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ASSET ALLOCATION INSIGHTS

May 2018

The T. Rowe Price Asset Allocation Committee meets regularly to assess market conditions and the relative values of major asset classes over a 6- to 18-month time horizon. This series of *Asset Allocation Insights* offers a look at specific topics of interest from the committee's recent discussions.

ASSET ALLOCATION COMMITTEE

Multi-Asset
- David R. Giroux, CFA (Cochair + CIO)
- Charles M. Shriver, CFA (Cochair)
- Sebastien Page, CFA
- Jerome A. Clark, CFA
- Wyatt A. Lee, CFA

Equity
- Christopher D. Alderson
- Frank Alonso
- Mark Finn, CFA, CPA
- Robert W. Sharps, CFA (Group CIO)
- Justin Thomson (CIO)

Fixed Income
- Arif Husain, CFA
- Daniel O. Shackelford, CFA
- Mark J. Vaselkiv (CIO)

Finding Opportunities Amid Higher Rates

KEY POINTS

- The U.S. Federal Reserve is likely to stay on its path of gradual policy tightening, which has led to higher short-term interest rates and created opportunities in asset classes such as cash, bank loans, and international bonds hedged to the U.S. dollar.
- Sovereign bonds from international developed markets hedged to the U.S. dollar currently offer compelling yields as well as portfolio diversification benefits.
- The Asset Allocation Committee expects that Fed policy will eventually transition from less accommodative to actual tightening, making the environment for equity returns more challenging.
- The Committee believes that the rate of global economic growth has crested but is likely to stabilize at a reasonable level.

With fiscal stimulus and tax cuts supporting U.S. economic growth at above-potential levels, coupled with recent firming in U.S. inflation data, the Asset Allocation Committee expects the Federal Reserve to remain on its path of gradual monetary policy tightening. Through much of 2017, the Fed steadily raised rates even though inflation remained low, pushing short-term interest rates—both nominal and real (adjusted for inflation)—higher. The Committee anticipates that interest rates and inflation both will trend higher, causing a sideways move in real rates, but the Committee does not see either rising to problematic levels. Higher short-term U.S. rates also are creating potential opportunities in asset classes that have languished in recent years, including cash.

PORTFOLIO IMPLICATIONS OF HIGHER U.S. SHORT-TERM RATES

The most obvious asset class beneficiary of higher short-term interest rates is cash. After years of money market rates at essentially zero, the three-month U.S. Treasury bill yield has climbed steadily into early 2018, remaining near its March 19 peak of 1.88%[1] as of mid-May. As a result, cash has suddenly become interesting as a nearly risk-free allocation option. Bank loans have also benefited from the increase in short-term rates because their coupon payments have adjusted upward with increases in their London Interbank Offered Rate

[1]Barclays Live data.

(LIBOR) benchmark reference rate. The Committee continues to favor bank loans over noninvestment-grade bonds within the high yield allocation, where credit fundamentals are still reasonably solid.

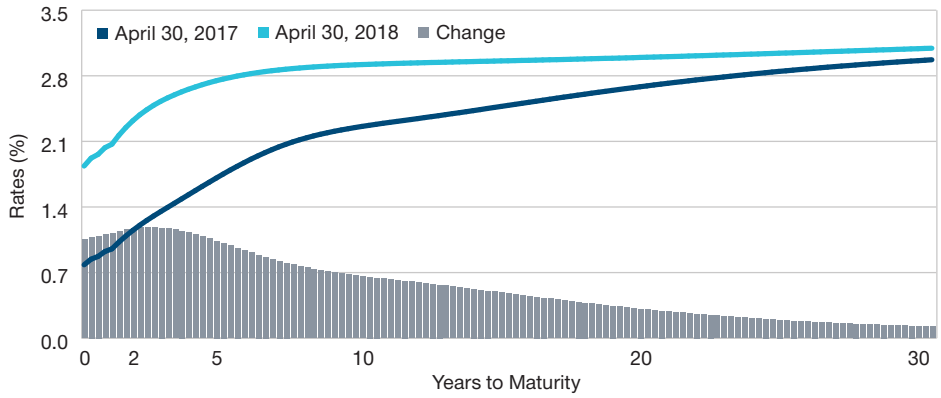
DOLLAR-HEDGED INTERNATIONAL BONDS ATTRACTIVE

