



OCTOBER 29, 2021

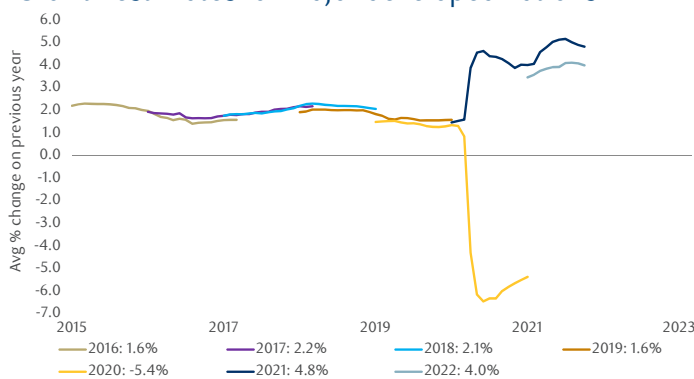
## Stocks fend off slowing growth, inflation pressures linger

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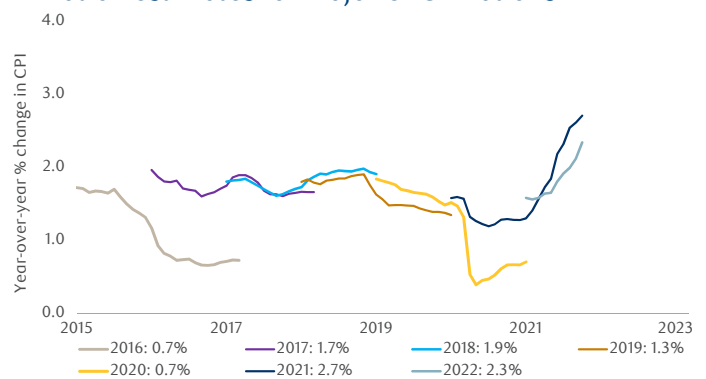
The global economy continues to experience a gradual slowdown from its intense recovery last year. Of particular concern has been China’s underwhelming growth, hindered by supply chain problems, property market issues, and tightening regulations on technology companies. As the world’s second largest economy and greatest contributor to global growth, a meaningful slowdown in China’s economy could weigh on economic activity more broadly. That said, some of the key challenges facing economies may actually be starting to fade. COVID-19 cases are falling throughout the world and supply chain blockages may finally be easing. Price pressures remain, however, and initial thoughts that inflation would be transitory are now being questioned. In this environment, economists have been gradually downgrading their outlooks for growth, but upgrading inflation estimates (Exhibits 1 and 2). Our own forecasts have followed a similar trend and they remain below consensus on growth and above consensus on inflation.

**Exhibit 1: Weighted average consensus real GDP**  
Growth estimates for major developed nations



Note: as of October 25, 2021. Source: Consensus Economics

**Exhibit 2: Weighted average consensus CPI**  
Inflation estimates for major OECD nations



Note: as of October 25, 2021. Source: Consensus Economics

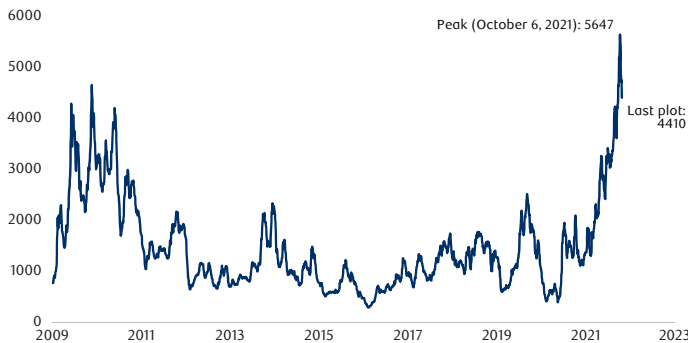
### Elevating shipping costs, order backlogs and rising wages

A variety of factors are contributing to higher inflation in the near term. Shipping costs as measured by the Baltic Dry Freight Index soared to their highest level in over a decade and the U.S. ISM survey of manufacturing order backlogs climbed to its highest level in the past 25 years (Exhibits 3 and 4). Although these indicators are off their highs and may be indicating that the worst is behind, the situation is still far from historical norms. Another example of inflation pressure in the economy is that U.S. wages have been rising extremely fast. Exhibit 5 plots the year-over-year change in the average hourly earnings of U.S. workers and it is showing that wages have recently been growing at their fastest pace in the last 35 years.

