GLOBAL
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Perspectives from the Global Portfolio Advisory Committee February 25, 2021

Can equities tolerate higher bond yields?

Frédérique Carrier – London

The spike in yields of late has sent shivers through stock markets, which recently reached all-time highs and whose valuations are seen as stretched. But this rise in yields, if contained, isn't necessarily bad news for stocks. Rather, it suggests to us that the rotation into reflation-driven cyclical stocks may have legs.

The inflation influence

Global bond yields have been trending higher for some time, but the pace of their gains has accelerated recently with the U.S. 10-year Treasury powering through 1.5 percent, its highest level in a year, up from 0.5 percent last August. Meanwhile, the German 10-year Bund yield has moved from a March 2020 low of negative 0.85 percent up to negative 0.31 percent, while the UK 10-year Gilt, which touched a low of a mere 0.08 percent last July, has jumped to 0.76 percent of late.

In last week's issue, we laid out how yields are being driven higher by rising inflation expectations as the global economy heads towards further reopening. WTI crude oil is a case in point: currently at more than $63 per barrel, it compares to an average price last year of $39.

The reopening of economies seems increasingly imminent to us. Recent vaccine data from Israel, where the rollout is most advanced, suggests vaccination lowers the transmission rate of COVID-19, fueling additional optimism for a faster, wider easing of restrictions.

Inflation expectations are also on the rise in the U.S. due to concerns there may be more fiscal stimulus in the pipeline than the economy needs. RBC Global Asset Management, Inc. Chief Economist Eric Lascelles thinks another relief package perhaps on the order of $1.5 trillion will ultimately pass, coming on top of the $900 billion stimulus delivered last December. Together, these two would amount to some 10 percent of GDP in additional stimulus among signs of the resilience of the U.S. economy in the face of the COVID-19 shock. Case in point, the ISM Manufacturing Purchasing Managers' Index was at 58.7 in January, far above the average since 2000 of 52.7. More stimulus in the form of an infrastructure bill may also be possible this year, but would likely take time to filter through to the economy.

However, Fed Chair Jerome Powell suggested in his recent testimony to Congress that inflation fears may be overdone. He pointed out that the pace of improvement in the labour market has slowed, as has that for the overall economy, while prices remain rather soft in the sectors most affected by the pandemic. In other words, the U.S. economy will likely remain below potential for some time even as it reopens.

Powell's testimony, the Fed's commitment to allowing inflation to overshoot its target, and the high level of government indebtedness persuade us that the rise in yields will be contained. As we pointed out last week, sharp rises in Treasury yields are typically followed by range-bound trends. We expect the U.S. 10-year Treasury

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.

yield to settle between 1.5 percent and two percent on a one-to-two-year horizon.

Higher yields not necessarily a problem for equities

Investors have been concerned that higher bond yields may threaten equity valuations, which are now in excess of long-term averages. After all, a share price reflects the present value of future cash flows, and if the discount rate increases, the value of future cash flows decreases.

In practice, however, that is not always the case. In fact, since the March 2020 lows, equities have gained on the days when bond yields were up and retreated when bond yields fell. That is because the market interpreted higher bond yields as a sign of improving economic growth prospects. In fact, similar behaviour has played out since 2000 (see table).

S&P 500 rises when bond yields go up

	10-year Treasury yield	
	Up	Down
Average daily S&P 500 performance:		
Since March 23, 2020	**0.7%**	-0.2%
Since 2000	**0.4%**	-0.3%

Source - RBC Wealth Management, national research correspondent

As long as yields hover around two percent and are up due to expectations of higher growth and inflation, we would expect this relationship to hold. After all, equity markets were strong prior to the pandemic when yields were at two percent—though admittedly, valuation levels were not as stretched as they are now with the S&P 500 trading at 22.1x the consensus forward earnings estimate versus a 10-year average of 16.1x. But it would be unusual for price-to-earnings ratios to contract meaningfully in the midst of an earnings growth cycle when central banks are still supportive. Moreover, according to RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina, just over half of the companies in the S&P 500 today have a dividend yield in excess of the 10-year Treasury yield, suggesting the search for yield should continue to underpin stocks.

