Market Comment: Filtering out the noise

Various markets have produced conflicting signals over the past few months. On the one hand, most equity markets sank as expectations emerged for a much slower second half for both the economy and earnings. Bond markets for their part went well beyond that, pricing in both a double-dip recession and an imminent onset of deflation. At the other extreme, copper prices, some emerging market equity indices and more recently oil all regained their footing and pushed higher apparently in anticipation of a reacceleration in the economies of China and greater Asia.

Is this what half speed feels like?

These conflicting messages are indicative of a significant amount of noise emanating from the economic data. Given our long-held expectations of a transition to what can best be described as a half-speed recovery in the year ahead, it is not surprising to witness multiple data series providing conflicting readings. Our analysis of this data arrives at the following conclusions:

- For the U.S., the more positive tone to recent data releases provides comfort that the probability of a double-dip recession remains low (see chart 1). Buoyed by decent income gains, consumers are growing their expenditures at a 2% clip and evidence suggests employment will continue at a slow, if unsatisfying, grind higher. Strong financial positions and profitability leave corporations in good shape to offset, by way of capital spending, some of the fading effects of fiscal stimulus and inventory replenishment. On balance, there is enough fuel to support positive GDP growth, but the fragile state of the recovery and longer-term structural challenges including large government deficits and the slow process of consumer deleveraging suggests that growth will remain well below its longer-term trend for some time.
- Outside of the developed world (U.S., Europe, and Japan), prospects appear brighter. Heavy cash inflows and low global interest rates have created highly supportive conditions for domestic demand growth in a number of emerging market economies (see charts 2-4). Of particular importance, recent Chinese data suggest that authorities have so far been successful in orchestrating a soft landing of the economy while reining in some of the excesses in the real estate market. JP Morgan Economics forecasts growth in the emerging market economies of 5.6% in 2011, versus just 1.9% for the developed economies.

