RBC Global Asset Management

Market Update

JULY 2021

Investors shift to defence amid rising infections and peaking growth

Eric Savoie, MBA, CFA
Investment Strategist, RBC Global Asset Management Inc.

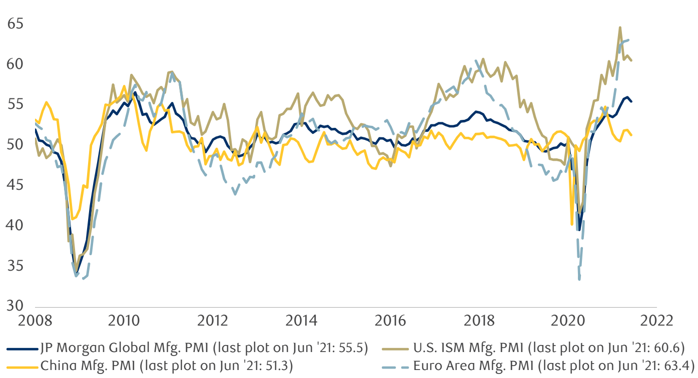
The rapid spread of the Delta variant is challenging the pandemic-response programs of governments throughout the world. Cases are rising even in countries that previously tamed the virus and/or have mostly vaccinated populations. The greater concern has to do with unvaccinated emerging-market countries that may not be properly equipped to deal with outbreaks and, in these regions, case counts may not start to fall until there is more progress on vaccinations or some level of immunity is achieved. The good news, however, is that vaccines are proving effective at preventing severe illness, meaning that hospitalizations and deaths are not rising commensurately with case counts. As a result, the U.K. is lifting all restrictions and COVID-19 measures are being relaxed elsewhere.

Another concern for investors is that economic growth may be peaking after a strong rebound from last year's deep recession. The eventual scaling back of stimulus and calming of pent-up demand could further weigh on growth and inflation going forward. Purchasing managers' indices (PMIs) are already moderating in most major regions and suggest momentum in economic growth is declining (Exhibit 1). But it is worth recognizing that these leading economic indicators remain strong in absolute terms and are consistent with a robust economic expansion. While economists look for growth to fall in 2022 from 2021, the consensus estimates for growth next year are still well above those that we have become used to in the post-financial-crisis era (Exhibit 2)

Inflation jumps, Fed exhibits patience

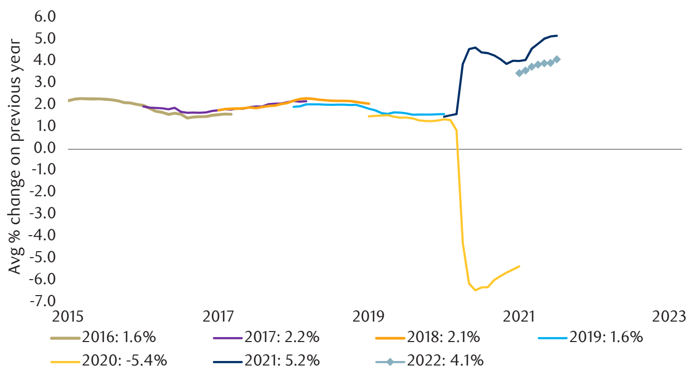
Inflation may be peaking after altered demand preferences, constrained supply chains and significant stimulus contributed to a spike in consumer prices earlier in the year. Certain goods and services, such as used cars, have experienced significant price increases while many baskets in the Consumer Price Index (CPI) were little changed. Moreover, measures that aim to remove the effect of extreme

Exhibit 1: Global purchasing managers' indices



Note: as of July 1, 2021. Source: Haver Analytics, RBC GAM

Exhibit 2: Weighted average consensus real GDP
Growth estimates for major developed nations



Note: as of July 19, 2021. Source: Consensus Economics price movements don't suggest that inflation is worryingly high (Exhibit 3). The "U.S. trimmed mean," for example, is a measure of core inflation that ignores the largest and smallest price fluctuations in the consumer baskets, and this metric's latest reading is 1.85%, below the Fed's 2.0% target. We also note that prices of some commodities like copper and lumber have declined in recent weeks, and shipping costs are no longer rising as quickly as they were earlier in the year. These moderating price trends could mean inflation readings will subside going forward. In fact, market-based measures of inflation expectations have already begun to moderate (Exhibit 4). U.S. Federal Reserve Chair Jerome Powell supports the view that recent price pressures are transitory and that inflation will fall back to more reasonable levels without the Fed having to intervene from a policy perspective.

