RBC Global Asset Management

Market Update

MARCH 2021

Economy gains traction with vaccinations underway

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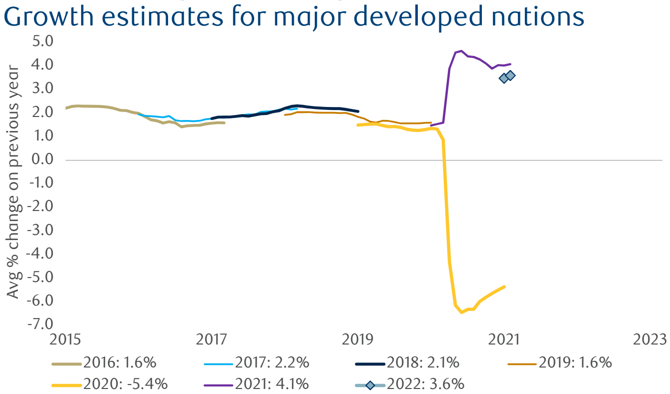
Economies have shown impressive resilience and data has consistently exceeded expectations since the pandemic began. With the beginning of mass vaccinations and the gradual reopening of economies, we are moving into a better growth environment supported by highly stimulative fiscal and monetary policies. This positive view is reinforced by leading indicators of economic growth rebounding to their highest levels since 2018. Moreover, as lockdowns and work-from-home orders curbed spending, many consumers accumulated savings throughout the pandemic and are now in a position to boost spending as virus risks fade. We look for a nearly symmetrical rebound in growth in 2021 from the deep contraction of last year. Our global growth forecasts are ahead of the consensus in most regions (Exhibit 1).

New variants, elevated unemployment and inflation represent potential risks

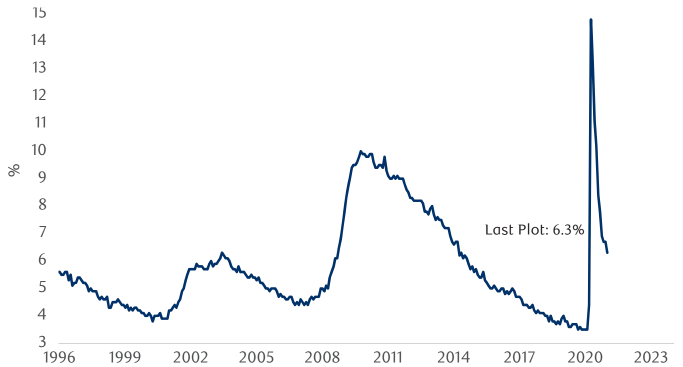
We recognize a variety of risks continue to challenge our constructive outlook. New COVID-19 variants are spreading rapidly and, while the current vaccines are proving effective against these strains, it's possible that certain mutations will be resistant, thereby delaying the return to normal. Unemployment also remains unacceptably high in most major nations as travel and leisure sectors of the economy are running well below capacity (Exhibit 2). However, in many places where consumers are able to spend, prices of goods are rising and could be pushed even higher as pent-up demand is unwound into the economy. Inflation pressures could mount in the near term especially due to low base comparisons with 2020 but, in our view, problematic levels of inflation are unlikely to be sustained.

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



Note: as of February 26, 2021. Source: Consensus Economics

Exhibit 2: U.S. unemployment rate



Note: as of February 26, 2021. Source: Haver Analytics, RBC GAM

Central banks committed to accommodative monetary policy

Against this backdrop, global central bankers have reiterated their commitment to maintain ultra-low interest rates for an extended period to support the recovery (Exhibit 3). In fact, even in the face of rising price pressures, the Fed's new operating framework allows for inflation to rise above its 2% for some time to make up for periods spent below. As a result we don't look for any short-term interest rate hikes over our 1-year forecast horizon.

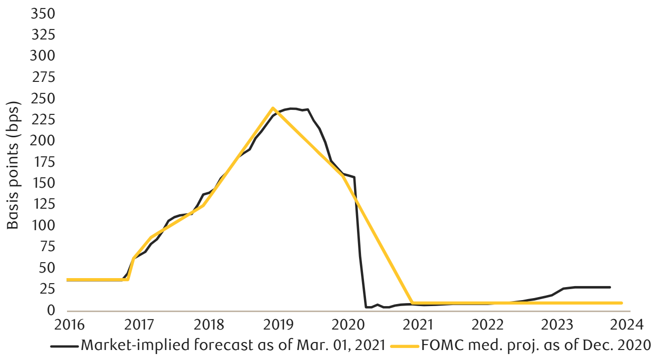
Bond yields rise, alleviating valuation risk

While short-term rates are anchored at ultra-low levels, long-term bond yields are more sensitive to changes in the macroeconomic backdrop and they have been moving higher. Rising inflation expectations and the prospect of better economic growth pushed yields gradually higher since their early 2020 lows and that trend accelerated in early 2021. The U.S. 10-year yield tripled from its summer 2020 low, climbing above 1.50% for the first time since the pandemic began, with more than half of that adjustment happening year-to-date. Though the U.S. 10-year yield remains below our modelled estimate of equilibrium, yields in other countries, including Canada and the U.K., have climbed above (exhibits 4 and 5). In our view, a significant amount of the valuation risk that existed in bonds following the COVID-19 related plunge has receded.

