



# Managing to the Other Side

Four themes driving our Midyear Market Outlook.

June 2020

## KEY INSIGHTS

- The sustainability of rallies in equity and credit markets will depend on the trajectory of the coronavirus and the strength of the economic recovery.
- The pandemic appears to have accelerated the growth and market power of the major technology platform companies by at least several years.
- Corporate credit is likely to offer the most attractive opportunities to fixed income investors, but wide dispersion requires selectivity.
- We believe the pandemic could exacerbate political risks in some countries and prompt a major reassessment of corporate finances and supply chains.

Fiscal and monetary stimulus appeared to stave off the worst in capital markets since the coronavirus spread across the globe. But as economies gradually reopen, we believe a sustained recovery will largely depend on controlling the virus in the second half of 2020 and beyond.

"Investors should pay close attention to whether we get a second wave of infections as economies reopen," cautions Robert W. Sharps, group chief investment officer (CIO) and head of investments. Expectations that a vaccine can be developed and administered relatively quickly may be overly optimistic, he adds. Nor is it clear when effective drug therapies might become available. "There's very limited visibility about that sort of relief."

Amid uncertainty, asset returns are likely to remain uneven across countries,

sectors, industries, and companies, creating potential to add value with a strategic investing approach but requiring careful analysis to identify opportunities and manage risk. "Investors will need to dig deeply to find the green shoots of recovery at the local level," says Mark Vaselkiv, CIO, fixed income.

In this environment, valuation metrics could be particularly difficult to interpret, warns Justin Thomson, CIO, international equity. "Aggregate market valuations have never been more meaningless because of the huge bifurcation between companies that are on the right or the wrong side of change."

"This is very different from the tech boom we lived through 20 years ago," Thomson argues. "Today's winners are backed by superior cash flow and cash-rich balance sheets."



**Robert W. Sharps**

*Group CIO and Head of Investments*



**Justin Thomson**

*CIO, Equity*



**Mark Vaselkiv**

*CIO, Fixed Income*

# The Road to Recovery

“...I do think the second quarter will prove to have been the most challenging for economic activity and earnings.

— Robert W. Sharps  
Group CIO and Head of Investments

Although the coronavirus pandemic delivered a staggering blow to the global economy, equity and credit markets rallied dramatically in the second quarter through mid-June. The central issue now is whether those rallies have gotten ahead of themselves, Sharps says.

“Anytime you’re in an economic downturn, there comes a point where markets begin to anticipate improvement,” Sharps notes. “Given that the spread of the virus appears to have slowed and many businesses are reopening, I’m not too surprised that markets are off their lows.”

Recent signs that U.S. employment is bouncing back more rapidly than expected as the economy gradually recovers are a significant “green shoot” that has pushed yields on 10- and 30-year Treasury bonds modestly higher, Vaselkiv notes.

That said, the near-term earnings outlook remains grim. While consensus forecasts at the start of the year anticipated global economic growth of around 3%, current estimates see a 3% decline for the year, Thomson says. Taking operating leverage into account, that could produce a 50% to 60% aggregate decline in corporate profits.

“We’re still very early in the recovery,” Sharps warns, “but I do think the second quarter will prove to have been the most challenging for economic activity and earnings.”

The key question, Sharps says, is how long it will take for companies to regain enough earnings power to justify current valuation levels while compensating investors for the risk that an economic recovery might not progress as rapidly or evenly as expected.

## STIMULUS CAN ONLY DO SO MUCH

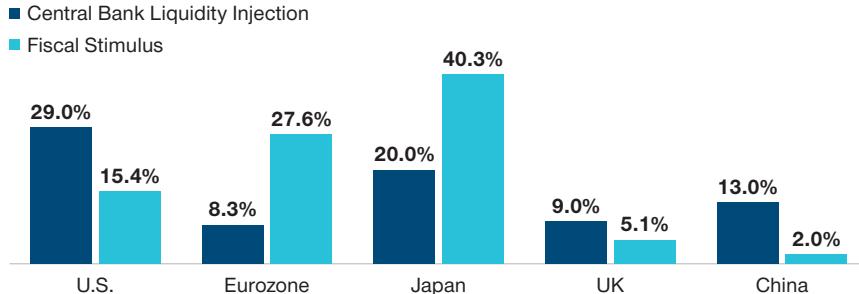
To a large extent, the rally in risk assets has been driven by massive doses of fiscal and monetary stimulus, which have been even larger than during the 2008–2009 global financial crisis. This, Thomson says, has set the stage for a tug of war between ample liquidity and the collapse in earnings. Further market volatility could result, he cautions.

