



Equity Perspectives: Global Equities – Disappointment, Volatility and Opportunity

T. ROWE PRICE
Investment *Viewpoint*

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This investment viewpoint reflects the views of Scott Berg, Portfolio Manager of our Global Large-Cap Equity Strategy.

EXECUTIVE SUMMARY

- Global equities delivered negative returns between 1999 and 2009 in both nominal and real terms. This period is now commonly referred to as “the lost decade,” and sections of the media have once again declared the “death of equities,” as they did at the end of the 1970s – the last time equities disappointed on such a large scale.
- When taken in conjunction with fears surrounding future growth and heightened equity volatility, the lost decade has damaged investor sentiment and prompted meaningful outflows from equities. Given a strong tailwind for government bonds as interest rates have fallen over the very same decade, fixed income has been a beneficiary of capital flows.
- However, following more than a decade of de-rating from the peak of the technology bubble in 2000, equities are now trading at a significant valuation discount versus historical averages and implying a gloomy outlook for corporate prospects.
- Valuation is one of the key drivers of future returns for equities and history shows that starting points matter for long-term returns. Global equities look cheap, especially when compared with government bonds.
- Despite near-term uncertainty, we believe that equities will deliver over the long term from today’s valuation start point. This point is enforced by our belief that many corporates are in good shape from a balance sheet, cost, and long-term earnings growth perspective. We believe that the market’s pessimism and focus on the near term leaves room for material upside for investors willing to take a disciplined, contrarian and long-term stance.

THE LOST DECADE FOR EQUITIES

Although recent equity market history has been defined by extremes, one of the most important trends to impact investors since the turn of the century has been a sustained period of poor returns for equities. Investors in equities during this period will be all too familiar with this backdrop, but how does the lost decade compare with historic periods of equity weakness

and what, if any, lessons can be learnt to help future decision-making.

While there are some limitations to comparing long-term data on a like-for-like basis, history suggests that the lost decade rivals almost any period in the past century in terms of the magnitude of disappointment, if not duration, for investors. Figure 1 shows the pattern of

annualized rolling 10-year returns for U.S. equities (where we have the longest data set available) and highlights just how rare lost decades have been.

Over the past century, U.S. equities have only delivered negative real returns in periods encapsulating World War I, the Great Depression of the 1930s, the 1970s when the so-called “misery index” (inflation and unemployment) hit its high point of the 20th century; and, most recently, the period spanning the collapse of the technology bubble and the global financial crisis. Being even more specific, the 10-year period ending 31 December 2008 ranks as the single worst period over 110 years on a per annum real return basis for U.S. equities at -4.1% p.a. The calendar decade concluding at the end of 2009 (which includes part of the rally post the global financial crisis) led to a return of -2.7% p.a., the sixth-worst period on record.

Figure 2 focuses on the calendar decade ended 31 December 2009 and explicitly shows nominal returns for global developed and emerging market equities. Even without adjusting for the impact of inflation, the promise of superior returns for developed world global equity investors failed to materialize in spectacular fashion. We will comment on the contrasting fortunes of emerging market equity returns later in this report.

Figure 1: Annualized Real Return of S&P 500
(Rolling 10 Years, 1900-2012)

