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June 2018

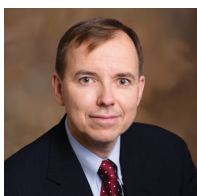
In-depth analysis and insights
to inform your decision-making.



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Chief Investment Officer, Fixed Income

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Midyear Market Outlook

GLOBAL GROWTH REMAINS SUPPORTIVE, BUT VOLATILITY HAS RETURNED

KEY TAKEAWAYS

- Moving into the second half of 2018, the global economic expansion appears intact, although momentum appears to be slowing in Europe and Japan.
- Earnings growth has been strong and underlying trends are positive, but peak levels likely were achieved in the first half of the year.
- Asset classes appear relatively expensive in most global regions, but higher Treasury yields have improved U.S. credit valuations in an absolute sense.
- Relatively tame inflation is enabling the U.S. Federal Reserve to pursue a moderate course of rate hikes. However, U.S. dollar appreciation is creating headwinds for emerging markets.
- Worries about populist policies could contribute to market volatility. A trade war between the U.S. and China could do significant global economic damage.
- Technology giants have seen rapid earnings growth. We believe these companies can continue to lead the broad market, despite privacy concerns.

A broad economic expansion, strong earnings growth, and a moderate pace of monetary tightening appear to provide a generally favorable environment for global financial markets in the second half of 2018. However, historically high valuations across most asset classes and a range of economic and policy risks—including the threat of trade protectionism and the impact of U.S. dollar appreciation on emerging market debtors—create the potential for renewed volatility.

These were among the key observations offered by three T. Rowe Price investment professionals—Rob Sharps, the firm's Head of Investments and Group Chief Investment Officer (CIO); Mark Vasselkiv, CIO, Fixed Income; and Justin Thomson, CIO, Equity—in a recent discussion of the midyear global outlook.

The three CIOs agreed that the positive case for global equities and credit remains intact, although they also suggested that investors may want to take a less aggressive stance compared with the bullish enthusiasm seen in late 2017 and early 2018.

More volatile market conditions in the second half of the year could produce potentially attractive buying opportunities for long-term investors, Vasselkiv suggested, while greater return differences among sectors and companies may make it easier for portfolio managers to add value through active security selection.

Over the course of their discussion, the three CIOs identified a number of themes that appear likely to influence—perhaps decisively—global market performance in the second half.

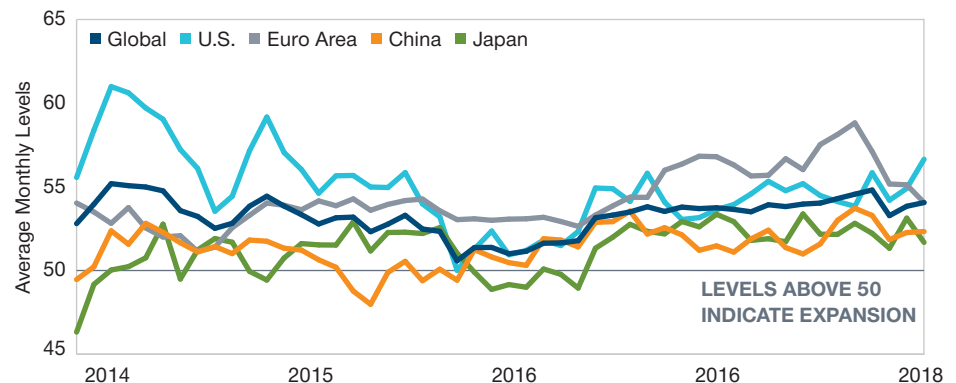
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GLOBAL ECONOMIC GROWTH: WHERE ARE WE IN THE CYCLE?

The synchronized global economic expansion that powered earnings growth in 2017 appeared to have plenty of steam coming into 2018. However, some indicators, such as global purchasing manager indexes (PMI), are pointing to slowing momentum, especially in Europe and Japan (Figure 1).

