Market update

Reflection of reality

The serious human toll and adverse economic and financial market consequences of COVID-19 continue to mount as the virus spreads further throughout North America and penetrates deeper in Europe. As a result, the global equity selloff has persisted with the S&P 500, at its worst point, plunging 34 percent from its all-time high reached a little more than a month ago. Stress in the fixed income market has also continued even though major central banks have acted swiftly and resolutely. We think financial market volatility is likely to remain over the near term—both to the downside *and* upside.

Due to the worsening economic conditions and the related adverse impact on corporate profits, RBC's economist and U.S. equity strategist have further downgraded their outlooks. Following are their latest thoughts about the crisis and also the potential path toward recovery, along with views of the Global Portfolio Advisory Committee.

A deeper recession but …

RBC Global Asset Management Inc. Chief Economist Eric Lascelles now believes a deep (yet potentially brief) recession will occur in the U.S., Canada, and Europe as day-to-day life has nearly come to a standstill.

The nine coronavirus downturn scenarios that Lascelles is evaluating for the U.S. economy—ranging from those that would have a shallow impact on growth, to a medium impact, and to a deep impact—have all deteriorated recently as authorities have implemented stringent preventative measures to halt the spread of the virus and protect the population.

- If the U.S. economic retrenchment is medium in depth and duration—the scenario Lascelles views as most likely at this stage—he anticipates it could result in U.S. GDP declining by 15 percent for a brief period, at its worst point. Because of the rapid, compressed nature of the health crisis thus far, he expects this blow to take place in Q2—potentially resulting in the largest quarterly decline in U.S. history. Lascelles wrote, "The employment bad news is already starting to roll in. U.S. regional jobless claims are already running around ten times higher than normal. The Canadian numbers are also surging."
- As economic data is released in April and May, and as corporations report Q1 earnings during the same period, the full impact of the virus will likely become more apparent in the U.S. and other major economies. The good news is that financial markets have already begun to factor this into price levels. In our view, this is a key reason major equity markets have fallen by more than 30 percent so quickly—markets are anticipating a big hit to GDP. But it is unclear at this stage if the coming economic and profits deterioration is fully factored into equity markets given the numerous uncertainties that linger and the difficult nature of modeling this exogenous health shock. We don't doubt there will be some surprises in the April and May data.
- If the spread of the virus wanes in the summer and the U.S. economy begins to stabilize and then recover toward year end—the most likely scenario in Lascelles' view—the full-year GDP hit would be nowhere near the severe retrenchment in Q2, but still sizeable. Lascelles forecasts a 2.8 percent decline in U.S. GDP in 2020, below his previous estimate of a shallow downturn when the spread of the virus had not been as severe in North America and Europe. To put this in context, a full-year decline of 2.8 percent—which includes a severe drop in Q2—would be slightly deeper than in

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2009 during the global financial crisis, and it would be the largest annual U.S. retrenchment since 1946. (*#MacroMemo: More about COVID-19*)

- Lascelles added, "Europe and Canada may suffer modestly more than the U.S., because of the severity of the disease in Europe and the additional blow of low oil prices in Canada."

… the recovery could be quicker and stronger

Because the coronavirus shock is such a unique event, we believe the contours of the recession *and* recovery could be unique as well.

- Lascelles wrote, "Fortunately, the trough [of the recession] is not likely to last for especially long. A further silver lining is that policymakers have now introduced truly extraordinary amounts of monetary and fiscal stimulus. This is key for preventing a temporary and artificial supply-led shock from turning into an enduring demand-side one."
- The Federal Reserve has thrown more than the kitchen sink at this crisis, including a liquidity backstop for credit markets. Importantly, its support has come much more quickly than during the global financial crisis—so quickly that the Fed's biggest detractor-in-chief, President Donald Trump, praised its actions. Other major central banks have stepped up forcefully as well.
- Fiscal support from governments is coming almost just as fast from the UK and Canada, and is in the works in Continental Europe. While there has been criticism that some in Washington are dragging their feet to pass a $2 trillion stimulus package, in reality, they are also responding much more quickly than during the financial crisis. We believe the fiscal and monetary actions will blunt the global downturn and boost the recovery.
- Lascelles also points out that economies have the potential to recover more quickly because the hit to labor supply and product demand are largely due to "stay at home" and "work from home" government edicts being implemented for public health purposes, and can be rapidly reversed when the virus wanes. He said, "Reflecting all of this, our tentative 2021 GDP forecast assumes quite an impressive rebound." Lascelles added, "We are working with the assumption that any rebound should be faster than usual … China has already demonstrated that it is perhaps 80 percent of the way back to normal a mere month after restarting its economy."

