T.RowePrice®
INVEST WITH CONFIDENCE

# Capital Markets Flash Report

*First Quarter 2018*

## Global Equity

### MARKET PERFORMANCE

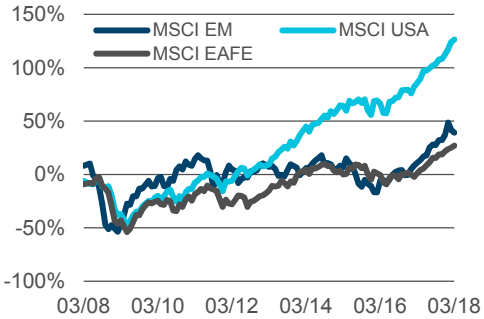
*Periods Ended 31 March 2018 (in USD)*

| | Three Months | One Year | Annualized Three Years | Five Years | Ten Years |
|---|---|---|---|---|---|
| MSCI World Index | -1.15% | 14.20% | 8.58% | 10.32% | 6.51% |
| MSCI Emerging Markets Index | 1.47 | 25.37 | 9.21 | 5.37 | 3.36 |
| MSCI AC World ex US Index | -1.08 | 17.05 | 6.68 | 6.37 | 3.17 |
| MSCI USA Index | -0.63 | 14.03 | 10.55 | 13.23 | 9.52 |
| MSCI EAFE Index | -1.41 | 15.32 | 6.05 | 6.98 | 3.23 |
| S&P Europe Pacific Asia Composite LargeMidCap Index | -1.15 | 15.97 | 6.41 | 7.12 | 3.51 |
| S&P Europe Pacific Asia Composite LargeMidCap Growth Index | -0.59 | 16.53 | 6.51 | 6.88 | 3.65 |
| S&P Europe Pacific Asia Composite LargeMidCap Value Index | -1.82 | 15.30 | 6.44 | 7.42 | 3.38 |
| S&P Europe Pacific Asia Composite SmallCap Index | -0.22 | 23.62 | 11.97 | 11.37 | 6.28 |

*Source: RIMES. Data analysis by T. Rowe Price.*

### CUMULATIVE RETURNS

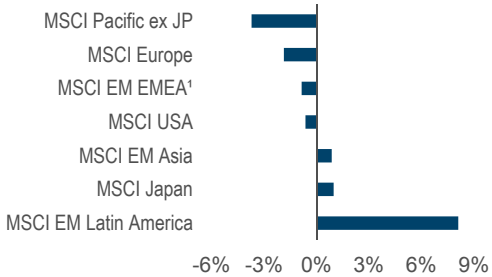
*March 2008 – March 2018*




*Source: MSCI.*

### REGIONAL PERFORMANCE

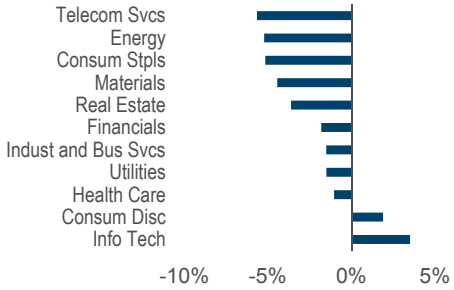
*For the Quarter Ended 31 March 2018*




*Sources: FactSet, MSCI. [1]MSCI EM EMEA: Emerging Markets Europe Middle East Africa*

