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What's ahead for the economy and the markets?

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2015

INVESTMENT AND ECONOMIC OUTLOOK

#TRPoutlook

"Looking ahead to 2015, we remain somewhat constructive on equity markets and more cautious on fixed income markets. We are mindful of risks in an environment where growth trajectories and central bank policies both seem to be decoupling."

—Brian Rogers

Global Economy:
DIVERGENT TRENDS SPAN DEVELOPED AND EMERGING MARKETS.

Alan Levenson, Ph.D.
Chief Economist

Economic decoupling remains a prominent theme around the globe as we head into 2015. The divergent paths seen today are a consequence of how individual countries have dealt with credit imbalances that accumulated prior to the global financial crisis. Recovery prospects continue to hinge on the speed, breadth, and quality of these adjustments.

The United States responded comprehensively to the bursting of its credit bubble—aggressively easing monetarily, applying fiscal stimulus to offset private sector deleveraging, and recapitalizing banks. The United Kingdom took a somewhat similar approach. A variety of factors, including institutional constraints on monetary and national fiscal policy and a fragmented, bank-centric financial system, have slowed the deleveraging process in the eurozone. Meanwhile, China weathered the global recession by investing heavily in real estate and manufacturing capacity. This temporarily lifted growth but left its economy overleveraged. (See Figure 1.)

Against this backdrop, the recoveries in the U.S. and UK are progressing at a respectable pace, setting the stage for the start of policy renormalization next year. In contrast, the European Central Bank (ECB) will be pressured to act more forcefully to combat deflation. Japanese policymakers, who prioritized a 2% inflation target in 2013, will be assessing the effectiveness of expanded monetary stimulus in reaching this goal. China is challenged with stabilizing growth at a more sustainable rate without worsening imbalances created by past stimulus. Other developing countries' prospects are mixed.

U.S.: RESILIENCE IN THE FACE OF GLOBAL WEAKNESS

Following a somewhat disappointing 2014, precipitated by an unexpectedly weak first quarter, the U.S. economy appears capable of sustaining an annual growth rate of 2.75% to 3.00% even with subpar performance abroad. Indeed, the drivers of U.S. growth are primarily domestic:

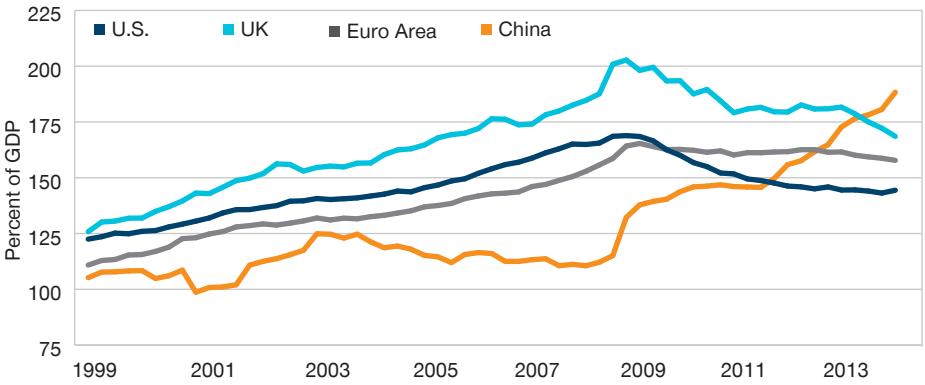
- Fiscal headwinds have eased, with government employment and spending no longer contracting.
- Although wage inflation has been subdued, an improving employment situation has begun to feed through to higher incomes, supporting consumer spending.
- Business capital investment is on the rise.

If growth falls short of expectations, it will be due to sluggish productivity. But regardless of whether productivity improves, employment gains should continue at a steady pace of over 200,000 jobs per month. With this consistent job growth, labor market slack continues to diminish. As a leading indicator of inflation, a tighter labor market will be the primary factor in the timing of an initial Federal Reserve rate hike.

The Fed remains on course to begin tightening policy around mid-2015. Rather than a threat to the recovery, rate hikes will be indicative of confidence in the economy. Still, the Fed will raise rates at a measured pace in order to observe potential reverberations in financial markets. And lower potential growth will warrant a lower terminal rate than in previous tightening cycles.