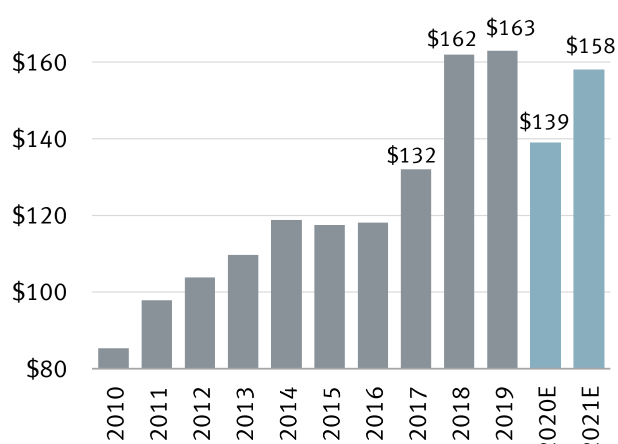
Shadow cast over profits

The much higher likelihood that a recession will unfold in 2020 is the main reason Lori Calvasina, head of U.S. equity strategy at RBC Capital Markets, LLC, has further cut her U.S. profits outlook.

- Calvasina now estimates S&P 500 earnings will retreat to $139 per share, much lower than her previous forecast of $165. The new estimate equates to a 15 percent year-over-year decline versus the $163 level achieved in 2019, as measured by FactSet. This estimate takes into consideration the earnings declines experienced during the previous three recessions since 1991—all of which transpired due to very different circumstances, but nonetheless can be a useful guide in aggregate, she believes.
- As the middle of this year approaches, more institutional investors will start to look past the valley of 2020 earnings, with an eye toward a potential bounce in profits in 2021. For now, Calvasina is "penciling in" an earnings forecast of $158 per share for 2021, which would represent almost 14 percent growth over her 2020 estimate. This assumes that the economic recovery would begin in Q4 of 2020, and persist in 2021. It also incorporates a moderate increase in operating margins.
- In the near term, however, the market still has to contend with the coronavirus and what is likely to be a difficult Q1 earnings reporting season. Calvasina wrote, "Equity investors need to get a better handle on the path of the coronavirus and the government's plan of attack for the virus and fiscal response in order to gain

S&P 500 annual earnings per share and estimates

Actual (gray) and RBC Capital Markets estimates (blue)



Source - RBC Capital Markets U.S. Equity Strategy, RBC Wealth Management, Refinitiv I/B/E/S, FactSet more visibility into and confidence about the path of the economy." Furthermore, the equity market typically needs at least some visibility into the earnings outlook before it can stabilize.

Canadian equities: Virus and oil markets form a one-two punch

- The Canadian equity market has underperformed relative to U.S. benchmarks as the dramatic decline in crude oil prices has compounded virus-related uncertainty. The S&P/TSX Composite Index is now trading at a forward price-to-earnings multiple of roughly 11.5x compared to 15.1x at the start of the year and a long-term average of 15.5x. Despite the market's seemingly compelling valuation, we expect earnings estimates to remain in flux with considerable downside risk. Accordingly, investors should continue to emphasize quality in their Canadian equity portfolios and resist the temptation presented by companies with severely discounted valuations but similarly challenged outlooks.