### SECTOR PERFORMANCE: MSCI WORLD

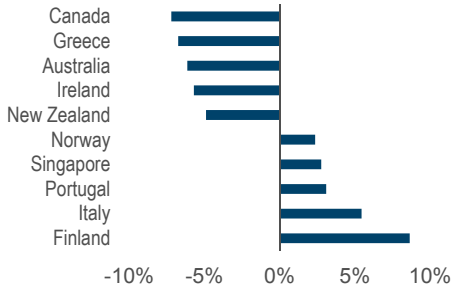
*For the Quarter Ended 31 March 2018*




*Sources: FactSet, MSCI.*

### BEST & WORST COUNTRY PERFORMANCE[2]

*For the Quarter Ended 31 March 2018*




*Sources: FactSet, MSCI. [2]MSCI World.*

### COMMENTARY

International stock markets posted negative returns in the first quarter. Emerging markets generated a small gain, outperforming developed markets. Key market drivers included strong synchronized global economic growth and solid corporate earnings, fears of an unexpectedly fast rise in inflation and interest rates, and worries about an international trade war following President Donald Trump's announcement of tariffs on steel and aluminum imports. Many major currencies, including the euro, the British pound, and the Japanese yen, strengthened against the U.S. dollar, lifting returns in dollar terms. Within the MSCI EAFE Index, which tracks developed markets in Europe, Australasia, and the Far East, the utilities, information technology, and consumer discretionary sectors posted gains. The health care, industrials and business services, and real estate sectors recorded losses. Growth stocks outperformed value stocks.

European shares rose at the start of the quarter, following a string of favorable economic news, including the strongest annual growth in gross domestic product (GDP) in a decade and solid employment numbers. Stocks became more volatile toward the middle of the quarter, however, as fears that robust growth would spark higher labor costs and an unexpectedly faster increase in interest rates and inflation prompted investors to sell shares. On February 6, the pan-European STOXX 600 Index posted its biggest one-day percentage drop since June 2016, around the time of the UK's Brexit referendum. UK stocks lagged as the UK's blue chip FTSE 100, whose companies earn much of their revenue outside the UK, dropped to a one-year low.

Japanese equities fell in local terms but strengthened modestly for U.S. dollar investors and outperformed the broad EAFE benchmark. Japan's economy grew for an eighth consecutive quarter—the longest GDP growth streak since 1989. However, later in the period, a decline in manufacturing and employment growth and fears of a brewing international trade war sparked a sell-off in Japanese shares. President Trump did not exclude Japan from his aluminum and steel tariffs, and the announcement of further tariffs on roughly USD $50 billion in annual imports from China weighed on equity markets. While weak inflation continued to be an issue, Bank of Japan Governor Haruhiko Kuroda said that the bank was considering exiting its ultra-accommodative monetary policy in fiscal 2019 depending on whether the pace of inflation picks up.

Emerging markets stocks rose as synchronized global growth helped drive demand for higher-risk assets, but those gains were tempered later in the quarter by rising concerns over the prospect of a trade war, as well as some negative economic news. Emerging markets in Latin America produced robust gains, led by a sharp rise in Brazilian shares. The domestic Ibovespa benchmark rose to a record in January after an appeals court upheld a graft sentence against former President Luiz Inacio Lula da Silva, dealing a blow to his reelection campaign. However, Brazilian stocks declined in the ensuing months as the economy remained weak. Brazil's economy grew a slower-than-expected 0.1% in last year's fourth quarter from the prior three months and 1.0% for all of 2017, and the central bank cut its benchmark interest rate in February and March. Mexican stocks edged higher despite concerns about the continuation of the North American Free Trade Agreement. Chinese stocks rose but yuan-denominated A shares declined as investors fretted that a trade war with the U.S. would hurt growth just as Beijing steps up measures to de-risk the economy. China's economy grew 6.9% in 2017, above the official 6.5% target and marking the country's first annual growth uptick since 2010.

The broadening global economic recovery should be supportive for risk assets in 2018, according to T. Rowe Price's Asset Allocation Committee. Positive factors include continued domestic demand-driven recoveries underway in Europe and Japan to underpin their respective markets, although growth in both regions is decelerating. Risks to the outlook include a rise in geopolitical or trade tensions and the possibility of a central bank policy misstep.

