



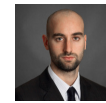
Staying Disciplined as Equities Confront a Wall of Worry

Lofty valuations in equity markets may not reflect potential risks.

October 2021

KEY INSIGHTS

- Central banks' aggressive monetary policies have contributed to elevated valuations that appear detached from business fundamentals.
- Profit margins near or above historical peaks, waning stimulus, and rising inflation create a challenging environment that may favor lower-beta strategies.
- We remain disciplined, seeking to take advantage of market dislocations to invest in quality companies at entry prices that we view as compelling.



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The historic market rally that took flight amid the coronavirus pandemic was also notable for another reason—the pursuit of short-term momentum appeared to crowd out the valuation discipline and focus on underlying business fundamentals that we believe are critical considerations for successful long-run investing.

A plausible case can be made that the conditions could be in place for further strength in equity markets. Many central banks' policies remain accommodative, while the combination of increased household savings, pent-up consumer demand, and the potential for a sharp rebound in corporations' capital expenditures could provide further fuel for economic growth.

While forecasting regime shifts in the market is, at best, inexact, we believe that the prevalence of elevated valuations, the prospect of waning monetary and fiscal stimulus, and the possible risks posed by inflationary

pressures could create a challenging environment for investors to navigate. In our view, such a climate would favor selectivity and, potentially, investment strategies that exhibit lower beta, or less correlation to movements in the broader market.

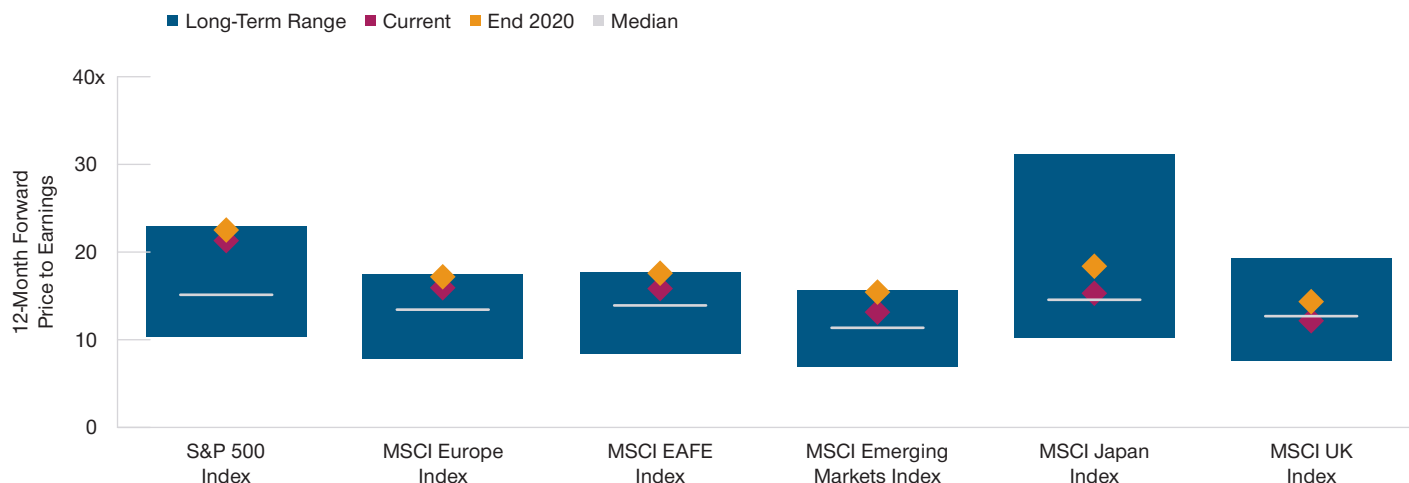
Demanding Valuations and Historically Elevated Margins

Aggressive central bank and government stimulus to address the coronavirus pandemic appear to have engendered significant market dislocations.

Accommodative monetary policies typically increase equities' relative appeal, as the downward pressure on the yields to maturity offered by fixed income securities tends to push investors toward riskier assets. Meanwhile, a low risk-free rate of return effectively boosts the present value of a company's future cash flows, which can encourage market participants to pay higher near-term valuation multiples

Valuations Appear Elevated in Many Markets

(Fig. 1) 12-month forward price to earnings versus history



June 30, 2003, to August 31, 2021.

