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2017 Global Market Outlook

Global Economy
Views on economics, equities, fixed income, and asset allocation

Emerging Markets
Views on equities and debt

European Markets
Views on equities and debt

Modest global growth and uncertainty about the pace of rising interest rates require a selective eye when it comes to making investment decisions. Read our 2017 Global Market Outlook to see how our professionals are navigating the new landscape as they help clients get on **the right side of change**.

Growth Solidifies Even as Uncertainties Deepen

While growth should continue in 2017, the rise of developed market populism has made the outlook more uncertain.

Alan Levenson
Chief US Economist

Nikolaj Schmidt
Chief International Economist

The pace of global gross domestic product (GDP) growth has accelerated meaningfully since its trough in the spring of 2016. The improvement in the momentum of global growth has been relatively broad-based and has been driven by looser global financial conditions and the delayed impact of Chinese stimulus measures taken early in 2016. Additionally, growth has benefitted from a slowing in the pace of inventory liquidation and the stabilisation in commodity prices.

As the impact of stimulus in both China and the developed world fades in early 2017, we expect global growth to slow a bit from its peak in late 2016. The global economic outlook has also grown more uncertain due to the rising wave of populism in developed markets, which may lead to stronger growth through greater fiscal support in some regions while threatening progress in others.

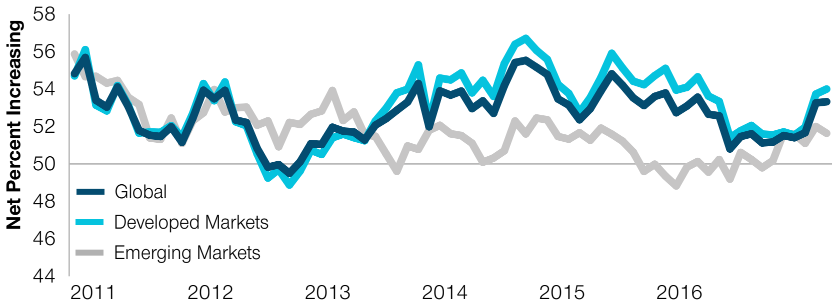
Monetary outlook grows more clouded as growth improves

As economic conditions have improved, uncertainty about the future stance of global monetary policy has increased. The assumption that the Fed will restrict itself to two or three interest rate increases in 2017 has been challenged by the prospect of increased fiscal stimulus under the incoming Trump administration. A wave of stimulus accompanied the first years of the Obama, Bush II, and Reagan administrations, but, in each case, fiscal expansion came against a background of substantial slack in the US economy. How inflation will respond to stimulus when the economy is near full employment is unclear, as is the Fed's likely reaction.

Financial markets are also adjusting to the reality that the European Central Bank (ECB) has started to implement a less accommodative monetary policy stance. There is no evidence that core inflation in Europe is rising significantly, but rising energy prices mean that headline inflation is poised to bounce in early 2017. Additionally, the output gap is closing in Europe's

How far this populist wave will travel in 2017, particularly in Europe, remains unclear but could have major impacts on global growth.

FIGURE 1: Global Growth Improving, but Off Low Base
Composite Purchasing Managers' Indexes
As at 30 November 2016



Sources: IHS Markit, JP Morgan, and Haver Analytics.

largest economy, Germany. As a consequence, longer-term inflation forecasts show headline inflation gradually rising toward 2% and provide the ECB with an argument to tiptoe toward a process of monetary normalisation. As announced in the December meeting of the monetary policy committee, the process of normalisation has taken the form of a slowing of the pace of quantitative easing (QE). The question about further tapering of the QE programme is likely to provoke fierce debate among ECB policymakers.

Asian economies have a similarly indeterminate policy outlook. In September 2016, the Bank of Japan made a substantial change to its monetary programme, announcing that it would adjust its QE purchases in order to target stable and positive longer-term yields. The new programme remains unproven, but it may help the bank control the appreciation of the yen, which has weighed heavily on the Japanese economy.

Meanwhile, China is wrestling with rising corporate debt loads, especially for state-sponsored firms, and the need to manage an increasing stock of nonperforming loans in its banking system. The fiscal spigots that helped stabilise the economy early in 2016 are likely to remain open as the top leadership in the Politburo Standing Committee undergoes a transition. The other major emerging markets appear to be continuing to go through a relatively orderly deleveraging process as they digest the lending boom that developed on the back of the very loose monetary policy stance in the developed economies. How these economies fare will be an important determinant of overall global growth.

An uncertain political environment is likely to encourage corporate managers and investors to defer irreversible decisions, which will likely create an additional headwind to growth and capital formation in Europe.

Populist wave in developed markets further clouds outlook

Late 2016 saw the headwinds of emerging market deleveraging—which have been evident to us for some time—joined by the crosswinds of developed market populism. Britain's decision to leave the European Union (EU) and Donald Trump's election in the US both reflected a broader pattern of disaffection among voters in developed economies, fed by widening inequality and a growing sense that the benefits of economic growth are not trickling down to the middle class. The uneven distribution of the wealth and income generated by globalisation is pushing voters to search for new champions in candidates who promise to protect manufacturing jobs by curbing immigration and reversing the flow of imports from low-wage developing economies.

How far this populist wave will travel in 2017, particularly in Europe, remains unclear but could have major impacts on global growth. Although Austria's far-right Freedom Party was unable to take the presidency in a runoff in early December 2016, electoral gains seem likely in 2017 for similar parties in France, Italy, Germany, Greece, and the Netherlands. While none of the anti-globalisation parties are currently favoured to win elections outright, recent history has shown that pollsters are seemingly ill-equipped to capture the intentions of frustrated voters. An uncertain political environment is likely to encourage corporate managers and investors to defer irreversible decisions, which will likely create an additional headwind to growth and capital formation in Europe.

Concerns have also deepened about the possibility of a so-called hard Brexit. Whether British Prime Minister Theresa May will be able to follow through with her promise to begin the formal process of withdrawal from the EU by the end of March is unclear, as the roles of the High Court and Parliament are still not fully settled. May and her political circle have sent conflicting signals over their willingness to sacrifice access to the customs union and the single European market in order to maintain control over immigration, and their position may evolve further.

A "hard Brexit" would have a widespread impact, but we would expect it to weigh most immediately and forcefully on the British pound. The Bank of England might respond with lower rates and an extension of its QE programme in order to protect the economy—even as the weaker pound has raised inflationary pressures in the UK.

Trump's election holds both promise and peril for economy

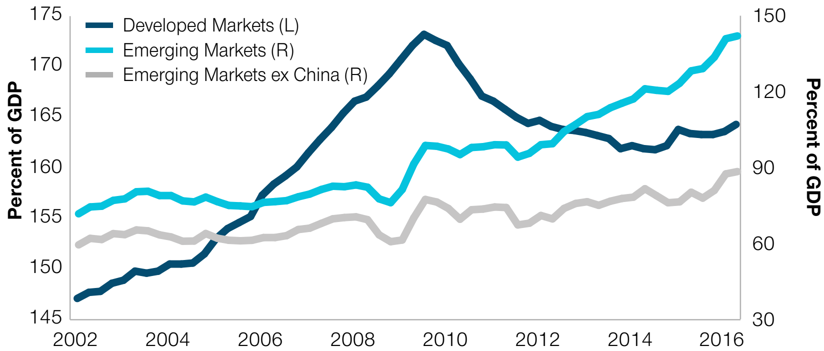
Populism in the US is taking a different form and will have disparate effects on the US economy. Central elements of Donald Trump's economic plan include a pro-growth tax plan, a new modern regulatory framework, including an unleashed energy sector, and an "America first" trade policy. Because many of Trump's priorities can be implemented by executive action, while others are shared by a GOP-controlled Congress, swift action is conceivable in some areas.

Reforming and simplifying the personal and business tax codes could boost growth even before taking into account any reduction in effective tax rates. Improvements in regulatory frameworks could also increase economic dynamism, and cutting taxes, along with deregulation, would likely support the economy. In contrast, a trade agenda emphasising tariffs or penalties for US multinational firms producing abroad would be a headwind for growth, disrupting supply chains and raising the prices of imported goods. More aggressive immigration enforcement could also have a negative economic impact, creating labour shortages in industries and states with high concentrations of unlawful immigrants, which would raise US wage costs and depress economic growth. Congress may not share Trump's willingness to risk trade wars, but it is worth noting that under the Trade Act of 1974 the president has the executive authority to withdraw from trade agreements and to impose import tariffs of up to 15% for up to 150 days, without consulting Congress.

