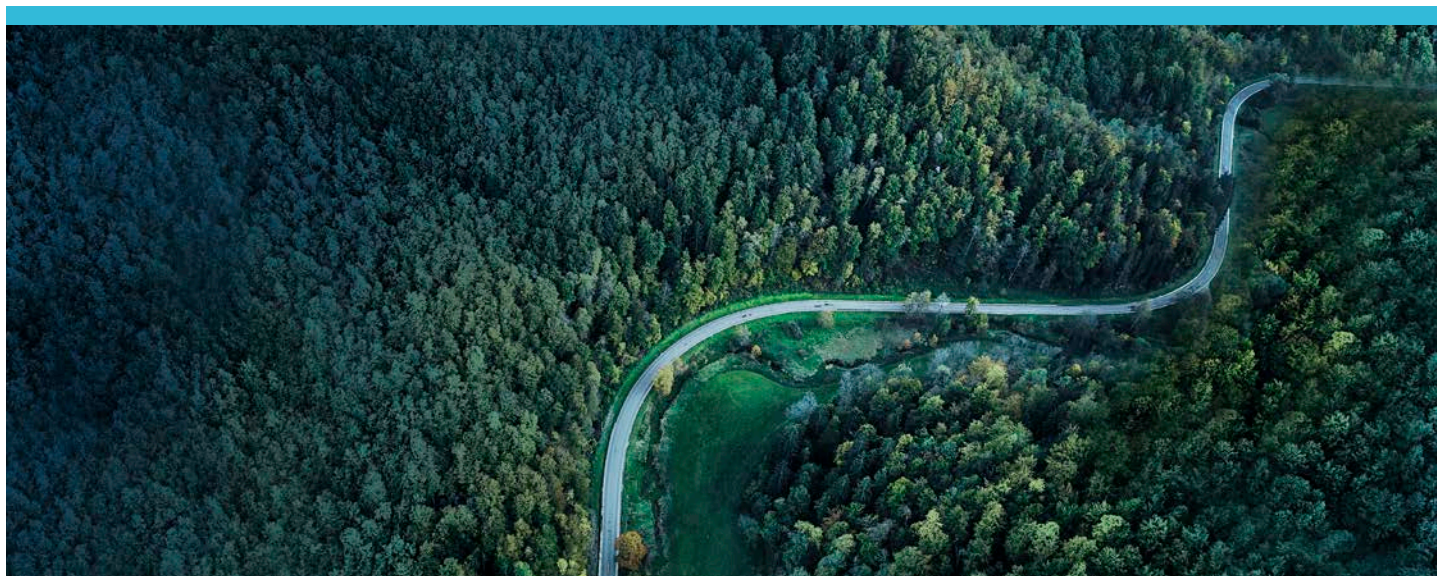




Global Market Outlook

Four factors for 2021



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After facing one of the most testing environments in history following the Covid-19 outbreak, investors are increasingly optimistic of a strong recovery in 2021 due to recent positive vaccine news and additional fiscal and monetary stimulus announcements. However, as the unprecedented health crisis continues to lock down many parts of the world, risks to the recovery remain.

In the following update, T. Rowe Price investment leaders – David Giroux, CIO Equity and Multi Asset, Justin Thomson, CIO Equity, and Mark Vaselkiv, CIO Fixed Income – highlight the four factors investors need to focus on for 2021.

The first factor discusses the current threats and opportunities for investors, particularly as the recovery is somewhat already being priced into asset markets. The second factor examines the backdrop for hard-hit value stocks, with expectations rising of a rotation in market leadership toward cyclical sectors in 2021 – in light of the vaccine news. The third factor centres on the current low interest rate environment and the need for fixed income investors to think creatively in order to extract yield in 2021. Finally, factor four looks at how the global pandemic has accelerated economic inequality and appears to have worsened political divisions in some countries, and what this means for investors.

As many uncertainties remain, the T. Rowe Price investment leaders all agree on one crucial element in the year ahead – the need for active management. With the uneven impact of the pandemic and the recovery likely to lead to bouts of heightened volatility, strong fundamental analysis and skilled active security selection is likely to be a key driver of investment success in 2021 and beyond.

