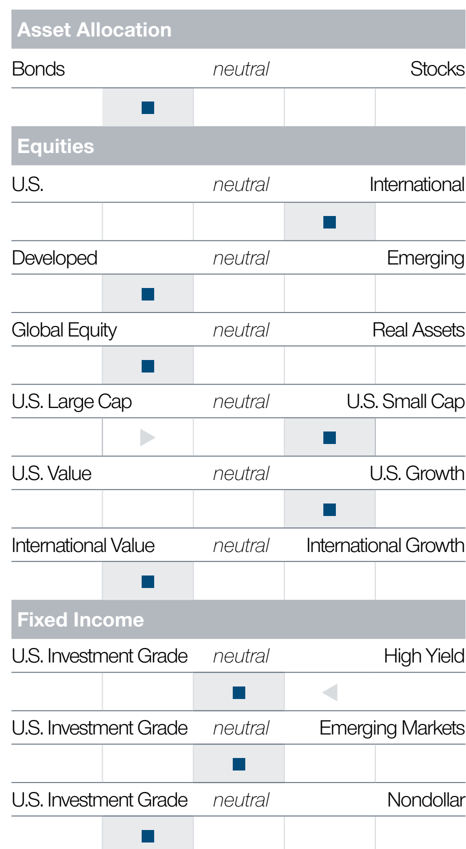
T.RowePrice®
INVEST WITH CONFIDENCE

ASSET ALLOCATION COMMITTEE VIEWPOINTS

Third 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

- The improvement in global growth that took hold at the end of last year is expected to continue with improvement occurring across most developed and emerging markets which has been uncommon in the current economic cycle
- Despite recent softening in some major economies' manufacturing surveys, including the U.S. and Japan, they continue to signal expansion, while European surveys are trending near six-year highs
- Developed markets are expected to see modestly higher growth this year, with European growth improving along with global trade as concerns over near-term political risks have abated
- Broad emerging markets growth is expected to improve supported by a return to growth of the large commodity-related economies of Brazil and Russia, offset by the potential for a modest slowdown in China; however, downside risks to emerging economies remain given the recent decline in energy prices
- Global monetary policies have begun shifting away from ultra-easy policies as the U.S. Fed interest rate normalization process advances and they confirm plans for reducing their balance sheet, the European Central Bank (ECB) looks for conformation of sustained inflation to begin reducing its quantitative easing measures, while the Bank of Japan (BoJ) remains fully committed to current policies
- Expectations for increased fiscal and corporate spending to replace receding monetary stimulus as the next leg of support for growth in 2017 have declined as fractured political environments in some major economies, such as in the U.S. and U.K., weigh on sentiment
- The political environment across the European Union (EU) has shifted back toward more stability and away from populist movements in several countries following the results of the French election, with polls in Germany showing a leaning toward further consolidation of power by Chancellor Merkel's pro-EU party
- Following a strong first half, global equity markets turn modestly lower at mid-year amidst concerns that other central banks, including the ECB and Bank of England (BoE), may soon join the U.S. in reigning in ultra-easy monetary policies
- U.S. yield curve flattens over the first half of the year as the Fed pushes up short rates while longer-term yields decline on softer economic data and declining inflation expectations
- European yields spike higher at the end of the 2nd quarter as markets reassessed monetary policy support after the ECB President and BoE Governor's hawkish comments, pulling U.S. Treasury yields up in sympathy from their lowest levels of the year
- Key risks to global markets include the negative impacts from protectionist trade policies, monetary policy missteps, fiscal policy disappointment in the U.S., political instability within Europe and the U.K., the sustainability of energy prices and instability in the Middle East, Korean Peninsula and South China Sea

U.S.

- U.S. economic growth rate revised higher to a 1.4% annualized rate in the 1st quarter of 2017, on stronger consumer spending and exports. Economic growth is expected to pick up in the 2nd quarter and back half of the year, expanding by a 2.5% or better pace
- Uncertainty remains surrounding the Trump administration's ability to deliver on planned policies on fiscal spending, trade, taxes and deregulation
- Inflation, as measured by the consumer price index (CPI), has steadily declined after peaking at 2.7% in February of this year as support from higher energy prices continues to moderate

- U.S. Federal Reserve raises interest rates again in June despite softening inflation data, while signaling their intent to continue at a gradual pace of tightening this year and into 2018. They also provided details of their plan to unwind its $4.5 trillion balance sheet by rolling off debt at a gradually increased pace over time
- While corporate leverage has increased, balance sheets remain relatively healthy and cash flows 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
- U.S. companies are expected to extend the positive trend in earnings growth for a 4th consecutive quarter, with mid-single digit profit growth expected in the 2nd quarter of 2017 led by the energy, technology and financials sectors. Positive earnings growth is expected to be sustained throughout the 2nd half of 2017 with high-single to low-double digit growth expected