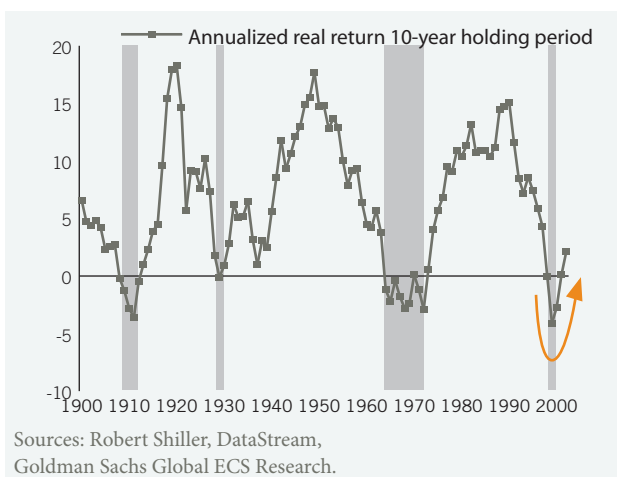
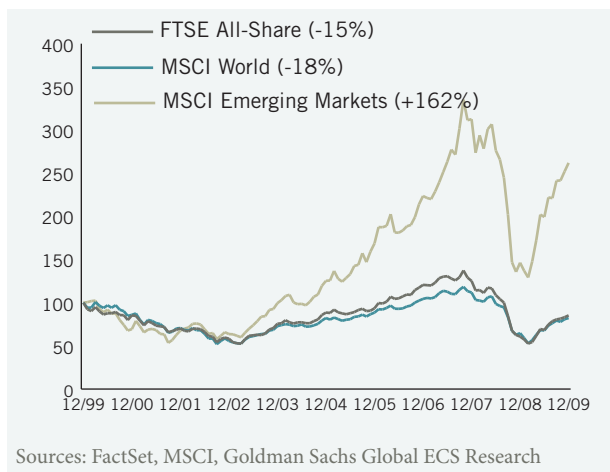


Figure 2: The Lost Decade
(January 2000 – December 2009)



The Roots of the Lost Decade

The roots of disappointment felt by equity investors can be traced back to the collapse of the technology bubble in 2000. As dynamic technological change occurred alongside a buoyant global economy and rapid credit and wealth expansion, optimism abounded and equity valuations rose aggressively. However, both the global economy and corporate earnings were about to enter a period of exceptional volatility over the next 10 years. This confluence of events led to the decade of disappointment for developed world global equity investors.

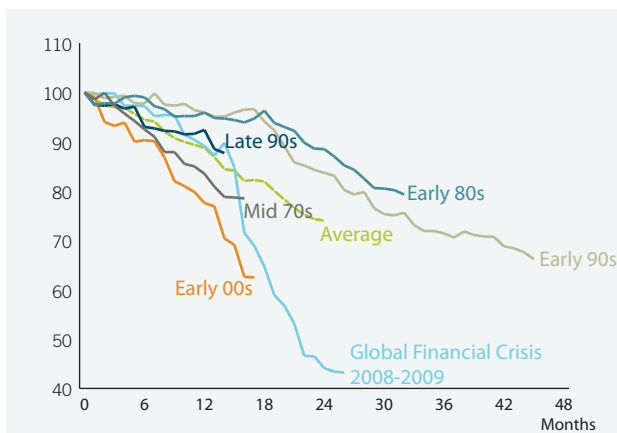
Of course there have been many bear markets over the past century, but few have been as deep or prolonged. The obvious questions are why have returns been so poor over such a long period of returns of time and, even more importantly, is the trend likely to continue in the future?

We highlight below several factors that we believe have contributed to this unusually poor period of returns for equities:

- The overvaluation of equities at the outset of the decade as investor sentiment exceeded company fundamentals
- Below-par earnings growth, with the decade encompassing the two largest earnings recessions of the past 40 years (Figure 3)

- The subsequent downgrading of forward-looking growth expectations following the global financial crisis, which has reduced the premium that investors have been willing to pay for long duration “growth” assets
- Deteriorating investor sentiment and the subsequent outflows from equities/search for safety, in a heightened volatility world

Figure 3: Earnings Recessions Since 1970 (previous peak = 100)



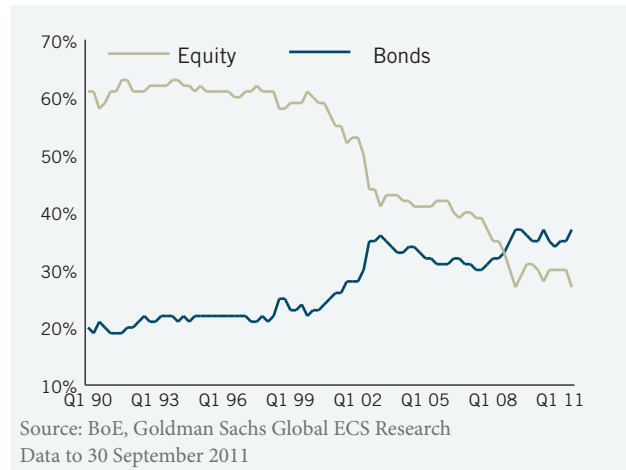
Sources: MSCI, CIRA

Periods: Mid 70s: September 1974 – January 1976; Early 80s: September 1980 – May 1983; Early 90s: August 1989 – June 1993; Late 90s: April 1998 – June 1999; Early 00s: February 2000 – July 2001; Global Financial Crisis: November 2007 – present