Chart 1: NY Fed sees low probability of double-dip

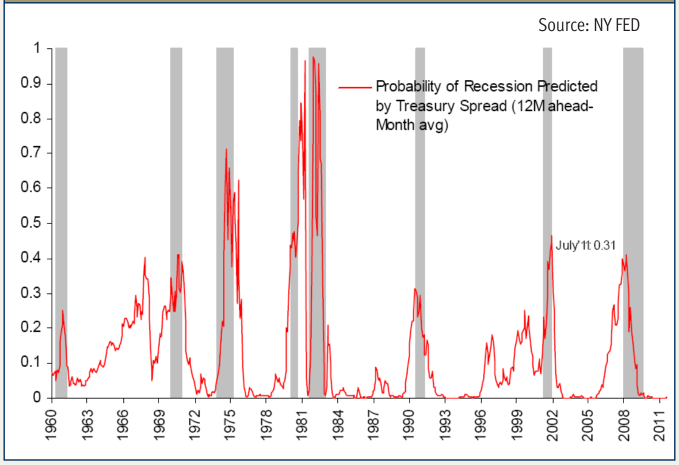


Chart 3: Global domestic demand growth

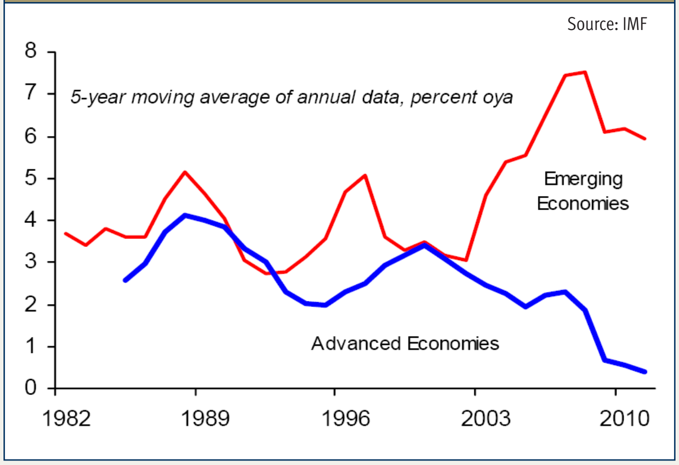


Chart 2: Global growth contributions

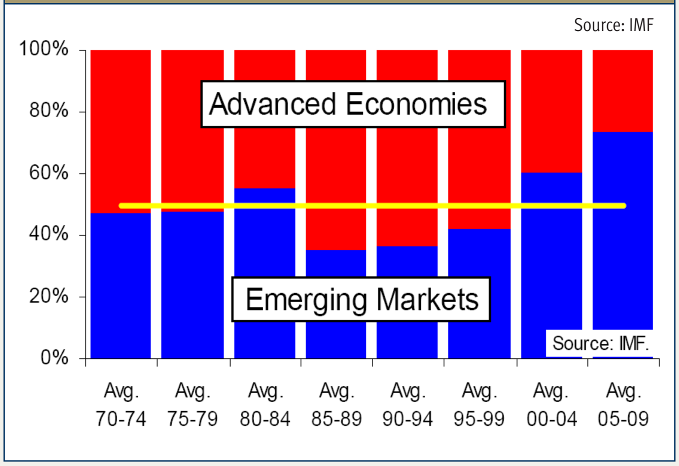
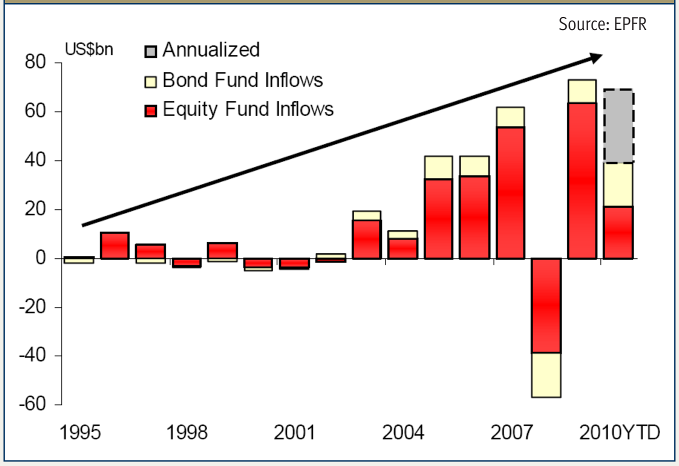


Chart 4: EM equity and bond fund inflows



- As long as the U.S. avoids a descent into outright recession, as we expect, the global picture remains constructive, with positive implications for commodity-producing countries such as Canada.

The Japan comparison rears its head … again

Falling bond yields during the month of August once again provoked concerns about the prospects for deflation and comparisons with the "lost decade" in Japan. A number of similarities exist: excessive leverage and declining asset prices have triggered an impulse amongst businesses and consumers to hoard cash and pay down debt, muting the impact of lower interest rates.

However, our U.S. Fixed Income team has noted a number of important differences. U.S. wage growth (an important driver of both inflation and consumer spending) is running at 2-3 times the average of the Japanese experience in the past two decades, overcoming a stagnant employment environment owing to strong gains in productivity. This is partially attributable to a substantial difference in labour force demographics (see chart 5). Most importantly, expectations are a significant determinant of the outlook: a deflationary mindset becomes self-fulfilling once populations begin to modify their behaviour in anticipation of falling prices. Japanese policy makers delayed taking decisive stimulative action long enough to allow such a mindset to sink in and take hold. By contrast, the Fed's actions, though by no means providing a silver bullet, appear to have been both swift and significant enough to keep expectations for positive inflation firmly in place as evidenced by various consumer and business sentiment surveys, as well as pricing in the U.S. TIPS market (see chart 6).