FIGURE 2: Emerging Markets Take Their Turn at Deleveraging

Debt of Private Nonfinancial Sectors

As at 30 June 2016



Sources: Bank for International Settlements, Haver Analytics, and T. Rowe Price.

Greater attention needed for tail outcomes

The prospects for fiscal stimulus and deregulation, on the one hand, and heightened trade frictions, on the other, have increased the risk of extreme, or "tail," outcomes for the US economy in 2017. While the political whirlwind of 2016 has not changed our base-case scenario for US growth of roughly 2%, we believe that investors should be prepared for the possibility that growth will be significantly faster or slower—a caution that also applies to the overall global economy. ■

KEY TAKEAWAYS

- Global growth has picked up meaningfully since its trough in early 2016, but the boost from stimulus is likely to fade a bit in 2017.
- Central bank policy has become harder to predict now that growth has picked up and higher oil prices are likely to cause a bounce in headline inflation.
- China's political transition is likely to keep the fiscal spigots open, but other major emerging markets appear to be going through an orderly deleveraging process.
- A populist wave in developed markets has further complicated the global outlook, increasing the possibility that growth is either much slower or faster than envisioned in our base-case scenario.

Earnings Growth, Not Politics, Is Central to the 2017 Equity Outlook

The foundations for an improved 2017 earnings environment appear to be in place in both developed and emerging equity markets.

Rob Sharps
Co-head, Global Equity

Chris Alderson
Co-head, Global Equity

While Donald Trump's election has captured the attention of analysts and investors worldwide, we believe global equity performance in 2017 is more likely to hinge on the prospects for a broad earnings recovery from the currency- and commodity-related downturn of the past two years. The foundations for an improved global earnings environment in 2017 appear to be in place:

- Forward earnings forecasts for the energy and materials sectors have turned sharply positive, reversing the drag on broader earnings from those two sectors over the past two years.
- Key emerging market (EM) currencies have stabilised and inflation pressures are lessening, allowing EM central banks to ease monetary policy to spur growth. Nascent economic recoveries are underway in several major EMs (such as Brazil and Russia) hard hit by commodity price declines.
- Aggressive quantitative easing by the European Central Bank (ECB) and the Bank of Japan (BoJ) has reduced the risk of broad price deflation, reducing the headwinds to earnings.
- The global consumer, health care, and technology sectors—which continued to grow through the commodity-related profits recession—also appear poised for earnings acceleration in 2017.
- Major companies in the US and Japan continue to commit cash to share buyback programmes, enabling earnings per share (EPS) to grow faster than both net earnings and revenue.

We believe that global equity markets appear poised for an earnings recovery in 2017, led by a return to growth in the sectors and regions hardest hit by the steep declines in energy and commodity prices.

The earnings recovery should be durable

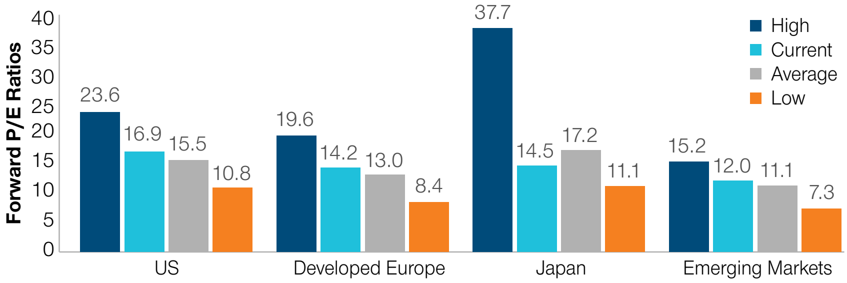
Despite the post-US election bond market sell-off, developed world yields remain quite low by historical standards. Past rate cycles suggest that when yields rise from relatively low levels—below 5% on the 10-year Treasury note—the impact on equities can be benign, as investors also begin to anticipate faster economic and earnings growth.

Moreover, while market expectations for interest rate hikes by the US Federal Reserve also have risen, we believe the Fed will continue to tighten slowly and incrementally.

These scenarios suggest an environment in 2017 in which rising interest rates and rising equity markets can peacefully coexist as long as economic growth is positive and inflationary pressures remain moderate, which is still our base case. Globally, the ECB and BoJ both are likely to remain accommodative, while many EM central banks will look to ease policy—although the latter group may be wary of the risk of faster US dollar appreciation.

Within the context of an expected earnings acceleration, equities appear fairly valued to us by most measures in most markets and relatively attractive in Japan and the emerging markets (Figure 1). Here again, the fact that developed market bond yields remain historically low should continue to support equity valuations.

FIGURE 1: Global Equity Valuations Appear Broadly Reasonable
Forward One-Year Price/Earnings (P/E) Ratios for Major Global Indexes*
15 Years Ended 30 November 2016



Sources: FactSet and T. Rowe Price.

*US = S&P 500 Index; Developed Europe = MSCI Europe Index; Japan = MSCI Japan Index; Emerging Markets = MSCI Emerging Markets Index. The forward 1-year P/E ratio is the capitalisation-weighted average of the price of each stock in an index divided by the consensus estimate of forward 12-month earnings for that stock as at 30 November 2016.

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In terms of relative valuation, European markets may benefit from the rotation to cyclical stocks, as the energy, materials, and financials sectors all have significantly higher weights in both the UK and core European markets than they do in the US market. Emerging Europe and select frontier markets appear to offer the most attractive values within the nondeveloped world.

Regional outlook

US equities have generally outperformed other developed markets since the end of the 2008–2009 global financial crisis and emerging markets equities since early 2013 (Figure 2). We expect this trend to persist into 2017; however, the US advantage should narrow. Our views on key regional markets are:

- **United States:** Third-quarter 2016 saw modestly positive year-over-year EPS gains for the S&P 500 companies, ending the string of EPS declines that started in the second quarter of 2015. Like the consensus, we expect earnings momentum to accelerate in 2017, with EPS growth in the mid- to high-single digits possible.

- **Developed Europe:** Europe's economic recovery appears on track, sustained by export demand, a return to growth in key peripheral countries, and the ECB. We continue to find attractive opportunities in the property sector and in major exporters. Steepening yield curves should be positive for European banks. However, the political risks to monetary union can't be dismissed.

- **Japan:** Earnings held up surprisingly well in 2016, despite yen appreciation. An acceleration in global growth should be supportive in 2017. We are also impressed by the governance reforms that are making Japanese firms more mindful of shareholder value. Dividend payouts and share buybacks rose sharply in both 2015 and 2016, and we expect that trend to continue in 2017.

- **China:** The rebalancing from investment and exports to consumption and services appears on track, and with almost US $3.5 trillion in foreign exchange reserves, Beijing should be able to prevent a destabilising yuan depreciation. Domestic credit imbalances, while substantial, appear manageable. However, confidence in China's equity markets remains fragile.

- **Other Emerging Markets:** Key commodity-producing economies, such as Russia and Brazil, are in recovery, while India could see economic growth of 7% or more in 2017. Given this momentum, we do not expect higher US interest rates or US dollar appreciation to derail the EM recovery.

The "Trump rotation"

Mr Trump's victory suggests that economic growth and inflation could move higher in the US and across the globe, as he is widely expected to propose major tax cuts and increases in federal infrastructure spending. However, key policy details remain uncertain, including whether he will attempt to renegotiate US trade deals or raise tariffs. Initially, the election results gave a strong push to a trend already visible before the election: a shift away from defensive utility, telecommunications, and consumer growth stocks toward more cyclical industries. However, investors are still trying to assess the potential impact of Mr Trump's programme on specific sectors:

- **Financials:** Higher interest rates and a steeper yield curve are positive for net lending margins. Mr Trump has promised to roll back some financial regulations imposed after the 2008–2009 financial crisis. Some analysts believe the Department of Labor may delay or revise rules imposing stricter fiduciary standards on brokers and advisors who sell financial products to retirement accounts.

- **Health care:** Voters in California rejected a ballot initiative that would have required the state to negotiate for lower drug prices. Some analysts had expected the Democratic candidate, Hillary Clinton, to seek similar federal authority if elected. However, Mr Trump's promise to repeal the Affordable Care Act could be negative for hospitals, device manufacturers, and other providers that benefitted from increased health spending under the act.

