



PANORAMA

QUARTERLY THOUGHT LEADERSHIP PUBLICATION FOR OUR CLIENTS

THIRD QUARTER, 2021

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Sheldon Chan
Portfolio Manager, Asia Credit Strategy

WELCOME.....

.....to the third quarter 2021 edition of Panorama, T. Rowe Price's investment magazine for Asian investors.

Following a very strong first half for global equity markets in which the MSCI AC World index rose 12.3%, investors face several challenges in the second half of the year. Earnings have made a stellar recovery in all regions, though forecasts for CY2021 are no longer being upgraded. Economic data continue resilient, though the new Delta variant of COVID-19 has seen the return of lockdowns in some countries. Valuations appear rich, and in a few months' time the Fed is expected to begin to reduce or taper its asset purchases. But while a note of caution may be warranted, overall, we still regard the investment backdrop as favorable.

We begin this edition with an article from Hari Balkrishna who manages T. Rowe Price's Global Impact Equity Strategy. Impact investing aligns the interests of stakeholders, including shareholders, fiduciaries, and listed corporates, to pursue positive social or environmental outcomes. Hari considers the challenges in building, managing, and measuring an impact portfolio.

After a decade of underperformance, the 'Value' investing style is currently outperforming 'Growth.' T. Rowe Price's Global Multi-Asset team look at some of the reasons for the historical divergence in performance and explain why we are currently overweight Value in our multi-asset portfolios.

Turning to the U.S., the recent surge in inflation is creating considerable uncertainty for investors used to the low inflation/low interest rate landscape that has prevailed for decades. Taymour Tammadon, who manages T. Rowe Price's U.S. Large Cap Growth Equity strategy, discusses the challenges investors face.

Next, Ernest Yeung, who manages the Emerging Markets (EM) Discovery Strategy, argues that a significantly faster economic recovery than in 2009 after the Global Financial Crisis can provide underlying support for EM value stocks. The global transition to green energy is the type of fundamental change that he seeks to leverage in his emerging markets portfolio.

Irmak Surenkok, a Portfolio Specialist for Emerging Markets, considers how to construct a Chinese equities portfolio that seeks to exploit market inefficiencies and extract value from the entire universe of investible Chinese stocks. With China continuing to undergo enormous change, there are many factors to monitor in this massive and highly complex economy.

Lastly, in our Personal Profile interview we speak with Sheldon Chan, who manages of T. Rowe Price's Asian Credit Bond strategy based in Hong Kong. Sheldon discusses some of the strategy's key features, including ESG issues and green bonds.

As always, we welcome your comments and feedback and our contact details can be found on the back cover of the magazine.

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WHAT MAKES AN “IMPACT” INVESTMENT MANAGER?

Understanding the required foundation to build, manage, and measure an impact portfolio.

- Impact investing aligns the interests of stakeholders, including shareholders, fiduciaries, and listed corporates, to pursue positive social or environmental outcomes.
- It involves directing capital toward desired impact outcomes and integrates impact-oriented company engagement, proxy voting, and a commitment to actively influence via the ownership and engagement feedback loop.
- Impact measurement is a separate and more complex discipline than performance measurement, but we believe that businesses addressing social and environmental needs, with a defined and sustainable business model, put themselves in an advantaged position to meet required impact and return thresholds.

Impact investing brings a nonfinancial dimension to the investment process—a values-based approach that seeks positive environmental and/or social impact as part of distinct performance targets. While originally the domain of private investors, we believe the potential to capture and create impact in public equity markets has broadened tremendously over the past decade.



*Hari Balkrishna
Portfolio Manager,
Global Impact Equity Strategy*

While originally the domain of private investors, we believe the potential to capture and create impact in public equity markets has broadened tremendously over the past decade.

This is largely a function of a growing urgency and demand for solutions to the pressing needs of society. The willingness of investors to supply capital to those businesses recognizing these needs has in effect created the potential to invest for impact in public markets, with greater scale and liquidity and on a truly global basis. Within public equity markets, understanding impact fundamentals and how companies are contributing to positive outcomes is crucial for shaping a credible portfolio. Understanding traditional fundamentals, including valuation and the persistence and durability of a business, is also key to ensuring that a portfolio performs financially, while contributing to change an investor wants to evidence.

Here, Hari Balkrishna discusses the essential elements that underpin the materiality of impact within an investment strategy.

Q. Can public equity investing really make an impact on key environmental and social concerns, especially when compared with private investing?

I think public markets are essential to achieving the collective goals of society. In its purest form, supplying new capital to an entity that could not otherwise access capital to generate its intended positive impact is the origin of impact investing. While impact investing has deep roots in private capital and philanthropy, solving for today's elevated and global environmental and social pressure points demands a complementary approach. In public equity markets, this means understanding, addressing, and aligning the interests of stakeholders—including shareholders, fiduciaries, and listed corporates—to capture, accelerate, and pursue positive outcomes.

While we understand and have engaged in the private versus public capital argument, we disagree that impact investing is purely a private-equity market domain. This is in line with the Global Impact Investing Network's definition of impact investing, albeit within high standards of intentionality, materiality, measurement, and additionality, which are clearly stated as requirements to be an impact investor.

Supplying new equity or debt capital to businesses to accelerate their impact profile is one fundamental opportunity that should present itself within public equity markets, while additionality has clear roots in engagement with corporates to further the positive impact of a business.

Given the magnitude of the world's environmental and social challenges, we believe that private markets alone will not suffice to build the required solutions to

the very real and very complex friction points that exist for our planet and our global community. To match the magnitude of the issue with a magnitude of response, governments, capital owners, and asset managers must work together to incentivize and align listed businesses with better practices. Impact investing is one way to do this by adding a perspective into the investment process directed at the broader consequences of a business's operations.

While we are early in this journey, we truly believe that being on the right side of change with respect to the focus on the true impact of a business will be crucial within private-equity and public equity portfolios alike.

We aspire to be partner to our clients, using our full breadth of ideas to harvest both impact and alpha over the long term...

Q. How do you make a difference for clients as an impact investment manager?

We aspire to be a partner to our clients, using our full breadth of ideas to harvest both impact and alpha over the long term, while managing for risk, given challenging times, will invariably come to our natural habitat of investing.

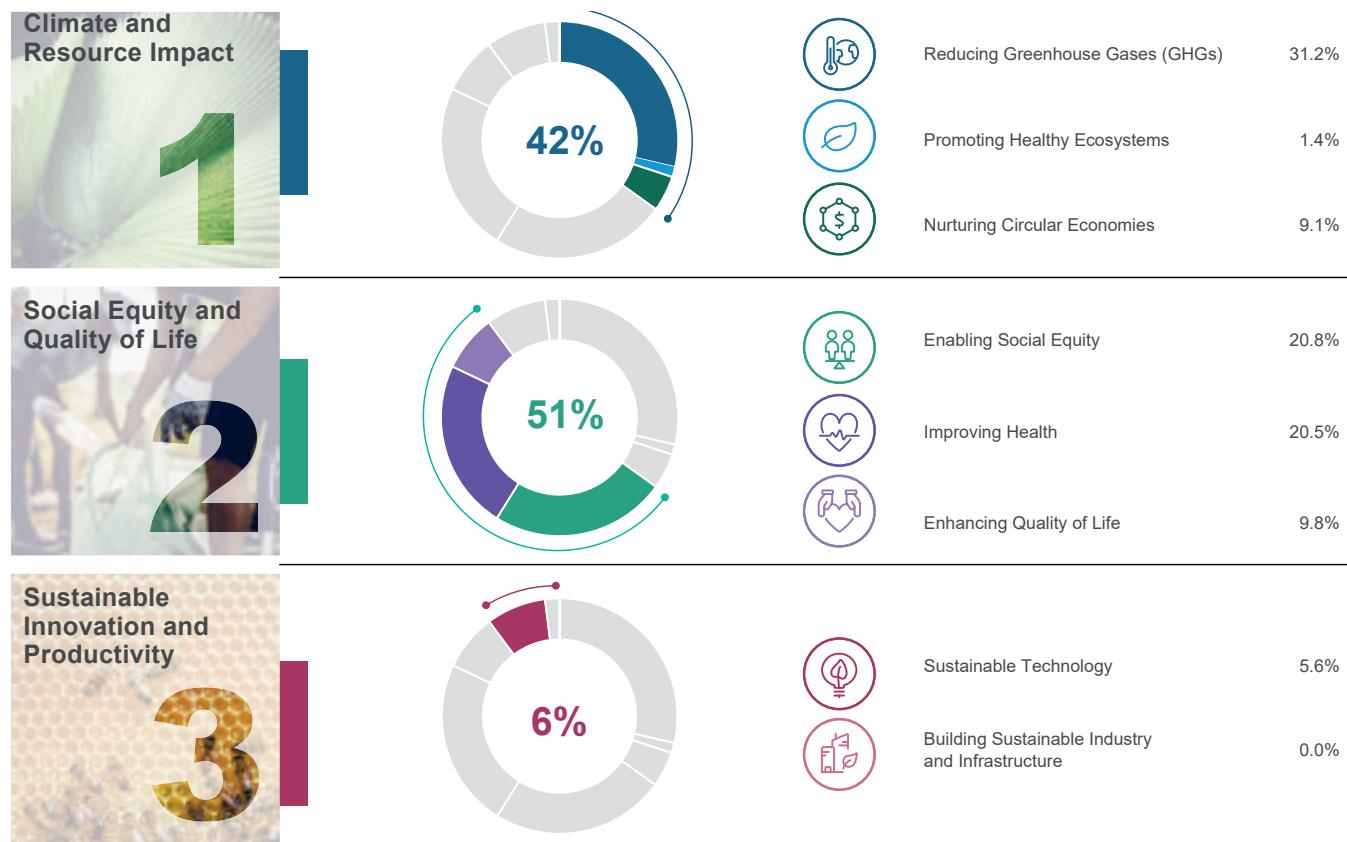
Impact investing has grown tremendously in recent years, and we do not believe there needs to be a sacrifice of return potential in order to implement a values-based approach. This is directly linked to how positive environmental and social outcomes are becoming more measurable, which in turn is being reflected in the economic potential of a business.

Part of my role as an impact investor is helping individuals and institutions make sense of what's happening in the world around us and how that could manifest into risks and opportunities within investment portfolios. For example, as the environmental costs of climate change accelerate, planning for the future and thinking about climate mitigation can genuinely help a company's bottom line.

