RBC Global Asset Management

Market Update

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Rising rates and Russia's invasion of Ukraine disrupted financial markets, re-pricing assets to more appealing levels

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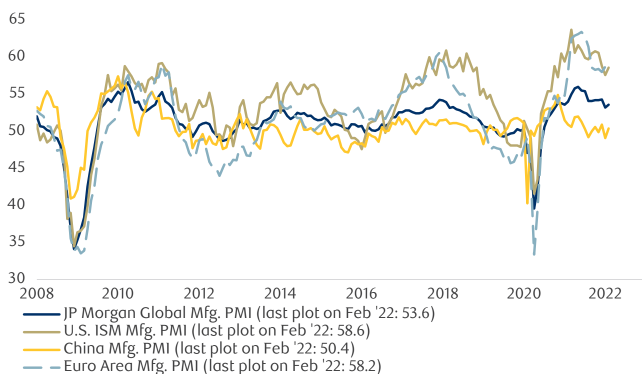
The most intense phase of the recovery from the pandemic is complete and the global economy is slowing as the expansion matures. Leading indicators have been moderating since their peaks of late 2020/early 2021 as stimulus subsides, central banks shift to tightening, fiscal programs are wound down and financial conditions in general become somewhat less accommodative (Exhibit 1). Although a tightening of financial conditions presents new risks to the economy and markets, these largely reflect the economy's solid footing with strong labour markets, rising wages and healthy consumer balance sheets. Inflation, though, is increasingly problematic, demanding a timely and appropriate policy response.

Russia's invasion of Ukraine complicates an already-challenging policy environment for central banks. It's hard not to think that Fed and ECB actions will be a bit more constrained and that additional pathways to negative outcomes have opened up. Historically, military engagement has had a limited impact on financial markets except in rare cases where the event ultimately changed the course of the economy. Clearly, the degree to which the outlook for inflation is altered by surging energy and other commodity prices, or that consumer and business confidence wanes during a period of already-tightening financial conditions, are now front of mind for central bankers and investors.

Exhibit 1: Global purchasing managers' indices



Note: as of March 1, 2022. Source: Haver Analytics, RBC GAM

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Lowering growth forecasts but expecting continued economic expansion

We now expect global GDP growth of 3.6% in both 2022 and in 2023. Although the risk of recession has increased as monetary conditions tighten and geopolitical risks rise, we expect the expansion to continue through the next 12 months at least, albeit at a slower pace. Inflation remains among the biggest threats to the expansion. We continue to look for a peak toward the middle of 2022 as pandemic-related distortions ease, although we now have our eye on the impact of energy and other commodity shocks related to the Ukraine invasion.

Central banks still on course for tightening at a measured pace

A pattern of upside inflation surprises moved the consensus on Fed policy to more than 6 rate hikes over the coming year, but the invasion of Ukraine has removed at least one hike from the consensus so far (Exhibit 2). We included only 4 hikes in our forecast, and now believe the risk of a negative growth shock is at least as large as a continuation of inflation's recent spiral.

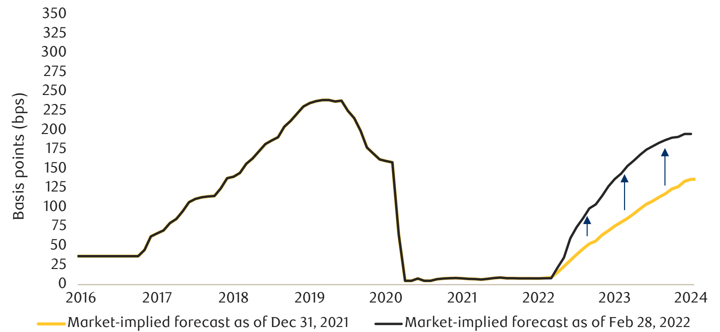
Surge in bond yields tempered by Russia's invasion

Prior to the invasion, fixed income markets had responded to rising rate expectations, moving the U.S. 10-year yield to 2.00%, more than 50 basis points above its level as the year began (Exhibit 3). Although we continue to believe that the direction of travel for yields is higher over the intermediate to long term, acute valuation risk has been moderated and Russia's invasion of Ukraine has encouraged safe-haven buying of sovereign bonds.

Global equities enter correction, improving valuations

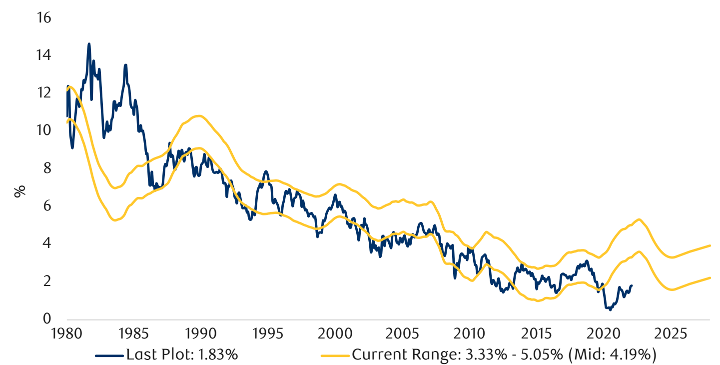
Volatility in global equities spiked and most major indices have entered correction territory, falling at least 10% from their peaks. Expectations for higher interest rates have reduced equity-market valuations and stocks with the highest price-to-earnings ratios suffered the largest declines. The tech-heavy Nasdaq, for example, fell briefly into a bear market defined by 20% below its peak, whereas Canada's TSX Composite, which features more value and cyclically-oriented sectors declined only 6% (Exhibit 4). Although some segments of the market remain expensive relative to fair value, the correction has improved the equity market's valuation underpinnings (Exhibit 5).