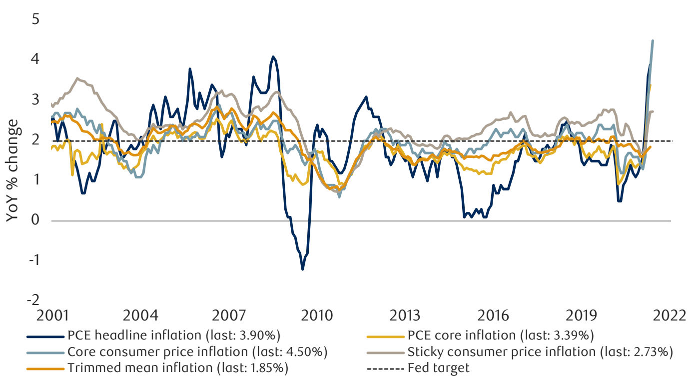
Bond yields drop, valuation risk swells

The notion of transitory inflation, decelerating growth and rising virus risk has pulled bond yields meaningfully lower in the past quarter. Since peaking at 1.75% at the end of March, the U.S. 10-year yield has fallen over 50 basis points to 1.20% – its lowest level since February of this year. The U.S. 10-year yield is now well below our modelled estimate of equilibrium and represents elevated valuation risk (Exhibit 5). The bond market may be reflecting concerns that initial optimism about the economic recovery was overdone. Other recent signs of moderating optimism are a flattening in the yield curve and a decline in real yields. These market movements suggest that the Fed's ability to raise interest rates throughout this cycle may be limited.

Credit markets wobble

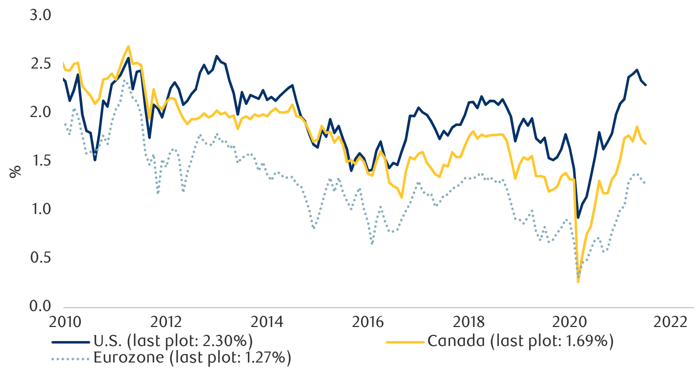
In credit markets, the gap between yields on government bonds and those on risker corporate bonds rose to their highest since May. While widening spreads can be an indication of problems, the current credit cycle appears to be in its early stages based on a spike in defaults that often takes at least five years to recur (Exhibit 6). Excesses

Exhibit 3: U.S. inflation measures



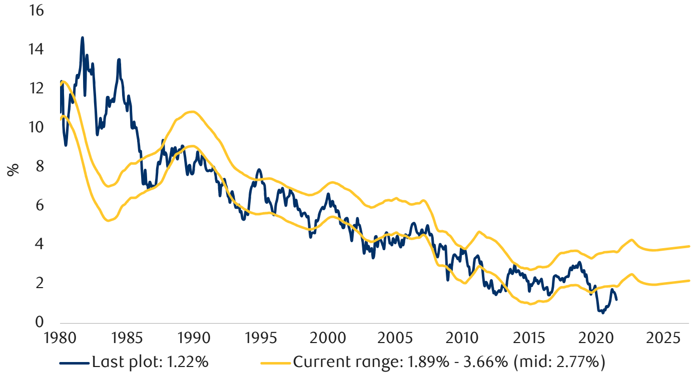
Note: as of July 19, 2021. Source: Bloomberg, RBC GAM

