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PRICE POINT

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Multi-Asset Strategies

FULL VALUATIONS SUGGEST CAUTIOUS APPROACH TO PORTFOLIO RISK

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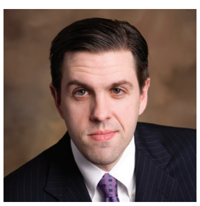

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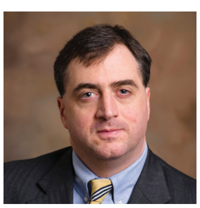

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KEY POINTS

- Broadening global economic growth should be supportive for corporate profits in 2018, but our equity positioning is tempered by extended valuations.
- Bonds also appear expensive, but can serve an important role as diversifiers should we face increasing headwinds from geopolitical events or if growth disappoints.
- Sovereign yields in developed markets are low. Valuations for U.S. investment grade (IG) bonds as well as high yield credit appear historically expensive.
- Most emerging economies are in better fiscal positions than prior to the 2013 Fed taper tantrum. However, emerging markets (EM) bond valuations have become less compelling.

While a broadening global economic recovery should continue to support risk assets in 2018, relatively high equity valuations and tight credit spreads in many major markets provide relatively little valuation support against unexpected market events, in our view. In this environment, bonds offer beneficial attributes within a portfolio as a counter to potential periods of heightened equity market volatility.

Given elevated valuations, we believe that equity returns in the coming year will be primarily driven by earnings growth. If global economic and earnings growth exceeds current expectations, we should expect positive returns in both developed and emerging equity markets. Supportive factors include the potential for major U.S. tax cuts to generate further earnings upside or for growth in Europe and Japan to be driven more by durable domestic recoveries than by stimulative monetary policies. Potential risks include a rise in geopolitical or trade tensions or a central bank policy misstep as interest rates and inflation both appear poised to rise from current low levels.

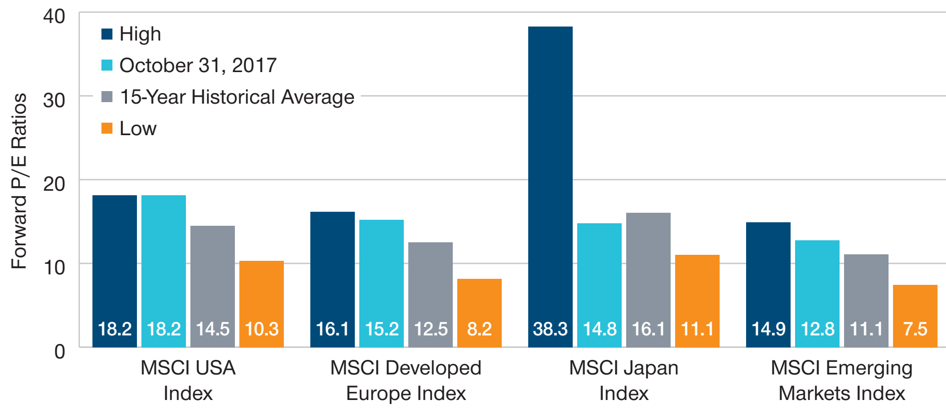
Our relative preference for bonds does not imply a bullish outlook for global fixed income assets. We expect that low yields, tight spreads, and less accommodative policy from the Federal Reserve and the European Central Bank (ECB) will leave little room for upside in any fixed income category. However, given current equity valuations, we are focused on the role that bonds historically have played in dampening total portfolio volatility.

Our multi-asset portfolios are designed to benefit from broad diversification across asset classes and sub-asset classes. We characteristically overweight or underweight segments of the market that we believe are more or less attractive over a 6- to 18-month investment horizon, taking into consideration a variety of factors, including valuations as well as economic and earnings trends.

Given elevated valuations, we believe that equity returns in the coming year will be primarily driven by earnings growth.

FIGURE 1: **Equity Valuations in Most Major Markets Are Trending Above Historical Averages**

Forward One-Year Price/Earnings Ratios, December 2001 Through October 2017



Sources: FactSet and T. Rowe Price.

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GLOBAL EQUITIES

Among developed equity markets, Europe and Japan appear more attractive than the U.S. based on improving economic fundamentals, diminished political risk, and potential upside for corporate earnings. Valuations are also modestly cheaper in Europe compared with the U.S. (Figure 1).

- The recent uptrend in European earnings appears sustainable, as profit margins and earnings in the region both tend to benefit from global trade linkages. Conditions for banks and other financial companies in the peripheral euro countries are improving.
- Japan features the most attractive valuations among the major developed markets, as well as supportive monetary policy, and high exposure to global trade. Corporate governance and shareholder returns also are improving, although gradually.
- In the U.S., earnings trends are positive, but expectations are elevated, leaving limited room for upside surprises. Valuations are above historical averages. A weaker U.S. dollar has been a tailwind for U.S.-based multinationals, but could be less supportive going forward.

Our outlook for EM equities has become somewhat more balanced. Earnings growth has improved and the near-term threat of a more protectionist approach to trade policy has diminished. While EM valuations are modestly above historical averages, they appear less expensive compared with developed markets. However, the potential for renewed declines in energy and other commodity prices is a downside risk.

GROWTH AND VALUE

In the U.S. market, valuations for growth stocks appear less attractive after their strong performance in 2017, and are more in line with historical averages relative to value stocks. The potential for tax cuts and deregulation may support cyclical value sectors, particularly financials. Although we expect that large technology and consumer discretionary stocks, which led the market in 2017, will continue to benefit from strong secular growth opportunities, we have lowered our allocation to growth stocks given the concentration risk reflected in this narrow market leadership.

