onset of a U.S. recession followed by rapid Fed rate cuts.

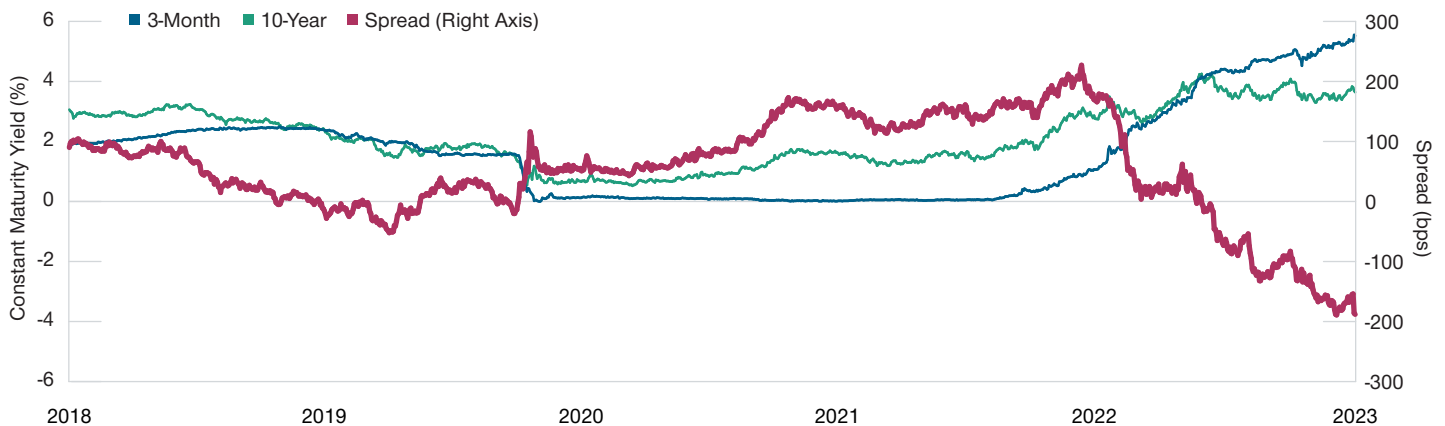
T. Rowe Price’s Asset Allocation Committee, Page notes, has modestly extended duration in its multi-asset portfolios—both to guard against a growth shock and to potentially enhance returns if one does push yields sharply lower. “When you look at our tactical positions, we’re playing both defense and offense.”

### High on High Yield

The rise in yields may have created more significant opportunities in corporate credit, Husain says. Yields in the 8%–10% range and credit spreads close to their 10-year average (Figure 5) make the global high yield market attractive in any scenario short of a deep global recession, he argues.

## Inverted Yield Curve Makes Buying Longer-Term Bonds Expensive

(Fig. 4) Treasury yield curve (10-year minus 3-month constant maturity)



As of May 31, 2023.

Source: Federal Reserve Bank of St. Louis.

<sup>2</sup>Duration is a measure of the interest rate risk on fixed income securities. Generally, bonds with longer maturities also have longer duration.

Slower economic growth and higher rates are likely to push default rates up gradually over the balance of 2023 and into 2024, Husain says. But with corporate balance sheets, on average, still featuring low leverage and ample debt service coverage, default risks appear moderate, he argues.

Based on their credit research, Page adds, T. Rowe Price analysts as of late May were forecasting a U.S. high yield default rate of about 3% over the next 12 months, roughly in line with the longer-term historical average.

“We don’t see default rates getting anywhere close to eroding the extra yield premium, relative to investment-grade bonds, that you can get in high yield right now,” Husain says.

Bottom-up research and skilled security selection will be critical to managing default risk, Page cautions. “Skilled active managers know how to differentiate between healthy versus true junk balance sheets.” This, he contends, can help investors avoid “zombies”—companies that are still technically in business but almost certainly are headed toward bankruptcy.

