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ASSET ALLOCATION INSIGHTS

November 2018

The T. Rowe Price Asset Allocation Committee meets regularly to assess market conditions and the relative values of major asset classes over a 6- to 18-month time horizon. This series of Asset Allocation Insights offers a look at specific topics of interest from the committee's recent discussions.

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Supportive Fundamentals, Attractive Valuations in EMs

KEY POINTS

- The recent broad sell-off in emerging markets (EM) assets has created some relative value opportunities in those markets, so we recently raised our allocations to both EM bonds and EM equities in T. Rowe Price's multi-asset portfolios.
- The current sound fundamentals in many EMs serve as a buffer against contagion that could drag the entire asset class meaningfully lower, and to date there have been few signs that markets expect the fiscal difficulties of a few EMs to put pressure on other asset classes.
- Potential catalysts that could trigger EM outperformance include a stabilization or inflection in EM currencies or a moderation or stabilization in the growth differential between the U.S. and the rest of the world.

We recently raised our allocations to both emerging markets (EM) bonds and EM equities in T. Rowe Price's multi-asset portfolios. The recent broad sell-off in EM assets has created some relative value opportunities in those markets. Looking across asset classes, dollar-denominated EM sovereign debt currently offers a particularly compelling risk/reward trade-off benefiting from attractive yields. Credit spreads for EM bonds are wide relative to historical averages and to other fixed income sectors with similar risk profiles, such as high yield bonds.[1] We also see opportunities in EM stocks, although our shift into the asset class was more moderate, reflecting the higher volatility of EM equities and their more direct exposure to weakness in EM currencies.

EM ASSETS LAGGING IN 2018

Through September 30, the MSCI Emerging Markets Index was down 7.4% for the year to date in U.S. dollar terms and lagged the S&P 500 Index by over 17 percentage points over the period. The J.P. Morgan Emerging Markets Bond Index Global, which measures the performance of dollar-denominated EM debt, returned -3.5% for 2018 through September, while the J.P. Morgan GBI-EM Global Diversified showed that local currency EM bonds lost 8.2%, dragged down by local EM currency weakness relative to a stronger U.S. dollar. The Turkish lira and the Argentine peso dropped most dramatically against the U.S. dollar, declining nearly 37% and almost 54%, respectively, for the year through September.

[1] Credit spreads measure the additional yield over a Treasury security with a similar maturity that investors demand to hold a bond with credit risk.

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INCREASED IDIOSYNCRATIC RISKS BUT LIMITED SIGNS OF CONTAGION

So far, the EM debt sell-off has largely focused on countries such as Argentina and Turkey that have notably weak fiscal and current account positions in addition to unorthodox monetary policies. Compared with the "taper tantrum" episode five years ago, when EMs fell sharply as the Federal Reserve began discussing how it would eventually normalize monetary policy, current accounts in many EM countries are now more balanced and foreign currency reserves are higher. Also, a more limited proportion of total EM debt is now denominated in U.S. dollars, making issuers less susceptible to challenges servicing the debt in periods of dollar strength. While a persistently stronger U.S. dollar and rising U.S. interest rates could prove problematic for a broad range of EMs, the current sound fundamentals in many EMs serve as a buffer against contagion that could drag the entire asset class meaningfully lower.

To date there have been few signs that markets expect the fiscal difficulties of a few EMs to put pressure on other asset classes. For example, credit spreads on high yield bonds typically widen when investors fear that sentiment toward risk assets is deteriorating; however, as of mid-October, high yield credit spreads were still narrower than they were at the start of the year. Additionally, EMs broadly have evolved over the past decade to be less dependent on exporting commodities and manufactured goods and increasingly focused on technology and other industries that cater to a growing domestic middle class. This shift makes it less likely that idiosyncratic problems in individual EM economies will impair the broad asset class or pose a threat to risk assets in general.

