

Special report



Wealth
Management

GLOBAL Insight 2021 Outlook

Equities should deliver for the investor in 2021 as long-term forces take back control.



For important and required non-U.S. analyst disclosures, see page 30.
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A look ahead

The pandemic has marked the start of a new economic era—one where old rules are swept away. World governments are racking up massive borrowing, money is being printed to buy government debt at an unprecedented pace, and governments' role as capital allocator has grown markedly.

As 2021 approaches, the promise of vaccines means we could leave behind a world of social distancing and lockdowns. But what are we heading toward?

We expect worthwhile equity returns and strong earnings growth as COVID-19 economic headwinds diminish. The persistence of ultralow interest rates should support above-average valuations and make equities the asset class of choice in 2021.

In this publication, we also address common concerns we often hear from investors—namely the impact of ballooning government debt and the prospect of surging inflation in the years to come, and their implications for investment strategy.

We surmise that high debt levels do not necessarily represent a systemic risk in the near term and that debt servicing costs will remain manageable even in the medium term, though they will likely restrict governments' budgetary choices.

We expect inflation to stay within acceptable bounds so long as major economies are operating below potential. Further out, lingering disinflation on the goods side of the equation together with the falling consumption intensity that typically comes with an ageing population will act to dampen inflation rates to some degree. Services inflation presents the biggest risk for an inflation breakout once the pandemic ends.

With high debt levels and low inflation enabling central banks to keep interest rates lower for much longer, what worked in the past for fixed income investors may not work in the future. Investors should look to split the roles of safety and income generation in portfolios.

Finally, we peer further into the future and assess the growth outlook for the corporate sector. We expect it to be somewhat slower due to the large buildup in government COVID-19-related debt and unhelpful demographics. This should lead to a more intensely competitive environment, further amplified by China's focus on forging a dominant role in the production of high-value goods and services. As such, the differences between corporate winners and also-rans will be defined more sharply.

We hope you enjoy this special outlook edition of Global Insight.

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Confronted by ultralow rates, what worked in the past for fixed income investors may not work in the future. So in the face of a challenging reinvestment environment, we believe it's sensible to split the roles of safety and income generation.

23 RBC's investment stance

The U.S. and other major economies should further absorb the economic fallout from COVID-19 in 2021. The continuation of ultralow interest rates should support higher stock prices while making fixed income investing more challenging.



The shape of things to come

The COVID-19 economic damage should diminish greatly through 2021, while confidence in a return to a recognisable social and business landscape will likely grow. As GDP regains its pre-pandemic peak and corporate earnings recover further, we expect equities could provide attractive all-in returns in 2021, and probably for 2022 as well.



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Equity investment attitudes in 2020 were mostly shaped by the pandemic and by scepticism that life and the economy would ever be the same. In our view, the COVID-19 economic damage will diminish greatly through 2021, while confidence in a return to a recognisable social and business landscape will grow.



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We believe the V-shaped recovery that began in May for most economies will give way to a less dynamic, possibly bumpier phase of growth. The U.S. and Canadian economies should regain their pre-pandemic high ground by late 2021/early 2022. For Europe, the UK, and Japan, it will likely take a couple of quarters longer. China's economy has already recovered all the ground lost to the first half's COVID-19 shutdown.

Earnings, already in recovery, could surprise to the upside in 2021 and 2022 as some sectors and groups, crippled by the pandemic, return to life. The strong rebound off the deep March lows suggests to us that investors have already paid in advance for some of that expected return to "normal." However, that still leaves the S&P 500 only modestly above where it was in February 2020 before the pandemic, with all the other major averages in Canada, Europe, the UK, and Japan lingering below their pre-pandemic peaks.

We expect equity prices will appreciate further from today's levels through 2021, although not by as much as earnings advance, bringing price-to-earnings ratios down modestly.



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Beyond next year

For 12–18 months following the end of a recession there is usually very rapid catch-up growth for both GDP and corporate profits. Thereafter, the GDP expansion settles into a trajectory more closely aligned to the economy's longer-term potential growth rate. Following are some observations on factors bearing on this long-term outlook.

Slow growth

In the decade following the global financial crisis, the U.S. economy and most other developed economies grew more slowly than they had in the post-World War II era up to 2007. U.S. nominal GDP growth (i.e., growth without taking out the effect of inflation) averaged 6.9 percent per annum from 1945 to 2007. Following the end of the financial crisis and associated deep recession, U.S. GDP grew for an uninterrupted 10 years but at a rate of just 4.1 percent. The slowdown was attributed to the combination of slower growth of the labor force as the baby boomers hit retirement age and the drag that resulted from the deleveraging of U.S. households.

There has been an implicit expectation that growth would pick up once the household deleveraging was over, but that has proven not to be the case. Now, the Congressional Budget Office, a nonpartisan federal agency that prepares long-term forecasts of the U.S. economy for Congress, projects nominal GDP growth will average just 4.3 percent from 2020 to 2030.

Slow/declining growth in the working-age population will likely continue to be the chief culprit aided and abetted by the drag stemming from the large buildup in government COVID-19-related debt, which RBC Global Asset Management estimates will shave about 0.1 percent to 0.2 percent from the per annum growth rate over the decade. All the developed economies are faced with these same two issues.

Birth rates per woman

World Bank replacement birth rate = 2.1

Canada	China	France	Germany	Italy	Japan	UK	U.S.
1.5	1.7	1.9	1.6	1.3	1.4	1.7	1.7

Source - World Bank

Immigration could be an offset to declining birth rates, but U.S. immigration policy has become steadily more restrictive over the last 20 years; the migrant crisis has diminished the appetite for newcomers in much of Europe; Brexit was in large part a reaction to unrestricted immigrant inflows from the EU; while Japan has never encouraged immigration nor has China. Canada still has an appetite for immigrants on its terms, but the doors are shut until the pandemic abates.

In broad terms, economic growth is the combination of growth in the workforce and the increase in the productivity of all workers. With workforces slowing or declining across the developed world, productivity is left to do the heavy lifting. Productivity is not easy to measure and notoriously difficult to forecast.

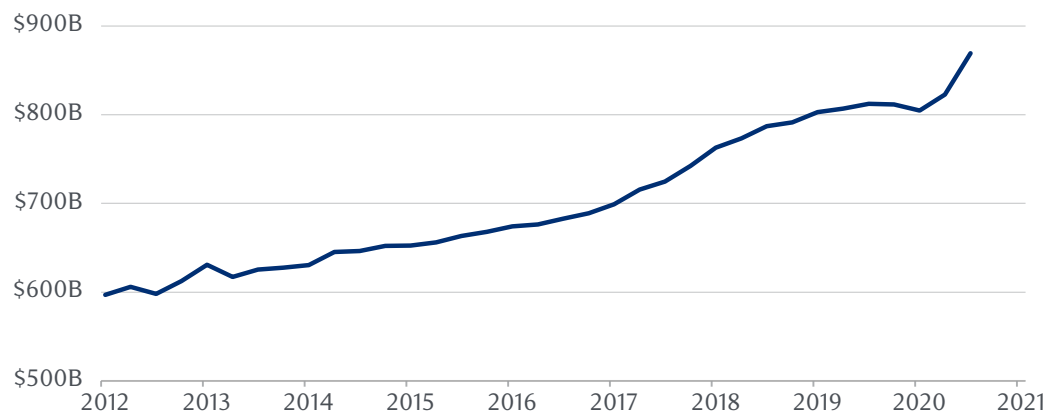
Intense competition

When the pie is growing quickly, as it was in the 65 years following World War II, it can nurture a great many businesses, from large established firms, to the up-and-coming, to start-ups. When that growth rate slows by a third, as it has done since 2008, competition intensifies, the weakest may get driven to the sidelines more quickly or absorbed, and corporate concentration becomes more apparent. A handful of dominant leaders emerges in many sectors, acquiring middle-level players along the way. These dynamics have played out over the past decade and are likely to do so again in the coming one.

Fierce competition for market share tends to drive up companies' capital spending. Increasingly that spending has become technology-focused. Firms need diverse capabilities if they intend to stay ahead or catch up: to reach customers and anticipate their needs; to rapidly develop new products and get them to market; to manage inventories, replenish, and reprice; to manage supply chains and working capital; etc.

The digital economy is now thought to be approaching 10 percent of U.S. GDP, and growing. That would make it larger than the financial sector. The pandemic has revealed that

Tech-related capital expenditure is soaring



Source - U.S. Federal Reserve, U.S. Bureau of Economic Analysis; private fixed investment in information processing equipment and software, billions of dollars, seasonally adjusted annual rate, quarterly data through July 2020

businesses without a viable, functioning digital presence are at an enormous competitive disadvantage. The race is on to acquire that capability.

This growth in capital spending is good for profits, employment, and productivity when looked at across the total economy. But within an individual sector or industry group, the willingness and capability to spend what it takes—maybe more than it takes—becomes a differentiating factor that can separate dominant industry leaders from the rest.

China slows, but still leads the pack

China's rate of GDP growth has been gradually slowing over the past decade. It will slow further over the next. But it is still likely to outpace all the developed economies, including the U.S.

It's clear that China is also experiencing the same demographic slowdown that the developed economies are faced with.

However, China enjoys several advantages on the productivity front. Among them are the ability to keep bringing under-employed agricultural workers (25 percent of total employment, down from 60 percent in 1993) into the urban industrial workforce—a powerful source of GDP and productivity growth by itself—and the continuing availability of higher-return infrastructure projects than are typically available in the developed economies. These tailwinds will continue to add to growth for at least another decade, in our opinion.

