RBC Global Asset Management

Market Update

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Challenges diminish and a variety of constructive signals emerge

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The macroeconomic environment has improved in recent weeks. Two of the largest headwinds to risk assets – Brexit and U.S./China trade – have faded as progress has been made on both fronts. The extension of the Brexit deadline to January 31, 2020 reduces the risk of a no-deal outcome. With respect to global trade, the 'Phase 1' deal between presidents Trump and Xi suggests at least some level of cooperation between the world's two largest economies and that further escalation of tariffs is less likely. While there is still much uncertainty surrounding these critical negotiations, we now assign a lower probability of the worst-case scenarios playing out. A variety of other signs also suggest that the outlook may not be as bad as initially feared. Chinese growth is stabilizing as stimulus may now be working its way through the economy. In the U.S., central-bank rate cuts have helped push yield curves back into positive territory, which could be a sign that the business cycle has longer to run. Finally, the change in equity market leadership since the summer could be signaling a re-acceleration in economic and corporate profit growth. Against this slightly better macroeconomic backdrop, the RBC Investment Policy Committee has dialed up the equity exposure in its recommended asset mix, a move that represents a partial reversal of the de-risking that has occurred over the past few years.

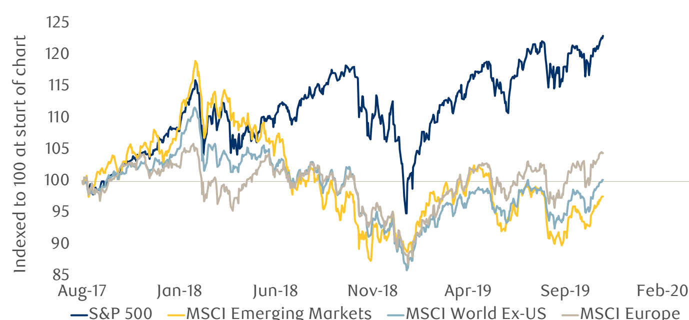
Market rotation hints at improving outlook for the economy and corporate profits

Underpinning the rally in risk assets since the summer has been a shift in leadership to more economically sensitive areas of the market. Since mid-August, value stocks have outperformed growth stocks, cyclicals led defensives, small caps beat large caps, and international and emerging-market equities rose more than U.S. equities (exhibits 1 to 2). This is important because for nearly two years, U.S. large-cap growth and mostly defensive sectors have been leading as investors sought protection against the possibility of a recession. This change in underlying market trends is a welcome sign and suggests that investors expect economic prospects to improve.

Exhibit 1: Value to growth relative performance
S&P 500 Value Index / S&P 500 Growth Index

Note: as of October 30, 2019. Source: Bloomberg, RBC GAM

Exhibit 2: Relative performance
Price levels, indexed to 100 at start of the chart



Note: as of October 30, 2019. Figures in USD except for MSCI Europe, which is in euros. Source: MSCI, Bloomberg, RBC GAM

Earnings slip in Q3, but earnings growth may be bottoming

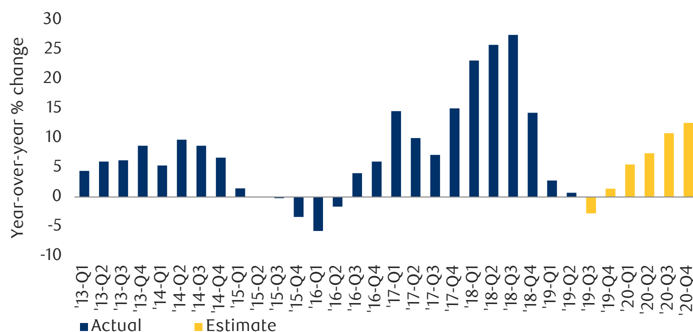
Data indicates that earnings growth could trough in the current quarter and re-accelerate thereafter. Exhibit 3 plots the year-over-year change in quarterly profits for the S&P 500 Index, with the blue bars on the chart representing actual results and the yellow bars representing the consensus of analysts' expectations for future earnings gains. Profit growth has slowed markedly since 2018 when earnings were bolstered by corporate tax cuts and faster economic growth, and profits are now declining slightly on a year-over-year basis. But notice that analysts expect the current quarter (i.e. Q3 2019) to mark the end of the profit-growth slowdown and for earnings to rebound gradually to a normal rate in the single digits or low double digits. If analysts are right and the third quarter is the trough, the subsequent re-acceleration in profit growth would provide fundamental support for a continuation of the equity-market rally.