- **Technology:** Many large technology companies sold off following the US election as investors became more mindful of tech valuations. However, the rotation toward cyclicals already has brought tech valuations closer in line with the broad market.

- **Industrials and business services:** Higher federal infrastructure spending could boost demand for heavy equipment and other industrial goods. But possible tariffs or other trade barriers, as well as the potential for US dollar appreciation if Mr Trump's fiscal programme is seen as inflationary, could squeeze operating margins for US-based manufacturers.

- **Energy:** Mr Trump has said he wants to open up more federal land to exploration and withdraw from the Paris climate agreement, measures widely backed by energy producers. However, if his proposals eventually boost oil, gas, and coal production, they could contribute to global oversupply, putting downward pressure on prices and profits.

Conclusions

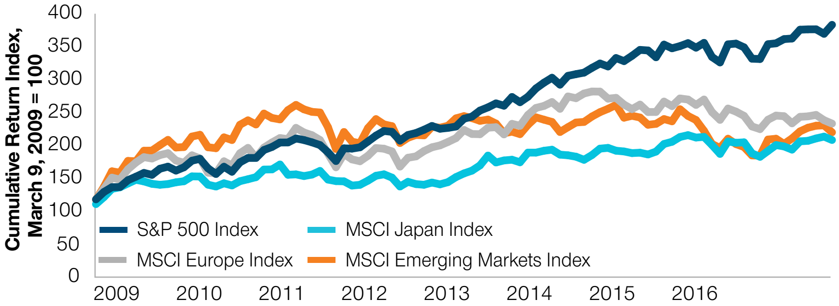
Developed market economies continue to face struggles with regard to economic growth as evidenced by recent referendums and elections, raising expectations for a turn toward fiscal stimulus in many countries. Financial and cyclical stocks have benefitted accordingly.

We believe that global equity markets appear poised for an earnings recovery in 2017, led by a return to growth in the sectors and regions hardest hit by the steep declines in energy and commodity prices. Faster US growth, improved operating results in Europe, and an easing of deflationary pressures in Japan also should support a cyclical upturn.

However, we would caution investors to keep their expectations in check. Large deficits and debt burdens appear to leave only limited room for fiscal stimulus in most developed economies, including the United States. While some emerging economies have room for fiscal stimulus, most are still focussed on structural reforms that reduce public spending. Under these circumstances, we would be cautious about pursuing the "Trump rotation" too aggressively, especially among lower-quality cyclical stocks.

FIGURE 2: US Has Maintained a Wide Performance Advantage Since the Trough of the 2008–2009 Global Financial Crisis

Cumulative Returns on Major Global Equity Indices, 9 March 2009, through November 2016



Past performance is not a reliable indicator of future performance.

Sources: Factset, Standard & Poor's, and MSCI. Returns in USD.

Note: MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products This report is not approved, reviewed, or produced by MSCI.

KEY TAKEAWAYS

- Earnings prospects are improving in both developed and emerging equity markets, although recent political referendums and elections could create market uncertainty.
- Expectations for somewhat faster global growth could continue to drive a rotation from defensive to cyclical and financial stocks.
- Equity investors appear to believe that the Trump administration will pursue aggressive fiscal stimulus, including large tax cuts and infrastructure spending. However, policy details are unclear.
- A gradual rise in US interest rates should not threaten global equity markets. The recovery in emerging equities appears strong enough to withstand moderate US dollar appreciation.

Uncertain Political Environment Underlines Importance of Selectivity

With US yields likely to rise, US floating rate loans and high yield bonds offer good value.

Mark Vaselkiv
Portfolio Manager,
Global High Income
Bond Strategy

Donald Trump's victory in November's US presidential election led to a dramatic sell-off in fixed income amid anticipation that his proposed infrastructure spending, tax cuts, and regulatory reforms will lead to higher US growth and inflation. Yields on US, UK, German, and Japanese government debt rose from record lows, wiping out more than USD $1 trillion from global bond markets as the dollar surged and US equities rallied. Political developments are expected to continue to dominate bond markets in 2017—not just in the US, where attention will be focussed on whether Trump can deliver on his campaign pledges, but also in Europe, where a number of elections will gauge the extent to which populist forces are a threat to the established order. The heightened uncertainty that this creates will necessitate a cautious approach to fixed income, with highly selective country, sector, and currency positioning.

In a challenging environment such as this, it pays to consider the full range of the fixed income universe.

All eyes on President Trump

The impact of the new Trump administration's policies on the US economy will not be the only factor influencing global fixed income markets in 2017, but it will likely be the most important one: the US bond market is the deepest and most liquid in the world, and anything that happens there will inevitably have a major impact elsewhere. It is widely believed that Trump's plans to spend USD $1 trillion on infrastructure and cut taxes will lead to higher growth and inflation. However, the US economy is already healthy and is getting stronger, with unemployment below 5%. Prices and wages were rising prior to the election; any further stimulus that Trump injects is likely to increase those inflationary pressures.

As things stand, the Fed is expected to make two to three rate hikes this year. If inflation picks up quicker than expected, the Fed could come under pressure to hike more aggressively, although the weak global economic environment may ultimately persuade it to adopt a more restrained approach. But even a relatively modest hiking cycle will set the US on a different path to most of the rest of the world, where historically low yields persist in many fixed income markets.

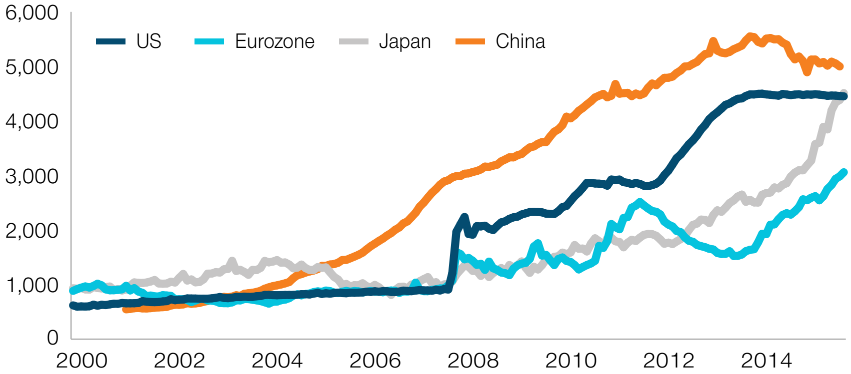
The monetary policies that created this situation are reaching the end of their useful life. As Figure 1 shows, the amount of debt on central banks' balance sheets has risen to enormous proportions, and political patience with accommodative monetary policy is wearing thin as it has notably failed to deliver the growth it was supposed to. However, we continue to expect yields in most developed markets outside of the US to remain low for some time to come.

Yields to remain anchored in Japan and Europe

The Bank of Japan (BoJ) has explicitly stated its intention to anchor its sovereign rates through "yield curve control." Essentially, this will involve using targeted quantitative easing to keep 10-year government bond yields at zero, thereby maintaining a steep yield curve as Japanese short-term bonds remain anchored in negative territory. Steeper yield curves

FIGURE 1: **Central Bank Balance Sheets (USD billion equivalents)**

As at 30 September 2016



Source: Bloomberg Finance, L.P.

typically increase profits for banks, which in turn leads to greater economic activity and inflation. However, the BoJ's move is expected to only have an incremental impact on the sluggish Japanese economy.

Yields in Europe also look set to remain low as the Continent navigates a year of political uncertainty amid a backdrop of growing anti-globalisation sentiment. The Netherlands' Freedom Party, France's National Front, and Germany's Alternative for Germany will compete in their respective countries' general elections, and while none of them are expected to win, the populist forces they represent could cause considerable turbulence. Overall, Europe looks likely to register moderate growth in 2017, and while the European Central Bank decided to slow the pace of its monthly corporate bond purchases from €80 billion to €60 billion from March 2016, we do not expect this to lead to a significant spike in yields given an absence of inflation pressures.

Emerging markets hit hardest by "Trump tantrum"

Prior to the US election, emerging markets looked well positioned coming into 2017. Local currencies had stabilised, inflation had come down, and central banks were either lowering rates or tightening less aggressively. However, Trump's victory—and the expectation that it will mean higher US rates and a stronger dollar—changed that. Emerging market bonds sold off sharply following the election, and the signs are that the Trump tantrum will not end soon. A stronger dollar will make it more expensive for overseas borrowers to service their debt commitments and may lead to capital outflows as money rapidly returns to the US.

