



Global Asset Allocation Viewpoints and Investment Environment

JUNE 2018

1 MARKET THEMES

Oil Prices at the Tipping Point?

Oil prices briefly surpassed 80 U.S. dollars a barrel in May (Figure 1), nearly tripling since the lows reached in early 2016. The rise can be attributed to OPEC's extended agreement to curtail supply and stronger global demand, despite increased U.S. production. However, the recent acceleration follows a growing rise of geopolitical tensions surrounding Iran and Venezuela. While still far from the 100+ U.S. dollars a barrel levels seen in the years before 2014, the sharp rise has raised concerns over its impacts on inflation and global growth. Energy leaders in Saudi Arabia and Russia have taken notice and may be considering easing supply constraints as they realize the risk of tipping the global economy into recession outweighs near-term gains from higher prices.

Greenback Finds its Footing

Since mid-April the U.S. dollar has been in an uptrend breaking its slump that started in early 2017. Despite the Fed hiking rates ahead of other central banks last year, the U.S. dollar declined. The weakness had been attributed to improved growth outside the U.S. and concerns over U.S. deficit spending to fund tax cuts. Now that global growth is showing signs of moderating the greenback has found some support (Figure 2). A continued uptrend could become a headwind for U.S. exports and a drag on earnings growth. More worrisome may be the dollar's impact on emerging markets that have significant U.S. dollar-denominated debt obligations. Emerging market bonds and currencies are already showing signs of weakness amidst rising trade tensions and idiosyncratic political risk. Further strength in the U.S. dollar may quickly bring back fears of a "tantrum."

Signs Emerge that U.S. companies are Spending

An increasing number of companies are reporting plans to boost spending and recent economic data has shown signs of improving demand for capital goods. The trend could finally be taking hold as a result of last year's tax reform which included benefits of accelerated depreciation and the repatriation of cash held overseas. U.S. companies could certainly benefit from increased spending to replace decades-old plant and equipment, a choice that may become a more attractive alternative should labor costs accelerate. However, the devil seems to be in the details as spending appears concentrated in a few sectors, namely technology and energy. A more broad-based pickup in spending could be a boost for U.S. economic growth and a tailwind for value-oriented, cyclical sectors that have lagged.

2 PORTFOLIO POSITIONING

Equity

- We are underweight equities as valuations remain elevated against a backdrop of receding global liquidity, rising rates and an aging economic cycle. While valuations are more attractive than levels seen at the start of the year, key factors that supported earnings, including tax reform, a weaker U.S. dollar and higher energy prices will likely be less of a tailwind going forward.
- We remain overweight to developed markets outside the U.S. as valuations are modestly more attractive, with most regions earlier in the economic cycle relative to the U.S. and still supported by monetary policy.
- We are overweight to U.S. small-cap stocks based on reasonable valuations versus large cap, potential benefits from lower corporate tax rates, a pickup in M&A activity and growth in capital spending. Small caps are also less likely to be exposed to trade policy risks.

Fixed Income

- We increased our underweight to high yield bonds as valuations appear elevated late in the credit cycle amidst high leverage and likely fading support from the recent strong trend in earnings and energy prices.
- We increased our overweight to floating rate loans relative to high yield bonds. With the Fed expected to continue raising rates this year and possibly into 2019, loans should benefit from their rate reset feature and shorter duration profile.
- We are underweight emerging market bonds as valuations may be at risk to rising developed market rates, protectionist trade policies, and increased political uncertainty amongst several key countries.

Real Assets

- We remain underweight real assets equities as we are still cautious on the long-term prospects for energy and commodity prices given continued advances in productivity growth and fading Chinese demand for industrial metals.
- However, energy prices may be supported near-term by increasing geopolitical risk (notably Iran and Venezuela), pipeline capacity, and OPEC production limitations.
- REIT valuations are relatively attractive, having been pressured by higher rates and structural disruption within the heavily-weighted retail sector. Outside of retail, fundamentals are broadly positive, with healthy growth in both occupancy and rental income. However, rising rates are likely to remain a near-term headwind.

