

THEME THREE
A Focus on Earnings

Equity returns were largely positive in the first five months of 2023. The question now is whether earnings forecasts, which stabilized in the first part of the year (Figure 6), will turn down again.

Page says he suspects they will. As of late May, he notes, 2024 earnings growth projections for the stocks in the S&P 500 Index were still in double digits. “We know that Wall Street analysts tend to wear rose-colored glasses, but I think those expectations will have to come down.”

Assuming the global economy enters a mild recession, 2024 global earnings could be flat to down 5%, Thomson estimates.³ Compared with past earnings cycles, that could be viewed as a bullish outcome. “At this stage, I think we’re looking at a fairly benign cycle.”

Even a modest earnings decline would put further pressure on stretched U.S. large-cap valuations. Back when the Fed was holding rates close to zero, Page recalls, a favorite Wall Street acronym was TINA—There Is No Alternative. “Well, TINA has left the building,” he says. “There are alternatives now.”

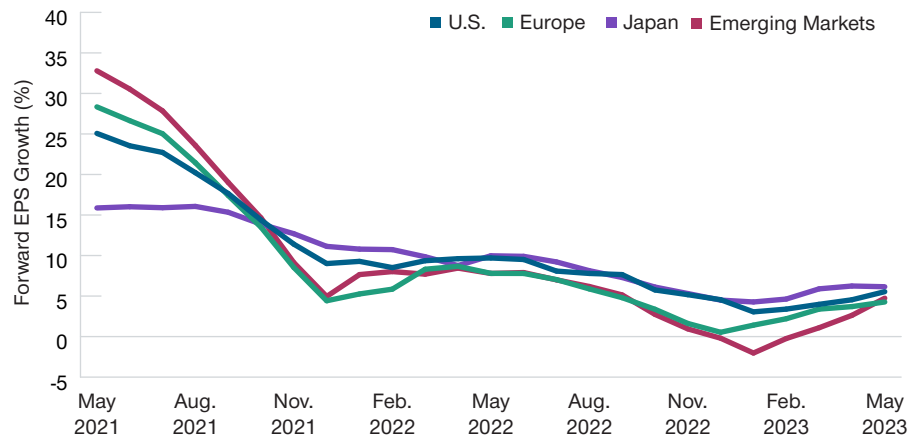
By some measures, U.S. large-cap stocks actually appear more expensive than they did before last year’s bear market, Page says, even though the price/earnings ratio (P/E) on the S&P 500 Index has fallen.

The valuation model used to calculate the equity risk premium—the added reward for taking on the additional risk of holding stocks rather than bonds—compares the earning yield on the S&P 500 (the inverse of the P/E) with the 10-year Treasury yield. At the beginning of 2022, Page notes, a P/E of 23 on the S&P 500 translated into an earnings yield of 4.3%, versus a 1.5% yield on the 10-year Treasury note. That put the equity risk premium at 2.8 percentage points.

By late May of this year, the P/E on the S&P 500 had fallen to 18.4, raising the earnings yield to 5.4%. But the 10-year Treasury yield had risen even more, to 3.7%. Net result: an equity risk premium of 1.7 percentage points—lower than before the 2022 equity sell-off.

Earnings Growth Expectations Have Fallen but Still May Be Too High

(Fig. 6) Forward earnings per share (EPS) growth estimates, next 12 months



As of May 31, 2023. Actual outcomes may differ materially from estimates. U.S. = S&P 500 Index. Europe = MSCI Europe Index. Japan = MSCI Japan Index. Emerging markets = MSCI Emerging Markets Index. Sources: Standard & Poor’s, MSCI (see Additional Disclosures). T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

³ Actual outcomes may differ materially. See Additional Disclosures regarding estimates.

“There’s an AI arms race underway, and I think that means the strong will get stronger.”

— Justin Thomson
Head of International Equity and CIO

By that same measure, Page adds, U.S. equity valuations currently are in the least attractive 5th percentile of their 10-year historical range.⁴

U.S. Small-Caps Are Cheap

There are, however, bargains to be found in the U.S. market, Page adds. Many quality small- and mid-cap stocks are trading at significant discounts to their historical averages. While the S&P 500’s P/E is closer to the top of its 10-year range than to its bottom, Page notes, the reverse is true for the S&P 600 Index—a leading U.S. small-cap benchmark. “U.S. small-caps are priced like it’s 2008,” he says.

Of course, small-cap valuations are low in part because many investors are worried about the risk of recession, and smaller companies historically have been more vulnerable in economic downturns. But, as with high yield bonds, skilled security selection can help active portfolio managers avoid companies with weak balance sheets and high cyclical earnings exposure, Page contends.

