GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

July 1, 2021

Transition time

Kelly Bogdanova – San Francisco

It's been a heady run for equity markets so far this year. We see a changing playing field from here that should see markets settle into more typical patterns. We look at four interrelated issues that should set the tone for the U.S. stock market for the rest of the year and into 2022.

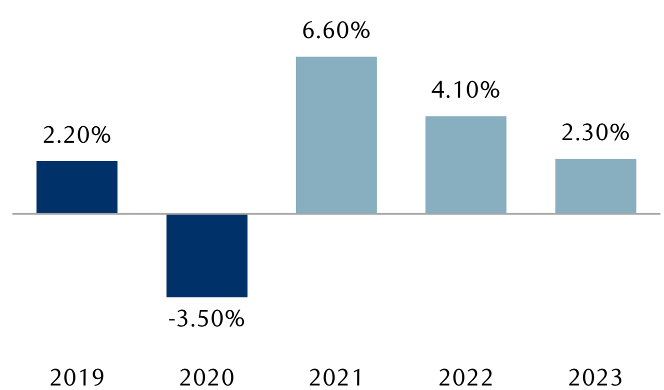
The U.S. equity market—and most markets, for that matter—finished the first half of the year on a positive note, adding to outsized year-to-date gains. The S&P 500 rose 2.2 percent in June, ending the month at an all-time high, and has rallied 15 percent so far in 2021.

We think major equity markets have further room to run due to the strong economic and corporate earnings momentum generated by the partial taming of the COVID-19 virus and related economic reopenings, and the already implemented supersized fiscal and monetary stimulus, as we stated in our 2021 Midyear Outlook.

Barring a vigorous return of the pandemic, we think the U.S. economy should keep powering ahead at an above-average rate through next year, at least. The consensus forecast is for U.S. Real GDP to grow 6.6 percent in 2021, and RBC Capital Markets believes it could be even higher, reaching eight percent. U.S. recession risks are nowhere in sight, according to our six leading indicators, and other major economies appear to be in favorable positions as well.

Economists expect GDP growth to jump this year, and then ease back to a more normal level by 2023

U.S. Real GDP (annual y/y %); actual in dark blue, consensus estimates in light blue



Source - RBC Wealth Management, Bloomberg estimates; data as of 6/30/21

The shape of things to come

Equity markets, however, will be confronted with a shifting landscape over the remainder of the year and into 2022 as central bank policies become less dovish and economic and earnings growth rates come off the boil.

For the U.S. market, we think this could lead to a transition period—from that of a robust rally phase (the S&P 500 has surged more than 90 percent since the March 2020 COVID-19 low) to a more typical market pattern of two steps forward, one step back.

For perspectives on the week from our regional analysts, please see pages 3–4.

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For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

There are four interrelated issues that should set the U.S. market's tone going forward:

Above-normal inflation: Consumer inflation reached 5.0 percent year over year in May, and we expect it to remain elevated in the near term before easing down to less lofty levels toward the end of the year. We think this path is largely accepted among market participants. The greater uncertainty is inflation's path over the next two to three years. RBC Global Asset Management's chief economist forecasts it will remain above average during this period, and we're not convinced the equity market has embraced this possibility. In the meantime, the debate about inflation—and the Fed's response to it—could jostle the equity market at times. (For our additional thoughts on inflation, see this article.)

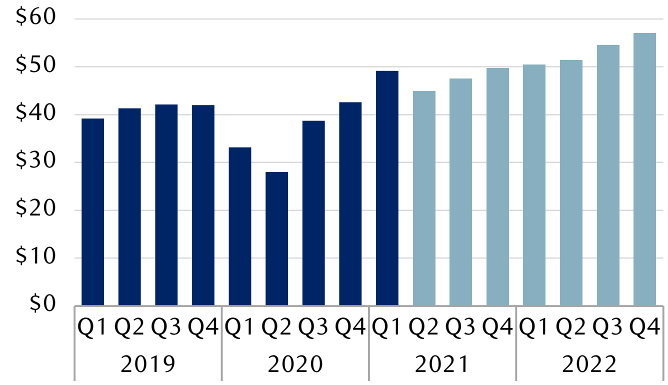
Less dovish Fed: The Fed has already signaled it plans to shift toward less accommodative policies soon with the start of tapering of asset purchases, and then the first rate hike of the cycle will follow, perhaps in 2023, which is the Fed's most recent projection. Neither tapering nor the beginning of the rate hike cycle would pose a threat to the equity market's medium-term trajectory, in our view. Even so, we think market participants will fret about Fed policy and the related movement of the 10-year Treasury yield and yield curve from time to time.

