RBC Global Asset Management

Market Update

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Investors embrace the economic rebound

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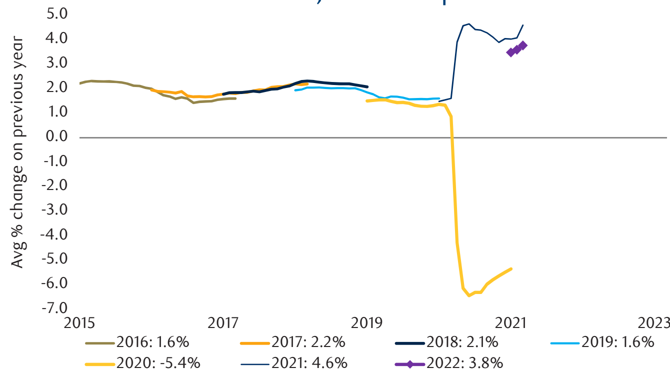
Global economies are rebounding nicely following last year's recession and our assessment is that we are at the early stage of a new business cycle. Interest rates remain low, unemployment is elevated but improving, and the economy is being supported by massive fiscal stimulus with potentially more on the horizon. All things considered, we think the economic expansion has further room to run, possibly for several years. The coronavirus remains a key challenge to our outlook, with new variants spreading rapidly and case counts rising in many regions of the world. However, progress on vaccinations should ultimately curb the spread of the virus and the economic hit from COVID-19 is unlikely to be severe given the economy's impressive resilience during the pandemic. We look for the world's major economies to grow between 4% and 8% in real terms in 2021 followed by slightly slower, but still strong, growth rates in 2022. Our own growth forecasts remain above the consensus, but slightly less so than before because the consensus has moved higher (Exhibit 1).

Economic activity is robust and broad-based

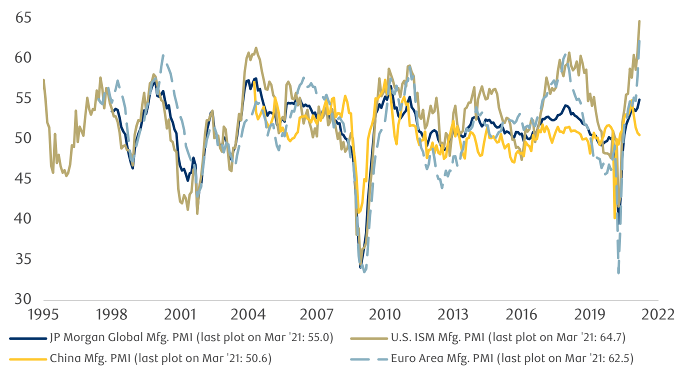
Purchasing managers' indexes (PMIs) confirm that a powerful economic expansion likely lies ahead. The U.S. ISM Manufacturing PMI rose to its highest level in decades, with unusually strong readings observed globally as well (Exhibit 2). Historically, we find that higher PMI readings are associated with faster economic growth. Exhibit 3 plots the range of U.S. real GDP growth, segmented by U.S. ISM Manufacturing PMI readings. The data on the chart shows that a PMI situated between 60 and 65 (currently 64.7) correlates with an average real U.S. growth rate of 4.6%. With vaccinations underway, economies continuing to re-open and extraordinary stimulus supporting the recovery, there is a good chance that U.S. real GDP growth in 2021 will be at the upper end of the 2.5%-to-6.6% range.

Exhibit 1: Weighted average consensus real GDP
Growth estimates for major developed nations



Note: As of March 22, 2021. Source: Consensus Economics

Exhibit 2: Global purchasing managers' indices



Note: As of April 7, 2021. Source: Haver Analytics, RBC GAM

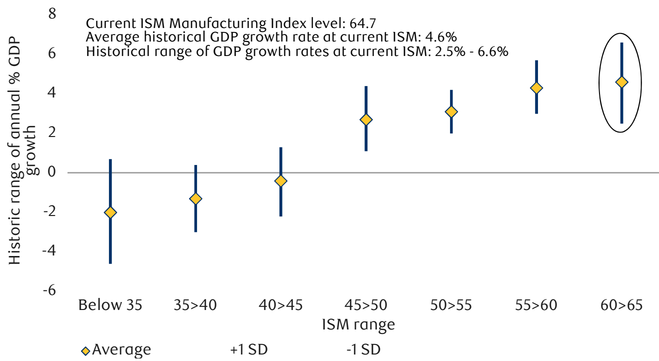
Central banks maintain easy policy stance

