RBC Global Asset Management

Market Update

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Near-term challenges ahead of a brighter future

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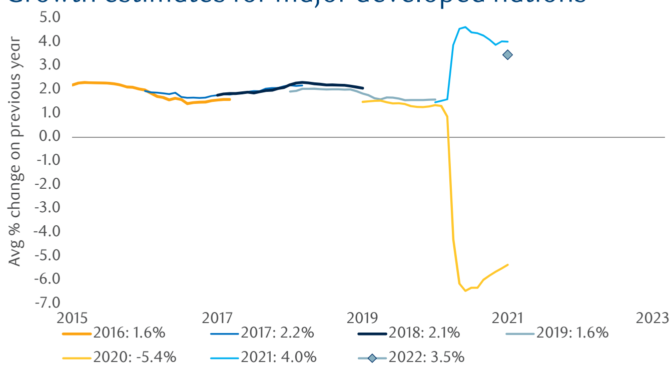
The economy is grappling with an assortment of challenges that may push back the eventual recovery from the crisis. The virus is proving more difficult to control than we had expected, new variants are being discovered, and restrictions have tightened in many regions to combat rising infection numbers. On the vaccine front, delays are a common occurrence and prior hopes of a near-perfect roll-out of the vaccine are being met with the harsh reality that the pace of delivery is not living up to expectations. In addition, inflation concerns are perking up as the money supply has ballooned and prices are starting to rise in some areas of the economy. All things considered, we continue to look for a solid rebound in economic growth in 2021 and our forecasts remain above the consensus (Exhibit 1). However, the bounce may have marginally less thrust than we had originally thought.

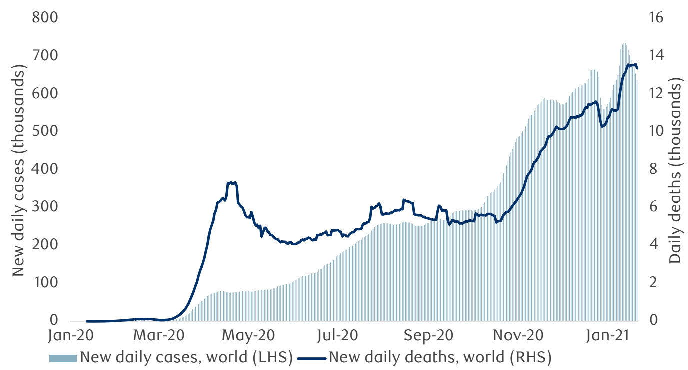
That said, there are reasons to be optimistic. Vaccine deliveries are still progressing, and infections and fatalities should decline as more of the population is inoculated. In fact, these counts may already be peaking globally (Exhibit 2). On the economic front, the new U.S. president, Joe Biden, has proposed a US$1.9 trillion stimulus package that would provide direct payments to individuals and support for businesses and health care. Massive fiscal support is being amplified by extreme monetary-policy accommodation through ultra-low interest rates and massive bond-buying programs by central banks. Although we recognize the near-term challenges, we think the economic recovery likely reasserts itself and, given how sharp and deep the contraction from 2020 was, we could still be in the early innings of a long period of expansion.

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



Note: as of January 20, 2021. Source: Consensus Economics

Exhibit 2: Global COVID-19 cases and deaths



Note: As of 1/21/2021. 7-day moving average of daily new cases and new deaths. Source: WHO, Macrobond, RBC GAM

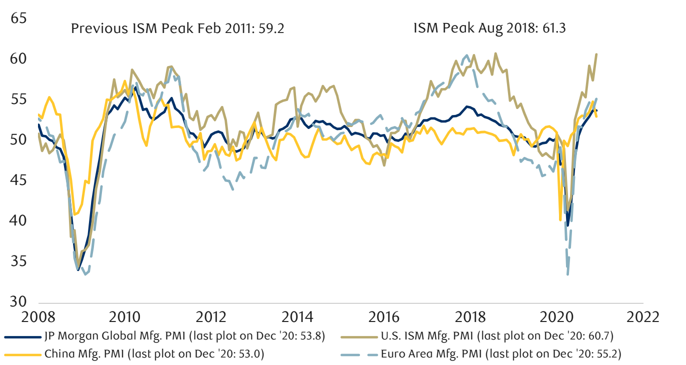
Signs of a firming economy

A variety of signals suggests the economy continues to improve and that a re-acceleration in growth is already underway. Leading indicators of growth are pointing decidedly to expansion and are near their highest levels since 2018 (Exhibit 3). One area of the economy that has done particularly well is housing, which has been supported by falling interest rates and an increased desire for more space amid stay-at-home orders. Sales of existing homes in the U.S. have risen 22% over the past year, the largest increase since the surge after the financial crisis of 2008-2009 (Exhibit 4). Commodity prices have also risen significantly. The Commodity Research Bureau Spot Price Index has risen 32% since March 2020 to the highest level since 2014 (Exhibit 5). These signals suggest that the economy is moving forward and that certain segments are doing quite well.

