RBC Global Asset Management

Executive summary

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The latest wave of COVID-19 infections is now retreating, allowing governments to incrementally reopen their economies. Strong growth, surging corporate profits and elevated investor confidence have helped to extend the bull market and boost global equities to record highs.

Economy buoyed by positive vaccine efforts

Vaccines have now reached close to half the population in many developed countries and are increasingly gaining traction in other nations. As containment of the virus improves and economies gradually reopen, considerable pent-up consumer and business demand is being unleashed and permanent scarring from the pandemic so far appears to be limited. Our business-cycle framework continues to situate the economy in the "early cycle" stage and suggests further room for gains, although we note that the cycle is moving more quickly than normal. We remain optimistic about the trajectory of the economy and anticipate rapid growth in 2021, followed by slower but still good growth in 2022. That said, a significant rise in market expectations tempers our enthusiasm somewhat as heightened expectations are becoming more difficult to surpass. Our economic forecasts are mostly at or slightly above the consensus, a marginally less bullish positioning than in past quarters.

Risks to our positive outlook

A variety of risks may challenge our positive base case scenario. The extremely contagious Indian variant of the virus could prompt further waves of infection similar to how the emergence of the highly contagious British variant contributed to a surge in the spring. Moreover, there is a risk of a fiscal hangover in 2022 as some spending initiatives expire, and the possibility exists that investor confidence will wane if central banks contemplate withdrawing monetary stimulus. Another key risk is that inflation has spiked higher. While we believe much of the increase is temporary, a period of sustained higher inflation would erode purchasing power, increase borrowing costs and encourage central banks to be more hawkish.

Inflation accelerates as price pressures mount

Base effects, higher commodity prices and factors such as shortages of shipping containers and computer chips are contributing to rising inflation, which is now accelerating in a number of countries. We expect elevated inflation over the next several months, moving to moderately above the long-term average over the next few years, but ultimately average or even slightly below average inflation over the longer term. Stimulus cheques have prompted many Americans to splurge on big-ticket goods such as cars and houses, pushing prices higher. But demand preferences should revert at least partially to historical norms as the impact of the pandemic fades. There are, however, several scenarios that could lead to an unwelcome period of relatively high inflation. Rising inflation expectations could become a self-fulfilling prophecy, a wage-price spiral could unfold, and/or a commodity supercycle could emerge. Inflation, an afterthought for the past decade, now requires some attention.

U.S. dollar bear market to persist

We think the U.S.-dollar bear market that began last year still has a few years to run. Currencies often move in cycles, from overvalued to undervalued, and the dollar remains rich even with the weakness of the past year. The stimulative fiscal and monetary policies pursued by the U.S. support the weakening trend. Cyclical periods of strength, like the one seen in the first quarter of this year, are good opportunities, we think, to position portfolios for a further U.S.-dollar decline. While the early stages of a bear market in the greenback will benefit all currencies, it is cyclical currencies, including the Canadian dollar, that have the most to gain from the global economic recovery underway. Broadly speaking, emerging-market currencies should also rally, although careful monitoring of country-specific risks is necessary to avoid individual currency underperformance.

Bond yields pause after massive rise earlier in the year

Much of the good news related to vaccines, a reopening of economies and firming inflation was priced into the bond market in late 2020 and early 2021, and so there was little impetus for yields to rise further in the past quarter. Bond yields everywhere were range-bound over the past three months after having reclaimed their pre-pandemic levels earlier in the year. Our models indicate the acute valuation risk evident in the sovereign-bond market immediately following the pandemic's declaration was greatly alleviated by the rapid rise in yields over the past year. Once the impact of the pandemic fades, we could be left with real (after-inflation) yields in the 0% to 1% range, with a 2% inflation premium for U.S. Treasury bonds. If these assumptions prove correct, it would be difficult for 10-year U.S. government bond yields to rise much above 2% to 3% over the medium to longer term. In the shorter term, we see yields peaking around 1.75% over the next year and, as a result, expect low returns in sovereign bonds.

Stocks rally to record levels on surging profits

Global equities extended their gains in the past quarter with most major indexes reaching record levels. The solid rally in stocks has pushed our global composite of equity-market valuations to its highest level since before the 2008/2009 financial crisis. We note that the extended valuation in stocks largely reflects the dominance of U.S. markets in our GDP-weighted model. While the S&P 500 Index may currently appear expensive, it could grow into those elevated valuations fairly quickly as a surging economy boosts volumes and pricing power, lifting revenues and earnings, and leading to a durable earnings expansion that could last several years. Analysts are quickly picking up on the fact that profits are rebounding quickly and earnings-per-share estimates for the S&P 500 have increased nearly 10% since the start of the year. Our conclusion is that U.S. stocks could offer decent returns in the mid to high single digits as long as investor confidence holds up and earnings come through. Return potential improves as we move outside of North America to regions such as Europe, Japan and emerging markets, all of which offer more attractive valuations.

Asset Mix – maintaining overweight in stocks, underweight in bonds

The economic recovery is fanned by the cyclical tailwinds of massive monetary and fiscal stimulus, an easing of virus-related restrictions and low interest rates. We expect strong economic growth in 2021 and again next year as the economy accelerates at a rate that supports solid corporate-profit gains. In this environment, we think a significant overweight in equities is appropriate. Recall that ultra-low return expectations in fixed income motivated our decision over a year ago to boost the strategic neutral weight in stocks to 60% from 55%. Investors with long-term savings plans, in our view, would likely want to minimize exposure to low-returning sovereign bonds and boost equity allocations. That said, the powerful advance of U.S. equities over the past year prompts us to recognize that their valuations are full and that the risk premium between stocks and bonds has narrowed somewhat. We have therefore trimmed our overweight equity exposure by 50 basis points from last quarter, sourced entirely from U.S. equities, and moved the proceeds to bonds. For a balanced, global investor, we currently recommend an asset mix of 64 percent equities (strategic neutral position: 60 percent) and 35 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

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