RBC Global Asset Management

FALL 2015

ECONOMIC OUTLOOK

Panic attack or bear market?

The combination of still-sluggish growth and significant downside risks creates a challenging environment for investors. Attention has focused on volatility in the stock market, but a wide range of other markets have also corrected this summer. Bond yields declined materially, commodity prices dropped and currency markets have been in flux (Exhibit 1).

Such turbulence tends to be difficult to anticipate. A key debate for investors now is whether the sell-off was the start of a new bear market or merely a panic attack within a secular bull market.

To understand the difference between the two types of corrections, we examined pricing, valuations and profit data from the last 15 years.

In our view, this recent episode looks more like a correction than the beginning of a bear market.

Headwinds remain

China concerns

Concerns over China's financial markets and slowing economy contributed to the sudden spike in market volatility in late August. These concerns are well-founded, given that China's economy generates a startling 33% of global economic growth.

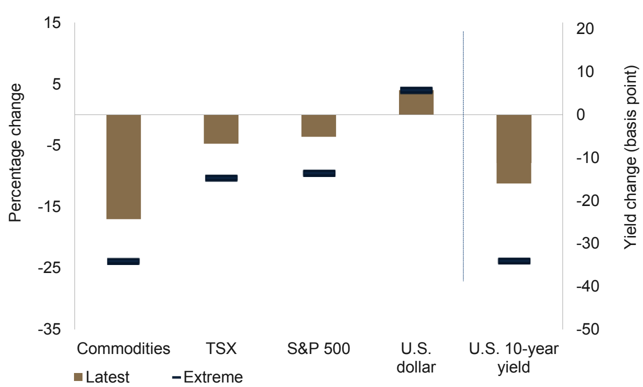
It is important to keep in mind, though, that the Chinese economy continues to grow at a rate that most other countries consider enviable, and its national government retains the tools necessary to resolve its credit excesses. We have long maintained a below-consensus growth forecast for China, but we do not expect a hard landing (Exhibit 2).

Oil prices

Oil prices have also grabbed headlines. After a brief revival in the early summer, they again slumped. This is great news for some countries, and bad for others.

The main culprit lies on the supply side, where production remains near an all-time high. This has forced market participants to rethink when the global oil market will return to balance. Previously, the consensus was that equilibrium would be restored by early 2016, but this now looks to be a 2017 proposition in significant part because of additional Iranian production.

Exhibit 1: Market turbulence this summer



Note: Percentage change of S&P Goldman Sachs Commodity Index, TSX, S&P 500 and broad trade-weighted US dollar since 6/30/2015. Basis point change of US 10yr yield since 6/30/2015. Source: Haver Analytics, RBC GAM

Exhibit 2: Chinese economy continues to slow

Note: PMI refers to Purchasing Managers Index, a measure of economic activities. Source: Caixin, Markit, Haver Analytics, RBC GAM

We believe that West Texas oil prices can rise moderately from here, but probably not all the way back to US$60 a barrel in the near term (Exhibit 3).

Global financial markets

In addition to China and oil prices, a number of other significant headwinds remain, much as they have in various combinations since the global financial crisis. Greek sovereign risks spiked higher during the past quarter, but have since settled back to a simmer. Other European political risks are notable but less intense.

Financial-market weakness and volatility are naturally concerns at present, though we expect the former will fade. Commodity-oriented risks – mostly connected with resource-exporting countries and companies – may linger due to a fundamental supply-demand mismatch. Lastly, there are a number of interest-rate and debt-related risks that could be triggered.

Economic forecasts nudged lower

We have nudged our global growth forecasts lower this quarter, with changes to both the developed and emerging-market outlook. Developed economies are nevertheless on track for improved growth in 2015, while emerging-market growth should slow materially this year.

Gazing into 2016, most regions should manage faster growth, though we have more conviction about this view for the developed world than emerging nations. In the developed world, North American growth prospects have been reduced, while the outlook for Europe and Japan is little changed. All appear on track for growth next year that is no worse than 2015, consistent with the economic-recovery narrative (Exhibit 4).

