Market Update

JUNE 2020

Virus-induced recession met with unprecedented stimulus, stocks rebound as lockdowns ease

Daniel E. Chornous, CFA
Chief Investment Officer, RBC Global Asset Management Inc.
Eric Savoie, MBA, CFA
Associate Investment Strategist, RBC Global Asset Management Inc.

Covid-19 has dealt a historic blow to the global economy. Leading indicators collapsed and unemployment surged as mass quarantine and lockdowns pushed the world into deep recession. Activity is now picking up alongside the easing of controls in regions that appear to have moved past the worst of the pandemic, but conditions remain severely depressed as governments, businesses and consumers seek to balance the desire for normalization against the still-considerable global health threat. We look for real global growth to shrink by 4.6% in 2020, below the current consensus, but for a symmetrically solid rebound to 6.3% growth in 2021. Massive slack in the economy has crushed the threat of inflation through the forecast horizon.

It goes without saying that there is an unusual degree of forecast risk in the current environment as critical variables could move in several directions. The degree to which the pandemic recedes with or without a treatment or vaccine, the speed that economies reopen, and businesses' ability to adjust their operations to accommodate the new environment and achieve past levels of profitability all cloud the future. More common but still-significant macro risks include U.S.-China relations, the U.S. Presidential election this fall and finishing the process of Britain exiting the EU. Added to the mix is the dramatic resurfacing of racial tensions in the U.S. through the past weekend. For all the uncertainty, we can be sure that 2020 will be remembered for enormous and fast moving events, and for durable changes that result.

Pandemic met with unprecedented stimulus

Fiscal and monetary authorities drew on lessons learned through the global financial crisis, with the speed and size of response first among these. In the U.S., the Federal Reserve Board reduced short-term interest rates to near-zero while expanding its asset purchases in both size and scope, pushing into corporate debt and even passive securities to ensure liquidity challenges did not morph into a solvency crisis. Working almost as quickly, Congress poured in over US$3 trillion in various aid programs targeted at business, workers, families and health care which, together with the monetary stimulus, sum to more than 35% of GDP (Exhibit 1). Similar fiscal and monetary programs in Canada, Britain and Europe appear to have stabilized near-term threats.

Yields fall to historic lows

In the U.S., T-bond yields plunged to only 31 basis points as safe haven buying came together with central bank yield suppression, pulling long-term interest rates to their lowest

Exhibit 1: Global COVID-19 stimulus packages

	Monetary stimulus		Fiscal stimulus	Relief package
Country/Region	Policy rate cut (bps)	Asset purchase (% of GDP)	Government outlay (% of GDP)	Outlay and others (% of GDP)
U.S.	150	22.1	11.3	15.0
Canada	150	17.0	6.5	11.8
Germany	0	7.3	13.7	45.4
France	0	7.3	2.3	16.3
Italy	0	7.3	6.3	49.3
Spain	0	7.3	5.5	18.2
Netherlands	0	7.3	4.1	8.5
Sweden	0	6.0	4.8	12.6
U.K.	65	9.0	4.7	20.5
Switzerland	0	0.0	3.3	9.3
Japan	0	18.6	14.5	42.2
Australia	50	0.0	10.8	16.1
China	30	0.0	4.8	6.1
India	75	0.0	5.4	12.9
South Korea	75	0.1	2.1	24.2
Mexico	175	0.0	0.0	3.4
Brazil	150	0.0	4.8	8.0
Russia	50	0.0	2.1	2.9

Note: As of May 29, 2020. RBA has implemented yield curve control in place of asset purchase. Asset purchase estimated for BoC, BoJ and Federal Reserve which have open-ended QE, based on an assumption of a duration of 1 year. Monetary stimulus carried out by ECB shown for Euro Area member countries. Fiscal stimulus estimates for Greece, Italy, Portugal and Spain include funding from €750 billion EU package announced on 5/27/2020. Fiscal stimulus only includes spending, tax cuts and non-repayable portion of loans and does not include relief measures such as tax and fee deferral, repayable loans, loan guarantees, and equity investment, etc. Source: National central banks, national government websites, Bruegel, IMF, ING, UBS, RBC GAM level in 150 years (Exhibit 2). Our models indicate significant valuation risk in U.S. and developed world sovereign bonds, but near-term movement will likely be limited by central banks' desire to sustain highly stimulative conditions as the economy seeks a solid footing. After initially convulsing as business conditions collapsed, credit markets rallied strongly on the back of government backstops put in place. Credit markets entered 2020 vulnerable to correction and the COVID-19 crisis sparked the event. After a massive widening followed by partial recovery, credit spreads now rest at attractive levels (Exhibit 3).

