T. Rowe Price®

2019 GLOBAL MARKET OUTLOOK

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Global Markets

DISRUPTIVE FORCES SEEN SHAPING 2019 INVESTMENT LANDSCAPE

Disruption in its various forms–technological, political, economic, and monetary–is likely to determine the direction of global markets in the coming year, T. Rowe Price experts predict.

KEY POINTS

- With the U.S. moving into the later stages of the business cycle, the U.S. Federal Reserve raising interest rates, and monetary and credit conditions diverging widely across the other major global economies, the potential for renewed volatility in both equity and fixed income markets remains high.
- Disruption goes well beyond technology. Secular change is forcing us as investors to heavily consider not only the winners, but also the losers of global disruption.

DISRUPTION IS SHAKING MARKETS

DAVID GIROUX, JUSTIN THOMPSON, ANDY MCCORMICK

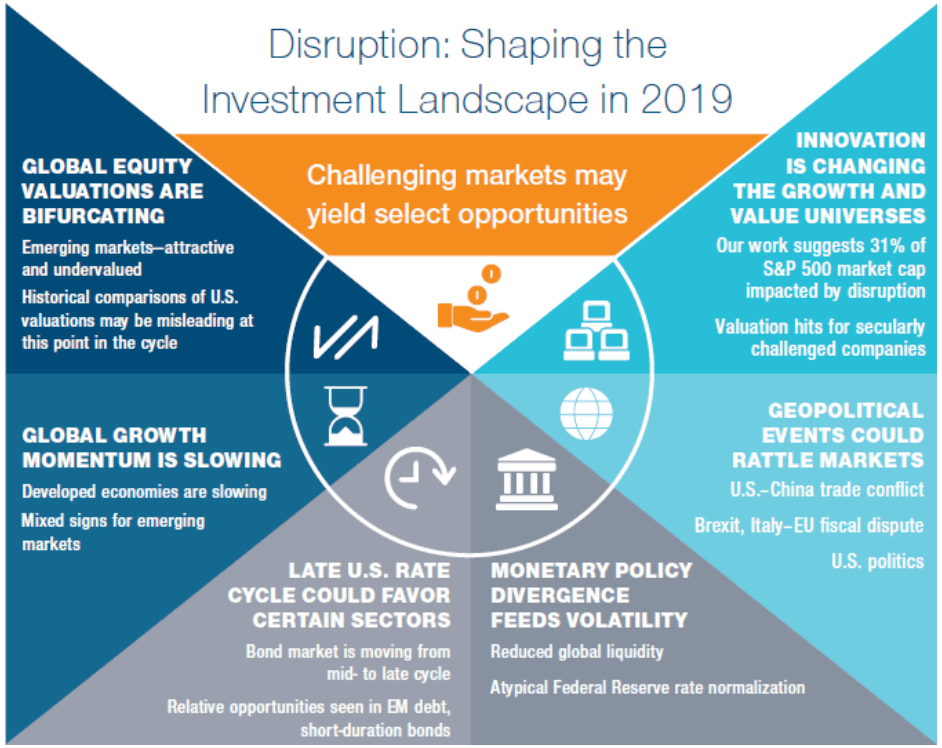
The global corporate landscape continues to be transformed by a revolutionary combination of technological innovation and changing consumer preferences, which is upending established business models. Although disruption creates risk, it also can generate potential opportunities for investors with a disciplined strategic approach.

Correctly identifying the winners and losers in this competitive struggle will remain the key to portfolio outperformance, Giroux contends.

“I’d argue that the disruptive environment we’re in is why active management will be well positioned over the next decade,” he says. “High-quality active managers can really benefit from having a longer-term horizon, which allows them to make the kind of investments that potentially will add value in our clients’ portfolios over the next five to 10 years.”

