JUNE 29, 2021

Fed rattled markets, but stocks powered through

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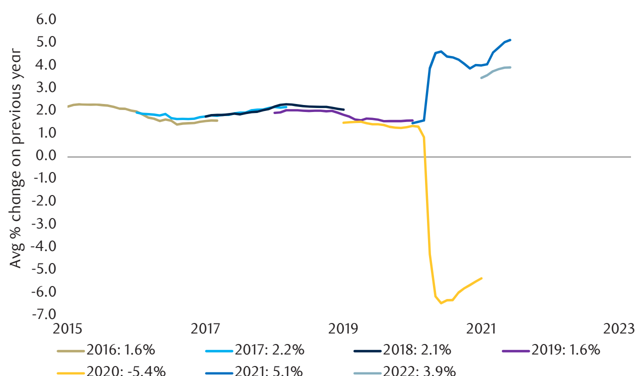
The economic recovery since March 2020 has largely been driven by massive monetary and fiscal stimulus programs, which provided support payments for businesses and individuals and spurred activity through the early phase of the pandemic. But with vaccinations underway and economies mostly reopened in some regions, the next phase of the pandemic will likely feature a bit less policy support. The winding down of government cheques to individuals could curb consumer spending and result in a deceleration in economic growth. One potential offset to fading stimulus could be that households are in solid financial shape, since limited opportunities to spend during lockdowns led to significant savings which could eventually be released into the economy. New government infrastructure spending programs could be another source of support.

While the virus situation is continually improving and the hospitalization and fatality rates are falling, COVID-19 remains a key risk to our outlook. Vaccines are being rolled out, but at a slowing pace and the Delta variant is spreading rapidly. Overall, the economic recovery remains in good shape, though the pace of improvement may be peaking. We continue to look for well-above average growth in 2021 and 2022, but we are no longer above the consensus mainly because economists' estimates have risen significantly (Exhibit 1).

Inflation pushing higher in a skewed fashion

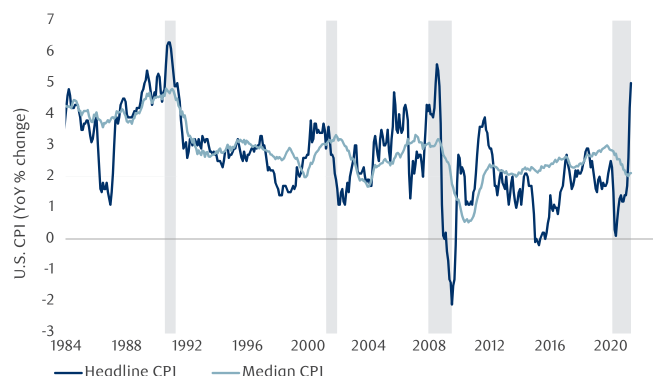
Surging demand, constrained supply chains and restrictions on certain activities have caused price disparities in some segments of the economy. For example, the cost of used cars, airline tickets and shipping are up significantly from last year. This is in part due to comparisons against a low base from a year ago, but the monthly data is also showing notable increases. Overall, headline CPI inflation is up 5% year over year, but much of this is due to a disproportionate increase in certain consumer-price baskets (Exhibit 2). The median CPI, which ignores outliers in the data, suggests inflation is

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



Note: Estimates as of June 28, 2021. Source: Consensus Economics

Exhibit 2: U.S. inflation
Year-over-year change in CPI



Note: As of May 2021. Shaded area represents recession. Source: BLS, Federal Reserve Bank of Cleveland, Macrobond, RBC GAM

just 2.1%. What this means is that the inflation we are seeing is heavily concentrated in a few areas rather than being widespread. While inflation may remain elevated for some time, it seems likely that it will gravitate back toward the median level as the near-term, pandemic-related price shocks subside.

