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GLOBAL MIDYEAR MARKET OUTLOOK 2015

June 2015

In-depth analysis and insights to inform your decision making.



Alan D. Levenson
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Global Economics: DIVERGENT MONETARY POLICIES STILL DRIVING THE GLOBAL ECONOMIC OUTLOOK

EXECUTIVE SUMMARY

More than six years after the global financial crisis, economies around the world are still reckoning with its consequences—with just about every nation's growth rate significantly lower than it was prior to the downturn. Unlike the synchronized global credit boom of the pre-crisis years, however, a moderate global growth rate masks considerable differentiation. The United States and United Kingdom have deleveraged enough that they are preparing to raise ultra-low interest rates. European economic data have improved versus six months ago as fiscal tightening dissipates, while Japan's outlook is better as a result of delaying a tax hike. Emerging markets with relatively low inflation and low debt have had room to ease monetary and fiscal policy; others that have improved their policy frameworks and tackled structural shortcomings also have better economic outlooks. Global economic risks include volatility following unpredictable geopolitical events around the world.

More than six years after the global financial crisis, economies around the world are still reckoning with its consequences—with the United States leading the recovery but still afflicted with slow growth relative to the pre-crisis norm.

Unprecedented central bank stimulus has had progressively less impact as the world endures a disappointing recovery from the crisis. Just about every nation's growth rate is significantly lower than it was prior to the downturn.

The latest projection for 2015 by the International Monetary Fund forecasts 3.5% growth in the world's gross domestic product (GDP), slightly higher than in 2014. Unlike the synchronized global credit boom of the pre-crisis years, however, this moderate rate masks considerable differentiation.

The United States and United Kingdom have deleveraged enough that they are preparing to raise ultra-low interest rates. European economic data have improved versus six months ago as fiscal tightening dissipates, while Japan's outlook is better as a result of delaying a tax hike. Both regions are easing monetary policy aggressively.

Varying policy responses to the crisis have led to a decoupling between improved conditions in developed nations awash in liquidity and slowing growth in emerging nations. In aggregate, growth in emerging markets is decelerating faster than in developed markets, though growth rates in emerging markets remain higher.

Among emerging markets, there also is dispersion because of policy responses. Emerging markets with relatively low inflation and low debt have had room to ease monetary and fiscal policy; others that have improved their policy frameworks and tackled structural shortcomings also have better economic outlooks.

Global economic risks include an unlikely hard landing as China's growth rate falls, a possible breakdown between Europe and Greece, and volatility following unpredictable geopolitical events around the world.

MODEST U.S. EXPANSION

Though headwinds still linger, the U.S. cyclical expansion is intact. A very weak first quarter means a 2015 GDP growth rate in the range of 2.50% to 2.75%[1], down from the 2.75% to 3.00% predicted at the start of this year. At the same time, the United States is growing faster than its currently reduced potential growth rate of less than 2.0% (based on labor force and productivity growth).

A year ago, many economists thought 3.0% growth was possible, but U.S. growth cannot reach that level without a more certain investment environment, an improved housing market, and a better global outlook.

Given where the United States is in the business cycle, recession is a low probability without an unforeseen shock. Indeed, economic tailwinds are evident: a still easy monetary policy; household sector deleveraging; the upsides implied by the low level of housing production relative to the population's needs and low capital spending relative to GDP; low gas prices; recently increased government spending; signs of wage growth; and, most important, continuing job growth.

U.S. job growth may be lower this year than last, but it's still strong enough to bring the unemployment rate down—to about 5.0%[1] by the end of the year, though with more under-employment than typically is seen at that level. Job growth has been driving income growth but, as unemployment falls, wage growth will become more important.

The U.S. core inflation rate—running this spring at a 1.3%[2] annual rate—likely will remain stable over the next three to six months. But it could rise sooner than anticipated, possibly to 1.6%[2], not far below the Federal Reserve target of 2.0%.

Despite much anticipation, the Fed's first interest rate hike since 2006 should not have much of an economic impact, though global markets could react in the short term. Our base case is a hike of 0.25% by September, followed by a meeting-by-meeting assessment that should result in a very gradual path of further hikes.

EUROPEAN GREEN SHOOTS

Growth in the eurozone is recovering faster than many expected, the result of lower oil costs and a weaker euro spurring exports. Eurozone GDP grew 0.4%[3] in the first quarter, and consensus GDP forecasts for 2015 and 2016 likely will be revised upward. Meanwhile, deflation fears have receded.

The 19-nation bloc also is benefiting from moves away from fiscal austerity, although late starters such as France are still maintaining tighter policies. The European Central Bank has taken several steps since last summer to increase the degree of policy accommodation, including an expansion of its bond-buying program this year. The quantitative easing effort, likely to run through September 2016, should promote cyclical recovery by keeping the euro weak and encouraging banks to lend. Stronger global growth also would be positive for Europe.

Short-term risks to Europe's recovery include a potential for a flare-up in the Ukraine conflict and uncertainty from Greece's debt situation. To grow longer term, Europe needs structural reforms to increase competitiveness and counter negative demographics.

JAPANESE REFORMS

Japan emerged from a mild recession at the end of 2014, and some signs of stronger growth are evident. Lower commodity prices are helping and exports are picking up, with the country producing a trade surplus in March for the first time in almost four years.

Prime Minister Shinzo Abe has continued to press his economic reform agenda after his party's reelection in December. A new fiscal plan is to be released this summer, aimed at balancing the budget by 2020. Among developed nations, Japan has the largest deficit as a percentage of GDP.

On the monetary front, the Bank of Japan has continued with very accommodative policies: a 0% interest rate and purchases of Japanese government bonds and other assets. The central bank remains committed to eventually reach its 2% goal on inflation.

Structural reforms, the "third arrow" of Mr. Abe's agenda, have been difficult to carry out, but there has been progress. Parliament has passed a corporate tax cut aimed at increasing economic growth, and an enhanced corporate governance code has been implemented.

EMERGING MARKETS DISPERSION

In China, more local government austerity measures, weak corporate profits, and slower housing construction have reduced growth prospects to slightly below the government's 7% target for 2015.

