RBC Global Asset Management

Market outlook

NEW YEAR 2022

The bull market encounters turbulence

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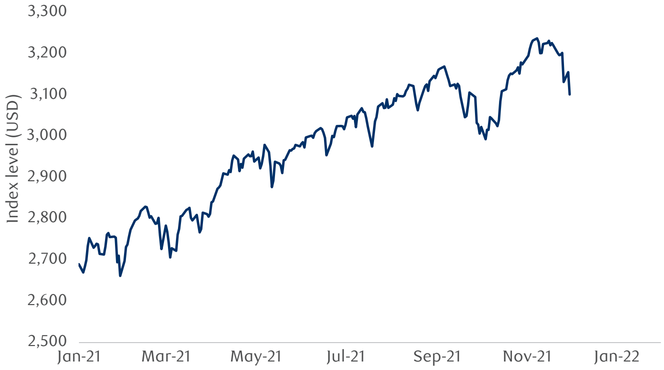
Global equities encountered volatility in November as financial markets absorbed a spate of negative news. The new Omicron coronavirus variant, the first signs of central-bank tightening, China's economic challenges and persistently high inflation all moved to the forefront, sending stock prices and bond yields lower in a bout of heightened market volatility (exhibits 1 and 2).

Inflation is elevated and represents a concern for central bankers and financial planners. The need for extraordinary monetary stimulus is becoming less evident, and policymakers are beginning to dial back accommodation and/or communicate their intention to raise interest rates. We think price pressures will ultimately calm as economies slowly resume normal operations and supply-chain issues are resolved. This scenario would provide central banks the opportunity to adjust monetary policy at a measured pace. At this time, there is little reason to suspect that the U.S. Federal Reserve (Fed) is behind the curve, and it is worth noting that a tightening in monetary policy does not always result in a negative outcome for risk assets.

Exhibit 1: MSCI World Index
U.S. dollars



Note: MSCI World Index in U.S. dollars. As of November 30, 2021.
Source: Bloomberg, RBC GAM

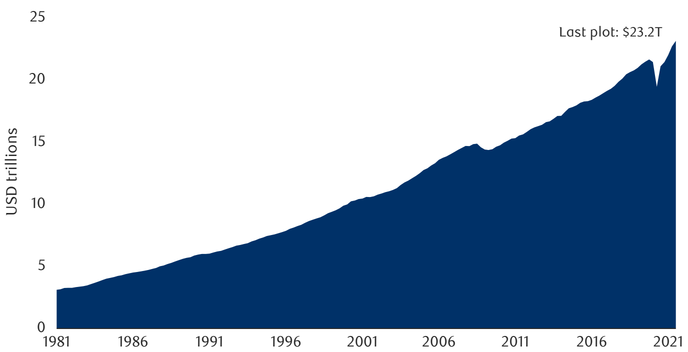
Exhibit 2: U.S. 10-year bond yield

Note: As of November 30, 2021. Source : Bloomberg, RBC GAM

Let's not forget the positive developments which have receded somewhat from view and yet remain quite prevalent. While the path to normalization is uneven and the recovery will undoubtedly hit speed bumps, the economy is progressing. It is worth recognizing that despite a variety of challenges, the U.S. economy is already the biggest it has ever been (Exhibit 3). And even though leading indicators of economic growth are off their highs, they are still at levels consistent with a robust and above-average expansion over the next 12 months (Exhibit 4). Moreover, the corporate-profit outlook remains robust, supported by strong nominal GDP growth which we expect to continue into next year.

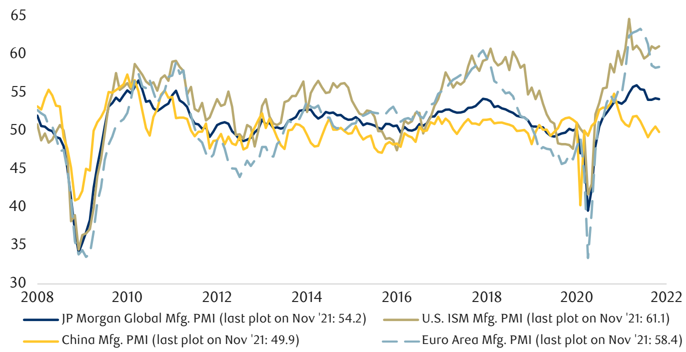
Our base case is for economic and corporate-profit growth to continue moderating, but remain at above-average rates. In this environment, we recognize the balance of risks to our outlook could be shifting. Valuations are demanding, stimulus is set to fade and a variety of technical indicators related to style leadership and market breadth are signaling caution. We remain overweight stocks in our asset mix, but acknowledge that the balance of risks and reward may be shifting as the economic cycle matures. We began to reflect this view during the summer by taking half a percentage point out of our equity allocation. This quarter, we trimmed our equity allocation by another 0.5% and placed the proceeds into cash. So we remain overweight equities, but have moderated the degree of overweight. We remain underweight fixed income as we believe bond yields are unsustainably low, and that any meaningful upward movement in yields from here will lead to low or negative returns in sovereign bonds. We have been building a small cash position over the past several quarters, sourced from both equities and fixed income. Our 3% allocation to cash should act as a cushion against portfolio volatility, but can also be deployed should opportunities arise, technical indicators become more supportive and/or risks prove less harmful than initially feared. For a balanced global investor, we currently recommend an asset mix of 63.5 percent equities (strategic neutral position: 60 percent) and 33.5 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

Exhibit 3: U.S. nominal GDP
U.S. dollars, seasonally adjusted annual rate (SAAR)



Note: As of September 30, 2021. Source: Bureau of Economic Analysis

Exhibit 4: Global purchasing managers' indices



Note: As of December 3, 2021. Source: Haver Analytics, RBC GAM

"Inflation is among the most important indicators we are monitoring, reflecting its critical impact on the course of monetary policy and our own investment outlook."

