



Global Asset Allocation Viewpoints and Investment Environment

AUGUST 2018

1 MARKET THEMES As of July 31, 2018

TRADE WARS: PRECISION MET WITH SHOCK-AND-AWE

In the most recent volley, President Trump has threatened tariffs on nearly all Chinese imports into the U.S., totaling nearly \$500 billion USD per year, while also considering increasing tariff rates to 25%. While China imports far less from the U.S. and cannot meet those numbers one-for-one, they could resort to other tactics, including currency devaluation, selling U.S. Treasury holdings or targeting U.S. businesses operating in China. So far, China has taken careful aim with their retaliatory tariffs, hitting U.S. agriculture the hardest—a perceived base of support for the U.S. president as the November elections approach. The European Union has been similarly calculated in their retaliation, with tariffs targeted at American iconic brands including motorcycles, whiskey and blue jeans.

CURRENCIES: THE NEXT BATTLEFRONT?

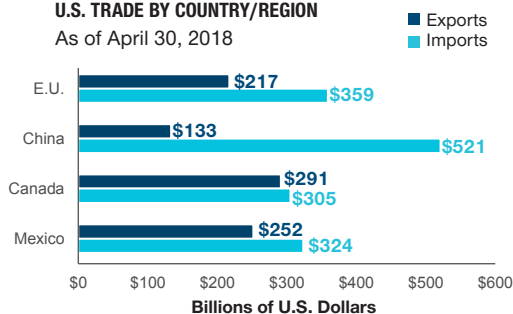
The Chinese yuan has depreciated nearly 5% against the U.S. dollar this year which may help offset the impacts of tariffs imposed on Chinese exports to the U.S. The euro has also declined against the greenback prompting President Trump to accuse the EU and China of manipulating their currencies to unfairly capture trade. Speculation that China will ease policy to mitigate the impacts of tariffs may be driving the yuan's move lower, however, it may also be the result of deliberate action by Chinese policymakers to counter tariffs. An escalation in a currency war and further steps to devalue the yuan should be watched cautiously as it could quickly spill over to other countries who would, in turn, need to defend their currencies.

U.S. EARNINGS: PUNCHING ABOVE THEIR WEIGHT?

U.S. companies are beating their already high 2nd quarter earnings growth estimates of +20% despite a modest economic growth environment. Backing out the benefits of tax reform, estimated at 6 to 7%, earnings are expanding well above their long-term average. Lower taxes are contributing to record net margins, offsetting rising labor and input costs. What has been surprisingly strong and broad-based is top-line growth, with the S&P 500 set to deliver +8% revenue growth for the third consecutive quarter. Earnings expectations remain high for the back half of the year as well, with consensus expecting the current pace of near 20% growth to continue. As the benefits from lower taxes fade, markets will be looking to see where earnings growth settles—the dollar is higher, energy prices have moderated and the impacts from tariffs remains uncertain.

U.S. TRADE BY COUNTRY/REGION

As of April 30, 2018



Source: [IMF] / Haver Analytics.

CHINESE YUAN PER U.S. DOLLAR

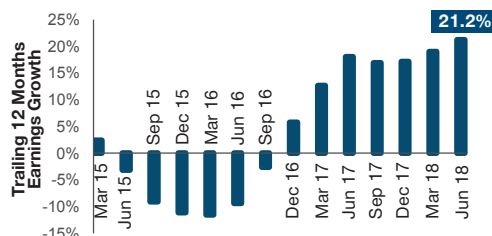
January 1, 2015–July 31, 2018



Source: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

S&P 500 OPERATING EARNINGS GROWTH

As of July 31, 2018



Source: Standard and Poor's.

2 PORTFOLIO POSITIONING

EQUITY

- We maintain an underweight to equities. While equity valuations are more attractive than levels seen at the start of the year, they remain elevated relative to history against a backdrop of receding global liquidity, higher rates, an aging U.S. economic cycle and rising trade tensions.
- We remain overweight U.S. small caps as relative valuations versus large-cap remain reasonable. Small-caps could continue to benefit from supportive growth, capex, M&A and earnings growth that is expected to outpace large-caps over the near term.
- We remain overweight to equities outside the U.S. based on more attractive valuations and the potential for greater earnings upside.

FIXED INCOME

- We are underweight to high yield bonds as valuations appear elevated late in the credit cycle.
- We favor floating rate loans within the high yield sector. With the Fed expected to continue raising rates this year and into 2019, loans should benefit from their rate reset feature and shorter duration profile.
- We are underweight developed-ex U.S. investment grade bonds due to extended duration, tight credit spreads, and an expectation of rising sovereign rates over the medium term.

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 further signs of a slowdown in China.
- REIT fundamentals are broadly positive, with muted supply growth and healthy occupancy rates and rental income. However, valuations have become somewhat less attractive and rising rates may pose a near-term headwind.