It is possible that the Organisation of the Petroleum Exporting Countries (OPEC) deal struck at the end of November to cut oil production will benefit emerging markets, particularly Brazil and Mexico, by putting a floor under oil prices. Before the agreement, the prospect of a continued oversupply of oil was a significant headwind for emerging markets as it threatened to keep the price of a barrel below USD $45. If the deal holds, however, the price may settle in the low to mid-USD $50s in the first half of 2017. After that, the benefits of the deal for emerging markets fades as the higher price may simply encourage more drilling in the US and other non-OPEC countries. Overall, any opportunities to invest in emerging market debt are likely to be tactical than strategic in nature.

Floating rate loans and high yield expected to offer best value

In a challenging environment such as this, it pays to consider the full range of the fixed income universe. Figure 2 reveals how different segments of the fixed income market responded when US Treasury yields rose by 100 basis points or more. It shows, for example, that floating rate bank loans performed well in periods of rising rates. This is unsurprising as floating rate notes do not have a fixed rate but are tied to a cash benchmark, giving them a potential advantage over fixed rate bonds in a rising-rate environment. Most of the floating rate loans underwritten over the past five years carry a Libor floor of around 1%, which means that if Libor rises above this level, coupons are reset higher. Moreover, as floating rate loans have a duration of close to zero, they can reduce the overall interest rate sensitivity of a portfolio. We expect floating rate loans to perform well this year.

US high yield also looks well placed for positive returns in 2017. High yield bonds sold off along with the rest of the global bond market in the wake of Trump's election, but risk premiums have not risen and companies look set to continue issuing bonds—suggesting that the market retains a positive outlook for the US economy. Defaults in high yield bonds are not expected to rise meaningfully this year thanks to higher oil prices arising from the OPEC deal, while their shorter duration is expected to provide some

FIGURE 2: Market Performance When Treasury Yields Rose 100 Basis Points or More

12 Months Ended	US Yield Move	US Treasury Bonds	US Corporate Bonds	US Core Bonds	Emerging Markets Corporate Bonds	Emerging Markets Hard Currency Bonds	US High Yield Bonds	Bank Loans
31/12/99	+179 bps	-2.60%	-2.00%	-0.80%	–	24.20%	3.40%	3.60%
31/05/04	130	-2.60	-0.40	-0.40	3.10%	3.10	13.20	7.50
30/06/06	120	-1.70	-2.20	-0.80	1.00	4.60	5.10	6.20
31/12/09	162	-3.60	18.70	5.90	37.50	28.20	58.90	52.50
30/09/13	140	-2.10	-1.60	-1.70	-0.10	-4.30	7.10	5.10
Reference Indices	10-Year Treasury Yield Move	Bloomberg Barclays US Treasury Bond Index	Bloomberg Barclays US Corporate Investment Grade Bond Index	Bloomberg Barclays US Aggregate Bond Index	J.P. Morgan CEMBI Broad Index	J.P. Morgan Emerging Markets Bond Index Global	J.P. Morgan Global High Yield Index	S&P/LSTA Performing Loan Index

Sources: Bloomberg Finance, L.P. and T. Rowe Price. **Past performance cannot guarantee future results.** It is not possible to invest directly in an index.

downside protection against rising yields at the long end of the curve.

Within high yield, the technology sector has strong potential value. Corporate tax reform should provide more free cash flow for capital spending, and technology applications are expected to be high on companies' priorities. Trump's infrastructure spending plans could also boost the metals and mining sector, particularly as the president-elect has pledged to take a tough line on steel imports.

Heavy borrowing among investment-grade issuers over the past five to six years has led to a deterioration in credit quality within the asset class. If rates in investment-grade corporates rise again close to 4.5%, the sector may begin to offer value again. However, for the time being, the yields and spreads available in investment-grade bonds do not offer significant opportunities at the broad sector level.

Caution and selectivity key in difficult market

The interplay between monetary tightening in the US, a relatively firm anchoring of Japanese and core European bond yields, and expected volatility in emerging markets in 2017 will provide opportunities to exploit the move in spreads between international markets as well as the shapes of the yield curves. Global investors will benefit from blending different country cycles together and, in particular, from exploring opportunities beyond traditional benchmarks. Overall, though, US credit looks set to offer the most potential if the new Trump administration delivers on its pledge to spend heavily on infrastructure, cut taxes, and reduce regulation. Until there is further clarity about how a Trump-led US economy will perform, however, it will pay to adopt a prudent approach, focussing on selective, high-conviction positions and embracing the global opportunity set.

KEY TAKEAWAYS

- Donald Trump's election as US president has raised the prospect of tax cuts, increased spending, and higher growth and inflation in the US.
- This could lead to higher yields in the US, while yields in most of the rest of the world look set to remain low.
- Emerging markets may be hit hardest by higher yields in the US, while Europe faces a year of uncertainty as a series of elections test the extent of growing anti-establishment sentiment.
- US floating rate loans and high yield bonds look set to offer the best value in the current environment, but it should pay to adopt a prudent approach overall, focussing on selective, high-conviction positions.

Charles Shriver
Portfolio Manager,
Global Allocation,
Balanced, and Target
Allocation Strategies

A More Cautious Attitude Toward Economic and Policy Risks

The Asset Allocation Committee has sought to moderate risk by moving to an underweight position in emerging market equities.

Prospects for shifting economic and financial conditions in the wake of the US presidential election—including expectations for modestly higher inflation and interest rates and a possible redirection of US trade policy—led the T. Rowe Price Asset Allocation Committee to make several tactical changes to its diversified multi-asset portfolios as 2016 drew to a close. These moves were designed to position our clients for a 2017 market environment that may be more volatile than previously anticipated.

Broadly, the committee's recent moves primarily reflect a focus on managing exposure to economic risks that potentially could work against international and/or non-US dollar assets in 2017. These risks include the possibility that a more expansionary US fiscal policy could push inflation higher and accelerate the Federal Reserve's policy tightening pace, leading to additional US dollar appreciation and potential capital outflows from emerging market (EM) countries.

Balanced against this cautiously optimistic equity outlook, we expect only modest returns from fixed income assets in a persistent low-yield environment.

At the same time, however, we believe expectations for somewhat faster US and global economic growth should be supportive for credit-sensitive fixed income sectors such as high yield bonds. The reflationary implications of looser US fiscal policy also should increase the relative attractiveness of assets that may offer some built-in protection against higher interest rates or inflation—such as floating rate bank loans and Treasury inflation protected securities.

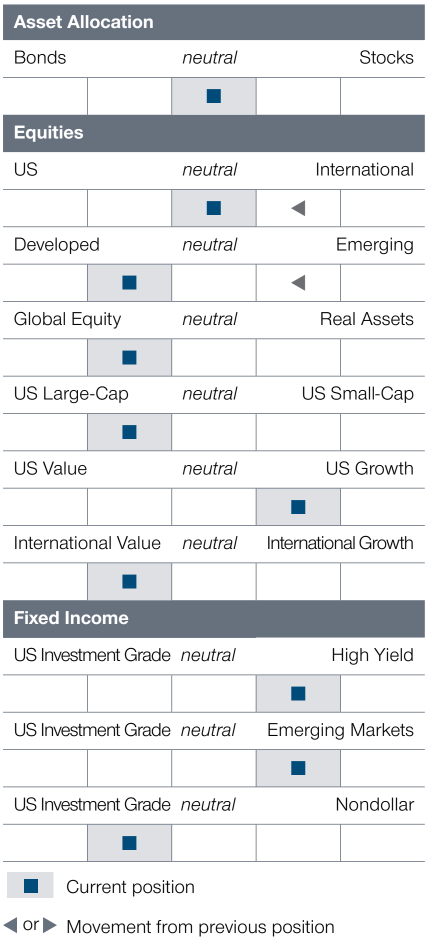
In this context, recent changes to the committee's portfolio positioning include:

- **Moving to neutral on international versus US equities.** Earlier in the year, our overweight to international stocks was based on the fact that the US is further along in the economic cycle, potentially leaving greater room for earnings acceleration in international markets. Continued quantitative easing by the European Central Bank (ECB) and the Bank of Japan (BoJ) also should be supportive of international equities. However, diminished growth expectations for many international developed economies, and the potential risks to global trade from the new US administration, leave potential risks and opportunities equally balanced between US and non-US equities, in the committee's view.

