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Global Asset Allocation: The View From the UK

September 2021

1 Market Perspective

As of 31 August 2021

- Global economic growth remains above trend, albeit past peak levels, supported by central bank liquidity, progress on vaccine distribution and continued reopening momentum despite the spread of the delta variant.
- Policy accommodation is expected to gradually tighten as central banks weigh economic growth outlook and increased coronavirus risk against more persistent inflation and improving labour markets.
- Long-term interest rates could trend higher amid the growth and inflation outlook, but upside may be limited as growth moderates and imbalances driving inflation ease while short-term rates could begin to price in tighter central bank policy, leading to flatter yield curves.
- Key risks to global markets include the path forward for the coronavirus, elevated inflation, central bank missteps, higher taxes, a stricter regulatory environment and increasing geopolitical concerns.

2 Portfolio Positioning

- We remain modestly underweight equities relative to bonds and cash as the valuations look less compelling amid peaking growth and stimulus. Higher rates, elevated inflation and potential tax increases could pose challenges to equities.
- Within equities, we continue to favour value-oriented equities globally, US small-caps and emerging market stocks as we expect cyclically exposed companies to continue to benefit from still supportive but slowing economic growth and continued global reopening.
- Within fixed income, we continue to have a bias toward shorter-duration and higher-yielding sectors through overweights to high yield bonds and selected emerging market debt given a constructive credit outlook.

3 Market Themes

Rock and a Hard Place

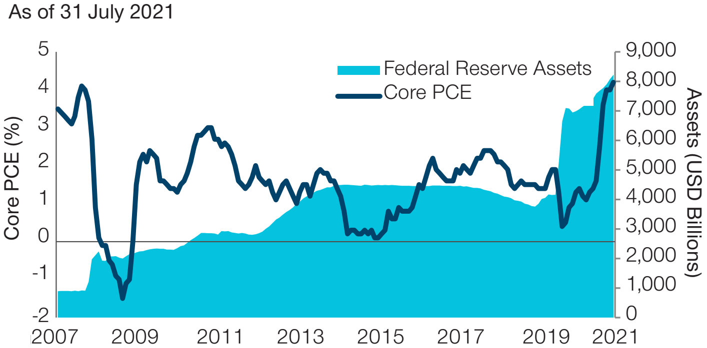
Coming out of the Jackson Hole Economic Symposium, Federal Reserve Chairman Jerome Powell signalled that the Fed could begin to wind down its monthly bond buying by year-end, if the economy and coronavirus cooperate, and acknowledged that the Fed is in no hurry to raise short-term interest rates. The equity market interpreted Powell's comments as very dovish, with the S&P 500 rallying to record-high levels on hopes that monetary policy will remain loose for longer. Powell also addressed concerns about inflation, calling it hot but temporary, attributing it to coronavirus-related supply disruptions. Recent softer-than-expected payroll data could also weigh against tightening as the Fed waits for more substantial progress towards employment goals. A scenario of moderating growth, waning employment and lingering inflation could put the Fed between a rock and a hard place—with tapering too quickly potentially jeopardising the nascent job market and complacency on inflation possibly forcing them to act more decisively down the road.

Cash Hoard

Coronavirus-related shutdowns curtailed spending by both consumers and corporations alike as expenditures on services fell significantly and corporations cut spending and dividends. Consumers working in lower-earning service sectors were the hardest hit with job losses, although they found support from fiscal aid. Higher earners, for the most part, were marginally impacted as they maintained their jobs and were able to save from less spending on services, travel and commuting. Now businesses and consumers are both seeing elevated levels of liquidity, as S&P 500 companies hold a record USD 2 trillion in cash and as household worth remains at an all-time high. Unleashed pent-up consumer demand remains as back-to-school shopping and the holiday season kicks off while, at the same time, corporations are looking to increase dividends and share buybacks. The potential for this cash hoard to come off the sidelines could provide a strong tailwind for cyclically exposed companies against a backdrop of fading fiscal and monetary support.

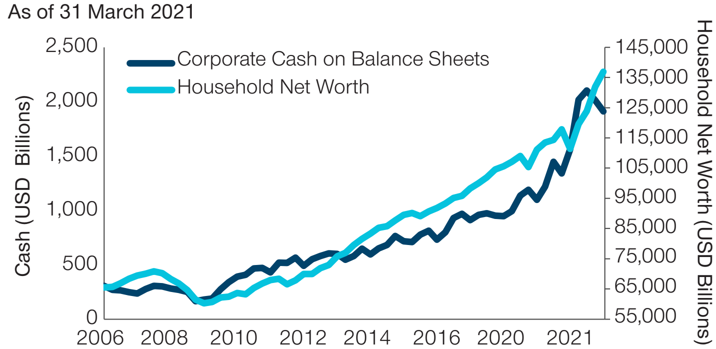
Inflation vs. Federal Reserve Assets

As of 31 July 2021



Corporate Cash and Household Net Worth[1]

As of 31 March 2021



Past performance is not a reliable indicator of future performance.

