



ASSET ALLOCATION INSIGHTS

How Much Upside is Left in Equity Markets?

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KEY INSIGHTS

- Given the strong rebound in equity markets, stock valuations are elevated, and investors are wondering if the rally will continue.
- We believe revisions in earnings estimates could potentially benefit small-cap, value, and emerging markets equities.

Equity markets have rebounded rapidly since the drastic coronavirus-induced sell-off a year ago and have powered past pre-crisis levels. As a result, stock valuations are elevated, and many investors wonder if the rally will continue.

With extended valuations, hope for further upside mainly rests in earnings growth. Massive pent-up demand, robust fiscal stimulus, and the prospects of fully reopened economies are good reasons to expect strong earnings growth in 2021 and 2022. However, as shown in Figure 1, U.S. equity markets seem

to have already priced in some of this expected earnings growth. Meanwhile, equity markets outside the U.S.—especially in emerging markets—appear to have more upside potential.

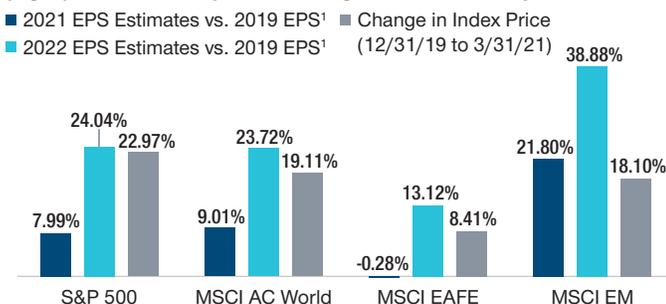
Keep in mind, earnings estimates are continually revised, and a review of estimate trends during the first two years of recovery following the last two recessions shows that estimates generally increased. In our view, such upward revisions may seem likely in periods of strong economic recovery, as is expected in 2021 and 2022. Notably, the pattern for three- to seven-year periods after recessions, however, shows a decline in earnings estimates over time.

Although positive revisions in earnings estimates could be supportive, most of the good news appears to be already priced into equity markets, and the upside potential going forward may be somewhat limited. Therefore, the Asset Allocation Committee recently decreased overall equity exposure but maintained a tilt toward segments most sensitive to economic conditions—such as small-cap, value, and emerging markets equities—that could likely benefit from upward revisions in earnings estimates.

The Upside Potential for Equities May be Limited

Upward revisions of earnings estimates could be supportive

(Fig. 1) Much of the Expected Earnings Growth is Already Priced In



As of March 31, 2021.

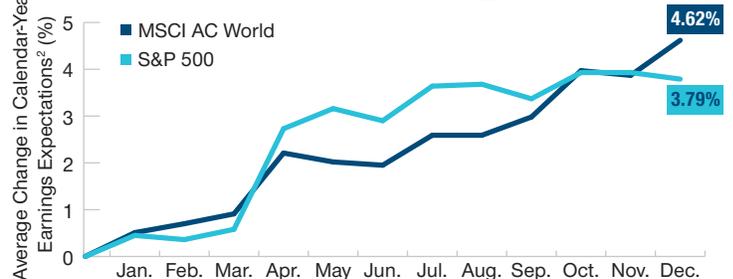
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Sources: Standard & Poor's, MSCI, and I/B/E/S. T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. See Additional Disclosures.

¹ Comparing percentage change in earnings growth estimates for 2021 (and 2022) versus pre-pandemic earnings generated in 2019.

² Shows the average monthly change in calendar-year earnings expectations during the first two years following the 2001 and 2007–2009 recessions.

(Fig. 2) Average Change in S&P 500 Earnings Expectations: One to Two Calendar Years After a Recession Ended²



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