T. Rowe Price REPORT

A Perspective On Financial Topics For Our Investors

Global Growth Scare, Again

For the third straight year, stock markets began the year with healthy gains only to fall back on fears of a global economic slowdown—or worse.

At midyear, the total return of the S&P 500 Index of large-cap U.S. stocks was up 9.49%, well ahead of international markets. The solid U.S. gain testified to the slow but sustained recovery of the American economy, given that markets faced significant obstacles.

These included the lack of a long-term solution to the European financial crisis, recession in parts of Europe, slowing growth in China, and U.S. uncertainties from the presidential election and the "fiscal cliff"—potential year-end tax increases and spending cuts that could trigger a recession.

As the third quarter began, no end was expected to the "risk on, risk off" trade, the market volatility driven more by macro factors than by corporate fundamentals. Economic policymakers may continue to have more impact than corporations' health.

The June European Union Summit took important, though small, steps toward greater financial integration in the eurozone but "financial market tumult likely will continue," says Ken Orchard, a T. Rowe Price analyst closely following the crisis. "A broader rescue of Spain's Treasury is probable in the coming months and a Greek exit from the euro is likely in 2013."

In the United States, Alan Levenson, T. Rowe Price chief economist, foresees modest but steady growth continuing despite drags from Europe and China. However, he has lowered his 2012 gross domestic product (GDP) growth estimate from 2.3% to 2.1%.

"The U.S. growth trend is more resilient to external shocks, but it won't be secure until rebalancing in major non-U.S. economies advances, which could take a few years," he says. "Potential disorderly events remain a threat."

Facing tough choices, investors should focus on the long term. Investor pessimism is such that the infamous 1979 *BusinessWeek* headline, "The Death of Equities," has been resurrected; the original preceded the bull market of the 1980s–1990s.

In this environment, T. Rowe Price managers of diversified asset allocation portfolios are leaning more than usual toward stocks, given that U.S. Treasury yields are near record lows and below the inflation rate. The advantage of U.S. stocks' earnings yield—earnings divided by prices—over the 10-year Treasury yield is the

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T. Rowe Price Celebrates Its 75th Anniversary

T. Rowe Price President and Chief Executive Officer James Kennedy discusses the firm's past and future in an interview on page 16. Also with this issue, the T. Rowe Price Report debuts a refreshed design. Please let us know what you think by e-mail to Price_Report_Feedback@troweprice.com.

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highest since the 1970s.

The firm also continues its tilt toward emerging markets stocks, with their valuations almost 30% below the norm despite their relatively high growth remaining intact. Emerging markets face fewer headwinds from debt and fiscal problems.

Brian Rogers, T. Rowe Price chairman and chief investment officer, predicts the eurozone will muddle through and the fiscal cliff will be put off temporarily. He says he would not be surprised if the S&P 500, even with more risk-on, risk-off cycles, was higher at year-end.

Mr. Rogers says investors should seek high-quality large-cap companies with low valuations, stable earnings, good dividend yields, and promising dividend growth.

"There are plenty of headline challenges, but this is nothing like 2008," he says, referring to the last global financial crisis. "Financial system liquidity is strong, valuations reasonable, and earnings growth positive, and there's a lot of cash kicking around in the world. If you look at companies' fundamentals, the progress is reasonably good."

U.S. Sanctuary

With European economies struggling, emerging market exporters and commodity producers facing slowing growth, U.S. banks relatively healthy, and a U.S. industrial renaissance under way partly from the rapid expansion of domestic energy reserves, U.S. stocks may be a sanctuary for now.

U.S. companies have record cash on their books, about half of all S&P 500 companies' dividend yields exceed the 10-year Treasury yield, and U.S. large-cap stock valuations are reasonable.

However, the S&P 500 Index at the end of June remained about 100% above the last market bottom in March 2009, while corporate operating revenues have barely grown since (despite soaring profits). Moreover, corporate earnings growth is slowing and is expected to slow more through 2013.

Looking forward, U.S. large-cap stocks are expected to continue to outperform smaller issues because large-caps remain more reasonably valued.

Greg McCrickard, manager of the Small-Cap Stock Fund, says small-cap valuations have come down but remain historically high. However, he notes small-cap revenues are less reliant on Europe, and he's found competitive returns in such growth areas as biotech and certain retailers.

Growth stocks generally are expected to continue outperforming value plays because growth stocks tend to be less reliant on a strong economy to generate rising earnings.

U.S. growth stocks suffered in the spring sell-off, and Rob Bartolo, manager of the Growth Stock Fund, expects a "choppy market" into the fall.

He's particularly focused on areas of "structural growth" less affected by global macro uncertainties, such as wireless data, infrastructure, and connectivity (Apple, American Tower, and Qualcomm). He also favors U.S. homebuilding and home improvement (Lennar and Home Depot), as the long housing slide may be ending.

Rites of Spring

Standard & Poor's 500 Index: A strong start gives way to a spring setback three straight years.

Source: T. Rowe Price. Data supplied by Standard & Poor's.

"Over the longer term, as the global uncertainties resolve, I am bullish as U.S. large-cap growth valuations are relatively inexpensive and many companies remain well positioned," Mr. Bartolo says.

Still, Mark Finn, manager of the Value Fund, is cautious in the near term. While stocks are reasonably priced, he says, "some may remain cheap until we get improvement in Europe."

So as the third quarter opened, he was investing in such relatively defensive health care stocks as drugmaker Pfizer and such cash-rich tech stocks as Texas Instruments.

In the first half of this year, the top S&P 500 sectors, in order, were: telecommunications, financials, information technology, and consumer discretionary.

