Global Equities

EARNINGS GROWTH, NOT POLITICS, IS CENTRAL TO THE 2017 EQUITY OUTLOOK

KEY POINTS

- 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 U.S. interest rates should not threaten global equity markets. The recovery in emerging equities appears strong enough to withstand moderate U.S. dollar appreciation.

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 stabilized 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 U.S. and Japan continue to commit cash to share buyback programs, enabling earnings per share (EPS) to grow faster than both net earnings and revenue.

**THE EARNINGS RECOVERY SHOULD BE DURABLE**

Despite the post-U.S. 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 U.S. 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 U.S. 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.

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 U.S. market. Emerging Europe and select frontier markets appear to offer the most attractive values within the nondeveloped world.

**Figure 1: Global Equity Valuations Appear Broadly Reasonable**

Forward One-Year Price/Earnings (P/E) Ratios for Major Global Indexes*
15 Years Ended November 30, 2016

<table>
<thead>
<tr>
<th></th>
<th>High</th>
<th>Current</th>
<th>Average</th>
<th>Low</th>
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<td>16.9</td>
<td>15.5</td>
<td>10.8</td>
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<tr>
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<td>13.0</td>
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<td>Japan</td>
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<tr>
<td>Emerging Markets</td>
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<td>12.0</td>
<td>11.1</td>
<td>7.3</td>
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Sources: FactSet and T. Rowe Price.

*U.S. = The S&P 500 Index; Developed Europe = The MSCI Europe Index; Japan = The MSCI Japan Index; Emerging Markets = The MSCI Emerging Markets Index. The forward one-year P/E Ratio is the capitalization-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 of November 30, 2016.
REGIONAL OUTLOOK

U.S. 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 U.S. 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 U.S.$3.5 trillion in foreign exchange reserves, Beijing should be able to prevent a destabilizing 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 U.S. interest rates or U.S. dollar appreciation to derail the EM recovery.

**Figure 2: U.S. Has Maintained a Wide Performance Advantage Since the Trough of the 2008–2009 Global Financial Crisis**

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

![Graph showing cumulative returns on major global equity indices from March 9, 2009, through November 2016.](image)

Past performance is not a reliable indicator of future performance.

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

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THE “TRUMP ROTATION”

Mr. Trump’s victory suggests that economic growth and inflation could move higher in the U.S. 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 U.S. 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 program 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 benefited from increased health spending under the act.

- **Technology:** Many large technology companies sold off following the U.S. election as investors became more mindful of tech valuations. However, the rotation toward cycicals 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 U.S. dollar appreciation if Mr. Trump’s fiscal program is seen as inflationary, could squeeze operating margins for U.S.-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 benefited 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 U.S. 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 focused 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.
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