**Past performance is not a reliable indicator of future results.**

# U.S. Equity

## MARKET PERFORMANCE

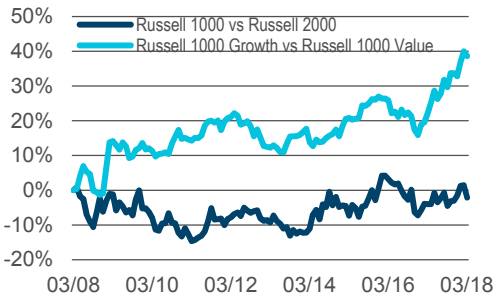
*Periods Ended 31 March 2018 (in USD)*

| | Three Months | One Year | Annualized Three Years | Five Years | Ten Years |
|---|---|---|---|---|---|
| S&P 500 Index | -0.76% | 13.99% | 10.78% | 13.31% | 9.49% |
| Russell 1000 Index | -0.69 | 13.98 | 10.39 | 13.17 | 9.61 |
| Russell 1000 Growth Index | 1.42 | 21.25 | 12.90 | 15.53 | 11.34 |
| Russell 1000 Value Index | -2.83 | 6.95 | 7.88 | 10.78 | 7.78 |
| S&P MidCap 400 Index | -0.77 | 10.97 | 8.96 | 11.97 | 10.90 |
| Russell MidCap Growth Index | 2.17 | 19.74 | 9.17 | 13.31 | 10.61 |
| Russell MidCap Value Index | -2.50 | 6.50 | 7.23 | 11.11 | 9.81 |
| Russell 2000 Index | -0.08 | 11.79 | 8.39 | 11.47 | 9.84 |
| Russell 2000 Growth Index | 2.30 | 18.63 | 8.77 | 12.90 | 10.95 |
| Russell 2000 Value Index | -2.64 | 5.13 | 7.87 | 9.96 | 8.61 |
| Nasdaq Composite Index | 2.32 | 19.48 | 12.96 | 16.67 | 11.98 |

*Source: RIMES. Data analysis by T. Rowe Price.*

## CUMULATIVE RETURNS

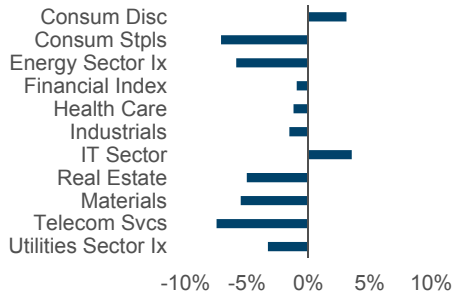
*March 2008 – March 2018*




*Source: Frank Russell Company.*

## S&P PERFORMANCE BY SECTOR

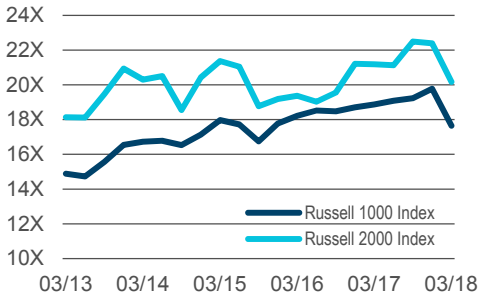
*For the Quarter Ended 31 March 2018*




*Source: Wilshire Atlas.*

## P/E RATIO (12 MONTHS FORWARD)

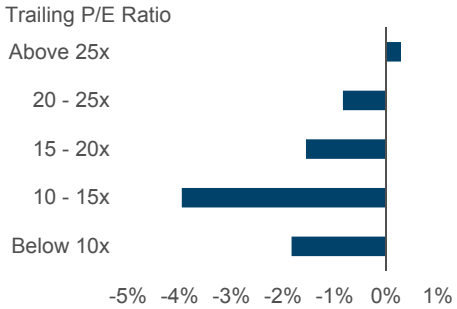
*March 2013 – March 2018*




*Source: IBES.*

## S&P 500 PERFORMANCE BY TRAILING P/E

*For the Quarter Ended 31 March 2018*




*Source: Wilshire Atlas.*

## COMMENTARY

After a strong start, stock prices fell and volatility spiked in the first quarter, bringing an end to an especially long and steady winning streak—the broad Standard & Poor's 500 Index recorded its quarterly first loss since 2015. The large-cap benchmarks fared worse than the small-cap indexes, while the technology-heavy Nasdaq Composite was the sole major index to record a gain in the quarter. Despite sharp declines late in the period, technology shares performed best within the S&P 500 Index, helping growth stocks handily outpace value shares. Consumer discretionary stocks were also strong, thanks in part to strong early performance from Internet-related media and retailing stocks. The small telecommunications sector performed worst, and consumer staples, energy, materials, and real estate shares were also notably weak.

