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Global Asset Allocation: The View From Europe

November 2022

1 Market Perspective

- The outlook for the global economy remains uncertain as central banks navigate battling stubbornly high inflation in the face of weakening growth expectations.
- Taming inflation remains the US Federal Reserve's number one goal despite the risk of creating more economic pain. Energy-driven inflation gives the European Central Bank (ECB) a more challenging task amid a divergence in fiscal flexibility across the European Union's members. While having held steadfast, the Bank of Japan (BOJ) may be forced to ease yield curve controls as inflation has started taking hold.
- Emerging market (EM) central banks are ahead in the global tightening cycle but may need to hold rates high to defend weak currencies. In contrast, China eases policy to balance growth risk from COVID lockdowns.
- Key risks to global markets include central bank missteps, persistent inflation, potential for a sharper slowdown in global growth, China's balance between containing the coronavirus and growth and geopolitical tensions.

2 Portfolio Positioning

As of 31 October 2022

- We are underweight stocks as we remain cautious on the environment for equities given still-aggressive central bank tightening and a weakening outlook for growth and earnings.
- We remain modestly overweight cash relative to bonds given the risk of higher rates weighing on bonds, while cash offers safety and more attractive yields given the push higher in short-term policy interest rates.
- Within equities, we are nearly balanced between value and growth. The slowing growth backdrop is unfavourable for cyclicals, while higher rates weigh on growth-oriented equities.
- Within fixed income, we are overweight EM dollar-denominated and local currency sovereign debt. EM bond yields offer reasonable compensation for risks. Default rates are expected to rise from today's historically low levels, although yields at current levels help provide a buffer. We also hold an overweight to euro government bonds as a risk-off ballast to equities.

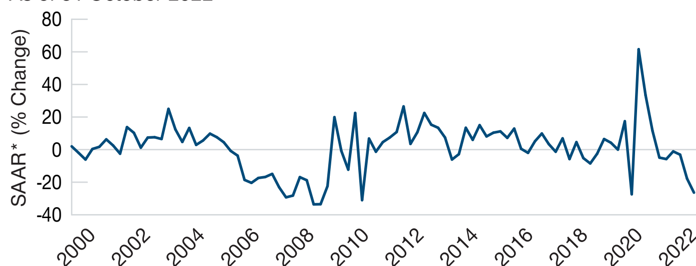
3 Market Themes

When Bad News Is Good

On the surface, the better-than-expected rebound in US gross domestic product (GDP) growth in the third quarter would reinforce the Fed's need to remain aggressive on tightening policy. However, looking at the details, there is growing evidence that the economy is feeling the bite of sharply higher rates. Consumer spending, comprising nearly 70% of GDP, declined while residential fixed investment, a broad measure of housing activity, slumped by more than 26%. Consumer confidence data last month also flashed warning signs that consumers were increasingly concerned about the impact of high inflation and are worried about the job market ahead. Signs of slowing were seen in the October ISM Manufacturing Index that fell to levels last seen in May 2020, although it did show promising signs on the inflation front with supplier deliveries and prices paid easing. US markets have responded positively to the batch of bad news, with US Treasury yields easing and equity markets climbing higher. While the Fed remains vigilant in its battle to fight inflation, evidence is building that its front-loaded rate hikes are having an impact, at least on growth and potentially preceding softer inflation data. Meanwhile, investors are likely to continue to cheer bad economic data in hopes that it brings good news of a Fed pivot in policy.

Real Private Residential Investment

As of 31 October 2022



Divided, We Rally?

US markets have historically championed periods of divided government, and with the midterm elections imminent, polls suggest that may occur with the increasing odds of Republicans take control of the House of Representatives—and with the Senate now being a toss-up. Amongst voters' top issues are record-high inflation and a slowing economy, which are weighing on Democrats, whose two-year reign saw them advance progressive policies and spending that voters may now blame for fueling inflation. Historically, a divided government has been seen as a positive, providing checks and balances of power, reducing the likelihood of extreme policies being passed and for legislation that requires more bipartisan compromise. Similarly, uncertainty that impacts corporate and household spending plans eases as the likelihood of significant changes to spending, taxation and regulatory policies ebbs. However, while gridlock may be welcomed by the markets, a divided government could raise the potential for volatility in other areas, such as raising the debt ceiling limit, support for Ukraine and regulation of the technology sector. China policy has been an area which has witnessed broader bipartisan agreement representing a potential risk to markets. So, while markets could rally on news of a divided government, we shouldn't expect political uncertainty to go away, particularly in today's world.

