RBC Global Asset Management

Market Update

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Economic recovery slows and markets consolidate as virus regains traction

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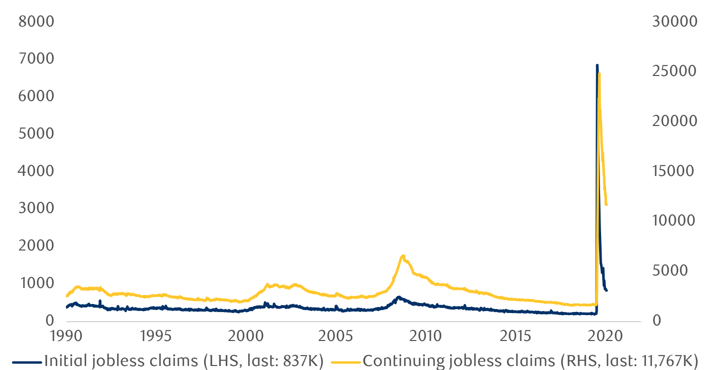
The economy and financial markets are contending with a second wave of COVID-19 as the re-opening of schools and colder, drier fall weather have coincided with a second wave of cases. The number of infections is rising in Europe, Canada and the U.K., and has plateaued in the U.S. after a steady decline. Most notably, the U.S. president has tested positive for COVID-19, amplifying political and economic uncertainty just a month before the election. While the initial stages of the pandemic were met with massive fiscal and monetary policy responses and mandated shutdowns, action to address the second wave is occurring with less urgency. Governments are being more selective in tightening restrictions, closing businesses in hot spots rather than forcing entire sectors to halt operations as they did earlier in the year. As a result, the economic damage from the second wave should not prove as severe as the first, and a recovery is still underway albeit at a slowing pace.

Progress is being achieved with the help of fiscal and monetary stimulus

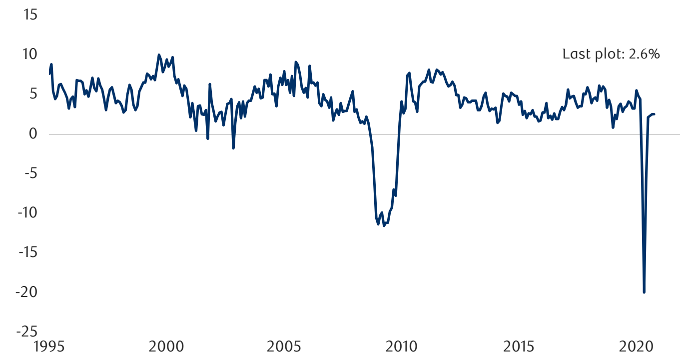
A variety of metrics suggests that the U.S. economy has made tremendous progress from the depths in the spring. Employment continues to improve, as evidenced by a declining number of new Americans filing for unemployment benefits and a reduction in those currently collecting them (Exhibit 1). While the trend is constructive, the current level of joblessness ranks near the worst recorded during the 2008-2009 global financial crisis. Offsetting the effects of mass unemployment on the economy has been the massive monetary and fiscal support, which has boosted retail sales and housing activity (exhibits 2 and 3). With unemployment still high, however, economic momentum could ebb without further rounds of fiscal support. Another stimulus bill is currently in the works, but Democrats and Republicans have yet to agree on the final details.

Exhibit 1: U.S. unemployment claims



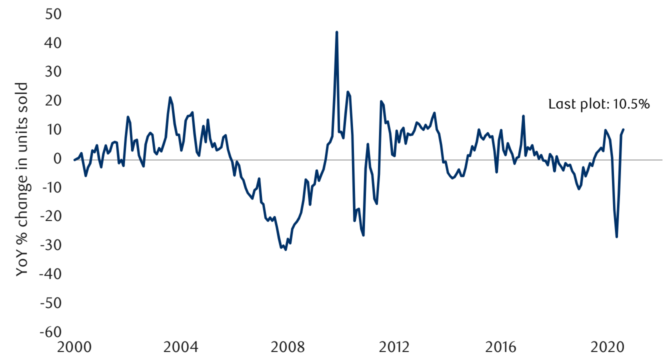
Note: As of October 02, 2020. Source: Bloomberg, RBC GAM.

