RBC Global Asset Management

Market Update

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Stocks rebound and bonds tumble as central banks respond to inflation pressures

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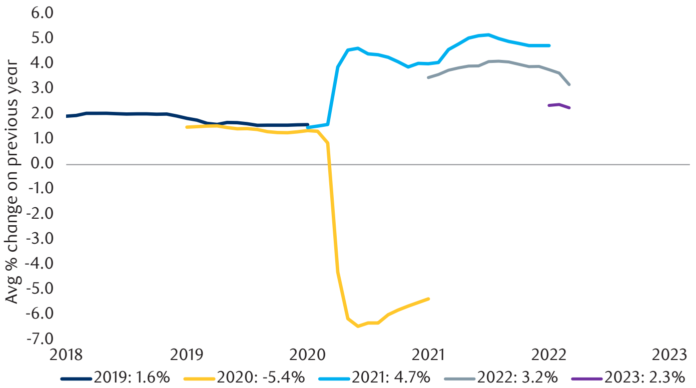
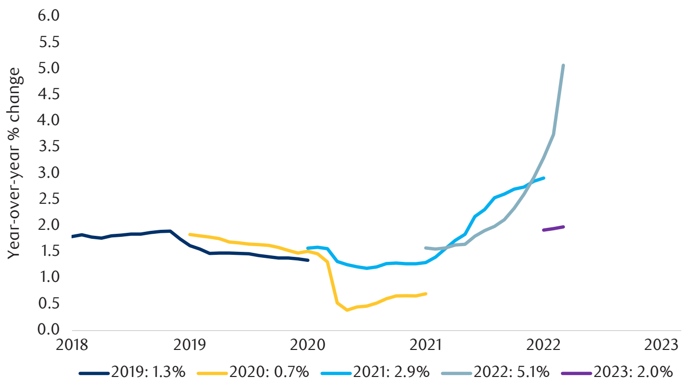
The war in Ukraine is persisting and attempts to de-escalate the conflict have so far proved futile. The consequences of the war between Russia and Ukraine will be severe and lasting, especially for those on the front lines. The rest of the world is also being affected through soaring prices for energy and food and renewed supply-chain challenges. Financial markets have encountered significant volatility as investors digest the possibility of slower growth and higher inflation stemming from the war, the resulting impact on monetary and fiscal policy, and the rising odds of recession. Against this backdrop, central banks have begun to raise interest rates, marking a transition away from the era of extraordinary monetary accommodation to one that should include a wind-up of quantitative easing and possibly even the introduction of quantitative tightening. This will likely act as a headwind to the economy and asset prices in general. Our own forecasts look for economic growth to continue slowing and for inflation to be higher for longer. However, we expect that price pressures will eventually start to ease toward the end of this year and into next. Our forecasts remain below consensus on growth, but above consensus on inflation (exhibits 1 and 2).

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



Note: as of March 21, 2022. Source: Consensus Economics

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



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

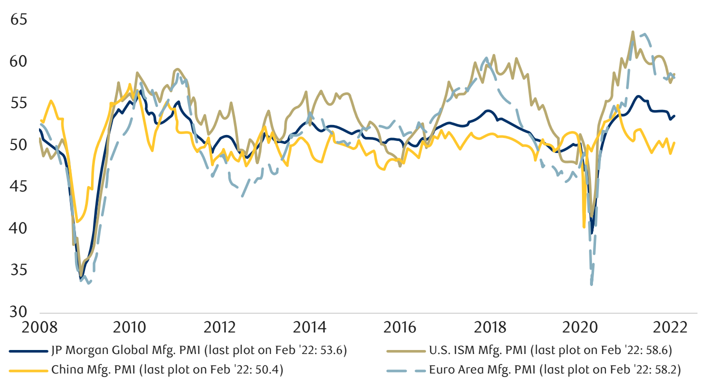
Maturing expansion features slowing growth, tight labour markets, high inflation

A slowdown in economic growth is natural after the period of extraordinary growth that followed the pandemic-induced recession, especially as the economy approaches its full potential. Purchasing managers' indices (PMIs) remain at levels consistent with an expansion, but have been declining at a gradual pace since peaking in early 2021 (Exhibit 3). This level of decline in PMIs is typical as a business cycle matures, and we would be more concerned about recession only if PMIs dropped to readings in the low 40s. Part of the reason that growth is slowing is that significant slack in the economy has been absorbed. The U.S. unemployment rate, for example, began the latest expansion near 15% and it has since dropped below 4% to near its pre-COVID low, which was the lowest level in the past 50 years (Exhibit 4). While the economy can continue growing, it is natural to expect a slower pace, especially amid geopolitical challenges, constrained supply chains and soaring commodity prices (Exhibit 5).