As businesses become more conscious and active in aligning capital with the economic returns that can legitimately flow from addressing environmental or social tensions, I expect opportunities to grow. That is important because breadth is a key foundation of consistency and meeting the return objectives of impact investing. In short, we are in an era of growth with respect to the opportunity set of impact stocks.

FIGURE 1: Positioning by Impact Pillar and Sub-pillar

Global Impact Equity Representative Portfolio



As of 31 March, 2021. Numbers may not total due to rounding. The representative portfolio is an account in the composite we believe most closely reflects current portfolio management style for the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from those of other accounts in the strategy. Please see the GIPS® Composite Report for additional information on the composite. Source: T. Rowe Price uses a proprietary custom structure for impact pillar and sub-pillar classification. Cash weight was 1.65% as at 31 March, 2021.

However, in the same way that our environmental sustainability journey requires resilience, commitment, iteration, and imagination, so too will the journey of investing for impact, with a deep analysis and a long-term belief system acting as a core driver of decision-making.

Q. How does an investment manager contribute to positive impact?

Impact is achieved within an investment portfolio in more ways than simply owning and capturing the economics and activities of certain types of companies. It involves directing fresh capital toward desired impact outcomes, alongside impact-oriented company engagement, proxy voting, and the associated influence feedback loop.

As a starting point, it is important to screen companies from an impact lens for both materiality and measurability of the desired outcome. This requires an understanding of a business in the context of a

defined impact framework expressing clear principles and intentions and identifying businesses that are best in class. For us, this is driven by a combination of evaluating a company's current and future operations and the alignment of earnings or revenues with the United Nations Sustainable Development Goals (UN SDGs), with a holistic perspective on a business, using the five dimensions of impact framework.¹ We use the word "future" very deliberately, given the rapid evolution of many businesses and the need to look forward from the starting point of today's well-known and understood fundamentals.

Our investment process embeds clear principles of materiality and measurability and forms the basis for identifying positive impact for clients. However, we also aim to be additional in the outcomes we create and accelerate through engagement and voting.

As a truly global asset manager, we are ready to supply new capital to areas of target impact. We will also use

¹ Five dimensions of Impact Framework: We use the Five Dimensions of Impact framework to carry out impact due diligence of a given stock. This framework provides a comprehensive assessment of the impact of a company, which is analyzed across five dimensions: **What** outcome is occurring in the period?, **Who** experiences the outcome?, **How Much** of the outcome is occurring (scale, depth and duration)?, **Contribution**—would this change likely have happened anyway? and **Risk**—What is the risk to people and planet if impact does not occur as expected?



As a truly global asset manager, we are ready to supply new capital to areas of target impact.

our position of ownership to enter into dialogues with companies where we can see the potential to accelerate the good aspects of their operations, while helping to mitigate the negative externalities that naturally exist even in the purest of business operations. Change will take time and require resilience, but this is consistent with many aspects of successful long-term investing.

Q. How does your portfolio differ from the theme/factor of ESG, sustainability, or even impact?

It is important to distinguish that impact investing is not environmental, social, and governance (ESG) integration, and it is also a different discipline from sustainable investing. It does, however, incorporate both and also takes a step further. In any era of rapid change, it is important to blend an understanding of the historic factor of a company's impact with the future footprint of a business, in both impact and economic terms.

Impact investing in public equity markets lives in the same domain as other styles of investing. We do not believe there needs to be a sacrifice of return potential, and we believe the opportunity set is unrecognizable from a decade ago. However, impact investing backed by stock-picking outcomes requires equal if not greater levels of due diligence in research to avoid excessive concentration, crowding, and disappointment. In our view, a forward-looking perspective, a stable and expert research foundation, and a good level of imagination will be key features of successful investment processes.

We start at the bottom-up level in all we do, blending the best of our fundamental research with the impact insights created by our responsible investment team. Given the breadth of the opportunity set, we apply breadth of ownership, which originates from our global nature and global research capabilities.

We appreciate that many clients may wish to focus on certain themes within the spectrum of impact, but we believe there are benefits in a degree of breadth and long-time horizon that we provide. Ultimately, success will depend on expert knowledge of bottom-up stock fundamentals, including the next generation of impact-oriented private companies that are expected to come to market over the next decade.

To give more detail, we use a decision-making structure based on three impact pillars (Climate and Resource Impact, Social Equity and Quality of Life,

and Sustainable Innovation and Productivity) and eight sub-pillars, so we can maintain breadth of impact and objectively manage position size. This approach is one of the stages we undertake in impact assessment, in this case identifying current and future revenue alignment with the desired future impact we are targeting. We believe looking forward is one of the key components that differentiates an index with a future outcome, a crucial aspect of successful impact investing.

Aside from the decision-making framework, we are also very conscious of the need to openly communicate stock selection decisions and impact outcomes to our clients. By looking at a portfolio through the lens of a business's operations and alignment with the UN SDGs, our approach goes some way to redefining the portfolio along the lines of impact we are seeking to capture, and clients desire evidence of that.

Q. How do you approach the challenge of data and measurement in the impact sphere?

With a forward-looking perspective and a combination of aggregate analysis where it makes sense, along with individual and holistic analysis where it does not. To be clear, data to measure impact today remain incomplete, while common standards of impact measurement have not been developed on a par with performance/returns analysis. This makes impact measurement inescapably complex.

In an environmental dimension, we are seeing strong and positive change in disclosure that is allowing for better measurement of environmental impact. In a social dimension, our key communication tool will need to focus on singular impact intentions and outcomes versus those intentions, in both discreet and compounded time horizons. The mechanism of any good impact manager to communicate successes and failures will be through the annual impact report attaching to any strategy.



The challenge for the industry is that impact investing lives in a complex world of risk and opportunity—one of great change and disruption.

Any system that relies solely on historic data is only part of the perspective you need to measure and capture impact. This is, at times, a strong debating point because evidence is important in the field of impact investing, as clients invest based on values they expect to be upheld.

The challenge for the industry is that impact investing lives in a complex world of risk and opportunity—one

of great change and disruption. The solution for us is to be a good partner and contribute to innovation in the field of impact measurement and reporting, helping clients navigate this journey with the data and trust they need. Leveraging multiple dimensions of our

research expertise (both responsible and fundamental) while investing for clients in the field of responsible investing and impact reporting will, we believe, be a real advantage over the long term. ■



HOW FAR ARE WE IN THIS VALUE ROTATION?

A quantitative perspective

- The Value style of investing 'caught a bid' after encouraging vaccine news from Pfizer last November. Since then, the Value style dramatically outperformed the Growth style.
- This came after a decade of underperformance. The extreme divergence in performance between the two styles before this rotation suggests it was long overdue.
- Our quantitative analysis suggests Value rotation may continue for another 6 to 12 months. We maintain an overweight to Value within our Multi-Asset portfolios.

At T. Rowe Price, our global multi-asset portfolios start from a diversified position between the Value and Growth investment styles. We deviate from the neutral position based on our tactical asset allocation views for the next 6 to 18 months. These views are defined using a wide range of quantitative and qualitative inputs. For the first time in about 10 years, we began to overweight Value versus Growth in September 2020. Since then, the Value style outperformed the Growth style significantly. One way to measure this rotation from Growth to Value is to look at the short-term divergence of factor returns. We define a factor portfolio for Value and Growth as a long-short portfolio (Please see p.9): the long position is the top quintile of stocks representing the factor and the short position is the bottom quintile of stocks representing the factor.



Thomas Poullaouec
Head of Multi-Asset Solutions,
APAC



Nathan Wang
Solutions Analyst, Multi-Asset
Solutions, APAC

...we began to overweight Value versus Growth in September 2020.

Strong reversal in Style factor return in the past 6 months.

In Figure 1, we calculate rolling 6-month factor returns for both Value and Growth. We compare the most recent 6-month return with all of the previous 6-month rolling returns since December 2002 (close to 20 years of history). We show the percentile, i.e. how the latest data compare with 220 previous periods of rolling 6 month returns.

This figure shows how extreme the rotation has been in the past 6 months. Basically, the 6-month return ending in September 2020 for Value was among the lowest 3% of 6-month returns for that factor since 2002, while it was the 97% highest return for Growth. The following 6-months delivered a completely opposite result: as of March 31st 2021, the latest 6-month return for the Value factor was amongst the best it has ever been since 2002 (99th percentile), while the latest 6-month return for Growth was amongst the worst ever (0.4 percentile).

A natural question for investors to ask now is: Has the Value rotation already run its course? Or is there still some fuel left in the Value tank?

While our decision to overweight Value depends largely on fundamental reasons (vaccine rollout, economic reopening, pent up demand, earnings rebound, rising yields), we decided to highlight three quantitative reasons why the Value rotation is unlikely to be over.

DEFINITION OF VALUE AND GROWTH FACTORS

We Use the MSCI World Universe as the Neutral Portfolio in Our Analysis

Value: The return differential of undervalued stocks versus overvalued stocks

The Value composite is an equal-weighted average of the market-cap weighted factor performance of EV/EBITDA (Enterprise Value/Earnings Before Interest, Taxes, Depreciation and Amortization), EV/Sales (Enterprise Value/Sales), FCF Yield (Free Cash Flow Yield), Price/Book, and Price/Forward 12-Month EPS (Earnings Per Share).

Growth: The return differential of high growth stocks versus low growth stocks

The Growth composite is an equal-weighted average of the market-cap weighted factor performance of Forward 2-year EPS Growth, Forward 2-year Sales Growth, Trailing 12-Month EPS Growth, and Trailing 12-Month Sales Growth.

...we decided to highlight three quantitative reasons why the Value rotation is unlikely to be over.

Reason #1 – the Valuation Divergence Remains Extreme

Beside the return, we can also calculate how expensive or cheap each stock is within each factor quintile. In Figure 2, we use the P/E ratio of each stock. We then calculate the difference between the average P/E of the top stock quintile minus the bottom stock quintile for each factor.