Cheaper oil has further dampened inflation expectations but is a net positive for the U.S. economy, particularly as it reflects a production boom more than it does weakening global demand. Lower energy costs will boost disposable household income, potentially adding to GDP if this windfall is spent.

FIGURE 1: Substantial Deleveraging Bolsters Growth Prospects in the U.S., UK
Debt of private nonfinancial sectors Jan 1999 Through Jan 2014



Sources: Bank for International Settlements, China National Bureau of Statistics, Eurostat, UK Office of National Statistics, U.S. Bureau of Economic Analysis, Haver Analytics, and T. Rowe Price

Downside risks are in roughly equal balance with upside risks. Challenges to our base economic outlook are primarily external in nature and include an unanticipated degree of slowing abroad and geopolitical factors, such as an escalation of Russia's confrontation with Ukraine.

EUROPE: POTENTIAL FOR A LATE 2015 RECOVERY

Growth in the eurozone remains anemic, prompting overdue downgrades to 2015–2016 GDP forecasts. Short-run projections may still be overly optimistic given that indicators continue to worsen. But several signs point to a modest rebound beginning in the second half of 2015:

- The recent declines in the euro and energy prices are beneficial for exports and consumer demand, respectively.
- Now that the ECB's stress tests and asset quality review are complete, there are early indications that banks are more willing to lend.
- Money supply data, which are predictive of business activity, suggest that the economy will bottom in late 2014.
- Although some countries, such as France, will still be retrenching, 2015 will be the first year since 2010 that governments are not tightening fiscal policy, in aggregate.

Monetary easing will continue, with potential for bolder measures. The ECB's purchases of securitized debt will have a minimal near-term impact but should help unlock credit supply over time. Concerned about deflationary risks, ECB President Mario Draghi may soon expand quantitative easing (QE) to purchases of high-grade corporate and agency bonds. But to achieve his goal of a €3 trillion balance sheet, sovereign QE will be necessary. A limited sovereign buying program seems likely next year, though objections from a minority of ECB Governing Council members make it far from certain.

Most imperative for sustainable long-term growth is structural reform. Spain has made incremental progress on critical reforms, while Italy and France have started down the path.

JAPAN: EASING TO CONTINUE UNTIL INFLATION TARGET MET

The Bank of Japan's (BOJ) forecast for 1.5% GDP growth in 2015 may be slightly too optimistic, and it is unlikely to achieve its 2% inflation target next year. Still, the BOJ's recent decision to expand the size and scope of its asset purchase program has helped restore Governor Haruhiko Kuroda's credibility as a deflation fighter and has other positive implications:

- An expanded monetary base provides support for Japanese risk assets.
- The additional QE should promote capital outflows into higher-yielding bond markets, keeping downward pressure on the yen.
- The additional asset purchases will offset sales of Japanese government bonds by the Government Pension Investment Fund as it reallocates into riskier securities.

Although still negative in real terms, Japanese wages have been on an upturn. With employment conditions relatively tight, there is potential for additional wage pressure to build. On the downside, exports have barely responded to the sharp depreciation in the yen. Japan needs to do more to address an unsustainable debt burden. And structural reforms—the key "third arrow" of Prime Minister Shinzo Abe's economic plan—have so far been underwhelming.

EMERGING ECONOMIES: CHINA MANAGING A DECELERATION; IDIOSYNCRATIC STORIES ABOUND

Growth in China is on a slow downward track, as officials seek to prevent a sharp slowdown while also discouraging credit expansion. The government will likely need to reduce its growth target for 2015, perhaps to 7% (from 7.5% in 2014). It has stepped up mini-stimulus efforts, but these are aimed at protecting against downside risk rather than re-accelerating the economy. The central bank's decision to cut benchmark deposit and lending rates was a surprising step for policymakers who seemed determined to not give into pressures for more aggressive easing measures that may further drive up leverage. Longer term it would be better for the government to allow for lower growth, but it historically has shown little tolerance for failing to meet targets.