Policymakers have responded by stepping up monetary easing in a series of rate cuts starting last year through this spring. After relatively timid responses in the past, this new injection of liquidity has a better chance at success. As a result, second-half growth prospects look better, but structural problems persist as China transitions to a more consumer-oriented economy and its workforce ages.

[1]T. Rowe Price
[2]Core Personal Consumption Expenditure Index
[3]Bloomberg, European Central Bank, WSJ

In other emerging markets, growth prospects vary. Lower oil prices benefit oil importers and hurt producers, and nations face a wide range of geopolitical and structural risks:

- India now appears to be growing faster than China, although a new method of computing its GDP has created confusion about its true growth pace. After taking office last year, Prime Minister Narendra Modi's government has set a course for steady economic reforms. With weakening inflation, the central bank has scope for additional rate cuts.
- In Turkey, economic momentum is slowing, with GDP growth likely to fall below 2.5% this year after 2014's 2.9%[4] pace. The central bank eased its policy rate lower in February to stimulate growth.
- Russia entered into recession in the first quarter, and recent data point to an economic contraction for the full year. Sanctions remain in place amid risks from potential reescalation of tensions with Ukraine. Fiscal conservatism allows the central bank to loosen monetary policy.
- Brazil faces multiple challenges. Its central bank is near the end of a series of rate hikes designed to cut inflation from over 8%—the highest level in more than 10 years—to below 6.5%, the upper level of the official target range. President Dilma Rousseff's government appears committed to fiscal adjustment to maintain the country's investment-grade credit rating, but slow growth could weaken its resolve.

As a result of such variations, emerging markets, once viewed as homogeneous, now must be viewed case by case.

[4]Turkish Statistical Institute, Trading Economics web site, various news reports.

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Chris Alderson
Head of International Equity



John Linehan
Portfolio Manager

Global Equity: LEADERSHIP PASSES TO NON-U.S. MARKETS

EXECUTIVE SUMMARY

Non-U.S. equities were lifted by a combination of trends in early 2015, including improved growth in Europe and Japan, aggressive monetary easing by several major central banks, and a slowdown in the rise of the U.S. dollar. We expect these factors to remain supportive over the balance of the year. The U.S. equity outlook is also reasonably positive, although investors may have grown too complacent about risk. Europe offers perhaps the best opportunity for an earnings acceleration in the second half. The Japanese market is being boosted by quantitative easing, purchases by public financial institutions, and corporate reform. Prospects for emerging equity markets remain divided by their positive or negative exposures to energy and commodity prices.

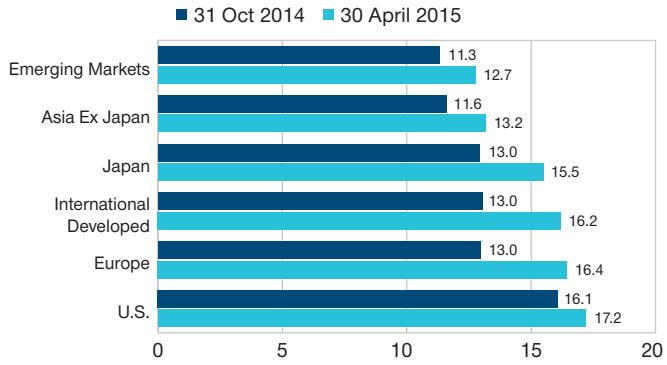
A better outlook for growth in the non-U.S. developed economies, signs that U.S. dollar appreciation has topped out, and aggressive monetary easing in Europe, Japan, and China, all combined to lift the performance of non-U.S. equities in early 2015—trends we believe are likely to persist in the second half of the year.

The outlook for U.S. equities remains generally positive, but after a six-year bull run that has seen the S&P 500 rise more than 200% without a significant correction, we think investors may have grown too complacent about the risk of short-term market volatility. On the plus side, the U.S. economy appears to be growing fast enough to generate reasonable earnings growth, but not so fast that the Federal Reserve will feel compelled to tighten monetary policy quickly.

Prospects for the emerging markets (EMs) remain divided by prevailing trends in energy and other commodity prices. Although commodity markets stabilized in the first half, our view is that the secular trend is still downward, as the so-called "commodity supercycle" continues to play out. Thus, our expectations are that equity markets in resource-exporting nations like Brazil, Russia, and the Persian Gulf states will remain at risk, while markets in consuming countries, such as China, India, and South Korea, should be poised to benefit. Political risk remains a significant issue for emerging Europe, given recent events in Russia and Ukraine.

Valuation multiples generally continue to favor non-U.S. markets over U.S. equities, although those differentials have narrowed since late 2014 (Figure 1, page 2). However, these comparisons are somewhat skewed by the substantial appreciation in the dollar against most global currencies over the past year.

FIGURE 1: Global Equity Forward Price/Earnings Ratios[1]

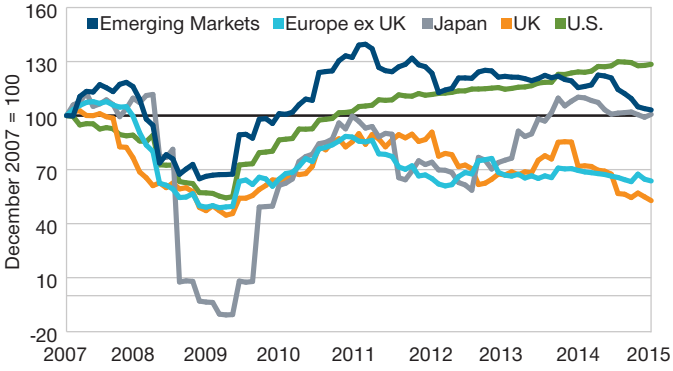


Source: MSCI

[1]U.S. equities are represented by the Russell 1000 Index; European equities by the MSCI Europe Index; international developed equities by the MSCI Europe, Asia, and the Far East (EAFE) Index; Japan equities by the MSCI Japan Index; Asia Ex Japan equities by the MSCI Asia Ex Japan Index; and emerging market equities by the MSCI Emerging Markets Index.