DISRUPTION COULD YIELD OPPORTUNITIES

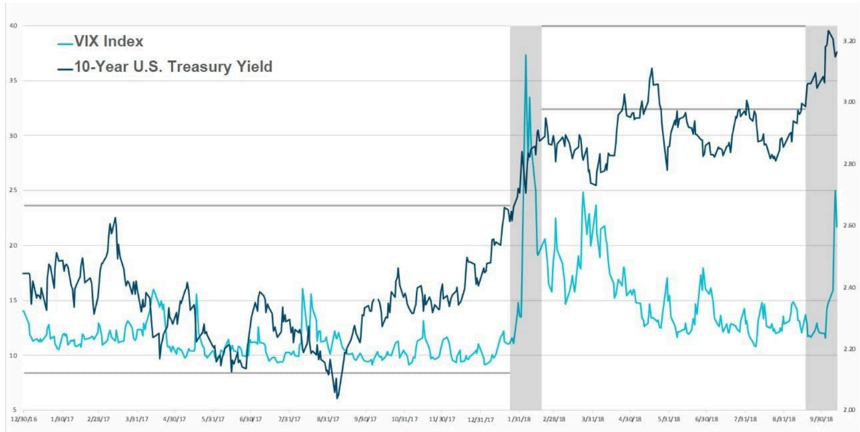
The upswing in volatility that disrupted global markets—equity markets, in particular—in 2018 appears likely to persist in 2019, driven by slowing economic momentum, tighter liquidity, monetary divergence, and political risk. Meanwhile, technological innovation and competitive challenges will continue to threaten established leaders in a host of global industries.



In this less supportive environment, McCormick notes, markets have begun to punish bad behavior, taking aim at overleveraged companies, antiquated business models, and inflation-prone sovereign debtors. As a result, security-specific risks are becoming increasingly critical. But these same risks also can generate potential opportunities for active investors to buy attractive assets at temporarily depressed prices. In-depth research and solid fundamental analysis are vital.

VIX INDEX VS 10-YEAR U.S. TREASURY YIELD

As of October 12, 2018



Sources: Bloomberg Finance L.P. and T. Rowe Price.

“There’s no question that markets tend to get trickier late in the cycle" McCormick says. **"But it also can be a great time to take a strategic approach to investing.”**

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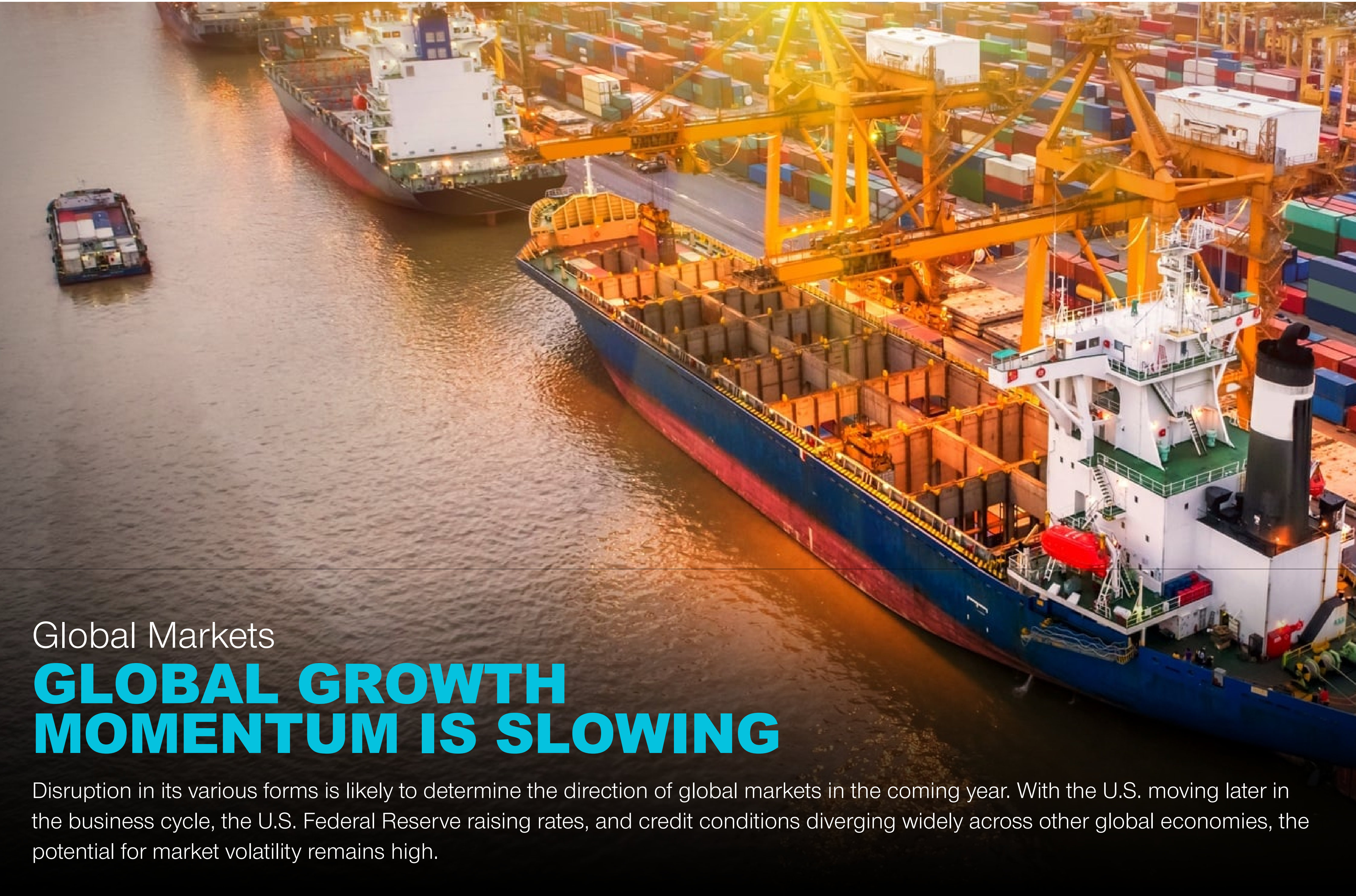


