GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee August 5, 2021

The great motivator

Kelly Bogdanova – San Francisco

Challenges are coming at the stock market from different directions, but still the rally continues. This behavior isn't that counterintuitive once we consider the one factor that sets the tone for equity performance—corporate profits. We look at the environment for equities and why we remain constructive.

The U.S. equity market has continued to drift higher despite a wall of worry: delta variant headwinds, the recent plunge in Treasury yields, ongoing inflation and supply chain challenges, and uncertainties about the economic recovery.

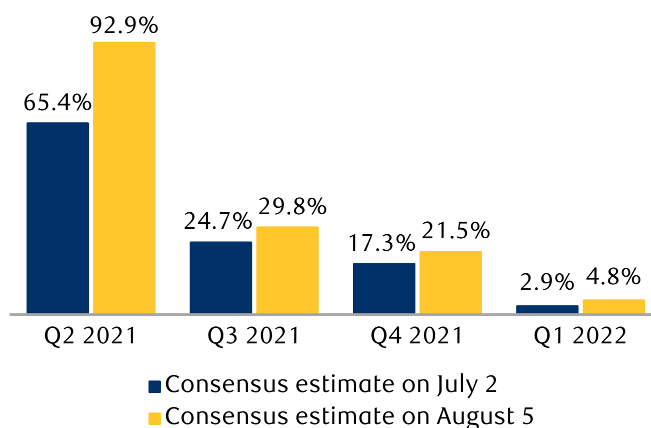
Is the market being complacent? No, not if you consider the great motivator: profits.

Investors seem more focused on what truly makes the market tick over the long run—corporate profit growth. The unusually strong Q2 earnings season and constructive outlooks from management teams have helped the S&P 500 inch up to a new all-time high. With 85 percent of S&P 500 companies having reported results so far, Q2 earnings growth is at an impressive 93 percent year-over-year.

Granted, much of this is due to "easy" COVID-19 comparisons. During the pandemic's first wave when the economy was mostly shuttered, S&P 500 profits fell sharply by 31 percent in Q2 2020, the period the current earnings season is measured against. And with the economy now largely open and many households with extra cash to spend from stimulus checks, corporate profits have bounced back significantly from that ultralow level.

Earnings growth estimates have risen for Q2 2021 and the three subsequent quarters

Consensus estimates of S&P 500 quarterly earnings growth (all data is year-over-year %)



Source - RBC Wealth Management, Refinitiv I/B/E/S; data through 8/5/21 with 85% of companies having reported Q2 earnings so far

But this is not the full story. A meaningful portion of the Q2 boost is because the release of pent-up demand for goods and services has been more robust than many Wall Street analysts and corporate executives initially

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

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Priced (in USD) as of 8/5/21 market close, ET (unless otherwise stated). Produced: Aug. 5, 2021 5:22 pm ET; Disseminated: Aug. 5, 2021 5:33 pm ET
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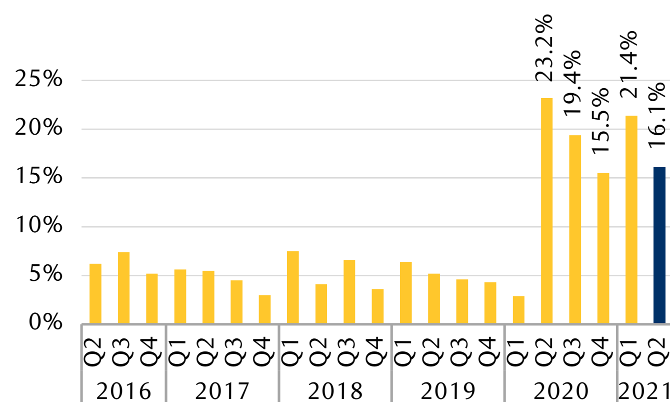
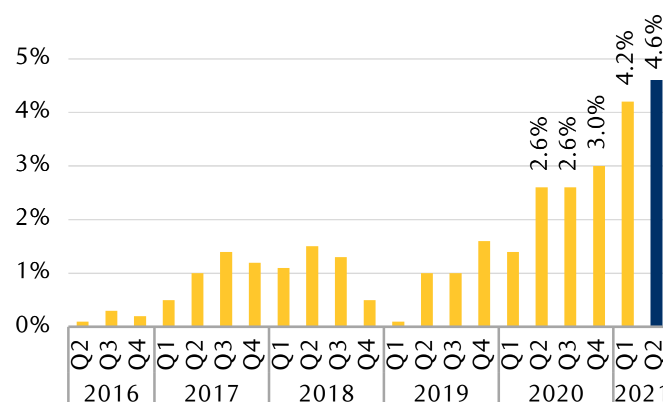
Earnings surprises strong, but below the recent peak