Growth rates are varied in other emerging markets, but an overarching theme is that they will remain lower than pre-financial crisis levels. With U.S. monetary policy turning less supportive, some countries have taken positive steps with fiscal reforms and improvements in current account deficits, while others have become more vulnerable to a reduction in global liquidity:

- New governments in India and Indonesia have made incremental progress on economic reform. Also encouraging for India are more orthodox central bank policy and a narrower current account deficit.
- The reelection of President Dilma Rousseff was discouraging given Brazil's weak economy and worsening fiscal situation under her watch. However, she will feel pressure to enact reforms to retain an investment-grade rating.
- Turkey continues to pursue pro-cyclical policies, prematurely cutting rates and increasing government spending. This will likely result in economic overheating, a widening current account gap, and larger financing needs.
- Russia's dependence on natural resources is a liability with energy prices falling. In addition, the ruble will remain under pressure as long as Western sanctions are in place.

Global Equities: **CAUTIOUS OPTIMISM STILL PREVAILS.**

Bill Stromberg
Head of Equity

The global equity outlook for 2015 is moderately favorable in our view, although economic weakness in Europe, uncertainty about the pace of U.S. monetary tightening, geopolitical instability, or unexpected events—such as West Africa's Ebola epidemic—all have the potential to trigger pullbacks like those experienced in early and late 2014.

On the positive side: corporate earnings continue to grind higher; interest rates and inflation remain low; and monetary conditions are still accommodative, especially in Europe and Japan. We expect the global economy to continue on its uneven upward trajectory, led by the U.S. While global equity valuations no longer offer the compelling opportunities they did earlier in the bull market, they do not appear to be near the extremes that have preceded major bear markets in the past. (See Figure 2.)

Returns are likely to be moderate going forward, however, as the global recovery and bull market continue to mature. In the U.S., where deleveraging and economic repair are fairly advanced, the Federal Reserve has successfully ended its quantitative easing (QE) program and will gradually try to raise short-term interest rates in 2015. Monetary accommodation is no longer a given.

Economic growth in Europe and Japan remains elusive, and deleveraging has considerably further to run. Sluggish wage growth and consumer demand remain key headwinds to earnings growth. There is good reason for optimism about some emerging markets, as important structural reforms are taking place in China, India, Mexico, and elsewhere.

For U.S.-based investors, one particular concern is the strength of the U.S. dollar, which on a trade-weighted basis rose almost 7.5% against other major global currencies in the first 10 months of 2014. We expect the dollar to remain firm in 2015 as the Fed begins to normalize interest rates, but gains should be more moderate than in 2014.

One wild card in the 2015 outlook is the potential for an upswing in mergers and acquisitions.

One wild card in the 2015 outlook is the potential for an upswing in mergers and acquisitions (M&A). M&A activity has accelerated in the U.S., with acquirers taking advantage of strong balance sheets, cheap borrowing rates, and improving confidence to grow their businesses. Outside the U.S., corporations have been reluctant to pull the trigger, despite an abundance of potentially attractive deals. Even a modest improvement in business sentiment could cause global M&A activity to heat up, boosting public equity prices.

THE EARNINGS OUTLOOK

Much of the volatility seen in October was generated by changing views about the global recovery and the potential impact on central bank policies and corporate earnings growth. Our outlook for some key regions:

- **Europe:** The eurozone recovery, while shallow and sputtering, appears intact. Further easing by the ECB seems likely, and easier fiscal policies in the core countries are now a possibility as economic weakness has spread even to Germany. Earnings growth, which has lagged the U.S., seems to have stabilized, and the potential for upside surprises is now greater. Europe is home to a host of well-run companies, and opportunities await those that can continue to drive productivity gains.
- **United States:** Earnings growth has been stellar this cycle despite modest economic gains, as corporations have carefully managed labor and capital costs, resulting in record profit margins. With unemployment falling, labor costs are bound to increase in 2015, but the pace should be manageable. Moderate sales growth and good cost management could produce 5%–6% earnings growth in 2015, a modest deceleration from the 8% growth we are seeing from S&P 500 companies in 2014.
- **Japan:** The Abe government's policies are designed to stop deflation by lowering longer-term interest rates, cheapening the yen, and encouraging risk taking. But offsetting this stimulus are headwinds from a highly indebted government that continues to raise consumption taxes and an aging population, which makes growth hard to achieve. Perhaps the most encouraging upside might be the growing adoption of more shareholder-friendly policies by Japanese corporations. We also see a growing focus on productivity that could boost earnings for years to come.
- **Asia Pacific ex Japan:** The 2015 outlook will depend heavily on whether

China can manage its transition to a more consumer-driven economy without a drastic slowdown in growth. So far, growth appears to have stabilized in the 6% range, and the banking system's credit problems, while significant, appear manageable.

