



2023 Global Market Outlook

The Need for Agility



Navigating the economic balancing act

The outlook for inflation and interest rates will remain critical in 2023, as investors try to estimate where rates will peak and when the Fed might 'pivot' towards monetary easing.

page 2



Expect a change in equity leadership

Soaring bond yields largely drove equity bear markets in 2022 by compressing valuation multiples.

page 3



Threats and opportunities as yield returns

A brutal year for bond markets in 2022 ended with a silver lining for investors.

page 4



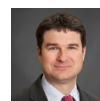
Reports of globalisation's death greatly exaggerated

Geopolitical tensions and supply disruptions have led some analysts to question whether an era of economic integration has ended, dimming prospects for productivity and growth.

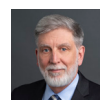
page 5



Sébastien Page, CFA
Head of Global Multi-Asset



Justin Thomson
Head of International Equity and Chief Investment Officer



Andrew McCormick
Head of Global Fixed Income

Introduction

After more than a decade of relatively benign markets, the investment environment rapidly changed in 2022 as historically high inflationary pressures forced global central banks to aggressively raise interest rates.

With expectations of a prolonged period of higher inflation and elevated rates, T. Rowe Price CIOs Andrew McCormick, Sébastien Page, and Justin Thomson discuss the key implications of ‘regime change’ in the 2023 Global Market Outlook.

Agility is set to be paramount in the year ahead, as uncertainty lingers over the severity of the coming slowdown. With the era of cheap money and multiple expansion likely to be over, the CIOs believe investors must be willing to be selectively contrarian when looking to exploit opportunities across the major asset classes.

Navigating the economic balancing act

By Justin Thomson, Head of International Equity and CIO, Andrew McCormick, Head of Global Fixed Income and CIO, and Sébastien Page, Head of Global Multi Asset and CIO

A slowing economy favours long duration, with long duration treasuries historically performing well in recessions. This could provide diversification as the economy weakens.

ACTIONABLE INVESTMENT SNAPSHOT

A slowing economy favours long duration, with long duration treasuries historically performing well in recessions. This could provide diversification as the economy weakens. There is also scope to play selective offense. For example, small-caps have priced in a dire economic scenario and may offer upside when inflation and growth outlooks improve. In addition, yields on high yield bonds are attractive relative to recent history, with support by strong fundamentals.

The outlook for inflation and interest rates will remain critical in 2023, as investors try to estimate where rates will peak and when the Fed might 'pivot' towards monetary easing.

US consumer inflation slowed in late 2022, thanks to a partial unwinding of the oil and other commodity price spikes seen earlier in the year. But inflation in the services sectors remained 'sticky', as tight labour markets continued to push wage costs up at a relatively rapid clip.

In the US, inflation has likely peaked, but the key question is where it lands. It is unlikely to be at the Fed's presumed target of 2%. We know inflationary shocks can take years, not months, to work through.

Sticky inflation creates considerable uncertainty about where interest rates will peak in this Fed tightening cycle. With rates now in 'restrictive' territory, Fed policymakers may slow the pace of hikes. But futures markets suggest investors still expect the Fed to lift the target for its key policy tool, the federal funds rate, to about 5%.

Fed policymakers hope to be able to pause at some point to allow the impact of previous rate hikes to work through the economy. Whether a pause turns into a pivot, or is followed by additional hikes, will depend on the balance between inflation and recession risks. But a quick turn to easing in 2023 appears unlikely. This means investors waiting for a clear sign that Fed policymakers are ready to cut rates could be left standing on the sidelines longer than they currently expect.

A mixed monetary picture

The inflation picture is more mixed in other major developed markets, as is the expected path of monetary policy. In Europe, high energy prices mean inflation is likely to be more stubborn than in the US, leaving the European Central Bank (ECB) in a difficult spot. Higher inflationary pressures, coupled with a high risk of recession, will be quite a test for the ECB.

As for Japan, policymakers may welcome higher consumer inflation in the hope it will bleed through into wage growth. The Bank of Japan shows no signs of abandoning

its version of quantitative easing, which involves managing the yield curve for Japanese government bonds.

Over the longer term, a number of structural factors are likely to tilt the US and other major developed economies towards higher inflation. These include slow or negative population growth in many developed countries, aggravated by lower workforce participation rates; a 'reshoring' of global supply chains, which could make production less efficient; demand pressure from heavy capital spending on the transition to sustainable energy sources; and a greater appetite for deficit-financed spending on the part of many developed market governments.

