T. Rowe Price®
INVEST WITH CONFIDENCE

Global Asset Allocation Viewpoints and Investment Environment

MAY 2018

1 MARKET THEMES

Why care about the LIBOR-OIS Spread?

With the tide of global liquidity—supported by a decade of ultra-easy central bank policies—now in retreat, the rise in LIBOR has caught the attention of the markets. The spread between LIBOR, a credit barometer for short-term borrowing costs, and the overnight index swap (OIS) rate, a less risky rate which banks swap fixed for floating rates, has moved higher (Figure 1). Could it be signaling rising risk in credit markets? There are some unique reasons for the widening spread, including recent tax policy changes allowing repatriation of foreign cash that resulted in lessened demand for short-term instruments. Additionally, increased deficit spending in the U.S. has led to a large supply of U.S. T-bill issuance. While the trend appears isolated and off its recent peak, the move higher has a real impact on corporate borrowing costs and is another factor contributing to market liquidity concerns.

U.S. curve back in focus, as 10-year breaks 3%

Following February's inflation scare that temporarily paused the trend in yield curve flattening, the curve is back in focus as the spread between 2 and 10 year treasury yields has fallen to levels last seen in 2007 (Figure 2). In hindsight, that ended up being a pretty timely warning signal. And while it is easy to say things are different this time, markets will be cautiously monitoring the trend to see if it leads to an inversion. Equity markets have historically shown that they can weather a flattening curve; it's after an inversion where they have proven less resilient—fearing recession or Fed overshoot. What is different this time is that yields remain at historically low levels despite Fed tightening since 2015, the fed funds "real yield" is still negative and global quantitative easing, while receding, is still weighing down long-term rates.

At odds: Macro data and earnings growth

Despite recent reports showing softening global economic data, earnings growth around the globe remains strong led by the U.S. First quarter earnings season in the U.S. is just underway and revisions have trended higher into the start. Earnings are expected to grow in the high teens supported by a boost from tax policy, a weak U.S. dollar and higher energy prices. Revenue growth is also strong with expectations in the high single digits—notable in a sub-3% economic environment. While companies are increasingly citing rising input and wage costs, tax benefits are more than compensating, pushing margins to highs last seen a decade ago. While equity markets have been mixed year-to-date, grappling with geopolitics and fears of trade wars, earnings expectations are elevated, suggesting underlying corporate fundamentals remain strong.

2 PORTFOLIO POSITIONING

Equity

- We reduced our overweight to Japanese equities, following a period of strong performance driven by their exposure to last year's pickup in global trade, given signs of a moderation in growth in Asia-Pacific and Europe and potential impacts of a stronger yen.
- We are overweight to U.S. small-cap stocks based on attractive relative valuations versus large-caps, potential benefits from lower corporate tax rates, a pickup in M&A activity and growth in capital spending. Small caps are also less exposed to trade policy risks.
- We remain underweight to equities as valuations remain elevated against a backdrop of increasing risks from higher inflation, rates and volatility. Above trend economic growth and strong earnings provide support, but appear fully reflected in valuations and vulnerable to disappointment.

Fixed Income

- We moderated our underweight to "hedged" developed market bonds outside the U.S. Increasing short-term rate differential between U.S. and non-U.S. markets has led to more competitive hedged yields on bonds in Europe and Japan for U.S. dollar-based investors.
- We remain overweight to floating rate loans relative to high yield bonds. With the Fed expected to continue raising rates this year and likely into 2019, we believe loans should benefit from their rate reset feature and shorter duration profile.
- We are underweight emerging market bonds as tight 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 prospects for energy and commodity prices, given continued concerns over supply and demand imbalances.
- Higher energy prices on the back of increasing global growth expectations and OPEC production cuts may continue to be challenged by increased production from U.S. shale producers.
- REITs have been pressured by rising rates leaving relative valuations more attractive and are at a modest discount to private market net-asset values. Fundamentals remain broadly positive, with healthy growth in both occupancy and rental income. However, rising rates are likely to remain a near term headwind.

FIGURE 1: SPREAD BETWEEN LIBOR AND OIS
January 1, 2007–April 30, 2018

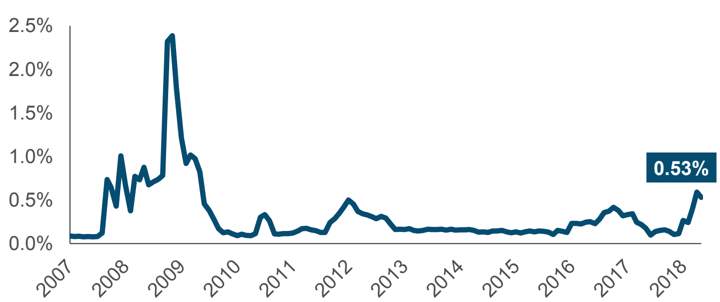
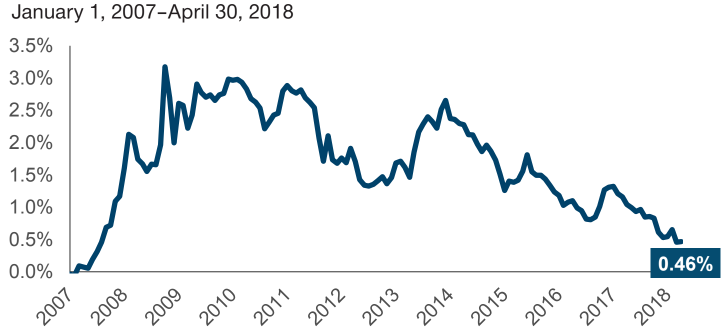


FIGURE 2: SPREAD BETWEN 10 YR AND 2 YR TREASURY YIELD
January 1, 2007–April 30, 2018



Sources: Bloomberg Barclays and FactSet.