RELATIVE VALUATIONS

As mentioned earlier, global equity valuations in aggregate look neither unusually cheap nor excessively expensive. But the balance between U.S. and developed non-U.S. equities has shifted somewhat. Whereas a year ago U.S. large-cap stocks appeared more attractive, we now see better values in international markets. One has to be correct in forecasting future earnings growth, however.

Collectively, emerging equities still appear attractively valued compared with the U.S. market, given our relative long-term growth expectations. However, the increasing diversity of the emerging markets makes it hard to draw broad conclusions. Going forward, the relative attractiveness of emerging market companies is likely to be tied predominately to stock-specific factors, such as their exposure (positive or negative) to global commodity prices.

THE OUTLOOK FOR KEY SECTORS

A scenario of continued moderate and uneven global economic growth ultimately should benefit cyclical sectors such as industrials and consumer durables. In the U.S., worries about the stronger dollar appear to us to be fully baked into prices—perhaps excessively so—creating the potential for upside surprises. Some of our specific views:

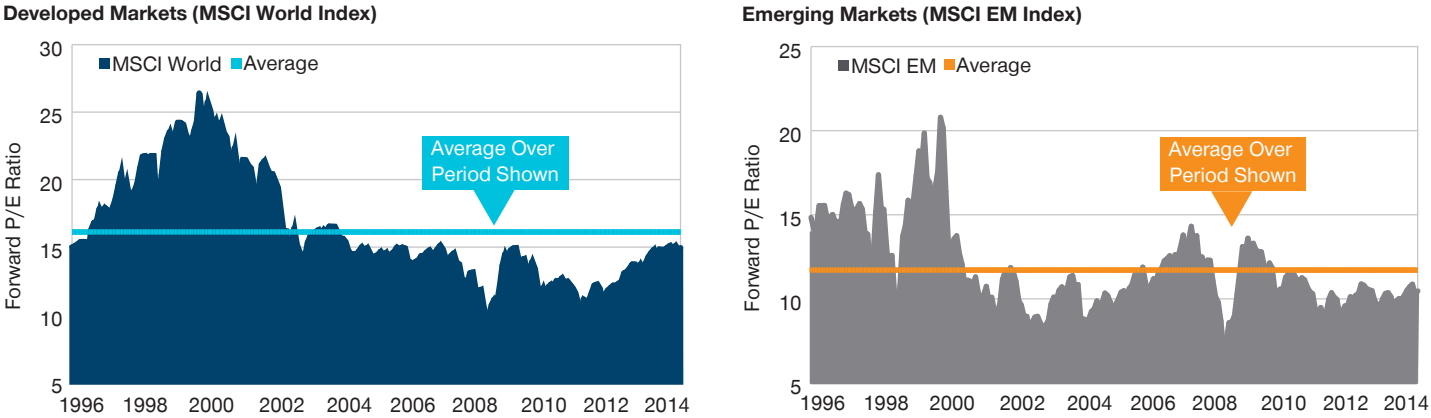
- **Energy:** Following a brutal sell-off in the second half of 2014, especially among oil drilling and service stocks, valuations appear cheap. This creates the potential for substantial rebounds for some depressed names. However, the longer-term outlook will depend on energy prices, where it is hard to be optimistic given moderating demand and the continued growth in U.S. production.
- **Financials:** Economic growth should lead to improving earnings prospects for banks and insurers, especially in the U.S. Contrary to what many believe, a gradual move toward interest rate normalization could also be positive—although shifts in monetary expectations could produce volatility. Investors should also be wary of regulatory intrusion.
- **Health Care:** The outsized market gains of the past few years and a wave of high-priced M&A deals in the biotech, med-tech, and pharmaceuticals industries make us a bit cautious. There is much vitality and discovery taking place in all parts of health care. While we think that can continue, we would be more inclined to buy health care stocks at cheaper valuations on corrections.
- **Technology:** Despite their non-U.S. earnings exposure, a number of technology stocks appear attractively valued, given our expectations for growth in mobile broadband, cloud computing, and emerging market consumer markets.