Dollar strength potentially challenged

Fed rate hikes contributed to a surge in the value of the US dollar in 2022, creating tight conditions for non-US borrowers, both public and private, which rely on dollar funding. Less clear is whether this trend will continue in 2023.

The dollar has always traded as a risk-off asset, but what was unusual this time around was its persistent strength against other major developed market currencies. Despite weakening somewhat in the last quarter of 2022, as of late November, the dollar remained between 35% and 50% overvalued against the euro, the yen, and the British pound on a purchasing power parity basis.

Exchange rates can defy fundamentals for lengthy periods, but given the level of dollar overvaluation, economic surprises – such as a sooner-than-expected Fed pivot – could easily push the US currency lower in 2023.

We should expect a weaker dollar and think about what this would mean for portfolio construction.

Expect a change in equity leadership

By Justin Thomson, Head of International Equity and CIO, and Sébastien Page, Head of Global Multi Asset and CIO

We see three possible US earnings scenarios – a soft landing, a ‘normal’ recession, and a recession plus a reversal in a 25-year trend towards higher US profit margins.

ACTIONABLE INVESTMENT SNAPSHOT

It may be wise to take a cautious view on equities and build a little cash buffer for future opportunities. While valuations are more reasonable, earnings expectations appear to be too optimistic. Time is needed to assess Fed progress on inflation and better understand the potential depth and duration of the economic slowdown. Within equities, we urge an emphasis on valuation and quality. Stocks that do not fit neatly into growth or value buckets have been somewhat overlooked. Many companies in this middle category offer attractive growth potential at more reasonable valuations than can be found at either style extreme.

Soaring bond yields largely drove equity bear markets in 2022 by compressing valuation multiples. But in 2023, earnings growth could move to the top of the list of investor concerns.

As of the end of November, forward consensus estimates predicted mid-single-digit growth in earnings per share (EPS) for the US and Japan over the following 12 months, and even slower EPS growth in Europe and emerging markets. Those estimates appear overly optimistic, as past US recessions typically have resulted in 15% to 20% earnings declines for the S&P 500 Index.

We see scenarios – a soft landing, a ‘normal’ recession, and a recession plus a reversal in a 25-year trend towards higher US profit margins.

In a soft-landing scenario, recent EPS assumptions for the S&P 500 Index appear reasonable. A ‘normal’ recession, based on the last four US recessions – not including the 2008-09 global financial crisis – could see EPS decline by 19% over the next 18 months. A recession with shrinking profit margins could produce EPS losses somewhat worse than in a ‘normal’ recession.

Although US equity valuations declined sharply in 2022, the price/earnings ratio (P/E) for the S&P 500 remained relatively high historically, as of the end of November. Excess liquidity and demand from passive investors could be propping up the index’s P/E, leaving it vulnerable to further compression if earnings disappoint.

New leadership amid regime change

Growth fears in 2022 boosted the popularity of stocks with relatively low historical exposure to market volatility and of ‘durable growers’ – companies with track records of delivering relatively stable revenue and earnings growth. Both groups now appear overvalued.

The trend towards higher inflation and interest rates marks a ‘regime change’, a structural shift with major implications for relative performance. Regime changes are nearly always associated with shifts in market leadership. The value style should be a long-term beneficiary of this rotation, and we are probably still early in the value cycle.

As a group, value stocks have historically outperformed growth in high-inflation periods. One reason for this is higher inflation tends to push up interest rates, fattening lending margins for banks, which carry a heavy weight in the value universe. Value also appears historically inexpensive relative to growth, even though US value benchmarks significantly outperformed growth counterparts in 2022.

US small-cap stocks could also offer relative performance advantages if the US economy does not fall into deep recession in 2023. On average, small-cap earnings have recovered more quickly than large-cap earnings in past economic recoveries. US small-cap valuations also appear cheap, both in historical terms and relative to large-caps.

However, we caution against painting the small-cap universe with too broad a brush – as it is a diverse asset class. The more cyclical parts should do well coming out of a recession, but small growth is likely to do less well.

Tailwinds for global equities

Regime change – the economic kind – could also boost the appeal of non-US equity markets in 2023. Value stocks, particularly banks, are less heavily weighted in the major US indices than in most non-US markets.

