T. Rowe Price®
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2018 Global Market Outlook

RIGHT SIDE OF CHANGE

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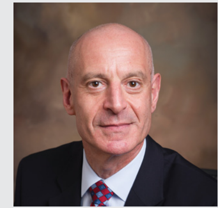
Investors face shifting currents as disruptive innovation and monetary uncertainty leave some markets open to surprises. Navigating volatility and discovering new opportunities requires an active management approach. The 2018 T. Rowe Price Global Market Outlook provides strategic insights that can help place you on the right side of change.

Broad Expansion Confronts Withdrawal of Monetary Accommodation

A pickup in capital expenditures has boosted the global economy and should help it carry momentum into 2018.

Nikolaj Schmidt
Chief International Economist



Alan Levenson
Chief U.S. Economist

Global Growth Solidifies

Nikolaj Schmidt

Global growth solidified in 2017, with all major regional economies accelerating in unison for the first time in almost a decade. The pickup in growth was most impressive among commodity exporters, such as Brazil, Mexico, and Russia, but Japan and major developed economies in Europe also performed well – especially relative to recent history. Although we expect that growth will decelerate in 2018, we expect the global economy to carry much of its momentum into the new year.

While China's surprising resilience deserved most of the credit early in 2017, the global economy's strong showing in recent months has been due largely to a rebound in capital goods expenditures (Figure 1). Energy- and metals-related investment, in particular, has provided an important boost, not only to emerging market exporters but also to Germany, the U.S., and other major developed markets. Global trade has accelerated alongside increased capital spending, suggesting that improvement has been broad-based.

"It is particularly encouraging that growth in Europe has become more self-sustaining and less vulnerable to imbalances."

– NIKOLAJ SCHMIDT, CHIEF INTERNATIONAL ECONOMIST

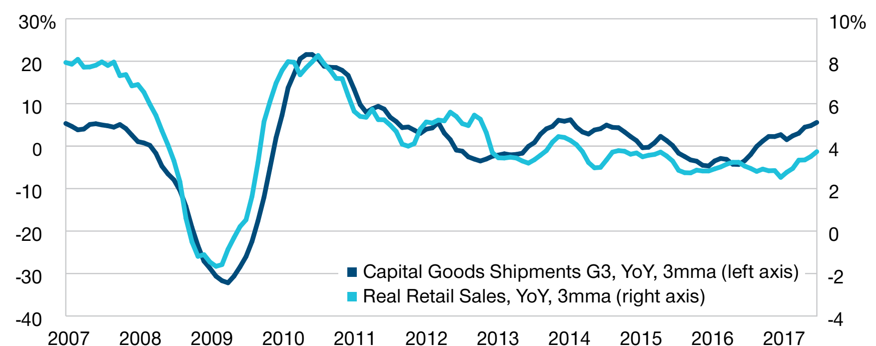
Reduced Imbalances Set the Stage for Self-Sustaining Growth

It is particularly encouraging that growth in Europe has become more self-sustaining and less vulnerable to imbalances. With unemployment down and incomes growing, European consumers are beginning to unleash several years of pent-up demand, putting the Continent squarely in the early stages of a cyclical recovery. European consumers have been somewhat vulnerable to higher oil prices, but the energy environment remains benign compared with earlier in the decade.

In Japan, Abenomics continues to show signs of progress. Labour shortages have emerged as Japan's unemployment rate has declined to a 23-year low, and the ratio of jobs to applicants has climbed to its highest

FIGURE 1: Capital Expenditures Have Driven the Global Acceleration

Final Demand: Sales and Capex, as of August 31, 2017



Sources: Haver Analytics; analysis by T. Rowe Price.

G3: U.S., Germany, and Japan. YoY: Year-over-year. 3mma: Three-month moving average.

level since 1974. While broad-based wage increases remain modest, workers are moving to higher-paid positions, especially in the part-time segments of the economy.

We expect China's growth rate to slow in 2018, but we are optimistic that its leaders can keep the economy expanding at a pace that does not threaten growth for its trading partners. The country's leadership, now exceptionally concentrated under President Xi Jinping, has shifted its focus from top-line growth to boosting the quality of life for Chinese citizens, chiefly by reducing pollution. Even as they pursue this new "China Dream" plan, Chinese officials are likely to step in with accommodation as needed in order to meet their other promise of doubling incomes over the current decade – implying an average annual growth rate of 6.3% until 2020.

Chinese officials have been adept, to date, at tightening regulation in the financial sector without strangling credit growth in the real economy, but the possibility that they may move too aggressively is one of the major risks to our outlook. Given that President Xi will probably remain in office well beyond the traditional two terms, he has an incentive to ensure that the financial system is built on a solid and lasting foundation.

> "We expect growth to run at an annualised rate of around 2% to 2¼% in early 2018, fed by moderate gains in nominal wages and the recent pickup in capital expenditures."
>
> – ALAN LEVENSON, CHIEF U.S. ECONOMIST

The Removal of Central Bank Accommodation Will Be a Test – but a Manageable One

On a broader level, the withdrawal of global central bank liquidity may be the main test facing financial markets in 2018. While only the Federal Reserve, the Bank of England, and the Bank of Canada have begun raising rates, a number of major central banks will take the first steps in reducing monetary accommodation.

We currently expect the European Central Bank to wind down its asset purchases by the end of 2018, with rate hikes probably following in 2019. When the Bank of Japan (BoJ) will make the turn away from accommodation remains less certain, but we expect moderation next year in the thrust of policy stimulus. The BoJ is likely to declare the end of deflation in the relatively near future, which it likely would follow with a reduction of its exchange-traded fund purchases. The BoJ is also likely to announce changes to its overall yield curve control policy, raising the target on the 10-year yield above 0% and perhaps targeting other points on the curve.

The wind-down of central bank balance sheet expansion should not necessarily pose a significant headwind to global growth. Worldwide, quantitative easing – not tightening – will likely continue through 2018, if at a reduced pace: from roughly USD $2 trillion in 2017 to USD $500 billion in 2018. Furthermore, the slowdown in accommodation will come against the backdrop of a much more balanced global economy. Fiscal conditions have made progress in the eurozone periphery, and current account balances in emerging markets have improved, while credit growth has moderated meaningfully.

U.S. Reaches Full Employment

Alan Levenson

After some modest volatility in the first half of 2017, the U.S. economy appears to be settling back into the moderate growth path that it has followed over the past several years. We expect growth to run at an annualised rate of around 2% to 2¼% in early 2018, fed by moderate gains in nominal wages and the recent pickup in capital expenditures. Similarly, inflation appears to be stalled at around 2%, which should keep the Federal Reserve on its current gradual-tightening path.

Growth statistics for the third quarter of 2017 seemed to show little impact from the hurricanes in August and September, with annualised GDP growth of 3.0% nearly matching its second-quarter pace. Inventory building and an increase in net exports helped compensate for the hurricanes' impact on manufacturing and consumer spending in the affected regions. It is further notable that there was an increase in inventory building despite a liquidation of retail auto dealer stocks – light vehicle sales spiked to a cyclical high in September as consumers replaced vehicles flooded in Hurricane Harvey. Less encouragingly, consumers dipped into their savings to pay for the new cars, which sent the saving rate to a cyclical low. The saving rate is unlikely to go any lower in coming months, but consumer spending should receive some

offsetting support from hurricane-related insurance payouts.

