



Global Markets Quarterly Update

Second Quarter 2023

KEY INSIGHTS

- Developed markets recorded strong returns in the second quarter, helped by signs of economic resilience and easing inflation pressures.
- U.S. markets outperformed, helped by mega-cap technology stocks tied to artificial intelligence, and Japanese stocks were also especially strong.
- China was an outlier, as signs of a faltering recovery weighed on sentiment.

HIGHLIGHTED REGIONS

- U.S.
- Europe
- Japan
- China
- Other Key Markets

What We're Watching Next
With Sébastien Page

U.S.

Stocks recorded solid gains in a rally that broadened and intensified in the last few weeks of the quarter. Thanks largely to its strong relative performance in the middle of the quarter, the technology-heavy Nasdaq Composite Index saw the biggest gains and rounded out its best start to a year since 1983. Technology stocks also performed best within the S&P 500 Index—up over 17% in total return (including dividends) terms—and the Russell 1000 Growth Index handily outperformed its value counterpart. Utilities and energy stocks recorded small losses, and other typically defensive sectors lagged.

Short-Term Treasury Yields Jump in Wake of Debt Showdown

Bonds recorded a modest overall loss as the yield on the benchmark 10-year Treasury note increased sharply in the back half of the quarter. (Bond prices and yields move in opposite

directions.) Short-term yields rose more dramatically, however, partly in response to a showdown over raising the federal debt limit that was resolved only shortly before the Treasury Department ran out of funds in early June. As the Treasury Department rushed to issue short-term debt once the ceiling was lifted, the yield on the two-year note jumped by 47 basis points (0.47 percentage point), marking an 81-basis-point increase for the quarter as a whole and further inverting the yield curve.

Technology's dominance and the market's rally in general seemed to owe much to the enthusiasm over generative artificial intelligence (AI). Outpacing the Nasdaq were mega-cap major AI players, including Facebook parent Meta Platforms (up 35.4% in the quarter), Google parent Alphabet (+16.3%), Microsoft (+18.4%), Amazon.com (+26.2%), and Apple (+17.8%), which became the first public company to be valued at more than USD 3 trillion. The standout was advanced

chipmaker NVIDIA, which gained 52.3% and surpassed USD 1 trillion in market capitalization.

Some increasingly hopeful economic signals appeared to support the rally and helped it broaden to include small-caps and value shares late in the quarter. After falling in four of the previous five months, retail sales rose in both April and May, and May saw surprise increases in durable goods orders, a jump in the construction and sale of new homes, a positive reading on consumer sentiment, and a solid rise in personal incomes. Weekly jobless claims spiked to their highest level in nearly two years in June, but continuing claims fell back over most of the quarter.

Banking Crisis Appears to Be Averted

Finally, the apparent containment of a potential regional banking crisis appeared to boost sentiment. Signs emerged in April that California's First Republic Bank was likely to follow

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similarly tech-focused Silicon Valley Bank into receivership. The Federal Deposit Insurance Corporation did take control of the bank's assets on May 1, marking the second-biggest bank failure in U.S. history, but the stocks of other regional banks stabilized over the following weeks. News late in the quarter that all 23 of the nation's largest banks had passed the Fed's stress tests also seemed to reassure investors.

The quarter's gains may have been restrained by signs that the Fed was poised for at least one more rate hike. Although policymakers kept rates steady in June, they continued to insist that the battle against inflation had yet to be won—suggesting that June's lack of action was probably a “skip” instead of the widely anticipated “pause” in their rate-hiking program. In prepared testimony before Congress late in the quarter, Fed Chair Jerome Powell stated that “nearly all [policymakers] expect that it will be appropriate to raise interest rates somewhat further by the end of the year.” As measured by futures contracts, expectations evaporated that the Fed would reverse course and begin cutting rates late in 2023.

Europe

The STOXX Europe 600 Index rose on expectations that inflation would slow and the European Central Bank (ECB) would end its monetary policy tightening. However, a faltering recovery in China and concerns that higher interest rates would cause an economic slowdown curbed gains. Major benchmarks in Germany, France, and Italy also advanced. The UK's FTSE 100 Index fell as the UK pound strengthened against the U.S. dollar, interest rates rose, and oil prices fell.

Eurozone in Recession, Inflation Slows Further

Annual inflation in the eurozone slowed for a third month in June, to 5.5% from 6.1% in May, as the cost of fuel fell, according to an initial estimate from

the European Union's statistics office. However, core inflation—which excludes energy, food, alcohol, and tobacco prices—ticked up to 5.4% from 5.3%. Germany was the only country in the bloc to report an increase.