Exhibit 2: U.S. retail sales
Adjusted retail & food services sales yearly % change



Note: As of September 30, 2020. Source: Bloomberg, RBC GAM

Exhibit 3: U.S. housing – sales of existing homes
Total existing home sales



Note: As of August 31, 2020. Source: National Association of Realtors.

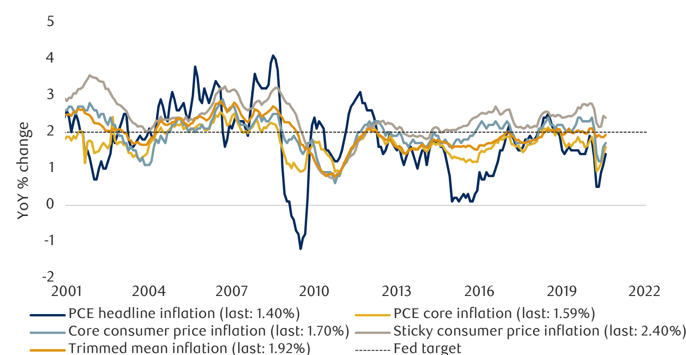
Central banks maintain low rates in the absence of inflation pressures

Against this challenging backdrop, central banks are maintaining ultra-low interest rates and large-scale bond-buying programs to support the economy and financial markets. U.S. Federal Reserve (Fed) chairman Jerome Powell has said interest rates likely won't rise until inflation rises above the Fed's 2% target. Moreover, the Fed has adjusted its policy framework to target 2% inflation over a period of time rather than focus on shorter-term changes in price levels, as had been the case previously. The shift is meant to better account for recessionary periods where inflation tends to be below target. A number of different measures suggest that inflation is reviving, but it remains low by historical standards and the conditions that would lead to problematically high inflation are not yet in evidence (Exhibit 4). These measures would likely need to persist above 2% for months or even quarters before the Fed hikes interest rates again.

Bond yields fluctuate in narrow range

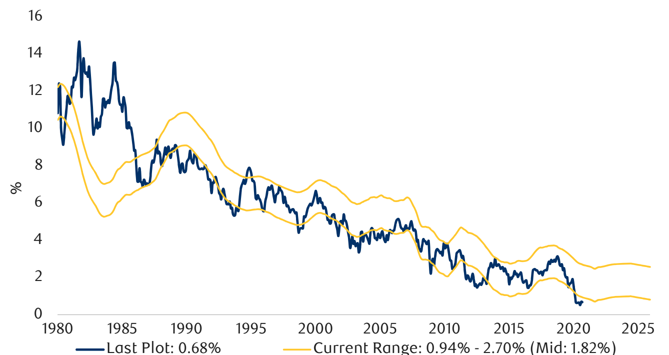
Highly accommodative central banks and relatively weak economic growth have kept global bond yields trading in a narrow range. The U.S. 10-year yield has fluctuated between 63 and 70 basis points in the past month and it remains well below our estimate of equilibrium (Exhibit 5). While valuation risk is quite elevated in sovereign fixed-income markets, we don't see any near-term catalysts that would push yields meaningfully higher. The fact that central banks continue to purchase bonds in large quantities and inflation pressures remain muted suggests that bond yields will likely remain low, and we forecast that yields will be mostly unchanged over the year ahead.

Exhibit 4: U.S. inflation measures



Note: As of August 31, 2020. Source: Bloomberg, RBC GAM

Exhibit 5: U.S. 10-year T-Bond yield
Equilibrium range



Note: As of September 30, 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, RBC CM

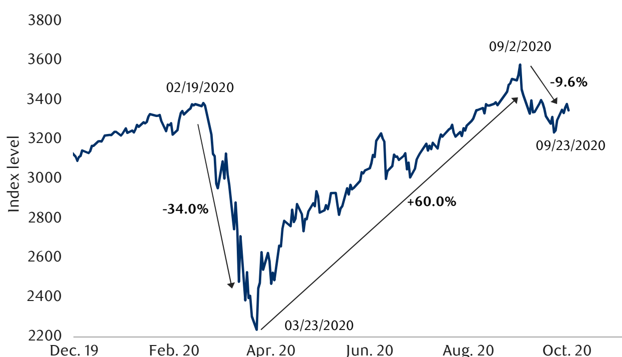
Equities encounter volatility as economic recovery slows

