GLOBAL Insight WEEKLY

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

May 27, 2021

European renaissance: Upgrade equities to Overweight

Frédérique Carrier – London

The European economy is reviving faster than most observers expected—so much so that it's sparked a debate about when the European Central Bank should take its foot off the gas. Yet we think monetary policy will stay loose for some time. We explore opportunities in the European equity market, which tends to outperform in cyclical upswings.

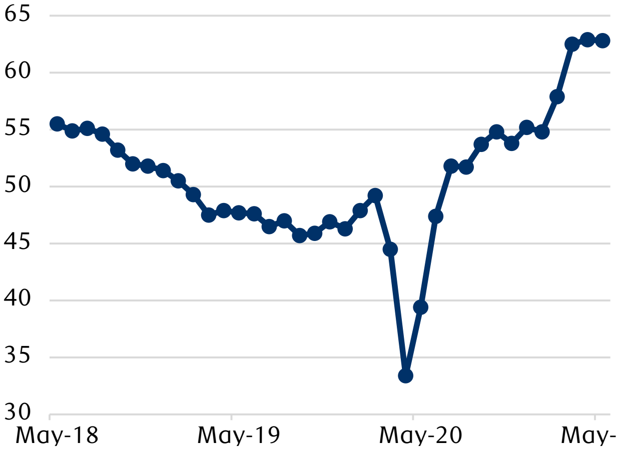
The economy is catching up ...

Europe, where many countries had to extend lockdown measures, is finally emerging from a long economic winter thanks to lower infection rates and an accelerating vaccine rollout. RBC Global Asset Management Inc. Chief Economist Eric Lascelles points out that while the region previously had been a laggard in overall vaccination rates among developed nations, it is now recording some of the highest numbers of new inoculations per capita. The two-week rolling new doses administered per 100 people in Germany, Spain, and Italy hit a high of 11.6, 11.4, and 10.9, respectively, as of May 16, according to Our World in Data. This comes against 8.4 in the U.S. and 10.1 in the UK.

The sharp bounce in the European Commission Economic Sentiment Indicator in March, which had seemed to be a precursor to an economic revival, was recently corroborated. The IHS Markit Eurozone Services Purchasing Managers' Index (PMI), which had lingered below the 50 level (indicating a contraction) early in the year, clawed its way back above 50 (indicating an expansion) in April and extended even more in May to 55.1, the highest level in close to three years. With France, Italy, and Spain having eased social distancing restrictions, activity in the euro area services sector may well recover even further in June. Meanwhile, manufacturing activity is plateauing due to certain supply chain shortages, but the IHS Markit Eurozone Manufacturing PMI has remained above 62, a very healthy level, since March.

European manufacturing activity plateaus at high level

IHS Markit Eurozone Manufacturing PMI



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

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

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Cheered by this brightening backdrop, on May 12 the European Commission sharply upgraded its economic forecast for the EU. It now expects GDP growth of 4.2 percent year over year in 2021, followed by 4.4 percent in 2022, versus its previous forecast for 3.7 percent and 3.9 percent in those years, respectively. For the first time, it factored in the impact of the €750 billion EU recovery fund, which is likely to start distributing funds in the third quarter of this year. Half the resources are earmarked for Italy and Spain, whose economies have been the hardest hit by the pandemic given their large exposure to tourism. Notably, the European Commission significantly raised its projections for GDP growth in Italy and Spain, and now sees all euro area economies returning to pre-pandemic levels before the end of 2022.

Sparking a tapering debate

According to the minutes of its recent meeting, the European Central Bank (ECB) has been focused on the strength of the recovery. In a change of tone compared to earlier this year, the ECB now sees the risks to activity as being marginally tilted "to the upside" in the medium term.

This has sparked a debate as to whether the ECB could start to discuss reducing its bond-buying pace under the Pandemic Emergency Purchase Programme (PEPP), which the central bank had upped to "significantly higher" a few months ago.

However, given the ECB's determination to "preserve favourable financing conditions," the recent rise in euro area sovereign bond yields, which results in higher borrowing costs, has caught the eye of ECB officials. The 10-year German Bund yield lurched up to its highest level in almost two years, at around -0.11 percent, driven by the improving outlook for Europe.