Source: T. Rowe Price analysis using data and analytics provided by FactSet Research Systems, Inc. All rights reserved. See Additional Disclosures.

Actual results will vary.

for names that are expected, rightly or wrongly, to deliver high levels of growth farther into the future.

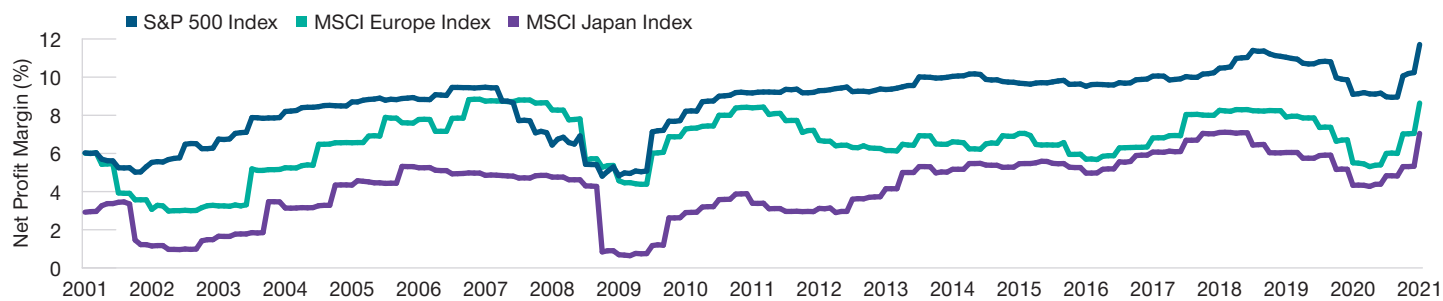
Price-to-earnings ratios in many markets have climbed to levels that are above the long-term median, with valuations in the U.S. appearing especially stretched on a historical basis. Compared with forward price-to-earnings ratios at the end of 2020, equity valuations in some international markets have moved lower, likely reflecting expectations for stronger earnings growth over the next 12 months as these economies reopen (Figure 1).

Meanwhile, the strength of the recent economic recovery, coupled with cost-saving measures enacted by corporations during the pandemic, has contributed to surging net margins that have approached or exceeded 20-year highs in some markets (Figure 2).

Sustaining such a high level of profitability and delivering sufficient earnings growth needed to drive strong equity market returns strike us as potentially challenging propositions. We do not believe that the market has priced in this risk and the difficulties that

Corporate Profitability Near or Above Historical Peaks

(Fig. 2) Net profit margins (trailing 12 months)



August 31, 2001, to August 31, 2021.

Source: T. Rowe Price analysis using data and analytics provided by FactSet Research Systems, Inc. All rights reserved. See Additional Disclosures.

“...conditions could be ripe for equity valuations to rerate lower if inflation were to remain at elevated levels.

an increasingly complicated macro environment may pose.

Potential Macro Headwinds

We believe that the economic expansion is likely to continue into 2022. However, at these valuation levels, the removal of the extraordinary stimulus deployed by governments and central banks last year could present a headwind for equities, especially names whose valuations appear most detached from business fundamentals after the risk-on rally. Any stumbles in the transition from government-supplied stimulus to organic economic growth—always a risk as the highly infectious delta variant contributes to spiking coronavirus case counts around the world—might also dent investor sentiment and the economic recovery.

In key economies, inflation has also surged well beyond the 1% to 2% level that we would consider healthy, potentially weighing on corporate profitability in sectors contending with rising input costs (Figure 3). Higher prices could also weigh on consumer sentiment and affect the pace of the economic recovery.

The recent wave of coronavirus infections and the lower vaccination rates in some countries could exacerbate supply chain constraints that have contributed to inflation.

A prime example is the shortfall in semiconductor production that has affected pricing and productivity in the auto industry and other end markets. At the same time, the resurgent COVID-19 case count has also extended the mismatch between labor supply and demand that has driven up wages, as some workers are hesitant to seek employment for fear of exposure to the coronavirus and others must stay home to care for unvaccinated children or other vulnerable family members.

