GLOBAL Insight WEEKLY

Wealth Management RBC

Perspectives from the Global Portfolio Advisory Committee January 28, 2021

Bubble trouble?

Frédérique Carrier – London

Given the exuberance in different pockets of the market, it's fair to wonder if we're seeing a bubble inflating close to a bursting point. We take stock of the signs of excess and look at how to position portfolios through this period.

Concerns are mounting as to whether financial markets may have entered bubble territory over the past few weeks. Certainly, instances of excessive behaviour in markets have become apparent, and, it seems, more frequent.

The usual key ingredients to form a bubble in financial markets include cheap credit or easy money and an enticing narrative, with both resulting in excessive behaviours and valuations. The dot-com bubble is a case in point. With central banks increasing money supply ahead of the transition to the new millennium and the new possibilities offered by the internet leading to a tantalising narrative, the Nasdaq went up more than fourfold from the beginning of 1995 until it peaked in early 2000. Then, with money supply starting to tighten, the bubble burst. By the end of 2002, the Nasdaq had lost more than 70 percent of its value.

Today's financial markets are grounded on easy money, and many market observers are worried about the impact of a reversal of central bank policies when the pandemic ultimately ends. Such concerns are valid, in our view, but we see the situation as a growing number of red flags rather than a definitive sign that we are in a bubble that is about to burst.

Red flags accumulate

There are visible signs of excess in financial markets as loose monetary policy and record-low bond yields push market participants to take on more risk. There have been several examples recently of market participants displaying FOMO—the fear of missing out—and assuming consistently rising prices rather than rationally assessing the value of an investment.

Investor attitudes are being shaped by the headline-making gains of some high-profile issues. For example, the 35 percent gain made by Bitcoin in the first nine days of 2021, on the heels of a fivefold surge in price from March to December 2020; or the more-than-sixfold increase in GameStop shares in less than two weeks to Jan. 26; or even Tesla, now the fifth-largest stock in the S&P 500 by market capitalisation, with a market cap larger than that of the major U.S., European, and Japanese automakers combined.

Interestingly, some of these have an enticing narrative and are perceived as providing a foothold in the economy of the future.

Other signs of excess include the increased participation of individual investors (aka retail investors) in markets.

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.

Being stuck at home due to pandemic lockdowns and restrictions seems to have spurred an influx of day traders. Another marker is the volume of initial public offerings (IPOs), which has reached a rapid pace, with $347 billion worth of IPOs announced in 2020 despite the pandemic, more than double the $165 billion announced the prior year, per data from Bloomberg. Moreover, according to a University of Florida report, the median age of companies coming to the market as IPOs in 2020 was nine years. The median age of companies going public hasn't been this young since 2007, the year the stock market peaked before the global financial crisis.

Stretched, but not overly

It would be remiss to ignore these warnings and we repeat our call for vigilance. But we see less evidence of bubble territory when we look at stock market valuations.

On the surface, U.S. equities appear expensive at 22.3x the 2021 consensus earnings estimate for the S&P 500. After excluding the five largest technology-driven stocks (Apple, Amazon, Microsoft, Google, and Facebook), which constitute more than 20 percent of the S&P 500's market capitalisation, the forward price-to-earnings (P/E) ratio drops to 17.5x, according to our national research correspondent. This compares to a 10-year average of 16.4x for the S&P 500 as a whole, suggesting to us that while valuations are expensive, they are not significantly overvalued.

Valuations elsewhere are also elevated and above their long-term averages, but they remain far below the heights reached at the time of the dot-com bubble. These higher valuations are underpinned by bond yields which are currently at historical lows.

Equities' currently high valuations are susceptible to declines if bond yields climb as the economy recovers. But we think any increase in yields will be contained this year, although the 10-year Treasury yield has the potential to rise to around 1.5 percent versus the current high of one percent, which if reached would leave it about where it was pre-pandemic and well below the 2.1 percent it averaged in 2019.

With elevated unemployment levels and a full economic recovery still years away, we believe the Fed will very likely maintain its current loose monetary policy stance, even if inflation picks up over the next few months. Likewise, other major central banks are likely to keep monetary stimulus in place. Tapering by central banks, or the reduction of monetary stimulus, is unlikely before early 2022, in our view.

Still, a pullback or correction cannot be ruled out, as much enthusiasm seems discounted in equity prices. The frothiest, most extended parts of the U.S. market would be most vulnerable, in our opinion. Difficulties with vaccine rollouts and delays in reopening economies that lead to disappointing earnings guidance could all trigger profit-taking.