Exhibit 4: Implied long-term inflation premium
Breakeven inflation rate: nominal vs 10-year real return bond



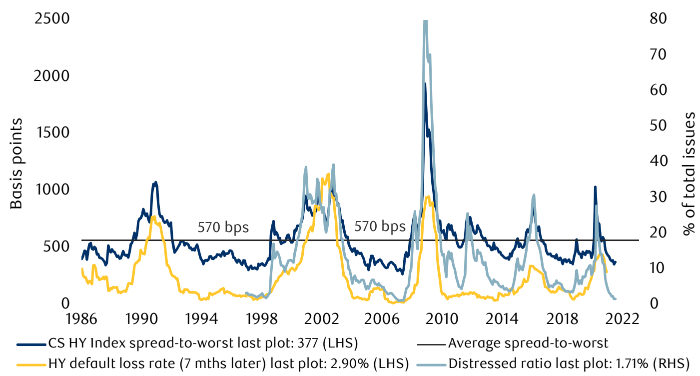
Note: as of July 19, 2021. Eurozone represents GDP-weighted breakeven inflation of Germany, France and Italy. Source: Bloomberg, RBC CM, RBC GAM

Exhibit 5: U.S. 10-year T-bond yield
Equilibrium range



Note: as of July 19, 2021. Source: RBC GAM, RBC CM

Exhibit 6: High yield bond spread



Note: as of July 16, 2021. Source: BofA, Credit Suisse, RBC GAM generally build gradually, and time passes before another round of defaults is triggered. While we might not see spreads narrow much further from current levels, especially if sovereign-bond yields keep falling, it would be unusual to see a sustained widening in credit spreads at this early point in the cycle.

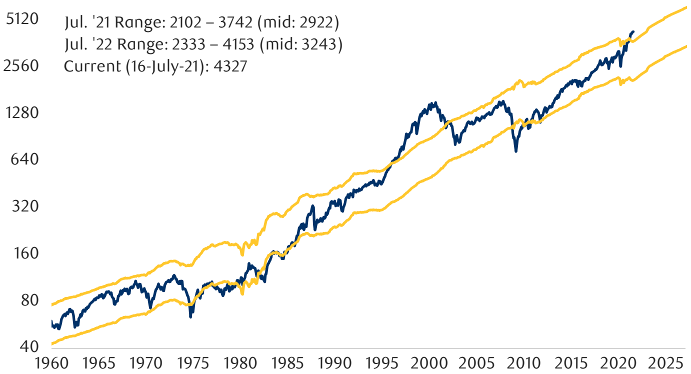
Stocks hover around record levels

Many equity market indices are hovering near records amid low interest rates and surging corporate profits. The S&P 500 Index has extended its year-to-date gains to 17% as profits have reclaimed their pre-pandemic levels and investors remained optimistic through the first half of the year. Nearly a quarter of S&P 500 companies have announced second-quarter results, with 88% exceeding expectations. While profit growth has been strong, investors are paying a high price for those earnings. The S&P 500 is trading more than one standard deviation above our modelled level of fair value, suggesting the need to lower return expectations and recognize that the market would be vulnerable should the positive outlook deteriorate (Exhibit 7).

A look into equity market trends reveals a risk-off tone

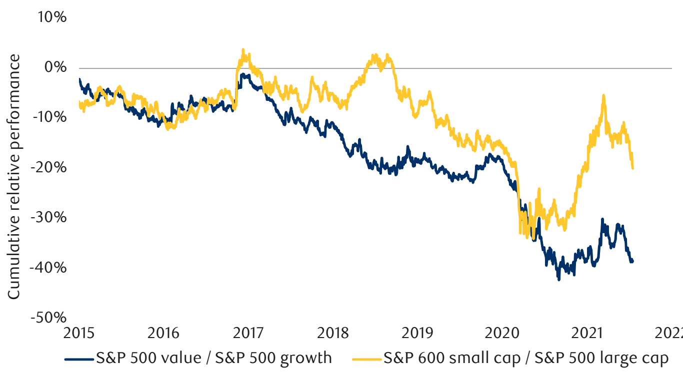
There are signs that investors are becoming more cautious. The constructive trends that occurred in late 2020 immediately following positive vaccine test data have been reversing since May. In recent months, growth stocks have outperformed value stocks, large-caps have dominated small caps, breadth has narrowed and international stocks have trailed U.S. equities (exhibits 8 to 10). All of these trends suggest investors are shifting away from economically sensitive segments of the equity market and are possible signs that the economy is about to enter a slowdown.