- The growth outlook appears most robust in the U.S., where confidence remains high and last year's tax cut package continues to put disposable income in the pockets of consumers and corporations. Deregulation efforts, including lifting some restrictions on the U.S. banking industry, also should support growth in the second half.
- The outlook for the European economies also is broadly positive, Thomson said, despite the recent softness in the PMIs and some sentiment indicators. One major exception: the UK, where Brexit uncertainties continue to weigh on business confidence and capital spending. Political instability in Italy and higher bond yields in the peripheral countries also could be negative for eurozone growth.
- Although corporate governance reforms are improving Japan's

FIGURE 1: The Synchronized Global Recovery Continued in the First Half of 2018
Purchasing Manager Composite Indexes, Average Monthly Levels, May 2014 Through May 2018



Sources: Haver Analytics (Markit), FactSet Research Systems Inc. All rights reserved.

longer-term economic prospects, in the short run Japanese growth depends heavily on demand for the country's exports and thus the strength of global growth, Thomson noted.

- China has been largely successful in sustaining economic growth despite Beijing's efforts to restrain credit expansion and restructure older industries, although momentum could slow in 2018. Chinese growth is helping sustain expansion in other emerging markets (EM), although currency weakness could create financial risks for countries with large fiscal and/or current account deficits.

The key question going forward, Sharps said, will be whether the global expansion—and, with it, the global bull market in risk assets—has entered its late stages, a phase typically marked by inflationary pressures, rising interest rates, and deteriorating profit margins. While some signs, including low U.S. unemployment and Federal Reserve tightening, point in that direction, it would be a mistake to assume that because the current expansion has been long (nine years and counting) it must be nearing its end.

"We've had a long recovery but a very slow recovery," Sharps noted. "It may be that we're in a midcycle pause as central banks around the world recalibrate

monetary policy for a more sustainable or self-sustaining economic expansion."

THE TRAJECTORY OF EARNINGS GROWTH: HAS MOMENTUM PEAKED?

U.S. earnings growth accelerated in the first quarter, with the companies in the S&P 500 Index seeing a 25% year-over-year rise in earnings per share (EPS)—in part due to U.S. corporate tax cuts, though still an extraordinary achievement for an economy not coming out of recession.

While earnings momentum slowed somewhat in Japan, Europe, and the emerging markets, underlying trends appear positive, the CIOs agreed (Figure 2). Indeed, strong earnings growth played a major role in stabilizing global equity markets following outbreaks of volatility in February and March.

Simple mathematics suggests that the rate of U.S. earnings growth seen in the first quarter is unlikely to be matched—much less beat—over the remainder of 2018, Sharps said. But consensus estimates indicate that analysts do not expect earnings growth to slow dramatically in the second half, and they appear to anticipate earnings growth in the high single digits in 2019. If met, these forecasts would imply a reasonably constructive environment for equities, Sharps added.

Europe saw strong earnings momentum in 2017 as well, with net revisions turning positive for the first time since the 2012 sovereign debt crisis. That performance also will be difficult to replicate this year, Thomson said, in part because so much of the global earnings recovery has been concentrated in the technology sector, which has a smaller weight in the major European indexes relative to the U.S. market. The banking sector, by contrast, has a much heavier weight, but European banking margins have yet to regain pre-crisis levels, nor are they likely to do so in this cycle, Thomson predicted, meaning European earnings also are unlikely to exceed their previous peak.

Earnings growth in Asia also has been heavily concentrated in the technology sector, which has produced performance results even more concentrated than in the U.S. market, Thomson noted. Earnings strength in Japan will largely depend on the global economic cycle, he added.