FIGURE 2: Earnings Recovery in Non-U.S. Markets Has Lagged

Trailing EPS for MSCI Indexes, 31 Dec 2007 Through 30 April 2015



Sources: FactSet, MSCI

EUROPE ON THE MEND

Europe offers perhaps the best opportunity for an earnings acceleration in the second half, in our view, as economic growth forecasts in the eurozone have begun to pick up both in core countries, such as Germany and France, and in most of the peripheral debtor countries—Greece excepted.

The profits recovery would also appear to have further room to run in Europe than in most global regions. While earnings per share (EPS) are almost 30% above their pre-financial crisis peak in the U.S.—and roughly on par with their pre-crisis highs in Japan and the emerging markets—they remain deeply depressed in both the eurozone and the UK (Figure 2, above).

Operating leverage is relatively high for many European large-cap companies, so even modest revenue growth can translate into sizable earnings gains. All this suggests that if the European recovery normalizes, it could have a potent effect on earnings. Meanwhile, aggressive quantitative easing by the European Central Bank (ECB) is providing direct support for asset prices.

U.S. EQUITIES: WAITING FOR THE FED

With the U.S. economy growing at a moderate pace, and few signs that inflationary pressures are building, monetary policy should remain relatively supportive for equities, even as the Fed moves closer to its first interest rate hike in almost nine years. Market expectations for the timing of that move have slipped into the second half of 2015 or even later.

The direct impact of the Fed's initial rate moves on the U.S. economy and corporate earnings is likely to be minimal. But we are concerned that the prolonged wait for the Fed to tighten may have dulled investor awareness of the substantial support that near-zero interest rates and historically low bond yields have been providing for U.S. equity valuations.

On an absolute basis, U.S. market multiples could be viewed as ranging between the high end of fair value and the low end of expensive. But on a relative basis—such as the S&P dividend yield versus the 10-year Treasury yield—equities still appear quite attractive. The question, then, is the Fed's expected timetable for returning interest rates to more historically normal levels. Shifts in investor expectations for that schedule could generate market volatility and/or a more substantial correction.

A mature economic cycle and a tougher environment for margin expansion also suggest that U.S. earnings growth will be harder to come by, increasing the importance of stock-specific performance factors. Greater dispersion of returns should increase the potential for active stock selection to add value.

JAPAN INC. GROWS MORE SHAREHOLDER FRIENDLY

Japanese equities surprised on the upside in early 2015, with the Morgan Stanley Capital International (MSCI) Japan Index returning more than 14%[2] in dollar terms through the first four months of the year. As in Europe, the lagged effects of a weaker currency and aggressive quantitative easing by the Bank of Japan were supportive both for the economy and for asset values, while the stabilization of the yen against the U.S. dollar since

[2]Morgan Stanley Capital International

the beginning of the year improved returns for U.S.-based investors. We expect these trends to persist in the second half.

Additional support for the Japanese market has been provided by the massive Japanese postal savings and insurance systems and the Government Pension Investment Fund (the world's largest), all of which have been moving assets from Japanese government bonds into equities. With Japanese 10-year notes recently yielding less than 0.5%[3], and the Abe government eager to boost asset prices, the shift to equities also seems likely to continue.

Longer-term structural support for equity values is coming from Japanese corporate managers who are adopting more shareholder-friendly policies—either on their own initiative or in response to the voluntary corporate governance code adopted by financial regulators late last year.

EMERGING MARKETS: THE PLAYING FIELD REMAINS UNEVEN

Although recent months have seen market advances in some of the EM regions hardest hit in the second half of 2014—such as Latin America and emerging Europe—these gains largely reflect the modest rebound in commodity prices, which we think is unlikely to strengthen in the second half.

Given our bearish expectations for the commodity supercycle, we see continued potential for wide return differentials among both companies and countries based on their production or consumption exposures. Careful analysis will be required to identify winners and losers.

As in the recent past, much will depend on China's efforts to transition from export- and investment-led growth to a more consumer-driven economy. To offset the continued industrial slowdown, the People's Bank of China has embarked on its own version of quantitative easing, cutting interest rates and easing lending restrictions. Real estate prices and the stock market have responded quickly, with the MSCI China Index returning more than 26%[4] in the first four months of 2015.

Given Beijing's intense desire to inflate asset prices, we think the market gains seen so far this year are sustainable, at least in the short run. However, valuations are excessive in some low-quality sectors, and speculative trading by retail investors is rising. We think caution is warranted.

[3]Bloomberg Business News
[4]Morgan Stanley Capital International

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Arif Husain, CFA
Head of International Fixed Income

Global Fixed Income: NAVIGATING THROUGH UNCERTAIN WATERS

EXECUTIVE SUMMARY

There is a high level of uncertainty in global fixed income markets at midyear, highlighted by recent turbulence in many sovereign markets. Amid divergent and less predictable central bank policy, the range of potential outcomes is wide, and higher volatility seems certain.

In this challenging environment, T. Rowe Price Head of International Fixed Income Arif Husain believes that investors need to be nimble. By utilizing the full global opportunity set and maintaining some defensive positions, investors will be better equipped to manage risks and take advantage of available opportunities in global rates, currencies, and credit markets.

The predominant theme in global fixed income markets at midyear is a high degree of uncertainty. Major central banks had coordinated monetary easing in response to the global economic downturn. But today, policy has become more divergent, and central banks are providing less guidance around their future plans. Against this backdrop, the range of potential outcomes for sovereign, credit, and currency markets is wide. It seems the only certainty is higher volatility.

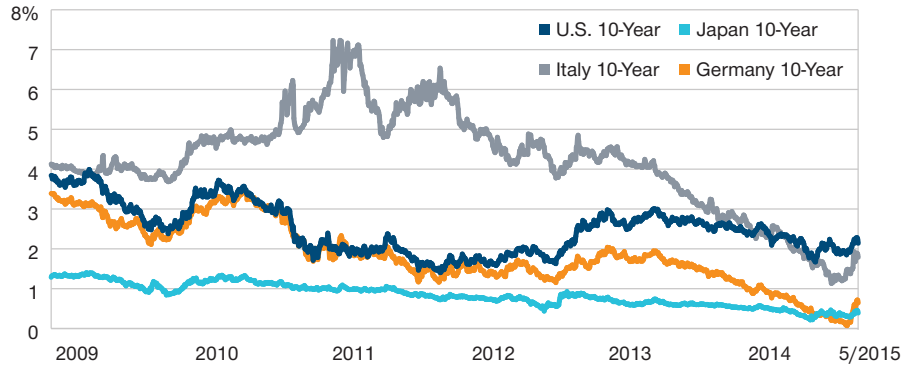
Fixed income markets have been unsettled recently, with sharp corrections in many government bond markets. The epicenter has been Germany, where yields on 10-year notes spiked from near 0% in mid-April to more than 0.70% in mid-May. Investors had crowded into eurozone sovereigns, hoping to sell to the European Central Bank (ECB) at higher prices, but retreated as valuations began to look unjustifiably rich and Europe's economic outlook improved.

