RBC Global Asset Management

FALL 2021

Executive summary

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The economic rebound from last year's deep recession is now behind us and some of the extreme dislocations that resulted from the pandemic are moderating. While the economy is slowing, growth remains robust and consumers are well positioned to support the expansion. Bond yields remain unsustainably low and we continue to prefer equities as surging corporate profits have pushed the bull market to new highs.

Growth downshifts as expansion progresses

The rapid spread of the delta variant is causing a rise in coronavirus infections throughout the world and challenging economies. Growth is moderating, though we should recognize that the economy was bound to slow following 16 months of extraordinary activity during which much of the slack made available from last year's recession was absorbed. We have dialed down our growth forecasts for 2022 and are now slightly below the consensus, mostly because the consensus outlook implies an optimistic outcome with no room for error. Even with our slightly less cheerful view, the pace at which the economy is expected to expand is still quite good and countries that suffered deeper recessions have the potential for even stronger growth. We forecast real GDP growth in many developed countries at nearly 4%, which is at least double the pre-pandemic norm.

Virus and other risks

The virus remains a key risk to the economy, especially with the delta variant being twice as contagious as its original form and perhaps more resistant to vaccines. As a result, more stringent measures would be needed to contain the spread even as tolerance for further lockdowns has diminished. Most governments are now turning to vaccine mandates and vaccine passports rather than forcing the lockdowns that were successful in curbing past virus waves. While it's not yet clear how effective these new measures will be at curtailing infections, they should be less harmful to the economy.

Another critical risk for the economy is the eventual shift in policy now that the economy has revived. Tremendous fiscal and monetary stimulus was delivered during the pandemic but the need for this support is less obvious and a reversal would be a headwind for growth in 2022. One factor that could offset these risks is that consumers have accumulated trillions of dollars in excess savings from the pandemic and can boost the economy through increased spending.

Inflation remains elevated, but peak may be behind

Elevated demand and constrained supply chains caused sharp price increases in a narrow set of goods and services that were popular during the pandemic. Shipping costs soared, used-car prices jumped, housing prices boomed and computer chips became difficult to source. On a broad basis, however, prices are now increasing at a normal rate in most areas of the economy, suggesting that the underlying trend to inflation is not as extreme. As a result, once distortions from the pandemic fade, we should expect headline inflation to return to rates more in line with pre-pandemic levels. We are already starting to see some price pressures easing. Commodity prices have leveled out and shipping costs may be peaking. While we recognize a diminishing threat of too-high inflation, we do consider the possibility that inflation could run above normal for a few more years. Longer term, however, inflation could be lower than normal due to structural factors such as technological advancements and aging populations.

U.S. dollar wobbles within long-term downtrend

Support from a few short-term themes helped the U.S. dollar trade sideways this year within a tight 4% band. We believe, however, that the greenback remains in a longer-term downtrend and that further weakness will persist in the years ahead. The dollar's decline should be most helpful for cyclical currencies that benefit from rising commodity prices and the global economic reopening, and we are particularly positive on currencies with central banks that will likely hike interest rates faster than the U.S. Federal Reserve (Fed). While our optimism on the euro has been tempered slightly, we remain positive on other G10 and emerging-market currencies.

Meaningful valuation risk in fixed income

Global bond yields fell significantly in the past quarter amid slowing growth and the expectation that central banks would maintain accommodative monetary policies. But according to our models, significant valuation risk exists in the sovereign-bond market and the odds, in our view, are tilted in favour of yields moving higher. Real, or after-inflation, rates of interest are deeply negative, suggesting that savers are subsidizing spenders, a situation that we don't think can persist. Although a variety of structural forces continue to depress real rates, our assessment is that real yields on U.S. 10-year Treasury bonds should be around zero or slightly above, which would represent a sizeable adjustment from current negative real rates. Further upward pressure on yields could result from the Fed and other central banks tapering their massive bond-buying programs in the coming quarters. We expect the U.S. 10-year yield to climb to 1.75% from 1.31% over our one-year forecast horizon, which would result in a slightly negative return.

