

The Changing Global Equity Landscape: Long-Term Positioning For New Norms

The following Investment Viewpoint is based on a presentation that Robert Gensler, portfolio manager for the Global Equity Strategy, delivered in February 2009 on the changing global equity environment and current strategy positioning.

Global stock markets are undergoing a profound shift. The duration of this transition remains uncertain. But the direction of the fundamental changes in the global economic and investing environment is becoming clear—as are the potential benefits of taking a long-term view of portfolio positioning for a new equity landscape.

From 2002 through 2007, investors were progressively operating in a wonderful world in which the appetite for risk was increasing, the cost of capital and labor were very low, and profit margins in virtually all regions around the globe were at historically high levels.

In 2008, however, the pendulum swung quickly and widely, devastating economies around the world and leaving global equity markets searching for a stable bottom.

“We are now in the process of a very severe contraction as the global economy deleverages,” Mr. Gensler says. “We don’t know the ultimate depth of this downturn, but with each passing data point we are getting closer to finding it—and the worldwide government stimulus response is a necessary and encouraging part of that process.

“The timing is very uncertain, but eventually the global economy will adjust to a lower level of economic activity,” he says. “This deleveraging process is different than anything we have experienced in recent decades, and it is going to have to run its course.”

This transition already is evident in the form of tighter credit, higher cost of capital, more risk aversion, restrained consumer spending in developed markets, less corporate expansion, and flat global growth—with economies in the United States, Western Europe, and Japan shrinking recently and the rate of growth in some emerging markets slowing markedly.

“This progression likely will take several years,” Mr. Gensler says. “And when the global economy stabilizes, we’re not going to return quickly to the old norms for growth and profits.”

The New Norms

Mr. Gensler expects the global economy to get worse before it gets better. Nonetheless, he is hopeful that investors will see some signs of economic stability forming in the latter half of this year or early 2010, with global equity markets reacting positively over a two- to three-year time frame.

Eventually, he foresees a new backdrop for global investing emerging from this slow transition that is characterized by:

- Lower real global economic growth, in the 1% to 3% range, with emerging markets as the key drivers.
- Slowly rising interest rates.
- Moderate consumer spending and recovering fixed-asset investment.
- A gradual return to corporate pricing power and improving profit margins.
- Equity risk premiums declining and valuations normalizing after having hit rock bottom.

Still, the transition to these new norms may be rocky.

Figure 1: The Global Landscape Is Transitioning

	Old Norm	Transition Period	New Norm
Global Real GDP	>5%	0% to negative	2% to 3%
Inflation	Modest 3% but rising	Spike then collapse	Deflation/inflation?
Pricing Power	Strong	Disappeared	Return slowly
Profit Margins	Continuously improving	Free fall	Improving
Real Interest Rates	at 0%	Rising	Resetting higher
ROEs	All-time highs	Collapsing	Normalizing
Consumer	Excessive consumption	Deleveraging	Moderate consumption
Fixed-Asset Investment	Excessive	Falling sharply	Recovering slowly
Source of Global GDP Growth	<50% emerging markets	>100% emerging markets	~66% emerging markets
Valuations	Modest expansion	Rock bottom	Normalizing
Risk Premiums	Historic lows	Historic highs	Declining

“The second-round effects of the large global job losses to date are yet to be felt,” Mr. Gensler says. “For those who think the loss of several million jobs in America is problematic, just think of the loss in China alone of 20 million migrant workers’ jobs.”

As markets establish their own base levels, he sees the potential for several powerful short-term, “indiscriminate” market rallies, so-called junk rallies, that “are likely to be followed by disappointment.”

On these rebounds, marginal corporate players—just because they have survived—may even see sharp gains from their cheap valuations. But in the long term, Mr. Gensler believes, they are not where global investors ought to be focused.

Seeking Quality

This historic collapse in global equity markets has resulted in extreme dislocations between equity prices and underlying corporate fundamentals. The realignment of valuations and fundamentals could take two or three years, but Mr. Gensler sees plenty of opportunity for investors willing to seek out quality companies now.

