



How Large-Cap Stock Investors Can Adapt to a Slowing Economy

While caution is warranted, cyclical opportunities exist.

February 2020

KEY INSIGHTS

- U.S. economic growth is slowing, but a recession is not likely in the near term.
- The presidential election and potential impact of the coronavirus will likely lead to more market volatility, creating opportunities as well as risks.
- Growth investing has significantly outperformed value investing over the past decade, but both strategies face different challenges in the current environment.

Q. How is the U.S. economic slowdown affecting large-cap stocks?

Joe Fath: I think the U.S. economy is showing steady, though slow, growth. After the Federal Reserve easing and the phase one trade deal with China, several companies—particularly some industrials and other cyclically sensitive sectors—are stabilizing and even seeing some pickup. Companies generally feel better now than they did six months ago when the trade war with China caused a lot of indecision.

I don't think the slowdown has yet affected companies significantly in terms of their profit and loss statements. This is particularly true for the disruptive secular growers.

Mark Finn: About half of the U.S. Russell Value Index is composed of companies with some level of cyclicality, including financials, energy, industrials, and materials. So an economic slowdown poses challenges for stock selection in those sectors in particular. However, the Fed has become more accommodative,

and China is boosting stimulus. This has increased the chances of leading economic indicators bottoming and, perhaps, a reacceleration of growth. As a result, investors need to reevaluate how much cyclical exposure they are willing to have. In the U.S., employment and consumer spending have held up well. Outside the U.S., developed market economies are notably more sluggish.

Q. What will be the impact of the coronavirus on markets and China's economy?

Mark Finn: Uncertainty regarding the impact of the coronavirus on a relative basis tends to favor large-cap stocks because no matter what the industry, the larger the company, the more likely it will hold up better. I expect China to attack any damage the virus does to its economy with monetary and fiscal stimulus. So the virus might impact China's economy for a quarter or two and cause some temporary weakness in the global economy, but this is obviously a



Joe Fath

Portfolio Manager, US Growth Stock Strategy



Mark Finn

Portfolio Manager, US Value Equity Strategy

“...after several years of benefiting from a more defensive posture, we are more constructive on the U.S. economic cycle.

— Mark Finn
 Portfolio Manager, US Value Equity Strategy

Global Growth Slowing

(Fig. 1) But no recession is expected near term



January 2015 to January 2020.

Sources: J.P. Morgan/IHS Markit/Haver Analytics (See Additional Disclosures) and Conference Board. Copyright ©2020, Markit Economics Limited. All rights reserved and all intellectual property rights retained by Markit Economics Limited. Purchasing managers indexes (PMI) are diffusion indexes with a range of 0 to 100. For individual countries the manufacturing PMI is the weighted averages of new orders, production, employment, vendor deliveries and inventory indexes, each indicating the net percent of respondents reporting increased activity relative to the previous month. The global PMI is a GDP-weighted average of 44 country PMIs. The CEO outlook index is the average of indexes of expected sales, capital spending and employment.

very fluid situation, and the impact could be more significant than we anticipate. We are carefully analyzing how it is affecting certain companies and industries.

Joe Fath: The initial reaction by the market was that the coronavirus is transitory and that investors will look past any weakness for a quarter or two. It will definitely have an impact on the Chinese economy, but China is adding stimulus and has been more flexible on tariffs with the U.S. due to its slowdown. But with the virus spreading to other countries, particularly South Korea, there is a greater chance that it impacts economies outside of China more than initially expected.

Luxury goods companies and industrials with exposure to China, particularly life sciences and medical device companies, are seeing a negative impact. Also, the gaming companies operating in Macau and a wide range of consumer companies are certainly affected. I think the world will focus on getting this virus under control so it doesn't trip up the global economy.

Q. What is your overall investment strategy in this environment?

Mark Finn: We continue to favor fundamentally sound companies with durable earnings profiles and high-quality balance sheets that could outperform amid more market turbulence. But after several years of benefiting from a more defensive posture, we are more constructive on the U.S. economic cycle. So technology is our largest overweight sector, particularly semiconductors and the semiconductor equipment manufacturers, which we believe should benefit from the continued proliferation of internet-connected devices and the development of 5G and other new markets. The use of semiconductors in just about everything should continue to grow. Also, a lot of the tech companies were disadvantaged by the China trade dispute, providing more attractive opportunities.

The health care sector is facing potential political headwinds, such as possible limits on drug pricing and single-payer health care initiatives. However, the sector should benefit longer term from secular tailwinds, including an aging population,

“We expect continued economic growth and low but stable inflation to support U.S. equity markets.”

— Joe Fath
Portfolio Manager, US Growth
Stock Strategy

new technology applications, and improved treatment options.

Joe Fath: Overall, my strategy looks like an upside-down pyramid. The top sleeve is composed of secular growth names such as Google (Alphabet), Amazon, Facebook, and Microsoft that represent 50% to 60% of the portfolio. The cyclical middle sleeve represents 15% to 25% in companies with double-digit earnings growth potential. The bottom part of the pyramid, with a range of 15% to 25%, consists of special situations, particularly companies exposed to industry structural change or companies pivoting from value to growth, which is where I have found opportunities lately.

The political controversy over drug pricing and proposals for a single-payer health care system create more volatility in the managed care and pharmaceutical sectors, but we are not avoiding them because valuations are attractive. We reduced our exposure to managed care last year, but we have a constructive view of the health care sector over a three- to five-year horizon.

One of the things we’re watching is whether the large platform companies can continue to innovate through more rigorous regulatory oversight, and we believe they will. They clearly have spent more time, money, and energy on privacy and security issues, but

the fundamentals of the business and valuations are really supportive.

