GLOBAL
Insight
WEEKLY

Perspectives from the Global Portfolio Advisory Committee

February 3, 2022

Valuation compression in all the right places

Kelly Bogdanova – San Francisco

One silver lining to the rough January is that the air has come out of the U.S. market's most expensive stocks. While we'll no doubt face some more bumps in the road this year, a less acute valuation problem is a healthy development and supports our constructive outlook for equities.

The S&P 500 is attempting to find its footing following a 12 percent pullback on an intraday basis in January.

Market participants seem like they are beginning to accept a more accelerated Fed rate hike cycle and the uncertainties that go along with it.

Importantly, the overall positive trends during the ongoing Q4 2021 corporate earnings season hint that 2022 consensus earnings estimates are not at much risk of retreating—at least during this reporting period.

Since the market's lowest intraday level on Jan. 24, performance has clawed back, and the S&P 500 is now down "only" 6.1 percent year to date.

As we examine underneath the surface of the pullback, with a particular focus on which stocks have been the worst performers (growth stocks in the Consumer Discretionary sector and technology-related industries) and which stocks have held up the best (value stocks, especially Energy, followed by Financials, Consumer Staples, and Utilities), we notice a positive development. The market's most acute valuation problem has become less troublesome. In other words, the reduction in the market's valuation has primarily come from the right places—the most expensive stocks. We view this as healthy.

The market's valuation drifted down in 2021 and dipped further during the recent pullback

S&P 500 price-to-earnings ratio based on 12-month forward consensus earnings estimates

Source - RBC Wealth Management, Bloomberg estimates; data through 2/3/22

Releasing some pressure

The S&P 500's overall valuation has been lofty since soon after the index began to recover from the COVID-19 low in the spring of 2020. But the price-to-earnings (P/E) ratio actually drifted a bit lower in 2021 as consensus

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

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earnings growth estimates and actual earnings growth far outstripped the price return of the index. The valuation dipped further during the January 2022 pullback, as the chart on page 1 illustrates.

The market is still rather pricey at 19.8x the consensus earnings estimate for the next 12 months. This is well above the 16.2x long-term average since 1990 and is higher than the 18.6x average that has prevailed during the ultralow interest rate period of the past five years. (This is one of the reasons we think investors should double-check equity allocations in portfolios to ensure there is adequate representation of less expensive markets outside of the U.S.)

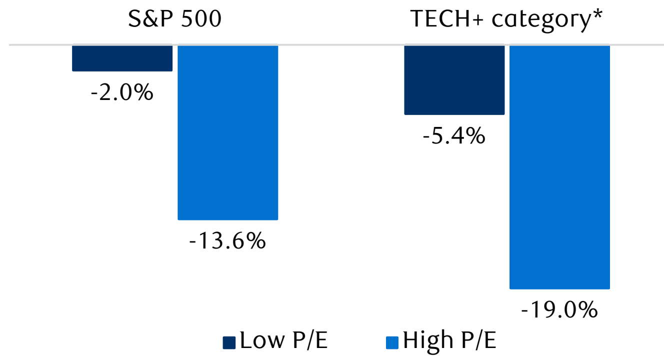
When it comes to the U.S. market, however, not all parts of it are equally expensive—some stocks are much richer than others. The biggest source of the valuation problem lies within the large-capitalization segment represented by the S&P 500 and Russell 1000. Roughly 20 percent of the stocks in these indexes have very rich valuations, with most residing in the growth category.

The good news is that the highest valuation stocks retreated the most—by far—during the recent pullback. In the S&P 500, low P/E stocks pulled back only two percent while high P/E stocks corrected by 13.6 percent in January. Even among technology stocks, there was a wide performance gap. In the "TECH+" category—technology-related stocks in the Information Technology sector and other sectors—low P/E stocks pulled back 5.4 percent, while high P/E stocks corrected by 19 percent, as the top chart shows.

Furthermore, RBC Capital Markets, LLC's Head of U.S. Equity Strategy Lori Calvasina points out that the valuation of the Russell 1000's most expensive stocks compared to the least expensive stocks pulled back notably during the recent correction, and is now near the pre-pandemic level—another positive sign.