Chart 5: Divergence in population trends between U.S. and Japan

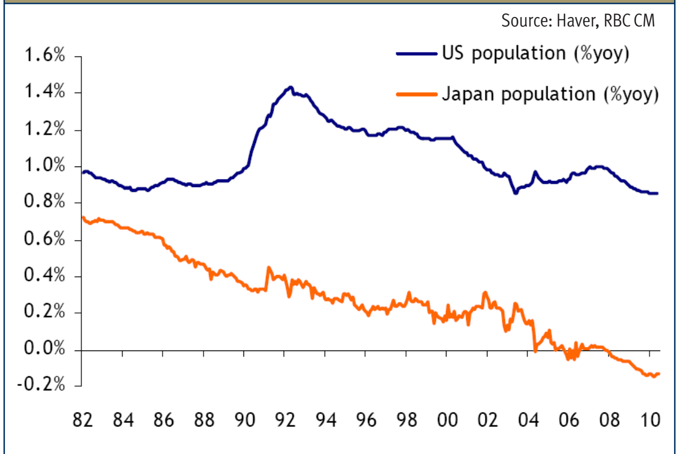
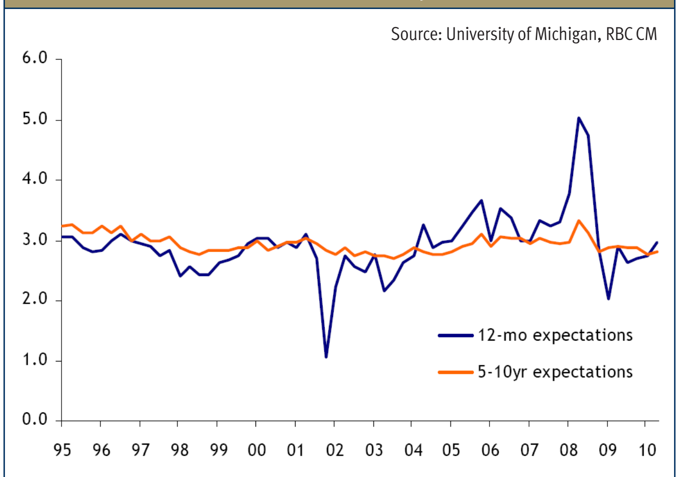


Chart 6: U.S. inflation expectations



All told, there are enough similarities that would lead us to draw a number of observations applicable to investors today:

- Deleveraging, high unemployment and depressed housing prices imply growth will remain below its potential for an extended period of time, with ongoing potential for periodic deflationary scares.
- Inflation is likely to remain benign for the foreseeable future despite aggressive reflationary monetary policy.
- Policy rates and bond yields will likely remain low until evidence of increased demand for credit and bank lending emerges alongside rising house prices and employment.
- Until this happens, equity markets are likely stuck in a wide trading range. Within this range, there is ample room for bull and bear markets triggered by changes in policy, investor positioning and traditional business cycle influences.
- Unusually, when viewed against historical experience, rising bond yields in this instance would be seen as positive for equity markets.
- Quality growth assets – those that offer a combination of predictable earnings growth, yield and quality – will remain in high demand.

Forecast updates

Softer economic data has led our economists to make a number of forecast revisions:

- RBC Economics lowered its U.S. growth outlook by 0.4% for 2010 and 2011 to 2.7% and 3.0% respectively. Canadian growth forecasts have been trimmed by 0.3% to 3.3% in 2010, and 3.2% in 2011.
- Our outlook for 10-year government bond yields has been revised down to 2.75% for year-end 2010 and 3.25% by mid-2011, down 35 and 50 basis points respectively.
- Expectations of Fed rate hikes have been pushed out to the third quarter of 2011 at the earliest. The Bank of Canada is likely to take a break until March of 2011 as it watches events unfold outside its borders.
- RBC CM forecasts S&P earnings at $74 for 2010 and $85 for 2011 implying earnings growth of 20% and 15% respectively, but below street consensus of $84 and $96 respectively.
- The RBC Investment Strategy Committee maintains one-year targets of 1,250 for the S&P 500 and 12,750 for the S&P TSX.

Asset allocation remains unchanged

We continue to believe that equities will outperform in the year ahead, both on an absolute basis, and relative to the low hurdles set by bonds and cash. We do not yet believe we are in an environment where the odds favor a blanket approach to taking on more risk than set out in an investor's long-term strategic asset allocation. For those with extra cash on hand, we see potential in the months ahead to add to equities at attractive levels.

