Focus article

Wealth Management

GLOBAL

Insight 2022 Outlook

Equity investing for the next 10 years

As we come out of the COVID-19 era and then move beyond it, what are the evolving forces driving the investment narrative and how can investors adapt?

Jim Allworth

For important and required non-U.S. analyst disclosures, see page 10.
All values in U.S. dollars and priced as of market close, Nov. 19, 2021, unless otherwise stated
Produced: Nov 24, 2021 4:16 pm ET; Disseminated: Dec 1, 2021 3:30 pm ET

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Equity investing for the next 10 years

Until well into 2023 we think the trajectory of the world's major economies will be shaped by the normal progression of the business cycle and the remaining effects of the policies put in place to contend with the pandemic. This phase should be good for equities for as long as U.S. and global recessions can be avoided.

Beyond 2023, those emergency policy-driven effects should quickly wane, leaving "first principles" to drive the economic bus. Those are the growth of the labour force and increases in productivity. These point to an extended period of slow GDP growth—perhaps slower than in the decade following the financial crisis. That, in turn, points to a period of intense corporate competition and even greater corporate concentration.

Equities can be rewarding in such an environment. But owning the right ones and avoiding the challenged will be even more essential ingredients of success.

Part I: Coming out of COVID-19

The recession accompanying the COVID-19 pandemic was the shortest on record, lasting less than three months. By the end of Q3 2021, the U.S. economy had regained all of the ground lost in the spring 2020 plunge.

Jim Allworth
Vancouver, Canada
jim.allworth@rbc.com

For Canada and the eurozone, that same transition will probably occur either in the current quarter or in Q1 2022, and not long after for the UK and Japan. China, the first to shut down and to reopen, had regained all the ground lost by way back in last year's third quarter. However, its growth rate has slowed dramatically in recent quarters due to renewed pandemic shutdowns, power shortages, shipping congestion and delays, as well as policy tightening.

No U.S. recession in sight

Our principal focus is always on the U.S. economy—the world's largest and the one that sets the rhythm and tone for much of the developed world. A U.S. recession has usually been bad news for other economies and for equity markets. Every bear market for U.S. stocks—and for most other equity markets—has been associated with a U.S. recession.

All six leading indicators of a U.S. recession that we follow are pointing in a direction consistent with this expansion having quite a bit further to run. Powerful tailwinds are driving the U.S. economy and most developed economies forward:

Credit conditions are very "easy." U.S. recessions, with few exceptions, have been triggered by the arrival of overly tight credit conditions featuring: (1) prohibitively high interest rates, high enough to discourage businesses and individuals from borrowing, and (2) an unwillingness by banks to lend.

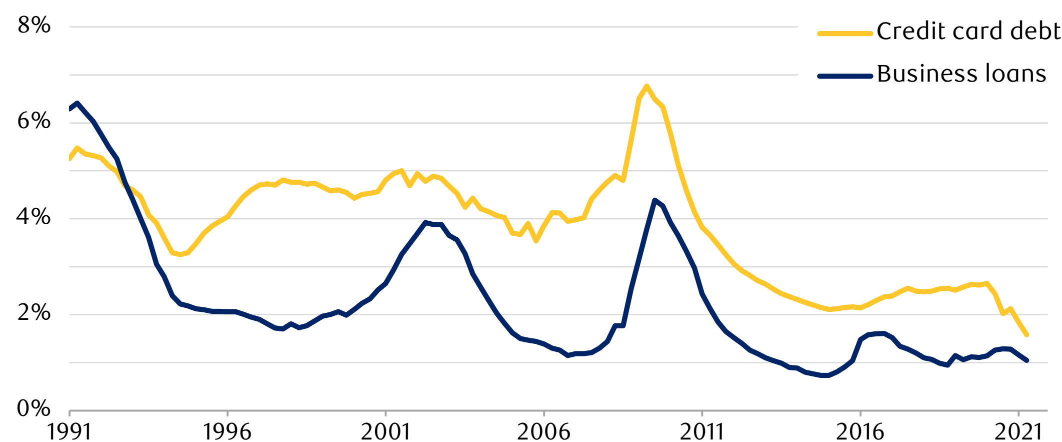
The opposite describes today's credit conditions. Rates are so low they encourage borrowing, while banks everywhere are looking for credit-worthy individuals, businesses, and projects to which to lend.