Throughout January, it appeared that the first quarter would be a happy repeat of 2017's market dynamics, with stocks steadily moving higher and setting new records amid minimal volatility. Investors appeared to remain enthused about the passage in December of significant corporate tax cuts, along with new tax provisions that would encourage U.S. corporations to use repatriated foreign profits to boost merger and acquisition activity and share repurchases. Strong economic data, particularly on retail sales, further boosted sentiment. Most importantly, perhaps, fourth-quarter earnings reports came in much better than expected, with overall profits for the S&P 500 increasing by nearly 15% on a year-over-year basis, according to FactSet—the best performance since late 2011.

February brought an abrupt reversal in stock prices, seemingly sparked by inflation fears. On the second trading day of the month, the Labor Department reported that employers had added 200,000 jobs in the previous month, modestly above expectations. More notably, the report also revealed that average hourly earnings had increased 2.9% over a year earlier, the healthiest gain since 2009 (although later revised lower). Stocks plunged as investors appeared to conclude that the tight labor market was feeding through into increased labor costs, while also providing the Federal Reserve with a reason to quicken its pace of interest rate hikes. The decline continued over the next four trading days as subsequent data seemed to confirm that the economy was picking up speed and perhaps in danger of overheating. The S&P 500 reached its low point for the quarter and entered correction territory—defined as a retreat of over 10% from recent highs—on February 8, following a report showing that weekly jobless claims had fallen to their lowest level since January 1973.

As the quarter wound down, fears that the economy was overheating seemed to give way to concerns that growth might be undermined by trade wars. On March 1, President Trump made the surprise announcement that the U.S. would impose tariffs on imported steel and aluminum. The tariff announcement was soon followed by the departure of two leading free trade advocates in the administration, top economic advisor Gary Cohn and Secretary of State Rex Tillerson, alongside reports of the growing influence of senior trade adviser Peter Navarro, a noted proponent of trade restrictions. Trade fears intensified again late in March, after the administration revealed that it was planning on imposing tariffs on roughly $50 to $60 billion worth of imports from China, as well as new restrictions on technology transfers and acquisitions of U.S. firms by Chinese competitors. The Chinese Commerce Ministry referred to the tariff plans as setting a "vile precedent," and Chinese officials declared that they would target $3 billion in U.S. goods with import duties of their own.

The end of the quarter also brought a sharp reversal in highly valued technology shares. The first blow came on March 16, when news surfaced that a British political consulting firm had made undisclosed use of Facebook customer data. Facebook's stock tumbled in response, soon followed by shares in Twitter, Alphabet (parent of Google), and other companies perceived to be vulnerable to accusations about the misuse of customer information. Subsequently, two fatal accidents involving self-driving cars weighed on Tesla, Nvidia, and other prominent companies involved in the technology. Finally, Amazon.com shares fell following reports that President Trump was "obsessed" with the company. Indeed, the president soon tweeted accusations that Amazon was not paying its fair share of taxes or adequately reimbursing the U.S. Postal Service for deliveries, leading to speculation that antitrust action or other regulations might follow.

In a recent investment roundtable, T. Rowe Price's chief investment officers acknowledged that increased regulations could disrupt the business models of dominant Internet companies. Specifically, privacy concerns and antitrust laws may yield significant headwinds. In Europe, firms are subject to increasing concerns about data privacy, and U.S. firms Google and Facebook were recently pulled into investigations regarding Russia's alleged involvement in the 2016 U.S. presidential election. Furthermore, these business models have monopolistic features, and the firm's top investment professionals recognize that governments' previous actions to rein in monopolies have often come at unexpected times—and much to investors' chagrin. They are closely monitoring developments that could attract the attention of regulators or the general public.

