RBC Global Asset Management

Executive summary

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Equity markets have staged a remarkable recovery as central banks provided critical backstops, economies gradually emerged from shutdown and investor confidence was restored. The economy rebounded quickly after mass quarantines, but progress has slowed as the easiest gains have already occurred.

Economic activity rebounds

The world is on a much better footing than a quarter ago as economic activity has substantially rebounded, the threat of COVID-19 has moderated and progress toward a vaccine has progressed. The recovery began earlier than many investors expected, supported by unprecedented amounts of monetary and fiscal stimulus. Real-time measures of activity started to turn up in mid-April and continued to improve until just recently. At this point, developed economies have reclaimed a little more than half of their lost output. Economies are again expanding, but we expect 2020 GDP to be less than 2019 given the magnitude of the decline earlier in the year. We now forecast a contraction in global GDP of 4.0% in 2020, which represents a 0.6 percentage point improvement versus last quarter.

New headwinds emerge and the pace of recovery is slowing

The economy continues to face a variety of challenges on the journey back to normal. Many of the sectors that remain depressed are likely to be structurally limited until virus worries abate. Unemployment remains elevated and those who are still jobless may have difficulty finding work until their industries return to normal operation, which could be months or even years out. For corporations, credit problems usually occur with a lag, meaning the 2020 recession could result in increased defaults in 2021. The latest survey of senior U.S. loan officers suggests some tightening in credit conditions is occurring and that fiscal headwinds are starting to mount. The U.S. has already dialed back its support for the unemployed which could limit consumer spending. We do not believe that these challenges will derail the economic recovery, but they do suggest that it will occur at a slower pace than what we have seen so far.

U.S. presidential election looms

The U.S. presidential election is fewer than two months away and betting markets are favouring a Biden victory over Trump at the time of writing. The Biden platform proposes substantial changes compared with Trump's mostly status quo plan. Some of Biden's proposals could hinder economic growth, including higher taxes, increased regulation and limitations on the energy industry. But there are several policies that could boost economic growth, such as a more coordinated national approach to the coronavirus, a larger fiscal stimulus package, less protectionism and

more immigration. Overall, Biden's platform may be worse for growth in the short term, but better beyond a one-year horizon. Equity investors, however, may be more concerned with his proposed corporate-tax hikes than economic growth, so a Biden victory could pose a headwind for the stock market to the extent that this outcome is not already fully priced in.

U.S.-dollar weakness expected to persist

The downtrend in the U.S. dollar is now clearly established. The 10% decline in the trade-weighted dollar since March is just the beginning of a longer-term period of U.S.-dollar weakness, supported by a number of structural, cyclical and political factors. We expect G10 currencies, most notably the euro and the yen, to continue to outperform their emerging-market peers during this phase in the U.S.-dollar cycle. Our view on the Canadian dollar is more nuanced. We have shifted from bearish to bullish on the Canadian currency in acknowledgement of some new positive factors and recognition that the U.S.-dollar downtrend will likely prevail as a more important influence on currency markets.

Sovereign-bond yields remain historically low

The weak economy and highly accommodative central-bank policies resulting from the pandemic pulled longer-term government-bond yields around the world to historically low levels. In the past quarter, yields remained near these levels and fluctuated in a narrow range. Our composite of global bonds suggests yields are well below our modelled equilibrium levels and represent severe valuation risk. Real, or after-inflation, yields are currently negative and we don't think this situation is sustainable as investors will eventually demand compensation for tying up their funds. However, we don't think yields will rise by a significant amount in the foreseeable future because of structural changes related to demographics, an increased preference for saving and the maturation of emerging-market economies. Even a gradual increase in sovereign-bond yields would generate low single-digit to slightly negative total returns, potentially for many years.

Stocks surge as investors bet on earnings recovery

The equity market rally that began in March extended into the summer, with most major indexes posting double-digit gains in the past three months to fully erase or greatly minimize their prior losses. To the extent that investors are looking beyond the pandemic, earnings lost due to COVID-19 have little impact on the present value of stocks as long as earnings ultimately regain their prior trajectory. Firms have experienced severe profit pressure during the shutdown and recovery, but investors are also focused on future earnings which are unlikely to feature COVID-19-related distortions. Within investing styles, the pandemic has accelerated the trend of growth-stock outperformance and the valuation gap between growth and value stocks has now reached extremes not seen since the late 1990s technology bubble. Valuations have crept up in the U.S. equity market, in particular. Our global fair-value composite is now above equilibrium and at its highest reading in over a decade. But valuation dynamics differ significantly among regions, with U.S. equities the most fully priced and other stock markets still at particularly attractive levels.

Asset mix – boosting equity allocation by one percentage point, sourced from bonds

Monetary policy is expected to remain highly accommodative in order to support the economy and financial markets, and price-insensitive asset purchases by central banks will likely keep bond yields from rising. In this environment, we expect sovereign bonds to deliver low-single-digit to slightly negative total returns. Critically, at these low yield levels, sovereign bonds offer less cushion in a balanced portfolio against any deterioration in the macroeconomic outlook.

We recognize that elevated equity-market valuations and optimistic investor sentiment leave stocks vulnerable to correction in the near term, and that style exposures should be managed given the massive valuation gap between growth and value stocks. Over the longer term, however, stocks offer superior return potential versus bonds, a view supported by the still significant equity-risk premium that exists in today's low-interest-rate environment. For these reasons, we shifted one percentage point from our bond allocation to stocks this quarter. For a balanced, global investor, we currently recommend an asset mix of 62 percent equities (strategic neutral position: 60 percent) and 37 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

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