RBC Global Asset Management

Market Update

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Taking some profits after a strong rally in risk assets

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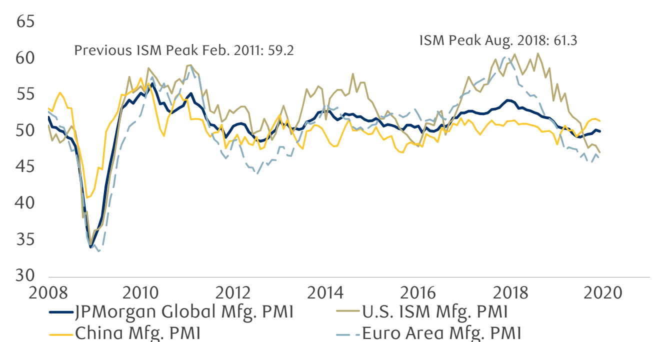
Risk assets delivered impressive gains in the fourth quarter of 2019 as challenges faded and investor optimism swelled. Progress towards a U.S.-China trade deal, diminishing odds of a hard Brexit and highly accommodative central-bank policies were all contributing factors to market gains. Furthermore, a variety of underlying signals late last year bolstered our conviction in an improving outlook and we added two percentage points to equities as a result.

However, these positive trends have not been sustained into the New Year. While economic growth has stabilized since mid-2019, we are not seeing evidence of a meaningful acceleration. Given the magnitude of the recent rally in stocks, we decided last week to reduce equities and lock in some profits from our earlier decision. We trimmed our allocation to stocks by one percentage point and moved the proceeds to cash. Since then, the novel coronavirus has emerged as a new risk and has caused heightened market volatility, and we are closely monitoring the situation.

Economy steadies but lacks signs of substantial growth acceleration

After nearly two years of declines, leading indicators of economic growth have stopped falling in most major regions, but they remain relatively weak. The JPMorgan Global Manufacturing PMI bottomed in September, but is now only marginally higher, and at a reading of 50.1 is on the cusp of the 50 threshold that indicates expanding economic activity (Exhibit 1). The U.S. has been an outlier in that the U.S. ISM Manufacturing PMI has continued trending down and is now at its lowest level since the financial crisis. The manufacturing sector is clearly facing significant headwinds and one of the major challenges has been protectionism. Even though the U.S. and China have reached a Phase 1 trade deal, a number of tariffs remain in place and are likely to continue weighing on manufacturing activity. The damage from tariffs in 2020 could be higher than in 2019 given that some only took effect in mid-2019 and we've only had a slight reduction since then. Moreover, surprise indices are still fairly mixed, suggesting economic data has not been better than expected (Exhibit 2). These data points suggest global economic growth is likely to remain sluggish.

Exhibit 1: Global purchasing managers' indices



Note: as of December 31, 2019. Source: Haver Analytics, RBC GAM

Central banks continue to provide significant monetary stimulus

In this slow-growth, non-inflationary environment, central banks remain committed to delivering monetary stimulus and keeping interest rates exceptionally low or even negative. The Fed continues to buy short-term Treasuries at a rate of US$80 billion per month and the ECB is executing monthly bond purchases of 20 billion euros with no end in sight. With central banks providing ample liquidity to stimulate growth and inflation, it seems unlikely that they would raise interest rates in the near term, and any policy shift would likely be towards more accommodation. Indeed, pricing in the futures market suggests investors are expecting at least one more Fed rate cut in 2020 (Exhibit 3).

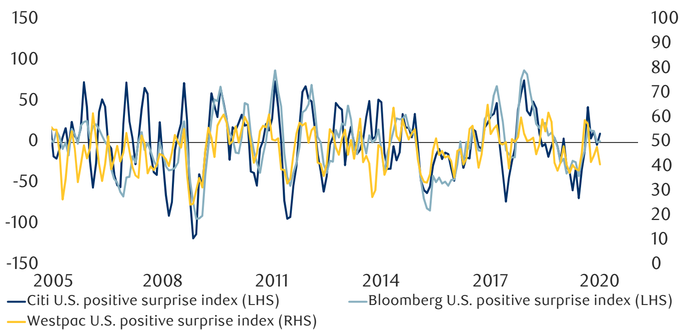
Sovereign-bond market signals caution

Global sovereign bond prices have rallied since late 2019 and are signaling that economic growth is likely to remain subdued for the foreseeable future. Government-bond yields declined in all major regions to three-month lows and are well below our modelled equilibrium levels (Exhibit 4). In addition, the U.S. yield curve as proxied by the spread between 3-month and 10-year yields has reversed some of its prior steepening since the summer (Exhibit 5). As a result, the yield curve is once again nearing inversion, a situation that in mid-2019 amplified concerns of recession. Falling bond yields and a flattening yield curve suggest economic growth is likely to be slower than investors had anticipated late last year.