So high interest rates and value leadership should favour the latter. Sectors that have historically proven resilient to inflation, such as energy and materials, are also better represented in many non-US equity markets – especially emerging markets. In addition, the ‘de-rating’ of the big technology platform companies has only just begun, and big tech is underrepresented in most global equity markets. For US dollar-based investors, a reversal in dollar strength would put a tailwind behind local currency returns in non-US markets.

Japan could be a less obvious beneficiary of these trends. If higher consumer inflation bleeds through into wage growth, it could shock the economy into a higher level of domestic demand, which would be good for Japanese equities.

Threats and opportunities as yield returns

By Andrew McCormick, Head of Global Fixed Income and CIO, and Sébastien Page, Head of Global Multi Asset and CIO

In all scenarios outside of a deep recession, the valuation case for US high yield appears strong.

ACTIONABLE INVESTMENT SNAPSHOT

Higher interest rates and wider credit spreads have lifted yields in many fixed income sectors. While a slowing economy could further widen spreads, current yield levels can help provide a buffer against a rise in default rates. Here, we are optimistic on high yield bonds. In addition, we see opportunities within emerging market debt, where attractive valuations offer reasonable compensation for risks, and fundamentals remain generally supportive.

A brutal year for bond markets in 2022 ended with a silver lining for investors – it raised fixed income yields to some of the most attractive levels seen since the global financial crisis.

Higher yields were mirrored in greatly improved valuations for both sovereigns and private credits, with many sectors selling close to or below 15-year historical medians, as of late November. Higher-quality credits in the mortgage-backed and asset-backed sectors are also attracting inflows from investors looking to put cash to work or extend duration.

In fact, this is the first opportunity to try to lock in high-single-digit yields in more than a decade. Each time there has been a glimmer that the Fed might be ready to slow its tightening pace, or that inflation might have peaked, money has found its way into the market.

High yield bonds could offer particularly attractive return opportunities in 2023, and we see three potential positives. First, credit spreads have widened, while default rates have remained relatively low. Next, corporate balance sheets generally are in strong shape. Finally, energy accounts for a smaller share of US high yield debt than in the past, helping to reduce default sensitivity.

Default rates almost certainly will rise if the US economy slips into recession, but it would take a substantial leap to offset the return advantage built into current spreads. In all scenarios outside of a deep recession, the valuation case for US high yield appears strong.

As of late November, T. Rowe Price credit analysts estimated US default rates could rise to slightly under 3% for high yield bonds, significantly less than current credit spreads. This forecast assumes the US economy passes through a mild recession.

The outlook for European high yield is more guarded. While yields have also improved in those markets, the value proposition is less compelling because of the economic backdrop.

Beware volatility in illiquid markets

Market liquidity deteriorated in 2022 as monetary tightening accelerated, and as central banks shrink balance sheets in 2023, new buyers will be needed. However, stricter capital rules put in place after the global financial crisis have made it harder for bond dealers to function as liquidity providers.

Here, we have already seen bouts of illiquidity in some high-quality markets – such as UK gilts and US treasuries.

The risk of further episodes remains elevated. But poor liquidity and price volatility can also create opportunities for longer-term investors.

Obtaining diversification during inflation

Higher volatility also has big implications for portfolio construction. But the key issue is the source of the volatility and its impact on asset correlations. Historically, returns on stocks and on high quality government bonds have tended to move in the same direction when worries about inflation and interest rates have been high – as was the case in 2022. This can destroy the diversification benefits of government bonds.

However, when concerns about economic growth are uppermost, returns can move in opposite directions, increasing the diversification benefits of treasuries.

If 2023 is dominated by concerns about growth, government bonds could resume their traditional role as portfolio diversifiers. But, over the longer run, different tools may be needed. These could include ‘barbell’ structures that divide bond allocations between long government bonds and fixed income diversifiers – such as high yield, floating rate, and EM debt. Other tools could also include alternative strategies seeking to deliver positive absolute returns, real assets equities – such as energy, real estate, and metals and mining stocks – and equity strategies able to potentially offer downside risk mitigation in inflationary environments when government bonds fail.

Reports of globalisation's death greatly exaggerated

By Justin Thomson, Head of International Equity and CIO, and Andrew McCormick, Head of Global Fixed Income and CIO

Adaption will also create potential opportunities for investors, with the companies able to carve out important roles in the newer supply chains to be among the big winners

ACTIONABLE INVESTMENT SNAPSHOT

Geopolitical tensions, decarbonisation, and global supply chain restructuring are likely to catalyse capital spending in a variety of industries and countries. This should drive demand for raw materials and infrastructure. As for China, the authorities are easing monetary and credit conditions and providing housing market support. We are slightly overweight emerging market equities in general, as equity valuations are attractive relative to the US.