De-Equitisation and the Rise of Fixed Income

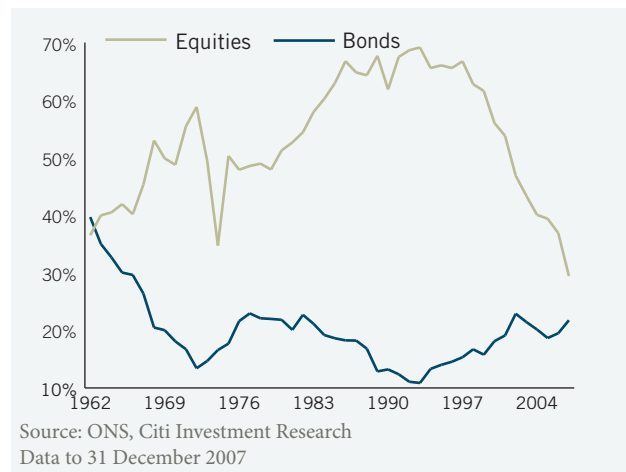
As this most recent lost decade has played out, we have seen large outflows of capital from equity markets around the world. Alongside the well-publicized loss of retail monies from equities following the global financial crisis, countries with equity-based pension fund systems have undergone large shifts in their equity allocations. In the UK, aggregate pension and insurance company exposure to equities has roughly halved from over 60% through much of the 1990s to under 30% at the end of 2011 as the pension fund system has evolved (including the closure of many defined benefit schemes) and as investor preferences have changed (Figure 4). A pattern of similar magnitude and direction has evolved in the U.S. (Figure 5) with the average equity exposure lower than at any point in the past 50 years. A combination of prolonged weakness in stock market performance and structural shifts in investing has led to a large and broad-based trend of capital outflow from equities, which has weighed on returns.

Figure 4: UK Pension Funds and Insurance Companies Asset Allocation (%)



Source: BoE, Goldman Sachs Global ECS Research
Data to 30 September 2011

Figure 5: U.S. Pension Asset Weights (%)



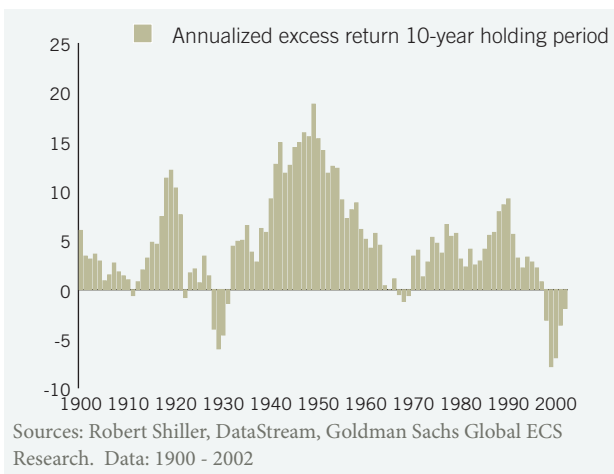
Source: ONS, Citi Investment Research
Data to 31 December 2007

While equity investors have felt the pain of this exceptionally disappointing period, government bond investors have conversely experienced an exceptional tailwind providing strong positive returns. In many areas of the world, interest rates have fallen to multiple decade lows causing government bonds to rise dramatically (given that bond prices and interest rates are negatively correlated). Many domestic bond markets have therefore generated record returns relative to equities in many countries, or vice versa, equities have underperformed bonds by the widest margin on record (see Figure 6 for U.S. market history).