U.S. Unemployment Rate May Fall Below Late 1990s Trough

While causing significant temporary disruptions in payroll growth, the hurricanes seemed to have little lasting impact on the overall labour market. Indeed, the unemployment rate has now fallen below its trough during the moderate expansion of the previous decade. We expect the economy to extend its overshoot of full employment in coming months, even as job gains slow, with the unemployment rate falling to 3.7% by the end of 2018 – below even its trough during the robust expansion of the late 1990s.

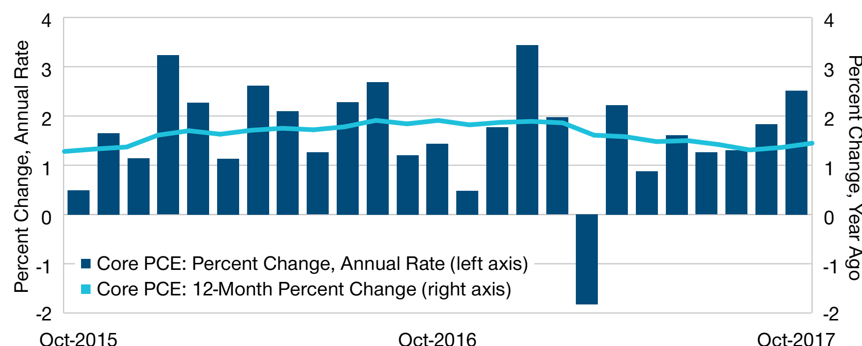
Nevertheless, we are sceptical that a tightening labour market will lead to sharply higher nominal wage growth and push the economy out of its low inflation and moderate growth track. Productivity growth remains well below its levels in the 1990s. Aside from the housing sector, most segments of the economy are seeing minimal price pressures, while the durable goods segment continues to experience outright deflation, fed by global competition, automation, and other pressures. As a result, it seems increasingly plausible that inflation may not reach the Fed's target of 2% in the personal consumption expenditures (PCE) price index in the current cycle (Figure 2). Notably, policymakers have recently revised inflation forecasts to show a later arrival of inflation at the 2% target.

Triple Mandate Suggests Fed Will Keep Raising Rates Despite Low Inflation

Messaging will become a larger challenge for monetary policymakers if inflation continues to disappoint,

FIGURE 2: Core Inflation Has Stalled at Around 1.5%

Core PCE Price Index From October 2015 to October 2017



Source: Bureau of Economic Analysis.

but we do not expect the Fed to stop raising rates in response. In part, this is because we recognise the importance of the Fed's mandate to maintain moderate long-term interest rates – the less discussed third leg of its *triple* mandate, alongside stable prices and maximum employment. Fed officials are aware that abnormally low long-term interest rates are fostering inflated asset prices and may pose risks to financial stability if they are sustained. Thus, the Fed is likely to tolerate sub 2% inflation while nudging rates higher, at least until the unemployment rate stabilises.

While the recent nomination of Jerome Powell as Federal Reserve chair signals little change in rate policy, we will keep an eye on whether he guides the Fed to adjust its approach to bank regulation. The new chair may loosen regulations for small banks, but we caution that investors should not expect Powell to be an advocate for wholesale deregulation.

KEY TAKEAWAYS

- We expect the global economy to carry much of its recent momentum into 2018, although growth is likely to be slower, overall, than observed in the middle of 2017.
- Capital expenditures have become the main driver of growth.
- A more balanced global economy is well positioned for the tapering of monetary accommodation.
- Tighter labour markets in the U.S. and other advanced economies are likely to lift wage growth and solidify a gradual inflation uplift.

Innovation Is Disrupting a Growing Number of Sectors

Rapid innovation and the evolution of new business models should continue to benefit a relatively small group of mega-cap technology companies.

Rob Sharps
Group Chief Investment Officer

Justin Thomson
Chief Investment Officer, Equity

Moving into 2018, we expect to see a further acceleration in the disruptive forces being unleashed in global equity markets by a powerful combination of technological innovation, changing consumer preferences, and evolving business models. These forces are upsetting the competitive balance in existing industries, while at the same time spurring rapid growth for new products and services.

This wave of change should continue to benefit a small group of mega-cap companies that have created dominant technology platforms in industries such as e-commerce, social media, mobile devices, and Internet search. Key advantages, including large user bases, massive computing power, skilled workforces, and ample financial resources, have allowed these companies to leverage powerful economies of scale, sustaining rates of growth that are almost unprecedented, given their current size.

Moving into 2018, we expect to see a further acceleration in the disruptive forces being unleashed in global equity markets by a powerful combination of technological innovation, changing consumer preferences, and evolving business models.

In our view, the valuation multiples currently awarded to some of these stocks are justified by their growth potential – although we recognise the need to differentiate between companies with high current cash flow and earnings and those that are largely reinvesting in their businesses. Looking ahead, we see two key trends worth watching in 2018:

- The scope of disruption is expanding. While retail, advertising, and consumer electronics have been the most visible arenas for disruption so far, advances in genetic mapping are driving the development of new drugs, while horizontal drilling technology has pushed global oil prices sharply lower. Technologies such as electric vehicles and autonomous driving suggest that the transportation industries could be next in line for rapid transformation.

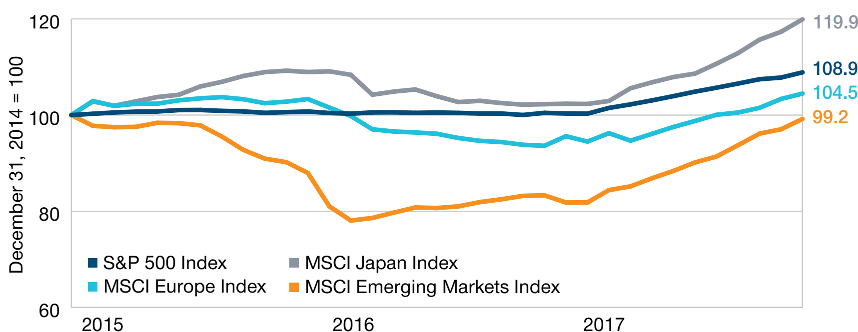
- Political attitudes are changing: Until recently, the technology giants have been widely admired for the benefits – selection, convenience, low prices – they have delivered to consumers. However, data privacy and security concerns, and controversies about social media's role in recent elections, have raised questions about corporate governance and how these firms wield their economic power. This creates the potential for a regulatory backlash.

We believe opportunities for profitable growth – both organically and through acquisitions – will remain plentiful for these winners as they extend their brand power and distributional control across markets and geographic regions. However, the political climate for them will bear watching in 2018.

Economic Outlook

For the first time since the 2008–2009 financial crisis, the global

FIGURE 1: Synchronised Global Growth Boosts the Earnings Recovery
Earnings Per Share Growth In Local Currency Terms, Through October 31, 2017



Sources: FactSet, Standard & Poor's, MSCI; data analysis by T. Rowe Price.

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economy appears to have entered a synchronised expansion. Strong growth, ample liquidity, and low inflation have produced an extended period of exceptionally low volatility – not just in global equity markets, but in credit and currency markets as well. While it remains to be seen whether this period of calm will persist in 2018, we would not necessarily view it as forecasting a correction to come. T. Rowe Price's research suggests that periods of low market volatility can resolve themselves to either the upside or the downside.

Similarly, valuation multiples that are above historical averages in most developed markets do not necessarily mean that global equities are overvalued. In the context of low interest rates and low inflation, equity risk premiums in many markets still appear reasonable, in our view.

Going forward, a key question will be whether strong growth and tightening labour markets will generate typical late-cycle inflationary pressures, forcing the major central banks into a more aggressive withdrawal of monetary stimulus. Current market expectations are for a continued gradual pace of Federal Reserve tightening and for the European Central Bank to begin a moderate tapering of its bond purchases in 2018. The Bank of Japan (BoJ) still appears committed to its own version of quantitative easing. These policies would be constructive for equities, in our view. However, considering the potential for faster growth and tighter labour markets, we are mindful of the risk of upside inflation surprises.