- **Reducing allocations to EM equities versus developed equities.** Earnings are beginning to recover in many of the EM economies hardest hit by energy and commodity price deflation, and valuations in many emerging equity markets are attractive relative to developed markets; however, these recoveries remain vulnerable to capital outflows triggered by currency and/or interest rate instability and to a potential protectionist turn in US trade policy.

- **Reducing allocations to non-US dollar bonds versus US dollar bonds.** The rise in global bond yields since the US election has widened the yield differential favouring US investment-grade bonds relative to non-US dollar-denominated debt.

FIGURE 1: Asset Allocation Positioning Relative to Strategic Portfolio Weights
As at 1 December 2016



Source: T. Rowe Price Asset Allocation Committee.

Quantitative easing by the ECB and the BoJ continues to suppress yields in the eurozone and Japan, offering unattractive risk/return trade-offs. However, we remain overweight to EM debt versus US investment grade, reflecting the substantially higher yields available in the EM fixed income space, although EM local currency bonds may face additional pressure from a stronger US dollar.

- **Increasing allocations to high yield bonds versus US investment grade.** Faster US growth and continued, if slow, earning recoveries in Europe and Japan should be supportive for high yield bonds. Floating rate bank loans, meanwhile, offer attractive duration characteristics in the event of an acceleration in US inflation. However, our optimism is tempered by the maturity of the credit cycle.

Current asset allocation perspectives

The committee's tactical portfolio positions are relative to our long-term strategic neutral allocations across our asset allocation portfolios and reflect our expectations for asset class and sector performance over the ensuing six to 18 months.

The committee typically focusses on overweighting segments of the market we believe are undervalued while lowering allocations to more richly valued asset classes or sectors. Our process incorporates a range of factors, including macroeconomic trends, market developments, and earnings expectations.

Changes within our portfolios tend to be gradual, building into meaningful positions over time based on our ongoing assessment of opportunities. Figure 1 provides an overview of our current positioning in the major asset classes and sectors.

Neutral between stocks and bonds

Expectations for pro-growth US economic policies have pushed equity prices to near-record levels since the US presidential election. US corporate earnings surprised to the upside in third-quarter 2016, breaking a string of five consecutive quarters of year-over-year declines for the S&P 500 companies. Although US valuations are above historical averages and profit margins may come under late-cycle pressure, low but stable economic growth should remain supportive of most sectors. While our global growth expectations for the next several quarters remain modest, quantitative easing by the ECB and the BoJ should continue to be supportive for international equities.

Balanced against this cautiously optimistic equity outlook, we expect only modest returns from fixed income assets in a persistent low-yield environment. Rising US interest rates are a potential headwind, although we still expect the pace of Fed tightening to be gradual. Moreover, most global central banks are expected to remain broadly accommodative in 2017, which should moderate downside risks.

Relatively subdued expectations for both global equities and global fixed income leave risks and opportunities evenly balanced between the two asset classes, in the committee's view.

Favour global equity over real assets

The committee remains underweight to equities linked to real assets, such as natural resources and real estate, in part reflecting our continued pessimistic outlook for energy prices given persistent global supply and demand imbalances (Figure 2). We are sceptical of the ability of the Organisation of Petroleum Exporting Countries to meaningfully reduce supply, despite the production cuts announced at the end of November. We believe any cuts in supply are likely to be replaced by US shale producers, who have been able to reduce their operating costs significantly. Meanwhile, demand for industrial metals should remain subdued as China seeks to rebalance its economy away from industrial production and exports.

The outlook for global real estate is more positive, as real estate equity valuations appear less extended versus broader equities. While real estate investment trust shares remain sensitive to rising interest rates, the expected gradual pace of Fed tightening should limit potential risk.

Favour US growth over US value

We remain overweight to US growth stocks relative to US value stocks as relative valuations favour the growth universe, as do our expectations that US economic growth will remain relatively subdued given the structural barriers (low population growth, slow productivity gains) to any pro-growth policy efforts.

To us, the post-US election rally among lower-quality value sectors, including industrials and materials, appears to be pricing in extremely optimistic outcomes from the policies expected to be pursued by the new Trump administration. While increased spending, tax cuts, and deregulation could provide support for sectors such as financials and energy, prospects for congressional approval for some of these measures remain uncertain, in our view.

Favour value over growth outside the US

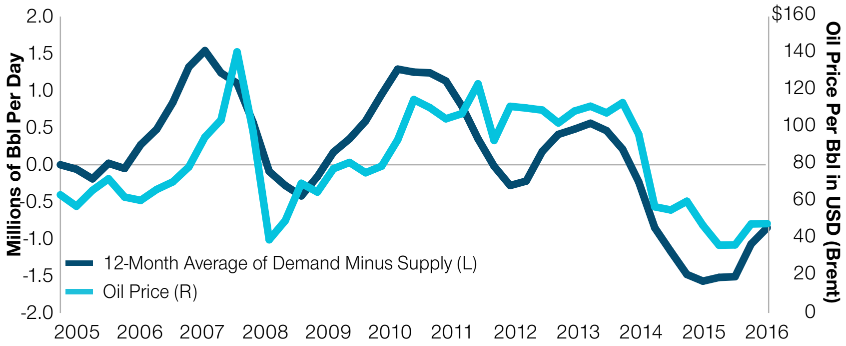
In international equity markets, we are modestly overweight to value stocks relative to growth stocks. Some key growth sectors—such as consumer staples—have become increasingly expensive, in our judgement. By contrast, many international value sectors remain attractively valued, although some sectors that are heavily weighted in the international value universe, including financials and energy, continue to face headwinds.

Favour US investment grade over non-US dollar fixed income

As previously noted, the Asset Allocation Committee reduced exposure to nondollar bonds relative to US investment-grade bonds in late 2016. This reflected our belief that US interest rates and the US dollar are both likely to continue moving higher in early 2017 amid widespread speculation about a shift to reflationary policies, such as higher federal spending and tax cuts, and the potential for a US turn toward protectionist trade policies.

FIGURE 2: Global Oil Supply Remains Well Ahead of Demand, Putting Downward Pressure on Oil Prices

Global Demand Minus Supply vs. Brent Oil Price, Through September 2016



Sources: FactSet, OECD, and Energy Information Agency; analysis by T. Rowe Price.

Despite the postelection rise in global bond yields, ECB and BoJ quantitative easing measures continue to produce negative yields on short- and intermediate-term maturities in the core eurozone and in Japan. The effectiveness of monetary policy in these countries also appears limited, creating further downside risk. For example, recent attempts by the BoJ to target yield levels have resulted in yields moving higher.

Going forward, the BoJ's ability to keep the yield on the 10-year Japanese government note at the bank's 0% target will be a critical test of monetary effectiveness. ■

KEY TAKEAWAYS

- T. Rowe Price's Asset Allocation Committee has moved from a modest overweight to international equities to a neutral position between US and international equities, reflecting prospects for somewhat stronger US economic and earnings growth and the potential for US dollar appreciation.
- The committee has sought to moderate equity risk in portfolios by unwinding its previous overweight to emerging market (EM) equities. While the EM earnings recovery appears intact, currency, interest rate, and trade policy risks have all risen.
- Persistent oversupply in oil and other commodity markets reinforces our preference for broad global equities over real assets. We remain sceptical of the ability of the major oil-exporting countries to unify to control global supply.
- Yields on non-US dollar bonds appear less attractive relative to US dollar investment-grade bonds. Prospects for somewhat faster global growth should be supportive for high yield, although we are mindful that the credit cycle is well advanced.

Strong Enough to Withstand Bumps in the Road

Gonzalo Pángaro
Portfolio Manager,
Emerging Markets
Equity Strategy

Across emerging markets, positive drivers are building. We believe there are very interesting pockets of growth that are hard to find in the slower-growing developed markets.

The outlook for emerging markets equities remains bright. Improving economic growth and a revival in corporate earnings should bode well for the year ahead. Economic growth relative to developed markets has now stabilised. In fact, the growth premium is once again expanding (Figure 1) as the larger economies of Brazil and Russia, which have been suffering tough recessions, now show signs of a turnaround. Meanwhile, Asian economies generally remain robust, with India, in particular, powering ahead. India is a great example of a country that is making the hard reforms now in order to maintain its future prospects. The country's prime minister, Narendra Modi, has shown willingness to push through reforms that may cause short-term pain so that the economy can be positioned for long-term gains.

