RBC Global Asset Management

Market Update

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Markets falter as central banks signal imminent rate hikes

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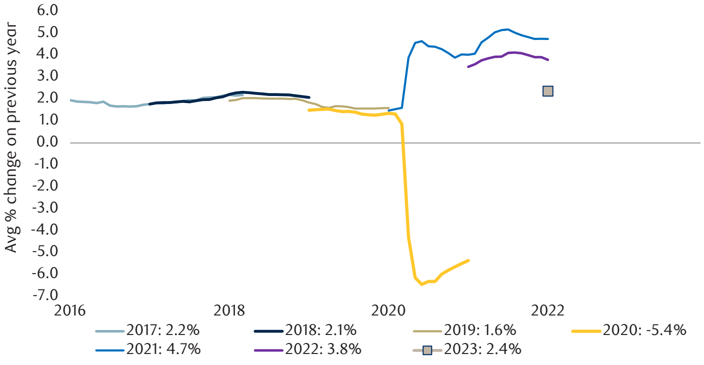
Nearly two years after the pandemic began, the economy has undergone significant healing and the extraordinary stimulus that was put in place to support businesses and individuals during the initial stages of the crisis is no longer required. Demand for goods and services is strong and labour markets are tight. Perhaps more importantly for central banks, inflation is running hot and they have been forced to shift from being spectators of inflation to activists leading the fight against it. With this shift comes the delicate balance of tightening to a degree that preserves the economic expansion without sending the economy into recession. Financial markets have been especially volatile so far this year as investors adjust their expectations for a faster round of tightening than was previously expected.

In addition to monetary-policy uncertainty, several other risks are worth monitoring. The virus remains a cause for concern, and although there are signs that new cases may be peaking, restrictions can still weigh on economies. That is particularly the case in China, where growth is already slowing and where a zero-tolerance policy for COVID-19 has been adopted ahead of the 2022 Winter Olympics. Other challenges include tensions between Russia and Ukraine and, later this year, U.S. mid-term elections that could change the balance of power between the two main political parties. Taking all of these factors into consideration, our expectation is that global growth will continue to moderate somewhat. As a result, our growth forecasts remain below the consensus (Exhibit 1).

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



Note: as of January 20, 2022. Source: Consensus Economics

> "Unwanted inflation is taking root across the economy, with costs for energy, metals and automobiles on the rise, and defying the predictions of central banks and economists that price spikes would be temporary and limited in scope."

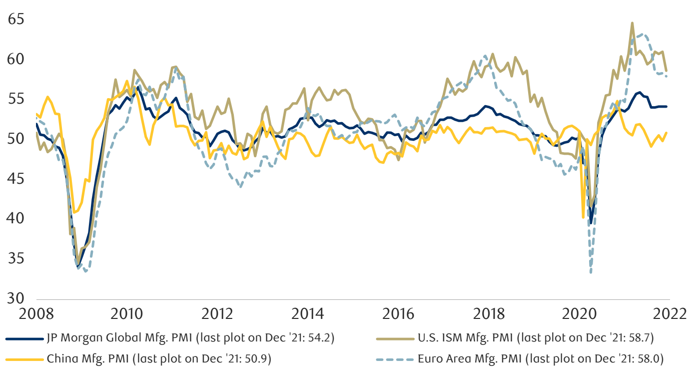
Economic indicators moderate

Consistent with our view that the economy is likely to moderate is the softening that we have seen in leading indicators and economic data. Global purchasing managers' indices are off their highs and have been trending lower in most of the world over the past year (Exhibit 2). Another key leading economic measure that we monitor is the Duncan Leading Indicator (DLI), which peaked in the second quarter of 2021 (Exhibit 3). This indicator, which measures durable-goods spending, residential investment and capital expenditures in relation to GDP, has tended to peak an average of four quarters ahead of a recession. While it is possible that the pandemic has caused distortions, the DLI has been a reliable indicator in the past and is flagging that slower growth could lie ahead. Moreover, economic data are no longer coming in much better than expected. Citi's U.S. economic surprise index has fallen back below zero, suggesting that data have been disappointing versus consensus estimates (Exhibit 4). Taken together, these indicators suggest the positive momentum that was in place for most of the recovery in 2020 and 2021 appears to be fading.

