RBC Global Asset Management

Asset class commentary

FALL 2020

Global Economy

The world is in a very different place than it was a quarter ago. Economic activity has substantially rebounded, the coronavirus is no longer accelerating and progress continues toward a vaccine.

There has been considerable turbulence along the way. The second wave of infections struck the U.S., while Europe is struggling anew with the virus. The economic rebound was initially quite strong, but the rate of progress has decelerated now that the easiest gains have been claimed, and given remaining social-distancing restrictions.

Looking forward, challenges include increased virus transmission, fiscal drag, lagged credit losses, the U.S. election, the end-of-2020 Brexit deadline, ongoing protectionism, and the possibility of an eventual increase in inflation. Each of these issues is ultimately likely to be manageable, but the recovery from here should nevertheless be more muted than it was from April to July. A significant subset of the economy will remain handcuffed until the vaccine has been widely distributed – likely a mid-2021 proposition.

Fixed Income

Government-bond yields in developed markets remain historically low, and we expect that they will be broadly unchanged 12 months from now. The dominant factor in our outlook remains the pandemic. A return to normal appears to be a long way off, so we can expect the pandemic to continue having an unprecedented impact on people, governments and economies for the foreseeable future. Eventually the pandemic will subside and at that point yields should rise. Investors should be prepared for lackluster government-bond performance.

The effect of current monetary-policy actions on government-bond yields cannot be underestimated. Central bank policymakers have lowered policy rates dramatically, and have been clear that they do not expect to raise rates for some time, perhaps years. In addition to an extended period of exceptionally low short-term interest rates, central banks have committed to purchasing substantial amounts of financial assets. Though government bonds are expensive based on historical valuation tools, policy support alleviates upward pressure on yields in the near term.

Canada

The S&P/TSX Composite Index is now flat for the year after recovering losses associated with coronavirus lockdowns in the spring. The swift overall recovery in equity markets has been supported by substantial global monetary and fiscal responses, which quickly eased the burden of the COVID-19-related lockdown on the global economy. We expect the spread of the virus to remain contained, supporting continued progress in business re-openings that would result in economic and profit forecasts being restored to 2019 levels by 2021. This outlook depends on governments' ability to continue slowing the spread of COVID-19, the discovery and implementation of a vaccine and continued improvement in consumer and business confidence.

Consensus forecasts call for Canada's GDP growth to drop by 6.5 percentage points in 2020, the deepest downturn on record, and then increase 4.8% in 2021 and 2.8% in 2022.

Analysts expect S&P/TSX earnings for 2020 to fall by 30%, led by the Energy, Financials, Industrials, Real Estate and Consumer Discretionary sectors.

United States

The S&P 500 Index experienced the fastest decline in history before bouncing back to a record high just six months from the trough. The turnaround was supported by unprecedented global monetary and fiscal stimulus.

The recovery has been more narrow than usual and led by more expensive, less economically sensitive sectors. The valuation gap between growth stocks and value stocks has become more extreme as economic growth has slowed over time. For value stocks to outperform, economic growth will need to increase and broaden out, and long-term interest rates will need to rise modestly. Also important is the upcoming U.S. elections as President Trump's corporate-tax cuts and deregulation are at risk if he loses.

The S&P 500 is expensive according to a variety of valuation metrics. We do not believe investors are pricing in another substantial wave of COVID-19 infections in the fall, the failure of Congress to provide additional fiscal support, or a Democratic electoral sweep. The path of the virus and the development of a vaccine continue to be key.

Europe

GDP plunged a dismal 12% in the second quarter of 2020, which is still good when compared to the 35% contraction of the U.S. economy. Europe's relative resilience comes from the fact that the European economy is as a whole less dependent on consumption than the U.S.

We believe that the most important global theme affecting European stocks has been the disruptive power of digital technology. Our analyses often show that the most important question is whether a company or industry will benefit or suffer from changes in technology. We expect the accelerating growth in the use of digital products and services ushered in by the pandemic to continue.

While infections in Europe have risen substantially in recent weeks, we are hopeful that we have seen the worst of the pandemic and that the slow reopening of the major economies will continue. The most likely outcome appears to be: "As goes the virus so goes the economy."

Asia Pacific

Asian equities continued to recover from the March 2020 bottom and had returned to pre-COVID-19 levels by the end of August of this year. Governments across the region relaxed lockdown restrictions and implemented fiscal stimulus and liquidity measures to support the economy. The recovery has been generally rapid, particularly in north Asia, where COVID-19 cases are under control and economies have gradually re-opened. We expect, however, that weak economic data will continue into the third quarter of 2020, and we note that a recent rise in new COVID-19 cases has the potential to weigh on the jobs recovery.

During the three-month period ended August 31, 2020, equity markets in China, South Korea and Taiwan outperformed, while Singapore, Hong Kong and Thailand lagged the benchmark. The Information Technology, Consumer Discretionary, Health Care and Communication Services sectors outperformed, while Utilities, Real Estate, Industrials and Financials underperformed.

Emerging markets

From the start of the year until the end of August, and in line with developed market equities, the emerging-market equity benchmark had recovered almost all of its recent losses, and was down only 0.5%. Excluding China, emerging-market equities were down 11% during the same period, reflecting China's strong performance on the way into and out of the pandemic-driven correction.

'Internet enabled' growth stocks continue to outperform, benefiting countries and sectors most exposed to this area. This trend in style, country and sector performance has only accelerated during the pandemic and will likely persist in a low global growth and inflation environment. A weak U.S. dollar often signals the outperformance of emerging market equities but could also lead to a style rotation where value starts to outperform. We therefore believe a barbell-type emerging markets equity portfolio that avoids the most expensive growth stocks and offers exposure to higher-quality value companies is most appropriate to manage this risk.

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