U.S. Treasury yields simultaneously climbed to their highest level of the year. Treasuries had enjoyed strong demand from foreign investors due to a strengthening dollar and attractive yields relative to Europe and Japan (see Figure 1). But rising global yields caused Treasuries to lose some of their luster. Higher oil prices, a reprieve in rampant dollar strength, and continued improvement in the labor market contributed to the sell-off.

The recent market turbulence has drawn comparisons with the "taper tantrum" of 2013, when investors unloaded Treasuries and other interest rate-sensitive assets after Federal Reserve officials signaled their intent to taper asset purchases. Volatility in the Treasury market spiked from low levels, and credit spreads rapidly widened amid a drought of market liquidity.

FIGURE 1: Sovereign yields have followed divergent paths

31 December 2009–15 May 2015



Source: Barclays.

A lesson from that episode is that there is considerable pent-up demand for bonds at higher yields. Institutional investors stepped in to stem the rout, becalming markets in relatively short order. We could be in store for a similar pattern of sharp sell-offs followed by gradual rallies as Fed rate hikes come into closer view. In this environment, investors will need to be nimble to manage risks and take advantage of opportunities.

SEEKING SHELTER FROM INTEREST RATE VOLATILITY

As demonstrated by recent events, volatility can quickly spread across global financial markets due to their interconnectedness. No country will be completely immune to volatility in large markets, such as the U.S. and Europe. But some may be less vulnerable because their interest rate cycles are at different stages.

Asian markets are one potential refuge from interest rate volatility. While European and U.S. rates rose sharply in April and May, sovereign yields held relatively steady across much of Asia. Although return potential is limited, some of these defensive countries include:

- **China:** Central bank policy is biased toward easing to support growth, which should keep yields well anchored. And policymakers have signaled their intent to keep the exchange rate stable, reducing currency risk.
- **South Korea:** The performance of Korean bonds has become less correlated with U.S. Treasuries. With slow growth, low inflation, and aging demographics, Korea's sovereign market behaves more like Japan than an emerging market. Its central bank may cut rates again, which would be positive for local bonds.
- **Thailand:** Like South Korea, sluggish growth and subdued inflation are keeping downward pressure on rates. Thailand's bonds also have low foreign ownership, making them less vulnerable to capital flight as the Fed begins tightening.

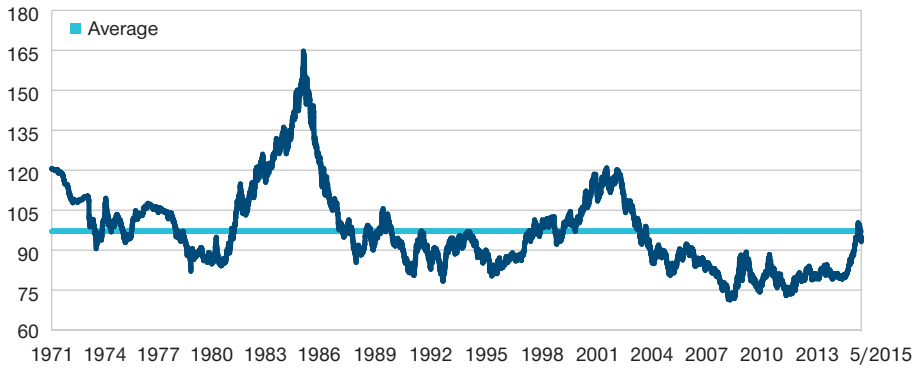
Elsewhere, Brazil offers a substantial yield cushion should global rates rise. Brazil's central bank has been raising rates since early 2013. It may be nearing the end of its cycle, and the government's commitment to fiscal thrift should eventually permit easier monetary policy. However, inflation remains high, and yields could move higher in this more volatile market. Inflation-linked Brazilian debt affords some downside protection.

A FORMIDABLE ENVIRONMENT FOR CURRENCIES

Currency volatility has been elevated amid pervasive U.S. dollar strength (see Figure 2). The dollar has recently given back some of its significant gains amid a spell of weak U.S. economic data. But this is likely only a pause given the divergent paths of central banks and expected acceleration in U.S. growth. That said, the dollar's earlier rise was intense, and further appreciation may occur at a slower velocity. With the ECB and Bank of Japan pursuing aggressive policy while the Fed pares back stimulus, there is scope for some additional weakness in the euro and yen. But the moves appear to have largely run their course.

FIGURE 2: Recent dollar strength intense but not unprecedented

4 January 1971–15 May 2015



U.S. dollar index (DXY) versus a trade-weighted basket of major currencies.
Sources: Thomson Reuters and T. Rowe Price.

In emerging markets, currency valuations have become more attractive, and some countries have seen improvements in terms of trade. But caution is warranted given the threat of dollar strength. Our highest-conviction positions are in countries that possess traits that should attract capital flows, such as strong growth, high yields, and positive economic reforms. Prime examples include:

- **Indian rupee:** Prime Minister Modi is slowly implementing promised reforms that include phasing out subsidies, removing barriers to foreign investment, and restructuring a complex tax system that discourages business investment. Relatively robust growth and an improved trade balance are also positive for the currency.
- **Mexican peso:** The Peña Nieto administration has instituted important reforms, most notably in the energy and telecommunication sectors. While growth remains modest, it should pick up over the medium term as these efforts take hold and the economy becomes more competitive.

A BOND-PICKER'S MARKET IN GLOBAL CREDIT

Valuations are generally unexciting at the sector level, but there are still compelling individual credit stories. As such, we expect security selection to be a larger driver of performance than broad sector exposures. We recommend taking full advantage of an expanding global opportunity set, which provides opportunities to exploit pricing discrepancies and unsynchronized credit cycles.