The latest Senior Loan Officer Survey taken by the Fed reveals a majority of U.S. banks continue to reduce lending standards. And why not? Delinquency rates on all types of business and consumer loans, including credit cards, are near or at all-time lows. Default rates on high-yield bonds—the lowest-quality corporate debt—are running at half their normal levels and near all-time lows.

If credit conditions were the only factor we could consider, it would lead us to conclude this expansion had at least a year or two to run.

Loan delinquencies are at or near historical lows

Percentage of loans delinquent at U.S. commercial banks



Source - U.S. Federal Reserve; quarterly data through 4/1/21, seasonally adjusted

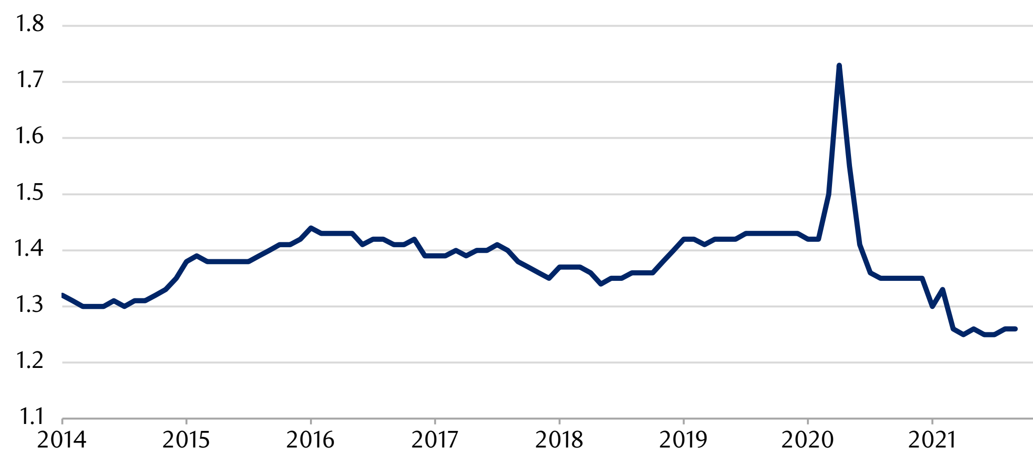
Excess savings and pent-up demand should keep the consumer spending. U.S. and Canadian households are sitting on excess savings built up over the pandemic of something greater than 10 percent of GDP. In the UK and eurozone it's less than half as much, but still significant. Sitting alongside savings is pent-up demand for many things including: new cars (chip shortages), holiday and business travel, entertainment/sports events, and dining out. Central bankers expect only about 20 percent of this savings pile will get spent in the coming year or two, enough we think to keep the consumer spending engine powering through 2023.

Inventories are too low, need to be rebuilt. Stocks of goods on hand are unusually depleted and need to be replenished for businesses to meet current demand. Shipping/supply chain disruptions are making this restocking difficult to accomplish. Some of the urgency may diminish following Christmas and the Lunar New Year.

But there may be a permanent shift upward in goods kept on hand as many companies have decided their just-in-time inventory model, often reliant on a far-flung supply chain, has left them too vulnerable and resulted in permanently lost business. Restocking should provide an underpinning to industrial production and GDP growth for at least the next year.

Relative to sales, inventories are as depleted as they have ever been

U.S. total business inventories-to-sales ratio



Source - U.S. Federal Reserve; monthly data through 9/1/21, seasonally adjusted

Capital spending is surging—with more to come. Capex by business in Q3 was up by about nine percent year over year in both the U.S. and Canada. The drivers of this vigorous growth include low interest rates, strong corporate profits, as well as the need for more capacity and a more resilient supply chain. Quarterly management commentary by many companies reveals capital spending intentions for the coming year are unusually elevated.