More concerning would be a sharper rise in yields, one much beyond that two percent level. Calvasina finds that stocks often struggle when yields climb more than some 275 basis points. For such a move to be replicated today, the 10-year yield would need to reach 3.25 percent.

Likewise, an increase in yields brought on by concerns about Fed tapering, i.e., a reduction in the Fed's bond-buying programme, could also upset the apple cart as it would highlight the risk of the economy being close to overheating. But tapering is not likely before next year, in our opinion.

Reflation trade

Overall, we think developed equity markets can cohabitate with higher bond yields. In Calvasina's view, volatility may increase and there could be more pressure on the shares of highly valued companies, particularly if such companies disappoint in some way (e.g., an earnings miss).

We believe the increase in yields will underpin the rotation into reflation-driven stocks, which started last November. In turn, defensive and secular growth stocks, which drove performance in 2020, may lag. As such, Tech stocks may become vulnerable to profit-taking (this would be in line with the sector leadership rotation observed around bond yield increases in previous cycles). In addition, the performance of the Health Care sector and certain areas of the Consumer Staples sector such as food producers may well be underwhelming going forward.

According to Calvasina, the Financials and Materials sectors show the greatest tendency to outperform when yields are rising, with their performance closely linked to shifts in inflation expectations. She notes that both sectors in the S&P 500 continue to look deeply undervalued.

With the rise in bond yields this year likely to be contained, we maintain our Overweight stance in global equities, as we expect to see modest gains over the course of 2021. In the current environment, the recent sector leadership rotation towards reflation-driven stocks looks set to continue.

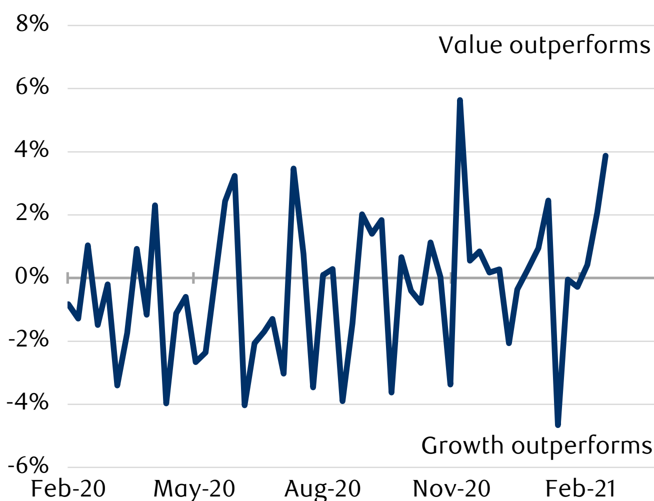
UNITED STATES

Ben Graham, CFA – Minneapolis

- **U.S. equities are widely dispersed this week** as value accelerates against growth and the VIX has risen from the sub-20 lows seen recently for the first time since the pandemic started. The S&P 500 has declined 2.0% thus far this week while the Nasdaq is down 5.4%. The value-oriented Dow Jones Industrial Average has actually bucked the trend broadly evident in equity markets as it's risen 1.5% so far this week. The small-cap Russell 2000 is down 2.9%. **Energy stocks continue to provide strength in 2021** as the sector provides market leadership this week with its 6.8% gain. Financials and Industrials were the only other two sectors to show gains on the week, climbing 1.5% and 0.5%, respectively. On the other side of the coin, laggards include Consumer Discretionary and Information Technology, each at least 4.5% lower.
- With interest rates rising and the Federal Reserve fighting the market's belief inflation will follow suit aggressively, **value has re-seized the leadership mantle**. February has been a good month so far for value, as the S&P 500 Value Index outpaces the S&P 500 Growth Index 9.1% to 2.7%. Furthermore, the gap has accelerated this week with the value index outperforming the growth one by its second-largest amount in the last year. Specifically, the S&P 500 Value is leading the S&P 500 Growth by 3.9% so far this week, a level not seen since mid-November.
- As U.S. 10-year Treasury yields have nearly risen to 1.50%, a level not seen in more than a year, **RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli looked recently at leading economic indicators for the U.S. during the COVID-19 recession and recovery and how they compare to previous recessions**. He noted the index of leading indicators has nearly rallied back to the pre-COVID-19 highs, a far faster recovery than historical averages would indicate. This recovery is a feat made even more impressive when considering initial jobless claims are part of the index and remain deep in recessionary territory. This comes despite the week's reading of initial jobless claims totaling 730,000, surprising positively by 90,000. Retail sales, ISM Purchasing Managers' Index data, durable goods orders, and consumer confidence are examples of leading economic indicators that have fully or nearly recovered to their pre-COVID-19 levels.