- **Investment grade:** The corporate credit cycle has entered its late stages in the U.S. amid rising merger and acquisition and shareholder-friendly activities. Shorter-maturity, lower-beta industrials and European banks hold potential, and high-quality Asian corporates are a source of higher yields and lower expected volatility.
- **High yield:** With the exception of commodities producers, fundamentals are mostly solid for below investment-grade firms. Valuations remain decent but are less attractive than earlier in the year, and sustained low oil prices remain a risk given the size of the U.S. high yield energy sector. We see value in energy names that can withstand low oil prices, as well as in shorter-maturity debt trading at a discount. In Europe, an improving economy and ECB easing are supportive of its burgeoning high yield credit market.
- **Emerging markets:** Valuations are compelling relative to comparable U.S. credit, and the oil price rebound has reduced near-term default risk. However, certain markets—such as Russia and Venezuela—face challenges, and the relatively young emerging market corporate sector is untested in a rising-rate environment. Poor liquidity is a risk, but it could also create opportunities to buy at wider spread levels.

RECENT VOLATILITY LIKELY TO PERSIST

Risks to the outlook include how effectively China responds to a slowing economy and the rapidly evolving situation in Greece. A collapse of the Greek government or the installation of capital controls would likely benefit "safe haven" securities, such as U.S. Treasuries and German bunds, while hurting peripheral eurozone sovereigns and the euro.

But the most glaring risk is the Fed given that the central bank is no longer "patient" with regard to renormalizing policy. After six years with a virtually 0% fed funds rate, any increase will be a paradigm shift for the investment environment. Of more importance than the timing of the first move, however, is the subsequent path and ending level. The Treasury market is pricing in a slower and shallower tightening cycle than Fed officials are projecting, which skews risk to the downside if an inflation surprise forces the Fed to move more rapidly. This implies higher volatility and bond yields.

Accommodative Fed policy has buoyed asset prices across the risk spectrum. There is a risk that the withdrawal of monetary support could lead to a scenario where stocks and bonds fall simultaneously. Within fixed income, markets that attracted large investor inflows in search of yield look most vulnerable to rising rates.

However, experience demonstrates that demand for duration is robust when yields climb to enticing levels. And the many countries that will not be raising rates should be less sensitive to rising U.S. yields. In this uncertain environment, maintaining a balanced portfolio that includes some defensive and liquid positions in global rates and currency markets is a prudent approach for riding out expected volatility.

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Dean Tenerelli
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Europe and Japan: IT'S NOT ALL ABOUT QE

EXECUTIVE SUMMARY

With both Japan and Europe having to adopt quantitative easing (QE) to turbocharge their economies and stave off deflation, equity investors have enjoyed the benefits of policy stimulus. A number of European stock markets have hit levels last seen before the financial crisis, while Japan's Nikkei 225 Index recently rose to its highest level in 18 years. There are clear concerns in the market that, beyond QE, there is no real fundamental improving bull case for European and Japanese equities. However, this aggregate top-down perspective belies structural improvements and a breadth of stock-specific opportunities that we are seeing in both asset classes.

There are many positive drivers in place for Europe already, while Europe also remains a diverse region with many high-quality companies with great pedigrees and robust balance sheets. Many of these are trading at a discount to their global peers. Japan combines both a domestic and a later-cycle earnings growth story. Attach attractive valuations compared with other regions and some selective self-help reform that will structurally improve Japan's profitability, and this provides a positive backdrop for further gains. However, at a stock level, it is becoming increasingly harder to find good companies at cheap valuations. Therefore, it is important to do your research to find the best investments.

QE ASIDE, STRUCTURAL REASONS TO BE POSITIVE

With both the central banks of Japan and Europe having to adopt quantitative easing (QE) to turbocharge their economies and stave off deflation, equity investors have enjoyed a boost to sentiment from policy stimulus. A number of European stock markets have hit levels last seen before the financial crisis, while Japan's Nikkei 225 Index recently rose to its highest level for 18 years. While the fundamental benefits of policy easing are only now evolving, the recognition among policymakers of the need to act is a positive.

Beyond QE, there are clear concerns in the market that there is no real fundamental bull case for European and Japanese equities. However, this aggregate top-down perspective belies structural improvements and a breadth of stock-specific opportunities that we are seeing in both asset classes.

POSITIVE DRIVERS ALREADY IN PLACE FOR EUROPE

The European Central Bank's (ECB) QE program has been positive for the market and should help to boost economic activity. Nevertheless, the underpinnings for a growth revival in the euro area were already in place, even before January's announcement:

- **Increased corporate investment**—European corporate management teams have largely avoided or deferred investment and acquisition decisions. With confidence increasing, and with an unavoidable buildup of deferred investment to renew aging fixed assets, we are finally beginning to see an increase in M&A activity and capital spending as the economic cycle strengthens.
- **Fiscal policy neutral/positive**—With the primary balance of the eurozone now in surplus, there is now less fiscal drag across large parts of Europe.
- **Weaker euro**—While QE has helped to weaken the currency, the expectation that the ECB will remain ultra-dovish for many years to come by keeping interest rates near zero has also pushed the common currency lower. Consensus estimates are for the depreciation of the euro to add approximately 0.6% to real GDP over the next two years.
- **Lower oil prices**—The IMF estimates that lower oil prices will boost euro area GDP by around 0.9%.
- **Easing of deleveraging pressures**—The flow of credit to the private sector is picking up. This is partly because borrowing yields have declined sharply and banks are relaxing lending standards. But it is also because the dearth of lending over the past few years has generated pent-up demand for new credit, which is now recovering from both consumers and corporates.
- **Potential for recovery in consumer spending**—The above factors should together engender a much more positive feeling among consumers.

It is important to note that Europe is a particularly open economy, with 50% of the revenues in the index coming from outside Europe, and any slowdown in global growth will have implications. However, China is still growing at around 7% per annum, despite its often-discussed slowdown. Meanwhile, the U.S. economy, one of Europe's major trading partners, continues to stand out versus peers for its economic improvement.

