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Global Market Volatility **WHAT'S BEHIND THE RECENT MARKET SELL-OFF?**

KEY POINTS

- Concerns about rising interest rates, trade, elevated valuations, and slowing growth have driven major global stock indexes downward.
- A key driver of the recent declines is that expectations have been growing that the U.S. Federal Reserve will continue raising short-term interest rates, while ongoing tensions between the U.S. and China over trade are causing considerable unrest in markets.
- Despite the downturn and the pickup in volatility, the backdrop for world equity markets remains generally favorable.

Concerns about rising interest rates, trade conflicts, elevated valuations, and slowing growth have driven down major global stock indexes. It is not yet clear how long or deep the sell-off will prove to be—indeed, markets are currently staging something of a recovery. Yet, investors are wondering what's driving the volatility and if it portends a more challenging period ahead.

“Some of the tailwinds that have thrust U.S. equity markets to record highs in 2018 could become headwinds over the next year or so,” recently commented Jeff Rottinghaus, a U.S. large-cap portfolio manager. “While the environment should remain supportive for investing, it could become more challenging.”

Despite the downturn and the pickup in volatility, the backdrop for world equity markets remains generally favorable. U.S. economic and corporate profit growth have been very strong in 2018, but some valuations are elevated, and slower growth is likely as interest rates rise and the impact of recent tax cuts fades.

Interest rates and inflation are still very low in Japan and many developed European countries, where equity valuations are attractive and corporate earnings growth is likely to continue. Although emerging markets have significantly underperformed this year, their fundamental valuations are attractive relative to the U.S. and most developed markets.

RATE HIKES, INFLATION CONCERNS

A key driver of the recent declines is that expectations have been growing that the U.S. Federal Reserve will continue raising short-term interest rates, which has led to a spike in bond yields. The fact that the Fed is also in the process of reducing its balance sheet as it winds down its quantitative easing program is also pushing yields higher, as is the U.S. government's ongoing large-scale issuance of Treasury securities to finance its budget deficit.

Expectations of continued Fed rate hikes have been growing because of the strong

performance of the U.S. economy, jobs growth, and accelerating wages, which are fueling concerns about inflation, even as current inflation signals remain tame. Higher import prices due to U.S. tariffs could also put upward pressure on prices.

Rising inflation increases the likelihood that the Fed will increase short-term interest rates to prevent the economy from overheating. Higher short-term rates translate into higher borrowing costs, which can dissuade consumers and businesses from making purchases and investments, weighing on companies' profit margins and potentially slowing the economy.

At present, the Fed is projecting that it will raise rates once more in 2018 and three times in 2019. T. Rowe Price Chief U.S. Economist Alan Levenson currently believes that the Fed will be a bit more aggressive, raising rates again in December and once per quarter through next year.

"I think market psychology is important now—the expectation over the last decade has been that the Fed will come to help, but the risk is that it cannot and will not help stabilize the markets anytime soon," says Quentin Fitzsimmons, portfolio manager and member of the fixed income global investment team. "In this sense, the markets will be very sensitive to short-term data developments."

TRADE TENSIONS NOT ABATING

The ongoing tensions between the U.S. and China over trade are causing considerable unrest in markets. The two countries have been implementing—and threatening to broaden—tariffs on a wide variety of imports from each other, and there is no indication that tensions will soon ease.

Over decades, large U.S. companies, particularly manufacturers, have developed extensive global supply chains, relying on worldwide sources

of lower-cost production. Higher component costs due to tariffs could bring higher inflation over the long term, says Peter Bates, manager of a global industrials strategy. "But companies would eventually learn how to maximize their returns under the new rules."

Larry Puglia, U.S. large-cap core growth portfolio manager, is encouraged by the agreements in progress with the European Union and Mexico and Canada. "Pursuing fairer trade terms is desirable but entails certain risks," he says. "It would be premature to make investment decisions that assume successful resolution of these issues. We're doing the math to determine what's at stake."