## Going Global

For investors in markets with inverted yield curves (like the U.S.), other global bond markets may offer attractive diversification and potential return opportunities, Husain says. “As I look around the world, I see some markets that actually have very steep, positive yield curves,” Husain observes. “So, investors are getting paid, in a sense, to own them.”

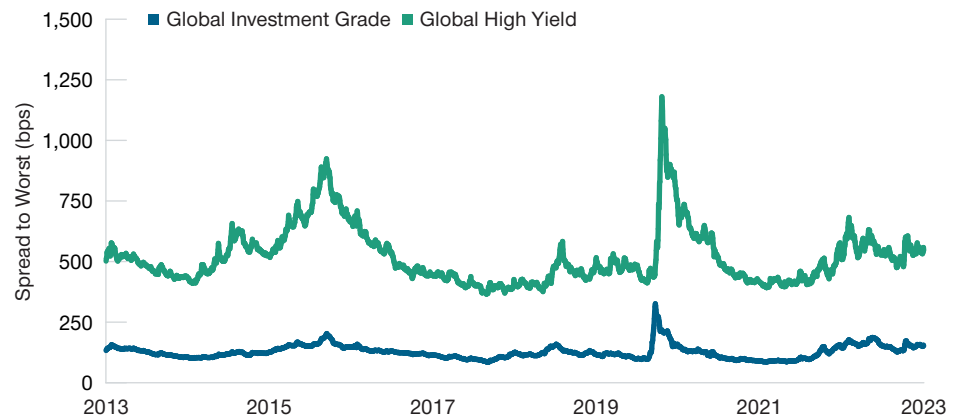
Some central banks, especially in the emerging markets, may be on the verge of cutting policy rates, Husain adds, creating a potential for capital appreciation in those markets. However, EM debt markets are only attractive on a very selective basis, he says.

Global investors also need to be mindful of several “black swan” risks—potentially high-impact events with probabilities that are difficult to estimate, Husain cautions. Key among these, he says, is the possibility of a change in monetary policy by the BoJ.

Japan’s version of quantitative easing, Husain notes, includes capping yields on longer-term Japanese government bonds. The BoJ has kept these controls

## Global Credit Sectors Offer Opportunities

(Fig. 5) Investment-grade and high yield spreads, in basis points



As of May 31, 2023. **Past performance is not a reliable indicator of future performance.** Global high yield = J.P. Morgan Global High Yield Index. Global investment grade = Bloomberg Global Aggregate Corporate Index. Spreads versus sovereign bonds with similar duration. Sources: J.P. Morgan Chase (see Additional Disclosures), Bloomberg Finance L.P. T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.



# Japanese monetary policy could be the San Andreas fault of global finance.

— Arif Husain  
 Head of International Fixed Income and CIO

in place even as the Fed and other major central banks have shifted to monetary tightening. “I would describe Japan as a last anchor of quantitative easing.”

But that anchor may be about to give way, which could have major implications for other global bond markets.

Japanese investors, Husain notes, control the world’s largest pool of financial wealth. But much of that wealth is invested outside Japan—a legacy, in part, of the years of negligible returns on Japanese bonds. However, if the BoJ allows yields to rise, Japanese investors could start bringing their wealth back home—delivering a significant shock to markets outside Japan.

“Japanese monetary policy could be the San Andreas fault of global finance,” Husain warns. “I know the BoJ is conscious of the effect it could have on global markets, but it’s a real and present danger, in my view. I certainly think it’s something that should be on our radar as investors.”

The threat of a broader systemic market event—perhaps triggered

by a U.S. liquidity crunch—is another potentially dramatic but hard-to-quantify risk, Husain says.

Notwithstanding the recent depositor runs from several U.S. regional banks, the global banking system isn’t the most likely candidate for such an event, Husain suggests. A depressed U.S. commercial real estate sector also poses risks, but bank lending in the sector also is unlikely to be the epicenter of the next crisis, he adds.

“The playbook the authorities have for a banking crisis is pretty much set,” Husain argues. “They know how to deal with it.”