There is only one historical incidence of tapering, during the previous economic expansion. The equity market was initially knocked back by the Fed's surprise tapering announcement and had difficulty with the Fed's later communications on this but went on to resume its bull trend thereafter. This go-around, the Fed has already more effectively prepared financial markets for tapering. In terms of rate hikes, the S&P 500 has typically rallied at an above-average pace one year before the first rate hike and has continued at an above-average rate in the two years after the first hike when a recession was not on the horizon, according to RBC Global Asset Management data going back to the 1950s. Typically, the equity market is threatened by rate hikes only when the Fed tightens too much, too fast such that a recession becomes a meaningful risk. This scenario is not currently in view.

Peak GDP growth: Q2 2021 will likely record the high-water mark of GDP growth for this recovery cycle. The consensus forecast is projecting 10 percent growth, while RBC Capital Markets believes it could reach 13.5 percent. Bursts of strong GDP growth are common early in the expansion cycle, following a recession. While the Q2 2021 level, which will be preliminarily announced on July 29, should be outsized compared to historical recovery periods, this is primarily due to the unique nature of the plunge in Q2 2020 caused by COVID-19 shutdowns and the subsequent business reopenings. More meaningful for the market will be the path of GDP growth thereafter. We think the unprecedented levels of fiscal and monetary stimulus already in the system will help GDP growth remain above average through next year, at least. In short, we are not concerned about "peak GDP growth" so long as above-trend momentum can persist.

The absolute level of earnings should continue to rise

S&P 500 quarterly earnings per share; actual in dark blue, consensus estimates in light blue



Source - RBC Wealth Management, Refinitiv I/B/E/S estimates; data as of 6/25/21

Peak earnings growth: Some market participants are already wringing their hands about how the upcoming Q2 earnings reporting season, which will begin in mid-July, is nearly certain to represent "peak earnings growth" for this bull market cycle, which could pose a challenge for the market. The consensus forecast is for S&P 500 earnings to grow 65 percent year over year, and once beat rates are factored in we think it could reach 75 percent year over year.

Indeed, RBC Capital Markets points out that periods of peak earnings growth have historically been followed by a loss of price momentum for the market. In the early stage of the past three bull market cycles going back to 1993, the S&P 500 declined by a range of 1.0 percent to 7.6 percent in the six months following the peak rate of earnings growth. However, the effect was temporary as the market eventually resumed its upward trajectory in all three instances. The S&P 500 climbed by a total of 26 percent to 50 percent during the 36-month period following the peak in earnings growth largely because the economic expansions persisted and the absolute level of earnings continued to march higher, albeit at a slower pace. We think a similar earnings growth pattern will play out this business cycle.

All in stride

Uncertainties or periodic data contradictions related to any of these issues could create market volatility or pullbacks, but we think all four of these transitions are manageable and will not hinder worthwhile market gains over the next six to 12 months. Any wobbles in the indexes should be temporary and superseded by another leg up for the economy, corporate profits, and equity market. We would maintain a moderately Overweight position in U.S. equities in balanced portfolios with a tilt toward value sectors.

