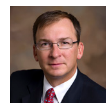
Global Growth Should Improve if Trade Disputes Don’t Worsen

Falling bond yields signal a sea change in monetary expectations.

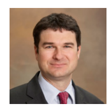
June 2019

KEY INSIGHTS

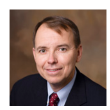
- While challenges to global economic expansion are evident in slower earnings growth, the risk of a recession in major markets appears limited.
- Widening trade disputes and populist politics have created notable downside risks, which could endanger hopes for an earnings reacceleration in late 2019.
- Monetary expectations have shifted dramatically since the beginning of the year, with the Federal Reserve now seen as likely to cut interest rates.
- Secular disruption continues to favor growth and the technology sector, but investors are becoming more cautious and some established firms are fighting back.



Robert W. Sharps
CIO and Head of Investments



Justin Thomson
CIO, Equity



Mark Vaselkiv
CIO, Fixed Income

Heading into the second half of 2019, senior T. Rowe Price investment leaders remain cautiously positive about global economies and financial markets, but they warn that political risks—in particular, escalating trade disputes—could trigger renewed volatility and further impede growth.

To a certain extent, market behavior in the first half of 2019 seemed to reflect two contradictory perceptions, argues Robert W. Sharps, chief investment officer (CIO) and head of investments:

- Falling bond yields and an inverted U.S. Treasury yield curve—a situation in which longer-term yields move below short-term interest rates—appeared to signal growing economic pessimism.
- On the other hand, the relatively strong equity gains seen in the U.S. and many emerging markets in the early months of 2019 seemed to suggest hopes for an earnings reacceleration later in the year.

On the positive side, market expectations for monetary policy shifted dramatically in the first half. Investors now lean toward the view that the U.S. Federal Reserve is more likely to cut interest rates rather than raise them further, according to Mark Vaselkiv, CIO, fixed income.

On the negative side, hopes for a trade deal between the U.S. and China deteriorated in May, and the Trump administration briefly threatened to impose tariffs on Mexican goods. Trade fears contributed to persistent strength in the U.S. dollar, keeping emerging market (EM) currencies under pressure, notes Justin Thomson, CIO, equity.

> “To a certain extent, market behavior in the first half of 2019 seemed to reflect two contradictory perceptions...

"A lot depends on a resolution of the trade war and on the emergence of green shoots of improving global economic and earnings growth," Sharps says. "If we get those things, we could see the U.S. equity market make new highs. If not, expectations for 2020 clearly will need to come down."

Global Growth Has Slowed, but Recessions Are Unlikely

> If there is one thing that would make us change our generally cautious stance [on global growth], it would be if China increases stimulus again.
>
> — **Justin Thomson**
> *CIO, Equity*

Concerns about the strength of U.S. and global economic growth returned in the second quarter of 2019. The stellar U.S. earnings gains seen in 2018 abruptly stalled (Figure 1).

While the consensus earnings forecast is for a reacceleration later in the year, to get that result "you will have to see economies begin to improve, particularly outside the U.S.," Sharps says. However, the global economic outlook remains subdued, according to Thomson:

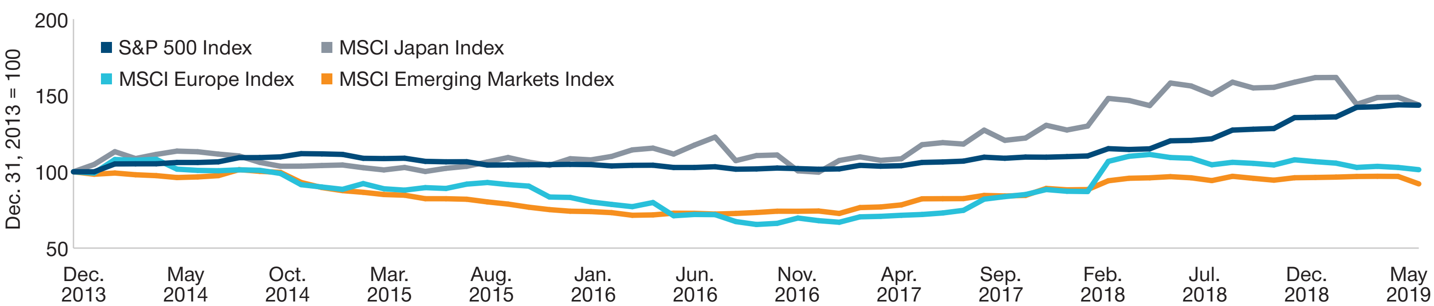
- Most developed economies are growing below their potential, and earnings momentum has turned negative in both Europe and Japan.
- In the emerging markets, the strong U.S. dollar effectively is a form of monetary tightening—unwelcome in economies still in the early stages of recovery.
- The trade war is having a corrosive effect on business confidence and capital spending, particularly in export-heavy economies such as Germany, Japan, Korea, and Taiwan.