Earnings Outlook

To a large extent, equity strength in 2017 reflected a broad-based recovery from the global profits recession that began in the second half of 2014 (Figure 1). In Europe, earnings revisions turned positive for the first time since 2012. Earnings momentum in the U.S. also appeared to reaccelerate. Meanwhile, Japanese companies generally did well despite a steady-to-stronger yen.

Faster-than-expected growth in China – despite tighter money and credit as Beijing addresses the country's bad debt problems – was in many ways the economic surprise of 2017. With China acting as the locomotive for the Asian economies, the broader earnings recovery in the emerging markets also accelerated.

Barring unpredictable political or economic shocks, we expect the global earnings recovery to continue in 2018; however, year-over-year growth comparisons will become more challenging. We believe markets will weather slowing earnings momentum as long as investors perceive the underlying growth trends are positive and can be sustained as the economic cycle continues to mature.

U.S. Tax Reform

As tax reform legislation moved swiftly through Congress in late 2017, it appeared many multinational firms were evaluating how a revamped U.S. corporate tax code could impact their businesses. In addition to boosting after-tax reported earnings, we believe meaningful rate cuts could spur capital spending and hiring, potentially giving a second wind to earnings growth.

In terms of economic sector performance, much still depends on whether U.S. fiscal stimulus leads to a further acceleration in the global economy in 2018. If so, the "reflation trade" favouring cyclical value could be revived, although rate-sensitive sectors such as real estate investment trusts, utilities, and consumer staples potentially would be challenged. On the other hand, if economic momentum slows, secular growth could regain favour.

Regional Overview

Emerging markets generally outperformed through the first

10 months of 2017, while the ex-U.S. developed markets, as measured by Morgan Stanley Capital International's Europe, Australasia, Far East (EAFE) Index, outperformed U.S. equities in U.S. dollar terms (Figure 2). Looking forward, our regional perspectives include:

- **United States:** After lagging secular growth stocks through much of 2017, cyclical sectors showed some strength in the second half, perhaps reflecting growing optimism about U.S. fiscal stimulus. U.S. corporate tax cuts would tend to favour U.S. small-caps, which are more exposed to the domestic economy and are more heavily taxed, on average, than their large-cap counterparts.

- **Europe:** Financials, energy, and materials are heavily weighted in the major European indexes, so higher interest rates, a steepening yield curve, and/or a more sustained recovery in commodity prices all would be constructive for earnings. While Catalonia's separatism crisis is negative for Spanish equities, we see no contagion effect that might undermine confidence in Europe more broadly.

- **UK:** The exception to a generally positive European picture is the UK, where there are growing signs of financial stress – in the London property market, for example. The longer Brexit negotiations go on without meaningful progress, the more hiring and investment decisions are likely to be put on hold, increasing the risk of a downturn.

- **Japan:** Japanese equities historically have been highly sensitive to the global economic cycle. With the BoJ focused on managing the long end of the yield curve, a combination of strong export demand and a weaker yen potentially could be very supportive for equities. Continued corporate reform and a shift to more shareholder-friendly policies are additional positives.

- **China:** We continue to focus on China's domestic technology titans, as recent equity performance has been even more concentrated in those names than it has in the U.S. market. However, structural reform of state-owned enterprises could create future opportunities in basic industries such as steel and coal.

- **Other Emerging Markets:** Lagging economies in Brazil and Russia have stabilised and asset prices have been strong. India was the one major negative surprise in 2017, as demonetisation caused temporary shocks, aggravated by bad debt burdens. Recent moves to address the debt situation will help. We see potential pockets of vulnerability should the U.S. dollar strengthen in 2018, including Turkey and some Central and Eastern European markets. However, these issues are not significant enough to create broader systemic risks, in our view.

FIGURE 2: Emerging Market Equities Led in 2017 While the U.S. Lagged the Other Developed Markets

Cumulative Returns, December 31, 2016, Through October 31, 2017, in U.S. Dollars

Source: MSCI.

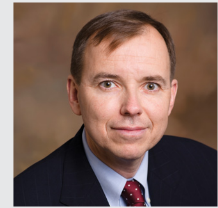
Past performance is not a reliable indicator of future performance.

KEY TAKEAWAYS

- Innovation and disruptive change continue to benefit a relatively small group of mega-cap companies. Despite recent gains, valuations for these stocks still appear reasonable.
- For the first time since the global financial crisis, the world economy is in a synchronised expansion, driving steady earnings growth in most markets.
- Barring unpredictable political or economic shocks, the global earnings recovery should continue in 2018. However, year-over-year comparisons will grow more challenging.
- Whether recent low market volatility persists in 2018 remains to be seen, but we do not believe low volatility in itself predicts that a significant correction is imminent.

Fixed Income Enters a New Era

Uncertainties about the pace of rate hikes and the withdrawal of quantitative easing reinforce the importance of a global approach to bond investing.



Mark Vaselkiv
Chief Investment Officer, Fixed Income

We expect 2018 to mark the beginning of a new era in bond investing as central banks begin the long process of withdrawing the quantitative easing (QE) measures introduced in the wake of the global financial crisis, with some monetary policymakers also set to hike interest rates. These tightening measures will be implemented at a time when sovereign yields in the developed markets are very low and credit spreads are tight, and while the global economy faces trade uncertainty, the potential return of inflation, and a number of geopolitical risks. However, we believe growth will remain firm in many parts of the world, creating compelling opportunities in select credit sectors.

In this environment, bond investors will need to cast a wider net and diversify their fixed income portfolios to meet their desired risk and return objectives, with an emphasis on detailed research, active security selection, and sector rotation.

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Central Banks Take Centre Stage

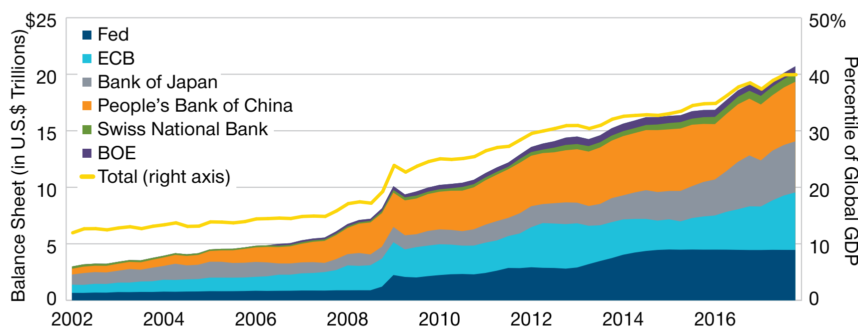
The year 2017 arrived amid high expectations that newly elected U.S. President Donald Trump's proposed infrastructure spending, tax cuts, and regulatory reforms would result in higher U.S. growth and inflation. It did not take long for these expectations to fade. When it became clear that Trump's policies would prove much harder than anticipated to put into practice, yields fell back down to levels last seen before the presidential election, interest rates declined, and the dollar slumped against the euro. Since then, interest rates have modestly picked up and the dollar has rallied slightly, but uncertainty persists over the extent to which Trump can deliver on his original mandate.

A bigger influence on markets in 2018 than President Trump's political fortunes, however, will be the extent and speed of central bank tightening. Following almost a decade of unprecedented monetary stimulus, central bank-owned assets equaled around 40% of global gross domestic product (GDP) at the end of September, compared with around 20% immediately prior to the 2008 financial crisis (Figure 1, page 9). This figure will fall again as central banks begin the long process of retrenching their balance sheets, but it is not yet clear how quickly they will seek to do this, nor what the cumulative impact on markets will be.