While fiscal and monetary stimulus have bolstered global markets, there are limits to what governments can do to sustain the recovery:

- In the U.S., a significant portion of the stimulus funds sent directly to low- and moderate-income Americans in April appear to have gone into savings, Vaselkiv says. This could hinder a

## Global Economic Stimulus to Fight COVID-19 Impact

(Fig. 1) Percent of Gross Domestic Product



January 31 through May 31, 2020

Sources: Cornerstone Macro, used with permission. Additional T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

The largest of the mega-cap technology giants appear well-positioned to benefit from accelerating disruption...

recovery in consumer spending, which typically accounts for roughly 70% of U.S. gross domestic product (GDP).

- Although French President Emmanuel Macron and German Chancellor Angela Merkel have proposed a European recovery fund to finance EU-wide fiscal stimulus, unanimous agreement among the EU's member nations will be required to implement it, Thomson notes.

- Many emerging market countries don't have the economic and financial strength to undertake massive fiscal stimulus, Thomson adds.

With much of the anticipated benefits of stimulus already priced into risk assets, economic fundamentals will have to take over for broad markets to move higher, Sharps says. "I think the going will be tougher from here."

## Disruption Accelerated

The economic and social consequences of the pandemic appear to have accelerated the rise of dominant technology platforms in retail, social media, streaming content, and remote conferencing. This trend is likely to widen the divide between industries and companies benefiting from disruption and those challenged by it.

T. Rowe Price analysts are carefully assessing companies to identify the ones they believe have the balance-sheet strength to get to the other side of the pandemic and how that could impact recoveries in equity and credit markets.

"The changes over the past few months in the ways we work, socialize, and entertain ourselves have advanced the

fundamentals of the big tech platform companies by several years," Sharps says.

Through the first five months of 2020, Sharp notes, technology was the strongest performing sector in the S&P 500 Index while energy—hurt by collapsing demand and a price war between Russia and Saudi Arabia—was the worst performing.

The largest of the mega-cap technology giants appear well-positioned to benefit from accelerating disruption, according to Sharps.

- Collectively, the five largest U.S. technology stocks by market capitalization—Microsoft, Apple, Amazon, Facebook, and Google—have

## Technology Weathers the Storm While Energy Struggles

(Fig. 2) Cumulative Returns on the S&P 500 Technology and Energy Sectors



**Past performance is not a reliable indicator of future performance.**

December 31, 2019, through May 31, 2020.

Sources: T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

J.P. Morgan Chase & Co., Bloomberg Finance L.P., and Standard & Poor's (see Additional Disclosures).

more than USD 500 billion in cash reserves, potentially enabling them to acquire startups or younger companies that are having difficulty obtaining financing in a distressed environment.

- We believe the major technology platforms not only have the ability to continue to grow earnings and cash flow in a challenging economic environment, but also have opportunities to gain market share from weaker competitors, such as bricks-and-mortar retailers.
- The tech giants can attract the best software developers, engineers, and business people, Sharps argues.

#### MARKET LEADERSHIP REMAINS NARROW

Going forward, Sharps suggests, disruption and the pandemic both

should continue to favor the top five U.S. technology platforms, which, as of early June, already accounted for more than 20% of market capitalization in the S&P 500 Index—greater than the bottom 340 index constituents combined.

Meanwhile, a number of sectors with heavy weights in the value universe—such as energy, transportation, and financials—have been deeply damaged by the crisis. “Large parts of the market still haven’t recovered yet,” Thomson says.

While better-than-expected economic news prompted a shift back toward some challenged sectors—growth to value, large-cap to small-cap, and U.S. to non-U.S. equities—in early June, a more sustained reversion trade will require an uptick in inflation and a weaker U.S. dollar, Thomson argues.

