

# Economy slows and volatility spikes as risks brew



**Eric Savoie, MBA, CFA**

Investment Strategist, RBC Global Asset Management Inc.

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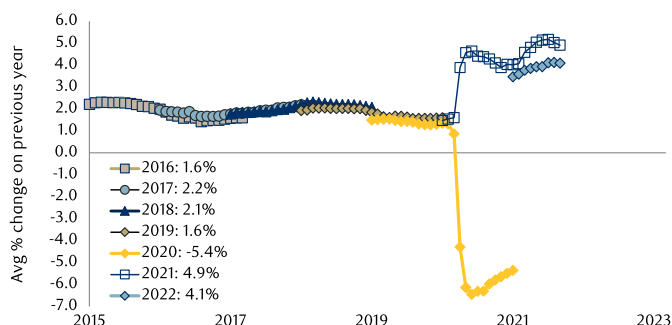
Momentum in the recovery appears to have peaked and tougher days for the economy likely lie ahead as challenges mount and the stimulus that has been in place since the early days of the pandemic starts to fade. Growth is slowing even as the expansion moves ahead and the contours of a post-COVID economy come into view. The virus continues to challenge economies, most predominantly in developing nations where vaccines have been less available and more difficult to administer. The unpredictability of virus waves has disrupted global supply chains and hampered the flow of goods, causing worldwide shortages and/or price increases that could extend beyond the short term. Other risks include China’s property market. The focus is currently on Evergrande, one of the country’s largest real-estate companies, which is heavily indebted and unlikely to meet its financial obligations without government intervention. Our GDP forecasts remain quite good historically speaking, but we look for growth in 2022 to be below the rate of 2021 and our forecasts are slightly below the consensus (Exhibit 1).

## Economic data softens

A weakening in leading indicators supports the view that economic growth is slowing. Global purchasing managers’ indices (PMI) peaked between early and mid-2021 and have been declining steadily since then (Exhibit 2). While most PMIs remain above 50 and are consistent with robust economic growth, China’s PMI slipped slightly below 50 in an indication that the economy may actually be contracting. Moreover, economic data more broadly hasn’t been meeting expectations, as evidenced by the fact that Citi’s U.S. Economic Surprise Index has fallen into negative territory (Exhibit 3). Although economic data is still fairly good, we recognize that investors and economists are no longer being as frequently surprised by the strength of the recovery as they were for the better part of the past year.

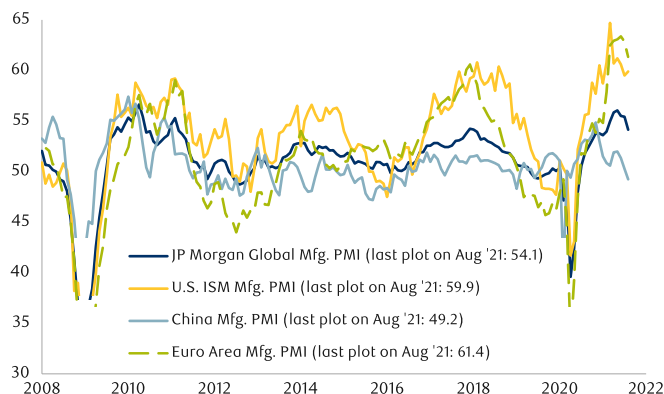
### Exhibit 1: Weighted average consensus real GDP

Growth estimates for major developed nations



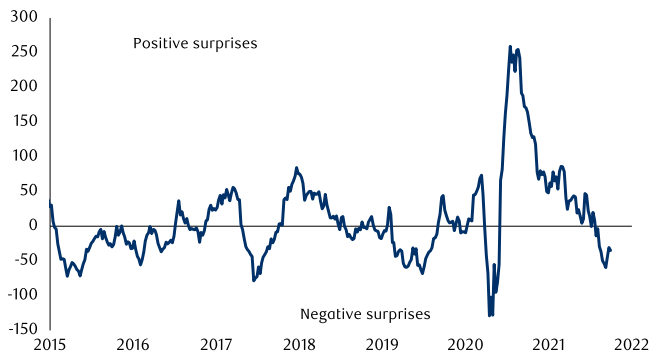
Note: as of September 28, 2021. Source: Consensus Economics