The selloff was most pronounced in high P/E stocks

Price return in January 2022 of low and high valuation stocks based on price-to-earnings ratios (P/E)



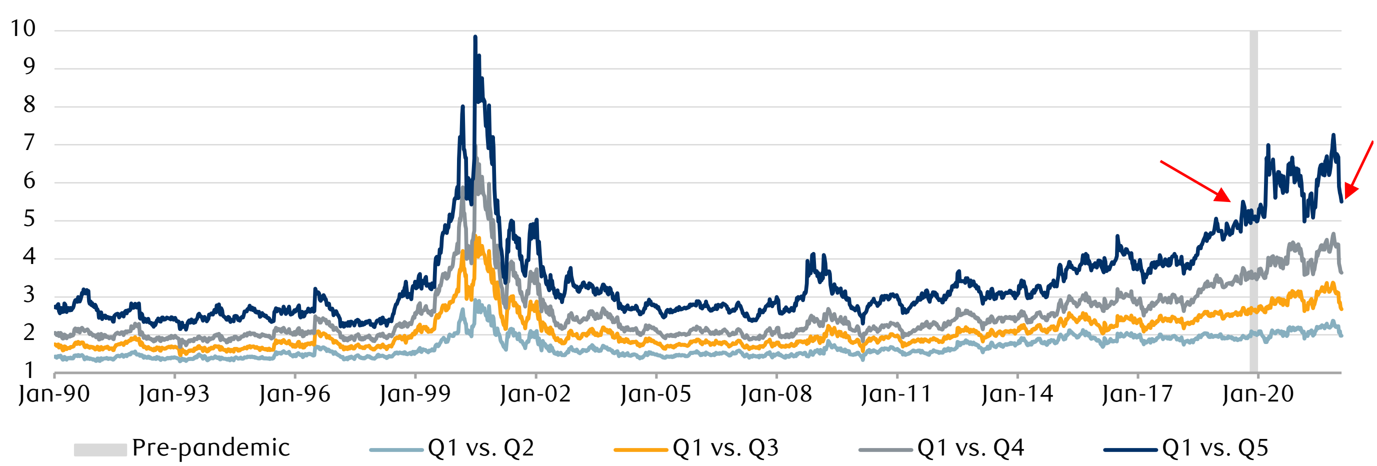
*TECH+ category represents technology-related stocks in the Information Technology and other sectors of the S&P 500
Source - National research correspondent, Refinitiv, FactSet

We doubt the highest P/E stocks are fully out of the woods. There could be more valuation compression as the market continues to work through lingering uncertainties about Fed policy, inflation, and economic and earnings growth.

While valuation isn't the most important factor when determining equity positioning in portfolios—the market's P/E ratio can stay lofty or cheap for long periods of time, longer than one might think is rational—the fact that air has come out of the U.S. market's most expensive stocks is a healthy development. We think it's supportive of our overall recommendation to hold a moderately Overweight equity position in portfolios. There are still likely to be bumps in the road this year, but we expect equity markets to ultimately regain their composure, opening the way to fresh new highs in the major indexes.

The valuation of the most expensive stocks compared to the least expensive stocks pulled back notably in January 2022 (top line), and is now near the pre-pandemic level

U.S. large-cap median P/E quintile comparison. Quintile 1 (the most expensive category) vs. the lower Quintiles 2-5 (Quintile 5 is the least expensive category)*



*Data based on 2023 consensus earnings per share forecasts (excluding negative EPS)
Source - RBC U.S. Equity Strategy, S&P Capital IQ/ClariFi, CIQ Estimates; Bloomberg, Large Cap Universe is the Russell 1000 Index, Quintiles are ranked based on FY2 P/E ex Neg EPS, Median FY2 P/E is used to represent every quintile; data as of late January 2022

UNITED STATES

Tyler Frawley, CFA – Minneapolis

- U.S. equities are on track for weekly gains as quarterly earnings continue to exceed consensus expectations. **All of the major indexes are higher**, with the Dow Jones Industrial Average leading the way with a return of 1.11%. The S&P 500 has outperformed the Nasdaq Composite, but each index is higher, having risen 1.03% and 0.79%, respectively. Sector leadership is evident in Energy (up 3.31%) and Financials (up 1.83%). Communication Services has been the poorest-performing sector, falling 0.39%.

- **Earnings season has continued to surprise to the upside** thus far with over 52% of the S&P 500 having already reported. Of the companies that have already announced, over 70% reported sales that exceeded consensus expectations, beating by an average of 3.5%. From an earnings perspective, **nearly 77% have beaten expectations by an average of 5.4%**. Financial and Technology companies have seen the strongest results, beating earnings expectations by 10.2% and 8.4%, respectively. Industrial companies have struggled so far, with earnings coming in 9.9% below expectations. As earnings reports continue to roll in over the next couple of weeks, the sectors to keep an eye on would be Utilities and Real Estate as only 14% and 35%, respectively, of companies have reported.

