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## T. Rowe Price Investment Professionals Cautiously Optimistic About Crisis Outlook.

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Some signs are beginning to emerge that the credit crisis that has thrown the global financial system into turmoil may be easing. A tentative stability appears to have returned to the short-term money markets, following repeated liquidity injections by the world's major central banks and public recapitalizations of troubled U.S. and European financial institutions. Interbank lending rates have declined, and credit default swap spreads for a number of major banks have narrowed sharply.

However, spreading signs of economic weakness continue to pressure both the developed and the emerging equity markets – with the latter also suffering from capital outflows and widening spreads on emerging market debt.

With world markets seemingly at a critical crossroads, T. Rowe Price's Steven Norwitz, recently interviewed a number of the firm's portfolio managers and other senior investment specialists, to learn their views on the credit crisis and the outlook for the U.S. and global markets.

These discussions revealed a cautious optimism that significant opportunities are emerging for long-term investors, although the near-term direction of the markets and the global economy remain uncertain. T. Rowe Price investment professionals noted the historically attractive valuations now seen in a number of equity and fixed-income sectors. However, for the most part they advised against making major changes in investment strategies – particularly in fixed-income portfolios -- until the extent of the economic damage done by the crisis becomes clearer.

The following is a summary of the key points made during the interviews:

### Financial Rescue Efforts

The U.S. Federal Reserve's recent announcement that it will establish a facility for enhancing the liquidity of commercial paper, combined with the FDIC's blanket guarantee of the deposits and senior debts of U.S. depository institutions (including commercial paper and interbank borrowing), should set the stage for the normalization of short-term money markets, predicts Alan Levenson, T. Rowe Price's chief economist. Stability has also been underpinned by the U.S. Treasury Department's plan to inject up to $250 billion in Tier I capital to U.S. banks, savings and loan institutions and their holding companies. Half of that amount has already been earmarked for nine large but relatively healthy U.S. financial institutions, in hopes that their acceptance will encourage other banks to participate in the program.

Proponents of the plan contend that by injecting capital directly into banks, the Treasury Department can stimulate lending and more effectively support the write down of bad loans than it can by buying troubled asserts directly. T. Rowe Price analysts, however, argue that the direct purchase – and timely restructuring – of impaired assets remains critical to restoring liquidity to the mortgage market and putting a floor under the downward trend in home prices. The recapitalization program, however, will absorb more than a third of the funds appropriated by the U.S. Congress for the rescue effort. "It's not clear how that will pan out," warns Mary Miller, T. Rowe Price's Director of Fixed Income.

The coordinated rate cut on October 8 by six central banks, including the Fed, the Bank of England and the European Central Bank (ECB), and a coincident rate cut by the People's Bank of China, has also had a positive effect on the markets – especially in light of the ECB's previous reluctance to shift to an accommodative policy. Rapidly improving inflation fundamentals – such as the dramatic decline in crude oil prices seen since late summer – should provide leeway for further central bank actions. However, with the key short-term federal funds rate now down to 1.5%, additional easing steps in the U.S. are likely to be reflected more in an expansion of the Fed's balance sheet than in further rate cuts, Levenson says.

**Short-Term Credit Markets**

After an initial period of skepticism, global money markets have begun to react more positively to government and central bank rescue efforts. Short-term lending rates have declined since the FDIC deposit insurance expansion was announced October 13, with the three-month dollar London Interbank Offered Rate (LIBOR) falling from 4.75% on October 9 to 3.83% on October 21. Measures of default risk, such as the difference between Treasury bill yields and yields of Eurodollar deposits of equivalent maturity (the so-called TED spread) have also narrowed.

However, similar improvements in money market conditions were observed after previous critical episodes, such as the March failure of Bear Stearns, only to give way to further instability as economic conditions and credit quality continued to deteriorate. "We're cautiously optimistic, but we've seen too much backsliding after previous steps to be wildly bullish," Miller says.

**The U.S. and Global Economies**

A global depression may not be on the horizon, but the short-term economic outlook remains poor. Levenson estimates U.S. Gross Domestic Product fell at a 1.1% annual rate in the third quarter, and projects a 2% rate of decline in the fourth quarter. Contractions in consumer spending, inventory investment and business capital spending are the primary culprits.