Let's focus on the Value factor first. It is well understood that the difference of the average P/E ratio between the cheapest stocks (top quintile) and the most expensive stocks (bottom quintile) would always be negative. From 2002 to 2017, we found that this difference has been in a range of between -10 to -15 in terms of the average P/E difference. Since 2018, this difference has widened significantly to reach a bottom at the end of 2020 around -40. This means that the difference in valuation between cheap and expensive stocks has never been that acute since 2002 when our sample begins. Despite the recent rebound in performance for Value stocks, the difference between styles remains elevated because the expensive stocks got more expensive at the same time. We believe there is room for this divergence in valuation to further mean revert. This would in turn support the Value factor as their average P/E would start to catch up with that of the most expensive (Growth) stocks. Hence, the Value style could benefit from both a rebound in earnings as well as an increase in P/E multiples. Both of which would be additive to their future returns.

....the Value style could benefit from both a rebound in earnings as well as an increase in P/E multiples.

From the same chart, it is also interesting to note that it is only in the last two years that there has been a difference in valuation between the top quintile of growth stocks and the bottom quintile of growth stocks. It used to be that their valuation difference was close to zero on average. Since 2018, however, a valuation premium has emerged in the top quintile of growth stocks. There is room for this divergence to also mean revert towards zero. Growth investors in this case should avoid the most expensive growth

FIGURE 1: A Record Swing from Growth to Value

Factor Return Percentile – 6-month rolling basis

31 Dec 2002 to 31 Mar 2021



Past performance is not a reliable indicator of future performance.

As of 31 March 2021.

Sources: Bloomberg Finance L.P. Analysis by T. Rowe Price.

stocks and rotate back to the growth stocks with the cheapest attribute. Separately, we noticed that among US large cap stocks, more than 30% currently have a P/E ratio that is higher than 50¹. This number has not been that high since the tech bubble in 2000/2001. Either the P has to come down or the E has to grow as this level of P/E doesn't look sustainable if history is any guide.

... the monetary impulse seems to lead the Value/Growth return by about 16 months.

Reason #2 – Follow the Money

Our research finds that monetary impulse is a lead indicator for certain financial market returns. For example, the monetary impulse seems to lead the Value/Growth return by about 16 months.

In Figure 3, we plot two data series. The shaded area is the monetary impulse of five large economies (US, EU, UK, Japan, and China) expressed as a

percentage of their GDP. The green line is the 12-month rolling return of the MSCI World Value vs the MSCI World Growth indices, with a 16-month lag.

From Figure 3, it seems that an increase in the monetary impulse leads an outperformance of Value over Growth. From 2003 to 2019, the variations in these two data series have been in the +/-10% range. It's interesting to note that the monetary impulse which started in late 2019, and which was greatly amplified by the response to the COVID crisis in 2020, completely outpaced previous impulse episodes: the year-on-year growth is in the 30% range. At the same time, the magnitude of underperformance of Value versus Growth was unprecedented with a low of close to -40% in Q3 2020².

.... we could expect the Value versus Growth 12-month return to reach at least 10% in the coming months....

Since then, the 12-month rolling return of Value versus Growth recovered sharply, following the sharp rebound in monetary impulse by 16 months. At -10% as of March 31 2021, it is only now catching up with the lower band of the historical range. If history is any guide, we could expect the Value versus Growth 12-month return to reach at least 10% in the coming months and even exceed that threshold given the unprecedented magnitude of the monetary impulse in 2020. On this metric, we can argue that the Value rotation is perhaps only half way through.

Reason #3 – How About Rising Yields?

The most heated debate in financial markets these days is arguably over the inflation outlook. A rise in

FIGURE 2: Valuation Spreads Between Top and Bottom Quintiles

Average P/E ratio spread for the Growth and Value factors

30 June 2002 to 31 March 2021



Past performance is not a reliable indicator of future performance.

As of 31 March 2021.

Sources: Bloomberg Finance L.P. Analysis by T. Rowe Price. See p.9 for factor definitions.

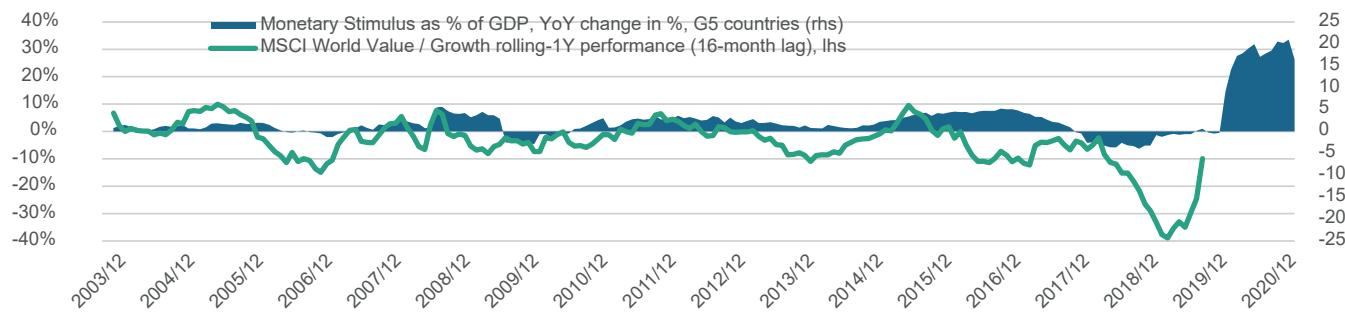
¹ Analysis by Empirical Research Partners, as at mid-April 2021. Share of large-cap stocks with trailing P/E ratios of 50x or greater, including companies with negative trailing earnings. Large cap universe defined as the largest 750 stocks in the U.S. by market cap plus S&P 500 constituents that do not meet the cap cutoff.

² Remember that the data series on the chart is lagged by 16 months.

FIGURE 3: Record Stimulus Implies Value Rotation Can Continue

Monetary stimulus & Value/Growth performance

31 December 2003 to 31 March 2021



As at 31 March 2021.

Past performance is not a reliable indicator of future performance.

Source: Bloomberg L.P. Analysis by T. Rowe Price.

Monetary stimulus is defined by the sum of the aggregated dollar amount of G5 Central Banks balance sheets (US, EU, UK, Japan, China) and the credit impulse in US, Euro, China, divided by the aggregated GDP of the same G5 economies. We show the YoY change.

inflation expectations has implications for the yield environment, future monetary policy, and market sentiment.

Not only will inflation and interest rates drive risk-on versus risk-off sentiment more than usual, but they will also drive the recovery trade as reflected in the returns of Value versus Growth. To get the rates regime call right, we must separate the nominal rate into the real rate and inflation expectations. These two components often move in opposite directions because they can react differently to the macro environment. Inflation may be more sensitive to

commodity prices, supply and demand bottlenecks or currency depreciation. Real rates are more likely to be reacting to growth expectations.

We can decompose previous market periods or regimes depending on the inflation and the real rate changes. For example, if both are positive as in the current environment, we define this as being “mid-cycle”. On the contrary, if both are dropping, we define this as a recession environment. In Figure 4, we use US inflation and real rates data to define regimes, and look at weekly returns of Value versus Growth.

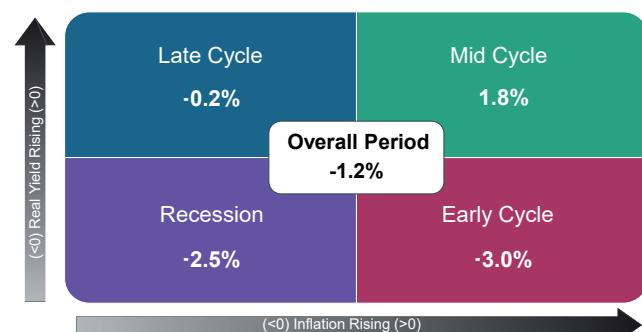
Over the reference period, Value underperformed Growth on average. But the only periods when Value outperformed Growth was during weeks where both inflation and real rates changes were positive at the same time: this is the Mid Cycle regime on the top right. We believe this is the environment we are most likely to be in for the next 6 to 12 months as both inflation and growth expectations get reset higher as the global economy recovers from the pandemic. This scenario justifies maintaining an overweight to Value if one expects inflation and real rates to increase in the near future. ■

FIGURE 4: Value Outperformed When Inflation And Real Yields Rose

Returns of Value vs. Growth conditioned on Real Rate/Inflation Regime

Average Annualized Weekly Returns, 5 Jan 2001 to 16 April 2021.

Inflation and real yields used to determine the regime are measured weekly.



Past performance is not a reliable indicator of future performance.

Sources: Bloomberg L.P. Analysis by T. Rowe Price. Inflation uses the US Breakeven Inflation Index. Real Yield uses the Generic Inflation Indexed United States 10Y Government Bond Index.

Value is the MSCI World Value Index and Growth is the MSCI World Growth Index. The names of the cycles are using market conventions.

We calculate the weekly returns of the difference between Value and Growth. Each weekly return difference is annualized and then the figures are averaged. Weekly figures are annualized to more readily understand the potential impact of inflation and interest rates on value vs. growth performance. The return shown is conditioned by each regime.

WHAT WE'RE WATCHING NEXT

There are solid fundamental reasons to tactically overweight Value versus Growth. In this study, we outline three quantitative reasons to support this view. Going forward, we will continue to monitor the divergence of valuation between cheap and expensive stocks, the monetary impulse and the changes in both inflation and real yields.



GROWTH STOCKS ULTIMATELY UNLIKELY TO BE TROUBLED BY SHORT-TERM INFLATION SPIKE

A Sharp Rise in U.S. Inflation is not Expected to Last

- The recent surge in U.S. inflation is creating uncertainty for investors used to the low inflation/low interest rate landscape that has prevailed for decades.
- For growth companies, in particular, high inflation, and the prospect of rising interest rates, poses a challenging near-term environment.
- However, we do not anticipate U.S. inflation remaining elevated, longer-term. As such, our positive outlook for growth companies remain unchanged.