ECB President Christine Lagarde pushed back on slowing asset purchases under PEPP, stating it is too early to remove monetary support. Other ECB officials have backed her view, enabling sovereign yields to retreat. We expect the ECB will stick to its dovish messaging at the June meeting.

As things stand, markets do not expect the ECB to be quick to increase rates as it continues to closely monitor monetary conditions in case they deteriorate. Moreover, core inflation (which excludes volatile food and energy prices) remains subdued at 0.7 percent and there seems to be less risk of wage inflation compared to the U.S., where there are reports of labour shortages partially due to the generous COVID-19 stimulus cheques incentivising people to stay at home. Europe's existing social support programmes, known as its automatic stabilisers, have meant economic compensation per employee was capped. Eurozone consensus inflation expectations have increased, but at 1.7 percent, they remain below the ECB's two percent target.

The consensus sees the ECB waiting until around mid-2023 to raise its deposit rate, currently at -0.5 percent, lagging the U.S. Federal Reserve and the Bank of England. This will likely weigh on the euro, in turn providing a tailwind to corporate earnings.

Conducive climate for European equities

As macroeconomic momentum builds, earnings delivery is strong and both management and consensus forecasts are being revised upwards. The Q1 reporting season was exceptionally robust, with companies in the Euro STOXX Index, an index of some 300 European companies, easily beating consensus expectations and generating earnings per share growth of close to 40 percent year over year, driven by sales increases and margin expansion. Moreover, management teams overall were optimistic on a demand recovery, though some noted concerns regarding supply shortages. Most were confident of their pricing power and ability to reduce costs. Following a heady Q1, upgraded forecasts suggest the earnings recovery is likely to last into next year. The consensus is looking for earnings growth of around 15 percent year over year for 2022.

Our national research correspondent points out that European equities typically outperform when bond yields rise, as they have comparatively high exposure to groups and sectors that are beneficiaries of rising yields, such as Banks, Industrials, Consumer Discretionary, and Materials. Conversely, they have relatively lower exposure to Technology and Communication Services, sectors that tend to underperform in that environment. We expect both the 10-year U.S. Treasury yield and the 10-year German Bund yield to close the year at slightly higher levels than today.

Valuations for European equities do not seem unduly stretched, in our view. On 16x the 2022 consensus earnings estimate, the Euro STOXX Index trades at a 20 percent discount to the S&P 500. It also trades at a wider-than-average discount to its U.S. counterpart on a sector-neutral basis.

We continue to favour the Consumer Discretionary, Industrials, and Materials sectors as we believe they are well positioned to benefit from both an improving global economy and long-term secular trends. In particular, Europe is a global leader in industries geared towards the green economy, ranging from renewables operators and green transportation to electrification and industrial automation. Companies in the Financials sector remain attractively valued, in our view, and are seeing positive consensus earnings revisions.

We believe all of this makes for a conducive climate for European equity performance over the next 6–12 months, and we would hold an above-benchmark position in portfolios.

With contributions from Thomas McGarrity, CFA

UNITED STATES

Atul Bhatia, CFA – Minneapolis

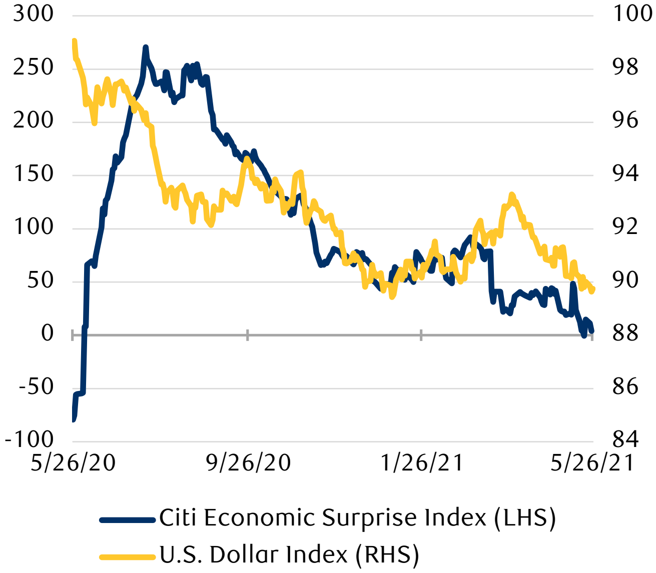
- **The 10-year Treasury bond yield continued to decline this week**, reaching 1.6%, its lowest closing level in over a month. Bond prices were pushed higher, in part, by economic data disappointments, including elevated continuing jobless claims and indications that the sharp rally in home prices has begun to curtail activity, as **expectations may have begun to outrun reality** in several key areas. A trio of Fed speakers also helped fixed income markets by reiterating that **policy makers continue to view recent inflation**—most notably April's 4.2% year-over-year increase in the Consumer Price Index—**as driven by largely transitory factors**. In our view, the combination of lagging employment numbers and a discounting of near-term inflation data suggests that even if the Fed begins to talk about tapering in an upcoming meeting, an actual reduction in the pace of asset purchases is unlikely before 2022.