Chances of Controlling the Senate

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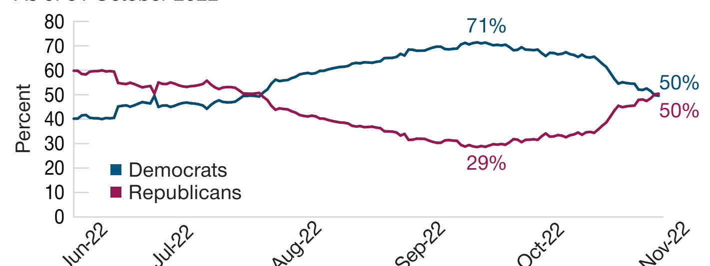

Past performance is not a reliable indicator of future performance.

*SAAR = Seasonally Adjusted Annual Rate.

Sources: Haver Analytics/Bureau of Economic Analysis and FiveThirtyEight.com

REGIONAL BACKDROP

	Positives	Negatives
Europe	▪ Fiscal spending is likely to increase ▪ Very attractive equity valuations ▪ ECB sovereign bond-buying backstop	▪ Recession risk is very high ▪ Industrial production will be curtailed by energy shortages ▪ ECB is tightening ▪ Sovereign debt risks are rising ▪ Limited long-term catalysts for earnings growth
United Kingdom	▪ Energy cap will partially offset mortgage and energy shocks to household finances ▪ The labour market remains strong	▪ The Bank of England will raise interest rates to high levels ▪ Fiscal consolidation will further weigh on demand next year ▪ A recession and sharp house price declines next year appear likely
United States	▪ Strong corporate and consumer balance sheets ▪ Resilient labour market ▪ Supply chain issues are improving rapidly ▪ Inflation eased in October	▪ Persistently high inflation ▪ Restrictive monetary policy ▪ Labour supply shortages ▪ Deteriorating corporate margins

	Positives	Negatives
Japan	▪ Earnings outlook remains healthy relative to other regions ▪ The policy setting remains accommodative with no change expected ▪ The Japanese yen is cheap helping the export sector	▪ Leading economic indicators continue to be weak due to elevated input prices ▪ Inflation is pushing investors to question the BOJ's commitment to its yield curve control policy ▪ The global slowdown is a concern for the export-heavy stock market
Asia Pacific ex-Japan	▪ Bad news is seen as good news, with the economic slowdown in China implying further stimulus support ▪ China company valuations remain undemanding with solid earnings growth being forecast in the next 12 months ▪ In Australia, consumer spending remains healthy despite headwinds. Consensus expects the Reserve Bank of Australia to moderate the pace of tightening going forward, reducing pressure on rising yields	▪ Risks of renewed mobility restrictions in China are increasing with the coronavirus spreading further ▪ The risk premium increased following China's Communist Party Conference ▪ In Australia, expectations for future earnings are becoming more cautious to reflect the slowing domestic economy. The housing market has peaked as evidenced by prices/activity levels
Emerging Markets	▪ Chinese authorities are easing monetary and credit conditions ▪ Equity valuations are attractive relative to the US ▪ EM central banks are further along in the tightening cycle ▪ Attractive currency valuations	▪ Global trade volumes are slowing ▪ COVID policy remains a headwind to economic growth ▪ Chinese housing concerns have impacted industrial activity ▪ Chinese regulatory actions are weighing on confidence ▪ Geopolitical risks are elevated

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EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 October 2022

