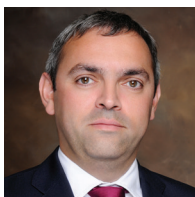




PRICE POINT

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Timely intelligence and
analysis for our clients.



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ARE YOU WORRIED ABOUT AN EQUITY MARKET SELL-OFF?

How much longer can the equity bull market last? It's a question nobody can answer for certain, but many investors are de-risking in anticipation of a market correction. Central banks are beginning to unwind the stimulus measures that have supported the market for the past decade, while increasingly strained trading relationships could threaten the global economy. Concerns over the vulnerability of stock markets are growing, putting increased focus on portfolio construction and diversification.

At T. Rowe Price, our T. Rowe Price Dynamic Global Bond (DGB) Fund seeks to provide diversification from equities to achieve optimal sustainable income while minimising downside risk. The fixed income landscape is vast and includes assets with different degrees of risk and varying levels of correlation to equities – we believe that it is important to invest across countries, sectors and securities to generate potential stable returns at different stages in the interest rate cycle, to minimise potential downside losses and to offer a different path of returns during equity market downturns.

A Strong Approach

Our track record in achieving this is strong, in recent years, the DGB Fund has consistently outperformed the S&P/ASX 200 Index during periods of negative equity returns. During the U.S. equity flow reversal witnessed at the end of January this year, the S&P/ASX 200 Index fell 4.18%, while the DGB Fund gained 0.99%. Prior to that, around the time of the UK's vote to leave the EU, the S&P/ASX 200 Index fell by 5.6% between 8-27 June 2016 while the DGB Fund gained 1.14% over the same period (see Figure 1).

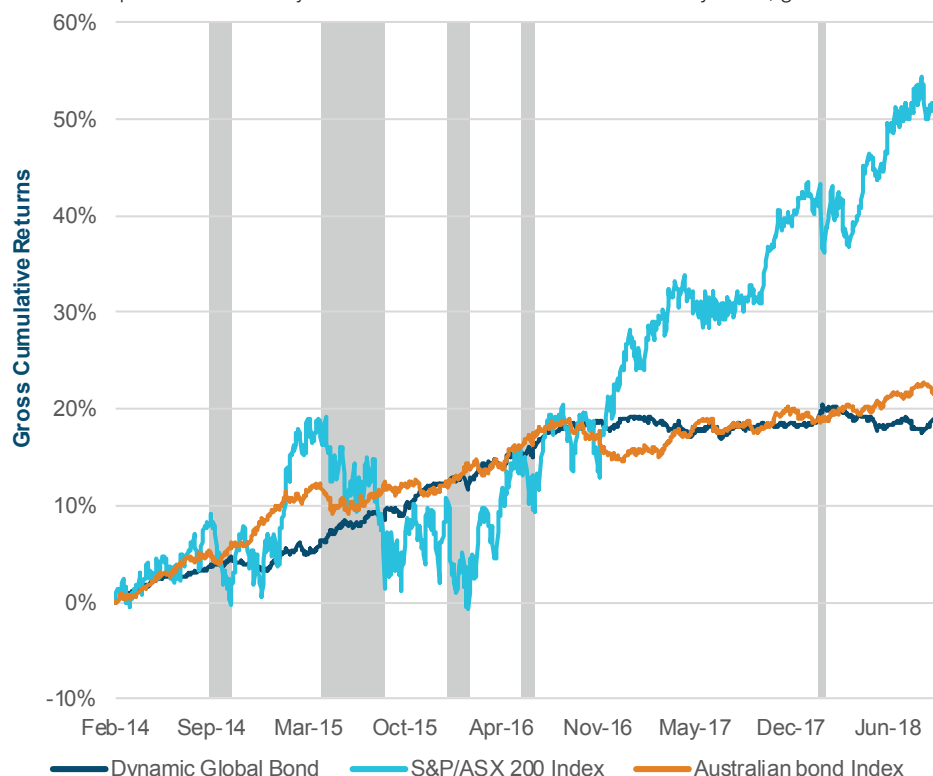
The DGB Fund also outperformed the S&P 500 Index during the three prior equity market drawdowns. We achieved this not only by allocating to high-quality fixed income assets with low correlation to equity markets, but also by implementing specific defensive strategies involving currency and credit markets to better mitigate the risk at times of stress.

