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EQUITY MARKETS PULSE

GLOBAL COMMENTARY AND OUTLOOK

FEBRUARY 2015

JANUARY 2015 - FALLING OIL PRICES AND THE RISING U.S. DOLLAR PROVE A HARMFUL MIX FOR STOCKS

Stocks started out 2015 on a down note, as plunging oil prices and a rising U.S. dollar dampened the earnings and outlooks for many firms. The weakness in several heavily represented bank, energy, and industrials holdings took a larger toll on the Dow Jones Industrial Average and Standard & Poor's 500 Index than it did on the Nasdaq Composite. The small-cap Russell 2000 Index performed in line with the large-cap benchmarks, but the S&P MidCap 400 Index fared somewhat better. Financials stocks performed worst among S&P 500 sectors, followed by energy shares, while the typically defensive utilities and health care sectors were the only two segments to record a gain for the month.

- Helen Ford – US
- Dean Tenerelli – Europe
- Archie Ciganer – Japan
- Gonzalo Pangaro – Emerging Markets

Elsewhere, Asian emerging markets posted solid gains; the Europe, Middle East, and Africa region was about flat; and Latin American stocks endured losses. Facing moribund economic growth and meager headline inflation, the European Central Bank (ECB) finally announced a full-blown quantitative easing (QE) program at its January 22, 2015, monetary policy meeting. The total size of the new QE program, €1.1 trillion ($1.2 trillion), was much more aggressive than most had anticipated. The ECB will buy €60 billion (about $67 billion) of bonds per month through at least September 2016.

OUTLOOK

UNITED STATES: We maintain our cautious outlook, as the U.S. equity market has continued its upward path in February. A stronger U.S. dollar threatens to weigh on the earnings of U.S. multinationals, as it reduces the dollar value of profits earned in weakening foreign currencies and makes goods produced in the U.S. more expensive overseas. Industrials stocks tied to the global economic cycle proved particularly poor performers late in the month. T. Rowe Price industrials analysts and managers expect revenues in the sector to face continued pressure in coming months, but they believe that lower prices for oil and other commodities will eventually boost consumer spending and provide a tailwind for industrials stocks.

T. Rowe Price Chief U.S. economist Alan Levenson expects that low gasoline costs in 2015 will further boost consumer purchasing power, and residential construction may pick up. T. Rowe Price managers note that rapid changes in commodity prices and currencies often create dislocations that ripple through global markets, such as occurred in 1997's Asian currency crisis. In addition, the full effects of such events can take years to unwind, as was the case with the oil price declines in the 1980s, which caused a slump in Texas property prices and eventually played a role in the broader savings and loan crisis. For these and other reasons, they caution that the volatility seen in the past few months may continue. On the positive side, correlations—or the tendency of stocks to move in sync with each other—have recently fallen to more historically normal levels. Generally high correlations since the financial crisis made finding market-beating stocks more challenging, since stocks often moved in response to geopolitical events or macroeconomic trends that are nearly impossible to predict. They are hopeful that the drop in correlations signals a return to a market in which stocks trade on their fundamentals and that rewards investors who research and select stocks based on their unique attributes.

EUROPE: European stock markets have continued to climb higher, with several at their highest levels since the 2008 financial crisis. The current earnings season is developing generally as we expected, certainly for the companies we are invested in. However, pronounced downgrades in the energy and materials sectors, which are being profoundly affected by the collapse in the price of oil and other commodities, will affect the headline number for the market this year.

Elsewhere, it is encouraging that more domestically-orientated companies seem to be at least meeting expectations. Although there have been some disappointments from companies more exposed to overseas, especially emerging markets, consensus expectations now appear more appropriately calibrated.

Regardless of what the ECB might have done in January, there are forces coming together that should be supportive for the Eurozone and European corporates in particular. The weaker euro should provide a huge boost to the export side of European businesses, and further increase the competitiveness of euro nations. Lower oil prices, more neutral fiscal policy, along with an easing of the deleveraging pressures should also prove beneficial.

As we witnessed in 2014, sentiment is likely to ebb and flow over the coming months. Therefore, for many active investors, 2015 is again likely to present opportunities to invest on bouts of stock-specific volatility. This is certainly likely if disinflation in Europe turns to deflation this year. There will certainly be data points for market bears to point to in the coming months, but these should be used to add to your highest conviction areas. This approach served us well when the environment was more challenging last year.

JAPAN: Japanese equities are now at 15-year highs as further QE and a weaker yen have boosted corporate earnings in many sectors. With evidence mounting that Japanese exports are finally beginning to feel the benefit of yen depreciation and that the business mood is improving - allowing firms to raise wages and hoist dividend payments - the stock market has responded in kind.

For a sustained recovery, we believe domestic consumption needs to be the next growth engine. To expect this, we need wage inflation to take hold. Abe has been applying intense pressure on corporations to raise wages in order to support the Japanese consumer and reverse a 20-year cycle of wage and price deflation. Indications of economic growth in Japan, together with corporate tax incentives, should also favour an increase in salaries. However, while bonuses and overtime payments are rising, we have yet to see firm evidence of a base wage increase cycle, at least in inflation-adjusted terms.

While patience is necessary, there are catalysts in the nearer term. We see scope for surprise versus consensus estimates, given forecasts have not fully accounted for yen weakness. Also, with margins and returns starting from a low base, we see ample room for expansion. From a valuation perspective, although the extreme undervaluation of Japanese equities has been rectified; current valuations remain well-below pre-crisis levels.

EMERGING MARKETS: Economic growth across many developing markets should continue to be higher than in the developed world in 2015, although that gap may continue to narrow. Those countries that push forward with reforms should do well, while countries that do not will struggle. Valuations are as compelling as they were a year ago and remain at a discount relative to their history and to their developed-market peers. However, we are likely to see a much more uneven world going forward, with less correlation and more divergent results. Investors will have to be much more granular in their approach.

Near-term risks include a worse-than-expected slowdown in China or a breakdown in its financial system; a sharp rise in U.S. interest rates; and an unexpected bout of risk aversion due to geopolitical events.

We believe that investor concerns may be overdone. The extent of the Chinese growth slowdown remains a key question but policymakers are now focused on structural reforms that will lead to higher quality and more sustainable growth. In addition, we believe the actual impact of interest rate increases on emerging markets will prove less significant than investors fear. When interest rates do start to rise, markets may suffer a mini sell-off as the hunt for higher yields pulls money out of emerging bonds and currencies. However, if rates move moderately higher because the U.S. economy is doing well, that would be good for the global economy, including emerging markets. Finally, political risk has diminished over the past year, with most elections resulting in new governments that seem willing to adopt more market-oriented reforms.

Overall, the environment will remain complex, but this should provide a good opportunity for active investors to take advantage of valuation anomalies. The emerging consumer remains a powerful force and should continue to drive strong growth in a variety of industries and companies, including retail, banking, technology and the internet.

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