While the global equity bull market that began in 2009 is in its mature stages, continued economic growth, ample liquidity, and generally reasonable valuations appear to support modestly positive expectations for 2015.

CONCLUSIONS

While the global equity bull market that began in 2009 is in its mature stages, continued economic growth, ample liquidity, and generally reasonable valuations appear to support modestly positive expectations for 2015. However, with earnings growth likely to remain in the single digits, and with limited room for multiple expansion, investors would do well to keep their return expectations in check.

FIGURE 2: Global Equity Valuations Still Appear Reasonable
Forward P/E Ratio Through 31 Oct 2014



Sources: FactSet, Standard & Poor's, and MSCI

Global Fixed Income:
A MORE COMPLEX LANDSCAPE CREATES CHALLENGES, OPPORTUNITIES.

Arif Husain, CFA
Head of International Fixed Income

Fixed income performance has been resilient this year, defying conventional wisdom that yields would rise globally as the Federal Reserve wound down its asset purchase program. A cloudier global growth outlook, generally subdued inflation, and geopolitical unrest revived demand for bonds. In addition, a continued deluge of low-cost liquidity from the world's major central banks kept downward pressure on yields. But as we head into 2015, monetary policies are becoming less synchronized, adding complexity to the investment environment.

With the Fed's third round of QE finished, attention has turned to the prospective timing and path of rate hikes. Since the global financial crisis, market participants have enjoyed startling policy clarity. When the Fed drops its longstanding commitment to keep interest rates near zero for "a considerable time," it will mark the end of this era. Greater uncertainty should be reflected in an increase in risk premiums and higher volatility.

...as we head into 2015, monetary policies are becoming less synchronized, adding complexity to the investment environment.

The impact of tightening in the U.S. will be partially mitigated by ongoing easing actions in the eurozone and Japan. Still, it will remove liquidity from global markets on a net basis. The "taper tantrum" of 2013 demonstrated that the mere threat of a reduction has the potential to destabilize markets across the risk spectrum. As the Fed's monetary support recedes, there will still be opportunities in sovereign, credit, and currency markets, but investors will need to be more discriminating.

Global growth concerns could moderate a rise in U.S. rates in the absence of an inflationary shock or a policy misstep. The comparatively low yields of German bonds and other top-tier sovereigns will also sustain demand for Treasuries. But a higher 10-year yield seems reasonable if the U.S. economy maintains its momentum.

LOCAL RATES SHOULD RETAIN A DOMESTIC ANCHORING

Other sovereign markets will not be impervious to the knock-on effects of higher U.S. rates. However, local rates are driven primarily by domestic economic conditions and policy responses. As depicted in Figure 3, individual countries—both developed and emerging—are at much different points in their rate cycles. Investors can take advantage of this diversity with targeted duration exposures:

- In contrast with major developed markets, rates have already been climbing in certain developing countries contending with high inflation and depreciating currencies. In Brazil and South Africa, the interest rate cycle is nearing a peak. Real yields are attractive, and cuts will begin at some point to stimulate sluggish economies.
- Other countries are experiencing muted inflation, providing scope for softer monetary policy. Eastern European countries like Hungary and Romania, for example, are feeling the Continent's disinflationary trend while offering higher yields than the eurozone's periphery.
- Some local markets typically have low correlations with global rates. These stable locales, which include Israel, Malaysia, and Thailand, may fare relatively well even when rates are rising elsewhere.

CREDIT INCREASINGLY DEMANDS A BOTTOM-UP APPROACH

Despite rising somewhat in recent weeks, risk premiums in credit markets are not far from multiyear lows. Combined with low underlying rates, tight spreads at the sector level limit upside potential and increase downside risk. In this environment, extracting alpha from bottom-up security selection is a more sensible strategy than capturing market returns via broad sector exposures. Within sectors, our global research teams remain focused on identifying situations where valuations do not reflect fundamentals:

- **Investment Grade:** Further spread tightening in the high-grade corporate market will be challenging, and fundamentals appear to have peaked for many issuers. But financials remain supported by solid fundamentals as banks continue to improve capital levels, and select issues hold some potential for spread compression.