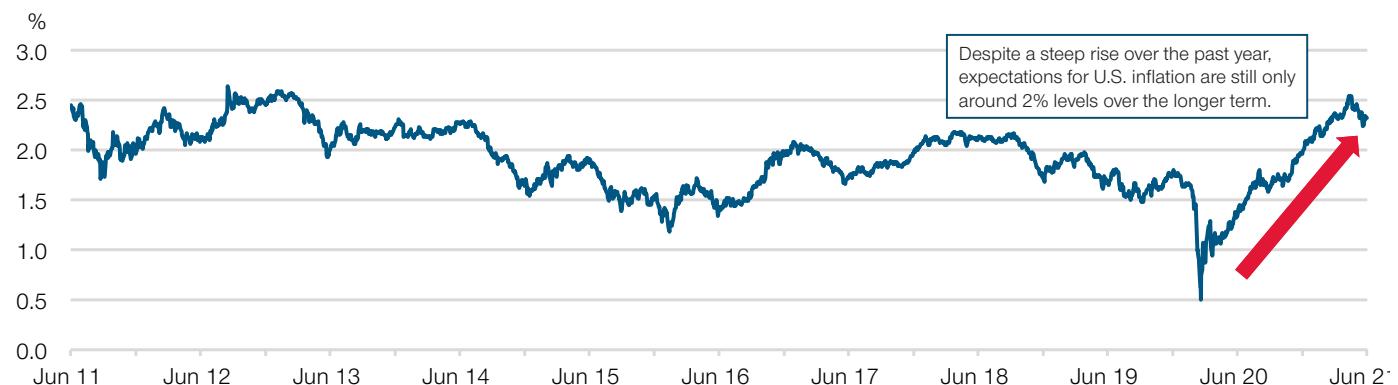
*Taymour Tammadon
Portfolio Manager
U.S. Large Cap Growth Equity strategy*

Optimism surrounding the nascent U.S. economic recovery, following one of the deepest downturns in history, has been tempered in recent months by a sharp rise in inflation. Annual CPI inflation in the U.S. soared to 5% in May – well above the Federal Reserve's 2% target – raising concerns that earlier than anticipated policy action might be necessary. This prospect has prompted a rise in equity market volatility, with growth-oriented stocks coming under particular pressure.

With the so-called “great rotation” from growth to value-oriented stocks already playing out in 2021, the emergence of inflationary pressure adds to a challenging near-term landscape for growth companies. However, we do not anticipate inflation remaining elevated for an extended time. As such, we maintain a positive view on the longer-term outlook for growth companies.

FIGURE 1: Longer-term U.S. Inflation Expectations Appear Well Anchored

10-Year Treasury Breakeven Inflation Rates



Source: Federal Reserve Bank of St. Louis. Data analysis by T. Rowe Price. The 10-year breakeven inflation rate is a measure of U.S. inflation expectations. It represents the difference in yield between 10-Year U.S. Treasury (Constant Maturity) Bonds and 10-Year U.S. Treasury Inflation-Indexed (Constant Maturity) Bonds. As of 30 June, 2021

The near-term challenge of inflation

The recent surge in U.S. inflation, to the highest levels since 2008, is an understandable source of uncertainty for investors that have grown accustomed to the low inflation/low interest rate landscape that has prevailed for two decades. For growth companies, the possibility of rising interest rates has particularly worrying implications as future cash flows would be discounted at a higher rate, impacting company valuations today. Indeed, the above-average valuation levels that growth-oriented companies have risen to today are a direct reflection of the fact that, for a long time, the value of future cash flows have been discounted at historically low interest rates.

5%

U.S. CPI Inflation in May 2021 – the highest level since 2008.

While it has surprised on the upside, the recent surge in U.S. inflation was not completely unexpected. This was always a risk once the government and central bank stimulus measures began to flow through to the economy as it progressively re-opened for business. Savings levels have risen during the pandemic, and as the roll-out of the coronavirus vaccine broadens to a greater proportion of the population, pent up demand is being released. We expect this higher trend inflation to continue over the next 12-18 months, before settling back around the Fed's target 2% level on a longer-term basis. This is not merely a random assumption, but what the financial markets are currently indicating. Importantly, the expectation that longer-term U.S. inflation will ultimately return

to more moderate levels, is central to our positive outlook for growth companies.

Why the rise in inflation is likely to be short lived

The belief that higher inflation will endure for longer is typically driven by the view that massive government and central bank stimulus, both in direct response to the coronavirus pandemic, as well as future spending plans recently announced by the Biden administration, will inevitably cause the U.S. economy to “run hot” for an extended period. However, a key element missing in such analysis is evidence of regime change, whereby a higher level of inflation becomes an embedded, secular trend, and, eventually, the new normal. Such regime change is rare; the current regime, for example, has been prevalent for more than 20 years.

A tightening labor market, leading to sustained wage inflation, is a principal driver of long-term regime change. The extreme upheaval generated by the pandemic over the past 18 months will have ramifications for the U.S. jobs market and overall employment levels. As to the extent of the impact, and over what timeframe, we will have to wait and see how things develop as the economic recovery broadens.

Longer-term inflation expectations remain anchored around 2%

Data on inflation expectations appear to support our view that the spike will be temporary. It does not appear that the markets are anticipating a sustained level of higher inflation. The 10-year breakeven inflation rate is a direct indication of U.S. inflation expectations over the next 10 years. The chart below shows a steep rise in the breakeven rate, from the lows of early 2020, which initially appears to be a significant shift. However, the breakeven rate has

merely moved back up to around 2% expected inflation – well below today's 5% level.

A similar message can be gleaned from the equity market. Given the severity of the market sell-off that occurred in the first quarter of 2020, the U.S. equity recovery has been nothing short of spectacular. While volatility has increased in recent months, the S&P 500 Index is up 14.4% year-to-date (as of 30 June 2021). It seems reasonable to assume that this recovery would not have been as rapid or robust if there were significant worries about inflation remaining at elevated levels, and potentially higher interest rates, on a longer-term basis.

Corporate Profits Have Recovered Strongly

At the corporate level, profits have also recovered well in recent quarters, having fallen sharply during the first quarter of 2020. The recovery has been helped in no small way by the substantial stimulus provided during the past 12 months. Clearly, this level of support cannot continue long term, so the all-important question is: how sustainable is the recent recovery in profits? In the near-term, at least, we are anticipating a sharp cyclical recovery in the U.S., and estimated GDP growth of around 6% p.a. as the recovery fully takes hold. The U.S. economy is not designed to expand at such a rapid pace, so there are questions around its durability. However, over the next 12-18 months, at least, we believe this growth should help underpin the ongoing recovery in corporate profits.

Growth to Reassert as the Value Reflation Trade Plays Out

The great rotation trade out of growth stocks into value is playing out in a significant way currently

as investors sell out of high-growth stocks, in favor of cheaply valued companies sensitive to economic recovery, in sectors like airlines, hotels and restaurants, and retailers. In an environment where U.S. GDP is expanding at such a rapid pace, we think that it is much easier for value stocks to grow, particularly from depressed valuation levels. This is encouraging investors to sell more expensive growth stocks. However, at some point, we believe the value reflation trade will play itself out and the long-term appeal of growth stocks, namely the ability to grow free cash flows over time, will reimpose itself. This may not be to the extent we have seen over the past 10 years, but the fundamental, disruptive, nature of growth stocks is undiminished.

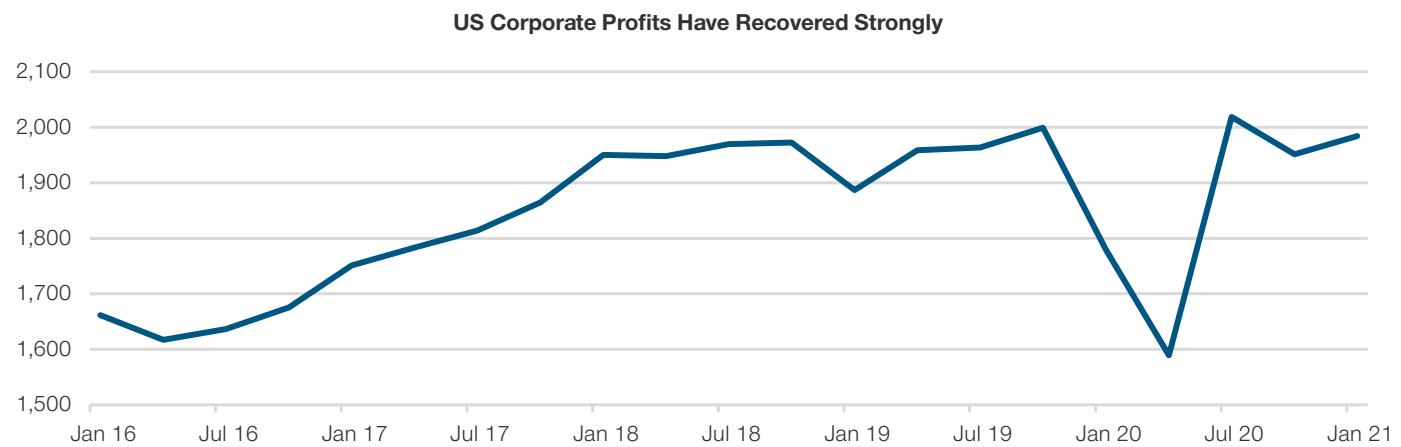
It is worth highlighting that the onset of the coronavirus pandemic has forced many growth companies to adapt their businesses, improve operationally, and provide better customer service. In 2020, for example, we saw the widespread adoption of e-commerce as people were forced to shop online.

...the onset of the coronavirus pandemic has forced many growth companies to adapt their businesses, improve operationally, and provide better customer service.

As a result, businesses like Amazon invested huge sums in streamlining operations and improving logistics, in order to provide better experiences for customers. Groceries was previously an area of Amazon's business that suffered from poor customer experience and over the past 12 months this has improved greatly. We expect to see more of this

FIGURE 2: Company Profits Have Recovered Strongly Since Early 2020

Quarterly U.S. Corporate Profits



Federal Reserve Bank of St. Louis. Data analysis by T. Rowe Price. Quarterly U.S. Corporate Profits After Tax, Seasonally Adjusted. As of 31 January 2021

reallocation of investment towards e-commerce, as well as digital advertising, during the second half of 2021.

The Appeal of U.S. Growth Companies is Fundamentally Unchanged

The principal appeal of growth companies is their ability to grow their free cash flow over time. This is an essential feature as it represents the surplus or

discretionary cash that a company generates. Over the past decade, the cumulative growth in free cash flows generated by U.S. growth companies has been massive. The key question now is, has this ability been materially impacted or diminished over the past 12 months? We believe that it has not. The inherent, fundamental, ability of growth stocks to grow free cash flows over time remains very much intact. ■



IS THE VALUE RALLY IN EMERGING MARKETS SUSTAINABLE?

Value investing is coming in from the cold.