- **Economic activity has been mixed this week**. The ADP Employment Change numbers showed a significant and unexpected drop, with **private payrolls falling** by 301,000 for January versus Bloomberg's estimated gain of 180,000. This was the first reported net job loss since December 2020 and came as surging omicron cases hit hiring. On the positive side, the Institute for Supply Management Manufacturing and Services Purchasing Managers' Indexes registered 57.6 and 59.9, respectively, both beating consensus expectations and indicating a **continued and robust expansion of the manufacturing and services segments of the economy** compared to last month.

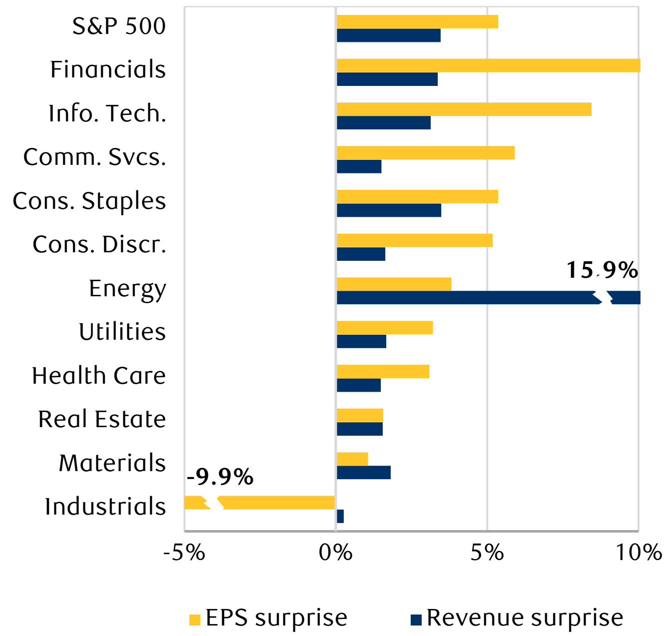
CANADA

Luis Castillo & Simon Jones – Toronto

- **Canada's GDP grew 0.6% m/m in November, according to Statistics Canada, exceeding the consensus forecast of 0.4%.** The economy was firing on almost all cylinders in November with 17 of 20 industries expanding relative to the prior month. Service-producing sectors continued to benefit from the economic reopening, boosted by a rebound in restaurant activity and increased attendance at major league sporting events. **However, Statistics Canada's preliminary data indicate GDP was "essentially unchanged" in December, and RBC Economics expects economic data could take a step back in January** due to regional governments enacting public health restrictions in response to omicron. Despite a slowdown in December, Q4 GDP growth continues to track RBC Economics' forecast of 6.0% (annualized) and is on pace to exceed the 5.8% estimate in the Bank of Canada's January Monetary Policy Report. With regions already beginning to ease containment measures, we believe the economic drag from omicron will likely be short-lived; thus, **November's stronger-than-expected GDP report further reinforces the central bank's decision to begin raising rates in the coming months.**

- **The Canadian yield curve has become noticeably flatter since reaching its steepest level since 2015 in early 2021.** As a reminder, the yield curve is a graphical representation of yield levels on sovereign debt at different maturity lengths. The curve is typically upward-sloping, with yields on longer-maturity bonds higher than those on shorter maturities, but its steepness can vary depending on where we are in the economic cycle; it can even invert, with longer maturities below shorter maturities. Throughout H2 2021, the yield curve has become less steep, a trend driven less by a drop in long-term yields than by an aggressive rise in the short end as bond markets anticipate that elevated inflation will force the Bank of Canada to hike policy rates more aggressively than previously expected. At current levels, **only about 50 basis points separate the yields on the 2-year and 10-year Government of Canada bonds.**

S&P 500 earnings report card: EPS & revenue surprises



Source - RBC Wealth Management, Bloomberg; data through morning earnings releases on 2/3/22

EUROPE

Rufaro Chiriseri, CFA & Frédérique Carrier – London

- **The Bank of England (BoE) made a historic decision and delivered the first back-to-back interest rate increases since 2004**. The BoE raised interest rates by 0.25%, as expected by the market, while the central bank will cease bond reinvestments and plans to fully unwind its stock of corporate bonds. With four of the nine voters on the BoE's Monetary Policy Committee voting for a 0.50% rate hike at Thursday's meeting, this highlights an appetite for further hikes this year in the face of BoE forecasts of inflation hitting 7.25% in April. BoE forecasts assume the Bank Rate reaching 1.5% in spring 2023; however, market-based expectations show a 1.5% Bank Rate in September 2022. This is excessive, in our view, and BoE Governor Andrew Bailey also stated that it's "a mistake to ... assume that rates are now on an inevitable long march upwards."