Stock volatility increased significantly in the past month as the rising number of coronavirus infections, U.S. election uncertainty and the lack of a Congressional stimulus bill weighed on investor confidence. The S&P 500 fell just shy of 10% in September from its record high, but the decline represents a small pullback relative to the exceptional 60% rally from the March low (Exhibit 6). Contributing to the market weakness were some of the familiar large-cap growth stocks that have given back a bit of their recent gains. Bank stocks have also struggled as the economic recovery appeared to slow, with the KBW Bank Index falling to a new low relative to the S&P 500 Index (Exhibit 7). U.S. banks have underperformed during the pandemic and their recent weakness is an extension of a trend in place since 2008. The underperformance of banks suggests that economic growth is likely to remain underwhelming and in that environment, growth stocks should maintain their leadership.

Asset mix – maintaining view that stocks will outperform bonds

In our view, the recent drop in stocks represents a consolidation within a broader upward trend. The pullback in September flushed out excessive optimism that had built up through August, and investor sentiment is now much more supportive (Exhibit 8). Moreover, credit markets appeared well behaved throughout the risk-off period and central banks are continuing to provide ample liquidity, suggesting a more meaningful decline in stocks is unlikely. Our view that equities are likely to outperform bonds over the medium to longer term remains unchanged given historically low bond yields and the fact that stocks are reasonably priced on a global basis (Exhibit 9). That said, we recognize that the upcoming U.S. election and evolving developments around the coronavirus are potential sources of volatility. Our bias would be to look for chances to boost risk exposures in our portfolios rather than dial them back.

Exhibit 6: S&P 500 Index

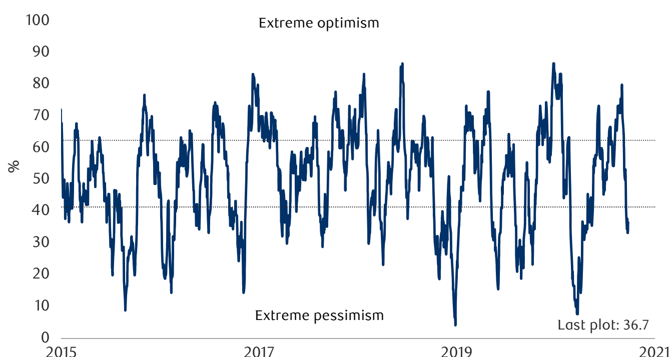


Note: S As of October 2, 2020. Source: Bloomberg, RBC GAM

Exhibit 7: Relative strength
Philadelphia (KBW) Bank Index relative to S&P 500

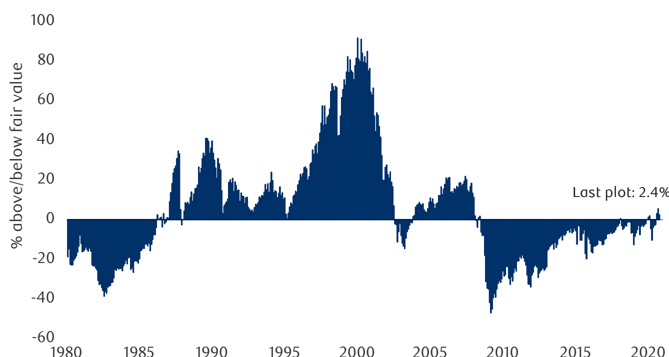
Note: As of October 1, 2020. Source: RBC GAM, RBC CM

Exhibit 8: Ned Davis Research Daily Trading Sentiment Composite – Percent bulls



Note: As of September 25, 2020. Source: Ned Davis Research, RBC GAM

Exhibit 9: Global stock market composite
Equity market indexes relative to equilibrium



Note: As of October 2, 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

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