



ASSET ALLOCATION COMMITTEE VIEWPOINTS

Third Quarter 2015

These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon. The approach is largely qualitative and valuation based, with attention to a broad scope of potential risks and potential return scenarios.

Asset Allocation		
Bonds	neutral	Stocks
	■	
Equities		
U.S.	neutral	Non-U.S.
		■
Developed	neutral	Emerging
		■
Global Equity	neutral	Real Assets
	■	
U.S. Large Cap	neutral	U.S. Small Cap
■		
U.S. Value	neutral	U.S. Growth
		■
Non-U.S. Value	neutral	Non-U.S. Growth
	■	
Fixed Income		
U.S. Investment Grade	neutral	High Yield
		■
U.S. Investment Grade	neutral	Emerging Markets
	■	◀
U.S. Investment Grade	neutral	Nondollar
	■	

■ Current position
◀ or ▶ Movement from previous position

Explore the themes and thinking behind our decisions.

THEMES

Global

- Global growth expectations tempered for 2015 as U.S. growth trending lower year-over-year while Europe and Japan improve; emerging markets growth weighed down by China and Brazil
- Central bank monetary policies diverge as the U.S. looks toward interest rate policy normalization, Europe and Japan advance quantitative easing measures and many emerging market countries lower interest rates to stimulate growth
- Key risks to global markets include the impacts of global monetary policy actions, currency volatility, and persistent geopolitical concerns, particularly in Greece, the Middle East and Eastern Europe

U.S.

- U.S. growth contracted by a 0.2% annualized pace in 1st quarter of 2015 impacted by severe winter weather, west coast port closures and a stronger dollar which weighed on consumer and business spending. Despite expectations for stronger growth in the back half of the year, the weak start has resulted in expectations for full year 2015 falling below 3%, which would be the tenth consecutive year of less than 3% growth
- While inflation remains below the Fed's 2% target, key factors that supported the trend in lower inflation have reversed with U.S. dollar strength moderating and oil prices above recent lows
- Evidence suggests that wages are beginning to inflect higher from trough levels as the labor market has improved
- U.S. Federal Reserve policy on track to begin interest rate normalization in the back half of this year, with the subsequent pace of rate hikes expected to be gradual and data dependent
- U.S. yields move higher with 10-year Treasury yields trending above 2% as dollar declines and energy prices advance off recent trough levels. We expect interest rates to increase as growth improves and the Federal Reserve begins to normalize interest rate policy, albeit gradually

- Healthy balance sheets and cash flows grant the corporate sector flexibility in the use of capital to increase capital spending, engage in M&A activity and return capital to shareholders
- Corporate buybacks and M&A activity remain strong supported by low financing costs and improved corporate confidence
- U.S. profit and revenue growth expected to decline in 2nd quarter of 2015 by low-single digits weighed down by weakness in the energy sector

Europe

- Growth outlook revised higher supported by diminished fiscal headwinds, improving credit environment, lower energy costs and weaker euro
- European Central Bank (ECB) progresses with quantitative easing program launched in March which includes monthly purchases of 60 billion euros of sovereign, agency and asset-backed debt
- Risks remain with uncertainty surrounding Greece, lingering structural issues, elevated unemployment, high debt levels and political instability in several countries

Japan

- Economy expands for the second straight quarter, growing at quarter-over-quarter annualized rate of 3.9% in the 1st quarter of 2015 supported by stronger capital spending. While growth has improved, consumer spending and wage growth remain tepid and substantial structural reforms have been slow to materialize
- Bank of Japan (BOJ) progresses with current quantitative easing measures facing challenges of meeting its 2% inflation target with recent stabilization of the Yen and lower oil prices

Emerging Markets

- Divergence across the fiscal conditions and monetary policies of emerging market countries, with the decline in energy prices helping many with lower inflation while other commodity-exporting related economies facing weaker growth

- Weak economic data persists in China with recent volatility within the domestic equity market raising fears of a bubble
- People's Bank of China reduces reserve requirements and lowers interest rates for the fourth time since last November, adding to other recent measures to stimulate growth and lending activity including the debt-for-bond swap allowing commercial banks to use local-government bailout bonds they purchase as collateral for low cost loans from the central bank

ASSET ALLOCATION

Neutral Between Stocks and Bonds

We are neutral stocks relative to bonds. Equity markets have continued to trend higher this year as earnings growth has moderated resulting in valuation levels above historical averages.

While valuations are above historical averages across multiple measures, underlying fundamentals remain solid and improving economic growth should be supportive.

Despite the recent rise in global bond yields, they remain at historically low levels. We expect modest returns from bonds as the current low-yield environment offers a weak foundation and rising interest rates should be a headwind once rates begin to rise. Global central bank monetary policy should remain accommodative for some time to come as they seek to support growth, which should moderate downside risks to bonds. Additionally, we expect that a rise in U.S. interest rates may be limited as growth remains subdued and demand for U.S. bonds persists as U.S. yields remains amongst the highest across developed markets.

Our global growth expectations remain modest over the next several quarters. Gradual improvement in U.S. economic activity is supported by stronger private sector demand, reinforced by an improving job market and higher wages, as well as increasing household formation and replacement-driven capital spending. Japanese growth has improved yet remains tepid following last year's tax-induced recession. Signs of improving growth in Europe supported by aggressive quantitative easing measures, a weaker euro and an

improving credit environment, although risks remain with many countries hindered by high debt loads and high unemployment. Slowing growth in China, Brazil, Russia and other emerging economies weighs on global trade.