“We’re going to see more positive trends, but we’re probably not going back to supernormal growth and stability of the 2005 to 2007 period,” he says.

As a result, Mr. Gensler’s strategy is focused on the market leaders that he foresees surviving the global downturn and—because of their healthy balance sheets and access to capital—taking market share from marginal players who may not survive.

Figure 2: A Snapshot of the World

As of 31 Jan 2009

Figures in USD and trillions where applicable

	Share of Global ¹			Estimated GDP Growth	
	Market Cap	Total GDP	GDP Growth	2009	2010
Europe ²	27%	20%	7%	-2.0%	0.2%
United States	45%	21%	8%	-2.0%	1.6%
Japan	9%	7%	3%	-2.6%	0.6%
Emerging Markets	10%	48%	76%	2.5%	5.0%
Australia	2%	1%	1%	-1.1%	2.3%
Total	T\$24 ³	T\$73	95% ⁴	0.0%	3.0%

¹ Based on 2007 IMF estimates.

² The Europe figures are for the European Union only.

³ Based on MSCI free-float adjusted market cap.

⁴ Does not total 100% as residual percentage is derived outside the regions that are shown.

Sources: MSCI, Morgan Stanley, IMF, and UBS.

In virtually every sector around the world, he says, quality companies are likely to take market share as the global downturn forces their weaker competitors out of business or into mergers: “Think of it as aircraft carriers versus patrol boats. When things are running fast, the patrol boat can outmaneuver the aircraft carrier. When things slow, an aircraft carrier can turn and capsize the patrol boat with its wake.

“The winners will be different from those in the past,” he adds, “Previous winners were the attackers that benefited from pricing power, excess demand, and tremendous financial and operational leveraging. Tomorrow’s winners are more likely the incumbents with traditional, relationship-based businesses, companies that can self-finance, and those that can absorb weaker market competitors.

“No one is going to experience the top-level growth that we have enjoyed in recent years. So you want to own the number one or two player in any market. The overall market pie may be shrinking right now, but I believe these leaders will end up with a bigger market share and more business on an absolute basis, which should grow their future earnings prospects.”

The Barbell Approach

Given the current economic uncertainty and market volatility, Mr. Gensler is taking a barbell approach to investing these days—positioning his portfolio in less volatile, less economically sensitive stocks as an anchor but also in depressed stocks that he expects to outperform in the longer term.

One end of the barbell reflects a defensive approach focusing on growth stocks that offer greater earnings durability and stability. The other end reflects a more opportunistic approach and includes stocks that are gaining market share as competitors falter and may benefit from expanded price/earnings ratios when markets recover. These stocks are considered more market sensitive and offer compelling valuations.

On the sector level, this means his strategy is overweight as follows:

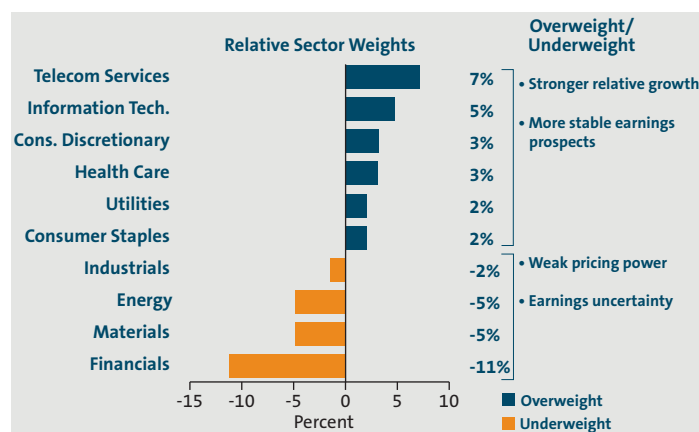
- Telecommunication services stocks, which have strong cash flow, are less economically sensitive, able to reduce their capital expenditures, and enjoying wireless and digital volume growth.
- Technology stocks, particularly market leaders with quality franchises, solid balance sheets, compelling valuations, and attractive growth prospects.
- Consumer discretionary and staples stocks, which offer relatively strong durable growth, well-known brands, scale advantages, and, again, solid balance sheets.

