RBC Global Asset Management

Executive summary

NEW YEAR 2022

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Underlying economic conditions remain good by historical standards and corporate-profit growth has been stellar. However, the backdrop is shifting and enthusiasm for the recovery has diminished. Moderating growth, the new Omicron virus variant and fading monetary stimulus have agitated financial markets.

Economy encounters a variety of headwinds

A new coronavirus variant, problematically high inflation, supply-chain challenges and China's property-market slowdown are among the main headwinds facing the global economy. Moreover, policymakers are acknowledging that the recovery is well advanced, allowing for a gradual dialing back of monetary accommodation and less generous fiscal support. As the recovery progresses and economies reach their potential, it is natural for growth to become less buoyant. The recovery is still in good shape and we expect growth to persist into 2022, albeit at a slower pace relative to 2021. Among all of the headwinds, there are two key factors that could continue to support the expansion. The first is that consumers are flush with savings and they have low financial obligations, putting them in a solid position to boost their spending. The second is that businesses have also expressed their desire to rebuild inventories and boost capital expenditures. Weighing the positives and the negatives, we look for 3.5% growth for most developed nations in 2022. This projected growth rate is nearly twice the pre-pandemic norm and consistent with an extension of the economic recovery. However, our below-consensus GDP projection means that the expansion will slow, perhaps to a degree that ends up disappointing investors.

The coronavirus regains traction

The pandemic has become more challenging in recent months as infections are rising throughout the developed world. Colder weather, the reopening of schools and the relaxation of social restrictions have made it easier for the virus to spread. The deterioration is most obvious in Europe, but cases are also ramping up in North America. While the bulk of the current wave is due to the Delta strain, the Omicron variant is proving more contagious than previous versions (though perhaps less deadly), superior at resisting vaccines and better at re-infecting people. Vaccine makers can adapt their formulas to take on the new variant, but it might take a number of quarters before production ramps up and distribution gets to the point where large portions of the population are again protected. Our base case scenario looks for a moderate wave of infections to subtract up to one percentage point from global output over a few quarters. This hit would be worse than the one caused by the Delta variant, but not much different from the late-2020 wave, and far less damaging than the original wave.

Inflation continues to run hot

The rate of inflation has increased further over the past quarter and now stands at extraordinary levels not encountered in decades. Economic demand has snapped back faster than supply, causing higher commodity prices, an insufficient workforce and shortages in a variety of goods. Inflation expectations have consistently been above expectations and real-time measures remain hot. Although supply-chain constraints may ultimately fade and oil prices come down, other inflation pressures may persist or even intensify. Central banks have printed significant amounts of money and are broadly accepting of higher inflation. For these reasons, our inflation forecasts over the next year remain above consensus. Shifting to the longer term, however, we continue to believe that high inflation is cyclical rather than structural. After distortions from the pandemic settle, we should eventually see a return to normal inflation readings. It is even conceivable that inflation over the long term could be lower than normal as the deflationary effect of demographics outweighs structural inflationary forces from climate change and the rising bargaining power of workers to set wages.

Currency markets face increased volatility

Volatility is returning to the foreign-exchange markets, fueled in part by a new COVID variant and in part by diverging central-bank monetary policies. The U.S. dollar has benefited from market expectations that interest rates will be raised next year, but may soon reverse some of its gains as moderating U.S. inflation would suggest less upward pressure on rates. While we have reined in our optimism on the low-yielding euro and Japanese yen, we remain positive on cyclical currencies such as the Canadian dollar. The resilience of the Chinese renminbi amid otherwise negative Chinese developments has been a stabilizing factor for currency markets and is a theme worth monitoring in the year ahead.

Sovereign-bond yields remain unsustainably low

Sovereign-bond yields began the year on a rapid upward trajectory amid the economic reopening, COVID vaccinations and firming inflation, but declined toward the end of the period as slowing growth and mounting concerns about the Omicron variant boosted the appetite for safe havens. Our models continue to suggest that yields are too low and that the key to higher yields lies in the eventual normalization of real interest rates to levels at or above the zero bound. Real rates are currently deeply negative and sovereign-bond investors are accepting an after-inflation loss in purchasing power over time. We don't think this situation is sustainable and, as a result, we expect a gradual increase in yields paced by a gradual upward adjustment in real interest rates. Our own forecast is 1.80% for the U.S. 10-year yield over the next 12 months.