- Emerging Markets (EM) Discovery seeks to invest in forgotten stocks about to experience positive fundamental change: the transition to green energy provides one such opportunity.
- The way EM governments employ fiscal stimulus has changed to targeting the consumer directly. This is another fundamental change that we intend to capture.
- With a capex-depreciation ratio around 1.0, non-financial EM companies have been under-investing. This is poised to change, bringing new investment opportunities.



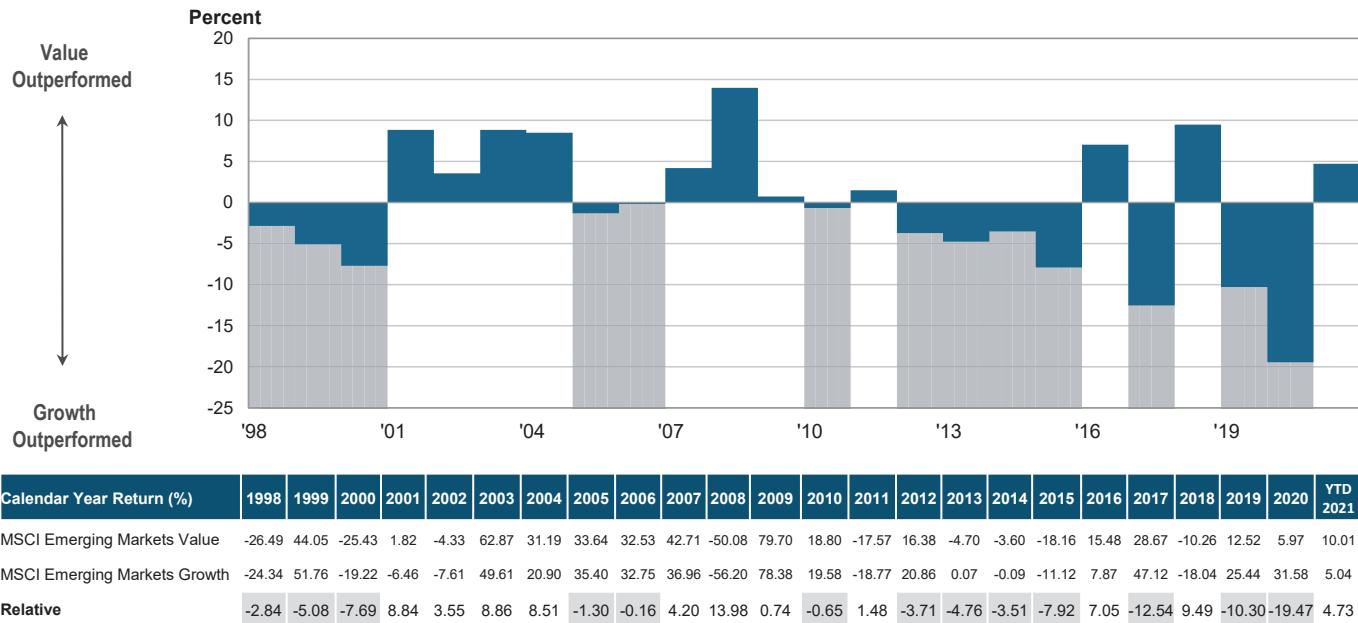
*Ernest Yeung
Portfolio Manager, Emerging Markets
Discovery Equity Strategy.*

After a decade of strong value outperformance in emerging market equities from 2001 to 2010 came a decade of sustained underperformance. In 2020 the value/growth divergence in EM reached an extreme not seen before, driven by the deep recession created by the global coronavirus pandemic (Figure 1). Before examining the disappointing performance of EM value since 2010 we should first ask ourselves “What drove value’s outperformance between 2000-2010?” We believe there were two key factors at work. Firstly, there was the Chinese economic “super cycle” as China spent a staggering USD12 trillion on infrastructure and industrial capacity over this period. This benefited ‘old economy’ sectors globally such as steel, cement, nonferrous metals, industrial machinery, and energy.

FIGURE 1: EM Style Divergence is Retreating from Extreme Levels

Annual Value-Growth Divergence for MSCI EM indices (%)

Calendar Year Value-Growth Divergence (%)



Past performance is not a reliable indicator of future performance.

As at 30 June, 2021.

Source: Financial data and analytics provider FactSet. Copyright 2021 FactSet. All Rights Reserved.

Secondly, the world was starting to recover following a number of EM shocks (1994 Lat Am tequila crisis, 1997-98 Asian financial crisis, 1998 Russian crisis) during which a large amount of capex and many banks had been destroyed.

Is This Episode Relevant to Investors Today?

We believe that it is, since although history does not repeat itself, it very often rhymes! We are of the view that the goal of carbon neutrality by 2050 (2060 for China) will boost many traditional or 'Old Economy' industries during the long transition period. To meet green energy and carbon emission targets the world will need to spend heavily on traditional industrial sectors during the transition years.

China is projected to need to spend around USD10-15 trillion to transition to a more energy efficient economy with zero net carbon emissions by 2060...

The massive USD12 trillion of infrastructure spending in China between 2000-2010 was one factor contributing to a decade of outperformance for global value investors. Today, China is projected to need to spend around USD10-15 trillion to transition

to a more energy efficient economy with zero net carbon emissions by 2060 that does not rely on fossil fuels (Figure 2). This is a sum not very different in magnitude to what China spent on infrastructure and industrialization over 2000-10. The G10 group of industrialized economies may also need to spend a roughly similar amount on their own green energy transition programs to achieve carbon neutrality in 2050.

Energy Transition is Commodity Intensive

During the transition to clean energy, the world will likely need to spend heavily on commodities like copper, nickel, lithium, aluminum, and natural gas as alternative energy and electric vehicles are metals-intensive. While a more controversial issue in developed markets, there is also little alternative to natural gas, the cleanest of the fossil fuels, for EM during the early stages of their fossil fuel transition. In an EM context, this makes sense from an ESG perspective, since gas is less polluting than other carbon-based fuels and hospitals, schools, fire stations etc. all need power. Renewable energy is not readily available in most EMs and we believe natural gas will play an important role in the early stages of their transition to cleaner energy.

FIGURE 2: China Super Cycle vs. Post-COVID Energy Transition

To meet green targets, the world needs to spend.

The diagram features a timeline with a grey double-headed arrow at the top. The left side is labeled 'China Super Cycle' with a map of China and the years '2000-2010'. The right side is labeled 'Post-COVID Energy Transition' with a solar panel icon and the years '2020 onwards'.

Spending	Gross Fixed Capital Formation in China: US\$ 12 trillion	Prelim estimation on green infrastructure to reach carbon neutral targets: <ul style="list-style-type: none"> China: 10 trillion U.S.: 12 trillion
Focus Area	Factories and Infrastructure	Renewable, Grid and Factory upgrade
Beneficiary	Steel, Cement, Copper, Oil, Coal	Copper, Aluminum, Lithium, Nickel, Gas

As of 31 December 2020

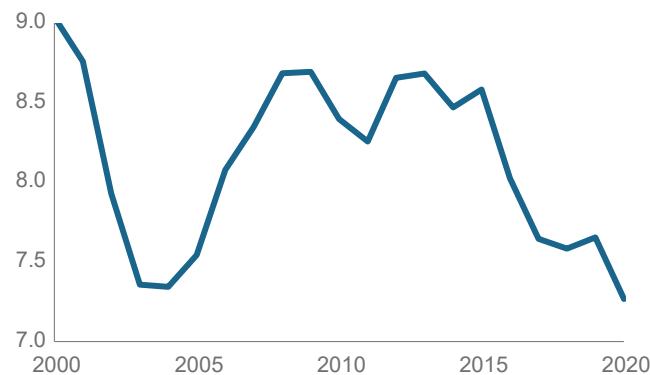
Source: Haver Analytics [China National Bureau of Statistics], Goldman Sachs (GS)

FIGURE 3: Current Corporate Capex is Maintenance Only

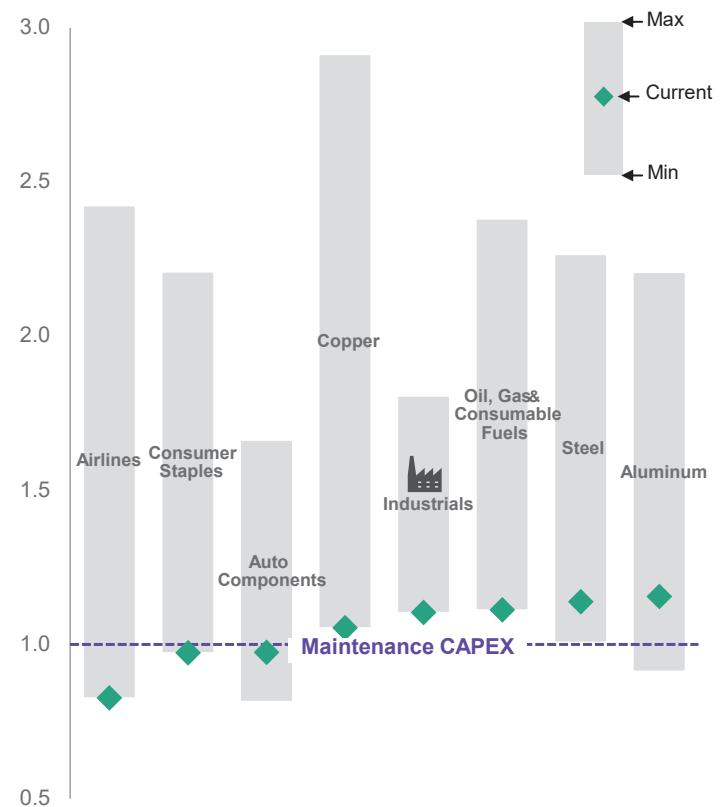
Emission targets require a major boost in net investment.

