MIDYEAR MARKET OUTLOOK—DISCUSSION TRANSCRIPT

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KURT UMBARGER: Hello, and welcome to the T. Rowe Price 2018 Midyear Market Outlook. My name is Kurt Umbarger, and I will be your moderator for today's session. Joining me are three of the firm's chief investment officers. Here in Baltimore with me is Rob Sharps, Group Chief Investment Officer and head of Investments. Rob has 22 years of investment experience, 20 of which have been with the firm. Also joining me is Mark Vaselkiv, Chief Investment Officer of Fixed Income. He brings 34 years of investment experience and 30 years of tenure with the firm to our discussion. And finally joining us from our London office is Justin Thomson, Chief Investment Officer of Equity, with a particular expertise in markets outside of the United States. He has 26 years of investment experience and is in his 20th year with the firm.

So let's start things today with a quick review of how we saw markets coming into 2018. We thought developed and emerging economies would be broadly supported by synchronized global economic growth, corporate earnings would be good, and disruption within industries due to technological advances would most likely continue. Monetary policy most notably in the US would turn more restrictive, with the feds signaling that it was on a path to continue raise short-term rates, but we did think that inflation was largely contained. We advised investors to prepare for more volatility after an unusually calm year in 2017. And, finally, we advised investors to also temper their return expectations after global stocks posted outsized returns in 2017 and given more valuation levels across financial assets stood coming into the year. I think it's fair to say that much of that has actually come to pass, as we reach the midpoint of 2018.

However, I think we would all agree that the path has been a windy one, and there have been some surprising developments which will likely impact how the rest of the year unfolds. So, I'd like to start by asking each of you to give your own perspectives about what has surprised you the most thus far in 2018. And Justin, maybe I'll turn things to you first to comment on that.

JUSTIN THOMSON: Thanks, Kurt. You've put it well, and a lot of what you said has been accurate, so growth has been good. Top lines have been growing, and corporate earnings have been very good. And you even correctly predicted the volatility outbreak that we had in early February, which was nice. I think what surprised me from this is how resilient markets have been and how well markets, particularly developed markets, have recovered from that volatility episode we saw in early February, small caps making new highs. And why this is surprising is because I feel that we're late in the cycle. We are not far away from being nine-and-a-half years into this bull market, which will be by some stretch one of the longest bull markets of all time, and in the face of a tightening liquidity cycle. So the fed moves are well telegraphed. That shouldn't be such a surprise.

But perhaps what is more surprising is that monetary aggregates are rolling over. And at the same time, we have a phased withdrawal of support from central banks. So the fed is going to retire $380 billion of instruments this year that needs to be put onto savers, which is a form of tightening. And from the emerging market perspective particularly, the rally in the dollar that didn't materialize in 2017 is happening in 2018, and given the structure of emerging market balance sheets, that is another form of tightening.

I guess the last issue is crude oil approaching $80 in the spot market. That is another form of consumer tightening. So markets have been resilient. I would say that there appear to be some cracks happening. Argentina most notably has gone from the pinup child of fiscal reform to calling in the IMF. Within the space of four weeks, we've seen a reverse of portfolio flows to emerging market credit, and we've seen weakness in emerging market currencies, not just the Argentinian peso, but the Turkish Lira, the Brazilian real, the Indian rupee, and the Indonesian rupiah have all been significantly weak over the last few weeks.

KURT UMBARGER: Justin, all those things are true, and we will continue to dig into much of those during the course of our discussion. Rob, biggest surprise this far?

ROB SHARPS: Yeah, Justin touched on it. Kurt, the biggest surprise for me would be strengthening commodity prices and in particular crude oil. Justin referenced Brent nearing $80, WTI at 70. If you look at sector performance within the US, energy is the second-best performer year to date behind only technology. And that's surprising to me mostly because we continue to be faced with evidence that we're able to produce more oil with fewer rigs and that the marginal costs of producing a barrel of oil continues to fall. So kind of with shale in the US, but kind of evened with kind of other methods and means of production, there's been a fair bit of deflation, and there continues to be improvement in productivity, yet we've seen this very persistent strength in the close - - price for crude oil. I think some of that has to do with the overall, the robustness of overall economic growth, and perhaps also has to do with some concerns from a geopolitical perspective, and maybe around the US pulling out of the Iran deal.

MR. MARK VASELKIV: Rob, I would just add that when you look at global oil production today, the world produces about 95 million barrels per day. And then you look at these geopolitical hotspots, Venezuela, 1.4 million barrels per day. Five years ago that was 2.3. So they're obviously in a world of hurt, but also Iran currently is at about the 3.7 million production level. Putting those two countries together, Venezuela plus Iran, that's 5.1 million barrels and a $95 million supply picture. So that could have a meaningful short-term impact on the technical balance in the commodities.

KURT UMBARGER: Interesting hearing a few comments with regards to markets actually holding up a little bit better in light of increased volatility than maybe you might have expected, oil prices higher as well. Pretty broadly speaking, global economy seems to be in good health. I think that's what might be underlying some of the commentary I've already heard.

So let's turn to the global economy itself. As we near the midpoint of the year, there does seem to be a bit of a debate emerging as to whether global growth is beginning to peak, or whether growth is set to accelerate in the back half of the year, supported by pretty healthy business and consumer sentiment, but also whether the US tax reform impact could be kicking in, in the back half of the year to help corporate. So again maybe Rob, I'd turn to you initially since some of that was US-based, how you would characterize the US economy at this point.