Fed begins hinting that monetary tightening is coming

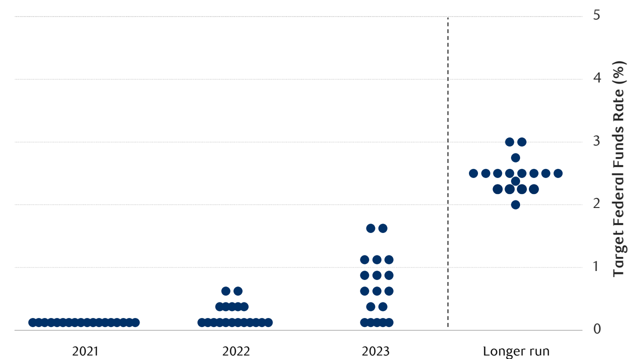
A strong economic recovery and upward pressure on inflation, even if deemed transitory, have the Fed starting to discuss policy normalization. The Fed's latest economic projections from the June 16 release showed a slight nudge higher in the dot plots, with as many as two hikes indicated for 2023 and some members even calling for a hike in 2022 (Exhibit 3). This is a notable shift because last quarter the median of the dots suggested no hikes even for 2023. Moreover, quantitative easing likely comes to an end before the start of any rate hikes. These adjustments in the Fed's projections are relatively small and don't represent a major change in the outlook, but investors may perceive this change, at the margin, as the Fed being more hawkish and a bit less market-friendly.

Bond markets wobble, yield curve flattens

Long-term bond yields encountered a bit of volatility following the Fed's statement and have settled toward the lower end of their recent trading range. At 1.50%, the U.S. 10-year yield is 25 basis points below its March high of 1.75% and is now situated slightly below the bottom of our modelled equilibrium band (Exhibit 4). At these yield levels, our models suggest heightened valuation risk in the sovereign bond market and, in our view, yields are more likely to resolve higher than lower over our one-year forecast horizon.

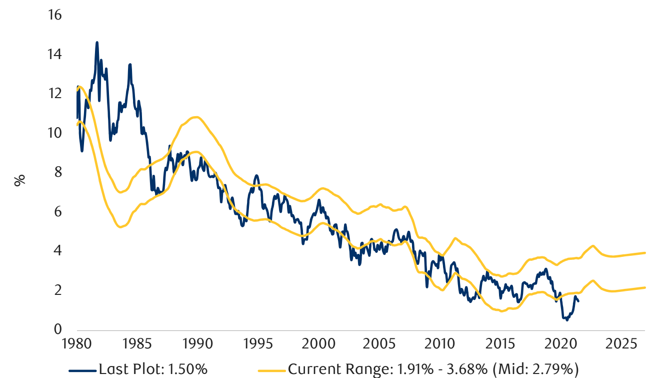
Although longer-term bond yields have declined, rising yields on shorter-term maturities have led to a flattening in the yield curve. A good proxy for the slope of the yield curve is the spread between 2-year and 10-year Treasury yields, which has narrowed considerably in recent weeks (Exhibit 5). At this point, the yield curve is only half the steepness that was reached near the start of past economic expansions. Significant intervention of central banks continues to suppress the long end of the curve, but the U.S. 2-year yield rose 12 basis points in June, representing a near doubling in short-term yields. The substantial flattening reflects increased investor uncertainty but also a view that investors view the Fed as being less behind the curve.

Exhibit 3: Target federal funds rate at year-end
FOMC Participants' Assessments of Appropriate Monetary Policy



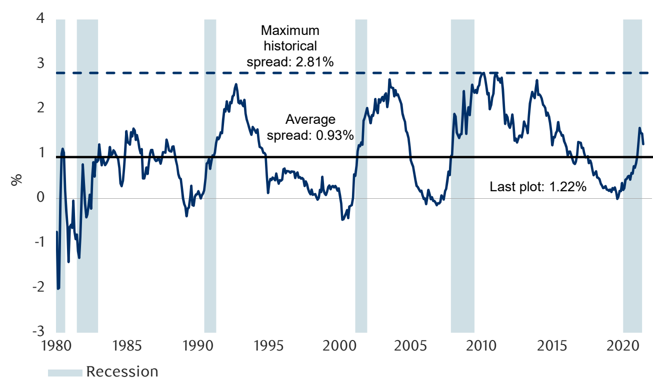
Note: As of June 16, 2021. Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate. Source: U.S. Federal Reserve