Central banks acknowledge inflation can no longer be ignored

It is becoming increasingly clear that central banks are abandoning their view of transitory inflation and that a meaningful policy response is needed. The U.S. Federal Reserve raised its benchmark interest rate by 0.25% on March 16, initiating a rate-hiking cycle that could feature a steady stream of rate hikes in the months ahead. At a recent speech to the National Association for Business Economics, Fed Chair Jerome Powell said one or more rate hikes of 50 basis points might be necessary in this environment of stubbornly high inflation. Pricing in the futures market suggests that rate hikes could total nearly 200 basis points by the end of this year and another 75 basis points next year which would lift the fed funds rate above its 2.50% peak in the 2015-2018 hiking cycle (Exhibit 6). It is worth noting that there are only six Federal Open Market Committee meetings remaining in 2022, which means investors expect at least one hike of 50 basis points. In a typical cycle, central-bank tightening reflects a

Exhibit 3: Global purchasing managers' indices

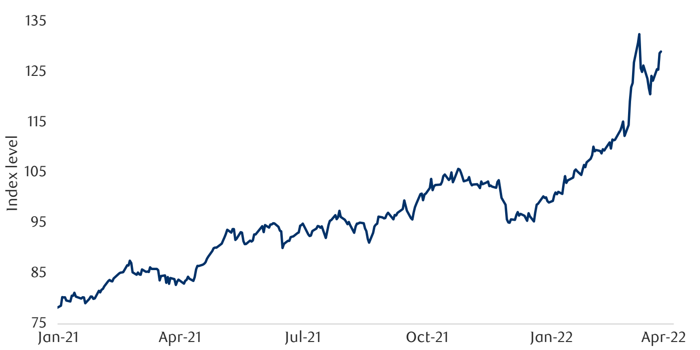


Note: as of February 28, 2022. Source: Haver Analytics, RBC GAM

Exhibit 4: United States
Unemployment rate

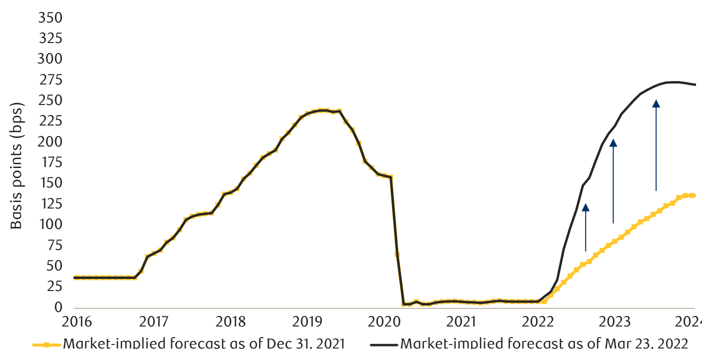
Note: as of February 28, 2022. Source: Bloomberg, RBC GAM

Exhibit 5: Bloomberg Commodity Index



Note: as of March 24, 2022. Source: Bloomberg, RBC GAM

Exhibit 6: Implied fed funds rate
12-months futures contracts



Note: as of March 23, 2022. Source: Bloomberg, U.S. Federal Reserve, RBC GAM strengthening economy in which rate hikes are warranted to prevent growth from overheating. But in a situation where central banks are aggressively raising interest rates to combat problematic inflation, the risk is that growth, which is already slowing, may falter more than the Fed and investors would welcome.

Bond rout worsens as yields surge

High inflation and hawkish central-bank commentary have pushed up bond yields and led to significant losses for fixed-income investors. The U.S. 10-year yield has climbed more than 50 basis points since the start of the month to 2.40%, its highest level since the spring of 2019. The significant and rapid climb in yields since December has led to a 7% loss in the ICE BofA U.S. Broad Market Index, a popular index of government and investment-grade bonds, the largest decline in the index since the early 1980s (Exhibit 7). Even with this massive increase in yields, our models continue to suggest that bond yields are unsustainably low given current conditions for growth and inflation (Exhibit 8). Nevertheless, the intensity in the recent climb in yields has greatly reduced sovereign-bond valuation risk in the near term.