Credit spreads tightened as investors reach for yield

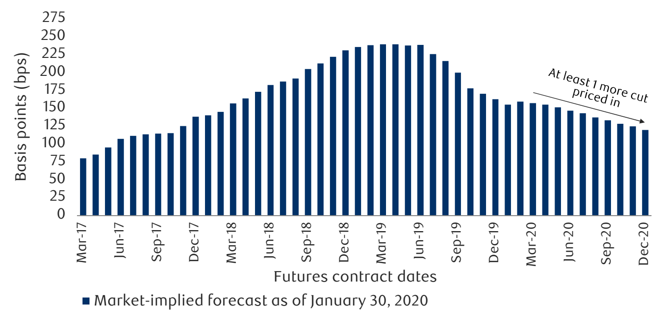
Credit markets have also performed well in recent months amid low interest rates, falling government-bond yields and heightened central-bank liquidity. Spreads narrowed to their tightest levels since 2018 and the absolute level of yields on corporate bonds has reached its lowest in five years (Exhibit 6). In contrast to the sovereign-bond market, which may be signaling caution, credit markets suggest a benign outcome for both economic and corporate profit growth. The fact that

Exhibit 2: United States
Economic surprise indices



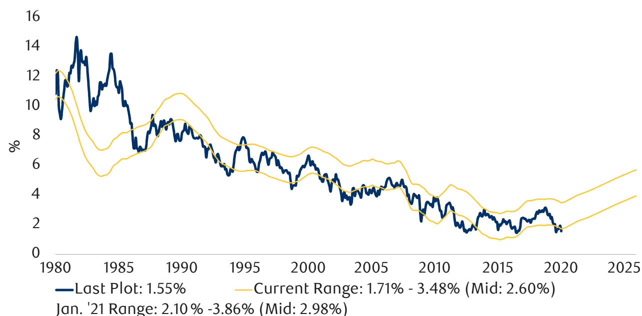
Note: as of January 30, 2020. Source: RBC GAM, RBC CM

Exhibit 3: Implied fed funds rate
12-month futures contracts



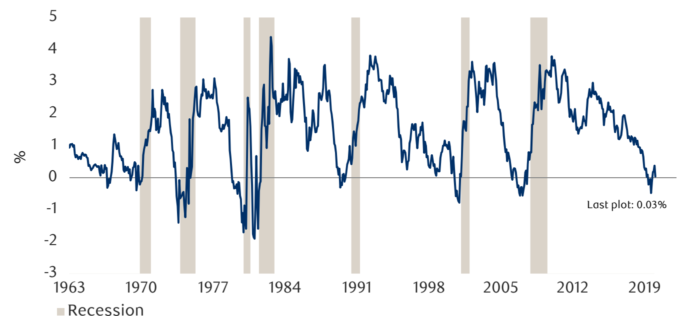
Source: Bloomberg, RBC GAM

Exhibit 4: U.S. 10-year T-Bond yield
Equilibrium range



Note: as of January 30, 2020. 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, RBC CM

Exhibit 5: U.S. Treasury yield curve
Spread between yield on 10-year and 3-month maturities



Note: as of January 30, 2020. Source: Bloomberg, RBC GAM

corporate-bond yields have fallen so much could extend the cycle as companies are able to re-finance their debt at cheaper rates. But somewhat rich valuations in the corporate-bond market pose a vulnerability to investors should the outlook deteriorate.