Europe

- European growth is expected to gradually improve throughout the year, supported by resilient household consumption, improving business investment and stronger global trade, although the recent strength in the euro could weigh on exports
- Economic growth in the 1st quarter of 2017 revised higher to a 0.6% quarterly rate (+1.9% year-over-year), the strongest pace of growth in nearly two years
- The ECB removed its bias toward easy policy in June, acknowledging improving economic growth and downplaying concerns about still low inflation. ECB President Draghi's comments late in the quarter suggesting factors weighing on inflation may be transitory were responded to by markets as a sign they will be looking to taper policy by year-end
- Although broadly improved, structural issues remain with several countries still having high debt levels and high unemployment. Greece, while no longer perceived as a systemic risk, reaches tentative deal to avert default in hopes of finally resolving its debt crisis
- The Italian government's rescue of two failed banks, as well as the bailout of Banco Popular in Spain, have staved off potential crises and were positively received by markets as a sign that European regulators and member countries could effectively deal with problems within the banking system
- While near-term risks surrounding key elections in continental Europe have declined following Macron's victory in France, Prime Minister May's failed snap election in the U.K. has thrown Brexit into further turmoil. German polls are currently leaning toward a Merkel victory, but upcoming elections in Italy remain a risk to stability

Japan

- Japanese economic growth expanded for a fifth consecutive quarter - the longest streak in more than a decade - growing by a 0.3% quarterly rate (+1.0% annualized) in the 1st quarter of 2017. Improving global growth and lower yen since last year contributed to stronger exports, while domestic consumption and business capex spending also improved, supported by spending for the 2020 Olympic games in Tokyo
- While the recent growth streak may provide evidence that "Abenomics" is finally working after more than four years, tepid wage growth and low inflation suggests success remains elusive
- Bank of Japan keeps policy unchanged in June after being forced to lower its inflation target for 2017 at its April meeting. The BoJ has pledged to keep policies in place as inflation remains well below their 2% target, including actively employing quantitative measures to target a 0% yield on the 10 year JGB
- 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 returning capital to shareholders, emphasis on profitability measures and including independent directors. Additionally, further improvement in global growth should be supportive of Japanese exporters

Emerging Markets

- While growth is expected to improve in 2017, export-oriented economies may be challenged by the recent decline in energy prices if weakness persists. Although concerns over protectionist trade policies, higher developed market interest rates and stronger U.S. dollar have abated recently, they remain potential risks
- 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 from China
- Political instability in Brazil related to corruption charges against President Temer may weigh on growth and slow progress on reforms within Brazil; however, it has not impacted broader emerging markets sentiment
- The downgrade of China's sovereign debt rating in May highlights the concerns over rising debt levels and lower growth trajectory going forward, as the central government works to curtail excesses in housing and credit and stave off capital outflows
- Chinese growth improved in the 1st quarter of 2017, expanding by 6.9% year-over-year, supported by stronger investment and manufacturing
- 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
- MSCI, Inc. announced in June that China A-shares would be added to their emerging markets indices starting in 2018; although the initial number of companies added will comprise a small portion of the indices, the move shows that China is making some progress in liberalizing their markets

ASSET ALLOCATION

Favor Bonds Over Stocks

We increased our underweight to stocks relative to bonds as equity valuations appear extended against a backdrop of continued modest economic growth and uncertainty surrounding the likelihood of pro-growth policies providing a catalyst for further upside.

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. While remaining broadly accommodative, global monetary authorities are expected to begin to reign in ultra-

loose accommodation which could put upward pressure on yields. Although, we expect any rise in U.S. interest rates to be limited while economic growth remains subdued and external demand persists with U.S. yields amongst the highest across developed markets.

We expect the broadening of global growth seen since the end of last year to continue over the next several quarters, albeit at still modest levels, as improving global trade provides a boost for more export-oriented developed and emerging economies. U.S. economic activity could benefit from fiscal stimulus, lower taxes and deregulation; however, the timing and scale of each remain uncertain. Japanese growth, although still tepid, should see support from improving global trade and still very accommodative monetary policies. European growth has improved and showing signs of stabilization amidst less political uncertainty and could benefit further from its links to stronger global trade. While emerging markets remain vulnerable to a further decline in energy prices, broader growth is showing signs of improvement.