CAPITAL EXPENDITURE DISCIPLINES

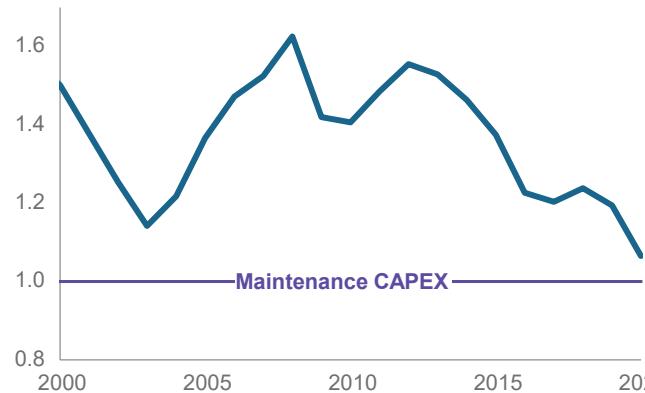
MSCI AC WORLD CAPEX TO SALES (ex Financials) (%)



CAPITAL EXPENDITURE TO DEPRECIATE RATIO 2000-2020



MSCI AC WORLD CAPEX TO DEPRECIATION (ex Financials) (%)



As of 31 December 2020

Source: Bloomberg Finance L.P. Financial data and analytics provider FactSet. Copyright 2021 FactSet. All Rights Reserved.

The post-COVID energy transition is the type of external fundamental change that we seek to leverage in our EM Discovery Equity strategy.

Investment Must Rise to Reach Net Carbon Targets

The post-COVID energy transition is the type of external fundamental change that we seek to leverage in our EM Discovery Equity Strategy. It is a theme that our portfolio managers Ernest Yeung and Haider Ali have spent a good deal of time analyzing. The world has badly under-invested in this area and countries will likely need to ramp-up capital expenditure quickly if net carbon reduction targets in 2050 are to be met.

Figure 3 shows that the MSCI AC World Capex-to-depreciation ratio (ex-financials) is currently hovering around 1.0, pointing to the fact that companies in recent years have mostly been spending on maintenance capex, investing 'for balance sheet rather than for growth.' This time there was no financial crisis – rather the under investment was caused by:

China overspending on industrial capex post Lehman - we have spent ten years digesting that excess capacity.

The massive performance divergence between growth and value sectors in stock market terms meant that capital exited the 'old economy' sectors and flowed into the 'new economy.'

Following a successful vaccine roll-out and strong global economic recovery, value investing has staged an impressive rebound in 2021.

We believe this will all have to change as the switch to green energy begins to gather pace, and capital is required to flow back to the 'old economy.' The share of investment spending in GDP will need to rise, becoming a new driver for economic growth during the green energy transition.

Following a successful vaccine roll-out and strong global economic recovery, value investing has staged an impressive rebound in 2021. Whilst this has been

welcomed, investors in EM value funds are naturally asking whether the outperformance of value can be sustained. We believe that it can. For one thing, we believe that the way governments supported their economies with fiscal and monetary stimulus during the coronavirus pandemic marks a fundamental change from previous recessions.

... fiscal stimulus measures are having a significant multiplier effect on economies.

Post-COVID Stimulus Targets Consumers & Green Infrastructure

Stimulus is now being targeted primarily at helping the consumer and boosting green infrastructure rather than being deployed towards supporting corporate and bank balance sheets, as was the case following the collapse of Lehman Brothers in 2008 that triggered the global financial crisis (GFC) and Great Recession. Empirical studies show that fiscal stimulus measures in the U.S. and other developed economies to support the consumer are working as intended and are having a significant multiplier effect on economies. This in turn is leading to a significantly faster economic recovery from the pandemic than was seen in 2009 after the GFC. A faster global economic recovery in turn can be expected to provide underlying support for the value style of investing (see Figure 4).

For example, by March 2021, U.S consumer goods spending (almost 1/3 of the global total) had risen to a level 9% above its pre-COVID trend, a big enough shock to drive a global recovery in demand. In that month U.S. households saw their biggest ever increase in average monthly incomes (21%) as they received their USD1400 bank cheques under President Biden's American Rescue Plan. In the past year, U.S. households have accumulated an estimated USD2 trillion of excess savings, some of which is very likely to be spent during the next year or two.

Besides fiscal stimulus, post-COVID recoveries are also supported by the extremely accommodative monetary policies implemented by major central banks. For the first time since QE began, we are seeing strong real growth rates in M2, or broad money supply, in the U.S., Europe and Japan. In our view, the emerging markets are well positioned to benefit as global growth picks up in response to such strong policy stimulus. China in particular

has been a big beneficiary of the stimulus-related increase in U.S. consumer goods spending, reflected in merchandise exports from China that are currently around 20% above their pre-COVID level.

Stars Appear Aligned For Value Investors

Looking at the way in which the global economic environment is currently changing, there are a number of conditions today that would appear to favor a further rotation toward value. Historically, periods of larger fiscal deficits and strong real GDP growth have often been associated with periods of

.... some believe the acceleration of new technologies triggered by the pandemic could usher in a period of higher productivity.

value outperformance. EPS growth is another key factor for value versus growth, with the growth style of investing naturally doing better in periods when earnings were scarce. Currently, the consensus bottom-up forecasts for emerging markets EPS growth in 2021 and 2022 are 50.1% and 10.2%, (MSCI EM Free index, as at 5 July, 2021) indicating that we have entered an 'earnings rich' environment that ought to favor value over growth.

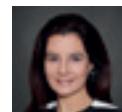
Interest rates are another factor to consider. Historically, real rates have shown an inverse relationship with value versus growth. As monetary policy in the U.S. and other countries begins to normalize next year, many analysts expect real interest rates to rise, which should also favor value. Lastly, some believe the acceleration of new technologies triggered by the pandemic could usher in a period of higher productivity. Such periods have tended to favor value rather than growth, as higher productivity in turn can be expected to result in stronger growth in earnings. ■



CONSTRUCTING A CHINESE EQUITIES PORTFOLIO

Seek to exploit market inefficiencies and extract value from entire investment universe.

- Discovering the future winners early in their cycle and capitalizing on inefficiency can potentially lead to outsized alpha generation.
- China is a deep market, and it is crucial to go beyond the crowded top 100 names; 98% of the opportunity set is where the hidden gems are likely to be found.
- To fully leverage on inefficiency, investors need a multidimensional framework capturing different types of opportunities with the potential for compounding growth, nonlinear growth, and special situation characteristics.



*Irmak Surenkok
Portfolio Specialist, Emerging Markets*

China continues to undergo enormous change, and there are many factors to monitor in this massive and highly complex economy. Significant change continues in relation to China's economic model, with concerted efforts to focus more on domestic growth drivers to help rebalance the economy. The rising power of the consumer, along with innovation and technology, are major dynamics driving economic growth.

Yet China remains substantially underrepresented within global indices. It makes up only around 5% of the MSCI All Countries World Index, while its economy represents a staggering 17% of total world gross domestic product (GDP) (Figure 1). This anomaly, however, is narrowing, and we expect China's weighting in global indices to increase considerably over the next few years.

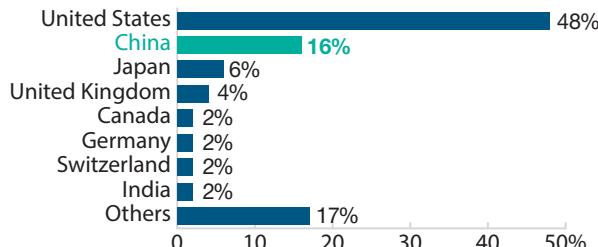
China remains substantially underrepresented within global indices.

FIGURE 1: China Market is Underrepresented in Global Equity Indices

This is an anomaly and is starting to change

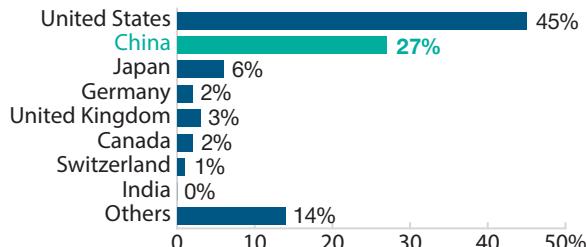
GLOBAL EQUITY MARKET CAP* DISTRIBUTION

As of 31 December, 2020



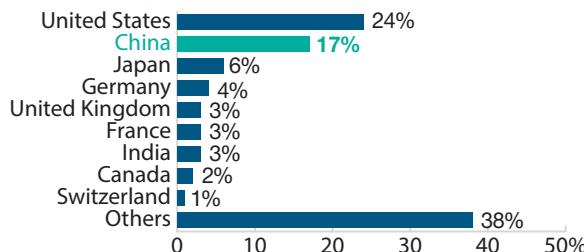
GLOBAL EQUITY TURNOVER* DISTRIBUTION

As of 31 December, 2020



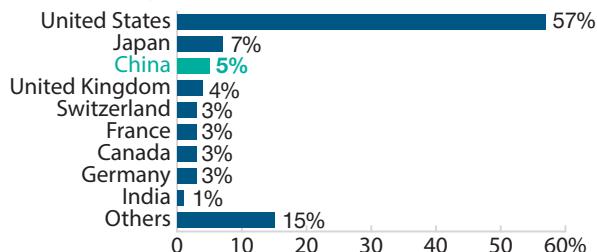
GLOBAL GDP DISTRIBUTION

As of 31 December, 2019[†]



MSCI AC WORLD INDEX WEIGHT

As of 31 December, 2020



*Figures for Global Equity Market Cap and Turnover Distribution are calculated using data for listed securities across all stock exchanges for the countries listed. Turnover: measurement of daily volume for listed securities traded on each country's individual exchanges.

[†] Global GDP Distribution is to end 2019 as data for certain countries has yet to be calculated.

Sources: Goldman Sachs, MSCI, World Bank/Haver Analytics, and FactSet. Financial data and analytics provider, FactSet. Copyright 2021 FactSet. All Rights Reserved. (See Additional Disclosures.)

There are also major inefficiencies inherent within Chinese markets that active stock picking can try to take advantage of to find strong potential alpha opportunities. For example, the MSCI China Index is made up of just over 700 stocks with around 13% representation from A-shares, but the entire universe comprises more than 5,200 stocks with 65% of it in A-shares.¹ The market is also heavily retail-driven, especially the A-share market, which means that market inefficiencies can occur. Currently, around 80% of the A-share market turnover comes from retail investors, with the average holding period being only 17 days.² This has generated great velocity and liquidity in the market but also offers fundamental investors an opportunity to invest in potentially mispriced assets.

Here, we identify ways in which we believe active investors can exploit market inefficiencies and construct a Chinese equity portfolio:

Look Beyond the A-Share Market and Mega-Caps—Adopt a Holistic and Active Approach

Many foreign investors think of China's investable universe as being confined to the MSCI China Index or the A-share market (as represented by the CSI

300 Index), which features many of the large- and mega-cap companies. But there are huge potential opportunities outwith these markets that investors may be missing. In fact, the investable universe in China has grown fivefold in the last 20 years. In the first three months of 2021 alone, we saw around 300 IPOs, and China has now overtaken the U.S. in terms of stock listings (Fig. 2).