Inflation soars

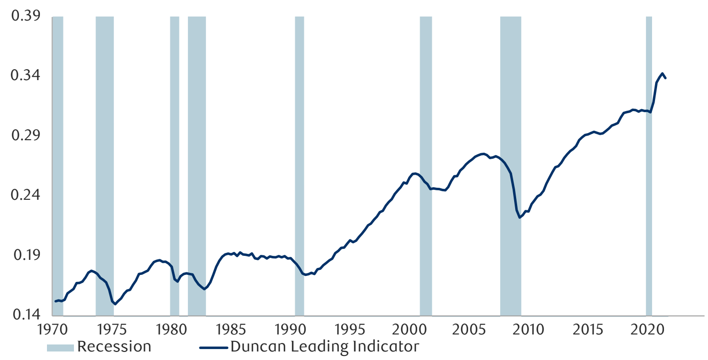
Although measures of economic growth may be softening, prices of goods and services are rising extremely fast. The U.S. Consumer Price Inflation (CPI) index rose 7.0% on a year-over-year basis as of December – the highest reading since the early 1980s (Exhibit 5). Unwanted inflation is taking root across the economy, with costs for energy, metals and automobiles on the rise, and defying the predictions of central banks and economists that price spikes would be temporary and limited in scope. Adding to the inflation pressures is an extremely tight labour market. The U.S. unemployment rate fell to 3.9% in December, near its lowest

Exhibit 2: Global purchasing managers' indices



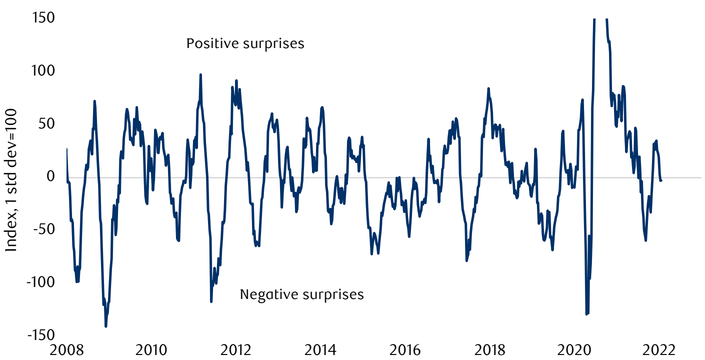
Note: as of January 20, 2022. Source: Haver Analytics, RBC GAM

Exhibit 3: Duncan Leading Indicator



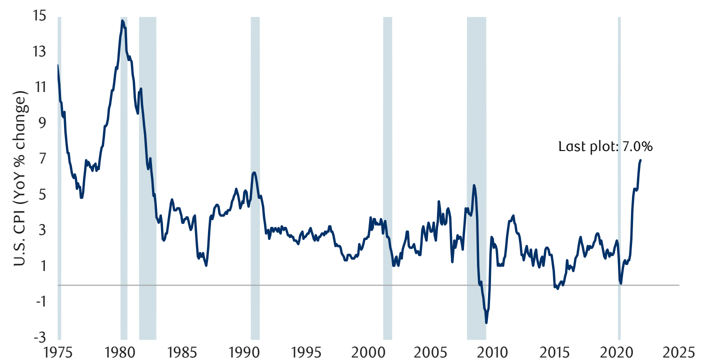
Note: as of September 30, 2021. Source: Duncan Wallace, Morgan Stanley Research, Haver Analytics

Exhibit 4: United States
Citi Economic Surprise Index



NNote: as of January 20, 2022. Source: Citigroup Global Markets Inc., RBC GAM

Exhibit 5: U.S. inflation
Year-over-year change in CPI



Note: as of December 2021. Shaded area represents recession. Source: BLS, Federal Reserve Bank of Cleveland, Macrobond, RBC GAM level in 40 years, and wages are rising at their quickest pace in four decades (exhibits 6 and 7). The power of employees to demand wage increases could lead to a wage-price spiral where higher wages cause higher prices and in turn spur employee demand for even higher wages. In our view, some of these inflationary pressures are temporary due to the pandemic, though our sense is that even if inflation cools from here it will likely remain above-normal over the medium term.