Labour market struggles keep Fed anchored to low rates

While the overall economy may be improving, the U.S. labour market is still severely bruised by the pandemic and may require significant support for an extended period. The number of Americans filing for unemployment claims has been rising in recent weeks and continues to outpace even the worst readings during the financial crisis just over a decade ago (Exhibit 6). As a result of the severe employment situation, the U.S. Federal Reserve (Fed) will likely keep interest rates extremely low for many years. In fact, the latest projections by the Fed's Open Market Committee suggest no interest-rate hikes through 2023, which is consistent with pricing in the futures market (Exhibit 7).

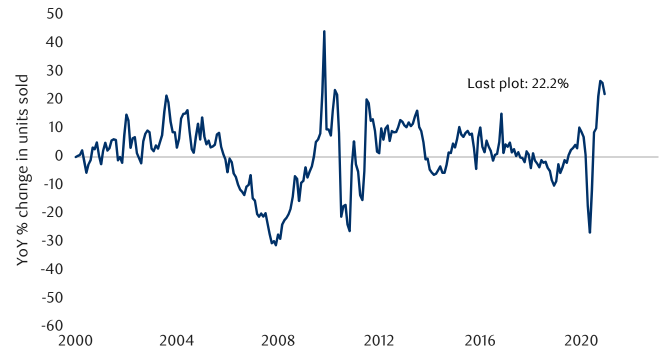
Exhibit 3: Global purchasing managers' indices



Note: as of January 2, 2021. Source: Haver Analytics, RBC GAM

Exhibit 4: U.S. housing – sales of existing homes

Total existing home sales



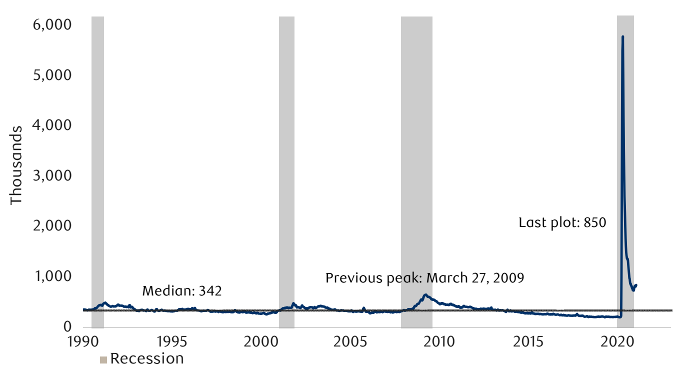
Note: as of January 22, 2021. Source: National Association of Realtors

Exhibit 5: Commodity Research Bureau (CRB) commodity index – U.S. spot all commodities

Note: as of January 22, 2021. Source: Reuters, Bloomberg, RBC GAM

Exhibit 6: U.S. initial unemployment claims filed

Four week moving average



Note: as of January 21, 2021. Source: BLS, Haver Analytics, Bloomberg

Bond yields nudge higher

The Fed is keeping short-term interest rates near zero, but the yield on longer-dated maturities has been rising as investors price in a recovery in economic growth and inflation. The yield on the U.S. 10-year benchmark bond recently climbed above 1.0% for the first time since early 2020 and is now back above the lower boundary of our equilibrium band (Exhibit 8). Despite the recent rise, valuation risk remains acute in sovereign bonds and our model suggests yields are still unsustainably low.