Significant healing in Fed indicators

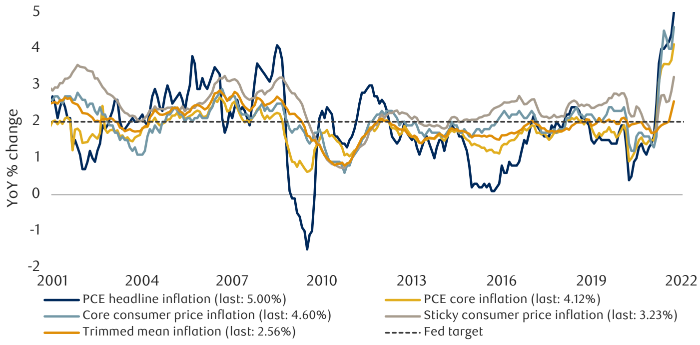
Many of the metrics the Fed is monitoring have healed considerably since the beginning of the pandemic. Economic growth and commodity prices have rebounded as demand for goods and services surged with the reopening of economies and the relaxation of restrictions. Consumer-price inflation was initially concentrated in areas such as computer chips, real estate and transportation, but all of the inflation indicators we monitor are now moving meaningfully higher, including the ones that remove extreme readings from their calculations (Exhibit 5). Inflation is among the most important indicators we are monitoring, reflecting its critical impact on the course of monetary policy and our own investment outlook.

While inflation has pushed higher, other metrics monitored by the Fed have improved. The U.S. unemployment rate is back down to 4.2% and wages are rising at their fastest pace in the past three decades (exhibits 6 and 7). Considering these factors together with elevated inflation, it now appears appropriate for the Fed to begin removing at least some of the massive stimulus that was injected into the system to offset the pandemic. The Fed has already begun tapering bond purchases, which have been reduced to a pace of US$105 billion per month as of November from US$120 billion, and rate hikes will likely begin once the asset purchases are fully unwound. The speed at which rates rise will depend on the Fed's view on the persistence of inflationary pressures.

Inflation expectations are critical, not yet problematic

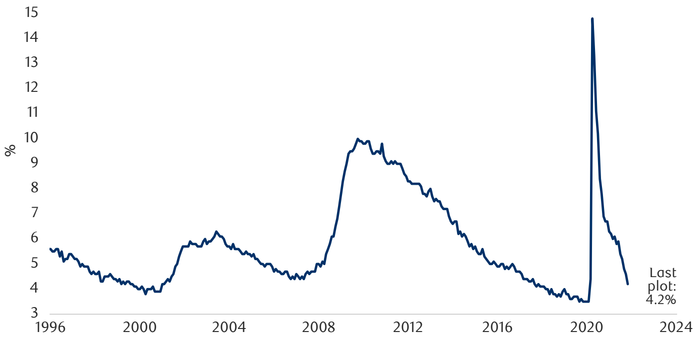
The real concern with inflation is not necessarily the published year-over-year change in the Consumer Price Index (CPI) that is reported every month, but rather consumer and investor expectations for inflation over the medium to longer term. The consensus view is for extremely high inflation in the near term, at close to 5% for 2021, and somewhere between 2% and 5% in 2022 (Exhibit 8). Longer-term inflation expectations have risen significantly over the past year and a half, but most of this move represents a rebound from extremely low levels. Expectations are now situated slightly above 2% in the U.S. and a bit below 2% in Canada and Europe (Exhibit 9). So it appears that there has been a shift in inflation expectations from below to above

Exhibit 5: U.S. inflation measures



Note: As of November 30, 2021. Source: Bloomberg, RBC GAM

Exhibit 6: U.S. unemployment rate



Note: As of November 30, 2021. Source: Haver Analytics, RBC GAM

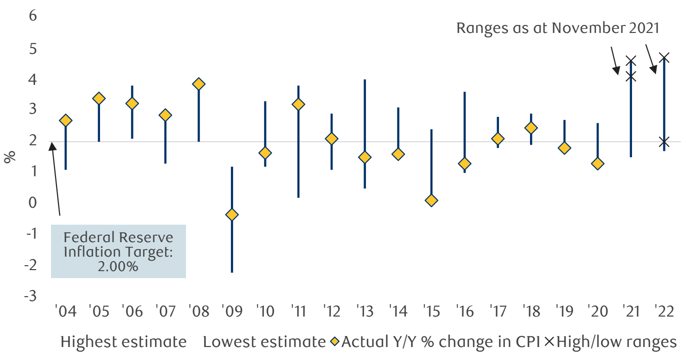
Exhibit 7: U.S. average hourly earnings

Note: As of November 30, 2021. Source: Haver Analytics, RBC GAM historical averages, but not significantly so. We believe this change is manageable, realistic and, as the current issues pass, we could see tempering inflation readings over the coming years.

Market is pricing in rate hikes as early as mid-2022

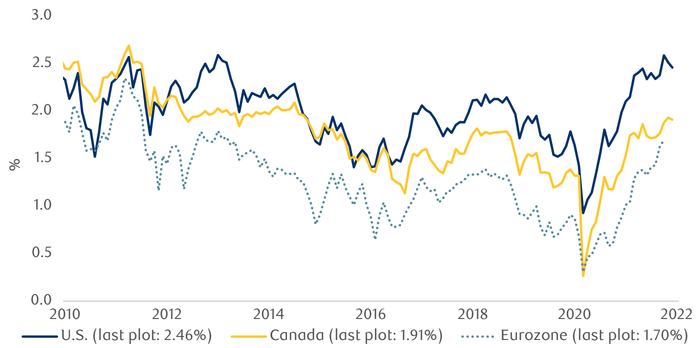
Given the extent to which the economy has recovered, a gradual tightening of monetary policy is becoming more appropriate and the market is beginning to price in U.S. rate hikes next year. The Koenig Taylor Rule, a function of GDP growth and inflation, suggests the fed funds rate should currently be above 3% (Exhibit 10). But Fed policymakers could tread carefully as they did in the aftermath of the global financial crisis and keep interest rates well below this modelled level. Pricing in the futures market is consistent with the view that the Fed will tighten at a gradual pace, with investors expecting two rate hikes in 2022 (Exhibit 11). Our own expectation is for only one hike, as we foresee the Fed exercising caution, particularly as the current inflationary pressures could subside. In any event, we think at least one rate hike sometime next year is warranted and it would represent validation that the economy is on a stronger footing. In this environment, we are confident that measured tightening decisions by the Fed are unlikely to destabilize markets.

