RBC Global Asset Management

Perspectives for a long-term investor

Stu Kedwell

Senior Vice President & Senior Portfolio Manager, Co-Head of NA Equities

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Stocks have had a volatile start to 2022, as market participants digest new potential threats. Notably, the moderating of growth expectations for some highly valued stocks, the impact of inflation and rising interest rates on valuations, and geopolitical risks have all impacted returns. While likely below historical levels, the ability of the market to deliver results to investors over time remains in place; a long-term perspective is critical in times like these.

Market moves upward are often at a slow, measured pace, while moves downward can be sharp and abrupt, exacerbated by leverage and programmatic trading. It's difficult to say whether we've seen the market bottom or if we'll revisit new lows. In any case, it's worth reminding ourselves that the importance of predicting the tops and bottoms diminishes as you extend your investment time horizon (*Figure 1*).

Central bank policy and the prospect of rising interest rates have been high on investors' radar so far in 2022. Historically the market rallies into the first Federal Reserve ("Fed") rate hike and this tends to continue through the tightening cycle (*Figure 2*). Interest rates are expected to increase this year, accompanied by the end of quantitative easing. However, this doesn't spell the end of economic growth. By our estimates, tightening monetary policy likely reduces growth by 0.50-0.75%, which would leave us in the 3.0-3.5% range. This is still a supportive backdrop for earnings growth.

Meanwhile inflation is also positive for earnings, as companies are able to pass on some rising costs to customers. So if we have a scenario where GDP growth is in that 3.0-3.5% range, combined with 3% inflation, that results in approximately 7% nominal growth – which is a quite an attractive setup.

After earnings, the other component of a stock's return is the multiple at which it trades. While earnings growth should be attractive, one reason that equity market returns are not likely to match those experienced recently is it's tough for valuations to expand from these levels when interest rates are rising. This could mean a persistence of volatility as the market looks to find a fair price for earnings. However, low yields on risk-free assets, plus healthy dividend and free cash flow yields for stocks, provide some support for higher valuations. Furthermore, the market isn't uniformly expensive; there are plenty of stocks and sectors where the valuation is much more enticing (*Figure 3*).

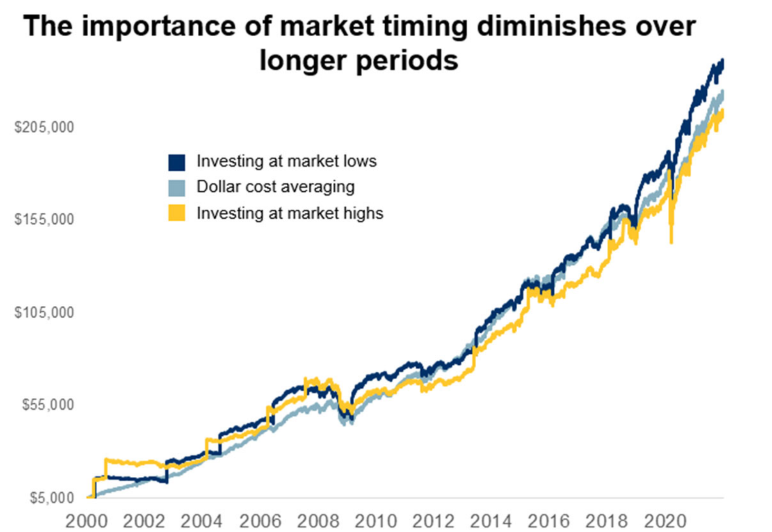

Figure 1. Source: RBC GAM. Reflects RBC Select Balanced Portfolio (Sr. A). From Jan 1, 2000 - Dec 31, 2021. Total investment is $105,000 in all three scenarios ($5000 initially, $10,000 during highs/lows). See disclosure for list of market highs and lows.*