3 Regional Backdrop

As of April 30, 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 stimulus at late stage may result in overheating ▪ Inflation normalizing amid tighter labor markets, but unlikely to accelerate sharply ▪ Aggressive trade policy poses a risk, but likely to be limited in scope	▪ Valuations trending above historical averages ▪ Earnings are very strong, but current pace of growth unlikely to be sustainable ▪ Tax reform has provided a near term boost to 2018 earnings expectations ▪ Margins could face headwinds from higher rates, wages and input costs	▪ Short-term rates rising in unison with Fed rate increases, likely to extend into 2019 ▪ Longer rates modestly higher amidst improving growth, rising inflation expectations and Fed balance sheet unwind	▪ Broad strength in global growth, a shift to tighter monetary policy outside the U.S., and valuation continue to weigh on the medium term outlook for the dollar ▪ Extended positioning and trade tensions, allied with higher relative yields have boosted the dollar near term
DEVELOPED EUROPE	▪ Eurozone growth moderating from above potential pace seen last year, but expected to remain stable ▪ The ECB cautiously taking initial steps toward unwinding quantitative easing with bond purchases set to end this September ▪ Improving employment trend continues, with labor conditions becoming tight in some core countries, notably Germany	▪ 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	▪ Eurozone inflation remains well below the ECB's 2% target ▪ Sustained growth and further evidence of rising inflation could gradually push rates higher	▪ Despite recent softening in economic growth, both the medium term economic and ECB policy trajectories remain positive drivers for the euro ▪ While no longer as cheap, valuations remain constructive and current account surplus is supportive of longer term strength
UNITED KINGDOM	▪ Brexit negotiations remain the central issue for growth trajectory ▪ Negotiators have agreed on the transition period, exit bill, single market stance and rights of EU citizens. However, discussions on whether the UK stays in the EU customs union are ongoing and could have a significant impact on UK trade ▪ 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 ▪ Over the longer term, rates will remain dependent on Brexit negotiations and inflation outlook	▪ Pound off recent highs versus U.S. dollar on growing uncertainty around U.S. and UK central bank interest rate paths ▪ Despite attractive valuations on a historical basis, the longer term outlook is challenging due to EU–UK negotiations and increased political uncertainty
DEVELOPED ASIA & PACIFIC	▪ Trade-driven economies likely to slow as global growth appears to have peaked—though growth remains at healthy levels ▪ Japanese economic momentum is moderating, however activity remains at healthy levels as indicated by the low unemployment rate and a resilient PMI ▪ Japanese wage inflation still not reflecting extremely tight labor market ▪ 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	▪ Valuations within the region remain attractive relative to other developed markets, but earnings remain vulnerable to currency and commodity price volatility ▪ Japanese equities remain supported by better relative valuations, strong earnings growth, and gradually improving corporate governance ▪ Australian natural resources sector has benefitted from global economic strength, but financials face uncertainties surrounding the Royal Commission	▪ The Bank of Japan continues to reaffirm its accommodative policy, with no change expected in the near term. Inflation remains benign despite tight labor markets ▪ Inflation remains on the low side of the RBA range, pointing to no policy change in the near term ▪ A continued rise in global yields could impact the long end of the curve in the region	▪ Broad U.S. dollar strength has improved Japanese yen valuations, taking it to the midpoint of its recent range ▪ Longer term, the yen remains cheap and external positions are supportive, making eventual normalization likely ▪ The Australian dollar has continued to weaken as domestic policy stance and global trade concerns have weighed
EMERGING MARKETS	▪ Emerging market growth trend likely to moderate relative to last year, but remain strong ▪ 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 ▪ China targets modestly lower growth as President Xi Jinping's government balances economic growth with needed reforms (e.g. debt reduction, pollution, corruption, and industrial capacity) ▪ Rising idiosyncratic and political risks in several key countries— including Mexico, Brazil, South Africa and Turkey	▪ Broad-based growth supporting demand for exports, but momentum may be 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 broadly more attractive as idiosyncratic factors have weighed in Russia, Turkey and Mexico in combination with recent U.S. dollar strength ▪ Politics may continue to be in focus as we move towards July elections in Mexico and Brazil late in the year ▪ Rising 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 April 30, 2018