Usually, such a dramatic trend would lead to calls for aggressive rebalancing away from bonds towards underperforming assets classes such as equities. One

data point that would support such action is the spread between bond yields and earnings yields which sits at its widest margin since investor sentiment reached the capitulation point in 1979. This certainly implies that relative valuations between equities and bonds are indeed stretched. However, sentiment is firmly in the camp that “this time is different” given the risks facing the global economy, while the demand for liquid and risk-free assets has been elevated by structural and regulatory change. These factors have thus far prevented a reversal of capital flowing back to equities in any magnitude.

Figure 6: Annualized excess return of S&P 500 (%)



The Importance of Valuation for Future Returns

One positive consequence of such poor sentiment towards equities is the implication for valuations. Many investors focus their attention on catalysts for impending improvement in economic fundamentals when estimating returns and perhaps naturally, the disappointment and negative surprises of the past 10 years appear to have increased this focus on the near term. Economic growth and the impact on global profits growth are certainly important drivers of stock returns, but it is important to note the role of valuation in determining returns to shareholders over the long term.

Expanding on our first driver of the lost decade, equity markets reached peak valuations in 2000 and markets have de-rated consistently since then, reaching a trough in Q1 2009. Equity returns in the decade subsequent to the peak of overvaluation in 2000 (or indeed in the three years following the depths of market levels in early 2009) have

demonstrated that analyzing valuations regardless of market sentiment is a central facet in determining equity returns.

Research shows that high correlation exists between starting valuations upon purchase and 10-year returns (see Figure 7). The implication is that an expensive entry point to markets is a likely headwind to future returns, and inexpensive markets are a good entry point when considering long-term return potential. The challenge from an investor perspective is that cheap valuations tend to coincide with controversy and negative sentiment, while expensive valuations often occur at times of consensus and bullish expectations. Separating stock fundamentals from market sentiment is naturally a difficult discipline, but even more so when markets are at extremes. Even so, decisions to add or reduce exposure to stocks at these extremes matter most from an empirical perspective.

The adjustment to today’s modest valuation levels from peaks in 2000 has been a painful process for equity investors. Encouragingly, valuations are now below long-term medians (Figure 8), with expectations for future growth modest at very best. We are therefore more optimistic that equities will provide positive long term gains from this attractive valuation starting point over the long-term, particularly if and when the global economy does show signs of improvement.

Figure 7: Global Equity Market Correlations

(1987 through 2011)

10-Year Return vs:	Starting Valuation (P/E)	Earnings Per Share (CAGR)
Developed Markets	-0.92	-0.15
Emerging Markets	-0.53	0.89
Global Markets	-0.67	0.67

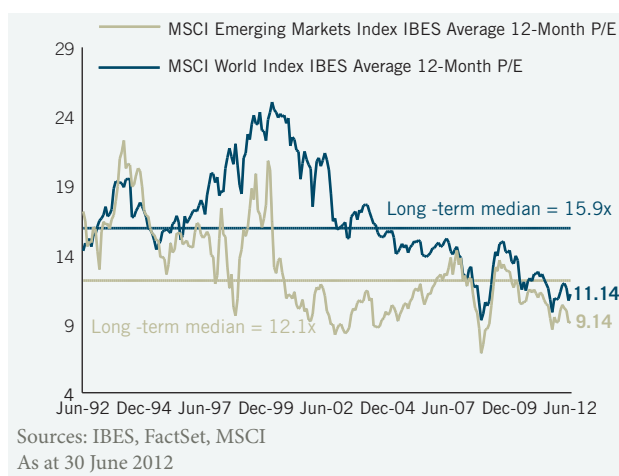
Sources: FactSet, MSCI, Goldman Sachs Global ECS Research

Emerging Markets and the Lost Decade

Although the unique growth dynamics occurring within emerging markets during the lost decade are important to recognize, the strength of emerging market equity returns during this period is also testament to the importance of valuation for long-term returns.

