Q&A with Justin Thomson, T. Rowe Price's CIO for International Equities

March 2022

On a recent visit to Asia, Justin held a fireside chat with clients across the region. Here we summarize the lively discussion that took place in Q&A form.

Q1: Justin, can you start with a recap of markets in the first quarter and how recent developments may have impacted your view of 2022?

As we entered 2022 I believe many of us expected it was going to be a year of 'normalization.' By normalization, I mean we would see a reduction in many of the distortions that had arisen as a result of the coronavirus pandemic. These included both supply-side and demand-side distortions. We expected the disruptions to supply chains, particularly for critical manufacturing components like semiconductors, to gradually fade in 2022 as operating conditions for the majority of firms returned to normal. On the demand side, we had seen strong coordinated economic stimulus from governments and central banks around the world in 2020 and 2021. And so we expected to see a tactical withdrawal of stimulus, with normalization of monetary policy being everybody's base case for 2022.

How would policy normalization impact financial markets? Well, primarily it would manifest itself through rising interest rates. Higher interest rates in turn meant that we were expecting a normalization in bond and equity valuations and a retreat from some of the 'pockets of excess' witnessed in 2021. As we entered 2022, markets had already become a bit bumpy during the fourth quarter. Investors had realized that inflation was going to be a more sustained issue for markets in 2022 than previously thought. The upshot was that both the journey and the final destination on short term policy rates are going to be longer and higher than previously thought and a bigger potential challenge for stretched valuations. Normalization was also expected to apply to earnings growth. The very high pandemic recovery rates of earnings growth were bound to slow, even if the underlying earnings environment remained robust.

Q2: If 2022 initially appeared to be the year for normalization, this theme was sadly interrupted by the conflict between Russia and Ukraine. How do you see these tragic events impacting global markets?

The first thing we must do is to acknowledge the tremendous scale of the human tragedy there and the massive relief effort that will be rquired to rebuild Ukraine after the conflict end. But putting those things to one side, let's think about what it means for financial markets. I don't believe that anybody was positioned for a full-scale incursion by Russia into Ukraine. In a war scenario the normal rules for markets do not apply. I can't think of a suitable parallel for what we are currently experiencing. We have seen one tail-event or shock, the Russian-Ukraine conflict, closely followed by a second – the determined and united response from the Western world to sanction Russia heavily.

Justin Thomson
CIO and Head of International Equity

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Economic sanctions against Russia were as surprising as much as they were rigorous. The reprisals of shutting off Russian banks from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) payment system was something that had been talked about. But sanctioning the Russian central bank by denying access to their own reserves was the most surprising element of the sanctions. As such, it represents a new form of economic warfare that no-one had previously thought about. And many people have been sitting up and taking notice of that.

I believe that we won't be in a position to understand the longer term impact of the Russia-Ukraine crisis for quite a while. The Germans have a very good expression for this – ***Zeitenwende***. It means that we have reached an inflection point in history that is going to be a game changer. And the world as we think of it is certainly going to change in ways that are difficult to predict as a result of Vladimir Putin's war against Ukraine. One of the first things we are likely to see is a re-orientation of energy strategies as Europe reduces its dependence on Russian oil and gas. There will be an acceleration of investment in renewables, especially as the switching costs are reduced if energy prices remain elevated. Another obvious implication of Russia's invasion of Ukraine is that we can expect higher defense spending. Germany in particular has been explicit in targeting a defense budget that reaches 2.0% of GDP for the first time.

Q3: The immediate impact of sanctions has been a sharp spike in energy prices, notably oil and gas, as happened during the Gulf war in 1991. How is this likely to play out?

What we're seeing today is broad commodity price inflation across a broad range of items – energy, food and metals – which makes this a very different scenario from what we saw in 1991. The way in which this unfolds for markets is absolutely crucial. The longer the dislocation in energy markets goes on, the more serious it becomes in terms of the direct inflationary impulse, which is obvious, and also in terms of the second-round effects on industry and services. And the second-round effects will be a deflationary, or potentially, a recessionary impulse. So, the rise in energy costs is one of the things we need to think seriously about. Despite all the talk today among investment managers of stagflation, forward oil prices remain below spot prices. I think this offers a glimmer of comfort, as it implies the market expects crude oil prices to be coming down over time.

Inflation is going to be unevenly spread. The inflationary impulse is not just in oil and gas, it's also in food prices, particularly wheat where Ukraine and Russia are about 25% of global supply and are a very important food source for countries in the Middle East and Africa. So there is going to be a direct effect through food inflation, with a knock-on negative effect on overall consumer spending. Asian economies, being largely rice-based, should be more isolated from these pressures.

Q4: There has been an active debate over whether inflation pressures in the post-Covid recovery are transitory or more permanent. Justin, what is your view?