Value is rallying in February, best week since November

S&P 500 Value weekly return minus S&P 500 Growth weekly return



Source - RBC Wealth Management, FactSet; data as of 11:45 am ET 2/25/21

CANADA

Arete Zafiriou & Sayada Nabi – Toronto

- **Canada's big six banks reported fiscal Q1 2021 earnings this week, and results came in better than Street expectations**. One key driver of strong performance was lower-than-forecasted provisions for credit losses (PCLs), which represent the amount set aside by the banks to cover potential losses due to underperforming loans. The banks reported total PCLs between 26% and 74% lower than fiscal Q4 2020, citing an improving economic outlook. Revenues also beat consensus expectations across the board. The big six banks remain well capitalized, with reported common equity tier 1 (CET 1) ratios—a measure of a bank's capital—flat to modestly higher quarter over quarter. RBC Capital Markets expects the Canadian banks to increase cash returns to shareholders once regulatory restrictions on dividend increases and buybacks are lifted—potentially later this year. **Canadian bank stocks bounced this week in light of the positive earnings results** and are ahead of the broader market in 2021. Year to date, ending Feb. 25, the S&P/TSX Canadian Banks sub-index is up 9.2% vs. 4.5% for the S&P/TSX Composite Index.
- **Canada's housing market remained hot through January**, according to RBC Economics. Low interest rates, high household saving rates, and evolving housing needs have fueled home buying across the country in early 2021. Tight demand-supply conditions for single-family homes continue to push prices up at an accelerating rate, and RBC Economics believes this trend will continue in the near term. On the other hand, **condo price trends are relatively weaker** because supply has been plentiful in the downtown cores of major Canadian cities. While that is the case currently, RBC Economics believes the growing affordability of condos compared to single-family homes, and the start of COVID-19 inoculations, will rekindle buyer interest in condos, and prices could be firming through this year.

EUROPE

Thomas McGarrity, CFA & Blaine Karbonik, CFA – London

- **UK Prime Minister Boris Johnson unveiled a "roadmap" to ease lockdown restrictions** and reopen the UK economy in stages over the coming months. The aim is to lift all restrictions by the end of June, data permitting.
- The announcement added to the vaccine-fueled optimism that has made **the British pound the best performing G10 currency** so far this year, up nearly 4% against both the U.S. dollar and the euro. At above 1.41, the pound is now trading less than 5% shy of its level against the U.S. dollar before the Brexit referendum.
- The UK's leadership in the vaccine race has suggested that the country could experience a faster recovery than other developed economies and has led to a **reassessment of the likelihood the Bank of England will introduce negative policy rates**. Although both of these factors have been positive for the currency, the vaccine story appears to be well-priced at current levels and **further upside from this catalyst could be limited**, in our view.
- **Increased optimism** around the economic recovery and the reopening of major economies was **evident again in the equity market** during the week. While the pan-European STOXX Europe 600 Index was down 0.5% during the week, beneath the surface was **a notable rotation with cyclicals outperforming and defensives underperforming**. This has been the story within European equities in 2021 thus far.
- **The Travel & Leisure sector was up 5% to top the leaderboard**, buoyed by the release of the government's COVID-19 roadmap, which includes the prospect of a return to international air travel from May 17. This provided some welcome clarity to the travel industry.
- Commodities sectors—**Energy and Basic Resources—also outperformed** as oil and base metal prices continued to rise, as did **Banks and Insurance alongside the rise in bond yields**. At the other end of the leaderboard, Technology, Health Care, Consumer Staples, and Utilities underperformed.