Magnitude of historical and current EPS surprises



Revenue surprises have hit a multiyear high

Magnitude of historical and current revenue surprises



Source - National research correspondent, Refinitiv I/B/E/S, FactSet; Q2 2021 data (in blue) is preliminary as of 8/4/21 and is subject to change as more companies report earnings

projected. Heading into this reporting season, the Q2 consensus forecast was for lofty 65 percent year-over-year earnings growth. The current 93 percent rate is far higher than even the highest estimates were at the time.

Furthermore, the proportion of companies beating Q2 consensus earnings and revenue estimates is at its highest level going back to at least 2004. Also, the magnitude of earnings beats is elevated, and the magnitude of revenue beats is at a cycle high, as the charts illustrate.

All of this has led to Q2 2021 earnings being 24 percent higher than the pre-COVID-19 level in Q2 2019—an impressive feat that was unthinkable at this time last year.

"Peak growth" isn't the be-all and end-all

Even though we are confident that this torrid pace will be as good as it gets for this business cycle, we expect S&P 500 profits to rise further in 2022, albeit at a more normal rate. In other words, Q2 2021 earnings should represent the peak year-over-year earnings growth rate but not the peak level of earnings for this expansion cycle.

This is an important distinction because bear market periods typically occur alongside a persistent, meaningful decline in the level of earnings as recession risks become palpable. At this stage, all six of our recession indicators are flashing green, so these risks are nearly nonexistent and are unlikely to change much over the near term, in our view—barring another outside shock to the system.

But we think the range of potential 2022 earnings outcomes is wide. During this extremely unusual period, it seems many economists and a lot of management teams are having just as much difficulty forecasting the magnitude of the recovery as they did during the initial COVID-19 downturn.

This is due to lingering COVID-19-related challenges and the uncertainties about the strength and quarter-by-quarter shape of economic growth, which could be less than or greater than current forecasts. The Q2 earnings season provides further evidence that high inflation levels, tight labor supply and wage pressures, and supply chain disruptions are generally manageable. But they are posing challenges for some companies, and it is unclear how long these headwinds will persist.

The consensus S&P 500 earnings forecast for 2022 has moved up to $219 from $214 per share in the past month, according to Refinitiv I/B/E/S. This would represent 9.3 percent year-over-year growth. We would take this estimate with a grain of salt given the unique forecasting challenges, and because most corporate management teams have not yet provided their 2022 estimates and Wall Street analysts have not yet sharpened their earnings models for next year.

The ability to cope

We remain constructive on U.S. equities because the headwinds seem manageable in light of our recession indicators, and the market's great motivator—profit growth—is sending the right signals.

But a market pause or pullback would be normal. RBC Capital Markets, LLC's Head of U.S. Equity Strategy Lori Calvasina points out that periods of peak earnings growth are often accompanied 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 one percent to 7.6 percent in the six months following the peak rate of earnings growth.

The effect was temporary, as the S&P 500 eventually resumed its upward trajectory in each of the three instances, climbing a total of 26 percent to 50 percent during the 36-month period following the peak in earnings growth. The market continued to rally 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.

UNITED STATES

Ben Graham, CFA – Minneapolis

- **U.S. equities have climbed their way higher this week, and in the cases of the S&P 500 and Nasdaq, to new all-time highs**. With growth leading the way, the S&P 500 has gained 0.8% while the Nasdaq has climbed 1.5%. The value-oriented Dow Jones Industrial Average and Russell 2000 Index have each climbed 0.4% thus far this week as the S&P 500 Growth Index outpaces the S&P 500 Value Index by a tally of 0.7% to -0.5%. One of the currents under the surface driving this performance is the ongoing flattening of the yield curve and the fall of the 10-year U.S. Treasury rate. The 10-year rate has dipped below 1.20% during several trading periods this week, increasing the scrutiny around consensus inflation expectations as well as acting as a tailwind for growth stocks relative to value thus far this week.