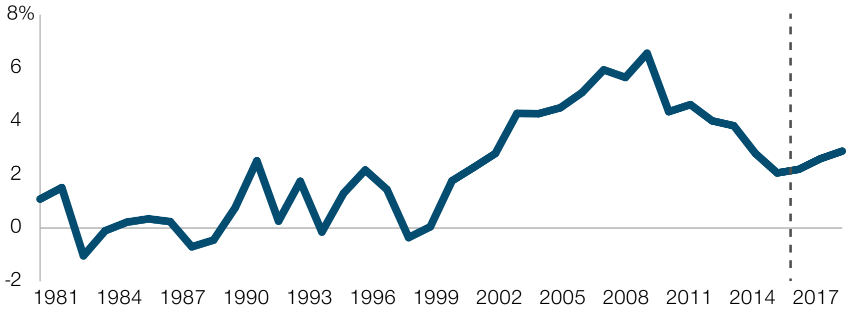
China's economy, however, continues to slow. But a growth slowdown should not be confused with a growth crisis, in our view. China ultimately has the ability and willingness to apply policy actions that should prevent its economic and debt dynamics from becoming disorderly. It is also important to remember that China is going through a major transition from an economy led by manufacturing and investment to one more based on services and consumer demand. This is a multiyear transformation and should be monitored as such. Beyond China, economic growth for emerging markets as a whole appears to be accelerating.

Positive macro backdrop feeding through to corporate earnings

Improving economic growth is providing a healthier environment for corporate earnings. 2016 marked a turnaround in earnings for emerging markets after a number of years in the doldrums. Some of this improvement was helped by the revival in commodities, but we have also increasingly seen more examples of self-help within companies, with a growing number of companies focussing more intensely on cost control, efficient capital expenditure, and improving shareholder returns.

Profit margins in most emerging countries remain below historical averages, but better growth and more disciplined cost management can help improve them. We are already seeing tentative signs of margin expansion among nonfinancial companies. Importantly, for the first time in five years, productivity is increasing at a faster pace than real

FIGURE 1: Emerging Markets Growth Turning Upward
Emerging markets gross domestic product (GDP) growth relative to developed markets
As at 31 December 2016



Sources: International Monetary Fund, and World Economic Outlook.

wages in some key markets. This can only help lift margins, although some countries have more scope for improvement than others.

Despite strong equity performance in 2016, valuations are still attractive as they remain at a discount relative to developed markets, particularly on a price-to-book basis. Valuations on a price-to-earnings basis are a bit more varied, with some sectors—such as consumer staples and health care—slightly above their long-term averages. Earnings growth, however, has been somewhat anaemic and may be poised to accelerate in 2017, making us more sanguine about current valuation levels.

What to look out for

One possible headwind facing investors in 2017 is the impact of President-elect Donald Trump's policies. The election of Mr Trump caused some volatility in the immediate aftermath following his victory. If he follows through on his protectionist rhetoric, trade could be damaged for a number of emerging countries.

It is early in terms of being able to assess the full impact. Most likely, the administration will pursue a pro-growth agenda that includes lower taxes, reduced regulation, and infrastructure spending. If so, these measures could pull global economic growth higher, and this historically has helped emerging markets. The question is whether or not developing markets will be allowed to participate in this based on Mr Trump's preelection trade and tariff threats.

While still uncertain, our current view is that Mr Trump will be more pragmatic in the priorities and policies he pursues. We expect him to ultimately embrace a more practical, business-friendly stance, particularly related to trade.

Meanwhile, expectations for stronger growth are pushing US inflation expectations higher, and the yield curve has steepened. Indeed, after many years, we may finally be on the cusp of change in the trajectory of US interest rates. Higher interest rates are resurrecting some of the concerns for emerging markets about lower capital flows and weaker currencies.

However, most emerging market countries are in much better shape to weather what should be modest increases in rates orchestrated by the Fed. Current account positions have improved, foreign exchange reserves have increased, real interest rates are higher, and many emerging market currencies have fallen over the past several years. Therefore, we are more upbeat and would only be concerned if we saw a dramatic and accelerated rise in US rates. Indeed, real interest rates are still relatively high in a number of emerging countries. As local inflation rates ease, there should be scope for central banks to cut interest rates in response.

Near-term concerns but long-term positives

Strong performance within emerging markets in 2016 was driven in part by expectations for stronger relative economic growth and a more benign global interest rate environment, with interest rates staying lower for longer. Both assumptions are now being challenged in the wake of the US elections, but we expect emerging equity markets to weather any potential storm based on the improved fundamentals and growth potential they offer. Earnings trends remain positive, and across the emerging market landscape, there remain very interesting pockets of growth that are hard to find in developed markets. We believe companies that are exposed to that growth, and that have strong management teams, should provide attractive returns for long-term investors.

The fundamental case for emerging markets remains in place. As confidence in the growth potential of these economies and companies increases, so, too, should capital flows into the asset class. ■

KEY TAKEAWAYS

- Economic growth relative to developed markets is now stabilising. China is the one exception, but a growth slowdown should not be confused with a growth crisis.
- This improved economic growth should provide a healthier environment for corporate earnings, particularly if margins begin to improve, as we expect.
- The potential for higher US interest rates is resurrecting some of the concerns for emerging markets. However, most countries are in much better shape to weather what should be modest increases orchestrated by the US Federal Reserve.
- The prospects for growth remain strong, although in the near term investors may see short-term market volatility as top-down concerns—including uncertainty about economic policies in the US under a Trump administration—circulate. Importantly, given robust fundamentals and areas of superior growth, we believe there are still many rewards to be found.

Attractive Amid Political Upheaval in Developed Markets

We believe that emerging markets bonds remain more attractive than the sovereign debt of developed countries.

Samy Muaddi
Portfolio Manager,
Emerging Markets
Corporate Bond
Strategy

Emerging markets debt generated strong returns through much of 2016, outperforming most fixed income sectors as oil prices stabilised above their lows and ultralow or negative yields on high-quality developed markets debt pushed investors into higher-yielding sectors. While these conditions may not last through 2017, we believe that emerging markets bonds remain more attractive than the sovereign debt of developed countries. Emerging markets have become structurally less vulnerable in terms of fiscal health, private sector liabilities, external obligations, and political stability.

Reduced fiscal and external funding vulnerabilities

Most emerging market countries have meaningfully improved their fiscal situations by exercising more budgetary discipline than in the past. On average, public debt as a percentage of gross domestic product is significantly higher in the G7 advanced economies than in emerging markets. The private sector liabilities of corporate borrowers in emerging markets also represent a less significant vulnerability, with 85% of emerging markets corporate leverage now held in the country of issuance.[1]

External funding pressures from current account deficits, which were a major vulnerability of emerging economies in the recent past, have also receded. The average emerging market now is running only a slight current account deficit. Most developing countries have also made great strides in bringing inflation under control, thanks largely to a shift toward independent central banks with policy mandates to target price stability. With inflation receding, some emerging markets central banks now have more room to cut interest rates to stimulate growth.

Narrower political risk differentials

While political risk has increased in many developed markets—as demonstrated by the UK's surprising vote to leave the European Union and Donald Trump's victory in the US presidential election—political risk in emerging countries has been broadly trending downward. Although political uncertainty is still generally higher in the emerging markets than in the developed world, the difference has narrowed. The 2017 calendar of major elections and other political events in emerging markets is lighter than it was in 2016.

Structural reforms to continue in some developing countries

Emerging market countries that can implement structural reforms to position their economies for growth are most likely to offer the best long-term investment opportunities going forward, in our view. Heading into 2017, a number of the countries that appear best positioned for reforms are concentrated in Latin America. Under new President Michel Temer, Brazil has begun to enact positive fiscal reforms aimed at controlling government spending. Argentina's president, Mauricio Macri, settled a dispute with the country's holdout creditors in 2016, and we anticipate that he will continue to make investor-friendly reforms.

[1] Sources: T. Rowe Price, J.P. Morgan, Bank of America, Fitch, and Bank for International Settlements. As at 31 December 2015.