EUROPEAN CORPORATES BEGINNING TO DELIVER

Importantly, corporate earnings are beginning to come through stronger again in Europe, certainly for the companies in which we are invested. In the latest earnings season, there have been more upgrades than downgrades, and the principal driver around the upgrades has been the European portion of companies' earnings. Earnings in Southern Europe, where our portfolio is particularly exposed to Spain, have come through stronger than in other areas. The Spanish economy is recovering well, and stronger growth is being echoed in companies' performance. We are also witnessing the normalization of property prices, with prices beginning to rise in France and in parts of the main cities in Spain. However, the equity market is now more stock specific than thematic. Today, you really need to do your homework to find the best opportunities.

MORE TO COME FROM EUROPE?

While some would disagree, we believe valuations are best described as "reasonable" for where we are in the economic cycle, although we would stress that this view is premised on the delivery of more broad-based earnings growth. On a cyclically adjusted basis, the P/E ratio for the European market is currently around 15, versus a longer-term average of closer to 20. As this measure utilizes the average of the last 10 years' earnings, we believe it is a useful indication of the market's attractiveness, assuming a normalized level of earnings.

Europe also remains a diverse region, with many high-quality companies possessing great pedigrees and robust balance sheets. Many of these are trading at a discount to their global peers. The corporate sector is also in robust shape—supporting capital expenditure, M&A activity, and income and earnings growth. Additionally, a dividend yield of over 3% can reward those seeking yield in this low-rate environment. At the same time, fear is subsiding, and we have witnessed some important structural changes in Europe since the financial crisis. Most encouraging for us, though, is that valuations do not yet reflect normalized earnings, so there remains potential for stocks to move further ahead.

WHAT ABOUT JAPAN?

Japanese equities have enjoyed a phenomenal ascent as QE (monetary policy delivery has continually surpassed expectations), an improving corporate earnings outlook, and a weaker yen have all helped the market rise strongly. However, we believe that what is priced into the market is only the first-order impact. We have seen stocks perform well due to a weaker yen, but also on an improving domestic outlook. What is not yet reflected in the market is the improved competitiveness of Japanese companies. We are witnessing this most in technology, where Japanese firms have been taking share back from South Korean competitors but also in other areas of the market.

It is also worth noting that Japanese companies have suffered yen appreciation for a number of years, and it will take time for that to reverse. Therefore, if the currency remains stable over the next two to three years, we should see Japanese companies start gaining share of global demand again, which will lead to higher profits.

Of course, a slowdown in the global economy would have a detrimental impact on Japan, as it is still the most cyclical of developed markets. There are concerns emerging about the first hike in interest rates in the U.S. and what impact that will have on the global economy. However, even when the Fed does begin to hike rates, it is most likely to be at a measured pace in order to assess the potential reverberations

through financial markets and the impact on domestic growth.

It is also important to highlight that the beginning of interest rate increases will not necessarily be bad for stock prices. Higher rates often coincide with improved economic conditions, which typically bode well for equities. Additionally, it will probably mean that the yen weakens further, thereby providing a boost to Japanese companies.

IS THAT THIRD ARROW READY TO BE RELEASED?

For many, much of the Japanese government's "third arrow" of structural reform has yet to be released. We have been monitoring the pause in progress given the need to reform, but more recently, we have become encouraged. First, both Japan and the U.S. have been making great progress in the Trans-Pacific Partnership negotiations, despite some challenges from the powerful agricultural lobby in Japan. We have also had some important labor law reforms passed in the Japanese Diet, with some of the changes rewarding employee performance. This is important as it will allow companies to pay more to employees who outperform and should allow for more flexibility within the labor market, which Japan so desperately needs.

Corporate governance in Japan is also sustainably changing. Encouragingly, much of this has been put into law, which gives it a much more powerful and secular force. Japan's government has also effectively decided to underpin the market where possible. We have witnessed a significant shift toward domestic equities from the vast Government Pension Investment Fund (as well as Japan Post), while the launch of the Nikkei 400 Index has also created an attractive method of investment in the theme of Abenomics reform. Therefore, we are increasingly witnessing a positive structural change within Japan, which should help support equities.

ARE FOREIGN INVESTORS LATE TO THE PARTY?

Japanese equities have enjoyed rallies like these in the past, especially in 2003–2006, when Prime Minister Koizumi promised to deliver change to Japan. When that rally started in March 2003, it was the bottom of the market, and it took until 2005 for foreign investors to participate. In contrast, we have recently seen foreign investors increasing their investment, through both mutual funds and direct participation.

This is encouraging, as we believe there is still upside potential for the market as a number of factors are supportive for further gains. Japan combines both a domestic and a later-cycle earnings growth story. Attach attractive valuations compared with other regions, along with some selective self-help reform that will structurally improve Japan's profitability, and the result is a positive backdrop for further gains. However, at a stock level it is becoming increasingly harder to find good companies at cheap valuations. Therefore, it is important to do your research to focus on where companies' returns are going to improve as the structural and corporate improvements happen. This means investors will need to be selective, but as Japan begins to deliver on its promise, investors should continue to be rewarded.

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GLOBAL MIDYEAR MARKET OUTLOOK 2015

June 2015

In-depth analysis and insights to inform your decision making.



Gonzalo Pángaro
Lead Portfolio Manager, Global Emerging Markets Equity Strategy

Emerging Markets Equity: DISPERSION OF RETURNS WILL REMAIN A FEATURE

EXECUTIVE SUMMARY

Emerging markets (EMs) continue to perform well, but performance within individual markets has shown a high degree of dispersion. For some, lower commodity prices and the relative strength of the U.S. dollar are evoking comparisons of EM crises of the 1990s. Today, however, most parts of the EM world are in a very different place.

We expect dispersion and volatility within markets to continue, so careful stock selection will be important. Although valuations are not as compelling as they were a year ago, EMs overall are still trading at a discount relative to their history and continue to look attractive versus their developed market peers. However, investors will have to be much more granular in their approach. We are likely to see a much more uneven world going forward, with less correlation and more dispersion of returns at both a country and a sector level.