More to go for the dollar rally, but proceed with caution

The U.S. dollar continued to perform very well last quarter, but the greenback has been in a bull market for four years now and we feel confident declaring that the “easy money” has been made. To be clear, we’re still bullish on the U.S. dollar but are more tentative now, recognizing that the pace of the gains has been significant and that the currency is no longer undervalued.

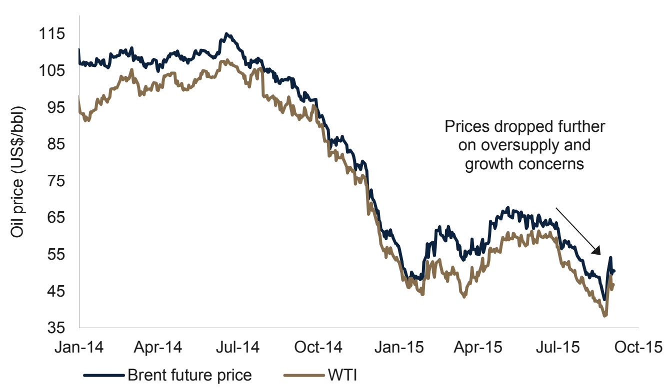
While the U.S. dollar will probably become significantly overvalued before this cycle ends, the latter stages of a bull market are more difficult to predict, and therefore more difficult to profit from.

Of the four major currencies, we think the pound will continue to hold its own against the U.S. dollar, while the Canadian dollar, the euro and the yen will continue to suffer. Our views are also informed by Chinese currency-market reforms, which are happening much faster than many investors had expected and carry important short- and long-term implications.

Low inflation likely to persist

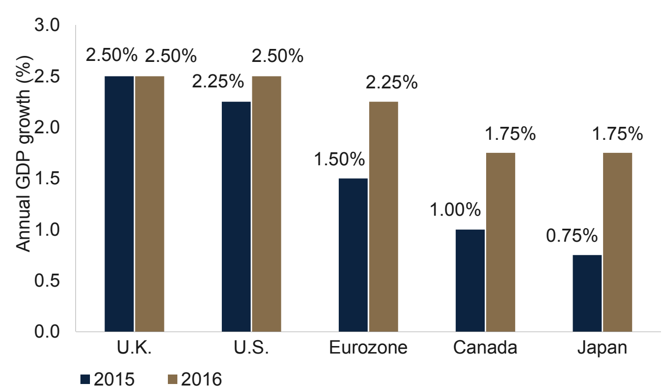
Global inflation remains very low and is likely to fall even more in the near term as the latest wave of oil-price weakness washes over the economy. Accordingly, we have edged down our 2015 inflation forecasts.

Exhibit 3: Oil’s summer slump



Source: Haver Analytics, Bloomberg, RBC GAM

Exhibit 4: RBC GAM GDP forecast for developed markets



Source: RBC GAM

Nevertheless, inflation should rebound somewhat over the next year as commodity prices stage a partial recovery and slack in the economy shrinks.

Policymakers in focus

Policymakers have played an unusually central role in determining the course of economic activity and financial markets since the 2008-2009 crisis. For this reason, market participants must maintain a close eye on fiscal and monetary-policy developments.

Global monetary-policy uncertainty has increased as some central banks debate raising rates. Chinese complications, greater financial-market uncertainty and lower commodity prices could combine to encourage other central banks to deploy another wave of monetary stimulus.

It has been 11 years since the U.S. Federal Reserve embarked on a tightening cycle. There has been much focus on the negative impact that such a cycle could have on the economy and the stock market. While a rate hike did not come in September, we still expect the Fed to move sometime this year.

