RBC Global Asset Management

Market Update

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Trimming U.S. equity exposure

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The macroeconomic backdrop remains strong and investors have many reasons to be optimistic. Economies continue to rebound from last year's deep recession, leading indicators are at multi-decade highs, risks related to the virus are fading as vaccinations progress and corporate profit growth is accelerating (Exhibit 1). In this environment, stocks have climbed to record levels and sovereign bond yields have reversed their pandemic-related plunge from early 2020. As a result, we believe that much of the cheerful outlook has been priced in, particularly in the U.S., where valuations are stretched and investor sentiment has reached extremes. As a result, we have decided to take some profits after a strong run by reducing our overweight position in stocks, sourced specifically from U.S. equities, and have placed the proceeds into bonds.

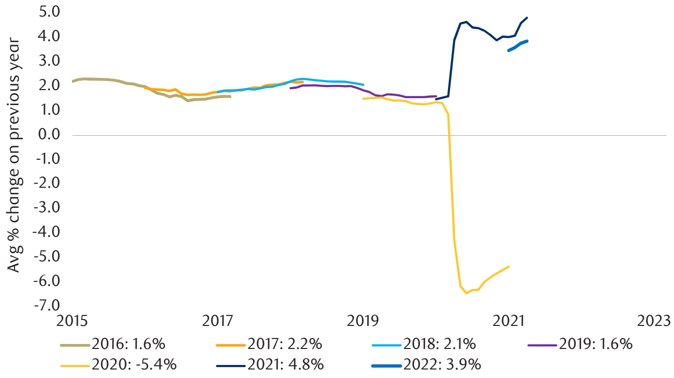
Strong outlook boosted yields, further increases may be limited

U.S. sovereign bond yields have nearly doubled since the start of the year as the announcement of vaccines, better economic growth and firming inflation diminished the demand for safe-haven assets. Valuation risk has been reduced significantly as the U.S. 10-year bond yield reclaimed its pre-pandemic levels and is now trading inside our modelled equilibrium band after falling below the lower boundary last year (Exhibit 2). In an environment where near-term inflation pressures prove temporary and central banks remain highly accommodative, we expect the U.S. 10-year yield could fluctuate within a relatively narrow range. Given that much of the good news is priced into the fixed-income market at this point, we would likely need to see improvement in the economic outlook beyond what is already expected to push bond yields sustainably higher.

Equity valuation risk is concentrated in the U.S.

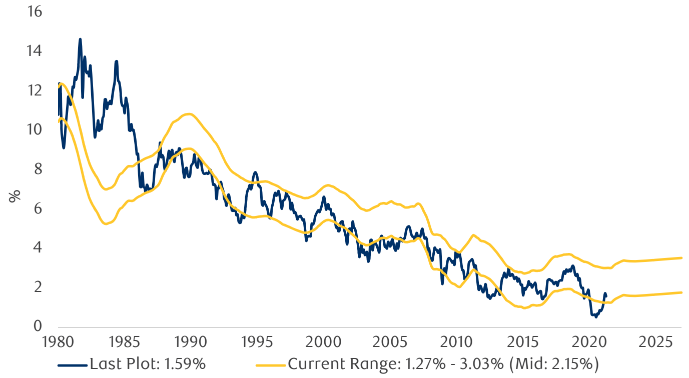
Most major equity indices are trading at or near record levels. The S&P 500 has climbed about 5% in April, bringing year-to-date gains to 12% and extending the already impressive

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



Note: As of April 23, 2021. Source: Consensus Economics

Exhibit 2: U.S. 10-year T-Bond yield
Equilibrium range



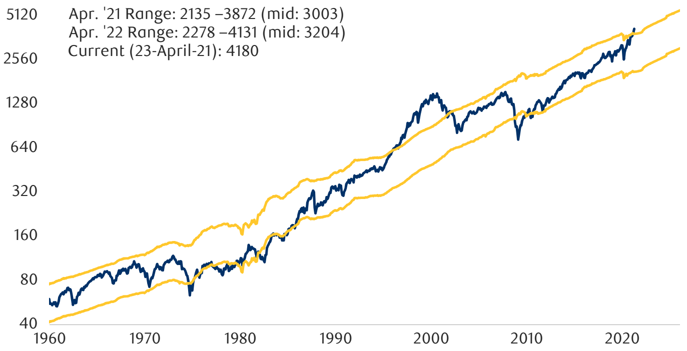
Note: As of April 23, 2021. Source: RBC GAM, RBC CM performance from 2020. Valuations have inched higher and the S&P 500 is now more than one standard deviation above our modelled fair value at levels not seen since the late 1990s (Exhibit 3). While we don't believe the market is as dangerously overvalued as it was during the tech bubble, there is some cause for caution, particularly with respect to investor confidence. Ned Davis Research tracks a variety of sentiment metrics and their Crowd Sentiment Poll indicator has reached levels of extreme optimism not seen since late 2017/early 2018. While extreme optimism and stretched valuations can persist for some time, we recognize that complacency may be creeping into markets, creating a vulnerability should that enthusiasm fade or the economic outlook deteriorate (Exhibit 4).

