RBC Global Asset Management

Market Update

JUNE 2021

Growth surges, inflation firms, maintaining overweight in stocks and underweight in bonds

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The global economy continues to rebound strongly from last year's recession. We believe the new cycle is durable, supported by significant fiscal and monetary stimulus. Progress on vaccinations and easing of restrictions has boosted consumer and business confidence, and leading indicators of economic activity have risen in some cases to their highest levels in decades. U.S. GDP in particular is back to its pre-pandemic high, though considerable slack remains, presenting room for continued strong growth. We've nudged our growth forecasts a bit higher this quarter and, depending on the region, they remain in line with or slightly ahead of the consensus (Exhibit 1).

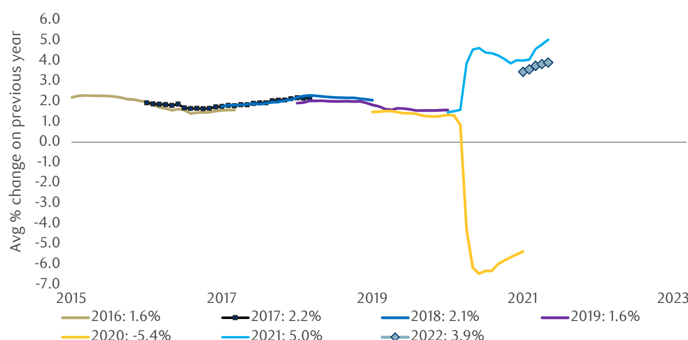
Virus and geopolitics present risks to the outlook

The virus remains a threat to the economy and new variants are spreading even in countries where populations have mostly been vaccinated. While the 3rd wave is indeed retreating in most of the world, the rise of these variants introduce the possibility of a 4th wave of infections and associated disruptions to the economy. Geopolitics present another risk with flare ups in U.S./China tensions, conflicts in the Middle East, and protectionist actions with U.S./Canada lumber trade.

Inflation spike is likely transitory

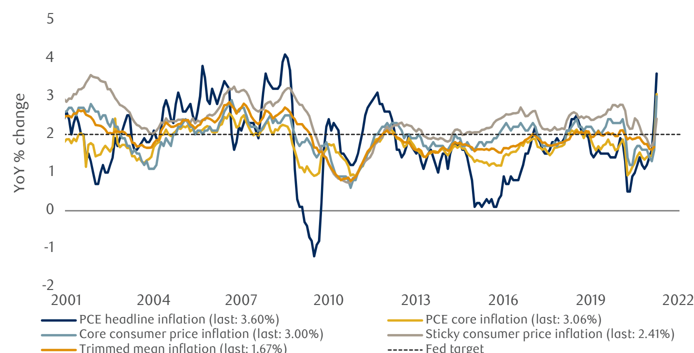
Prices of commodities, housing, and fuel have spiked higher, as pent-up demand from extended lockdowns and supply constraints are causing inflation pressures to mount (Exhibit 2). Not only have the year-over-year changes in consumer prices been increasing as a result of a low base comparison from a year ago, but the month-over-month changes, which are not impacted by last year's base effects, have also been accelerating. That said, we think that the near-term pressures on inflation will soon abate and that, over the long

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



Note: As of June 1, 2021. Source: Consensus Economics

Exhibit 2: U.S. inflation measures



Note: As of June 1, 2021. Source: Bloomberg, RBC GAM

term, structural forces placing downward pressure on price increases will prevail.

Accommodative monetary policy persists

Central banks also appear to believe that the recent inflation spike will be transitory and, as a result, are maintaining highly accommodative monetary policies. Many sectors of the economy are still challenged by the pandemic and unemployment rates remain elevated in most of the world. While inflation has risen above 2%, the Fed's new average-inflation targeting framework allows for inflation to run above 2% for some time before triggering rate hikes. The futures market is pricing in the first U.S. rate hike in late 2022, though the latest Federal Open Market Committee projections suggest the first rate hike won't occur until sometime in 2023 (Exhibit 3). In any event, tapering of asset purchases likely occurs prior to the first rate hike.

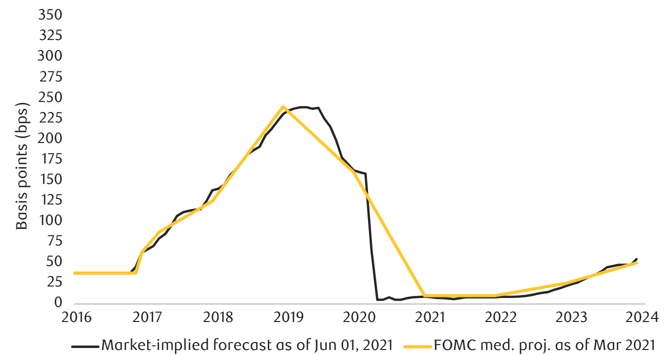
Government bond yields consolidate after massive increase

In fixed income markets, the rise in government bond yields slowed in the past quarter after the massive jump from late 2020/early 2021. The economy's powerful recovery now seems reasonably reflected in yields. For long-term interest rates to move meaningfully higher from here, we'll need even greater upside surprises in growth and inflation. The valuation risk that existed as a result of the massive plunge in sovereign bond yields in the early stage of the pandemic has been greatly alleviated as the U.S. 10-year yield has now climbed back up within our modelled range of equilibrium (Exhibit 4). Over the longer term we do expect yields to continue climbing higher but the pace of increase will likely be limited by factors related to aging populations, increased preference for saving versus spending and the maturing of emerging economies which depress real rates of interest.