- **Negotiations continue between Senate Republicans and the Biden administration on infrastructure legislation**. Press reports indicate broad agreement between the parties on the need for additional investment, but significant differences remain on both the size of the plan—the two sides' most recent proposals differ by almost $700 billion—and how to pay for it, with Republicans opposing any tax funding component. The Democrats have the ability to pass some measures without Republican support, although Senate rules would require any single-party bill to be budget-neutral over a 10-year period.

- **The U.S. dollar is approaching a multiyear low against a basket of developed-market currencies**. Rising interest rates and strengthening growth prospects in other G10 economies have reduced the relative attractiveness of the greenback. With the Fed emphasizing the need for accommodative monetary policy, **relative interest rates may not provide much boost to the dollar in the near term**. Continued U.S. currency weakness would tend to drive up commodity and import prices, potentially adding to near-term inflation.

Dollar weighed down by economic data

Numbers fail to keep up with heightened expectations



Source - RBC Wealth Management, Bloomberg; data through 5/26/21

CANADA

Simon Jones & Luis Castillo – Toronto

- **Housing prices and household indebtedness were the main areas of focus in the Bank of Canada's annual Financial System Review**. With more Canadians working from home during the pandemic, demand for suburban homes quickly outpaced supply, causing prices to rise nationwide. Although the central bank anticipates these price increases will prove temporary as supply constraints begin to ease, it noted signs of exuberance are beginning to emerge in certain housing markets, namely the Greater Toronto Area, Montreal, and Ottawa. The report also gave special attention to the increase in mortgage debt driven by the rising number of Canadian households that required a large mortgage relative to their income; **this increase offset the broad decline in consumer debt, leaving the average Canadian more indebted than a year ago**. These factors, either individually or in combination, could have a destabilizing effect on the economy by leaving household consumption vulnerable to potential economic shocks. Other key **vulnerabilities highlighted in this year's report** included market liquidity, climate change, the viability of businesses relying on government support, cyberattacks, and the rapid evolution of crypto assets.

- **Canadian retail sales printed a month-over-month gain of 3.6% in March**, coming in ahead of economists' expectations and contributing to a third consecutive quarterly increase. However, following strong retail sales growth figures in February and March, preliminary estimates from Statistics Canada revealed that **retail sales fell 5.1% in April** as a result of renewed pandemic lockdowns in some provinces. As expected, the third wave of COVID-19 has triggered a pause in the pace of economic recovery. **The pause was also felt by the labour market in April, when the majority of job losses came from the regions and sectors most impacted by the tightening of restrictions**. Despite the weaker-than-expected preliminary retail sales figure for April, retail sales overall remain significantly above pre-pandemic levels.

EUROPE

Thomas McGarrity, CFA – London

- **The two largest German residential landlords are set to combine, after Vonovia said it agreed to acquire rival Deutsche Wohnen** for over €18 billion (c. $22 billion) in an all-cash transaction. The latter's shares jumped over 16% on May 25 following the announcement. This is Vonovia's third attempt to acquire Deutsche Wohnen, and the proposed deal would represent the biggest takeover in Europe so far this year.