Following the Asia crisis in 1998 and the collapse of corporate profits in the wake of the technology bubble, emerging market equities experienced an exceptionally weak period of performance, and consequently, valuations fell to what was then an historic low (Figure 8).

Figure 8: Price/Earning Ratio (x)



However, as sentiment and expectations troughed, an entry point for long-term investors was established that has since proved to be extremely profitable (see Figure 2 for emerging market returns during the lost decade). Albeit improvement of economic fundamentals was the catalyst for stock prices to accelerate, **one lesson from the decade is that investing when equities are inexpensive and sentiment is poor often defines the magnitude of return over the long term.** Given that markets are at their least expensive before the recovery phase, this requires a contrarian spirit and the willingness to stay invested and engaged in an asset class during the most challenging times and a focus on the long term.

PLAYING THE CONTRARIAN CARD

Forecasting stock returns during periods of uncertainty carries several caveats: fundamental corporate risks are always apparent and earnings growth is often slowing or unpredictable near term. From our bottom-up perspective, this reinforces our focus on longer-term fundamental analysis. In particular, the grounding principles of fundamental investing, including durability and stability of a business model, balance sheet strength, and earnings growth potential, are all considered against today's valuation.

As well as such an approach being intuitive, history shows that thoughtful, contrarian investing and the identification of durable businesses at times of uncertainty are key contributors to superior returns. In part, this is due to the tendency of the market to sell first and consider individual stock characteristics second, evidenced in recent years as stock correlations have reached multi-decade peaks. Outside of the market-level opportunity when panic dominates, this often gives prudent stock pickers attractive entry points for durable and growing businesses.

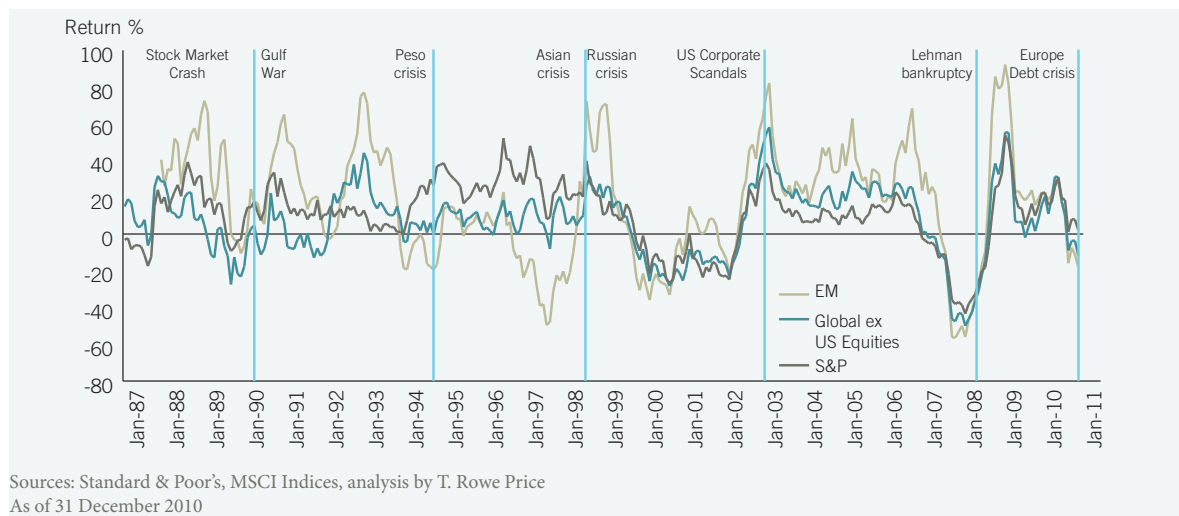
However, this requires us to follow a discipline of buying companies when valuations are attractive (and sentiment is poor) and selling when valuations are expensive (and sentiment is strong). **This can lead to the addition of stocks and volatile areas of the market when it feels counter-intuitive, but history shows the benefits of maintaining a disciplined approach during times of market stress and fear.** Figure 9 shows one perspective on this principle. The y-axis shows returns in the one year following points of crisis over the past 25 years, and the reversion of markets after dramatic "market events" is clear.