Chart 7: S&P 500 equilibrium

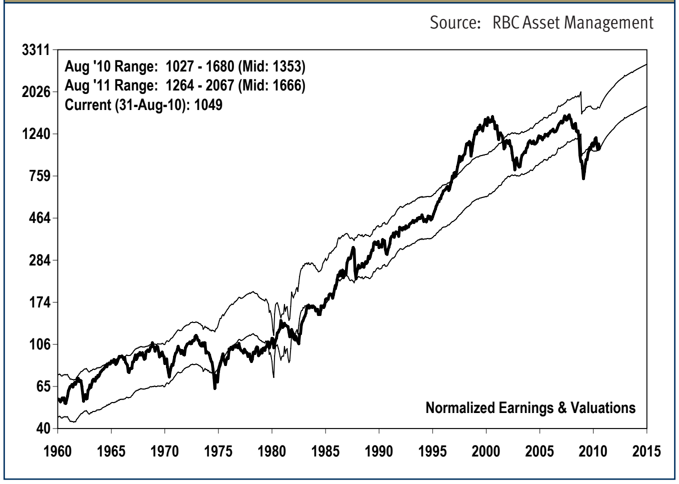
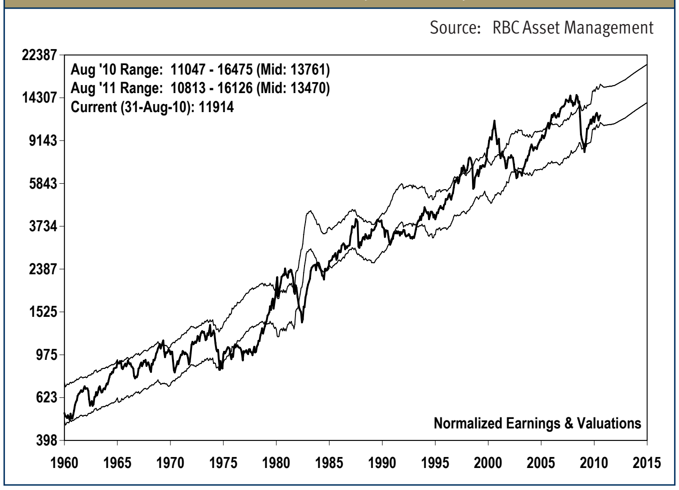


Chart 8: S&P/TSX Composite equilibrium



Equity markets

Equity markets remain attractively valued from a longer-term view as illustrated by the RBC Investment Strategy Committee's valuation models (see charts 7, 8). However, in the current environment, these valuations imply reluctance by investors to pay the historical going rate for earnings given the complexity of the challenges faced by developed world economies.

Current readings of key leading indicators continue to suggest only modest prospects for the year ahead. A near-term challenge for equity markets is that moderating growth in earnings has yet to filter into analyst estimates, reflecting the tendency to overestimate earnings at the top of an economic cycle and underestimate them at the bottom.

For those with idle cash, we see potential opportunities to add equity exposure over the months ahead:

- We expect economic data will ultimately provide evidence of enough strength to thwart serious risk of a double dip and support continued growth of corporate earnings. Paradoxically, a more negative economic outcome in the near term would increase the odds of further quantitative easing by the Fed. Such a move, while not a long-term remedy in and of itself, would likely be very supportive of markets were it to occur.
- Investors have by and large committed themselves to a negative outlook, suggesting the risk of surprise is likely biased towards the upside. Funds flows have heavily favored bond funds over the past year, with some of the money coming from equities. Investor sentiment data as recently as August were at depths not seen since the March 2009 lows, despite the equity markets being largely flat for the year.
- For tactical insights, we often turn to our Trend & Cycle technical research team, which currently views the market as transitioning between the end of one four-year cycle and the beginning of a new one in the months ahead. These cycles often conclude with some weakness followed by a more sustainable cyclical upswing. We remain alert to the potential buying opportunity that the commencement of such a cycle would represent.

Fixed-income markets

U.S. and Canadian 10-year government bond yields, at less than 3.00%, recently touched what we view as unsustainable lows given our economic outlook, although we have also lowered our interest rate forecasts. Were they to move back above 3%, bonds would be appropriately priced when viewed against the backdrop of today's inflation and monetary policy, however at those levels they would provide very little protection should economic growth revert to its long-term trend in the years ahead. Of course, were the economy to perform worse than we expect, buying bonds issued by trustworthy governments (a.k.a. Canada) would deliver worthwhile returns. The 3-4 year maturity area strikes us as offering the most attractive tradeoff between price volatility and yield. However, we would also avoid the temptation to own only short-term bonds. A core ladder of 1-10 year bonds with an overweight 3-4 year position makes sense to us. Corporate bond spreads have become more attractive by historical standards and provide some degree of protection from rising rates. That said, the greatest value can be found in the high-yield sector, which is most effectively accessed through bond funds or ETFs.

Investment strategies

Year to date, equity markets have continued to trade in a range bracketed by the April highs and July lows, with the direction largely set by economic data surprises. At this juncture, upswings tend to favor the cyclically sensitive sectors of the markets (materials, industrials, consumer discretionary and financials), while downswings heavily favor those investments most likely to retain value in a deflationary environment (government bonds, health care, utilities, consumer staples).