Despite these headwinds, the risks of a U.S. or global economic downturn still appear limited. "I don't see any major imbalances that would suggest a recession is imminent or even likely," Sharps says.

The strength of the Chinese economy remains a key variable. Slow growth in late 2018 led Beijing to ease credit and boost spending, but the results may not have been as positive as Chinese policymakers desired. "If there is one thing that would make us change our generally cautious stance [on global growth], it would be if China increases stimulus again," Thomson says.

(Fig. 1) U.S. and Global Earnings Growth Has Stalled

Cumulative Growth in Earnings Per Share by Region
December 2013 Through May 2019



Sources: Standard & Poor's (see Additional Disclosures) and MSCI (see Additional Disclosures). T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

Trade War Tops List of Geopolitical Risks

Thomson warns that the trade war is metastasizing into a technology war.

A series of events in May—including fresh tariff hikes by the U.S. and China; U.S. sanctions against Huawei, a major Chinese telecommunications firm; and the Trump administration's threat to impose tariffs on Mexico—helped reignite fears of an escalating trade war.

Although the U.S. and Mexico reached a deal in June that appeared to avoid tariffs, these and other geopolitical events contributed to a surge in perceived economic policy uncertainty—particularly in China, but also in the U.S. and Europe (Figure 2).

A trade deal between the U.S. and China is still within reach, but neither country may feel a need to compromise quickly:

- With President Trump facing reelection in 2020, he may want to put off any agreement until next year, Sharps suggests.
- Political incentives also might favor delay on the Chinese side, Vaselkiv says. Denying Trump a trade success could damage his reelection prospects, allowing Beijing to negotiate with his successor.
- Thomson warns that the trade war is metastasizing into a technology war. This could make settlement harder, as both countries may believe that critical technology advantages are at stake.

While the direct impact of tariffs on economics and earnings growth appears manageable at the moment, the secondary effects on business confidence, capital spending, and hiring could diminish hopes for a second-half earnings rebound, Sharps warns. "I don't think that's likely, but it certainly is a possible outcome."

Trade may be the most significant political risk facing investors, but it's not the only one. Recent elections in Europe have shown that populist anger remains a potent political force.

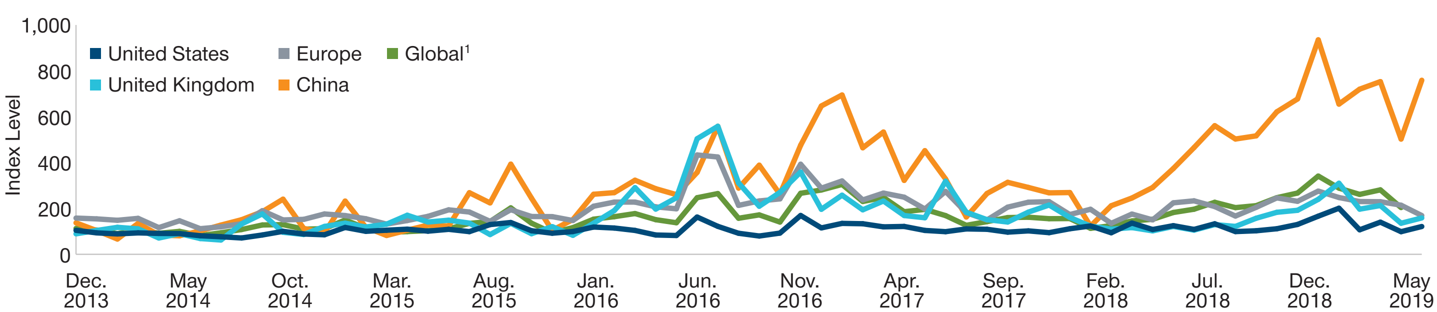
Europe's moderate political parties took "an absolute drubbing" in European Union parliamentary elections in May, Thomson notes. The outcome could encourage Italy's populist coalition to continue pushing fiscal reflation, resulting in wider yield spreads between Italian debt and German bunds.