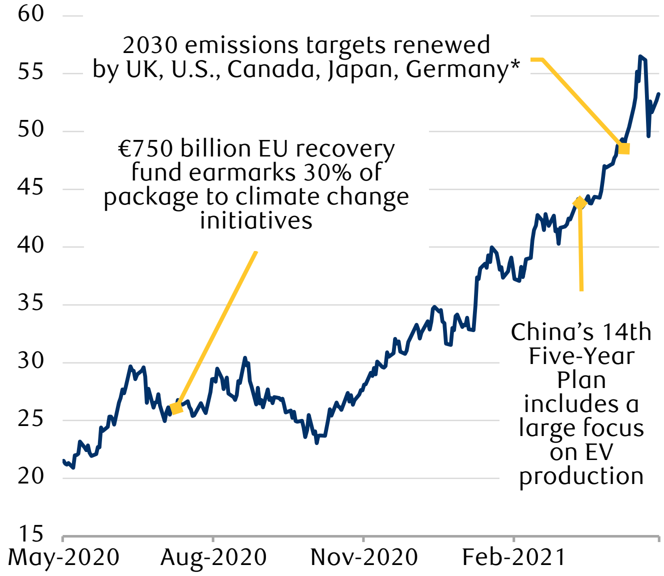
- The German residential rental market has faced intense public pressure in recent years given the rapid increase in rental prices, particularly in Germany's capital, Berlin. **To make the deal palatable to politicians, the two companies presented policymakers with a "Future and Social Housing Pact" containing specific measures to address the strained rental market in Berlin**. It includes a limit on rent increases until 2026, with a maximum of 1% per annum over the next three years and inflation-adjusted increases for the following two years. It also offers the State of Berlin the opportunity to acquire a significant number of apartments to expand the municipal housing stock and to foster new construction in Berlin.

- **The UK launched its Emissions Trading Scheme (ETS) last week**. An ETS is a market-based approach to reducing carbon emissions, with companies that produce emissions of CO_2 and other greenhouse gases above a set level having to buy allowances through the ETS to offset their excess emissions. The UK ETS is modelled on the European Union's (EU) well-established and largest carbon trading system in the world. Following an initial period of volatility, UK carbon prices have settled broadly in line with EU prices.

- We believe that for the world to reduce emissions at a fast enough pace to bring global energy-related CO_2 emissions to net zero by 2050, **the price of CO_2 in different cap-and-trade ETS systems will likely have to increase over the next 15 years**, as decarbonisation technologies (e.g., renewable energy, electric vehicles, and carbon capture and storage technologies) are unlikely to be enough on their own for the required emissions reduction by 2035 (for more, see our article on GreenTech).

The EU carbon allowance price has more than doubled over the past year

Price of EU carbon allowances (euros/tonne)



*UK target emissions are for 2035
Source - RBC Wealth Management, Bloomberg; data through 5/25/21

ASIA PACIFIC

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

- **Asian stocks recovered from a slump in early May**, with the MSCI Asia Pacific Index climbing above its 50-day moving average on May 26. Recent comments from Federal Reserve officials that the current jump in consumer prices is temporary, partly eased concerns about rising inflation, while a softening U.S. dollar also benefit Asian equities.

- Japanese equities overcame recent turbulence and **the Nikkei 225 posted its fifth straight day of gains** on May 26. Investors were encouraged by signs of calm in overseas markets and optimism over a ramp-up of Japan's COVID-19 vaccination program.

- **Chinese officials are attempting to cool commodity prices and reduce speculative trading activity in commodity markets**. According to Reuters, China's banking regulator has asked Chinese banks to stop selling investment products linked to commodity futures to individual investors. It has also asked banks to liquidate their existing books for these products. The market believes the regulator is aiming to prevent losses like those incurred a year ago by the Bank of China on crude oil-linked investment products.

- **China's yuan has advanced to its highest level since June 2018 in onshore markets** as the People's Bank of China signaled that it is comfortable with the recent rally by setting a strong daily reference rate. The advance has made the currency the best performer in Asia this year. **China's real estate sector outperformed** on May 26 as the strong yuan can ease the debt pressure from U.S. dollar-denominated bonds.

- **Xiaomi** (1810 HK), the leading Chinese smartphone maker, said on May 26 that the **"U.S. District Court for the District of Columbia issued a final order vacating the U.S. Department of Defense's designation of the company as a Communist Chinese Military Company."** According to the statement, the court formally lifted all restrictions on U.S. persons buying or holding Xiaomi's securities.