ROB SHARPS: I'd characterize the US economy overall as very robust. P-growth in the first quarter just over 2%, but we've been in a pattern where first quarter GDP growth has been less than full year GDP growth for the last couple years. If you think about kind of what's going on in the US economy, we've pulled a number of levers to boost growth. Some of those layer in over time and should be supportive of growth over kind of a multi-quarter if not a multi-year timeframe. One of them is reduced regulation, I think particularly around the banking system, but kind of broadly, I think the impact of more business-friendly regulatory environment should continue to be helpful to overall economic growth.

The second is obviously a big tax cut from a corporate tax cut perspective, which I think ultimately will be supportive of US GDP growth over several years. So my observation is that kind of there are a number of areas of the economy that are performing very, very well. I think this is the best economic environment that we've seen in the US and probably around the globe since the global financial crisis and arguably maybe since the mid-nineties. Consumer confidence is holding at very high levels. And kind of broadly speaking, I think the question is whether or not we're able to sustain these very high levels where we are now, or if in response to some of the things that Justin articulated earlier, tighter monetary policy and more restrictive credit growth, if ultimately we begin to decelerate as we work our way into later this year and into 2019.

KURT UMBARGER: Well let's take that discussion then to Justin, looking outside the United States. We've had some robust data as 2017 was coming to a close. But some of the more recent forward-looking indicators in Europe and Japan and even to some extent in China have looked a little bit softer, Justin. So how would you broadly speak to the economies outside the US?

JUSTIN THOMSON: Let me divide this into three major blocks and start with Europe, at least continental Europe, where economies have been growing above trend. - - earnings in 2017 had positive momentum, and that was the first occasion since 2011 that had had happened. And there's a lot of good things going on in European economies. I would reiterate what was in your question is that some of the sentiment indicated in some of the second derivatives for Europe have been turning down a little bit, partly because the strength of the currency, the strength of the Euro has taken the shine off exports and the shine off earnings.

The real positive outlier, the real positive factor here could be France and if they are successful with some of their structural reforms. That could give Europe generally another leg up. The outlier here of course is the UK, and you can't see me. I'm sitting here in Europe. Despite what's going on globally, UK economic performance has been relative to other parts of the world, has been quite weak, and asset prices have also been weak. And of course that is in part because of the Brexit decision to leave the EU, where ultimately on a three to five-year view, we have shot ourselves in the foot if not both feet. So that will continue to be a little bit weak for the time being.

Let's move onto Japan. And what you're seeing in Japan is deep reform in the corporate sector and the codification of better corporate governance and a better adherence to shareholder returns. I believe in this long-term, but that is a very long-term factor, and certainly Japanese equities tend to be a derivative on global growth. And that was very much what happened with Japanese earnings in 2017. So if you believe the global trade and global growth scenario is weakening, then expect Japanese equities to do less well.

I think the most surprising thing that's happened in the last 18 months is how well China has adapted, how well they've continued to grow while dealing with the debt position in the corporate sector. And I also wouldn't just to reiterate, I would also, having just got back from China, I wouldn't underestimate what's going on there with innovation with the emergence of a powerful technology sector with a powerful biotech sector and how well, further to that, how well they've done restructuring a lot of their sunset industries. So it's been as much about the supply side as the demand side there. So there's a lot to like that's going on in China, but I think economic impulse, the second derivative will be less strong this year than it was in 2017.

MARK VASELKIV: Kurt, we've highlighted the positive driver of strong corporate earnings during this expansionary period, but I believe we're now beginning to face several cross currents that are necessary to highlight. One would be that earnings are beginning to experience some shrinkage from cost pressures in many areas, inflation, like energy ultimately will filter through expenses for companies that are heavy on the energy usage spectrum.

But then also I think you have the perspective that beyond earnings, and this is more a positive trend that I see, is that management teams are paying more attention to their balance sheets. In many sectors, they've paid down debt with the express purpose that once leverage gets to a reasonable safe level, they begin returning more capital to shareholders in the form of both dividends and buybacks. So there are, I think that's what's leading to some of the confusion in terms of the future of the equity markets, is which of these factors will really drive the performance of stocks over the next three to four years. Some are positive, and some not so positive.

KURT UMBARGER: That's an interesting dynamic at this stage, for sure. We're going to explore earnings in just a little bit, but Rob, any reaction to Justin and Mark's comments with regards to the economy?

ROB SHARPS: Yeah, I think the big question at this point is whether or not we're very late cycle, and when the next recession will be. And I guess I would guard against assuming that simply because this has been a very long expansion, that we're necessarily at the end of the cycle. There are some things that would suggest that we're getting late in the cycle, the unemployment rate before 4%, some signs of inflation, as Mark highlighted, as well as the fed establishing a more regular cadence of raising interest rates. But I think it's important to take a step back and remember that we've emerged from a very deep recession in the global financial crisis. And while this has been a long recovery, it's been a very slow recovery. Industrial production has improved and come a very long way off the bottom, but I think by many measures, would still be below trend. You can look at a number of things like housing starts and other, kind of other broad metrics that would suggest that this recovery could have quite some way to go. And it may be that we're really kind of in a mid-cycle pause as central banks around the world recalibrate monetary policy for a more sustainable or self-sustaining economic expansion. It might be that we're going through a period of time where similar to what happened in '94, where financial market returns weren’t great. We were adjusting to higher short rates, but it didn't necessarily mark the end of the cycle.

And as I look around, I think investors should broadly probably be prepared for lower rates of return from a financial asset perspective. We've gone through a very long period of time where financial assets have outpaced the macro economy, and maybe we'll go through a period of time where the macro economy outpaces financial assets. But it's not clear to me that there's a lot of misallocation of capital or speculative behavior or many of the source of things that you typically see at the very end of an economic cycle, the sort of overconfidence or exuberance that really would mark the end of a cycle.

MARK VASELKIV: I heard one thoughtful commentator say several months ago it's not morning in America; maybe it's happy hour instead. The question is can we contain happy hour? As Rob has mentioned, generally speaking, corporate America is behaving themselves responsibly, but over a long period of great fundamentals and stimulus, we've always seen some increase in speculative practices in corporate America and other parts of the world. So, so far, so good. I think companies are acting responsibly, but let's make sure that we don't go to the next level of extreme.

KURT UMBARGER: Very interesting thoughts, and I think maybe now we can turn our attention where as an organization we spend most of our time, and that's corporate fundamentals, when it comes down to earnings, valuations, how the markets actually look. And Rob, you shared some comments about where we are potentially in the cycle, and Mark, you had comments with regards to things that could weigh on earnings going forward. I thought maybe we could explore that a little bit more. Simply put, corporate earnings worldwide have been very good and supportive of equities in particular, and we've also seen some revenue growth picking up to start 2018, something that has not really underpinned the bull market for much of the period since the financial crisis.

But ironically, while Main Street seems to be picking up, Wall Street at least year to date is largely yawning, to put it like that, so quite the opposite of what we heard throughout much of the bull market. So I think really just in terms of earnings, are they peaking? What should we expect as we roll through the back half of this year? Because they have been quite good into early 2018. Rob?

ROB SHARPS: Yeah, I think the arithmetic would suggest pretty clearly that earnings are peaking. We were up 25% year over year in the first quarter of 2018. And that's an extraordinary number when you're not coming out of a recession, right. And yes, some of that is the benefit of a lower corporate income tax rate. But even if you take that out, we had corporate earnings growth in the mid to high teens on a year-over-year basis, again not coming out of a recession. That's a meaningfully above trend and obviously not a sustainable number.

But Kurt, as you mentioned, it's a number that is not just driven by buyback or the tax rate or cost-cutting. Revenue growth came in quite healthy, kind of the md to high single digits, in the first quarter. I think the big question for investors is not whether or not they're peaking. It's how quickly they come down. And if you look at the consensus in the US, for the rest of this year, the answer is people were not expecting them to come down a lot. I think if you look at the quarter-over-quarter consensus for the S&P 500, it will come down from 25% in Q1.

But I think people are still expecting high teens or approaching 20% for each quarter through the rest of this year. The expectations for 2019 are a little more pedestrian but still pretty healthy, in the kind of 8% or so range. So I guess the bottom line is that if we're able to meet consensus, it should lay the groundwork for a reasonably constructive environment, particularly if we get a year of consolidation where the earnings can come in underneath the prices of stocks and give you a little bit of more attractive PE valuation relative to what we were dealing with at the outset of the year.

KURT UMBARGER: And so Justin, how would you characterize the earnings trajectory outside of the States broadly in the context of what Rob has just shared in the US. Obviously tax cutting in the US has been a big part of this. We haven't seen that direct impact outside the US, but how would you see things in the back half of the year for earnings?

JUSTIN THOMSON: I would echo what Rob said on it's going to be difficult to replicate either the rates of growth of earnings we've seen in the recent past or the degree of momentum. By that I mean the degree of upgrade here. If we take stock of what's happened to earnings over a longer period of time, the US market really stands out because earnings are at a record high. If you look at Europe, actually European earnings, despite having a good 2017, are still well below peak, which was 2007.

And a lot of this comes down to the predominance of the banking sector in European markets and the fact that interest rate margins or leverage will not exceed previous peaks and therefore earnings in aggregate are unlikely to surpass a previous peak. And so markets have got a very interesting dynamic here, and it's partly technology, and technology in the US has been a huge part of the driver of the growth, versus financials, where financial earnings have been weaker. And that’s part of what's going on.

Interestingly, in the rest of the world, you're seeing a similar technology dynamic in the Asian markets. In fact it's been an even more concentrated effect. So in 2017, over 50% of your excess return in a pan-Asian strategy came from just three stocks. That was a very unusual situation. Japan I think had covered, I mean Japan, despite the structural changes to the good that are happening there, will be beholden to the global cycle. So a lot depends on where the global cycle is going.

MARK VASELKIV: Kurt, one of the surprises I did not have a chance to share is the lack of pressure on wages and income for American workers. And - - studying the labor statistics very carefully this year. Every 30 days we look at those reports on unemployment and wage growth, and they've stayed stubbornly low.

And yet I wonder whether the pendulum is beginning to swing from the owners of capital to labor. I recently read that our 3.9% unemployment rate, which is historically very low, American companies today are posting 6.6 million job openings which they cannot fill. And that's affecting a lot of industries. There's literally a job opening today for every person who's unemployed and seeking a new job, which is a remarkable statistic - -. Unfortunately, companies cannot match those openings with the right amount of skilled or unskilled workers. And I think it's true over at least a half a dozen sectors, and ultimately corporate America, small, medium, even large companies I think will ultimately have to pay more to get the type of people that they need to keep their businesses running.

ROB SHARPS: Yeah Mark, I think there's an argument to be made that a big part of the reason why we haven't seen pressure on wages is that we came from a very low labor force participate rate coming out of the global financial crisis. I think if you look at the recovery in the labor force participation rate, we're probably now at a level where it's unlikely to increase. And demographics might suggest that it will actually decrease on a go-forward basis as the baby boomers age out of the workforce, which could particularly, combined with tougher immigration stance, kind of ultimately prove to tip the supply-demand balance in favor of labor.

Now on the other hand, we are seeing really the first time in this recovery, capital expenditures start to improve in a meaningful way, so kind of maybe both capital and labor, or kind of getting a shot in the arm here as a means of trying to catch up to improve broad demand.

MARK VASELKIV: It would be great to see some productivity improvement because that's been a missing dynamic in this recovery as well. Ultimately growth is a function of demographics and productivity, and both of those are kind of weak right now.

ROB SHARPS: Yeah, and the demographics, there's not a lot we can do a lot, not much we can do about in the short term. But I think you're right; productivity growth has been a missing element of this recovery. And kind of longer term, given levels of debt in the global economy, given kind of what we know about demographics, I think in order for us to sustain growth anywhere near the levels we are now, or even kind of at a healthy level that would be below where we are now, we're going to need to see some pickup or improvement in productivity.

KURT UMBARGER: Very good. Let's maybe make some comments with regards to valuations. I said at the outset that one of our thoughts coming into 2018 or financial assets in general were somewhat expensive. So we've had some consolidation in equity markets. Bond markets, yields have drifted up. I guess how would you characterize valuations from your perspective today? And let's start on the fixed income side Mark, with you.

MARK VASELKIV: I would argue that valuations are improving in an absolute sense and still expensive on a relative sense. So when you look in my world of credit strategies, people pay a lot of attention to the compensation or spread you receive for taking on high quality and low investment grade quality risk. And those spreads remain pretty expensive by historical standards, let's say maybe about 100 basis points for high quality companies, 4% or 400 basis points for below investment grade. However, the risk-free rates have moved up, and that's significant. If you look at an average double B high yield bond today, which is the better end of the quality spectrum in my world, you're now getting about 5.5%, single Bs about 7%. So we've moved our asset class up to about a 6.5% blended or aggregate yield. And I've always noticed in my long-term work in the high yield market, when absolute valuations start to kind of get to that 7% level, the compounding effect of 7% over a long investment period generally leads to pretty good outcomes if you're taking the long view. So I do believe that the credit strategies still have some vulnerability in terms of those credit spreads widening, but they are looking a lot more interesting than they were six months ago. In October of last year, 40% of the high yield market yielded below 4%. And that bucket is virtually gone today, and now we're getting back to real yields and spreads.

KURT UMBARGER: Maybe on the equity side, Rob and Justin, whoever wants to tackle that one first.

ROB SHARPS: I'll kick it off briefly with regard to aggregate US equity valuations. And I think I would characterize it a very similar way to what, the way Mark characterized bond spreads, where PEs at the aggregate level have improved but still are not attractive. They're kind of moderately expensive relative to history. And you've lost a pillar of the argument that you've had very, very low risk-free rates in support of PEs. So I think with the S&P 500, kind of current year PE between '16 and '17 times were certainly well off the peak. And I think probably kind of reasonable by historical standards, but far from compelling. But one point I'd make though is that I think aggregate statistics on the S&P 500 are less and less meaningful when we have really narrow market leadership in the amount of disruption that we have in the market as a whole. So I think it becomes harder and harder to draw a conclusion from the S&P 500 PE ratio today relative to kind of what you might have been able, the conclusions you might have been able to draw some time ago.

MARK VASELKIV: Yeah, I would add Rob that while spreads in the credit markets haven't moved a lot this year, the dispersion of those spreads has widened significantly. So while the average spread is 400, there now are companies that are significantly more interesting. And I think to a degree, that favors the work of active managers, to be able to find those opportunities. We consider ourselves value in our philosophies, and we're starting to see more and more bargains.

ROB SHARPS: Yeah, you've seen kind of a pickup in dispersion and return from a sector perspective in the US as well with a lot of the typically more defensive or rate-sensitive sectors, telecom, utilities, consumer staples performing quite poorly, kind of down on order of double digits year to date. And a handful of the more cyclical sectors, tech, consumer discretionary, energy, really kind of leading the way in the market. But a pretty broad dispersion of returns within sectors in the US so far year to date.

KURT UMBARGER: Justin, we've said for a while that there's a discount to valuations outside of the US. Many of the economies are in earlier stages of their economic recovery. How would you characterize absolute and relative valuations from your view?

JUSTIN THOMSON: I mean just on your point, we've dealt with Europe, and we've dealt with the banks and structural issues there. So maybe a comparison with history is not that relevant. I think it's difficult to argue that equities are not expensive relative to history or in most markets. And this is in danger of sounding clubby between the three of us, but we're seeing a similar pattern all over the world, emerging markets included, where markets are highly bifurcated between companies that can demonstrate structural growth and companies that are structurally challenged. And the blend that comes out in the aggregate is perhaps a less meaningful number than it once was.

KURT UMBARGER: Very good. Let's turn our attention to rates. We've talked about rates to some extent. I think one of the things that has happened this year, which has been interesting, is that markets have really become a bit more laser-focused on rates, sort of transitioning from earnings, which have been very robust, but placing greater focus on the path of interest rates from here. So there's been a fair amount of hand-wringing with regard to that. Now the fed has raised rates and is expected to do so two, maybe even three more times this year. We will see. The ten-year has breached the psychologically important, at least for now psychologically important 3% mark. But we've also seen yields melting up in Europe, at the LIBOR end and also even at the ten-year end for many sovereigns. Not as much in Asia. So Mark, I come to you as our fixed income chief investment officer. Fixed income can often be the canary in the coal mine. So are there real concerns about mounting inflation, or is this just a natural normalization of rates after nearly a decade of ultra-low levels?

MARK VASELKIV: I was going to say that one of my big surprises for the year is how quickly the broad consensus and the complacency related to interest rates has unraveled. If you were to dial the clock back to the end of 2017, pretty much all the bond gurus were in this range for the ten-year Treasury at least. I'm going to focus my comments on the ten-year because I think it's such a benchmark issue, and so many people price securities off the ten-year. The consensus was 265 to 295, very tight, 30 basis points, and a significant preoccupation with 3% as the threshold. Magically if we ever broke through that 3%, buyers would emerge and buy risk-free assets for safety purposes. Well guess what? We've gone through 3%, and it looks like rates want to move higher.

But I would add some long-term historical perspective here. We've been in a 30-year bull market for bonds. The US defeated inflationary trends roughly in the middle of the 1980s. So about 1985, a ten-year Treasury, believe it or not, was at 10%. And it got to a low of 1.5%. Throughout this decade, 2010 to 2018, the ten-year has averaged 2.4%. In the aughts, which was Y2K to 2010, the average yield on the ten-year was 4.4%, and in the 1990s it was 6.6.

So for us to be sitting kind of in this 3% area with a very strong economy, stimulus, significant fiscal policy leading to trillion-dollar deficits, to expect that longer-term interest rates stay at these incredibly low levels, I think is too optimistic. I think we should, since I'm a bond guy and I'm always glass half empty, I think we want to recognize the risks that could take long-term interest rates higher, and that sort of tight band of, now I think people are saying 3 to 3.5%, yeah that's more reasonable. But there are some scenarios that could take us even beyond those levels. And that's when I think the markets could start getting into real trouble. And it could have an impact on the real economy as well.

KURT UMBARGER: So one specific question to you then, given the economic backdrop, your probability or concerns about an inversion in the yield curve for--

MARK VASELKIV: [Interposing] Yeah, I think one of the big surprises this year has been that the yield curve is steepening--

[Crosstalk]

KURT UMBARGER: Steepening--

MARK VASELKIV: [Interposing] So here's my point, and I think Rob would agree with me. In May you could've bought a ten-year Treasury at about 3%, give or take a little bit. But you could also own a five-year Treasury at 2.9%. Why would you necessarily want to take all that interest rate risk when you're only giving up ten basis points to own a security that will mature in 2023, and you'll get your money back in a certain rate of return. So I think longer Treasuries, because of that flat yield curve, have grown less attractive than they might've been in a steeper yield curve.

ROB SHARPS: Yeah, Sebastian Page, head of Multi-Asset Solutions, has done some work that he presented to our asset allocation committee that basically suggested that historically, a flattening or flat yield curve has not necessarily spelled imminent trouble for the economy or for financial assets. But that once the yield curve goes inverted, that it's important to pay attention, because the risks really do increase once you have an inverted yield curve. So actually I think it was interesting and probably healthy to see that slight steepening where we saw the kind of short rates rise a little bit less than the pretty rapid rise in the ten-year yield that we saw so far in 2018.

KURT UMBARGER: And for equities, I mean is it the absolute level of ten-year? Is it the magnitude of the increase? How do equities respond to rising rates?

ROB SHARPS: Historically I think it has more to do with not being surprised in the pace for sure. Certainly to the extent that ten-year is below 4 or 5%, I think that the underlying earnings growth and fundamental environment will trump what's happening with rates as long as we're not getting surprised, right, if the fed's not doing - - moves or 50 or 75 basis points at a time, because they feel like they're behind the curve from an inflation perspective. Clearly that's not where we are right now. I think it's unlikely that we get there kind of throughout the course of this year. We're going to see a little bit of inflation work its way through the system kind of throughout the course of the rest of this year, but then it's likely to peak. And to the extent that it does, then kind of that could give us a little bit longer runway here with the economic recovery and kind of give the fed a point, the ability to take a pause and kind of take assessment of kind of where we are.

KURT UMBARGER: And I think sometimes we get preoccupied with the ten-year Treasury, but obviously rates outside of the US, particularly in many of the major economies still remain very low, albeit maybe a little bit up from where they were this time last year. Justin, your thoughts about rates and what the implications are for equity markets outside the States?

JUSTIN THOMSON: Yeah, I haven't got a great deal more to say on what it means for equities. I mean in Europe, you've got to put this in historical context. When you say they melted up, they've melted up from an extremely low base. And a significant stock of sovereign bonds in Europe still have a negative yield. So we're still at very low rates. We know that the ECB is going to enter some form of quantitative tapering this year. We think it's likely to be - - of EUR 40 billion that they're going to put onto the market.

In Japan, their current form of monetary policy or quantitative easing called yield curve control, they're managing to ride out the curve, ride out to ten-year to 0%, and they seem to be managing that with some effect. And to an extent, that is anchoring rates around the world at a lower level than it might be. I would just reiterate that market hates surprises, and if we were to have a 1994 moment where you had rates move up quickly in a short space of time, that would be damaging for equity markets. But as it stands, I don't particularly see rates as being the real issue here.

MARK VASELKIV: I would highlight here too that government bonds are the most global of all the asset classes. It's the largest, most liquid market, and it's dependent on a significant number of foreign investors. So take our trillion dollar budget deficit in the US. Roughly half of that will get covered in any Treasury auction by non-US buyers. So we have to think a little bit about what are the alternatives that a Japanese or a Chinese investor has to US Treasuries for safety? And the reality is that most of those international investors engage in some type of currency hedging when they buy a Treasury or a bond or a Japanese sovereign issue. And the way the currency issues and hedging are happening today, you actually get a significant pickup from some other bond markets.

And if you invested today in a number of countries like France or Germany and then hedged those purchases to US dollars, you would actually get paid more today than for owning a US Treasury outright. So other sovereign safety markets are becoming more competitive with US Treasuries, even though it still remains the largest, most liquid market. And I think that could have some interesting dynamics going forward f the world starts to lose a little bit of confidence in our geopolitical situation, particularly our trillion-dollar deficits, which look like they're going to persist for many years to come.

ROB SHARPS: Mark, do you think that's happening now, given meaningful reduction in corporate income tax rates and a big spending bill, while we run sizable deficits very late in an economic recovery, right.

MARK VASELKIV: Right.

