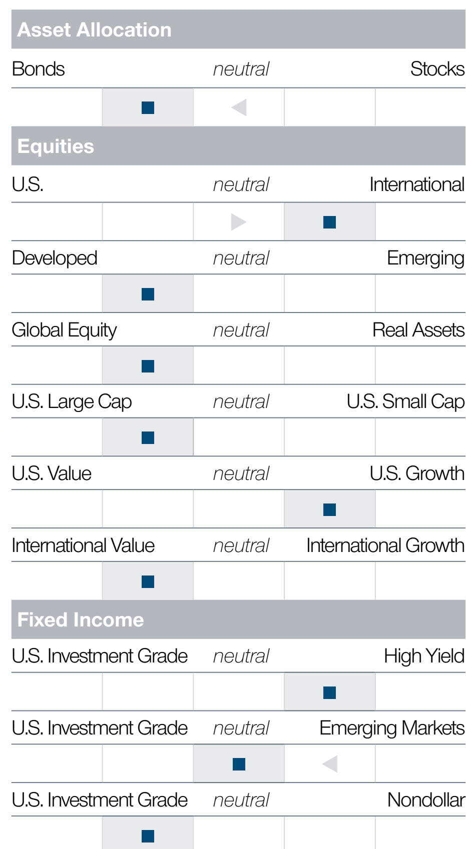
T. Rowe Price®
INVEST WITH CONFIDENCE

ASSET ALLOCATION COMMITTEE VIEWPOINTS

Second Quarter 2017

These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon. The approach is largely qualitative and valuation based, with attention to a broad scope of potential risks and potential return scenarios.



Asset Allocation				
Bonds		*neutral*		Stocks
	■	◀		
Equities				
U.S.		*neutral*		International
		▶	■	
Developed		*neutral*		Emerging
	■			
Global Equity		*neutral*		Real Assets
	■			
U.S. Large Cap		*neutral*		U.S. Small Cap
	■			
U.S. Value		*neutral*		U.S. Growth
			■	
International Value		*neutral*		International Growth
	■			
Fixed Income				
U.S. Investment Grade		*neutral*		High Yield
			■	
U.S. Investment Grade		*neutral*		Emerging Markets
		■	◀	
U.S. Investment Grade		*neutral*		Nondollar
	■			

■ Current position
◀ or ▶ Movement from previous position

Explore the themes and thinking behind our decisions.

THEMES

Global

- Although still at modest levels, global growth momentum has continued into the start of this year with evidence showing improvement occurring across most developed and emerging markets which has been uncommon in the current economic cycle
- Developed markets are supported by expectations for modestly higher growth in the U.S., Japan and Europe, although Europe faces downside risks from the potential impacts of upcoming elections and Brexit
- Broad emerging markets growth expected to improve led by a return to growth of the large commodity-related economies of Brazil and Russia, offset by a modest slowdown in China; however, downside risks to emerging economies are elevated given uncertainties to developed market trade policies, higher interest rates, a stronger U.S. dollar and the sustainability of energy prices
- While remaining broadly supportive, global monetary policies to diverge further as the U.S. Fed interest rate normalization policy advances and the European Central Bank (ECB) looks for signs of stabilization to begin reducing its quantitative easing measures
- Markets are anticipating increased fiscal and corporate spending to be the next leg of support for growth as the effectiveness of monetary policies remains muted
- Global equity markets post strong first quarter performance supported by data suggesting improving global growth, with international markets outpacing U.S. markets in dollar-terms as the U.S. dollar weakened against most major currencies
- U.S. Treasury yields trending near 2.4% (10-yr.), just below levels that were reached after the U.S. election on expectations that fiscal spending, lower taxes, less regulation and more restrictive trade policies prove reflationary. Other developed market yields are mixed as European yields react to improved economic data and risks over upcoming elections
- Key risks to global markets include the negative impacts from protectionist trade policies, fiscal policy disappointment in the U.S., political instability within Europe, monetary policy missteps and the sustainability of recovery in energy prices

U.S.