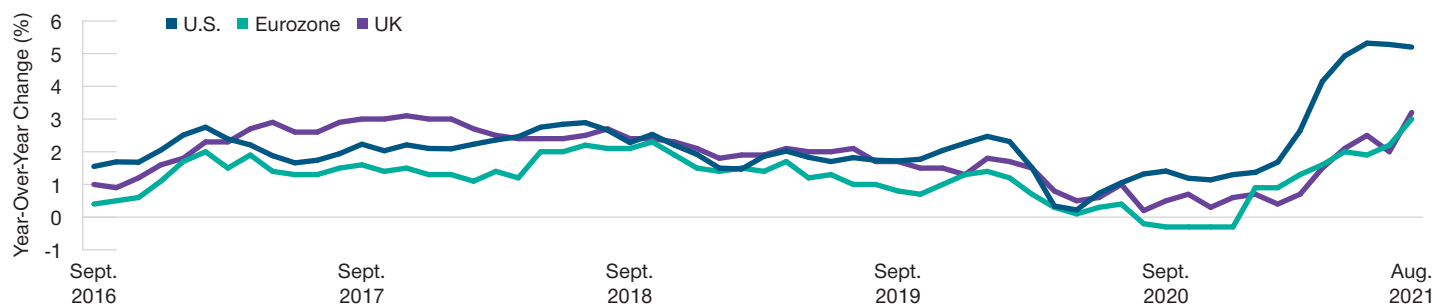
The consensus expectation appears to be that recent inflationary pressures associated with the sudden, pandemic-driven shutdown and subsequent restarting of broad swaths of the economy should prove transitory—that view underpins the Federal Reserve’s and the European Central Bank’s apparent tolerance for above-target consumer price increases in the near term.

However, we see the possibility that the stickiness of wage gains and the upsurge in coronavirus infections could create a scenario where inflationary pressure may prove more persistent than the consensus view and what equity market valuations suggest.

In the past, periods of higher inflation have coincided with lower cyclically

Surging Inflation Rates

(Fig. 3) Headline consumer price indexes (all items)



Five years ended August 31, 2021.

Sources: U.S. Bureau of Labor Statistics, EuroStat, and the UK Office for National Statistics via data provided by FactSet Research Systems, Inc. All rights reserved.

“This divergence between equity markets that strike us as priced to perfection and what we regard as an increasingly imperfect—and complicated—macro backdrop could set the stage for increased volatility.

adjusted price-to-earnings (CAPE) ratios,¹ suggesting that conditions could be ripe for equity valuations to rerate lower if inflation were to remain at elevated levels (Figure 4). Given the low-inflation regime of the past few decades, we believe that a reminder of the historical correlation between inflation and equity valuations may be apt in the current environment, especially if the uptrend in consumer prices and business costs were to persist.

In such a scenario, we could also see a proliferation of other concerns and uncertainties that would likely roil the markets, including the risk that a central bank might raise interest rates too far, too fast. At the same time, the prolonged period of relatively accommodative monetary policies that followed the 2008–09 financial crisis and, in some instances, higher sovereign debt loads could limit the extent to which certain central banks could raise interest rates to combat inflation.

We will monitor trends in consumer prices and producer costs closely,

along with the shape of the yield curve. A flattening or inverted yield curve could signal the risk of stagflation, an undesirable phenomenon characterized by a combination of negligible economic growth, rising inflation, and elevated unemployment. Even the threat of such a scenario, while not our base case, could bode ill for most asset classes.