Current valuations are all above long-term averages

Index	2021 P/E ratio (x)	P/E long-term average (x)
S&P 500	22.3	16.4
S&P/TSX Comp (Canada)	16.8	14.8
MSCI China	15.9	14.6
TOPIX (Japan)	16.3	14.1
MSCI Europe ex UK (Europe)	18.0	13.5
MSCI UK	14.5	13.0

Note: Long-term averages use time frames most relevant to each market given changes in constituents over the years. U.S. 10 years; Canada and Japan 20 years; Europe and UK 22 years; and China 5 years.
Source - RBC Wealth Management, Bloomberg; China and Japan data as of 1/28/21, all others as of 1/27/21

How to position?

We maintain our Overweight stance in global equities, and we are willing to withstand possible volatility as we think equities will eventually move slowly higher over the course of the year. We expect the sector rotation into cyclicals that started in November 2020 to continue as the economy approaches a reopening. We would continue to look for exposure to more attractively valued cyclicals, without neglecting exposure to resilient defensive stocks.

UNITED STATES

Alan Robinson – Seattle

- **Stocks endured a volatile week**, driven by the competing forces of optimism over a post-COVID-19 earnings rebound set against concerns over stretched valuations and speculative investment behavior. During the week, the Volatility Index (VIX), a measure viewed as a classic “fear gauge,” jumped to 37 from 23. While investors’ natural inclination may be to take money off the table during periods of extreme volatility, we note that since 1991, **when the VIX exceeds 37, the market has posted positive returns 83% of the time** over the subsequent six months.
- However, **the near-term path for stocks may be more challenging** as pockets of extreme market action appeared during the week. On Jan. 27, the market posted the largest share-volume day on record, and the third-largest dollar-volume day on record. The volume of shares that traded away from the major exchanges was 45% of the total, indicating heavy speculative trading. According to Bloomberg, several hedge funds were forced to close their bearish positions on individual stocks as social media-driven investors pushed their prices higher. This triggered hedge fund selling in larger core holdings to fund their losses, which fed the midweek market decline.
- With Q4 2020 earnings season in full swing, **several bellwether companies posted impressive quarterly results**. Microsoft’s $2.03 earnings per share (EPS) beat the consensus $1.64 estimate, while Facebook (FB) reported EPS of $4.43 vs. $3.43 consensus. The solid tech stock results follow similar positive reports from the banking industry the prior week, suggesting a broad-based earnings rebound.
- The Federal Reserve concluded its regular policy meeting during the week with **Fed Chair Jerome Powell downplaying the “rising inflation” narrative**, suggesting interest rates will remain low for the foreseeable future.
- **The U.S. economy posted solid preliminary 4.0% (annualized) quarter-over-quarter growth in Q4 2020**, to leave the level of economic output within 2.5% of year-ago levels. The bounceback in the second half of the year limited the annual GDP decline to a still-large 3.5% in 2020 after the plunge in output in the spring.

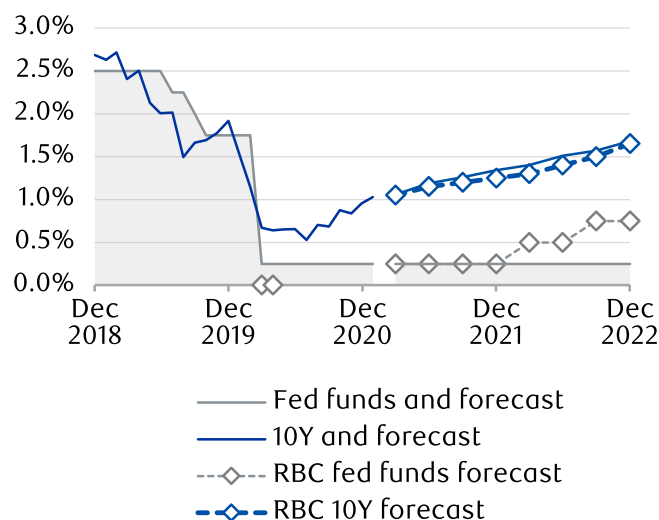
CANADA

Luis Castillo – Toronto

- In spite of recent political setbacks, **energy has been one of the best-performing credit sectors in recent months** as fixed income investors have become more comfortable deploying capital in the space. However, **a recent credit warning threatens its momentum**. Following an industry review, credit rating agency S&P Global increased the risk score of companies in the oil and gas industry (exploration and production [E&P] and integrated) to “moderately high” from “intermediate,” which resulted in a number of companies being placed on “CreditWatch with negative implications” and two placed on “Negative Outlook.” Amongst those affected were Canadian energy giants Suncor Energy and Canadian Natural Resources. The agency noted, “The revision to the industry risk assessment reflects our concerns about the trajectory of oil and gas supply/demand and the impact on producers of fossil fuels, given the increasing adoption and transition of renewable energy alternatives to address climate change.”
- **Canadian retail sales, up for a seventh straight month, beat expectations in November, rising 1.3% m/m, according to Statistics Canada.** Although the labour market remains below pre-pandemic employment levels we believe the continued resilience in retail sales can be largely attributed to government transfer payments, which have more than offset lost wages. This dynamic has helped fuel the inflation narrative and propelled Canada’s inflation breakevens, a measure of market-implied inflation expectations, above pre-pandemic levels and towards their highest level since early 2019. However, **the positive surprise was short-lived** as Statistics Canada’s preliminary December holiday season estimates revealed that sales potentially fell by 2.6% m/m as lockdowns in parts of the country intensified, although at a more gradual pace and less widespread than before. This would mark the lowest reading since April, and RBC Economics expects weakness to continue into January.