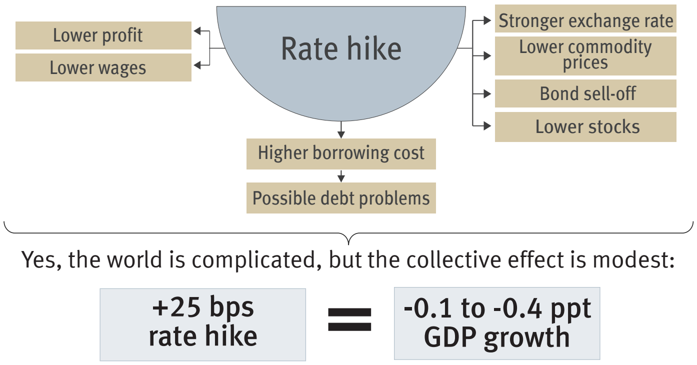
Many market participants have expressed concern about what will happen when the Fed does tighten. A common fear is that rate hikes will impose a truly dizzying array of problems, including lower corporate profits, falling equities, a stronger U.S. dollar and higher borrowing costs. However, we feel that these concerns are exaggerated. Linkages such as these do exist to varying degrees, but none are very strong.

Historically, a 25-basis-point rate hike can be expected to subtract no more than 0.1 to 0.4 of a percentage point from economic growth. This is material, but hardly a killer blow (Exhibit 5). The Fed understands this math and plans to proceed gingerly. As such, disaster is unlikely when the Fed tightens.

Modest increase in bond yields

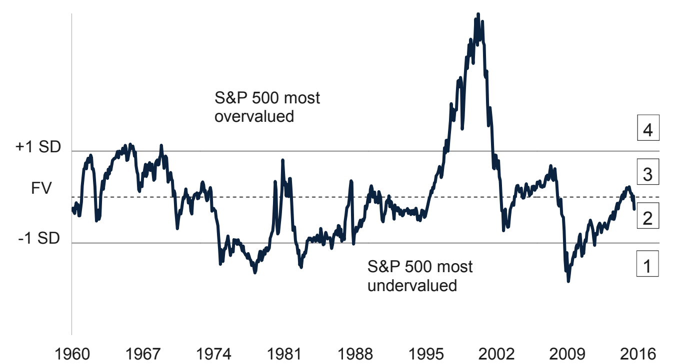
Bond yields have moved in a fairly wide range over the past year based on highly variable outlooks for inflation, economic growth and actions by central banks. We continue to look for a modest increase in bond yields over the coming year because developed-world economic growth continues to improve, inflation should begin a gradual rise this fall as commodity prices stabilize, and the Fed still appears likely to raise rates before the end of the year.

Exhibit 5: Complexity need not be paralyzing



Source: RBC GAM

Exhibit 6: Standardized S&P 500 fair value bands



Source: Haver Analytics, RBC GAM

Even a modest increase in yields poses a significant risk to bondholders. We expect that returns to sovereign bondholders will be low, or potentially negative, through the quarters ahead.

Equities remain compelling

Stock markets sold off heavily in late August, reflecting renewed concerns over global growth. The evidence so far suggests we are not in a bear market. In our view, the long-term case for stocks remains intact. Equity valuations were broadly fair before the downturn, but the decline has pushed equity markets below equilibrium, potentially providing an attractive entry point for investors (Exhibit 6). With stable earnings and the potential for rebounding valuations, total-return prospects for equities remain compelling.

Taking a longer-term view of equity markets, the rally over the past few years has pushed stocks above the broad trading range (or secular bear market) that existed from the late 1990s through the early years of the current decade, indicating that we may have shifted into a secular bull market. While secular bear markets are characterized by weak rallies and deep corrections, secular bull markets typically feature short, shallow declines and powerful, sustained rallies.

We prefer stocks over bonds

The valuation mismatch between stocks and bonds is sufficiently large to continue to warrant an overweight equity position, despite the risks described above. In fact, our analysis shows that returns for stocks could exceed those for fixed-income markets across most relevant time frames, with bonds producing low or even negative total returns for many quarters ahead.

After underperforming significantly following the technology-stock boom and bust of the late 1990s, the relative performance of equities bottomed in 2009, and at its lowest plot in over 75 years. Stocks have since moved ahead significantly on a relative basis, but the relationship remains below the long-term average, which may support continued equity outperformance.

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For more on our current view and outlook, please consult the full version of *The Global Investment Outlook* posted on our website at www.rbcgam.com/investment-insights/research-publications.

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