GLOBAL
Insight

RBC Wealth Management

Global Equity Perspective

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A dose of perspective

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After a two-month rally into mid-August, equity markets resumed their decline through September. Most now sit at or below their June lows, down some 20% or more year-to-date.

As major markets perched near all-time highs early in the year, there was a general expectation 2022 would bring further improvement to economies still emerging from the dislocations set in motion by the pandemic. There then followed the rapid arrival of a number of market-unfriendly developments:

- The onset of yet another wave of Omicron variant infections, which disrupted the reopening of economies in much of the developed world and led to a series of output-crippling lockdowns in China that are ongoing;
- Surging inflation well beyond what forecasters had expected as too much money chased an inadequate supply of goods. Shortages were exacerbated by supply chain disruptions which have taken much longer than originally anticipated to resolve;
- The rapid rise of food and energy prices due to constrained supplies, dramatically escalated by the war in Ukraine;
- Labor shortages which hobbled the reopening of large parts of the service economy; and
- The abrupt shift of central bank policies from tolerating rising inflation to actively trying to rein in price increases through aggressive interest rate hikes and quantitative tightening.

Equity views

Region	Current
Global	=
United States	=
Canada	=
Continental Europe	–
United Kingdom	–
Asia (ex Japan)	+
Japan	+

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

Punishing bond yields

From an equity investor's standpoint, the biggest villain has been the dramatic rise in bond yields. Since the beginning of the year, the 10-year U.S. Treasury yield has soared from 1.50% to 3.75%. Corporate bond yields have jumped from 3.40% to 6.00%. Higher bond yields play out in the form of much higher borrowing rates for consumers, businesses, and homebuyers, which reduce disposable incomes and slow, or even reverse, GDP growth.

But there is a more "direct drive" impact on share prices. Higher inflation lowers the present value of

For important and required non-U.S. analyst disclosures, see page 5.
All values in U.S. dollars and priced as of market close, Sept. 30, 2022, unless otherwise stated.
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future earnings. For example, a dollar of earnings booked 10 years from now has a present value of $0.82 assuming inflation averages 2% per annum over that decade. Raise the inflation assumption to 4% and the present value of a dollar earned 10 years out drops to $0.67. If current conditions cause inflation expectations to move up in that way, price-to-earnings (P/E) multiples usually fall to reflect the drop in value of future earnings. And at the same time, the higher interest rates that normally come with rising inflation act to raise the discount rate by an additional amount, further squeezing the P/E ratio.

At the peak of the market in January, the S&P 500 traded at 23x trailing 12-month earnings. At the recent low, the P/E multiple had sunk to just 16x.

Perspective called for

All that said, it is worth putting this market retreat of the last nine months into perspective. From the pandemic low in March 2020 to the market peak in early January of this year—a stretch of 21 months—the S&P 500 gained about 2,600 points or 118%. Over the past nine months it has given back not quite half of the points gained in that advance. In the same 21 months of rising markets to January of this year, Canada's TSX rose by a more subdued 99% (if one can call it that) but has since given back just over a third of the points gained. Japanese, European, and UK markets all look to be variations on this theme.

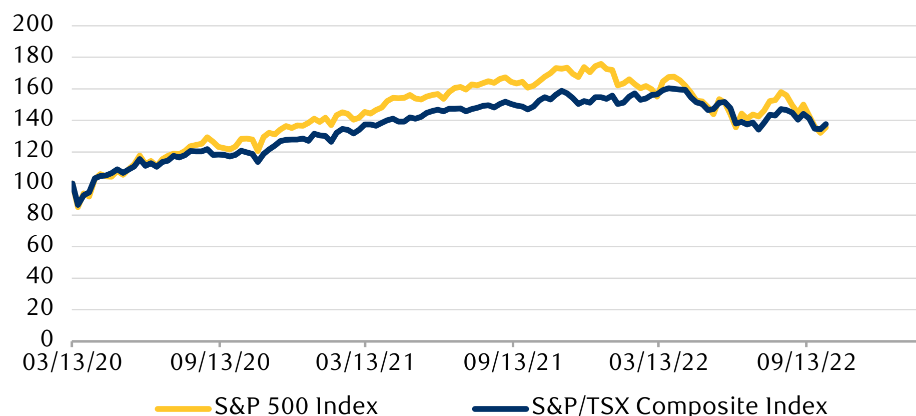
So far, in the case of the North American markets, leaving aside the strident headlines, it looks to us very much like a strong bull market up-leg followed by a pretty normal period of correction and consolidation of those gains.