MARKETS TODAY – VOLATILITY AND OPPORTUNITY

Moving on from the past, our current view of global equity markets is summarized as follows:

- The fiscal crisis facing the developed world is rooted in the 2008 financial crisis and will remain a source of elevated market volatility
- We expect anemic growth in developed markets and moderating but durable growth in emerging markets
- Global earnings are growing at a reasonable level given the economic environment, but the durability of profit margins is being questioned
- The starting point for equity markets is better than it was in 2008 – corporations have improved balance sheet strength
- Equity valuations remain attractive and valuation matters when considering future returns from equity markets

Figure 9: One-Year Forward Equity Returns



Economic Problems Persist, Growth Remains Muted

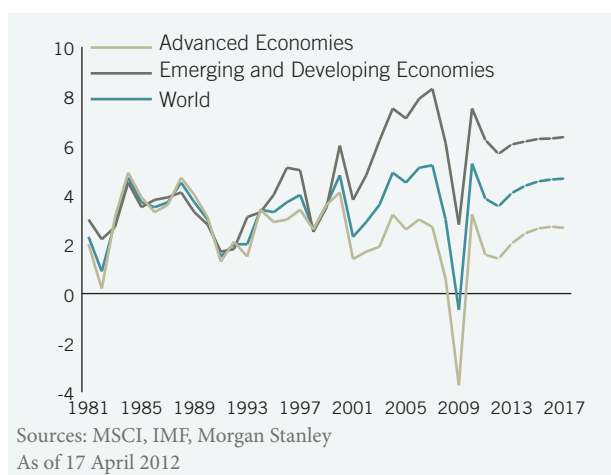
Addressing the problems at the macroeconomic level up front, we recognize the serious issues facing global equity markets and anticipate both elevated volatility as well as ongoing bouts of risk aversion in the near term. Sub-par economic growth, sovereign debt burdens and the interaction effect between the two as governments cut spending and stunt growth, are well documented. High levels of unemployment and the impact on aggregate demand will remain an issue together with today's uneasy reliance on political decision makers to think long term in their policy making. On the growth front, Figure 10 shows that at +1.4% (as at 17 April 2012), developed world GDP growth is muted and is likely to remain so in the near term given the focus on deleveraging by many developed world governments. We would note that the aggregate figure disguises shifts in profit pools within industries and between companies, however, in what is a dynamic a world as ever.

It should also be noted that although the outlook is uncertain, on a global basis including emerging markets, growth is trending slightly above the 30-year average at 3.5% (as at 17 April 2012). This is due to the contribution by the emerging world to total global GDP, which will reach 38% in 2012, up from 20% in 2002. Many areas of the emerging world that were deemed almost uninvestable 10 years ago now constitute some of the most robust growth stories within this figure. Following on from the volatility of the 1990s, South-East Asia and many parts of Latin America have made enormous strides forward from

a debt stability perspective in particular. This process of deleveraging and rebuilding is clearly now the central focus in parts of the developed world.

In aggregate, emerging markets as a whole are likely to constitute over 70% of total global GDP growth in 2012 which is cushioning the globe from the issues occurring in the developed world to some degree. However, emerging nations are certainly not immune to the weakening global demand environment that we find ourselves in today and growth is slowing from peak levels.

Figure 10: Real GDP Growth (Annual % Change)
Actual data 1981 through 2011, IMF forecasts 2012 through 2016



Corporate Fundamentals Remain Attractive

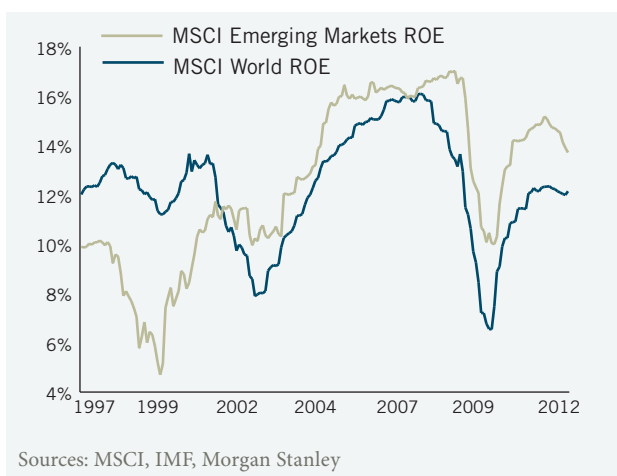
Despite the low growth outlook, when we consider company fundamentals we believe there is cause for optimism