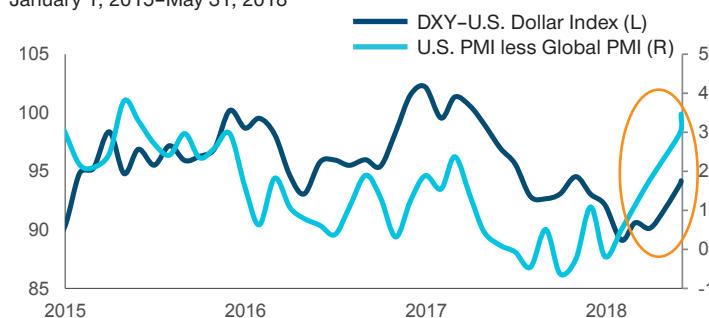
FIGURE 1: OIL PRICE

Five Years Ending May 31, 2018



FIGURE 2: U.S. DOLLAR VS. GROWTH DIFFERENTIAL

January 1, 2015–May 31, 2018



Sources: [Markit] Haver Analytics and FactSet.

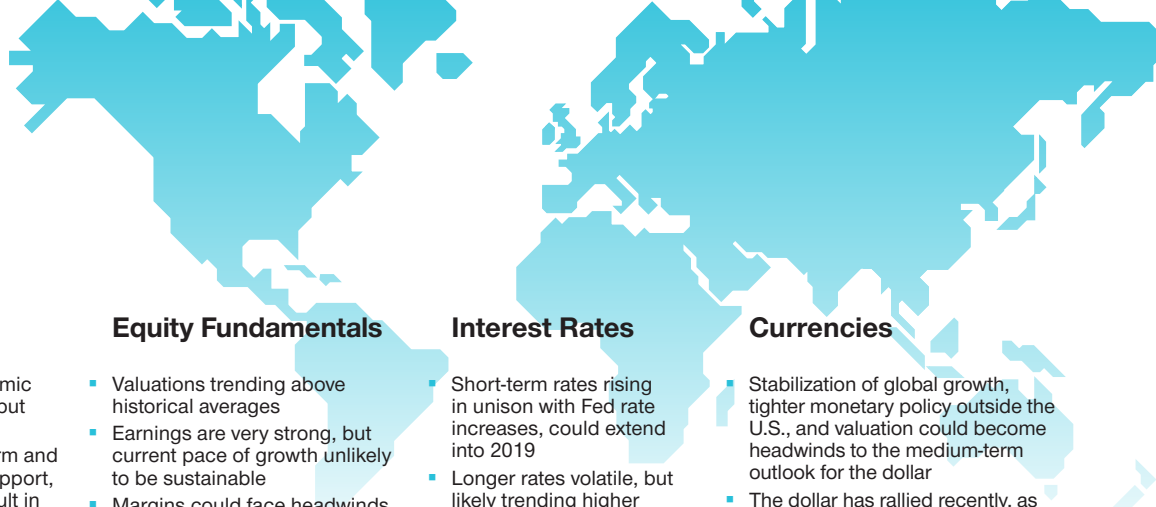
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3 Regional Backdrop

As of May 31, 2018



Macro-Economic

Equity Fundamentals

Interest Rates

Currencies

UNITED STATES

- In the later stages of the economic cycle, with recession risks low but rising
- Pro-cyclical policies of tax reform and deregulation offer near-term support, but late cycle stimulus may result in overheating
- Inflation normalizing amid tighter labor markets, with added pressure from higher oil prices
- Aggressive trade policy poses a risk, but may ultimately be limited in scope

- Valuations trending above historical averages
- Earnings are very strong, but current pace of growth unlikely to be sustainable
- Margins could face headwinds from higher rates, wages and input costs
- Earnings disappointments are being harshly punished

- Short-term rates rising in unison with Fed rate increases, could extend into 2019
- Longer rates volatile, but likely trending higher amidst improving growth, rising inflation expectations, expanded budget deficit, and Fed balance sheet unwind

- Stabilization of global growth, tighter monetary policy outside the U.S., and valuation could become headwinds to the medium-term outlook for the dollar
- The dollar has rallied recently, as extended positioning and trade tensions, allied with higher relative yields have provided notable support

DEVELOPED EUROPE

- Eurozone growth moderating, but expected to stabilize and remain above potential
- The ECB cautiously taking initial steps toward unwinding quantitative easing with bond purchases set to end this September
- Recent Italian political events have re-introduced concerns regarding sustainability of the E.U.