## A Focus on Credit Quality

The economic damage wrought by the coronavirus pushed credit quality into the spotlight in the first half of 2020, as fixed income investors sought shelter in sovereign debt and other top investment-grade (IG) assets.

While credit spreads have narrowed from the worst of the market sell-off in March, they remain wide and volatile, Vaselkiv notes. However, as in global equity markets, performance has been highly uneven.

In the high yield market, yield spreads for BB rated bonds perceived as defensive have tightened to pre-crisis levels. Yet, some “fallen angels”—companies that have recently lost their IG ratings—have been forced to sell bonds with yields as high as 9% to shore up their balance sheets. In this environment, investors need to carefully analyze relative value on a case-by-case basis, Vaselkiv says.

In forecasting potential default rates, T. Rowe Price analysts have divided the high yield universe into three broad groups, Vaselkiv says:

- Industries like airlines and cruise lines that face existential risks. Some of these issuers are likely to undergo restructuring either inside or outside of bankruptcy. A number of energy companies also may fall into this category if oil prices remain below USD 40 a barrel.

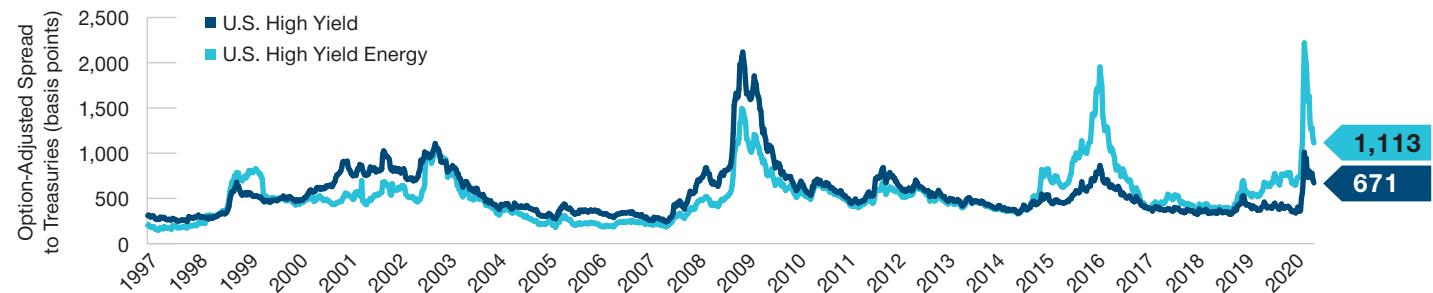
- Cyclical industries, such as automakers and homebuilders, where revenues and profits have fallen sharply but new bond issues can help companies build bridges to recovery.

- Sectors that are well-positioned to benefit from changing consumer behavior. These could include some media companies, quick-service restaurants, and supermarket chains.

Many fixed income managers already have rotated into well-positioned sectors and now are cautiously expanding their cyclical exposures, Vaselkiv says. How that latter category fares in the recovery will determine the peak default rate for the high yield universe as a whole. An

## Credit Spreads Have Tightened Since March but Remain Wide and Volatile

(Fig. 3) U.S. High Yield Spread History<sup>1</sup>



**Past performance is not a reliable indicator of future performance.**

January 1, 1997, through May 31, 2020.

Sources: Bloomberg Index Services Limited, and ICE BofAML (see Additional Disclosures). T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

<sup>1</sup>U.S. High Yield = ICE BofA US High Yield Index. U.S. High Yield Energy = ICE BofA US High Yield Energy Index.

Right now, corporate credit—both investment grade and high yield—remains our dominant theme.

— Mark Vaselkiv  
CIO, Fixed Income

aggregate rate close to 10% appears warranted, he adds.

### CORPORATE CREDIT REMAINS THE THEME

Attractive fixed income opportunities in the second half appear relatively limited, in Vaselkiv's view. Defensive assets, such as U.S. Treasuries and other developed sovereigns, AAA rated munis, and even some high-quality securitized sectors, are expensive and vulnerable to a further backup in interest rates if the recovery

proves faster than expected and/or a vaccine becomes widely available.