A more likely venue, Husain says, is the so-called shadow banking system—lenders that are less regulated, less liquid, and more opaque than commercial banks. Many of these lenders, and the complex financial instruments they’ve created, have not yet endured a full economic cycle, Husain notes. “If we’re looking for potential trouble spots, I think that’s where we might find them.”

## BONDS ARE BACK?

Investment Idea	Rationale	Examples
Take Advantage of Attractive Yields	Bonds may not be a good source of capital appreciation in 2023, but do provide yield. Equity upside may be limited by an uncertain economic landscape, so high yield bonds may offer better return opportunities.	<ul style="list-style-type: none"> <li>Global high yield</li> <li>EM local currency bonds</li> </ul>

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## THEME THREE

# A Focus on Earnings

Equity returns were largely positive in the first five months of 2023. The question now is whether earnings forecasts, which stabilized in the first part of the year (Figure 6), will turn down again.

Page says he suspects they will. As of late May, he notes, 2024 earnings growth projections for the stocks in the S&P 500 Index were still in double digits. “We know that Wall Street analysts tend to wear rose-colored glasses, but I think those expectations will have to come down.”

Assuming the global economy enters a mild recession, 2024 global earnings could be flat to down 5%, Thomson estimates.<sup>3</sup> Compared with past earnings cycles, that could be viewed as a bullish outcome. “At this stage, I think we’re looking at a fairly benign cycle.”

Even a modest earnings decline would put further pressure on stretched U.S. large-cap valuations. Back when the Fed was holding rates close to zero, Page recalls, a favorite Wall Street acronym was TINA—There Is No Alternative. “Well, TINA has left the building,” he says. “There are alternatives now.”

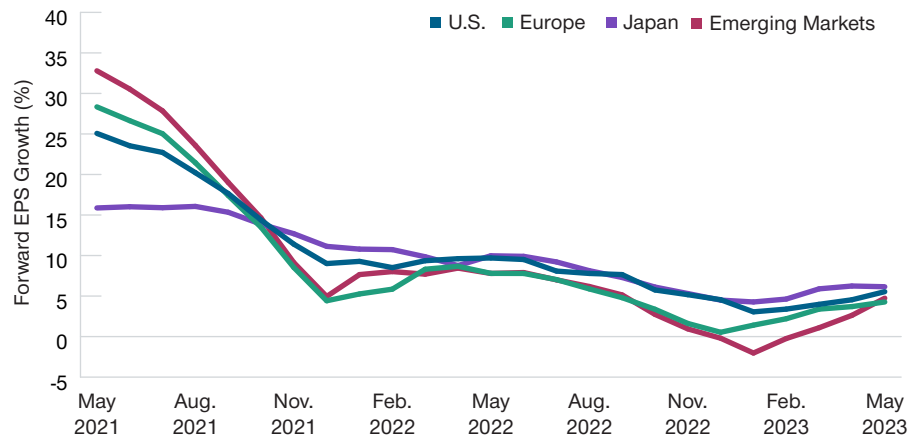
By some measures, U.S. large-cap stocks actually appear more expensive than they did before last year’s bear market, Page says, even though the price/earnings ratio (P/E) on the S&P 500 Index has fallen.

The valuation model used to calculate the equity risk premium—the added reward for taking on the additional risk of holding stocks rather than bonds—compares the earning yield on the S&P 500 (the inverse of the P/E) with the 10-year Treasury yield. At the beginning of 2022, Page notes, a P/E of 23 on the S&P 500 translated into an earnings yield of 4.3%, versus a 1.5% yield on the 10-year Treasury note. That put the equity risk premium at 2.8 percentage points.

By late May of this year, the P/E on the S&P 500 had fallen to 18.4, raising the earnings yield to 5.4%. But the 10-year Treasury yield had risen even more, to 3.7%. Net result: an equity risk premium of 1.7 percentage points—lower than before the 2022 equity sell-off.

