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CRISIS OR NO CRISIS?

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Recent weakness within equity markets has focused investors on whether the aging bull can keep staring down an "end of cycle" bear case—a valid question given the shifts in sentiment we are currently seeing. Our view is that we have now passed "peak growth" in economic and earnings terms and the next few quarters will see a fade from recent highs. While naturally uncomfortable for investors, this fade is somewhat inevitable given the intense period of Chinese and, more recently, U.S. stimulus that is now rolling off.

REGIME CHANGE—DIFFICULT FOR INVESTORS

While equity valuations are reasonable and earnings growth is likely to be positive in the near term, this deceleration at the macro level is significant given that investors typically dislike regime change. The deceleration is marking a shift in regime, moving away from the stimulus-driven period that has benefited investors so much. As expectations adjust, this naturally creates uncertainty and volatility but also a refreshed ability to acquire stocks that are misunderstood.

While the latter stage of this equity cycle has been defined by an unusual calm and high returns, our own global economic framework has not changed significantly from more uncertain and volatile times. We have long maintained a belief that we are living in an era defined by:

- Low Dollar GDP growth,
- Excess debt,
- Excess oil, and
- Low inflation driven by technology and automation.

The consequences of this framework are very broad and cut across politics, economics, and corporate earnings power. We call the environment "deflationary progress," and its structural foundations are strong and lasting.

Importantly, a world of relatively low growth and inflation does not imply a world absent of positive change, progress, or opportunity. If anything, it implies a broad dispersion of stock returns and a need to position portfolios actively on the right side of change, as it evolves.

Deflationary progress does create challenges, however, and these include populism stemming from anemic wage growth as well as markedly different market patterns versus previous cycles. A forward-looking approach is essential in such a world of secular change.

Figure 1: **What Does Deflationary Progress Imply for Investors?**

Source: T. Rowe Price.

SHIFTING GEARS

Within this economic framework, our outlook is that we remain in a CRIC cycle, a cycle defined by ongoing bouts of Crisis, Response, Improvement, Complacency. The world is now moving out of stimulus-driven Complacency and into the Crisis and Response phases.

As we look out, we are focused on three policy responses that will shape the path and slope of growth into 2019–2020. These are:

- China's domestic economic stimulus response,
- The U.S. Federal Reserve slowing the pace of interest rate rises, especially if oil prices continue to weaken as we expect, and
- Some resolution of the U.S.-China trade dispute.

We believe enough policy response tools exist to shepherd the global economy back toward the "new normal" environment (i.e., a low growth, low return world) being reestablished, although the highly unusual political environment is certainly adding to the complexity underlying this opinion. However, our base case remains that politicians will avoid the worst scenarios of economic self-harm when rhetoric ultimately meets reality and defines policy.

OUR APPROACH

So what are the consequences as we manage the Global Stock Fund?

- Complacency peaked earlier in 2018 and that volatility will be an integral part of equity markets as we move through the next stage of the cycle.
- Do not fear the next stage of the cycle; instead, intensify your search for high-quality companies where you can imagine better corporate fundamentals over the next 12–24 months.

- We remain of a view that the prospect of a broad break out of inflation to the upside is unlikely and that inflation will peak in the next six to nine months. (Technology, demographics, and globalization have subdued inflation over the past decade.)

- Find companies that are beneficiaries of fading growth and inflation expectations, coupled with an idiosyncratic insight about positive change.

In terms of risk management:

- Avoid challenged companies even if valuations look "reasonable," because average/reasonable or even below-average valuations do not protect capital in harder times. Extreme valuations are powerful to future returns, however.

- Acknowledge the reemergence of populist policy and rhetoric, which is inherently uncertain in outcome but important to sentiment at the single stock and aggregate level.

- Stick to our philosophy that embeds the search for improving fundamental returns at the stock level, in part to defend our portfolio against deceleration; we firmly believe that stock-specific insights can be defensive.

- A focused portfolio is important in times of volatility, but any concentration of risk factors is equally important to manage. A strong portfolio construction discipline remains key.

On this basis, we have been defending our favored stock positions amid the volatility, trimming pockets on strength through earnings season, and making sure we are looking around corners for potential portfolio risks.

While economic growth is fading, this remains an environment of change, progress, and opportunity. Importantly, it is still an environment that we can work with as stock pickers searching for fundamental improvement, wherever it may exist.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

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