In emerging fixed income markets, some specific opportunities appear attractive, but the sector as a whole remains under severe pressure from the pandemic and, in some countries, such as Brazil, from poor political leadership, Vaselkiv says. Sovereign default rates have risen.

"Right now, corporate credit—both investment grade and high yield—remains our dominant theme," Vaselkiv concludes.

## Policy, Politics, and Populism

While the coronavirus crisis dominated the policy agenda in early 2020, investors will need to monitor a host of other risks—some potentially worsened by the pandemic—in the second half. These include rising tensions between the U.S. and China, social unrest, opposition to economic globalization, and U.S. elections scheduled in November.

Even before the coronavirus disrupted their operations, the ability of multinational firms to exploit global economies of scale was being challenged by protectionist pressure, Sharps notes. Now, after seeing the pandemic play havoc with supply

chains, corporate managers themselves are likely to emphasize resilience over efficiency, even if it lowers profit margins.

- For corporate balance sheets, this new emphasis is likely to mean reduced leverage, higher liquidity, and more conservative financing practices.
- Share buyback programs, which have been a key support for equity prices in recent years, could be cut back.
- At the operating level, "near sourcing"—placement of production in or close to end-user markets—could become a priority, rather than the search for the lowest-cost labor markets.

...investors should expect more gradual recoveries in risk assets—not a continuation of the powerful rallies that lifted markets off their March lows...

The economic benefits are too compelling for globalization to go into reverse, Sharps contends. “But if you add in the ongoing trade tensions between the U.S. and China, a trend toward reevaluating global supply chains seems inevitable.”

Thomson says he is optimistic that the U.S. and China will step back from an escalation in their trade war, easing one potential threat to the global economic recovery. However, he predicts a longer-term competition for dominance in key technology sectors is likely to produce continued friction between the two economic giants.

Hong Kong, China’s special administrative region, is caught in the middle of these tensions, Thomson says. However, while western critics decry Beijing’s efforts to push through a new security law for the city, Thomson predicts that China will not impose its legal framework directly on Hong Kong as that would threaten the city’s viability as a financial center.

#### ECONOMIC INEQUALITY COULD MAGNIFY SOCIAL UNREST

High unemployment, social distancing, and the digital divide between those able to work from home and those

who’ve seen their incomes destroyed by the coronavirus all could worsen a long-running shift toward income inequality in the U.S. and other developed countries.

Vaselkiv notes that the pandemic has been especially damaging for lower-income workers in the service sector, many of them women and/or people of color. This has added to anger over racial injustice and claims of widespread police brutality that have prompted mass protests in many U.S. cities.

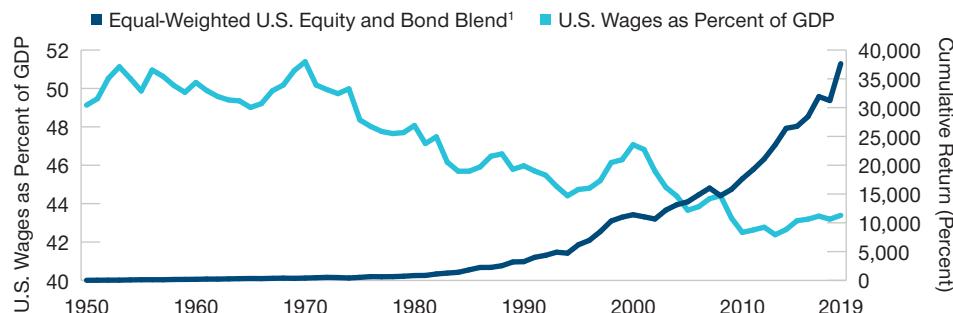
The upcoming U.S. election also poses risks for markets, Sharps warns. A victory by Democrat Joe Biden, he says, could lead to increases in both corporate and individual taxes, especially if the Democrats also take control of the Senate. Tighter regulation under a Biden administration could impose heavy compliance costs on energy, financials, and some manufacturing industries, Sharps adds.