- Valuations are modestly attractive relative to the U.S.
- Operating leverage provides for further earnings upside potential, with the recent uptrend in earnings expected to continue
- Euro strength could be a headwind to earnings growth

- Sustained growth, recent euro weakness, and further evidence of rising inflation could gradually push rates higher
- The rise of euroskeptics in Italy has led to a significant spike in Italian yields and a divergence between core and peripheral European debt yields

- Political risk, most notably in Italy of late, has served to undermine the euro recently, already weakened by softer economic growth in recent weeks
- Valuations more attractive after recent weakness and the medium-term economic and ECB policy trajectories remain positive drivers

UNITED KINGDOM

- Brexit negotiations remain the central issue for growth trajectory
- The UK's second chamber, the Lords, has sent a range of amendments on the Brexit bill back to parliament, requiring a series of new votes which the government may lose
- UK inflation has declined to its lowest level in a year (2.5%), contributing to higher real wages

- UK valuations continue to trade at a discount to other markets
- Domestically-driven revenues remain disappointing
- Allocations to UK equities by global investors are at extremely low levels

- Falling inflation and subdued growth has diminished pressure on BoE to continue raising rates at the front end, while back end rates have fallen sharply on the back of the Italian deadlock
- Over the longer-term, rates will remain dependent on Brexit negotiations and inflation outlook

- Sterling remains under pressure due to diverging interest rate paths versus the U.S. dollar
- Despite attractive valuations on a historical basis, concerns remain over the long-term political and economic outlook post Brexit

DEVELOPED ASIA & PACIFIC

- Trade-driven economies likely to slow as global growth appears to have peaked—though growth remains at healthy levels
- Japanese economy contracted in 1Q18 ending a string of eight consecutive quarters of growth
- Fading political support for Japanese Prime Minister Abe could become a concern
- Australian economic activity improved from last year with business confidence elevated and consumer-based indicators improving
- Easing tensions on the Korean Peninsula may reduce uncertainty in the region

- Valuations within the region remain attractive relative to other developed markets, but earnings remain vulnerable to currency and commodity price volatility and a slowdown in global trade
- Japanese equities remain supported by better relative valuations, strong earnings growth, and gradually improving corporate governance
- Australian equities supported by strength in mining and energy sectors—however, valuations beginning to appear stretched

- A continued rise in global yields could impact long rates in the region
- The Bank of Japan continues to reaffirm its accommodative policy, with no change expected in the near-term amid benign inflation
- RBA delaying rate increases despite some modest price pressure

- Broad U.S. dollar strength has improved Japanese yen valuations, taking it to the midpoint of its recent range
- On a medium-term view, the yen remains cheap and external positions are supportive
- The Australian dollar has treaded water recently, after notable weakness in the past quarter as interest rate differentials and global trade concerns have weighed

EMERGING MARKETS

- Emerging market growth trend is moderating, but not rolling over
- Trade protectionism a risk, but real impact on the economic trajectory should be limited as long as the dialogue between U.S. and China continues
- Chinese growth is slowing but remains actively controlled as policy makers continue to focus on deleveraging the economy, albeit at a gradual pace
- Rising idiosyncratic and political risks in several key countries—including Mexico, Brazil, Argentina, Venezuela, and Turkey

- Broad-based growth supporting demand for exports, but momentum is fading
- Earnings growth remains broadly strong, although technology sector momentum may be fading
- Relative valuations modestly attractive versus developed markets, yet elevated to own history

- Interest rates could trend higher as financial conditions tighten in response to rising inflation and higher U.S. rates
- Significant inflation disparity remains across major emerging countries