Exhibit 8: United States
Inflation estimate dispersion



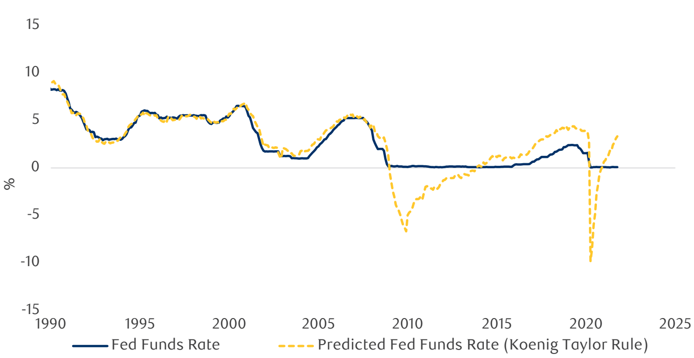
Note: As of November 30, 2021. Source: Consensus Economics, RBC GAM

Exhibit 9: Implied long-term inflation premium
Breakeven inflation rate: nominal vs 10-year real return bond



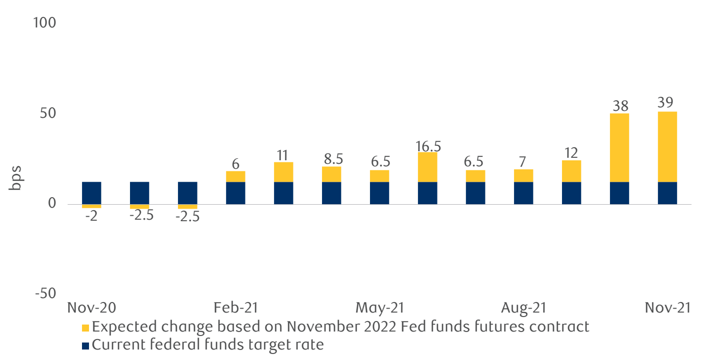
Note: As of November 30, 2021. Eurozone represents GDP-weighted breakeven inflation of Germany, France and Italy. Source: Bloomberg, RBC CM, RBC GAM

Exhibit 10: Koenig Taylor rule and fed funds rate



Note: As of October 31, 2021. Source: Federal Reserve Bank of Dallas, RBC GAM

Exhibit 11: Fed funds rate and implied expectations
12-month futures contract



Note: As of November 30, 2021. Source: RBC GAM

Exhibit 12: S&P 500 return statistics prior to and following the first rate hike
Data since July 1954

	# of observations	Trailing returns (%) 12 months	Trailing returns (%) 6 months	First rate hike	Forward returns (%)* 6 months	Forward returns (%)* 12 months	Forward returns (%)* 24 months	Forward returns (%)* 36 months
April 1955		34.3	19.8		11.6	27.4	9.8	4.6
September 1958		18.0	18.6		10.8	13.6	3.4	10.1
July 1963		21.4	5.8		11.1	21.9	11.5	8.1
November 1967		17.1	4.1		3.5	13.2	-0.4	-3.3
December 1968		13.0	7.0		-9.1	-14.6	-8.2	-2.1
July 1971		29.8	6.5		4.3	7.8	3.3	-5.8
January 1973		17.0	11.1		-14.7	-17.2	-23.0	-8.7
August 1977		-5.8	-2.8		-9.5	5.8	5.0	8.6
September 1980		15.5	19.2		5.9	-4.7	-0.6	9.4
March 1984		3.0	-6.6		6.1	14.1	23.3	23.5
April 1987		22.4	18.3		-12.7	-9.4	3.6	4.7
March 1988		-12.2	-19.2		4.8	12.4	14.5	13.0
February 1994		4.5	4.7		-2.4	1.9	16.3	18.9
March 1997		21.4	15.1		18.9	39.6	27.9	24.6
June 1999		21.1	11.4		6.7	6.0	-5.6	-10.3
June 2004		17.1	2.8		6.4	4.4	5.5	9.6
December 2015		5.1	-1.1		0.2	8.9	13.6	7.8
	# of observations	Median trailing returns (%)			Median forward returns (%)*			
All cycles	17	17.1	6.5		4.8	7.8	5.0	8.1
No-recession cycles	8	19.2	5.3		3.9	11.1	12.6	8.0
Recession cycles	9	17.0	11.1		5.9	5.8	3.4	8.6
Worst (1973)		17.0	11.1		-14.7	-17.2	-23.0	-8.7