### Central bank tightening moves into view

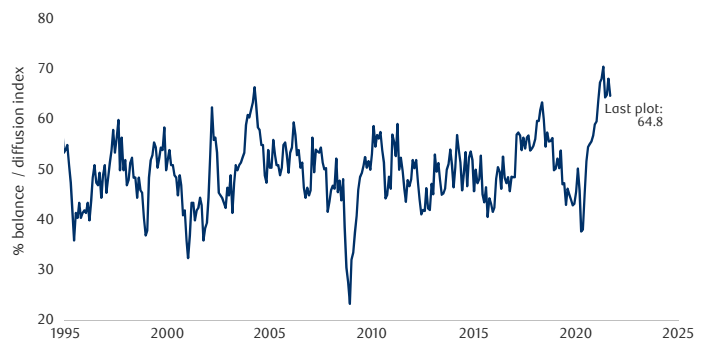
With economic damage from the pandemic mostly repaired and inflation running fairly hot, central bankers are on board with dialing back monetary stimulus. For example, just this week the Bank of Canada ended its bond-buying program and suggested that rate hikes may be appropriate starting in the middle of 2022. In the U.S., the Federal Reserve (Fed) voiced the possibility of scaling back its US\$120 billion per month bond-buying program sometime in the next few months. Actual rate hikes likely would not occur until quantitative easing (QE) is completely wound down, which could happen by the middle of 2022. The important question for investors is what happens after QE ends and, once the Fed begins hiking, how far will rates ultimately rise? Investors are constantly adjusting expectations with new information, but as of the time of this writing pricing in the futures market suggests investors expect two Fed hikes in 2022 and two to three more in 2023 (Exhibit 6).

**Exhibit 3: Baltic Dry Freight Index**



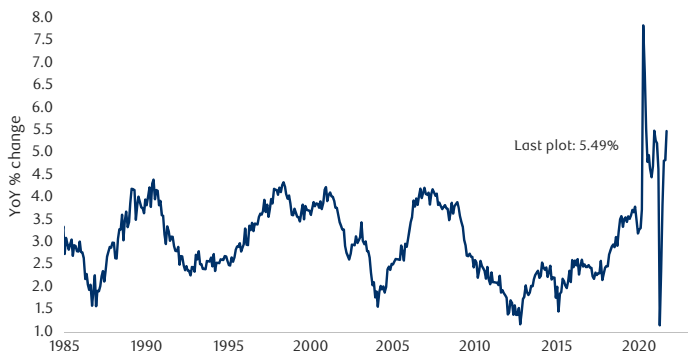
Note: as of October 22, 2021. Source: Bloomberg

**Exhibit 4: U.S. ISM Manufacturing Business backlog of orders**



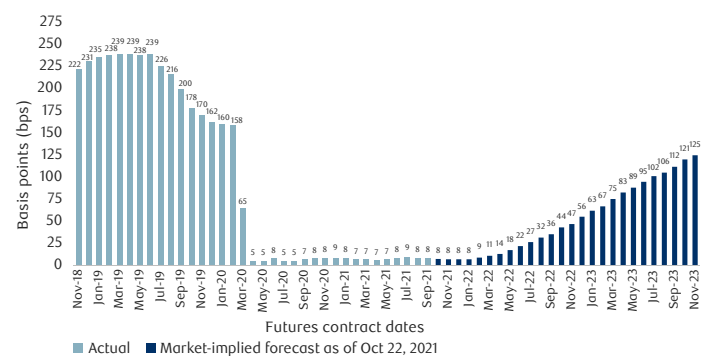
Note: as of September 30, 2021. Source: Bloomberg, RBC GAM

**Exhibit 5: U.S. average hourly earnings**



Note: as of September 30, 2021. Source: Bureau of Labor Statistics, Haver Analytics, RBC GAM

**Exhibit 6: Implied fed funds rate 12-month futures contracts**



Source: Bloomberg, RBC GAM

### Bond yields climb, led by increases in shorter term maturities

The anticipation of imminent central-bank tightening has pushed bond yields higher across shorter-term maturities, but the longer-end of the yield curve has been flat to slightly down in recent weeks. The U.S. 2-year yield climbed to 47 basis points, more than doubling from the 21 basis points level in September as investors brought forward expectations for rate hikes (Exhibit 7). The U.S. 10-year yield also moved higher, rising to 1.69% in October and nearing its high during the spring, although it remains well below our modelled estimate of equilibrium (Exhibit 8). Yields on longer-term maturities, however, have not been rising and have even been declining more recently. As a result, the spread between the 10-year and 30-year Treasuries has been narrowing (Exhibit 9). The rise in short-term yields reflects the market’s view that the Fed is about to embark on a tightening cycle, but the flattening in the long-end of the yield curve may indicate that investors lack confidence in economic growth over the

longer term. Taken together, it appears we are getting mixed signals from the bond market with respect to the economic outlook.

