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Investment Conference - Post Event Summary

What will the aftershock bring?

Investment markets and the broader global economy have shown surprising resilience this year, following the extremely harsh environment encountered in 2022. However, while interest rate hikes may have peaked in many developed markets, and inflation continues to gradually decline, numerous clouds of uncertainty still hover overhead.

One thing is for sure, after experiencing seismic economic and market change over the past 12 months, investors need to be prepared for a regime vastly different to what was witnessed following the global financial crisis.

To help make sense of this change, as well as share ideas for navigating through what could be continued choppy waters, a number of investment professionals from across T. Rowe Price's global platform assembled for the annual Investment Conference in Frankfurt and London at the end of September.

See below for a recap of the Investment Conference's primary presentations, which provide insights into the current global economy picture, and the risks and opportunities for active managers across bond and equity markets.

Global Market Outlook: Finding the signal through the noise

Justin Thomson
Head of International Equity and CIO
T. Rowe Price

Arif Husain
Head of International Fixed Income and CIO
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Justin Thomson, Head of International Equity and CIO, and Arif Husain, Head of International Fixed Income and CIO, discuss the paradigm shift the global economy has recently witnessed, as well as how investors can navigate through the distorted macro signals.

Arif Husain: As a fixed income investor, it is my job to be bearish. However, far from being a permabear, my concerns today surround the evolution of the consensus view. The pessimism we witnessed at the beginning of the year has completely flipped and a soft landing is now consensus. But a soft landing is simply a fairytale, and a hard landing is inevitable – it is just a matter of when.

Justin Thomson: While financial conditions are tightening and there are other brakes – such as higher yields and increasing energy prices – I do not have a bearish narrative when it comes to equity markets. One dominant narrative for markets has surrounded generative AI – where the big players continue to get bigger. There is an arms race to acquire capability - we believe we are still early in the hype cycle. Like in the dotcom bubble, this market is going to resemble a cappuccino – a lot of froth on top but something strong underneath. It will be important to responsibly navigate between the winners and losers.

AH: If we look at monetary policy, we are likely witnessing policy mistakes in some parts of the world. After the global financial crisis, we spent a decade not talking about inflation, like it did not exist. We have now spent the last two years talking only about inflation. The view in 2022 was that it was a horrible sprint race, but what happens if it was not a sprint and is now a relay? The baton of volatility is being handed from the short end of the curve to the long end. We are moving from QE to QT, the major buyers of bonds have stopped, and government across the world will have a lot of debt to sell in the coming years. This is going to place immense pressure on the long end of the curve. Fixed income is not yet back – unless you are investing at the short end, particularly in high-quality corporate credit out to five years.

JT: Another major market narrative currently surrounds China. I recently visited the country for the first time since 2019 and it was encouraging speaking to companies. The macro picture is likely weaker than government statistics show and there is a clear consumer confidence gap, which is understandable given 70% of Chinese wealth is tied to property. China is going through structural change and needs a new growth model. When investing in China in the past, we liked to say that the macro was good, while the micro was disappointing. This has now reversed. China has been sold off aggressively by investors and almost every EM manager in the market is underweight. However, I am a careful contrarian when it comes to China, and with over 6000 stocks, there are selective idiosyncratic opportunities.

Emerging Markets: Old problems, new ideas

Samy Muaddi
Head of Emerging Market Fixed Income
T. Rowe Price

Ernest Yeung
Portfolio Manager of the Emerging Markets Discovery Equity strategy
T. Rowe Price

Samy Muaddi, Head of Emerging Market Fixed Income, and Ernest Yeung, Portfolio Manager of the Emerging Markets Discovery Equity strategy, highlight the current state of play in the developing world, and how best to capitalise on opportunities within this diverse – and currently unloved – region.

Samy Muaddi: When we mention 'old problems' for sovereign debt, these are incredibly old problems, with 200 years of history in international finance. Put simply, a government does not generate enough tax revenue to pay back its debt, and it needs to refinance. What we look for are anchors for a country's profile allowing it to continue accessing the bond market – namely fiscal risk, external monetary considerations, and political and institutional instability. There are about 10 countries that have defaulted this cycle and are going through a debt restructuring. The silver lining here is that we know how to manage around this.

Ernest Yeung: The golden years of emerging markets (EM) investing were between 2000 to 2010, with markets rising strongly in most years. However, the following decade was incredibly poor, with EM lagging behind other regions. All the wealth created from 2010 to

2020 was downstream in developed markets - sectors like Services and Technology, with offshoring and the quick flow of cheap goods coming from China and Asia. But there is significant risk in the supply chain today, post Ukraine to 2010 `golden years'. Perhaps the bargaining power and wealth creation will return to the upstream and midstream once again - sectors like commodities and industrials will need to continue digging for copper and drilling for oil and we could see more onshoring – EM will also benefit should the supply chains for goods move to places like Mexico and Hungary, for example.

SM: In terms of allocations, most investors are still engaging with EMD in a relatively antiquated fashion. Positioning preferences have not evolved for decades, as EMD allocations continue to have a strong ballast in sovereign debt, with some satellite exposure in corporate debt or local debt markets. This is completely backwards. By any measure of risk – credit rating, volatility, or drawdown – there is a higher probability of success in compounding interest within corporate debt, relative to sovereigns. Corporates should therefore be the ballast, with sovereign debt as the satellite.