- U.S. economic growth revised higher for the 4th quarter of 2016 to a 2.1% annualized rate, supported by stronger consumer spending and imports. Despite the improvement, the economy grew by just 1.6% in 2016, the weakest since 2011
- Uncertainty has increased surrounding the Trump administration's planned policies on fiscal spending, immigration, trade, taxes and regulation following the failed attempt to advance healthcare legislation
- Inflation, as measured by the consumer price index (CPI), may have reached a near-term peak of 2.7% as the support from higher energy prices has moderated. Core CPI (excluding food & energy) has gradually risen to modestly above 2%. Recent data shows wage growth rising from low levels along with the improvement in the job market
- U.S. Federal Reserve raises rates in March, the third time since December 2015, while signaling their intent to continue a modest pace of tightening this year amidst a stronger labor market and higher inflation, with markets expecting at least two more rate increases in 2017
- While corporate leverage has increased, balance sheets remain relatively healthy and still provide the corporate sector flexibility in the use of capital to increase capital spending, engage in M&A activity and return capital to shareholders
- The pace of corporate buybacks continues to slow from near record levels along with M&A activity. While financing costs remain low, interest rates have risen sharply

- U.S. companies reported high-single digit rise in profits in the 4th quarter 2016. The positive earnings growth trend is expected to be sustained throughout 2017 with high-single digit growth, supported by stronger revenue growth and a positive contribution from the energy sector

Europe

- European growth expectations increased for 2017 and 2018 despite the political uncertainty ahead supported by resilient household consumption and modestly improving business investment
- Economic growth in the 4th quarter of 2016 improved modestly, expanding by a 0.4% quarterly rate (+1.7% year-over-year)
- Last December the ECB announced an extension of its quantitative easing measures through at least the end of 2017, while "tapering" the size of monthly purchases from 80 to 60 billion euros. President Draghi pledged that the bank is ready to expand the size and duration of easing measures should they be necessary
- Although broadly improving, structural issues remain with several countries still having high debt levels and high unemployment. Greece, while no longer perceived as a systemic risk, remains embroiled in resolving its debt crisis
- Near-term risks remain elevated surrounding the impacts of Brexit and political uncertainty pertaining to key upcoming elections in France and Germany, although results from the election in the Netherlands and recent polling suggests populist movements losing ground

Japan

- Japanese economic growth expands for the fourth consecutive quarter, growing by a modest 0.3% quarterly rate (+1.6% year-over-year) in the 4th quarter of 2016, supported by stronger exports and government spending, while domestic demand was flat
- "Abenomics" remains challenged by still weak consumption, tepid wage growth and low inflation. A persistently stronger yen since the start of the year may also begin to weigh on the profit outlook for exporters
- Bank of Japan (BOJ) keeps policy unchanged in March while pledging to keep policies in place as inflation remains well below their 2% target. The bank has been challenged by the rise in global rates to maintain its target 10 year yield level of around zero percent
- While markets remain skeptical of Prime Minister Abe and the BoJ's progress on increasing inflation and economic growth, Japanese companies are showing positive trends toward improving corporate governance and shareholder value, including rising level of buybacks

Emerging Markets

- While growth is expected to improve in 2017, emerging economies face increased risks from protectionist trade policies, rising developed market interest rates and a stronger U.S. dollar
- Broad emerging market growth supported by the large commodity-related economies of Russia and Brazil returning to positive growth helping offset a modest decline in growth rates in China and India
- Divergence persists across emerging market countries in terms of economic conditions, monetary and fiscal policy flexibility, dependence upon commodities and progress toward structural reforms
- While inflation remains broadly low across emerging markets, Mexico recently raised interest rates to support the peso and to defend against higher inflation, while Russia surprised markets in March by lowering interest rates as inflation has declined and the ruble has strengthened
- At the National People's Congress meeting in March, Chinese leaders lowered the growth target for 2017 to "around 6.5%" (6.7% in 2016) as they seek to balance growth amidst elevated housing prices and rising bad debt
- China's five-year plan promised to ease controls on overseas investment, increase access for foreigners to China's capital markets and allow the yuan to become fully convertible by 2020. Leaders maintained their goal of doubling the size of the economy by 2020, as compared to its size in 2010

ASSET ALLOCATION

Favor Bonds Over Stocks

We moved to an underweight to stocks relative to bonds seeking to reduce risk against a backdrop of a strong equity rally on a positive, but limited, inflection in underlying economic growth. The rally in stocks since the U.S. election comes amidst very optimistic views for pro-growth policy implementation and lofty earnings growth estimates, leaving valuations vulnerable to policy disappointment or less than expected earnings growth. However, low but positive economic growth and the potential for increased fiscal spending and lower taxes should provide support for most sectors.

