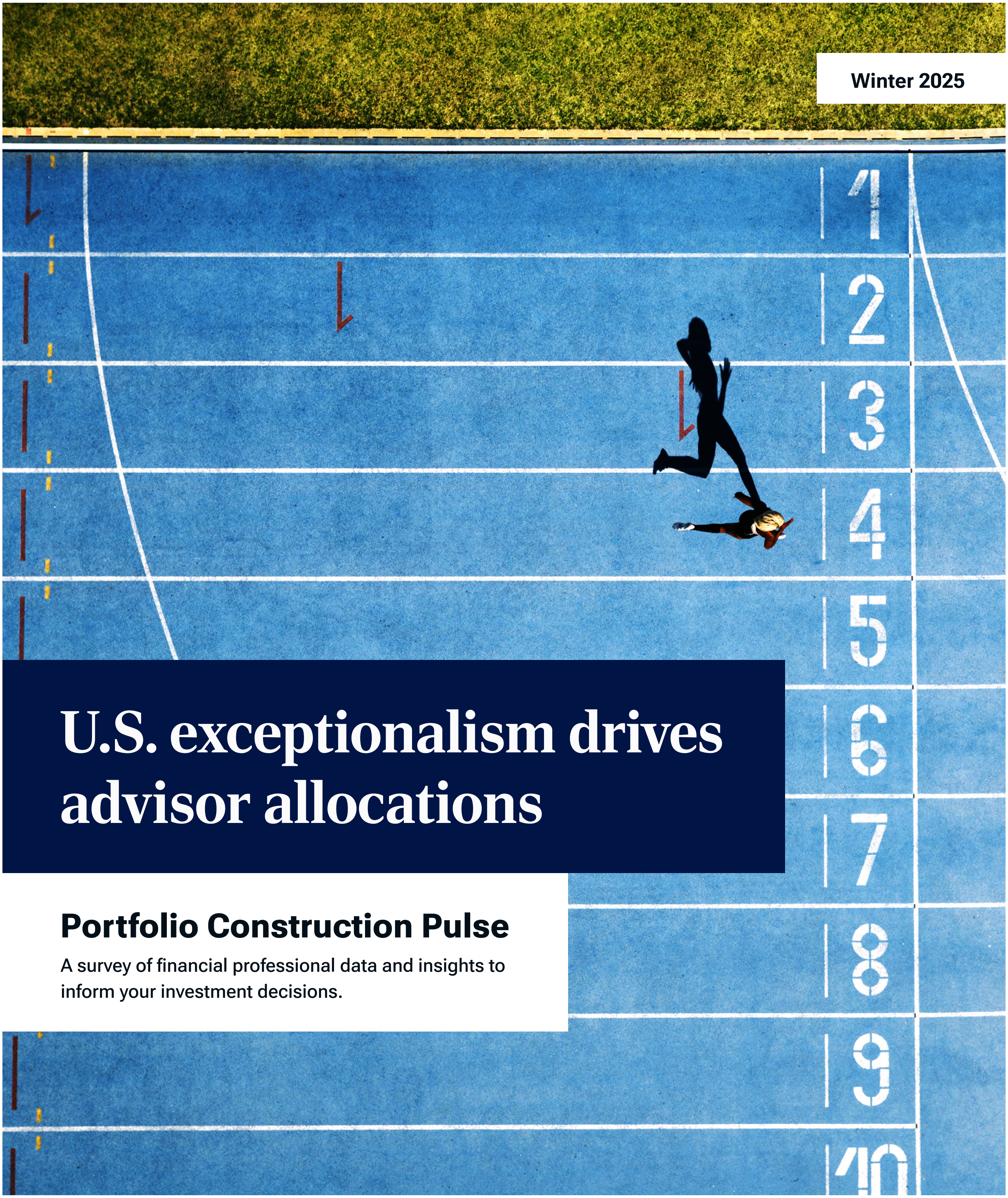
T. Rowe Price



Winter 2025

U.S. exceptionalism drives advisor allocations

Portfolio Construction Pulse

A survey of financial professional data and insights to inform your investment decisions.

Advisors tended to position capital where it performed best in 2024. The S&P 500 Index was a standout performer as themes involving U.S. exceptionalism and artificial intelligence (AI) drove many allocation decisions. In fact, the S&P 500's 25% annual return was over 21 percentage points higher than the MSCI EAFE Index, a common measure of international equities. Perhaps not surprisingly, we observed large shifts toward U.S. stocks in moderate allocation models, with a reduction in international exposure. We also saw a shift toward large-cap blend equity strategies at the expense of large-cap value, small-cap, and mid-cap holdings. Policy priorities are top of mind for advisors as they rethink their fixed income allocations. Advisors tended to adjust with more flexible mandates and also moved cash from the sidelines into shorter-duration mandates. We expect 2025 to be a year of transition, marked by a broadening of investment opportunities combined with potential risks.