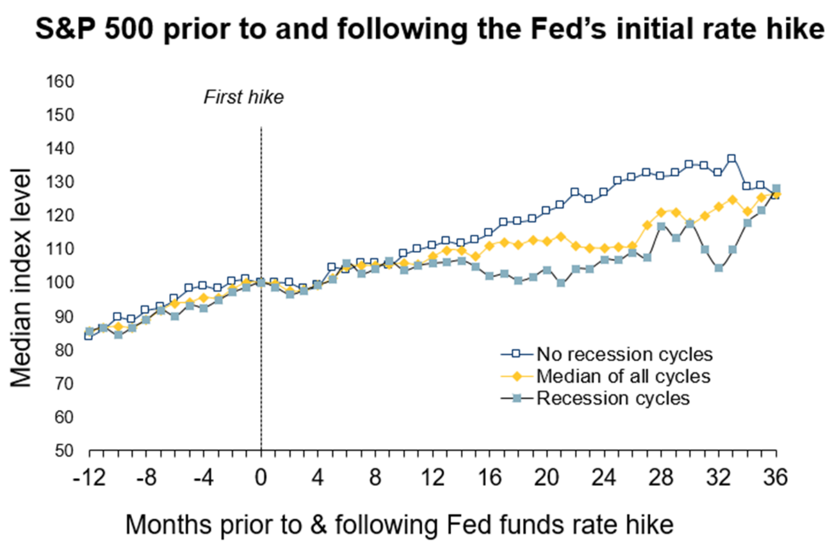

Figure 2. Source: RBC GAM. "Median index level" is compared to date of initial rate hike. July 1954- Jan 2022.

Over the intermediate term, it is reasonable for investors to expect total returns that are comprised of the earnings growth and dividends. If our expectations for earnings growth in the mid-to-high single digit range are achieved, coupled with dividends, that's a reasonable setup for investors with a medium-to-long time horizon.

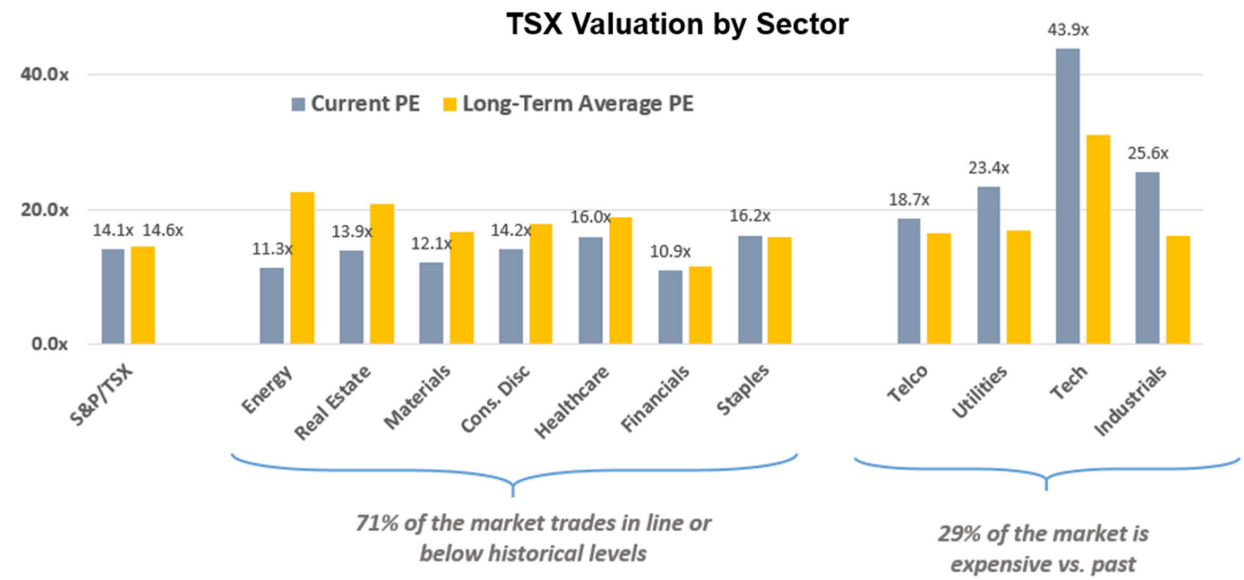

Figure 3. Source: Scotia GBM; closing prices as of January 25, 2022

Even in the scenario where valuations contract, the opportunity for reasonable gains in the stock market present themselves. Looking out 10 years, assuming reasonable earnings growth in the 6-7% range and a reversion to a normal valuation of 15 times earnings (today we're at 19 times), the total return potential for the market is around 6%. While lower than the traditional 8-9% the S&P 500 has delivered in the past, it's still quite attractive, particularly when compared to longer-term interest rates.