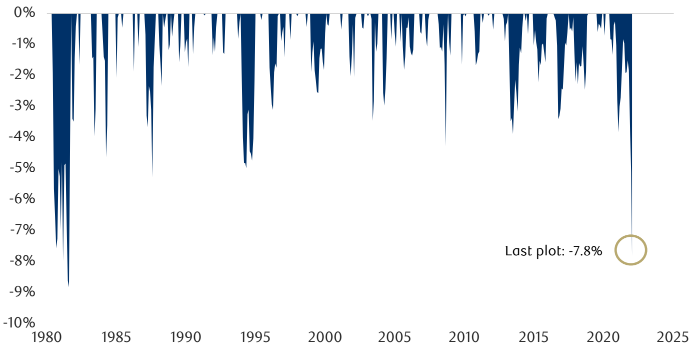
Flat yield curve consistent with late-cycle environment

The considerable flattening in the yield curve since the start of the year is worrying some investors because it could be a sign that recession is drawing closer. Exhibit 9 plots the slope of the yield curve as proxied by the spread between the yield on 2-year and 10-year Treasuries. A rising line on the chart means the yield curve is steepening and a falling line indicates flattening. An inversion occurs when the slope of the yield curve falls below zero, a level that has preceded each of the six U.S. recessions dating back to 1980. The yield curve is again approaching inversion. Importantly, though, there is often a meaningful lag between the inversion signal and the start of the subsequent recession. On average, inversions on the 2-year to 10-year yield curve occurred 18 months prior to recession and 15 months prior to the stock market's cycle peak. Given that the curve is positively sloped (albeit slightly), it is possible that a recession is still some time away, but the extreme flatness of the yield curve suggests we could be beyond the midpoint of the current business cycle.

Credit markets are not discounting significant risks

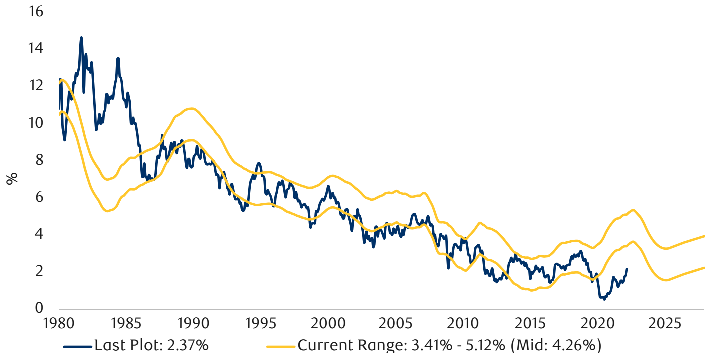
Most of the sell-off in fixed-income markets has been the result of rising government bond yields, whereas credit markets have been relatively well behaved. Spreads on

Exhibit 7: ICE BofA U.S. Broad Market Index
Drawdowns (total return index)



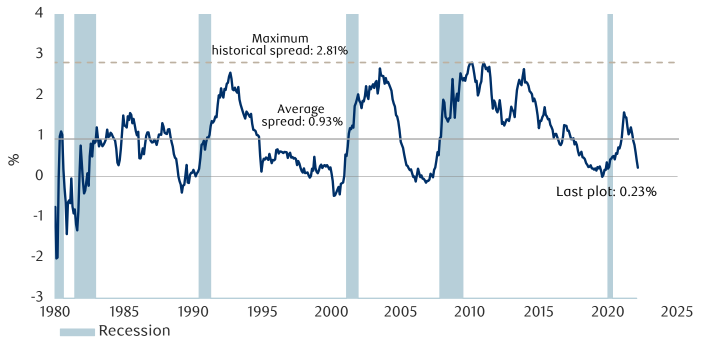
Note: as of March 23, 2022. Chart indicates declines from new highs, based on monthly closes in the total return index of the ICE BofA U.S. Broad Market Index. Source: Bloomberg, RBC GAM

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



Note: as of March 24, 2022. Source: RBC GAM, RBC CM

Exhibit 9: U.S. Treasury yield curve
Spread between yield on 10-year and 2-year maturities



Note: as of March 24, 2022. Source: Bloomberg, RBC GAM high-yield bonds, while widening a bit since the start of the year, remain well below historical averages, default rates remain low and the proportion of high-yield bonds considered distressed is at historical lows (Exhibit 10). Default rates would likely rise and credit spreads balloon should the economy enter a downturn. Given the heightened uncertainty in the outlook and increased chance of recession, it appears that credit investors are not being appropriately compensated for the potential risks.