So What Does This Mean?

One of the consequences of being diversified from equities is that it can be more difficult to outperform when equity markets are rising. This has been the case for most of the period since the Global Financial Crisis – excepting the relatively short-lived equity drawdowns shown in Figure 1, there has been a continuous equity bull market since March 2009.

FIGURE 1: The Benefits of Diversification

Cumulative performance of Dynamic Global Bond Fund since February 2014, gross of fees.



Past performance is not a reliable indicator of future performance.

Source: T. Rowe Price, Standard & Poor's and FactSet.

Getting back to the question of how much longer the equity bull market will run, there are signals to suggest it may be coming to an end. The U.S. Federal Reserve has hiked its benchmark lending rate twice since January and is expected to raise it twice more before the end of the year, which will likely be followed by tightening measures from other central banks. Rising interest rates increase borrowing costs for business and consumers, as well as encouraging investors to shift money from stocks to bonds. Rate hikes can also trigger recessions, which often kill off bull markets – as they have done for three of the past five U.S. recessions, which were triggered by Fed rate rises.

At the same time, concerns are continuing to rise about the prospect of an extended trade war between the U.S. and its trading partners, particularly China. If U.S. President Donald Trump presses ahead with aggressive tariffs on imports to the U.S., and if these

are followed by retaliatory measures from other countries, the impact on the global economy could be severe: the International Monetary Fund has warned that a trade war could cost the global economy \$430 billion by 2020 – potentially triggering major stock market declines.

The likely timing of a drawdown is difficult to predict. This year there have been potential warning signals in the form of short-lived spikes in volatility, but so far this has not led to persistent equity market declines – indeed, the S&P 500 Index reached a new record high as recently as August. There are signs that certain parts of the market are becoming more volatile, particularly emerging markets, but as yet there has been no systemic risk aversion or contagion. This has meant that many of our defensive positions in the DGB Fund have not paid off – in periods of equity market strength, defensive assets effectively become insurance premiums. However,

we strongly believe that our positioning is correct given the risks we believe are present in the market.