Factor 1: recovery threats and opportunities

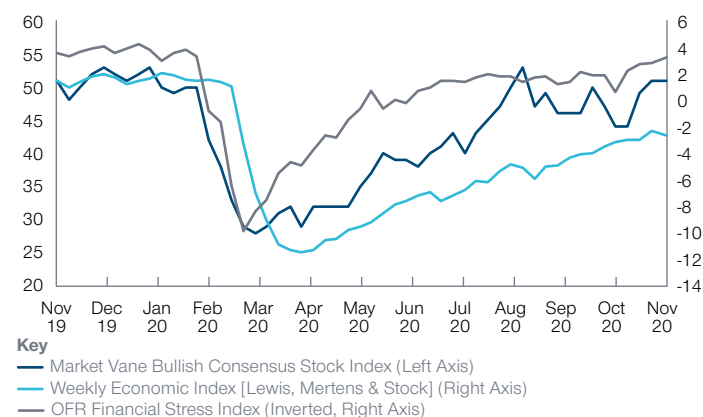
Although most global economies saw a relatively rapid economic rebound from the initial onset of the pandemic (figure 1), the world still has not returned to normal.

As 2020 ended, a major spike in COVID 19 cases in the US and Europe posed a renewed threat to the recovery. While the new vaccines and improved treatment therapies are encouraging signs for 2021, the economic effects of the pandemic are likely to echo for some time and uneven progress could produce periods of market volatility.

The first quarter of 2021 could see a trough in economic activity, but assuming the new vaccines can be distributed on an accelerated scale – especially to higher risk populations – economic conditions could improve rapidly in the second quarter. People are going to want to travel, to get back to work, to have deferred elective medical procedures. If so, the second half of 2021 could look more like 2019 than like the first half of 2020.

A 'swoosh' shaped recovery so far

(Fig. 1) Investor sentiment, economic and financial stress indicators



As of November 27, 2020.

Past performance is not a reliable indicator of future performance.

Source: Bloomberg Finance LP, Haver Analytica/Barron's, Federal Reserve bank of New York, Office of Financial Research and Standard & Poor's (see additional disclosure)

Encouraging signs globally

A key economic variable will be whether governments in the US and Europe will provide additional fiscal support to supplement the monetary stimulus provided by the US Federal Reserve and the European Central Bank.

Fed Chairman Jerome Powell has emphasised fiscal stimulus needs to take priority over additional monetary stimulus because it has a more significant impact on the real economy. The size and timing of any additional US fiscal stimulus may depend on the partisan balance of power in Washington. A divided government could require lengthy negotiations and limit the scope of any aid package.

In Europe, on the other hand, the fiscal outlook appears encouraging. Unlike in past economic emergencies, such as the 2012 European sovereign debt crisis, the European Union is not imposing austerity but rather has committed to fiscal stimulus. It finally appears Europe is acting in a concerted, cohesive fashion.

China's recovery appears robust, relative both to the developed world and to other emerging market economies, and the country should see positive economic growth for 2020 as a whole. However, Chinese corporate bond yields have started to rise, which could limit credit growth in 2021.

A bullish 2021 case can be made for Japan, based on historically close correlations between Japanese equities and the global cyclical sectors that could benefit most from a pandemic recovery. Increasing shareholder activism is another potentially positive factor for the country.

"A lot of the recovery already is priced into the markets".

David Giroux

Chief Investment Officer, Equity and Multi-Asset

Rapid earnings recovery

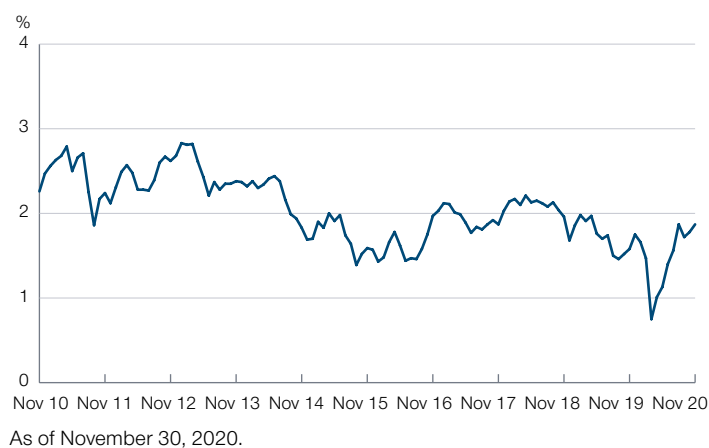
For US and global equity markets, a rapid economic recovery could bring an accelerated earnings recovery. Following the last three recessions, it took the S&P 500 Index three, four and five years, respectively, to regain its previous earnings per share peak. This time, it potentially could happen in 2021.

