RBC Global Asset Management

Market Update

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Growth moderates, stimulus fades and virus flares up, motivating another modest trim to our equity overweight

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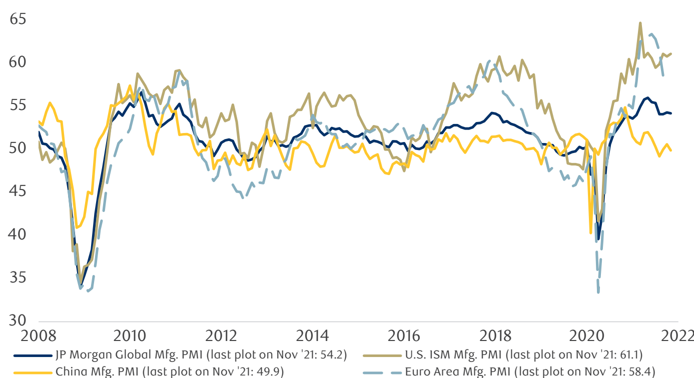
The global economy has demonstrated impressive resilience throughout the pandemic, buoyed by accommodative monetary policy, ample fiscal spending and human ingenuity. Vaccines are proving effective at curbing infections and hospitalization rates, and economies have largely re-opened enabling consumers, flush with savings, to spend again. Leading indicators for the economy are at levels consistent with robust economic growth although they are off their highs from early 2021 as the extraordinary growth rates of the initial phase of the recovery moderated (Exhibit 1). We look for global growth to continue on its moderating trend but to remain above normal levels from the past decade.

Key risks: virus, China, inflation

A variety of risks could derail our benign base case scenario. The Omicron virus variant presents a new threat, and the extent to which the spread can be contained and/or the speed at which populations get vaccinated will be critical for economies to operate at their full potential. China presents another major source of uncertainty where stricter regulations, slowing growth and a highly indebted real estate sector pose challenges to the world's second-largest economy. Another key risk is that inflation is running hot amid high demand, a shortage of workers and supply chain constraints (Exhibit 2). That said, inflationary pressures could soon begin to calm given that shipping costs and certain commodity prices are off their recent highs. But because consumer-price adjustments often occur on a lagged basis we continue to expect above-normal inflation over the medium term.

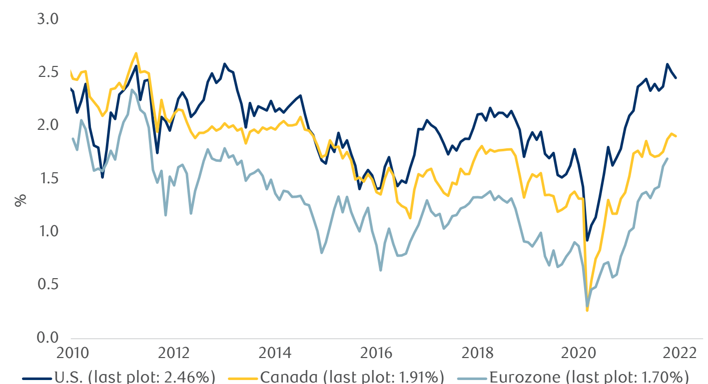
Exhibit 1: Global purchasing managers' indices



Note: as of December 1, 2021. Source: Haver Analytics, RBC GAM

Exhibit 2: Implied long-term inflation expectation

Breakeven inflation rate: nominal vs 10-year real return bond



Note: As of December 1, 2021. Eurozone represents GDP-weighted breakeven inflation of Germany, France and Italy. Source: Bloomberg, RBC CM, RBC GAM

Central banks dial back stimulus

In this environment, central banks are looking to dial back monetary stimulus and some have already begun outright tightening. In the U.S., the Fed started tapering its asset purchases in November and seems increasingly ready to begin raising rates, which we expect to begin sometime next year (Exhibit 3). Although any tightening is likely to be measured, flexible and telegraphed well in advance, the gradual removal of accommodation represents a shift in monetary policy stance which, at the margin, should be less supportive for financial markets.

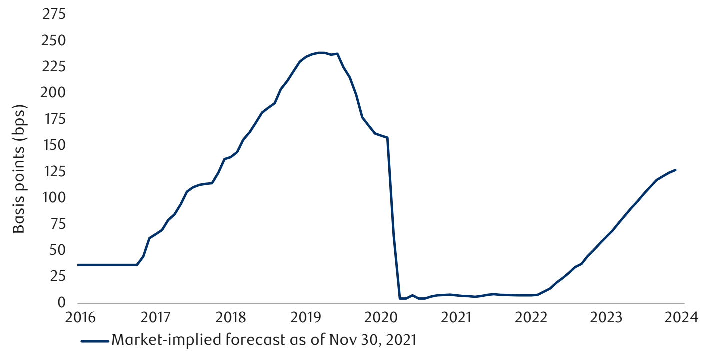
Rise in bond yields limited by virus and secular forces

Bond yields increased over the past quarter reflecting higher inflation expectations and the prospect for higher interest rates. The bulk of the rise in interest rates occurred at the short-end of the yield curve, while longer-term bond yields have been more tempered, perhaps signaling that the current surge in growth and inflation is likely temporary. Our own models continue to suggest that real rates (deeply in negative territory) are unsustainably low and that sovereign bonds exhibit significant valuation risk (Exhibit 4). We expect that nominal yields will rise gradually higher over time, but we also recognize that secular forces as well as the ebb and flow of the virus threat may limit the pace of such an increase.