#### MAINTAINING A STRATEGIC INVESTING APPROACH

Looking ahead to the second half of 2020, investors should expect more gradual recoveries in risk assets—not a continuation of the powerful rallies that

### The Pandemic Could Widen the Divide Between Wall Street and Main Street

(Fig. 4) U.S. Wages as Percent of GDP vs. U.S. Stock and Bond Returns



**Past performance is not a reliable indicator of future performance.**

January 1, 1950, through December 31, 2019.

Sources: FactSet, Standard & Poor’s, Bureau of Economic Analysis, Federal Reserve Board, Tax Policy Center, and Citizens for Tax Justice/Haver Analytics (see Additional Disclosures).

<sup>1</sup> Equal-weighted total return of U.S. equities (S&P 500 Index) and U.S. 10-year government bonds.

lifted markets off their March lows, the three T. Rowe Price leaders say.

"There are still potential opportunities, but they're clearly less compelling than they were in April," Sharps says.

Thomson says he is relatively optimistic about the second half outlook, although markets could be "choppy" at times. "I think reopening economies, plus the scale of the stimulus and the potential for medical breakthroughs, create the potential for stocks to move higher between now and the end of the year," he predicts.

But in a fast-changing environment, investors will need to be able to generate fundamental insights, look at the full opportunity set within sectors and industries, and prioritize the most attractive opportunities in order to be successful, Sharps observes.

A long-term investment perspective and close attention to potential risks also could be critical. "It took over a decade for economies to recover fully from the global financial crisis," Vaselkiv notes, "and we're facing even bigger challenges today. So I would encourage investors to carefully monitor the risk exposures in their portfolios."

The specific securities identified and described are for informational purposes only and do not represent recommendations.

#### **Additional Disclosures**

Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright © 2020, J.P. Morgan Chase & Co. All rights reserved.

Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

ICE Data Indices, LLC ("ICE DATA"), is used with permission. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD PARTY SUPPLIERS DISCLAIM ANY AND ALL WARRANTIES AND REPRESENTATIONS, EXPRESS AND/OR IMPLIED, INCLUDING ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, INCLUDING THE INDICES, INDEX DATA AND ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM. NEITHER ICE DATA, ITS AFFILIATES NOR THEIR RESPECTIVE THIRD PARTY SUPPLIERS SHALL BE SUBJECT TO ANY DAMAGES OR LIABILITY WITH RESPECT TO THE ADEQUACY, ACCURACY, TIMELINESS OR COMPLETENESS OF THE INDICES OR THE INDEX DATA OR ANY COMPONENT THEREOF, AND THE INDICES AND INDEX DATA AND ALL COMPONENTS THEREOF ARE PROVIDED ON AN "AS IS" BASIS AND YOUR USE IS AT YOUR OWN RISK. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD PARTY SUPPLIERS DO NOT SPONSOR, ENDORSE, OR RECOMMEND T. Rowe Price OR ANY OF ITS PRODUCTS OR SERVICES.

Copyright © 2020, S&P Global Market Intelligence (and its affiliates, as applicable). Reproduction of any information, data or material, including ratings ("Content") in any form is prohibited except with the prior written permission of the relevant party. Such party, its affiliates and suppliers ("Content Providers") do not guarantee the accuracy, adequacy, completeness, timeliness or availability of any Content and are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such Content. In no event shall Content Providers be liable for any damages, costs, expenses, legal fees, or losses (including lost income or lost profit and opportunity costs) in connection with any use of the Content. A reference to a particular investment or security, a rating or any observation concerning an investment that is part of the Content is not a recommendation to buy, sell or hold such investment or security, does not address the suitability of an investment or security and should not be relied on as investment advice. Credit ratings are statements of opinions and are not statements of fact.

The S&P 500 Index is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates ("SPDJI") and has been licensed for use by T. Rowe Price. Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); these trademarks have been licensed for use by SPDJI and sublicensed for certain purposes by T. Rowe Price. T. Rowe Price's Midyear Market Outlook is not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the S&P 500 Index.

## INVEST WITH CONFIDENCE<sup>SM</sup>

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

# T. Rowe Price<sup>®</sup>

### Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** Investment involves risks. 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 material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

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.

**Hong Kong**—Issued by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission ("SFC"). This material has not been reviewed by the SFC.

© 2020 T. Rowe Price. All rights reserved. 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.