In the UK, a heated leadership contest following Prime Minister Theresa May's resignation could intensify pressure for a "no deal" Brexit, with major negative implications for the UK and European economies.

(Fig. 2) Escalating Trade Disputes Are Fueling Uncertainty

Economic Policy Uncertainty Indices

December 2013 through May 2019



Source: Economic Policy Uncertainty, policyuncertainty.com. ©2012 by Economic Policy Uncertainty.

[1] Global Index through April 30, 2019.

Growth Fears Will Pressure the Fed

> ...if the Fed goes with a 50-basis point cut, I think that could really spook the markets because that would say, 'Wow, things are worse than anticipated.'
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> — **Mark Vaselkiv**
> *CIO, Fixed Income*

The first half of 2019 ushered in a dramatic shift in market expectations for Fed policy. By late May, futures markets were pricing in as many as three Fed rate cuts by the end of 2020 (Figure 3).

A deepening inversion in the U.S. Treasury yield curve signals growing market confidence that the Fed's next policy move will be downward, Vaselkiv says. "Fixed income investors in essence are daring and insisting that the Fed cut rates."

But with policy rates still at historically low levels, and with the 10-year Treasury note yielding less than 2.20% at the end of May, Fed policymakers have limited room to maneuver, Vaselkiv adds.

"We would not be surprised to see a 25-basis-point cut at some point later in the year to try to calm down volatility," Vaselkiv says. "But if the Fed goes with a 50-basis-point cut, I think that could really spook the markets because that would say, 'Wow, things are worse than anticipated.'"

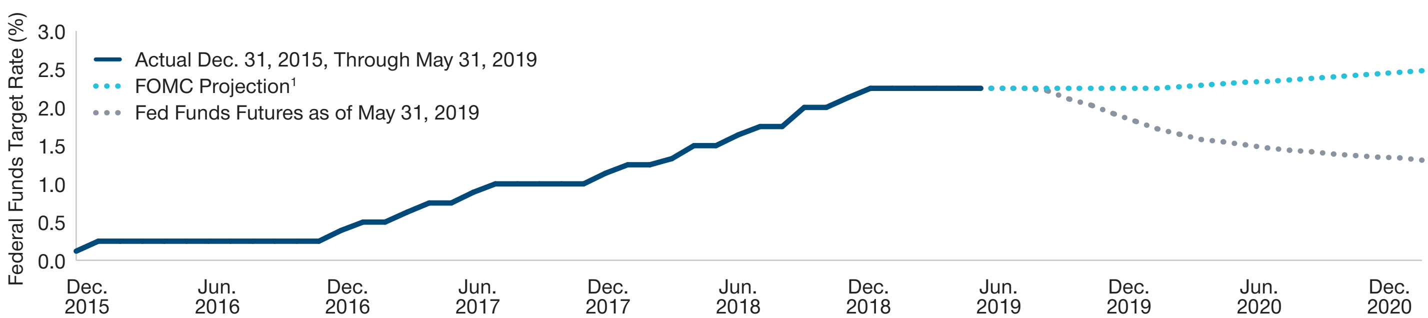
If the Fed has limited room to cut rates, the European Central Bank (ECB) and the Bank of Japan (BoJ) appear to have virtually none, Thomson says. The ECB's overnight deposit rate already is negative, while the BoJ is continuing to hold interest rates out to 10 years effectively at zero.

"The glass-half-full view would be that all of this is highly stimulative," Thomson says. "The glass-half-empty interpretation would be that [the ECB and the BoJ] have run out of bullets."

