



EQUITY VALUATIONS: CAN WE SEE A BUBBLE YET?

FEBRUARY 2017

Laurence Taylor

Portfolio Specialist, Global Equities

Pre-election rhetoric and post-election change are often two very different things, a reality the stock market will have to grapple with in 2017. The election of Donald J. Trump as US President followed a similar pattern to growing protest votes around the world. Voters rejecting stagnation and voting for change – with or without a defined course of political action.

In the weeks following the Republican's clean sweep success, the stock market has been quick to price a change in fundamentals associated with what could go right with a Trump presidency, without necessarily accounting for the 'boring' detail or what could go wrong. While optimism has been in short supply for many years, the sharp change does mean that investors should remain alert to new valuation-based risks that are emerging, given fundamentals tend to move in smaller increments than changes in market opinion.

We believe that aspects of the Trump "honeymoon" rally have been built on expectations for policy that will either prove harder to enact than rhetoric would have us believe, or be more anemic in real impact terms. This naturally sets up some stocks for a rough ride given raised expectations, and while early 2017 has seen a pause in the ascent of the 'Trump basket' of themes and stocks, more cyclical optimism without real cyclical improvement has the potential to create a bubble in equity markets. The key questions to ask therefore are whether equity valuations already reflect a bubble, and whether the broader global economy is likely to deliver a better reality to match clearly improving expectations.

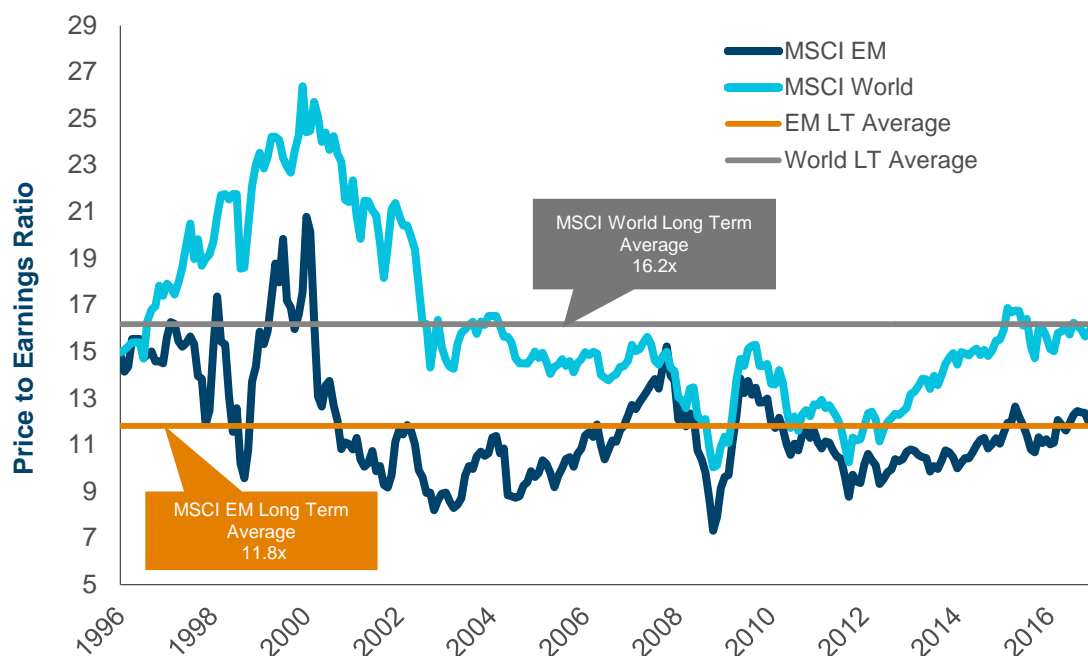
One certainty is that the battle between the bulls and bears is heating up once again, with much of the basis for this ongoing conflict surrounding equity valuations and whether they offer any upside to investors, or merely just risk.

So, do we see a bubble in equity market valuations given the second longest bull market in history has received another dose of return-adrenaline? While valuations are clearly no longer cheap, we would state upfront that we do not find broad valuations to be excessive either. In fact, global developed and global emerging valuations are around average when considering the past two decades (see Figure 1). It is important to note that the period considered is influenced by the extremes of the technology bubble in the 1997-2000 period (a 'proper' bubble when comparing valuations then and now), which skews the average upwards.

Figure 1: Price to Earnings Based Valuations Are Average

Developed vs Emerging Markets – 12 Months Forward Price to Earnings Ratio (P/E)

January 1996 – December 2016



Past performance is not a reliable indicator of future performance.

Sources: FactSet, MSCI.