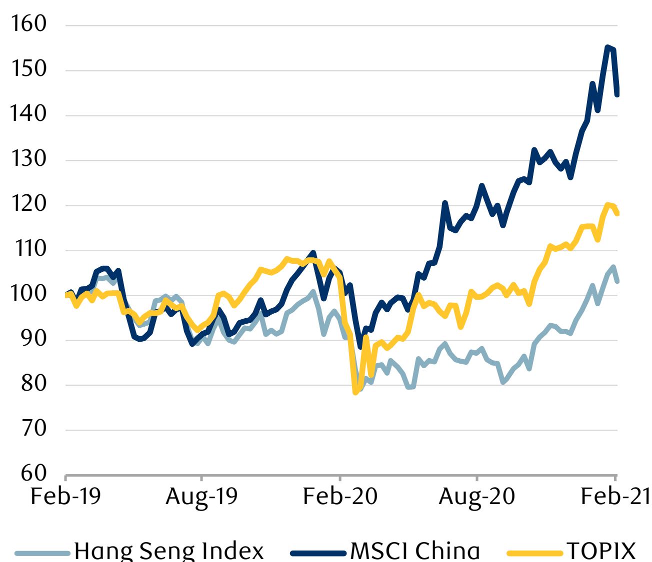
ASIA PACIFIC

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

- **The Hong Kong equity market posted its worst intra-day performance in five years** on Wednesday (Feb. 24) after the government surprised the market by announcing **the first stamp-duty increase on stock trades since 1993**. The increase is part of the new measures announced in Hong Kong's budget. The **trading tax will increase to 0.13% from 0.10%** and is due to be in place on Aug. 1. The government expects the increase to generate an extra HK$12 billion a year, local media including Apple Daily and NowTV reported. In the 2019–2020 fiscal year, the duty contributed HK$33.2 billion in revenue. Unsurprisingly, Hong Kong Exchanges and Clearing Ltd. (388 HK) led the decline on Wednesday. We think higher transaction costs for investors could hurt some short-term and high-frequency trading activities; however, the impact to total market turnover should be manageable.
- **The China Banking and Insurance Regulatory Commission will be imposing new restrictions on financial institutions working with online micro-lenders**, including those led by Ant Group, a sister company of Alibaba Group (9988 HK). Among the key changes: banks must cap overall joint lending with internet platforms or other partners at no more than 50% of their outstanding loans, and co-lending with one platform should not exceed 25% of the bank's tier-1 net capital. The new restrictions add to draft rules issued on the sector since late 2020, when the authority significantly increased its oversight on the fintech space.
- **Australian business investment rose 3% to AU$29.4 billion in Q4 2020**, the first increase since the end of 2018 and the biggest since September 2013, according to figures from the Australian Bureau of Statistics (ABS). Analysts in a Reuters poll had forecast no change. Separately, **the Australian Wage Price Index rose 0.6%** during the same period, double what analysts had forecast. The stronger-than-expected outcome was influenced by businesses rolling back short-term wage reductions, returning salaries to pre-COVID-19 levels, the ABS said.

