RBC Global Asset Management

Asset class commentary

NEW YEAR 2021

Global Economy

The pandemic that engulfed the world in early 2020 is still the dominant issue as the year winds down. The return of stricter social-distancing rules to fight the current wave are set to inflict mild to moderate economic damage at the end of 2020.

Nevertheless, on the cusp of 2021, we see four reasons for mounting optimism: the economic recovery so far has repeatedly exceeded expectations; vaccine-development efforts are beginning to yield big results; the market is pleased with the outcome of the U.S. presidential election and European nations are starting to emerge from their especially severe second wave.

As a result, and despite the prospect of a mini-economic swoon in the very near term, our refinements to the 2021 outlook have almost uniformly been upgrades rather than downward revisions, and our forecasts are now modestly above the consensus for the coming year.

Fixed Income

Bond yields have been inching up for several months, buoyed by the results of clinical trials suggesting that highly effective COVID-19 vaccines may soon be available.

Yields remain far below their pre-pandemic levels, and we expect this to continue over the next year. Central banks will remain concerned with nurturing a labour market recovery that will likely stretch over several years, and policy support is likely to be removed gradually.

Earlier this fall, the U.S. Federal Reserve (Fed) announced that it would begin linking changes in interest rates and bond purchases to an average inflation rate instead of current inflation – an approach known as average inflation targeting.

For the past several decades, bond investors enjoyed the role that government bonds served as insurance against declines in equities and the significant capital gains that bonds generated as yields steadily fell over time. Today, the apparent determination of central bankers to indefinitely hold short-term policy rates near zero should erode confidence that bonds can fulfill this insurance role.

Canada

The recent news of successful vaccine testing and related hopes for a powerful economic rebound in 2021 have helped the S&P/TSX Composite Index erase this year's earlier losses. Inflation expectations and interest rates will be the focus in the short to intermediate term as a rapid rise in either could jeopardize the equity rally. Optimism about solid economic activity has boosted the stock market's sizeable cyclical and commodity sectors, which will continue to benefit as long as the economic recovery accelerates. In the near term, we could experience some increased volatility because the resurgence of the coronavirus in Canada has raised the potential for more lockdowns and decreased profit expectations.

Consensus forecasts call for Canada's GDP growth to drop by 5.6% in 2020, much better than the decline of almost 8% originally forecast in the spring. Forecasts foresee the economy expanding 4.7% in 2021 and 3.2% in 2022. The S&P/TSX is currently trading at 23 times 12-month trailing earnings, heralding a full recovery in Index profits by late 2021.

United States

The S&P 500 Index rebounded from the depths of coronavirus panic in March to reach all-time highs last month after word broke that at least two vaccines had been shown to combat COVID-19. November's big run, on the order of 11%, also reflected the market-friendly outcome of the U.S. presidential election.

What is particularly striking was the outperformance of value and cyclical stocks in November, after the election result was determined and the vaccine news was announced. The key to sustained value-stock outperformance is for economic growth to increase and broaden out, and for long-term interest rates to rise modestly.

The S&P 500 is expensive at a multiple of 22 times the consensus 12-month forward earnings estimate of US$165, compared with a trailing five-year average of 18. It seems clear to us that earnings will have to continue exceeding expectations to keep the stock market moving higher.

Europe

European equities were fairly range-bound from June to October. They then rallied strongly in November, with some markets up well over 20% and bank stocks advancing even more. This recovery has heralded an improvement in Europe's performance versus the rest of the world, and while the rapid bounce could lead to some near-term consolidation, we believe the supportive backdrop will remain.

Entering next year, the chances are that earnings will pick up again, perhaps by as much as 45%, along with what we expect will be a quickening pace of economic activity considering the favourable vaccine news over the past number of weeks.

We have emerged from the worst global recession since the Great Depression and the quickest bear market, and now find ourselves in the midst of a historic bull market characterized by huge variances in performance across sectors and industries. In this environment, our efforts to manage risks are tied to monitoring the individual factors linked to performance.

Asia Pacific

Asian equities continue to recover from their March lows and many regional indexes have reached pre-COVID-19 levels. We expect GDP growth in Asia to improve in the second half of 2020, rebounding from the plunge in this year's second quarter, but the pace of recovery will vary by country. Recovery signs are especially strong in China, Taiwan and South Korea, where the outbreak is under control and economies have almost fully re-opened. Governments across Asia have continued to provide fiscal stimulus and liquidity measures to support the economy, but tourism and consumer spending are areas that continue to be hurt by the pandemic.

The best-performing markets during the quarter were China and South Korea, as emerging markets benefit from investor flows, and the Philippines, whose equity market has a large number of outperforming value stocks. Malaysia and Indonesia lagged the benchmark. The best-performing sectors were Consumer Discretionary, Information Technology and Communication Services, while Utilities, Energy and Consumer Staples underperformed.

Emerging markets

The emerging-market equities team has been focused on the increasing concentration of Chinese stocks in the MSCI Emerging Markets Index and the extreme underperformance of emerging-market value stocks relative to growth stocks.

It is clear that the stock markets of countries that have done a good job controlling the coronavirus are outperforming. China, Taiwan and South Korea, which account for two-thirds of the emerging markets index, have all but eliminated the virus within their borders and are reaping the benefits of superior stock returns.

We expect emerging-market earnings to rebound over the next two years after three years of weakness. The MSCI Emerging Markets Index is trading at 1.7 times price-to-book in line with the historical average and at a 35% discount to developed markets. We are just coming out of a decade of underperformance for emerging-market equities and U.S.-dollar strength, and we believe this is about to reverse.

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Publication date: December 15, 2020

100755 (12/2020)
ASSET CLASS COMMENTARY_NEW YEAR 2021_E 12/16/2020