We continue to expect only modest returns from bonds as the current low-yield environment offers a weak foundation and rising interest rates will continue to be a headwind. Global monetary policies are expected to remain broadly accommodative this year which should moderate the downside risks to bonds. Additionally, we expect any rise in U.S. interest rates to be limited while economic growth remains subdued and demand persists as U.S. yields remain amongst the highest across developed markets.

Our global growth expectations remain modest over the next several quarters, balanced by prospects for increased fiscal spending offset by unfavorable impacts on global trade that may result from protectionist policies. U.S. economic activity could see a boost from fiscal stimulus, lower taxes and deregulation; however, the timing and scale of each remain uncertain. Japanese growth has remained tepid despite aggressive fiscal and monetary stimulus. While growth in Europe is showing signs of improvement, considerable risks remain related to the potential impacts of Brexit and upcoming elections. While emerging markets face increased risks to higher rates and a stronger U.S. dollar, broader growth is showing signs of improvement supported by higher commodity prices which is helping the Brazilian and Russian economies exit recessions this year.

U.S. corporate earnings grow for a second straight quarter, expanding by high-single digits in the 4th quarter 2016. The pace of earnings growth is expected to be sustained in 2017 supported by a positive contribution from the energy sector and broader strength in revenues; however, tightening financial conditions, including higher rates and stronger dollar, could be headwinds for growth. While corporate leverage has increased and interest rates have moved higher, corporate credit fundamentals remain broadly supportive.

EQUITIES

Favor International Over U.S.

We moved to an overweight to international stocks relative to U.S. stocks from neutral based on signs of improving economic fundamentals and upside to corporate earnings, notably within the Eurozone. Major international developed market countries are in earlier stages of the economic cycle than the U.S. and remain supported by aggressive quantitative easing measures and relatively more attractive valuations, although disparate across countries and sectors.

While Europe faces near-term political headwinds and the impacts of Brexit, economic growth expectations have improved modestly, the ECB remains broadly supportive and earnings growth expectations have improved. Japanese growth remains tepid as domestic consumption has yet to improve despite aggressive policy measures; however, corporations are advancing shareholder friendly policies, including buybacks, and focus on improving profitability and corporate governance.

While emerging markets growth is showing signs of stabilization, the rise in developed markets interest rates, stronger U.S. dollar and sustainability of energy prices are risks to capital flows. However, increased fiscal spending in the U.S. and other major developed countries could provide support for emerging markets if it were to create sustainable trade and demand for commodities.

Favor Developed Over Emerging Markets

We increased our underweight to emerging markets stocks relative to developed market stocks as emerging market economies face increased risks to higher developed markets interest rates, a stronger U.S. dollar, sustainability of energy prices and the potential for more protectionist trade policies impacting global trade and capital flows.

While emerging markets relative valuations remain broadly attractive versus developed markets, their absolute valuations are expensive versus their historical averages.

Favor Global Equity Over Real Assets

We are underweight to real assets equities as we remain cautious on the prospects for energy and commodity prices given continued concerns over supply and demand imbalances. While the potential for U.S. infrastructure spending has increased post-election, the impact on industrial-related commodities remains uncertain as to the probability, timing and scope of the spending. Despite OPEC's (Organization of Petroleum Exporting Countries) announcement last November of plans to limit production, rising oil prices have been challenged by additional supply as U.S. producers respond to rising prices with increased production. U.S. shale producers have become a larger contributor to global oil supply and with their increased efficiency can now operate profitably at lower price levels.

Demand for industrial metals is expected to remain subdued as China struggles to maintain growth levels while shifting its economy away from its dependence on industrial production and exports to one more balanced by domestic consumption. Fundamentals for developed market REITs remain positive, supported by modestly improving economic environments and limited supply outside the U.S. While REITs remain sensitive to rising interest rates, they should be supported near-term if U.S. Fed interest rate policy normalization proceeds at a modest pace.

The post-election rise in inflation expectations has moderated as headline inflation has likely peaked near-term as energy prices have moderated. Further strength in the U.S. dollar could also be a headwind to higher inflation as import prices fall and exports are pressured.