Interest rates remain at rock-bottom levels in the developed world and most major central bankers have voiced their intention to keep them that way for an extended period even with economic growth accelerating quickly. The latest interest-rate projections from the Federal Open Market Committee (FOMC) suggest U.S. short-term interest rates could be on hold until at least 2022, and possibly through 2023, as the majority of FOMC participants indicated that a fed funds rate near zero is appropriate over the next two years (Exhibit 4). One development that could prompt policymakers to raise rates earlier than expected would be if inflation runs too hot for a sustained period. While inflation expectations have climbed rapidly in the past year, they are not at concerning levels and have, in fact, moved away from being alarmingly low (Exhibit 5). Inflation expectations would have to move meaningfully higher and above historically normal levels to trigger central-bank interest-rate hikes.

Sovereign bonds find support

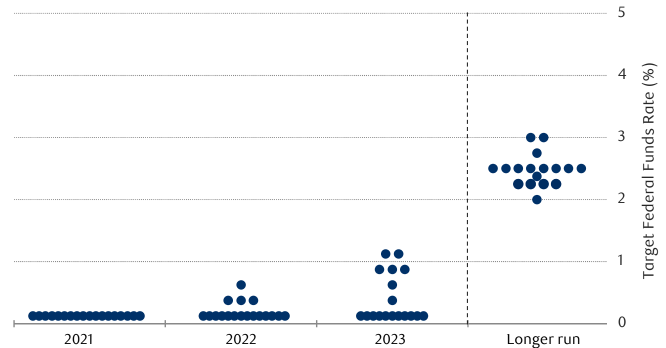
The rise in global bond yields appears to have paused after a significant increase and may have boosted the appeal of sovereign fixed-income assets. The U.S. 10-year bond yield has fluctuated between 1.60% and 1.75% since mid-March, after having nearly doubled since the start of the year as better growth, higher inflation and diminishing risks reduced demand for safe-haven assets. These higher yields are now more appealing to investors and, importantly, the acute valuation risk that existed following the plunge in yields in early 2020 has been alleviated as the U.S. 10-year yield climbed back into our model's equilibrium band (Exhibit 6).

Exhibit 3: United States
ISM levels and real GDP growth estimates



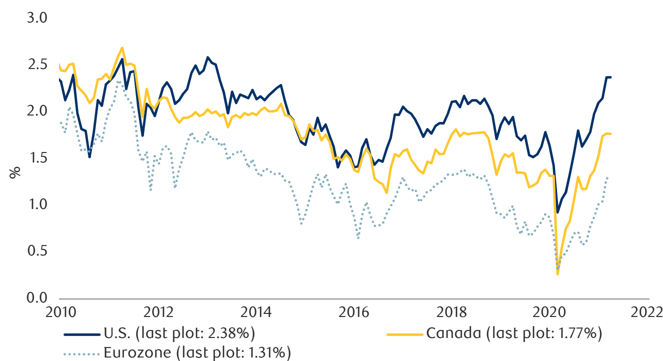
Note: As of April 7, 2021. Source: Wolfe Trahan & Co.

Exhibit 4: Target federal funds rate at year-end
FOMC Participants' Assessments of Appropriate Monetary Policy



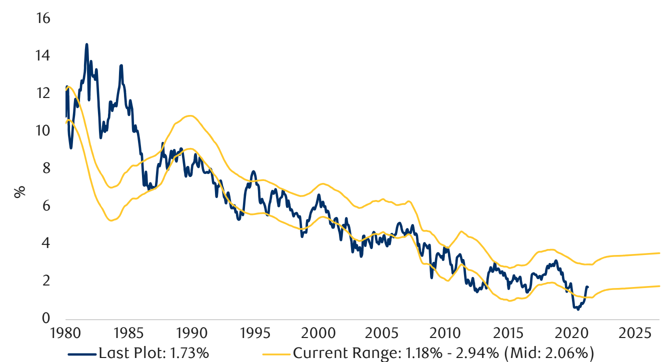
Note: As of March 17, 2021. Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate. Source: U.S. Federal Reserve