Geopolitical tensions and supply disruptions have led some analysts to question whether an era of economic integration has ended, dimming prospects for productivity and growth. But that risk appears to have been exaggerated.

Globalisation is not dead. It may not even be dying. Economically, globalisation has been defined by the five-fold rise in international trade as a percentage of world GDP since the early 1950s. While this ratio has stopped rising, it is also not falling.

However, recent events have shown globalisation is changing. A number of economies have become dependent on critical imports from one specific part of the world. Europe's heavy reliance on Russia for natural gas, for example, put its energy security at risk when the war in Ukraine sent gas prices soaring.

Market forces can correct such imbalances if given time, as demonstrated by the large declines seen in European gas prices in the second half of 2022. With demand forecasts slashed, new supply was rerouted to those markets.

Over the longer run, energy development could drive a massive global surge in capital spending on the transition from fossil fuels to renewable energy sources. Here, the numbers required are mind-boggling, with estimates as high as \$100trn.

Capital expenditures of this magnitude should generate investment opportunities on an equally grand scale in the technology, materials, and capital goods sectors, as well as in alternative energy producers and efficiency innovators.

Healing global supply chains

Widespread fears Covid-related supply shortages could linger for years, which would strangle global growth, also appear to have been overly pessimistic. Instead, supply chain reliability improved steadily over the course of 2022.

Moving into 2023 and beyond, supply chains in some industries are likely to be reconfigured to limit future disruptions. This will impose frictional costs, which supports the argument inflation will be stickier and volatility higher going forward.

Nevertheless, adaption will also create potential opportunities for investors, with the companies able to carve out important roles in the newer supply chains to be among the big winners. This could be the investing story of the next five years, if not the next decade. Skilled active management will be critical to take advantage of potential opportunities, as the quality of management teams will become crucial.

A contrarian case for China

Investor anxiety about the economic and political future of China, the world's second-largest economy, weighed heavily on Chinese markets in 2022. Trade and technology conflicts added to investor malaise, as the Biden administration unveiled new export controls designed to restrict China's access to advanced semiconductor technologies.

In fact, sentiment surrounding China has never been worse. However, this pessimism has been overdone. Firstly, easing Covid restrictions in China should help clear the way for an acceleration in economic and earnings growth. In addition, despite a turn towards stricter market regulation, China's political leaders – including President Xi Jinping – remain committed to a pro-growth agenda. While much of China's growth over the last three decades has come from property development, this era is coming to an end. However, different sectors should continue to drive a more moderate pace of economic growth.

As for the relationship with the US, Washington and Beijing both have an interest in avoiding a major break. A large-scale economic decoupling between the US and China would be a mutually assured depression. It is a frightening thought, but highly unlikely.

Even though these issues will continue to weigh on asset valuations and raise capital costs, it is important to stay objective, keep an open mind, and watch the data points as they evolve.

INVEST WITH CONFIDENCESM

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

Additional Disclosures

Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright © 2022, J.P. Morgan Chase & Co. All rights reserved.

Copyright © 2022, Markit Economics Limited now part of S&P Global. All rights reserved and all intellectual property rights retained by S&P Global.

"Bloomberg®" and Bloomberg U.S. Investment Grade Corporate Index, Bloomberg EuroAggregate Credit Index, Bloomberg U.S. Aggregate Credit—Corporate High Yield Index, Bloomberg Global High Yield Index, and Bloomberg Emerging Markets USD Aggregate Index are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by T. Rowe Price. Bloomberg is not affiliated with T. Rowe Price, and Bloomberg does not approve, endorse, review, or recommend T. Rowe Price products. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to T. Rowe Price products.

The "S&P 500 Index" is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates ("SPDJI"), and has been licensed for use by T. Rowe Price. Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); and these trademarks have been licensed for use by SPDJI and sublicensed for certain purposes by T. Rowe Price. T. Rowe Price products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the S&P 500 Index.

MSCI and its affiliates and third party sources and providers (collectively, "MSCI") makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. Historical MSCI data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

© 2022 T. Rowe Price. All rights reserved. T. Rowe Price, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc.