



Navigating Global Disruptive Forces

Q&A with David Giroux and Mark Vaselkiv.

February 2019

KEY INSIGHTS

- More cautious Fed policy benefits fixed income investors, but lack of liquidity poses risk for below investment-grade bonds.
- An increasing number of companies are facing secular risk, or disruption, that can derail their earnings growth and valuations.
- The number of attractive industries is shrinking, so navigating secular risk is critical to investment success.

While financial markets have rebounded from the sharp and steep sell-off in December, the investment environment and outlook remain highly uncertain. David Giroux, chief investment officer of equity and multi-asset and head of investment strategy, and Mark Vaselkiv, chief investment officer of fixed income and portfolio manager of the firm's Global High Yield and High Income Strategies, recently discussed the market environment and the disruptive forces that pose longer-term risks for many companies. Following are some highlights of that discussion.

Q: The same concerns that troubled investors in the fourth quarter of last year and that sparked a virtual bear market for equities are still present. Yet the stock market has rebounded strongly, and bond performance also has improved. How do you generally view the investment environment now?

Giroux: Last year was one of above-normal gross domestic product growth and abnormally strong earnings growth fueled by tax cuts and fiscal stimulus. We knew coming into 2019 that it would be a slower-growth year. Stock valuations became very attractive in December, but with the rebound, the market may be a little ahead of itself as valuations have moved above the long-term average. A higher valuation can be expected early in the economic cycle when earnings growth is usually above trend. But late in the cycle—when earnings growth is below trend and the odds of recession are greater—valuations should be lower.

The one thing that has changed is the Federal Reserve, which has reversed course on raising interest rates and maybe the pace at which it moderates its massive balance sheet.

Vaselkiv: I agree that the recent commentary from the Federal Reserve is an important change from the tone set



David Giroux

Chief Investment Officer of Equity and Multi-Asset and Head of Investment Strategy



Mark Vaselkiv

Chief Investment Officer of Fixed Income and Portfolio Manager, Global High Yield and High Income Strategies

31%

Percent of the U.S. stock market impacted by secular risk.

last year. The Fed is going to be more patient with raising rates and show more flexibility on drawing down its balance sheet, which grew to well over USD \$4 trillion during the period of quantitative easing. So, yield spreads across markets have narrowed over the past month or so, and current valuations are fair compared with historical averages.

However, there is dispersion globally because global credit cycles are increasingly unsynchronized. For example, China and Brazil are in the repair stage, the eurozone and Russia are in recovery, the United States and Canada are still in expansion, and the United Kingdom and Australia are in the downturn phase.

The best opportunity for long-term investors is to invest in the repair and recovery phases of the cycle. Conversely, there is danger in overweighting countries and regions during periods of expansion and at the cusp of potential downturn. Our emerging market strategy has capitalized on this trend in recent years, most recently in Brazil as new leadership there is undertaking structural reforms. At the same time, we are concerned with the U.S. being late in the credit cycle and Mexico being very tied to the U.S. economy.

One thing that hasn't changed is the overall strength of the U.S. consumer. That should provide a solid foundation for the U.S. economy for the foreseeable future.

Q: In terms of risks, one risk, which also poses an opportunity, is the significant disruption unfolding across the economy. David, you have studied what you call secular risk. How do you define that?

Giroux: This is a topic I have been dealing with for 20 years. Secular risk is the emergence of a new competitive force, technological advance, change in customer habit, or regulatory change that is structural and long term. It results in slower topline growth rates, margin depression, and/or compression in the valuation multiple. This is not cyclical or some temporary market share loss; it is

structural. We believe these disrupted companies' topline revenue growth, the earnings per share growth, and valuation multiple will be lower in the next 10 years than in the last 10 years.

Our analysis indicates that about 31% of the U.S. stock market is impacted by secular risk, and about 35% of the S&P 500 earnings are derived from companies facing secular risk. Two years ago, secular risk affected about 20% of the market and about 24% of S&P 500 earnings.

Q: What are examples of secular risk?

Giroux: Amazon is probably the biggest factor driving secular changes for other companies, particularly traditional retail, malls, and grocery stores, and with the emergence of AWS, its cloud-based platform, tech hardware has come under pressure as well. IBM had double-digit earnings growth for years, but earnings have been under pressure in recent years as IBM faces the secular threat of cloud-based services. Netflix has disrupted cable networks and cable systems like Viacom and Discovery, which had great business models that have now come under pressure. Technological advances in shale drilling have disrupted energy majors, offshore drillers like Exxon and Chevron, and energy service companies. Changes in consumer habits, such as preference for new brands and organic products, have pressured packaged food companies. A large part of the health care sector is facing secular pressure. Banks could face pressure on deposits in the future from alternative banks like Square or PayPal.

It's not impossible to overcome secular risk, but the odds are against most companies. When I joined T. Rowe Price in 1998, Apple was viewed as a dead company. Now it's the second largest company in the S&P 500 as it has been able to innovate its way out of secular risk. A couple of years ago under prior management, Microsoft was considered a secular loser. But a new management team has transitioned that company to a secular winner with a strong number two

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— David Giroux

Chief Investment Officer of Equity and Multi-Asset and Head of Investment Strategy

position in cloud computing, competing with Amazon.

Vaselkiv: Secular risk also impacts fixed income markets. Many value-oriented companies have taken on more debt on their balance sheet, so that amplifies the secular risk some of them face. We look to invest in companies on the right side of change. Netflix is one of our favorite high yield companies. It has USD \$2 billion in operating cash flow and is now moving outside the United States to develop specific content around the world.

Q: What industries are insulated from secular risk or might even benefit from it?

Giroux: Utilities are one of the few beneficiaries, with the growth of renewables like solar and wind helping drive faster rate-based growth while lowering customers' bills. Industrials, including defense, are less exposed unless Amazon or Google or Netflix start developing aircraft engines and jet fighter planes. Parts of business and information services so far have been immune to secular risk. The 70% of the companies that are not threatened by secular risk should see their valuation multiples rise over time.

Q: What are the implications of secular risk for markets and investors?

Giroux: The number of attractive industries is shrinking, so navigating secular risk is critical to investment success. Relying on traditional mean reversion for companies is more difficult than in the past, particularly for value investors. A company that encountered difficulties in the past due to a market share loss or cyclical downturn might turn around with new management or by buying back stock, driving mean reversion. But that becomes more difficult if they are secularly challenged companies. It's hard to paint a picture of how companies like Viacom, Discovery, or General Mills innovate their way out of secular challenges. Even a successful company that is not exposed to secular risk or disruption but hits an air pocket can suffer

severe multiple compression if the market perceives its problems as a secular risk.

It's important to identify companies that are secularly challenged because earnings may decline while their valuation multiples compress dramatically. So the emergence of secular risk creates a powerful tailwind for active investing and poses a significant challenge for passive investing over the next five to 10 years. It also highlights the importance of long-term investing on a three- to five-year time horizon. T. Rowe Price managers try to manage that risk by having a lower exposure to or being structurally underweight secularly challenged companies.

Q: Aside from companies facing secular risk, what concerns you in the fixed income markets?

Vaselkiv: The major risk in the market for below investment-grade companies is the lack of liquidity. When the Fed moderated its position on rate increases toward the end of last year, we saw massive outflows in the bank loan market that essentially wiped out nearly all the gains for last year. The high yield bond market also suffered huge outflows toward year-end. Keep in mind that since the global financial crisis a decade ago, corporate debt in America has grown to over USD \$75 trillion, and the ability of major Wall Street broker-dealers to trade has significantly diminished because of regulatory changes.

Declining liquidity will amplify the uncertainty and volatility in fixed income markets. But there are good opportunities for credit around the world, and broad diversification with a global strategy should reduce the risk of some of the more troubled regions.

We also use the liquidity issue to our advantage. We like to say that there are two kinds of investors in credit markets: permanent residents and tourists. There have been a lot of tourists in the high yield bond market. When yield spreads widened in December as the tourists fled, we were able to take advantage of that for clients with a longer-term view.

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