The lack of short-term visibility provides a challenging backdrop for investors hoping to anticipate the timing of rapid market shifts. With that in mind, we offer below some proven longer-term strategies that seem particularly well-suited for the current market environment:

- **The quality growth theme.** In a market where investors are no longer rewarded just for showing up, there exist many companies that manage to create wealth for their shareholders. They are ones that can reliably deliver earnings growth through market share gains, industry leadership, standard-setting technologies and products and oligopolistic market structures. RBC CM notes that we are currently in that part of the market cycle where these companies are favored by investors seeking a balance between growth and predictability (see chart 9). Our Canadian Focus List is currently positioned to provide a balance between these themes.

- **Dividend stocks.** A complementary strategy to the quality growth theme puts an emphasis on companies that can deliver sustainable and growing dividends. This offers a suitable strategy for all environments, but particularly for conservative to moderate investors seeking a combination of reduced volatility and growth in the current environment. Our Equity Income Focus List looks to include companies that meet these criteria. An important consideration for investors following such an approach is to realize that it is too easy for a dividend portfolio to inadvertently become overweight the traditional dividend-paying sectors of the market such as financials, utilities, telecoms and energy while building in little or no exposure to some important sectors like technology and basic materials (including mining) that typically pay no dividends. Investors should be aware that being underweight these latter sectors, which can account for some 25% of the total S&P/TSX Composite Index, will cause material differences between their portfolio returns and the broader index on a quarter-to-quarter basis.

- **U.S. companies selling to emerging market consumers.** While the deflationary impulse is greatest in the U.S., there are many large-capitalization U.S. companies that derive a disproportionate share of their revenue from consumers in the emerging markets and other countries experiencing greater domestic economic growth and consumer activity. In addition, RBC CM notes that within the S&P 500, the mega-cap companies (those in the top

Chart 9: Recommended style bias over the business cycle

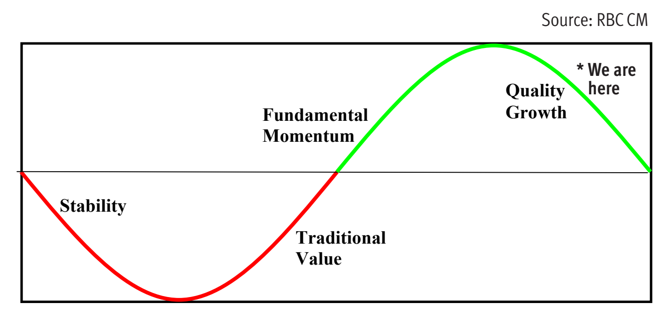
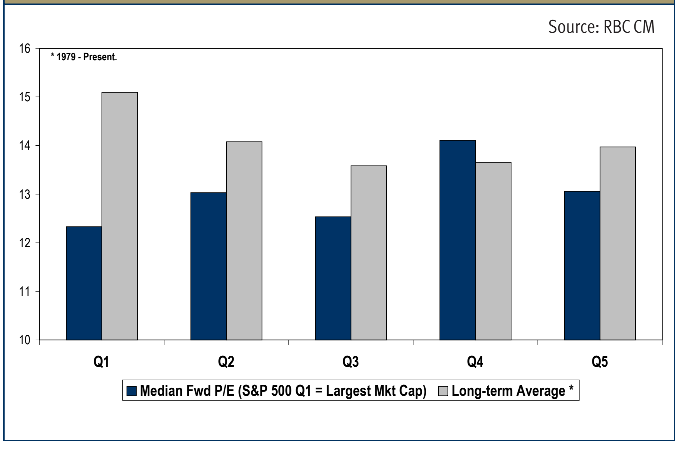


Chart 10: Mega-caps attractively valued



20% by market capitalization) are amongst the most attractively valued, both relative to historic norms, and relative to their peer group (see chart 10). Our U.S. Focus List offers a number of ideas that aim to exploit these themes.

While conflicting economic data is creating a great deal of "noise" for investors, in filtering this noise, we believe that in the year ahead, we will find ourselves in a restrained, yet positive economic environment where the risk of a double-dip recession remains low, and in which investors can find long-term investment opportunities. For a more complete summary of our view of the global economy and markets, please ask us for our most recent edition of *Portfolio Strategy Quarterly*.