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



Note: As of June 28, 2021. Source: RBC GAM, RBC CM

Exhibit 5: U.S. Treasury yield curve
Spread between yield on 10-year and 2-year maturities



Note: As of June 28, 2021. Source: Bloomberg, RBC GAM

Stocks shrug off Fed and climb to new records

The idea that the Fed may start hiking rates as early as late 2022 caused stocks to sell-off initially, but they ultimately rallied back to record levels. The S&P 500 Index extended its year-to-date gains to 14% and remains more than one standard deviation above our modelled estimate of fair value (Exhibit 6). While rising interest rates could act as a headwind to stock valuations, the bull market can be sustained so long as earnings continue growing.

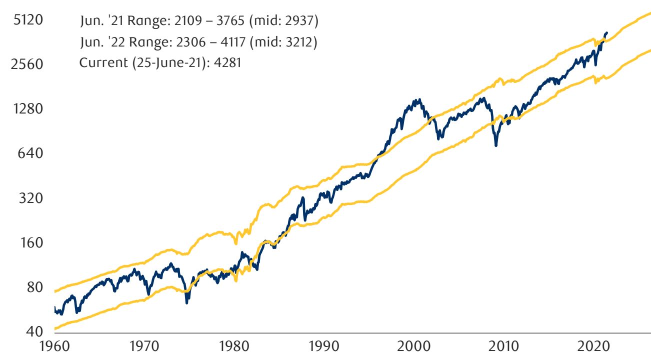
A powerful earnings recovery has been underway for nearly a year and analysts expect profits to continue to surge at least through 2023. Exhibit 7 plots S&P 500 earnings per share (EPS) on a 12-month trailing basis, with the shaded area representing future estimates. Despite the economy having fallen into its deepest recession since the 1930s Great Depression, profits have rebounded incredibly fast and are expected to surpass their pre-COVID peak of US$165 by the second quarter of 2021. Analysts have penciled in EPS of US$232 for 2023, which would represent a 40% increase over the prior peak. Barring any negative shocks, we recognize the possibility that these estimates could materialize or even be exceeded, which would support further equity gains.

Rate hikes are not necessarily bad for stocks

As we draw closer to the potential start of a new tightening cycle, the behavior of stocks through past rounds of rate hikes may serve as a useful guide for what to expect this time around. We identified 17 tightening cycles since 1954 and then monitored the S&P 500 in the 12 months leading up to the first hike and in the 36 months following. Exhibit 8 plots a road map of the S&P 500 through these tightening periods segmented into three groups to reduce the noise on the chart. We grouped the cycles that ended in recession and those that did not, and the third line represents the median experience of all cycles combined.

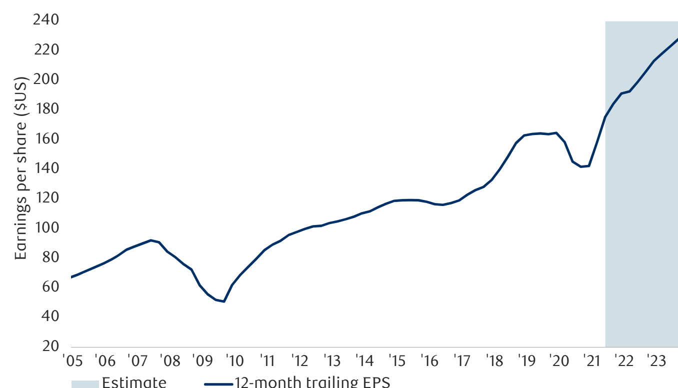
There are two noteworthy observations from this data. The first is that stocks generally do well leading into the first rate hike, rising a median of 17% in the 12 months preceding the first hike (Exhibit 9). Perhaps this is because the start of a tightening cycle provides validation that the economy is on a strong enough footing to warrant higher interest rates and that investors have taken note. The second observation is that after the first hike has occurred, stocks performed much better in instances where the economy avoided recession (nine of the 17 cycles) as compared to the recession cycles (eight of the 17 cycles). In the no-recession set, stocks rose 11% per year for the two years following the first rate hike, whereas stocks were flat over that same period when the