U.S. corporate earnings are forecasted to expand by mid-single digits in the 2nd quarter of 2017. The pace of earnings growth is expected to be sustained throughout 2017 supported by a positive contribution from the energy sector and broader strength in revenues; however, tightening financial conditions, including higher rates and the recent decline in energy prices could be headwinds for growth. While corporate leverage has increased and interest rates are expected to rise from current low levels, corporate credit fundamentals remain broadly supportive.

EQUITIES

Favor International Over U.S.

We increased our overweight to international stocks relative to U.S. stocks based on further signs of improving economic fundamentals, diminished political risk and upside to corporate earnings outside the U.S., 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.

Europe is supported by diminished political uncertainty following Macron's victory in France, stronger economic growth and earnings expectations and still supportive monetary policies. Japanese equity valuations are the most attractive amongst developed markets and economic growth is showing signs of stabilization, albeit at low levels and with stubbornly low inflation. Japanese corporations are also advancing shareholder friendly policies, including increasing dividends and focusing on improving profitability and corporate governance.

While emerging markets growth is showing signs of stabilization and should benefit from further improvement in global trade, they remain vulnerable to a further decline in commodity prices and their linkage to China's growth trend.

Favor Developed Over Emerging Markets

We are underweight to emerging markets stocks relative to developed market stocks due to the risk of a further decline in energy and commodity prices. While near-term concerns over protectionist trade policies, higher developed markets interest rates and a stronger U.S. dollar have receded, they remain credible threats to capital flows and stability.

While emerging markets absolute valuations are lower than developed markets, they 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) continued efforts to limit production, 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 continues on a slower growth path, driven by a shift away from industrial production in favor of 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 declined.

Favor Small Cap Over Large-Cap

We initiated an overweight to U.S. small-cap stocks relative to large-caps based upon more attractive valuations following recent underperformance. Measurements such as free cash flow yields are more compelling on a relative basis to large-caps historically. 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 in the U.S. has waned. The potential for increased U.S. fiscal spending and lower corporate taxes could provide catalysts for small-caps to outperform given their higher sensitivity to the domestic economy and higher marginal tax rates.

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. Economic growth in Europe is improving, borrowing costs are low, credit is expanding and employment is rising which should be supportive for domestically-oriented, smaller companies. Monetary policy also remains a substantial force to support growth in Europe and Japan in contrast to the U.S. where the Fed has been tightening policy.

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

We are overweight to growth stocks relative to value stocks based upon modestly more attractive valuations and our expectations for an environment of continued modest economic growth. The strong post-U.S. election "reflation" rally amongst lower quality value sectors, including industrials and materials, faded following disappointment with progress on pro-growth policies allowing growth sectors, led by technology, to strongly outperform value sectors.

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. Values stocks may find support from the financials sector following the announcement of positive results from the banking sector stress tests which will allow banks to increase buybacks and dividends, although the sector remains vulnerable to the direction of U.S. yields.

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 headwinds.

FIXED INCOME

Neutral Between High Yield and U.S. Investment Grade

We reduced our overweight to high yield bonds relative to U.S. investment grade bonds to neutral as valuations are trending above historical averages following strong high yield sector performance despite the recent weakness in energy prices. While high yield bonds continue to have 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.

Neutral Between Emerging Markets and U.S. Investment Grade

We are neutral emerging markets bonds relative to U.S. investment grade bonds as valuations for emerging markets bonds have become less compelling following the risk-on rally since the U.S. election. While emerging market economies benefitted from the rise in commodity prices last year, energy prices have been in a recent downtrend and concerns remain 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 currencies varies.

Favor U.S. Investment Grade over Nondollar

We reduced our underweight to nondollar bonds relative to U.S. investment grade bonds as the strength in the U.S. dollar that has reinforced our underweight positioning may be less supportive. However, bond yields and extended duration profiles outside the U.S. continue to offer an unattractive risk-to-return trade-off.

After declining throughout the first half of the year, the U.S. dollar may find support as the Fed advances on its path to tighter policy and begins to wind down its balance sheet later this year. However, economic growth is improving in Europe and the ECB is anticipated to take initial steps later this year to begin tapering its asset purchases which could put upward pressure on yields and support for the euro.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence and retirement services that investors can rely on—now and over the long term.

To learn more, please visit **troweprice.com**.

IMPORTANT INFORMATION

This report represents the views of the T. Rowe Price Asset Allocation Committee only and are subject to change without notice; these views may not reflect the opinion of all T. Rowe Price portfolio managers. This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are as of June 30, 2017 and may have changed since that time.

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.

T. Rowe Price Investment Services, Inc.

07/17

201707-220760