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# Global Fixed Income

## MARKET PERFORMANCE

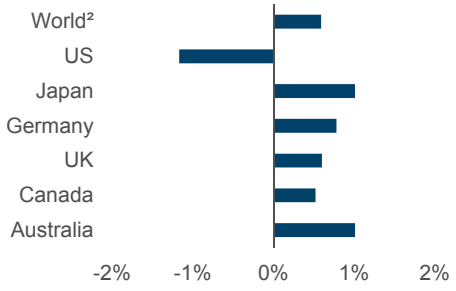
*Periods Ended 31 March 2018 (in USD)*

| | Three Months | One Year | Annualized Three Years | Five Years | Ten Years |
|---|---|---|---|---|---|
| Bloomberg Barclays Global Aggregate Index | 1.36% | 6.97% | 3.14% | 1.49% | 2.57% |
| Bloomberg Barclays Global Aggregate ex-US Index | 3.62 | 11.75 | 4.63 | 1.23 | 1.85 |
| Bloomberg Barclays Global Credit Index | -0.59 | 6.53 | 3.73 | 2.91 | 4.37 |
| Citigroup World Government Bond Index | 2.50 | 8.49 | 3.45 | 1.18 | 1.97 |
| J.P. Morgan Global High Yield Index | -0.69 | 4.53 | 5.93 | 5.24 | 8.45 |
| J.P. Morgan Emerging Markets Bond Index Global | -1.78 | 3.34 | 5.48 | 3.86 | 6.80 |
| J.P. Morgan GBI – EM Global Diversified Index | 4.44 | 12.99 | 5.43 | -0.67 | 3.78 |

*Source: RIMES. Data analysis by T. Rowe Price.*

## SOVEREIGN BOND MARKET PERFORMANCE[1]

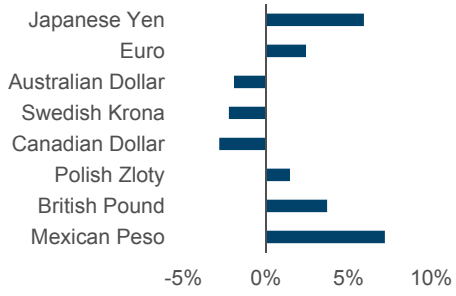
*For the Quarter Ended 31 March 2018*




*[1]Hedged into USD.*
*[2]World: Citigroup World Government Bond Index*
*Source: Citigroup.*

## CURRENCY PERFORMANCE VS. USD

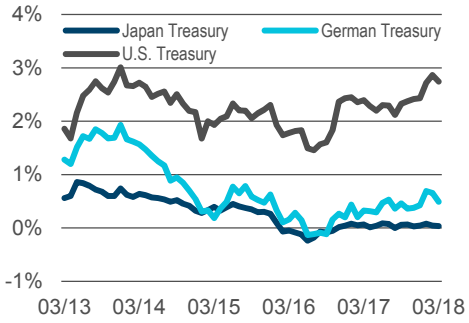
*For the Quarter Ended 31 March 2018*




*Source: J.P. Morgan.*

## GLOBAL YIELDS

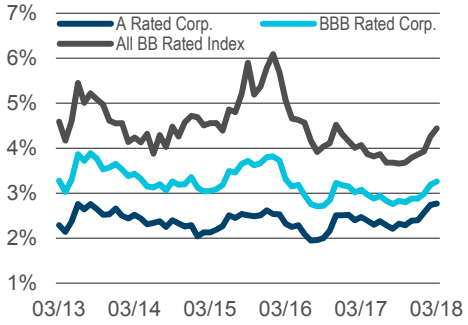
*March 2013 – March 2018*




*Source: Bloomberg Barclays.*

## QUALITY YIELDS

*March 2013 – March 2018*




*Source: Bloomberg Barclays.*

## COMMENTARY

Non-U.S. bonds offered positive returns to U.S. investors in the first quarter, helped by a rise in the euro, yen, and other major currencies. The major developed market central banks outside the U.S. generally kept their monetary policies unchanged in the quarter, but the Bank of England raised expectations of a future hike in its March post-meeting statement, noting that "an ongoing tightening of monetary policy over the forecast period will be appropriate to return inflation sustainably to its target." The European Central Bank (ECB) also shifted to a slightly less accommodative policy as it dropped language from its statement that mentioned a commitment to expand its quantitative easing program if necessary.