Stocks rebound, mostly erasing post-invasion losses

Global equities have staged an impressive rebound in the wake of intense selling that followed Russia's invasion of Ukraine on February 24. The S&P 500 Index has risen more than 8% from its recent low in mid-March, and stocks outside of North America have risen even more. Canada's TSX composite, helped by rising commodity prices, climbed to a record this week and is up more than 3% so far this year. Most financial markets have recovered to their pre-invasion levels, with the exception of emerging markets (Exhibit 11). But even emerging markets have experienced a significant bounce, with the rebound in Chinese technology stocks being particularly strong as fears that Chinese stocks would be delisted from U.S. exchanges eased and Beijing vowed to support asset prices.

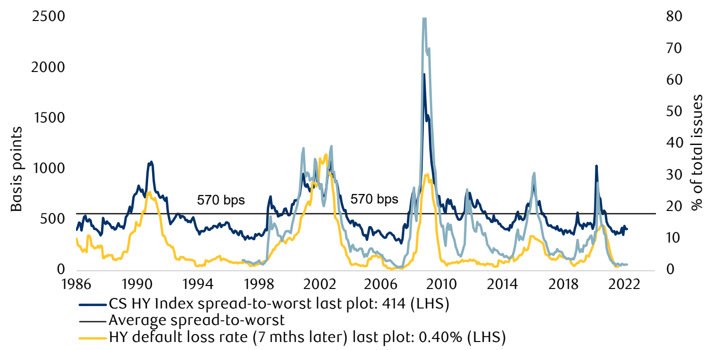
Latest equity-market rally re-introduces valuation risk and lowers return potential

The intense market volatility stemming from geopolitics, changes in interest-rate expectations and heightened uncertainty in the growth outlook has caused massive swings in market valuations from week to week. The sell-off in early March pulled the S&P 500 below 4200 and within one standard deviation of our modelled estimate of fair value. But the latest rally to 4500 pushed it decidedly back above that threshold into expensive territory (Exhibit 12). As a result, valuation risk has been re-introduced and total-return potential has diminished.

Positive momentum in earnings may be fading

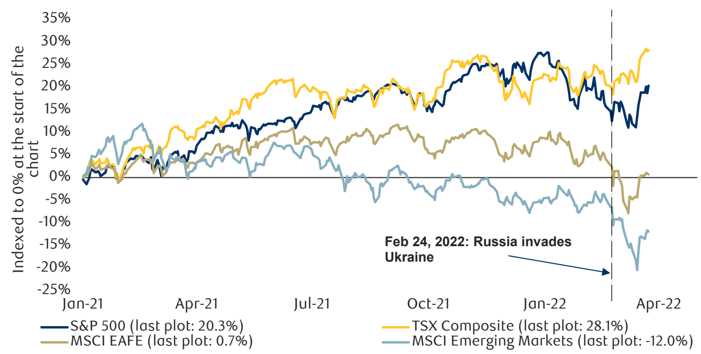
Upgrades to earnings forecasts had been a solid and consistent support for markets over the past 20 months, but it appears the momentum provided by earnings revisions may be waning. Exhibit 13, which plots the month-by-month progression of S&P 500 earnings estimates, shows a steady climb since mid-2020. Notice, however, that they have been moving sideways for the past few months. This leveling off