Source: RBC GAM. *periods greater than 12 months are annualized

Monetary tightening is not necessarily bad for risk assets

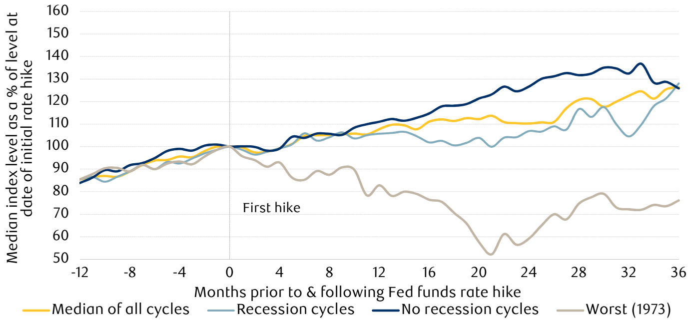
Although a new cycle of monetary tightening may intuitively seem harmful for risk assets, a look at past hiking cycles reveals this is not always the case: stocks tend to do quite well leading into a period of rising rates. We have identified 17 cycles of monetary tightening dating back to the 1950s and listed returns for the S&P 500 Index in each of those instances in Exhibit 12. The first part of the table looks at market returns 12 months and six months leading into the first rate hike. On average, the S&P 500 gained 17% and 6% in those periods, respectively. This experience is also plotted in Exhibit 13, where t=0 on the chart represents the date of the first rate hike in any given tightening cycle. Notice that all of the lines on the chart are rising into the first hike. Even in cycles where the economy ultimately fell into recession, stocks more often than not delivered strong returns leading up to a period of rising rates. Where the experience tends to differ between cycles is once rate hikes get underway. In roughly half of cycles, the Fed found itself behind the curve and was forced to hike aggressively, sending the economy into recession and often leading to a market correction. But in instances where the Fed is removing stimulus because the economy is on solid footing and there is no recession, stocks do very well, rising another 11% in the 12 months after hiking begins. While there are questions around inflation, the removal of stimulus and whether economic growth can be sustained in an environment of rising rates, we think it is worth keeping the potentially positive implications of this table in mind.

> "As pandemic-related distortions fade and economies return to normal, we would look for yields in all major regions to rise at a gradual pace."

Sovereign bonds exhibit meaningful valuation risk

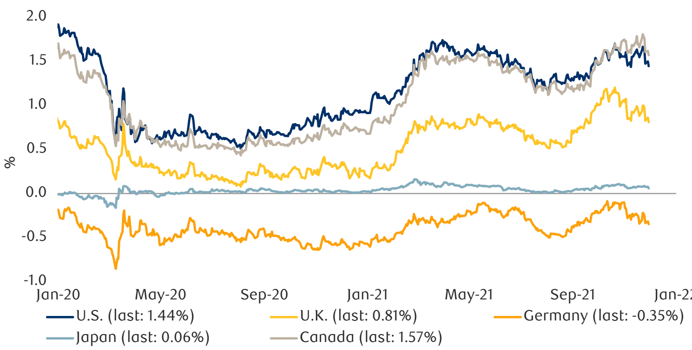
Global bond yields climbed over the course of the year but encountered significant fluctuations, and they remain well below where our models would deem appropriate. Yields began the year on a rapid upward trajectory amid the economic reopening, COVID vaccinations and firming inflation, but declined toward the end of the period as slowing growth and mounting concerns about the Omicron variant boosted the appetite for safe-haven assets – a pattern displayed in all major regions (Exhibit 14). The U.S. 10-year yield, for example, began the year below 1.00% and climbed as high as 1.74% in the spring before settling back toward 1.44% at the end of November. Although bond yields are above their lows, valuation risk remains extreme according to our models. Exhibit 15 plots our global composite of bond yields relative to their respective equilibrium levels and it suggests that yields, in aggregate, are 73% below normal. As pandemic-related distortions fade and economies return to normal, we would look for yields in all major regions to rise at a gradual pace (Page 45).

Exhibit 13: S&P 500 and the fed funds rate hike
Implications for current cycle, following first rate hike



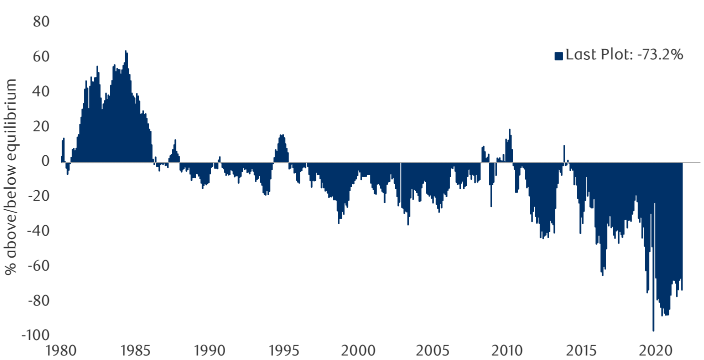
Note: As of November 30, 2021. Source: RBC GAM

Exhibit 14: 10-year government-bond yields



Note: As of November 30, 2021. Source: RBC GAM

Exhibit 15: Global bond-market composite – 10-year government-bond yields relative to equilibrium