However, rapid earnings growth might not translate into strong equity returns in 2021. Despite the sharp earnings decline seen during the pandemic, most global equity markets finished 2020 with strong gains and a lot of the recovery is already priced into the markets.

A broader economic recovery could also produce a modest uptick in inflation, which decelerated in early 2020 as the pandemic spread. Forward looking measures of inflation expectations, such as spreads between nominal and inflation protected government bonds (figure 2) have rebounded sharply since mid 2020. There is a risk the US could pierce the 2% inflation ceiling – not quickly, but perhaps in 2022 or 2023.

Upside inflation risks should not be ignored

(Fig. 2) US ten-year government yield minus government inflation-linked 7- to 10-year yield



Past performance is not a reliable indicator of future performance.

Source: T.Rowe Price analysis using data from Factset Research Systems Inc. All rights reserved.

Actionable investment ideas

When uncertainty is elevated and markets are choppy, investors should balance return seeking and defensive assets to navigate volatility and ensure true diversification. Offensive assets such as stocks, corporate bonds and emerging market debt can be balanced by defensive assets like high quality long dated duration, safe haven currencies and other defensive strategies. In addition, procyclical assets tend to outperform during economic recovery. Some of these assets – such as small cap stocks and credit markets – have lagged in the 2020 rally in risk assets, so valuations may be attractive. Finally, volatility and change cause prices to diverge from valuations. This is an environment for skilled active managers to add value, in particular when some valuations are rich. Fundamental driven security selection and tactical asset allocation can adapt to new conditions rather than relying on past behaviours.

Factor 2: best backdrop for value in a decade

David Giroux, CIO Equity and Multi Asset, and Justin Thomson, CIO Equity

The pandemic has dramatically accelerated the adoption of the technologies and business models – from video conferencing to remote medicine and home meal delivery – needed for companies and consumers to function amid a public health emergency.

In 2021, the key question for equity investors is whether mass vaccinations and a rapid decline in new COVID 19 cases could spur a rotation in market leadership toward cyclical sectors that are positioned to benefit from more normal economic conditions.

The pandemic fundamentally changed how consumers spent money and time and did it over an unprecedentedly short horizon. Spending on goods and services such as gym memberships, elective surgery, dental care, theme parks and restaurants fell by 50% to 80%. We have not seen anything like it since probably World War II.

The second half of 2021 could see a partial reversal of those trends. If vaccination progress accelerates the economic recovery, the fundamentals of many of the industries badly damaged by the pandemic could improve rapidly. Some companies could get back to 2019 earnings levels relatively quickly.

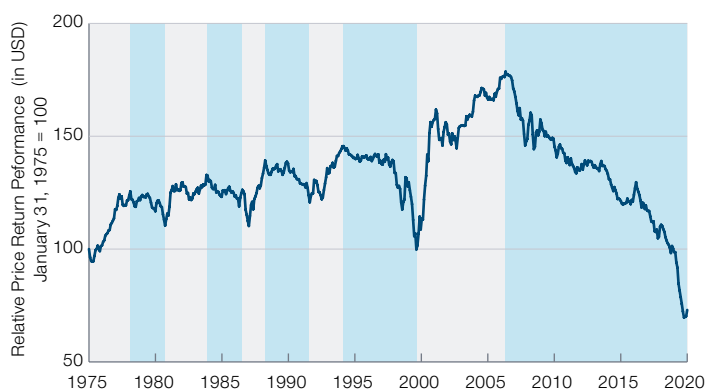
By the same token, however, a spending shift toward the COVID-19 losers could come at the expense of the sectors many equity investors bought aggressively during the pandemic – particularly technology, e commerce, social media and housing.

Revival for value

In style terms, a more normal cyclical recovery could continue to boost value relative to growth, a reversal of the powerful trend toward growth dominance – and unprecedented dispersion of stock returns – seen since the 2008-09 global financial crisis (figure 3). Signs of such a rotation appeared in late 2020 in response to the news about vaccine development. However, valuations for many 'pandemic winners' also have continued to rise, even though those firms could face difficult year on year earnings growth comparisons in 2021.