Exhibit 5: Implied long-term inflation premium
Breakeven inflation rate: nominal vs 10-year real return bond



Note: As of April 1, 2021. Eurozone represents GDP-weighted breakeven inflation of Germany, France and Italy. Source: Bloomberg, RBC CM, RBC GAM

Exhibit 6: U.S. 10-year T-Bond yield
Equilibrium range



Note: As of April 1, 2021. Source: RBC GAM, RBC CM

Global equities extend gains to new records

Most of the world's major stock indexes rose to record highs in April as investors looked beyond near-term virus concerns to an environment of stronger growth and ample stimulus. The S&P 500 Index climbed above 4000 for the first time, extending its gain so far this year to just over 8% and up a whopping 80% from the March 2020 low. As a result, the U.S. large-cap market is one of the most expensive that we track and the S&P 500 is trading at more than one standard deviation above our modelled fair value (Exhibit 7).

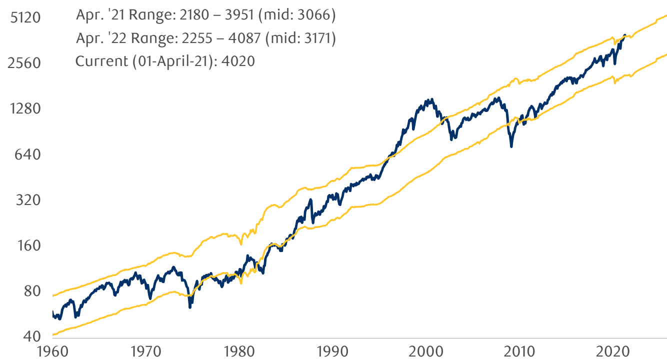
The S&P 500 may be expensive, but there are other equity markets around the world that remain attractive. Accelerating growth could benefit economically sensitive regions such as Canada and some emerging markets, and more attractively valued EAFE markets. Worth noting is that many of these other indexes have lagged the S&P 500 for the greater part of the past decade amid sluggish economic growth (Exhibit 8).

While valuations in U.S. large-cap equities may appear stretched, the bull market in global equities could have room to run if some of these markets begin to perform better after a long period of underperformance.

Strong economic growth to propel corporate profits

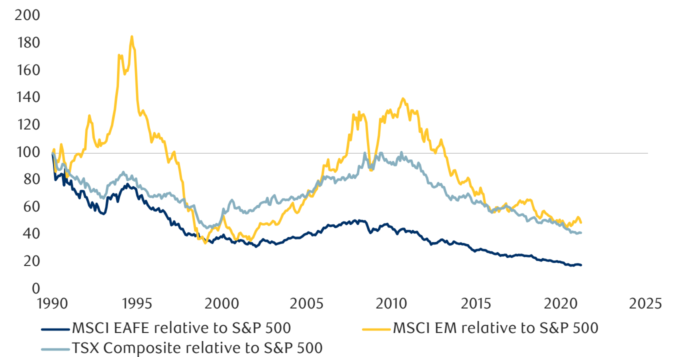
One of the reasons U.S. equity valuations are so elevated is that profits are expected to increase at an extraordinary rate going forward, and investors are willing to pay up for that growth in advance. A way to estimate profit growth from a top-down perspective is to start with an economic forecast. Based on a historical regression between S&P 500 earnings and economic growth, S&P 500 earnings should increase 27.3% in 2021 if U.S. nominal GDP rises by 8.2%, as we expect (Exhibit 9). In fact, the relationship is backed by analyst consensus profit-growth estimates of 25.9% in 2021. Importantly, the consensus suggests low double-digit gains for 2022 and 2023, and these estimates have been climbing in recent months (Exhibit 10).