- EM currency valuations have cheapened as a stronger U.S. Dollar and a number of idiosyncratic factors have weighed in certain markets
- U.S. rate policy, global growth and politics will continue to be the major areas of focus for EM, particularly with elections in Mexico and Brazil later in the year
- Commodity prices support the terms of trade of a number of EMs. Currencies such as the Malaysian ringgit and Colombian peso have scope to benefit if oil prices remain elevated

4 Asset Allocation Committee Positioning

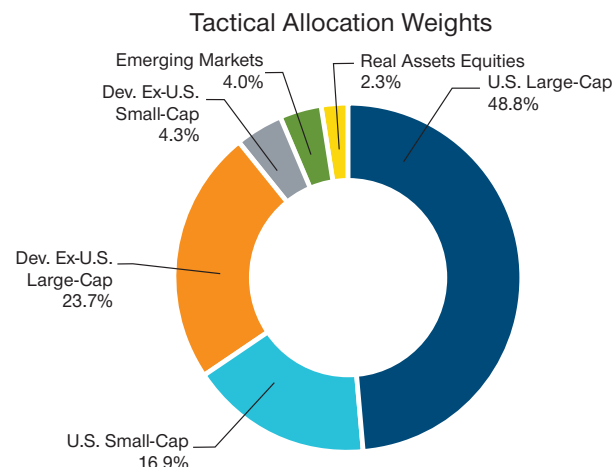
As of May 31, 2018

		<div>Underweight</div> <div>Neutral</div> <div>Overweight</div>					▼ or ▲ Month Over Month Change
		Change					
ASSET CLASS	Equities		■				Valuations remain elevated against a backdrop of receding global liquidity, rising rates and an aging economic cycle in the U.S., although broad global growth remains supportive
	Bonds				■		Upward trend in rates may be tempered by demand for yield, still modest growth expectations and increased volatility surrounding Italy/EU and trade policies
	Cash				■		Yields more attractive as Fed advances rate hikes. Cash can provide a buffer against extended stock and bond valuations
EQUITIES	Regions						
	U.S.		■				Valuations have fallen due to stronger earnings, but remain slightly elevated to history. Margins at risk to rising input and wage costs, but tax policy is a tailwind
	Global Ex-U.S.				■		Modestly attractive valuations relative to U.S., stable economic growth, positive earnings trends and higher beta to global trade
	Europe				■		Modestly attractive relative valuations and earnings upside potential from operating leverage, offset by rising risks from Italian politics and moderating economic growth
	Japan				■		Valuations remain attractive, but dependence on global trade a headwind as global growth momentum may be peaking. Stronger yen remains a threat to exports
	Emerging Markets			■			Attractive relative valuations, global growth and positive earnings trends are supportive. Rising risk from higher rates, hawkish trade policies and stronger U.S. dollar
	Style						
	U.S. Growth			■			Expect secular growers to continue to benefit in low growth environment, but valuations are less attractive. Leadership has been narrow and tech at risk from regulatory scrutiny
	U.S. Value			■			Valuations neutral, amidst still modest growth. Tax reform, higher rates, and higher oil prices could be supportive for cyclicals, financials, and energy
	Global Ex-U.S. Growth		■				Relative valuations are above historical averages, particularly within cyclically sensitive areas, most notably industrials
	Global Ex-U.S. Value				■		Relative valuations remain attractive, while economic growth in Europe and Japan is moderating but still supportive
	Capitalization						
	U.S. Large-Cap		■				Valuations still above historical levels, although less expensive on stronger earnings growth. Tailwind from lower dollar is fading and trade policy remains a threat
	U.S. Small-Cap				■		Less vulnerable to trade policy and could benefit from tax-related capex spending and pickup in mergers and acquisitions
	Global Ex-U.S. Large-Cap				■		Relative valuations are attractive, with earnings upside potential due to depressed margins. Cautious on trade policy risks and fading global growth
	Global Ex-U.S. Small-Cap		■				Higher leverage to improving domestic growth trends, but valuations have become more challenging and may be susceptible to lessened liquidity
BONDS	Inflation-Sensitive						
	Real Asset Equities	■					Energy supply/demand imbalances and fading Chinese metals demand remain headwinds. REITs valuations and fundamentals are relatively attractive but vulnerable to rising rates
	U.S. Investment Grade	▲			■		Yields more attractive after rise year-to-date. U.S. yields remain the most attractive among developed markets with Fed likely to advance policy at measured pace
	Developed Ex-U.S. IG (Hedged)		■				Expanding short-rate differential between U.S. and other developed markets has made hedged U.S. dollar yields more attractive, but durations remain extended
	Inflation-Linked				■		Inflation expectations have reset higher, making valuation less compelling. Higher oil prices and tight labor markets are supportive, offset by Fed tightening
	Global High Yield	▼	■				Limited upside potential from current valuations. Despite late stage of credit cycle, fundamentals remain broadly positive with low default expectations
	Floating Rate Loans	▲			■		Fundamentals supportive and rate-reset feature could offer defense against rising rates. However, loan terms have weakened and strong flows have crowded an illiquid sector
	EM Dollar Sovereigns		■				Attractive carry, but vulnerable to tightening monetary policy (both in developed and emerging markets) and rising country-specific risks
	EM Local Currency				■		Despite yields below historical averages, carry is still attractive versus investment grade with potential upside from select currencies