Asset mix – increasing equity weight, sourced from cash

The global economy continues to face a number of challenges, but we are starting to see evidence that the outlook is looking less challenging than it did during the summer. A variety of leading indicators remain weak, but may be bottoming, and the market rotation into cyclical sectors away from defensive ones supports this view. In fixed income, our models continue to suggest that bond yields are too low and represent valuation risk, particularly should the global economy avoid recession (Exhibit 4). We don't expect particularly attractive returns from bonds, but do acknowledge they provide protection in a balanced portfolio should the outlook deteriorate. For these reasons, we have maintained a slight underweight in fixed income in our asset mix.

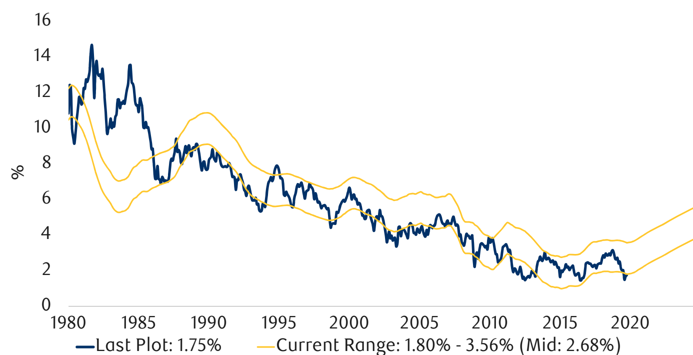
On the other hand, global equities remain below our modelled estimates of equilibrium in aggregate (Exhibit 5). If earnings grow in the mid-to-high single digits next year, stocks are likely to outperform bonds and remain overweight stocks as a result. Although we had been dialing back the equity weight in our portfolios due to concerns over the perceived lateness of the business cycle, slowing economic and earnings growth, Brexit and protectionism, we think these risks have diminished sufficiently for investors to add back some risk. We mentioned last month that we would prefer to see signs of sustainability in the early signs of market rotation before dialing up the risk exposure in our portfolios, and this trend has persisted. As a result, the RBC Investment Policy Committee took action this week by adding one percentage point to its recommended equity allocation, sourced from cash. The current recommended asset mix for a global balanced investor is 58.0% equities (strategic: "neutral": 55%), 40.0% bonds (strategic "neutral": 43%) and 2.0% cash.

Exhibit 3: S&P 500 Index earnings per share
Quarterly earnings % change from same quarter in prior year



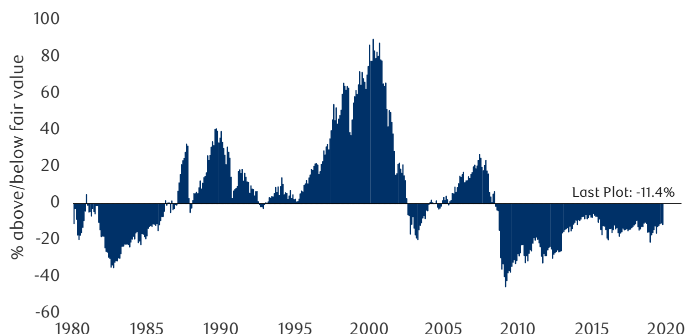
Note: as of October 30, 2019. Source: Thomson Reuters, RBC GAM

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



Note: as of October 17, 2019. 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, RBC CM

Exhibit 5: Global stock market composite
Equity market indexes relative to equilibrium



Note: as of October 17, 2019. Source: RBC GAM

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