- **High Yield:** The fundamental picture remains intact, with a muted default rate expected next year. Yet discretion is warranted. In the primary market, the thirst for yield has encouraged low coupons and call structures that are unfavorable for investors. Our analysts favor certain lower-rated issuers that are working to improve balance sheets, as well as higher-rated names that look to be upgrade candidates. Bank loans are a more defensive way to play decent high yield fundamentals, with negligible duration and lower volatility than fixed rate bonds. (However, bank loans can be less liquid than high yield bonds.)
- **Emerging Markets:** Sovereign and corporate debt from the developing world continue to provide yield premiums over similarly rated developed market assets. But similar to 2014, we expect performance to remain uneven given numerous idiosyncratic stories and dissimilar growth prospects, necessitating careful analysis of countries and companies (See page 9).

GLOBAL GROWTH DIVERGENCE WILL DRIVE EXCHANGE RATES

Volatility in the foreign exchange market rose from low levels in the second half of 2014 amid concerns about global growth and a less accommodative Fed. This trend is likely to persist, creating fertile ground for alpha generation in currency markets:

- A key question is whether the U.S. dollar can maintain its recent strength. Having rallied versus nearly every global currency in 2014, widely held long positions in the dollar may be due for some consolidation. But additional appreciation is a distinct possibility if prevailing forces remain in place.
- The euro looks vulnerable despite the currency bloc's current account surplus. International flows into European assets have slowed. And if interest rate differentials between Europe and the U.S. widen, as we expect, the euro should weaken further.
- After significant depreciation, the Japanese yen has become less enticing as a short candidate. The yen has declined dramatically since the Bank of Japan embarked on large-scale QE. Yet this has provided only a modest boost to exports, while hurting consumers and small businesses. Moreover, we are mindful of the possibility of safe-haven flows into the yen if risk aversion rises.
- Some of the most interesting trades are found outside of the major currencies. Pairing less-traded currencies—the Chinese renminbi versus the Australian dollar, for instance—provides a way to isolate relative value discrepancies.
- Finally, there are compelling growth stories in smaller currency markets. The Mexican peso and Indian rupee should benefit over the long term from efforts to reform economies that have been performing below potential. A less well-known currency, the Zambian kwacha, possesses a very high yield and is supported by strong growth and improving government finances.

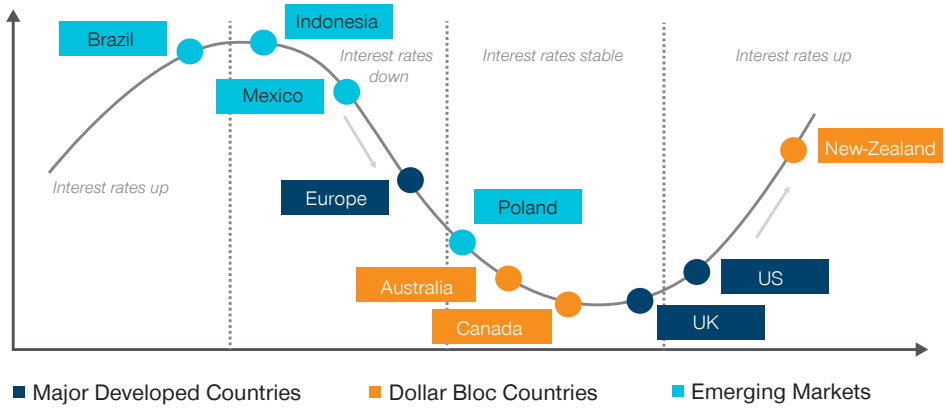
CONCLUSION

We are entering a period of greater uncertainty, as markets contend with the prospect of reduced Fed largesse at a time when global growth is fragile and geopolitical risks abound. We anticipate higher volatility in rates, spreads, and currencies, and there could be dislocations in corners of the markets where the reach for yield has led to crowded positioning. Retaining some liquidity in portfolios will be valuable for taking advantage of opportunities that arise.

