T.RowePrice®
INVEST WITH CONFIDENCE

PRICE POINT

May 2018

Timely intelligence and analysis for our clients.

Ernest Yeung
Portfolio Manager, Emerging Markets Value Stock Fund

Emerging Market Equities

FINDING "UNLOVED" VALUE IN EMERGING MARKETS

KEY POINTS

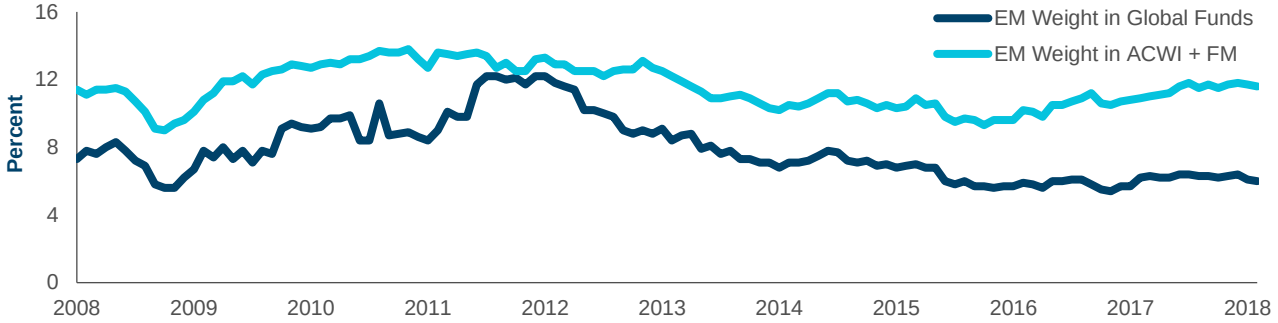
- Within global equity portfolios, an interesting dichotomy is currently observable, namely that while investors are generally fully allocated to global equities, they remain notably underallocated to emerging markets.
- This is a direct reflection of the strong performance of developed markets in recent years, particularly U.S. equities. However, few would disagree that U.S. equities, having performed so well, are now looking fully valued, even expensive, compared with history.
- In contrast, having experienced a trough in late 2015/early 2016, we are roughly only 24 months into the cycle in emerging markets. As a result, valuations remain historically undemanding.
- Also, the rally in emerging market equities over the past two years has been largely concentrated in a select group of "new economy" stocks, mainly within the technology/Internet and health care areas, as well as Chinese A-share companies.
- Today we think there is real opportunity to be found in looking more closely at some of the forgotten "old economy" stocks—names that have fallen out of favor with most investors, yet have catalysts that could drive their valuations higher over time.
- A number of state-owned enterprises, for example, offer good value potential, in our view. Financial stocks are another rich vein of unloved opportunity, as are building materials/construction companies, given activity in most emerging market countries remains at historically low levels.

Within global equity portfolios, an interesting dichotomy is currently apparent, namely that while investors are generally fully allocated to global equities, they remain notably underallocated to emerging markets. In fact, the current exposure to emerging markets within global equity portfolios is at the lowest levels seen in recent history (Figure 1).

This is perhaps not difficult to understand, given the strong returns generated by developed markets (DM) in recent years, particularly U.S. equities. However, having performed so well, it is also true that U.S. equities are now looking fully valued compared with history. In contrast, emerging market (EM) equities are still in the early stages of the market cycle, with valuations looking reasonable and even cheap in certain sectors.

Figure 1: **Emerging Markets Weighting Lowest in Recent History**

As of March 31, 2018



Sources: MSCI, EPFR Global, and HSBC calculations.
MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

DM VS. EM—LATE VS. EARLY MARKET CYCLE

Certainly, most U.S. and global investors would agree that they have done very well in recent years from being fully allocated to U.S. equities. Most would also agree that the current high level of U.S. valuations is an increasing point of concern. In contrast, EM equities experienced a trough in late 2015/early 2016, so we are roughly only two years into the market cycle in emerging markets. As a result, valuations remain generally reasonable both compared with history and relative to developed markets. At the same time, the rally in EM equities over the past two years has been largely concentrated in a select group of new economy* stocks, mainly within the technology/Internet and health care areas, as well as Chinese A-share companies. “Old economy”** stocks, however, have fallen out of favor with investors and so have lagged the rally in emerging markets over the past two years. As such, valuations of EM old economy companies currently appear cheap relative to history.

OLD ECONOMY COMPANIES HAVE LAGGED THE EM RALLY

Today we believe that there is real opportunity to be found in looking more closely at some of these forgotten old economy stocks, many of which fall into the EM value space. However, simply being cheap is not reason enough for us to invest in a company. We are looking for those forgotten or out-of-favor companies, but which also have solid potential for rerating, or an expansion in valuations. Every company that we invest in must have one or more catalysts for change that we believe can unlock value in the near term. These might include a change in management, an improving economy, or any business-specific event that can drive the stock price back to fair value. We look to buy in at deeply discounted valuations, opening up the potential for outsized gains as sentiment subsequently turns positive.