Markets outside of U.S. equities continue to offer attractive upside potential

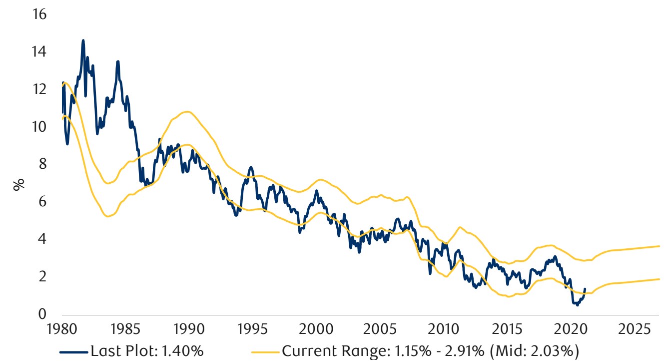
Global equities extended their gains to record highs in the past quarter as the virus situation improved, vaccinations progressed and earnings were better than expected. The S&P 500 finished the quarter up 5% and reached more than one standard deviation above our modelled estimate of fair value (Exhibit 6). In contrast to most of the pandemic era, the

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



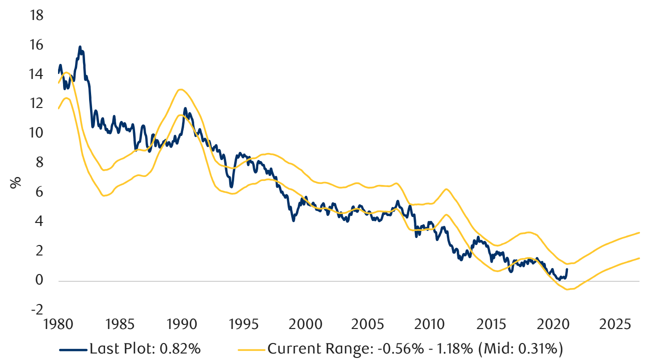
Source: Bloomberg, U.S. Federal Reserve, RBC GAM

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



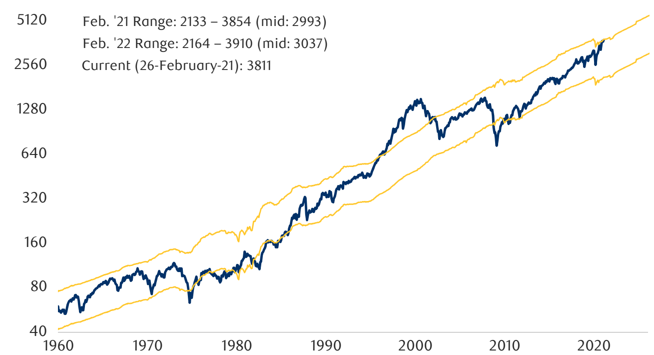
Note: as of March 2, 2021. Source: RBC GAM, RBC CM

Exhibit 5: United Kingdom 10-year bond yield
Equilibrium range



Note: Aa of March 2, 2021. Source: RBC GAM, RBC CM

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



Note: as of February 26, 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

U.S. large-cap market was a laggard in the past quarter, as U.S. small caps gained as much as 28% and emerging market equities climbed nearly 20%. There are still equity markets featuring attractive valuations and return potential. Stocks in the U.K., Europe, Canada and Japan continue to trade at discounts relative to our modelled levels of fair value and offer compelling upside potential against a backdrop of strong economic growth (Exhibit 7).

Corporate profit outlook is compelling

In the U.S., corporate profits have continued to exceed analyst expectations and are rebounding rapidly from the COVID-19 recession. Although S&P 500 earnings declined 12% in 2020, the drop was much less than the 23% expected. Looking ahead, analysts anticipate S&P 500 earnings to rise 23% in 2021, surpassing their 2019 peak to reach $173/share by the end of the year and climbing just above $200/share in 2022 (Exhibit 8). While the S&P 500 is expensive by many measures, investors are paying a premium for earnings growth in an environment of historically low interest rates.

Asset mix – maintaining overweight in equities, underweight in bonds

In our base case scenario we see the economy recovering quickly from last year's sudden and deep recession, supported by ample monetary and fiscal stimulus and progress on vaccinations. In this environment, yields could lift higher still, acting as a headwind to returns for bond holders. As a result, we expect low single-digit total returns for sovereign fixed income over the year ahead. Stocks continue to offer superior return potential although we recognize valuations are highly demanding in certain markets and could be vulnerable to mounting risks, including rising yields, which may weigh on price-to-earnings ratios. That said, we are comforted by the strength of the economic and corporate profit recovery which, barring unforeseen negative shocks, is likely to continue providing fundamental support for equity markets. Balancing the risks and rewards, we are maintaining an overweight position in stocks and underweight in fixed income. 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%) and 1.0% in cash.

Exhibit 7: S&P/TSX Composite equilibrium
Normalized earnings and valuations

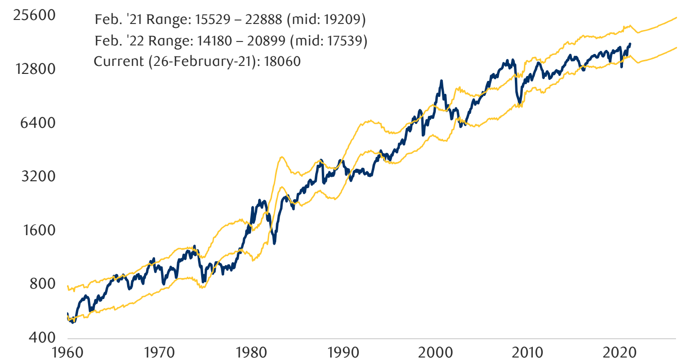


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Exhibit 8: S&P 500 Index
12-month trailing earnings per share

Note: as of February 26, 2020. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, RBC GAM

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