Bringing farm workers into urban employment can only happen if there is sufficient demand for what they produce. With more than half the workforce employed in agriculture until 2003 there was never enough domestic demand. That left exports as the prime driver of modernisation.

Between the late 1990s and 2008, China's exports grew almost tenfold, and over the next seven years to 2015 by another 60 percent. Since then, they have stagnated, not growing at all, falling from 21 percent of GDP to 17 percent. In the process China's economy has become more balanced, driven more by domestic demand than foreign.

With the urgent need to export behind it, China has shifted its priorities to becoming globally competitive, then dominant, in the production of high-value goods and services, particularly in technology and production equipment. It already has a growing presence in several strategically important fields. This thrust by the fastest-growing and second-largest economy in the world will just add to the intense competitive pressures already evident in the developed economies.

Protectionism: “Everybody’s doing it”

So too will protectionism, which looks set to be a prominent and growing policy feature globally. President-elect Joe Biden’s “buy American” proposals, if implemented, will further encourage a trend already in evidence for several years—the building of new manufacturing facilities in the U.S., whether by foreign companies wanting to ensure access to the U.S. market or by domestic companies who have watched the cost gap between U.S. and China-based production narrow dramatically over the past decade.

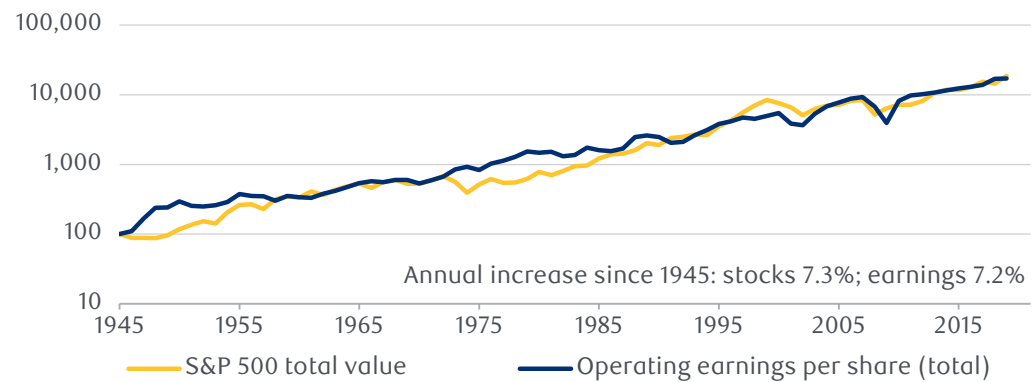
Unsurprisingly, as the past several years have evidenced, trade barriers erected by one party have usually produced a tit-for-tat response from the other. Whatever a country might stand to gain from keeping imports out, it loses some or all of it from the export account. The long-term benefits of “comparative advantage” are a tough sell to voters and politicians tempted to take the short-term gain, justified by perceived grievances of “unfair” treatment.

Whatever the concerns about potential long-term misallocation of capital or the undercutting of free markets, in this case, at least for a few years, the “buy American” policy tilt will likely provide a welcome boost to capital spending, to employment, and to productivity. So too might the responses of trading partners for their respective economies.

Implications for equity markets

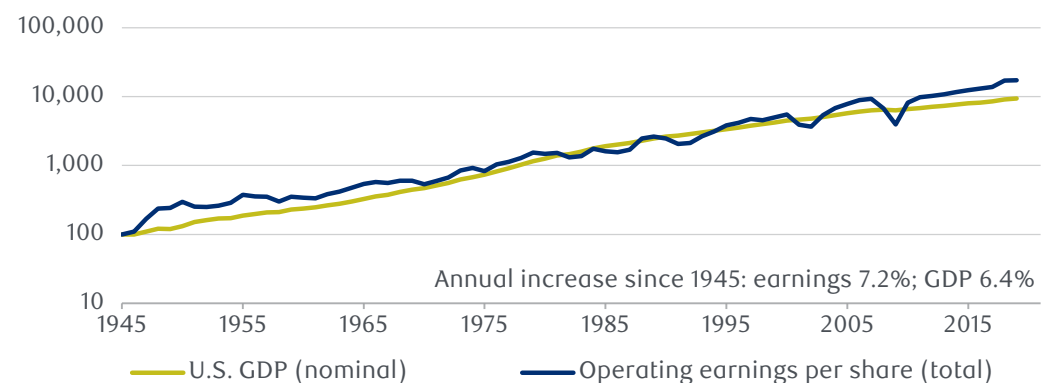
Over the long term, equity values have appreciated in line with earnings. And earnings have grown at a pace somewhat faster than, but close to, that set by economic growth—in this case, nominal GDP growth (i.e., growth before any adjustment for inflation). If, as we expect, a slower-paced economy is acting to restrain the overall growth of earnings and business values over the coming couple of decades, then we would expect the resulting intensely

Share prices have risen with earnings ...



Source - Standard & Poor’s, Thomson Reuters, RBC Capital Markets; annual data 1945–2019, normalised to 1945 = 100

... and earnings have risen somewhat faster than the economy has grown



Source - Standard & Poor’s, Thomson Reuters, U.S. Federal Reserve, RBC Capital Markets; annual data 1945–2019, normalised to 1945 = 100

competitive business environment will make the differences between the winners and also-rans more sharply defined.

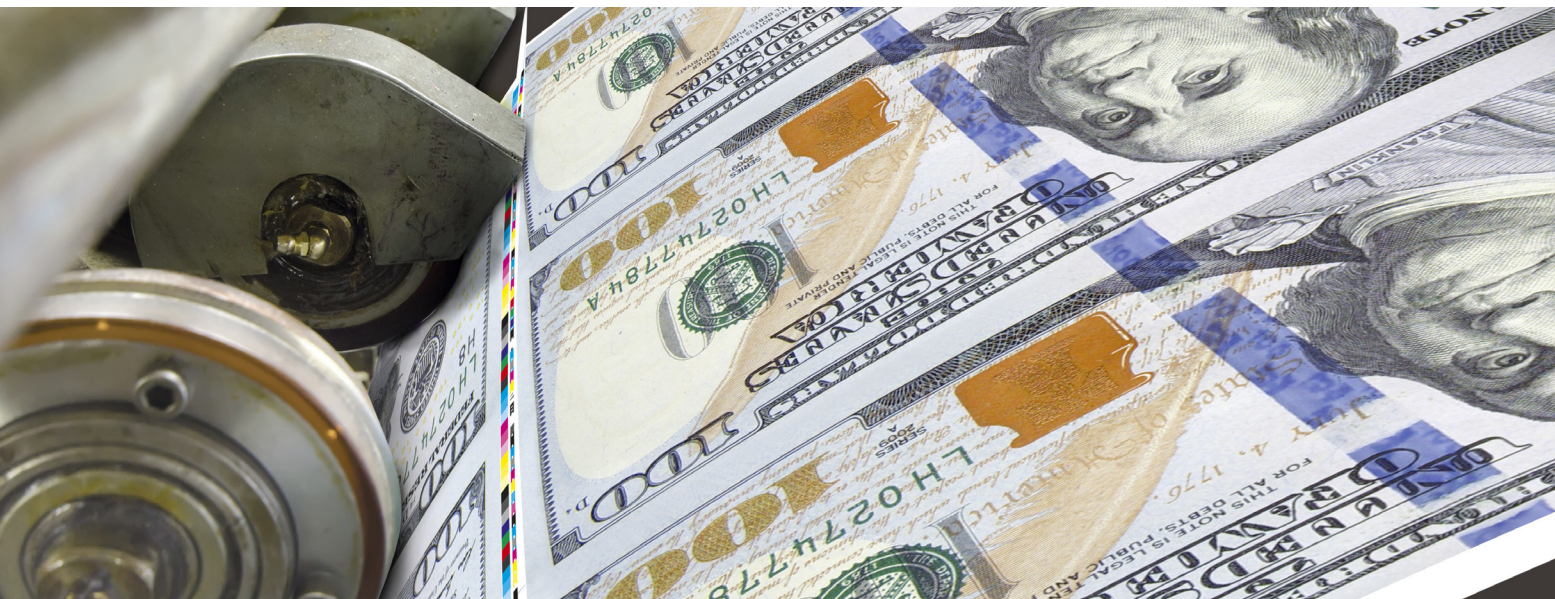
That sets a useful hurdle rate for stock selection. In terms of long-term positioning, we think portfolios should be populated to the greatest extent possible with the shares of those businesses for which there is high conviction that sales, earnings, and dividends can grow faster than the economy.

Those companies will almost always be trading more expensively than the average. That would be even more the case if, as we expect, the corporate concentration that is likely to come with slow GDP growth and more intense competition winnows down the number of sustainable dominant leaders in each sector. If it turns out these companies are able to deliver that superior, sustainable growth, then they will likely go on being more expensive than average.

Positioning for today

We recently changed our recommended exposure to equities in a global balanced portfolio from a benchmark weight to Overweight, or above-benchmark. This is not a big tactical shift. Rather, it is a recognition that the driving force behind earnings growth and equity valuations is rapidly shifting away from the outsized volatility risks presented by the pandemic and back toward the long-term expectations for sustainable economic growth.

The COVID-19 economic damage should diminish greatly through 2021, while confidence in a return to a recognisable social and business landscape will likely grow. As GDP climbs back toward its pre-pandemic peak, corporate earnings, already recovering, could perform better than expected through 2021 and 2022. Stocks in the major markets have priced in some of this better earnings trajectory but not all. We expect equities could provide attractive all-in returns in 2021, and probably for 2022 as well.