ROB SHARPS: Maybe you look back to the economic expansion that ended in the late nineties. We actually got to the point where we had balanced budgets, right. We've not really used the opportunity afforded to us by this economic expansion to address any of the structural imbalances from an entitlement reform perspective.

MARK VASELKIV: Right.

ROB SHARPS: And kind of neither political party at this point seems to stand for fiscal discipline or to really have an interest in trying to balance the budget.

MARK VASELKIV: Yeah, I think that's a great point. I spend a lot of time working with international clients, particularly in continental Europe. And one message that I'm hearing loud and clear is the unpredictability and the chaos of our current political system is causing them to grow a little bit more sour on US. I think for those of us who have now dealt with this administration for 18 months, I think we're getting, we're trying to figure out, and I think we've grown a little bit more accustomed to the way Trump and Congress operate, and the market seems power through a lot of those bouts of volatility. But I think outside the US, Europe, and Asia, they're expressing more concern about how the US is currently operating.

KURT UMBARGER: There are a lot of thoughts there, and one of the things that comes to mind is the implications for the US dollar. So in terms we've seen, in particularly the latter half here of the start to 2018, the US dollar showing some strength, something that was broadly expected in 2017 but didn't materialize where the dollar was largely weak. But we have started to see it rise maybe alongside that Treasury yield, so Mark maybe, any thoughts, - -?

MARK VASELKIV: Yeah, that's a great question. I think there have been three fundamental debates this year that have remained unanswered, and these debates are leading to the uncertainty and maybe the volatility in the markets. We touched on two of them already. One is inflation. Will it eventually pick up? Two is the length of the economic cycle, and I think the third is the direction of the US dollar. As you've said, it had been through a long period of decline, and that was actually creating some very favorable dynamics for financial assets. One, helping corporate earnings, particularly for multinationals--

KURT UMBARGER: [Interposing] US-based multinationals.

MARK VASELKIV: --that have a lot of operations overseas. And let's also remember that was very, very positive for emerging markets, debt, and equity strategies. And now that has reversed. And typically when the dollar begins to appreciate, that's going to be a pretty negative environment for emerging markets, for a variety of reasons related to, well one for example would be how much dollar-denominated debt does an emerging market country carry, both in sovereign and in corporate. So as the dollar appreciates, the cost of that debt grows more and more expensive. And then they're expensive, and then there are currency implications as some of these emerging countries see their own currencies weaken.

So we're starting to face, because of this spike in the dollar, a little bit of, I shouldn't say a little, a considerable amount of volatility in the emerging space, which in 2017 was the star performer, on both equities and fixed income. And all of a sudden, there was a lot more angst and a lot more concern. And I think many of these crises potentially could be solved quickly with effective action from central banks around the world. But they do have a tendency to spread a little bit. So as Justin has mentioned, Argentina has gone through this period of difficulty. Well potential that could spread to Brazil, which is a major country in the emerging universe. So I think that's one of the key trends we need to be watching over the next six months to see how this plays out, and a lot of it does come back to trends of the dollar.

KURT UMBARGER: And you talk about contagion or the potential for that. And so Justin, bringing you into this side of the conversation with regards to emerging markets, I mean those with wide or current account deficits historically have been more exposed to dollar strength. You mentioned Argentina, the likes of Turkey. But I guess Justin, maybe can you put in context from your perspective how you'd characterize the overall health of emerging market countries today in the context of if we have dollar strength continuing, can they weather that storm?

JUSTIN THOMSON: Yeah, I think if all the predictions that we make on this type of - -, the one we're likely to get right 50% of the time less cost is currency. But I mean you've partly answered your own question. I mean it is the impact on those with current account deficits. But as Mark has explained, where it's more pernicious, where it's more dangerous is where you have a currency mismatch. Or indeed like Brazil, you have a fiscal imbalance. And if you have a fiscal imbalance, you need to keep the capital account flowing, and you need to be importing capital effectively so that the real exchange rate is very important in that in terms of contagion, the one market that appears to be very dangerous is Turkey because monetary policy appears to be highly politicized for want of a better way of describing it. And that is where the currency mismatch is most acute, and it manifests at the corporate level where we think there is the foreign debt held at corporate level that's both denominated in Euros and in dollars, is in the -- magnitude of 4 to $500 billion. And if the Lira should continue to depreciate, that may be an issue. Yeah, Latin America I think is weak. You've seen some weakness in India, in Indonesia, in South Africa. Those are the markets you typically see. China following on from the currency wobbles in 2016, their currency, which is, as you know is partly managed, has been resolute, so you're already seeing some degree of differentiation here. But yeah, I take Mark's point. This, I'm not sure this is a buying opportunity. This could go on for a little bit more.

ROB SHARPS: Justin, I recently saw an interesting publication by an economic research firm that has created an EM vulnerability index and ranking the top ten countries in terms of most risk. Turkey finished number one by a wide range with Argentina as number two.

But I was struck that Mexico was number three on the list, and I think part of that probably relates to US policy again, and here we touch on the unpredictability of Washington D.C. I think a lot of that Mexican uncertainty relates to the future of NAFTA. Mexico has been one of the great success stories in the developing world because of NAFTA and its close relationship with American corporations. But a bad outcome on NAFTA coupled with a nasty election that veers the government towards pro-leftist-type philosophy, and we could be seeing a great EM story begin to unravel. I mean clearly it's not a Venezuela, but to go from something that's been very stable to more uncertain is kind of disappointing.