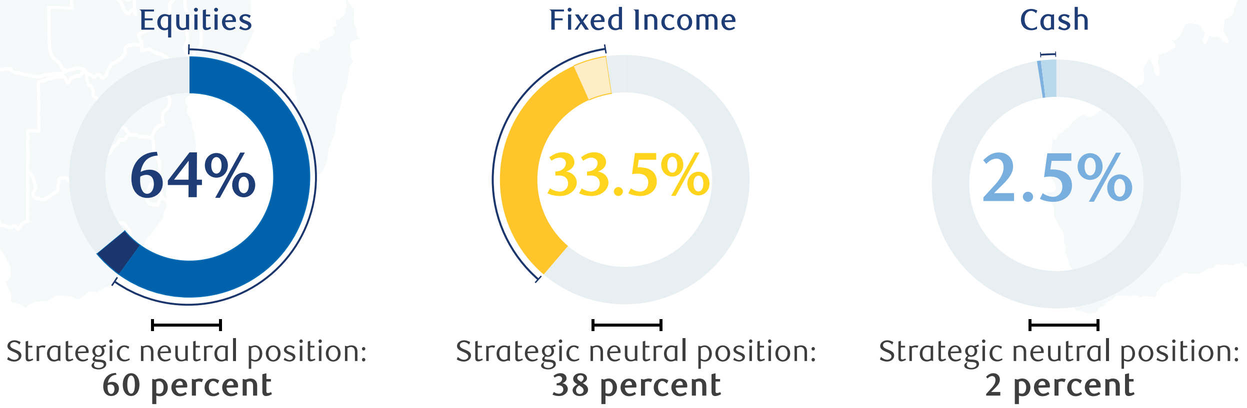
Soaring corporate profits extend bull market in stocks

Global equities continued to march higher, rising to records on elevated investor confidence and surging profits. The S&P 500 Index climbed to an all-time high of 4500 in the past quarter, representing a doubling from its March 2020 low and a 20% gain so far this year. The rapid increase in stocks has pushed our composite of global valuations to its most expensive reading since the late 1990s technology bubble, although it remains considerably below the all-time peak. While the degree of overvaluation has been concentrated in U.S. equities for most of the latest bull market, many indexes outside the U.S. are now near or above fair value. At these valuation levels, profit gains will be critical to keeping the bull market alive and earnings have indeed been stellar so far. S&P 500 profits are on track for the most rapid recovery on record, already surpassing the pre-pandemic high, and are expected to grow at an above-average pace for the next several years. With profits having rebounded to their long-term trend, further gains may be more difficult to come by and we should not expect the pace of gains experienced so far this cycle to be repeated. Although valuations are elevated, we think stocks can still deliver modest returns given low interest rates, transitory inflation and sustained corporate-profit growth. We look for mid-single-digit gains in North American equities, with slightly better return potential elsewhere over the year ahead.

Asset Mix – trimming bond allocation in favour of cash

The economy has moderated but growth remains quite good and, in our view, the economic cycle is in its early to middle stages with several years of expansion ahead. In this environment, interest rates remain low, but central banks are contemplating reductions in their bond-buying programs before raising interest rates. As distortions from the pandemic fade, we think that bond yields are likely to gravitate higher at a gradual pace. From current levels, even a slight increase in yields would result in negative returns for sovereign bonds. As a result, we took two steps in the past quarter to further reduce our allocation to bonds, trimming our fixed-income position by one percentage point in July and another 0.5 percentage point in August, and placing the proceeds in cash. We remain overweight stocks as they offer better upside potential. We recognize, however, that valuations are demanding and that continued strong growth in profits and heightened investor confidence will be needed to keep the bull market going. For these reasons we are keeping a modest cash position to cushion against any volatility and to provide funds for opportunities as they arise. For a balanced, global investor, we currently recommend an asset mix of 64 percent equities (strategic neutral position: 60 percent) and 33.5 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

Recommended asset mix



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