While lower energy prices will provide some relief to consumers, job losses and decelerating income gains are likely to keep personal spending under pressure, Levenson predicts. Levenson currently foresees the U.S. recession extending into the first quarter of next year, with a gradual recovery beginning in second half 2009.

With other major developed economies either in recession or at serious risk of it, a key question is whether the emerging markets will avoid the same fate. Bill Stromberg, T. Rowe Price's Director of Global Equities, says he expects economic growth to continue in emerging markets, but at a slower pace. "I think the downshift is going to be abrupt enough that it will feel like a recession in those countries."

Mike Conelius, lead portfolio manager of the T. Rowe Price Emerging Markets Bond Fund, offered a more positive perspective, noting that the major developing economies are in relatively strong financial positions compared to the emerging markets financial crisis of the late 1990s. Many of these countries have accumulated huge foreign currency reserves, which their central banks are tapping to add liquidity to local markets and replace lines of credit being withdrawn by the major money center banks. This should cushion the economic damage – at least for now. "The question is how quickly they are going to burn through those reserves now that commodity prices are falling," Conelius adds.

**Fixed Income Markets**

With money market conditions on the mend, at least for the moment, the flight to quality that pushed U.S. Treasury yields sharply lower – particularly at the front end of the yield curve -- has started to unwind. Dan Shackelford, lead portfolio manager of the T. Rowe Price New Income Fund, suggests the immediate beneficiaries of this reversal could be the investment-grade sectors of the market. "There are some very high-quality investments outside of the Treasury space that are offering very attractive yields at the moment," he says.

While investment-grade corporate credits have held up relatively well, the sector has not been immune to crisis, which has widened spreads even in relatively insulated industries such as utilities. This has created valuation opportunities that could prove rewarding over a one- or two-year timeframe, Shackelford says.

Federal aid for banks and other financial institutions has also enhanced the appeal of debt and mortgages issued by the two big U.S. mortgage agencies, Fannie Mae and Freddie Mac. Yields fell sharply after the pair were taken under federal control in early September, but that trend has now reversed somewhat, says Shackelford. This, too, is creating potential opportunities for investors seeking high-quality alternatives to Treasuries.

T. Rowe Price professionals offered a somewhat mixed assessment of conditions in the high-yield corporate market. Miller suggested that the selloff seen in the high-yield market since early September has effectively priced in a "worse case" scenario for defaults. "It seems investors are being much better compensated for accepting risk than at any time we can remember in recent history," Miller says.

Mark Vaselkiv, lead portfolio manager of the T. Rowe Price High Yield Fund, was somewhat less optimistic, noting that the high-yield market – among others – remains under heavy pressure due to forced selling by hedge funds and other funds seeking to meet redemption demands – at a time when fundamental-minded investors are keenly aware that the U.S. economy is entering a potentially deep recession. "Massive outflows, coupled with scant demand for the securities being sold, has translated into the worst six-week period in the history of the high-yield market," Vaselkiv notes.

Poor demand and sky-high yields could create a vicious circle for some corporate borrowers, many of whom will need to refinance their existing debt over the next three years, Vaselkiv warns. In previous downturns, he says, "we've found that refinancing challenges often precipitate restructurings and bankruptcies more so than the actual recession itself."

Refinancing is a key concern in emerging debt markets as well, adds Conelius. While most major sovereign borrowers appear solid – thanks to their huge foreign currency reserves -- recent years have seen a surge in corporate debt issuance. Many of these credits are now trading at yields of 20% or even 30%. "Some of these are very attractive, very solid companies," Conelius says. "But their ability to roll over debt through a two or even three-year global recession is still a worry."

As that last comment indicates, the timing of any recovery in the fixed-income markets remains highly uncertain. In the high-yield sector, much will depend on the severity and depth of the recession – and any refinancing problems it may cause. "If there is an anticipation that 2010 is largely going to be improving, the high yield market could stabilize and perhaps even generate good performance in 2009." Vaselkiv says. "But if 2010 is going to be as bad as 2009, we are going to be struggling for quite some time."

For Treasuries and investment-grade corporates, on the other hand, economic recovery carries its own risks, as renewed growth – and revived inflation expectations – could pull money out of fixed income and into equities. "We need to stay somewhat liquid," Shackelford says, "because the reality is that there is a massive rebalancing on the horizon."