Global Markets

GLOBAL GROWTH MOMENTUM IS SLOWING

Disruption in its various forms is likely to determine the direction of global markets in the coming year. With the U.S. moving later in the business cycle, the U.S. Federal Reserve raising rates, and credit conditions diverging widely across other global economies, the potential for market volatility remains high.

GLOBAL GROWTH MOMENTUM IS SLOWING

KEY POINTS

- Although the odds of a downturn appear above average given where we are in the economic cycle, we believe a global recession is a relatively low risk in 2019.
- With growth expected to slow in most developed markets, a critical issue will be whether China can restimulate its economy.

ALAN LEVENSON AND JUSTIN THOMSON

October 2018 forecasts by the International Monetary Fund (IMF) projected that growth will slow across the developed markets and in China in 2019.

While the U.S. is farthest along in the economic cycle, and the risks to growth are tilted to the downside, a healthy private sector, strong consumer demand, and the lingering effects of the 2017 tax cut stimulus should continue to sustain the expansion through the first half of 2019, T. Rowe Price economists say.

European economies are earlier in the cycle, but growth has been slowing since the fourth quarter of 2017, Thomson notes. The UK economy continues to suffer from Brexit uncertainties.

In the eurozone, the German labor market shows some signs of overheating, but unemployment is significantly higher in most other continental economies, curbing inflation pressures but also limiting income gains. Efforts by European households to rebuild savings could dampen eurozone growth in 2019.

3.07%

IMF FORECAST OF GLOBAL REAL GDP GROWTH IN 2019

The IMF forecasts that Japan, which saw economic momentum slow sharply in 2018, will decelerate further in 2019. On the positive side, Japanese corporate profitability is at an all-time high, according to Thomson, suggesting the risk of deflation has eased.

CAN CHINA SHIFT BACK INTO HIGHER GEAR?

China's economic outlook is a particular focus of concern, as official economic reports in late 2018 showed a slowdown in growth. Independent indicators of consumer demand, such as auto sales and Macau casino revenues, also have shown weakness, Thomson says.

"What's crucial is the extent to which China restimulates," Thomson adds. "Beijing is trying to reduce indebtedness in its corporate sectors. But they do have scope for selective tax cuts in certain areas, or for reducing banking reserve requirements, which is a way of loosening policy as well."

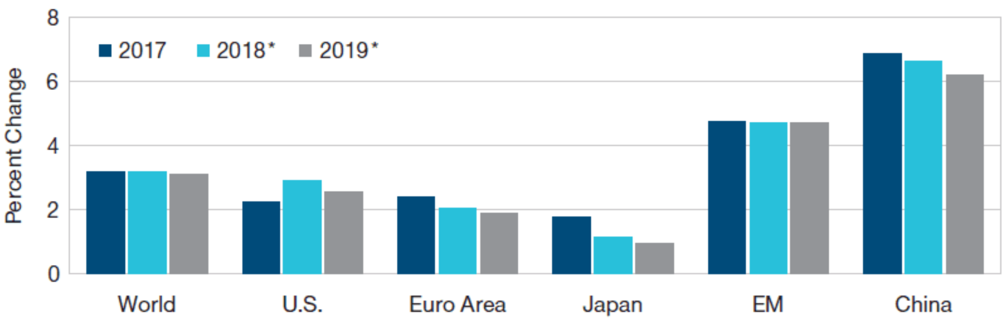
Overall, growth in the emerging markets (EM) is expected to remain stable in 2019, the IMF predicts, with the slowdown in China offset by recoveries in some other major EM economies.