### Exhibit 2: Global purchasing managers’ indices



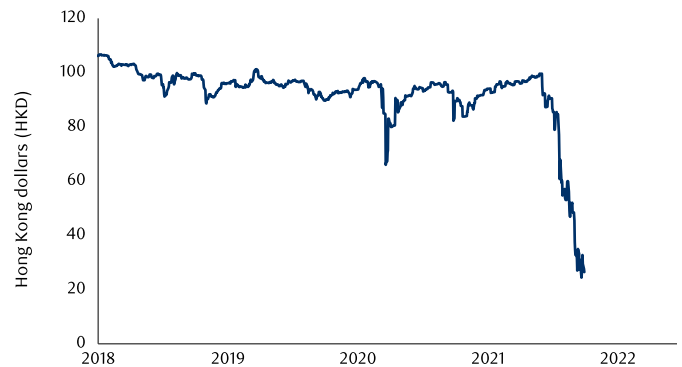
Note: as of August 31, 2021. Source: Haver Analytics, RBC GAM

**Exhibit 3: United States**  
Citi Economic Surprise Index



Note: as of September 28, 2021. Source: Citigroup Global Markets Inc., RBC GAM

**Exhibit 5: Evergrande 8.25% March 2022 bond price**  
Daily data



Note: as of September 28, 2021. Source: Bloomberg.

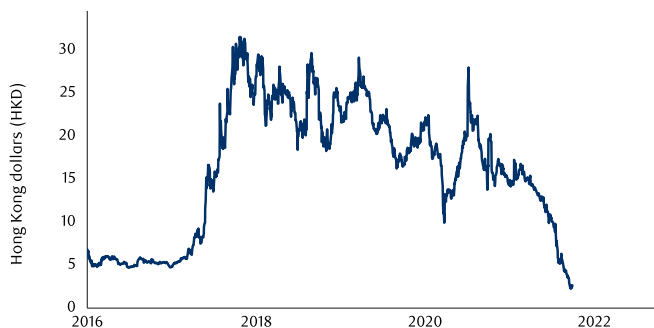
**Evergrande woes**

Adding to the headwinds for economies and markets over the past few weeks has been concerns about Evergrande’s ability to meet its debt obligations. The 25-year-old developer has used excessive leverage to build one of China’s largest real-estate empires, but the company’s US\$300 billion debt load is proving burdensome as the firm struggles. Evergrande’s stock has declined 85% from the spring (92% from its 2017 peak) and the company’s bond prices have also collapsed (exhibits 4 and 5). Investors are intimidated by the sheer size of the company, which has approximately 800 active projects in over 200 cities. The Real Estate sector and real-estate-linked industries account for what some analysts estimate is nearly a third of the country’s economic output, so it is vital that the company’s financial troubles be resolved in an orderly fashion. The good news is that the Chinese government appears to be intent on a swift resolution and progress on the repayment of some late debt installments has been made.

**Fed hints at tapering soon**

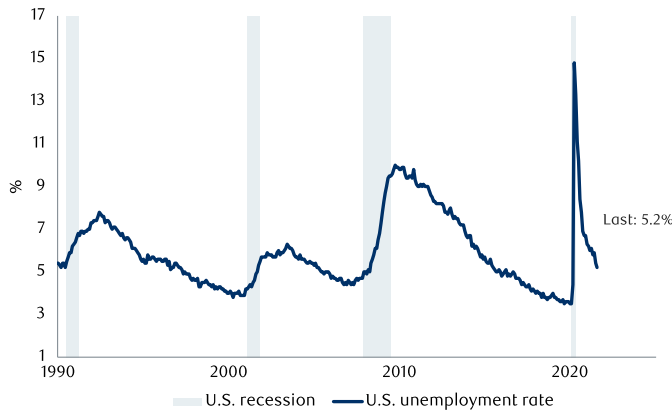
In the U.S., continued progress in the economic recovery means there is a diminishing need for the extraordinary stimulus that has been in place since the beginning of the pandemic. The U.S. Federal Reserve (Fed) has expanded its balance sheet by over US\$4 trillion since March 2020. Over that period, the economy has added more than 17 million jobs, bringing the unemployment rate down to 5.2% from a peak of 14.8% in the spring of 2020 (Exhibit 6). The other half of the Fed’s dual mandate is price stability. Inflation has been fairly high since the spring of 2021 and most measures of inflation are well above the Fed’s 2% target (Exhibit 7). With the economy on stronger footing and inflation running hotter than expected, the Fed has hinted that it may begin reducing the pace of its US\$120 billion monthly bond purchases by the end of this year. Adherence to that timetable would suggest the completion of the tapering process by mid-2022 and a new round of rate hikes in late 2022 or early 2023. It is important to note that the scaling-back of quantitative easing does not represent a tightening of monetary conditions, but rather less easing. The Fed remains accommodative with interest rates still at rock-bottom levels. A reduction in quantitative easing means only that the Fed’s balance sheet will expand at a slower rate.