This is a much different environment than a period like the Tech Bubble. At that time the market was trading 60% above its long-term average, meaning on a 10 year horizon investors could lose most of the market's 6-7% earnings growth to multiple reversion. Moreover, at that time the 10 year bond was yielding 6%, providing a very enticing risk-free alternative. That isn't the setup today, as the market trades at a more reasonable valuation and risk-free assets trade at much lower yields.

The most likely scenario in which valuations normalize comes through higher interest rates. However, to take the S&P 500 multiple back down to 15 times earnings, it would likely take a 3.5-4.0% yield on the U.S. 10-Year Treasury. This is a long way from 1.8% today and well beyond our forecast of 2% for year end.

In the context of a 10 year plan, it's prudent to prepare and incorporate one, if not two, recessions (*Figure 4*). However, recession risk right now appears quite low, as reflected by a number of recession indicators that we focus on. One signal we look at is credit spreads, which reflect the expense of cash flowing through businesses and commerce on a daily basis. Credit spreads to this point haven't matched the reaction of the stock market, which is a positive indicator. Similarly, the strong financial position of consumers provides a positive backdrop and the yield curve slope remains positive (i.e. long-term rates are higher than short-term rates).

Overall, the ability of the market to deliver results to investors over time remains in place. When the market sells off, it adds to return potential for a long-term investor. Investment principles like rebalancing and dollar cost averaging are effective ways to manage the emotional aspect of volatility without derailing a long-term plan.

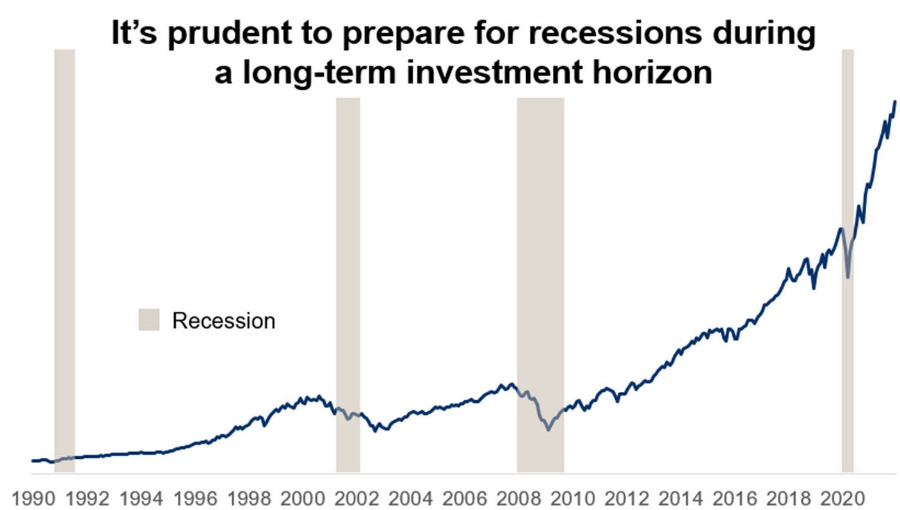

Figure 4. Source: Bloomberg, RBC GAM. Blue line reflects S&P 500 performance from 1990-2021 in USD.

*Short-term market lows: 04/14/2000 | 10/09/2002 | 08/13/2004 | 06/13/2006 | 03/09/2009 | 06/24/2013 | 02/11/2016 | 02/08/2018 | 24/12/2018 | 03/23/2020. Short-term market highs: 03/26/2000 | 09/04/2000 | 03/01/2004 | 04/05/2006 | 07/19/2007 | 05/21/2013 | 04/12/2015 | 01/23/2018 | 07/19/2018 | 02/19/2020. "Regular monthly investor" made pre-authorized contributions on the last trading day of each month over the period indicated.

RBC Select Balanced Fund (series A): 1Y 10.1%, 3Y 11.3%, 5Y 7.7%, 10Y 8.0%. As of Dec 31, 2021.

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