HIGHER RATES,
FLATTENING YIELD CURVE CREATE DOWNSIDE RISK

Although U.S. growth is slowing, T. Rowe Price economists expect the U.S. unemployment rate to continue to fall, putting upward pressure on inflation. Higher interest rates, plus a flattening U.S. yield curve, could increase the risk of a sharper economic slowdown in 2020.

GLOBAL GROWTH IS SLOWING

Actual and Projected Real GDP Growth
As of October 2018



Source: IMF/Haver Analytics.
*IMF projection.

"It is crucial to consider to what extent China stimulates or re-stimulates. China's stimulus plan is already taking hold, and they do have scope to reduce taxes in certain areas and to reduce reserve requirements, which is a way of loosening policy as well. The U.S. data remains strong, so far the Fed hasn't blinked, and China stimulus hasn't bitten, so those two things together mean the U.S. outperforms. However, if either of those conditions change, we'll likely see a turnaround for emerging markets over U.S. equity."

Justin Thomson
Chief Investment Officer, International Equity

Global Equities

DISPARITIES IN GLOBAL EQUITY VALUATIONS REQUIRE SELECTIVITY

Faster U.S. growth and widening interest rate differentials helped lift the U.S. dollar in 2018. Whether that trend continues or reverses in 2019 will heavily influence the relative attractiveness of international assets—EM assets, in particular.

DISPARITIES IN GLOBAL EQUITY VALUATIONS REQUIRE SELECTIVITY

KEY POINTS

- Faster U.S. growth and widening interest rate differentials helped lift the U.S. dollar more than 8% on a broad trade-weighted basis in the first 10 months of 2018. Whether that trend continues or reverses in 2019 will heavily influence the relative attractiveness of international assets—EM assets, in particular.

- U.S. equity valuations may appear high compared to Europe, but sector differences can help to explain the valuation gap.

DAVID GIROUX AND JUSTIN THOMSON

As of the end of October, U.S. equity valuations appeared relatively high compared with those in Europe, Japan, and the emerging markets—especially the latter.

However, differing sector weights also need to be taken into account, Giroux says.

The U.S. market, with its large technology, health care, and business services sectors, tends to sell at a higher average price/earnings (P/E) ratio than most European markets, which have smaller tech sectors and tend to be more heavily weighted with financial stocks that typically feature lower P/E multiples.

Adjusted for sector mix, relative valuations between the U.S. and Europe appear to be within historic norms, Giroux adds.

“Maybe you can still make the argument that Europe is earlier in the cycle and thus more attractive, but it’s not just because of valuations.”

U.S. VALUATIONS NEED TO BE SEEN IN CONTEXT

Relative to their own history, U.S. equity valuations do not appear excessively rich, Giroux says. As of mid-November 2018, the S&P 500 Index was trading at roughly 15.5 times expected forward earnings, within range of the 20-year historical average of 15.9. However, with the U.S. moving into the later stages of the business cycle, that multiple might be less attractive than the long-term average would suggest, he cautions.

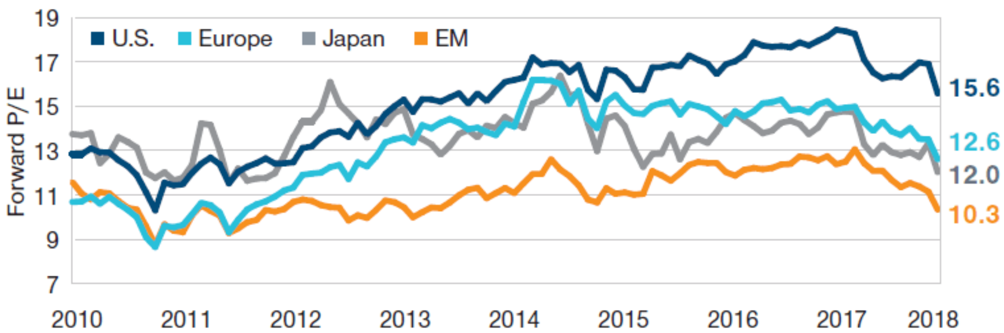
"What we've typically seen is that once you hit an earnings peak, it can take between three and five years to get back to that peak," Giroux observes. "So, the S&P 500 might actually be selling at 15.5 times 2024 earnings, which is saying something very different." Boosting the appeal of EM assets, in Thomson's view: extremely undervalued EM currencies.

> **Emerging markets are cheap relative to their own history, relative to the U.S., and relative to Europe. EM equities are an outlier today where we see really good relative value.**
>
> David Giroux, CFA
>
> Chief Investment Officer, U.S. Equity Multi-Discipline

U.S. EQUITY VALUATIONS APPEAR HIGH VS. REST OF WORLD

12-Month Forward Price/Earnings Ratio

As of October 31, 2018



Sources: FactSet Research Systems, MSCI, and T. Rowe Price.
U.S. = MSCI USA Index, Europe = MSCI Developed Europe Index, Emerging Markets (EM) = MSCI Emerging Markets Index, Japan = MSCI Japan Index.