### Credit markets indicate little stress

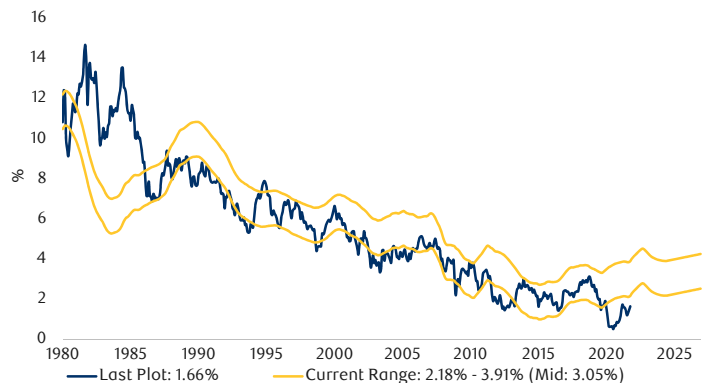
Although financial markets have encountered some volatility since September, the credit market has been relatively calm. Spreads have widened only slightly during recent weeks and any minor sell-offs in credit markets were seen as buying opportunities for investors with an appetite for income in a low-yield environment. The spread between the yields on U.S. 10-year bonds and those on investment grade and high-yield corporate debt remain near their lowest levels in the past decade (Exhibit 10). With spreads at historically narrow levels, though, credit markets only have so much room to absorb increasing government bond yields and, at some point, a further rise in the Treasury yield curve would pressure high yield bond prices.

**Exhibit 7: U.S. 2-year government bond yield**



Note: as of October 26, 2021. Source : Bloomberg, RBC GAM

**Exhibit 8: U.S. 10-year T-bond yield Equilibrium range**



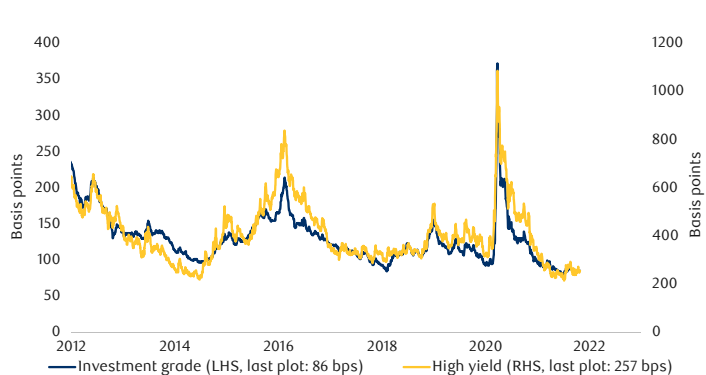
Note: as of October 25, 2021. Source: RBC GAM, RBC CM

**Exhibit 9: U.S. yield curve 30-year minus 10-year government bond yields**



Note: as of October 26, 2021, Source: Bloomberg, RBC GAM

**Exhibit 10: U.S. corporate bond spreads Difference with U.S. 10-year Treasury yield**



Note: as of October 25, 2021. Source: Barclays Capital, Bloomberg, RBC GAM

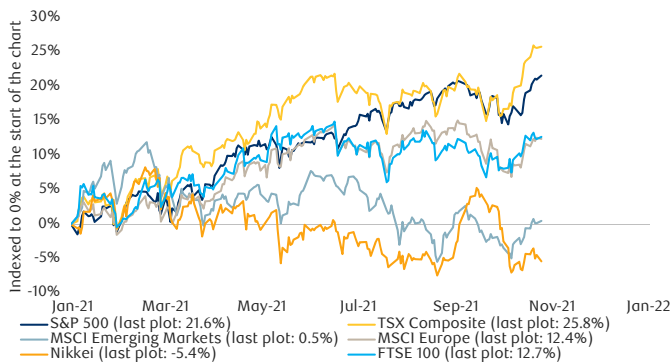
### Equity markets bounce back

Stocks enjoyed a solid rally in October as the economic recovery continued even though it is slowing, China’s Evergrande situation appears manageable and earnings have been better than expected. Cyclically-sensitive stocks have been performing especially well, lifting Canada’s TSX Composite to a new high and it is the best performing major equity market year-to-date in U.S. dollar terms up nearly 26% (Exhibit 11). Emerging markets and Asian equities have lagged considerably, in large part due to challenges in China which weighed on investor confidence in those regions. In the U.S., the S&P 500 also rose to a new record, helped by strong earnings results and a rebound in mega-cap technology stocks. With the S&P 500 at more than one standard deviation above our modelled estimate of fair value, we recognize that stocks are expensive and that valuations are especially demanding (Exhibit 12).

