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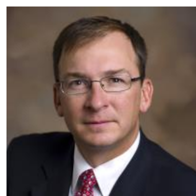
Global Equities

PUTTING RECENT MARKET VOLATILITY IN PERSPECTIVE



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KEY POINTS

- The upswing in equity market volatility can be attributed largely to investor uncertainty about the future direction of Federal Reserve policy.
- Equity markets could remain unstable in coming days as investors adjust to the return of volatility and greater uncertainty about the course of U.S. inflation and interest rates.
- However, economic and earnings fundamentals continue to be supportive for equity valuations, in our view.
- Our expectation is that broad global growth will continue in 2018.

Following a powerful rally that lifted the S&P 500 Index almost 22% in 2017, U.S. stock prices have fallen sharply in recent days, ending—or at least interrupting—a lengthy period of unusually low market volatility. The selling pressure quickly spread to other global equity markets, producing similarly abrupt price declines.

To a certain extent, a short-term correction in U.S. and global equity prices could be viewed as overdue, given the strength and speed of the market gains last year and in the opening month of 2018. The immediate trigger for the downturn appears to have been a spike in U.S. long-term Treasury yields, which accelerated in January as fixed income investors became more wary of the outlook for U.S. economic growth and inflation.

Rising Treasury yields can translate into higher borrowing costs, such as interest rates on mortgage loans. Higher borrowing costs, in turn, could discourage consumers and businesses from borrowing to make purchases and investments and slow the economy. Rising wages and other input costs eventually could start to weigh on corporate margins. Higher yields can also make bonds relatively more attractive than stocks.

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Some perspective on the recent market volatility is warranted. First, corporate fundamentals and the global economy appear strong. Second, T. Rowe Price economists believe the Fed remains on a gradual tightening path. Third, it's important for investors to keep short-term market volatility in perspective when compared with long-term market results.

EQUITY FUNDAMENTALS STILL APPEAR STRONG

Equity markets could remain unstable in the coming days as investors adjust to the return of volatility and greater uncertainty about the course of U.S. inflation and interest rates. Technical factors, such as program trading activity tied to the Chicago Board Options Exchange's Volatility Index (the VIX), could also drive large intraday market movements, both up and down.

However, while short-term trends in the stock market are almost impossible to forecast, economic and earnings fundamentals continue to be supportive for equity valuations, in our view:

- Global economies are in a synchronized expansion.
- The backdrop for corporate earnings, which have been growing at a double-digit pace in the U.S. and other important markets, is favorable.
- Interest rates and inflation are still relatively low in developed countries.
- Recently passed U.S. tax reform legislation is likely to lead to a pickup in domestic economic growth and even stronger corporate profits in 2018.

These positive fundamentals are also reflected in credit spreads—the yield differentials that corporate bonds and other bonds without a government repayment guarantee offer over U.S. Treasuries. Spreads remain very tight by historical standards, suggesting that fixed income investors expect strong economic and earnings growth to continue, limiting debt defaults.

THE GLOBAL ECONOMY IS GROWING STRONGLY

The powerful rally that lifted equity markets in 2017 can be attributed in large part to strong global economic growth, as developed and emerging economies saw the first synchronized expansion since the 2008–2009 financial crisis. Our expectation is that broad global growth will continue in 2018.

Recent economic reports have indicated strong fixed investment spending and continued healthy consumer demand in the U.S. The package of personal and corporate tax cuts enacted late last year is likely to give a modest additional boost to growth in 2018. While tight U.S. labor markets and accelerating wage growth have contributed to the inflation concerns pressuring global bond and equity markets, they also should help sustain consumer demand and corporate earnings going forward.

The eurozone business cycle is in earlier stages as compared with the U.S., with growth benefiting from both improving global trade and healthier domestic consumers. The European Central Bank (ECB) has extended its bond-buying program until at least September 2018, but starting in January, the ECB halved its monthly asset

purchases. The one exception to this positive outlook: the UK, where the central bank raised short-term interest rates in November amid accelerating inflation and heightened uncertainty about the course of Brexit negotiations.