Exhibit 6: S&P 500 equilibrium
Normalized earnings & valuations



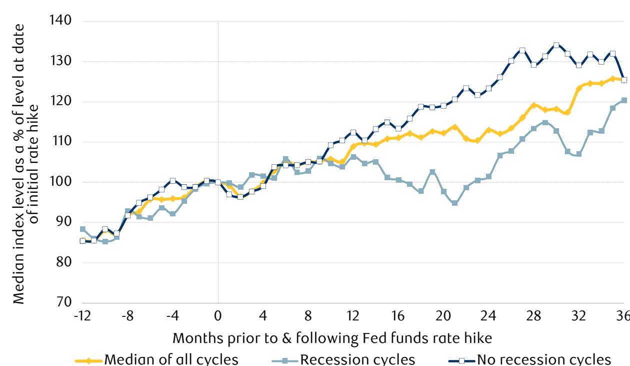
Nota: Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM

Exhibit 7: S&P 500 Index
12-month trailing earnings per share



Note: As of June 27, 2021. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, RBC GAM

Exhibit 8: S&P 500 and the Fed funds rate hike
Implications for current cycle, following first rate hike



Note: As of June 28, 2021. Source: RBC GAM

Exhibit 9: S&P 500 return statistics prior to and following the first rate hike

		Median trailing returns (%)		First rate hike	Median forward returns (%)*			
	# of observations	12 months	6 months		6 months	12 months	24 months	36 months
All cycles	17	16.8	4.4		5.0	8.9	6.3	7.8
No-recession cycles	9	17.1	3.9		4.2	12.4	11.0	7.8
Recession cycles	8	13.2	9.7		5.9	6.4	0.7	6.4

Note: As of June 28, 2021. Data since July 1954. *Periods greater than 12 months are annualized. Source: RBC GAM

economy fell into recession. While the first hike may still be over a year away, this historical analysis suggests that investors should likely not fear the first hike, but that once tightening begins, monitoring for signs of potential recession becomes increasingly crucial.

Asset mix – maintaining overweight in equities, underweight in bonds

The global economy continues to experience a healthy recovery from last year's recession and, while the positive momentum in growth may be peaking, the expansion could last for several more years. The virus remains a key risk, as well as the potentially negative impact of scaling back stimulus programs. An eventual tightening of monetary policy could lead to rising yields, which would generate low or potentially negative returns on sovereign bonds. Moreover, the U.S. 10-year yield is toward the bottom of our expected range and is likely to rise over our one-year forecast horizon.

As a result, we remain underweight fixed income. Stocks, on the other hand, continue to offer decent upside potential against a backdrop of strong economic growth, which should translate to strong revenue gains and significant corporate profit growth as long as profit margins can be sustained. While U.S. equities may appear expensive according to our models, other regions offer superior return potential. Furthermore, the current environment of historically low interest rates, moderate inflation and limited alternative opportunities for investors is supportive of above-average valuations. For these reasons we are maintaining a moderate overweight position in stocks. Our current recommended asset mix for a global balanced investor is 64.0% equities (strategic: "neutral": 60%), 35.0% bonds (strategic "neutral": 38%) and 1.0% in cash.

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Publication date: June 29, 2021