U.S. corporate balance sheets and profit margins remain healthy. Earnings growth trending lower with negative single digit expectations for the 2nd quarter of 2015. Recent stabilization of the U.S. dollar and energy prices could prove supportive of corporate earnings, by removing headwinds to the energy, manufacturing and export-oriented sectors.

EQUITIES

Favor Non-U.S. Over U.S.

We increased our overweight to non-U.S. equities based upon prospects for stronger earnings growth and modestly more attractive valuations, although disparity exists in valuations across regions and sectors. While the U.S. economic cycle is further advanced than many non-U.S. economies which are in earlier stages of recovery, non-U.S. economies and companies are expected to benefit from their relative weaker currencies and support from aggressive monetary policies. Earnings and margin levels in Europe remain well below pre-crisis levels as compared to the U.S. where earnings and margins are at peak levels.

Favor Emerging Over Developed Markets

We are overweight to emerging market (EM) equities as valuations are at attractive levels relative to developed markets. The potential for slowing EM economic growth and U.S. Federal Reserve interest rate normalization leading to increased volatility remain near-term risks. While energy and commodity prices have risen from trough levels they remain well below year ago levels and may continue to weigh on commodity exporters while consumer driven and service-oriented economies benefit.

Favor Global Equity Over Real Assets

Despite the recent rise in some commodity prices, we remain underweight to real assets as prospects for muted global economic growth are likely to continue to weigh on energy and materials prices. Increased global energy production capacity and the impact of drilling technology have improved supply. Demand for commodities is expected to remain subdued as China continues shifting its growth model away from industrial production and exports toward domestic consumption. Real interest rates remain at low levels; rising real rates have historically been less favorable for real assets related equities. Fundamentals for REITs are favorable and they may benefit from improving economic environments supported by lower energy prices, yet valuations remain rich and REITs remain sensitive to rising rates.

Favor Large-Cap Over Small-Cap

We are underweight to U.S. small-cap stocks as small-cap stocks remain richly priced relative to large-caps. Heightened market volatility and tightening of U.S. Federal Reserve interest rate policy have historically been negatives for small-cap stocks' relative performance versus large-cap stocks.

We are modestly overweight small-cap stocks outside the U.S. as they may benefit from improving domestic economic environments supported by quantitative easing measures in Europe and Japan.

Favor U.S. Growth Over U.S. Value

We are modestly overweight to U.S. growth stocks. While the current low level of economic growth favors growth stocks, which tend to be less reliant on a strong economy to generate rising corporate earnings, a gradually improving U.S. economy has moderated this outlook.

Favor Non-U.S. Value Over Non-U.S. Growth

Outside the U.S., we remain overweight to value stocks as valuations are attractive in value-oriented sectors, such as European financials that should benefit from improving economic and credit growth. Further, we see greater potential for a broad improvement in earnings and margins, which remain well below their 2007 peaks in Europe. Both Japan and Europe are in earlier stages of recovery versus the U.S. and more cyclical, value-oriented sectors may benefit as these economies are supported by aggressive monetary easing and more competitive currencies.

FIXED INCOME

Favor High Yield Over U.S. Investment Grade

We increased our overweight to high yield relative to investment-grade bonds based on attractive yields, lower duration profile with less sensitivity to rising rates. We continue to monitor the credit impact of lower commodity prices on the energy and commodity related sectors which represent a significant portion of the market. Continued strength in M&A activity could be supportive of select issuers.

High yield bonds remain attractive relative to other sectors in this low-yield environment, particularly given prospects for a slowly improving economy. Many high yield issuers have improved their liquidity profile by extending maturities and refinancing to lower-coupon debt. While default rates may trend higher within the energy sector, in aggregate, default rates are expected to remain low relative to history.

Neutral Between Emerging Markets and U.S. Investment Grade

We reduced our overweight to emerging market bonds relative to U.S. investment-grade bonds to neutral. Muted growth, a strong dollar and the start of Federal Reserve interest rate policy normalization remain near-term risks. While emerging market bond yields are at less attractive levels, many emerging market currencies remain notably undervalued. Considerable disparity exists in the strength of various EM economies, with the potential for lower commodity prices to further the divide.

Favor U.S. Investment Grade Over Nondollar

We reduced our underweight to nondollar bonds relative to U.S. investment-grade bonds as the pace of dollar strength has stabilized.

Despite recent U.S. dollar weakness after a significant rise since 3rd quarter 2014, the dollar remains supported by the prospects for stronger growth and higher interest rates relative to other developed countries. Aggressive monetary stimulus measures by the European Central Bank and Bank of Japan to stimulate growth and inflation could provide catalyst for their currencies to decline even further relative to the dollar.

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IMPORTANT INFORMATION

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There are inherent risks associated with investing in the stock market, including possible loss of principal, and investors must be willing to accept them. The stocks of larger companies generally have lower risk and potential return than the stocks of smaller companies. Since small companies often have limited product lines, markets, or financial resources, investing in them involves more risk than investments primarily in large, established companies. The value approach carries the risk that a stock judged to be undervalued is actually appropriately priced. International investing involves unique risks, including currency fluctuation. Bond yields and prices will vary with interest rate changes. Investments in emerging markets are subject to abrupt and severe price declines, and should be regarded as speculative. High yield, lower-rated bonds generally involve greater risk to principal than investments in higher-rated securities.

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