Midyear Outlook – As good as it gets? transcript
Janet Engels & Tylar Lunke
RBC Wealth Management
7/6/21

Tylar Lunke:

Hello, and welcome to a midyear update from RBC Wealth Management. It is Wednesday, July 7th, 2021, and I hope everybody had a wonderful 4th of July. This recording is intended for RBC Wealth Management clients. My name is Tylar Lunke and I lead the managed portfolio strategies team. I'm joined today by Janet Engels, head of the portfolio advisory group. Janet has extensive experience working with clients and advisors at RBC Wealth Management, as well as guiding our investment strategy. We want to say thank you for joining us today. And over the next 10 to 15 minutes, we'll provide some perspective on our view of this year thus far, what we're watching from here and what it means for the economy and your investments. So Janet, welcome. With the setup complete let's get going. We're halfway through the year, and it's been quite a comeback for the economy and markets. In your view, what are some of the highlights?

Janet Engels:

Well Tylar, it has been quite a first half of the year. From politics and the pandemic to recovery and reopening, the major averages are at or near all-time highs. Consumer and business confidence are roaring back. The economy is reopening, consumer spending is spreading beyond the spend on durables to more service-oriented and recreational activities. For the markets, the S&P 500 is up nearly 15% for the first 6 months. Tylar, as you would imagine, that is considered or would be considered a very impressive full-year number. It's the second best, first half start to the year since 1998. And that was before the dot com bubble. If we look at sectors of the market, all 11 sectors were in positive territory at the halfway point with the Energy sector being the true standout with that sector performance up over 40% for the first half of the year. And that is alongside a gain of nearly 50% for crude oil prices.

Tylar Lunke:

All right, so I've heard you use the phrase here in 2021, that it's a simple story. What do you mean by that? And is it still that simple?

Janet Engels:

Well, the simple story goes something like this. Robust, above trend economic recovery supported by double barrel stimulus and low interest rates, help drive earnings growth. Earnings drive share prices and leads to positive returns for stocks, essentially a Goldilocks-like scenario, one that has played out in the market for the first half of the year. Is it still that simple? I think, yes. This economic recovery has further to run and will continue at an above average pace. This is supported by the continued reopening of the economy, pent up demand and a very strong consumer, which is a key driver of economic activity in the United States.

Janet Engels:

We've talked previously about the three Cs of the consumer: their confidence, their capacity, and the cash that they have and all three are in very good stead. The landscape, however, is shifting a bit. Inflation has picked up and there are indications that monetary authorities specifically, the Federal Reserve have plans to shift policy in response to this very strong growth and higher levels of inflation. So the story is still simple. But we may have some twists in the plot as we move throughout the second half of the year.

Tylar Lunke:

So related to that, with so much noise and news available these days, what indicators or events do you view as the most important for our clients to focus on?

Janet Engels:

There are four intertwined issues that we're focused on and that will likely set the tone for markets going forward. So those four issues are above normal inflation, a less dovish Fed, peak in GDP or economic growth in the United States, and peak earnings in the United States, at least for this cycle. So let's take a minute to touch on inflation and the prospect of a less dovish Federal Reserve. So on the inflation front, consumer inflation has been running higher than normal and reached 5% year over year in May. And we might expect it to remain elevated in the near term before easing back.

Janet Engels:

There have certainly been a number of factors which have contributed to these higher levels, comparisons with last year when the economy was basically shut down, supply chain disruptions, low inventory levels, higher input prices have all contributed to these above normal levels. My colleague Kelly Bogdanova recently penned an article and did an audio clip on the issue of inflation if our listeners want to have a more in-depth study of that. Higher than normal inflation in the short term we believe is largely anticipated, accepted and factored into the market. The greater uncertainty is what happens with inflation over the next two to three years.

Janet Engels:

The second issue we're focused on is the shift in Fed policy or a less dovish Fed. The Fed has already signaled it plans to shift towards less accommodative policies, and they will start to do that soon with the start of tapering of asset purchases. And then at some point, the first rate hike of the cycle will follow perhaps in 2023, which is right now, the Fed's most recent projection. In our view, neither tapering nor the beginning of the rate cycle would pose a threat to equity markets, medium-term outlook, or trajectory. Even so, market participants from time to time will likely fret about the Fed policy shifts. There'll be thinking, will they or won't they, and they will watch closely any related movement on the 10-year Treasury yield as well as the yield curve.