**Exhibit 4: Evergrande share price**  
Daily data



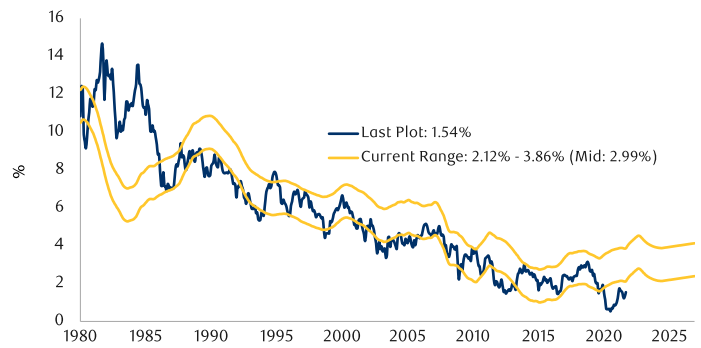
Note: as of September 28, 2021. Source: Bloomberg.

### Exhibit 6: U.S. unemployment rate



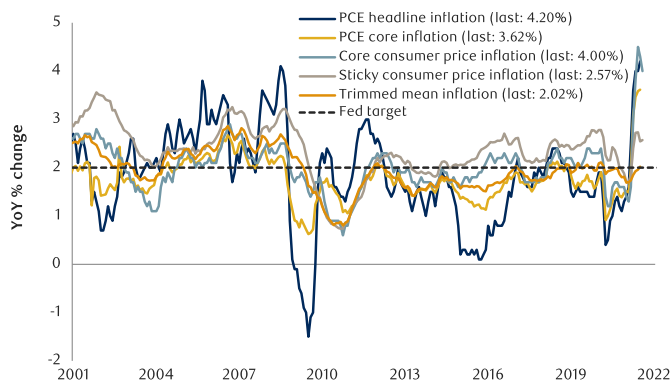
Note: as of August 31, 2021. Source: Bloomberg, RBC GAM

### Exhibit 8: U.S. 10-year T-Bond yield Equilibrium range



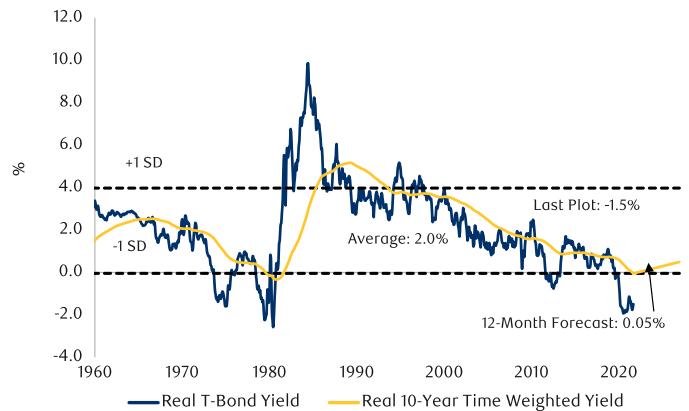
Note: as of September 28, 2021. Source: RBC GAM, RBC CM