I think what we all need is a sound framework for how to think about inflation, which issues are temporary and which issues are more structural or longer term. When it comes to supply chain problems, for example, there is a great phrase that the cure for high prices is even higher prices which create additional supply and lower demand, in turn bringing prices down. This applies to semiconductors and other electronic inputs, secondhand cars, and other items that we bought in great quantities during the lockdown, such as PCs, bicycles, and caravans. Exceptional price increases for these items are largely pandemic-related and should likely normalize as countries generally learn to live with Covid. Overall there was exceptionally strong demand for consumer goods that was a direct result of the huge policy stimulus delivered in 2020 and 2021.

As the stimulus is withdrawn, we can expect the demand effect to fade.

There is also a need to think about the more permanent or structural effects on inflation due to the pandemic. One important channel concerns labor force participation rates, where many people left the work force, dubbed the "Great Retirement." This has created a strong bid in the labor market, particularly for those with technology skills. So higher wage and salary inflation has become a growing concern for policymakers. It could lead to second-round effects on inflation expectations and also to strong capex demand to substitute away from more expensive labor. And to the extent that we see a trend toward deglobalization as supply chains become more localized, that also is likely to have some impact on inflation.

On top of this, I also detect in policymakers and governments a higher political acceptance of inflation, in part related to the need for greater equality and leveling up. With this we may see more largesse in fiscal spending and a greater appetite for fiscal deficits. And I think these are important structural changes that signal the end of the era of austerity that we've been living through since the global financial crisis 13 years ago. If I'm to nail my colors to the mast, I think we are currently experiencing a paradigm shift under which inflation is going to be more elevated in the years ahead than we have become accustomed to.

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Q5: Another hot topic is the debate on interest rates, which is almost impossible to separate this from the view on inflation. Where should interest rates be? How do you see central bank policies evolving in response to all that is happening?

To think about interest rates one needs to again have a framework, starting first with policy rates and, secondly, what it means for market rates or bond yields. Following the Federal Reserve's (Fed) first 25 basis point[1] rate hike at the March Federal Open Market Committee (FOMC) meeting, markets expect a series of rate hikes this year, with more to come in 2023. There is nothing in the current market situation that leads me to disagree with this expectation. Besides the Fed, we are seeing central banks around the world having already raised or starting to raise interest rates, in both developed and emerging economies.

What was highly unusual in this rate environment is that at the start of the year real bond yields were at 50-year lows. Something needs to change. If real interest rates are too low, then either nominal rates[2] and bond yields must go up, or inflation subsides. I suspect the outcome in 2022 is going to be some combination of the two. My own view is that the direction of least resistance is for interest rates and bond yields to go up. So I would expect bond yields globally – with a few exceptions, such as Japan – to be steadily moving up from current levels.

With regard to stock markets, history shows that equities can perform well in an inflationary environment up to a certain point or threshold, typically an inflation rate of around 3% to 4%. It has only been when inflation has been sustained for a period above 4% that equity markets have tended to suffer. Much will depend on the pace of interest rates hikes and on the starting point for economies. In the present episode we have already seen a pretty decisive sell-off. All equity markets in March had fallen into correction territory, down 10% or more. Some had entered bear market territory, defined as a drawdown of in excess of 20%[3]. So, from this starting point it is difficult to say exactly how rates and markets will interact going forward. Many emerging markets, though not all, appear to be well progressed in their tightening cycles. A few, such as China, may even be on the cusp of a rate cutting cycle.

[1] A basis point is 0.01 percentage points.
[2] Nominal rates refer to the interest rates before taking inflation into account.
[3] Source: Bloomberg Finance L.P. Index percentage changes from December 31 2021 to March 15 2022 for S&P500 Index, NASDAQ Composite Index, MSCI Emerging Markets Index, MSCI AC World Index, Shanghai SE Composite Index, and Hang Seng Index.

> There's a lot happening in emerging markets today for investors to like....

Q6: Next question, after a number of disappointing years how should clients think about investing in emerging markets? What do you feel is the strongest case for maintaining exposure to emerging markets in the portfolio?

Obviously, being overweight emerging markets (EM) is a bet that hasn't paid off for a while now. But I think it is still possible to construct both a tactical and a structural case for investing in emerging markets. There's a lot happening in emerging markets today for investors to like, which I think defies the popular narrative that we're seeing in markets at the moment. And that's in spite of what happened in February, with the sudden removal of Russian securities from certain emerging markets indices. Despite this shock, the tactical argument for EM is that there is an attractive valuation case to be made. If I look at it on a price-to-book basis, EM are at a 40% discount to developed markets, a 20-year relative low.[4] Sector adjusted, so that you're comparing apples with apples, emerging markets today look relatively cheap.

On a dividend-yield basis also, EM are at a premium to the dividend yield in developed markets of approximately 40%, a two standard deviation event.[5] Another tactical argument concerns monetary policy. Emerging markets in the main are better placed in the monetary cycle than the developed markets. And in fiscal policy, China is the only large economy that plans to add significant fiscal stimulus this year, which should likely benefit Asian economies in particular.