KURT UMBARGER: Well - - transition a little bit towards government policy, I guess in some respects last year seemed to be a market view of government policy, kind of looking at the glass as half-full in anticipation of maybe some progress on particularly US tax reform. This year I'd argue or contend that the markets have looked at things a little bit more from the glass half-empty standpoint. We've seen certainly trade and protectionist fears to the brink of concerns about an all-out trade war. We have and are getting closer to Brexit deadlines on the horizon. So I guess let's explore this a little bit further, 'cause I think it's contributed to volatility this year. And Justin, maybe turning things to you first with regards to Brexit, we have a date set now for the UK leaving the European Union that’s just a little bit more than nine months out at this stage. But there's still a lot to work through and things that are unclear. So your thoughts, are markets being overly fearful with regards to Brexit or not fearful enough?

JUSTIN THOMSON: I mean what markets dislike most is uncertainty. And it's the uncertainty surrounding the nature of UK's relationship with Europe and the predominance of the trade that we do with Europe that the market dislikes. And while there is uncertainty, decisions regarding hiring, decisions regarding capital expenditure, all of those things are not happening. Now it may be that we get through this, and on a ten-year view, this is very good news for the UK if we manage to negotiate some strong bilateral trade agreements. But I think for the next, in the immediate future, this uncertainty is not good for confidence.

KURT UMBARGER: And Rob and Mark as well, any comments with regards to - - we have the ongoing negotiations when it comes to trade with our partners from the United States' perspective, to the north with Canada and south with Mexico, and also with a major trading partner in China?

ROB SHARPS: Kurt, if I take a step back, I'd say the big question around government policy, you basically have risks rising, right. You either have meaningful tailwinds that are abating, or some emerging headwinds, right. In terms of monetary policy, we've talked a lot about it, but we've gone from extreme accommodating to less accommodating, and we're probably starting to border on tightening. Regardless of your politics, I think it's difficult to argue that the first few major initiatives of the Trump administration weren't really healthy for American business, corporate tax reform, deregulation, etc. What you kind of start to see now is maybe the Trump administration making good on some campaign promises, withdrawing from the Iran nuclear deal, which I think does lead to uncertainty, to Justin's point about markets not liking that, and then kind of a multiple front, the potential for trade war. Who knows if it ultimately comes to fruition? I was two weeks ago in Beijing with Chris Alderson [phonetic] and the US ambassador to China, Terry Branstad spoke there. I think most people feel like ultimately we'll be able to work through this and that eventually it could be helpful for the US if we're able to get some intellectual property rights and a little bit more access to certain elements of the Chinese market. But it certainly does elevate the level of risk in the near term. And I guess my commentary would be when you combine that with the resignation of some people who I guess I thought were adults in the room, the Gary Cohns, HR McMaster, and you see the Paul Ryans deciding to kind of opt out of another term, at the margin it has to create a little bit more unease when you think about government policy and its implication on forward asset returns and markets.

MARK VASELKIV: I know we're talking about the two largest countries in the world, the US at $20 trillion of GDP and China at number two at 13. And if you're going to be constructive about emerging market strategies, you have to recognize that all emerging countries revolve around China. That is really the major player in the developing world. So a meaningful conflict between the two superpowers economically in the world is very serious. Put that in context, countries like Germany and France have GDPs of 5 and $4 trillion, so we're talking about multiples the size of the next-largest economic players around the globe.

KURT UMBARGER: Let's maybe turn our attention to market leadership. It was interesting at the end of 2017. As a group, our chief investment officers got together, and we discussed the platform companies, or the tech titans, as we often refer to them. And we've heard Justin talk about the significance of the emergence of some of the Chinese tech-oriented companies on Asian markets. So one of the things we cited in that discussion was some of the pressures that may ultimately come toward the tech titans, be it regulation, be it a bit of a social backlash. And as would have it, we've seen that materialize in the beginning of 2018 to some extent. So I guess a question again, I come to Rob first with this, is just do we see these platform companies continuing to play the role that they have played for many years now in terms of market leadership, or are we entering a new era in terms of if you will, their own dominance of equity performance?

ROB SHARPS: Kurt, your point's spot on when you think about Mark Zuckerberg being, kind of hauled in front of Congress, when you think about President Trump directly pressuring the post office to change the rates that they charge Amazon. It is clear that the power and influence of the platform companies have caught people's attention and probably rightly so. That said, it certainly hasn't manifested itself in kind of any meaningful change to the trend of really powerful, fundamental strength. And just really remarkable growth at scale for these companies as we look at their first quarter earnings. I do think that the potential for government intervention, regulation, etc. is a longer-term risk for these companies that we'll want to continue to monitor. But we continue to have reasonably sizable exposure to a number of the platform companies kind of in our portfolios around the globe. And I think the point being that look, while they're far from undiscovered at this point, seven of the ten largest market cap companies in the world, cumulatively almost $5 trillion in market cap, I think there's a case to be made that they might still be underappreciated as kind of more and more of the global economy shifts into the digital age, as these companies continue to provide immense value to a lot of their constituents. I think that there's a case to be made that with a long time horizon, several of the platform companies can continue to be very attractive investments. From a market leadership perspective, technologies continue to lead. That's one thing that's been consistent from 2017 to 2018. So kind of best-performing sector year to date, kind of technology and energy depending on the day, kind of right there neck and neck. Consumer discretionary is third, but somebody noted that if you were to take Amazon out of consumer discretionary. Consumer discretionary actually would have been an underperformer. So the impact of the platform companies continues to be felt and I think is going to continue to be at the center of kind of almost any investment debate kind of for years to come.

KURT UMBARGER: And this has implications for a question that we have been getting for some time now, and that is leadership from a style perspective, growth versus value investing. And really since circa 2006, we have had growth outperforming value by a pretty wide margin when you stop the clock today. So in the context of your comments about market leadership, I guess is there anything that might reduce the disparity of growth versus value outperformance as we look forward, even if the technology companies continue to put up good results?