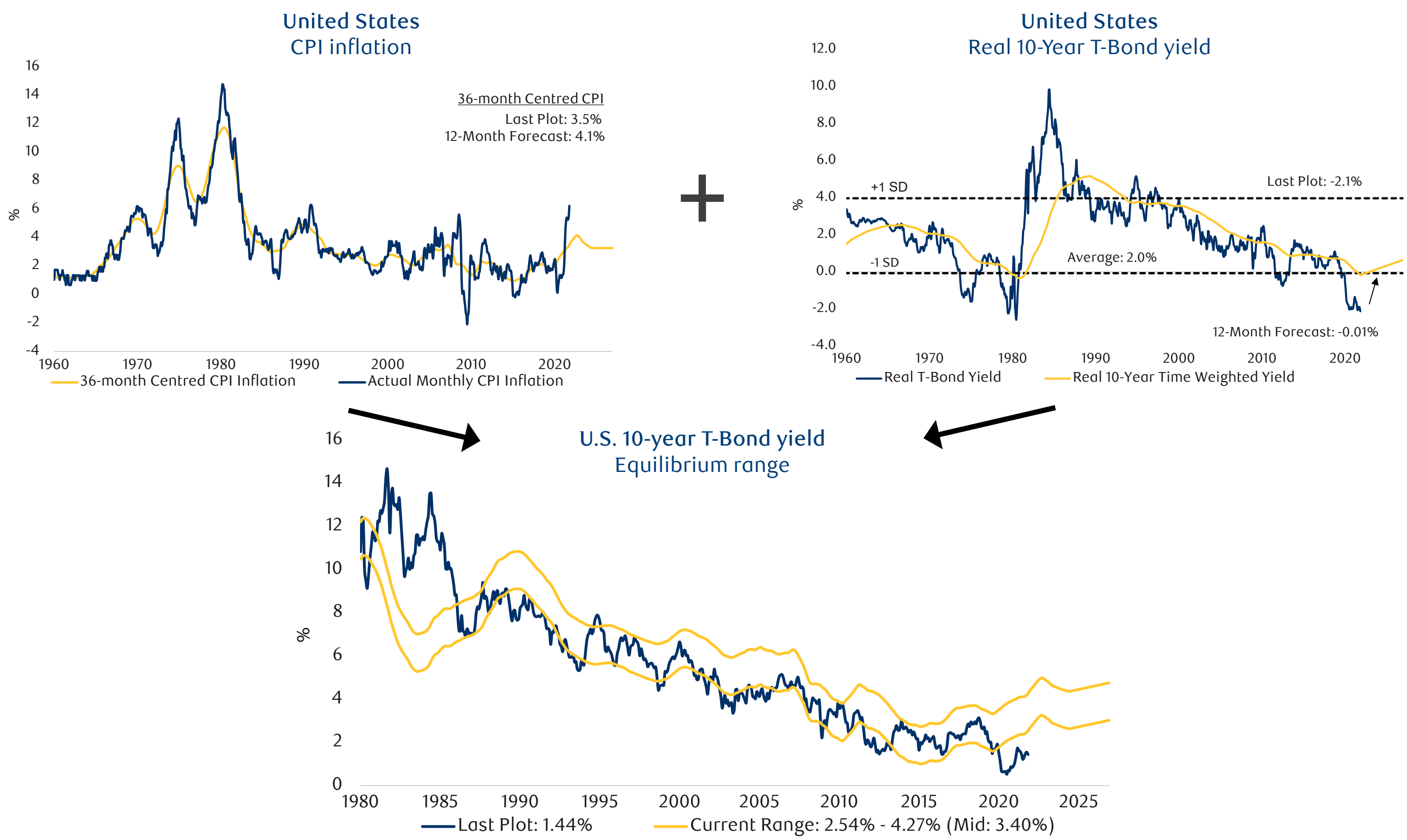


Note: As of November 30, 2021. Source: RBC GAM

Real interest rates are unsustainably low

A closer look at our bond model's components reveals that the key to higher yields lies in the eventual normalization of real interest rates to levels at or above the zero bound. Exhibit 16 decomposes our model for 10-year Treasuries into an inflation premium and real interest rate that added together arrive at a nominal bond yield. Our approach to modeling inflation uses a 36-month moving average that smooths the current short-term spike. But the model still situates the inflation premium over 3%, and that figure will likely decline as the current inflation spike rolls through our moving average. However, we think the real rate of interest, or after-inflation interest rate, remains unsustainably low and is likely to rise from here. It is currently at negative 2.1%, suggesting that sovereign-bond holders are accepting an after-inflation loss in purchasing power over time. As we have mentioned in past writings, a number of secular forces such as aging populations, an increased preference for saving and slowing economic growth have held real rates low. But our models suggest that even accounting for these factors, a more appropriate real rate would be around 0% or slightly above. If real rates rise to 0% and the inflation premium buried in the model is 3.5%, then the nominal yield should be 3.5%. A rise to this level from the current 1.44% would represent a painful experience for bond holders. We do think the direction of travel for yields is higher, but we don't think reported inflation will actually be reflected to its full extent as investors look ahead to alleviation of the special factors that have pushed it higher. We therefore think 3.5% on a 10-year Treasury yield would be an excessive expectation over our 12-month forecast horizon. If we are wrong, our model gives a sense of where yields could go if inflation takes solid root. Our own forecast is 1.80% for the U.S. 10-year yield over the next 12 months.

Exhibit 16: U.S. 10-year bond yield
Fair-value estimate composition



Note: As of November 30, 2021. Source: RBC GAM, RBC CM

Equities in review: stocks enjoyed strong start to 2021, followed by increasing divergence

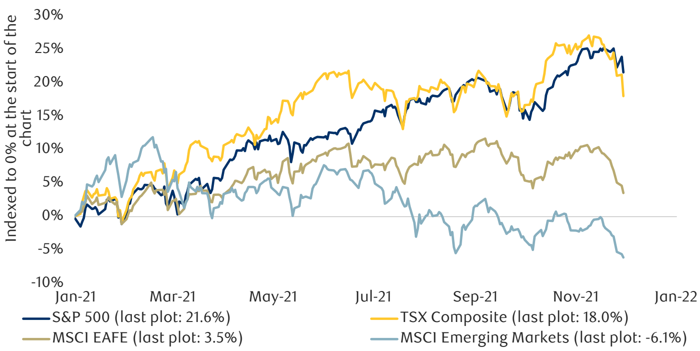
Global equities extended gains from 2020 to record another strong year in 2021, supported by vaccine rollouts, a reopening of economies and ample stimulus. The MSCI World Index rose 15.3% in the 11 months ended November 30, 2021, in U.S. dollars. In contrast to last year, however, returns varied widely by region. North American equites led, with the S&P 500 gaining 21.6% and the TSX Composite up 18.0%, while the MSCI EAFE Index was up only 3.5%, all in U.S.-dollar terms (Exhibit 17). Emerging-market equities were down slightly through November as troubles in China's property market and developing nations' increased difficulty dealing with the coronavirus weighed on returns. Most equity markets encountered heightened volatility in November on concerns about slowing growth and the discovery of Omicron.

