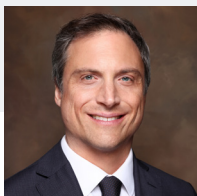




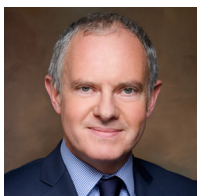
**PRICE
POINT®**

November 2018

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



Kenneth Orchard
*Co-portfolio Manager,
Diversified Income Bond Strategy*



Quentin Fitzsimmons
*Senior Portfolio Manager,
Fixed Income Division*

Global Economics **TAPERING AND TARIFFS: A PARADIGM SHIFT?**

KEY POINTS

- The U.S. economy looks in reasonably good shape at the moment, but the end of quantitative easing (QE), combined with rate hikes, will likely result in a slowdown—possibly even recession—at some point.
- However, it is very difficult to predict when this will occur. Growth in Europe is stable and the European Central Bank is only just on the verge of tightening, so the European economy should remain healthy for the time being.
- One of the side effects of QE has been an increase in the gap between rich and poor, which in turn has led to short-term policymaking and populism.
- U.S. President Donald Trump—and the leaders of some other countries—seems to regard trade as a zero-sum game in which there must be both winners and losers, but we believe this populist view is wrong and can lead to economic inefficiencies.

With several central banks poised to follow the U.S. Federal Reserve in tightening monetary policy and President Donald Trump's trade wars showing no signs of abating, T. Rowe Price Portfolio Specialist Stephen Marsh recently asked two of our leading fixed income investors to share their views on the prospects for the global economy. Their responses are detailed below.

How worried are you about the prospect of U.S. recession?

Ken Orchard: There's still a lot of fiscal stimulus in the pipeline that will continue to power the U.S. economy into next year, so I think the chance of a recession in 2019 is very remote. But when that fiscal stimulus comes off and the Fed has made a few more rate hikes, the U.S. economy is likely to slow. The question is whether that slowdown will turn into a recession—and I think

for that to happen it would require an external shock similar to the collapse in the U.S. housing market in 2007 and the end of the dot-com bubble in 2001. This time around it could be a slowdown in China or a domestic issue in the U.S. Overall, I think there is an elevated probability of a recession in the U.S. in 2020 or 2021.

Quentin Fitzsimmons: We're clearly at the mature stage of the cycle, but predicting exactly when it will end is extremely difficult because the U.S. economy is still benefiting from the fiscal stimulus and is in a very healthy state. If current optimism leads to greater capital expenditure and companies spend it effectively, the cycle could continue for a while yet. It's interesting to note that bond markets are concerned about the cycle ending but equity markets seem to believe it has further to run.

“The paranoia about the yield curve inverting is a bit odd.”

—Ken Orchard

Is concern over the flattening U.S. yield curve justified?

Quentin Fitzsimmons: This is an important question—the flattening of the curve has been a good predictor of recessions in the past. But there’s evidence to suggest that the world has changed—that longevity-driven demand from pension funds has dragged down the long end of the curve and quantitative easing (QE) has suppressed term premiums. If this is the case, maybe we shouldn’t be too concerned about the signal the yield curve is giving us. And if the curve doesn’t flatten as much as some people fear when quantitative tightening really kicks in, that would actually be an optimistic signal.

Ken Orchard: The paranoia about the yield curve inverting is a bit odd. In the past, the length of time between the curve inverting and a recession occurring has been anything from six months to three years, so it’s strange to see so much fear about the curve at the moment, especially as it has yet to invert.

How vulnerable is Europe at present?

Ken Orchard: I don’t think Europe is particularly vulnerable in the near term. This year growth has slowed from the frothy levels seen at the beginning of the year, but it seems to have stabilized at around 1.5%, which is sustainable. European companies have spent the past five years deleveraging, and the

European Central Bank (ECB) is only just on the verge of tightening policy, so the European economy looks in good shape for the time being.

The biggest threats to Europe are external. If the next U.S. recession is severe it could drag Europe in, but if it’s not too long or deep, Europe may avoid a recession itself. China is also very important—a hard landing there would hit European capital goods exports, which would make Europe vulnerable to a recession.

How much of a threat is Brexit to Europe and the rest of the world?

Quentin Fitzsimmons: The UK accounts for just 4% to 5% of global GDP, but it has a very open economy and plays an important role in a number of supply chains, especially in Europe. If you’re a German auto manufacturer, you’re going to be worried about losing access to your second or third largest market on top of other headwinds relating to emissions and electrification, and so on. If you work in Ireland, you’re going to be worried because around 40% of the Irish economy is dependent on open free trade with the UK. Everybody is hoping that a sensible agreement on trade is reached, because if it isn’t, the European economy could be in for a very bumpy ride next year. And given that the rest of Europe did not vote for Brexit, that may cause a lot of frustration.