- Health care stocks, particularly companies with more stable earnings prospects, leading therapeutics, and no regulatory risk.

By contrast, his portfolio is underweight in financials due to continued instability and in materials and energy because of demand pressures.

“The current transitional situation poses very challenging global economic circumstances, and there’s been only modest improvement in the stability of the world financial system,” Mr. Gensler says. “But quality companies with balance sheet strength and solid cash flow offer compelling opportunities. So, my two- to three-year view is bullish.”

Figure 3: Global Equity Representative Portfolio¹ vs. MSCI All Country World Index
As of 31 Dec 2008



Sources: T. Rowe Price and MSCI. T. Rowe Price uses the MSCI/S&P Global Industry Classification Standard (GICS) for sector and industry reporting. Effective September 1 of each year, MSCI and S&P make changes to the GICS structure. T. Rowe Price will adhere to all future updates to GICS for prospective reporting.

¹The representative portfolio is an account that we believe most closely reflects the current portfolio management style for the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from those of other accounts in the strategy. Information regarding the representative portfolio and the other accounts in the strategy is available upon request.

Important Information

Issued in the U.S. by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD 21202, which is regulated by the U.S. Securities and Exchange Commission. The material is not intended to be a solicitation for any product or service not available to U.S. investors, including the T. Rowe Price Funds SICAV, and may be distributed only to institutional investors.

Issued in Japan for purposes of its investment management business by T. Rowe Price Global Toshi Komon—Tokyo Branch (TRPGTK) (KLFJ Registration No. 445 (Financial Instruments Service Provider), JSIAA Membership No. 011-01162), located at Yamato Seimei Building 20F, 1-7, 1-chome Uchisaiwai-cho, Chiyoda-ku, Tokyo 100-0011. If instead this material is used in Japan on behalf of an affiliated T. Rowe Price company, TRPGTK has compiled, translated, and provided this material. This material is intended for use by professional investors only.

Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc., enters into written delegation agreements with affiliates to provide investment management services. T. Rowe Price (Canada), Inc., is not registered to provide investment management business in all Canadian provinces. Our investment management services are only available to select clients in those provinces where we are able to provide such services. This material is intended for use by accredited investors only.

Issued in Australia by T. Rowe Price Global Investment Services Limited (TRPGIS), Level 29, Chifley Tower, 2 Chifley Square, Sydney, NSW 2000, Australia. TRPGIS is exempt from the requirement to hold an Australian Financial Services License (AFSL) in respect of the financial services it provides in Australia. TRPGIS is regulated by the FSA under U.K. laws, which differ from Australian laws. This material is not intended for use by Retail Clients, as defined by the U.K. FSA, or as defined in the Corporations Act (Australia), as appropriate.

Issued outside of the U.S., Japan, Canada, and Australia by T. Rowe Price Global Investment Services Limited, 60 Queen Victoria Street, London EC4N 4TZ, which is regulated by the U.K. FSA. This material is not intended for use by Retail Clients, as defined by the U.K. FSA.

T. Rowe Price, Invest With Confidence, and the bighorn sheep logo is a registered trademark of T. Rowe Price Group, Inc., in the United States, European Union, Australia, Canada, Japan, and other countries. This material was produced in the United Kingdom.

The T. Rowe Price group of companies includes T. Rowe Price Associates, Inc., T. Rowe Price International, Inc., T. Rowe Price Global Investment Services Limited, and T. Rowe Price (Canada), Inc.

All charts and tables are shown for illustrative purposes only.

This material is provided for informational and educational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are as of 16 Feb 2009 and may have changed since that time.

MARCH 2009