- With earnings season past its quarterly crescendo, investors are starting to have a better idea where the relative winners and losers fall in relation to the very high bar they began earnings season with. **The sectors with the most positive aggregated bottom line results include Consumer Discretionary, Financials, and Communication Services**. These sectors are all seeing quarterly results at least 20% higher than original consensus expectations. Meanwhile, **Utilities, Materials, and Health Care are experiencing the smallest surprise factors**, albeit all of them are indeed beating consensus expectations. For this group, none of them can show a quarterly result that beats original consensus expectations by more than 8%.

- **Economic data this week continued to indicate an ongoing expansion**, despite a few releases that slightly missed consensus expectations. The Institute for Supply Management (ISM) Manufacturing Purchasing Managers' Index (PMI) result for July showed a robust expansionary reading of 59.5. However, it was still lower than consensus estimates looking for 60.8. Weekly initial jobless claims filings followed this trend as well after last week's tally of 385,000 managed to move the four-week average lower despite coming in above consensus estimates at 380,000. Finally, the services activity index, the ISM Non-Manufacturing PMI, bucked this trend with its reading of 64.1 coming in well ahead of consensus expectations at 60.4. Bottom line—this indicates to us that **the recovery remains on track with incremental strength coming from the services side of the economy**.

Rates move steadily lower after early Q2 peak

U.S. 10-year Treasury rate, 2021 YTD

Source - RBC Wealth Management, St. Louis FRED; data through 8/4/21

CANADA

Richard Tan, CFA & Arete Zafiriou – Toronto

- **Tight demand and supply dynamics continue to support the rich valuations of the Canadian housing market**. Prices remain elevated across core geographies and housing type, but we note that RBC Capital Markets sees detached home demand potentially softening up whereas condo demand is showing early signs of acceleration. Overall, RBC Capital Markets believes **housing prices will likely remain elevated** due to factors such as strong consumer demand, weaker inventories, and accommodative credit conditions, which in turn should benefit the mortgage industry. RBC Capital Markets believes **the industry outlook is favourable** driven by improving loan growth, the potential for capital restrictions to be lifted, and the prospect for further expansion of valuation multiples as earnings visibility increases. Residential mortgage growth in particular increased 8.4% y/y in May 2021 and is running above the 10- and 20-year averages. Lastly, while housing affordability has deteriorated, RBC Capital Markets highlights that delinquency rates are near historical lows.

- Statistics Canada reported that **real GDP declined 0.3% in May** after falling 0.5% in April. Accommodation and food services fell 2.4% and retail trade dropped 2.7% as pandemic-related restrictions contributed to lower activity. The real estate and rental and leasing sector also contracted as housing market activity moderated from recent highs. With the recent easing of public health measures in multiple provinces, Canadian economic output most likely rebounded in June, as Statistics Canada's preliminary estimates are indicating a 0.7% rise in real GDP over the month, supported by a recovery in the hospitality segments. This estimate puts **GDP on track for a 2.5% annualized gain in Q2**, short of RBC Economics' forecast of 3.5%. However, **RBC Economics expects output to accelerate in the second half of the year** as industries in the services sector continue their upward trajectory.

EUROPE

Frédérique Carrier & Thomas McGarrity, CFA – London

- The current European recovery is showing itself stronger than previous ones. **The euro area economy grew 2% q/q in Q2**, considerably beyond the 1.5% consensus expectation, and this leaves euro area GDP a mere 3% below pre-pandemic levels.

- Survey data suggest this momentum will likely continue into August. **The July IHS Markit Eurozone Composite Purchasing Managers' Index (PMI) remained above the 50 mark, which suggests expansion, for a fifth successive month**. Manufacturing cooled a little after a very strong expansion in Q2 as suppliers struggled to raise production fast enough to meet demand. The July survey showed new orders outstripped production to an extent unseen in the survey's 24 years of data collection. Eurozone unemployment fell to 7.7% in June, from 8% in May.