The debt dilemma

COVID-19 has left governments flooded with debt, and it looks like the fiscal taps will have to remain wide open. With governments at risk of pushing into territory not seen by many since World War II, will we emerge from the COVID-19 crisis only to face a whole new set of financial and economic risks?

Governments are awash in debt. There are no signs that borrowing will let up anytime soon with COVID-19 still on the march, infrastructure systems in need of investment, military budgets at lofty levels, and pension and other social obligations mounting.

Some economists point out that the COVID-19 paradigm shift, which has given central banks and governments more control over capital allocation, may provide an impetus to undertaking development opportunities such as modernizing infrastructure or accelerating the transition to energy-efficient economies.

However, the debt trends beg some tough questions. Is further debt accumulation sustainable, and what are the risks for major economies, financial markets, and taxpayers?



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New high ground and not done yet

Public debt has ballooned since the COVID-19 pandemic began, with that of advanced economies jumping almost 27 percent as a group since January 2020, according to the International Monetary Fund (IMF). This debt level now sits beyond what was reached after World War II, at greater than 120 percent of GDP.

Global debt is tamer at 102 percent of GDP because many of the largest emerging economies have lower official debt burdens. However, this is also a record level.

All of these figures actually understate the situation. Obligations are higher when off-balance sheet debts, in the form of future social promises, are taken into account.

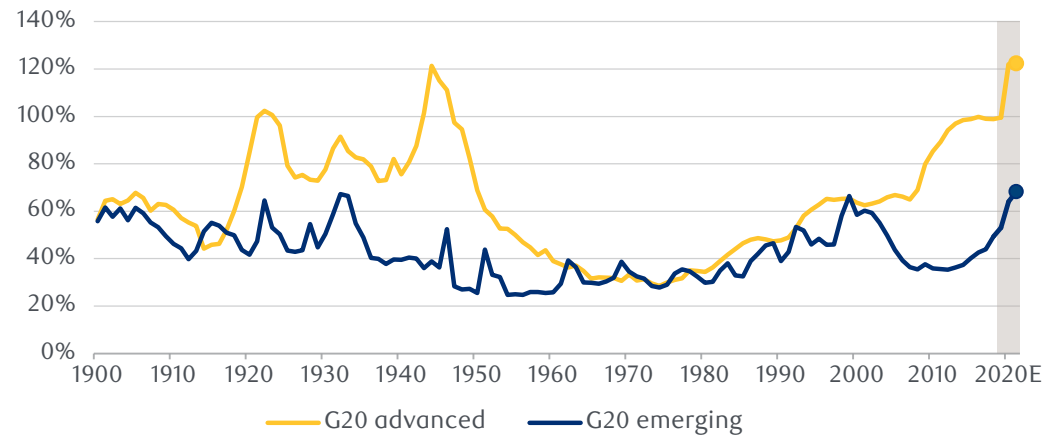
For example, the U.S. data that is used in most global estimates just tallies the debt that has officially accumulated on the books. This \$27 trillion debt pile, as estimated by the Treasury Department, represents 124 percent of U.S. annual GDP. The debt load would be much higher if off-balance sheet promises such as Social Security (pension) and Medicare (health care) were factored in—these are future expenditures the government is obligated to pay by law, unless current laws are changed.



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Advanced economies' debt is expected to eclipse the World War II high

Average debt-to-GDP ratio in country groupings (% of GDP)



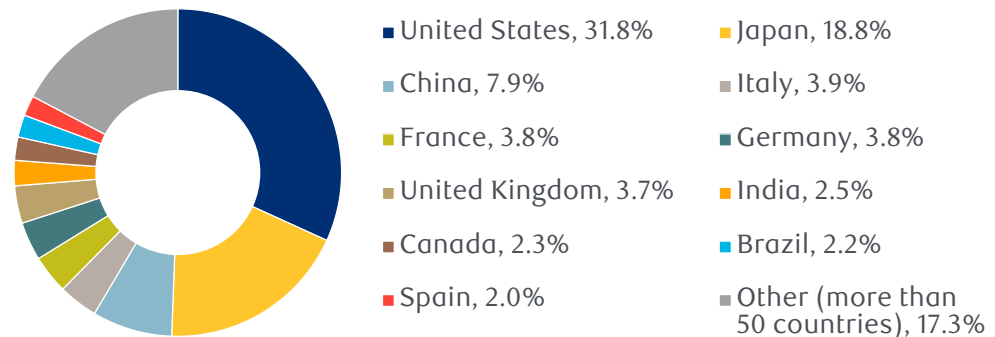
Source - RBC Global Asset Management, International Monetary Fund (IMF); data as of June 2020 and uses IMF estimates for 2020 and 2021

If the present value of these off-balance sheet items for the next 75 years were included, the debt would soar from \$27 trillion to \$137 trillion, according to the nonpartisan group Truth in Accounting. Even if these social and health care “obligations” are eventually reduced by means testing and/or in other ways, as many Americans presuppose will ultimately occur, they could still represent a meaningful share of the future public debt load.

Such off-balance sheet obligations, whether massive in size or much reduced, would also cause advanced economy and global debt to jump since the U.S. debt represents the highest share of both—by far.

The U.S. and Japan account for half of total global government debt

Share of global government debt by country



Source - International Monetary Fund, World Economic Forum; 2018 data, does not include off-balance sheet obligations

The increase in public debt loads seems justified as the COVID-19 economic shutdowns earlier this year were imposed by governments themselves, and created an enormous vacuum for many households and businesses, with the output loss, at the worst moment in the spring, approaching that experienced during the Great Depression. This explains why governments in developed countries moved quickly to fill the gap, trying to ensure economic ties were maintained, and to keep individuals employed and businesses solvent during the shutdown. Their measures have arguably helped economies recover more quickly than they otherwise would have.

Higher debt levels not necessarily a systemic risk

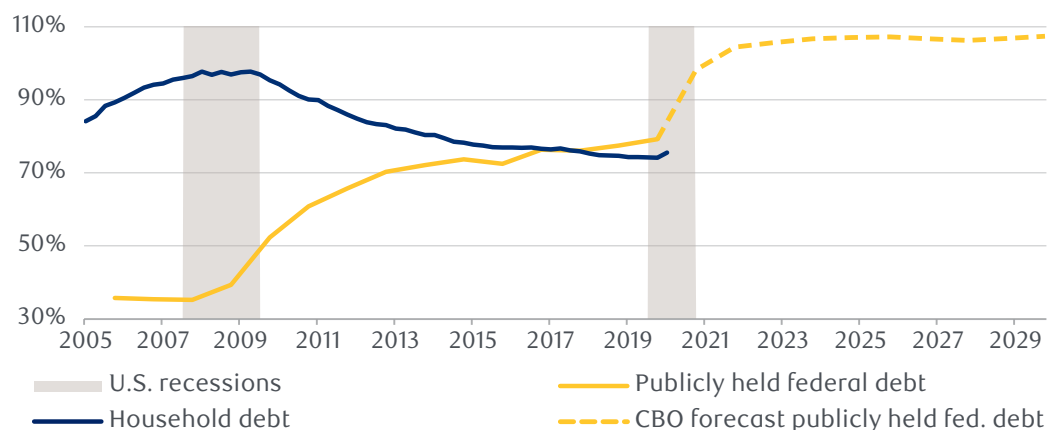
A separate issue to consider in the debt load discussion is the role of household debt and, specifically, the balance between household and public debt.

For some countries the household debt burden is currently a greater concern than public debt. For example, in the decade following the global financial crisis (2009–2019) Canada has seen household debt rise from 93 percent of GDP to 106 percent, while federal debt fell from a peak of 47 percent of GDP to 40 percent prior to the COVID-19 surge.

In the U.S., it's the reverse. Consumer debt used to be much higher than government debt, but the former has retreated while the latter has continued to swell.

Trading places: As U.S. federal debt has risen, household debt has declined

Debt as percentage of U.S. GDP



Note: CBO federal debt data differs from Treasury Department data, which is cited in the text of this article and is a broader measure of federal debt

Source - RBC Wealth Management, Bloomberg, Congressional Budget Office (CBO); data as of September 2020

U.S. household debt obligations fell from nearly 100 percent of GDP to around 75 percent in the decade that followed the 2008–09 global financial crisis, largely driven by a reduction in mortgage-related debt (brought on by bankruptcies, in some cases, as the housing bubble burst). Over the same period, publicly held federal debt rose from around 50 percent to about 80 percent.

Our fixed income strategist asserts that “while some may harbor reservations and fears about rising debt levels, that shift should be a net-positive in terms of systemic risks, in our view, as the federal government obviously has greater capacity and more avenues to address debt service than the U.S. consumer, not least of which is the ability to print its own money.”