Rate hikes are imminent

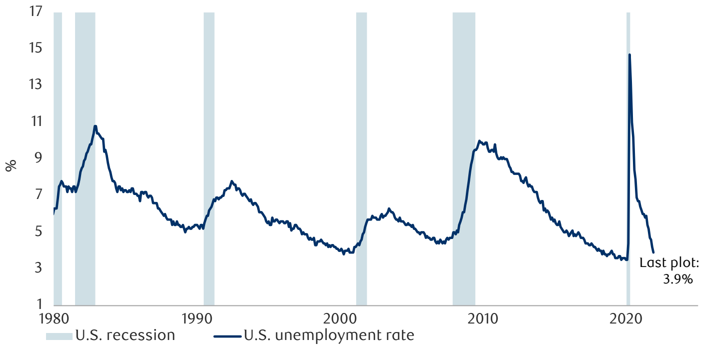
The macroeconomic backdrop no longer warrants extremely accommodative monetary policy and while it had been communicated for some time that interest rates would eventually normalize, there now seems to be a bit more urgency. Pricing in the futures market is signaling four rate hikes in 2022, up from the three indicated a month ago, and investors now expect the first rate hike to take place in March instead of June (Exhibit 8).

Moreover, the latest minutes from the U.S. Federal Open Market Committee (FOMC) suggested that not only would quantitative easing end in early 2022, but that quantitative tightening – outright shrinking of the U.S. Federal Reserve's bond holdings – could occur sometime this year. These changes in expectations represent a meaningfully more hawkish U.S. Federal Reserve, and mean that monetary policy will, at the margin, be less supportive of financial assets.

Bond yields surge; inflation expectations remain anchored

The prospect of faster monetary tightening than was previously expected led to sudden and significant surge in sovereign-bond yields. The U.S. 10-year yield has risen over 30 basis points since the start of the year to 1.80%, reaching its highest level since before the pandemic. Our models continue to suggest that yields remain too low and that they are likely to continue rising gradually over time, but the recent increase has moderated valuation risk in the near term (Exhibit 9).

Exhibit 6: U.S. unemployment rate

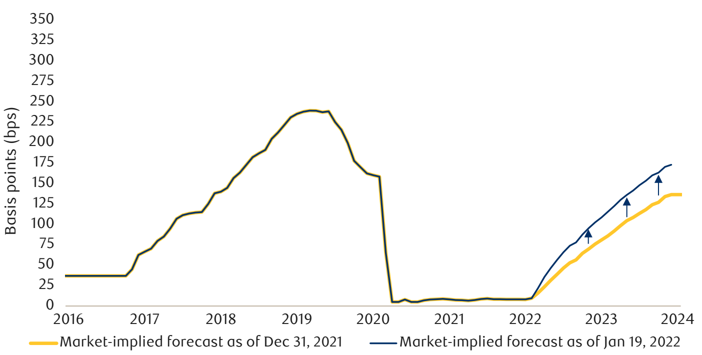


Note: as of December 31, 2021. Source: Bloomberg, RBC GAM

Exhibit 7: U.S. average hourly earnings

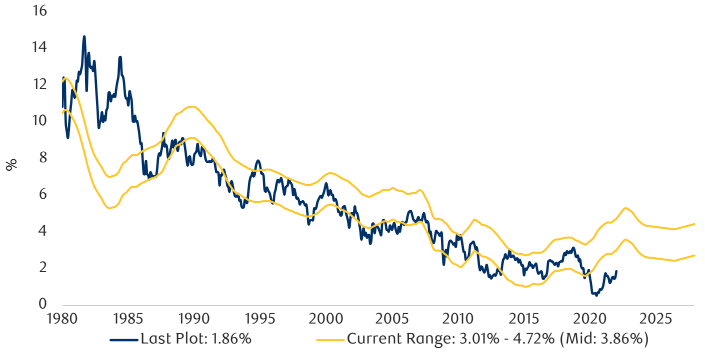
Note: as of December 31, 2021. Source: Bureau of Labor Statistics, Haver Analytics, RBC GAM

Exhibit 8: Implied fed funds rate
12-months futures contracts



Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 9: U.S. 10-year T-Bond yield
Equilibrium range



Note: as of January 20, 2022. Source: RBC GAM, RBC CM

Fast inflation has been a contributor to rising bond yields, but a closer look at market-based inflation expectations suggests that future increases in yields may be limited. Exhibit 10, which plots breakeven rates between 10-year and 2-year Treasuries, suggests that investors expect inflation to be lower over the longer term (i.e. 10 years) than in the near term (i.e. 2 years). Also note that the level of expected inflation is around 2% to 3%, which is a bit above normal but far less than the 7% we see today. We monitor these breakeven rates because any meaningful rise in them would signal a persistent inflation problem. For now, inflation expectations seem relatively anchored, and relatively low breakeven rates offer some comfort that the current surge in bond yields will be limited.