Exhibit 7: S&P 500 equilibrium
Normalized earnings and valuations



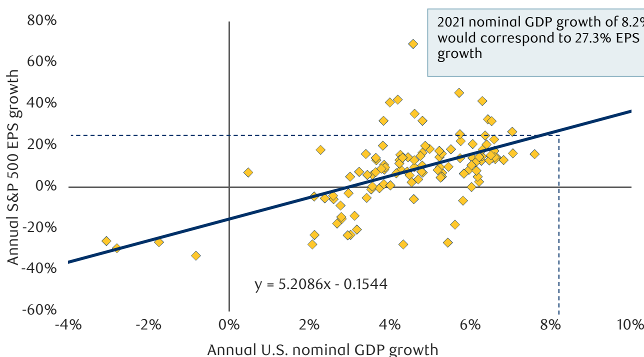
Note: Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM

Exhibit 8: Major price indices relative to the S&P 500
Indexed to 100 at start of the chart



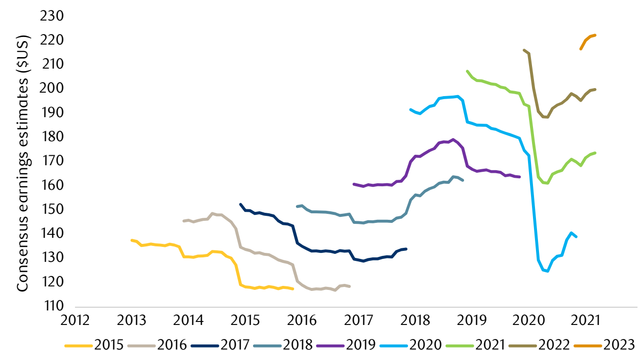
Note: As of March 31, 2021. Chart displays relative price changes between major indices and the S&P 500. Source: RBC GAM

Exhibit 9: S&P 500 EPS vs U.S. nominal GDP growth



Note: As of March 31, 2021. Based on quarterly data back to January 1990. Source: Bloomberg, RBC GAM

Exhibit 10: S&P 500 Index
Consensus earnings estimates



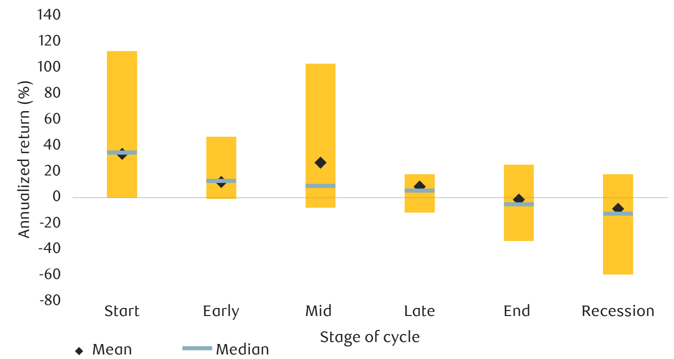
Note: As of April 7, 2021. Source: Thomson Reuters, Bloomberg

While an increase in corporate taxes proposed by the U.S. administration could be a potential headwind to profits, they would be relatively minor compared to the massive gains in expected profits against a backdrop of unusually strong economic growth.

Asset mix – maintaining overweight in equities, underweight in bonds

With vaccinations progressing and economic activity ramping up, the global economy is on track to grow at a rapid pace supported by ultra-low interest rates and massive government-spending programs. In this environment, sovereign bonds don't look especially appealing. However, the recent adjustment higher in yields means that the risk of sovereign-bond losses has been greatly diminished. That said, stocks continue to hold superior return potential and they have historically generated more attractive returns in the earlier stages of a business cycle – where we believe we are currently – versus later stages (Exhibit 11). We recognize that valuations are demanding in some markets, especially U.S. large-cap stocks, and that strong profit growth will be required to justify elevated prices. We believe, however, that there is good reason to expect that the aggressive earnings expectations embedded in consensus estimates can be achieved or even exceeded. As a result, we are maintaining an overweight in stocks and underweight in bonds in our reference portfolio for global balanced investors. The RBC GAM Investment Strategy Committee's recommended asset mix for a global balanced investor is 64.5% equities (strategic "neutral": 60%), 34.5% bonds (strategic "neutral": 38%) with the balance in cash.

Exhibit 11: Annualized S&P 500 return ranges by cycle phase



Note: As of 2021/03/12. Shaded area represents range. Based on data from 1949 business cycle to 2021. Source: Macrobond, RBC GAM

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