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Growth moderates as recovery progresses, trimming bond allocation in favour of cash as yields tumble

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With the easing of restrictions, economies have progressively reopened and activity has been restored to pre-pandemic levels throughout most of the world. Strong demand and still-challenged supply chains are leading to consumer price increases and, while inflation is likely to remain above-normal for some time, many of the forces affecting prices appear to be transitory. In fact, the peak in the recovery's intensity may now be behind us. Leading indicators of the economy are off their recent highs suggesting a slight moderation in the still-favourable growth outlook (Exhibit 1). Tailwinds from monetary and fiscal packages will fade as stimulus is ultimately withdrawn, but consumers flush with savings are well positioned to spend and provide support for the economy. All in all, we continue to look for above-average global growth next year but at a reduced clip versus 2021.

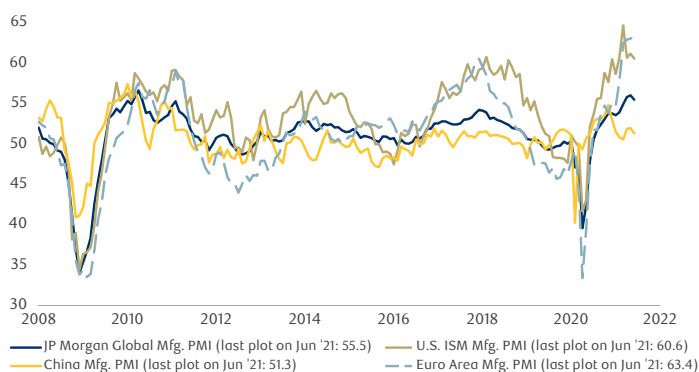
Virus and other macroeconomic risks

The virus remains a key challenge for economies as infection levels ebb and flow, but vaccines have been widely distributed and are providing protection against COVID-19. Although the spread of the Delta variant is accelerating, the extent of its economic impact will ultimately depend on governments' response and many are now reluctant to impose harsh restrictions. Other macroeconomic risks include Chinese policy tightening and geopolitical tensions related to Afghanistan.

Fed contemplates dialing back stimulus

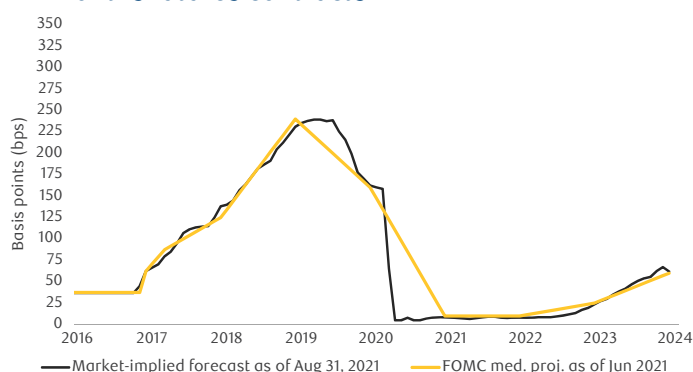
Another potential concern for investors is the eventual removal of monetary stimulus that has been in place since the early days of the pandemic. Global central banks have added trillions of dollars to the financial system through asset purchases but some central banks have already begun taking steps to dial back stimulus efforts. In the U.S., the Fed is contemplating tapering its bond purchases sometime this year. Actual increases in the fed funds rate are unlikely to occur until tapering is complete meaning the first hike may not be until late 2022 or early 2023 (Exhibit 2). Less

Exhibit 1: Global purchasing managers' indices



Note: as of August 31, 2021. Source: Haver Analytics, RBC GAM

Exhibit 2: Implied fed funds rate 12-months futures contracts



Note: as of August 31, 2021. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

accommodation could, at the margin, take away support for asset prices but the fact that policy decisions are being telegraphed well in advance reduces the chances of investors being caught off guard.

Drop in bond yields re-introduced valuation risk

In the bond market, yields have declined meaningfully in the past quarter on the back of moderating growth and inflation expectations and a slower-than-anticipated path to monetary tightening. The U.S. 10-year yield fell as low as 1.17% from its peak of 1.75% in March and yields almost everywhere are once again well below our modelled estimates of equilibrium (Exhibit 3). The latest decline has reintroduced meaningful valuation risk in the fixed income market and our expectation is that yields rise gradually from here paced by an increase in real interest rates as the economy normalizes and stimulus is withdrawn.