## Earnings Growth Expectations Have Fallen but Still May Be Too High

(Fig. 6) Forward earnings per share (EPS) growth estimates, next 12 months



As of May 31, 2023. Actual outcomes may differ materially from estimates.

U.S. = S&P 500 Index. Europe = MSCI Europe Index. Japan = MSCI Japan Index. Emerging markets = MSCI Emerging Markets Index.

Sources: Standard & Poor’s, MSCI (see Additional Disclosures). T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

<sup>3</sup> Actual outcomes may differ materially. See Additional Disclosures regarding estimates.

“There’s an AI arms race underway, and I think that means the strong will get stronger.”

— Justin Thomson  
Head of International Equity and CIO

By that same measure, Page adds, U.S. equity valuations currently are in the least attractive 5th percentile of their 10-year historical range.<sup>4</sup>

### U.S. Small-Caps Are Cheap

There are, however, bargains to be found in the U.S. market, Page adds. Many quality small- and mid-cap stocks are trading at significant discounts to their historical averages. While the S&P 500’s P/E is closer to the top of its 10-year range than to its bottom, Page notes, the reverse is true for the S&P 600 Index—a leading U.S. small-cap benchmark. “U.S. small-caps are priced like it’s 2008,” he says.

Of course, small-cap valuations are low in part because many investors are worried about the risk of recession, and smaller companies historically have been more vulnerable in economic downturns. But, as with high yield bonds, skilled security selection can help active portfolio managers avoid companies with weak balance sheets and high cyclical earnings exposure, Page contends.

Potential opportunities also may be available at the opposite end of the capitalization spectrum: among the mega-cap technology companies that were hard hit in the 2022 sell-off, in part because of their expensive valuations.

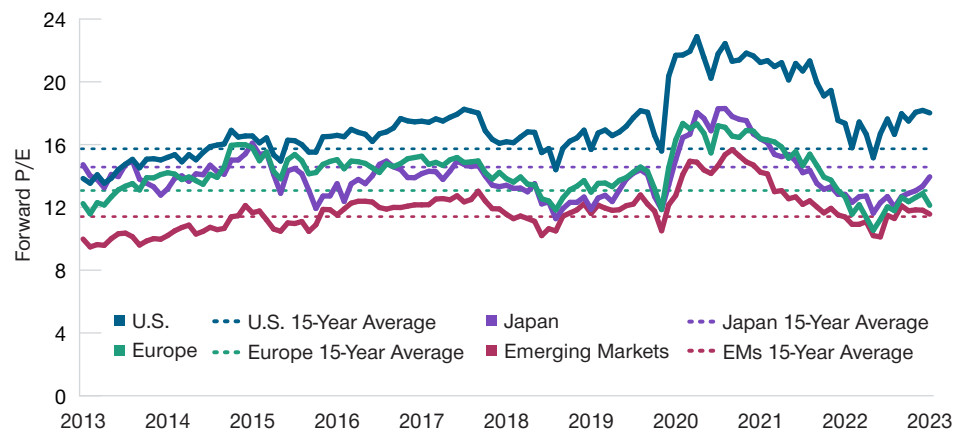
Big tech rebounded strongly in the first half of 2023, in part driven by growing investor enthusiasm for artificial intelligence (AI) applications such as ChatGPT, the widely publicized interactive chatbot launched last November.

Thomson says he expects AI to continue to drive investment in a range of tech sectors, including semiconductors, memory, and cloud storage. AI programs also require expensive training, he notes. All this plays to the strengths of the largest tech platform companies, which have the resources to develop new AI applications and/or refine existing ones.

“There’s an AI arms race underway, and I think that means the strong will get stronger,” Thomson argues.

## Equity Valuations Appear More Attractive Outside the U.S.

(Fig. 7) Forward 12-month P/E ratios in major equity regions



As of May 31, 2023.