In markets outside the U.S., we have increased our overweight to value relative to growth based on valuations, the outlook for sustained economic growth, and the potential for higher interest rates to benefit certain cyclical areas, such as European banks. Valuations in many growth sectors outside the U.S., including consumer staples, are above their historical averages.

LARGE-CAP AND SMALL-CAP

Following a period of small-cap underperformance in 2017, valuations versus U.S. large-caps are more in line with historical averages, although still relatively high in absolute terms. Corporate tax cuts and stronger U.S. economic growth are potential upside catalysts that could disproportionately favor small-cap companies given their higher marginal tax rates and greater exposure to domestic demand. Potential U.S. dollar strength would be more challenging for U.S. large-cap, multinational companies. However, small caps could underperform if volatility rises from current low levels.

Small-cap stocks in Europe and Japan also appear relatively more attractive compared with the U.S., as they offer higher leverage to domestic economies that are in earlier stages of recovery, with the additional benefit of central bank policies that are still accommodative.

REAL ASSET EQUITIES

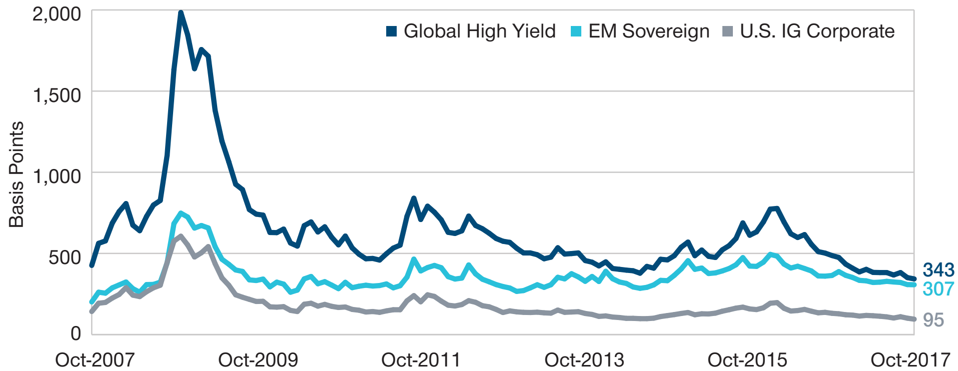
Real asset equities have historically outperformed the broad market in periods of high or rising inflation, particularly unexpected upturns in inflation rates. Consequently, the sector serves an inflation-hedging role in our portfolios. However, while inflation may rise from current low levels, we remain underweight to real asset equities, as we do not anticipate a significant acceleration in inflation in 2018.

We continue to be cautious about natural resource stocks, as global energy prices are still challenged by persistent production increases and falling costs among U.S. shale producers. Similarly, we expect that demand for industrial metals will be subdued as investment and growth in China continues to shift from basic manufacturing toward consumer-oriented and service industries.

While an upturn in economic growth in 2018 potentially would benefit real estate stocks, U.S. real estate appears to be in the late stages of the economic cycle as fundamentals are decelerating along with the prospects for rising interest rates.

FIGURE 2: **Fixed Income Spreads Have Narrowed to Some of Their Tightest Levels Since Before the Global Financial Crisis**

Option-Adjusted Spreads Over U.S. Treasuries, Through October 31, 2017



Sources: Bloomberg Barclays, BofA Merrill Lynch, and JP Morgan.
U.S. IG Corporate = the Bloomberg Barclays U.S. Investment Grade Index; Global High Yield = the BofA Merrill Lynch Global High Yield Index; EM IG Sovereign = the JP Morgan Emerging Markets Bond Index (EMBI) Global Investment Grade.

FIXED INCOME

Sovereign yields in the developed bond markets are extremely low, held down by continued quantitative easing from the ECB, the Bank of Japan (BoJ), and, until recently, the Bank of England. EM and high yield bonds potentially offer more attractive yields as well as lower duration, but credit spreads are tight relative to history (Figure 2).

In developed markets, we currently favor IG bonds in the U.S. over other regions due to more attractive valuations, shorter duration, and the potential for a period of U.S. dollar strength after the relative weakness seen in 2017, which would weigh on non-U.S. dollar bond returns.

- U.S. Treasury yields appear relatively more attractive than the other developed sovereign markets, and we believe the Federal Reserve is likely to tighten policy at a modest pace.

- Bond prices in Europe could be at risk in 2018 as the ECB tapers its quantitative easing purchases. While the euro may face near-term headwinds as rising rates support the U.S. dollar, we believe that intermediate-term fundamentals favor the euro.

- In Japan, long-term bond yields are weighed down by slow wage growth, low inflation, and demographic challenges. With the yield curve anchored by the BoJ, foreign exchange moves in the yen are likely to be driven by the actions of other major central banks, as well as possible flight-to-safety effects.

HIGH YIELD BONDS AND BANK LOANS

High yield credits appear less attractive relative to U.S. IG bonds as valuations are high versus historical averages following a period of strong sector performance. Although economic conditions are supportive and default rates are low, we see less opportunity for further appreciation at current yield levels.

Renewed declines in energy prices are a potential downside risk for high yield, as the energy sector carries a heavier weight in the high yield universe relative to IG corporates. In addition, bond covenants that protect investors have generally been weaker on new issuance. Current yields provide only a limited buffer against capital loss if the credit environment grows more challenging.

EMERGING MARKET BONDS

We are neutral on the attractiveness of EM bonds relative to U.S. IG, as valuations in many emerging markets are less compelling following strong performance in 2017.

Yields on EM U.S. dollar sovereign bonds appear especially low, and may face headwinds from less accommodative monetary policy by major central banks in the developed markets. EM local currency yields are also less compelling following the 2017 rally, but we believe there are opportunities for active managers to add excess return and alpha as select currencies remain cheap and several EM central banks are still easing interest rates in a low-inflation environment.

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