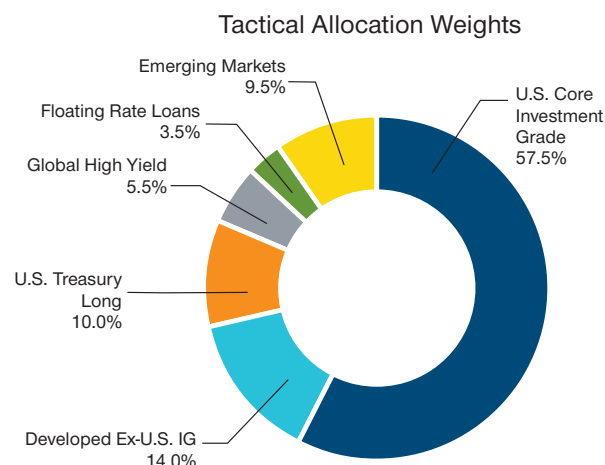
5 Portfolio Implementation

As of May 31, 2018

Equity	Neutral Weight	Tactical Weight	Relative Weight
■ U.S. Large Cap	51.0%	48.8%	-2.2%
■ U.S. Small Cap ¹	15.0%	16.9%	+1.9%
■ Dev. Ex-U.S. Large-Cap	21.0%	23.7%	+2.7%
■ Dev. Ex-U.S. Small-Cap	4.0%	4.3%	+0.3%
■ Emerging Markets	4.0%	4.0%	0.0%
■ Real Assets Equities	5.0%	2.3%	-2.8%
Total Equity:	100.0%	100.0%	



Fixed Income	Neutral Weight	Tactical Weight	Relative Weight
■ U.S. Core Investment Grade	55.0%	57.5%	+2.8%
■ Developed Ex-U.S. IG (Hedged)	15.0%	14.0%	-1.0%
■ U.S. Treasury Long	10.0%	10.0%	0.0%
■ Global High Yield	8.0%	5.5%	-3.0%
■ Floating Rate Loans	2.0%	3.5%	+1.8%
■ Emerging Markets - (Local/Hard Currency)	10.0%	9.5%	-0.5%
■ Cash	0.0%	0.0%	0.0%
Total Fixed Income:	100.0%	100.0%	



¹ U.S. Small-Cap includes both Small and Mid-Cap allocations.

Source: T. Rowe Price.

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Neutral equity portfolio weights representative of a U.S. biased portfolio with a 70% U.S. and 30% International allocation; includes allocation to real assets equities. Core fixed Income allocation representative of U.S. biased portfolio with 55% allocation to U.S. Investment Grade.

Additional Disclosures:

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