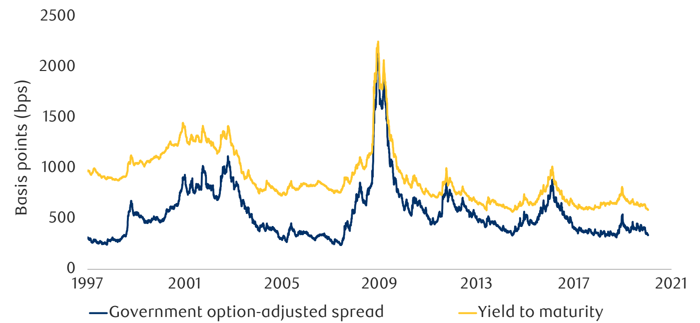
Stocks soar, valuation risk intensifies

Global equities gained significantly in 2019 and continued to rally into early 2020. The S&P 500 Index rose 29% in 2019 and gained another 3% in the first three weeks of 2020, reaching a new all-time high. The bulk of these gains were delivered by rising valuations as earnings growth has been relatively flat (Exhibit 7). The latest rally pushed the S&P 500 Index to its move expensive level relative to our modelled estimate of fair value since before the financial crisis (Exhibit 8). As a result, we think that U.S. equities are trading at a noteworthy premium, and that further gains are becoming increasingly dependent on earnings growth, as well as the maintenance of elevated risk appetite.

Asset mix - locking in profits after a strong rally

Our base case continues to look for moderate economic growth and subdued inflation. Downside risks related to trade, Brexit and prior monetary tightening have shrunk but have not disappeared and other risks have emerged (i.e. the coronavirus). Falling interest rates have supported risk assets over the past year and we think it will be difficult for stocks to continue delivering such strong gains without significant further easing in monetary policy. We have become a bit more cautious on risk assets in the near term, given a combination of optimistic investor sentiment, elevated U.S. equity valuations and the fact that several underlying market technicals have worsened since December. Part of our conviction last quarter that the market rally could have legs was the rotation into value stocks, the steepening yield curve and the outperformance of international equity markets, but the late-2019 move to value has proved short-lived, the yield curve has been flattening again and market leadership has shifted back to large-cap U.S. growth stocks. We decided to take some profits following the recent rally in stocks, reducing our equity allocation by one percentage point, moving the proceeds to cash. Over the longer term, we continue to expect stocks to outperform bonds and we are maintaining a slight overweight exposure to stocks and underweight in fixed income as a result. Our current recommended asset mix for a global balanced investor is 58.0% equities (strategic: “neutral”: 55%), 40.0% bonds (strategic “neutral”: 43%) and 2.0% in cash.

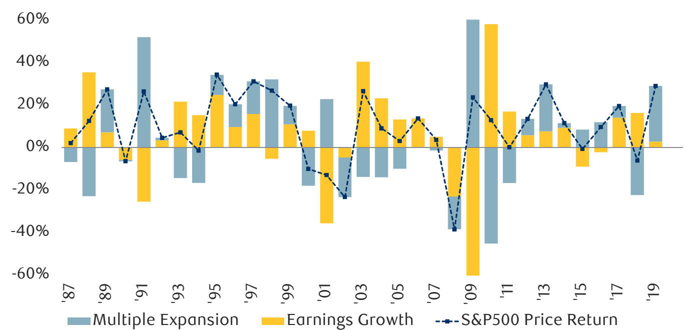
Exhibit 6: ICE BofAML U.S. High Yield Index



Note: as of January 20, 2020. Source: ICE BofAML, RBC GAM

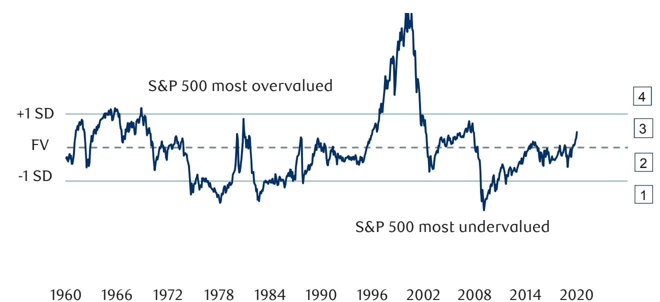
Exhibit 7: S&P 500 return decomposition

Return contribution of earnings growth and multiple expansion



Note: as of December 31, 2020. Source: RBC GAM, RBC CM

Exhibit 8: Standardized S&P 500 fair value bands



Note: as of January 30, 2020. Source: Haver Analytics, RBC GAM

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