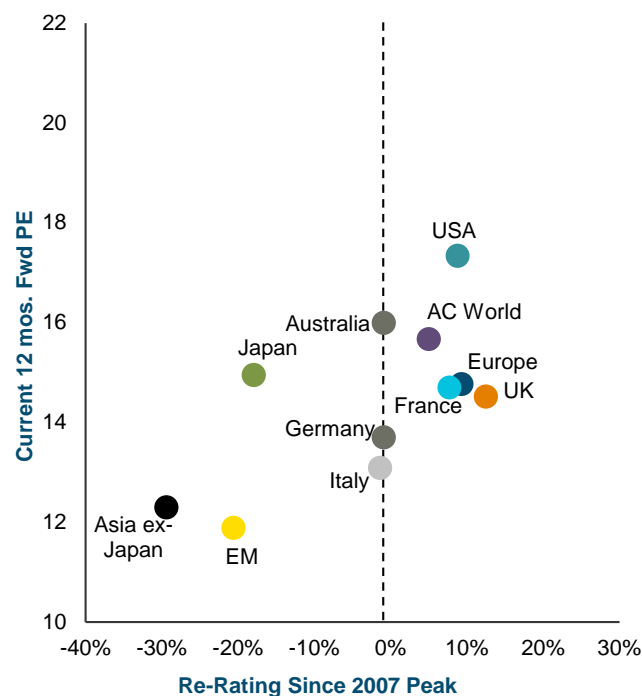
Source for MSCI data: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products.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

While stocks and valuations have clearly risen strongly, to the extent that many markets are trading around cyclical highs reached in 2007 (see Figure 2), there is a case to be made that the re-rating has foundation when looking forward. From their depths in early 2016, economic indicators have been rising steadily led by upside surprise in manufacturing and service PMIs, while earnings revisions continue to move in the right direction. This was our core scenario despite the pessimism early last year, and in many respects, the data has been better than our own expectations. With inflation also ticking up, the economic environment continues to gradually improve, a foundation that normally bodes well for equity returns. The challenge of course is that we have not lived in 'normal times' for approaching a decade now.

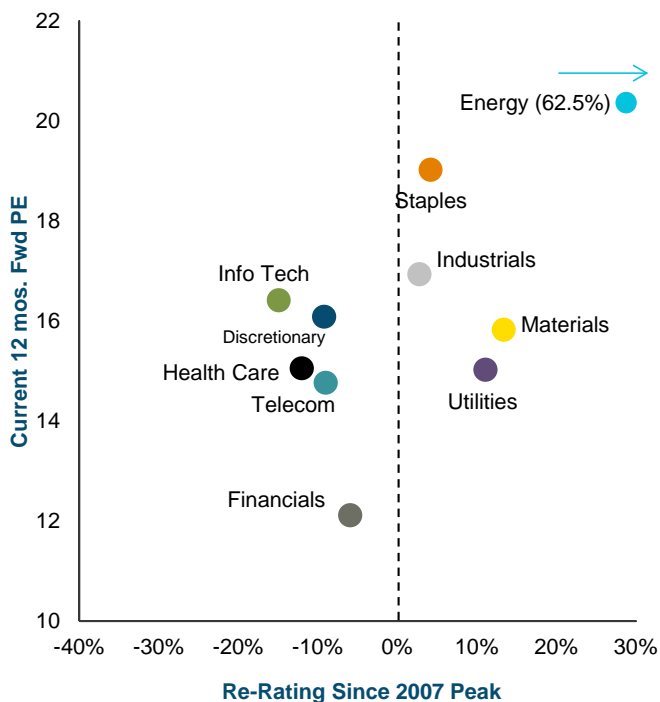
Figure 2: Earnings Based Valuations Are Around The 2007 Cycle High