INFLATED VALUATIONS MAKE COMPANIES VULNERABLE

U.S. stocks, particularly large-cap and growth stocks, have been trading at elevated levels. Given that equity markets have been rising for almost 10 years (after bottoming in March 2009) and that economic and corporate earnings growth have also been strong for a long period, these high valuations may reflect a view that current favorable fundamentals will remain for the foreseeable future. If this is the case, markets could be vulnerable to any developments that imply a weaker economic outlook.

Recent declines in the so-called FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google), which have led the U.S. stock market for some time, may have contributed to the wider sell off. Other high performers, such as car-maker Tesla and Chinese companies Alibaba and Tencent Holdings, have also seen their shares retreat from their best levels. While many of these stocks seem to have favorable fundamentals, it would not be unusual for them to experience a period of weaker performance.

"The market's pullback is being generally driven by the technology sector and

Internet companies," explains Don Peters, Diversified Mid-Cap Growth and Tax-Efficient Equity portfolio manager. "Frankly, I'm surprised that it has taken so long for the highest-growth, highest-momentum names that have led the market for quite some time to experience a correction."

European equity valuations are modestly attractive compared with the U.S., while UK equities are trading at a discount to most global equity markets, probably due to ongoing uncertainty over Brexit. In Asian and Pacific developed markets, valuations are generally attractive compared with the U.S., but earnings remain vulnerable to any slowdown in global trade. Japanese equities, in particular, are supported by strong relative valuations, positive earnings growth, and gradually improving corporate governance.

Equity valuations in emerging markets are more attractive than those of developed markets as equities have sold off on the back of trade concerns and currency weakness and have significantly underperformed as a result. In the six-month period ended September 30, 2018, the MSCI Emerging Markets Index trailed the S&P 500 Index by about 20 percentage points in dollar terms (-8.73% for the MSCI Emerging Markets Index versus 11.41% for the S&P 500 Index).

GLOBAL GROWTH FIRM—FOR NOW

Recent U.S. economic growth has been strong. Fiscal spending, tax reform, and deregulation are driving the current period of accelerating growth, but late-cycle stimulus, such as from last year's tax cuts, may result in the economy "overheating," or growing at an unsustainably fast pace.

"The U.S. economy, buoyed by tax reform and deregulation policies, is strong," says Rottinghaus. "Manufacturing has reached new highs, leading indicators are positive, consumer confidence is

favorable, and small business optimism is at an all-time high. However, we are in the later stages of this economic cycle with less accommodative monetary policies, higher interest rates, and inflation and labor costs rising amid tighter labor markets.”

Growth in developed Europe is slowing but remains relatively stable. However, sentiment indicators are at their lowest levels in about nine months. In the UK, economic growth appears healthy, with low unemployment, reasonable wage growth, and limited degrees of slack.

Trade-driven economies in the Asia-Pacific region are healthy but slowing as global growth continues to moderate. Japanese economic activity has surprised to the upside but may face a soft patch due to recent natural disasters. Australia’s economic activity continues to soften, with the housing market a particular concern.

In emerging markets, economic momentum in China is fading, but policymakers will likely continue to respond with accommodative measures. Growth is expected to slow in other emerging countries, where interest rates are trending upward and central banks are tightening monetary policies. Countries that are major importers of oil, such as Turkey and India, are also being hurt by higher oil prices—the price of a barrel of global benchmark Brent crude recently above USD \$80, a four-year high.

WHAT HAPPENS NOW?

Although downturns are always disconcerting, occasional periods of turbulence are to be expected. It should be noted that despite the sell-off and the pickup in volatility, the backdrop for world equity markets remains generally favorable.

It is impossible to predict with certainty whether the sell-off will prove to be

a temporary dip or something more serious. What’s more, timing the market is notoriously difficult, even for investment professionals. A failed attempt to time the market can hurt long-term investment performance in two different ways: first, by selling assets when they have lost some value and going to cash, effectively locking in those losses; and second, by missing out on at least some of the gains when the market bottoms and starts to rebound.

“While the economic and capital market environment is more favorable than it’s been for some time, investors should not reasonably expect the market’s robust returns to continue indefinitely,” Peters says. “Given the strong performance we’ve had in the last few years, it would not be surprising to see lower stock market returns in the years ahead. That said, equities are still the best choice for investors seeking long-term capital growth.”

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