over both the medium and long term. Importantly, we believe that given the pessimism surrounding the global economy and global equity markets, these positive aspects are unappreciated and undervalued. This is a key point when thinking about long-term returns as we have discussed.

This cautiously optimistic outlook is primarily based on our view of bottom-up stock fundamentals and the discount that many stocks are currently trading at, versus our own expectation for medium-term earnings growth. Over the past 12 months, we have seen a deceleration of global earnings growth, which is not surprising at this stage of a cycle, but it has naturally been a source of volatility for stocks. As downgrades have gathered pace, skeptics have pointed towards the risk of another earnings recession to rival the 2008-2009 collapse, but we remain confident that we can identify companies with not only earnings growth potential, but with this scarce growth attached to balance sheet strength and a discounted valuation.

In contrast, many argue that the recovery in return on equity (ROE) levels since 2008 (Figure 11) is coming to an end given a belief that profit margins are at historic highs and cannot be maintained irrespective of changes to companies' cost structure over the past decade. Albeit the outlook will be more dispersed on a company-by-company basis in an unequal and growth challenged world, we continue to find companies with both improving and sustainable margins in both the developed and emerging world.

Figure 11: Return on Equity
(31 Jan 1997 through 30 Jun 2012)



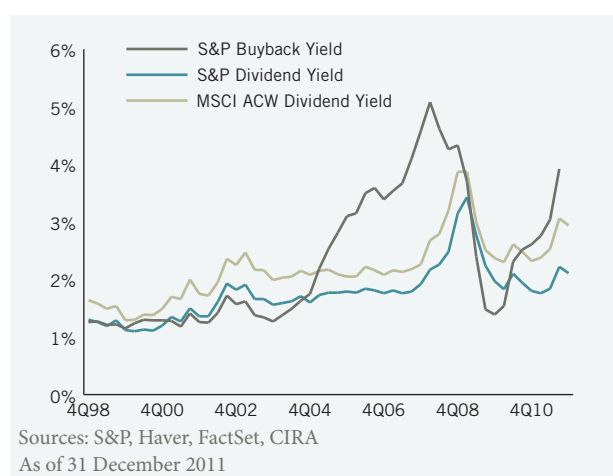
We also view the positive change in balance sheets across the globe as an important future driver of returns from global equities. Following three years of deleveraging by the corporate sector, balance sheets are cash-rich and levels of debt to equity have fallen to decade lows (Figure 12). This is in marked contrast to 2008 when many companies were caught off-guard by the credit crisis and subsequently faced serious default risks as credit markets ceased to function, shutting down the availability to much needed re-financing.

Figure 12: MSCI All Country Index – Total Debt as % of Total Equity



In contrast, balance sheet strength today is acting as a source of ongoing return for shareholders via dividends and share buybacks and will provide a buffer for companies during any challenging periods ahead (Figure 13).

Figure 13: Dividend and Buyback Yields



This trend is a clear positive if free cash flow levels allow a continuation of this source of return. With current yields of over 5% (2% from dividends and 3% from share buy-backs) U.S. equities compare very favorably with 10-year bonds yielding below 2%. This pattern of dividend yields rising above long bond yields is consistent across most developed world countries and as per the widening of the gap between earnings yields and bond yields mentioned earlier, this has historically been indicative of impending equity market strength. The likelihood of a prolonged low interest rate environment may indeed have changed the relationship between dividend yields and bond yields, but this is yet to be determined. Our belief remains that strong balance sheets are a good starting point for attractive prospective returns and as a minimum, protection in times of economic hardship.