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Global Equities

SECULAR CHALLENGES ARE DISRUPTING GROWTH AND VALUE

The value and growth universes may have fundamentally changed. A significant share of global equity capitalization is being challenged by disruption.

SECULAR CHALLENGES ARE DISRUPTING GROWTH AND VALUE

KEY POINTS

- The value and growth universes may have fundamentally changed. A significant share of global equity capitalization is being challenged by disruption.
- Correctly identifying the winners and losers in this era of significant change will be key to investment outperformance.

DAVID GIROUX AND JUSTIN THOMSON

Relative valuations between equity styles are also being impacted by disruption, pushing valuations for the winners and the losers in sharply opposite directions.

Although many investors equate disruption with the major technology platform companies, the effects also are being felt in a host of other sectors and industries, Giroux says. Energy markets, for example, are being disrupted by the crosscurrents of shale fracking and the increased competitiveness of solar and wind.

"Our work suggests that about 31% of S&P 500 market capitalization—and up to 35% of S&P revenue—is being impacted by some level of secular challenge," Giroux says.

27%

TECHNOLOGY SECTOR WEIGHT IN THE MSCI EMERGING MARKETS INDEX[1]

[1]As of September 30, 2018

DISRUPTION CREATES MORE VALUE TRAPS

Challenged companies are likely to experience slower revenue and earnings growth over the next 10 years than they did in the previous decade, Giroux warns. The hit to valuations could be dramatic. “When companies fall into the secularly challenged bucket, what we normally see is that multiples compress even more than earnings growth,” he says. “Those can be horrible stocks to own.”

This same bifurcation is playing out in other global equity markets, Thomson says. Japan is a case in point: Although the MSCI Japan Index sported a relatively low 12.03 P/E ratio as of October 31, 2018, the Japanese market is sharply divided between firms that are increasing shareholder returns and those that are essentially stagnating.

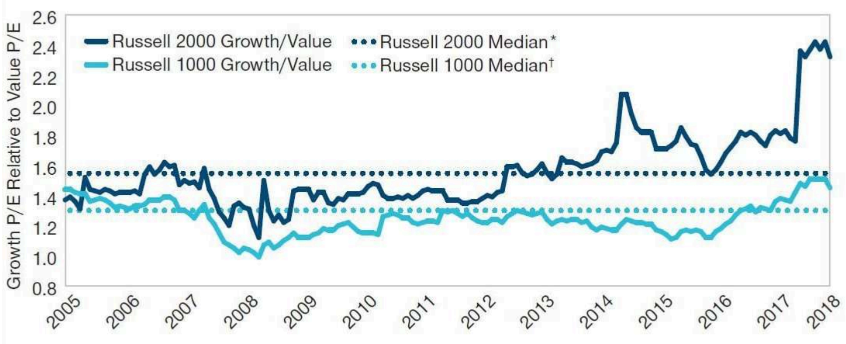
“In situations like that,” Thomson says, “the aggregate multiple doesn’t give you much useful information.” On the other hand, structural change may have made aggregate EM equity valuations more attractive. As of the end of third quarter 2018, technology accounted for 27% of the MSCI Emerging Markets Index, up from virtually nothing 10 years ago, Thomson notes.

This reflects not only the growth of China’s own technology giants, but also the rise of other high-value EM industries based on intellectual property. “You not only have strong growth potential, but the opportunity set is widening and deepening as well.”

EQUITY VALUATIONS ARE BIFURCATING

One-Year Forward P/E Ratio, Growth Relative to Value

As of October 31, 2018



Sources: T. Rowe Price analysis/calculations using data from FactSet Research Systems Inc. All rights reserved.

* December 1997 through October 2018.

† September 1998 through October 2018.

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Global Fixed Income

DESYNCHRONIZED GLOBAL CREDIT CYCLES COULD SPARK VOLATILITY

Fed rate hikes have fueled global volatility, in part by pushing the U.S. dollar higher. But it's not too early for investors to prepare for a dollar peak.

DESYNCHRONIZED GLOBAL CREDIT CYCLES COULD SPARK VOLATILITY

KEY POINTS

- Fed rate hikes have fueled global volatility, in part by pushing the U.S. dollar higher. But it's not too early for investors to prepare for a dollar peak.
- 2019 may be an excellent time for investors to consider moving some of their fixed income assets into global markets.