VALUATIONS FOR MOST ASSET CLASSES ARE HIGH, BUT SO IS DISPERSION

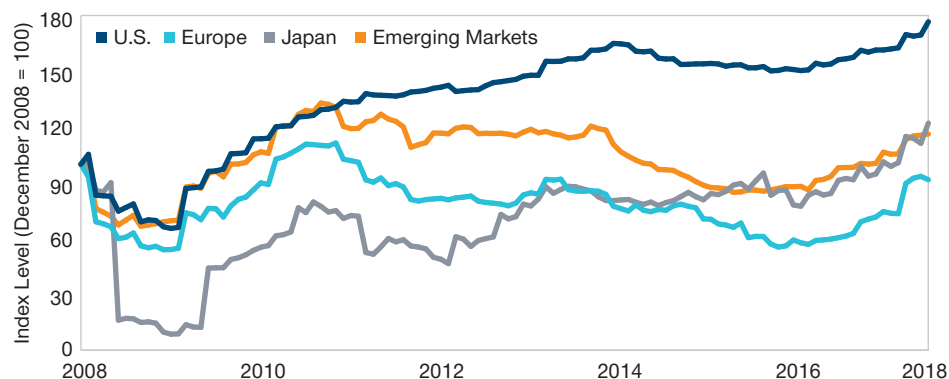
Most broad global asset classes appear relatively expensive relative to their longer-term averages—averages which themselves have been pulled higher by the equity and bond price gains seen since the global financial crisis (Figure 3). For equity valuations, the first half of 2018 saw two offsetting trends, Sharps observed:

- With global equity markets generally moving sideways despite strong earnings growth, price/earnings (P/E) multiples slipped from their late-2017 peaks.
- On the other hand, higher U.S. interest rates and bond yields eroded the support that extremely low rates have provided for equity valuations since the financial crisis.

On balance, U.S. large-cap valuations—as measured by the S&P 500 Index—appeared moderately expensive as

FIGURE 2: Earnings Momentum May Be Peaking but Growth Remains Strong

Regional Earnings Per Share, December 31, 2008 Through May 31, 2018*

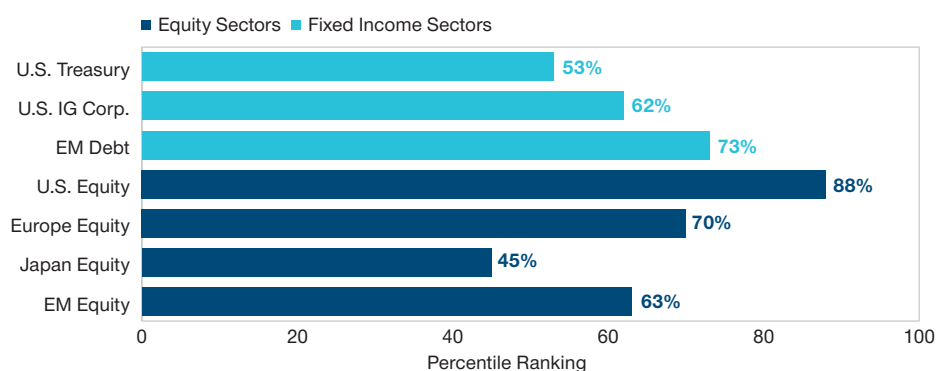


* United States is represented by the S&P 500 Index. Other countries/regions are represented by their corresponding MSCI index.

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FIGURE 3: Valuations Are High Across Most Asset Classes

Percentile Ranking vs. 15-Year Average, as of May 31, 2018*



*Indices used, from top to bottom, Bloomberg Barclays U.S. Investment Grade Corporate, Bloomberg Barclays Emerging Markets USD Aggregate, S&P 500, MSCI Europe, MSCI Japan, MSCI Emerging Markets. U.S. Treasury valuation percentile based on 10-year benchmark government bond yields. U.S. IG Corp. and EM Debt valuation percentiles based on option-adjusted spread of the Bloomberg Barclays U.S. IG Corporate Bond Index and the Bloomberg Barclays EM USD Aggregate Bond Index. U.S., Europe, Japan, and EM equity valuations based on an equal-weighted average of next 12 month price-to-earnings, price-to-book, and price-to-cash-flow ratios for the S&P 500, MSCI Europe, MSCI Japan, and MSCI EM indexes.

