RBC Global Asset Management

Executive summary

SPRING 2020

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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.

Economic growth disrupted by Covid-19

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. As a result, we have reduced our outlook for global growth to 2.9% from 3.25%, which would be the lowest in more than a decade. This updated forecast leads us to anticipate subdued global growth in 2020, but we expect a recovery in 2021 as fears of Covid-19 diminish.

Macroeconomic risks escalate

Several geopolitical risks had faded near the end of 2019, including the U.S.-China trade dispute and Brexit uncertainty, creating a favourable environment for risk assets. However, a collection of new challenges has reversed this positive trend and increased uncertainty for economies and global financial markets. Most turbulent of all is the Covid-19 virus, whose negative impact continues to propagate through the economic system, disproportionately affecting the poorer emerging-market economies. The steep decline in the price of oil, while a near-term benefit to consumers, has directed investor's attention to the vulnerability of energy and other sectors facing lower cash flows, especially where balance sheets have been significantly leveraged through the past decade. Tensions remain in relations between the U.S. and Iran, and the upcoming U.S. presidential election poses another potential source of volatility for markets. The socialist candidate, Bernie Sanders, continues to mount a serious claim for the Democratic nomination and uncertainty remains regarding the effectiveness of his policies. Overall, we believe that the macroeconomic risks facing investors are more severe than they were a quarter ago.

Central banks provide additional stimulus

Central banks including those in Canada, the U.S. Australia and China have recently bolstered monetary accommodation by reducing interest rates in a coordinated effort to combat the risks to economic growth. While further monetary stimulus is expected, its implementation and effectiveness have become worrisome as policymakers continue to move rates toward zero. Some central banks have lowered rates into negative territory and the potential for unintended consequences from such unorthodox monetary policies is a concern. While fiscal spending is more cumbersome and takes longer to implement than rate cuts, governments may find that it is the next logical – and perhaps more effective – step for supporting economic growth.

Late-business-cycle concerns

Our assessment of the U.S. business cycle using a scorecard approach continues to indicate that we are at a late stage in the cycle. At nearly 11 years, the economic expansion is lengthy by historical standards and the labour market is extremely tight. Within our framework, the odds of a recession have risen due in part to changes in the yield curve. In contrast to the previous quarter, when recession risks were moderating, the yield curve has flattened again, signaling an increased risk of recession following the Covid-19 outbreak.

Expecting U.S.-dollar weakness ahead

Currency markets whipsawed on concerns that Covid-19 will have a detrimental impact on growth and push the global economy into a recession. Initial concerns led to a U.S. dollar rally in a safe haven scenario, but heavy flows into U.S. Treasuries changed the narrative for the dollar. It became obvious that the spread beyond China will lead the Fed to cut rates aggressively eroding the interest rate advantage the dollar held. This may be the last straw that was needed to resolve and accelerate the toppy dollar range to the downside. With these developments our confidence in calling the start of the new dollar cycle is increasing. When we consider valuations and the ability to benefit from global fiscal measures we expect the euro and Japanese yen to outperform the Canadian dollar and the pound.

Bond yields plunge to unsustainably low levels

In this environment of heightened uncertainty, investors have flocked to safe-haven government bonds, sending yields to historically low levels that are unlikely to be sustained. Even considering secular headwinds that are depressing real interest rates, our models suggest that the U.S. 10-year yield is well below our modeled estimate of equilibrium and represents significant valuation risk. While yields are being suppressed more recently due to the virus's impact on investor confidence in a time of stress, we expect that investors will eventually demand a real, or after-inflation, return on their savings. For that to occur, yields would need to rise from current levels, leading to low or even negative returns for bonds.

Sharp sell-off in stocks reduces valuation risk

Global equities have declined sharply as the Covid-19 outbreak and the collapse in the oil price pose a new threat to corporate profits and damaged investor confidence. The S&P 500 Index has declined significantly from its record high, erasing solid gains from earlier in the year. Historically, market reaction to crisis events tend to be short-lived as long as the shock doesn't cause sustained and meaningful harm to the economy. While the sell-off has lowered equity prices and alleviated valuation concerns, a lack of clarity surrounding corporate profits means a wide range of potential outcomes is possible. However, in the event that worst-case outcomes for the economy and highly leveraged companies are avoided, the recent sell-off in stocks could provide for attractive returns in equity markets.

Asset mix – capturing the equity risk premium

Our asset mix reflects the fact that economies are likely to continue growing over the longer term, though we recognize that the Covid-19 outbreak may have delayed progress anywhere from two to four quarters. Prior to the outbreak, we had trimmed our equity allocation by one percentage point amid concerns of stretched valuations, excessive investor optimism and the fact that economies were stabilizing but not accelerating meaningfully. Since then, the valuation risk in stocks has diminished, especially outside of the U.S., and the plunge in bond yields has boosted the relative attractiveness of stocks versus bonds to its most appealing level in many years. As a result, we added back the one percentage point to our equity allocation and sourced the funds from fixed income. For a balanced, global investor, we currently recommend an asset mix of 59 percent equities (strategic neutral position: 55 percent) and 39 percent fixed income (strategic neutral position: 43 percent), with the balance in cash.

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Publication date: March 10, 2020

32467 (03/2020)
EXECUTIVE SUMMARY_SPRING 2020_E 03/12/2020

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