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3 Regional Backdrop

As of July 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 are driving the current period of strong growth, but late cycle stimulus may result in overheating
- Inflation and labor costs gradually rising amid tighter labor markets
- Aggressive trade policy poses a significant and growing risk, but may ultimately be limited in scope

- Valuations above historical averages, with significant bifurcation between winners and losers
- Earnings are very strong, but current pace of growth unlikely to be sustainable
- Margins likely to 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 biased higher over the long-term amidst improving growth, rising inflation expectations, expanded budget deficit, and Fed balance sheet unwind

- The dollar has benefitted from perceptions of U.S. growth and monetary policy exceptionalism. In addition, continuing trade tensions and tariffs have been supportive
- Stabilization of global growth, valuations and tighter monetary policy outside the U.S. over time remain headwinds to the medium-term outlook

DEVELOPED EUROPE

- Eurozone growth moderating, but expected to stabilize and remain above potential
- Rising trade protectionism is a significant risk, most notably for Germany given its export focus
- A forthcoming event to watch is the Italian budget, which needs to be fiscally prudent and meet the large spending and tax-cutting pledges made by the coalition

- Valuations are modestly attractive relative to the U.S.
- Operating leverage offers further earnings upside potential, with the recent uptrend in earnings expected to continue
- Despite a recent recovery, European banks are still significantly weaker both on an absolute basis and versus the broader market

- Sustained growth, recent euro weakness, and further evidence of rising inflation could gradually push rates higher
- The large moves in Italian asset prices after a false rumor regarding the resignation of the finance minister illustrate that markets remain fragile due to political risk in Europe

- Political risks, ECB policy, and relatively lackluster activity data have continued to restrain the euro versus the dollar
- Valuations remain attractive as do both the medium-term economic and ECB policy trajectories versus the U.S. and other currencies

UNITED KINGDOM

- Economic growth appears very healthy after rebounding from its early 2018 soft patch, but Brexit uncertainties loom
- The UK government agreed on a Brexit negotiating stance, although this was formally rejected by the EU and resulted in numerous government resignations
- Both the UK and the EU have stepped up planning for a “no deal” situation, whose risk has increased in recent weeks

- 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

- Bank of England (BOE) is likely to hike rates in August, increasing the rate to 75bps
- Over the longer-term, rates will remain dependent on Brexit negotiations and inflation outlook

- Despite a modestly more hawkish BOE of late and attractive valuations versus history, we remain concerned over the implications of the political and economic outlook both before and after Brexit

DEVELOPED ASIA & PACIFIC

- Trade-driven economies likely to slow as global growth appears to have peaked—though growth remains at healthy levels
- Slowdown in Japan has continued although a near term rebound seems likely, absent any external shock
- Prime Minister Abe’s likely re-election suggests a stable macro policy outlook for now
- Australian economic activity improved from last year with net exports and government spending the main contributors
- 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 a slowdown in global trade
- Japanese equities remain supported by better relative valuations, strong earnings growth, and gradually improving corporate governance
- Australian equities enjoying a period of strength, with valuations that are attractive relative to international peers

- A continued gradual rise in global yields could impact long rates in the region
- The Bank of Japan (BOJ) continues to hold its accommodative policy, with no meaningful change expected in the near-term, despite rumors to the contrary
- RBA appears to be delaying their next rate increase

- The yen has recently seen support from the potential for a more active BOJ vis-a-vis its yield curve control program
- On a medium-term view, the yen remains cheap and external positions are supportive
- The Australian dollar has weakened modestly recently, to historically cheap levels, due to adverse interest rate differentials, global trade and China growth concerns

EMERGING MARKETS

- Growth is slowing, but will likely stabilize in the latter half of 2018
- Trade protectionism a growing risk, but impact could be limited if the dialogue between U.S. and China continues
- Chinese macro policies are becoming significantly more supportive of near term growth as China braces for a potential trade war with the U.S.
- Idiosyncratic and political risks remain elevated in several key countries—including Mexico, Brazil, Argentina, Venezuela, Malaysia and Turkey

- Valuations considerably more attractive, as equities have sold off on trade concerns, U.S. dollar strength, and elevated country-specific risks
- Demand for exports is healthy but fading
- Earnings growth remains broadly strong, with ROEs improving

- Interest rates trending higher as financial conditions tighten in response to rising inflation and higher U.S. rates
- Many central banks have shifted toward a tightening bias

- EM currency valuations remain cheap versus history driven recently by the stronger U.S. Dollar and idiosyncratic factors
- Several EM currencies look attractive on valuations and relative rate differentials, such as the Czech koruna and Indonesian rupiah