[1] Corporate Cash and Household Net Worth returns are represented by the FOF Balance Sheet of Nonfinancial Corporate Checkable Deposits & Currency Asset Index and the FOF Federal Reserve US Households & NPO Net Worth Nominal $ Value Index respectively. Figures are shown in USD.
Source: Bloomberg Finance L.P.

	Positives	Negatives
United Kingdom	▪ Return to offices and schools implies further rise in near-term activity ▪ Investment tax super-deduction could support strong recovery ▪ Many key economic indicators are either at or close to record highs	▪ The Bank of England could remain very hawkish in light of strong real economy data ▪ Demand risks from delayed, but likely large, fiscal consolidation in two to three years remain ▪ Overheating housing market could pose future financial stability risk ▪ Unwinding of furlough scheme could lead to a short-term rise in unemployment ▪ Scottish experience suggests a further COVID-19 wave could be on the horizon
Developed Europe	▪ Higher exposure to more cyclically oriented sectors that should benefit from economic recovery ▪ Vaccination rates improving rapidly ▪ Monetary policy remains accommodative ▪ Fiscal stimulus poised to get a boost from upcoming German elections ▪ Equity valuations remain attractive relative to the US	▪ Limited long-term catalysts for growth ▪ Limited scope for European Central Bank to stimulate further ▪ Brexit likely to negatively impact trade ▪ Demand from China fading ▪ Microchip shortage impacting auto production rebound
United States	▪ Vaccinations widely distributed ▪ Infrastructure spending bill likely to be passed ▪ Healthy consumer balance sheets and high savings rate ▪ Exceptionally strong earnings growth	▪ Elevated stock and bond valuations ▪ Elevated corporate and government debt levels ▪ Fed accommodation has peaked ▪ Fiscal stimulus has peaked ▪ Corporate taxes likely to rise ▪ Delta variant spread is muting economic reopening

	Positives	Negatives
Japan	▪ Local stock markets look attractive due to favourable relative valuation, light positioning and the possibility of a politically induced stimulus ▪ Earnings are strong and being revised higher ▪ Policy setting remains extremely accommodative, with unspent fiscal spending expected to offer further boost to the economic recovery ▪ Prime Minister Suga's resignation was a surprise but it may lead to a positive stimulus package	▪ The normalisation of economic activities has been delayed due to prolonged states of emergency ▪ Favourable base effects from last year are rolling over ▪ Stagnant productivity remains a structural issue for margins in the face of a tight labour market ▪ Suga's resignation adds some uncertainty
Asia Pacific ex-Japan	▪ The slowdown in Chinese economic activity suggests further easing may come ▪ The Reserve Bank of Australia is likely to remain dovish and supportive for longer as economic data soften ▪ Australian dollar is likely to rebound given low expectations and positioning after the fall in commodity prices	▪ Chinese consumer spending is still lagging the recovery and below expectations, with consumers acting cautiously in the face of localised coronavirus outbreaks ▪ Credit risk is increasing in the Chinese property sector ▪ The impact of current lockdowns on the Australian economy and earnings seem to be underestimated
Emerging Markets	▪ Exposure to cyclical areas of economy should benefit from broad global recovery ▪ Commodity prices are elevated ▪ Equity valuations attractive relative to developed markets	▪ Vaccine supply and distribution infrastructure are well behind developed markets (excluding China) ▪ Stimulus from China is fading ▪ Accommodation from central banks is fading ▪ Limited ability to enact fiscal stimulus (excluding China) ▪ New variants remain a threat to economic activity