The yields on 10-year government notes in Germany and the UK rose during the period, with the German bund increasing from 0.430% to 0.498%, while the British gilt moved from 1.191% to 1.353%. The Japanese 10-year note yield finished little changed, ticking down from 0.050% to 0.048%.

Emerging markets bonds struggled later in the period as equity market volatility and concerns about the potential for trade wars weighed on demand for riskier assets. Credit news was mixed in the sector. In a widely expected decision, S&P Global Ratings cut Brazil's credit rating to BB- from BB, noting that the country had failed to pass meaningful fiscal reform needed to support continued economic growth. However, in South Africa, the rand rose more than 1% after Moody's Investors Service kept that country's credit rating above junk status and lifted its outlook to stable. In the wake of the announcement, yields on South Africa's benchmark local-currency government bonds fell to their lowest level in almost three years. The other major ratings agencies, S&P and Fitch Ratings, downgraded South Africa to junk status last year. If Moody's had also downgraded the country's debt, South African bonds would have been pushed out of the key investment indexes and the government would have likely faced higher borrowing costs.

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# U.S. Fixed Income

## MARKET PERFORMANCE

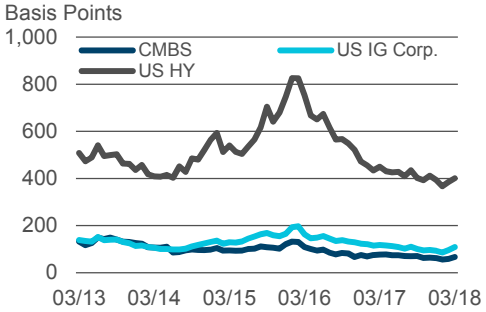
*Periods Ended 31 March 2018 (in USD)*

| | Three Months | One Year | Annualized Three Years | Five Years | Ten Years |
|---|---|---|---|---|---|
| Bloomberg Barclays U.S. Aggregate Index | -1.46% | 1.20% | 1.20% | 1.82% | 3.63% |
| Bloomberg Barclays Government Bond Index | -1.15 | 0.44 | 0.48 | 1.07 | 2.70 |
| Bloomberg Barclays U.S. Credit Index | -2.13 | 2.59 | 2.16 | 2.83 | 5.15 |
| Bloomberg Barclays ABS Index | -0.39 | 0.62 | 1.18 | 1.20 | 3.12 |
| Bloomberg Barclays CMBS Index | -1.32 | 1.12 | 1.50 | 2.04 | 4.97 |
| Bloomberg Barclays MBS Index | -1.19 | 0.77 | 1.12 | 1.80 | 3.46 |
| Bloomberg Barclays Municipal Bond Index | -1.11 | 2.66 | 2.25 | 2.73 | 4.40 |
| Credit Suisse High Yield Index | -0.85 | 3.68 | 5.21 | 4.93 | 7.84 |

*Source: RIMES. Data analysis by T. Rowe Price.*

## SECTOR SPREADS

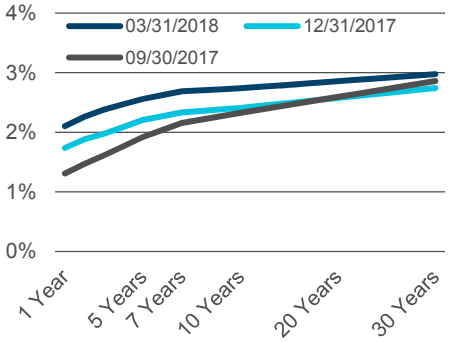
*March 2013 – March 2018*




*Sources: HY: Credit Suisse High Yield Index Spread to Worst , US IG and CMBS: Bloomberg Barclays OAS.*