One of the side effects of QE is that the gap between the rich and the poor has widened. What impact is this having on markets?

Ken Orchard: One impact has been the rise in populism over the past few years. There has been an increasing focus on tariffs and protectionism, and of countries challenging traditional trading agreements—the most extreme example being Brexit. Expansionary fiscal policy is also becoming more prevalent—we’ve seen it in the U.S., Italy, and Turkey, and it

may be coming to the UK. There’s more short-termism in policymaking, which is likely to lead to higher volatility as the markets can’t see what governments are going to do from one year to the next.

Over the longer term, it’s a bit more complicated. On one hand, short-term policymaking, expansionary fiscal policy, and increased protectionism would usually lead to lower GDP growth, which in turn would mean lower bond yields. On the other hand, we expect much larger budget deficits in the future, which would ordinarily have to be funded through higher real rates. So we may have a tug-of-war between lower growth and higher real rates, which will mean some countries—the net borrowers—are likely to see much higher bond yields, while in other countries—the net savers—yields could go much lower.

U.S. President Donald Trump seems to regard trade as a zero-sum game in which there must be both winners and losers. Do you agree?

Quentin Fitzsimmons: No—and I think 99% of economists would also disagree with him. The whole point about growth is that it allows for better allocation of resources globally, and tariffs prevent that from happening. But we have to remember that over the past generation or so, globalization has led to the arrival of new firms that have priced traditional manufacturers out of their markets. This has caused huge anxiety around immigration and trade and has led to politicians in democratic countries picking on easy targets in an attempt to gain votes. This is not an efficient way of doing things, but I don’t think it’s going away anytime soon—the question is which countries are able to cope well with this new reality, and which are not.

By contrast, China is not a democratic country and is therefore able to plan a long-term economic strategy without worrying as much about popular opinion.

“At the moment...it’s about being defensive but active.” –Quentin Fitzsimmons

Given the cost of QE, will central banks have the tools at their disposal to tackle future crises?

Quentin Fitzsimmons: The Fed is the best positioned of all the central banks because it has already begun tightening—it is well ahead of the game in that respect. The others are in a much more difficult position because most are sitting on huge balance sheets, and QE works best when it comes from a very low base. They need to get their houses in order, and time is arguably running out for them to do that. I do wonder whether the likes of the ECB, the Bank of England and the Bank of Japan are beginning to panic.

Ken Orchard: The ECB is obviously still very much focused on getting growth and inflation up—it’s not worrying too much about the next recession. But there will come a time when it does worry because it can’t expand QE any more from current levels without breaking its self-imposed limits on

how much debt it can buy of each government—and it may be legally impossible to do that anyway. So QE may not be an option for the ECB next time.

Italian one-year bonds are currently yielding the same as German 10-year bonds. Which would you prefer to own?

Ken Orchard: I would prefer to own Italy. The risks to Italy are long-term in nature—a wider budget deficit, a growth slowdown, or a wider eurozone or global recession. These are things that make Italy vulnerable over the longer term, but I don’t think are much of a threat over the next 12 months or so. On the other hand, if you buy a German 10-year bond, you’re locking in a very shallow rate-hiking path and a negative yield of around 120 basis points for 10 years’ time. That’s not a good deal given our expectations for growth and risk over the next 12 months.

How are you currently positioned?

Ken Orchard: First, we’re underweight the dollar, increasingly against the euro. This is a high-conviction position for us given the growing signs that the eurozone economy is stabilizing and beginning to grow. Second, we’re modestly overweight credit, where we are shifting our exposure from the U.S. to Europe for the same reason. And third, we are underweight duration given the underpricing of interest rate hikes.

Quentin Fitzsimmons: My guiding star is the U.S. Treasury market—if the Fed continues to tighten on a quarterly basis over the next 12 months, three-month Treasury yields will climb above 3%. As Treasuries are the global risk-free benchmark, that’s what I have to judge every investment decision by. It means I am defensive on duration and also a little circumspect on credit.

At the moment I think it’s about being defensive but active. Some fantastic opportunities arose in late August when emerging markets were distressed, but there was a very quick snapback in those markets, so you had to be agile to take advantage of those opportunities. That will continue to be the case, I think.

INVEST WITH CONFIDENCE®

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

To learn more, please visit troweprice.com.

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

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

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

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

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

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

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

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

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

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

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

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

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

© 2018 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.