Favor Large-Cap Over Small-Cap

We further reduced our underweight to U.S. small-cap stocks relative to large-caps close to neutral based upon improving relative valuations. Following a strong post-election rally last year, small-cap stocks have lagged large-caps since the start of this year as expectations for pro-growth policies has waned, bringing relative valuations in-line with historical averages.

A focus on U.S. fiscal spending and lower corporate taxes could benefit small-caps more than large-caps given their higher sensitivity to the domestic economy and higher marginal tax rates that could decline further than those of large-caps. Additionally, protectionist policies and a stronger U.S. dollar could weigh more heavily on large-caps given their higher exposure to foreign trade.

We are modestly overweight small-cap stocks outside the U.S. as they provide select opportunities within domestic economies that are in earlier stages of recovery than the U.S. While growth in Europe may be tempered near-term by Brexit, growth has stabilized, albeit at modest levels, borrowing costs are low, credit is expanding and employment is rising. Monetary policy also remains a substantial force to support growth in Europe and Japan in contrast to the U.S. which has started to tighten policy.

Favor U.S. Growth over U.S. Value

We increased our overweight to growth stocks relative to value stocks based upon more attractive valuations and our expectations for an environment of continued modest economic growth. The strong post-U.S. election rally amongst lower quality value sectors, including industrials and materials, has moderated with growth sectors outperforming value sectors since the start of the year. While increased spending, tax cuts and deregulation should provide support for cyclical sectors, like financials and energy, the scope and prospects for these measures receiving congressional approval remain uncertain.

Favor International Value Over International Growth

We are modestly overweight to international value stocks relative to growth stocks as sectors within growth, such as consumer staples are expensive relative to their historical averages. International value sector valuations remain broadly attractive and may benefit from improving global growth outlook; however, major sectors within value including financials and energy continue to face longer-term headwinds.

FIXED INCOME

Favor High Yield over U.S. Investment Grade

We reduced our overweight to high yield bonds relative to U.S. investment grade bonds as spreads have narrowed to levels below historical averages as the high yield sector has performed strongly despite recent weakness in energy prices. While high yield bonds continue to offer a yield advantage to investment grade bonds, current yield levels offer less opportunity for further appreciation and are vulnerable to a pullback in commodity prices.

While the current credit cycle appears extended with leverage increasing, improving earnings and low default expectations should provide support for credit spreads.

Neutral Between Emerging Markets and U.S. Investment Grade

We reduced our overweight to emerging markets bonds relative to U.S. investment grade bonds to neutral as valuations for emerging markets bonds have become less compelling following the risk-on rally since the U.S. election. While emerging markets benefitted from the rise in commodity prices last year, concerns have increased about the impacts of protectionist trade policies, higher developed market interest rates and a stronger U.S. dollar.

Emerging market economies are broadly in better fiscal positions than they were during the taper-tantrum sell-off in 2013 and an increase in developed market fiscal spending could be supportive for emerging markets exports. Considerable disparity exists amongst emerging markets countries in their fiscal positions, political stability and progress toward reforms. The flexibility for emerging markets countries to use fiscal and monetary policy to offset weak growth or defend their currency varies.

Favor U.S. Investment Grade over Nondollar

We are modestly underweight to nondollar bonds relative to U.S. investment grade bonds. Despite a recent rise, bond yields and extended duration profiles outside the U.S. continue to offer an unattractive risk-to-return trade-off. However, the strength in the U.S. dollar that has reinforced our underweight positioning to nondollar bonds may be less supportive. The factors that have supported the U.S. dollar's more than 25% appreciation since 2014, including stronger relative economic growth and the Fed tightening in advance of other central banks, may be less supportive as growth outside the U.S. improves and the Fed's tightening path remains modest while other central banks, including the ECB, take initial steps to reign in accommodative policies.

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IMPORTANT INFORMATION

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There are inherent risks associated with investing in the stock market, including possible loss of principal, and investors must be willing to accept them. The stocks of larger companies generally have lower risk and potential return than the stocks of smaller companies. Since small companies often have limited product lines, markets, or financial resources, investing in them involves more risk than investments primarily in large, established companies. The value approach carries the risk that a stock judged to be undervalued is actually appropriately priced. International investing involves unique risks, including currency fluctuation. Bond yields and prices will vary with interest rate changes. Investments in emerging markets are subject to abrupt and severe price declines, and should be regarded as speculative. High yield, lower-rated bonds generally involve greater risk to principal than investments in higher-rated securities.

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