Exhibit 2: Implied fed funds rate
12-months futures contracts



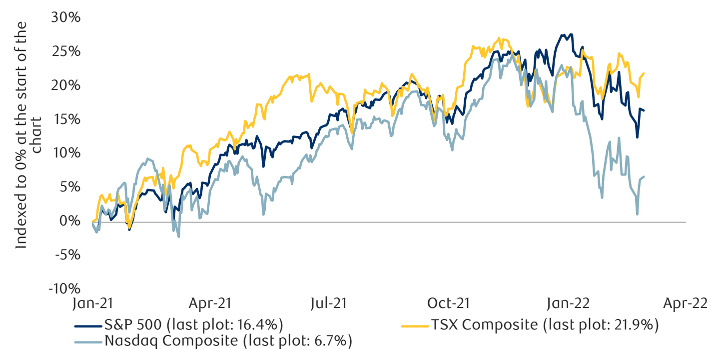
Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 3: U.S. 10-year T-Bond yield
Equilibrium range



Note: as of February 28, 2022. Source: RBC GAM, RBC CM

Exhibit 4: Major equity market indices
Cumulative price returns indices in USD



Note: as of February 28, 2022. Price returns computed in USD.
Source: Bloomberg, RBC GAM

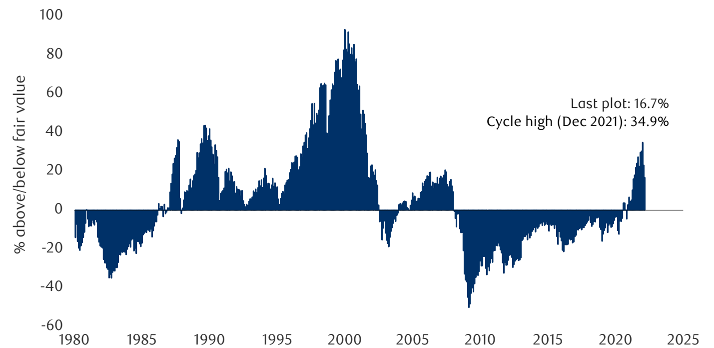
Solid earnings provide support to stocks

Rising interest rates have pressured equity-market valuations, but solid earnings growth could continue to provide an offset. Analysts look for S&P 500 earnings to rise approximately 8% in 2022 and even our revised nominal GDP forecast indicates double-digit profit growth is a possibility (Exhibit 6). Should inflation follow our expected path and earnings achieve the current consensus or better, today's levels for the S&P 500, TSX and others would likely prove to have been attractive entry points.

Asset mix – re-deploying cash reserves into stocks and bonds at more attractive premiums

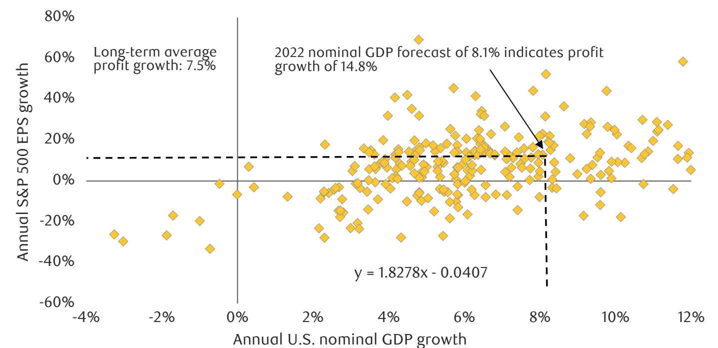
Our base case scenario continues to look for sustained growth in the global economy, albeit at a reduced pace as the recovery from the pandemic moderates, and inflation peaks by the second half of the year. The invasion of Ukraine and collateral damage in market prices and confidence may reduce growth by 0.25 – 0.75% over the year ahead, but a cushion against recession remains. The distribution of outcomes is changed significantly though, as the risks of stubborn inflation or a weakening of confidence must have risen since Russia unleashed the invasion. Against that, a spike in market volatility provided us with an opportunity to re-deploy cash reserves that we had built up over the past two quarters. We trimmed our bond and equity allocations slightly last year believing that yields were unsustainably low and returns on stocks were increasingly challenged by high valuations and the expectation of rising rates. The recent rise in yields and decline in stock prices allowed us to add back to these positions at more attractive levels. Specifically, we boosted our fixed income allocation by 0.5% as higher yields would provide additional cushion to portfolios in the event of a downturn in the economy or stocks, but we remain underweight our benchmark, reflecting our view that bonds are likely to deliver low to even negative returns over our forecast horizon in our base case scenario. We have also added 0.5% back to our equity position, sourced from cash. Although risks to capital markets have risen measurably over the past several months, a significant equity market adjustment has taken place, reducing valuation risk and improving expected returns. Our current recommended asset mix for a global balanced investor is 64.0% equities (strategic: "neutral": 60%), 34.0% bonds (strategic "neutral": 38%) and 2.0% in cash.

Exhibit 5: Global stock market composite
Equity market indexes relative to equilibrium



Note: as of February 28, 2022. Source: RBC GAM

Exhibit 6: S&P 500 EPS vs U.S. nominal GDP growth



Note: as of February 28, 2022. Based on quarterly data back to January 1990. Source: Bloomberg, RBC GAM

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