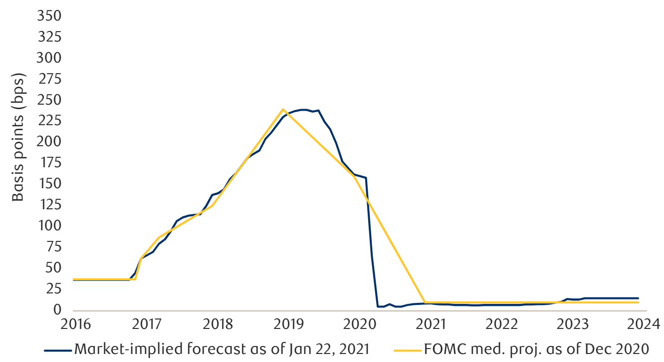
Yields could rise further if inflation exceeds expectations

Yields are likely to rise at only a gradual pace over many years, but one thing that could cause them to increase more rapidly would be a run-up in inflation beyond what is already anticipated. Inflation break-even rates, which represent the rate at which Treasuries and inflation-protected bonds would generate an equal return, provide a lens into investor expectations about inflation. These rates have climbed significantly in recent months and are now higher than they were before the pandemic (Exhibit 9). The 2-year break-even inflation rate of 2.48% has risen above the 10-year rate of 2.08%, suggesting that investors expect short-term inflation to exceed longer-term inflation. This relationship is consistent with the Fed's new inflation-targeting program, which will allow inflation to run above 2% for some time. In the event that these market-based expectations are too low and inflation actually runs hotter, bond yields would likely move higher.

Stocks soar to records, led by small caps and international equities

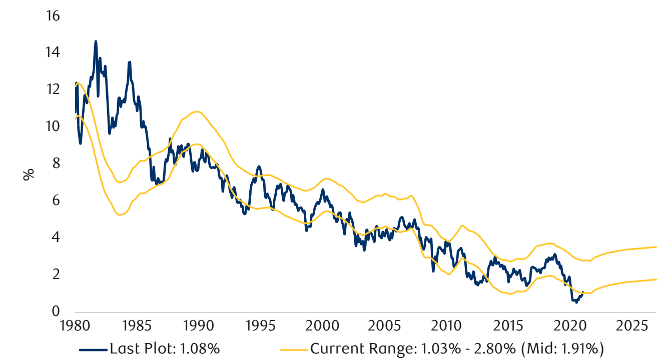
Global equities extended their gains from 2020 into the New Year and climbed to new records amid highly supportive fiscal and monetary policies and optimism that vaccines could fuel better economic growth in 2021. The S&P 500 has risen 71% from its March 2020 low and is now situated more than one standard deviation above our modelled estimate of fair value (Exhibit 10). Other markets have been trading at

Exhibit 7: Implied fed funds rate
12-months futures contracts



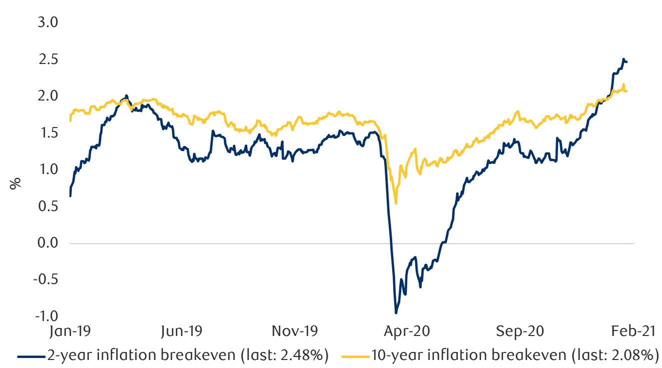
Note: as of January 22, 2021. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 8: U.S. 10-year T-Bond yield
Equilibrium range



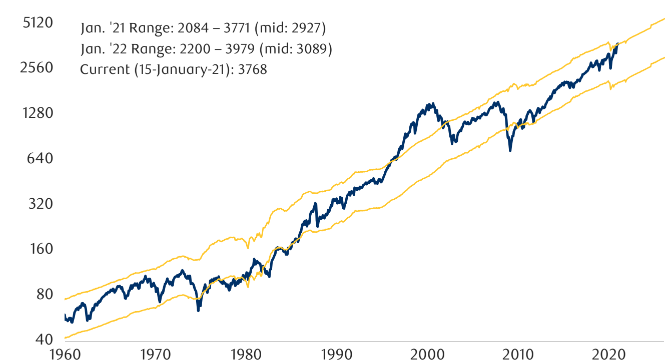
Note: as of January 15, 2021. Source: RBC GAM, RBC CM