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Underweight — *Neutral* — *Overweight* ▼ or ▲ Month-Over-Month 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.**
	Change						
ASSET CLASSES	Equities		■				Exceptional earnings growth and upward revisions have driven strong performance. However, valuations are elevated amid peaking growth and stimulus. Additional concerns include coronavirus challenges, input cost inflation, tax increases and higher rates.
ASSET CLASSES	Fixed Income				■		Yields should be biased higher on the back of growth and inflation trending at above pre-pandemic levels, as well as tightening global central bank policies. Credit sectors offer solid fundamentals and opportunities for carry.
	Region						
EQUITIES	US		■				Elevated valuations reflecting strong recovery, earnings rebound and low interest rates. Slowing growth, delta variant challenges and taxes could be headwinds. Cyclical sectors should continue to benefit from strong macro backdrop, but a lot of good news is already priced in.
EQUITIES	Europe ex-UK		■				Cyclically oriented sector profile, low valuations among financials and improving vaccination rate supportive. Continued monetary policy support and recent launch of the EU recovery fund should provide additional tailwinds.
EQUITIES	UK				■		Vaccination pace is likely to lead to easing lockdown and strong real activity.
EQUITIES	Japan				■		Accelerating vaccine rollout, attractive valuations and strong global trade outlook should be supportive. Improving corporate governance also provides a long-term tailwind.
EQUITIES	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.
EQUITIES	Emerging Markets (EM)				■		Valuations very attractive, and Chinese regulatory pressures may have peaked. Strength in global trade, appreciating currencies and a dovish Fed offer further support. Inflation and vaccine and delta variant challenges remain concerns.
	Style and Market Capitalisation						
EQUITIES	Global Growth vs. Value[1]		■				Deep cyclical orientation of value stocks combined with attractive relative valuations and improving earnings outlook could be catalysts. Vaccine progress, a rebound in manufacturing, and easing of supply bottlenecks could also provide a boost.
EQUITIES	Global Small-Cap vs. Large-Cap[1]				■		Strong domestic growth trends remain supportive for small-caps, and idiosyncratic opportunities are plentiful. Meanwhile, strong global economic outlook should benefit large-caps given cyclical orientation and exposure to international trade.

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* Includes Australia.

[1] For pairwise decisions in style and market capitalisation, positioning within boxes represents positioning in the first-mentioned asset class relative to the second asset class.

UK INVESTMENT COMMITTEE POSITIONING

As of 31 August 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.

		Change	Underweight	Underweight	Neutral	Overweight	Overweight	
BONDS	UK Gilts			■				Strong activity and inflation data could trigger the next big bout of Bank of England hawkishness. The bad news of the delta variant of the coronavirus is already priced in.
	UK Inflation Linked	▼			■			While inflation expectations are on the rise, actual inflation can surprise on the upside.
	UK IG Corporates					■		Market technicals remain supportive, but there are still plenty of uncertainties around corporate fundamentals during the economic recovery.
	US IG Aggregate			■				Scope for rates in the UK to rise more than in the US. However, stronger inflation and economic growth are expected in the US.
	European IG Aggregate			■				High-frequency indicators suggest scope for very fast catch-up growth in the next one to two months. Vaccination pace is healthy and cases are still falling, but delta variant risk is likely to emerge.
	Global High Yield					■		Limited upside given elevated valuations; relative yields still attractive versus alternatives within fixed income. Fundamentals broadly supported by positive macroeconomic backdrop.
	EM Dollar Sovereigns				■			Attractive yield versus developed markets with improving growth broadly supportive; however, vulnerabilities across countries vary in coronavirus spread/vaccine accessibility, rising inflation and susceptibility to rising rates.
	EM Local Currency					■		Valuations remain modestly attractive; improving macroeconomic backdrop and potentially weaker US dollar could provide tailwinds. Shift higher in US rates and EM central bank rate hikes could be headwinds.
	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	GBP vs. USD					■		The valuation of the pound is more attractive after recent weakness. The US Federal Reserve has become more dovish in its rhetoric, while the Bank of England may turn more hawkish.
	GBP vs. EUR					■		We expect a stronger economic recovery in the UK than in the eurozone and that the pound will continue its positive momentum against the euro. One risk to our view is the spread of the delta variant.
	GBP vs. JPY				■			The pound may appreciate against the yen; however, we retain a neutral bias given the yen's safe-haven properties.

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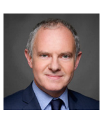
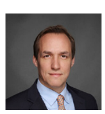
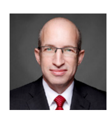
UK INVESTMENT COMMITTEE



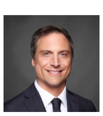
Quentin Fitzsimmons
Senior Portfolio Manager, Fixed Income Division



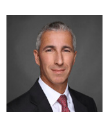
Andrew Keirle
Portfolio Manager, Emerging Markets Local Currency Bonds



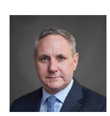
Yoram Lustig
Head of Multi-Asset Solutions, EMEA



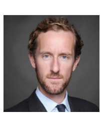
Ken Orchard
Senior Portfolio Manager, Fixed Income Division



David Stanley
Portfolio Manager, European Corporate Bonds

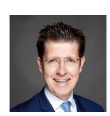


Toby Thompson
Portfolio Manager, Multi-Asset Division



Mitchell Todd
Co-head of EMEA Equity

Michael Walsh
Solutions Strategist, EMEA



Tomasz Wieladek
International Economist

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