STRONG FOCUS NEEDED IN THIS TRANSITIONING WORLD

Periods of volatility and dynamic change are invariably difficult for investors given the challenges of making decisions among the extremes of sentiment. We believe that a strong philosophy and consistent process is crucial during times of uncertainty. Through experience and the lessons of the past, we will continue to apply the following principles in our search for companies with long term growth potential, given a belief that these principles improve the chances of success in global equity investing:

1) Stay engaged with global equities, especially in times of disappointment

The scars left by two 50%+ falls in equity markets in the space of a decade and the prospect of anemic growth within the developed world economy have naturally caused some investors to distance themselves from global equities. As much as this is understandable, such periods of disillusionment and apathy are often indicative of an opportunity being created through falling valuations.

At a market level, we recognize the risks and overhangs on global equities and believe that volatility and negative surprises will be a feature of investing for some time to come. However, we are confident that for those able to take a medium- to long-term focus, equities offer meaningful upside from today's valuation start point and history suggests that a contrarian approach during times of uncertainty is beneficial to success long term. Posi-

tion sizing is an important mechanism in investing and we believe in both the principle of adding exposure when markets are weak as well as maintaining exposure to stocks we wish to hold long term, to ensure that opportunities are not missed.

At the stock level, we continue to see a broad range of opportunities in growing, well-run, and profitable companies, with the added advantage of attractive valuations attached. We have consistently used times of fear and panic to add to some of the highest conviction ideas we can find across the globe in developed and emerging markets and believe that through constant engagement with companies during times of uncertainty, we are well placed to make these decisions when markets retrench into risk aversion.

2) Maintain discipline, diversify and be respectful of the unknown

As markets have increasingly been driven by top-down events and a pattern of risk-on/risk-off sentiment, correlations have risen, theoretically dampening the benefits of diversification and causing some to question the opportunity for stock pickers in a new top-down world.

A narrow and short-term momentum-driven market environment clearly presents many investors with a challenge, but we do not believe that the principles of bottom-up investing or the benefits of diversification have been altered by recent market conditions. As with any trend of material strength, extreme correlations and narrow momentum markets create opportunity for unloved and overlooked stocks that fall out of favor. We remain respectful of the many unknowns in today's world however and believe that diversification is both a prudent and effective tool to help navigate markets. Used effectively, diversification can increase conviction and enable what we believe clients ask their asset managers to deliver – a high-conviction portfolio with thoughtful use of risk to generate meaningful outperformance.

3) Focus on the long term, that's where inefficiencies are most likely to occur

Given that uncertainty and pessimism dominates markets today, our primary focus remains on identifying companies with unique and enduring long-term growth characteristics. Such businesses are rarely acquired at discount valuations, but times of skepticism about global

growth often present an ideal opportunity to acquire such companies. We believe that whether analyzing the market in aggregate or on an individual stock basis, periods of stress in the market tend to focus investors on near term data points. By remaining focused on the long term, we believe that we stand ourselves in good stead to profit from such periods.

Whether investors can profit from long-term opportunities while navigating near term risks will depend heavily on the research capabilities and expertise they are able to bring to bear on their buy and sell decisions. The ability to formulate and compare investment ideas across regions, and integrate those insights into a global perspective, will be crucial to investment success.

CONCLUSIONS

We continue to believe that equity markets will move higher over the medium term. Corporate fundamentals have held surprisingly firm in among deteriorating sentiment while balance sheets are strong. Importantly, equity valuations remain attractive and valuation matters when considering future returns from equity markets. The long-term growth outlook remains strong in emerging markets, as they are buoyed by minimal debt burdens, healthy employment levels, rising wages, and growing consumer demand. **Moreover, the recent pullbacks in emerging market equities have made valuations considerably attractive.**

However, the encouraging long-term view remains hampered by near-term uncertainty. Unrest in the Middle East and North Africa, sovereign debt problems in the eurozone, political stalemate in the U.S., and deceleration of GDP and earnings growth are likely to cause further market volatility. Given this mixed environment, we remain leveraged to the relative certainty that exists in longer-term growth trends, while actively navigating through the inevitable surprises along the way.

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