Analysts don’t expect a significant rise in interest rates this year

Key rate forecasts for January



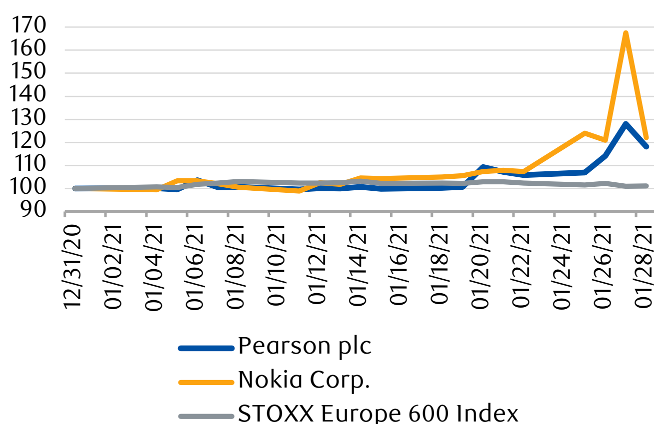
Source - RBC Wealth Management, Bloomberg Economists Survey for January, RBC Economics

EUROPE

Thomas McGarrity, CFA & Alastair Whitfield – London

- **Pan-European equities were in risk-off mode during the week**, with the STOXX Europe 600 down 1.8% over the past five trading days amid the UK tightening travel restrictions, rising COVID-19 cases, and concerns around the pace of the vaccine rollout in Continental Europe following manufacturing issues of the AstraZeneca/Oxford vaccine in the EU. **Defensives outperformed cyclicals**, while apparent short covering led to a strong rally in some of Europe's most heavily shorted stocks, including communications equipment provider Nokia and education-focused publisher Pearson.
- **UK-listed insurance group Prudential announced it is planning to demerge its U.S. business**, Jackson National, in Q2 2021. This is a change of course from previous guidance, in which Prudential had indicated it would pursue a minority IPO of the business. As part of the process, Prudential is considering an equity raise of around $2.5–$3.0 billion to "increase financial flexibility and take advantage of Asia growth opportunities." Prudential shares fell 8% following the announcement.
- **European Central Bank (ECB) President Christine Lagarde spoke on the topic of green banking and green central banking** at a speech in Europe this week, which may set the stage for other central banks to have similar discussions in the future. This has been echoed by other ECB board members suggesting that climate-related risk should be taken into account when conducting monetary policy. Lagarde further referenced the ECB contributing to the support of the EU's economic policies and its priority of combating climate change.
- **The EU has been active in issuing social bonds since last year to support the impact of the pandemic**, and these have attracted sizeable investor interest. This week alone, over €115 billion of orders were submitted by investors for issuance of just €14 billion. With this existing framework to be extended towards green and sustainability EU bonds and given ongoing trends in new bond supply towards sustainable investing and high levels of investor appetite, we expect further ESG-oriented issuance to continue in the weeks and months ahead.

Heavily shorted European shares have staged strong rallies to confound the bears



Source - RBC Wealth Management, Thomson Reuters Refinitiv. Normalized with 12/31/20 levels = 100

ASIA PACIFIC

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

- **Asia Pacific equity markets traded broadly lower during the week**, with the decline led by Vietnam and Indonesia. The Vietnam Ho Chi Minh Stock Index is down 12.2% week-to-date, the biggest weekly decline since the onset of COVID-19. Sentiment weakened sharply after two new locally transmitted COVID-19 cases were reported, the first in over two months.
- **South Korea could come out of the pandemic in the best shape of any OECD country**, in our view. Fourth-quarter 2020 GDP grew at a faster-than-expected pace (+1.1% q/q vs. a median estimate of +0.7% q/q in a Reuters poll). **Growth has been supported by overseas demand** for semiconductors and tech devices. Reuters also reported that Oxford Economics expects recovery momentum to gather pace from the second quarter onwards, led by strong export prospects as global growth and 5G deployment pick up speed.
- **Tencent Holdings (700 HK) slumped after a 10.9% surge** on Monday that pushed its market capitalization to the cusp of US$1 trillion for the first time. The stock has given back all its gains this week as many traders took profits after the rally while others exited their positions after an adviser to China's central bank signaled that excessive liquidity was creating asset bubbles. According to a Bloomberg report, **China onshore funds have purchased a record amount of Hong Kong shares this month**, with about a quarter of that targeting Tencent.
- **Ant Financial**, an affiliate of Alibaba Group (9988 HK), is **planning to turn itself into a financial holding company overseen by China's central bank**, according to a report by the Wall Street Journal. The report said the restructuring plan could be finalized before China's week-long Lunar New Year holiday in mid-February. Top Chinese financial regulators recently hinted they are happy with the progress being made at Ant. On Tuesday, when asked during a virtual meeting of the World Economic Forum if Ant would **revive its IPO**, the People's Bank of China governor said if laws and regulations are followed, "you will have the result."