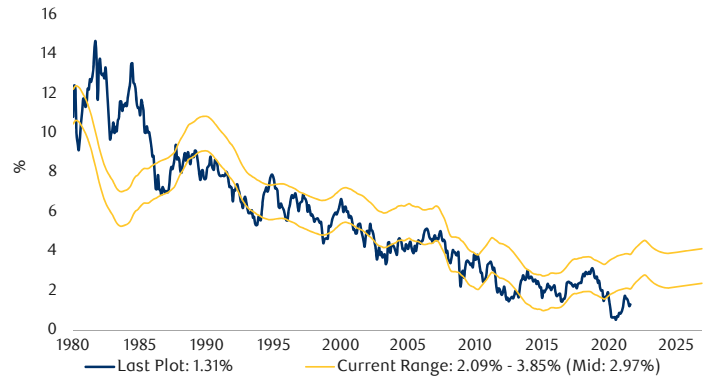
Stocks extend gains to new records

Global equities extended their gains and most major indices climbed to record levels as investors remained confident in the recovery. The S&P 500 rose above 4500 in August, representing a more than doubling from its March 2020 low (Exhibit 4). Emerging market stocks underperformed in the past quarter in part due to slowing growth in China amid policy tightening and also the fact that developing countries are struggling more with the virus than advanced nations. According to a variety of metrics, valuations are stretched in U.S. large-cap stocks in particular but other markets continue to offer attractive upside potential.

Equity rally fueled by soaring profits

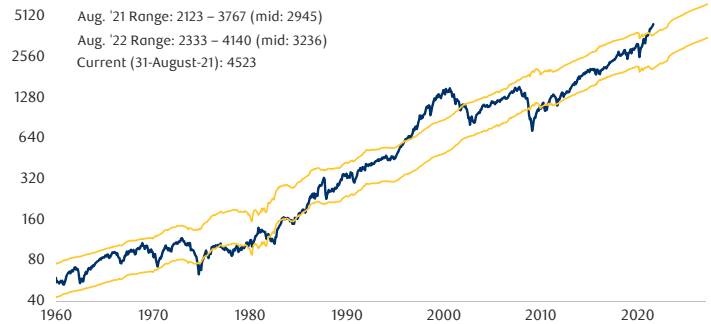
Fueling the equity rally has been the massive surge in corporate profits and the expectation that earnings will continue marching higher at a rapid clip for at least several years. A recurring theme since the pandemic began has been better-than-expected profit results, and the earnings per share for the S&P 500 has already exceeded its pre-COVID peak of \$165 on a 12-month trailing basis (Exhibit 5). Analysts expect that figure to reach just over \$200 by year-end which would represent a 21% gain above the prior high. Although tax hikes could pose a headwind to these figures, analysts are currently looking for earnings to reach \$236 by the end of 2023. This strong upward trend in corporate profits, if sustained, would justify elevated valuations especially in an environment of low interest rates and limited investment alternatives.

Exhibit 3: U.S. 10-year T-bond yield Equilibrium range



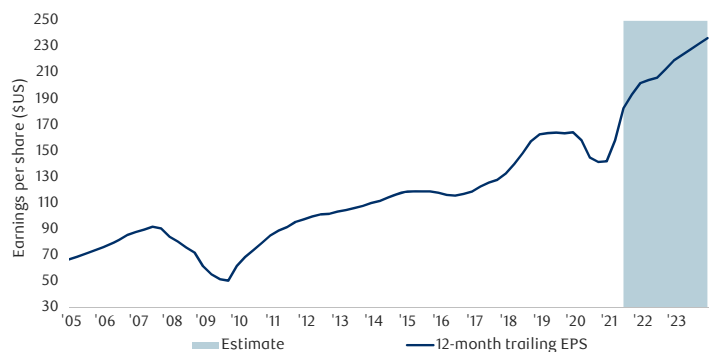
Note: as of August 31, 2021. Source: RBC GAM, RBC CM

Exhibit 4: 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 5: S&P 500 Index 12-month trailing earnings per share



Note: as of August 24, 2021. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, RBC GAM

Asset mix – trimming fixed income allocation in favour of cash

Balancing the risks and opportunities, our asset mix continues to maintain a bias toward risk taking. We acknowledge that the economic recovery is slowing after a strong rebound, but our assessment is that the cycle is in its early-to-mid stages and could still have several years of growth ahead. Policy support is likely to fade as the expansion matures and against this backdrop we expect interest rates and bond yields to climb gradually higher, which would lead to low or even negative returns in fixed income. As a result we have been trimming our exposure to bonds throughout the past quarter. Harvesting the expensive

valuations in fixed income, we reduced our bond allocation by one percentage point in July and by another 0.50% at the end of August. Stocks, in our view, continue to offer superior return potential though we recognize that valuations are stretched in some markets and that risks related to the virus, China, geopolitics and U.S. taxation policy could be sources of volatility. For these reasons we have opted to place the proceeds of the fixed income sale into cash for the time being while maintaining a modest overweight in stocks. Our current recommended asset mix for a global balanced investor is 64.0% equities (strategic: “neutral”: 60%), 33.5% bonds (strategic “neutral”: 38%) and 2.5% in cash.

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