### Exhibit 7: U.S. inflation measures



Note: as of September 28, 2021. Source: Bloomberg, RBC GAM

### Exhibit 9: United States Real 10-Year T-Bond yield



Note: as of September 28, 2021. Source: RBC GAM, RBC CM

## Sovereign-bond yields rise from unsustainably low levels

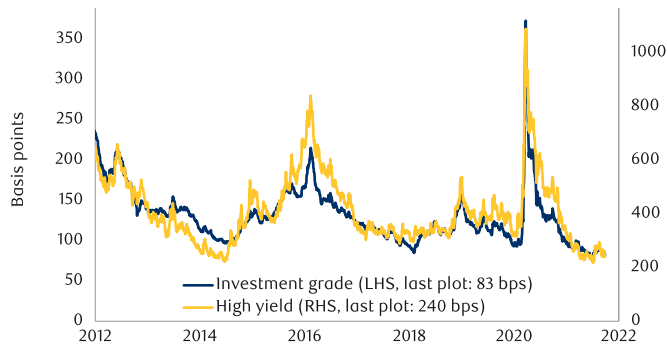
Global bond yields have begun moving higher again after a period of consolidation through the spring/summer and our models suggest they could continue to rise. The U.S. 10-year yield climbed back above 1.50% in September after falling as low as 1.17% in August, but it remains below its March 2021 peak of 1.74%. Although the increase in yields has reduced valuation risk, our models continue to suggest that the appropriate level for yields is higher (Exhibit 8). The reason is that real, or after-inflation, interest rates are still extremely negative and we don't think such a situation can persist. As the economy moves to a more normal environment and quantitative easing ultimately ends, we see a gradual rise in real interest rates back to zero or slightly above (Exhibit 9). If this scenario plays out and inflation hovers around 2.0%, the U.S. 10-year yield would be at or above 2.0%, an adjustment that we think will occur gradually over time. We remain comfortable with our forecast of 1.75% for the U.S. 10-year yield.

## U.S. credit market relatively calm

Credit markets in North America have been fairly benign and there is little evidence that Evergrande's troubles are spreading to financial market outside of China. Spreads on U.S. investment-grade and high-yield bonds have been hovering near their lowest levels in the past decade, suggesting investors still have a healthy appetite for risk-taking (Exhibit 10). Moreover, the distressed ratio, which identifies bond issues with yields over 10%, is also near historic lows (Exhibit 11). If concerns were starting to creep into North American credit markets, we likely would have seen a widening in spreads and more distressed bonds. It seems that the credit market is largely taking the view that Evergrande is a localized problem and that any contagion risk could be managed by China.

### Exhibit 10: U.S. corporate bond spreads

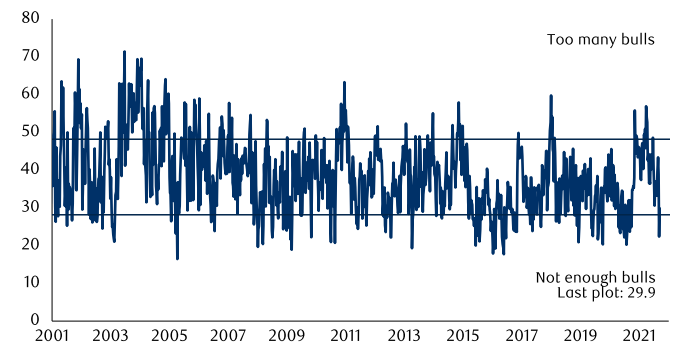
Difference with U.S. 10-year Treasury yield



Note: as of September 28, 2021. Source: Barclays Capital, Bloomberg, RBC GAM

### Exhibit 12: AAI sentiment survey

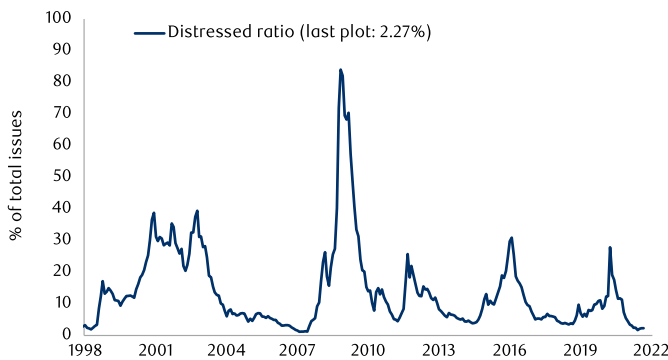
Percent bullish



Note: as of September 23, 2021. Source: American Association of Individual Investors (AAII)

