



What's Behind the December Sell-Off and What's Next?

December Rout May Give Investors a New Entry Point

December 2018

KEY INSIGHTS

- The December market sell-off has provided long-term investors attractive opportunities in high-quality companies with solid fundamentals.
- T. Rowe Price managers are buying into the sell-off, particularly in some of the more severely depressed cyclical sectors.
- Investors should expect continued volatility with moderate growth in corporate earnings, but economic underpinnings should remain supportive in 2019.

A confluence of disruptive market forces, many of which have been looming on the horizon for some time, have led to the recent sharp and widespread retrenchment in global markets. Now, heightened volatility is here to stay, but the economic

underpinnings should remain favorable as some of those headwinds dissipate, according to T. Rowe Price's chief investment officers.

"We were set up for a good correction, and investors were looking for a reason as

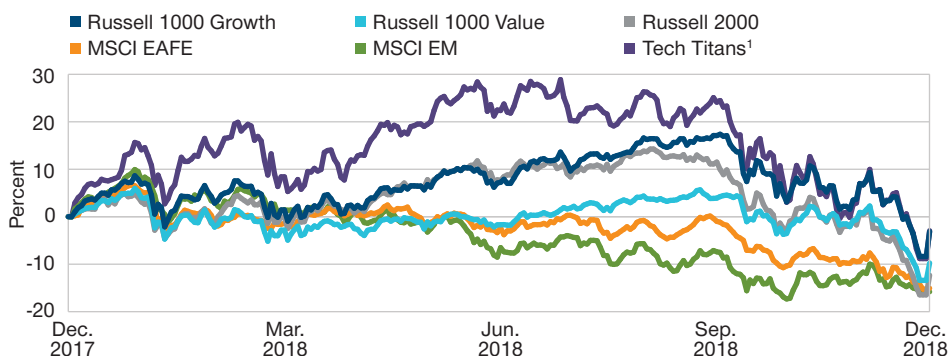
Markets abhor uncertainty, and uncertainty seems to be all around us.

— John Linehan
CIO, U.S. Equity Value

(Fig. 1) Q4 Equity Sell-Off Was Broad, Deep

2018 Equity Market Performance

As of December 26, 2018



Past performance is not a reliable indicator of future performance.

¹ Equal-weighted basket of Facebook, Amazon, Apple, Netflix, Google, Microsoft, Baidu, Alibaba, and Tencent. Sources: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

40%–50%

Decline in some of the “growth cyclicals” sectors, such as industrials, consumer discretionary, housing-related businesses, and materials.

markets made new highs in Q3,” explains T. Rowe Price Group Chief Investment Officer Rob Sharps. “We got several reasons in Q4 in rapid succession.”

Concerns about slowing global growth, tightening monetary policies, valuations, and geopolitical uncertainty, among other factors, have made markets vulnerable. Several specific events brought those concerns to light in December. “Markets abhor uncertainty, and uncertainty seems to be all around us,” explains John Linehan, CIO, U.S. equity value.

Yet, for those with longer time horizons, which include T. Rowe Price portfolio managers, the sell-off has provided attractive opportunities, especially in high-quality companies with solid fundamentals at more attractive valuation levels. Indeed, T. Rowe Price managers are taking on more risk to take advantage of such opportunities, particularly in some of the more severely depressed cyclical sectors of the markets.

David Giroux, the firm’s head of investment strategy and CIO, U.S. equity multi-discipline, notes that he has been underweight equities for several years but moved to an overweight position on Christmas Eve. Moreover, he believes any further market weakness could provide more opportunity to take on risk.

“While the flattening yield curve, the upcoming presidential election, and trade wars all continue to be concerns, the risks may be overstated,” Giroux says.

Henry Ellenbogen, CIO, U.S. equity growth, has been taking advantage of the market decline to add to his portfolio what he sees as leaders of the next upcycle. He notes that some of the “growth cyclicals” in such sectors as industrials, consumer discretionary, housing-related businesses, and materials had declined as much as 40% to 50%.

T. Rowe Price’s Asset Allocation Committee, composed of senior investment professionals, has reduced its underweight position to equities with the expectation of returning to neutral if the market weakens further.

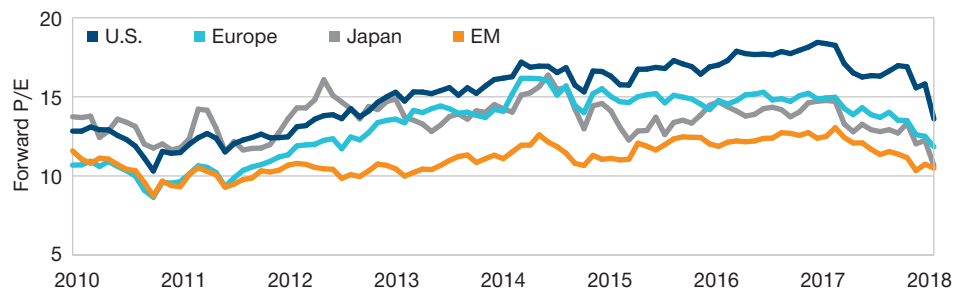
Mark Vaselkiv, CIO, fixed income, is a little more dubious as yield spreads for U.S. and European high yield bonds, as well as investment-grade bonds, relative to government debt widened significantly in the fourth quarter.

