RBC Global Asset Management

Asset class commentary

SPRING 2020

Global Economy

New sources of uncertainty have disrupted financial markets and undermined economic growth prospects. There is no question that many different pathways now exist for the global economy, and some of these could lead to recession. However, a coordinated response by central banks and politicians, the fact that past health scares have proven temporary, and the massive repricing of assets that has occurred over the last few weeks encourages us to maintain a moderately constructive outlook.

The recent decline in risk assets followed several quarters of financial market gains amid stable economic growth, supported by improved financial conditions and central-bank stimulus. An assortment of geopolitical risks remain, but the sudden spread of the Covid-19 virus, closely followed by the collapse in oil prices are the main culprits disrupting economic growth and investor confidence. We must recognize the growing presence of these risks and their potential adverse impact on near-term growth. We anticipate subdued global growth in 2020, but expect a recovery in 2021 as fears of Covid-19 diminish.

Fixed Income

The emergence in China of the new coronavirus has become a real threat to global trade and investor confidence. Accordingly, global bond yields recently declined to the lowest levels ever recorded. In the short term, the success or failure of efforts to combat the spread of the virus will be among the most important drivers of bond yields.

Our expectation is that the outbreak will be brought under control before it threatens severe economic damage given the enormous public resources being marshalled to fight the spread of the virus. Until investors are able to get a better handle on the progression of the disease, we expect volatility and demand for safe assets such as government bonds to remain high.

Faced with a continuation of extremely high fixed-income valuations in long-maturity bonds, it is useful to revisit some of our longer-term fair-value models. Based on an analysis of short-term interest rates, inflation and the term premium, our estimate of the fair-value range for the U.S. 10-year yield lies somewhere between 1.00% and 3.50%.

Canada

The S&P/TSX Composite Index recorded all-time highs toward the end of last year amid signs of global economic improvement, rising oil prices and a moderation in U.S.-China trade tensions. Since then, the spread of the new coronavirus makes all that a distant memory, as the outbreak raised considerable uncertainty about the outlook for the economy and corporate profits. In the three months ended February 29, 2020, the Canadian stock benchmark was down 3.8% on a total-return basis.

In January, the Bank of Canada lowered its GDP growth forecasts, noting weakness in domestic business investment, hiring and consumer spending. In early March, it cut its key interest rate by 50 basis points to 1.25%.

We forecast S&P/TSX earnings growth in 2020 of 5%, up from 4% last year. However, estimates could be revised lower to account for the economic impact of the coronavirus and continued commodity-price weakness. The overall S&P/TSX valuation is 15.8 times trailing earnings, under the long-term average of 16.7 and well below the S&P 500 Index's 18.3 multiple.

United States

At the end of February, the S&P 500 was down 13% from the peak as the coronavirus dashed hopes that the global economy might quickly emerge from a period of soft economic growth. Sectors with more dependable earnings performed best, led by Consumer Staples, Real Estate, Utilities and Health Care. Industrials, Materials, Information Technology, Financials and Energy lagged.

We expect that monetary and fiscal authorities globally will support economies, and the increased stimulus should bolster financial markets. We expect the corporate response to be equally aggressive. The biggest wildcard is the response of U.S. consumers if the outbreak becomes serious enough that officials quarantine populous areas and close schools.

History of prior viral outbreaks, natural disasters and acts of terrorism suggests that economic activity and financial markets rebound quickly once there is clarity about the event. Investors usually model the hit to corporate earnings as a delay rather than a fundamental change to earnings power. The volatility and uncertainty in the markets could provide investors with opportunities to add equity exposure to their portfolios.

Europe

Europe's macroeconomic dynamics appear to be broadly positive. Leading indicators such as Purchasing Manager Indexes (PMIs) and earnings estimates appear to be bottoming. Prospects for the economy as measured by Europe's Economic Surprise Index sit at a two-year high, both in absolute terms and relative to other regions.

While the course of the coronavirus outbreak injects a degree of uncertainty into our macroeconomic outlook, we remain focused on the relationship among PMIs, GDP and the pace of earnings growth in the region. Current earnings growth projections for Europe in 2020 are about 9% and should hold up better than past history suggests, given the macroeconomic improvements.

European equity P/E ratios are moderately high at 14.9 compared with a long-run average of 13.2. Still, equities continue to offer the highest dividend yields ever versus fixed income. The yield advantage of European stocks relative to 10-year government bonds rests at a 100-year high of 3.5 percentage points.

Asia Pacific

Asian equities started the period strongly after a preliminary U.S.-China trade deal in mid-January. In addition, signs of stabilization of Chinese retail sales and industrial output fueled hopes for economic growth this year. This optimism was short-lived as the coronavirus outbreak led to declines in late January and again toward the end of February. While China has made progress in stopping the spread of the disease, the virus is taking hold in other parts of the world.

In India, the government is again raising the percentage of domestic companies that foreigners can own to promote investment. The increased openness has helped Indian stocks trade near record highs, but slowing growth and consumption are at hand.

Equity markets in Australia, China, Taiwan and India outperformed the Asian benchmark while Thailand, Singapore and the Philippines lagged. Japanese stocks underperformed the rest of Asia.

Regionally, the Information Technology, Communication Services, Consumer Discretionary and Health Care sectors outperformed. Energy, Real estate, Industrials and Utilities underperformed.

Emerging markets

Emerging market equities have fallen so far in 2020 due to virus concerns and its impact on what was a nascent, yet fragile, economic recovery. It is still the base case that the virus will behave in a similar way to the SARS virus and recede when the weather improves. We expect this impact will be transitory, and that central banks and governments will act in a synchronized manner to reduce the damage.

Looking beyond the coronavirus, we believe there are four key factors that will play an important role in determining the performance of emerging market equities: the U.S. dollar, the economic growth differential between emerging markets and developed markets, earnings growth, and valuations. In our view, there is a high likelihood that in the coming years some of these factors will move from headwinds to tailwinds, and such changes would ultimately support a sustained improvement in relative emerging market performance.

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