### Exhibit 11: U.S. high yield distressed ratio

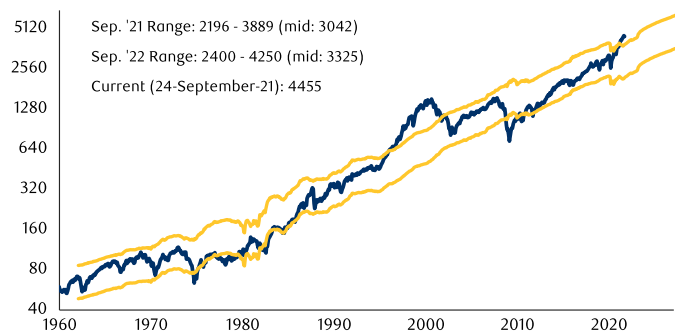
Percent of total issues with OAS spreads in excess of 1000 bps



Note: as of September 28, 2021. Source: BofA, Credit Suisse, RBC GAM

### Exhibit 13: S&P 500 equilibrium

Normalized earnings & valuations



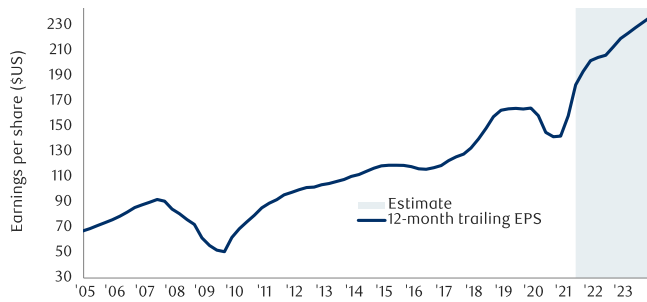
Note: The fair value estimate is based on the current estimate for normalized earnings. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. Source: RBC GAM

## Equity markets wobble as optimism retreats

Most major stock-market indices encountered turbulence in September as mounting risks and rising yields tempered investors' enthusiasm. The S&P 500 Index fell as much as 5% from its record high earlier in the month and underperformed other global equity markets, weighed down by mega-cap growth and technology stocks which tend to be more sensitive to changes in discount rates. Optimism waned, as indicated by the American Association of Individual Investors survey showing an extreme lack of bulls (Exhibit 12). That said, stocks remain relatively fully valued, with the S&P 500 trading at more than one standard deviation above our modelled estimate of fair value (Exhibit 13).

## Earnings growth has been solid and outlook is bright

A resumption in the stock market's ascent will likely require continued strong growth in corporate profits. The recovery in earnings from the pandemic lows has been extremely powerful, with profits having already exceeded their pre-pandemic level and on track to be 20% above that prior peak by the end of this year (Exhibit 14). While the strength of the recovery is truly impressive, investors may be shifting their focus to what will happen beyond the initial recovery and what would be required to extend profit increases beyond these levels. We still expect the economy to grow at a fairly rapid pace next year, which should translate to a strong corporate-profit growth and provide support for equity markets. However, continued earnings gains are becoming increasingly critical as valuations are rather demanding.

**Exhibit 14: S&P 500 Index****12-month trailing earnings per share**

Note: estimate is based on a consensus of industry analysts' bottom-up expectations.

Note: as of September 28, 2021. Source: Thomson Reuters, RBC GAM

### **Asset mix – maintaining overweight in stocks, underweight in bonds and cash reserve**

In our base case scenario, the economy continues to grow at an above-average, yet slowing, rate and central banks move forward with intentions to gradually dial back monetary accommodation. In this environment, we expect yields to continue to rise which will act as a headwind to bond returns. As a result, we remain underweight fixed income in our asset mix. Stocks continue to offer superior return potential and we think the economy will grow at a sufficient pace to maintain strong corporate-profit growth. We recognize, however, that elevated valuations and strong investor confidence are critical to sustaining the bull market and that there are a number of threats that could cause heightened periods of market volatility. With this in mind, we remain overweight stocks, but are holding a cash reserve as protection against volatility and to take advantage of opportunities should they present themselves. 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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