However, while markets are now deeply oversold, it's possible they could become even more so in the coming days and weeks. A sustained equity rally, one with the potential to reach or exceed the old highs, would require a powerful catalyst from here. The one conceivably strong enough, in our view, would be a decisive weakening of inflation on a broad front, putting an early 2023 end to Fed tightening back on the table and pushing bond yields lower in the process.

Is that likely? The answer is, "less so than it would have appeared a couple of months ago"—ironically because of a stronger-than-expected U.S. economy. Q3 GDP growth looks to be running at a better-than-2% (annualized) pace, as the consumer continues to spend, albeit at a somewhat subdued rate.

The employment picture remains highly supportive. Weekly unemployment claims, which were on the rise through the spring and early summer, have been falling steadily since mid-July and are now within striking distance of their cycle lows set back in March (see our U.S. recession scorecard). The

Bear market or correction?



Note: Indexed to 100 on 3/13/20

Source - Thomson Reuters; data through 10/3/22

Fed is unlikely to back off its rate-hiking agenda in the absence of some decisive weakness on the employment front. No such weakness has as yet materialised.

Near-term relief

There are some particular factors in the current economic/market mix that may give some upside fuel to the equity market:

Extreme investor pessimism. Surveys of equity investor sentiment reveal a large majority of individuals expect markets to decline further. A substantial majority of professional market observers feel the same. Put buying—a strategy that profits only if the market declines—reached extreme levels in late September. Such negative unanimity often occurs near important lows.

At the same time, bond investors are displaying similarly one-sided, negative opinions about the outlook for bond yields—a sizeable majority expects them to rise even further. History suggests such extreme one-sidedness occurs around peaks in rates. Any reversal downward in bond yields would likely give stock prices an upward boost.

U.S. midterm elections are usually associated with positive equity outcomes. Corrections are common in midterm years, and so are follow-on rallies (see chart).

Some prospects for better inflation readings. Shipping costs are falling, as are the prices of most industrial and many agricultural commodities. In the September ISM Report On Business for the U.S. manufacturing sector, the "prices paid" sub-index had fallen to 51.7% (from close to 90% back in the first half), implying that almost half of the firms surveyed were experiencing declines in average input costs.

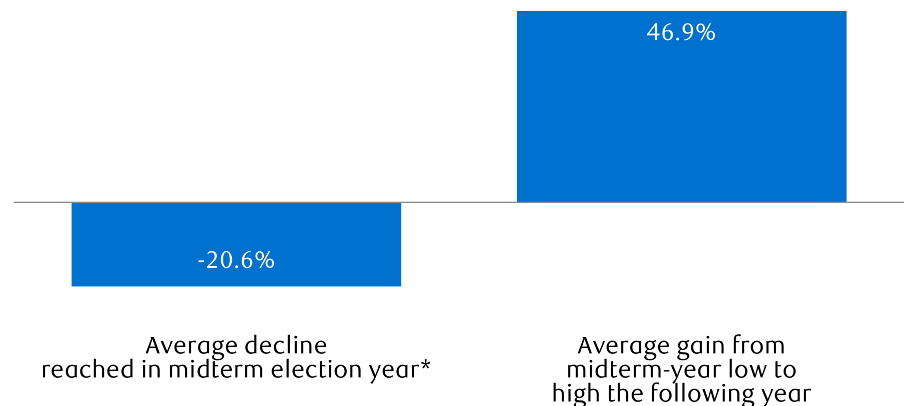
Market Weight exposure

In our view, equity markets have become so deeply oversold over the course of the last nine months that some near-term relief is probably not far off. However, more market turmoil could be expected next year if further Fed tightening were to push the U.S. economy into recession, as now seems likely (see our U.S. recession scorecard). But some portion of any future economic weakness looks to have been priced in over the course of this year's decline.

Taking a 12-to-18-month forward view, we regard an equity exposure of Market Weight as appropriate for a global balanced portfolio.

Corrections are common in midterm years, and so are follow-on rallies

S&P 500 returns surrounding midterm elections (1934 - 2019)



* Measured from the peak within 12 months before the midterm-year low, to that low. In 22 of 23 instances, the low was reached before the midterm election; the exception was in 2018 when it occurred after the election.

Source - RBC Wealth Management, Bloomberg; performance surrounding 22 midterm election years

Research resources

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As of Sept. 30, 2022

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