...the A-share market no longer offers the same diversification benefits that were once heralded.

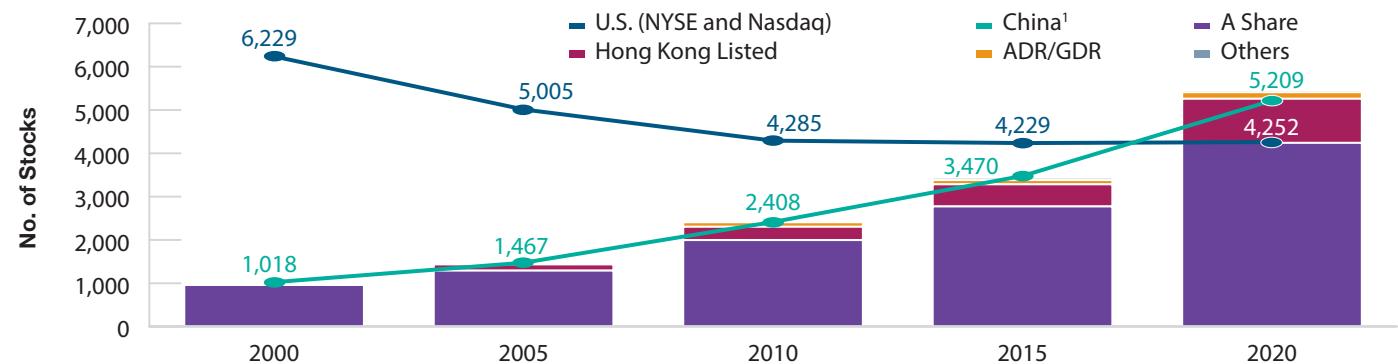
We would also argue that the A-share market no longer offers the same diversification benefits that were once heralded. The correlation of the China A-shares market with global indices has increased markedly since 2015 (Fig. 3). In particular, the correlation of the MSCI All Countries Asia ex-Japan Index and the MSCI China Index has become very high. This is primarily due to the increased participation of global investors, especially after the launch of the Stock Connect program in 2014. It proved to be a breakthrough for global investors

¹ As of 31 December, 2020. Source: Goldman Sachs.

² Source: Goldman Sachs Global Investment Research.

FIGURE 2: China's Growing Investment Universe

Steady increase in the opportunity set that has surpassed the U.S.



As of 31 December, 2020.

¹China total represents all listed stock. Dual listed ADR/GDR excluded to avoid double counting.

Sources: Bloomberg Finance L.P. and FactSet. Financial data and analytics provider, FactSet. Copyright 2021 FactSet. All Rights Reserved.

Investment universe comprises more than 5,200 stocks.

seeking to invest in China, but it has contributed to the A-share market becoming more aligned to the performance of global markets.

Seek to Uncover the Future Winners

With the majority of flows being directed toward the 100 largest stocks in China (which only represent 2% of the total investment universe), we believe there is a huge opportunity for active managers to invest in the underresearched and under-owned today. It is important to be style-agnostic, however, and focus on a bottom-up fundamental approach to help identify potential future winners early in their cycle, before they have potentially grown into the mega-caps

of tomorrow. That way, investors can focus on idiosyncratic alpha generation, which also means that returns may have a lower correlation with macro factors and overall market returns.

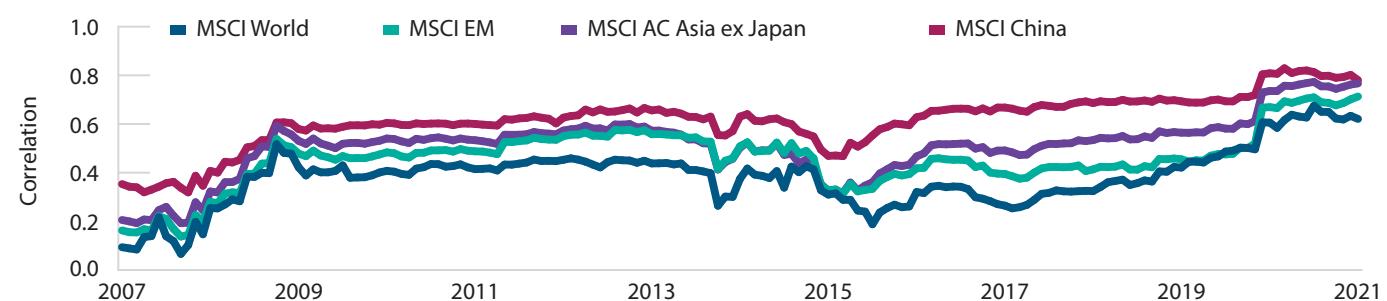
Encouragingly, China offers a number of companies with a long runway for growth. These potential “compounders” or “secular growers” can be attractive for long-term investors as often their potential is not recognized by the short-term nature of market participants. Allocation to these, however, should be balanced with other areas, such as nonlinear growers and what we call special situation stocks. Nonlinear growers are companies that may be about to experience a positive product,

...we are focusing our efforts on finding value in sectors that are not correlated to macro factors, where we can use our stock-picking skills.

FIGURE 3: Diversification Benefits Have Become More Limited for Chinese A-Shares

Steady increase in correlation with global markets since 2015 on increased global investor participation

Rolling Five-Year Monthly Return Correlation to CSI 300 Index



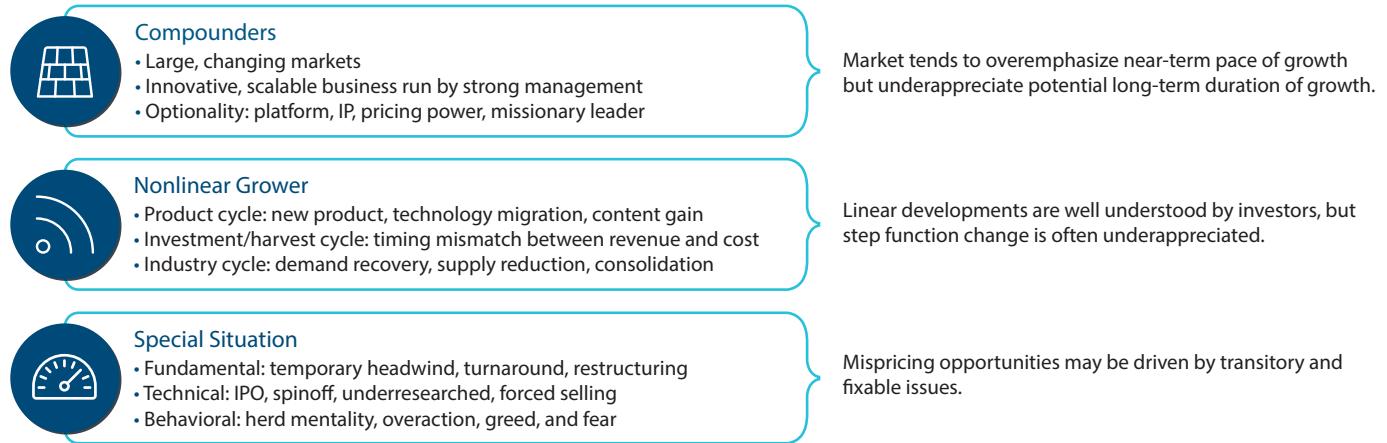
Past performance is not a reliable indicator of future performance.

As of 31 March, 2021.

Sources: MSCI (see Additional Disclosures) and FactSet. Financial data and analytics provider, FactSet. Copyright 2021 FactSet. All Rights Reserved.

FIGURE 4: A Multidimensional Framework

Three areas of focus in aiming to capture the best opportunity set



industry, or harvest cycle following investment. Meanwhile, special situations are stocks that may be experiencing a temporary headwind or have been sold down due to a technical issue, such as forced selling following a spinoff, perhaps.

Focus on Key Areas and Themes That May Offer the Greatest Potential for Future Growth

In managing our portfolio we are focusing our efforts on finding value in sectors that are not correlated to macro factors, where we can use our stock-picking skills. We believe that we are well positioned to take advantage of the changes that are happening in China as the focus shifts from “growth at any price” to “quality growth.”

Consumption is an important pillar of growth for Chinese policymakers. Here, we are concentrated on companies that we believe can offer compounding growth opportunities but also ones where there is currently a positive product cycle. The shift of domestic demand from foreign brands to local brands is also important. We believe that many of these homegrown businesses can eventually take a leap further and expand into global leaders.

China is also striving to build a robust health care system for its 1bn+ population, and homegrown players are integral to that plan. We are also

increasingly seeing ways to potentially benefit from China’s goal of becoming a greener economy. The transition away from a carbon-intensive economy to a more sustainable economy offers a tailwind to industrialization, with support being gradually shifted from traditional sectors such as oil and gas to modernized industrial and business services sectors.

Finally, we highlight “consolidation,” which is gaining increased momentum. Many sectors, from hotel chains and restaurants to offline pharmacies, are gaining market scale and becoming the main low-cost producers in their field. Importantly, this trend has nothing to do with how the macroenvironment is behaving, and it also doesn’t even matter if the underlying industry is growing or not. If the consolidation tailwinds are strong enough, they can prove beneficial.

Positive Backdrop Provides Robust Reasons for Investment

For many investors, Asia likely offers the greatest potential right now, and China is at the heart of that. We believe it is a highly inefficient market, making it ideal for alpha generation. We also expect the underrepresentation of China within global indices to materially change in the next few years. We encourage investors to explore the full opportunity set to find the best opportunities. ■

MEET SHELDON CHAN

An Interview with Sheldon Chan, Portfolio Manager, Asia Credit Bond Strategy



Sheldon Chan
Portfolio Manager
Asia Credit Bond
Strategy

BIOGRAPHY

Career

Sheldon has 16 years of investment experience, 9 of which have been with T. Rowe Price.

2004 – 2011

Worked with HSBC as a credit analyst after experience in construction industry. He worked in the London and Hong Kong offices of the bank as a director in fixed income research.