### Earnings coming through better than expected, but estimates stall

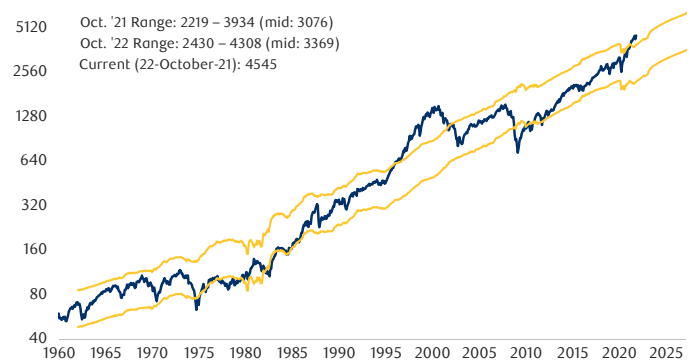
Perhaps one of the reasons investors continue paying a high price for stocks is that companies have been consistently exceeding analysts’ earnings estimates. Again this quarter, the vast majority of S&P 500 companies have beat expectations, with 82% of reports so far for Q3 2021 coming in ahead of the consensus (Exhibit 13). A recurring theme since the pandemic began has been that estimates have been too low and analysts have been consistently raising their expectations to catch up to reality. However, we are starting to see a shift in this trend of frequent upward revisions. Many companies have warned of potential challenges with respect to rising costs and supply chain issues that could hamper future profit growth. Earnings estimates have stopped rising and we now see an even balance between upward and downward revisions after nearly a year of persistent upward revisions (Exhibit 14). Higher taxes, if passed, could also pose a further headwind to profits.

**Exhibit 11: Major equity market indices**  
Cumulative price returns indices in USD



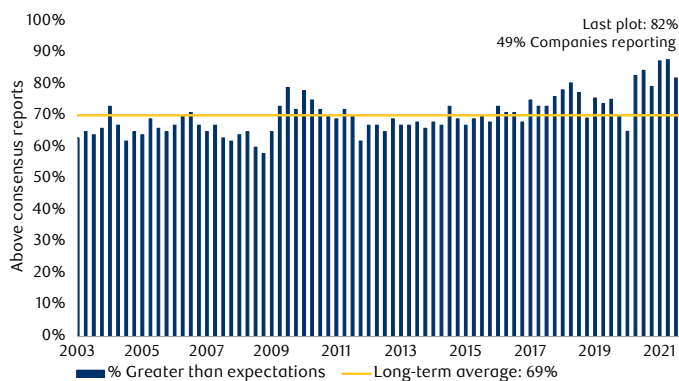
Note: as of October 25, 2021. Price returns computed in USD.  
Source: Bloomberg, RBC GAM

**Exhibit 12: S&P 500 equilibrium**  
Normalized earnings & valuations



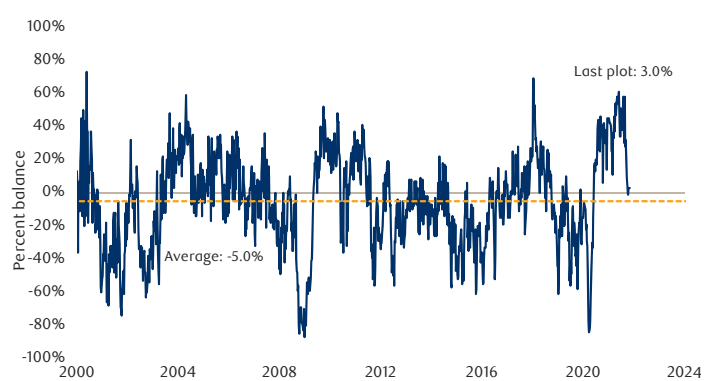
Note: the fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index.  
Source: RBC GAM

**Exhibit 13: Companies reporting results above consensus forecasts**



Note: as of October 27, 2021. Source: Refinitiv

**Exhibit 14: U.S. equities**  
Companies with upward earnings revisions



Note: as of October 25, 2021. Source: Citi, RBC GAM

### **Asset mix – continuing with overweight in stocks and underweight in bonds**

In our base case scenario, the economy continues expanding albeit at a slowing pace, and inflation remains firm over the medium term prompting central banks to begin dialing back monetary accommodation at a gradual pace. We expect bond yields to continue rising this environment acting as headwind for fixed-income returns, which we forecast to be low or even slightly negative over the year ahead. As a result, we remain underweight fixed income in our asset mix. Stocks, in our view, offer superior upside potential relative to fixed income. While we recognize that valuations are demanding and there is little room for error, we also consider the potential that strong nominal GDP could continue to supporting decent gains in corporate profits which should support the bull market. Balancing the risks and opportunities, we remain overweight stocks but we are also maintaining a small cash allocation to cushion portfolios against volatility and to be used tactically should opportunities arise. Our current recommended asset mix for a global balanced investor is 64.0% equities (strategic “neutral”: 60%), 33.5% bonds (strategic “neutral”: 38%) and 2.5% in cash.



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Publication date: October 29, 2021

(10/2021)

MARKET UPDATE \_OCTOBER 29\_2021 10/29/2021