After an era of growth dominance, value could be poised for a rebound

(Fig. 3) MSCI World Value Index versus MSCI World Growth Index, relative price return in US dollars (USD)



As of November 30, 2020.

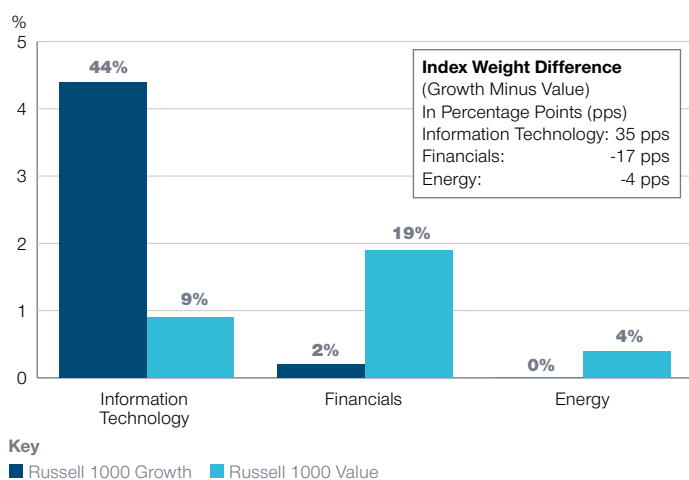
Past performance is not a reliable indicator of future performance.

Source: MSCI via Factset (see Additional Disclosures).

A return toward pre pandemic consumer spending patterns could further improve the attractiveness of sectors such as financials and energy – areas heavily represented in the value universe relative to the tech stocks dominating the major growth benchmarks (figure 4).

Strong backdrop for select value investing

(Fig. 4) Sector weights in Russell large-cap style indexes



As of October 31, 2020.

Past performance is not a reliable indicator of future performance.

Source: Russell via Factset (see Additional Disclosures).

The backdrop for selective value investing has not been this strong in a decade. However, the gains seen in many value sectors in late 2020 suggest the market already has priced in some of the benefits of a faster recovery. It is a little less of an easy call now than it was before the vaccine news.

“The backdrop for selective value investing hasn’t been this strong in a decade”.

David Giroux

Chief Investment Officer, Equity and Multi-Asset

As mentioned, the financials and energy sectors could offer particularly attractive shorter term value opportunities in 2021. Within financials, steepening yield curves have improved net lending margins and the reserves set aside to cover expected pandemic loan losses appear to be larger than needed. European banks appear especially cheap based on price-to-book value multiples.

As for energy, a broad collapse in capital spending should reduce excess oil and gas supplies, potentially supporting prices. An easing of the pandemic could boost travel in 2021, reviving demand. However, the longer term outlook for traditional fossil fuel producers remains challenged by renewables and regulatory pressures.

Actionable investment ideas

Investors seeking value opportunities will need to be careful about stock selection. It is vital to seek companies well positioned to emerge from the pandemic with lasting competitive advantages, while avoiding firms facing longer term secular challenges – such as the conventional automakers behind in the race to dominate electric vehicle markets. Skilled stock selection backed by strong fundamental research resources is especially critical. Instead of guessing which style is likely to lead and which will lag, investors should balance styles in portfolios and use tactical views to tilt portfolios to styles they think are likely to outperform. This means balancing growth and value, as well as large and small caps.