- The delta variant is causing some delays in the easing of restrictions as well as supply chain problems, and we see these as the two most significant risks to the outlook. However, **we think the rebound will maintain its brisk pace in Q3** as both domestic and foreign demand remain strong.

- **Eurozone CPI inflation increased to 2.2% in July** from 1.9% in June. The uptick was attributable to base effects related to last year's German sales tax cuts. With the European Central Bank (ECB) having signalled its willingness to look past temporary factors, inflation above its 2% target is **unlikely to carry implications for the ECB's monetary stance**.

- The trend of UK-listed midcap companies being acquired by trade buyers or private equity companies continued, with **U.S.-listed diversified industrial group Parker-Hannifin announcing an agreed bid to purchase Meggitt, the UK-listed aerospace and defence firm, for £7.1 billion**. Meggitt's shares are up 55% since the announcement on Monday, Aug. 2, but remain 10% below the 800p per-share offer, reflecting the political hurdles to completing the deal. With UK equities continuing to trade at a marked valuation discount to other developed market regions, and the cost of debt financing low, we expect inbound acquisitions of UK-listed corporates to remain a theme in the second half of the year.

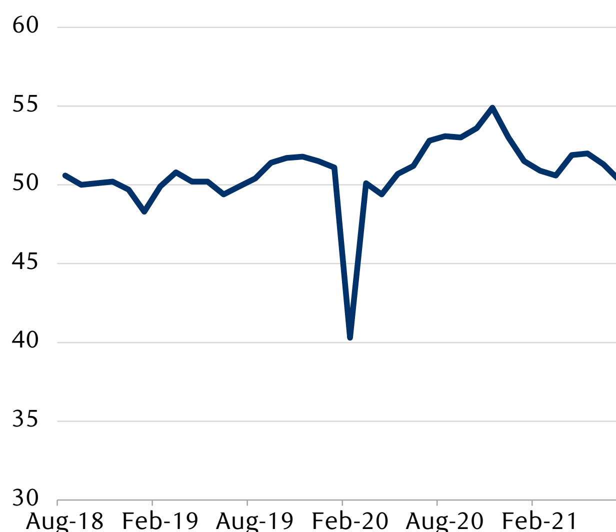
ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Daily new COVID-19 cases are on the rise again in China**. State media Xinhua News Agency reported that authorities have urged people to limit travel and avoid gatherings, and suspended some flights, trains, and long-distance bus services. We expect such firm and decisive **actions to control the spread are likely to weigh on near-term economic growth prospects for China**. Recent

Normalization of China economic growth

Caixin/Markit Manufacturing PMI



Source - RBC Wealth Management, Bloomberg; monthly data through July 2021

macro data continue to suggest normalization following the sharp rebound in 2020—the July Caixin/Markit Manufacturing Purchasing Managers' Index came in at 50.3, down from 51.3 the month before, the lowest level since April 2020 and below a Reuters' poll of analysts that expected 51.1.

- **Shares of major Chinese online game developers/distributors fell sharply this week after the state-run Economic Information Daily published a critical article on online gaming** featuring an on-the-ground survey about young people's excessive game habits and called for more regulation on the sector. The article was subsequently removed by the Economic Information Daily and republished with some of its harsher words and tone removed. Since 2018, the government has introduced various measures on the online game industry to promote responsible development (tighten monetization and protect minors). We expect **new measures (if any) to have limited operational impact** on the developers/distributors, but the **regulatory overhang will continue to drag on sentiment**.

- **Afterpay (APT AU), a leader in the "buy now, pay later" space, has agreed to an all-stock offer from Square (SQ US)** worth US$29 billion, making it the largest acquisition deal in Australia's history. Afterpay has been the bellwether of the niche online payments sector, which burst into the mainstream last year as more people chose to pay in installments for everyday items during the pandemic. The deal will create an online payments giant and help accelerate Afterpay's growth in the key U.S. market as well as globally. Afterpay's board has unanimously recommended the deal to its shareholders, the companies said in a joint statement.