## U.S. TREASURY YIELD CURVES

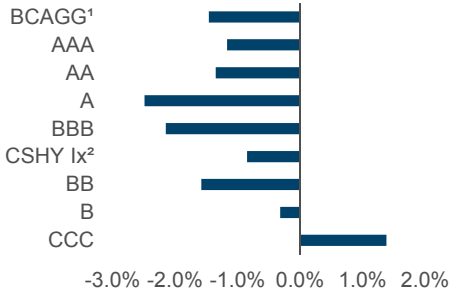
*For the Quarter Ended 31 March 2018*




*Source: FactSet. Data analysis by T. Rowe Price.*

## QUALITY PERFORMANCE

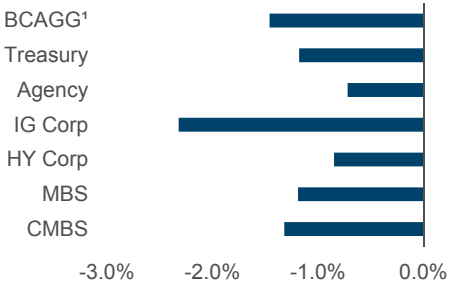
*For the Quarter Ended 31 March 2018*




*[1]BCAGG: Bloomberg Barclays U.S. Aggregate Index.*
*[2]CSHY Ix: Credit Suisse High Yield Index*
*Sources: Bloomberg Barclays, Credit Suisse.*

## SECTOR PERFORMANCE

*For the Quarter Ended 31 March 2018*




*[1]BCAGG: Bloomberg Barclays U.S. Aggregate Index.*
*Sources: Bloomberg Barclays, Credit Suisse.*

## COMMENTARY

Treasury yields reached multiyear highs during the first quarter as the prospect of an increasing supply of Treasury securities and rising inflation expectations worried investors. (Bond prices and yields move in opposite directions.) The two-year Treasury note's yield reached its highest level since January 2008, the benchmark 10-year Treasury yield hit a four-year high, and the 30-year yield climbed to a 2½-year high. Longer-term Treasury yields peaked for the quarter on February 21 before receding somewhat in March. The Federal Reserve continued to slowly shrink its holdings of Treasuries and mortgage-backed securities, a process it began in October, and also appeared more committed to a gradual tightening of monetary policy. In addition, there were concerns about other central banks starting to reduce their stimulus programs, and a weakening dollar reduced the appeal of Treasuries for non-U.S. investors.

The interest rate hike at the Fed's March policy meeting, which was widely expected, moved the federal funds rate to a range of 1.50% to 1.75%. It was the first meeting under the leadership of Jerome Powell, who succeeded Janet Yellen as Fed chief in early February. The Fed's median projection is currently for two more hikes this year. Another measure of short-term interest rates, the three-month London interbank offered rate (Libor), also increased. Libor, the interest rate that banks charge each other for U.S. dollar loans, rose to 2.31% by the end of March from 1.69% at the end of 2017. Many analysts believe an increased supply of Treasury bills and commercial paper (short-term corporate debt) contributed to the bump in Libor.

Mortgage-backed securities (MBS) performed in line with Treasuries and held up better than the broader investment-grade bond market. The Fed's continued slow reduction of its MBS holdings was a headwind for the sector; however, rising interest rates helped reduce mortgage prepayment risk, and investor demand for high-quality securities provided support.

Investment-grade corporate bonds faced headwinds from elevated supply and waning demand outside the U.S. The issuance of $40 billion of new bonds in March by pharmacy chain CVS to fund its purchase of health insurer Aetna was the third-largest investment-grade corporate bond deal on record and was generally well received by the market. High yield bonds lost ground but held up better than the broad U.S. investment-grade market. The sector was supported by solid corporate earnings reports and a low default rate. Generally higher oil prices during the quarter were also beneficial for energy issuers, which make a large portion of the high yield indexes. Below investment-grade credit spreads—the yield premium offered by riskier bonds compared with similar-maturity Treasuries—reached the tightest levels since 2007 in January, but spreads widened later in the period as equity weakness weighed on the sector.

Municipal bonds recorded negative results for the quarter but narrowly outperformed Treasuries. The Wall Street Journal noted that this year's first-quarter return was the weakest start to the year for the sector in 15 years. Tax-exempt bonds faced a mixed technical environment as a result of tax reform. New issuance was muted, but, with lower corporate tax rates, some banks and insurance companies had less need for munis in their portfolios. Lower-rated segments of the muni market, including high yield tobacco bonds and debt from troubled issuer Puerto Rico, outperformed higher-quality tax-exempt securities.