We expect that some central banks will also hike interest rates in 2018 – possibly more aggressively than currently priced in by the markets. The Fed has signaled it will hike rates three times next year, which would take the federal funds rate to 2.25% and – if long-term rates remain stable – flatten the U.S.

FIGURE 1: Central Bank Support Is Set to Wind Down

Central Banks Balance Sheet Versus Percent GDP, as of September 30, 2017



Sources: Haver Analytics and T. Rowe Price. Based on moving sum of last four quarters' GDP figures.

Treasury yield curve. If the Fed hikes more than that, or seeks to reduce its balance sheet more quickly than anticipated, the U.S. yield curve could even become inverted. Based on past experience, this would imply a negative outlook for the U.S. economy. When longer-dated assets generate less income than shorter-dated ones, the incentive to make new loans dries up, depriving the economy of a vital source of funds. If the Fed proceeds more cautiously, however, a reasonable rate of economic growth should be achievable.

Europe remains at an earlier stage in the credit cycle than the U.S., with reasonable growth prospects for 2018. The European Central Bank (ECB) has signaled its intention to begin tapering its bond purchase programme next year, but it is unlikely to begin raising interest rates until 2019. Although the eurozone yield curve is also likely to flatten, it is unlikely to invert. Elsewhere, however, there are growing expectations that the Bank of England (BOE) will raise rates more quickly than previously thought to curb inflation, and the Bank of Canada appears likely to move into an aggressive cycle of rate hikes.

A tightening move by one central bank in isolation would probably not cause too much concern; a number of banks doing so at the same time is a very different proposition. Developed market yields remain close to record lows, while credit spreads are tight on the back of years of accommodative monetary policies and benign economic conditions. Synchronised tightening in this environment could be disruptive; although, given that banks are likely to adopt a cautious approach, liquidity will very probably remain ample for an extended period. The key question, therefore, is: Which factor is more important – the flow of QE (which will be negative) or the remaining stock of QE (which should still be very substantial)? How the markets answer this question will play a major part in determining whether 2018 sees a return to volatility or a continuation of stability, in our view.

Trade Uncertainty and Geopolitical Risks Challenge Growth

Uncertainties over trading relationships and Chinese growth pose further challenges. If the negotiations between the UK and EU over Brexit collapse, or if U.S. President Donald Trump delivers on his threat to scrap the North American Free Trade Agreement, the restrictions on trade that would likely ensue could negatively impact global growth. Following the 19th National People's Congress in October, the Chinese authorities are expected to ramp up their efforts to reform China's state-owned enterprises and reduce corporate debt, which could slow the Chinese economy in 2018. China's growth is still expected to come in above 6%, but a downside surprise could cause significant disruption given China's importance as the world's second-biggest economy.

Geopolitical risks persist, too. Tensions between the U.S. and North Korea show no sign of abating. While full-scale war seems unlikely given the costs on both sides, the potential impact of the diplomatic standoff on U.S.-China relations is a concern. Elsewhere, the threat to European unity has receded following the failure of populist, anti-immigration parties to make major inroads in the Dutch, French, and German elections, but the Catalan independence movement and ongoing negotiations over Brexit have the potential to unleash further volatility, as does the forthcoming Italian general election.

In addition, while under control for a number of years, inflation may make a comeback in 2018. The broader economic environment continues to show improvement, and there is a possibility that central banks may misinterpret underlying inflation signals and stresses.

The Importance of Being Uncorrelated

The past year was notable for the tranquility of the markets – bad news came and went without causing too much disruption. Efforts to hedge portfolios against risk generally did not pay off, hampering the returns of investors who opted to tread carefully. As noted above, whether the markets remain as nonchalant in 2018 will depend largely on how investors respond to the beginning of the withdrawal of monetary stimulus. We believe it is very possible that a risk event, or a combination of events, could unleash considerable volatility, making it prudent for investors to manage risk exposure by adopting underweight positions or adding risk-free assets like U.S. Treasuries to their portfolios.

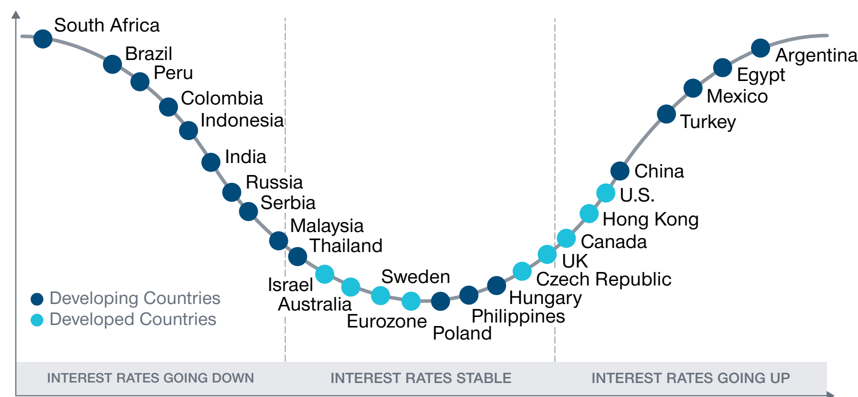
Diversification will also be key. While sovereign yields in the developed markets are low, a number of emerging markets are at different stages in their interest rate cycles and offer higher sovereign yields. High yield bonds and bank loans appear to offer better return potential and lower duration than developed sovereigns, but they do not appear cheap in the current environment and also are highly correlated to equities – meaning they could be vulnerable in the event of a market correction.

We believe a barbell strategy – one that pairs credit instruments on one side with asset-backed securities or sovereigns (which historically have been less correlated with equities) on the other – may offer advantages in 2018. Another potentially promising approach could be to invest in countries undergoing positive transformational change. We believe Argentina, India, and Indonesia fall into this category, while prospects for Turkey and South Africa are less favourable, in our view.

More generally, given the potentially volatile nature of markets, a willingness to adopt an active approach to security selection and rotate between sectors where necessary could be advantageous for bond investors in 2018.

Illustrative Interest Rate Cycle

As of October 31, 2017



Sources: CRB Rates and T. Rowe Price.

We believe it is possible that a risk event, or combination of events, could result in volatility. It may therefore be prudent to consider diversifying and managing risk exposure, for example through selective underweight positions or risk-free assets such as U.S. Treasuries.

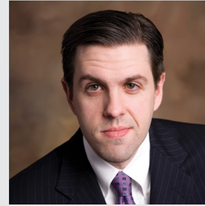
KEY TAKEAWAYS

- Developed market central bank tightening is set to begin in earnest in 2018, ending an almost-decade-long period of monetary stimulus.
- Monetary tightening will take place against a background of low yields, tight valuations, the possibility of inflation, and a number of ongoing geopolitical risks.
- However, we believe growth will remain firm in many parts of the world, creating compelling opportunities in select credit sectors.
- In this environment, it may pay to employ barbell strategies that combine higher yield assets with assets that have lower correlation to equities.

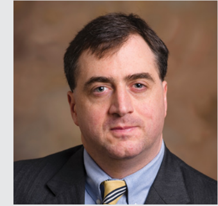
Full Valuations Suggest Cautious Approach to Portfolio Risk

While coordinated global growth creates a favourable environment for risk assets, high valuations leave markets vulnerable to geopolitical shocks, rapid central bank tightening, and other surprises.