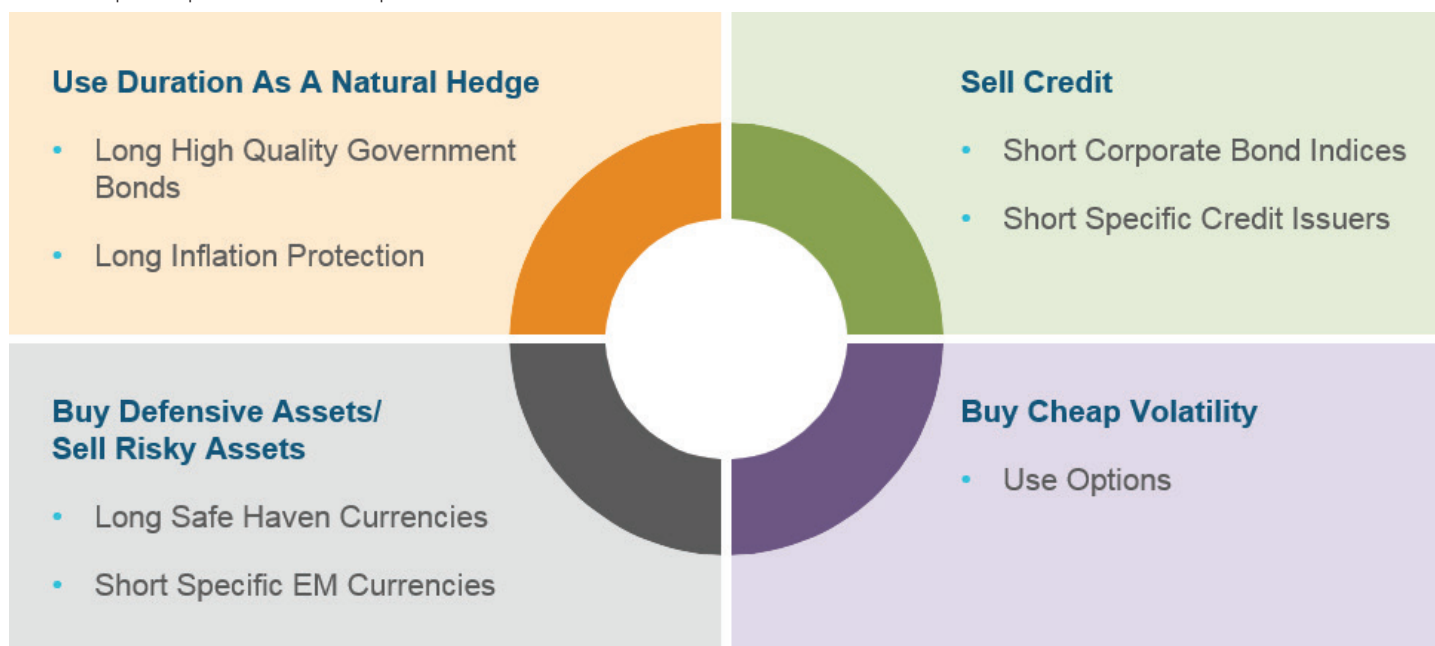
Four Ways We Diversify Against Equities

To explain this a little better, let's look at the four main ways that we seek to provide diversification away from equities (see Figure 2). These are: 1) Use duration as a natural hedge; 2) Buy defensive assets and sell risky assets such as EM currencies 3) Sell credit markets; and 4) Buy volatility.

In ordinary circumstances, we would use duration as a hedge by investing in U.S. Treasuries or other high-quality developed market sovereign bonds. However, we have not done this on this occasion as we believe the likelihood of central bank interest rate hikes means that developed market bonds are vulnerable to sharp falls in value.

FIGURE 2: How We Diversify Against Equities

Four examples of potential defensive positions



In currencies, we have adopted short positions on some Asian currencies as we believe the main risk to equity markets was a deterioration in trade negotiations between China and the U.S., which would negatively impact open Asian economies that are dependent on Chinese growth. These decisions have worked to some extent, but have been largely offset by long positions we took on emerging market sovereign debt and currencies of countries such as Brazil and Russia after the first sell-off in May, which have not performed as well as expected in the short term.

We have also allocated to specific 'safe haven' currencies such as the Japanese yen, which has recently shown little capacity to appreciate as fears over a possible trade war have negatively affected the perception towards Japan. The openness of Japan's economy – and therefore its susceptibility to negative sentiment – has effectively prevented the yen from appreciating and to fully play its traditional hideout role.

One of other strategies we have implemented is a short credit posture, at a time when credit markets have remained robust. Ordinarily, we would expect an emerging market sell-off to

have a contagion effect on corporate bonds, for two main reasons: first, because many corporates have exposure to emerging markets; and second, because when corporate bond valuations are stretched (as they are now), this is an area where many investors would be likely to de-risk. Neither of these things has happened yet, although we continue to affirm our negative view on credit markets in general and remained positioned accordingly.

We also routinely buy volatility primarily through option strategies with the aim of minimizing the impact of tail risk events, such as equity markets falling by more than 10%, major declines in G3 currencies or a significant correction in credit markets. By definition these are low probability scenarios, but they are not zero probability and we therefore need to diversify against them. None of these tail risk events has yet occurred during the current cycle, but we continue to hedge against them through various option strategies.

Our Continuing Commitment

As stated above, our investment approach has served us well during past

equity drawdowns and we believe that it will continue to do so. We are committed to genuine diversification, which means avoiding strong exposure to areas that are highly correlated with equities, such as credit markets. What has been more unusual about our approach in the current environment is that we are not long duration – ordinarily, we would expect to have allocated more to 'safe haven' assets such as U.S. Treasuries and German bonds but have chosen not to do so at present because of the risk of interest rate rises and a potential breakdown in correlations.

It is important to emphasize that we are not positioned defensively just because we have a negative view on markets at present – we are positioned in this way because that is the role we seek to play in investor portfolios. The DGB Fund seeks to generate sustainable income and to minimise capital losses for our clients, and we seek to achieve these objectives through genuine diversification, dynamic active management through flexibility and a 'go-anywhere' approach, together with rigorous risk management. We will maintain this approach in the period ahead and beyond.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

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