Exhibit 10: High yield bond spread



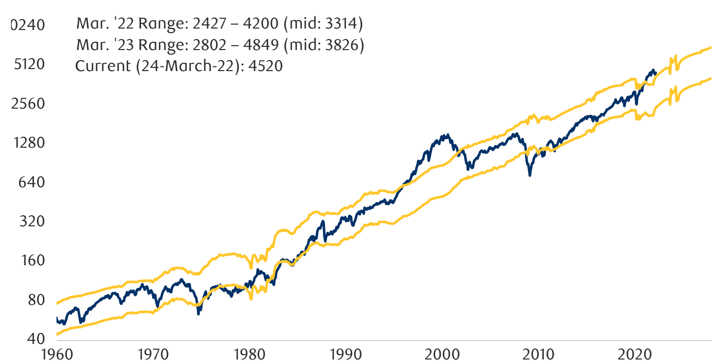
Note: as of March 18, 2022. Source: BofAML, Credit Suisse, RBC GAM

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



Note: as of March 24, 2022. Price returns computed in USD.
Source: Bloomberg, RBC GAM

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



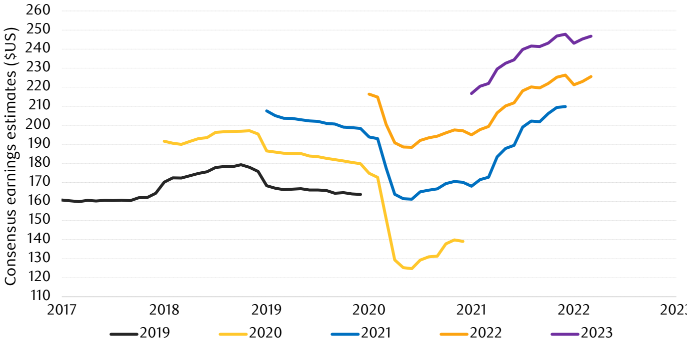
Note: the fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index.
Source: RBC GAM

suggests that earnings revisions, while still rising, are no longer a source of added thrust for equity markets. Moreover, slowing growth, tightening financial conditions and risks related to the war may not yet be fully reflected in analysts' estimates. Downgrades to profit estimates, if they occur, would likely present a challenge for stocks, and highly valued equities in particular.

Asset mix – trimming equity overweight, placing the proceeds into bonds

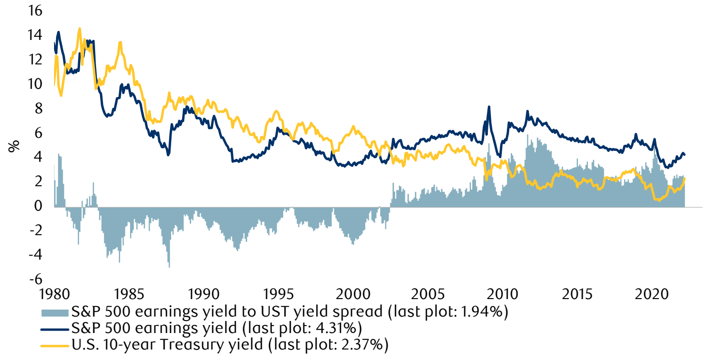
Our base case is for the economy to continue growing, albeit at a slowing pace, and we recognize that the range of potential outcomes is much wider than usual as a result of the ongoing conflict in Ukraine, surging commodity prices and a meaningful tightening in financial conditions. We expect that central banks will likely have to raise interest rates at a steady pace over the next year to combat inflation, but also recognize that the recent surge in bond yields may have already priced in a significant amount of the expected tightening. At these higher levels of yields, the risk that further capital losses will offset coupon income has been reduced. We expect low but positive returns from government bonds over the next year and believe that their higher yields will provide more of a cushion in a balanced portfolio in the event of a downturn. We continue to expect stocks to outperform bonds over our 1-year forecast horizon and are maintaining an overweight allocation to equites, but we recognize that the premium that investors expect to receive for holdings stocks versus bonds has narrowed, lessening the attractiveness of equities relative to bonds at the margin (Exhibit 14). As a result, we decided to take advantage of the rally in stocks and rise in bond yields to trim our equity overweight by 0.50%, moving the proceeds to fixed income. Our current recommended asset mix for a global balanced investor is 63.5% equities (strategic: "neutral": 60%), 34.5% bonds (strategic "neutral": 38%) and 2.0% in cash.

Exhibit 13: S&P 500 Index
Consensus earnings estimates



Note: As of March 23, 2022. Source: Thomson Reuters, Bloomberg

Exhibit 14: S&P 500 earnings yield
12-month trailing earnings/index level



Note: As of March 24, 2022. Source: RBC GAM, RBC CM

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