U.S. = S&P 500 Index. Europe = MSCI Europe Index. Japan = MSCI Japan Index. Emerging markets = MSCI Emerging Markets Index. Actual outcomes may differ materially from estimates. Sources: Standard & Poor’s, MSCI (see Additional Disclosures). T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

<sup>4</sup> Earnings yield on the Russell 3000 Index compared to the yield on the 10-year Treasury note for the 10 years ended May 23, 2023, based on monthly data.

### An End to U.S. Outperformance?

For global equities more broadly, a key question for the second half is whether a record-long run of U.S. stock market outperformance will finally end.

Through the end of 2022, the S&P 500 Index had posted higher returns than the MSCI Europe, Australasia, and the Far East (EAFE) Index—a benchmark for developed markets outside the U.S. and Canada—for 53 consecutive rolling three-year periods, measured quarterly, Thomson notes. But financial gravity could pull the U.S. market closer to earth:

- Most global ex-U.S. markets continue to feature significantly lower valuations, relative to both U.S. equities and their own 15-year averages (Figure 7).
- Recent earnings growth estimates have been higher for Japan, and comparable for developed Europe, relative to the S&P 500.
- A weaker U.S. dollar could enhance global return potential for unhedged U.S. dollar-based investors.

Developed ex-U.S. equities, as a group, already are catching up with the U.S., Thomson says. The MSCI Europe Index outperformed the global market (as measured by the MSCI All Country World Index) by a full percentage point through the first five months of 2023, he notes.

Japan's equity market could be the standout going forward, Thomson argues. For the most recent fiscal year, which ended in March, he notes, 5% growth in Japanese corporate earnings translated into a hefty 12% rise in earnings per share, thanks to major share buybacks.

Longer-term structural factors, such as improved corporate governance and capital allocation, also bolster the case for Japanese equities, Thomson contends, as does the potential for Japanese pension funds to reverse their 25-year pattern of being net sellers of Japanese equities.

Thomson also says he maintains a positive view on Chinese equities despite the country's structural economic issues. Money supply growth in China currently is outstripping real economic growth, he notes. "Under normal circumstances, that's usually a strong backdrop for financial asset prices."

But investors need to be mindful of the geopolitical risks—most particularly, the potential for conflict over Taiwan. "We can't make the Taiwan tail risk go away," Thomson says. "I think it's probably overstated, but it's there."

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

A FOCUS ON EARNINGS		
Investment Idea	Rationale	Examples
Equity Markets With Unique Profiles	U.S. small-caps offer attractive valuations. Structural changes in corporate policies could be a long-term tailwind for Japanese equities. Mega-cap technology companies are well positioned to benefit from artificial intelligence.	<ul style="list-style-type: none"> <li>■ U.S. small-caps</li> <li>■ Japanese equities</li> <li>■ Mega-cap tech</li> </ul>

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# Summary

My takeaway fits in a fortune cookie: Stay invested; stay diversified.

— Sébastien Page  
Head of Global Multi-Asset and CIO

Entering 2023, T. Rowe Price investment leaders argued that fears of a deep global economic downturn were exaggerated. Pessimism, they suggested, could create contrarian opportunities. As of late May, both propositions appeared correct:

- Recessions in the U.S. and Europe, widely predicted at the start of the year, had yet to materialize.
- Major equity markets in the U.S., the eurozone, and Japan showed positive year-to-date returns.
- Default rates remained low, supporting attractive returns on high yield bonds.

“So far this year, the good news has roughly outweighed the bad news,” Husain says.

The market consensus still seems to foresee a global recession starting later this year or early 2024, but now expects it to be mild, Thomson says. However, “I think markets also understand that the biggest tail risk is a credit crunch leading to a much deeper recession.”

A list of economic and financial paradoxes has made it hard to estimate that risk, Husain notes. Resolution of the U.S. debt ceiling dispute avoided one potential crisis

but could tighten liquidity in the second half. Low unemployment helps support consumer demand, which is positive for earnings, but is potentially negative for inflation and interest rates. Reflation in Japan is good news but could lead the BoJ to decontrol yields, which would be bad news for other global markets.