Positioning Highlights

Asset Allocation: Pivoting in the face of policy changes

- Advisors pivoted away from performance-challenged areas and meaningfully increased their large-cap U.S. exposure. Inflation hedges were reduced, with commodity-related holdings dropping. Within fixed income, advisors moved to more flexible multi-sector and ultrashort mandates, while they cut back from core-plus and cash holdings. In the face of greater uncertainty around policies and interest rates, we saw an uptick in flexible strategy usage. This includes multi-sector bond within fixed income and both defined outcome and multi-strategy funds within alternative allocations.

Equities: U.S. exceptionalism gathers steam

- **U.S.:** Earnings growth, fiscal spending, solid economic growth, and AI-led capital spending and innovation continued to fuel performance and interest in U.S. stocks. Large-caps gained 3.6% in advisor models, led by large-cap blend stocks. Large- and mid-cap value lost share in models.
- **Sectors:** At a high level, we saw reduced interest in sector-specific allocations. Inflation hedges were reduced, with natural resources and energy allocations losing share. Better-performing sectors, including technology, industrials, financials, and communications, saw increased chance of usage in models.
- **International:** International stocks fell further out of favor. We saw a 1.8% drop in share in moderate allocation models, with international accounting for 19.9% of total equity. Large-cap value saw the largest drop, while small- and mid-cap strategies also decreased. Allocations to global growth mandates increased by 0.9%, while emerging markets saw the largest gains with a 2.2% increase in allocation.

Fixed Income: Policy uncertainty leads to a shift to multi-sector and ultrashort allocations

- The Federal Reserve closed the year with a market-moving meeting on December 18, 2024, lowering expectations for the number of interest rate cuts in 2025. The fed funds rate finished the year at 4.5% after 100 basis points of interest rate cuts. (A basis point is equal to 1/100 of a percentage point.)
- While there was notable progress on the inflation front in 2024, inflation closed the year at 3.3% on the core consumer price index (CPI) and 2.7% for headline CPI. There was also greater advisor concern around deficit spending levels.

- Policy uncertainty surrounding the economy, interest rates, and elections drove advisor use of flexible multi-sector mandates, with the category increasing by 2.0%. Core-plus mandates were cut by 1.6%, and cash dropped by 1.4%. Some of of this money found its way into ultrashort mandates, which gained 1.0% of share in advisor models.
- Duration extended in typical advisor models, finishing the year at 4.84 versus 4.67 at the end of 2023.

Alternatives: Inflation hedges reduced while defined outcome gains favor

- Allocations to inflation hedges fell as inflation returned to more normal levels between 2 and 3%. Real assets saw the largest drop within alternatives, led by a 4% cut to natural resources and a 1.4% reduction in commodity allocations. The one bright spot within this category was infrastructure.
- Exposure to systematic trend-following strategies fell by 4.7% as their potential for negative equity correlation was out of favor.
- The hedged category continued to gain share, but in this edition of Portfolio Construction Pulse, the newly created defined outcome category was the biggest gainer. These products typically provide for more limited downside exposure in exchange for limited equity upside.

Outlook

Investment opportunities broaden:

- Performance definitively favored U.S. large-cap equities at the expense of more diversified equity portfolios. While small- and mid-cap stocks began to perform, a correction in December led to another year of underperformance. The gap between U.S. and international equities was particularly wide at over 21 percentage points.
- We look for a broadening in the investment opportunity set against the backdrop of elevated starting valuations. A strong economy and increased earnings estimates support the theme of broadening investment opportunities highlighted in our global market outlook. Areas of opportunity include industrials, financials, and energy investment at the sector level and value and small- and mid-cap equities at the portfolio level.

U.S. exceptionalism expands:

- U.S. economic outperformance has been notable with AI-related capital spending and innovation, fiscal spending, and monetary policy supporting robust gross domestic product growth and fueling increased equity earnings. Service sectors continued to strengthen into the year's end. This strength is particularly noteworthy given the divergence with other developed economies as well the challenges in China.
- The labor market has normalized, and our economist is looking for job creation to slow into 2025. Key risks to the outlook include tariff policy, a reversal in inflation progress toward 2%, and fiscal spending levels that upset fixed income markets.

Focus on fixed income:

- Fixed income has proven challenging; however, we saw very solid credit performance in 2024 with high yield corporate bonds and bank loans both up 8.1% on the year. The Bloomberg U.S. Aggregate Index was more muted with a modest 1.4% return.
- Advisors positioned away from core-plus with a 1.6% reduction. They also put cash to work with a 1.4% cut and partially allocated this to ultrashort positions, which gained 1.0%. Flexible multi-sector mandates were the biggest addition with a 2.0% gain.
- Despite tight spreads, T. Rowe Price continues to favor high yield bonds and bank loans given the robust economic backdrop combined with attractive yields. Our multi-asset team also continues to be moderately underweight duration. Policy priorities and their impacts will be closely followed. Tariff policies, a slowing in Federal Reserve rate cuts, and fiscal deficits are just a few areas likely to receive greater scrutiny in 2025.