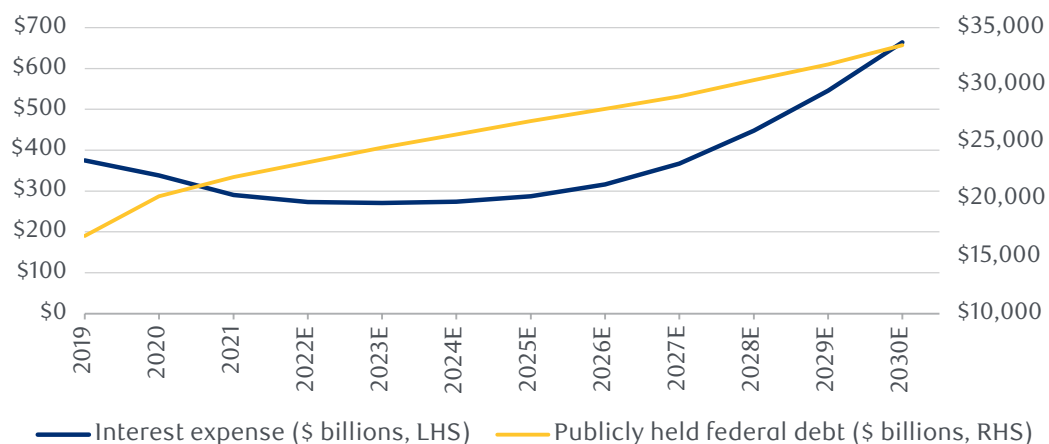
He goes on to add, “We continue to believe that deficits and overall levels of publicly held U.S. federal debt are not a material concern for investors over the near and intermediate term. Higher Treasury supply alone is not sufficient to send yields higher, based on historical correlations. Factors such as the path of Fed policy rates, GDP growth, and inflation expectations matter to a much greater degree.”

Debt servicing costs will reduce budget flexibility, but only in the long term

Another factor that makes the situation tolerable for the time being is that debt service costs for most governments are relatively low and manageable due to prevailing ultralow interest rates.

U.S. federal debt costs manageable

The Fed's ultralow interest rate policies allow interest expenses to decrease even as total debt mounts



Source - RBC Wealth Management, Congressional Budget Office; data as of September 2020

U.S. federal debt costs have actually declined this year despite the total amount of outstanding debt surging higher. That is because there continues to be existing government bond issues carrying much higher coupons that are maturing and being refinanced at today's ultralow rates. These debt costs are set to move even lower through 2023 and remain low for much of this decade, according to Congressional Budget Office estimates.

For its part, RBC Global Asset Management's forecast over the next decade does not anticipate a large increase in the cost of servicing the debt, or the share of GDP spent on interest payments. The latter should remain relatively subdued, only gradually moving up to 2.5 percent of GDP more than a decade down the road as the debt load increases. In other words, it will not take much more of GDP to pay for servicing the debt than it did in the last two decades, when it averaged some 1.5 percent of GDP. The cost of servicing the debt was higher in the 1980s and the first half of the 1990s, when more than three percent of GDP was spent on debt servicing. With debt servicing costs set to increase only modestly as a percentage of GDP, G20 nations are unlikely to default, in our view. However, their choices on how to use their budgets will likely become gradually more constrained.

Beyond this decade, for the 2030s, as public debt loads swell, RBC Global Asset Management estimates that U.S. debt servicing as a share of GDP will rise to something greater than the average of the last several decades, limiting the government's ability to cut taxes or spend on desirable government programs.

Lack of will

Within advanced democracies, we think it will be difficult for elected and appointed officials as well as voters to resist the temptation of further debt accumulation. The path of least resistance seems to be pointing toward increasing fiscal spending, not restraint.

Policymakers lack the incentive to address the issue given borrowing costs in the market have remained low despite debt levels spiking. In all likelihood, debt loads will be forced ever higher as further stimulus measures for the COVID-19 crisis are implemented and other crises inevitably hit.

The U.S. may find it easy to turn a blind eye to its growing debt because the U.S. dollar's status as the world's reserve currency means there is underlying demand from institutional investors and governments globally for the debt America issues. Given this ease to finance itself and to print money, the U.S. may be even less inclined to reduce debt levels or meaningfully lower its rate of debt accumulation.

In Europe, recent moves toward some form of debt mutualization (i.e., all members are collectively responsible for the debts issued to fund spending anywhere in the EU) could further unify member countries, binding them not just by joint monetary policy, but by fiscal policy as well. This could make higher debt levels more sustainable in the eyes of investors.

As for emerging markets, those countries with high debt loads that are also heavily dependent on commodity prices could become more susceptible to debt restructurings or defaults.

Consequences: Lower interest rates, slower growth

Persistent debt accumulation will likely be one more factor that will keep central banks suppressing interest rates over the medium and longer term, further burdening savers and fixed income investors.

According to RBC Global Asset Management, interest rates will need to be permanently lower than before, given that public debt loads will likely permanently remain higher and given there is no obvious, relatively painless way to pay those debts down. Interest rates should rise over time, but they will probably be lower than would otherwise have been the case.

Despite low interest rates, the debt levels may well cap economic growth.

Japan is a case in point. The country has accumulated high levels of debt over the years, reaching 238 percent of GDP in 2018, according to Japan's Ministry of Finance. It has hovered above 200 percent for 10 years. This situation and the decline of the working-age population along with the commensurate rise of the retiree population are viewed by many as the primary reasons why the country has struggled with anemic economic growth for some 30 years. Japan's real GDP averaged 1.3 percent growth per year from 2010 through 2019, whereas China and the U.S. averaged 7.7 percent and 2.3 percent growth, respectively.

On the other side of the coin, Japan has proven that higher debt levels can be more sustainable than one might think, at least for a time, although undesirable due to the drag on economic growth.

Higher for longer

There seems to be greater acceptance of high debt loads in the financial community and among government officials in the wake of the pandemic crisis. From a pure "balance sheet" perspective, we believe higher debt loads are manageable in the near and intermediate term. However, at a minimum, high debt levels, while sustainable for the time being in most advanced economies, will eventually restrict governments' budgetary flexibility and are likely to result in higher tax rates, in our view.

High debt loads will likely also be a powerful incentive for policymakers to further suppress interest rates. This is a key reason we recommend that investors consider strategies for a low interest rate environment that may linger for much longer than one might think is reasonable. (We explore such strategies in "[Fixed income: Not dead, just different](#)", page 19.)

The more that debt and debt-to-GDP mount over the longer term, the more governments and taxpayers will enter uncharted territory. It's unclear to us where the tipping point is between manageable and unmanageable debt loads. So far, markets are behaving as though any tipping point is a long way from here.



Inflation: To be, or not to be?

In a dialogue with RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli, we look at prospects for inflation in the context of a U.S. economy still in the process of reopening. Where is inflation going from here and what sort of things should investors look at to gauge how price pressures may be building?

Jim Allworth: Tom, we've seen some bumps in the Consumer Price Index (CPI) in recent months that seemed kind of large. Is this a trend we should be concerned about or is it just transitory?



Tom Porcelli
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Tom Porcelli: Keep in mind that inflation is experiencing a reflexive bounce back from weaker readings in the spring. We shut the economy down and then turned it back on. Inflation is responding to the “turning back on” part. Inflation has bounced back in the context of the economy reopening. Importantly, the Fed is not thinking about recent inflation as something pernicious at all. I think it's very aware this is a normalizing bounce after a massive growth decline.

Where we go from here is a bigger, more important question. And when considering that future path, we should remember the CPI will likely bounce rather sharply in mid-2021 because of weak year-before readings. The CPI could be easily sitting around 2.5 percent, where we expect it will linger into the second half of next year.



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And that is just our baseline estimate. Prospects for 2021 are looking more promising on the back of good news on the vaccine front. The eventual positive impact on the consumer psyche could embolden households to draw down on their historically bloated savings profile. That could make the inflation dynamic look quite different in 2021.

Make no mistake, we are not arguing for some type of rampant/pernicious style of inflation, rather just enough inflation to get the market wondering when the Fed will respond to it.

Interview conducted Nov. 20, 2020; edited prior to publication.

There is worry among investors that all the “money printing” that has come with the massive stimulus is going to inevitably cause some damaging inflation down the road. But there were the same worries after the financial crisis. Instead, we had a decade of benign inflation. Is there something different this time that should keep us on guard?

I think a lot of people wrongly have compared what the economy has been enduring now to the global financial crisis. However, there’s one comparison I think is reasonable—even if slightly different—and that’s about inflation.

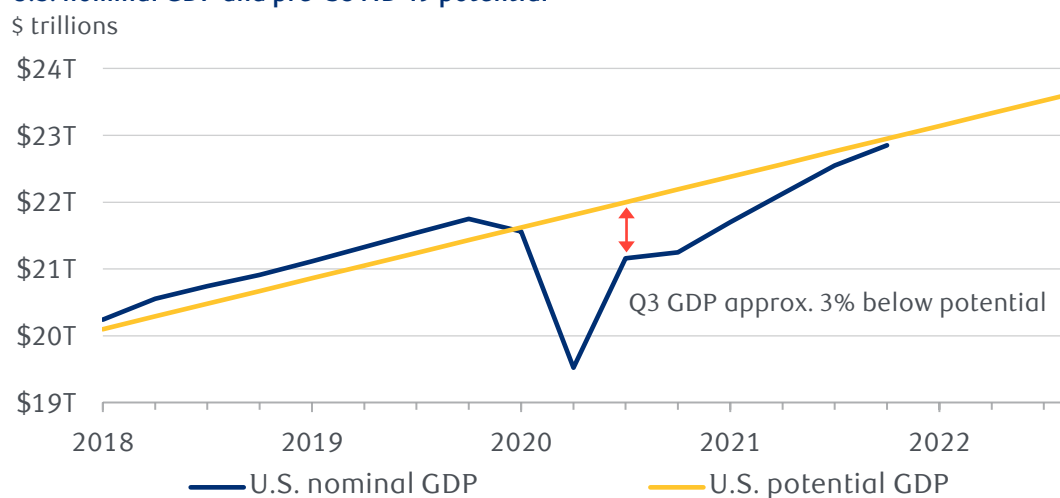
I vividly remember people fearing inflation was about to ramp up during the financial crisis because of all the stimulus that had been put in place. But we kept on saying there were obstacles in the way that would prevent all of this stimulus from turning into an inflationary impulse. Primarily back then, people weren’t in the mood to borrow and banks weren’t in the mood to lend. That really stunted the build-up of inflationary pressures.