Source: FactSet Research Systems Inc. All rights reserved.

of late May, according to Sharps. “A current-year P/E between 16 and 17 is certainly well off the peak, and probably reasonable by historical standards, but it’s far from compelling,” he said. A relatively painless path to more attractive broad valuations, Sharps suggested, would be if earnings continued to rise at a faster pace than equity prices over the balance of 2018 and into 2019.

While core European and Japanese sovereign yields remain anchored at

extremely low—and, in some cases, negative—levels by central bank accommodation, U.S. investment grade and high yield valuations have improved in an absolute sense thanks to the rise in Treasury yields, Vaselkiv said. However, they appear historically expensive in a relative sense, despite some widening in credit spreads.

For longer-term investors, absolute yield may be the more important valuation metric, Vaselkiv suggested. “We’ve moved [high yield] up to about

a 6.5% blended or aggregate yield. And I've noticed in my long-term work in the high yield market that when absolute valuations start to get to the 7% level...over a long investment period it generally has led to pretty good outcomes."

But it's not clear how much useful information broad index valuations provide in a market environment marked by wide dispersion and—for equities, at least—relatively narrow leadership. According to Thomson, this is particularly true in Japan, where equities appear cheap overall compared with longer-term averages but the value universe includes many companies with relatively poor future prospects.

"We're seeing a similar pattern all over the world, emerging markets included, where markets are highly bifurcated between companies that can demonstrate structural growth and companies that are structurally challenged," Thomson observed. "And the blend that comes out in the aggregate [valuations] is perhaps less meaningful than it once was."

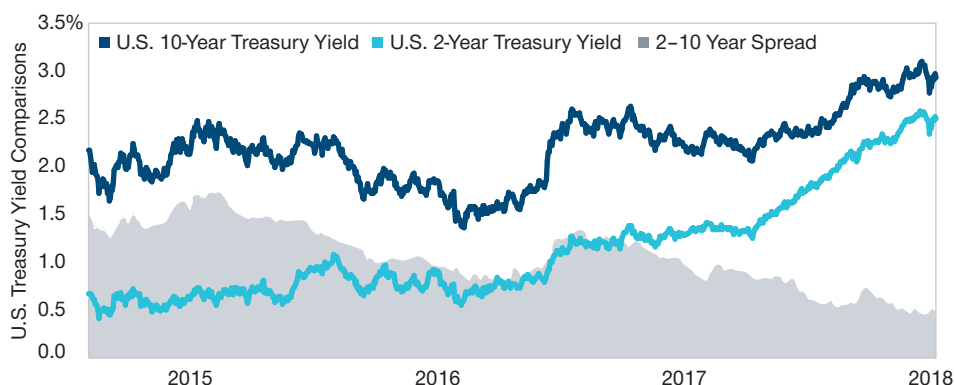
RIISING RATES AND A STRONGER U.S. DOLLAR POSE HEADWINDS

Strong U.S. growth, low unemployment, and expectations of future Fed rate hikes combined to push Treasury yields sharply higher in the first half of the year. Perhaps more significantly, the Treasury yield curve—the spread between shorter- and longer-term maturities—continued to flatten (Figure 4). The European Central Bank, meanwhile, was widely expected to begin "tapering" its quantitative easing programs later this year, which could put upward pressure on European sovereign yields.

Rising yields and flattening yield curves typically are headwinds for economic growth and equity returns, but the impact on U.S. equities in the second half should be limited, Sharps suggested. "Historically, markets

FIGURE 4: U.S. Rates Rose Significantly in Early 2018

U.S. Treasury Yield Comparisons, December 31, 2014 Through June 7, 2018*



*Yields are based on benchmark U.S. Treasury notes.