The much-anticipated U.S. infrastructure bill, at just $500 billion of new spending over 10 years (vs. the $2 trillion talked about initially), will add a useful but underwhelming estimated 0.01 percent to 0.02 percent to GDP in each of the next two years.

Could the Fed and other central banks spoil the party?

Yes—eventually. But before that happens, monetary conditions have to transition from “easy,” what we have now, all the way to “tight,” which is some considerable distance down the road. Typically, “tight money” is around for six to 12 months before the U.S. economy tips into recession.

A good gauge of how restrictive credit conditions are now is demonstrated by looking at the difference between the federal funds rate and how fast the economy is growing. It has always been the case that the fed funds rate has climbed above the nominal growth rate of GDP (i.e., the growth rate before the effect of price increases has been taken out) some months before or just after a recession got underway.

The fed funds rate currently sits just above zero, and nominal GDP is running nine percent higher than it was a year ago. We believe that pace should slow to between six percent and seven percent next year, and to between four percent and five percent in 2023. While the Fed has indicated it could begin raising rates next year and continue through 2024, policymakers still project a policy rate of just 2.5 percent over the long run—well short of projected nominal economic growth rates over the next three years.

But recent higher-than-expected inflation readings have left many market watchers worrying out loud that the Fed may be forced to raise rates faster and further. That is not our forecast, but for the sake of argument, if the Federal Open Market Committee were to start with a first rate increase in the middle of 2022 and hike rates by a quarter of a percentage point at each meeting thereafter, then by the end of 2023 the fed funds rate would stand at three percent, still short of the four percent to five percent projected growth rate of the economy.

It's worth remembering that the Fed doesn't tighten with the intention of pushing the economy into recession. It is always trying to engineer a "soft landing" wherein the economy slows enough to reduce inflationary pressures but avoids an outright downturn. Of the 17 Fed tightening cycles since 1953, only eight ended in recession, while nine produced no recession.

We expect inflation to ebb in H2 2022 and recede further in 2023 under the influence of:

- Resolution of the factors that have artificially produced shortages;
- The return of more people to the labour force as benefit programmes end and personal safety issues fade; and
- The capital spending boom, already underway, yielding productivity gains that somewhat offset higher employment costs.

If this proves to be the case, then the Fed and other central banks may be able to end any series of rate hikes before credit conditions pass the point of no return for the economy.

Either way, the economic tailwinds enumerated earlier provide good reasons to expect above-trend GDP and corporate profit growth through 2022 and probably 2023 as well. It would be unusual for share prices not to maintain an upward trend for at least another 12–18 months in that case.

In the right groove

History is reassuring on that front. As we highlighted earlier this year, a statistical look by RBC Global Asset Management at all Fed tightening cycles since 1953 shows that in the 12 months leading up to the first Fed rate hike, the S&P 500 rose in 15 out of 17 occurrences with a median return of 17 percent over 12 months. In the year following the first rate increase, the results were also encouraging, up 13 times out of 17 with a median return of nine percent.

Arguably, we are almost halfway through the "year before" stage. The historical probabilities favour a bullish stance toward equities for another year at least, in our opinion.

What could go wrong?

Our Recession Scorecard persuades us the business cycle is alive and well and has much further to run. It would take some powerful exogenous event or set of circumstances to produce a sustained downturn from here. There is no shortage of ink in the financial press about "torpedoes" or "black swans" that might threaten to do this. Examples might be the threat of contagion from possible credit defaults within the large Chinese property sector, a failure by the U.S. Congress to raise the debt ceiling by early December, or a geopolitical flare-up (Taiwan? Ukraine? Middle East?). The arrival of the omicron variant or any other that proved to be more deadly, or infectious, or resistant to existing therapies, serves as a reminder that the pandemic remains capable of seriously disrupting economic momentum.

These and many more come on and off the stage with regularity. They are always worth being aware of. So too is considering what they might mean for the economy and financial markets. But structuring a portfolio as if one or more carried a high probability of occurring soon would have left the portfolio uninvested, or at least underinvested, for most of the past 15 years if not much longer.