- The uneven representation of sectors in the Canadian market (i.e., Financials and Energy account for over 40 percent of the benchmark) brings particular challenges. With limited visibility on how the COVID-19 outbreak and the global oil price war might play out, we are mindful of the risk that business activity disruptions could last longer and inflict more durable damage to the Canadian economy than what markets currently anticipate. We suggest investors consider markets outside of Canada for exposure to sectors that are under-represented in Canada.

- Balance sheet preservation is now the top priority among companies in the Energy sector. We have already seen capital spending plans across the sector cut by roughly 30 percent and a number of companies reduce their dividends. In the event that energy prices remain depressed for a protracted period of time, even the largest and best-capitalized companies could be forced to reevaluate their dividend policies.

- Not unlike the overall Canadian economy, the banks are confronting the dual shocks of COVID-19 and depressed energy prices. While direct lending exposure to the oil & gas industry is manageable, in our view, the greater concern for the banks is the potential for broad-based credit weakness that could accompany a longer and deeper pullback in the economy. The banks are well-capitalized and, as a result, dividends should be sustainable under a range of economic scenarios. As such, dividend yields may look attractive but bank investors must be willing and able to stomach the volatility that we expect through this period of uncertainty.

- The Canadian federal government announced an CA$82 billion aid package to complement the monetary easing enacted by the Bank of Canada. The package consists of CA$27 billion in direct support and a further CA$55 billion in tax deferrals. RBC Economics notes that the direct initiatives amount to 1.2 percent of GDP, which pales relative to more ambitious spending plans unveiled by other developed nation governments. As such, RBC Economics expects more aggressive announcements in the weeks to come.

Finding value in credit markets

Rumblings in the credit market have been just as important—if not more so—than the developments in equity markets.

- The yields on the main U.S. high-yield and investment-grade bond indexes have both roughly doubled over the past few weeks and now sit around 11 percent and five percent, respectively, as a confluence of fundamental and technical factors has placed upward pressure on corporate bond yields.

- A number of corporations have been in search of capital in anticipation of a dip in cash flow, but potential buyers have also seen their capital base depleted as investors pulled roughly $36 billion from investment-grade corporate bond funds last week. This represents the biggest weekly withdrawal ever, nearly four times the size of the previous largest withdrawal.

- Despite these outflows, nearly $75 billion in corporate bonds have been issued since Mar. 17. Issuance has mostly come from the most creditworthy borrowers, but issuing corporations have had to offer generous pricing terms thanks to the aforementioned supply/demand imbalance.

- The Federal Reserve's announcement on Mar. 23 of a slew of new and unlimited bond purchase programs helped stabilize funding costs. A pair of facilities aimed at the primary & secondary markets were the most relevant to the corporate bond market as these programs essentially purchase shorter-term investment-grade corporates and related exchange-traded funds.

- We believe the rapid repricing of risk in the corporate bond market has tilted the medium-to-long-term risk-reward profile back in favor of investors and makes it an attractive market for some value investors. From current valuations, corporate credit has historically outperformed government bonds and often managed to keep pace with equities in the initial leg of a recovery.
- This theme can be extended to the Canadian preferred share market, which hit a fresh all-time low in price terms on Mar. 23. We view this market as down, but not for the count, as yields in excess of seven percent are available on a diverse mix of structures, and companies must continue to serve this dividend stream unless common equity dividends are reduced to $0. Our guidance is to maintain or add exposure.

Stabilization signposts

As financial markets continue to work through this challenging period, Lascelles will be monitoring a number of factors that might signal some stabilization or turning points. The list starts with developments that could theoretically arrive fairly soon, and finishes with items that will likely take longer to achieve:

- Further significant enhancements to containment, border control, and disease testing efforts
- Further major government stimulus announcements
- A decline in the number of new daily cases in Italy
- A decline in the number of new daily cases in the U.S.
- A decline in the daily fatality rate
- A decline in the total number of people actively sick
- The development of an important therapeutic treatment for COVID-19
- The end of quarantining
- A return to economic growth
- The development of a vaccine

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