Factor 3: creativity can solve low-yield conundrum

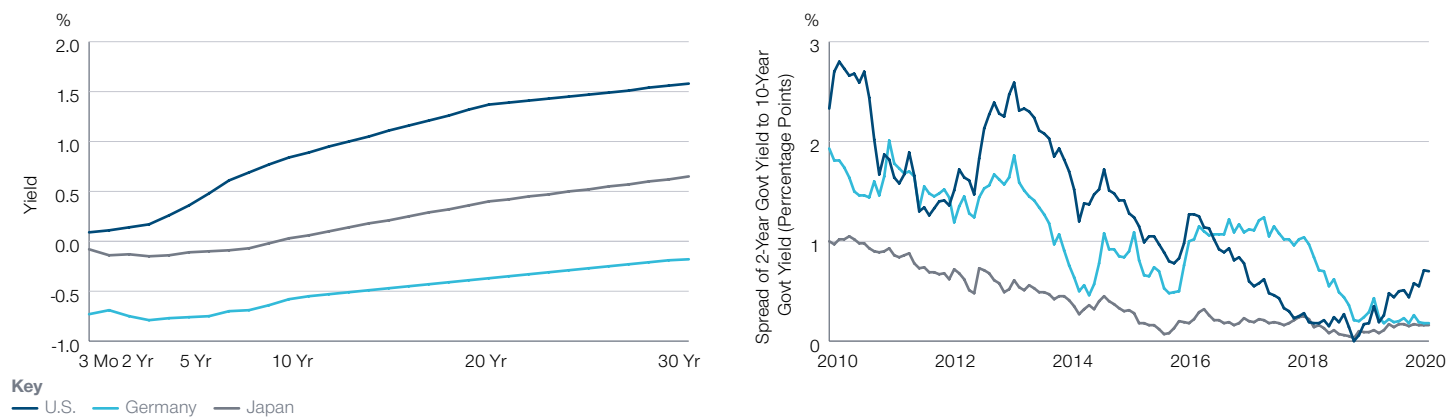
Mark Vaselkiv, CIO Fixed Income, and David Giroux, CIO Equity

Massive infusions of central bank liquidity successfully stabilised global credit markets in 2020, even as a pandemic driven flight to quality pushed already low sovereign yields even lower. This dual trend produced strongly positive returns across most fixed income sectors.

However, investors face a more challenging environment in 2021. With short term yields at ultra-low or negative levels and the US yield curve steepening as economic growth and inflation expectations revive (figure 5), interest rate risk could become a critical issue.

Yield curves are lower but steeper than at the beginning of 2020

(Fig. 5) Sovereign yield curves (left) and yield curve slopes (right)



As of November 30, 2020.

Past performance is not a reliable indicator of future performance.

Source: T.Rowe Price analysis using data from Factset Research Systems Inc. All rights reserved.

Credit markets also no longer appear as attractive as they did after central banks launched rescue operations in 2020. With investment grade and high yield credit spreads back closer to historical norms – despite the lingering effects of the pandemic – active sector and security selection are likely to play more critical roles in seeking yield and managing risk in 2021.

It will take significant creativity to find attractive opportunities in such a low interest rate environment. Creativity could mean moving further out the credit risk spectrum or seeking opportunities across global debt markets. Skilled credit analysis could be crucial to success.

“Historically, US dollar currency cycles have tended to last for significant amounts of time.”

Mark Vaselkiv

Chief Investment Officer, Fixed Income

Expanded credit universe

For credit investors, the flood of new US dollar denominated corporate issuance seen in 2020 – an estimated \$2trn in investment grade and more than \$500bn in high yield debt – offers both potential opportunities and additional risks.

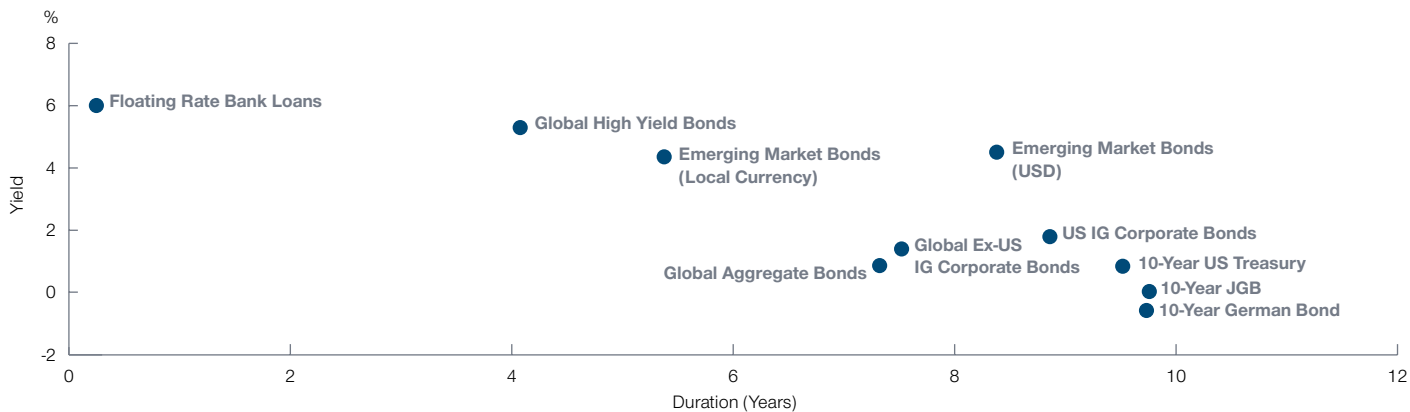
On one hand, yields in the credit universe still appear attractive on a relative basis. While many companies have increased debt loads, in many cases liquidity ratios actually have improved. This should help businesses in cyclical sectors – such as energy, airlines and lodging – fend off insolvency until economic conditions normalise.