Exhibit 9: U.S. Treasuries inflation breakevens



Note: as of January 22, 2021. Source: Bloomberg, RBC GAM

Exhibit 10: S&P equilibrium
Normalized earnings & valuations



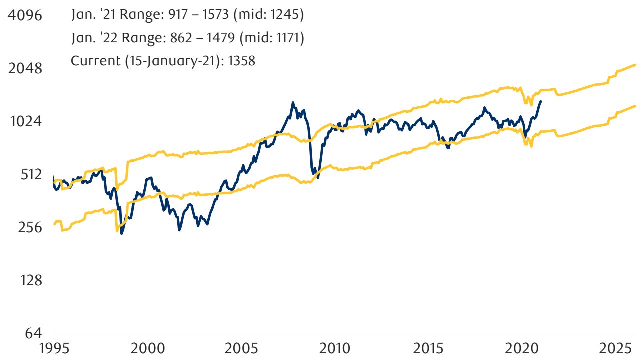
Note: as of January 15, 2021. Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM relatively attractive levels, but in some regions we have seen big increases in valuations. Emerging-market equities, for example, have surged in recent months and are 83% above their March 2020 low. After trending sideways for over a decade, the latest rally pushed the MSCI Emerging Markets Index above its prior all-time high from 2007, and the index is now closer to the top of its fair-value channel after being close to one standard deviation below in March 2020 (Exhibit 11).

U.S. large-cap equities have led global equity markets for some time and outperformed for most of the pandemic era. Since Pfizer's positive vaccine news in early November, leadership has shifted toward smaller-cap stocks and international equities. Exhibit 12 plots U.S.-dollar returns for a number of major indexes from November 9, 2020, to January 22, 2021. The best returns were delivered by the S&P 600 and the Russell 2000 small-cap indexes, both of which surged more than 30%, and mid-cap and emerging-market equities generated gains close to 20%. Notice, though, that the worst performers were the S&P 500 large-cap and S&P 100 mega-cap indexes, which delivered gains of less than 10%. This shift in market leadership could be a sign that investors are expecting an acceleration in economic growth and broad-based increases in corporate profits that will benefit more than just a narrow set of mega-cap technology stocks.

Analysts expect earnings to exceed their 2019 peak this year

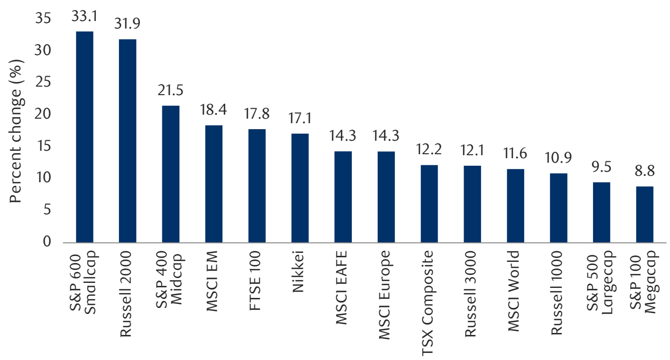
Profits are, in fact, expected to rise quite rapidly in 2021, recovering all of their lost ground from 2020 and even a bit more. Exhibit 13 plots S&P 500 earnings per share on a trailing 12-month basis, with the shaded part of the graph representing the consensus of analyst estimates going forward. The expected rebound in 2021 would bring earnings per share to US$169, exceeding the previous US$165 peak from 2019. Profits have mostly been beating estimates, so it's possible that earnings surpass these expectations (Exhibit 14).

Exhibit 11: MSCI Emerging Markets equilibrium
Normalized earnings & valuations



Note: as of January 15, 2021. 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 12: Major indices' price change in USD
November 9, 2020 to January 22, 2021

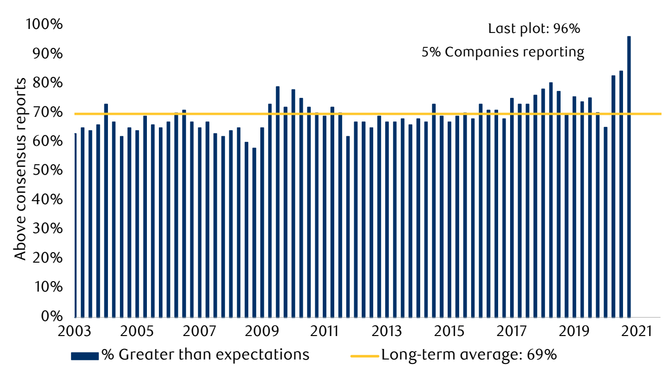


Note: as of January 22, 2021. Source: Bloomberg, RBC GAM

Exhibit 13: S&P 500 Index
12-month trailing earnings per share

Note: as of January 22, 2021. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, RBC GAM