After a long streak of gains, stocks have become increasingly expensive and valuations are at levels that haven't been seen for two decades. As of November 30, our composite of global equity market valuations was 25% above fair value, which is the most since the late 1990s technology bubble (Exhibit 18). To be clear, valuations are nowhere near as extreme as at the peak in 1999/2000 when valuations on this measure approached twice their fair value. The contribution to the latest overvaluation is mostly from U.S. equities, but Canada too has been a driver more recently. As we step outside of North America, valuations are more attractive on a relative basis, especially in Europe (page 46). The relative attractiveness of international stocks has motivated us to hold tactical overweight positions in those regional markets. The overvaluation of U.S. equities merits special attention because it is the world's bellwether stock market and has significant influence on the course of equities around the globe.

U.S. equities situated in high-volatility valuation zone

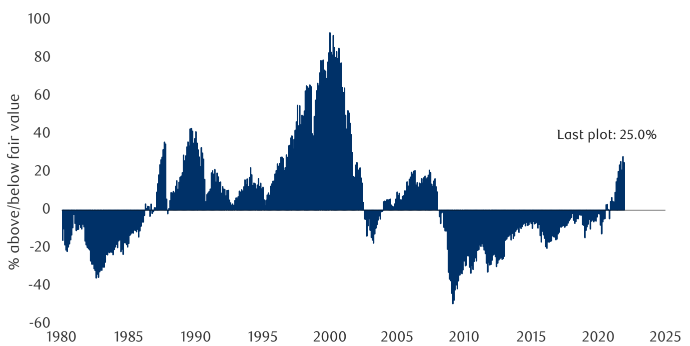
Elevated valuations like those we see in the U.S. large-cap market have important implications for investors, particularly with respect to volatility, but also for return expectations. We've computed return statistics for the S&P 500 based on historical valuation levels to get a sense of what we can expect in the current environment. Our analysis starts with Exhibit 19, which plots a standardized

Exhibit 17: Major equity-market indices
Cumulative price-returns indices in USD



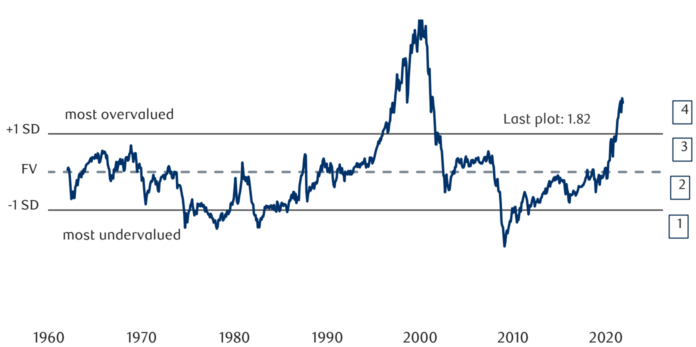
Note: As of November 30, 2021. Price returns computed in USD. Source: Bloomberg, RBC GAM

Exhibit 18: Global stock-market composite
Equity-market indexes relative to equilibrium



Note: As of November 30, 2021. Source: RBC GAM

Exhibit 19: Standardized S&P 500 fair-value bands



Note: As of November 30, 2021. Source: RBC GAM

Exhibit 20: S&P 500 Index
Return prospects by valuation zone

Valuation	Data set (Bucket)	1-year average return	Batting average^	1-year average return in win*	Max loss	1-year return std. dev.
(S&P 500 most overvalued)	4	9.3%	65.7%	22.3%	-27.5%	20.5%
1 SD above						
	3	3.5%	66.7%	11.3%	-39.5%	14.0%
Equilibrium						
	2	9.7%	78.0%	15.9%	-44.8%	15.0%
1 SD below						
(S&P 500 most undervalued)	1	16.3%	90.1%	18.8%	-12.8%	14.4%

*Win = Periods where returns are above 0%. ^Batting average = Incidence of winning in any given period. As of November 30, 2021.
Source: RBC GAM

version of our S&P 500 fair-value model where fair value is the dotted line running down the centre of the chart and the solid lines represent one standard deviation above and below the midpoint. The chart was segmented into four zones or buckets. Bucket 4 is more than one standard deviation above fair value, Bucket 1 is more than one standard deviation below fair value and buckets 2 and 3 are within one standard deviation from fair value on either side of the midpoint. Return statistics were computed based on where the S&P 500 was situated at the start of any one-year measurement period dating back to the 1960s and are shown in Exhibit 20. Notice that stocks have performed the best, on average, when starting from the cheapest zone (Bucket 1). In this zone stocks delivered yearly gains averaging 16.3% and rose in 90.1% of months. This has been the most favourable bucket for investors and it is where stocks began the bull market that emerged from the depths of the global financial crisis in 2009. But stocks have gotten significantly more expensive after a long bull run and now have climbed all the way to Bucket 4 – the most expensive zone. Interestingly, this zone doesn't necessarily feature the lowest 1-year returns on average, but it does have the lowest incidence of positive returns, at only 65.7%, and the highest standard deviation of returns compared with the other buckets. Investors should recognize that this valuation zone has historically been the most volatile place to hold stocks and, while profits can be realized in this space, any doubts about corporate profits are likely to lead to heightened instability.