However, ample financing also could allow structurally weak firms to survive even though longer term prospects for profitability appear dim. We may end up with a universe of companies limping along for the next five to seven years just because credit markets keep them afloat.

In an environment where short term rates are at or close to zero but prospects for a post pandemic recovery appear to be brightening, duration – a key measure of interest rate risk – could become a top issue for many fixed income investors in 2021. Extended durations for high quality sovereigns and investment grade corporates (figure 6) mean even modest upticks in interest rates and inflation could produce significant capital losses on those assets.

Interest rate risk potentially makes shorter-duration assets more attractive

(Fig. 6) Yields versus interest rate risk (duration)



As of November 30, 2020.

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Floating Rate Bank Loans – J.P. Morgan Leveraged Loan Index; Global High Yield Bonds – Bloomberg Barclays Global High Yield Index; Emerging Market Bonds (Local Currency) – J.P. Morgan GBI-EM Global Diversified Composite Index; Emerging Market Bonds (USD) – J.P. Morgan EMBI Global Index; Global Ex-US IG Corporate Bonds – Bloomberg Barclays Global Corporate IG Index; US IG Coporate Bonds – Bloomberg Barclays US Investment Grade Corporate (300MM) Index; Global Aggregate Bonds – Bloomberg Barclays Global Aggregate Index; 10-Year US Treasury – US Benchmark Bond-10 Yr; 10-Year German Bund – Germany Benchmark Bond-10 Yr; 10-Year Japanese Gov't. Bond – Japan Benchmark Bond-10 Yr.

Actionable investment ideas

Income seekers should expand their opportunity set in the search for yield. Some assets, such as high yield, enjoy explicit support from central banks. Others, such as emerging market local currency sovereign debt and emerging market corporate debt, may benefit from recent US dollar weakness – which we expect to be a continued trend in the medium term.

Factor 4: problematic politics and pandemic pressures

David Giroux, CIO Equity and Multi Asset, Justin Thomson, CIO Equity, and Mark Vaselkiv, CIO Fixed Income

The global pandemic has accelerated economic inequality and appears to have worsened political divisions in some countries – trends that could continue to create geopolitical tensions and influence markets in 2021.

In the US, the Biden administration is widely expected to seek additional fiscal stimulus to bolster the economy. However, a divided government in Washington would likely hamper the administration's more ambitious legislative proposals.

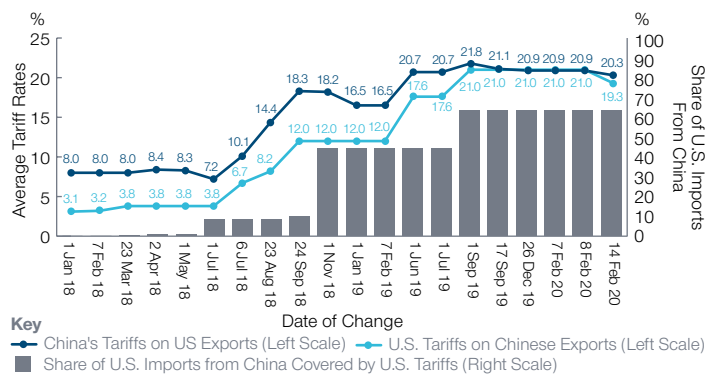
One potential flashpoint that could impact global markets in 2021 will be ongoing trade and diplomatic tensions between the US and China.

Continued trade tensions

The Biden administration will have to decide whether and how to challenge Beijing on trade, intellectual property (IP) rights, human rights and other issues. Given the hard-line trade policy toward China has broad bipartisan support in Washington, we do not expect the new administration to roll back the tariffs on Chinese goods imposed by President Trump (figure7). However, the intensity of the trade conflict might be reduced.

Higher tariffs on US-China trade appear unlikely to be rolled back.

(Fig. 7) US and Chinese tariff rates and share of imports from China covered by US tariffs



As of November 30, 2020.