Revised data showed that the eurozone economy shrank in the first quarter by 0.1% sequentially due to lower household and government spending. This followed a similar contraction in the final three months of 2022, putting the economy in a technical recession. Germany's economy shrank, while gross domestic product (GDP) grew modestly in France, Italy, and Spain.

ECB Raises Interest Rates, Hints More Ground to Cover

Despite economic conditions and slowing headline inflation, the ECB raised its deposit rate in two quarter-point steps to 3.5% and signaled that more tightening was likely. Subsequent comments from ECB President Christine Lagarde and hawkish policymakers strongly indicated that the central bank would hike rates again in July. However, some influential Governing Council members, including Chief Economist Philip Lane and Vice President Luis de Guindos, opined that any increases thereafter were less certain and would depend on incoming economic data.

BoE Surprises With Half-Point Rate Hike, Bond Yields Jump

UK sovereign bond yields surged as data suggested that inflation is more deeply entrenched than in other countries, prompting the Bank of England (BoE) to raise interest rates by a surprise half a percentage point in late June to 5.0%. BoE Governor Andrew Bailey asserted that rates may stay higher for longer than markets expect.

Year-over-year inflation failed to slow for a fourth month running in May, sticking at 8.7%. Core inflation—which excludes volatile food, energy, alcohol, and tobacco prices—accelerated to

a 31-year high of 7.1%. Meanwhile, the UK economy skirted a recession, expanding 0.1% sequentially in the first quarter, compared with the final three months of 2022.

Central banks in Norway, Switzerland, and Sweden raised interest rates and indicated that more hikes were likely as policymakers sought to tamp down elevated inflation. Norway's Norges Bank further surprised markets by reaccelerating to a half-point increase in June.

Japan

Amid continued strong foreign investor interest, Japanese equities had a strong second quarter of 2023. A weak yen benefited the country's exporters, and the Bank of Japan's (BoJ) ultra-accommodative monetary policy stance provided a supportive backdrop. The MSCI Japan Index gained 15.6% over the three months in local currency terms—halfway through the year, Japan's stock market was one of the world's best performers, although yen weakness moderated returns in U.S. dollar terms.

Given continued monetary policy divergence between Japan and the U.S., the Japanese currency weakened to about JPY 144 against the U.S. dollar, its lowest level in seven and half months, from around 132 at the end of March. In June, it briefly hit the 145 level that had prompted the BoJ to undertake a yen-buying intervention in September 2022, leading to investor anticipation that the central bank would again step in. While Japan's monetary authorities stated that every option is on the table to cope with excess volatility in the foreign exchange markets, no concrete action was forthcoming.

The yield on the 10-year Japanese government bond (JGB) rose to 0.39%, from the prior quarter's 0.32%. Domestic yields remained under pressure as the dovish BoJ continued to diverge from the tightening stance of the other major

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central banks, which appear poised to raise rates further in the second half of the year.

BoJ Leaves Ultra-Loose Monetary Policy Unchanged

At its June meeting, by a unanimous vote, Japan's central bank kept its short-term interest rate at -0.1% and that of JGB yields at around 0%. It also made no tweaks to its yield curve control program, which allows JGB yields to fluctuate in the range of around plus and minus 0.5 percentage points from zero. However, BoJ Governor Kazuo Ueda hinted that when it comes to its yield curve control program, a certain degree of surprise may be unavoidable in order to deal with the changing economic environment.

Earlier in the quarter, at its April meeting, the BoJ announced that, given challenges around achieving its price stability target over the past 25-year period, it would conduct a broad-perspective review of monetary policy, with a planned time frame of around one and a half years. Ueda emphasized that policy change can take place while the review is being conducted.

Hot Inflation Print, Better-Than-Expected First-Quarter Economic Growth

On the economic data front, Japan's core consumer price index rose by 3.2% year on year in May, more than forecast and remaining well above the BoJ's 2% inflation target. Japan's gross domestic product expanded by an annualized 2.7% quarter on quarter over the first three months of the year, higher than initial estimates. Much of the upward revision to first-quarter GDP was due to stronger corporate investment, with businesses increasing their spending as sentiment remained resilient despite concerns about slowing global and particularly Chinese growth.

Signs of Tourism Rebounding

According to preliminary data released by the Japan Tourism Agency, the country's hotels and other accommodation facilities recorded over 10 million overnight stays by foreigners in April, the first time this has occurred since the outbreak of the coronavirus pandemic. Inbound tourism was buoyed by the weak yen, an increase in international air traffic, and the start of Japan's cherry blossom season.