Driven by Apple's outperformance, tech has grabbed attention. "There have been weak areas," says Ken Allen, manager of the Science & Technology Fund, "but there's been a continuing lift from innovation, movement toward mobile and cloud computing, and emerging markets."

Yet, due to growth concerns, tech stock valuations remain fairly low. Many tech firms have at least 30% exposure to Europe, Mr. Allen says, but that provides opportunities in oversold stocks such as Autodesk, a computer-aided design firm.

Moreover, new product cycles—such as the next generation iPhone and Microsoft Windows 8 software—could fuel more gains, he says.

At the start of the year, Eric Veiel, manager of the Financial Services Fund, predicted a U.S. financials turnaround, which appears under way, though Europe, China, and record-low interest rates still weigh heavily.

He sees positive drivers from U.S. economic improvement and from big

banks exposed to a housing recovery; certain homebuilders, mortgage servicers, and property insurers; and commercial and industrial loan growth.

"Financials are at historically low levels of valuation," he says. "Over the next three to five years, even with the risks, it's much more likely that the sector will get better."

Looking Abroad

In the first half of this year, non-U.S. stocks—particularly in developed markets—have lagged U.S. stocks. European and Chinese growth are challenged, and both have created headwinds for such commodity-driven economies as Russia's and Brazil's.

Emerging markets, hard hit by the European crisis, have done well over the last 15 years, and T. Rowe Price managers still believe long-term prospects exceed those in developed markets given favorable demographics, productivity gains, and the continuing rise of a huge middle class of consumers.

Gonzalo Pángaro, manager of the Emerging Markets Stock Fund, notes emerging markets are particularly attractive because they are trading at a 15% discount to global developed market stocks as measured by their forward price-to-earnings ratio—though by many other metrics, non-U.S. developed markets are even cheaper.

Specifically, Mr. Pángaro is finding value in China, with Chinese stock valuations at nine times forward earnings versus the more typical mid-teens. He discounts fears of a hard landing for the Chinese economy, predicting a managed soft descent in its annual GDP growth rate from about 10% to a lower long-term level of 7%.

Globally, he's focused on consumer stocks—for example, Want Want, a Taiwanese snack food maker in mainland China; Lojas Renner, a Brazilian clothes retailer gaining market share; and BIM, a Turkish discount retailer expanding abroad.

At the same time, Mr. Pángaro says he's cautiously keeping a relatively high cash position. "We're waiting for good opportunities once there is more clarity on Europe," he says.

Pending that, investors may be avoiding European companies. But Dean Tenerelli, manager of the European Stock Fund, notes "investing in Europe is investing in the world." European companies are more globally diversified than U.S. companies, and many still enjoy solid cash flows and profits while valuations have plummeted, he says.

The fund is light on financials given the crisis while favoring consumer discretionary and technology stocks. He believes stocks such as Experian, a credit rating firm, should continue to do well.

"Investors should look beyond the headlines," he says. "Some of the world's best companies are available at historic discounts."

Ray Mills, manager of the Overseas Stock Fund, agrees. He's pulled back some from European stocks given "the macro overhang" but adds that "even under the worst of circumstances, there are good European businesses that will do well over time."

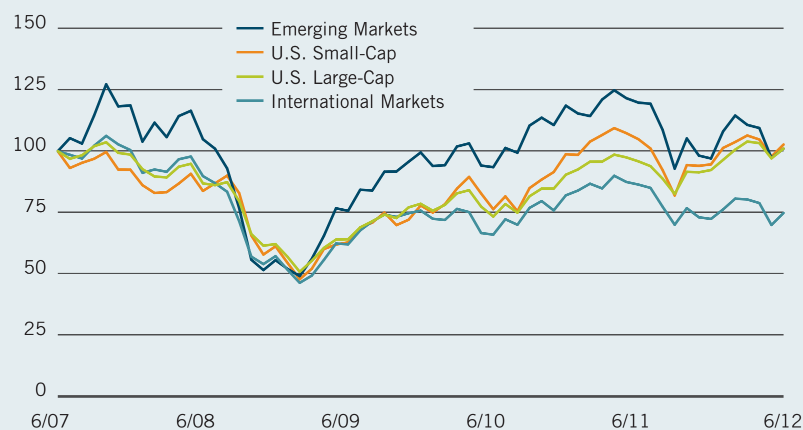
While he has a focus on European stocks that export globally—such as Nestlé in Switzerland and Bayer in Germany—Mr. Mills also has been looking toward Asia and emerging markets.

"There are really great companies around the world selling at reasonable valuations," he says. "We now see emerging markets aren't a slam dunk, but emerging economies are still growing faster than developed ones. Investors can leverage that growth not only in emerging markets directly, but also through developed market companies that sell into emerging markets."

Investing in international markets entails particular risks, including volatility, liquidity, currency, regulation, corporate governance, valuation, and political and economic uncertainty. Emerging markets are subject to the risk of abrupt and severe price declines.

As of June 30, 2012, the stocks mentioned by Mr. Bartolo, Mr. Finn, Mr. Allen, Mr. Pángaro, Mr. Tenerelli, and Mr. Mills made up, respectively, 17.2% of the Growth Stock, 6.5% of the Value, 1.9% of the Science & Technology, 3.3% of the Emerging Markets Stock, 1.6% of the European Stock, and 4.2% of the Overseas Stock Funds.

A Long Round Trip for Investors
U.S. and International Stock Market Performance
Total return indexed to 100 as of June 30, 2007



Sources: MSCI Inc., Russell Investments, and Standard & Poor's. Performance results based on the S&P 500, Russell 2000, MSCI EAFE, and MSCI Emerging Markets stock indices.

All funds are subject to market risk, including possible loss of principal.

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