Past performance is not a reliable indicator of future performance.

Source: Paterson institute for international Economics www.piie.com.

Control of IP, on the other hand, is likely to remain a key battleground. The fight for dominance over the next generation of technology is one neither side feels it can afford to lose. However, while the IP conflict poses potential economic risks, it also could create new opportunities for investors as China seeks to develop its own supply chains – including an onshore semiconductor industry.

Meanwhile, Beijing's campaign to bring Hong Kong under tighter control appears to have achieved its objective, as opposition members on the city's Legislative Council either have been removed or have resigned. However, these developments are unlikely to pose a threat to the city's status as a global financial centre. As long as the renminbi is not fully convertible, the Hong Kong dollar will remain highly relevant.

Stimulus still needed

While global capital markets have benefited from generous central bank liquidity and encouraging news on vaccines, the prosperity gap between owners of financial assets and many workers and small businesses continued to widen in 2020. This could further fuel populist pressures.

“...additional fiscal stimulus is so important now—to help save jobs”.

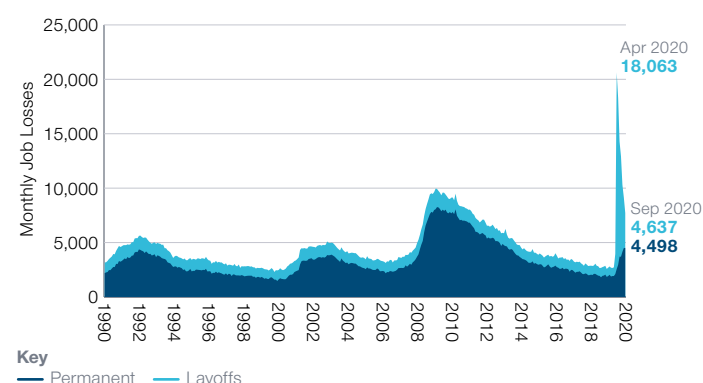
Mark Vaselkiv

Chief Investment Officer, Fixed Income

In the US, the initial waves of pandemic layoffs were primarily temporary, with federal paycheck assistance programmes helping cushion the blow. Many of those employees have since returned to work (figure 8). However, as the pandemic has dragged on, permanent job losses have mounted.

The gap between temporary and permanent job losses has closed

(Fig. 8) US layoffs versus permanent job losses



As of October 31, 2020.

Source: US Department of Labor/Haver Analytics

If new vaccines and continued fiscal and monetary stimulus support a return to more normal economic conditions in 2021, a key question – one with significant political implications – will be how quickly global labour markets improve as a result. Large corporations have access to the capital markets, but we should not forget that state and local governments employ millions of people – while small businesses are the lifeblood of many communities. This is one reason additional fiscal stimulus is so important now – to help save jobs.

Actionable investment ideas

Investors looking globally are better placed to avoid the risk of a major geopolitical development affecting a domestic market. More specifically, China and emerging Asia – which represent about 80% of the MSCI Emerging Markets Index – may emerge as winners, as these countries have been less impacted by the pandemic.

Conclusions

In the opening months of 2021, the short-term economic risks from a worsening pandemic could weigh on global equity and credit markets, Giroux says. However, economic and earnings growth could improve dramatically later in the year if the new vaccines can rapidly bring down infection rates.

But a 2021 earnings recovery might not translate into continued strong rallies in global equity prices, Giroux cautions. To a large degree, he says, an economic and earnings recovery already has been priced in by the markets. “Expectations are high, so we could see good earnings results but still see the market trade off a bit.”

Thomson thinks global equities could perform reasonably well in 2021, helped by the same factors that propelled the 2020 rally: supportive fiscal policy and ample monetary liquidity. “It feels to me like there’s still a lot of money on the sidelines that could make its way into risk assets,” he says.

For fixed income investors, 2021 could be challenging, as the falling yields and tightening credit spreads that boosted broad market returns in 2020 aren’t likely to play that role again. Rather, extended durations and the potential for a modest revival in inflation could make managing interest rate risk a portfolio priority, boosting the appeal of floating rate assets.

In both equity and credit markets, T. Rowe Price investment leaders say, the uneven impact of the pandemic and the recovery on countries, industries, and individual companies is likely to make strong fundamental analysis and skilled active security selection a critical component of investment success.

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