Equity markets stumble

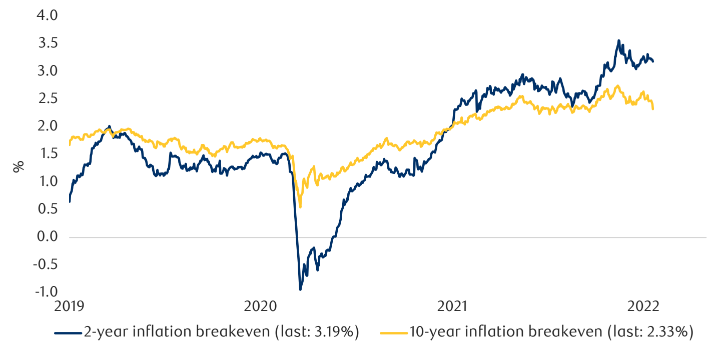
Equity markets have declined amid slowing growth, hawkish central banks and the recent surge in bond yields. High-priced growth and technology stocks were hit the hardest as higher discount rates weighed on valuations. In Canadian-dollar terms, the S&P 500 Index has declined more than 8% from its record high, but the Nasdaq Composite Index, which has a greater weighting in technology stocks, is down more than 13% (Exhibit 11). Canada's TSX Composite has outperformed, supported by energy and financial stocks which benefit from rising oil prices and anticipation of higher interest rates. Even with the recent sell-off, however, stocks remain fully valued, particularly in the U.S. large-cap space. The S&P 500 remains more than one standard deviation above our modelled fair value, a level that has historically been consistent with higher volatility and lower returns (Exhibit 12).

Style rotation underway

One of the main features of the recent market volatility has been the shift in preference away from growth stocks toward value. Although growth stocks have mostly led since the pandemic-era bull market began in early 2020, the recent uptick in inflation and the prospect of tighter central-bank policy means that growth stocks, which tend to trade at higher valuations, have become marginally less appealing. In an environment where strong economic growth lifts the profits of all companies, investors can get a better bang for their buck in lower-priced value stocks, and investors have been favouring value stocks since the beginning of December. From that time until now, the S&P 500 Value Index has beaten the S&P 500 Growth Index by 13 percentage points (Exhibit 13).

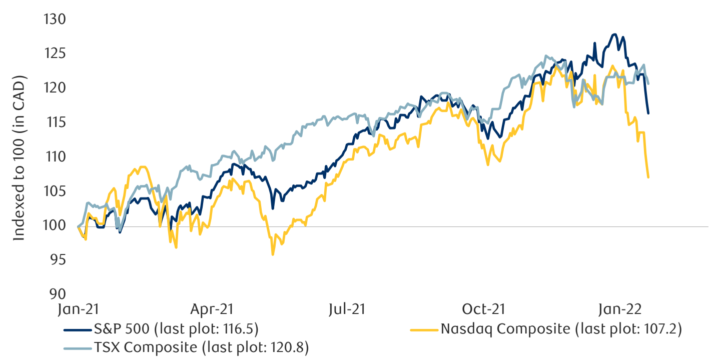
Several elements that could propel a sustained rally in value stocks appear to be falling into place (i.e. firm inflation, rising interest rates, strong GDP growth). That said, value stocks have failed many times to take the reins from growth stocks, so it is still too early to tell if the change in trend will hold.

Exhibit 10: U.S. Treasuries inflation breakevens



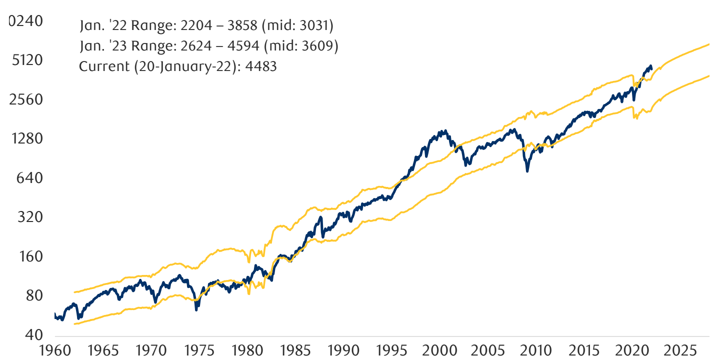
Note: as of January 20, 2022. Source: Bloomberg, RBC GAM