(Fig. 3) Investors Expect the Fed to Cut Rates

Futures Markets Versus FOMC Projections of the Federal Funds Rate

As of May 31, 2019



Sources: Federal Reserve Board/Haver Analytics. T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

[1] Median of participants' forecasts in the March 20, 2019, Federal Open Market Committee Summary of Economic Projections.

Secular Disruption: Incumbents Fight Back

> I think you need to be open to the fact that the regulatory regime could change at some point in time.
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> — **Robert W. Sharps**
> *CIO and Head of Investments*

Technological innovation, changing consumer preferences, and revolutionary new business models continue to disrupt established industries. This process has contributed to a stark disparity in the fortunes of the growth and value equity styles (Figure 4).

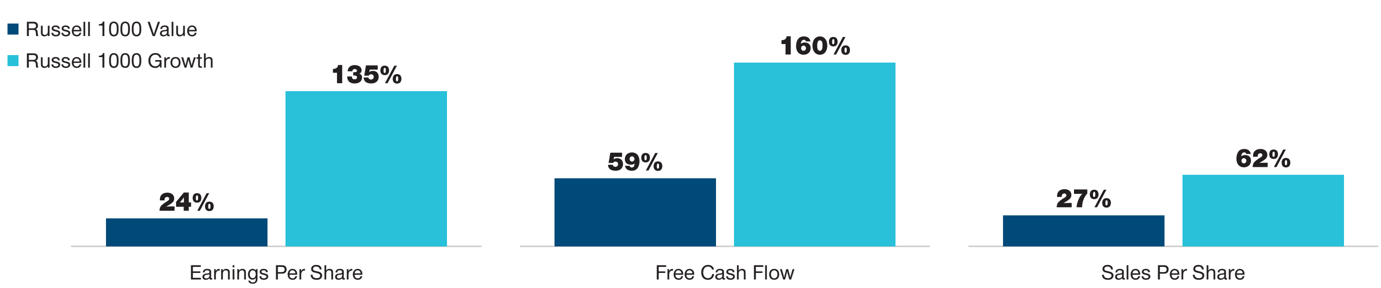
Nothing in the first half of 2019 suggested that disruption is slowing down, Sharps says. However, the narrative may have shifted:

- Investors appear more aware of the risks in financing business plans that push profitability into the distant future. This could be seen in weak demand for the initial public offerings of the two leading ride-share companies.
- Established firms are using their financial strength and brand positions to fight back. Sharps noted that Disney recently announced major investments in its own streaming video service to compete with Netflix.

Political attitudes toward the major technology platform companies also are changing due to rising concerns about market power, data privacy, and false or misleading content. Such complaints have not yet generated serious legislative efforts to restrict the major technology platforms. But the issue bears watching. "I think you need to be open to the fact that the regulatory regime could change at some point in time," Sharps says.

(Fig. 4) Disruption Tilts the Fundamentals Toward Growth

Cumulative Changes, June 30, 2007, through May 31, 2019



Source: Russell (see Additional Disclosures). T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

Maintaining a Strategic Investing Approach

> ...it is a good time to be diversified and to have your shopping list ready in case things go on sale.
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> **— Robert W. Sharps**
> *CIO and Head of Investments*

Positive economic growth, low inflation, and accommodative monetary policies should support financial asset prices in the second half of 2019. However, the escalating trade war creates substantial risks.

For U.S. equities, much depends on whether earnings growth resumes later in the year. But if trade uncertainty drags down sentiment, Sharps says, "I don't see a lot of mitigating upside catalysts" that could diminish those negative effects.

The outlook for international equities also is tied to earnings, but second-half prospects appear weak. "Save for a stronger Chinese stimulus, I expect the earnings impulse will continue to be negative," Thomson says.

For bond investors, slow but positive economic growth, limited inflation pressures, and friendly central banks should create a supportive environment in the second half, Vaselkiv says. However, trade tensions and U.S. dollar strength suggest a relatively cautious approach to EM debt. "At this point in the cycle, perhaps U.S. high yield should be considered a little bit more defensive."

For most investors, keeping a disciplined long-term perspective is the best approach, Sharps concludes. "This is no time to be a hero," he says. "But it is a good time to be diversified and to have your shopping list ready in case things go on sale."

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