Stocks encountered volatility, valuations remain elevated

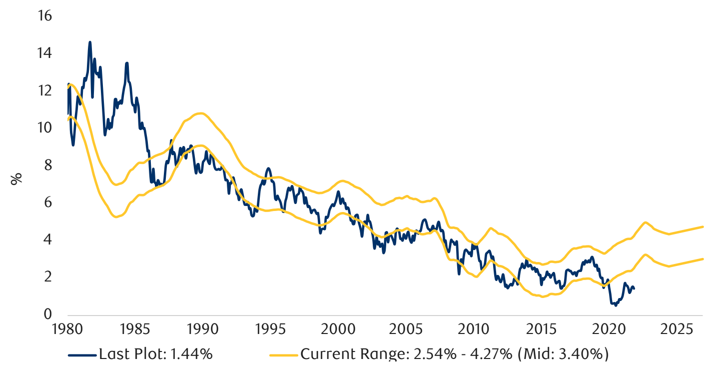
Many equity indices climbed to new highs during the quarter but retreated toward the end of the period on concerns of fading stimulus, slowing growth and a flare up in the virus. Performance was highly varied between regions, with emerging markets lagging and developed markets ahead. In particular, U.S. large-cap growth stocks outperformed and the technology-heavy S&P 500 eked out a slight gain for the quarter bringing its year-to-date gains over 21%. Our multi-factor model situates the S&P 500 at more than one standard deviation above fair value and it is the most expensive of the major markets (Exhibit 5). While other regions are more attractive on a relative basis, many markets outside of the U.S. are no longer trading at discounts to their own fair values. Elevated valuations pose a headwind to further upside for stocks, may result in more volatility and pose a vulnerability should economic conditions deteriorate.

Exhibit 3: Implied fed funds rate
12-months futures contracts



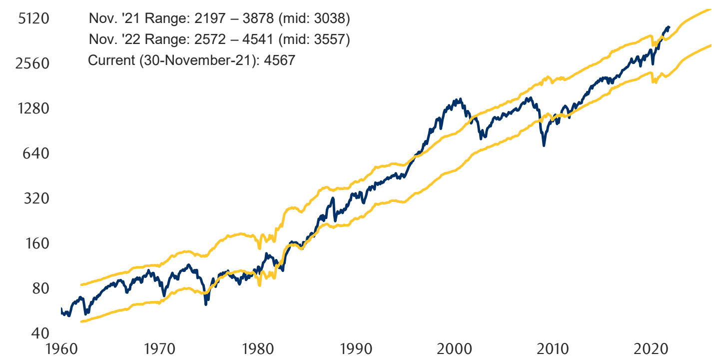
Note: as of November 30, 2021. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 4: U.S. 10-year T-bond yield
Equilibrium range



Note: as November 30, 2021. Source: RBC GAM, RBC CM

Exhibit 5: S&P 500 equilibrium
Normalized earnings & valuations



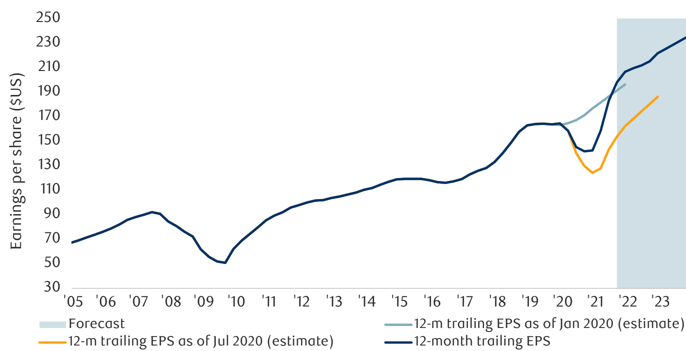
Note: the fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM

Corporate profits surge

Supporting the strong gains in equities this year has been the tremendous growth in corporate profits. S&P 500 earnings are expected to be $205 in 2021, up 47% versus 2020 and soaring past the prior high of $163 in 2019. The recovery in corporate profits has been spectacular and earnings are now tracking ahead of their pre-pandemic expected trajectory (Exhibit 6). Analysts have been persistently underestimating profits in this environment evidenced by more than 80% of earnings releases exceeding estimates in each of the past several quarters. Looking ahead, expectations for mid-to-high single digit nominal U.S. GDP growth are consistent with double digit profit growth for the S&P 500 again next year.

Exhibit 6: S&P 500 Index

12-month trailing earnings per share



Note: as of December 1, 2021. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, RBC GAM

Asset mix – another modest trim to our equity overweight

Our base case scenario sees the economy slowing but to a pace that is still above historic norms. The bulk of the initial recovery is now behind and our analysis suggests the business cycle has advanced to a middling stage. In this environment, central banks are beginning to dial back policy accommodation and/or raising interest rates. Any meaningful increase in bond yields from current levels would lead to low or potentially negative returns for sovereign bonds and as a result we remain underweight fixed income. Stocks continue to offer better upside potential, especially relative to bonds and we remain overweight stocks in our asset mix. We recognize however, that elevated valuations, narrowing equity-market breadth, recent widening in credit spreads and high inflation are concerns, and the new Omicron virus variant poses an additional threat. As a result we are flagging this deterioration in the backdrop with a second modest cut in our equity allocation of 50 basis points, moving the proceeds to cash. Our current recommended asset mix for a global balanced investor is 63.5% equities (strategic: "neutral": 60%), 33.5% bonds (strategic "neutral": 38%) and 3.0% in cash.

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