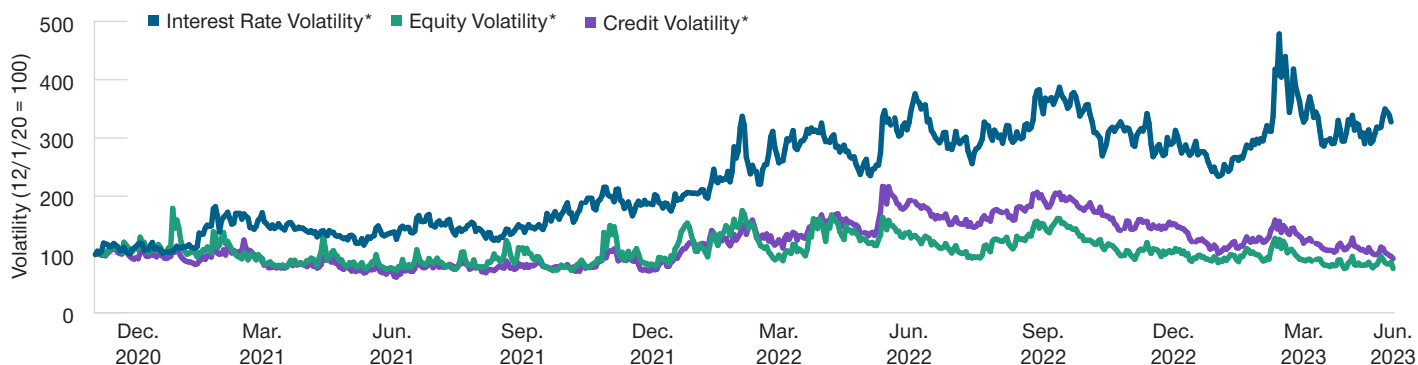
Given these uncertainties, and the low “signal-to-noise ratio” in the data, it’s no surprise that interest rate volatility has remained high (Figure 8). It’s likely to remain that way, Husain says.

From an asset allocation perspective, however, investors should remember the longer-term historical record, Page says. “U.S. stocks have outperformed U.S. bonds 67% of the time, on a rolling 12-month basis, by an average of seven percentage points<sup>5</sup>,” he notes. “That’s based on over 80 years of data.”

That record is one reason Page describes himself as a “reluctant bear” on U.S. equities, despite high valuations and a poor earnings outlook. It also shapes his overall market view: “My takeaway fits in a fortune cookie,” he says. “Stay invested; stay diversified.”

## Market Volatility Is Likely to Persist

(Fig. 8) Implied volatility measures



As of June 1, 2023. **Past performance is not a reliable indicator of future results.**

Interest rate volatility = MOVE Index, which represents implied volatility on 1-month Treasury bill options. Equity volatility = VIX index, which represents expected volatility of the S&P 500 Index. Credit volatility = high yield 3-month implied volatility, which represents expected future volatility of the iShares iBoxx High Yield Corporate ETF. This exchange-traded fund is shown for illustrative purposes only to demonstrate high yield volatility.

\*Values rebased to December 1, 2020.

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

<sup>5</sup> Stocks based on Ibbotson® SBBI® US Large-Cap Stocks from 1926 to 1939; S&P 500 Index from 1940 to present. Bonds based on Ibbotson® SBBI® US Intermediate-term Government Bonds Index from 1926 to 1975; Bloomberg U.S. Aggregate Bond Index from 1976 to present. Rolling monthly observations January 1926 through April 2023.

