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GLOBAL ASSET ALLOCATION: THE VIEW FROM EUROPE

March 2021

MARKET INSIGHTS

As of 28 February 2021

Your Move, Mr. Powell?

After years of muted inflation, investors are becoming concerned as a massive amount of pent-up demand is expected to be unleashed as the economy reemerges in the coming months, bringing higher price pressures. The excess savings that consumers have accumulated over the past year, plus an additional near USD 1.9 trillion fiscal package on the way, could also lead to demand outstripping existing supply, placing upward pressure on prices. As inflation expectations have already breached the 2% threshold, investors are beginning to question the resolve of the Fed to hold monetary stimulus at current levels. So far, Fed Chairman Jerome Powell has repeatedly reiterated a dovish stance, stating that price pressures are likely to be mild and temporary. Until unemployment levels make significant strides toward the Fed's goals, an easy monetary policy appears to be staying in place. Currently, the bond market's recent rise in yields may already be containing inflation for the Fed; however, if rates continue to increase, the Fed may need to step in and take action to rein in longer-term rates.

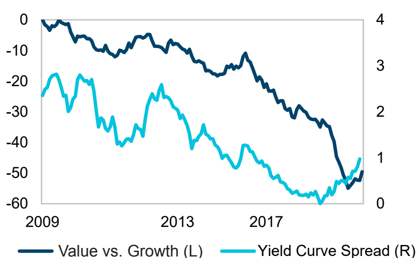
Yield Scare

The recent sharp spike in yields is scaring equity investors, who, this time last year, saw the 10-year Treasury yield dip below 1% for the first time. Although rising rates are often a sign of healthy economic growth and should benefit cyclical sectors, such as financials, energy and industrials, they may spell trouble for higher-growth sectors, like technology, that have benefited in an environment of scarce growth and low rates. The high-flying technology sector's extended valuations may become harder to justify amid rising rates. More broadly higher rates could impact borrowing costs for companies and weigh on certain sectors, such as housing, that have benefited from low rates. While historically we are far from yield levels that have negatively impacted stocks, what is unique today is that we are starting from a level of zero policy rates, high-equity valuation levels and the market dominance of technology and related sectors. A further rate rise could challenge broad markets as investors continue to rotate away from higher-growth stocks, such as technology, into more cyclically oriented sectors.

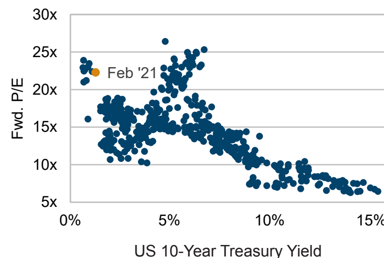
Pedal to the Metal

Commodity markets have climbed to their highest level since 2018 on hopes for a rebound in demand as the global economy reopens and travel resumes later this year. After collapsing in 2020 amid the pandemic-driven shock, oil prices have reached recent highs as demand has gradually recovered, and supply has not kept pace, partially due to supply cut agreements from OPEC+. Industrial metals such as copper have also been on a tear, further supported by a shift in focus toward renewable energy and electric vehicle technology. Some investors are suggesting that the commodity rally may have more durability as the worldwide push for cleaner, greener energy could keep upward pressure on commodities such as copper, platinum and lithium for years to come, many with limited supply. After years of underperformance, a new commodity supercycle could be emerging with cyclical and secular trends finally in their favour, particularly among industrial metals. As inflation expectations continue to rise amid evidence of increasing demand, real assets equities could be poised to outperform broader markets.

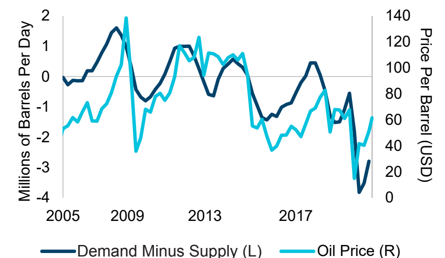
Value vs. Growth and Treasury Yield Spread[1]
As of 28 February 2021



Historical Stock Valuations vs. Interest Rates[2]
As of 28 February 2021



Oil Demand/Supply and Oil Prices[3]
As of 28 February 2021



Past performance is not a reliable indicator of future performance.