Underweight — *Neutral* — *Overweight*

▼ or ▲ Month-Over-Month Change

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

		Underweight	Underweight	Neutral	Overweight	Overweight	Change / View
ASSET CLASSES	Equities		■				Stocks remain vulnerable amid tightening liquidity and a hawkish Fed. Earnings expectations are fading rapidly but remain elevated. However, valuations are at reasonable levels after falling considerably through the year.
ASSET CLASSES	Fixed Income				■		The balance between central bank tightening, high inflation and deteriorating growth likely keeps rate volatility elevated. Credit sectors, such as EM debt, offer attractive yields and fair spreads with supportive fundamentals.
	Region						
EQUITIES	US		■				US equities remain expensive on a relative basis. However, the less cyclical nature and stronger near-term outlook may provide some support as global growth weakens.
EQUITIES	Europe ex-UK		■				Valuations are compelling, but elevated energy costs and weakening manufacturing activity have made a recession highly likely. Meanwhile, the ECB is constrained in providing support, with inflation concerns rising.
EQUITIES	UK			■			Brexit adjustments probably exacerbate the effects of supply shortages and the rise in energy prices. Uncertainty about the future path of fiscal and monetary policy will lead to gilt curve steepening and a weaker British pound.
EQUITIES	Japan				■		Despite cyclical concerns, Japan offers historically cheap valuations, relatively lower inflation, accommodative monetary and fiscal policy and improving corporate governance. Yen weakness has reached extreme levels but may face further weakness over the near term.
EQUITIES	Developed Asia ex-Japan*			■			Valuations are attractive relative to the US. Chinese stimulus is supportive. Export-driven economies face challenges because of the global economic slowdown.
EQUITIES	Emerging Markets				■		Valuations and currencies are attractive. Central bank tightening may have peaked. However, the near-term outlook in China has deteriorated due to ongoing COVID lockdowns, housing market concerns and geopolitical uncertainty.
	Style and Market Capitalisation						
EQUITIES	Global Growth vs. Value†		■				Relative valuations for value stocks remain attractive, and energy sector earnings could provide support. However, the more cyclical nature of value stocks makes them more vulnerable if inflation concerns give way to increasing recession risks.
EQUITIES	Global Small-Cap vs. Large-Cap†				■		Small-cap stocks offer historically attractive relative valuations, reflecting elevated recession concerns and the impact of higher financing costs. However, small-cap earnings have held up well thus far and could improve if the outlook stabilises. Higher-quality bias is warranted.

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*Includes Australia.

† 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.

EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 October 2022

Underweight — *Neutral* — *Overweight* ▼ or ▲ Month-Over-Month Change

		Underweight	Underweight	Neutral	Overweight	Overweight	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.**
FIXED INCOME	Euro Government Bonds				■			The ECB should continue rate hiking. Bond supply may increase due to energy compensation. High-quality duration can mitigate some risks given the decreasing likelihood of the global economy dodging a recession.
	Euro Inflation Linked			■				Inflation expectations are expected to ease.
	Euro Investment-Grade (IG) Corporates		■					Underweight credit risk in expectation of further slowing growth and widening credit spreads, particularly in Europe.
	US IG Aggregate		■					Scope for rates in Europe to rise more than in the US. However, stronger inflation and economic growth are expected in the latter.
	Global High Yield			■				Credit fundamentals and the default outlook remain stable but may be challenged as economic growth continues to deteriorate. Higher yields offer reasonable compensation for risks, with spreads fairly valued and likely to remain volatile.
	EM Dollar Sovereigns				■			Yield levels look attractive versus developed markets but are reflective of rising global growth and inflation concerns. Prospects for stimulus from China are supportive.
	EM Local Currency				■			EM yields are at attractive levels amid central bank tightening and risk-off sentiment. However, a strong US dollar continues to be a headwind.
	EM Corporates			■				The impact of the pandemic on the asset class is difficult to quantify, but the prospect of normalisation bodes well. Country-specific risks remain elevated.
CURRENCIES	EUR vs. USD			■				While the euro seems cheap at present, the likelihood of the European economy slipping into recession and the safe-haven properties of the US dollar could keep prices at these levels.
	EUR vs. JPY		■					The yen remains a safe-haven currency. The valuation of the yen is at an attractive level. Any hint of change of policy by the BOJ could support the yen.

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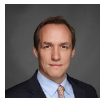
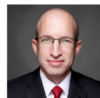
EUROPEAN INVESTMENT COMMITTEE

Quentin Fitzsimmons
Senior Portfolio Manager, Fixed Income Division



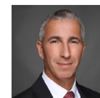
Andrew Keirle
Portfolio Manager, Emerging Markets Local Currency Bonds



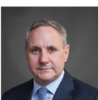
Yoram Lustig
Head of Multi-Asset Solutions, EMEA

Tobias Mueller
Portfolio Manager, Equity Division

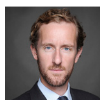
Ken Orchard
Senior Portfolio Manager, Fixed Income Division



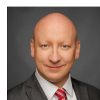
David Stanley
Portfolio Manager, European Corporate Bonds



Toby Thompson
Portfolio Manager, Multi-Asset Division

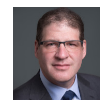


Mitchell Todd
Portfolio Manager, Equity Division



Michael Walsh
Solutions Strategist, EMEA

Tomasz Wieladek
International Economist



Lowell Yura
Head of Multi-Asset Solutions, North America

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