4 Asset Allocation Committee Positioning

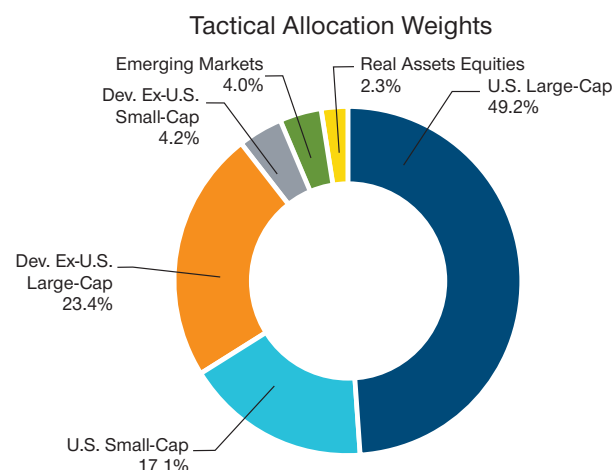
As of July 31, 2018

		<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, an aging economic cycle in the U.S., and rising trade tensions
	Bonds				■		Upward trend in rates may be tempered by demand for yield, still modest growth expectations and increased volatility surrounding trade policies
	Cash				■		Yields more attractive as Fed raises rates. Cash can provide a buffer against extended stock and bond valuations
EQUITIES	Regions						
	U.S.		■				Valuations slightly elevated to history, with narrow market leadership. Earnings supported by strong revenue growth, yet likely to moderate from elevated levels
	Global Ex-U.S.				■		Attractive valuations relative to U.S., above-potential economic growth, and positive earnings trends. Increased risks from trade wars and weakness in European financials
	Europe				■		Modestly attractive relative valuations and earnings upside from operating leverage offset by rising political risks, moderating economic growth, and banking system weakness
	Japan			■			Valuations remain attractive, but dependence on global trade a headwind as global growth momentum has peaked and trade war concerns loom
	Emerging Markets			■			Attractive relative valuations and positive earnings trends are offset by U.S. dollar strength, rising rates, hawkish trade policies, and country-specific risks
	Style						
	U.S. Growth			■			Growth companies may benefit in a structurally low growth environment. While valuations are elevated, leadership has been narrow and trade policy could impact tech supply chains
	U.S. Value			■			Valuations attractive with potential support from fiscal stimulus. However, late stage credit-cycle and flat yield curve could weigh on financials
	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 are attractive, but fundamentals have weakened, most notably within European financials
	Capitalization						
	U.S. Large-Cap		■				Valuations still above historical levels, although less expensive on stronger earnings growth. Tailwind from weak dollar has faded and trade policy remains a threat
	U.S. Small-Cap				■		Reasonable valuation. Less vulnerable to trade policy and could benefit from tax-related capex spending, and a pick-up in mergers and acquisitions
	Global Ex-U.S. Large-Cap				■		Valuations are attractive relative to small-cap, with earnings upside due to depressed margins. Cautious on trade policy risks and fading global growth
	Global Ex-U.S. Small-Cap		■				Valuations have become more challenging and may be susceptible to fading liquidity, while domestic growth trends are moderating
	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
BONDS	U.S. Investment Grade				■		Yields more attractive since start of the year, with risk moderated due to limited upside potential from growth and inflation
	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, near term default expectations remain low
	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 a less liquid sector
	EM Dollar Sovereigns		■				Yields are attractive, but offset by tightening monetary policy (both in developed and emerging markets), U.S. dollar strength, and rising country-specific risks
	EM Local Currency				■		Yields are attractive versus investment grade with potential upside from select currencies. However, volatility is likely to be elevated

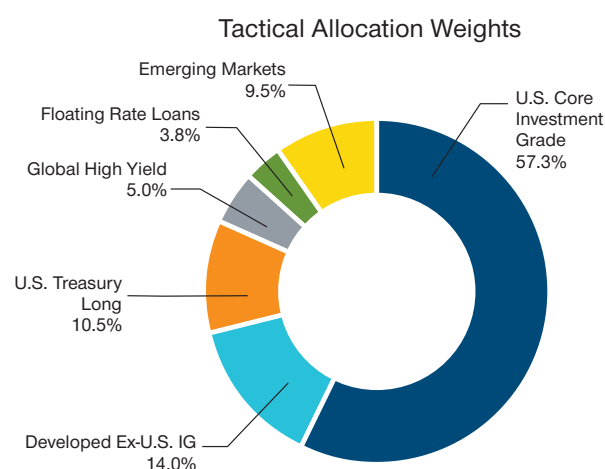
5 Portfolio Implementation

As of July 31, 2018

Equity	Neutral Weight	Tactical Weight	Relative Weight
■ U.S. Large Cap	51.0%	49.2%	-1.8%
■ U.S. Small Cap ¹	15.0%	17.1%	+2.1%
■ Dev. Ex-U.S. Large-Cap	21.0%	23.4%	+2.4%
■ Dev. Ex-U.S. Small-Cap	4.0%	4.2%	+0.2%
■ 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%	57.3%	+2.3%
■ Developed Ex-U.S. IG (Hedged)	15.0%	14.0%	-1.0%
■ U.S. Treasury Long	10.0%	10.5%	+0.5%
■ Global High Yield	8.0%	5.0%	-3.0%
■ Floating Rate Loans	2.0%	3.8%	+1.8%
■ Emerging Markets - (Local/Hard Currency)	10.0%	9.5%	-0.5%
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.

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