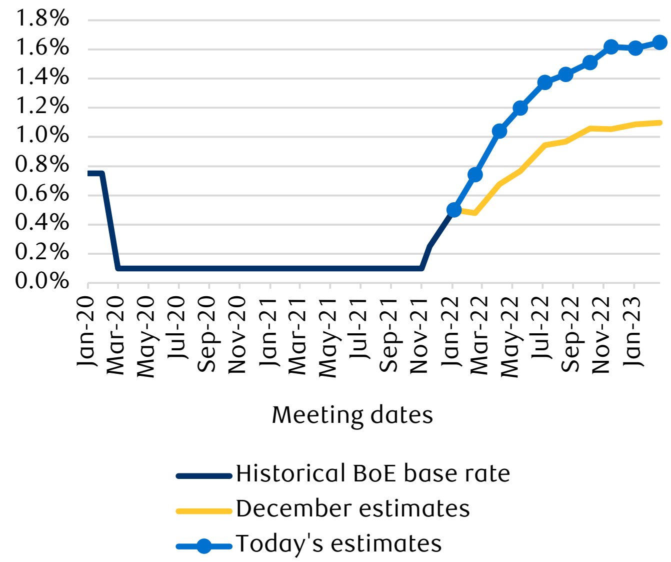
- **A surprise in euro area inflation this week is mainly attributable to energy price increases**, which accelerated to 28.6% y/y from 25.9% y/y in December. The 5.1% y/y inflation reading is significantly above the consensus forecast, which expected a deceleration to 4.4% y/y. It's no surprise that the European Central Bank's (ECB) press conference after its policy decision on Thursday focused on inflation, with ECB President Christine Lagarde's view on inflation as being "tilted to the upside" setting the tone for future interest rate hikes. All eyes are now on the March meeting when more data will be available for the ECB to digest before providing its forward guidance. Conversely, markets show little patience as expectations point to 0.40% in rate hikes by the end of 2022.

- **Italian President Sergio Mattarella was re-elected for a seven-year term**. This should ensure government continuity and enable Prime Minister Mario Draghi to focus on delivering the national reforms he envisaged. This stability also increases the likelihood of EU fiscal rules reforms, of which Draghi has been a proponent.

- **The Italian economy grew by 6.5% in 2021**—a robust performance, particularly in light of the COVID-19 restrictions which the country endured during much of that period.

The markets expect the BoE base rate to increase to around 1.5% by September 2022

Historical and market-implied future Bank Rate



Source - RBC Wealth Management, Bloomberg; data as of 7:55 am ET 2/3/22

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **The MSCI Asia Pacific Index fell 4.35% in January**, the largest monthly decline since July 2021. The drop was driven by concerns about tighter U.S. Federal Reserve policy, omicron variant outbreaks across Asia, tensions in Eastern Europe, and disappointing earnings calls from the heavyweights in developed markets. Several analysts noted that **risks are shifting for rate hikes to come sooner than expected in Asia**. The latter half of the month saw China and Hong Kong equities outperforming the region on further signs of policy easing. ASEAN equities also did relatively better, fueled by the recovery in growth indicators.

- **China's official manufacturing purchasing managers' index (PMI) registered 50.1 in January, down from 50.3 in December**. The official results contrasted with those from a private survey of mostly small manufacturers in coastal regions, which showed activity fell at the fastest rate in 23 months—the Caixin/Markit Manufacturing PMI fell to 49.1 in January, the lowest level since February 2020. Key factors weighing on the manufacturing sectors were a resurgence of new COVID-19 cases and the associated tough lockdowns, a weakening housing market, and Beijing forcing high-polluting plants to shutter during the Olympics to improve air quality. We believe the unexpectedly weak Caixin PMI reading is likely to reinforce market views that policymakers need to roll out more support measures to stabilize the economy.

- **Sony Group's (6758 JP) share price fell as much as 8.6% on Thursday** after management cut its fiscal-year PlayStation 5 (PS5) sales forecast by three million units (to 11.5 million) and announced weaker-than-expected earnings from its gaming division. The PS5 sales cut was due to supply bottlenecks, and Sony warned that the challenge will persist for the rest of 2022. The strong performance of its movie and image-sensor businesses helped offset some of the drag. We think investors are increasingly concerned about the long-term outlook for the gaming segment—tougher comparisons and the need to invest, with potentially more acquisitions, to maintain its lead.