Source: FactSet Research Systems Inc. All rights reserved.

have responded negatively to higher rates when the pace of increases is a surprise, but to the extent the 10-year Treasury is below 4 or 5%, I think the underlying earnings growth will trump what is happening with rates."

Emerging markets potentially could be more at risk. Much of this vulnerability, Thomson and Vaselkiv both noted, stems from weakness in a number of EM currencies against the U.S. dollar, including the Turkish lira, Argentine peso, Brazilian real, and South African rand. "Typically when the [U.S.] dollar begins to appreciate, that's a pretty negative environment for emerging markets," Vaselkiv said.

A key risk that EM markets face is the potential mismatch between the dollar liabilities and local currency revenues of both sovereign and corporate debtors—the same factor that laid many EM economies low during the debt crises of the 1990s. While economic and balance sheet fundamentals in many EM countries have improved greatly since then, and local currency debt issuance has expanded, the

potential for financial contagion can't be dismissed, particularly among countries that have made less progress in curbing chronic fiscal and current account deficits. "I think that's one of the key trends we need to be watching over the next six months to see how this plays out," Vaselkiv said.

There are developments worth monitoring that point to potentially higher inflation down the road, such as the tight U.S. labor market and rising capital expenditures, Sharps said. Oil and other commodity prices also bear watching, as these could be influenced not only by the strength of global demand but by political factors such as the impact of U.S. sanctions on major oil producers Iran and Venezuela.

For now, the U.S. and other developed debt and equity markets continue to benefit from a relatively benign inflation environment. This should allow the Fed to remain on a gradual policy course, avoiding the kind of sudden or large rate hikes that might cause the yield curve to invert—with short-term term rates moving higher than long-term yields.

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“Historically, a flattening or flat yield curve has not necessarily spelled imminent trouble for the economy or for financial assets,” Sharps said. “But once the yield curve inverts, it’s important to pay attention, because then the risks really do increase.”

GOVERNMENT POLICY IN AN AGE OF POPULISM

Markets largely welcomed major policy developments in 2017, including a major U.S. package of individual and corporate tax cuts, the Trump administration’s deregulation efforts, and the election of a French president committed to pro-growth reforms. But 2018 has seen a revival of concerns about a turn toward populism—trade protectionism in particular.

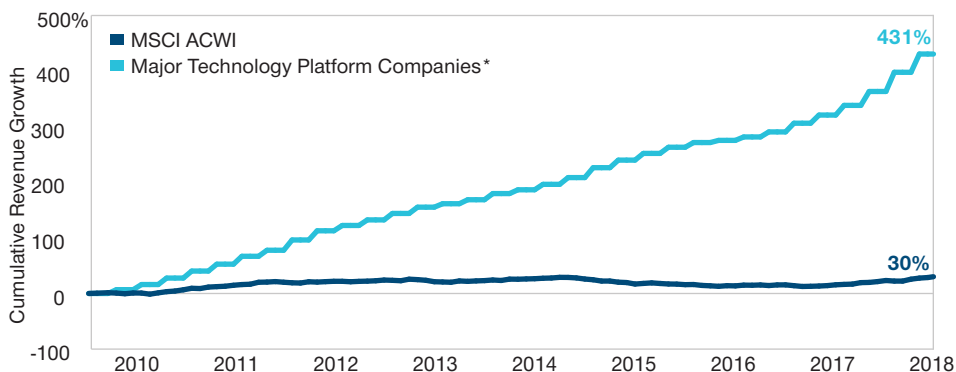
Many of these worries center on the Trump administration, which has raised tariffs on steel, aluminum, and possibly auto imports; demanded large reductions in China’s trade surplus with the United States; and pushed for concessions from Canada and Mexico in talks to revamp the North American Free Trade Agreement (NAFTA).

