RBC Global Asset Management

Market Update

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Global equities reach new highs as economy rebounds and virus threat moderates

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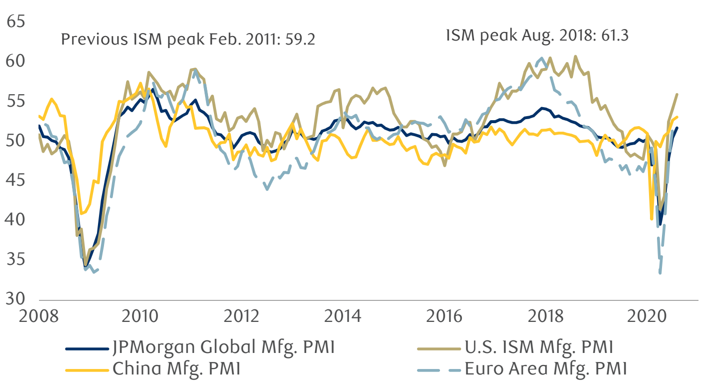
Global economic activity rebounded as lockdowns eased and the virus threat diminished through much of the world. Leading indicators of growth are once again pointing to expansion after falling deep into contraction territory in the winter/spring and Purchasing Managers' Indices (PMIs) in some regions are now above their pre-pandemic levels (Exhibit 1). Although the economy is now moving ahead, we still look for a 4% contraction in global GDP for full-year 2020, followed by a notable rebound of 5.1% in 2021. We don't expect a full return to "normal" conditions until a vaccine is developed and widely distributed, which experts suggest may be delayed until mid-2021 or even later.

A variety of challenges continue to cloud the outlook. Social distancing measures still in place are limiting economic activity and extremely high unemployment is weighing on consumer confidence. The combination of schools reopening in the fall and cooler weather could spark more virus outbreaks. That said, we also recognize the potential for upside surprise if a vaccine or an effective therapeutic gets rolled out sooner than expected. Aside from virus-related risks, the U.S. presidential election in November and renewed tensions between U.S. and China are additional sources of volatility for the economy and financial markets.

Massive monetary and fiscal stimulus provides support for economy and markets

Policy makers delivered unprecedented stimulus this year to support the economy and markets given the massive disruption caused by COVID-19. Central banks are fostering liquidity by maintaining ultra-low interest rates and continuing large-scale bond-buying programs. Governments have also delivered trillions of dollars in aid via payroll support, funding for hospitals, and loans for small businesses among other efforts. The massive scale of the stimulus injected could cause consumer prices to rise, but downward pressure on prices from weak demand, slack in labour markets and weak energy prices should provide effective offsets, limiting the threat of unwanted inflation in the intermediate term.

Exhibit 1: Global purchasing managers' indices



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

Sovereign bond yields held down by central banks and secular forces

Bonds yields hovered near historic lows in the past quarter as the weak economy paired with aggressive central-bank buying maintained elevated demand for safe-haven assets. Yields are well below our modelled estimates of equilibrium in all regions and, even after adjusting for the impact of structural changes depressing real interest rates below historic norms, valuation risks appear elevated in sovereign fixed income markets (Exhibit 2). Nevertheless, through the forecast horizon, massive and price insensitive buying by central banks will likely dominate valuations, holding nominal interest rates at historically low levels.

Equity markets surge, led by U.S. large-cap growth stocks

The strong rally in global equities that began in March has extended through the summer and a number of markets have now completely erased their prior losses. Helped in large part by mega-cap technology stocks, the S&P 500 has climbed 56% from its March 23 low and is now up 8.3% year to date. COVID-19 caused a wide divide between winners and losers as work-from-home measures and mass shutdowns crippled certain businesses while boosting the proposition of technology companies in particular and retailers with a strong online presence. As a result, the valuation gap between growth and value stocks has moved to an extreme matched only by the late 1990s/early 2000s technology bubble (Exhibit 3). That said, the elements of a rotation out of growth and into value are not yet in evidence (self-sustaining economic recovery, rising inflation and pricing power, among others). With the S&P 500 now decidedly above fair value, forward return potential is reduced, but most markets outside the U.S. remain attractively valued according to our models and, in aggregate, global equities are reasonably valued.