Stocks rise to new records, valuations outside U.S. large-cap growth remain appealing

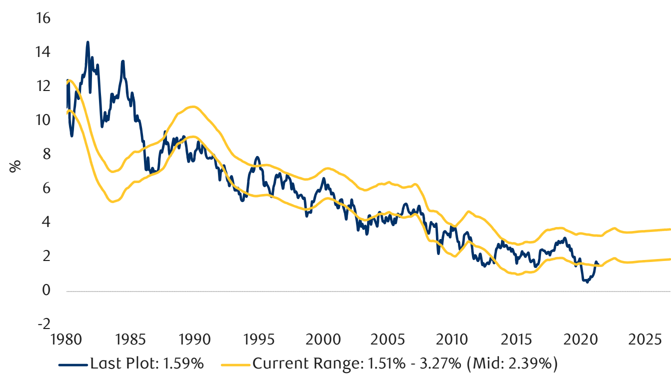
Global equities have extended their gains with many major indices climbing to record levels in the past quarter. The S&P 500 Index has spiked 10% in the past quarter and is now more than one standard deviation above our modelled estimate of fair value (Exhibit 5). We recognize that valuations are elevated in U.S. equities, but other markets are not nearly expensive and some trade closer to fair value (Canada, Europe, EM) and others at discounts (Japan, U.K.) (Exhibit 6). The rebound in the economy and acceleration in growth could provide impetus for a shift in leadership toward more cyclically-sensitive segments of the market that are trading at relatively attractive valuations.

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



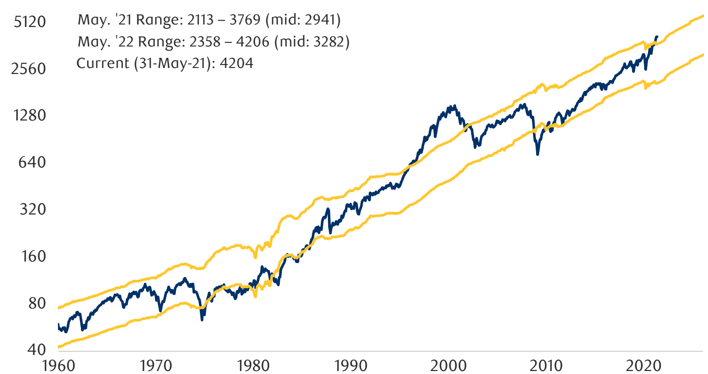
Note: As of June 1, 2021. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

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



Note: As of May 31, 2021. Source: RBC GAM, RBC CM

Exhibit 5: 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

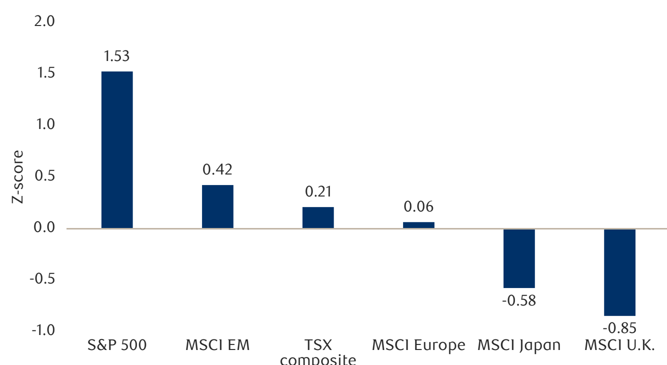
Corporate profit outlook improves as results greatly exceed expectations

Analysts have been too pessimistic on the outlook for earnings and have been playing catchup as profits have greatly exceeded expectations. In the second quarter, 87% of S&P 500 earnings reports beat estimates and we've seen broad-based upward revisions to profit forecasts going forward. The consensus now looks for S&P 500 earnings per share to reach $210 by the end of 2022, up from $195 from the start of the year (Exhibit 7). While valuations are elevated, there is fundamental support for the market. Should the expansion progress for several more years, the earnings numbers could ultimately be quite compelling.

Asset mix – maintaining overweight in equities, underweight in bonds

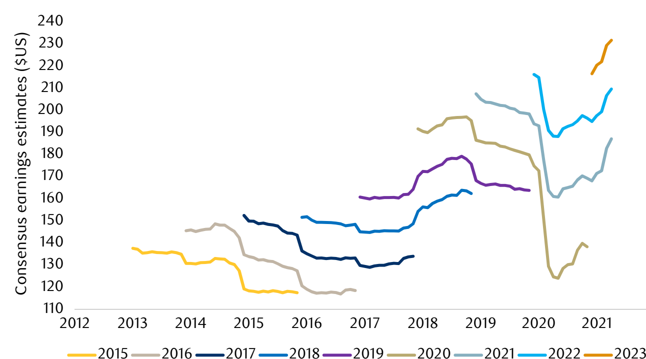
In our view, the economy will continue to grow at a rapid clip on the back of strong demand and significant policy support. We expect central banks to remain accommodative in this environment so long as inflation pressures prove transitory. As a result we don't expect any rate hikes over our 1 year forecast horizon. Our base case is for bond yields to remain range bound over the next 12 months, providing low single-digit returns for sovereign bonds. In this environment, stocks continue to offer superior upside potential and, while U.S. equities are expensive, non-U.S. markets are more attractively priced. We continue to expect stocks to outperform bonds and are maintaining an overweight allocation to equities and underweight exposure to fixed income as a result. Earlier in the quarter, as U.S. stock in particular advanced to full valuation levels, we trimmed our overweight exposure to equities by 50 basis points, entirely from U.S. equities, and placed the proceeds in bonds. 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.

Exhibit 6: Normalized stock market valuations
Standard deviations from fair value



Note: As of May 31, 2021. Source: RBC GAM

Exhibit 7: S&P 500 Index
Consensus earnings estimates



Note: As of June 1, 2021. Source: Thomson Reuters, Bloomberg

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Publication date: June 2, 2021