Another implication of the increase in U.S. short-term interest rates is that they are now meaningfully higher than rates in most other developed markets, including the eurozone and Japan. Under these conditions, "hedging foreign currency bonds into the U.S. dollar adds additional return on top of the yield to maturity—known as the hedged yield. This comes from the currency forward contracts used to hedge the foreign exchange risk," explains international bond Portfolio Manager Ken Orchard. For a U.S. dollar-based investor, this hedged yield is currently more compelling than the yield on unhedged international bonds.

Given the more competitive yield profile, the Committee recently added to hedged international bond exposure to take advantage of this diversifying source of yield. Indeed, for many T. Rowe Price U.S.-based multi-asset portfolios, the majority of the international bond allocation is now currency hedged to reduce the impact of foreign exchange volatility.

According to Charles Shriver, multi-asset portfolio manager and a member of the Asset Allocation Committee, "the benefits of this strategy include the diversification advantages of holding bonds from countries that are not at the same stage of central bank tightening as the U.S. Fed. However, a risk of this strategy is that you would not participate in foreign currency appreciation if the U.S. dollar weakens and you still have longer-duration bonds in Europe and Japan that would be adversely affected when the European Central Bank [ECB] or the Bank of Japan eventually begin to raise interest rates. This would also diminish the potential advantage of the hedged yield, but we think those moves are still relatively distant."

FIGURE 1: U.S. Treasury Yield Curves



Source: Barclays Live.

U.S. YIELD CURVE FLATTENS

As short-term rates have increased, longer-term interest rates have risen by a lesser amount, contributing to a flattening of the U.S. Treasury yield curve; however, it maintains a modestly positive slope. A flattening U.S. Treasury yield curve, in which the spread between short- and long-maturity yields is narrowing, is also an important barometer of economic growth and the performance of risk assets. However, equities historically have not underperformed meaningfully until short-term rates have risen above long-term yields, creating an inverted yield curve. Shriver notes that "as we advance further into the hiking cycle and Fed policy transitions from less accommodative to actual tightening, the environment for equity returns could be more challenging." Yield curve inversion has historically been a reliable recession indicator, so we will continue to monitor the slope of the curve.

CRESTING GLOBAL GROWTH

While we do not anticipate a U.S. recession in 2018, global purchasing managers' indexes (PMIs), which are high-frequency indicators of economic strength, turned downward in the first quarter of the year across the services and manufacturing sectors in both developed and emerging markets. The Committee believes this trend reflects a cresting of global economic growth but sees growth stabilizing at a reasonable level—particularly relative to the current long-run potential expansion rate. Fiscal stimulus should also support U.S. growth.

In light of this outlook, the Committee expects equity performance in 2018 to lag the strong gains seen in 2017 with higher volatility. However, assets such as bank loans, U.S. dollar-hedged international bonds, and cash may provide benefits in a lower-return environment characterized by slowing global growth and rising short-term U.S. rates.

The T. Rowe Price Asset Allocation Committee comprises some of our firm's most senior investment professionals. The Committee's decisions are reflected across our multi-asset portfolios, which accounted for USD $ 298.9 billion in assets under management as of March 31, 2018. The combined multi-asset portfolios managed by T. Rowe Price group of companies. The T. Rowe Price group of companies includes T. Rowe Price Associates, Inc., T. Rowe Price International Ltd, T. Rowe Price Hong Kong Limited, T. Rowe Price Singapore Private Ltd., and T. Rowe Price (Canada), Inc. This figure includes assets that are held outside of T. Rowe Price, but where T. Rowe Price influences trade decisions. For a broader perspective on asset allocation positioning in our multi-asset portfolios, please see our Asset Allocation Viewpoints.

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