Sébastien Page
Head of Global Multi-Asset



David Giroux
Chief Investment Officer, Equity and Multi-Asset



Charles Shriver
Portfolio Manager, Global Allocation, Balanced, and Target Allocation

While a broadening global economic recovery should continue to support risk assets in 2018, relatively high equity valuations and tight credit spreads in many major markets provide relatively little valuation support against unexpected market events, in our view. In this environment, bonds offer beneficial attributes within a portfolio as a counter to potential periods of heightened equity market volatility.

Given elevated valuations, we believe that equity returns in the coming year will be primarily driven by earnings growth. If global economic and earnings growth exceeds current expectations, we should expect positive returns in both developed and emerging equity markets. Supportive factors include the potential for major U.S. tax cuts to generate further earnings upside or for growth in Europe and Japan to be driven more by durable domestic recoveries than by stimulative monetary policies. Potential risks include a rise in geopolitical or trade tensions or a central bank policy misstep as interest rates and inflation both appear poised to rise from current low levels.

Given elevated valuations, we believe that equity returns in the coming year will be primarily driven by earnings growth.

Our relative preference for bonds does not imply a bullish outlook for global fixed income assets. We expect that low yields, tight spreads, and less accommodative policy from the Federal Reserve and the European Central Bank (ECB) will leave little room for upside in any fixed income category. However, given current equity valuations, we are focused on the role that bonds historically have played in dampening total portfolio volatility.

Our multi-asset portfolios are designed to benefit from broad diversification across asset classes and sub-asset classes. We characteristically overweight or underweight segments of the market that we believe are more or less attractive over a 6- to 18-month investment horizon, taking into consideration a variety of factors, including valuations as well as economic and earnings trends.

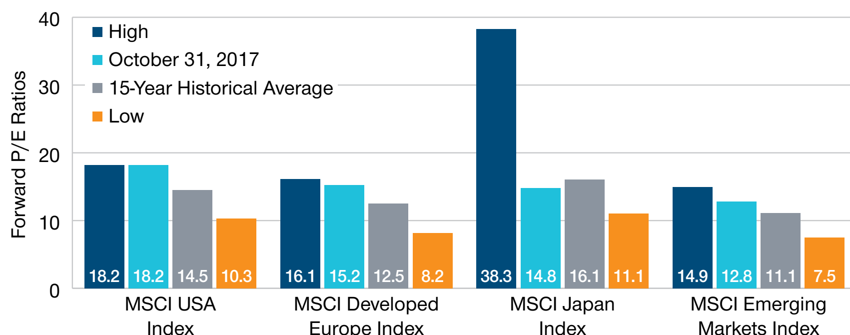
Global Equities

Among developed equity markets, Europe and Japan appear more attractive than the U.S. based on improving economic fundamentals, diminished political risk, and potential upside for corporate earnings. Valuations are also modestly cheaper in Europe compared with the U.S. (Figure 1, page 12).

- The recent uptrend in European earnings appears sustainable, as profit margins and earnings in the region both tend to benefit from global trade linkages. Conditions for banks and other financial companies in the peripheral euro countries are improving.
- Japan features the most attractive valuations among the major developed markets, as well as supportive monetary policy, and high exposure to global trade. Corporate governance and shareholder returns also are improving, although gradually.

FIGURE 1: Equity Valuations in Most Major Markets Are Trending Above Historical Averages

Forward One-Year Price/Earnings Ratios, December 2001 Through October 2017



Sources: FactSet and T. Rowe Price.

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- In the U.S., earnings trends are positive, but expectations are elevated, leaving limited room for upside surprises. Valuations are above historical averages. A weaker U.S. dollar has been a tailwind for U.S.-based multinationals, but could be less supportive going forward.

Our outlook for emerging markets (EM) equities has become somewhat more balanced. Earnings growth has improved and the near-term threat of a more protectionist approach to trade policy has diminished. While EM valuations are modestly above historical averages, they appear less expensive compared with developed markets. However, the potential for renewed declines in energy and other commodity prices is a downside risk.

Growth and Value

In the U.S. market, valuations for growth stocks appear less attractive after their strong performance in 2017, and are more in line with historical averages relative to value stocks. The potential for tax cuts and deregulation may support cyclical value sectors, particularly financials. Although we expect that large technology and consumer discretionary stocks, which led the market in 2017, will continue to benefit from strong secular growth opportunities, we have lowered our allocation to growth stocks given the concentration risk reflected in this narrow market leadership.

In markets outside the U.S., we have increased our overweight to value relative to growth based on valuations, the outlook for sustained economic growth, and the potential for higher interest rates to benefit certain cyclical areas, such as European banks. Valuations in many growth sectors outside the U.S., including consumer staples, are above their historical averages.

Large-Cap and Small-Cap

Following a period of small-cap underperformance in 2017, valuations versus U.S. large-caps are more in line with historical averages, although still relatively high in absolute terms. Corporate tax cuts and stronger U.S. economic growth are potential upside catalysts that could disproportionately favour small-cap companies given their higher marginal tax rates and greater exposure to domestic demand. Potential U.S. dollar strength would be more challenging for U.S. large-cap, multinational companies. However, small-caps could underperform if volatility rises from current low levels.

Small-caps stocks in Europe and Japan also appear relatively more attractive compared with the U.S., as they offer higher leverage to domestic economies that are in earlier stages of recovery, with the additional benefit of central bank policies that are still accommodative.

Real Asset Equities

Real asset equities have historically outperformed the broad market in periods of high or rising inflation, particularly unexpected upturns in inflation rates. Consequently, the sector serves an inflation-hedging role in our portfolios. However, while inflation may rise from current low levels, we remain underweight to real asset equities, as we do not anticipate a significant acceleration in inflation in 2018.

We continue to be cautious about natural resource stocks, as global energy prices are still challenged by persistent production increases and falling costs among U.S. shale producers. Similarly, we expect that demand for industrial metals will be subdued as investment and growth in China continues to shift from basic manufacturing towards consumer-orientated and service industries.

While an upturn in economic growth in 2018 potentially would benefit real estate stocks, U.S. real estate appears to be in the late stages of the economic cycle as fundamentals are decelerating along with the prospects for rising interest rates.

Fixed Income

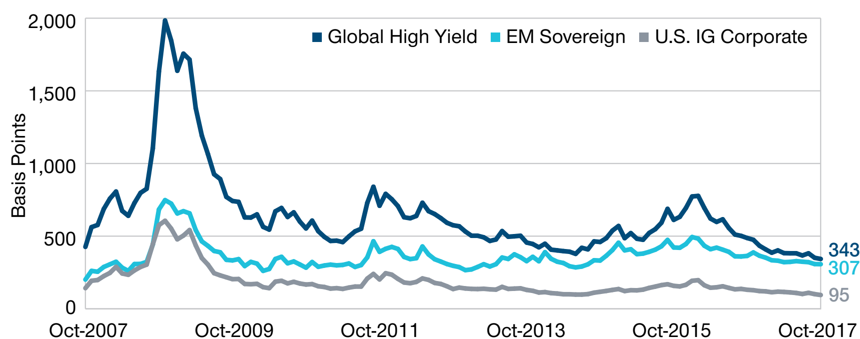
Sovereign yields in the developed bond markets are extremely low, held down by continued quantitative easing from the ECB, the Bank of Japan (BoJ), and, until recently, the Bank of England. EM and high yield bonds potentially offer more attractive yields as well as lower duration, but credit spreads are tight relative to history (Figure 2).

In developed markets, we currently favour investment-grade (IG) bonds in the U.S. over other regions due to more attractive valuations, shorter duration, and the potential for a period of U.S. dollar strength after the relative weakness seen in 2017, which would weigh on non-U.S. dollar bond returns.