Janet Engels:

So what would be the impact on the markets from a change in Fed policy specifically when it relates to rate hikes? In terms of rate hikes, the S&P 500 has typically rallied at an above average pace one year before the first rate hike, and has continued at an above average rate in the two years after the first rate hike, when a recession was not on the horizon. We've looked at data going back to the 1950s for some of this analysis. Typically, the equity market is threatened by rate hikes only when the Fed tightens too much, too fast, such that a recession becomes a meaningful risk. This scenario is not currently in view, in our opinion, higher inflation, shifting Fed policy will give investors things to fret about.

Janet Engels:

So in our opinion, this could lead to a transition period for markets, from a robust rally phase, keep in mind, we've come a long way in a relatively short period of time. The S&P 500 is up nearly 90% from those COVID March lows of 2020. And so a transition to a more typical market pattern of 2 steps forward, 1 step back seems to be what can happen, or what we would anticipate for the second half. While we don't have a specific catalyst in mind, we do remind investors that pull backs are normal and are part of a market cycle, but a pullback in the context of a strong economic cycle should not be an overwhelming concern for investors.

Tylar Lunke:

So you've touched on this just a little bit, but given the strength of the economy's recovery and the returns we've seen in share prices over the last year, there are some who worry that this is as good as it gets. Is there more room for stocks to run from here in your view?

Janet Engels:

So as good as it gets, I think that applies to the case for year-over-year growth in the economy, and year-over-year growth in earnings. But it does not imply an end to this bull market in stocks that we're experiencing. For the second quarter, if we focus just on economic growth, for the second quarter, U.S. growth is estimated to be up 10% on a year-over-year basis. At RBC, we have a forecast that is even higher than that. We believe that year-over-year growth could be close to 13%. Keep in mind, this is against a longer-term average growth rate in the U.S. economy of between 2.5% and 3%. So this period is in fact quite remarkable. And the number for the second quarter is a very, very strong number.

Janet Engels:

So as we move throughout the year, the comparisons become a bit more challenging and the impact of stimulus wanes on the economy but this is still an economy growing at well better than 6% for the year. Our estimate is higher than that. And we anticipate growth of better than 4% for 2022 for the U.S. economy. Again, both well-above the longer term averages. So too for earnings, earnings have recovered, and we are past those levels of earnings from the end of 2019. And for the upcoming quarter, which we'll be watching closely as we always do during any earnings reporting season, we believe year-over-year earnings can be up as much as 65%. And we are looking for full-year gains of nearly 30% in earnings for the market. Yes, we can say that might be as good as it gets for year-over-year economic and earnings growth, but stocks will continue to be driven by those above-average trends in economic and earnings growth.

Tylar Lunke:

So Janet, as we close out the recording, any final thoughts you'd like to share today?

Janet Engels:

Keep it all in stride, Tylar. We might experience some wobbles here and there, but we still feel that worthwhile equity returns on the horizon and we remain overweight stocks.

Tylar Lunke:

Great. Well, thank you, Janet. Really appreciate your perspective today. Thank you to everybody for listening. If you would like to read more, the Midyear Outlook is available. So please reach out to your advisor directly. There is also other content available. If you'd like to explore a bit more, head over to rbcwealthmanagement.com and click on the research and insights tab, and you can browse from there. As always, if you have questions about your investments, we would encourage you to stay in touch with your financial advisor, access various resources from across RBC, and as always, make sure your wealth plan is up to date. Thank you all for your time today and for your trust in RBC Wealth Management, take care and have a great day.

Disclaimer:

This audio file is provided by RBC Wealth Management for informational purposes only. In Canada, RBC Wealth Management is the brand name that refers to RBC Dominion Securities, Inc, and applicable affiliates. In the United States, RBC Wealth Management is a division of RBC capital markets, LLC. In the United Kingdom and Channel Islands, RBC's Wealth Management international division in these jurisdictions is comprised of an international network of RBC companies and includes RBC Europe Limited and RBC Investment Solutions, CI Limited. In Asia, RBC Wealth Management is the global brand name to describe the wealth management business of the Royal Bank of Canada and its affiliates and branches, including Royal Bank of Canada, Singapore branch, Royal Bank of Canada, Hong Kong branch, and RBC Investment Services Asia Limited.

New Speaker:

The comments contained in this audio file are general in nature, do not have regard to the particular circumstances or needs of any specific person and do not constitute legal, investment, trust, estate, accounting or tax advice. They are based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. Unless otherwise, qualified any opinions, estimates, and projections in this audio file, are those of the speakers as of the release date, are subject to change without notice and may not reflect those of RBC Wealth Management. This audio file may not reflect all available information, the investments or services contained in this audio file may not be suitable for you, and it is recommended you consult with your investment advisor if you are in doubt about the suitability of such investments or services. In Canada, to obtain additional disclaimers concerning this audio file, please speak with your investment advisor.