MARKET
Scorecard

Data as of February 3, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,477.44	-0.8%	-6.1%	16.9%	37.8%
Dow Industrials (DJIA)	35,111.16	-0.1%	-3.4%	14.3%	23.6%
Nasdaq	13,878.82	-2.5%	-11.3%	2.0%	49.7%
Russell 2000	1,991.03	-1.8%	-11.3%	-7.8%	22.0%
S&P/TSX Comp	21,094.01	0.0%	-0.6%	17.7%	21.4%
FTSE All-Share	4,222.74	0.7%	0.3%	13.9%	3.6%
STOXX Europe 600	468.63	-0.1%	-3.9%	15.1%	13.8%
EURO STOXX 50	4,141.02	-0.8%	-3.7%	14.7%	13.1%
Hang Seng	23,802.26	0.0%	1.7%	-18.8%	-9.7%
Shanghai Comp	3,361.44	0.0%	-7.6%	-4.4%	22.4%
Nikkei 225	27,241.31	0.9%	-5.4%	-4.9%	18.6%
India Sensex	58,788.02	1.3%	0.9%	17.0%	47.4%
Singapore Straits Times	3,315.99	2.0%	6.2%	13.3%	6.4%
Brazil Ibovespa	111,695.90	-0.4%	6.6%	-6.7%	-2.6%
Mexican Bolsa IPC	51,145.11	-0.4%	-4.0%	16.4%	16.0%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.838%	6.1	32.8	70.0	31.1
Canada 10-Yr	1.802%	3.1	37.6	85.3	54.5
UK 10-Yr	1.368%	6.6	39.7	99.7	85.5
Germany 10-Yr	0.143%	13.2	32.0	60.7	58.5
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.11%	0.1%	-2.1%	-2.6%	1.7%
U.S. Investment-Grade Corp	2.76%	0.3%	-3.1%	-2.5%	2.9%
U.S. High-Yield Corp	5.06%	0.7%	-2.1%	2.3%	10.3%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,804.94	0.4%	-1.3%	-1.6%	14.5%
Silver (spot $/oz)	22.42	-0.2%	-3.8%	-16.6%	26.8%
Copper ($/metric ton)	9,877.75	3.1%	1.4%	25.8%	79.5%
Oil (WTI spot/bbl)	90.27	2.4%	17.2%	62.1%	80.1%
Oil (Brent spot/bbl)	91.25	0.0%	17.3%	56.1%	67.6%
Natural Gas ($/mmBtu)	4.93	1.1%	32.1%	76.7%	170.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	95.3550	-1.2%	-0.3%	4.6%	-2.5%
CAD/USD	0.7889	0.3%	-0.3%	0.9%	4.8%
USD/CAD	1.2677	-0.2%	0.3%	-0.9%	-4.6%
EUR/USD	1.1439	1.8%	0.6%	-5.0%	3.4%
GBP/USD	1.3601	1.1%	0.5%	-0.3%	4.7%
AUD/USD	0.7141	1.0%	-1.7%	-6.3%	6.7%
USD/JPY	114.9800	-0.1%	-0.1%	9.5%	5.8%
EUR/JPY	131.5300	1.7%	0.5%	4.1%	9.4%
EUR/GBP	0.8410	0.7%	0.0%	-4.6%	-1.2%
EUR/CHF	1.0527	1.1%	1.5%	-2.7%	-1.5%
USD/SGD	1.3438	-0.6%	-0.4%	0.8%	-1.8%
USD/CNY	6.3612	0.0%	0.1%	-1.6%	-9.4%
USD/MXN	20.5580	-0.4%	0.1%	1.8%	9.3%
USD/BRL	5.2874	-0.4%	-5.2%	-1.7%	24.5%

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 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD -0.08% return means the Canadian dollar fell 0.8% vs. the U.S. dollar year to date. USD/JPY 115.37 means 1 U.S. dollar will buy 115.37 yen. USD/JPY 0.3% return means the U.S. dollar rose 0.3% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 2/3/22

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As of December 31, 2021

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Rating	Count	Percent	Count	Percent
Buy [Outperform]	831	57.59	365	43.92
Hold [Sector Perform]	557	38.60	180	32.32
Sell [Underperform]	55	3.81	3	5.45

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