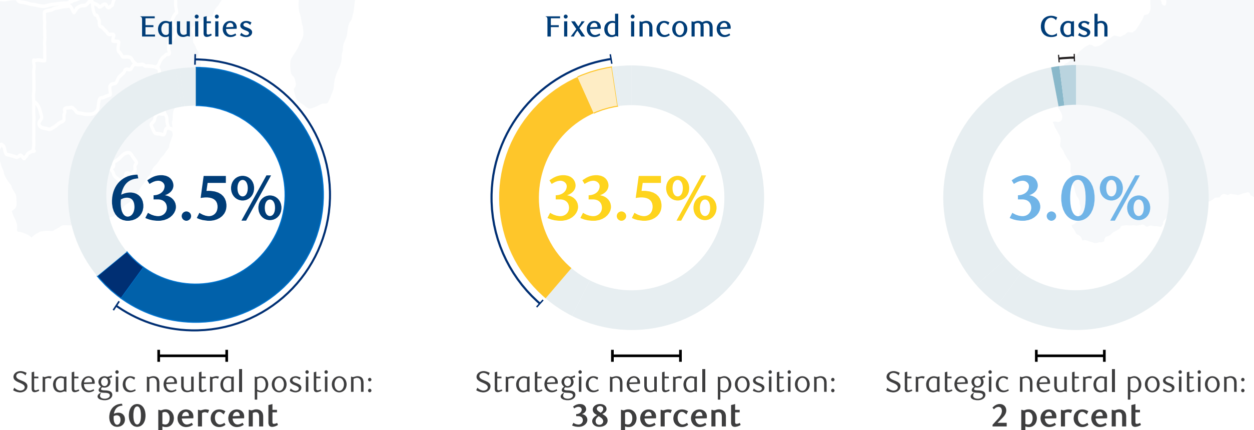
Stocks are fully valued, so profit growth will be critical to sustaining the bull market

Global equities extended gains from 2020 to record another strong year in 2021 and the rally has pushed our global composite of equity market valuations to 25% above fair value. At these levels, stocks are pricing in a favourable outlook for the economy and corporate profits, and the risk is that conditions deteriorate such that equities are left in a vulnerable position. Highly demanding valuations like those we see in the U.S. large-cap equity market are consistent with higher volatility as any doubts over profit growth will likely lead to heightened instability. Continued strong gains in corporate profits will be critical to supporting higher stock prices, and earnings have indeed been spectacular. Stocks are expensive, but an environment of still-low interest rates, and where inflation could transition back to normal levels alongside strong growth in corporate profits, the equity market could deliver mid-single-digit to low-double-digit gains over the next few years.

Asset mix – a second modest trim to stocks

Our base case scenario is for the economy to continue growing at a rapid yet slowing rate as the recovery matures and much of the economic damage from the pandemic has been repaired. As the economy moves into its middling stage, central banks are starting to dial back monetary accommodation and, although conditions fully justify the need for tightening, we recognize that financial markets will be receiving less support. Prospective returns for fixed income are especially unappealing in this environment and any meaningful increase in yields would lead to low or negative returns in sovereign bonds. Stocks continue to offer better return potential relative to fixed income. However, we recognize that the cycle is advancing, valuations are elevated and the market is vulnerable to correction should risks mount. We reduced our equity allocation by 50 basis points during the summer in recognition of the maturing of the recovery. Since then, narrowing market breadth, slowing growth, a lack of leadership outside of U.S. large-cap equities and the threat of the new Omicron variant have motivated us to reduce our equity weight by another 50 basis points this quarter, placing the proceeds into cash. For a balanced, global investor, we currently recommend an asset mix of 63.5 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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