

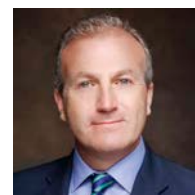


The State of US Equities: GROWTH STRATEGIES HAVE RUN A GOOD RACE—BUT IT'S NOT OVER

APRIL 2018

Julian Cook

Portfolio Specialist, US Equities



Where next for the U.S. equity market? That is the question more and more of our clients are now asking. Certainly we are in the late stages of the cycle and U.S. stock valuations are clearly at the top end of their historical range. However, we believe synchronised global growth and very low inflation supports these valuation levels.

CORPORATE EARNINGS SHOW NO SIGNS OF WEAKENING

U.S. corporate earnings continue to prosper, boosted by the recent U.S. tax reforms. Even without the contribution from the tax cuts, we are still seeing improving top-line growth, the tech sector being a standout example. The Q4 2017 earnings season was very positive, with more than 80% of U.S. companies either meeting or beating expectations.¹ So far in 2018, the positive trend has continued; we're seeing record levels of positive earnings guidance, helped in no small part by the recent tax reforms.

In similar instances of major tax overhauls, we have generally seen higher levels of growth as investment is refocused domestically.

THE TAX BENEFIT IS SIGNIFICANT – BUT WHICH COMPANIES WILL KEEP IT?

The windfall from recent tax reforms is benefiting U.S. companies on an immediate basis, particularly more domestically-focused businesses. But it is important to understand which companies can keep hold of that benefit. For example, a company in the highly-competitive retail industry might be tempted to exploit this windfall by offering price concessions to customers to try and win market share—thus giving much of the benefit away.

Contrast this with a company like Boeing, the leading player in what is effectively a global aerospace duopoly. The company has a six or seven-year backlog of aircraft already sold to customers at agreed prices. They don't need to entice customers or build their profile, so they can keep the whole tax saving (roughly 15%). These are two stark examples of how the same tax benefit can mean very different things to different companies.

Meanwhile, the tax reforms also bring the U.S. more into line with the tax regimes of many other countries. This is significant as it means that many U.S. companies will no longer need to go offshore in search of more favourable tax treatment. This is particularly supportive of the U.S. domestic economy as companies invest back into the U.S. and in U.S. jobs. In similar instances of major tax overhauls, we have generally seen higher levels of growth as investment is refocused domestically.

¹ Source: Factset "Earnings Insight", as of 16 March 2018.

One of the key risks to the U.S. market outlook is the prospect of a sharp acceleration in inflation. So far we have seen a rise in inflation expectations, but not in actual inflation.

INFLATION REMAINS A KEY RISK

Of course, this can be a curse as well as a blessing. Encouraging substantial investment in a late-cycle economy that is already running close to full capacity could have significant inflationary implications. One of the key risks to the U.S. market outlook is the prospect of a sharp acceleration in inflation. So far we have seen a rise in inflation expectations, but not in actual inflation.

The possibility of a trade war between the U.S. and China is another key risk to the U.S. market outlook. Investors should be wary of its impact, both economically and on the markets.

SIGNS OF RECESSION?

From a U.S. growth perspective, one of the things that we misjudged in 2017 was our expectation of a steeper U.S. yield curve (based on where we thought growth and inflation were headed). What we saw instead was a flattening of the curve. When we have seen this kind of yield compression in the past it has usually been a lead indicator of recession. However, amid global synchronised growth, positive global PMIs, tax cuts leading to greater capex and robust earnings growth, we are reluctant to believe that a flatter yield curve this time around suggests impending recession. Today's post-financial crisis bond market is also very different to the past; this too is potentially not as reliable an indicator as it has been in past cycles.

ARE TECH STOCKS OVERPRICED?

Following a growth strategy in the U.S. has been very successful recently, with large-cap growth stocks up 30.2% in 2017 versus +13.7% for U.S. large cap value.² This is a significant variation within one country. While certain value-oriented sectors clearly underperformed in 2017, the gap is largely attributable to the performance of the tech sector, which was up by 38.8% for the year.

Another question we are continually asked by clients is: are tech stocks overpriced? In fact, when we look at the relative valuation of U.S. sectors versus their 20-year history, only three currently stand out as being clearly valued below their 20-year average, and one of them is technology! (The other two are healthcare and telecoms). If tech stocks don't appear cheap right now, neither are they particularly stretched. We think it is still too early to suggest that the tech sector has run its race.

In summary, we are clearly in the late stages of the cycle, and while stock valuations are looking relatively full, they appear adequately supported by solid growth and low inflation. Meanwhile, corporate earnings show no signs of weakening, given an extra boost by US tax reforms.

Strong employment data obviously gives rise to concerns that this will feed through to wage inflation. However, this is being partly offset by various secular factors including cost-reductions from new technologies and lower drug/healthcare prices.

Overall, we believe economic growth globally and earnings growth in the U.S. make U.S. equities a solid stay in investors' portfolios.

² Russell 1000 Growth index versus Russell 1000 Value index. Russell Investment Group is the source and owner of the trademarks, service marks, and copyrights related to the Russell indexes. Russell® is a trademark of Russell Investment Group.

Important Information

The specific securities identified and described above do not necessarily represent securities purchased or sold by T. Rowe Price. This information is not intended to be a recommendation to take any particular investment action and is subject to change. No assumptions should be made that the securities identified and discussed above were or will be profitable.

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, and 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.** 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.

It is not intended for distribution to retail investors in any jurisdiction.

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.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified 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. All rights reserved.