Adding to investor anxieties: continued lack of progress in working out a post-Brexit trade relationship between the UK and the EU, political disarray in Italy following the election of a populist coalition promising relief from fiscal austerity, and the refusal of U.S. policymakers to even consider cuts in entitlement spending despite a soaring federal budget deficit.

These issues have elevated the near-term risks of a major policy shock, Sharps said, contributing to the volatility seen in the first quarter. The threat of a U.S.-China trade war is especially unsettling, Vasekiv added, given that it would embroil the world’s two biggest economies. “You have to recognize that all emerging countries economically revolve around China,” Vasekiv said. “So a meaningful conflict

FIGURE 5: Tech Platform Companies Have Led the Bull Market

Cumulative Revenue Growth, December 31, 2009 Through May 31, 2018



* Aggregate revenue growth for the following companies: Facebook, Alphabet, Amazon, Apple, Netflix, Microsoft, Baidu, Alibaba, Tencent.

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between the two largest economies in the world is a very serious risk.”

While buoyant earnings helped global equity markets rebound from policy-related “risk off” episodes in the first half of the year, the U.S. bond market could be more vulnerable, Vasekiv warned. Non-U.S. buyers, he said, have accounted for roughly half of the demand at recent Treasury auctions, but current interest rate differentials also make it possible for Chinese and Japanese investors to purchase German or French government bonds, hedge their currency exposure into U.S. dollars, and earn a combined return that in some cases is higher than the yields on comparable Treasuries.

“I think we could have some interesting dynamics going forward if the world starts to lose a little bit of confidence in our geopolitical situation, particularly our trillion dollar deficits,” Vasekiv said.

TECHNOLOGY PLATFORMS LEAD THE MARKET: RAPID GROWTH OUTWEIGHS PRIVACY CONCERNS

The technology sector continued to lead global equity markets in the first half of 2018, with much of that

leadership concentrated in a relative handful of U.S. and Chinese mega-cap companies with dominant platforms in Internet search, social media, cloud computing, and streaming video. Revenue and earnings growth among firms has been explosive, far outpacing the broad market (Figure 5).

Commanding market positions have allowed these “Tech Titans” to leverage powerful economies of scale, producing impressive returns for investors but also drawing the attention of policymakers concerned about data privacy and political manipulation. These concerns flared in early 2018, leading some analysts to speculate that the platform giants might be due for a correction.

For now, however, the risks of a political or regulatory backlash are dwarfed by the growth potential of the major tech platforms, Sharps said. “Government intervention is a longer-term risk that we’ll want to continue to monitor,” he said. “But it certainly hasn’t manifested itself in any kind of meaningful change to the trend of really powerful, fundamental strength.”

In the U.S., technology strength has helped drive relative outperformance

for the growth investment style through much of the current bull market—a trend that persisted in the first half. Whether growth continues to lead in the second half largely will depend on the outlook for economic growth, interest rates, and energy prices, Sharps said.

The energy sector, Sharps noted, has been lifted by higher oil prices, while the financials sector, which also has a heavy weight in the value universe, should benefit from improved net lending margins as interest rates rise. On the other hand, rate-sensitive value sectors such as utilities, telecommunications, and consumer staples could continue to perform poorly.

The ex-U.S. markets appear to offer some attractive potential opportunities for value investors, Vasekiv said. This is especially true in the emerging markets, where some large-cap companies that are dominant in their national markets have been shunned by investors because of macroeconomic factors beyond their control. “You can buy some very cheap companies that have substantial scale and competitive strengths,” Vasekiv said.

CONCLUDING THOUGHTS

Sharps had the following thoughts for investors when asked about the direction of markets from here: “I would summarize by saying the

fundamental environment is great, but it’s not getting any better. Risks are rising and my counsel would be to position portfolios a little more conservatively at the margin, but don’t overdo it. I don’t think we are necessarily at the end of a cycle or that a recession or bear market is imminent. However, if you take a multiyear view, you probably should expect lower returns going forward than what we’ve experienced over the last couple of years.”

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