Outside Latin America, India's Prime Minister Narendra Modi should be able to continue to make reforms that position the country's economy for growth. Modi's recent "de-monetisation" move to take certain large denomination currency notes out of circulation to combat the country's underground economy and tax evasion was a bold change that should bring long-term benefits despite some near-term turmoil. Additionally, we think that many observers and investors underappreciate the potential for further reforms in China as the country evolves from an export-driven economy to one based primarily on domestic consumption.

China's 2017 party congress to limit "hard landing" risk

While China's economic transition is creating opportunities for structural reform, it also presents a potential risk to emerging markets as a whole. If China's government were to fail to engineer an economic "soft landing" as the country moves toward a more balanced but slower rate of growth, it could have profound negative effects around the world. However, we believe this risk will be mitigated in 2017 by the fact that China's Communist Party will hold its Party Congress, which takes place every five years, in October to select its top government officials. Beijing will be strongly motivated to keep its economy from slowing sharply in advance of this key political event.

Dollar-denominated emerging markets sovereign debt appear best positioned for 2017

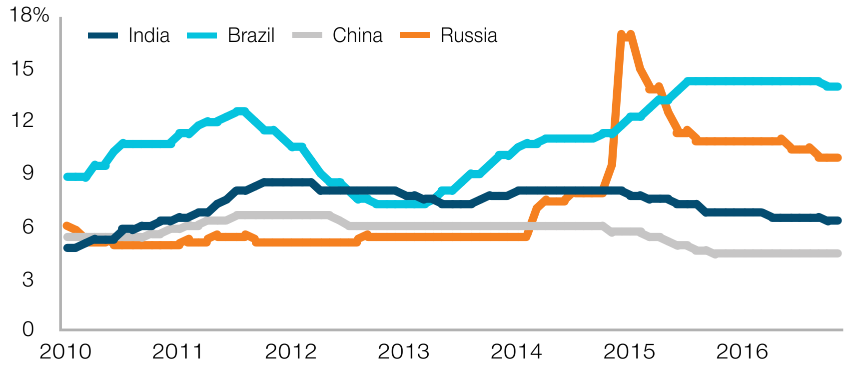
In our view, the three most significant risks facing emerging markets debt in 2017 are the possibility of a further rise in yields in developed markets, the potential for another downturn in oil prices, and a possible push by the incoming Trump administration to implement restrictive US trade policies. Yields on high-quality sovereign debt from developed markets increased meaningfully after the US presidential election, and further increases would eliminate part of the yield advantage that helped emerging markets bonds post strong returns in 2016.

Oil prices that levelled off in the USD $45 to $50 per barrel range generally were supportive for emerging markets bonds in 2016, but another large move downward could pressure the asset class. Finally, if the Trump administration acts on its protectionist campaign rhetoric, emerging economies such as Mexico and China could suffer.

The potential risks previously outlined would weigh most heavily on emerging markets currencies versus the US dollar. Given that the more limited structural economic vulnerabilities of emerging markets countries now allow them to handle the consequences of currency depreciation, bonds denominated in local currencies are our least-favoured emerging markets debt sector. Within the asset class, we believe sovereign bonds denominated in US dollars appear best positioned for relative outperformance in 2017, followed by dollar-denominated emerging markets corporate debt. ■

FIGURE 1: Emerging Markets Central Bank Interest Rates Over Time

As at 30 November 2016



Sources: Haver Analytics and T. Rowe Price.

KEY TAKEAWAYS

- Many emerging debt markets have become less vulnerable in terms of fiscal health, private sector liabilities, external obligations, and political stability.
- The aggregate difference in political risks between emerging and developed markets has narrowed.
- Higher interest rates in developed markets, another downturn in the prices of oil and other commodities, and protectionist trade policies under the Trump administration are potential risks for emerging markets debt in 2017.
- Going into 2017, we broadly favour US dollar-denominated emerging markets sovereign and corporate bonds over locally denominated debt because of the risk of further weakness in emerging markets currencies versus the US dollar.

Staying Nimble and Balanced in Unusual Times

While more uncertainty lies ahead, we believe the foundations for investing in Europe are more solid than investors may appreciate, once one looks below the surface.

Dean Tenerelli
Portfolio Manager, European Equity Strategy

Sentiment toward European equities is negative following the unusual challenges of 2016. There were significant fund outflows throughout the first 10 months of the year, which seemed to indicate that some investors had capitulated.[1] The continuing moderate pace of growth, despite unprecedented doses of central bank stimulus; several years of disappointing corporate earnings; and growing political uncertainty may have proved too much for many investors to bear. The market environment was also volatile, as quantitative easing made equity markets very rotational, often wrong-footing investors.

We believe there will be more uncertainty in the year ahead, with the prospect of further potentially sizeable shifts in the European political landscape. However, in our view, the foundations for investing in Europe are more solid than investors may appreciate, once one looks below the surface. In particular, economic growth and the corporate earnings outlook are both currently meeting expectations.

One encouraging sign for European equities is that the Citigroup Economic Surprise Index for Europe, which rises when economic data exceed economists' consensus estimates, climbed to its highest level since March 2015 at the end of October 2016.[2] Analysts have also become more confident about the impact of the economic expansion on corporate earnings growth. The 12-month earnings revision ratio for the MSCI Europe Index advanced strongly through the first 10 months of 2016, which means that there were more upgrades than downgrades and that companies were meeting or exceeding consensus forecasts.[3] In recent years, expectations have typically fallen as the year has progressed. At present, hopes for a return to earnings growth in the year ahead seem to be more soundly based.

European macroeconomic conditions seem to have improved as well. Markets, consumer sentiment, and demand have largely recovered from Brexit's initial shock. Fears of a sharp slowdown in the UK economy have subsided, at least for the time being, as recent economic data show demand holding up. Continental Europe's economy has, so far, continued to grow at a moderate pace.

Concerns about European unity

However, it would be premature just yet to say that the gloomy perceptions of the European economy are beginning to lift. The UK's exit from the European Union (EU) may still turn out to be disruptive. The European Central Bank appears to be less certain about growth in 2017, and its policy remains highly accommodative. Political uncertainty is expected to persist in the year ahead with crucial elections in Germany and France, the two largest eurozone members, which could be additional flashpoints for instability in the EU. Mainstream political parties are preparing to counter a rising tide of populism that has already upended incumbents in the UK and the US and reignited concerns about European unity.

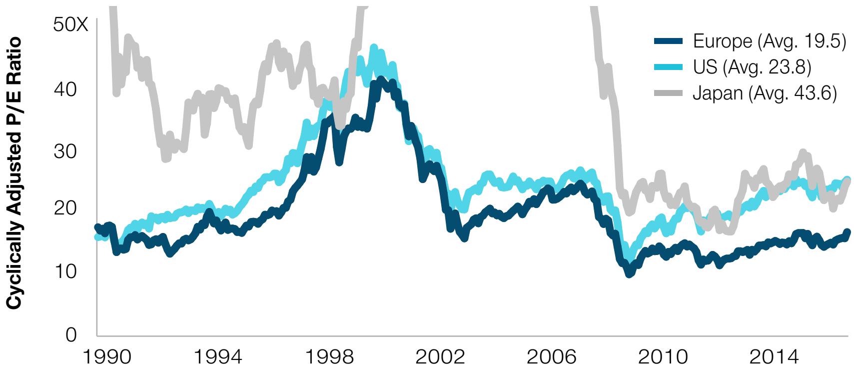
Meanwhile, Donald Trump's victory in the US presidential election has

[1] Source: Broadridge Financial Solutions, FFMI Fund File. As at 31 October 2016.

[2] Sources: Citi and Bloomberg Finance, L.P. As at 31 October 2016.

[3] Source: Morgan Stanley. As at 31 October 2016.

FIGURE 1: Cyclically Adjusted Real Price-to-Earnings (P/E) Ratio
As at 31 December 2016



Past performance cannot guarantee future results.
Sources: FactSet and T. Rowe Price.

triggered an unexpected change in market sentiment, providing a welcome respite for investors resigned to the idea of a prolonged period of secular stagnation. The ensuing rally has favoured stocks on both sides of the Atlantic, with the main beneficiaries in Europe being in the banking, materials, and capital goods sectors. Whether this surge will extend into 2017 depends at least in part on the execution of the promised fiscal stimulus by the incoming administration.