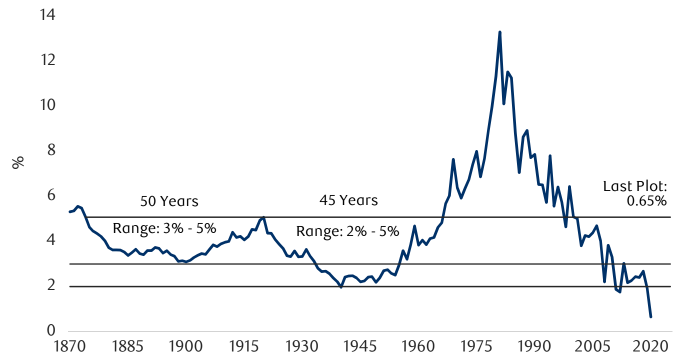
Bear market in stocks boosted return potential

Equity markets crashed in late February/early March as the scale of the crisis became clear. At their troughs, the S&P 500 and the MSCI World Index had both tumbled 34% from their prior highs. As with credit markets, massive support programs and early signs that the crisis could be contained sparked a massive rally. Especially in the U.S. where the tech-heavy S&P 500 index has recovered more than 2/3 of its losses, the V-shaped pattern has moved stocks well past valuation levels consistent with current and near-term corporate earnings prospects (Exhibit 4). Stock markets in most countries, though, remain below fair value and even in the U.S., should corporate profits approach normalized levels over the coming 12-24 months, further gains in equities are a possibility.

Asset mix – resetting strategic asset mix

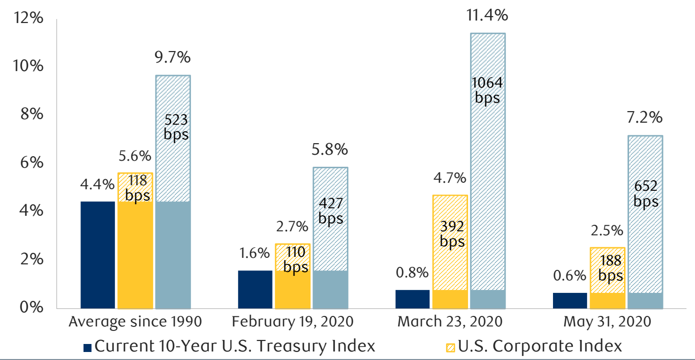
As with all crises that preceded COVID-19, we are confident that economies and corporate profits will eventually move beyond their prior peaks. In no way does that diminish the scale of suffering and disruption caused by the pandemic or its power to touch off significant and durable change in society and capital markets. As importantly, the crisis seems likely to reinforce trends already in place that will have major impacts on savers and investors. First among these is the massive reduction in the real rate of interest which now looks to stick near zero for a very long time into the future, likely bringing down nominal returns on all risk assets even if risk premiums do not change. Sovereign fixed income markets could be locked into low single digit coupons and returns for many years, reducing their utility as a risk modifier in multi asset portfolios and the income they provide. Investors will be challenged to find substitutes for the role played by fixed income through the past 40 years, although credit and private markets hold promise as a result of some combination of higher yields than sovereign fixed income, lower volatility than stocks and, frequently, correlations not perfectly tied to equity market indices. Modest additions to risk assets, including stocks, may make sense, especially for those with time horizons beyond a single business cycle. Reflecting this and recognizing the long holding periods of many of our clients, we are shifting the strategic asset mix for our reference portfolio recommended for global, balanced investors from 55% equities, 43% fixed income, 2% cash to 60% equities, 38% bonds, 2% cash. Based on the new strategic neutral setting and our tactical view that stocks will outperform bonds and cash, our current tactical asset mix is 61% equities, 38% bonds, 1% cash.

Exhibit 2: U.S. 10-year bond yield



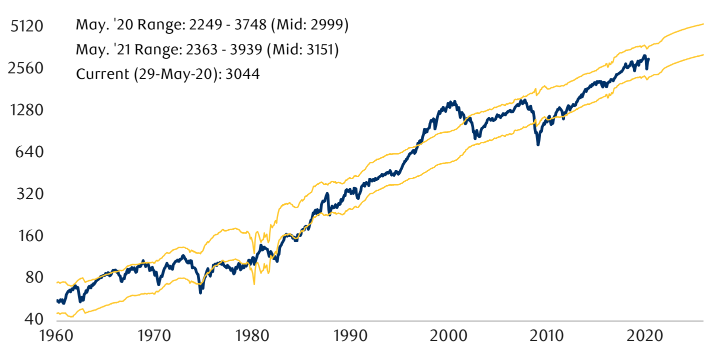
Note: As of June 1, 2020. Source: RBC GAM, RBC CM

Exhibit 3: Yield to maturity



Note: Current spread as of May 31, 2020. Shaded areas within the bars indicate the yield spread versus the U.S. 10-year Treasury bond yield. Source: ICE BofA, RBC GAM

Exhibit 4: S&P 500 equilibrium
Normalized earnings & valuations



Note: As of May 29, 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

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. 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.

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

This document is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when printed. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

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.

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. 2020

Publication date: June 2, 2020