China

Chinese equities retreated as a growing number of indicators pointed to an economy that is losing momentum following a post-lockdown bounce in the first quarter. The MSCI China Index declined 9.65% while the China A Onshore Index gave up 9.78%, both in U.S. dollar terms.

China's official Purchasing Managers' indexes (PMIs) released at the end of June were the latest sign of the country's sputtering recovery. The manufacturing PMI ticked up to 49.0 in June, a slight improvement from the 48.8 recorded in May, but marked the third straight month of a sub-50 reading, indicating a contraction in activity. The nonmanufacturing PMI, which measures construction and services activity, declined to a below-consensus 53.2 in June, slower than the previous month's pace.

Consumption-Driven Recovery Appears to Fade

China's gross domestic product expanded a better-than-expected 4.5% in the first quarter of 2023 from a year earlier. But subsequent data showed that the consumption-driven recovery earlier in the year was fading. The consumer price index rose 0.2% in May from a year earlier, compared with April's 0.1% expansion, a 26-month low. The producer price index fell a worse-than-expected 4.6% and marked the weakest reading

since May 2020. The latest inflation data showed the rising deflation risks weighing on the economy.

Premier Li Qiang, the country's second-ranking official, said that China is still on track to reach its annual growth target of around 5%. Speaking at the World Economic Forum's annual meeting of the New Champions in Tianjin in June, Li stated that Beijing would roll out more practical and effective measures to strengthen domestic demand, boost markets, and support the country's development and growth.

On the monetary policy front, the People's Bank of China cut its medium-term lending facility rate by 10 basis points to 2.65% in June, marking the first reduction since August 2022. The move was largely expected by investors after the central bank unexpectedly lowered the seven-day reverse repurchase rate, a short-term policy rate, by the same amount days before. Analysts predict that the central bank's pivot toward stimulus may lead to targeted support for some industries.

Other Key Markets

Colombian Stocks Shrug Off Political Uncertainty

Stocks in Colombia, as measured by MSCI, returned 12.53% in the second quarter versus 1.04% for the MSCI Emerging Markets Index. A gain of more than 11% in the peso versus the U.S. dollar boosted local returns to U.S. investors.

Colombian assets were volatile amid political uncertainty, as President Gustavo Petro called for his entire cabinet to step down in late April even as he announced a formal rupture in his ruling coalition. Petro had been frustrated that the leadership from the more moderate parties in the coalition stymied his efforts to enact reforms related to issues such as health care, labor, politics, and pensions.

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As the new Cabinet ministers took office in early May, T. Rowe Price emerging markets sovereign analyst Aaron Gifford was surprised that Ricardo Bonilla—one of Petro’s trusted economic advisors and his former finance minister in Bogota when Petro was mayor there—replaced outgoing Finance Minister Jose Antonio Ocampo. In his first outreach to the investor community, Bonilla tried to assuage investors’ fears by saying that the government would be fiscally responsible and make no abrupt changes. However, unlike Ocampo, who actively spoke against some of Petro’s plans, Gifford noted that Bonilla may be more inclined to take them as a given. While some of Bonilla’s actions so far have been market-friendly, the Finance Ministry’s decision to widen its fiscal deficit target for both this year and 2024 are of concern.

Toward the end of the quarter, Petro’s reform efforts hit some additional roadblocks. These included the president of the lower house of Congress putting a hold on reform debates in early June, as evidence of illegal financing for President Petro’s election campaign began to pile up. Later in the month, when the president’s agenda seemed to be moving forward again, Petro’s labor reform bill was torpedoed by Congress. Also, consideration of health care and pension reform was postponed until the next legislative period starting July 20.

Gifford believes that pension reform may have the highest probability of passage in the near term, but there is likely to be a significant watering down of the legislation. Overall, Gifford believes that Petro’s political capital is waning, given his lower approval ratings among voters and recent demonstrations in major cities, with some calling for Petro to leave office.

Stocks Drop in Turkey

Stocks in Turkey, as measured by MSCI, returned -10.59% versus 1.04% for the MSCI Emerging Markets Index.

In April, political parties and candidates for office ramped up their campaign activities in preparation for the general election and the first round of the presidential election on May 14. In the general election, the ruling AKP-MHP coalition—known as the People’s Alliance—won 323 seats in the 600-seat parliament and maintained its simple majority. After a close finish in the first round of the presidential election, the incumbent Recep Tayyip Erdogan faced the six-party National Alliance’s candidate Kemal Kilicdaroglu in the runoff election on May 28. Erdogan defeated Kilicdaroglu and was sworn in for another five-year term.