- U.S. Treasury yields appear relatively more attractive than the other developed sovereign markets, and we believe the Federal Reserve is likely to tighten policy at a modest pace.
- Bond prices in Europe could be at risk in 2018 as the ECB tapers its quantitative easing purchases. While the euro may face near-term headwinds as rising rates support the U.S. dollar, we believe that intermediate-term fundamentals favour the euro.
- In Japan, long-term bond yields are weighed down by slow wage growth, low inflation, and demographic challenges. With the yield curve anchored by the BoJ, foreign exchange moves in the yen are likely to be driven by the actions of other major central banks, as well as possible flight-to-safety effects.

FIGURE 2: Fixed Income Spreads Have Narrowed to Some of Their Tightest Levels Since Before the Global Financial Crisis

Option-Adjusted Spreads Over U.S. Treasuries, Through October 31, 2017



Sources: Bloomberg Barclays, BofA Merrill Lynch, and JP Morgan.

U.S. IG Corporate = the Bloomberg Barclays U.S. Investment Grade Index; Global High Yield = the BofA Merrill Lynch Global High Yield Index; EM IG Sovereign = the JP Morgan Emerging Markets Bond Index (EMBI) Global Investment Grade.

High Yield Bonds and Bank Loans

High yield credits appear less attractive relative to U.S. IG bonds as valuations are high versus historical averages following a period of strong sector performance. Although economic conditions are supportive and default rates are low, we see less opportunity for further appreciation at current yield levels.

Renewed declines in energy prices are a potential downside risk for high yield, as the energy sector carries a heavier weight in the high yield universe relative to IG corporates. In addition, bond covenants that protect investors have generally been weaker on new issuance. Current yields provide only a limited buffer against capital loss if the credit environment grows more challenging.

Emerging Market Bonds

We are neutral on the attractiveness of EM bonds relative to U.S. IG, as valuations in many emerging markets are less compelling following strong performance in 2017.

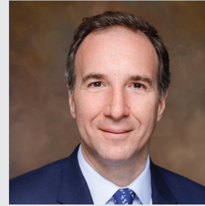
Yields on EM U.S. dollar sovereign bonds appear especially low, and may face headwinds from less accommodative monetary policy by major central banks in the developed markets. EM local currency yields are also less compelling following the 2017 rally, but we believe there are opportunities for active managers to add excess return and alpha as select currencies remain cheap and several EM central banks are still easing interest rates in a low-inflation environment.

KEY TAKEAWAYS

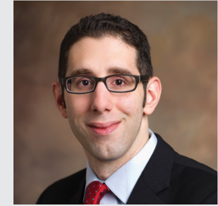
- Broadening global economic growth should be supportive for corporate profits in 2018, but our equity positioning is tempered by extended valuations.
- Bonds also appear expensive, but can serve an important role as diversifiers should we face increasing headwinds from geopolitical events or if growth disappoints.
- Sovereign yields in developed markets are low. Valuations for U.S. investment-grade bonds as well as high yield credit appear historically expensive.
- Most emerging economies are in better fiscal positions than prior to the 2013 Fed taper tantrum. However, emerging markets bond valuations have become less compelling.

Despite Higher Valuations, Opportunities Can Still Be Found

Attractive relative valuations, improving growth, and positive earnings trends characterise many markets, but hawkish trade policies, falling energy prices, or geopolitical risks could impede progress.



Gonzalo Pángaro
Portfolio Manager,
Emerging Markets
Equity



Samy Muaddi
Portfolio Manager,
Emerging Markets
Corporate Bond

We believe global emerging markets (EMs) continue to offer attractive investment opportunities even after the strong performance seen in 2017. Many of these markets are in much better shape today, boosted by the ongoing progress of meaningful economic and political reforms in key developing countries. Many of their traditional vulnerabilities, such as large current account deficits and low inflation-adjusted interest rates, have markedly improved.

After 2017's strong performance, valuations for both equities and bonds are not as compelling as they were a year ago. However, they remain attractive relative to their history and to most developed markets. Importantly, they do not reflect emerging markets' contribution to the global economy and to overall growth. In fact, we would view a pricing dislocation triggered by an event in developed markets as an opportunity to broadly add to EM debt at lower valuations.

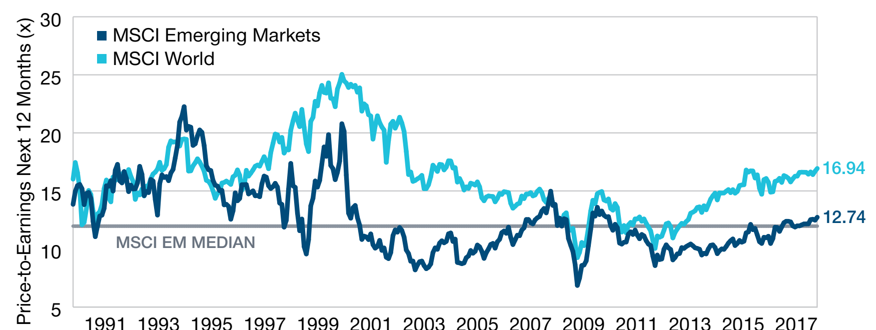
EM Growth Should Continue to Outpace Developed Markets

Broadly speaking, economic growth in EMs outpaced developed markets growth in 2017. This stronger growth should continue in 2018 as countries like Brazil, Russia, and India improve, widening the growth advantage for EMs over developed markets. This supportive economic backdrop should allow for further gains in corporate earnings, which recovered strongly in 2017. Furthermore, we continue to see many companies undertake steps to control costs and improve profit margins. Importantly, margins have more room to improve, as they remain below historic averages in most emerging countries. Also, more disciplined capital spending is contributing to a strong recovery in cash flows, which should help support increases in dividends.

EM equity valuations, as measured by price-to-earnings ratios, still look competitive versus developed markets and their own historical levels, even if they are not as cheap across the board as they were a year ago (Figure 1).

FIGURE 1: Emerging Markets Equity Valuations Remain Attractive

Emerging Markets Price-to-Earnings Valuations Relative to Developed Markets, as of October 31, 2017



Sources: MSCI and FactSet.

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Asian EMs Lead on Reforms

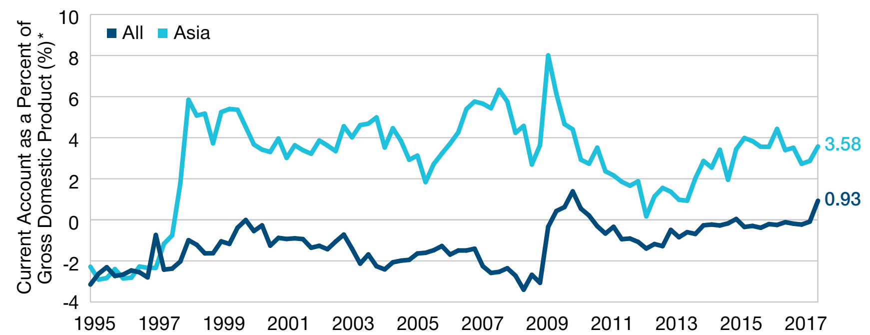
Emerging countries in Southeast Asia are leading the way in enacting reforms and correcting the fundamental imbalances that made them vulnerable in past financial crises. India and Indonesia, in particular, have made notable progress implementing needed reforms. Capital flows into these countries were unexpectedly strong in 2017 while inflation was contained, helping them improve their current account balances, which contributed to better average balance sheets across EMs. This should help their economies achieve more sustainable growth (Figure 2).