Select Asian equity market performance

Two-year performance data, indexed to 100



Source - RBC Wealth Management, FactSet; data through 2/24/21

MARKET Scorecard

Data as of February 25, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,829.34	3.1%	2.0%	22.4%	37.0%
Dow Industrials (DJIA)	31,402.01	4.7%	2.6%	16.0%	20.4%
Nasdaq	13,119.43	0.4%	1.8%	46.3%	73.7%
Russell 2000	2,200.17	6.1%	11.4%	40.0%	38.5%
S&P/TSX Comp	18,223.54	5.1%	4.5%	6.1%	13.5%
FTSE All-Share	3,788.74	4.0%	3.1%	-3.4%	-3.8%
STOXX Europe 600	411.73	4.0%	3.2%	1.8%	10.6%
EURO STOXX 50	3,685.28	5.9%	3.7%	3.2%	12.4%
Hang Seng	30,074.17	6.3%	10.4%	11.8%	3.8%
Shanghai Comp	3,585.05	2.9%	3.2%	19.0%	21.1%
Nikkei 225	30,168.27	9.1%	9.9%	33.5%	40.1%
India Sensex	51,039.31	10.3%	6.9%	26.7%	40.9%
Singapore Straits Times	2,973.54	2.4%	4.6%	-5.8%	-9.1%
Brazil Ibovespa	112,256.40	-2.4%	-5.7%	-1.3%	15.4%
Mexican Bolsa IPC	44,310.27	3.1%	0.6%	2.9%	1.5%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.492%	42.7	57.9	14.0	-117.0
Canada 10-Yr	1.456%	56.7	77.9	24.2	-43.8
UK 10-Yr	0.784%	45.7	58.7	26.5	-39.2
Germany 10-Yr	-0.232%	28.6	33.7	28.0	-34.0
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.39%	-1.5%	-2.2%	2.1%	17.3%
U.S. Investment-Grade Corp	2.03%	-2.0%	-3.2%	2.7%	22.9%
U.S. High-Yield Corp	4.05%	0.8%	1.2%	8.1%	18.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,773.36	-4.0%	-6.6%	8.5%	33.6%
Silver (spot $/oz)	27.41	1.6%	3.8%	52.3%	72.4%
Copper ($/metric ton)	9,340.00	18.8%	20.5%	64.9%	43.2%
Oil (WTI spot/bbl)	63.48	21.6%	30.8%	27.6%	14.7%
Oil (Brent spot/bbl)	66.86	19.6%	29.1%	21.7%	3.2%
Natural Gas ($/mmBtu)	2.76	7.8%	8.9%	49.6%	-2.5%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	90.2450	-0.4%	0.3%	-8.8%	-6.4%
CAD/USD	0.7930	1.3%	1.0%	5.3%	4.6%
USD/CAD	1.2609	-1.3%	-0.9%	-5.0%	-4.4%
EUR/USD	1.2171	0.3%	-0.4%	11.8%	7.2%
GBP/USD	1.4011	2.2%	2.5%	7.7%	7.0%
AUD/USD	0.7869	2.9%	2.3%	19.2%	9.8%
USD/JPY	106.2000	1.5%	2.9%	-3.6%	-4.4%
EUR/JPY	129.2600	1.7%	2.4%	7.8%	2.5%
EUR/GBP	0.8687	-1.9%	-2.8%	3.8%	0.2%
EUR/CHF	1.1019	1.9%	1.9%	3.7%	-3.0%
USD/SGD	1.3259	-0.2%	0.3%	-5.2%	-1.8%
USD/CNY	6.4549	0.4%	-1.1%	-7.0%	-3.5%
USD/MXN	20.8682	1.4%	4.8%	9.4%	9.1%
USD/BRL	5.5212	0.9%	6.2%	46.1%	47.3%

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 0.79 means 1 Canadian dollar will buy 0.79 U.S. dollar. CAD/USD 1.0% return means the Canadian dollar rose 1.0% vs. the U.S. dollar year to date. USD/JPY 106.20 means 1 U.S. dollar will buy 106.20 yen. USD/JPY 2.9% return means the U.S. dollar rose 2.9% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 2/25/21.

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As of December 31, 2020

			Investment Banking Services Provided During Past 12 Months	
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Buy [Outperform]	828	54.83	299	36.11
Hold [Sector Perform]	615	40.73	166	26.99
Sell [Underperform]	67	4.44	12	17.91

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