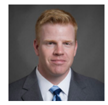
ASSET ALLOCATION INSIGHTS

Should Rising Inflation Be a Concern?

September 2021



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KEY INSIGHTS

- High inflation over an extended period has typically been a headwind for stock and bond investors.
- Although markets appear to assume the current inflation spike will be temporary, durable increases in housing costs and wages could defy those expectations.

Inflation is rising, but the market-implied 10-year-forward inflation expectation for most developed market countries remains relatively muted, reflecting widespread assumptions that the inflation spike may prove temporary (Figure 1).

For financial markets, elevated inflation for an extended period could be problematic. Higher inflation typically brings higher interest rates, and, given their sensitivity to rising rates, bond markets would likely sell off. Also, significantly higher inflation historically has depressed equity valuations (Figure 2), a potential headwind for stocks. In such an environment, higher correlation between stocks and bonds could diminish the diversification benefits of a balanced portfolio.

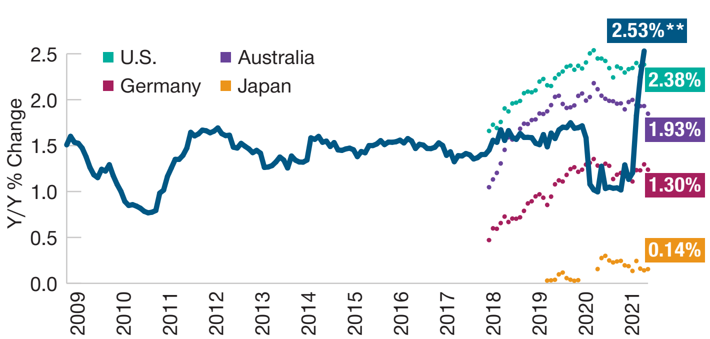
We expect inflation to be higher than it has been over the past decade but not high enough to be a major concern. Recent results have been heavily influenced by extreme price hikes in categories that experienced a sudden stop and restart due to the pandemic, such as used cars and travel. We believe these trends are likely to moderate in the near term. Further, as seen in Figure 2, the recent inflation spike does not appear to have depressed equity valuations, likely reflecting the expectation that it will prove transitory.

Going forward, we are closely monitoring housing costs—a significant component of consumer prices—and wage inflation. Housing costs have been rising steadily for the past decade, a trend heightened by increasing work-from-home arrangements. Meanwhile, higher wages have historically led to price hikes as employers sought to offset rising labor costs. Durable increases in these two components could, in our view, generate more sustained inflation.

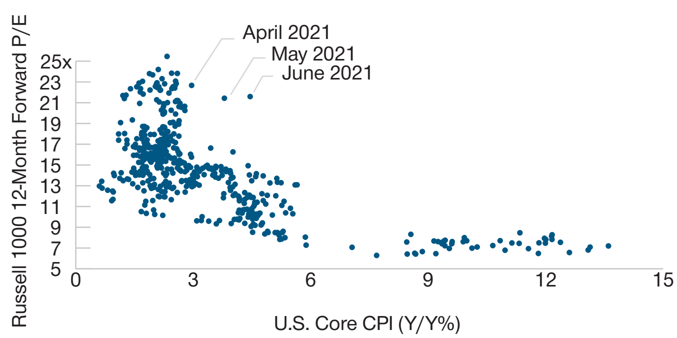
Rising Inflation

Will the inflation spike be temporary?

(Fig. 1) Market-Implied 10-Year Core CPI* for G10 Countries (as of June 2021)



(Fig. 2) Price/Earnings (P/E) vs. Inflation (December 1978 to June 2021)



*Core Consumer Price Index (CPI) is the CPI excluding energy and food prices.
**Line represents the market-implied inflation expectations for the next 10 years.
Sources: Bloomberg Finance L.P./Haver Analytics. Russell. See Additional Disclosures. T. Rowe Price analysis using data from FactSet Research Systems Inc. See Additional Disclosures.

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