Most developed Asian economies are benefiting from leverage to global growth and trade. In Japan, where the economy has grown for seven consecutive quarters—a streak not seen there in more than 15 years—monetary and fiscal policies remain tailwinds. China's rapid growth is slowing, but at a measured pace and in line with official targets.

In the emerging markets, synchronized global growth is supporting demand for their exports, and lower inflation has provided the latitude for many emerging markets central banks to lower interest rates.

CORPORATE EARNINGS HAVE BEEN SURPRISING TO THE UPSIDE

A global economy that appears to be firing on almost all cylinders has produced a surge in corporate earnings growth. According to financial data provider FactSet, as of February 2, 2018, approximately 50% of S&P 500 Index companies had reported financial results for the fourth quarter of 2017. Of those companies, 75% had positive surprises in earnings per share, and 80% reported positive sales surprises. As of early February, FactSet reported that overall earnings for the companies in the S&P 500 Index grew by 13.4% in the fourth quarter of 2017 versus a year earlier.

We believe the combination of further upside in energy sector earnings, a continuation of mid-single-digit core non-energy earnings growth, and a weaker dollar has the potential to keep earnings growth in 2018 to the low- to mid-teens range. David Giroux, one of our portfolio managers, estimates that the reduction in the U.S. corporate tax rate—from 35% to 21%—could drive 6% to 7% earnings growth (net of offsets) in 2018.

Many investors who "stayed the course" through past periods of volatility have even found that short-term corrections ultimately have worked in their favor, by making it possible for their portfolio managers to purchase shares with strong fundamentals at attractive long-term valuations.

THE FED APPEARS TO REMAIN ON A GRADUAL PATH

The upswing in equity market volatility can be attributed largely to investor uncertainty about the future direction of Federal Reserve policy. Strong economic growth, signs of faster wage gains, and the fiscal impact of the U.S. tax cut package have raised concerns about a broader acceleration in consumer price inflation.

The latest U.S. employment report, released in early February, indicates that wages rose at a 2.9% rate year-over-year through January 2018, the best pace in nearly a decade. Investors worry that if wage growth remains strong, Fed policymakers might be forced to raise short-term interest rates higher and more quickly than the gradual move toward a "neutral" level they have been signaling to the markets.

T. Rowe Price Chief U.S. Economist Alan Levenson currently believes that the central bank will raise rates at least three times, and possibly four times, in 2018. However, this course would still leave Fed policy rates at levels that have not posed a serious threat to equity valuations in previous market cycles.

KEEP A LONG-TERM PERSPECTIVE

The equity market's long-term trend has been positive. Many investors who "stayed the course" through past periods of volatility have even found that short-term corrections ultimately have worked in their favor, by making it possible for their portfolio managers to purchase shares with strong fundamentals at attractive long-term valuations.

Given the strong market gains seen over the past year, it is understandable that some investors may wish to moderate their equity exposure at this point. However, trying to time the market by moving aggressively from stocks to cash and then back to stocks is very difficult, even for investment professionals.

Failed attempts to time the market can hurt long-term investment performance in two different ways: By selling assets when they have lost some value and going to cash, investors essentially lock in those losses. In addition, investors run the risk of missing out on at least some gains when the market bottoms and starts to recover.

Market turbulence is a fact of life in equity markets—a fact that some investors may have overlooked amid the remarkably low volatility seen over the past couple of years. Short-term downturns can be disconcerting. However, we believe that a sound approach is for investors to shift their focus away from short-term trends and concentrate on their long-term investment strategy. That means keeping short-term market volatility in perspective when compared with long-term market results, establishing a proper asset allocation and diversifying investments to help mitigate the impact of volatility on one's portfolio, and considering reducing the number of decisions by automating investments.

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