Potential opportunities also may be available at the opposite end of the capitalization spectrum: among the mega-cap technology companies that were hard hit in the 2022 sell-off, in part because of their expensive valuations.

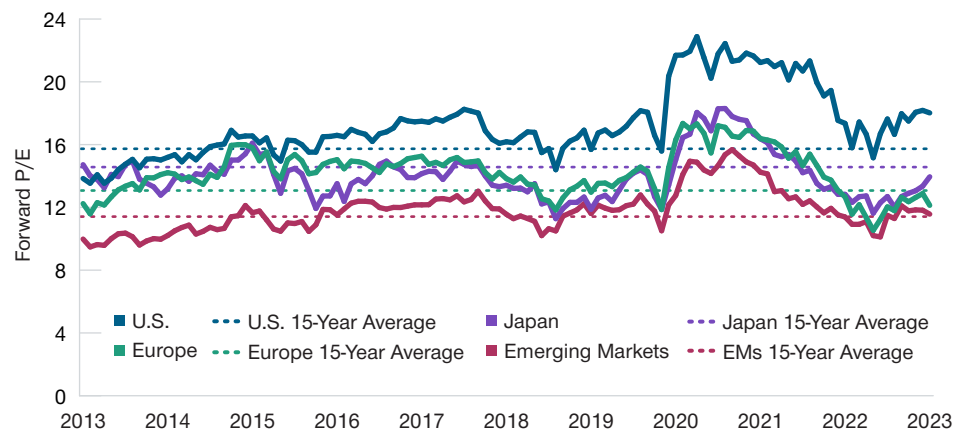
Big tech rebounded strongly in the first half of 2023, in part driven by growing investor enthusiasm for artificial intelligence (AI) applications such as ChatGPT, the widely publicized interactive chatbot launched last November.

Thomson says he expects AI to continue to drive investment in a range of tech sectors, including semiconductors, memory, and cloud storage. AI programs also require expensive training, he notes. All this plays to the strengths of the largest tech platform companies, which have the resources to develop new AI applications and/or refine existing ones.

“There’s an AI arms race underway, and I think that means the strong will get stronger,” Thomson argues.

Equity Valuations Appear More Attractive Outside the U.S.

(Fig. 7) Forward 12-month P/E ratios in major equity regions



As of May 31, 2023.

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⁴ Earnings yield on the Russell 3000 Index compared to the yield on the 10-year Treasury note for the 10 years ended May 23, 2023, based on monthly data.

An End to U.S. Outperformance?

For global equities more broadly, a key question for the second half is whether a record-long run of U.S. stock market outperformance will finally end.

Through the end of 2022, the S&P 500 Index had posted higher returns than the MSCI Europe, Australasia, and the Far East (EAFE) Index—a benchmark for developed markets outside the U.S. and Canada—for 53 consecutive rolling three-year periods, measured quarterly, Thomson notes. But financial gravity could pull the U.S. market closer to earth:

- Most global ex-U.S. markets continue to feature significantly lower valuations, relative to both U.S. equities and their own 15-year averages (Figure 7).
- Recent earnings growth estimates have been higher for Japan, and comparable for developed Europe, relative to the S&P 500.
- A weaker U.S. dollar could enhance global return potential for unhedged U.S. dollar-based investors.

Developed ex-U.S. equities, as a group, already are catching up with the U.S., Thomson says. The MSCI Europe Index outperformed the global market (as measured by the MSCI All Country World Index) by a full percentage point through the first five months of 2023, he notes.

Japan’s equity market could be the standout going forward, Thomson argues. For the most recent fiscal year, which ended in March, he notes, 5% growth in Japanese corporate earnings translated into a hefty 12% rise in earnings per share, thanks to major share buybacks.

Longer-term structural factors, such as improved corporate governance and capital allocation, also bolster the case for Japanese equities, Thomson contends, as does the potential for Japanese pension funds to reverse their 25-year pattern of being net sellers of Japanese equities.

Thomson also says he maintains a positive view on Chinese equities despite the country’s structural economic issues. Money supply growth in China currently is outstripping real economic growth, he notes. “Under normal circumstances, that’s usually a strong backdrop for financial asset prices.”

But investors need to be mindful of the geopolitical risks—most particularly, the potential for conflict over Taiwan. “We can’t make the Taiwan tail risk go away,” Thomson says. “I think it’s probably overstated, but it’s there.”

Past performance is not a reliable indicator of future performance.