Sovereign and corporate debt from the developing world continue to provide yield premiums over similarly rated developed market assets.

Because central bank actions have been supporting both "risk free" and risky assets, traditional safe havens like Treasuries may be a less effective hedge against equity and credit risk than they have been in the past. A more prudent approach is sourcing duration from sovereign markets that should be less affected if global yields rise from their current low levels. Selectivity is also needed in credit markets; research-driven, bottom-up ideas have become even more important given uninspiring valuations at the sector level.

FIGURE 3: Economies Around the World at Different Stages of the Interest Rate Cycle



Source: T. Rowe Price

Emerging Markets Equities: **GREATER DISPERSION REQUIRES INVESTORS TO BE MORE ACTIVE.**

Gonzalo Pángaro
Lead Portfolio Manager, Emerging Markets Equity

Emerging markets equities performed reasonably well in 2014, but we witnessed great dispersion within markets. Countries such as India, Indonesia, the Philippines, and Thailand outperformed, while other markets, including Russia, Greece, China, and South Korea, struggled. Investors have been far more selective, a pattern that should continue in 2015.

ECONOMIC GROWTH ADVANTAGE TO BE MAINTAINED

Emerging markets have enjoyed strong tailwinds over the past decade: Chinese GDP growth of more than 10% per annum and a bull market in commodities. However, policies in China are now focused on structural reforms with policymakers seeking lower, more sustainable growth, but of better quality. Our base case remains that China will engineer a soft landing, however.

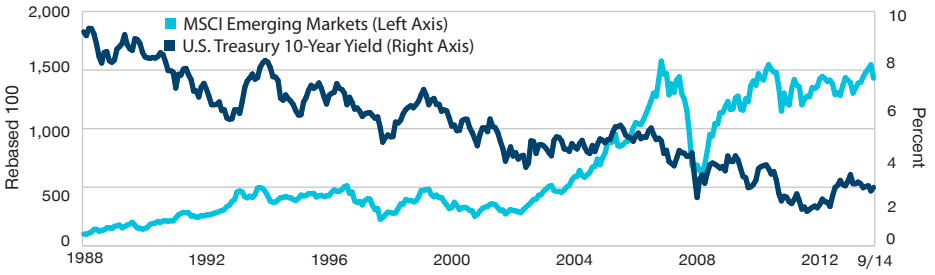
Economic growth across emerging markets will be lower but will continue at a higher rate than in the developed world. Also, because of more difficult conditions and falling commodities prices, there will be greater divergence. Those countries that push forward with reforms will do well, while countries that do not will struggle. Investors will therefore have to be more selective, with fundamental analysis becoming even more important.

Emerging markets have suffered margin pressure for the last few years. Revenues have continued to grow, but rising costs, especially unit labor costs, have negatively impacted margins. However, we believe that earnings expectations have bottomed out, and the bulk of the earnings adjustment has taken place in many countries. If anything, in some places, such as India or the Philippines, earnings are starting to accelerate again. Overall, we do not expect any major negative adjustments (excluding Russia), and going forward the outlook should continue to improve.

THE IMPACT OF RISING INTEREST RATES IN THE U.S.

Now that the U.S. Federal Reserve has ended its QE program, the actual impact on emerging markets may prove less significant than what the market expects. When U.S. interest rates do start to rise, markets may suffer a mini sell-off, but we do not expect the economic impact to be significant. (See Figure 4.) Short term, it may create some uncertainty as the hunt for yield in emerging markets may start to look less attractive. However, much will depend on why rates are hiked, and at what pace. If rates rise at a moderate pace because the U.S. economy is doing well, it would be a good sign for the global economy and should be positive for emerging markets.

FIGURE 4: **Historical Impact of Rising Interest Rates**
As of 30 Sept 2014



Source: FactSet

VALUATIONS ARE ATTRACTIVE, BUT INVESTORS WILL HAVE TO BE MORE SELECTIVE

With the end of the global commodities boom and the double-digit annual growth in China, careful stock selection will be important to long-term outperformance. Near-term risks may include a worse-than-expected slowdown in China or a breakdown in its financial system, a sharp rise in U.S. interest rates, and an unexpected bout of risk aversion due to geopolitical events.