Emerging markets (EMs) as a whole continue to perform well, and performance within individual markets has again shown a high degree of dispersion. What has changed so far in 2015 has been a rotation out of some of the best-performing markets in 2014 into some of the laggards. This has been especially true of Russia and China, which have both performed very strongly so far this year. Russia has benefited from the recovery in the oil price, while a peace deal in Ukraine that potentially paves the way for the loosening of sanctions has also helped sentiment. Meanwhile, in China, hopes of further stimulus measures, interest rate cuts, and some better earnings numbers have helped to boost stock prices. By contrast, countries that had performed strongly in 2014, such as India, Indonesia, and Thailand, have suffered from some profit taking. These short-term swings in sentiment highlight exactly why you need to be active in these markets.

EARNINGS TURNING A CORNER

Much of the underperformance for EMs over the last few years was due to the narrowing of the economic growth premium between EMs and developed markets (DMs), along with weaker earnings and earnings expectations. Revenues had continued to grow, but it was a mixed picture across the EM universe. Some benefited from commodity price declines, while others suffered due to rising unit labor costs, which reduced margins.

We believe that earnings expectations have begun to bottom out, and the bulk of the earnings adjustment has taken place in many countries. If anything, in some places, such as India or the Philippines, earnings are starting to accelerate again.

FEARS THAT WE ARE HEADING BACK TO THE '90s....

For some investors, the two headwinds to EM growth—lower commodity prices and the relative strength of the U.S. dollar—are evoking comparisons to with the EM crises of the 1990s. An appreciation in the dollar and falling commodity prices provided the backdrop for financial crises in several emerging economies in the 1990s. In that environment, central banks' ability to defend local currencies was severely tested, and many countries were forced to break their hard-currency pegs.

While the environment today is somewhat similar, the growth outlook also depends upon individual countries' unique characteristics. The relative strength of the U.S. dollar is generally a negative for economies that are reliant on international dollars to fund their domestic credit markets and to finance imports. Economies such as South Africa and Brazil that run current-account deficits are more vulnerable in a period of sustained U.S. dollar appreciation than nations less dependent on foreign financing, such as China.

Similarly, weak commodity prices have been detrimental to exporters such as Russia and other oil-exporting nations. By contrast, there have been a number of beneficiaries of lower commodity prices, especially countries in Asia, such as India.

...BUT FUNDAMENTALS DON'T SUGGEST IT

Today, however, most parts of the EM world are in a very different place, which is testament to the structural reforms and better macroeconomic policies implemented over the past decade. Notable positives include a build-up of foreign exchange reserves and use of floating currencies, which increases a countries' ability to withstand market stress and to avoid currency runs. Most emerging countries also now have lower sovereign debt-to-GDP ratios than during the crises of the 1990s, while many have transferred their debt from U.S. dollars to local currencies, which is much more manageable.

Nevertheless, we expect the headwinds from lower export growth in many EM economies to persist for a time, even if commodity prices and the U.S. dollar stabilize. For us, this will mean finding companies that can ride out such a period, but that can also benefit in such an environment as their competitors struggle. Encouragingly, we are finding many of these opportunities.

"LOWER FOR LONGER" MESSAGE PROVIDES A POSITIVE BACKDROP

We believe the backdrop for EM equities remains favorable. With indications that most central banks plan to maintain interest rates at lower levels for longer periods of time, this means the search for capital appreciation will continue, and EMs remain a great source for this.

EMs sold off in the summer of 2013 on the announcement that the U.S. Federal Reserve was "tapering" its QE quantitative easing program, and many investors are now worrying over a repeat as we approach the long-anticipated first hike in U.S. interest rates.

When U.S. interest rates do start to rise, EM stocks may indeed suffer a temporary pullback, but we do not expect the economic impact to be significant. Short term, it may create some uncertainty as the hunt for yield in EMs may start to look less attractive. However, much will depend on why rates are hiked, and at what pace; if rates rise at a moderate pace because the U.S. economy is doing well, it would be a good sign for the global economy and should be positive for EMs.

In addition, we have also seen both Japan and Europe ease monetary policy since 2013, allaying some concerns surrounding EM access to capital in a world of rising DM rates and tightening DM liquidity. Meanwhile, much of the concern during the taper tantrum centered on whether EM policymakers would act rationally and thoughtfully in the face of twin deficits that were real sources of potential risk and instability. While the policy action has varied country by country, there are good reasons to believe that many policymakers are aware of the actions necessary to avoid a real economic crisis. Indeed, countries like India and Indonesia have surprised with their reform programs and their frank acknowledgment of the need for economic stability to attract and retain global capital. In addition, the decline in oil prices has helped control inflation and improved the current account and fiscal deficits in many EM nations. These factors should help counter a repeat of the taper tantrum in 2013.

VALUATIONS REMAIN ATTRACTIVE, BUT INVESTORS WILL HAVE TO BE MORE SELECTIVE

We expect dispersion and volatility within EM markets to continue, so careful stock selection will be important to long-term outperformance. Although valuations are not as compelling as they were a year ago, EMs are still trading at an overall discount relative to their history and continue to look attractive versus their developed market peers. However, investors will have to be much more granular in their approach. We are likely to see a much more uneven world going forward, with less correlation and more dispersion of returns at both a country and a sector level.

Economic growth is showing signs of stabilization, and we may see global growth levels rise going forward, which would help to boost sentiment. The strength of any recovery is difficult to predict with any degree of certainty, while overly optimistic earnings growth estimates can sometimes lead to market volatility as expectations are adjusted downward. However, we continue to believe that EM equity markets will move higher over the medium to long term. Monetary policy is extremely accommodative, and the risk/return profile for equities compared with bonds remains attractive. Importantly, corporate fundamentals have also held up surprisingly well in recent years despite economic challenges, and with a focus on fundamentals, there remain many opportunities for EM investors.

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GLOBAL MIDYEAR MARKET OUTLOOK 2015

June 2015

In-depth analysis and insights to inform your decision making.



Andrew Keirle
Portfolio Manager, Emerging Markets Local Currency Strategy

Emerging Markets Local Currency Bonds: OPPORTUNITIES TO GAIN YIELD AND TIME

EXECUTIVE SUMMARY

A traditional international bond portfolio that consists mostly of the largest debt issuers (i.e., developed market governments) has serious drawbacks in the current environment: Yields are minimal, and interest rate risk is high. At the same time, both emerging market (EM) local currency bonds and EM bonds denominated in U.S. dollars look relatively cheap versus developed markets.