MARKET
Scorecard

Data as of August 5, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,429.10	0.8%	17.9%	33.1%	55.7%
Dow Industrials (DJIA)	35,064.25	0.4%	14.6%	28.9%	36.3%
Nasdaq	14,895.12	1.5%	15.6%	35.4%	92.8%
Russell 2000	2,236.01	0.4%	13.2%	44.6%	50.3%
S&P/TSX Comp	20,375.48	0.4%	16.9%	23.5%	25.2%
FTSE All-Share	4,089.91	1.5%	11.3%	20.3%	3.7%
STOXX Europe 600	469.96	1.8%	17.8%	28.7%	27.2%
EURO STOXX 50	4,161.08	1.8%	17.1%	27.3%	25.7%
Hang Seng	26,204.69	0.9%	-3.8%	4.4%	0.2%
Shanghai Comp	3,466.55	2.0%	-0.2%	2.6%	22.9%
Nikkei 225	27,728.12	1.6%	1.0%	23.2%	33.8%
India Sensex	54,492.84	3.6%	14.1%	44.7%	48.5%
Singapore Straits Times	3,175.10	0.3%	11.6%	25.4%	-0.6%
Brazil Ibovespa	121,632.90	-0.1%	2.2%	18.3%	21.5%
Mexican Bolsa IPC	51,134.93	0.5%	16.0%	34.9%	29.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.222%	0.0	30.9	67.4	-48.6
Canada 10-Yr	1.169%	-3.4	49.2	66.7	-20.5
UK 10-Yr	0.524%	-4.1	32.7	39.4	1.2
Germany 10-Yr	-0.498%	-3.7	7.1	0.8	1.8
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.35%	0.2%	-0.3%	-0.5%	19.6%
U.S. Investment-Grade Corp	1.91%	0.3%	0.4%	1.4%	27.5%
U.S. High-Yield Corp	4.02%	-0.2%	3.8%	9.9%	21.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,804.30	-0.5%	-5.0%	-11.5%	23.3%
Silver (spot $/oz)	25.16	-1.3%	-4.7%	-6.7%	53.4%
Copper ($/metric ton)	9,443.75	-2.7%	21.9%	45.3%	66.8%
Oil (WTI spot/bbl)	69.09	-6.6%	42.4%	63.8%	26.3%
Oil (Brent spot/bbl)	71.30	-6.6%	37.6%	57.8%	19.2%
Natural Gas ($/mmBtu)	4.16	6.4%	64.0%	90.0%	101.1%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	92.2700	0.1%	2.6%	-0.6%	-5.4%
CAD/USD	0.8000	-0.2%	1.9%	6.1%	5.7%
USD/CAD	1.2500	0.2%	-1.8%	-5.8%	-5.3%
EUR/USD	1.1832	-0.3%	-3.1%	-0.3%	5.6%
GBP/USD	1.3927	0.2%	1.9%	6.2%	14.7%
AUD/USD	0.7401	0.8%	-3.8%	2.9%	9.5%
USD/JPY	109.7800	0.1%	6.3%	4.0%	3.6%
EUR/JPY	129.9000	-0.3%	2.9%	3.7%	9.4%
EUR/GBP	0.8496	-0.5%	-4.9%	-6.1%	-7.9%
EUR/CHF	1.0727	-0.2%	-0.8%	-0.5%	-1.6%
USD/SGD	1.3510	-0.3%	2.2%	-1.4%	-2.4%
USD/CNY	6.4615	0.0%	-1.0%	-6.9%	-8.4%
USD/MXN	19.9283	0.3%	0.1%	-10.9%	1.6%
USD/BRL	5.2340	0.4%	0.7%	38.5%	31.6%

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 1.9% return means the Canadian dollar rose 1.9% vs. the U.S. dollar year to date. USD/JPY 109.78 means 1 U.S. dollar will buy 109.78 yen. USD/JPY 6.3% return means the U.S. dollar rose 6.3% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 8/5/21

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As of June 30, 2021

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Rating	Count	Percent	Count	Percent
Buy [Outperform]	787	55.70	318	40.41
Hold [Sector Perform]	575	40.69	173	30.09
Sell [Underperform]	51	3.61	4	7.84

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