As at 31 December 2016

REGIONS AND COUNTRIES—
Valuations and Comparison To 2007 Peak



GLOBAL SECTORS—
Valuations and Comparison To 2007 Peak



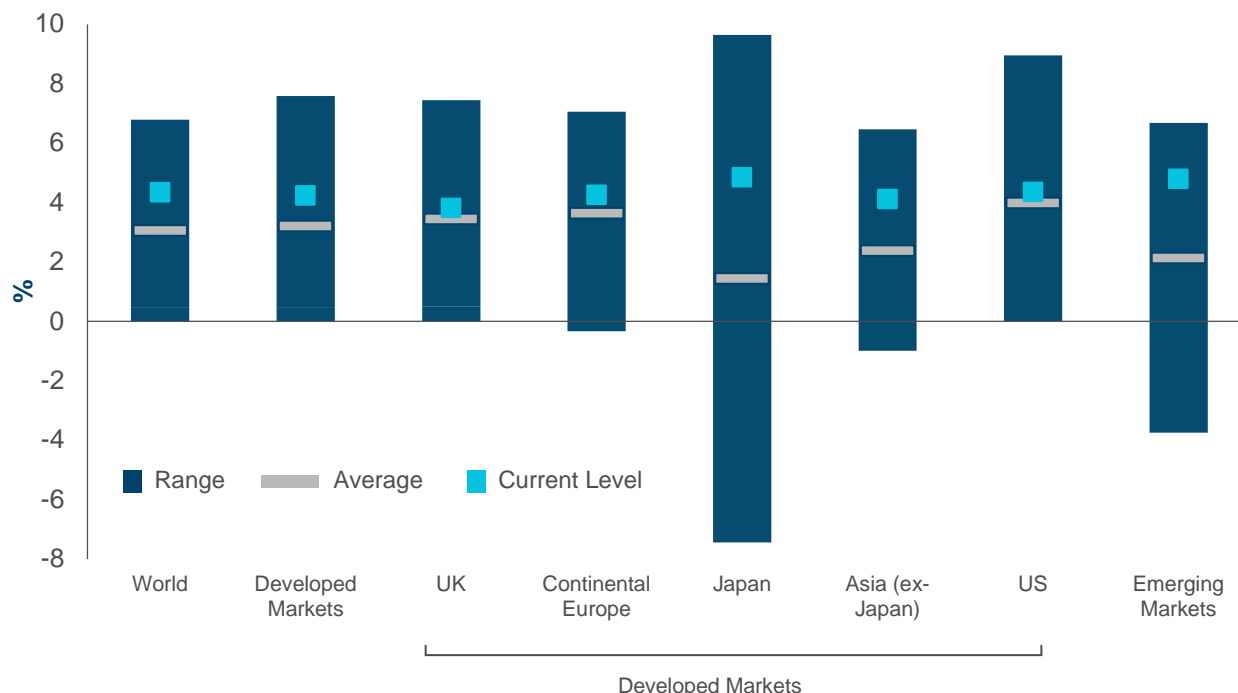
Sources: FactSet, Wilshire Atlas, MSCI/S&P GICS Sectors. Analysis by T. Rowe Price Associates, Inc.

Even if the economic backdrop is one of slow but gradual improvement, how far is too far in terms of valuations, especially following the rally post the US election? In our view, while we expect volatility and inevitable market pull-backs as we work through 2017, it's premature to sound an alarm based solely on prevailing valuations. This view is partly formed by looking at valuation data more broadly than just P/E ratios.

While the P/E ratios mentioned above are important to understand, versus history as well as versus realistic expectations of future earnings, the relatively high free-cash-flow yield of equities is supportive of the belief that valuations are still quite reasonable, if not slightly cheap (Figure 3). While adding a more attractive view than just earnings-based figures, cash-based valuations also have an advantage via their implication for future capital return to shareholders through dividends and buybacks, a key source of return over time.

Figure 3: Free Cash Flow Based Valuations Remain Attractive

World Nominal Free Cash Flow Yield By Region¹
1986 through early January 2017



Past performance is not a reliable indicator of future performance.

Source: Empirical Research Partners Analysis.

¹ Capitalisation-weighted data, excluding financials

Every bull case has a bear base however, and here we are focused on ensuring that cash-flow based valuations do not become unattractive should equity prices rise faster than free cash flow fundamentals near term. Equally, we remain focused on any shift in the fundamentals themselves, if a combination of higher borrowing costs, a stronger corporate investment cycle, or the return of wage inflation outstrips any improvement in the overall trading backdrop. It is inevitable that these potential changes will create risks for some stocks. This will need management over the next stage of the cycle. Therefore, investors should be mindful that pricing power for corporates will be important to maintain profit margins and grow corporate earnings, especially as the inflation regime strengthens.

One additional layer of equity valuation analysis would be to bypass averages that might blur the lines between many different environments spanning history, and instead to look more specifically at periods that 'echo' more today's outlook.

