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T. Rowe Price Midyear 2016 Market Outlook: Modest Revenue And Earnings Growth Expected Globally; U.S. Recession Unlikely This Year

Improving global growth could provide investors with attractive investment opportunities

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NEWS

The first half of 2016 has been volatile, with the global economy facing several challenges that unsettled financial markets around the world. Abrupt swings in sentiment created a difficult environment for buy-and-hold investors, and markets were tested by slow global growth, the potential for rising inflation and interest rates in the U.S., and lingering concerns about China.

Despite these concerns, T. Rowe Price experts expect to see modest revenue and earnings growth. The fears plaguing the first half of the year are being slowly alleviated; stabilizing markets, a pause in the Fed's gradual monetary tightening, and easing fears of the financial volatility of China could turn a difficult start into a more promising finish. In this environment, security selection will be key, both in stock and bond markets.

MIDYEAR MARKET AND ECONOMIC OBSERVATIONS

- Signs of financial and economic stabilization in both developed and emerging markets appear to have set the stage for an improved global equity climate in the second half of 2016. However, this view depends heavily on stability in energy prices, the U.S. economy, and the Chinese financial system.
- Emerging market stocks outperformed developed markets in the first half of 2016. This has been a result of corporate earnings showing signs of improvement, and a short-term revival in commodities, oil, and currencies. In many cases, countries have improved their fiscal and current account deficits, debt positions, and inflation levels, leaving them in a better position to absorb economic shocks.
- Among the most important risk factors for emerging markets is the continued improvement of corporate earnings. Current valuations reflect pessimistic estimates for earnings growth and any positive surprises are likely to bring relief to markets. Companies will need to deliver over the medium- and long-term, however, to allay fears and bring about a re-rating of individual stocks and markets.
- Economic environments globally are struggling against two primary headwinds as they enter the second half of 2016: the need for emerging market economies (EMs) to deleverage and the end of the commodity "super-cycle." These winds are gusting forcefully over China and Brazil. Given that EMs represent 40% of global economic output, the impact is also being felt in developed economies.
- The Brazilian and Chinese markets have been challenging for investors. Brazil's economic and political travails have created an uncertain environment, but there is the potential for improvement with a transfer of political power and a renewed focus on long-overdue micro- and macro-economic reforms. The new government has an opportunity to achieve significant steps toward structural reforms.
- China remains the largest influence on EMs. Two key concerns have been the currency drop and the amount of debt in the financial system. A further unexpected and sharp decline in the renminbi could hasten capital outflows and put more pressure on the economy.
- EM headwinds are also influencing U.S. interest rate policy. Because global capital flows often have more influence on financial conditions in emerging markets than do local policymakers, the U.S. Federal Reserve has to tread lightly in order to avoid stressing EM financial markets and economies.
- Fixed income markets appear to offer limited upside potential and greater downside risk, but astute investors can use bouts of risk aversion and subsequent rallies to their advantage. China's economic deceleration, the Fed's need to balance the risks of further tightening, divergent central bank policies, and suppressed yields globally are signs of caution. Investors are advised to consider a highly selective and risk-aware approach to best exploit potential opportunities.
- Overall, the path appears clear for the global equity rally to continue, especially as year-over-year earnings comparisons grow less difficult in the second half and into 2017. However, the election cycle in the United States could produce short-term volatility.

QUOTES FROM T. ROWE PRICE INVESTMENT PROFESSIONALS

Ted Wiese, Head of Fixed Income: "In coming months, fixed income markets seem likely to generate coupon returns but have less potential for additional price gains. Skittish investor sentiment, divergent central bank policies, and conflicting macroeconomic signals leave markets susceptible to bouts of risk aversion and subsequent relief rallies. These episodes will provide nimble investors with opportunities to profit from volatility, but strong macro and credit research skills will be critical."

Alan Levenson, Chief U.S. Economist: "While the U.S. economy has not been sheltered from the global headwinds, they are taking a much smaller toll on it. The weakness in commodities has led U.S. energy and mining firms to cut back investment in plant and equipment spending, which we calculate has reduced the annual rate of real GDP growth by 0.5% since the end of 2014. That drag appears to be fading at midyear, however. Following a weak first quarter, we expect a return to 2% to 2¼% annual growth over the balance of the year."

David Eiswert, Portfolio Manager, Global Stock Fund, on U.S. economic stability and U.S. equities: **"**U.S. economic expansion appears intact, although still subdued. The Federal Reserve's reluctance to force the pace of interest rate hikes means monetary policy should remain supportive, and U.S. consumers are in strong shape. Despite industrial weakness, continued economic growth driven by consumer spending should be supportive for equities in the U.S, A continued 'Goldilocks' economy (not too hot, not too cold) would also be a strong positive for financial markets and the global economy. However, the U.S. presidential election outlook reflects the general rise of populism globally and presents some complicated risks to sentiment."

Nikolaj Schmidt, Chief International Economist, on China: "The world cheered in early 2016 as Beijing finally intervened strongly enough to stop the downward growth spiral that has plagued the economy over the past few years. Whether the bounce that Chinese growth has experienced in recent months is more than temporary is highly questionable, however, as the improvement is largely the result of a more expansionary fiscal stance and an unsustainable acceleration in the pace of credit expansion."

Nikolaj Schmidt, Chief International Economist, on Europe: "EM headwinds are being felt more strongly in Europe than in the U.S., but these are being overcome by the domestic policy tailwinds. The recent gain in both the euro and oil prices should moderate growth in the second of the year, however, to an annual rate of roughly 1.5%."

Nikolaj Schmidt, Chief International Economist, on Brazil: "Brazil appears to have turned a corner. Higher metals and oil prices have helped, but local asset markets caught fire as the country moved toward removing President Dilma Rousseff and the Workers' Party from power. We expect the new government to achieve significant steps toward structural reform, including progress in breaking the link between pensions and the minimum wage, which has drained government finances."

Gonzalo Pangaro, Portfolio Manager, Emerging Markets Stock Fund: "We continue to witness great dispersion among advancing countries, which we have highlighted for some time. The dispersion of EM fundamentals is as great today as it has been for over a decade. Reflecting this dispersion, valuation levels are mixed. EM equities are trading at a significant discount to developed markets, creating pockets of opportunity for us to identify quality businesses with reasonable valuations that offer an attractive balance of compounding growth potential and improving returns."

ABOUT T. ROWE PRICE

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