Inflation and interest rates are key valuation drivers

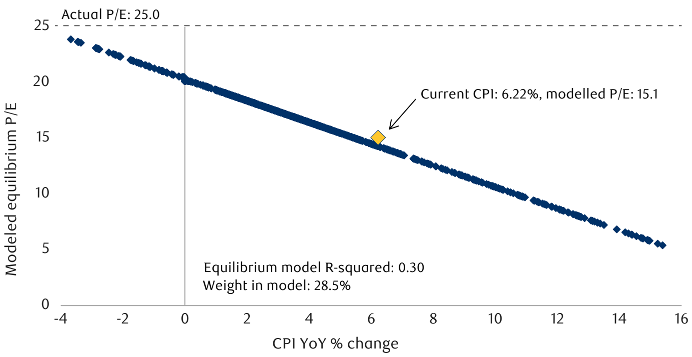
Part of the reason stocks are expensive is that the macroeconomic environment supports high valuations. Low interest rates and, until recently, low inflation have been key drivers that boosted the price investors were willing to pay for riskier assets. Our own models determine an equilibrium price-to-earnings ratio (P/E) for stocks based on a combination of six macroeconomic factors. The model weights these factors based on the strength of their historical relationships with valuations. The inflation, interest rate and bond yield components greatly influence the end result as they make up a combined 86% of the weight in the final equilibrium P/E equation. These three key drivers have an inverse relationship with P/Es, meaning that higher inflation, interest rates and/or yields are consistent with lower P/E ratios. Exhibit 21 plots the relationship between inflation and P/Es. Notice that, as we get further to the right of the graph, higher inflation rates are associated with falling P/Es. But what it also means is that from current high inflation readings, a decline in inflation back toward more normal levels could act as a support for valuations.

The relationships between P/Es and interest rates are more interesting, as they exhibit a hockey-stick shape (exhibits 22 and 23). Usually, falling rates are consistent with higher P/Es, but below certain levels, falling interest rates and yields reflect an economy in crisis and P/Es actually fall in this situation. As the crisis environment subsides, though, the initial lift-off in interest rates and yields from extraordinarily low levels actually coincides with rising valuations. We saw this play out in the rise of the 10-year yield from the March 2020 low to a level that until recently was actually consistent with rising valuations. But we are now past the crest in the chart where any further increase in the U.S. 10-year yield would likely weigh on valuations. Short-term interest rates, still near zero, could be raised several times by the Fed before meaningfully hindering P/Es.

Earnings surge, propelled by strong nominal GDP growth

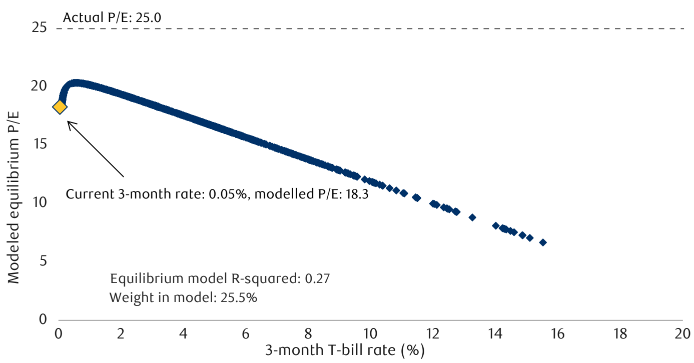
The other critical part of the equity equation, and one that could justify today's high valuations, is that corporate-profit growth has been outstanding. Our model suggests a favourable earnings environment is likely to persist, with S&P 500 profits projected to rise 47% in 2021 from 2020

Exhibit 21: S&P 500 equilibrium model
P/E factor as a function of CPI



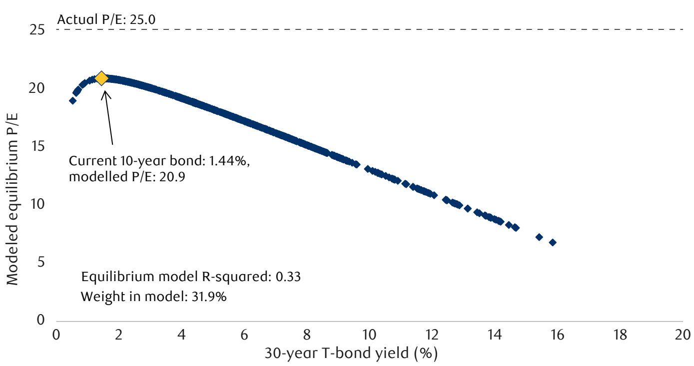
Note: As of November 30, 2021. Source: RBC GAM

Exhibit 22: S&P 500 equilibrium model
P/E factor as a function of 3-month T-Bill rate



Note: As of November 30, 2021. Source: RBC GAM

Exhibit 23: S&P 500 equilibrium model
P/E factor as a function of 10-year bond yield

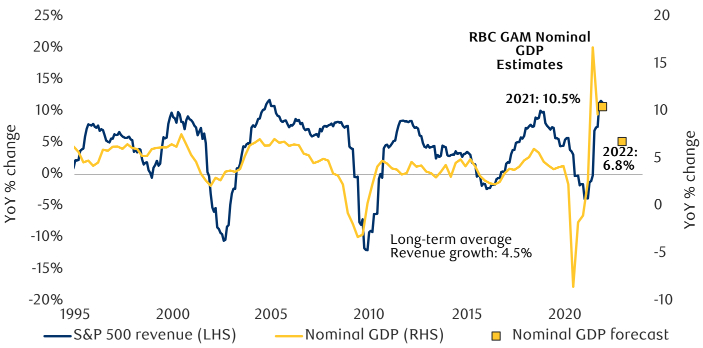


Note: as of November 30, 2021. Source: RBC GAM

as a powerful economic recovery has put earnings on track to exceed their pre-pandemic trajectory. Significant nominal GDP growth has contributed to double-digit gains in revenues and, while we expect GDP to slow a bit next year, we continue to look for above-average growth (Exhibit 24). A simple regression of nominal GDP growth versus S&P 500 profit growth suggests our forecast of 7.3% nominal GDP growth in 2022 is consistent with an 18.9% gain in earnings for next year (Exhibit 25).