“Absolute spreads across the board are not forecasting a recession yet, but the dramatic spread widening is worrisome, especially in U.S. high yield. The drop in the oil price is the biggest problem,” he says.

(Fig. 2) Valuations Appear More Reasonable

12-month forward price/earnings ratios

As of December 25, 2018



Sources: FactSet Research Systems Inc., MSCI, and T. Rowe Price.

U.S. = MSCI USA Index, Europe = MSCI Developed Europe Index, Emerging Markets (EM) = MSCI Emerging Markets Index, Japan = MSCI Japan Index.

“The bottom line is that complacency has been shaken out of risk markets.

— Rob Sharps

T. Rowe Price Group CIO

With the Christmas Eve rout, the S&P 500 Index virtually suffered its first bear market (declining 19.8% from its September 20 high) since its recovery from the global financial crisis that began in March 2009. Declines from recent peaks for the Russell 2000 index of small-cap stocks, the Nasdaq composite index, and emerging markets index exceeded the 20% bear market threshold. Developed markets outside the U.S., on average, fell 17%.

Although markets rebounded strongly after Christmas, the underlying concerns troubling investors remain. Some of the key concerns cited by T. Rowe Price's CIOs include:

- Sluggish economic growth outside the U.S., particularly in Europe, Japan, emerging markets, and China.
 - Concern that the U.S. economy, which has led global growth since the financial crisis, might slow more than expected.
 - A likely deceleration in U.S. corporate earnings growth, which expanded at a blistering 25% pace over the first three quarters of 2018.
 - Fear that the Federal Reserve, which raised the federal funds rate four times in 2018, could tighten too much and too fast.
 - Still expensive market valuations, especially among secular growth stocks.
 - Concern that the U.S. trade war with China could get worse before it gets better. “No one seems to know for sure what the end game is in terms of our trade rhetoric with China,” says Linehan. “That uncertainty has crept into the business world.”
 - Inflationary pressures in the U.S. are building amid a tightening labor market.
 - A regulatory backlash against leading U.S. technology platform companies.
- A sharp widening of yield spreads in some global bond markets, particularly in the U.S. high yield market, relative to government debt.
 - Plummeting oil prices.
 - The growth of exchange-traded funds and computer-driven automated investing, along with less capital from banks and traders to support markets, exacerbating market gyrations.
 - Geopolitical tensions, including recent high-level resignations in the Trump administration, a partial U.S. government shutdown, Britain's unresolved exit from the European Union (EU), and Italy's fiscal stimulus plan that conflicts with EU deficit limits.

Meanwhile, the global corporate landscape continues to be transformed by a combination of technological innovation and changing consumer preferences, which is disrupting many industries and upending established business models.

“The bottom line is that complacency has been shaken out of risk markets,” says Sharps. “The question now is whether this is a sentiment-driven correction creating an opportunity for investors, or are the markets telling us we are headed toward recession, which could lead to new lows.”

Where Do We Go From Here?

Sharps and other CIOs remain sanguine on the prospects for recovery, citing more appealing valuations, slower but still healthy corporate earnings growth, continued strength in the U.S. economy, a fading headwind from U.S. monetary policy, and possibly reduced tensions on trade and other geopolitical concerns.

While overall global growth is expected to slow in 2019, T. Rowe Price managers do not anticipate a recession in the U.S. and expect some rebound in European and Chinese growth. Most of the Fed tightening “is behind us and should become less of a challenge

“What’s crucial is the extent to which China restimulates.”

— Justin Thompson
CIO, International Equity

as we work through 2019,” Sharps says. “The U.S. auto sector is late in the cycle and housing has slowed, but I don’t see the sort of distortions that are typically apparent at the end of a market cycle. It is hard to have a bust when you haven’t had a boom. Usually you see misallocation of capital and euphoria in certain sectors, such as telecom infrastructure in 1999 and housing in the mid-2000s. I don’t see that now.”

In Europe, fiscal policy should be slightly stimulative in 2019, and the European Central Bank has not even started to raise interest rates. The Italian government seems to have reached a truce with the EU. Europe is an oil importer, so the significant decline in oil prices should be supportive, and auto production in Germany, which accounts for 20% of German exports, should improve.

“What’s crucial is the extent to which China restimulates,” adds Justin Thomson, CIO international equity. “China does have scope for selective tax cuts or for reducing bank reserve requirements. It’s probable that China announces further stimulus measures post-Chinese New Year in February, 2019.”