While geopolitical tensions involving North Korea continue to present a risk, stable growth in China has been a key factor in supporting the rest of the EMs, particularly the Asian economies that are closely linked to the Chinese supply chain. As China addresses overcapacity in some of its industries, tackles true reform of its state-owned enterprises, focuses on improving quality of life, and works through its buildup of debt, its growth could slow, but only modestly. Furthermore, concerns about potential instability in the Chinese financial sector due to the country's growing debt levels have eased.

> Broadly speaking, economic growth in EMs outpaced developed markets growth in 2017. This stronger growth should continue in 2018 as countries like Brazil, Russia, and India improve, widening the growth advantage for EMs over developed markets.

FIGURE 2: Emerging Markets Current Account Balances Have Improved

Surpluses in Emerging Asian Countries Have Helped Broad EM Current Accounts, as of June 30, 2017



Sources: National central banks and Haver Analytics.

*Moving average of the most recent four quarters.

A Broad Shift in Latin American Politics

While volatility is likely to remain in the short to medium term for some Latin American countries, we see attractive long-term equity investment opportunities in the region, even after the market gains of the past year. Latin American countries are benefiting from a broad shift towards political leaders who tend to implement investor-friendly policies and away from populist politicians who have dominated the region more recently. For example, Argentine President Mauricio Macri, elected in 2015, has already made significant progress on meaningful reforms and looks likely to win reelection in 2019.

On the other hand, we remain cautious towards Mexico because of the twin risks of the U.S. renegotiating the North American Free Trade Agreement and a potential victory for leftist candidate Andrés Manuel López Obrador in Mexico's July 2018 presidential election. Although continued political corruption scandals have knocked reform momentum in Brazil off course, optimism that Michel Temer's administration will eventually accomplish meaningful structural reforms has contributed to an impressive rally as the country's economy shows signs of recovering from its deepest recession in 100 years.

Willingness to Implement Reforms Lagging in Emerging Europe

Countries in emerging Europe are broadly behind other EM regions in terms of their willingness and ability to make meaningful reforms. The governments of Russia and Turkey are key laggards. However, Russia enjoyed impressive domestic demand-led growth in 2017. Russia's central bank continues to have room to cut interest rates amid moderate inflation, which could bode well for growth going forward and could support both bonds and equities.

The Primary Risks for EMs Are Now External

Unlike in the past, when internal political or economic problems were most typically the triggers for sell-offs in EMs, today we think that the primary risks for these markets

are mostly external. However, while unexpectedly hawkish monetary policy in developed markets would likely lead to some volatility, we view EMs as being relatively well positioned to maintain stability in an environment of gradually higher interest rates, primarily due to healthier current account balances and more prudent fiscal positions. Furthermore, inflation-adjusted interest rates in some EMs remain high, giving their central banks the flexibility to lower rates if necessary.

Another downturn in commodities prices could cause some selling pressure, although the EMs as a whole are more broadly balanced between commodity-importing countries and commodity-exporting nations than in the past. Although concerns about a sharp downturn in China have eased, we continue to monitor the country's transition to an economy based on domestic consumption – with a particular focus on the health of its financial system.

Rigorous Fundamental Equity Analysis Is Essential

We believe the future path for EM equities is likely to be less homogenous and more divergent than it was in an era when commodity prices were rising, global trade was strong, and China's economy was growing at over 10% annually. This suggests that rigorous analysis of company fundamentals will be more important than ever in 2018. Being proactive will be essential to identify and invest in the most attractive opportunities within these highly diversified markets.

Correction Caused by External Factors Could Be a Potential Buying Opportunity

We would view any correction in EM bonds caused by an external event – such as a further escalation of geopolitical tension involving North Korea, political instability in developed markets politics, or protectionist trade policies in the U.S. – as a potential opportunity to add to our favoured positions. As of late 2017, we preferred local currency EM debt over U.S. dollar-denominated bonds, as some major local currencies appeared poised to gain against the U.S. dollar.

Active Management Seeks Opportunities in Frontier Markets

We see select opportunities to capture value in frontier markets bonds, which tend to involve more country-specific idiosyncrasies than mainstream EMs. For example, Sri Lanka's local currency debt currently offers some of the highest inflation-adjusted yields in the world. This, combined with the country's improving fiscal condition and funding agreement with the International Monetary Fund, makes it attractive for us.

Argentina continues to look attractive, and we increased our overweight positions in the country's stock and debt following the recent midterm elections that solidified support for President Macri's reform agenda. We believe the ability to invest in countries – such as the frontier markets – that are not included in the standard EM benchmarks is an important benefit of active portfolio management.

Active management of EM bonds also provides the ability to overweight countries, such as Brazil, that are easing monetary policy and to make country allocations based on fundamentals as opposed to a given issuer's amount of debt outstanding. In equities, we actively target well-managed companies that we believe can open up potential opportunities to outperform passive benchmarks.

KEY TAKEAWAYS

- Emerging markets (EM) equity valuations appear competitive versus developed markets and their own historical levels, although not as cheap as a year ago.
- Although yields on EM bonds have compressed, the asset class still offers broadly healthy fundamentals as well as attractive yields relative to historical volatility.
- Alongside a sharp China slowdown or Korean Peninsula conflict, external 2018 EM risks include the withdrawal of quantitative easing or a downward commodity price shock.
- Active management lets equity investors focus on attractive pockets of EM growth and allows debt investors to own countries that are not in their benchmark.

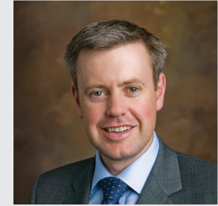
Key Risks

The following risks are materially relevant to the strategies highlighted in this material: Transactions in securities denominated in foreign currencies are subject to fluctuations in exchange rates which may affect the value of an investment. Returns can be more volatile than other, more developed, markets due to changes in market, political and economic conditions. Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default which may affect the value of an investment.

Europe's Recovery Continues, but Risks Loom

While monetary tapering could lead to periods of instability, Europe's fundamentals remain strong, supporting the Continent's equity and bond markets.

Dean Tenerelli
Portfolio Manager,
European Equity



Mike Della Vedova
Portfolio Manager,
European High
Yield Bond

Underpinned by strong fundamentals, the European economic recovery should continue in 2018, providing support for the Continent's equity and bond markets. However, lingering political risks, the prospect of central bank tightening, and stretched valuations mean that periods of volatility cannot be ruled out. We believe investors could benefit from adopting a highly selective approach, with an emphasis on identifying strong companies within sectors that appear likely to benefit from the European recovery but potentially could be less exposed to periods of market instability.

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Populist Threat Has Subsided, Not Disappeared

Following the UK's watershed decision to exit the European Union (EU), the established order in Europe seemed under threat from populist movements in a number of countries in 2017. Elections in the Netherlands, France, and Germany – and a planned unofficial referendum on independence for Catalonia from Spain – all were seen as potential flashpoints that could challenge the EU's attempts at closer integration.