THE RETURN OF CAPEX AND SUBSEQUENT “VIRTUOUS CYCLE”

Certainly, evidence of stronger management discipline is one factor underpinning our positive outlook for EM equities generally. Companies in emerging markets are generating substantially more free cash flow compared with previous years as management teams have begun paying more attention to spending and other capital

*New economy: consumer services, auto, Internet, tech hardware, pharma, consumer durable, health care, and semiconductors.

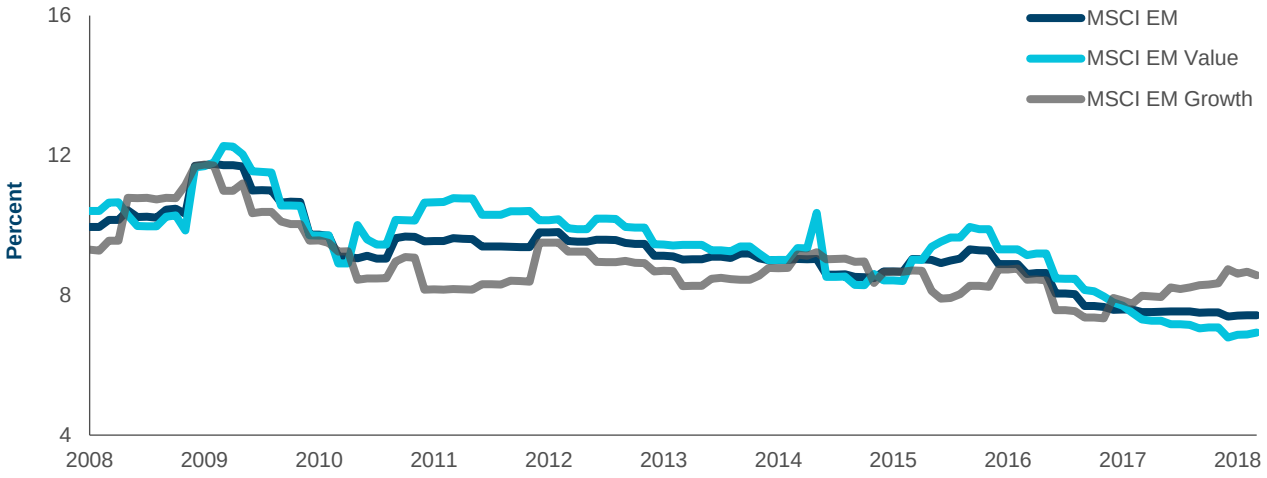
**Old economy: real estate, construction materials, coal, metals and mining, insurance, household and personal products, transport, utilities, conglomerates, banks, machinery, food, beverage and tobacco, chemicals, electrical equipment, diversified finance, construction and engineering, telecoms, and oil and gas.

allocation decisions. Profit margins have improved as a result, giving us confidence that EM companies are positioned to help deliver better earnings growth and shareholder returns.

Significantly, capital spending as a percentage of sales for EM companies has dropped to the lowest level in at least a decade (Figure 2). We believe that a resumption of capital spending after many lean years could spur job creation, loan growth, and wage increases for some countries and sectors in the developing world. This anticipated capital spending recovery—and the likelihood that it will produce a "virtuous cycle"—could be a powerful trend with the potential to drive valuations higher for many companies we own. In 2017, we have already seen a return of capital spending among new economy companies. We believe that old economy companies will soon follow suit and start to increase their capex as 2018 progresses.

Figure 2: EM Capital Spending at Lowest Levels in More Than a Decade

As of March 31, 2018



Source: FactSet Research Systems Inc. All rights reserved.
MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

Given this expectation of increased spending, one area that we like currently is financials. Banks, for example, stand to benefit considerably from an expected upturn in borrowing/loan growth. A number of EM economies have undergone painful adjustments in recent years, but we believe that the worst of the bad loans/bad credit cycle is now behind us. Meanwhile, analysis shows that the financials sector is currently one of the most meaningful underweight sector positions within EM investor portfolios. As a result, valuations are well below long-term average levels.

Within the EM value equity portfolio, we own select South African financials, including Nedbank, the country's fourth-largest lender, and financial services company Barclays Africa. We bought these companies in early 2017 when most investors shunned South Africa reflecting our contrarian approach, focusing on forgotten companies with underappreciated potential. Both companies' balance sheets are strong, both have made significant efforts to clean up bad debts, and both have paid an attractive dividend. The companies are leveraged to the macro recovery cycle in South Africa as well as have good exposure within continental Africa, a neglected part of the world by investors, but a region where we see good signs of recovery.