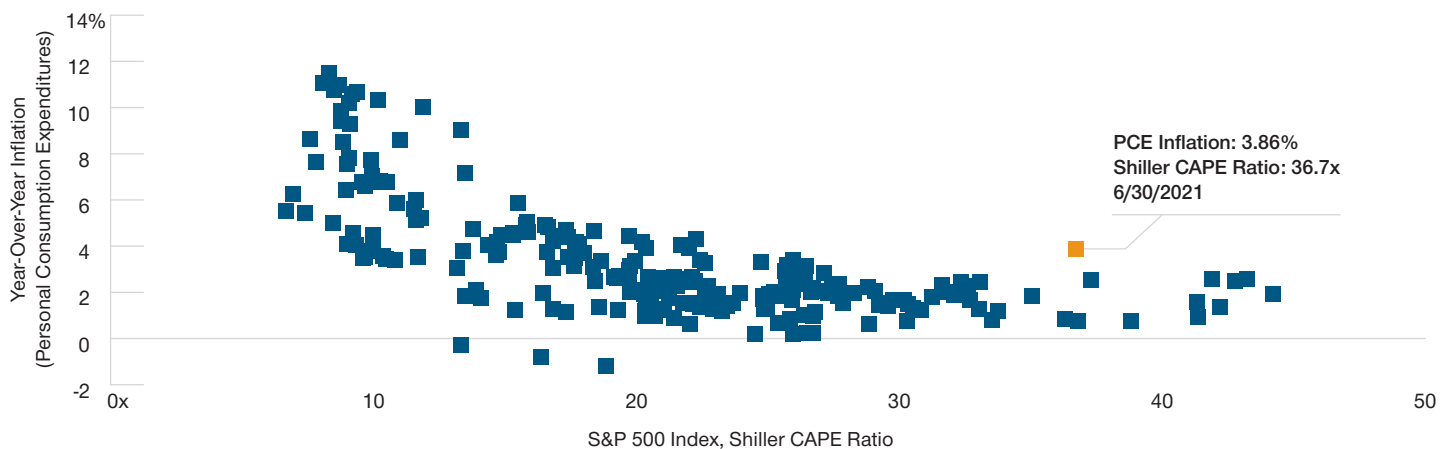
Selectivity Amid Uncertainty

The prevalence of lofty valuations at a time when corporate profit margins hover at or above long-term peaks suggests, in our view, that investors generally have focused more on the ascent than the wall of worry that we believe equity markets have been climbing. In our view, equities have not yet priced in the risk that inflation might end up being higher than expected for longer than expected—let alone the second-order concerns that could follow.

This divergence between equity markets that strike us as priced to perfection and what we regard

Higher Inflation Has Coincided With Lower Valuations

(Fig. 4) PCE price index inflation (all items) versus S&P 500 Index's Shiller CAPE ratio



June 30, 1961, to June 30, 2021.

Past performance is not a reliable indicator of future performance.

Sources: Shiller CAPE ratio data are from Department of Economics, Yale University. Year-over-year change in personal consumption expenditures price index is from the U.S. Bureau of Labor Statistics via data provided by FactSet Research Systems, Inc. All rights reserved. (See Additional Disclosures.) Data analysis by T. Rowe Price. PCE is personal consumption expenditures price index, a measure of U.S. consumer prices.

¹ The Shiller CAPE ratio compares a stock's price with its average inflation-adjusted earnings over the past 10 years, an approach that can smooth out some of the cyclical volatility that may distort valuations that consider a shorter time frame.

as an increasingly imperfect—and complicated—macro backdrop could set the stage for more volatility. Selectivity, in our experience, is likely to be critical in this environment. Although we believe that good entry points in quality companies have become harder to find across the board, we view the opportunity set in some international markets as relatively more appealing than the setup in U.S. equities.

We are sticking with our disciplined process, which seeks to balance

business quality with what we regard as attractive valuations. We feel that this approach has the potential to help us manage risk as we strive to add value over a full market cycle. To this end, we believe that our rigorous research into individual companies and bottom-up approach to stock selection should give the strategy exposure to an array of potential upside drivers that are company-specific and may not hinge on a shift in market regimes to play out.

WHAT WE'RE WATCHING NEXT

Given the range of international markets in which we can invest, we are closely monitoring coronavirus case rates, vaccination programs, and how the resumption of economic activities in these countries is progressing. Other macro-level considerations on our radar screens include inflation rates and yield spreads, with an eye toward how these developments might affect our holdings and the prospective opportunities that could be created. At the same time, we seek to add to our in-depth understanding of individual companies and industries as part of our ongoing due diligence and search for potentially compelling investment ideas.

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