A FOCUS ON EARNINGS		
Investment Idea	Rationale	Examples
Equity Markets With Unique Profiles	U.S. small-caps offer attractive valuations. Structural changes in corporate policies could be a long-term tailwind for Japanese equities. Mega-cap technology companies are well positioned to benefit from artificial intelligence.	<ul style="list-style-type: none"> ■ U.S. small-caps ■ Japanese equities ■ Mega-cap tech

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2023 Tactical Allocation Views

■ Underweight ■ Neutral ■ 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.

ASSET CLASS				
ASSET CLASS	Stocks	■	Outlook remains uncertain due to tight financial conditions, a slowing economy, and elevated valuations. However, a resilient labor market, services sector strength, and positive sentiment around AI are providing support.	
	Bonds	■	Interest rate volatility could remain elevated as central banks continue to balance persistent inflation and growth concerns. Credit sectors continue to offer attractive valuations with broadly supportive fundamentals.	
	Cash	■	Cash currently offers attractive yields and a shorter-duration profile if interest rates drift higher, and provides liquidity should market opportunities arise.	
<i>Equity Regions</i>				
STOCKS	U.S.	■	Despite a resilient economy, the outlook remains clouded by Fed uncertainty, manufacturing sector weakness, and narrow market breadth. Elevated valuations make large-cap U.S. equities unappealing given this backdrop.	
	Global Ex-U.S.	■	Valuations are attractive on a relative basis and local currencies have room to appreciate. However, the impact of China's economic reopening has been disappointing thus far. Global monetary policy remains a headwind.	
	Europe	■	Valuations are attractive on a relative basis and the euro has room to appreciate; however, restrictive monetary policy remains a headwind.	
	Japan	■	Japan has historically cheap valuations and, despite cyclical concerns, should continue to benefit from better corporate governance and improved pricing power.	
	Emerging Markets	■	Valuations and currencies are attractive. Central bank tightening may have peaked. Meanwhile, Chinese growth momentum has stalled pending further stimulus.	
	<i>Style and Market Capitalization</i>			
	U.S. Growth vs. Value*	■	While relative valuations for value stocks remain attractive, a tilt toward higher-quality businesses is important given the weakening macroeconomic backdrop. AI could also provide a structural tailwind for growth.	
	Global Ex-U.S. Growth vs. Value*	■	Value stocks offer attractive valuations. Cyclical and geopolitical risks remain a concern, but persistently higher rates may benefit financial stocks.	
	U.S. Small-vs. Large-Cap*	■	Small-caps offer attractive upside potential, having already priced in a dire economic scenario with historically attractive relative valuations. A bias towards quality and selective exposure to regional banks is warranted.	
	Global Ex-U.S. Small-vs. Large-Cap*	■	Small-caps offer attractive valuations and could benefit from any further U.S. dollar weakening. However, caution is warranted due to a potential flight to quality that could favor large-caps.	
<i>Inflation Sensitive</i>				
Real Assets Equities	■	Commodities offer a hedge if inflation remains elevated; however, commodity prices may face pressure due to economic concerns. Real estate investment trusts face pressure from higher rates and commercial property weakness.		
BONDS	U.S. Investment Grade	■	Despite resilient fundamentals, lagged effects of rapid Fed hikes and tighter lending standards warrant caution.	
	Developed Ex-U.S. IG (Hedged)	■	Developed ex-U.S. yields could remain volatile as global central banks balance elevated inflation versus slower growth.	
	U.S. Treasury Long	■	While yield volatility could persist in the near term, longer-duration Treasury bonds may have peaked and offer ballast amid a deteriorating macroeconomic backdrop.	
	Inflation Linked	■	Core inflation is proving to be stubbornly high, but upward price pressures are easing. However, slower inflation rates already are priced into current breakeven yields.	
	Global High Yield	■	Credit fundamentals and attractive yields remain supportive. Although default rates are rising from historically low levels, they are not expected to rise significantly above long-term averages.	
	Floating Rate Loans	■	Valuations remain attractive, but as the Fed moderates its tightening path, the benefits of the rate resetting feature and the lower-duration profile become less compelling.	
	EM Dollar Sovereigns	■	Yields are still attractive, and a potential peak in EM central bank tightening and moderating inflation both should also support the sector.	
	EM Local Currency	■	EM currencies and local currency yields remain at attractive levels but reflect cautious sentiment. A further weakening of the U.S. dollar would be supportive of EM currencies.	

*For pairwise decisions in style and market capitalization, boxes represent positioning in the first asset class relative to the second asset class.

The asset classes across the equity and fixed income markets shown are represented in our multi-asset portfolios. Certain style and market capitalization asset classes are represented as pairwise decisions as part of our tactical asset allocation framework.

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