RBC Global Asset Management

Asset class commentary

NEW YEAR 2020

Global Economy

Despite recurring bouts of volatility, the stock market ultimately found its form in 2019, first unwinding the damage done in late 2018 and more recently reaching new highs. Two main developments have underpinned this swell of optimism.

First, central banks are delivering a significant economic boost, which may allow global economic growth to stabilize after nearly two years of deceleration. Already, some leading indicators of the manufacturing sector have tentatively stopped falling.

Second, while negative macroeconomic risks remain significant, several have diminished over the past quarter, presenting a better risk-taking environment for investors. Important progress has occurred with regard to Brexit, trade negotiations, the resilience of the business cycle and Chinese stimulus.

After a decade of growth, the global economy is now operating near its full potential. This is a happy development in the sense that it means both workers and businesses are enjoying unusual prosperity. But if history is any guide, it also hints that there is less room remaining for further outsized economic and market gains.

Fixed Income

Global long-term bond yields have been moving in tandem in recent years, prompting Canadian investors to question whether fixed-income portfolio diversification can continue to support returns to the same degree that it has in recent decades. Our view is that the current low-yield environment actually strengthens the case for holding a diversified portfolio of global bonds as dwindling liquidity in fixed-income markets, shifts in monetary policy, indebted governments, trade tensions and spreading social discord create global uncertainty. We expect this backdrop to result in periods of volatility that will demonstrate the benefits of a diversified bond portfolio.

We expect a combination of monetary and fiscal stimulus to boost economic growth and eventually lead to a modest rise in long-term interest rates that would steepen the yield curve. However, quantitative easing and risks associated with richly valued higher-yielding fixed-income markets should keep government bonds well supported. As long as bond-purchase programs remain in place, the pressure of monetary-policy tightening is pushed further out and suggests limited room for long-maturity government-bond yields to rise over our forecast horizon.

Canada

The S&P/TSX Composite Index gained 4.7% during the three months ended November 30, 2019, lagging most global markets. While acknowledging that Canada's economy has been resilient in 2019, the Bank of Canada (BOC) remains focused on the impact of global trade on domestic economic growth beyond this year. Canada's economy has been bolstered by a stabilization of housing prices, strong labour markets, and resilient consumer and capital spending. As a result, the BOC has held its benchmark interest rate steady at 1.75% for a year, during which time 50 other central banks have eased monetary policy.

S&P/TSX earnings are on track to rise close to 5% in 2019 and analysts expect 9% growth in 2020. We expect more of next year's earnings growth to come from the Financials, Materials and Industrials sectors, shifting away from reliance on the Energy sector to drive growth. Progress on trade talks and global economic stability could raise growth expectations. However, we believe that returns may be limited if trade negotiations fail to reach a deal, business and consumer confidence wanes, and global economic data deteriorates.

United States

The S&P 500 Index returned 7.9% during the three months ended November 30, 2019, rising to an all-time high with gains in each month. The big stories during the period were two interest-rate cuts by the U.S. Federal Reserve (Fed), which led to a steepening of the yield curve, and a de-escalation of the trade war between the United States and China. The Fed's action loosened financial conditions, reducing the risk of recession next year and possibly lengthening the expansion.

U.S. economic growth in 2020 is forecast at about 2% and global growth at 3%, similar to average rates since 2010. In the United States, where consumption drives more than two-thirds of economic activity, consumers remain in good shape to continue supporting growth. Although consumer confidence remains high for the time being, we are also monitoring for further signs of weakness in manufacturing employment, particularly in states that are key to President Trump's re-election bid.

Europe

Europe's economy appears to have stabilized after decelerating over the past year, and this benefited financial markets. The immediate risks remain the same – trade negotiations between China and the United States and the possibility of a disorderly Brexit. Both situations have been heavily researched and are probably fairly well discounted in financial markets. We will watch them carefully because there is always the possibility that things will tilt in an unexpected direction.

The backdrop for corporate profitability remains good in general but growth is really only available to companies that have international exposure or are less vulnerable to substantial technological disruption. Valuations in Europe look cheap relative to the United States, partly because large parts of the European index are in challenged industries or are composed of companies that are domestically focused. Emergent risks are concerning but do not look sufficient at the current time to undermine the market's trajectory. The key risks appear to be private-equity debt and the changing relationship between corporations and governments as evidenced by suggested changes to corporate-tax regimes and a renewed antitrust focus on large technology companies.

Asia Pacific

Asian equities gained during the three months ended November 30, 2019. Returns benefited from an improvement in market sentiment starting in late September, as the U.S.-China trade conflict abated and the U.S. Federal Reserve continued to cut interest rates. Developments affecting individual Asian countries included India cutting its basic corporate-tax rate to 22% from 30% in September. In China, the central bank cut its benchmark interest rate to stimulate lending, in part to counter the negative economic impact of continuing street protests in Hong Kong.

Equity markets in Taiwan, India and South Korea outperformed, while Indonesia, Hong Kong and the Philippines lagged the benchmark. Japanese stocks outperformed the rest of Asia.

Regionally, the best-performing sectors were Information Technology, Consumer Discretionary and Health Care. The Real Estate and Utilities sectors underperformed.

Emerging markets

Emerging-market equities have underperformed developed markets over the past nine years given a strong U.S. dollar and slowing earnings and GDP growth relative to developed markets. We believe these factors will reverse over the coming years and will ultimately support an improvement in emerging-market stock performance relative to developed markets.

There are several reasons to believe that the period of U.S.-dollar strength may be coming to an end: the Fed move from quantitative tightening to balance-sheet expansion; a diminution of international risks; and a stock rally that looks extended, both in terms of duration and degree. Additionally, earnings and relative emerging-market economic growth appears set to improve as a result of improved productivity, structural reforms and more growth-friendly fiscal policies.

Persistent earnings downgrades have occurred in 2019 although the pace of downgrades does seem to be stabilizing. The underperformance of emerging markets relative to developed markets over the past few years has left emerging-market equities looking attractive from both an absolute and relative valuation perspective. There is also a powerful case that emerging-market currencies can perform well, driven by cheap valuations and strong current accounts.

Disclosure

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction. This document is not available for distribution to people in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the above-listed entities in their respective jurisdictions. Additional information about RBC GAM may be found at www.rbcgam.com.

This document is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when printed. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

Publication date: December 15, 2019

100755 (12/2019)