Importantly, investors with an international bond portfolio currently invested in only high-quality sovereigns are only receiving a yield of around 1% with a seven-year duration. Effectively, within the developed world, durations have lengthened while the amount of money received has lessened. By contrast, EM local investors are currently receiving a yield of around 6% with less than a five-year duration. That provides a solid starting point for investors who do not have particularly large investments in EM local but who have large international bond exposures.

For many emerging market (EM) debt investors, the last year or so has been a difficult period. However, the fundamentals remain strong, and there remains a compelling case for investors looking for a higher yield with less duration—a measure of a bond's sensitivity to changes in interest rates.

LOOKING BACK TO LOOK FORWARD

Attracted by high yields and currency momentum, investors plowed into EM local funds following the 2008 financial crisis. These one-way flows suddenly reversed course in June 2013, when the "taper tantrum" hit a number of EM markets. This marked the start of an extended period of cash outflows from the asset class, which have only recently receded. At the same time, expectations for higher U.S. interest rates have fueled a rally in the U.S. dollar and a general retreat from EM currencies.

IS IT ALL ABOUT THE FED NOW?

The prospect of the U.S. Federal Reserve (Fed) hiking rates has made investors cautious about EM assets in general. When it happens, it is likely to lead to tighter liquidity conditions. However, with both Japan and Europe having eased monetary policy since 2013, this should help provide a palliative to EMs importing capital.

Much of the concern during the taper tantrum centered on whether EM policymakers would act in an appropriate manner. While the policy action has varied country by country, there are good reasons to believe that many EM policymakers are aware of the actions needed. Indeed, the likes of India and Indonesia have surprised with their reform programs and the balanced approach they have taken in attracting and retaining global capital. Moreover, with lower inflationary pressures, cheaper currencies, and better fiscal positions, the conditions

for a taper/tightening tantrum this time seem less obvious.

DISPERSION WILL REMAIN TO THE FORE

Last year we saw widespread dispersion in the performance of individual countries within the EM universe. The disparate trend seems likely to persist this year, although probably not to such an extreme degree. Reinforcing the pattern, there are a number of countries at different stages of the economic and interest rate cycle. Some Asian markets such as India, Indonesia, Sri Lanka, and the Philippines are recording economic growth rates in excess of 5%, while a number of European and Latin American economies are running at a more subdued pace. Indeed, recessionary growth prints in two of the largest markets—Brazil and Russia—will suppress overall EM growth this year.

Meanwhile, a continued easing in the pace of growth in China will also have a negative impact on countries that are major commodity exporters. Such is the rerating of China's growth over the past five years that India's growth rate may well surpass China's over the next year or two as India continues on its reform path. In spite of this baton change, the importance of China remains substantive. China is still five times the size of India, so at an aggregate level, the slowdown in China will still be a headwind globally and for EMs.

We believe that currencies are likely to remain a performance headwind in the near term, but this should gradually subside as the year progresses. While history shows that U.S. dollar strength can persist for long periods, it has already made a significant move to the upside. Additionally, it seems unlikely that U.S. growth will witness the strong levels associated with the late 1990s technology boom (which drove U.S. dollar strength to levels not seen again until recently). In part, a protracted period of unilateral dollar strength seems less plausible in an increasingly intertwined global economy. Rampant dollar strength combined with weakness abroad would eventually weigh on the U.S. economy and, as a consequence, the strong dollar dynamic.

Meanwhile, given the bias of yields to trend higher in developed markets (DMs), the likelihood of further yield compression in EM local as an overall asset class is relatively low. Dispersion in yield moves will likely remain high, however, supporting active management.

AN ATTRACTIVE ASSET CLASS FOR GLOBAL DIVERSIFICATION

With U.S. Treasury yields likely to rise from low levels and negligible yields on offer in Europe and Japan, investors across DMs have substantial incentive to diversify globally. However, a traditional international bond portfolio that consists mostly of the largest debt issuers (developed market governments) has serious drawbacks in the current environment: Yields are minimal, and interest rate risk is high.

Based on the yield and duration data in Figure 1, an EM local portfolio may offer a more attractive value proposition in comparison with international bonds, as the combination of higher yield and lower duration may provide better protection against rising rates in the medium term.

Additionally, both asset classes demonstrate a similar negative correlation to the U.S. dollar over the past five years. In a world where the dollar is likely to remain relatively well supported, EM local debt could prove a useful destination for diversifying international debt allocations.

Given that durations of international bond portfolios have risen as interest rates have fallen, investors are effectively waiting longer for less. Diversifying into EM local bond markets helps redress this trend. Additionally, studies suggest that many investors tend to have relatively low allocations to EM debt opportunities but can often have large international bond exposures. This suggests that investors' capacity to allocate more to EM local debt markets remains high.

Last, valuations have also broadly cheapened over the past two years. This is particularly so on the foreign exchange side, where a number of currencies are trading at all-time lows versus the U.S. dollar. Similarly, as investors have raised risk premia required on EM assets, both EM local currency bonds and EM bonds denominated in U.S. dollars look relatively cheap versus DMs.

Importantly, long-term fundamental drivers in emerging markets debt remain sound, with solid sovereign balance sheets and higher growth profiles relative to DMs over the medium term. Additionally, the opportunity set available to investors continues to grow; a positive for investors wishing to gain access to this diverse asset class. Although the prospect of the Fed raising interest rates later this year has the potential to increase volatility in the coming months, from a medium-term perspective, this should provide a good opportunity for clients to accumulate EM local allocations.

FIGURE 1: EM local bonds offer higher yields with shorter durations

As of 27 February 2015

	Yield	Duration	Five-Year Return Correlation With U.S. Dollar
International Bonds (ex U.S. Dollar)	0.93%	7.30 years	-0.58
Emerging Market Local Bonds	6.15%	4.94 years	-0.47

Sources: Barclays, J.P. Morgan, and T. Rowe Price
International Bonds Benchmark: Barclays Global Aggregate ex USD Index
EM Local Index: JP Morgan GBI-EM Global Diversified Index

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