These political and economic factors all have a bearing on our assessment of market conditions. However, we believe that Europe's market is reasonably priced, and the potential for more positive momentum has improved. European valuations are by no means extended versus historical averages. At the end of the fourth quarter 2016, investors were paying just over 16 times forward 12-month earnings for developed European equities, which only slightly exceeded the longer-term historical average.[4]

Balanced approach required

The UK's vote to leave the EU is a pivotal event for Europe, and the full breadth and depth of its impact remain to be seen. While we have reduced our UK holdings, selling some of our companies solely with domestic exposure, we are not attempting to position our European equity strategy to benefit from one particular scenario or another. Rather, we continue to invest in a blend of high-quality growth and value stocks that we believe could benefit whether Europe's economy stays on course for recovery or if it falters due to Brexit-related risks.

Some of our investments may suffer in periods when markets are dominated by macroeconomic events and themes, but our experience has been that companies fall in and out of favour during these periods and other good-quality stocks often become available at more attractive prices. We are currently finding potentially attractive opportunities in retailing, where profitable European companies are operating across the globe; in communications, where some firms are benefitting from convergence and market consolidation; in technology, where e-commerce is helping firms become more efficient; and in financials, particularly banks in consolidated markets that are poised to benefit from steeper global yield curves in the wake of the US election.

Whatever the prevailing economic and market conditions, we stick to our investment philosophy and process—tried and tested for more than a decade. We get to know the businesses that meet our quality criteria, we establish a price we are prepared to pay for those companies, and we act on those opportunities if and when our valuation requirements are met. ■

KEY TAKEAWAYS

- The European economy is still managing to deliver a modest recovery, with the help of the European Central Bank, and there are reasonable grounds for believing that this will continue.
- Corporate earnings are currently close to a cyclical trough, and the potential for more positive momentum has improved.
- We are cautious given the increased uncertainty sparked by the Brexit vote and the potential for political upsets in the months ahead.
- While sentiment toward European equities is negative, the reality is more balanced and should favour our approach based on fundamental research and active stock selection.

[4] Sources: FactSet and T. Rowe Price. As at 31 December 2016.

Political Risks Dominate European Bonds

David Stanley
Portfolio Manager,
European Corporate
Bond Strategy

We expect European bond markets will be dominated by political risks in 2017 as parliamentary elections are held in key countries.

We expect European bond markets will continue to be heavily influenced by technical factors in 2017. Growth and inflation both are likely to remain muted, leaving the markets particularly sensitive to monetary policy decisions and political developments.

In December, the European Central Bank (ECB) announced that its corporate sector purchase programme (CSPP), which was due to end in March, will be extended until December 2017. This should keep sovereign yields low and compress spreads, limiting the attractiveness of the opportunity set. However, a series of upcoming general elections in European Union (EU) member states, set against a backdrop of growing anti-establishment forces, could bring further volatility and yield spikes this year.

The end of CSPP still looms

The extension of the CSPP was expected; the only question was whether or not it would be tapered. ECB President Mario Draghi argued that the ECB's decision to slow the pace of monthly purchases from €80bn to €60bn did not amount to tapering, and he insisted that tapering had not "even been on the table." However, market reaction suggested that not all investors were convinced by this: yields spiked briefly before settling back down again.

What is clear is that the marginal benefit of CSPP is falling and that it will have to end at some point. Speculation about the precise longevity of the programme will likely intensify toward the end of 2017, potentially sending yields higher again.

In November, the European Commission downgraded its forecast for EU growth in 2017 to 1.6%—0.3 percentage points lower than it had predicted earlier in the year. The commission said that economic risks in Europe had "clearly tilted to the downside," and claimed that the UK's vote to leave the EU had "raised uncertainty and can be seen as an indicator of heightened policy risks in the current environment." It also warned of political uncertainty arising from a "new backlash against globalisation."

Will Trump's triumph strengthen European populism?

The true extent of the backlash against globalisation will be tested this year in parliamentary elections in the Netherlands, France, and Germany. The main populist parties—Netherlands' Freedom Party, France's National Front, and Germany's Alternative for Germany—are all polling strongly ahead of these elections, and while none are expected at present to win, strong performances by them may cause yields to spike if investors become spooked. The prospect of the UK triggering Article 50 (stating its formal intention to leave the EU) and Catalonia's plan to hold a referendum on independence from Spain—with or without Spain's permission—may cause further volatility.

Populists in Europe will no doubt have been encouraged by Donald Trump's victory in the US presidential race. European sovereigns sold off following the US election amid anticipation that Trump's plans to cut taxes and boost infrastructure spending will lead to higher US inflation and interest rates. However, any inflationary pressures arising from new projects are unlikely to be felt this year, although the anticipation of stronger growth may exert some upward pressure on yields. Additionally, if Trump pushes ahead with his plans to impose protectionist trade measures, it could dampen growth around the globe, including in Europe.

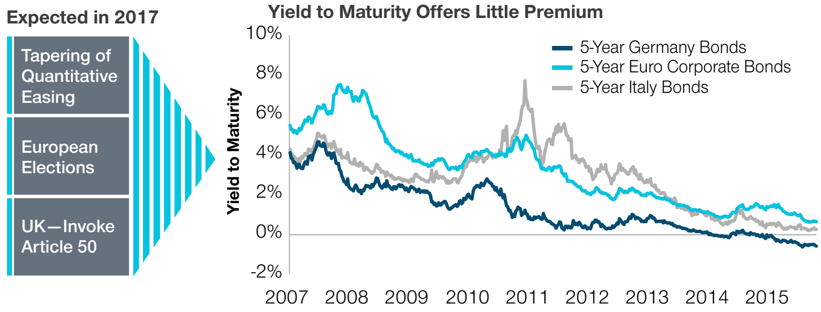
Credit fundamentals remain mixed

The overall picture for Europe in 2017 is one of continued low yields against a background of significant policy and political risks (Figure 1). Credit fundamentals remain mixed. While corporate leverage is on a slowly rising trend in Europe, interest coverage remains very healthy as a result of low funding costs. Moreover, companies in Europe remain very mindful of the last financial crisis and are wary of something similar recurring. This caution has persuaded many firms to focus on maintaining balance sheet strength.

We expect the performance of European credit strategies in 2017 to be heavily influenced by the interplay between domestic and external political developments. If anti-establishment parties are seen threatening the status quo in national elections, or if European growth comes in lower than expected, this will likely lead to increased volatility, weak equity market performance, and spread widening. At the same time, however, the extension of the CSPP is likely to act as a cushion against spread widening.

The CSPP has also led to divergence in performance among bonds, depending on their eligibility for ECB purchase. This should continue to create relative value opportunities next year, including in the European banking sector, which is not part of the programme. For banks, rising and steepening government yield curves should alleviate some earnings pressure, and valuations appear attractive, but we expect bank issues to continue to be strongly influenced by political risk. Periods of weakness and volatility may present good buying opportunities.

FIGURE 1: Low Yields Combine With Key Risks in European Debt Markets
As at 30 September 2016



Past performance cannot guarantee future results.
Sources: Bloomberg Finance, L.P., Bloomberg Barclays Euro Aggregate Corporate Index, and Bloomberg Index Services, Ltd.

Continued uncertainty argues for caution

Continued uncertainty over how the various political and policy developments of 2017 will affect European debt markets necessitates a cautious investment approach. The extension of the CSPP should help to contain spread widening in the short term, but the inevitability of the programme being tapered at some point—combined with the beginning of the European "election supercycle" in March—means that risks will be embedded throughout the year. The flexibility to respond quickly to extreme market moves will be key in this environment, but even more important will be the continued focus on fundamentals and security selection. In our view, the coming year likely will be a difficult investment environment, but it should also create interesting opportunities. ■

KEY TAKEAWAYS

- We expect European bond markets will continue to be heavily influenced by technical factors in 2017. Growth and inflation are likely to remain muted, leaving the markets particularly sensitive to monetary policy decisions and political developments.
- The extension of the European Central Bank's corporate sector purchase programme should continue to impact valuations by keeping sovereign yields low and compressing spreads, limiting the opportunity set.
- However, a series of parliamentary elections in European Union member states against a backdrop of growing anti-establishment forces could bring further volatility, and spikes in yields, during the year.
- The flexibility to respond quickly to extreme market moves will be key in this environment, but even more important will be the continued focus on fundamentals and security selection.

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

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2017

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