Exhibit 11: Major equity indices
Indexed to 100 at start of chart, in Canadian dollars



Note: as of January 20, 2022. 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

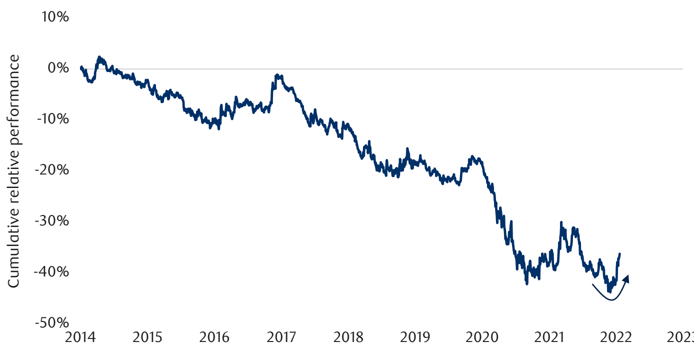
Earnings outlook remains solid, supported by strong nominal GDP

Although stocks have been on edge due to changes in interest-rate expectations, fundamentals still appear quite robust. Current estimates suggest analysts are looking for the S&P 500 to deliver US$223.63 in earnings per share this year for a year-over-year increase of 8.5% (Exhibit 14). During the pandemic, earnings estimates have proved to be much too low. It is possible that earnings will continue to surprise to the upside given our expectation of strong nominal GDP growth. While we expect real U.S. GDP growth to slow to 3.5% in 2022, meaningful inflation could boost that number in nominal terms to over 7%. Exhibit 15 plots a historical regression between earnings growth and nominal GDP growth, and it suggests that our 7.3% nominal GDP growth forecast could translate to 18.9% profit growth – more than double the consensus estimate. The correlation between the regression and earnings growth is not a perfect fit but it does suggest we should be open to the possibility that profits could come in better than the consensus estimate. While valuations may come down due to rising rates and high inflation, strong profit growth could provide an offset.

Asset mix – narrowing fixed income underweight as yields surge

Our base case scenario sees the economy growing at a moderate but slowing pace alongside firm inflation. In this environment, central banks seem intent on dialing back the extreme accommodation that has been in place since the pandemic began by ending quantitative easing and starting to raise interest rates. We expect bond yields to continue moving higher at a gradual pace, resulting in low or even negative returns for sovereign bonds over the year ahead. We remain underweight fixed income, but the recent surge in yields has somewhat moderated the extreme degree of overvaluation in bonds. At current rates, sovereign bonds will offer slightly more of a cushion against any downturn in the economy, and we have decided to add 0.25% to our fixed-income allocation, sourced from cash, resulting in a slight narrowing of our underweight position in bonds. We have left our equity position unchanged with a modest overweight as we continue to expect stocks to outperform against a backdrop of firm growth, potentially easing inflation concerns and rising corporate profits. Our current recommended asset mix for a global balanced investor is 63.50% equities (strategic: "neutral": 60%), 33.75% bonds (strategic "neutral": 38%) and 2.75% in cash.

Exhibit 13: Relative style performance
S&P 500 Value Index / S&P 500 Growth Index

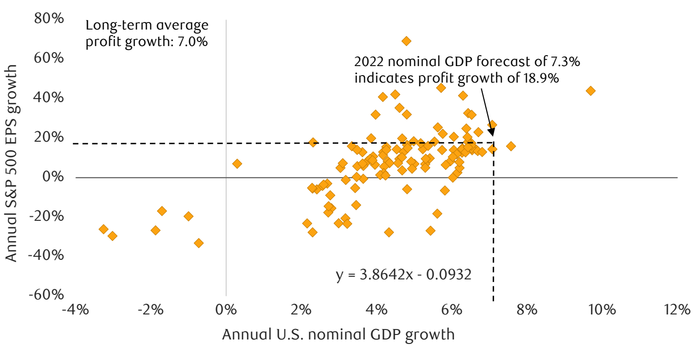


Note: as of January 20, 2022. Source: Bloomberg, RBC GAM

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. Source: Thomson Reuters, RBC GAM

Exhibit 15: S&P 500 EPS vs U.S. nominal GDP growth



Note: as of November 30, 2021. Based on quarterly data back to January 1990. Source: Bloomberg, RBC GAM

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