RBC Global Asset Management

Executive summary

NEW YEAR 2020

Financial markets staged a solid recovery in 2019 as a number of key macro challenges from last year faded and new tailwinds emerged. Although risks remain, several positive signals have led us to a more constructive outlook with lesser odds of a negative scenario unfolding.

Economic growth may be bottoming

After nearly two years of decline, economic growth may be close to bottoming. While actual data has yet to improve, leading indicators of growth have stabilized and/or turned higher in most major regions. In 2019, the economy has been supported by a strong service sector and resilient consumers, offsetting weakness in manufacturing. More recently, monetary easing has helped stabilize economies and we expect the boost from lower interest rates to kick in on a lagged basis. We have, however, trimmed our outlook for 2020 global growth to 3.25% from 3.50%, mainly because of slower-than-expected momentum carrying over from 2019. Emerging-market economies are set to rebound, while developed-market growth may continue to decelerate marginally. With this updated forecast, we expect global growth in 2020 to match that of 2019, which is an encouraging sign after two years of deceleration.

Macro risks have faded, but not disappeared

Progress on U.S.-China trade and Brexit has reduced two of the key macro risks to our outlook. Trade relations between the U.S. and China have improved as the two countries are nearing a "Phase One" trade deal. That said, there remains friction between the world's two largest economies and there is no certainty that they will reach a deal that significantly improves the global trade outlook. Brexit is also looking a bit better as the risk of a "No Deal" Brexit has shrunk. The U.K.'s departure from the EU will still inflict economic damage, but less than we had initially feared. The U.S. presidential election in November is likely to provide a new source of uncertainty as the campaign unfolds. Overall, we believe that the macro risks facing economies and markets are less severe than we would have imagined a quarter ago.

Odds of imminent recession reduced slightly

Our assessment of the U.S. business cycle continues to indicate that we are late in the cycle, a view that we have held over the past few years. That said, some of the inputs to our scorecard framework have become less concerning recently. The most noticeable change is that the U.S. yield curve – proxied by the spread between 3-month and 10-year Treasury yields – is no longer inverted. This indicator has been a classic recession signal and the steepening in the yield curve since the summer suggests that the odds of recession have declined. However, other measures continue to show that we are fairly late in the business cycle. For example, most output-gap estimates suggest that the U.S economy is already operating at full capacity. We estimate the risk of recession at approximately 35% over the next year, which is still elevated but down from our prior assessment of 40%.

U.S. dollar tailwinds are waning

After touching multi-decade lows in 2011, the U.S. dollar has appreciated for nearly nine years, buoyed by relatively strong growth and higher interest rates. These tailwinds are beginning to dissipate, however, as the Fed has

undertaken a series of rate cuts and resumed quantitative easing. Next year's U.S. election introduces additional downside risk for the greenback, adding to the mounting headwinds of overvaluation, and fiscal and trade deficits. An acceleration in global growth would further erode the relative attractiveness of the dollar and tip the greenback into a period of sustained weakness. In this environment, we are constructive on emerging-market currencies with strong fundamentals and expect the euro and yen to outperform the loonie and the pound.

Central banks deliver monetary stimulus

Financial assets benefited this year from the major tailwind of aggressive monetary easing. The U.S., the Eurozone, China and India all lowered interest rates and some regions restarted quantitative easing. While the U.K. and Japan did not provide additional monetary support, they did not dial back prior stimulus efforts. One challenge that this new round of stimulus presents is the possibility that policymakers will have little room for additional easing in the event that economies require more stimulus. While some central banks have lowered rates into negative territory, we hope that such unorthodox policies don't last as they could have unintended consequences. With substantial monetary stimulus in place, a logical next step would be for governments to turn to fiscal spending as a tool for supporting economic growth.

Low-yield world is likely to persist

Although bond yields have rebounded somewhat in the last quarter, we don't believe this increase marks the start of a sustained rise in yields. Real interest rates are being depressed by a number of secular factors such as aging populations, an increased preference for saving versus spending, and slower rates of economic growth. The downward pressure on real rates from these forces is expected to reverse only marginally over the coming decade. We forecast that inflation will be relatively stable, meaning the direction of bond yields will be linked to changes in real interest rates. Our models suggest that bonds are susceptible to valuation risk as yields are below their equilibrium levels, especially outside North America. However, we think that any increase in yields is likely to be gradual and extend over a long period. Given the starting point of extraordinarily low yields and the fact that they are likely to move higher over time, if only a little, we can expect low sovereign-bond returns for the foreseeable future.

Stocks soared in 2019, but could still have room to run

Equities delivered impressive gains in 2019 amid low interest rates, stable inflation and moderate economic growth. The S&P 500 has rallied over 25% so far this year and is now the closest to fair value of the major indexes that we track, while stock markets outside the U.S. still look quite attractive. Profit growth will likely need to resume in 2020 to support further equity gains. Analysts expect earnings growth to re-accelerate and a variety of market signals reinforce this view. Since the summer, economically-sensitive sectors have outperformed defensives, value stocks have led the growth style, and international markets have participated in the rally. In the past, these types of market rotations have been associated with improving economic and corporate-profit growth, and may indicate the bull market has room to run.

Boosting equity weight, sourced from cash

In our view, the economy is likely to continue to expand at a moderate pace and we therefore expect bond yields to be relatively contained. We remain underweight fixed income given uninspiring return projections over our 1-year forecast horizon. Stocks offer the potential for bigger gains and, balancing the risks and rewards, we think that the risk premium between stocks and bonds is worth capturing at this time. As a result, we have leaned toward taking on more risk this quarter after de-risking our portfolios for more than two years. Stabilization in economic leading indicators, the rotation into value, and improving global market breadth have heightened our conviction in a positive outcome for risk assets. We added two percentage points to our equity allocation this quarter, sourced from cash, marking the first steps in the reversal of our prior de-risking. For a balanced, global investor, we currently recommend an asset mix of 59% equities (strategic neutral position: 55%) and 40% fixed income (strategic neutral position: 43%), with the balance in cash.

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Publication date: December 15, 2019

32467 (12/2019)
EXECUTIVE SUMMARY_NEW YEAR 2020_E 12/16/2019

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