The structural investment case for emerging markets remains a strong one, in my view. The investable universe for EMs has changed dramatically over the past decade with much less reliance on resources and commodities and growing exposure to sectors such as consumer discretionary, healthcare, technology, and the internet, with growing levels of innovation and R&D spending. There have also been structural improvements in EM's macro fiscal and external balances that appear to be underappreciated by markets. In many cases, EM currencies have not followed the many improvements in current accounts and balance of payments. And the adage that I've observed over the years is that you buy emerging markets, both equity and fixed income, you buy emerging markets when their FX is fundamentally cheap, which it is today based on relative exchange rate parities.

Q7: Turning to China, what do you think drove the recent heavy selloff in Chinese equities? How is it different from previous selloffs?

Chinese equity markets came under considerable pressure in March, and there are a few different reasons for this, we believe. Firstly, there has been increased investor concern around the crisis in Ukraine and the potential risk of sanctions being imposed on China given the relationship the country has with Russia. Secondly, concerns around the potential delisting of Chinese ADRs in the US came to the fore again, as we had the first batch of ADRs identified by the PCAOB in the US (Public Company Accounting Oversight Board) as potential de-listing candidates under HFCAA (Holding Foreign Companies Accountable Act).

Finally, we also had news of the recent outbreak of omicron in China with the authorities announcing a lockdown in Shenzhen (a major manufacturing and technology hub as well as the 4th largest port in the world) and this likely re-ignited concerns around supply-chain issues. The confluence of these factors likely exacerbated negative sentiment in the short term, triggering some extreme price action, but we do believe that there are factors the market is overlooking currently.

The ADR delisting issue is not new, and we think it is important to remember

[4] Source: Bloomberg Finance L.P. MSCI Emerging Markets Price-to-Book Value Index less MSCI Developed Markets Price-to-Book Value Index from January 2000 to February 2022.

[5] Source: Bloomberg Finance L.P. MSCI Emerging Markets Dividend Yield relative to MSCI Developed Markets Dividend Yield from March 2002 to February 2022.

that stocks will not be delisted immediately. The HFCAA requires companies to comply to auditing standards within three years of being put on notice. This is more than enough time for companies to setup a secondary – or even a primary – listing on another exchange. Also important to recognize is that many of these ADRs already have a secondary listing, so there is low likelihood that the shares will be untradeable. In cases where ADRs do get delisted, provided the secondary listing has been established, the ADRs and local shares will be fully fungible.

We have also seen the regulatory environment adjust – when the ADR issue came back into the headlines, one of the concerns over setting up a secondary listing was the relatively strict requirements on the Hong Kong exchange. However, the Hong Kong exchange has loosened its listing requirements to accommodate companies to either list in Hong Kong (if they have not done this already) or to switch Hong Kong to their primary listing over the next few years.

As such, it seems that the recent selling pressure on Chinese equities, is not being driven by "new" news, but rather a combination of previous concerns and negative headlines in a market with fragile sentiment. Previous market sell-offs were driven by a range of different factors, but largely focused on domestic issues. Last year we had the ongoing regulatory focus on sectors such as technology and online education with a view to promoting social equity by addressing perceived anti-competitive practices, high cost burdens and low wage levels. We also saw selective selling of some Chinese equities on environmental, social, and governance (ESG) concerns.

2021 also saw concerns around the real estate sector impact the equity market as the government took action to prevent overheating in the property market. Worries around potential default risk against a backdrop of slowing growth and concerns over the health of the financial system contributed to the market sell-off. This recent sell-down is quite different as it has been focused on the off-shore sector, and to some extent, negative sentiment in the market became a self-fulfilling narrative.

> "Some Chinese stocks are trading at one to two standard deviations from their Western peers.....

Q8: Following the regulatory shocks last year there has been some debate as to whether China is "investible" at this point. Can you please share your thoughts on this?

We at T. Rowe Price strongly refute the notion that "China is un-investible" and believe one should not lose sight of the opportunity going forward. The investible universe in China is rapidly expanding, and one can look below large cap technology / state-owned enterprises (SOEs) to find really interesting companies that are good capital allocators, and which we think present many exciting investment opportunities. Also, today the Chinese economy is in a position where the authorities are looking to loosen economic policy in order to support growth. The credit impulse is increasing, which in the past has tended to have a positive impact on the stock market.

And lastly, I think valuations in many cases are looking attractive compared to history and to other regions. Some Chinese stocks are trading at one to two standard deviations from their Western peers, and history would suggest that dislocations like these tend to provide longer term opportunities.

One final thought I would like to leave our clients with in this time of market turbulence and geopolitical tensions is that the world rarely comes to an end. As surely as day follows night, the sun will rise on markets again. On markets more broadly, I remain optimistic even if in the short-term we experience more bumps and volatility.

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APAC-PAN-3096
202204-2106412