Global Equity

LOOKING FOR A GROWTH CATALYST IN THE SECOND HALF

KEY POINTS

- The “reflation trade” that boosted cyclical stocks in the final months of 2016 faltered in early 2017, despite a broad acceleration in global earnings growth.

- Because the earnings recovery is more advanced in the United States, there appears to be greater room for equity gains in Europe, Asia, and emerging markets.

- Hopes for a growth stimulus seem to rest largely on U.S. fiscal policy. However, it isn’t clear President Trump can achieve major cuts in U.S. corporate taxes.

- If economic growth strengthens in the second half, value and small-cap stocks should benefit. Absent an economic stimulus, more defensive areas may outperform.

Supported by a broad acceleration in global earnings growth, most global equity markets posted gains in the opening months of 2017. However, leadership has shifted from the cyclical and financial stocks that benefited most from the reflation trade—the powerful rally that followed last year’s U.S. presidential election.

Heading into the second half, broad upward earnings momentum is visible across both developed and emerging equity markets (Figure 1, page 2). But investors appear less certain that momentum will be sustained going forward. Growth names, especially large-cap technology stocks, and more defensive sectors have moved into relative favor.

As long as the global expansion continues—our base case—we believe equity markets have the potential to deliver modestly positive returns in the second half, balanced more evenly between growth and value and large-cap and small-cap. However, more substantial gains for the cyclically sensitive sectors—i.e., a revival of the reflation trade—will require a fresh catalyst for economic growth at a time when global monetary policy is becoming less supportive.
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There is a plausible scenario in which U.S. tax cuts, reduced political risk in Europe, and corporate and consumer optimism all help sustain the global expansion in the second half. However, given the controversies swirling around President Trump, it is not clear his administration has the political capital to achieve the kind of sweeping tax reforms that could spur U.S. and global economic growth and further accelerate the earnings recovery. Lacking such a stimulus, equity markets may be more exposed to a number of potential headwinds. These include:

- Signs of slowing economic momentum. Purchasing manager indexes—good leading or coincident indicators of economic growth—appear to have peaked or plateaued in a number of countries.

- Additional tightening by the Federal Reserve, as it seeks to lift short-term rates to more historically normal levels and shrink its $4.5 trillion balance sheet.

- Less certainty about monetary policy in the eurozone, as investors look forward to the European Central Bank’s eventual exit from its own quantitative easing programs.

- Reversal of monetary and fiscal stimulus in China, as Beijing’s priorities shift from meeting economic growth targets to curbing credit growth.

- Excess global oil supply. Rebounding energy profits have been one of the mainstays of the earnings recovery, so another downturn in oil prices would threaten equities and financial markets in general.

**Figure 1: The Global Earnings Recovery Accelerated in Early 2017, but Stronger Economic Growth Will Be Needed to Sustain Momentum**

Earnings Per Share Growth in Local Currency Terms, Through April 30, 2017

Sources: FactSet, MSCI, and Standard & Poor’s; data analysis by T. Rowe Price.

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THE ECONOMIC ENVIRONMENT IS STILL POSITIVE

There are grounds for second-half optimism. The profits recovery in core Europe has finally arrived, with the first quarter seeing the first wave of upward revisions in eurozone earnings since 2012. Economic growth appears to be recovering in key emerging markets (EMs). Although recent political events have damaged investor confidence in Brazil, there seems relatively little risk of a broader EM contagion effect.
EQUITIES APPEAR FULLY VALUED IN MOST MARKETS

Like many financial assets, broad equity indexes appear fully valued in most markets—a legacy of years of central bank accommodation and steady, if unspectacular, economic growth (Figure 2).

- As of mid-May, the major U.S. large-cap indexes were selling at roughly 17 to 18 times forward earnings versus historical norms closer to 15. This leaves little room for multiple expansion, in our view.

- European valuations look less expensive on a cyclically adjusted basis, but this partly reflects the heavy weight of banks in the European large-cap indexes. Whether those institutions can regain the earnings power they enjoyed prior to the global financial crisis is an open question.

- Japanese equities also appear relatively cheap, but here, too, historical valuations are questionable forward-looking guides, given the structural changes in the Japanese market over the past decade.

- Emerging markets appear inexpensive compared with developed markets, but not with their own historical averages. Broad EM indexes are heavily weighted toward energy and banks, where valuations remain depressed. High-quality EM growth companies, on the other hand, appear richly priced.

Figure 2: Most Global Equity Markets Appear Fully Valued Relative to Historical Norms

Price/Earnings Ratios Based on Forward 12-Month Earnings, Through April 30, 2017

Sources: FactSet, MSCI, and Standard & Poor’s.

GLOBAL SECTOR OUTLOOK

The uncertain outlook for global growth makes us reluctant to predict whether cyclical or defensive sectors will lead in the second half. With few, if any, sectors looking particularly attractive based on fundamentals, we are more inclined to highlight industries we would underweight—such as energy and autos. That said, several areas appear to offer selective opportunities:

- Technology: While the first-quarter rally in large tech raised concerns that the rebound from the sector’s 2016 underperformance has come too far, too fast, we think those gains were more a case of prices catching up with underlying earnings growth. We continue to believe in the disruptive potential of e-commerce, cloud-based services, and social media, although lofty valuations could leave some companies vulnerable in risk off environments.

- Financials: Banks and other intermediaries should benefit from steeper yield curves and wider net interest margins. Regulatory changes making it easier for banks to return capital to shareholders also could improve return on equity. Recoveries in peripheral Europe are improving loan quality, although Italian banks remain impaired by chronic bad debt burdens.
• Health Care: Like other defensive sectors, health care was out of relative favor through much of last year, despite solid revenue and earnings results. Although the health care reform debate creates some uncertainty for U.S. providers, the regulatory environment for drug pricing has brightened at a time when biotechnology research continues to yield breakthrough products.

CONCLUSIONS
Global equity markets generally performed well in early 2017, sustained by a broad acceleration in global earnings. As of this writing, analysts and investors appear relatively optimistic, although enthusiasm for the cyclically sensitive sectors has cooled.

Whether the second half will see a revival of the reflation trade, or whether rising interest rates and slower growth in some key markets will pose mounting headwinds, is unclear at this point. Given that the earnings cycle is more advanced in the U.S., Europe and emerging markets may offer greater return potential, although a shift to credit restraint in China could disproportionately impact EM economies.

Economic policy—the prospect for U.S. tax reform in particular—is likely to remain a key variable. Market volatility measures have risen somewhat from the exceptionally low levels seen earlier this year, and abrupt “risk off” episodes are possible.

In this environment, fundamental research, strong stock selection skills, and close attention to portfolio risk are likely to remain critical to investment success.
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