[1] Value represented by Russell 3000 Value Index. Growth represented by Russell 3000 Growth Index. Treasury yield spread represents the difference between the US 10-year and 2-year Treasury yields.
[2] Chart represented by monthly data from 31 December 1978 to 28 February 2021. Fwd. P/E represented by the Russell 1000 Index.
[3] Demand Minus Supply is based on 12-month averages. Oil price is represented by brent crude oil prices.
Sources: OECD/Haver Analytics, London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group") (see Additional Disclosure). T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

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	Positives	Negatives
Europe	▪ Higher exposure to more cyclically oriented sectors that should benefit from economic recovery ▪ Monetary and fiscal policy remains accommodative ▪ Equity valuations remain attractive relative to the US ▪ Stronger long-term euro outlook	▪ Vaccination effort facing supply shortages ▪ Limited long-term catalysts for growth ▪ Limited scope for European Central Bank (ECB) to stimulate further ▪ Brexit likely to negatively impact trade
United Kingdom	▪ Rapid vaccination means that the economy could return closer to normal by the autumn, potentially two to three months ahead of European Union countries ▪ Fiscal support for firms and workers continues to be extended during the second wave ▪ The prospect of negative rates has been pushed back by at least six months ▪ A Brexit deal has been achieved	▪ Brexit transition and third lockdown could continue to weigh on economic growth ▪ Demand risks from a delayed, but likely very large, fiscal consolidation remain ▪ Bank of England has already said negative policy rates remain a prospect should growth not materialise as forecast
United States	▪ More fiscal support on the way ▪ Vaccination rollout underway; COVID-19 cases falling ▪ Monetary policy remains very accommodative ▪ Healthy consumer balance sheets and high savings rate	▪ Elevated stock and bond valuations ▪ Corporate and government debt at high levels ▪ US dollar weakness continues ▪ Unemployment remains elevated

	Positives	Negatives
Japan	▪ Leading economic indicators are finally breaking through the expansion levels ▪ Domestic stocks are a global reflation play, with positive correlations to Purchasing Managers' Indices and bond yields, while solid earnings reports are confirming the global recovery ▪ The central bank should maintain its accommodative stance despite minor changes expected in March	▪ Equity markets reaching record highs could raise concerns from policymakers on potential financial risks ▪ Although COVID-19 cases have trended downward recently, the pandemic is still not yet under control and vaccine rollout has started relatively late ▪ The yen should appreciate, reducing companies' competitiveness and profitability
Asia Pacific ex-Japan	▪ Chinese economic growth remains solid, supported by strong exports and the potential for domestic consumption to follow through ▪ Demand for Chinese assets is expected to attract significant inflows, adding pressure on bond yields ▪ Australian economic momentum is firing on all cylinders, evidenced by the economic surprise index at record-high levels ▪ Australia's central bank was more dovish than expected, indicating that any policy normalisation may be a long way off	▪ Chinese economic momentum is showing early signs of having already peaked ▪ Tech dominance in the Chinese equity markets may be a headwind in the face of new regulations and a value rotation ▪ Early signs of inflationary pressures seen in Australian housing and construction markets ▪ Yields have risen, challenging the Reserve Bank of Australia's policies. Valuation gap between stocks and bonds is not as attractive anymore
Emerging Markets	▪ Exposure to cyclical areas of economy should benefit from broad global recovery ▪ Chinese economy remains strong ▪ US dollar weakness continues ▪ Equity valuations attractive relative to developed markets	▪ Stimulus from China likely to fade going forward ▪ Limited ability to enact fiscal stimulus (excluding China) ▪ Vaccine supply and distribution infrastructure are well behind developed markets

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EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 28 February 2021