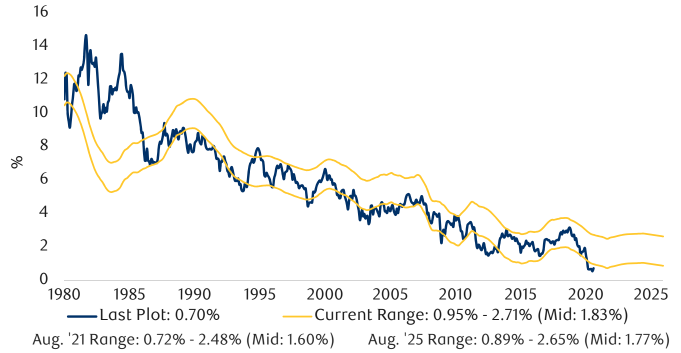
Earnings outlook stabilizing/improving

Profits are down significantly due to COVID-19, but the loss of earnings due to the virus will not have a lasting impact on markets if earnings rebound quickly. In the U.S., S&P 500 earnings fell 30% on a year-over-year basis in the second quarter (versus expectations of -43%) and are expected to be down 20% for the full year 2020 (Exhibit 4). Analysts expect S&P 500 profits to reclaim their pre-COVID levels by the end of 2021. Our discounted cash flow analysis reveals that a temporary decline in profits, even if severe, has a minimal impact on the market's value as the bulk of the stock market's present value is based on a very long term earnings outlook.

Asset mix – increasing equity allocation, sourced from bonds

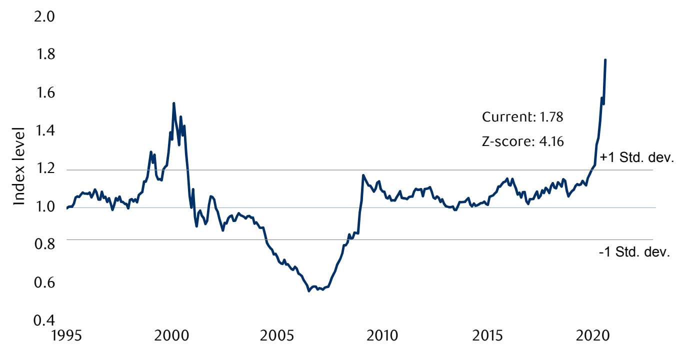
In our view, the global economy will likely continue recovering, albeit at a slower pace than was experienced since March and corporate profits should continue their upward trajectory towards pre-COVID levels. In the current environment, sovereign bonds offer limited room for capital gains and the low yields offer little cushion against equity-market volatility. Some stock markets could be vulnerable in the near term as valuations have crept up, namely in U.S. large-cap growth stocks, but over the intermediate to longer-term we think stocks offer superior return potential versus sovereign bonds. As a result, this quarter we raised our allocation to equities by one percentage point, sourced from fixed income. Our current recommended asset mix for a global balanced investor is 62.0% equities (strategic: "neutral": 60%), 37.0% bonds (strategic "neutral": 38%) and 1.0% in cash.

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



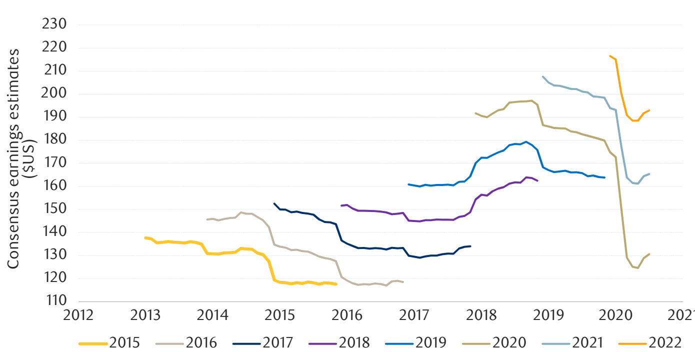
Note: As of August 31, 2020. Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM, RBC CM

Exhibit 3: Russell 3000 Growth % of equilibrium relative to Russell 3000 Value % of equilibrium
U.S. equity styles: relative valuation



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

Exhibit 4: S&P 500 Index
Consensus earnings estimates



Note: As of August 31, 2020. Source: Thomson Reuters, Bloomberg

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