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



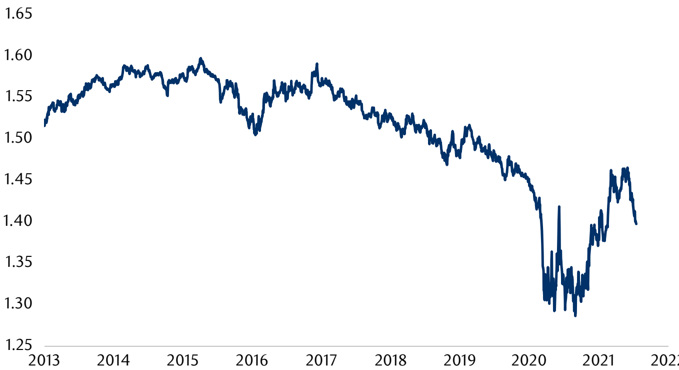
Note: fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM

Exhibit 8: Relative style performance



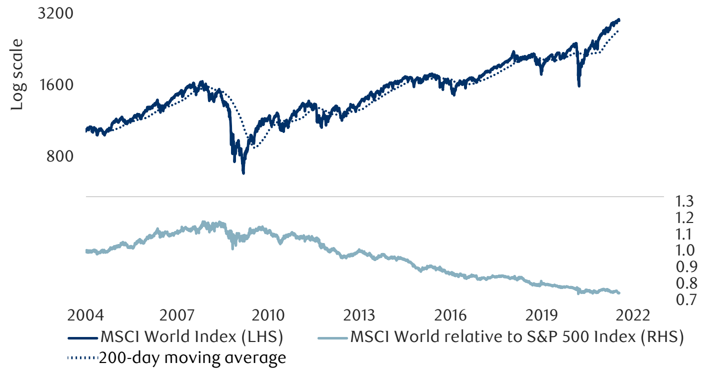
Note: as of July 16, 2021. Source: Bloomberg, RBC GAM

Exhibit 9: S&P 500 Index
Equal-weighted index/cap-weighted index



Note: as of July 16, 2021. Source: Bloomberg, RBC GAM

Exhibit 10: MSCI World Index



Note: as of July 16, 2021. Source: RBC GAM

Asset mix – trimming fixed income allocation, moving proceeds to cash

The economy is growing at a rapid pace and the current expansion could still have several more years to run. We expect that, once the economy is strong enough to withstand rate hikes, bond yields may move higher as the Fed embarks on monetary tightening. Rising bond yields would weigh on total returns for fixed income, and we expect low to slightly negative returns in sovereign bonds over our one-year forecast horizon. As a result, we remain underweight bonds and took advantage of the recent decline in yields to trim our allocation to fixed income by one percentage point.

Stocks continue to offer superior upside potential and we are therefore maintaining a modest overweight in equities. However, we recognize that valuations are demanding and that a variety of indicators are recently signaling the need for caution. For these reasons we opted to move the proceeds from the sale of bonds into cash instead of stocks. Our current recommended asset mix for a global balanced investor is 64.0% equities (strategic: “neutral”: 60%), 34.0% bonds (strategic “neutral”: 38%) and 2.0% in cash.

Disclosure

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to people in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

Additional information about RBC GAM may be found at www.rbcgam.com.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the above-listed entities in their respective jurisdictions.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions.

RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

® / ™ Trademark(s) of Royal Bank of Canada. Used under licence.
© RBC Global Asset Management Inc. 2021

Publication date: July 2021