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

# 2023 Tactical Allocation Views

■ Underweight   ■ Neutral   ■ Overweight

**These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.**

ASSET CLASS				
ASSET CLASS	Stocks	■	Outlook remains uncertain due to tight financial conditions, a slowing economy, and elevated valuations. However, a resilient labor market, services sector strength, and positive sentiment around AI are providing support.	
	Bonds	■	Interest rate volatility could remain elevated as central banks continue to balance persistent inflation and growth concerns. Credit sectors continue to offer attractive valuations with broadly supportive fundamentals.	
	Cash	■	Cash currently offers attractive yields and a shorter-duration profile if interest rates drift higher, and provides liquidity should market opportunities arise.	
<i>Equity Regions</i>				
STOCKS	U.S.	■	Despite a resilient economy, the outlook remains clouded by Fed uncertainty, manufacturing sector weakness, and narrow market breadth. Elevated valuations make large-cap U.S. equities unappealing given this backdrop.	
	Global Ex-U.S.	■	Valuations are attractive on a relative basis and local currencies have room to appreciate. However, the impact of China's economic reopening has been disappointing thus far. Global monetary policy remains a headwind.	
	Europe	■	Valuations are attractive on a relative basis and the euro has room to appreciate; however, restrictive monetary policy remains a headwind.	
	Japan	■	Japan has historically cheap valuations and, despite cyclical concerns, should continue to benefit from better corporate governance and improved pricing power.	
	Emerging Markets	■	Valuations and currencies are attractive. Central bank tightening may have peaked. Meanwhile, Chinese growth momentum has stalled pending further stimulus.	
	<i>Style and Market Capitalization</i>			
	U.S. Growth vs. Value*	■	While relative valuations for value stocks remain attractive, a tilt toward higher-quality businesses is important given the weakening macroeconomic backdrop. AI could also provide a structural tailwind for growth.	
	Global Ex-U.S. Growth vs. Value*	■	Value stocks offer attractive valuations. Cyclical and geopolitical risks remain a concern, but persistently higher rates may benefit financial stocks.	
	U.S. Small-vs. Large-Cap*	■	Small-caps offer attractive upside potential, having already priced in a dire economic scenario with historically attractive relative valuations. A bias towards quality and selective exposure to regional banks is warranted.	
	Global Ex-U.S. Small-vs. Large-Cap*	■	Small-caps offer attractive valuations and could benefit from any further U.S. dollar weakening. However, caution is warranted due to a potential flight to quality that could favor large-caps.	
<i>Inflation Sensitive</i>				
Real Assets Equities	■	Commodities offer a hedge if inflation remains elevated; however, commodity prices may face pressure due to economic concerns. Real estate investment trusts face pressure from higher rates and commercial property weakness.		
BONDS	U.S. Investment Grade	■	Despite resilient fundamentals, lagged effects of rapid Fed hikes and tighter lending standards warrant caution.	
	Developed Ex-U.S. IG (Hedged)	■	Developed ex-U.S. yields could remain volatile as global central banks balance elevated inflation versus slower growth.	
	U.S. Treasury Long	■	While yield volatility could persist in the near term, longer-duration Treasury bonds may have peaked and offer ballast amid a deteriorating macroeconomic backdrop.	
	Inflation Linked	■	Core inflation is proving to be stubbornly high, but upward price pressures are easing. However, slower inflation rates already are priced into current breakeven yields.	
	Global High Yield	■	Credit fundamentals and attractive yields remain supportive. Although default rates are rising from historically low levels, they are not expected to rise significantly above long-term averages.	
	Floating Rate Loans	■	Valuations remain attractive, but as the Fed moderates its tightening path, the benefits of the rate resetting feature and the lower-duration profile become less compelling.	
	EM Dollar Sovereigns	■	Yields are still attractive, and a potential peak in EM central bank tightening and moderating inflation both should also support the sector.	
	EM Local Currency	■	EM currencies and local currency yields remain at attractive levels but reflect cautious sentiment. A further weakening of the U.S. dollar would be supportive of EM currencies.	

\*For pairwise decisions in style and market capitalization, boxes represent positioning in the first asset class relative to the second asset class.

The asset classes across the equity and fixed income markets shown are represented in our multi-asset portfolios. Certain style and market capitalization asset classes are represented as pairwise decisions as part of our tactical asset allocation framework.

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