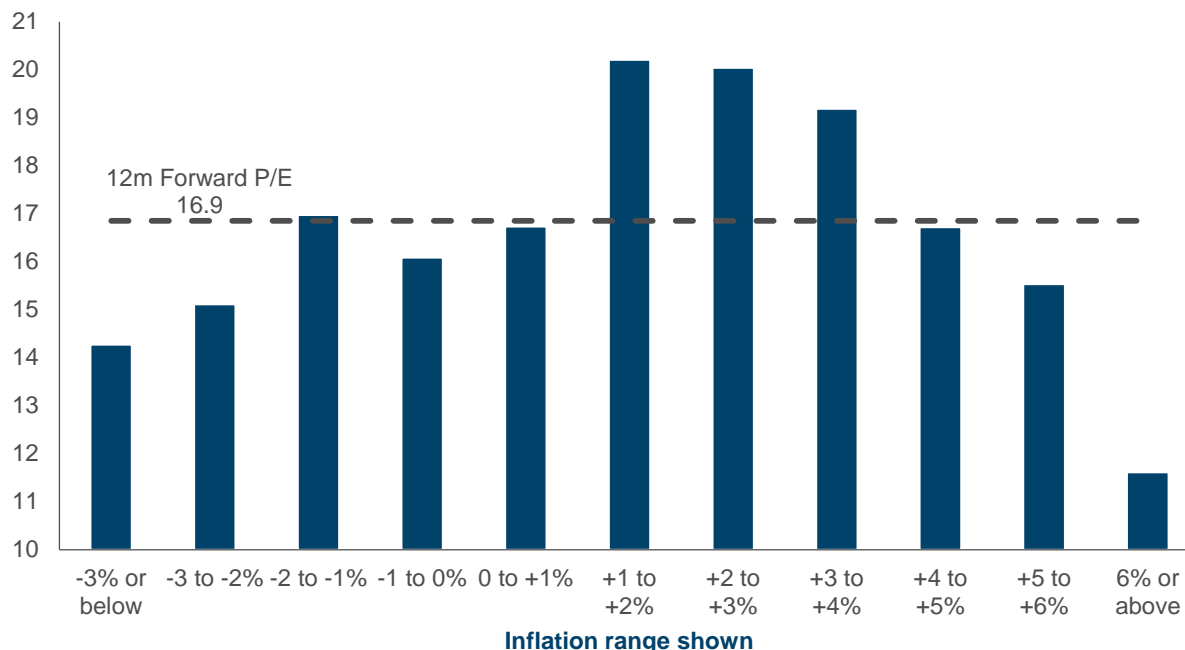
Currently, the US is the most expensive equity market in the developed or emerging market world on a P/E basis. With both chambers now Republican, there is increased likelihood of fiscal stimulus, led by tax cuts, which should modestly spur economic growth and lead an uptick in inflation from today's 1-1.5% range. However, even without stimulus, inflation is heading higher as a function of a strengthening wage growth cycle and a year-on-year recovery in oil prices.

As seen in Figure 4, looking over the long-term history of the US, modest inflation between 1-4% is traditionally associated with higher US equity valuations; higher than periods where inflation is very low or very high and also higher than today's P/E multiple. Why? Because such periods generally coincide with the economy performing well, and where improvement in both equity fundamentals and investor sentiment support valuations, at least in the near term while the good times continue. While history never repeats itself, this environment does rhyme when considering our view of global equities today.

Figure 4: Valuations Are Below Average In The Context Of The Inflation Backdrop

S&P 500 Average P/E, 1871 to Present

As at 31 December 2016



Past performance is not a reliable indicator of future performance.

Sources: Credit Suisse, Empirical Research Partners Analysis.

Often the key to success in mature bull market periods is resisting the temptation to be too bearish, too soon, as long as the improvement phase is real and valuations are not unrealistically high. We see enough improvement to maintain optimism that the equity cycle can deliver positive returns, even from this current valuation starting point. Policy mis-steps and market pull-backs are almost inevitable, however, certainly as we extend our time horizon. What remains true is that key to success over a cycle is the ability to differentiate between stocks in both good and bad times, but particularly to make sound decisions when renewed valuation opportunities emerge. On this point, the bears will have their day, but we do not believe that it's today, and we certainly do not believe that equities embody a valuation bubble looking at current data.

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

This material, including any statements, information, data and content contained within it and any materials, information, images, links, graphics or recording provided in conjunction with this material are being furnished by T. Rowe Price for general informational purposes only. The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price. The material does not constitute a distribution, an offer, an invitation, recommendation or solicitation to sell or buy any securities in any jurisdiction. The material has not been reviewed by any regulatory authority in any jurisdiction. The material does not constitute advice of any nature and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The views contained herein are as of January 2017 and may have changed since that time.

Australia—Issued in Australia by T. Rowe Price International Ltd. (ABN 84 104 852 191), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. T. Rowe Price International Ltd. is exempt from the requirement to hold an Australian financial services licence in respect of the financial services it provides in Australia. T. Rowe Price International Ltd. is authorised and regulated by the UK Financial Conduct Authority under UK laws, which differ from Australian laws. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Issued in the European Economic Area by T. Rowe Price International Ltd., 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH ("TRPSWISS"), Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE and the Bighorn Sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc. in the United States, European Union, and other countries. This material is intended for use only in select countries.