**U.S. Equity Markets**

Global equity markets are discounting a global recession that will be deeper and possibly longer than the post-World War II average, according to Stromberg. Markets are also under pressure from forced selling from hedge funds and other portfolio managers facing large redemptions, a situation which could extend until the end of the year. As a result, prices may well "overshoot" fundamental values in coming months, Stromberg says.

In the U.S., recent price levels indicate investors anticipate a 40% decline in S&P 500 earnings, peak to trough. Stromberg's forecast is slightly more optimistic, and foresees an earnings decline of 30-40%, with the trough reached in the second half of 2009. Even taking this downturn into account, however, U.S.

equities still appear attractively valued based on metrics such as sales and cash flow. Measures of short-term investor sentiment, Stromberg adds, are at “multigenerational lows” – traditionally a bullish sign.

Overall, U.S. equity market valuations are comparable to the levels last seen at the bottoms of the 1974 and 1982 bear markets, notes Larry Puglia, lead portfolio manager of T. Rowe Price’s U.S. Large-Cap Core Growth Strategy. But, the fact that equity valuations are low doesn’t mean they can’t go lower, cautions Larry Puglia, lead portfolio manager of the T. Rowe Price Blue Chip Growth Fund. A key support for the last U.S. bull market, he notes, was the strength of non-U.S. economies, which helped boost earnings for many U.S. large-cap growth stocks. “To the extent that is no longer operative, it will present problems, I think, for many multinationals,” Puglia says.

At the same time, however, some US companies are still producing strong earnings growth and using their financial strength to good advantage in this environment, Puglia adds. Ultimately, he says, it is important to differentiate between industries and companies. His current favorites include:

- Health Care. “If we’re on the cusp of a pretty meaningful and prolonged slowdown, I think health-care earnings will hold up better,” he explains.

- Technology. Puglia says he is leaning towards several well-known computer and Internet giants that have “tremendous financial resources, very little debt and a lot of cash on the balance sheets.”

- Financials. With central banks worldwide cutting rates, and the worst of the crisis damage discounted into prices, Puglia thinks it is time to do some preliminary bottom fishing. “I think people are going to look back two years from now and say there was a good opportunity in financial stocks.”

Preston Athey, lead portfolio manager of the T. Rowe Price U.S. Small-Cap Value Fund, offered a more cautious outlook for U.S. small-cap stocks. He notes that while the sector outperformed the large-cap universe in the early stages of the credit crisis, this relative performance trend sharply reversed in October, as investors began to discount the expected impact of a deep recession on small-cap earnings.

Given that past bear markets typically have produced greater multiple compression for small stocks, small-cap investors have good reason to be wary, Athey says. “As a manager, I’m finding lots of interesting companies to buy, at valuations we haven’t seen for a decade or more. But from an asset-allocation perspective . . . I think large companies are still somewhat more attractive than small, given the risks.”

**International Equities**

With the other major developed economies lagging somewhat behind the United States in the global economic downturn, the balance of 2008 and the first half of 2009 may bring considerable earnings disappointments for international equities, warns Bob Smith, lead portfolio manager of the T. Rowe Price International Stock Fund. On the other hand, he adds, recent price declines, particularly in the European and emerging markets, have discounted much of the bad news – and perhaps then some.

Strong earnings growth in the first half of this year in many non-U.S. markets will make for tough year-over-year comparisons next year, Smith explains. “Expectations basically have gone from good to horrible.” However -- to cite one example -- European equities would need to suffer a 40% or even 50% drop in earnings to be considered overvalued at current multiples. “That would be a pretty draconian move,” Smith notes.
Japanese equities, by contrast, have bifurcated, Smith says. While the major Japanese exporters are “as cheap as they have ever been” (reflecting the deteriorating outlook for key global markets) domestic-oriented stocks remain relatively expensive. “Japanese domestic companies are probably the one place in the world where valuations have held together,” Smith says. He attributes this largely to Japanese investors seeking refuge in their home market.

Smith is relatively positive about emerging equities, particularly consumer stocks. While emerging economies will be impacted by the global slowdown, he expects them to continue to outperform in relative terms – barring more serious credit disruptions. Slumping commodity prices and falling export demand should be offset, at least in part, by declining inflation pressures. “Growth will slow, and some [emerging] companies will miss their numbers,” Smith says. “But at this point we would still say current valuations are very attractive.”

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