MARKET Scorecard

Data as of May 27, 2021

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 0.82 means 1 Canadian dollar will buy 0.82 U.S. dollar. CAD/USD 5.5% return means the Canadian dollar rose 5.5% vs. the U.S. dollar year to date. USD/JPY 109.82 means 1 U.S. dollar will buy 109.82 yen. USD/JPY 6.4% return means the U.S. dollar rose 6.4% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 5/27/21

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,200.88	0.5%	11.8%	38.4%	48.6%
Dow Industrials (DJIA)	34,464.64	1.7%	12.6%	34.9%	34.7%
Nasdaq	13,736.28	-1.6%	6.6%	45.9%	79.9%
Russell 2000	2,273.07	0.3%	15.1%	58.3%	50.1%
S&P/TSX Comp	19,774.41	3.5%	13.4%	29.5%	21.0%
FTSE All-Share	4,013.50	0.7%	9.3%	18.2%	0.8%
STOXX Europe 600	446.44	2.1%	11.9%	27.6%	18.5%
EURO STOXX 50	4,039.21	1.6%	13.7%	32.4%	20.1%
Hang Seng	29,113.20	1.4%	6.9%	24.9%	6.7%
Shanghai Comp	3,608.85	4.7%	3.9%	27.2%	24.8%
Nikkei 225	28,549.01	-0.9%	4.0%	33.3%	34.8%
India Sensex	51,115.22	4.8%	7.0%	61.7%	28.8%
Singapore Straits Times	3,164.82	-1.7%	11.3%	25.6%	-0.2%
Brazil Ibovespa	124,366.60	4.6%	4.5%	41.4%	31.1%
Mexican Bolsa IPC	49,627.95	3.4%	12.6%	34.5%	16.8%

Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	1.605%	-2.1	69.1	92.3	-71.6
Canada 10-Yr	1.488%	-5.8	81.1	94.0	-11.0
UK 10-Yr	0.810%	-3.2	61.3	61.7	-14.6
Germany 10-Yr	-0.172%	3.0	39.7	24.2	-2.8

Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.49%	0.3%	-2.3%	-0.2%	17.2%
U.S. Investment-Grade Corp	2.12%	0.7%	-2.9%	4.1%	23.3%
U.S. High-Yield Corp	4.11%	0.2%	2.1%	15.3%	19.9%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,897.32	7.2%	-0.1%	11.0%	47.6%
Silver (spot $/oz)	27.86	7.5%	5.5%	61.4%	90.9%
Copper ($/metric ton)	9,961.25	1.3%	28.5%	90.6%	67.9%
Oil (WTI spot/bbl)	66.85	5.1%	37.8%	103.7%	14.4%
Oil (Brent spot/bbl)	69.39	3.2%	34.0%	99.7%	-1.0%
Natural Gas ($/mmBtu)	2.96	1.0%	16.6%	72.0%	14.0%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	90.0010	-1.4%	0.1%	-9.1%	-7.8%
CAD/USD	0.8288	1.9%	5.5%	14.0%	11.4%
USD/CAD	1.2065	-1.8%	-5.2%	-12.3%	-10.3%
EUR/USD	1.2196	1.5%	-0.2%	10.8%	9.0%
GBP/USD	1.4203	2.8%	3.9%	15.8%	12.0%
AUD/USD	0.7744	0.4%	0.6%	16.9%	11.9%
USD/JPY	109.8200	0.5%	6.4%	1.9%	0.3%
EUR/JPY	133.9300	1.9%	6.1%	13.0%	9.3%
EUR/GBP	0.8587	-1.3%	-3.9%	-4.4%	-2.7%
EUR/CHF	1.0937	-0.4%	1.2%	2.6%	-2.7%
USD/SGD	1.3242	-0.5%	0.2%	-6.8%	-3.7%
USD/CNY	6.3833	-1.4%	-2.2%	-8.1%	-7.5%
USD/MXN	19.9409	-1.5%	0.1%	-10.7%	4.6%
USD/BRL	5.2564	-3.3%	1.1%	39.1%	30.0%

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As of March 31, 2021

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Hold [Sector Perform]	559	40.68	179	32.02
Sell [Underperform]	53	3.86	4	7.55

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