ANDY MCCORMICK

Since the recovery from the 2008–2009 global financial crisis, global credit cycles have grown increasingly out of step. McCormick says he expects that trend to continue in 2019.

"Diverging monetary policy is likely to be another catalyst for volatility," says McCormick. "Markets were simpler to understand when every force was moving in a similar direction. It's a little bit more interesting now."

The low volatility seen in many major markets in recent years wasn't sustainable without the ample liquidity provided by the world's major central banks in the wake of the financial crisis, McCormick contends.

Now, with the Fed shrinking its balance sheet and the European Central Bank shifting to a less stimulative posture, "markets are searching for a new footing at more sensible valuation levels given less accommodative monetary conditions."

U.S. DOLLAR STRENGTH WILL BE A KEY VARIABLE

Faster U.S. growth and widening interest rate differentials helped lift the U.S. dollar more than 8% on a broad trade-weighted basis in the first 10 months of 2018. Whether that trend continues or reverses in 2019 will heavily influence the relative attractiveness of international assets—EM assets, in particular.

“The dollar exchange rate is crucial,” Thomson says. “Not just because of the currency effect on returns, but because in many markets, a strengthening dollar raises the cost of funding in dollars, which is another form of [monetary] tightening.”

Relative growth trends will largely determine the dollar’s course in 2019, McCormick argues. If markets perceive that U.S. growth is slowing, they are more likely to believe the Fed is nearing the end of—or at least a pause in—its tightening program.

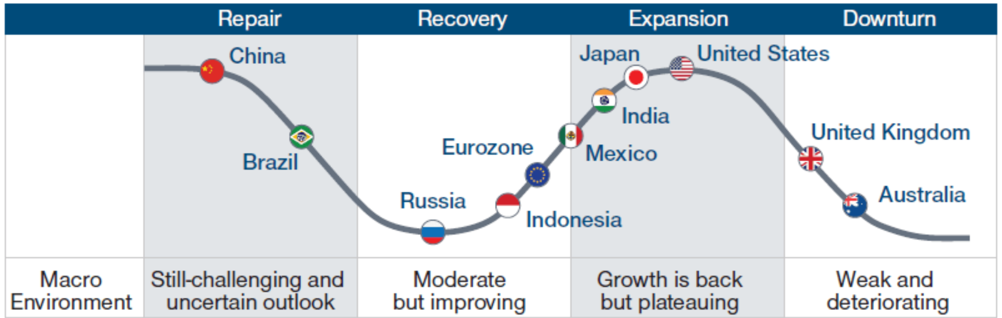
Stronger growth in the rest of the world also could weaken the dollar. “If the U.S. economy surprises to the upside, or if Italy turns out to be a bigger problem for the eurozone than we expect, the dollar could stay strong,” McCormick says.

However, he adds, “If we do get to a place in 2019 where the dollar stalls, we think that would be an excellent time for U.S. investors to consider moving some fixed income assets into global markets.”

GLOBAL CREDIT CYCLES HAVE DESYNCHRONIZED

T. Rowe Price Estimates of Macroeconomic Positions

As of October 31, 2018



Source: T. Rowe Price

The disruptive force in fixed Income is the reduction in global liquidity. The subsequent spikes in volatility create compelling opportunities to buy dislocated assets at attractive prices and we are uncovering tremendous value-rich opportunities on the short-end of the U.S. yield curve today—but investors should stay risk aware.

Andy McCormick

Head of U.S. Taxable Fixed Income

T.Rowe Price®

Global Fixed Income

LATE-CYCLE SHIFTS SHOULD FAVOR CERTAIN SECTORS

Bond investors may want to consider raising exposure to sectors, such as EM debt or U.S. government debt, that historically have done well late in the late-cycle.

LATE-CYCLE SHIFTS SHOULD FAVOR CERTAIN SECTORS

ANDY MCCORMICK

KEY POINTS

- Bond investors may want to consider raising exposure to sectors, such as EM debt or U.S. government debt, that historically have done well late in the cycle.
- Longer-duration U.S. Treasuries have reached relatively attractive yield levels, so it may be a smart defensive posture in 2019.

Historically, bond market sectors have shown varying return patterns over the economic cycle. As the U.S. economy moves into the later stages of that cycle in 2019, McCormick says, some sectors may offer attractive relative value opportunities.

"In the middle of the cycle, the aggregate bond indexes typically have had very positive risk-adjusted returns," McCormick notes. "Bond returns tend to decrease in the late cycle. They're not necessarily negative, but you don't get paid as much for taking risk."