Today, there’s another impediment in the way. For all the stimulus that’s been put in place, the only way that stimulus becomes inflation is if the economy is fully open. And it’s not.

One of the interesting ways of capturing the essence of the idea is to look at where growth is relative to potential. And right now we’re still three percent below potential (see chart) because the U.S. economy is not fully open. In theory, stimulus in and of itself can be inflationary. But in practice, you need a path for that stimulus to flow into the economy.

If magically these things all just went away, if the economy jumped into high gear and the unemployment rate, still very elevated today, continued to materially improve, then yes, I do think that’s a set of circumstances under which we would worry about inflation.

U.S. nominal GDP and pre-COVID-19 potential



Source - RBC Capital Markets, U.S. Federal Reserve

So you have to use up all the excess capacity in the economy before businesses and labor get pricing power?

Yes, but I wouldn’t think of it so much in terms of capacity utilization, which is a manufacturing concept. The U.S. economy is a service-dominated economy. Services account for about 60 percent of the CPI inflation basket. So arguably, to get a real handle on this you need to see how much of the services capacity is not yet fully utilized, which the Fed’s capacity utilization data does not capture.

It's better to think of it in terms of what I just defined—how far below potential the economy is. I think that does a great job of capturing an economy-wide utilization.

Late in the last cycle while inflation was consistently running below the Fed's two percent target, you pointed out that when you dis-aggregated the inflation data it turned out that the prices of goods were actually deflating while services prices were inflating at a brisk 2.5 percent to three percent.

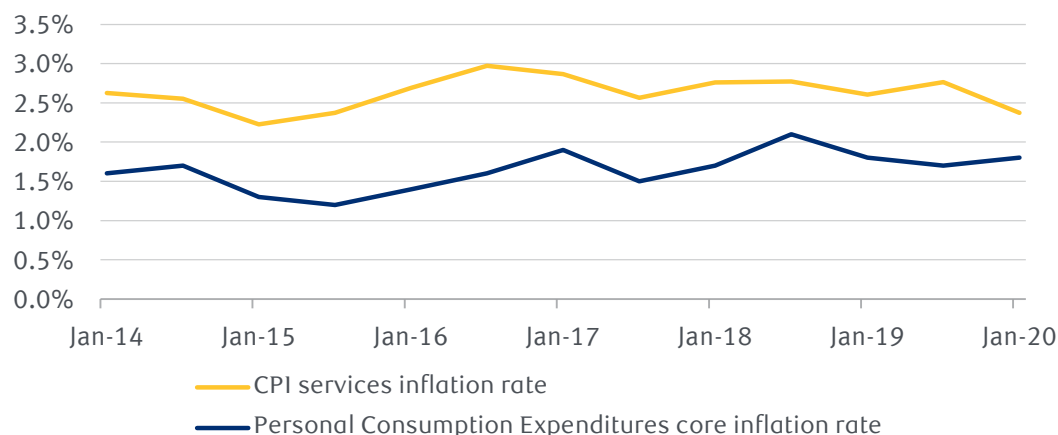
I think this really gets to the heart of the challenge for people when they see the monthly inflation report that shows inflation running comfortably below the Fed's two percent target.

There are two major components to inflation. One is goods inflation, the other is services inflation. As you point out, prior to the downturn services inflation was running between 2.5 percent and three percent, while the more closely followed total economy inflation readings—in particular, the Fed's preferred measure, the Core Personal Consumption Expenditures Price Index—were consistently between 1.5 percent and two percent.

If you really want to know what the underlying inflation dynamics are of a service-dominated economy—which the U.S. is—then look at services inflation, where the core measure has been running near three percent.

Goods prices, on the other hand, have been in a sustained state of disinflation for the past 20 years. That's not a guess; that's the reality, which the data clearly shows.

U.S. services inflation running ahead of core inflation



Source - RBC Capital Markets, U.S. Bureau of Labor Statistics; semiannual data through January 2020

The question is why. And the answer to that is mostly because the U.S. imports quite a lot of disinflation because it doesn't produce a lot domestically. As I'm sure is widely appreciated, the U.S. is a big importer of goods. And many of the countries the U.S. imports these goods from are able to land them here at a much lower price than domestic producers could do here in the States. That's the key reason why the U.S. imports this disinflation.

I think people need to be aware that services are far and away the largest component of the U.S. economy. Services account for 60 percent of the weight in the overall inflation calculation. So here you are with inflation from this gigantic services segment that has been running at close to three percent, while the overall inflation number, which includes that services component, has been growing at a much slower 1.5 percent to two percent rate. That really drives home how much disinflation you're dealing with on the goods side.

There's one category that always seems to be a bit of a mystery in terms of how it's looked at, and that's asset price inflation. Central bankers seemed to have operated as though that didn't count, or at least that wasn't the thing they were going to lean against. What do you think the Fed's position is? Is it going to pay attention to asset price inflation?

I think every Fed under any Fed chair always pays attention to asset price inflation. It always matters.

In the current context, the Fed will very closely monitor any imbalances that develop in asset markets. That's the factor driving its thought process. It's not enough just to say that asset price inflation is doing "x." Rather, the pertinent question is, is asset price inflation indicative of imbalances building that could pose a risk to the economy? That's almost always what is going to get the Fed to perk up and pay attention.

I realize you focus almost exclusively on the U.S., but this general pattern that you talked about—the closing and then reopening of an economy, and then seeing where you are with respect to inflationary forces—is playing out in almost all economies. Do you see the developed economies generally in the same position as the U.S.?

Yes, I do. And you know most of the developed world, including the U.S., is facing another challenge as it relates to inflation that we haven't touched on. And that's the reality of aging populations. Because, as the population on average grows older, their spending habits and patterns tend to change. They tend to slow down. And we've seen this across many of the developed economies already.

Japan is the economy that probably comes immediately to mind for most people. From the 1950s right up until the early 1990s the Japanese economy grew consistently faster than the rest of the developed world. From that point on, the working age population of Japan started to decline and the over-65s came to dominate. Japan's GDP growth since then has been decidedly slower than that in North America and much of Europe.

Now we're seeing that same dynamic play out in Europe. Trend rates of growth are slowing down as the population rapidly ages. The U.S. trends just happen to be trailing some of those economies, but we're going down the same path.

I love that great Mark Twain quote, "History doesn't repeat; it rhymes." I don't think the U.S. will necessarily suffer the same kind of disinflation that Japan has gone through on the back of an aging population. There's a host of other additional factors that were at play in Japan as well. But I do think the rhythms of it will be very similar.

So in the U.S. you can easily make an argument that over time, just on the aging of the population, you could see trend rates of economic growth slow from what is about two percent today closer to one percent over the coming decades. And that will put some disinflationary forces into play if that whole dynamic is left unchecked.

How might this demographic headwind be fought off?

There are a few ways of addressing this challenge. The most critical way, and I think the most effective approach, would be to encourage a productivity boom.

Of course, the pieces need to be in place to have a productivity boom. And usually that comes from the fiscal side of the equation. But that's one of the things that could help save the day. So the fiscal authorities need to recognize that we're headed down this path.

This big demographic shift is out there for anyone to see if they choose to look at it. At some point, it's going to have to become a big conversation that people are having in D.C. But I don't know if that's a conversation that's been widely happening, either before the pandemic or now. The reality is, it will take years to put in place the pieces necessary to

create a productivity boom. And then it will take years longer for that improved productivity to emerge. I think the fact that we continue to ignore that conversation is much to our detriment.

If you don't mind, I'm going to go further down that path. Is there any chance there's a hidden productivity gain that might have been triggered by the pandemic? Many people working from home the past eight months report their productivity has gone up. Could the pandemic have provided a plausible path toward improved productivity?

Anytime these big seismic events occur, I think it always gets people thinking about how they can address some of the long-term challenges in their business. A useful, tangible example would be the restaurant business. You can now basically scan your menu onto your phone, so you don't need to hold a menu. Changes like this will almost certainly usher in some dramatic productivity enhancements for the restaurant business. So will the phenomenon of home delivery.

Working from home may have some lasting productivity benefits. As undoubtedly will the explosive adoption and acceptance of video conferencing as a way to meet with colleagues, customers, and suppliers.

I can see that happening in an even broader way. And there are changes that may be hard to see, particularly from where we are today. But I think we're moving into a different environment now on the back of COVID-19.

So let's wrap up with what we should be watching. Is there any particular string of things that would start to get our attention about inflation on the horizon?

Before we see any potential for inflation to trend higher on a sustained basis we want to see the economy open more, more than it is. That's especially true now that we are dealing with cross-currents of "second wave" shutdowns and vaccine optimism.

So what are some things we can look at to gauge how the reopening is proceeding? Well, there are a host of ultra-high frequency data points that I think will be really helpful. For instance, Open Table, the app where you can make restaurant reservations, provides daily data and across each state. From there we can see how the reopening is unfolding in one segment that has been deeply affected by the pandemic. Early on, this data rose pretty dramatically. But it has flattened out over recent weeks and months. This will be a really useful indicator to keep track of.

Then there's credit card data that comes out on a weekly basis and provides a sector breakdown. That's incredibly helpful to gauge how the consumption backdrop is evolving. And there are the old standby employment gauges like weekly unemployment claims and continuing claims, both of which have been trending sharply lower since their spring peaks, as has the unemployment rate, although none are as yet anywhere near the low levels that prevailed prior to COVID-19.