2011 – 2020

Joined T. Rowe Price in the Emerging Market Fixed Income Division and is a vice president of T. Rowe Price Group, Inc., and T. Rowe Price Hong Kong Limited. Sheldon is currently portfolio manager of the Asia Credit Bond Strategy

Professional & Education

Sheldon earned a B.A. (with honors), an M.A., and an M.Eng. in engineering from Trinity College, University of Cambridge.

Sheldon, can you begin by telling us about your career background and what first attracted you to asset management?

My transition into the world of high finance after acquiring an engineering degree at Cambridge was a smooth one even if a bit unusual. I had been working at construction sites and sewage treatment plants for a while when one summer it occurred to me it was not something I wanted to do for the rest of my life. That decision took me to HSBC where I dabbled in European investment grade credit research at a time when funding costs were low and spreads tight – a difficult market which taught me a lot. The move to Asia covering high yield credits in the aftermath of the Global Financial Crisis gave me a taste of asymmetric information and inefficient markets and broadened my experience.

After spending 8 years on the sell side, I came across an opportunity at T. Rowe Price which was hiring for its fixed income platform in Asia. I was the second member of the fixed income team here when there were just 30 employees in Hong Kong.

This was yet another significant professional shift for me.

While on sell side you are also doing financial analysis, making recommendations, and assessing relative value, it is only when you are on the buy side that you are constructing portfolios, executing trades and creating value. You are putting money where your mouth is – one of the key factors that influenced my move to the buyside.

What are the key features of T. Rowe Price's Asian Credit Bond Strategy? How is it evolving with regard to issues like ESG and 'green bonds'?

We have taken a measured approach in our entire investment process since we began managing the strategy. We launched the strategy as credit spreads peaked in early 2018 and have been facing headwinds like the US-China trade tensions, the outbreak of COVID and Beijing's deleveraging campaign. It was the good work by our team that produced a decent performance in such tumultuous times. While China comprises a big part of traditional benchmarks due to its sheer size our choice of benchmark ensured a lower weightage due to the greater diversification. This lower geographic concentration has paid off for us given the direction of monetary policy and US-China tensions in the past few months. This is a standout difference between the Asia Credit Bond Strategy and its peers.

Governance concerns are one of the biggest issues when investing in Asia and often drives a successful investment strategy. We have been using this approach for some time now – ensuring that the key stakeholder interests and those of the management are aligned. The

FIGURE 1: A weekend hike with the family in Hong Kong.



push for stronger ESG creates stakeholder value – something which we have already been pursuing for a while.

The lack of professional management is more evident in EM than in DM as a large section of the corporate landscape is state-owned or managed by owner-founders. We have been in meetings where a company chairman has justified aggressive acquisition plans with “Because it is my company and I can do what I want”. So that's areas where you want a bit of warning signs when as a creditor and a bond holder, you feel your incentives with the management aren't so much aligned.

That should tell prospective investors that in Asia due diligence goes beyond looking at cash flow statements and balance sheets. Having local knowledge and insights helps. Our equity colleagues' perspectives help too, because many bond issuers come to us after equity roadshows and IPOs.

The same goes for ESG – Asia is starting at the back of the grid with its fast-growing population and high energy intensity. This also means a longer time to phase out them out given the assets' young age and low costs. And if you look at all the fixed income benchmarks globally, Asia credit has the highest carbon footprint per dollar of revenue. But on the positive side we see the emergence of funding platforms which are pushing for green assets, giving investors a growing menu of options. For example, we have an opportunity set in Indian renewable credits that has grown to USD\$9 billion from scratch

in a matter of a few years; and will likely continue to do so given the government's policy push.

With the fast growth in the opportunity set, it's important that we remain selective in our investment choices and not blindly jump on the 'green' bandwagon. In most green bonds issued in Asia, dedicated ESG investors account for only a minority of the order book, so documentation and structure of these bonds might be less scrutinized and looser. Our credit analysts collaborate very closely with our Responsible Investing specialists to analyze companies and bond structures through the ESG lens, and make sure we don't fall into the trap of greenwashing. The pace at which the corporate world and investment industry is addressing these issues is remarkable – I find it fascinating and am learning more about it all the time.

We have seen an increase in corporate credit defaults in China over the past couple of years. How should investors see this trend – is it a good thing, or a bad thing? local government financing vehicles (LGFVs) view?

Beijing's policy objective seems to be aimed at reducing moral hazard in the financial system and to improve credit discipline via market driven pricing. This is reflected in default rates having quadrupled in a span of four years. That said, it still remains low versus the global average.

This time around even state-owned enterprises (SOEs) are not being spared, driving us towards

greater price differentiation and forcing a revisit of the assumption of state support.

The other sector that is seeing more stress is property – an industry which has grown quickly but also one that is incredibly leveraged and fragmented. It is natural that there will likely be more consolidation triggering government policies like the three red lines policy are aimed at curbing debt and promoting cleaner balance sheets. Still, there will be accidents and some companies may run to the end of the line.

But authorities are not too perturbed by these defaults as the economy has recovered well and these episodes are not causing a crisis of confidence in the market.

The fact that some of our best performers have been in the China property sector underlines the importance of a bottom up approach and due diligence in our investment process. We have identified these outliers early in the cycle and rose their successes – a prime example is Country Garden which we added to our portfolio much before it was upgraded to investment grade.

These defaults have steepened the credit curve – a phenomenon which every investment manager wants to see as it creates dispersion and rewards the right decisions. And the pattern of these defaults is also reducing concerns about contagion risks. The sell off after every such episode is getting shallower and the pullback is getting quicker – a healthy sign.

This transformation makes credit analysis more meaningful and rewarding. It is for this reason we are not actively involved in the LGFV sector – the lack of transparency and the amount of guesswork that goes into assessing the extent of government support makes us uncomfortable.

China has come to dominate the Asia ex-Japan credit universe in terms of market size. Where do you see the opportunities elsewhere in Asian credit?

We see pockets of opportunities in ASEAN markets like Philippines, Thailand and Malaysia where the attractive risk adjusted returns are albeit partially driven by scarcity value. For example, Philippines has many consumption-driven stories that benefit from the country's huge overseas remittances.

In other parts of Asia we see opportunities in Indian high yield names which are relatively insulated from the fallout of a sovereign rating downgrade risk. The country's renewables sector is hot right now and it

has benefited from India's resource rich environment and progressive government policies. The governance side is supported by a bank of strategic investors and although valuations are not cheap the bonds provide a good carry in certain duration buckets in these volatile markets.

The dollar bond market in Asia has grown significantly, outpacing the rest of EM and is now a USD\$1.2 trillion asset class. Its technicals are improving too – the Asian investor holding has gone up to 75-80% from half at the time of the 2008-2009 financial crisis. So this dynamic of Asia buying Asia, or the home bias ensures bonds are in stronger hands. In a global market sell off, there are investors from within the region who are happy to hold on to familiar credit stories.

Asia's sector mix is important too in that it is less reliant on some of these extractive commodity economies. So you don't see that same magnitude of swings seen during commodity cycles. For example, default rates in Asia stayed low in 2015 and 2016, when oil prices dropped so sharply.

Many expect the Fed to begin to taper or reduce its QE policy support later this year. Should investors in Asian credit be worried about a 'taper tantrum' similar to the one in 2015?

It is a risk to bear in mind all the time – but from a fundamental standpoint Asia occupies the higher quality segment of EM with most countries well anchored from a fiscal sustainability and a political infrastructure perspective. The rating transition bears testimony to this and contrasts with the rest of EM with that of Brazil, South Africa and Turkey headed in the opposite direction.

Asia has a high-quality bias versus the rest of the EM. It would be a BBB plus asset class, 75% of the USD USD\$1.2 trillion opportunity set is investment grade. It's an underpenetrated market too as the bond markets are still very much opening in Asia. You see a lot of new IPOs, those are going to be future issuers into the market. While many of these debut issuers are unfamiliar to the bondholder community, it adds some uncertainty to the price discovery process, often leading to dislocations and opportunities. So in the event of tapering Asia would be in a better position given higher domestic savings, current account surpluses and better forex reserves. Even countries like Indonesia and India which came under scrutiny during tapering 1.0 in 2013, have shored up their forex reserves, and bettered their current account balances.

Fiscal policies are becoming more targeted, like we saw in the case of India, so despite the devastation caused by the pandemic to the economy, the reparation costs are better controlled. Governments are taking a more measured approach to supporting the economy and showing greater discipline.

During the March 2020 COVID selloff, the investment grade segment of Asia credit outperformed U.S. IG markets. Asia IG tends to be as defensive as developed markets. So, investors may own Asia investment grade credit with higher income potential, lower duration than U.S. IG, and you can likely achieve a similar downside management property as well.

Sheldon, can you tell us a bit about how you spend your time outside of work, any particular hobbies, or interests that you have?

My daughters – aged 6 and 8 – keep me grounded in that I try to spend as much time with them as I can in these times of market volatility and back to back calls. My weekends and evenings are spent getting as much quality time with them as I can – reading stories, talking about their days, going hiking together, or even just driving them to the different classes and activities that they have! Other than that, I try to stay active and exercise when I can. I grew up playing a lot of football, and although the body can no longer do what the mind thinks it can, I still try to play as much as possible. I am an avid Manchester United supporter – so I try to stay up and catch the games whenever I can. ■

ABOUT US

T. Rowe Price is a global independent investment management firm. We are solely focused on long-term results for our clients, managing a full range of investment strategies in multiple asset classes. For over 80 years, our consistent investment approach has helped us focus on promising opportunities while at the same time carefully managing risk.

We established our Tokyo office and Hong Kong office in 1982 and 1987 respectively, and since then we have expanded our business by operating in Australia and Singapore. Today we have more than 200 associates based locally.

INDEPENDENT ASSET MANAGER

Our sole business is managing our clients' interests

ALIGNMENT OF INTERESTS

We are a publicly listed company with substantial employee ownership

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We carry no outstanding long-term debt and maintain substantial cash reserves

GLOBAL EXPERTISE

Continually growing global team of investment professionals

Founded in

Baltimore, USA in 1937

USD1.62

trillion in assets under management^{1,2}

760

investment professionals worldwide³

Local presence in

16

countries³

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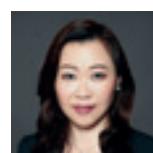
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² As at 30 June 2021. Preliminary data. Subject to adjustment.

³ As at 30 June 2021.

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