In our view, an investment portfolio diversified across asset classes where the equity component is diversified sensibly across industry sectors and owns the most attractive, resilient businesses in each sector is the appropriate stance in a world of unpredictable possibilities. As things stand, we recommend such a portfolio be moderately Overweight equities.

Part II: Beyond COVID-19

As the pandemic diminishes, so too will the effects of the massive fiscal and monetary measures put in place in response to it. And as emergency support is withdrawn, we believe the pace of economic growth will increasingly come to depend on growth in the labour force and increases in productivity.

Projected growth in the labour force can be looked at through the lens of demographic trends. Productivity, meanwhile, is difficult to measure and even more difficult to predict.

Working-age population is slowing or declining in developed economies

Birthrates have fallen steadily across the developed world for decades. They are now well below the 2.1 replacement rate (see table) needed to keep the population of a country from falling (ignoring any effects of immigration). This has brought about the absolute decline of the working-age population (15–64) in several important economies including: Japan, China, Germany, France, Italy, Russia, Spain, and the Netherlands. In most of these the decline is likely to continue for decades. In the case of Japan, for the rest of the century.

Some other developed economies will see the growth of this 15-to-64-year-old cohort slow down but not go into outright decline. The U.S., for example, saw this age group grow by 1.1 percent per annum between 1980 and 2000 and by just 0.7 percent per annum over the following 20 years to 2020. According to the UN's population projections (the source for all the demographic data in this report), the U.S. working-

Fertility rates

Number of live births per 1,000 women (ages 15 to 49 years) per year

U.S.	Canada	UK	Germany	France	Spain	Italy	Netherlands	Japan	China	India
1.7	1.5	1.6	1.5	1.9	1.2	1.3	1.6	1.4	1.7	2.2

Source - United Nations World Population Prospects

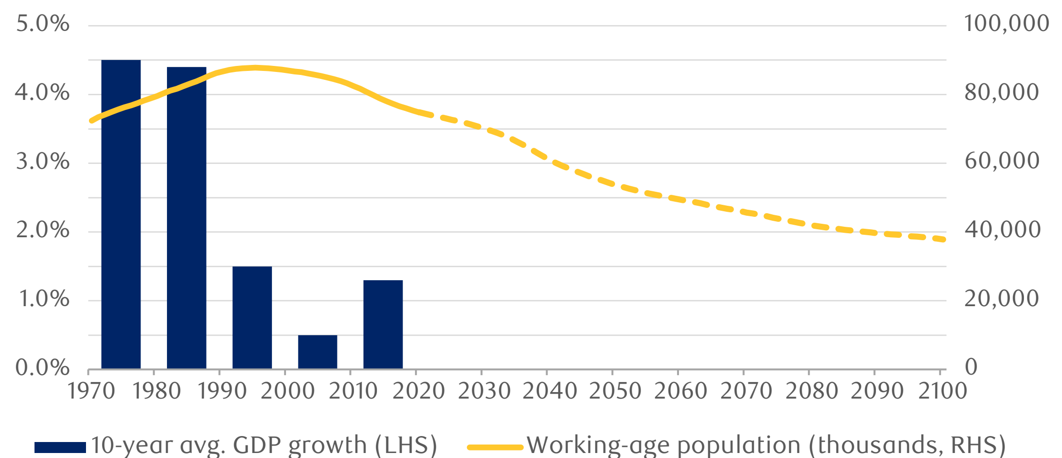
age population is projected to grow much more slowly between 2020 and 2040 at just two-tenths of a percent per annum.

A declining working-age population probably means a declining number of people employed, a substantial headwind to GDP growth. Japan is a case in point. From 1960 until 1990, its working-age population grew steadily and its GDP climbed by 6.5 percent per annum, consistently much faster than the U.S. economy (3.5 percent per annum). Many observers thought Japan would supplant the U.S. as the world's largest economy by the turn of the century.

Instead, in 1989, Japan endured a massive collapse of real estate and the stock market, crippling its banking system. A decade later Japan's economy had regained its footing but its growth "mojo" had deserted it. In the early 1990s, Japan's working-age population began to decline and that drop accelerated over the next 25 years. Between 1999 and 2019, the country's GDP grew by less than one percent per annum.