Generally, we favor companies that have more control over their destiny, are positioned to benefit from powerful secular trends, and are using innovation to disrupt less efficient business models and create new ones. I believe that firms that are effective at leveraging innovation will be able to sustain robust growth in earnings and revenues as they exploit new markets and seize share in existing ones.

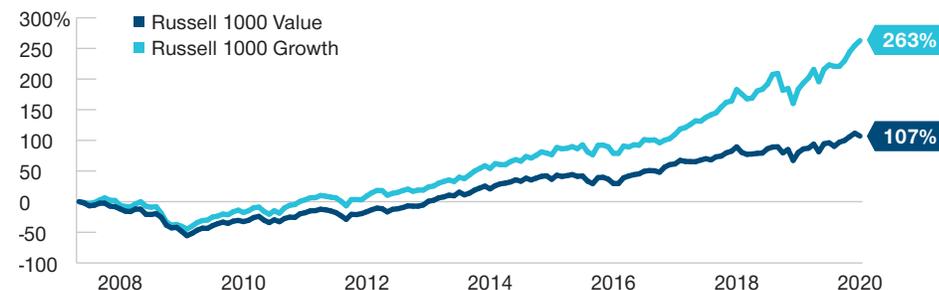
Q. What is your outlook for the U.S. economy and corporate earnings?

Joe Fath: We expect continued economic growth and low but stable inflation rates to support U.S. equity markets. The risks of a significant U.S. or global economic downturn still appear limited. However, a few risks could trigger more market volatility, including political uncertainties as we approach the election and potential valuation excesses amid modest earnings growth. Earnings should be moderately better than last year. However, any outside shock could be more pronounced given current valuations and how strong the market has been, so I would not be surprised to see a sharp correction at some point this year.

Another risk is that late in the economic cycle some companies have taken advantage of cheap capital to do deals, so they have taken on more debt and

Historic Outperformance for Growth Over Value

(Fig. 2) Both strategies face different challenges.



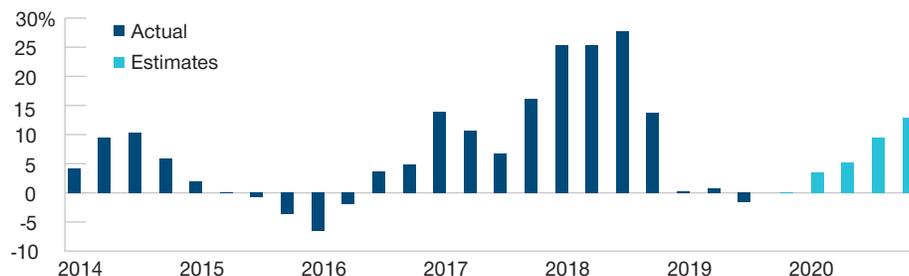
Past performance is not a reliable indicator of future performance.

Cumulative total return, May 31, 2007, to January 31, 2020.

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

Slowing Growth in Corporate Earnings

(Fig. 3) S&P 500 quarterly earnings



Year-over-year growth, December 31, 2013, to December 31, 2020.

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

2% to 2.5%

Expected growth rate of the U.S. economy this year

become more leveraged. At this stage of the cycle, I pay more attention to debt levels on the balance sheet.

In a slower growth, more uncertain environment, with a wide dispersion of returns possible in sectors and industries, selectivity is key. In-depth fundamental research will be particularly critical for identifying companies that are well positioned and have a very good management team that can execute well by navigating through choppy waters.

Mark Finn: The U.S. economy should be fine, with expected growth in the 2% to 2.5% range. Economic indicators appear to be bottoming, and the Fed's accommodative monetary policy and improving U.S.-China trade relations provide an improved operating environment for U.S. businesses. Earnings should show modest improvement, probably single-digit growth this year.

Energy may be pressured because oil has sold off and demand for industrials dropped during the China trade war, so there could be weakness in those sectors. The problem is that valuations are fairly high, so there won't be a lot of patience for dramatic earnings misses.

Low interest rates continue to support equities. The presidential election and the candidates' positioning will

become increasingly important, as will prospects for continued phase two trade negotiations with China. Both could spur market volatility, but investors should try to take advantage of it.

In our strategy, we are ever diligent about the risks that companies face and how disruption is impacting companies more generally. That is really important for value investors because half the battle in value investing is avoiding value traps.

As of December 31, 2019, the 10 largest holdings in the US Growth Stock representative portfolio were Amazon.com (6.5% of market value), Alphabet (6.3%), Microsoft (6.1%), Facebook (5.7%), Apple (4.6%), Visa (3.8%), MasterCard (3.4%), Alibaba Group Holding (3.0%), Boeing (2.7%), and Netflix (2.2%).

The representative portfolio is an account we believe most closely reflects current portfolio management style for the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from those of other accounts in the strategy. Information regarding the representative portfolio and the other accounts in the strategy is available upon request.



WHAT WE'RE WATCHING NEXT

Several factors could increase market volatility in the coming months, notably unresolved trade issues with China and policy debates on taxes, health care, and wealth disparity during the U.S. presidential election campaign, as well as the election outcome. Also, with equity valuations less forgiving than a year ago, further market advances will likely hinge on a resumption of earnings growth. T. Rowe Price analysts are also closely following how disruptive forces such as innovation, technological change, and automation could impact a growing number of global industries. As active managers, we always consider that volatility can be an investor's friend, and we believe that in-depth fundamental research that integrates environmental, social, and governance considerations will be critical to successfully assess opportunities and risks.

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the portfolio, and no assumptions should be made that the securities identified and discussed were or will be profitable.

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