UNITED STATES

Atul Bhatia, CFA – Minneapolis

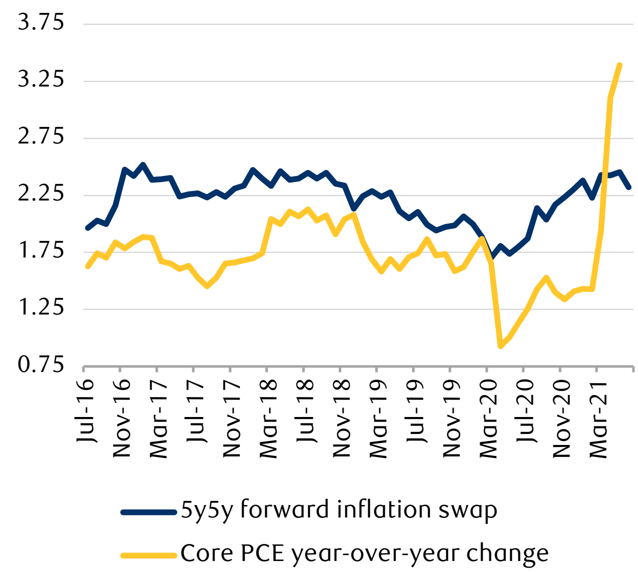
■ **A bipartisan group of legislators and the Biden administration agreed to boost federal infrastructure spending by almost $600 billion** over eight years. The deal faces an **uncertain path to approval** as House progressives—concerned about losing negotiating leverage—are threatening to vote against the measure unless accompanied by additional legislation. This more expansive—and expensive—bill will almost certainly have to be passed with exclusively Democrat votes under the Senate's reconciliation procedure, which only requires a simple majority. Senate Republicans for their part are threatening to scuttle the deal over the linkage, arguing that the single-party program negates the bipartisan negotiations. **The impasse—combined with the bipartisan deal's relatively small size—has blunted the impact of the agreement**. The most likely result, in our view, is eventual passage of the joint measure and a $1 trillion to $2 trillion fiscal package, but significant uncertainty remains. The details—particularly on the bill's funding—will be crucial to determining its economic and market impact.

■ **Fed speakers continue to discuss transitory inflation**, although there is a **growing divide between members who put the emphasis on "transitory" and those who stress "inflation."** The impact of the split on rate policy is probably limited, as several of the more hawkish Fed members will not be voting on policy in 2022 under the central bank's rotating vote system. These members are voters this year, however, and may succeed in pulling forward the tapering announcement, potentially to August. The Fed as an institution puts a premium on unanimity, and accelerating tapering's start by a month or two may be an acceptable tradeoff for minimizing dissenting votes.

■ **An existing glut of liquidity may also ease the path to tapering**. The Fed's reverse repo facility has grown to nearly a trillion dollars as a shortage of Treasury bills has led investors to place cash at the central bank facility. Against that backdrop, adding liquidity at the same pace may be counterproductive, particularly with the bills shortage that should intensify with debt ceiling limits coming back in August.

Inflation points higher; markets say transitory

Annual inflation expectations are well below current core price rises



Note: 5y5y inflation refers to expectations for inflation over a five-year period starting five years in the future.
Source - RBC Wealth Management, Bloomberg; core PCE data through 5/31/21; inflation swap data through 6/30/21

CANADA

Carolyn Schroeder & Richard Tan, CFA – Torontoo

■ While parts of the country are fighting off record-high temperatures, investors have likely been more welcoming as it pertains to the recent series of all-time highs in the equity markets. **The S&P/TSX Composite has generated a solid total return of approximately 16.6% year to date**, outpacing the S&P 500's return of approximately 15.1% in local currency terms. Adjusted in Canadian dollar terms, Canadian equities have outperformed their U.S. counterparts by approximately 470 basis points as the loonie has strengthened against the greenback year to date. **From a sector perspective, the majority of the S&P/TSX Composite remains firmly in the green** year to date, with Materials as the notable exception driven in part by the pullback in metals and lumber prices over the last month. High-growth Technology stocks also made a comeback in June with Technology quickly becoming one of the index's best-performing sectors but still trailing Energy and Financials on a relative basis year to date.

■ **Affordability in a majority of Canada's housing markets further eroded** in Q1 2021 as aggregate home prices rose broadly across the country. The RBC Housing Affordability Measure, the ratio of ownership costs to household income (which is calculated by RBC Economics), rose for the third straight quarter in Q1 2021, up 0.9 percentage points to 52.0%. The deterioration was most significant in Vancouver (Affordability Measure up 1.9 percentage points), Halifax (up 1.7 percentage points), and Victoria (up 1.2 percentage points), though Montreal and Toronto were not far behind. The situation improved in a few markets concentrated in the Prairies led by Calgary, Edmonton, and Regina, and in Saint John. **In the near term, we believe challenging conditions appear poised to raise the home ownership bar higher-still for buyers in most markets**, including smaller cities and rural areas that have attracted much interest during the pandemic.

EUROPE

Frédérique Carrier – London

- **Another wave of COVID-19 is sweeping through the UK, and with a lag of two months has reached continental Europe**. With vaccination rollouts in the UK and Europe progressing, we believe hospitalization and fatality rates should remain fairly low. According to RBC Global Asset Management, as public policy has been set in significant part based on hospital capacity, governments are unlikely to lock down or will likely only impose mildly stricter rules. Therefore, **economic damage should be minimized**, in our view.