There are a host of others including layoff and available job openings data, average hours worked, as well as automobile and airline traffic.

This gives us a way to think about a big issue that we know has been on a lot of people's minds, so thanks very much.

I would just say in closing that this is just the tip of the iceberg. This is a very big conversation that is likely to intensify over the next year or two. There's quite a bit more to drill into. But if you're trying to consider the outlook for inflation in high level terms, then I think that this is the right framework.



Fixed income: Not dead, just different

Confronted by ultralow rates, what worked in the past for fixed income investors may not work in the future. So in the face of a challenging reinvestment environment, we believe it's sensible to split the roles of safety and income generation. We explore the ways investors can manage this balancing act.

The best of times, the worst of times

It was a mix of good news and bad news in 2020 for fixed income investors. The good news was that most fixed income portfolios posted total returns well in excess of their starting yield at the beginning of the year as falling yields lifted bond prices. The bad news is that starting yields in 2021 are much lower and the environment for reinvestment is more challenging.

Fortunately, there are many different fixed income instruments that can be used to meet financial goals. In the current low interest rate environment, we believe it is sensible to split up the two roles of safety and income generation between different securities in portfolios. High-quality bonds and cash-equivalent securities provide safety and a potential source of funds during periods of market volatility. These lower-yielding positions can be offset by lower-rated and subordinated securities that provide higher yields in an attempt to maintain overall income and purchasing power.



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Downward drift

Looking back on the year, 2020 marked another leg lower in what has been a 40-year trend in bond yields. Short-term government bond yields shifted downward as central banks lowered policy rates in response to the COVID-19 pandemic, while longer-term government bond yields also fell as expectations for economic growth were reduced. As the economic and financial market recovery has played out, central bank purchases of government bonds have kept longer-term government yields pinned close to the March lows. Meanwhile, corporate bond yields reversed their surge in March and moved steadily lower over the course of the year as investors gravitated to this category in search of yield enhancement.

These more docile market conditions have afforded companies an opportunity to extend debt maturities. This story can be told on a global basis by observing the decline in the Bloomberg Barclays Global Aggregate Bond Index yield over the last two years. At the end of October 2018, this index yielded approximately 2.25 percent. As of the end of October 2020, the index yield sits below one percent.

Income generation is more difficult

The challenge confronting income-oriented investors in 2021 is captured in the chart below, which looks at the combined income profile of a 50-50 mix of U.S. stocks and bonds. This combined yield has been weighed down over time—the primary culprit being the fixed income side as bond yields, as measured by the 10-year U.S. government bond yield, have fallen from over 10 percent to below one percent. The annual average decline in yields of around 25 basis points (bps) helped produce capital gains for bondholders on this path, but past gains don't help generate future returns. Investor goals have largely not changed over the years either, creating an investment challenge that we believe calls for a more nuanced approach.

Declining yields have reduced income profile of balanced portfolios

Yield profile of a hypothetical portfolio of 50% U.S. stocks and 50% 10-year Treasuries



Source - Bloomberg; yield of U.S. stocks represented by the S&P 500 dividend yield; data through 11/2/20

Not one answer: Splitting the role of safety and income generation

We believe investors should be open to splitting the role of capital preservation and income generation across multiple positions when setting up fixed income portfolios in this uniquely challenging environment. Such an approach means a portfolio is populated with a mix of securities, those that can serve as a source of funds during periods of market volatility, and those that provide higher yields that deliver a source of cash flow to help returns keep pace with inflation. This approach can be utilized by all investors as it can be undertaken using individual bonds, as well as mutual funds and exchange-traded funds (ETFs), or a combination of all three.

Safety

Key for investors with a need to access funds

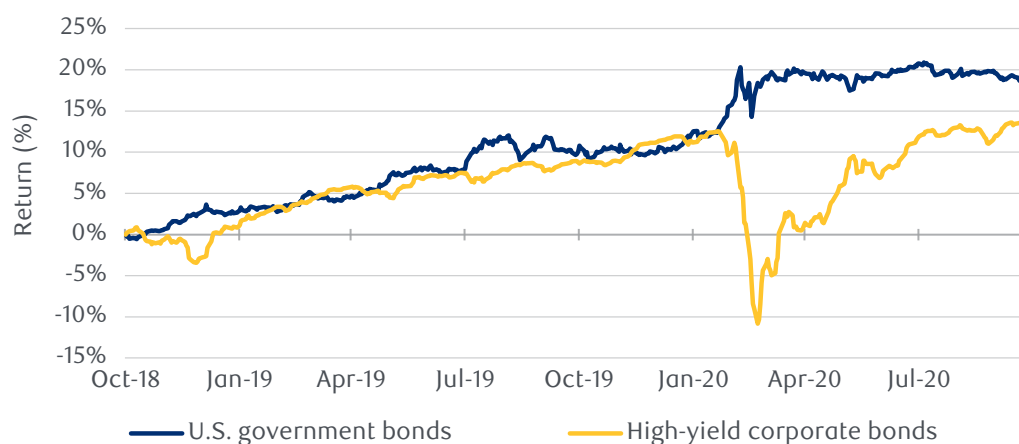
High-quality bonds and cash-equivalent securities can provide safety and a potential source of funds during periods of market volatility. This is of critical importance for investors with a known schedule of spending needs as it allows those needs to be met without the permanent impairment of capital that might occur if investors were forced to sell assets that may be subject to larger price swings during moments of financial volatility.

Peace of mind and flexibility

Even for investors without defined spending needs, we believe there is a significant portfolio management benefit to holding positions with a lower volatility profile that extends beyond smoothing returns. This is the ability to use these higher-quality securities as a source of funds after periods of financial market volatility, allowing an investor the flexibility to opportunistically rotate into securities that have become relatively much cheaper.

A prime example of an opportunity like this emerged in March 2020 when high-yield bonds underperformed government bonds by over 25 percent. Two years ago in the Global Insight 2019 Outlook we cautioned against reaching for yield in lower-quality bonds because valuations were such that only a modest amount of repricing could offset the incremental yield provided by these securities. The price action in February and March 2020 provided an example of what a period like this looks like. After this price adjustment occurred, there was a two-month stretch where the Bloomberg Barclays US Corporate High Yield Bond Index yielded over eight percent, providing at least 700 bps of yield pickup versus sub-one percent yields on government bonds.

Government bonds significantly outperformed high-yield corporate bonds in Q1 market stress



Source - Bloomberg; total returns shown; U.S. Treasury return measured by Bloomberg Barclays US Treasury Index, high-yield corporate bond return measured by Bloomberg Barclays US Corporate High Yield Bond Index; data through 10/30/20

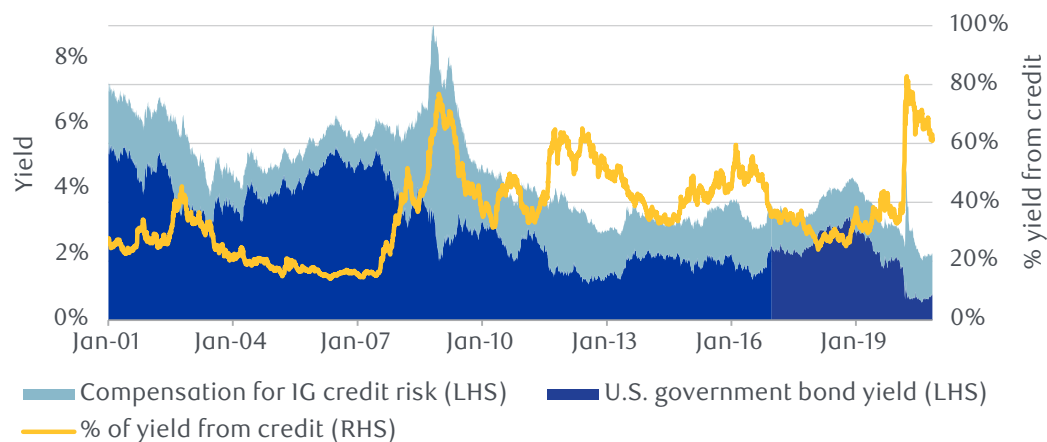
Income

A key role in meeting cash flow needs and maintaining purchasing power

The “safer” positions can be offset by higher-yielding securities in an attempt to generate an increased level of investment income to assist in maintaining purchasing power of the total investment capital. Given near-zero percent yields in most developed government bond markets, we believe mid-to-high single-digit yields from higher-risk securities—denoted by their lower credit ratings and their subordinated position in the capital structure—can be used to help returns keep pace with inflation.

The additional yield available on corporate bonds versus government bonds (i.e., the compensation for taking credit risk) remains near historical averages, even as government bond yields are at record lows. Compensation for credit risk makes up the lion’s share of the yield available on many bonds. For instance, compensation for credit risk accounted for only 25 percent of the total yield on the Bloomberg Barclays US Corporate Bond Index when it sported a yield in excess of four percent in 2018. That same index yielded two percent at the end of October 2020, but nearly two-thirds of that yield comes from compensation for credit risk. This valuation method, while far from perfect, offers a lens into one of the reasons why investors have shown a strong appetite for higher-yielding corporate securities recently.

Compensation for credit risk represents large portion of total yield



Source - Bloomberg; compensation for credit risk is measured by comparing the option-adjusted credit spread to the total yield; Bloomberg Barclays US Corporate Bond Index option-adjusted credit spread and yield to worst used for calculations; data through 11/4/20

Be mindful of the “hidden cost” of higher-yielding positions

One cost of owning higher-yielding securities is price volatility. This cost can be hidden for extended periods of time, but during market selloffs higher-yielding fixed income securities are typically correlated with equities. This is something to be mindful of but can also be managed by holding higher-yielding assets in conjunction with those in the safety bucket, so that the portfolio is not overly concentrated.