MARKET Scorecard

Data as of January 28, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,787.38	0.8%	0.8%	15.6%	43.3%
Dow Industrials (DJIA)	30,603.36	0.0%	0.0%	6.5%	24.8%
Nasdaq	13,337.16	3.5%	3.5%	43.9%	88.2%
Russell 2000	2,106.61	6.7%	6.7%	27.0%	43.0%
S&P/TSX Comp	17,657.20	1.3%	1.3%	0.9%	14.8%
FTSE All-Share	3,699.97	0.7%	0.7%	-10.9%	-0.5%
STOXX Europe 600	403.39	1.1%	1.1%	-3.4%	13.8%
EURO STOXX 50	3,557.04	0.1%	0.1%	-4.4%	13.4%
Hang Seng	28,550.77	4.8%	4.8%	2.2%	3.5%
Shanghai Comp	3,505.18	0.9%	0.9%	17.8%	35.0%
Nikkei 225	28,197.42	2.7%	2.7%	21.5%	36.6%
India Sensex	46,874.36	-1.8%	-1.8%	14.4%	31.5%
Singapore Straits Times	2,920.30	2.7%	2.7%	-8.2%	-8.7%
Brazil Ibovespa	118,883.30	-0.1%	-0.1%	2.1%	24.6%
Mexican Bolsa IPC	44,280.73	0.5%	0.5%	-1.0%	1.5%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.048%	13.5	13.5	-60.8	-169.6
Canada 10-Yr	0.815%	13.8	13.8	-56.0	-114.9
UK 10-Yr	0.287%	9.0	9.0	-26.5	-97.8
Germany 10-Yr	-0.539%	3.0	3.0	-19.8	-74.4
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.15%	-0.5%	-0.5%	5.4%	19.3%
U.S. Investment-Grade Corp	1.84%	-1.0%	-1.0%	6.9%	25.8%
U.S. High-Yield Corp	4.29%	0.3%	0.3%	7.3%	17.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,842.28	-3.0%	-3.0%	17.6%	41.3%
Silver (spot $/oz)	26.46	0.2%	0.2%	51.4%	68.1%
Copper ($/metric ton)	7,821.25	0.9%	0.9%	37.8%	30.8%
Oil (WTI spot/bbl)	52.34	7.9%	7.9%	-2.1%	0.7%
Oil (Brent spot/bbl)	55.49	7.1%	7.1%	-6.8%	-7.4%
Natural Gas ($/mmBtu)	2.69	6.0%	6.0%	39.2%	-7.5%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	90.5400	0.7%	0.7%	-7.6%	-5.4%
CAD/USD	0.7800	-0.7%	-0.7%	2.6%	3.4%
USD/CAD	1.2821	0.8%	0.8%	-2.5%	-3.3%
EUR/USD	1.2120	-0.8%	-0.8%	10.0%	6.1%
GBP/USD	1.3726	0.4%	0.4%	5.4%	4.3%
AUD/USD	0.7678	-0.2%	-0.2%	13.5%	7.1%
USD/JPY	104.2600	1.0%	1.0%	-4.5%	-4.7%
EUR/JPY	126.3600	0.1%	0.1%	5.0%	1.1%
EUR/GBP	0.8830	-1.2%	-1.2%	4.4%	1.7%
EUR/CHF	1.0770	-0.4%	-0.4%	0.4%	-5.0%
USD/SGD	1.3289	0.5%	0.5%	-2.1%	-1.8%
USD/CNY	6.4495	-1.2%	-1.2%	-7.1%	-4.4%
USD/MXN	20.2444	1.7%	1.7%	8.1%	6.3%
USD/BRL	5.4405	4.7%	4.7%	44.0%	44.5%

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 -0.7% return means the Canadian dollar fell 0.7% vs. the U.S. dollar year to date. USD/JPY 104.26 means 1 U.S. dollar will buy 104.26 yen. USD/JPY 1.0% return means the U.S. dollar rose 1.0% vs. the yen year to date.

Source - Bloomberg; data as of 4:44 pm ET 1/28/21.

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As of December 31, 2020

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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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