- For now, the recent **relaxation of restrictions in the eurozone is encouraging services activity to recover swiftly while strong global demand continues to drive the manufacturing sector**. The preliminary IHS Markit Eurozone Composite Purchasing Managers' Index (PMI) exceeded consensus expectations, reaching a six-month high of 59.2 in June, up from 57.1 in May. Moreover, the European Commission Economic Sentiment Indicator for the Eurozone reached a 21-year high of 117.9. The Eurozone Consumer Price Index for June retreated slightly to 1.9% from 2% in May given the less favourable energy price base effects, with petrol prices having started to recover as economies reopened a year ago.

- With the economic recovery ongoing but potentially vulnerable to new COVID-19 variants and inflation at subdued levels, **we continue to believe that the European Central Bank will lag other major central banks in reducing monetary stimulus**.

- In the UK, while the preliminary Services and flash Manufacturing PMIs fell back modestly, they remain at very elevated levels, pointing to a robust recovery. **July 1 marks the start of the unwinding of the UK government's Coronavirus Job Retention Scheme**, or furlough scheme. At the peak of the crisis, in spring 2020, up to 30% of the workforce was on furlough. This has now dropped to 7%, or two million employees, according to the Office for National Statistics. **How fast these workers are absorbed back into the economy will be key to gauge the overall health of the labour market**, a key determinant of the Bank of England's monetary policy.

ASIA PACIFIC

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

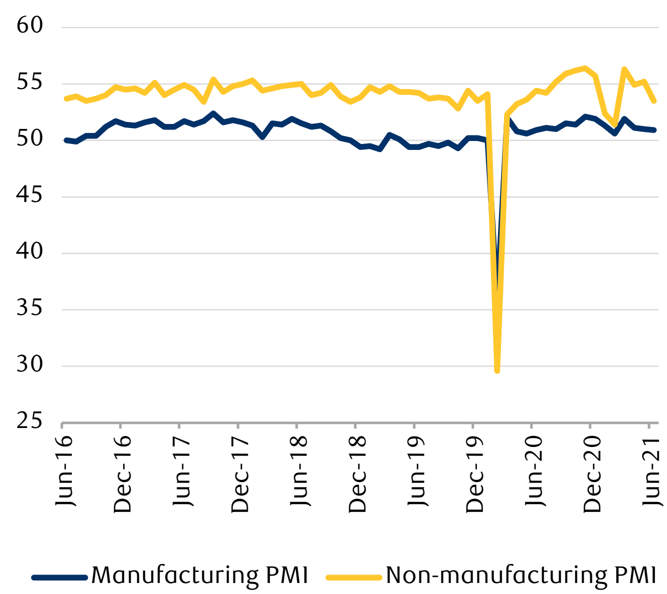
- **Asia-Pacific equity markets traded mostly lower during the last few trading days of H1 2021**, with Hong Kong lagging most of the region. The Hang Seng Index was down for three consecutive days and posted its first monthly decline since March of this year. **Sentiment weakened this week** following the release of China's June Purchasing Managers' Index (PMI) data with both manufacturing and non-manufacturing indicators slipping from the prior month but remaining in expansionary territory. Notwithstanding the near-term weakness, we maintain our positive view on the Hong Kong equity market on the back of undemanding valuations, new local COVID-19 cases getting under control, and headwinds in the technology sector increasingly getting priced in.

- **Japan's tax revenue is expected to reach an all-time high in FY2020 (which ended in March) and likely exceeded 60 trillion yen**, according to a Reuters report. The revenue increase is due largely to the boost to corporate profits from solid U.S. and Chinese economic recoveries. Against this backdrop, we believe the relatively weaker economic growth in Japan and a looming general election later this year will keep the government under pressure to roll out even more stimulus in the months ahead.

- **In the Monetary Authority of Singapore (MAS) annual report, the central bank highlighted that a firmer global recovery is likely in H2 2021** with the U.S. and China witnessing strong rebounds, and barring any external macro setback, Singapore's GDP growth could exceed the 4%–6% forecast range. The MAS noted that **the property market has been "remarkably resilient" in the face of the pandemic**, and while the market is not overheated at this juncture, the MAS remains "highly vigilant" to the risk of a sustained increase in housing prices relative to income trends and is ready to act if needed. In the banking sector, which we hold a positive view on due to its being a beneficiary of the economic recovery and the prospect of higher short-term interest rates, the **MAS is conducting additional stress tests** to assess whether it is necessary to extend the current dividend restrictions.