T. Rowe Price sovereign analyst Peter Botoucharov believes that the new government is likely to make adjustments to the current economic policy framework and return to a more orthodox policy approach. Erdogan often refers to this framework as the

“new economic program,” which is based on a highly stimulative monetary policy and an exchange rate that increases the competitiveness of Turkish exporters in world markets. The downside has been higher inflation and a drawdown in foreign exchange (FX) reserves.

On June 22, the central bank—now led by Governor Hafize Gaye Erkan—raised the one-week repo auction rate from 8.5% to 15.0% versus an inflation rate of about 40%. According to the post-meeting statement, policymakers “decided to begin the monetary tightening process in order to establish the disinflation course as soon as possible.” As for the pace of monetary tightening, central bank officials plan to raise rates “as much as needed in a timely and gradual manner,” as opposed to an abrupt policy pivot.

A few days later, the central bank began to gradually ease some of the previously established macroprudential regulations that have forced banks to convert large portions of their non-lira deposits to lira—thus stifling the normal functioning of Turkey’s currency and fixed income markets. According to Botoucharov, these reversals, if they continue, will allow transactions involving lira and government bonds to clear more smoothly and efficiently. He believes it is crucial for the FX and local interest rate markets to have improved price discovery and achieve a more sustainable equilibrium.

Major Index Returns

Total returns unless noted

As of 6/30/2023 Figures shown in U.S. dollars	Q2 2023	Year-to-Date
U.S. Equity Indexes		
S&P 500	8.74%	16.89%
Dow Jones Industrial Average	3.97	4.94
Nasdaq Composite (Principal Return)	12.81	31.73
Russell Midcap	4.76	9.01
Russell 2000	5.21	8.09
Global/International Equity Indexes		
MSCI Europe	3.13	14.21
MSCI Japan	6.45	13.24
MSCI China	-9.65	-5.39
MSCI Emerging Markets	1.04	5.10
MSCI All Country World	6.35	14.26
Bond Indexes		
Bloomberg U.S. Aggregate Bond	-0.84	2.09
Bloomberg Global Aggregate Ex-USD	-2.16	0.83
Credit Suisse High Yield	1.87	5.84
J.P. Morgan Emerging Markets Bond Global	1.53	3.81

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Note: Returns are for the periods ended June 30, 2023. The returns include dividends and interest income based on data supplied by third-party provider RIMES and compiled by T. Rowe Price, except for the Nasdaq Composite Index, whose return is principal only.

Sources: Standard & Poor's, LSE Group, Bloomberg Index Services Limited, MSCI, Credit Suisse, Dow Jones, and J.P. Morgan (see Additional Disclosures).

What We're Watching Next



**Sébastien Page, CIO,
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While the global economy and stock prices have proved remarkably resilient in recent months, investors should still take account of the headwinds facing markets in the second half of the year. Above all, central banks' continued rate hikes in the face of sticky inflation still pose clear risks. The strongest bear argument may be that the full impact of the Federal Reserve's 500 basis points in rate hikes has yet to make its way into the economy—and policymakers have recently indicated that they haven't finished raising rates yet.

Indeed, investors may also have to consider that the Fed will hike rates

more aggressively if risk assets rally too exuberantly. In other words, the “Fed put”—the notion that the Fed and/or the other major central banks can be counted on to pump liquidity into the markets if asset prices fall too far or too fast—may now have turned into a “Fed call.”

Whether earnings and valuations will support further market gains is also open to question. By some measures, U.S. large-cap stocks appear more expensive than they did before last year's bear market, leaving them vulnerable to even a modest decline in earnings. Corporate profits remained surprisingly steady in the first half of the year, but slowing economic growth could lead to a deceleration later in the year. Healing supply chains, while positive for inflation, could also limit pricing power and eat into margins.

Whether markets are entering an artificial intelligence (AI) “bubble” also remains to be seen, but the history of the dot-com

bubble—which may serve as a guide—suggests that any current bubble is unlikely to pop within the coming months. Current technology valuations are nowhere near their peaks in early 2000, and the enthusiasm over AI is far below earlier enthusiasm over the internet, as measured by positive media mentions.

Indeed, pockets of attractive valuation remain in certain sectors and asset classes. Small-cap stocks and high yield bonds seem to offer opportunities, and a weaker U.S. dollar also could make global ex-U.S. equity markets attractive.

In all areas, careful stock selection will be necessary. Above all, we believe investors should understand the risks of remaining passive in a fast-changing market environment. Capitalization-weighted indexes may be poorly positioned for structural change, making skilled active management a critical tool for identifying risks and opportunities.

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