Although valuations are not as compelling as they were a year ago, emerging markets overall are still trading at a significant discount relative to their history and continue to look attractive versus their developed market peers. However, investors will have to be much more granular in their approach. We are likely to see a much more uneven world going forward, with less correlation and more dispersion of returns.

This more complex environment should provide a good opportunity for active investors to take advantage of valuation anomalies. There are particularly interesting opportunities in Chinese Internet stocks and Indian financials.

Overall, we believe that current conditions may offer investors able to view the market with a long-term horizon an opportunity to add to the region at what may prove to be attractive levels.

Emerging Markets Debt: **HEADLINE RISKS STILL PRESENT, BUT LITTLE CHANCE OF CONTAGION.**

Michael J. Conelius, CFA
Portfolio Manager, Emerging Markets Bond and Emerging Markets Corporate Bond

Andrew J. Keirle
Portfolio Manager, Emerging Markets Local Currency Bond

Dollar-denominated emerging markets debt has been one of the top-performing fixed income asset classes. In contrast with 2013, when emerging markets lost ground in unison, this year saw significant differences in the returns of the bonds of individual countries. Russian debt, for example, sold off amid continuing worries about the economic impact of U.S. and European sanctions on the country. Indian bonds, on the other hand, generated impressive returns after the election of reform-friendly Narendra Modi as prime minister.

FUNDAMENTALS IMPROVE

The fundamental condition of most of the developing countries whose debt experienced the worst losses in 2013 steadily improved this year.

- While some individual countries still have significant current account deficits, emerging markets on average maintain a current account surplus.
- The outcomes of major elections in emerging markets over the course of 2014 were largely neutral or positive for investors, as candidates with the ambition and ability to implement reforms tended to win. The notable exception was Brazil, where presidential incumbent Dilma Rousseff defeated Aécio Neves, who investors believed was more willing to make changes to improve the country's economy. Nevertheless, there are early signs that modest reforms may come to fruition in Brazil.
- Country-specific risks, such as Argentina's default and the conflict between Russia and Ukraine, moved to the forefront in the past year, but the emerging markets debt asset class overcame these issues to post solid gains. Most developing countries now have flexible exchange rates and monetary policy, ample foreign exchange reserves, and relatively low debt burdens—all of which will help prevent contagion from headline risk.
- In addition, incremental reform and growth levels that likely bottomed out in 2014 should support a number of emerging economies going forward.

INCREASING INVESTOR DIFFERENTIATION

These trends will likely lead to an even wider dispersion of returns among emerging markets going forward. We think that the days of investors treating all emerging markets debt as one homogeneous asset class are largely over. Active portfolio managers who conduct thorough fundamental analysis of specific countries and companies are now best positioned to find the bonds and currencies that can outperform while simultaneously managing the inherent risks of investing in developing countries.

Emerging markets debt valuations are still attractive relative to other fixed income asset classes, where prices have reached very expensive levels. We anticipate that continuing demand for developed market sovereign bonds will keep their yields low and sensitivity to changes in interest rates high. Despite their gains in 2014, emerging markets bonds still present strong value compared with the alternatives and can also have the advantage of relatively low sensitivity to changes in interest rates. We have noticed that institutional investors have been moving into the asset class. This influx of buyers who are more oriented toward the longer term should lend support to emerging markets debt.

We think that Mexico, India, and Indonesia are countries that can enact—or have already embarked on—sensible reforms that will help their economies grow, likely benefiting the prices of their bonds. With that said, it is likely that the majority of the return from emerging markets bonds in 2015 will come from their relatively high coupon payments as opposed to price appreciation.

We anticipate that the trend toward dollar strength will continue in the near term, creating a potentially attractive entry point for locally denominated debt in the coming months.

We also think that some bonds denominated in local currencies represent particularly strong value, although we are very selective about currency exposure. Local currency bonds lagged emerging markets debt denominated in dollars or euros in 2014. We anticipate that the trend toward dollar strength will continue in the near term, creating a potentially attractive entry point for locally denominated debt in the coming months.

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#TRPoutlook

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