One can also purchase a variety of income-producing assets that diversify risk across different product structures and sectors. In a simple example, investors looking to take credit risk to drive enhanced returns could allocate 100 percent of their fixed income holdings to investment-grade corporate bonds at a two percent yield, or get the same total yield by allocating just a quarter of their fixed income allocation to high-yield bonds and keeping the rest of their holdings in government bonds. There are a number of different ways of getting to the desired result.

Theory versus practice

While fixed income securities are categorized in a way that is designed to denote their risk—government bonds, investment-grade corporate bonds, and non-investment-grade corporate bonds—it can be a misconception to think there is a clear line of demarcation that separates each of these categories from a risk perspective. While there can be clarity at the extremes, i.e., short-term government bonds on one end and long-term bonds from a low-rated, highly-indebted corporate issuer on the other, we believe much of the key decision-making comes down to investments that sit somewhere in-between.

The continuum of risk concept can be extended at the portfolio level to include equities. Many investors prefer a more equity-focused approach on income generation, but the more heavily a portfolio is tilted to equities for income and growth, the more important it can become to have an adequate layer of safety in the fixed income holdings.

A balancing act is required

Balancing safety and liquidity with income generation is a task that requires more attention in the current environment. Investors with an excessive preference for liquidity are likely to experience lower returns in the current low interest rate world. Those on the other end of the spectrum who prioritize income over liquidity are more likely to experience a higher level of price volatility in their portfolio. To the extent that either aim is over-emphasized, resulting in insufficient income or higher-than-desired volatility, this can cause investors to fall short of their long-term goals. Striking the right balance in a portfolio is especially important in today’s environment when it is difficult to achieve the dual roles of safety and income with one investment type.

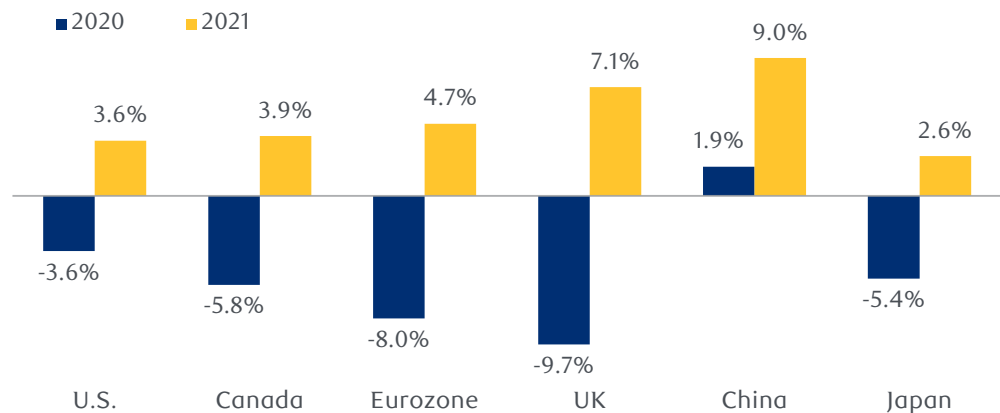


RBC's investment stance

The COVID-19 economic damage should diminish greatly through 2021, while confidence in a return to a recognizable social and business landscape will likely grow. We think central banks and governments will hesitate to back away from their accommodative policies until the global economic recovery is firmly rooted.

The U.S. and other major economies have recouped a significant portion of the output lost during the COVID-19 recession of 2020, and China's economy has moved to new output highs. We believe the V-shaped recovery that began in May of 2020 for most economies will give way to a less dynamic, possibly bumpier phase of growth. But all major economies seem set to reach their previous peak output levels much faster than they did following the global financial crisis. The continuation of ultralow interest rates should support higher stock prices while making fixed income investing more challenging. Following are our thoughts about portfolio positioning for 2021 by asset class and region, and our forecasts for currencies and commodities.

RBC's annual real GDP growth forecasts (y/y)

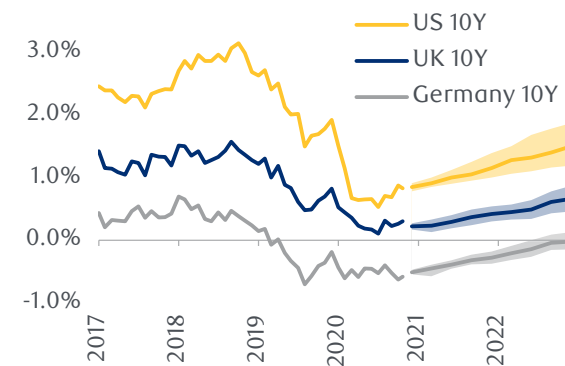


Source - RBC Global Asset Management; data as of November 2020

Fixed income

The major global central banks will likely keep the stimulus pedal to the metal in 2021, but amid concerns policy tools are already nearing speed limits, look for policymakers to fine-tune current programs in order to deliver the most efficient and focused aid to support the economic recovery. Negative rates will likely remain off the table for the Federal Reserve even as the Bank of England explores their efficacy. We believe expanded asset purchase and lending programs will remain the primary economic support vehicles.

Yield forecasts signal a long road to recovery



Source - RBC Wealth Management, November 2020 Bloomberg Survey; data through 11/20/20; forecast period of Q4 2020 to Q4 2022 shows median estimates, shaded regions represent central range of forecasts

United States

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- Fiscal support will likely be lacking in 2021 amid political gridlock, with the burden of the economic recovery again falling on the Fed. Regardless of any COVID-19 vaccine rollouts or the pace of the economic recovery, we believe the Fed will need to keep policy rates at 0% for years to come. Asset purchases are likely to continue, but we see the Fed shifting the composition toward longer-dated Treasuries in an effort to anchor rates and provide more stimulus.
- Though Fed policies should act as an anchor on Treasury yields, we still see yields rising and curves steepening on improving growth and inflation expectations over the course of 2021, though at a shallow and glacial pace, meaning the 10-year Treasury yield is likely to hold below approximately 1.25% for the balance of 2021.
- We believe credit markets will remain well-supported throughout the year as the Fed's lending programs are likely to remain in place, with additional support from high equity market valuations and an ongoing economic recovery. However, current fixed income valuations already reflect this as credit spreads—or the additional yield compensation for credit risks over Treasuries—are below historical averages. With little threat of sharply higher Treasury yields, we think investors should look to preferred shares for additional income within portfolios in a low-yield environment.

Canada

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- The Canadian sovereign yield curve remains at record lows in the front end due to central bank policy rates while yields further out the maturity spectrum fluctuated more as 2020 progressed. In an unappealing yield environment like this, we recommend traditional Government of Canada bonds for their liquidity characteristics in portfolios but look away for income generation. We maintain a focus on Real Return Bonds given the cost of inflation protection remains relatively cheap in Canada.
- Corporate bonds became less appealing for investors as 2020 evolved. The Bloomberg Barclays Corporate Bond Index in Canada has a sub-2% yield and an average maturity of approximately nine years, which is better than is available in government bonds, but leaves us less enthused about this segment as we head into 2021.

- Preferred shares remain one of the few areas of the Canadian fixed income space where investors can find 4%–6% yields. We believe the combination of a steady demand for income and a reduced supply of preferred shares due to refinancing will support prices over 2021. However, our excitement must be tempered with the knowledge that preferred shares are highly sensitive to changes in market sentiment. A higher-than-normal allocation to preferred shares should be combined with defensive securities to produce a portfolio of income and safety.

Europe & UK

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- Substantial central bank action by the European Central Bank (ECB) and Bank of England (BoE), with corresponding strong fiscal support from national governments and at the EU level, has been effective at anchoring interest rate expectations, while supporting government spending, corporate refinancing, and households during 2020.
- Europe still has to contend with the uneven recovery and re-opening of some countries' economies over the months ahead. However, the outlook is constructive given the considerable joint fiscal and monetary stimulus across the euro area, with a further extension expected to come from the ECB.
- In the UK, the end of the transition period means the country leaving the EU single market for good. This heralds a challenging growth outlook which could see the BoE potentially doing more to support the economy. At best, we would expect range-bound market moves; however, we could see the low yields of 2020 being revisited.
- This leaves investors in an environment of low yields and flat yield curves heading into 2021. Given this backdrop, we continue to favour corporate credit over government bonds, and adopt a flexible and tactical approach in our credit selection. We see cyclical sectors benefiting from the recovery as it slowly starts to gain momentum during the first half of next year. However, the more defensive sectors that performed well throughout the pandemic may start to lag.

Asia Pacific

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- We believe Asian bonds are particularly attractive for 2021 including their balance between rewards and risks. Asia's economic recovery has been led by China, where an impressive V-shaped rebound is underway. GDP rose sharply by 3.2% y/y and 4.9% y/y in Q2 and Q3, respectively, after a contraction of 6.8% in Q1. At the Fifth Plenum of the 19th Party Congress held at the end of October, the Chinese government emphasized its aim of sustaining quality growth under its 2021–25 national economic and social development plan.
- In the current zero interest rate environment, we think the search for yield is here to stay. Asian bonds provide what we believe is an attractive yield pickup versus developed markets. At the same time, Asia is economically better positioned compared to the other emerging market regions of Latin America and Central and Eastern Europe Middle East and Africa.
- In Asia, we prefer high-yield to investment-grade bonds. The 7%–8% yield in the high-yield market is attractive but we caution clients the ride may not be a smooth one. Investors need to be nimble and selective as heightened idiosyncratic risks amid COVID-19 challenges, trade tensions, and debt burdens remain. However, we believe the risks should be contained.