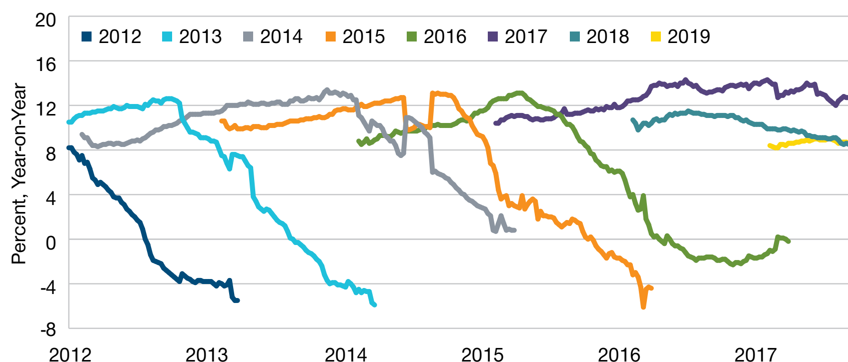
In the end, mainstream parties prevailed in the Netherlands and France, but anti-immigration, anti-EU candidates made some headway in Germany and in Austria's early election. Although the "yes" vote in October's Catalan referendum was driven more by longstanding regional grievances against the Spanish government than by anti-immigration or anti-EU sentiment, the issue of Catalan independence still could play a decisive role in influencing other separatist movements in Europe.

Despite these risks, the eurozone grew at a healthy rate throughout the year – consistent with economies in other parts of the world that proved similarly impervious to negative geopolitical events. The big question for 2018 is whether this resilience will continue. At a fundamental level, the prospects look good: Europe is at an earlier stage in the credit cycle than the U.S., corporate earnings are strong, and the recovery seems to be broad-based enough to sustain itself.

Risks remain, however. While the threat from anti-EU and other separatist forces has abated, it has not disappeared. The situation in Catalonia could take a while to resolve, the eurosceptic Five Star Movement and Northern League parties both are expected to perform well in the Italian general election due in March, and negotiations over Brexit could yet collapse. The possibility remains that other member states will seek to leave the EU or that populist movements will gain stronger footholds in their national parliaments, influencing policy. Any such developments would be regarded as threats to EU unity.

FIGURE 1: European Earnings Per Share Estimates Through Time

As of October 3, 2017



Source: Morgan Stanley.

ECB to Play a Major Role

The prospect of central bank tightening is another potential risk to the 2018 outlook. In October, the European Central Bank (ECB) announced plans to scale back its monthly asset purchase programme from €60bn to €30bn beginning in early 2018. But it also clarified that it would continue reinvesting the proceeds of its bond purchases for "as long as necessary" to support growth and would not raise rates until after its bond purchases have been ended.

We believe the ECB's announcement suggests that monetary policy in the eurozone will remain highly accommodative for the next few years at least, which is good news for investors concerned about the vulnerability of the European recovery. However, if the eurozone economy expands more quickly than expected, the ECB could be forced to tighten more aggressively, which would risk putting upward pressure on credit spreads.

Elsewhere, the U.S. Federal Reserve is expected to raise rates three times in 2018 and adopt a fairly moderate approach to shrinking its balance sheet, but the pace could change depending on growth and inflation data. If the Fed surprises the markets with more aggressive tightening, any subsequent spike in volatility also could affect the recovery in Europe.

Growth-Generating Stocks Could Outperform

Investors in European equities benefited from rising corporate earnings throughout 2017 on the back of the strong fundamentals and diminishing concerns over political risk. We expect earnings growth to be slower in 2018 and in 2019 (Figure 1), mainly due to a stronger euro and the difficulties some companies could have offsetting input cost pressures from higher raw material prices. However, as many other asset classes appear to be fully valued, we believe that further upside potential to European equities is possible if corporations continue to build on their recent solid growth.

In our view, the best European equity opportunities in 2018 are likely to be found in high-quality, growth-generating companies that are well placed to benefit from the economic recovery. The telecommunications sector is particularly interesting in this regard because consolidation is driving competition and boosting margins. European banks are generally undervalued and stand to benefit from the gradual removal of monetary stimulus by the ECB. However, we do not expect financial stocks to outperform significantly in 2018 as interest rates are unlikely to rise appreciably.

We also see potential opportunities in the software services industry, where a number of companies are innovative disruptors and are delivering excellent rates of compound growth. Although we do not generally favour automakers given their expensive valuations, regulatory issues, and complex financing structures, opportunities can be found among the industry's suppliers – particularly original equipment manufacturers using innovative technologies to develop irreplaceable parts.

Our focus on growth has led us away from defensive sectors such as consumer staples, which have fallen out of favour with the market more broadly. However, these sectors have become cheaper recently, and opportunities may arise if valuations fall further, as a number of companies offer good earnings growth, strong returns, and healthy dividends.

Low Yields Emphasise Need for "Strong Stories"

Strong corporate fundamentals meant that European credit markets also performed well in 2017. The ECB's huge monetary stimulus programme played a major role in supporting the rally by making it cheaper than ever for corporations to borrow and by reducing default risk to record-low levels, encouraging investment.

However, lower risk has also brought lower returns. Monetary stimulus

has compressed yields, although the rewards available in European credit markets have been better than in many other markets. Assuming the ECB keeps its pledge to adopt a cautious approach to tapering, we believe that European corporate debt markets will deflate rather than burst and that yield curves will rise only gradually in 2018 (Figure 2).

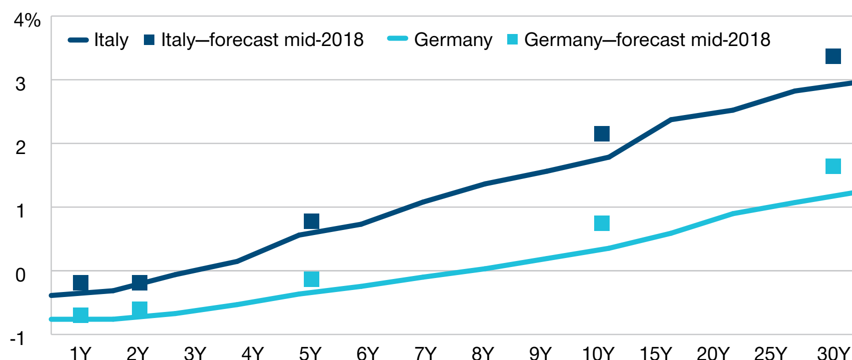
Given the risk of holding low-coupon securities at a time when political risks are present and central banks are seeking to remove monetary accommodation, we believe a sensible approach for investors is to seek to identify corporate issuers whose individual "stories" have the potential to improve irrespective of how credit benchmarks perform. This strategy may lead to underperformance during market rallies, but over the longer term, it is likely to be a more effective way of navigating a period of monetary tightening and market volatility, in our view.

Attractive European high yield issuers currently include media, cable, telecommunications, and packaging companies, all of which appear well positioned from both a cyclical and a secular perspective. We believe the most promising opportunities within investment-grade debt can be found in broadly the same sectors and also among financial companies, which form a much bigger part of the investment-grade universe. The new capital rules put in place after the 2008–2009 financial crisis are now being tested – and so far, they seem to be working. If this continues, we believe European financial debt issues can perform strongly again in 2018.

> We believe a sensible approach for investors is to seek to identify corporate issuers whose individual "stories" have the potential to improve irrespective of how credit benchmarks perform.

FIGURE 2: Italian and German Sovereign Yield Curves, Current and Projected

As of November 10, 2017



Sources: Bloomberg Finance LP and T. Rowe Price European Fixed Income team projections.

The projections are based on current data as of the date stated and projections of economic/political conditions.

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KEY TAKEAWAYS

- We expect the European economic recovery to continue in 2018, supporting the Continent's bond and equity markets.
- However, lingering political risks, the prospect of European Central Bank tightening, and stretched credit valuations mean that periods of volatility are possible.
- In equities, we see potential opportunities in high-quality, growth-generating companies that are well placed to benefit from Europe's economic recovery.
- The most effective approach to active bond selection may be to identify corporate issuers whose "stories" are likely to improve irrespective of how credit benchmarks perform.

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