On Balance, A Positive Outlook

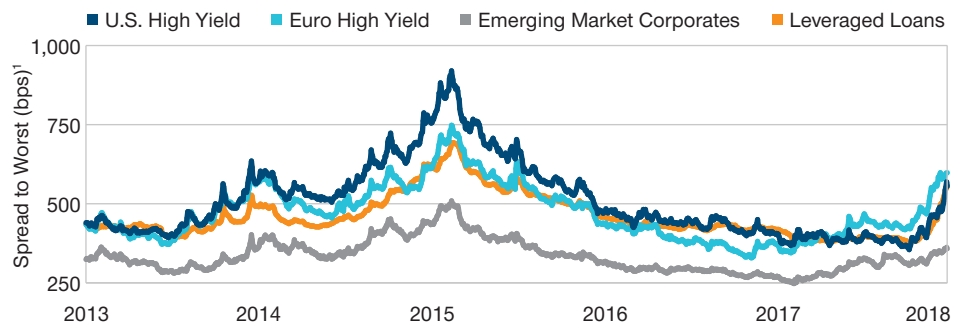
While many of the risks that unsettled global markets remain, T. Rowe Price managers are cautiously optimistic that investors will adapt to a less buoyant but still supportive market environment.

While conditions could improve, with all the uncertainty overhanging markets, Linehan cautions, “my sense is we are in for a choppy ride until we have more visibility on how the trade situation with China is resolved. I do see value in cyclicals as many of these stocks entered bear market territory a while ago. What would get me to add more risk will be attractive valuations and the belief that we are discounting a moderate recession. In that environment, I think risk/reward trade-off would be compelling.”

Ellenbogen remains “largely positive” on the outlook for 2019. “I think President Trump makes a deal with China, which will steady global growth; the Fed begins to pause; the U.S. economy decelerates in the first half but stabilizes and gets better in the second half; inflationary pressures from oil, steel, and interest rates have already peaked; and the market valuation at 15x to 16x earnings is reasonable in an environment of 2%

(Fig. 3) Spreads Across the High Yield Markets Still Shy of Long-Term Average

As of December 26, 2018



Past performance cannot guarantee future results.

¹ Leveraged loan shows spread—forward to 3-year takeout.

Source: J.P. Morgan.

Based off the J.P. Morgan Domestic High Yield Index, J.P. Morgan European Currency High Yield Index, J.P. Morgan CEMBI Broad Diversified Index, and J.P. Morgan Leveraged Loan Index.

“...I don’t see the sort of distortions that are typically apparent at the end of a market cycle. It is hard to have a bust when you haven’t had a boom.

— Rob Sharps
T. Rowe Price Group Chief
Investment Officer

to 2.5% economic growth and interest rates below 3%.”

Sharps thinks returns can improve from here given that a lot of stocks are very attractive on valuation and fundamentals. “While the expected slowdown in corporate earnings probably began in the fourth quarter and will continue into 2019, it will be important for investors to see stable to improving earnings growth as they look ahead to 2020,” he says. “I expect that to happen if we don’t have a recession, and I don’t anticipate one.

“Trade is the big wild card,” he adds. “The unresolved trade issues are causing uncertainty, which can delay decision-making regarding hiring and capital expenditures. The tension between the U.S. and China is also not healthy for the market.”

In the credit markets, Vaselkiv says the overall yield for the junk bond market in the U.S. is 8.3%, which should

provide some cushioning for further rate increases. “If the U.S. stays out of recession next year, high yield should post a good recovery,” he says. “Even if it gets worse, a lot of bad news is already priced in. Emerging market corporate bonds also have good prospects going into 2019.”

Sharps adds, “From here, I think returns can be healthier. I think this is a good entry point for investors with a multi-year time horizon.”

During such periods of market turbulence, T. Rowe Price financial planners encourage investors to review their asset allocation and try to maintain a long-term perspective. They advise that as long as investors’ asset mix of stocks, bonds, and cash appropriately reflects their financial goals, time horizon, risk tolerance, and personal circumstances, sticking with their investment plan should prove rewarding over longer periods.

WHAT WE’RE WATCHING NEXT

Six areas of potential disruption merit watching. **(1)** How much will global growth slow? **(2)** Valuations are lower, but are multiples attractive amid market uncertainty? **(3)** Our work suggests that about 31% of S&P 500 market capitalization is being impacted by some level of secular challenge, so who will be the winners and losers? **(4)** How much more will global credit cycles desynchronize? **(5)** As the U.S. economy moves into the later stages of its cycle, which fixed income sectors will offer attractive relative value opportunities? **(6)** Will the political risks that have the potential to disrupt global markets be resolved?

INVEST WITH CONFIDENCE®

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

To learn more, please visit troweprice.com.

T.RowePrice®

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc. © 2018 T. Rowe Price. All rights reserved.