Equity

Our view for 2021 features worthwhile equity returns and strong earnings growth as the COVID-19 economic headwinds diminish. For 12–18 months following the end of a recession there is usually very rapid catch-up earnings growth. Stocks in the major markets have priced in some of this anticipated better profits trajectory, but not all. The persistence of ultralow interest rates should support above-average valuations and make equities the asset class of choice in 2021. We recommend holding an Overweight position in equities.

Price-to-earnings (P/E) ratios of major equity indexes

Index	Forward P/E	10-year average
S&P 500	21.2x	15.8x
S&P Small Cap 600	20.8x	18.4x
S&P/TSX Composite	17.1x	15.0x
STOXX Europe 600	17.7x	13.7x
FTSE All-Share	15.4x	13.1x
Hang Seng	11.6x	10.8x
Shanghai Composite	13.4x	11.0x
TOPIX	17.7x	13.5x

Source - Bloomberg, Refinitiv I/B/E/S (S&P 500); data as of 11/23/20; represents forward P/E ratios based on consensus earnings forecasts for the next 12 months

United States

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- A number of economic indicators continue to move in the right direction, albeit at an uneven pace, despite lingering COVID-19 challenges. We expect corporate profits and U.S. equity indexes to gain more ground as the economic foundation becomes sturdier with the help of ongoing ultraloose monetary policies, another round of fiscal stimulus, and the taming of COVID-19 headwinds.
- The S&P 500 consensus earnings forecast of \$168 per share for 2021 seems reasonable to us, and would represent roughly 20% y/y growth after the final 2020 results shake out. If this is achieved, it would push profits to a record level, beyond the pre-COVID-19 high of \$163 per share reached in 2019.
- The S&P 500's valuation of 21.2x the forward consensus earnings estimate is uncomfortably above average, but should not prohibit the index from advancing given that interest rates are likely to remain extraordinarily low. We think equity valuations will stay elevated as more investors come to realize that returns in fixed income are limited. To start 2021, we would position equity portfolios with a mix of cyclical (economically-sensitive) and defensive dividend-paying sectors. We would Overweight U.S. equities.

Canada

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- A greater return to normalcy such as that afforded by a successful COVID-19 vaccine could be a powerful tonic for Canadian equity market performance in 2021. The S&P/TSX Composite trades at a marked valuation discount relative to some developed markets. An improvement in the perceived durability of the economic recovery could boost sentiment toward key sectors of the domestic market and help shrink its relative discount.
- Big Six banks have amassed CA\$21 billion in credit loss provisions through three quarters of fiscal 2020. If the economic outlook brightens, actual credit losses could prove to be less than feared, and we could see a portion of these provisions released back into earnings. This is not our base case but is illustrative of what further evidence of sustained economic growth could provide to Canada's largest industry group.
- Energy's weight in the benchmark has eroded in recent years, but improved performance could further propel Canadian equities. RBC Capital Markets forecasts higher crude prices in 2021, which we believe is reasonable if a sustainable improvement in demand helps

drain both oil and refined product inventories. We recommend a Market Weight position in Canadian equities.

Europe & UK

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- We would hold a Market Weight position in both Europe and UK equities. Both economies face a difficult winter due to COVID-19, but based on a 12-month outlook, they should recover as infection rates subside and monetary and fiscal support work their way through.
- For Europe, the landmark €750 billion rescue package backed by joint EU debt should ensure aid is available in H1 2021. We believe an improving economic outlook would favour cyclical, such as select Industrials companies underpinned by secular trends, and luxury and sporting goods categories where long-term fundamentals appear structurally attractive. Long term, we favour Health Care, a sector supported by demographics and rising global health care expenditures, and renewables-focused companies in the Utilities sector as governments target green and sustainable investments.
- The UK is continuing to adjust to leaving the EU single market, and we believe its economy will adapt to these challenging times.
- The FTSE All-Share Index has been a perennial underperformer since the 2016 Brexit referendum, and valuations are attractive relative to other developed markets. Moreover, we expect a notable rebound in dividends over the coming year as many companies are likely to reinstate their payouts as the outlook improves.
- We prefer UK companies that are well positioned to benefit from long-term structural growth tailwinds or possess internal levers to grow, particularly in the Consumer Staples, Health Care, and Industrials sectors.

Asia Pacific

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- We remain Overweight on China equities. We believe the Chinese economy and corporate earnings are likely to record stronger growth in H1 2021 than in H2 2021 due to easy comparisons to 2020. The liquidity situation could be tighter compared to 2020 as the economy continues to recover. The renminbi may continue to strengthen versus the U.S. dollar, which could benefit sectors with large U.S. dollar debt exposure or whose raw materials costs are settled in dollars.
- The market generally believes the U.S.-China relationship would marginally improve under a Biden presidency. On the positive side, Biden views China as a “serious competitor” instead of a rival, and he believes imposing extra tariffs on Chinese goods is unwarranted. However, curbing Chinese tech firms could remain a key U.S. strategy, but this may be undertaken via a more traditional approach.
- For Japan, we expect economic growth to recover moderately in 2021 after a weak 2020 (the Bank of Japan estimates GDP for FY2020–21 at -5.5% and +3.6% y/y, respectively). With the global economy recovering, we expect the downward revisions to Japan’s corporate earnings to reverse. The term of Japan’s House of Representatives will expire in October 2021, and we expect the current administration to call a snap election. A strong mandate for Prime Minister Yoshihide Suga could be a catalyst for Japan’s equity market. We expect the stronger yen to persist, which would weigh on Japan’s key export sector. All in, we are neutral on Japan equities in 2021.

2021 forecasts

U.S. Dollar Index	94.71
EUR/USD	1.16
USD/CAD	1.33
GBP/USD	1.21
USD/JPY	103

Source - RBC Capital Markets; for prices at year-end

Currencies

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USD – Mixed performance. The dollar’s highly anti-cyclical characteristics could point to underperformance against more growth-oriented currencies as the global economy recovers and investors seek higher-yielding assets, particularly with ultra-loose Fed policy poised to persist. However, risk appetite remains a key driver of the dollar’s performance, and bouts of “safe-haven” demand could provide support amid ongoing tail risks.

EUR – Limited upside. The outlook for the euro has turned more constructive with the passing of the EU recovery fund and joint fiscal-monetary response to COVID-19. However, with positive catalysts largely priced in and concerns of slowing growth momentum amid the latest COVID-19-related lockdowns, gains could be limited for the euro in 2021.

CAD – Supportive risk backdrop. Although the Canadian dollar faces challenges with the growth rebound stalling and a rising fiscal deficit, we expect risk sentiment will continue to be the primary driver of the currency. A more positive risk backdrop and increased demand for commodities could keep the Canadian dollar supported.

GBP – After Brexit. Looking past the transition period when the Brexit process concludes, we still have reason to be cautious on the British pound through 2021. The UK’s weak financial position, challenging domestic growth outlook, and the possibility of negative rates could point to sterling underperformance.

JPY – Domestic flows. Alongside risk appetite catalysts, the yen will likely be driven by flows from Japanese investors. Due to low global rates, Japanese investors are repatriating foreign investments and adding hedges to foreign holdings, keeping domestic demand strong for the yen. These flows could provide support regardless of risk appetite.

Commodities

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2021 forecasts

Oil (WTI \$/bbl)	\$46.15
Natural gas (\$/mmBtu)	\$2.60
Copper (\$/lb)	\$3.25
Gold (\$/oz)	\$1893
Soybean (\$/bu)	\$11.28
Wheat (\$/bu)	\$6.04

Source - RBC Capital Markets forecasts (oil, natural gas, copper and gold), Bloomberg consensus forecasts (soybean and wheat); for prices at year-end

WTI – Fuel the economy. Global lockdowns led to sharp double-digit losses for West Texas Intermediate crude in 2020. While vaccine news is positive for crude, RBC Capital Markets suggests further upside would require a resurgence in consumer demand and an improvement in refining margins. We expect further volatility but also upside participation alongside an economic recovery in 2021.

Natural gas – Economic drawdown. Natural gas surprised to the upside in 2020, and RBC Capital Markets believes the supply-demand dynamic should improve heading into 2021 driven by moderating gas production and increased liquefied natural gas export activity. Inventories remain elevated due to government shutdowns, and we expect drawdowns to pick up as restrictions are lifted.

Copper – Surplus position. Copper experienced a V-shaped recovery, bouncing 45%+ off its 2020 lows and is trading near the top end of its 18-month range. As China consumes roughly 50% of global demand, swift action by its government to curb the pandemic has benefited copper. Going into 2021, we expect the copper market to remain in a surplus position.

Gold – Resetting expectations. Gold has pulled back from its 2020 high driven by news of potential vaccines and therefore improved risk appetite. While a “normalized” economy may be a headwind for assets considered to be “safe havens,” we believe the environment remains conducive for gold due to low real rates and political/economic uncertainties going into 2021.

Soybeans – Soy-ing higher. Soybean prices rallied to an 18-month high on the back of growing Chinese demand and lower global production as a result of unfavourable weather conditions. Global ending stock for the 2020/21 season is well below the previous two seasons. We would expect a rebound in production and prices to normalize.

Wheat – Another record. Wheat prices have benefited from sustained purchases from China as part of the U.S.-China Phase 1 trade agreement and were up about 9% in 2020. The U.S. Department of Agriculture expects global ending stock to reach another record high in the 2020/21 season.

Research resources

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