China manufacturing slows

China official Purchasing Managers' Index



Source - RBC Wealth Management, Bloomberg; monthly data through 6/30/21

MARKET Scorecard

Data as of July 1, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,319.94	0.5%	15.0%	38.6%	45.7%
Dow Industrials (DJIA)	34,633.53	0.4%	13.2%	34.6%	29.6%
Nasdaq	14,522.38	0.1%	12.7%	43.0%	79.5%
Russell 2000	2,329.35	0.8%	18.0%	63.2%	48.4%
S&P/TSX Comp	20,165.58	0.0%	15.7%	30.0%	23.1%
FTSE All-Share	4,062.45	1.2%	10.6%	19.2%	-0.8%
STOXX Europe 600	455.63	0.6%	14.2%	26.1%	17.5%
EURO STOXX 50	4,078.89	0.4%	14.8%	26.3%	16.6%
Hang Seng	28,827.95	0.0%	5.9%	18.0%	1.0%
Shanghai Comp	3,588.78	-0.1%	3.3%	18.6%	17.9%
Nikkei 225	28,707.04	-0.3%	4.6%	29.8%	32.1%
India Sensex	52,318.60	-0.3%	9.6%	47.7%	31.8%
Singapore Straits Times	3,124.19	-0.2%	9.9%	19.7%	-7.4%
Brazil Ibovespa	125,666.20	-0.9%	5.6%	30.6%	24.0%
Mexican Bolsa IPC	50,376.89	0.2%	14.3%	33.9%	16.0%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.463%	-0.5	55.0	78.7	-56.1
Canada 10-Yr	1.389%	0.0	71.2	86.1	-7.7
UK 10-Yr	0.730%	1.4	53.3	51.9	-8.4
Germany 10-Yr	-0.201%	0.6	36.8	19.4	15.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.50%	0.0%	-1.6%	-0.3%	18.0%
U.S. Investment-Grade Corp	2.04%	0.0%	-1.3%	3.1%	25.4%
U.S. High-Yield Corp	3.75%	0.0%	3.6%	15.1%	21.7%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,776.93	0.4%	-6.4%	0.4%	28.4%
Silver (spot $/oz)	26.04	-0.3%	-1.4%	44.5%	71.9%
Copper ($/metric ton)	9,351.50	0.0%	20.7%	54.6%	57.5%
Oil (WTI spot/bbl)	75.23	2.4%	55.0%	88.9%	27.3%
Oil (Brent spot/bbl)	75.52	0.5%	45.8%	79.7%	16.1%
Natural Gas ($/mmBtu)	3.67	0.4%	44.3%	119.3%	61.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	92.5610	0.1%	2.9%	-4.8%	-4.4%
CAD/USD	0.8039	-0.3%	2.4%	9.2%	5.6%
USD/CAD	1.2440	0.3%	-2.2%	-8.4%	-5.3%
EUR/USD	1.1848	-0.1%	-3.0%	5.3%	5.0%
GBP/USD	1.3758	-0.5%	0.6%	10.3%	8.8%
AUD/USD	0.7468	-0.4%	-2.9%	8.0%	7.2%
USD/JPY	111.5600	0.4%	8.0%	3.8%	2.9%
EUR/JPY	132.1800	0.3%	4.8%	9.3%	8.0%
EUR/GBP	0.8612	0.5%	-3.6%	-4.5%	-3.5%
EUR/CHF	1.0967	0.0%	1.4%	3.1%	-1.6%
USD/SGD	1.3489	0.3%	2.0%	-3.2%	-0.5%
USD/CNY	6.4691	0.2%	-0.9%	-6.8%	-5.6%
USD/MXN	20.0065	0.4%	0.5%	-11.9%	4.6%
USD/BRL	5.0501	1.6%	-2.9%	33.7%	31.5%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.80 means 1 Canadian dollar will buy 0.80 U.S. dollar. CAD/USD 2.4% return means the Canadian dollar rose 2.4% vs. the U.S. dollar year to date. USD/JPY 111.56 means 1 U.S. dollar will buy 111.56 yen. USD/JPY 8.0% return means the U.S. dollar rose 8.0% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 7/1/21

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Hold [Sector Perform]	575	40.69	173	30.09
Sell [Underperform]	51	3.61	4	7.84

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