McCormick points to several sectors that historically have featured relatively strong late-cycle performance.

These include: Floating-Rate Bank Loans, Collateralized Loan Obligations, Emerging Markets Debt, Short-Duration Treasuries and Investment-Grade Corporates.

- **Floating-Rate Bank Loans:** In 2018, strong U.S. growth supported credit fundamentals, while U.S. floating rates, as measured by London Interbank Offered Rates (LIBOR), rose in line with Fed rate hikes. As long as credit conditions remain favorable, bank loans should continue to perform relatively well, even if the Fed pauses raising rates. However, the sector's bull run has stretched valuations and raised concerns about underwriting standards, requiring careful credit analysis by investors.

- **Collateralized Loan Obligations (CLOs):** These floating rate instruments typically carry AAA ratings from the major credit agencies and historically have traded at yield spreads over LIBOR comparable to lower-quality investment-grade (IG) corporate bonds. Their short-duration profile and structural credit enhancements make CLOs attractive, especially as the end of the credit cycle approaches, McCormick says.

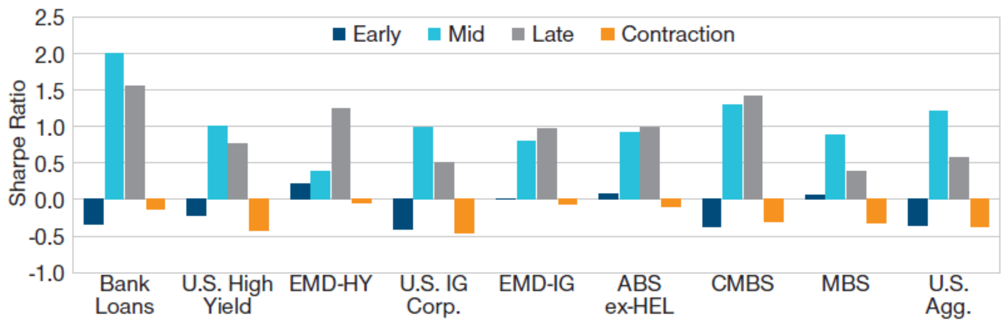
- **EM Debt:** Historically, corporate and sovereign EM bonds both have outperformed late in the U.S. credit cycle, typically because the U.S. dollar has started to depreciate, boosting commodity prices and easing financial conditions in EM economies.

- **Short-Duration Treasuries and IG Corporates:** Investors who did well with riskier assets in 2018 now have an opportunity to earn relatively attractive yields at the less volatile short end of the U.S. yield curve, McCormick says.

BONDS ARE MOVING FROM MID- TO LATE CYCLE

Sharpe Ratio of Excess Returns

As of October 31, 2018*



Sources: Federal Reserve, Goldman Sachs, and Bloomberg Finance LP; all data analysis by T. Rowe Price.
*Based on excess returns versus similar-duration Treasuries. Sector returns since January 1994, except for CMBS, which begins January 2000, and EMD-IG, which begins January 1998. Late cycle = market environment where either: economic growth is accelerating and Fed policy is tight, with tight policy defined as a real federal funds rate above both the Williams-Laubach neutral rate and its own 12-month moving average; or economic growth is falling and the Fed is tightening policy, with tightening policy defined as a real federal funds rate below the Williams-Laubach neutral rate but above its own 12-month moving average.

Giroux recommends that investors also consider another, relatively battered, fixed income sector: U.S. Treasuries.

Although they performed poorly in the strong growth/rising rate environment of 2017 and 2018, longer-duration Treasuries have reached relatively attractive yield levels, Giroux says, especially compared with comparable sovereign assets, such as German bunds and Japanese government bonds.

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Global Markets

GEOPOLITICAL FLASH POINTS MAY TRIGGER MARKET VOLATILITY

Political events could trigger volatility in 2019. However, the markets should not underestimate the possibility that the U.S. and China will be able to resolve their trade dispute.

GEOPOLITICAL FLASH POINTS MAY TRIGGER MARKET VOLATILITY

KEY POINTS

- Political risks are adding to uncertainty, including the unresolved issues surrounding the U.S. and China trade dispute.
- Other lingering risks include Brexit, Italy, and U.S. politics, any of which could trigger renewed volatility in 2019.

DAVID GIROUX

A number of political risks have the potential to disrupt global markets in 2019, with perhaps the most serious being the danger of a trade war between the U.S. and China.