EY: Naturally, China features in the majority of headlines when it comes to EM. Unlike many of my peers, who have heavily reduced positions, I am neutral in terms of China. I understand the structural concerns, but I have followed this market for two decades and understand China is a command economy – the authorities can orchestrate a rally at any time. It is incredibly easy to be bearish, but China can also easily go up 50%.

Positioning for change within a new global equity era

David Eiswert
Portfolio Manager of the Global Focused Growth Equity strategy
T. Rowe Price

David Eiswert, Portfolio Manager of the Global Focused Growth Equity strategy, explains how his investment framework is constantly adapting to the challenges of change.

While we continue to see innovation and disruption as a source of extreme positive outcomes, especially in healthcare and technology, in the new equilibrium, we will see growth redistributed across industries. Pricing power and monetisation in the present will take on more significance for corporates and investors alike, especially in a less forgiving financing environment.

We believe we are starting to see the emergence of key data points that imply we may be in the early stages of a new equilibrium path. A new path that will influence investor outcomes and impair the rule book of the low growth-low inflation world that defined the period of `secular stagnation' post the global financial crisis (GFC).

One of the conundrums facing economists and many investors relates to why equity markets have recovered in the face of the fastest rate hike cycle in history, a hike cycle implemented explicitly to create a recession. Instead of recession, the US economy remains stubbornly healthy.

The reality is that without a credit cycle, it has proved to be very challenging to create a hard landing and a permanent impairment of the inflation feedback loop, critically because of the influence of Covid on balance sheets. Covid and the extreme stimulus it necessitated may have broken the rule book. The nature of stimulus and negative interest rates have afforded US consumers the ability to refinance mortgages at incredibly attractive rates, while corporates entered and exited Covid with low leverage. This has meant an absence of refinancing and in turn, the absence of a default cycle.

In the same way that low inflation led to low inflation after the 2008 crisis, the Covid crisis in combination with military conflict is leading to a different path where inflation is creating inflation. This is being born out across the economy as higher wages, distribution costs, and commodity prices are all feeding into an inflation cycle that is supportive of interest rate levels, even as monetary policy has tightened aggressively.

The importance of a shift in regime is profound in many dimensions. When considering the implications of the GFC to Covid equilibrium, ownership of long-duration assets was a high efficacy strategy, with low borrowing costs enabling innovation, disruption and in many cases, consistent multiple expansion for emerging growth stars.

The end of secular stagnation and with it, the Fed cutting rates with positive consequences for ever-expanding equity multiples, may be uncomfortable as a concept for some. However, we are comfortable being uncomfortable and will continue to look for improving economic returns wherever they evolve in this environment.

Generative Artificial Intelligence - The most important innovation since electricity?

Dom Rizzo
Portfolio Manager of the Global Technology Equity strategy
T. Rowe Price

Dom Rizzo, Portfolio Manager of the Global Technology Equity strategy, believes generative AI will be a major productivity enhancer for the global economy and highlights how investors can navigate through this evolving space.

Research into artificial intelligence (AI) has been undertaken for decades, with initial papers on the subject written in the 1950s. However, the step function change occurred with the launch of ChatGPT last November.

The old saying 'finding a needle in a haystack' is a good analogy for AI. Here, AI is the metal detector, and it looks at all the haystacks to determine where the needle is most likely to be. AI can study data sets across different technologies and then predict the next token – which could be a biological drug discovery or a potential cybersecurity threat. This is why we hold conviction in the statement AI will be the most significant productivity enhancement for the global economy since electricity.

Our investment framework has four core components. First, we are looking to identify 'linchpin' technologies – companies critical to the success of their customers or make the lives of their users better. Second, we seek companies taking share in fast-growing secular markets. Third, we need to see improving fundamentals. Lastly, the stocks must be trading on a reasonable valuation.

Nvidia is a good example of a linchpin. The moat Nvidia has created across its hardware, its software ecosystem, and its developer buy-in, has been truly incredible. The market for AI chips is set to go from $30bn in 2023 to $150bn by 2027, which highlights the strength of this secular growth market. As for valuation, the global technology index historically peaks at 27-28x earnings on a two-year forward view, but this is only at 22-23x today. Nvidia itself is trading at just 26-27x. It began the year trading at about 50x earnings, but its earnings estimates have since been revised up from $6 per share to $16.

Whenever we witness a major productivity cycle, a bubble will form – as seen from railroad mania through to the internet boom. Importantly, this is a cash flow-driven bubble – not a debt-driven bubble. Looking back to the dotcom bubble, highly levered companies were the drivers of the new technology build-out. Today, the leaders in advancing AI are some of the most cash-generative businesses in history.

Alongside the need for data is a second key component – distribution. This is required to quickly push out innovations into the ecosystem. The likes of Apple, Microsoft, Alphabet, Amazon, Meta and Nvidia are among the largest companies in the world for a reason – dominance in data and distribution. These companies control the core components for the step function change and productivity enhancements we will witness in the future.

Conclusion

The new economic regime is likely to look markedly different to what investors became accustomed to in the years following the global financial crisis. While this may bring more frequent bouts of volatility, it will also bring opportunity.

Just as there were clear winners of the largely benign backdrop of the prior decade, there will also be beneficiaries of this expected new world of higher inflation and elevated rates. While it may be too soon to know whether this change will herald a sustained reversal of fortune for previously unloved investment areas – such as emerging markets – it may be time to consider being a careful contrarian.

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