RBC Global Asset Management

Executive summary

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The COVID-19 shock altered the course of the global economy and ravaged financial markets, prompting policymakers to step in quickly and with scale. Unprecedented monetary and fiscal stimulus, combined with signs of an economic recovery as lockdowns eased, triggered a rapid rebound in risk assets.

Largest and most abrupt shock to growth in modern history

The easily transmitted virus spread rapidly around the globe, infecting more than 6 million people. Although deaths and illness are certainly a tragedy, the biggest impact to global economies came from government-imposed lockdowns that shuttered businesses and curtailed consumer activity. As a result, we have slashed our growth forecasts over the past quarter, and they are now mostly below-consensus. Our base case outlook for the U.S. is for a 7.1% decline in 2020 GDP, though we recognize a variety of scenarios are possible based on the depth and duration of the shutdowns and the speed of the subsequent recovery. Relative growth expectations between global regions vary based on the severity of lockdown measures in place, the sector makeup of their economies, and country-specific vulnerabilities such as older populations.

Numerous risks as economies begin reopening and beyond

As countries ease lockdown measures, the most prominent risk is that the virus regains traction and forces economies into a second closure. In attempting to gauge which countries are most at risk of suffering a second wave of infections, we focus on variables such as the number of infections per capita, the rate of change in new cases, the strictness of the lockdowns and the degree to which they are being loosened. The pandemic's longer-term repercussions include elevated debt levels that could hinder growth and lifestyle changes that could lower productivity. Inflation could also emerge as a concern once economies eventually recover. While the virus has dominated our thinking, there are other risks that are worth keeping in mind. The U.S. election in November, an important Brexit deadline and the deterioration of U.S.-China relations could all serve as sources of volatility for economies and financial markets.

Policymakers deliver record stimulus

Mandated lockdowns required governments to support workers who could not work and companies that were not allowed to operate. The fiscal stimulus provided has been massive and broad-based, spanning many countries and sectors, with provisions for households as well as businesses. In the U.S., the federal government delivered nearly US$3 trillion in financial aid, almost double the US$1.6 trillion doled out during the financial crisis of 2008-2009.

The U.S. Federal Reserve also supplied substantial relief on the monetary side, slashing short-term interest rates by 150 basis points in early March, and expanding its balance sheet by trillions of dollars to ensure the proper functioning of financial markets. Together, the U.S. fiscal and monetary programs have so far amounted to more than 35% of GDP.

U.S. dollar reverses gains from initial crisis-driven surge

The U.S. dollar ended a nine-year stretch of gains after the liquidity shortage experienced during the early days of the COVID-19 crisis led to what we believe was one final rally in the greenback's lengthy bull market. The dollar's subsequent weakness in late May and early June signaled that investors have begun to factor in its overvaluation as well as the country's fiscal and monetary excesses. Shorter-term considerations, such as lower U.S. interest rates and election uncertainty, may also be weighing on the currency. The euro and yen are likely to benefit most during this initial phase of the U.S.-dollar decline, while we expect the Canadian dollar and British pound to lag. In the months to come, the performance of individual emerging-market currencies will depend largely on the evolution of the pandemic.

Sovereign-bond yields fall to record lows, held down by central banks

The U.S. 10-year Treasury yield fell to an all-time low of 31 basis points as investors sought safe havens and central banks ramped up bond buying. Government-bond yields are well below our modelled estimates of equilibrium indicating meaningful valuation risk in all major regions that we track. Over time, our models suggest that yields should ultimately rise from current levels, but large-scale quantitative-easing programs and highly accommodative central-bank policies will probably limit the extent to which that will happen in the near and intermediate terms. Nevertheless, the current low level of sovereign-bond yields is set to deliver unimpressive returns over our 1-year forecast horizon and possibly beyond. Corporate bonds offer higher yields and widening credit spreads caused by the crisis have boosted their return potential. We think exposure to credit, if properly managed, could serve as a useful avenue for enhancing portfolio yields.

Stock crash sent global equities into a bear market, but the panic was short-lived

Major market indexes fell more than 30% in a matter of weeks in February and March as volatility surged. The crash lowered our global equity composite to its largest discount to fair value since 2012, and a number of technical indicators reached values consistent with durable market bottoms. But the window of opportunity for outsized gains was brief. The S&P 500 Index has already recovered two-thirds of its losses, led by growth stocks and companies with highly predictable earnings. As a result, U.S. large-cap equities are back above our modelled estimate of fair value, suggesting investors should moderate their return expectations going forward. That said, non-U.S. markets remain attractively priced.

Corporate profits are being severely impacted by the COVID-19 crisis, but we think our measure of normalized earnings provides a better guidepost for what earnings could be under normal conditions, and it's this measure that we use to determine fair value. The fact that investors are paying a high price for stocks today amid a recession may reflect confidence that a rebound in profits will accompany a recovery in the economy. Our scenario analysis suggests further upside for stocks is possible as long as investor confidence stays elevated, inflation and interest rates remain low, and earnings ultimately rebound to their long-term trend.

Asset mix – resetting strategic neutral asset mix in favour of stocks

The pandemic has reinforced many trends that were already in place before the virus, such as our world being stuck in an indefinite period of slow economic growth, low interest rates and highly accommodative central-bank policies. Other factors held constant, sustained low real interest rates suggest a long period of below long-term average returns lies ahead for the traditional asset classes. Our view that stocks will provide superior returns, that results for sovereign bonds will be unappealing for an extended period and that sovereign bonds will not provide the income or risk-diversifying properties of the past 40 years have led us to adjust the strategic neutral weights in our multi-asset and balanced portfolios. Effective June 1, 2020, we shifted the strategic asset mix for our reference portfolio for global balanced investors from 55% equities, 43% fixed income, 2% cash to 60% equities, 38% bonds, 2% cash. Managing our tactical exposures around these new neutrals, we are maintaining a modest overweight allocation to stocks given our view that stocks will outperform bonds over the longer term, but we have narrowed the degree of overweight given our modest return assumptions for equities and our below-consensus growth forecast. For a balanced, global investor, we currently recommend an asset mix of 61% equities (strategic neutral position: 60%) and 38% fixed income (strategic neutral position: 38%), with the balance in cash.

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