Moves by the Trump administration to raise tariffs on Chinese goods, plus Beijing's retaliatory measures, already have taken a toll on U.S. stocks that rely on China-related revenues. While the top China-oriented stocks in the S&P 500 outperformed the index by a considerable margin in 2016 and 2017, much of that return advantage quickly disappeared after trade tensions rose to a boiling point in the summer of 2018.

Although President Trump and Chinese President Xi Jinping agreed in early December to a temporary halt to tariff increases set for the end of 2018, the underlying issues remained unresolved. T. Rowe Price economists estimate that higher tariffs on Chinese exports could do real, but manageable, damage to the U.S. economic expansion.

However, they add, the 2019 outlook would turn darker—both for the

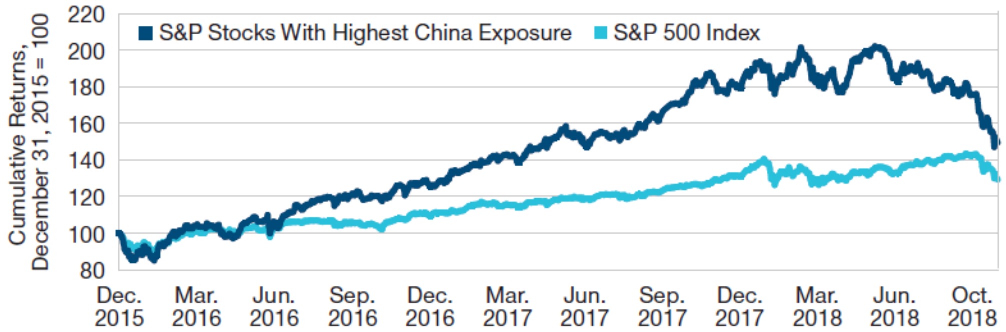
U.S. and the global economy—if the Trump administration were to follow through on its threats to impose tariffs on all foreign auto and auto-part imports.

Giroux thinks markets should not underestimate the possibility that the U.S. and China ultimately will be able to settle their trade dispute. Beijing, he argues, has signaled its willingness to accommodate the U.S. in some areas, such as tariff cuts, safeguards for intellectual property, and increased purchases of U.S. goods and services. “The question is whether that will be enough for the Trump administration,” Giroux says.

Some of President Trump’s advisors, Giroux says, may not trust China to comply with any deal. Others may believe criticizing China would be smart politics in the runup to the 2020 presidential election. Still, he adds, given the economic benefits and the boost a successful deal could give to asset valuations, there also are strong political incentives for Trump to compromise.

TRADE FEARS HIT CHINA-RELATED STOCKS

Relative Returns on S&P 500 Stocks
with Highest China Revenue Exposure
Through October 31, 2018



Sources: Strategas Research Partners. T. Rowe Price analysis/calculations using data from FactSet Research Systems Inc. All rights reserved. Performance shown for stocks with the highest China exposure consists of an equal-weighted portfolio of the 15 companies in the S&P 500 Index with the greatest proportion of total revenues generated in China, as of August 27, 2018.

“

Don't underestimate China's determination to delever with the money supply and reduce the levels of indebtedness that mainly manifest in the state-owned enterprises.

Justin Thomson, Chief Investment Officer, International Equity

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THE U.S.-CHINA TRADE BATTLE IS NOT THE ONLY RISK

A number of other geopolitical developments could trigger renewed volatility in 2019, T. Rowe Price investment professionals say. These risks include:

Brexit: While the UK government and EU leaders have agreed on the technical terms of Britain's exit from the EU, the narrow path to resolution suggests that the key issues will complicate the UK–EU relationship for years to come. While negative headlines have weighed on investor sentiment, a successful deal would give a considerable lift to UK assets, particularly the British pound, Thomson says.

Italy: The populist coalition that took power in 2018 has put forward a fiscal stimulus plan that exceeds EU deficit limits, bringing it into conflict with EU authorities. However, market measures of default risk suggest those fears have not—as yet—spread to other peripheral euro countries such as Spain and Ireland. "This tells us the markets believe the tail risk of a dissolution of the single currency is still limited at this point," Thomson says.

U.S. Politics: Although the Democratic Party regained the majority in the lower house of the U.S. Congress in November's elections, Giroux calls the result "a nonevent, or at least a neutral event," since the Senate remains in Republican hands.

The main event, he says, will be the 2020 elections, when the House, the Senate, and the presidency all will be at stake.

ADDITIONAL INFORMATION

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Chief Investment Officer
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Andy McCormick
Head of U.S. Taxable
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Justin Thomson
Chief Investment Officer
International Equity

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2019 GLOBAL MARKET OUTLOOK

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