▼ or ▲ Month Over Month Change

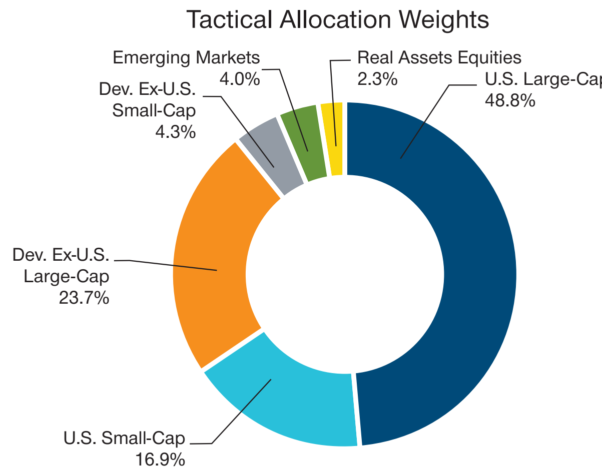
These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.

		Change	Underweight		Neutral	Overweight		
ASSET CLASS	Equities			■				Valuations modestly more attractive amidst decline in prices and stronger earnings growth. Global growth remains supportive. Rising rates, tight labor markets and inflation are headwinds
	Bonds					■		Yields more attractive after recent move higher on rise in inflation expectations. Upward trend may be tempered by demand and still modest growth expectations
	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 down from recent peak, but remain elevated. Margins could be pressured by rising input and wage costs. Earnings momentum supported by tax policy and weaker dollar
	Global Ex-U.S.					■		Modestly attractive valuations relative to U.S., improving economic growth, positive earnings trends and higher beta to global trade
	Europe	▲				■		Modestly attractive relative valuations with economic growth moderating from above potential trend. Potential earnings upside from operating leverage, while stronger euro could weigh
	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, improving global growth and positive earnings trends are supportive. Higher rates, hawkish trade policies and a reversal in the U.S. dollar are potential risks
	Style							
	U.S. Growth				■			Expect secular growers to continue to benefit in structurally low growth environment, but valuations are less attractive, leadership has been narrow and risk rising from regulatory scrutiny
	U.S. Value				■			A sustained pickup in growth and higher rates could be supportive for cyclical stocks. Financials benefit from decreasing regulation. Tax reform impacts could provide support
	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, growth in Europe and Japan 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 and fiscal stimulus while trade policy a threat
	U.S. Small-Cap					■		Attractive relative valuations versus large-caps. Less vulnerable to trade policy, and could benefit from tax policy related capex spending and pickup in M&A
	Global Ex-U.S. Large-Cap					■		Relative valuations are attractive, with potential earnings upside due to depressed margins. Cautious on trade policy risks
	Global Ex-U.S. Small-Cap			■				Small-caps may offer higher leverage to improving domestic growth trends, but valuations have become more challenging and may be susceptible to lessened liquidity
	Inflation-Sensitive							
	Real Asset Equities		■					Energy supply/demand imbalances and slower Chinese growth remain headwinds. REITs more attractive after declines, though late cycle in U.S. and vulnerable to rising rates
BONDS	U.S. Investment Grade	▼				■		Yields more attractive after sell-off on higher energy/inflation concerns. 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 non-U.S. has made hedged yields more attractive for US$ based investors, but durations remain extended
	Inflation-Linked					■		Inflation expectations have reset higher, making valuation less compelling. Higher oil prices, tight labor markets, and weaker U.S. dollar are supportive, but 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					■		Floating-rate feature and shorter duration could offer defense against rising rates. Fundamentals broadly positive with less energy exposure
	EM Dollar Sovereigns			■				Attractive carry, but vulnerable to developed market central bank tightening, a stronger U.S. dollar, political risks and slower Chinese growth
	EM Local Currency					■		Yields less compelling following strong rally, but carry still attractive versus investment grade with potential upside from select currencies

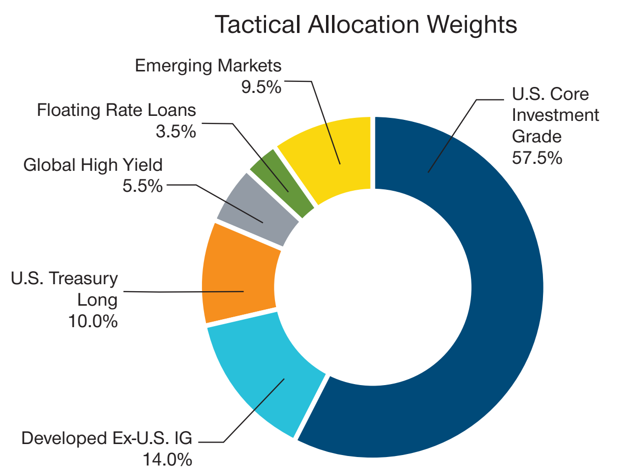
5 Portfolio Implementation

As of April 30, 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%	+2.5%
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%	-2.5%
Floating Rate Loans	2.0%	3.5%	+1.5%
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.
Information presented herein is hypothetical in nature and is shown for illustrative, informational purposes only. It is not intended to be investment advice or a recommendation to take any particular investment action. This material is not intended to forecast or predict future events and does not guarantee future results. These are subject to change without further notice. Figures may not total due to rounding.
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:

IMPORTANT INFORMATION

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