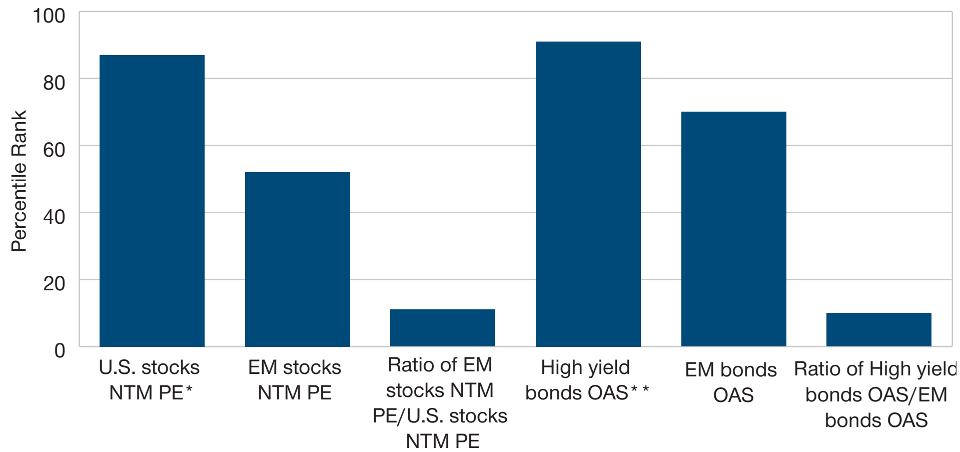
CHINESE STIMULUS MEASURES

Although trade tensions between the U.S. and China and the potential for slower Chinese growth both pose risks for EMs, it appears that the Chinese government is intent on implementing stimulus measures to prevent an abrupt economic slowdown. "While a trade war could derail China's economic expansion—and global growth as a result—China has started to institute a number of stimulus measures in response to U.S. tariffs," explains Charles Shriver, multi-asset portfolio manager and cochair of the Asset Allocation Committee. "These steps include lowering the reserve requirement ratio for Chinese banks, changing the tax code, and placing less emphasis on deleveraging and regulation. Allowing for a weaker yuan should also help export-oriented industries impacted by tariffs," Shriver adds.

FIGURE 1: **Emerging Markets Stand Out Amid Broadly Elevated Valuations**

Valuations across asset classes as percentile of 15-year history

As of September 30, 2018



*NTM PE: price/earnings ratio based on next 12 months' earnings

**OAS: option-adjusted spread

Indexes used to represent market segments: U.S. stocks–S&P 500 Index, EM stocks–MSCI Emerging Markets Index, high yield bonds–Bloomberg Barclays U.S. Aggregate Credit-Corporate-High Yield, EM bonds–Bloomberg Barclays Emerging Markets USD Aggregate

Sources: T. Rowe Price analysis using data from FactSet Research Systems, Inc.

VALUATION-BASED OPPORTUNITIES IN EMS

While it is difficult to call a near-term bottom, the recent sell-off in EM stocks and bonds has created some valuation-based opportunities (Figure 1). Within the broad EM universe, U.S. dollar-denominated EM bonds appear to present the best opportunities, and T. Rowe Price's multi-asset portfolios added to the asset class amid supportive technical conditions. "The market's tone has recently shifted from universally bearish on EMs to a more constructive sentiment, which has supported renewed flows into the asset class," says Michael Conelius, EM debt portfolio manager. "EM bond valuations are attractive on a historical basis, with relative value concentrated in a few key markets."

EM bonds currently offer attractive returns from yield as well as potential contributions from price appreciation. Relative to equities, the expectation of receiving par value at maturity helps support valuations and reinforces the importance of fundamental credit research as prices also discount the potential for issuer defaults. In addition, we carefully monitor liquidity in EM debt markets, which can be limited at times.

We believe that EM equities represent an additional opportunity at attractive valuations, particularly relative to U.S. equities. As of the end of September, U.S. equities were in the upper ranges of valuations relative to the last 15 years, while EM equities appeared more reasonably valued relative to both their own long-term averages and, more notably, their historical relationship to U.S. equities. "Earnings and profitability metrics also are supportive, as EM equities have the potential for earnings growth in the low teens and have an attractive return on equity profile," explains Gonzalo Pángaro, EM equity portfolio manager. However, EM equities are more volatile than EM debt and more directly impacted by falling EM currencies, which led us to add cautiously to the asset class in our multi-asset portfolios.

POTENTIAL SIGNS OF AN INFLECTION

There is a positive historical correlation between EM currencies and the relative performance of EM equities. As an illustration, the MSCI EM Index returned -2.6% in 2018 through the first three quarters of 2018 in local currency terms, but the return in U.S. dollars was nearly five percentage points lower, reflecting the impact of currency depreciation. Thus, a stabilization or inflection in EM currencies would represent a positive tailwind.

Other potential catalysts that could trigger EM outperformance include a moderation or stabilization in the growth differential between the U.S. and the rest of the world. In our view, a continued constructive economic and earnings environment would also support EM outperformance relative to developed markets going forward. Recent progress in trade negotiations with Mexico regarding the United States-Mexico-Canada Agreement represents a positive evolution in the backdrop for emerging markets, and we believe that any moderation in trade tensions with China would be similarly supportive for sentiment.

Key Risks—The following risks are materially relevant to the information highlighted in this material:

Equity risk—in general, equities involve higher risks than bonds or money market instruments.

Credit risk—a bond or money market security could lose value if the issuer's financial health deteriorates.

Currency risk—changes in currency exchange rates could reduce investment gains or increase investment losses.

Default risk—the issuers of certain bonds could become unable to make payments on their bonds.

Emerging markets risk—emerging markets are less established than developed markets and therefore involve higher risks.

Foreign investing risk—Investing in foreign countries other than the country of domicile can be riskier due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments.

Interest rate risk—when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.

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