However, equity markets outside the U.S. offer better value. Stocks in emerging markets, Canada and Europe are more or less in line with our modelled fair value, and those in the U.K. and Japan are situated at relatively attractive valuations (Exhibit 5). As a result, global equity markets are not necessarily as stretched as investors focused solely on the S&P 500 may believe.

Asset mix – trimming exposure to U.S. equities, moving the proceeds to bonds

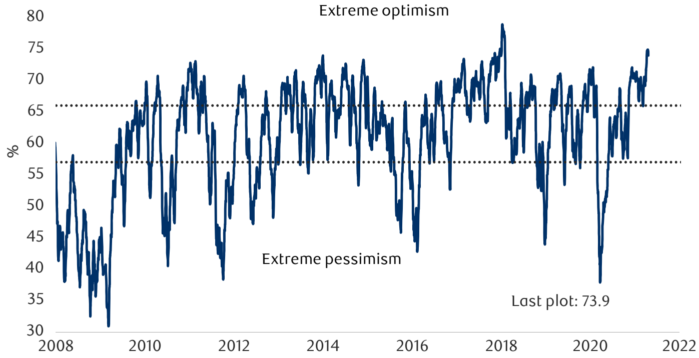
We recognize that economies are experiencing a strong recovery, supported by significant monetary and fiscal stimulus, and the outlook for corporate profits is robust. As a result, we are maintaining an overweight exposure to equities and underweight in bonds in our recommended asset mix. But elevated valuations, particularly in U.S. equities, reduces the future return potential, and moreover, the relative attractiveness of stocks to bonds has been diminished as a result of the rapid increase in bond yields (Exhibit 6). We opted to dial back our equity exposure by 50 basis points, sourced entirely from the U.S. and moved the proceeds to fixed income. Our 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 3: S&P 500 equilibrium
Normalized earnings & valuations



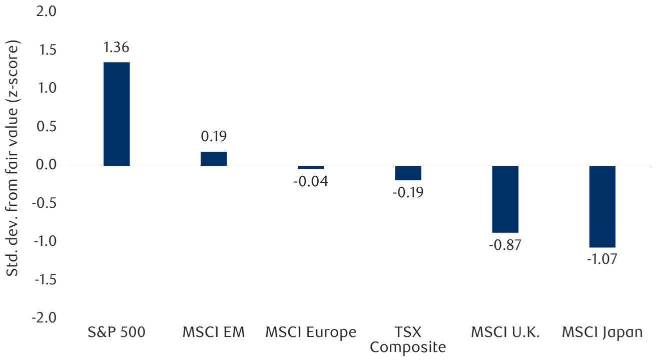
Note: Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM

Exhibit 4: Ned Davis Research Crowd Sentiment Poll
Percent bulls



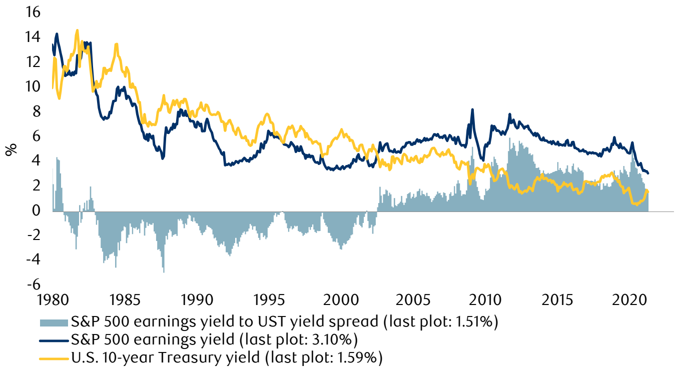
Note: As of April 20, 2021. Source: Ned Davis Research, RBC GAM

Exhibit 5: Global equity markets
RBC GAM fair value equilibrium



Note: As of April 23, 2021. Source: Haver Analytics, Bloomberg, RBC CM, RBC GAM

Exhibit 6: S&P 500 earnings yield
12-month trailing earnings/index level



Note: As of April 23, 2021. Source: RBC GAM, RBC CM

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