Decline in working-age population hampers Japan's economy

Japan average GDP growth by decade and population aged 15–64



After 40 years of world-beating GDP growth, Japan saw its working-age population start to decline in the mid-1990s; this ushered in 25 years of frustratingly slow economic growth, barely exceeding 1% per annum—with no end in sight.

Source - United Nations World Population Prospects, World Bank; population after 2020 estimated

So it's hard to look at the demographic projections and make a case for even average GDP growth for most of the developed countries, as well as China. For the U.S. and Canada, there may still be a modest addition to growth from this source but not enough by itself to make one confident of predicting a robust upward trajectory for GDP.

It falls then to productivity growth to supply all the "oomph" to the U.S. economy, and to the rest of the developed world and China. Is that likely?

Productivity comes and goes

Big innovations that have driven productivity sustainably higher have usually arrived out of the blue, taken a long time to be widely used and accepted, and were never developed (intentionally) as a result of government policy. Think of the steam engine, railroads, the telegraph, the internal combustion engine, electrification, mainframe computers, the personal computer, the internet, and the smartphone.

Today, the hope is that the digitisation of everything combined with Big Data will enable dramatic new technologies such as artificial intelligence to produce the next beneficial productivity wave. Promising developments, e.g., the unprecedented year of vaccine development, suggest this could be a rewarding avenue to go down. But the wait for highways filled with self-driving electric vehicles is likely to be measured in decades.

How much can productivity add to economic growth? In the decades from 1950 to 2019, the 10-year run rate for productivity growth in the U.S. ranged between 2.8 percent per annum and 1.1 percent per annum. The slowest decade was the one from 2010 to 2019, despite it being a stretch in which smartphone ownership and usage exploded, digitisation in many industries accelerated, and capital investment grew two-and-a-half times faster than the overall economy.

Productivity may be able to move into a higher gear in the coming decade, but it is far from a foregone conclusion that it will do so. The nonpartisan Congressional Budget Office (CBO), the most reliable long-term forecaster of the U.S. economy in our experience, appears not to be building in any overly optimistic expectations for productivity growth. From 2023 to 2031, the CBO forecasts U.S. GDP growth will average just 1.5 percent per annum, down from the 2.3 percent per annum it averaged from 2009 to 2019 and from the 3.5 percent to four percent average that prevailed from the end of World War II to the onset of the financial crisis.

Investment implications of slow growth

The post-financial crisis decade taught us some things to expect in a prolonged stretch of slower growth.

The first would be even greater intensity of corporate competition. When the total economic pie is growing more slowly than it has been, then each individual business has to work that much harder to maintain its share of the pie, let alone gain share. In such a scrap, the biggest and strongest will likely come out on top, but the second- and third-tier competitors are not going to simply lie there and accept their fate. We see another big wave of tech spending as the most obvious consequence of a long stretch of intense competition.

The pandemic revealed that businesses well down the road to digitisation were much more resilient and took market share away from laggards. Spending on this is likely to accelerate over the coming decade.

In our view, a prolonged period of elevated competition will produce even greater corporate concentration. By the end of the post-financial crisis decade, it was the case in most sectors or industries that the largest three or four companies accounted for a greater share of sector revenues than the same number of the largest companies had when the decade began. The winners tended to be the largest businesses with the widest margins and deepest financial strength who could invest heavily in new technologies and could afford to lower prices to gain a competitive advantage. We expect more of the same.

We think equity portfolios should lean toward companies that are likely to be in this dominant group at the end of the next decade. Selecting for a company's ability to grow sales, earnings, and dividends as fast as or faster than the economy expands should permit a portfolio to deliver above-average returns and demonstrate more resilience in periods of economic downturn.

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Tat Wai Toh – Head of Portfolio Management, BI & Asia, Royal Bank of Canada, Singapore Branch

Joseph Wu, CFA – Portfolio Manager, Multi-Asset Strategy, RBC Dominion Securities Inc.

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Sell [Underperform]	52	3.68	3	5.77

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