Underweight — *Neutral* — *Overweight*

▼ or ▲ Month-Over-Month Change

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

		Underweight	Underweight	Neutral	Overweight	Overweight	
	Change						
ASSET CLASSES	Equities			■			Recovery in earnings and strengthening economic outlook supportive, but extended valuations are vulnerable to disruption of recovery timeline and higher rates.
	Bonds			■			Short-term yields remain anchored. Longer-term rates biased higher on stronger growth and inflation expectations. Yield scarcity supportive for credit, although limited upside to valuations.
	Region						
EQUITIES	US		■				Defensive, growth-oriented profile less supportive as cyclical sectors should benefit from improving outlook. Weak US dollar could be further headwind. Stimulus still providing a backstop.
	Europe ex-UK		■				Cyclically oriented sector profile and low valuations among financials are supportive. However, long-term catalysts are scarce, and vaccine supply issues remain problematic.
	UK				■		Vaccination pace is likely to lead to easing lockdown and strong real activity.
	Japan				■		Improving global trade outlook is a key driver. Refocus on reform efforts remains an important catalyst for improving productivity and attracting foreign capital.
	Developed Asia ex-Japan*			■			Valuations attractive relative to the US. Chinese stimulus and successful containment of virus are supportive. Export and commodity-driven economies face challenges.
	Emerging Markets				■		Exposure to global trade and rising commodity prices offer strong tailwinds. However, fading Chinese stimulus and limited vaccine supply and distribution pose challenges.
	Style						
	Global Equity Growth		■				Vulnerable to extended valuations, narrow leadership, political headwinds, rising rates and continued rotation toward cyclicals. However, longer-term secular trends remain favourable.
	Global Equity Value				■		Cyclical orientation could benefit from pent-up demand, economic improvement, higher rates and further fiscal stimulus. Valuations have increased but remain attractive on a relative basis.
	Capitalisation						
	Global Equity Large-Cap		■				Larger companies face challenging valuations, particularly in tech, and could lag as recovery advances. Second-half earnings comparisons will be challenging.
	Global Equity Small-Cap				■		Smaller companies should benefit most from unleashed pent-up demand and fiscal stimulus. However, valuations within small-cap growth have become challenging.

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* Includes Australia.

EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 28 February 2021

▼ or ▲ Month-Over-Month Change

	Asset Class	Change	*Underweight*	*Underweight*	*Neutral*	*Overweight*	*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.**
FIXED INCOME	Euro Government Bonds	▼	■					Bund will likely range trade for the next three months. Lower risks from Italy and a more cautious ECB will be balanced against lockdowns and outbreaks of new coronavirus variants.
	Euro Inflation Linked	▲				■		Inflation expectations remain benign, but inflation can surprise on the upside.
	Euro IG Corporates				■			Market technicals remain supportive, but there are still plenty of uncertainties around corporate fundamentals. Little value at current spreads, though ECB buying is supportive.
	US IG Aggregate			■				Nominal Treasury yields remain at low levels; potential for improving growth and additional fiscal stimulus could place upward pressure on yields.
	Global High Yield					■		Valuations less compelling, but relative yields remain attractive. Fundamentals broadly supportive on improving growth environment.
	EM Dollar Sovereigns				■			Sector offers attractive yield versus developed markets, but less compelling after rally. Concerns around capacity for additional fiscal support and vaccine distribution remain.
	EM Local Currency					■		Valuations remain modestly attractive after recent rally but could be vulnerable to rising rates.
	EM Corporates				■			The impact of the pandemic on the asset class is difficult to quantify, but the prospect of normalisation bodes well. Country-specific risks remain elevated.
CURRENCIES	EUR vs. USD				■			EUR vs. USD will likely range trade for the next three months. Lower risks from Italy and a more cautious ECB will be balanced against lockdowns and coronavirus outbreaks from new variants.
	EUR vs. JPY			■				The yen remains a safe-haven currency.

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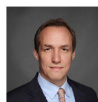

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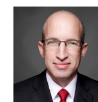

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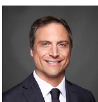

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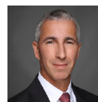

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