T. Rowe Price's multi-sector bond portfolio managers believe that leveraged loans are a compelling option for fixed income investors who are seeking an asset class with less sensitivity to rising interest rates. Unlike most other fixed income alternatives where prices fall as rates rise, leveraged loans, which are also called bank loans, have their coupons reset higher as rates increase. As a result, leveraged loans have historically outperformed other fixed income sectors during periods of rising Treasury rates and monetary policy tightening.

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# Economic Outlook

## GLOBAL EX-U.S. ECONOMIES

Even as U.S. growth accelerates somewhat, the expansions in many other developed markets and China appear poised to moderate. Purchasing managers' indexes (PMIs) in Europe, while still indicating healthy expansion, have recently weakened a bit, suggesting that growth in manufacturing may have peaked around the start of the year. On the other hand, European consumers remain in generally good shape despite the recent rise in energy costs, and European non-financial corporations boast manageable debt levels that compare very favorably with their U.S. counterparts.

China appears to remain on track for a guided slowdown as officials seek to deleverage and rebalance the economy, improve environmental conditions, and rein in financial risk. Indeed, Chinese growth data has recently surprised on the upside, partly due to a rise in exports. PMIs suggest that the services sector is performing somewhat above expectations, while manufacturing conditions have been more mixed. Inflation remains contained, and Chinese officials seem to have enjoyed success in curbing the speculative boom in the housing market—although property prices have recently begun to edge higher again.

The prospect of a full-blown trade war between China and the U.S. is a key risk to the global economic outlook, of course, but a remote one. A number of the Trump administration's demands relate to issues that China had already signaled its willingness to negotiate, and Chinese officials are likely to continue responding to the announcement of new U.S. tariffs or other protectionist measures in a calibrated and proportionate manner. A harder response, including devaluing the yuan or dumping China's holdings of U.S. Treasuries, seems unlikely, as it would weaken the global economy and rebound on China's economy. Nevertheless, trade tensions are likely to remain ongoing, especially concerning China's plans to subsidize nascent advanced industries as part of its "Made in China 2025" program.

## U.S. ECONOMY

The U.S. economy appears on track to expand by roughly 2.5% in 2018, a modest pickup over recent years. Consumer spending fed by a healthy labor market continues to support growth, with hourly earnings in March increasing by 2.7% over the previous 12 months, near the upper end of the range that has prevailed over the past two years. Further acceleration in wages is likely as the labor market tightens, but the pace will be slow, reflecting low inflation and subdued productivity growth. The average workweek has also been lengthening, however, providing an extra boost to labor income.

Capital spending is also supporting the economy. Core (excluding defense and aircraft) capital goods spending began its current expansion in the middle of 2016, and nonresidential construction has continued the expansion it began in 2011. Meanwhile, business sentiment surveys recorded a notable uptick in late 2017 and suggest that capital spending is on track to maintain or even improve its momentum in the coming year. It is worth noting that this view is not predicated on investment incentives in December's Tax Cut & Jobs Act (TCJA). Rather, fundamental support comes from pent-up demand after the 2015-16 capex recession, healthy corporate earnings, and strong export demand—although tit-for-tat tariff increases are a risk to this last support.

Inflation pressures are firming in this environment, but not to an extent that appears likely to cause the Fed to pick up their planned path of rate increases—we continue to expect a total of three, and perhaps four, quarter-point rate hikes in 2018. The latest data suggest that growth in core personal consumption expenditures (PCE), having dipped in 2017, is reaching back to the 2% rate that is widely viewed as the Fed's target—a level not reached since early 2012. The Fed's latest summary of economic projections reveals that the median expectation of policymakers is for PCE inflation to hit 1.9% in 2018 and 2.1% in 2019. Recent statements suggest that the Fed will allow inflation to run a bit higher than 2% in order to achieve some stability around that level after being well below the target for several years. Likewise, it seems that the Fed will allow the unemployment rate to drop well below the level of full employment before adjusting their policy stance. Policymakers' median expectation for the unemployment rate is that it will fall from 4.1% currently to 3.6% in 2019—well below their longer-run expectation of 4.5%.

# Notes & Sources

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