THE MUCH MALIGNED STATE-OWNED ENTERPRISES

Certainly, many of the state-owned enterprises (SOEs) in EM countries also represent good opportunities, in our view. Generally speaking, global investors have a very negative view of these businesses. However, analysis of

historical data suggests that the difference in overall returns, leverage levels, and payout ratios, between SOEs and non-SOEs, is not especially significant. This suggests that the overtly negative sentiment toward SOEs is perhaps colored by a small group of bad companies. Perhaps this disconnect also comes down to the fact that investors generally seem to believe that most SOEs are concentrated in China and Russia, a number of which are indeed poor-quality companies. However, the reality is that SOEs exist in all EM countries, and it is certainly possible to uncover a number of good-quality, but unloved, SOEs trading at cheap valuations.

In Russia, for example, Sberbank is owned by the Russian central bank and is widely regarded as one of the highest-quality banks in the EM universe. The company has fallen out of favor with investors as several rounds of U.S. sanctions have weighed on Russia's headline gross domestic product (GDP) growth. However, domestic economic activity is stable, and Russian companies are paying healthier dividend yields thanks to a newfound focus on minority shareholders. In terms of the quality of the business and standards of governance, it is every bit as well run and progressive as any privately run business. Brazil's state-owned oil giant Petrobras is another example. Back in 2014, Petrobras became embroiled in a major corruption scandal, as the former government used the business to syphon money from the corporate sector to use for its own political means. However, following the dismissal of the former president, the replacement interim government has implemented wide-ranging reforms in the business in recent years, transforming it into a better-run, more efficient, and more accountable company. After a decade of consistently negative cash generation, Petrobras has generated positive free cash flows each year since 2015, irrespective of the movement in oil prices.

Meanwhile, it is perhaps among the Chinese SOEs that we are seeing the greatest change. Not only has Beijing cut excess industrial output, boosting profits for many SOEs, but significant efforts are also being made to become more shareholder friendly, something that the majority of investors still do not seem to be aware of. Over recent years, for example, we have seen an increasing number of large SOEs paying out special dividends, something very rarely seen in the past. Significantly, a number of Chinese SOEs are also reintroducing stock option incentive programs for management, having largely removed such incentives in 2009, and this is a positive moving forward.

In contrast, EM equities experienced a trough in late 2015/early 2016, so we are roughly only two years into the market cycle in emerging markets. As a result, valuations remain generally reasonable both compared with history and relative to developed markets.

LEVERAGED TO A RECOVERY IN REAL ECONOMIES

Given the economically sensitive nature of most value sector companies, a sustained recovery is often necessary to spark a turnaround in their prospects. While EM equities have performed strongly in the past two years, for example, we have not seen a similar major recovery in the real economy of many EM countries. For example, Russia and Brazil experienced a deep recession in 2015 and 2016, and growth in both countries has remained in low single digits in recent years. Accordingly, building and construction activity in these countries, as well as in India and South Africa, remains very low versus history. Even among the Association of Southeast Asian Nations (ASEAN), considered the higher-growth economies of Asia, construction remains depressed. Pre-sale volume of houses, for example, has declined for the past four years in the ASEAN countries. We expect this situation to soon start to reverse, and those areas leveraged to the recovery in these economies—and unloved by the wider investment community—offer exciting opportunities, in our view. Accordingly, we currently own Posco Steel in Korea, Anhui Conch Cement in China, and Lafarge Holcim, the largest cement company in the world, which is listed in Switzerland but does most of its business in emerging markets.

We have indeed been through a very slow period of growth in EMs between 2010 and 2015, during which the overall level of GDP growth in EMs underperformed that of developed markets. However, we feel the structural growth potential of EMs is likely to accelerate moving forward, reverting to the mean rate of growth. Hence, we believe that EM growth is likely to outperform DM growth over the longer term. Meanwhile, we believe that emerging markets' improved macro conditions, better corporate fundamentals, and constructive valuations are likely to support the potential for outperformance in 2018. EMs remain a fertile hunting ground for "forgotten" value opportunities, particularly as many investors continue to focus on quality-growth names and neglect the many misunderstood and undervalued companies in the EM space. Moreover, information asymmetry in EMs provides active investors with a heightened opportunity to identify valuation anomalies. We remain steadfast in our focus on stocks cast aside by mainstream investors, but where we believe there is good potential for a rerating.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

Important Information

Call 1-800-225-5132 to request a prospectus, which includes investment objectives, risks, fees, expenses, and other information you should read and consider carefully before investing.

Because of its concentration in rapidly developing economies, the fund involves a high degree of risk. Share prices are subject to market risk, as well as risks associated with unfavorable currency exchange rates and political or economic uncertainty abroad.

The companies mentioned comprised the fund as of 3/31/18 as follows: Nedbank 2.42%, Barclays Africa 2.31%, Posco Steel 2.11%, Sberbank 1.80%, Anhui Conch Cement 1.76%, Petrobras 1.23%, Lafarge Holcim 1.12%.

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action.

The views contained herein are those of the authors as of May 2018 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

FactSet—Copyright © 2018 FactSet Research Systems Inc. All rights reserved.

This information is not intended to reflect a current or past recommendation, investment advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Investors will need to consider their own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance cannot guarantee future results. All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc., Distributor.

T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc. © 2018 T. Rowe Price. All rights reserved.

ID0001531
201805-504536