Exhibit 14: Companies reporting results above consensus forecasts



Note: as of January 22, 2021. Source: Refinitiv

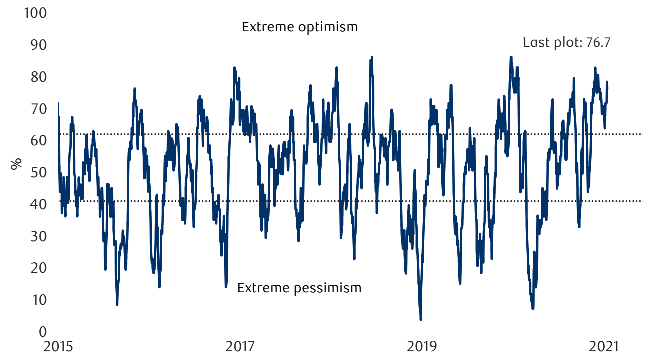
Investors are extremely optimistic

The predicted recovery in the economy and corporate profits has investors feeling good about the future. However, measures of sentiment have climbed to extremely optimistic readings, which can be a sign of investor complacency. The Ned Davis Research Daily Trading Sentiment Composite has climbed well into extreme optimism (Exhibit 15). Another way to gauge investor enthusiasm is to track positive momentum in stock prices. Almost 90% of stocks listed on the New York Stock Exchange are above their 200-day moving averages, which indicates strong and broad-based positive momentum across the entire stock market (Exhibit 16). These sentiment and momentum indicators are generally better at signaling market bottoms than tops, but we recognize that these measures are stretched and that equity markets could encounter a pullback.

Asset mix – maintaining view that stocks will continue to outperform bonds

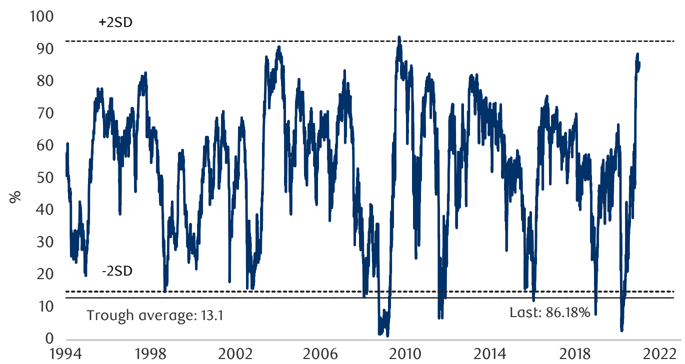
The economy faces a variety of challenges in the near term, but if we look beyond the immediate difficulties posed by the pandemic, we see an improving economy, still-low interest rates and rising corporate profits. This constructive medium- to longer-term view is reinforced by a steepening yield curve and an equity rally that is broadening out to smaller-cap and international equities. In this environment, we continue to favour stocks over bonds as even a small increase in yields from the current low levels would result in capital losses that would more than offset coupon income. As a result, we look for low-single-digit to potentially slightly negative returns for sovereign bonds over the year ahead. Should the economy re-accelerate and corporate profits rebound as expected, stocks hold the potential for much better returns than bonds, especially in more attractively valued markets outside of the U.S. large-cap space. Moreover, even though stocks have had a good run, they continue to offer a historically attractive risk premium relative to fixed income (Exhibit 17). As a result, we maintain 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 15: Ned Davis Research Daily Trading Sentiment Composite – Percent bulls



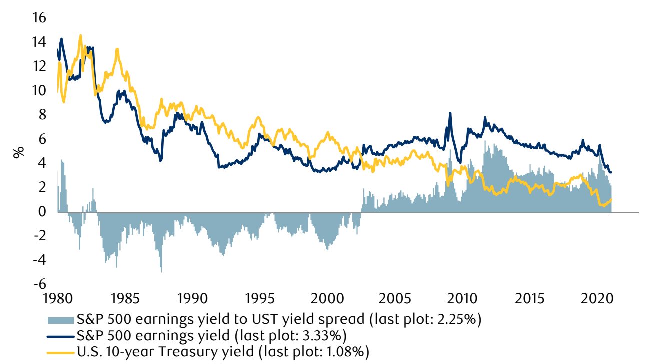
Note: as of January 14, 2021. Source: Ned Davis Research, RBC GAM

Exhibit 16: New York Stock Exchange Composite Index – % of stocks above their 200-day moving average



Note: as of January 15, 2021. Source: Bloomberg, RBC GAM

Exhibit 17: S&P 500 earnings yield
12-month trailing earnings/index level



Note: as of January 22, 2021. Source: RBC GAM, RBC CM

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