ROB SHARPS: There are some signs of hope for a few of the sectors that populate the value indexes, right, energy being one of them, kind of having that $80 Brent. It could be very helpful to the extent that it's sustained for the earnings power and ultimately the returns on capital for energy companies around the globe. Financials will benefit from this interest rate environment, also kind of very big industry and sector representation within the value indexes. That said, some of those kind of more defensive sectors, kind of some of the more rate-sensitive sectors, the utilities, the staples, the telecom also were heavily populated in the value indexes.

So I think it's been kind of give a little, take a little from that perspective, Kurt. I think if we do see sustained, robust global economic growth, kind of that rising tide lift all boats, which that will be more helpful to a value-oriented investment strategy, and if we were to remain in a more tepid kind of global economic growth environment where kind of organic growth is the only game in town. But broadly speaking, these big trends of disruption have favored growth investing relative to value investing. And while from a positioning perspective, that doesn't go in a straight line, that's not something that I personally see changing kind of as we look forward.

MARK VASELKIV: I would argue that value investing is taking on more of a global international flavor as well. We've talked about the volatility in the emerging markets. And the reality is there's some amazing national champion-type companies in the emerging markets that get caught up in a period of volatility or financial crisis. So I think the value universe has broadened substantially, and it's not just a bunch of small cap, little companies in the US anymore, but in the developing world you can buy some very cheap stocks in companies that have substantial scale and competitive strengths.

ROB SHARPS: And I do think kind of in any discussion with regard to market leadership, kind of one of the things that we need to highlight is the strength in small cap stocks, right. I mean - - the only broad indexes that's making new highs on a year-to-date basis here, and I think a lot of that might have to do with the underlying strength in domestic earnings and beneficiary of corporate tax reform. But it's an interesting development to watch.

KURT UMBARGER: Then I'd like to bring us home here, I guess, at this stage. We made some comments earlier in our discussion, but we are in the second-longest bull market on the equity side of things in history. We are 30-plus years into a bond bull market. We talked a little bit about where we think things are in terms of the stage of the cycle. But T. Rowe Price is an organization, when you think about many of our asset allocation portfolios, which you all sit on that committee, we've gradually been de-risking a bit into this environment. I guess what I'd like to ask each of you is really the thoughts that you want to share with our audience today about how we see things going forward, and how we're taking advantage of opportunities, but also managing risk in our portfolio. Justin, maybe thoughts from you to start things?

JUSTIN THOMSON: Well in my own strategy, given the circumstances I've described, so valuations high particularly in high quality growth companies, valuation is very high, the positive impulse from credit and policy rates rolling over a little bit, I think it makes sense to have a little bit of cash in your portfolios, particularly now in dollar terms, that cash has something like a credible return in it.

I think this whole debate about market leadership, it just proves at least on the equity side that what we're here to do, what we should be focusing on is finding truly great companies that we can buy, hold, and compound for many years. And it may seem, it may seem unusual at the moment that we've got this, what appears to be a very market, a very concentrated market leadership. But I'm going to close out by alluding to the relatively recent academic report from Hendrik Bessembinder from University of Arizona, which was in effect a long run attribution analysis of the US market where he looked at the returns from 26,000 stocks in a paper entitled "Do Stocks Outperform Treasury Bills?" And he sort of answered the question as you would expect. The answer is that the average stock or the median stock does not outperform Treasury bills. And over 80, near 90 year of history since 1926, over 50% your excess return had come from just 90 stocks. Out of a universe of 26,000, that's a truly remarkable statistic.

KURT UMBARGER: Mark?

MARK VASELKIV: Since I'm the fixed income representative on the call today, I'll direct my final comments back to a new regime for interest rates and particularly central bank policy. My favorite quote of the year, and hopefully we can use this several times, is when the fed taps the brakes, someone goes through the windshield. And I think we're beginning to see that. And the point the strategist was making is that in every fed tightening cycle, you will experience some type of financial crisis. And they don't have to be existential in nature. It doesn't necessarily have to look like another 2008 crisis. And I would argue that we should expect those. We've already seen one in Argentina, just in the last quarter.

And perhaps those crises do create buying opportunities. I would not use this quote as an indication of completely de-risking a portfolio, but just to say we need to expect more accidents going forward given higher interest rates and some of these vulnerabilities that we're seeing around the world but ultimately stay the course and look for opportunities through those periods.

KURT UMBARGER: And Rob?

ROB SHARPS: Yeah, I would just summarize by saying the fundamental environment is great, but it's not getting any better. Risks are rising, and my counsel would be for people to basically position themselves a little more conservatively at the margin, but not necessarily to overdo it. I don't think that we're necessarily at the end of a cycle or that we're in for a recession or a bear market.

One thing I do think that I can say with a fair bit of confidence is if you have a multi-year lens, that you can expect lower returns going forward than what we've experienced over the course of the last couple of years. And I think to have a little bit of dry powder, kind of per Justin's comment with regard to what he's doing in his portfolio, makes a tremendous amount of sense in the environment that we're in right now.

KURT UMBARGER: Makes sense. So some of my summarizing thoughts when I hear that, we are in a period where given this stage of both the cycle as well as the economic turn that we've experienced where volatility is probably back to normalized levels, then we should expect that. Hopefully not a crisis, but heightened volatility. Should be prudent with your allocation with a sound financial plan long-term that you're committed to. And that while things potentially are in the process of peaking, I don't think anybody here is looking on a very near-term basis for the recession on the immediate horizon that would cause you great concern. So I want to thank you for joining us today. I want to thank Rob Sharps, Justin Thomson, and Mark Vaselkiv for sharing their thoughts on the markets as we reach the midpoint of 2018, and we look forward to addressing you again hopefully at the end of the year. Thank you.

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