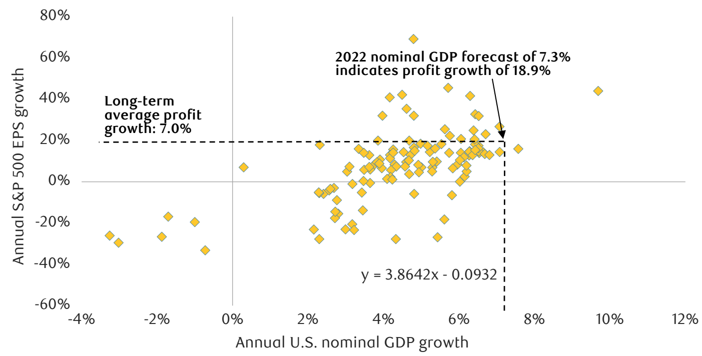
The consensus of analysts' estimates projects an 8% increase in S&P 500 earnings in 2022, but this forecast could well be exceeded as analysts have been persistently underestimating profits since the pandemic began. Exhibit 26 plots the month-by-month S&P 500 earnings estimates, which have been subject to constant and meaningful upward revisions as the recovery progressed. In fact, in each of the past six quarters, 80% to 90% of earnings releases exceeded the consensus of analysts' estimates (Exhibit 27). The risk now is that sufficient upward revision has been baked in, and future forecasts could be more difficult to surpass. Our simple regression model, however, would suggest that estimates may still be too low. The bull market could be well supported if this trend of upward revisions to earnings estimates continues.

Exhibit 24: United States
S&P 500 revenue and nominal GDP



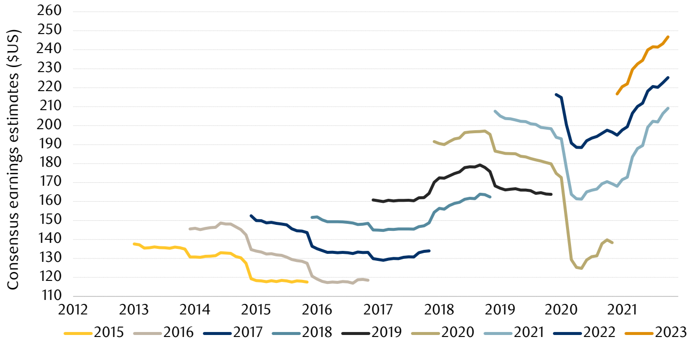
Note: As of November 30, 2021. Source: RBC GAM. Source: RBC CM, RBC GAM

Exhibit 25: S&P 500 EPS vs U.S. nominal GDP growth



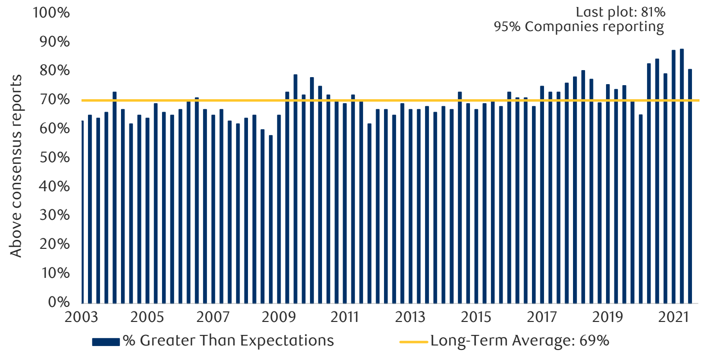
Note: Based on quarterly data back to January 1990. Source: Bloomberg, RBC GAM

Exhibit 26: S&P 500 Index
Consensus earnings estimates



Note: As of November 29, 2021. Source: Thomson Reuters, Bloomberg

Exhibit 27: Companies reporting results above consensus forecasts



Note: As of November 30, 2021. Source: Refinitiv

Exhibit 28: Earnings estimates & alternative scenarios for valuations and outcomes for the S&P 500

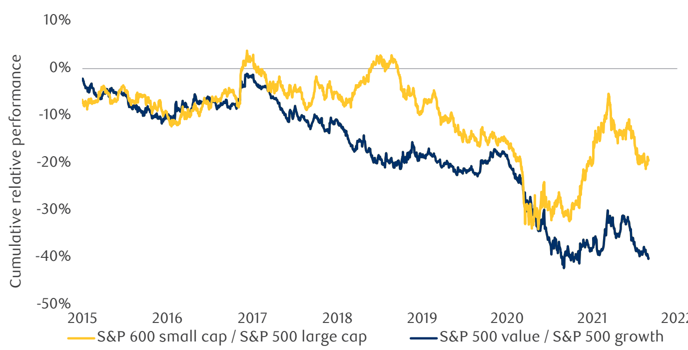
		Consensus			
		2022 Top down	2022 Bottom up	2023 Top down	2023 Bottom up
	P/E	$228.0	$225.6	$241.9	$247.0
+1 Standard Deviation	23.4	5326.0	5268.8	5650.0	5770.3
+0.5 Standard Deviation	21.1	4814.0	4762.3	5106.9	5215.6
Equilibrium	18.9	4302.0	4255.8	4563.7	4660.9
-0.5 Standard Deviation	16.6	3790.0	3749.2	4020.5	4106.1
-1 Standard Deviation	14.4	3277.9	3242.7	3477.3	3551.4

Note: As of November 30, 2021. Source: Bloomberg, Thomson Reuters, RBC GAM

Scenario analysis reveals high valuations and strong earnings growth are necessary for meaningful gains in stocks

Decent returns for stocks are still possible but, given today's level of valuations, the bar is elevated. Exhibit 28 plots a variety of scenarios for the S&P 500 based on different earnings and P/E ratios. Our model suggests that the equilibrium P/E for the S&P 500 is 18.9 in 2022 based on expected interest rates, inflation and corporate profitability. If the market traded at this P/E and generated earnings in line with the consensus estimate, the outcome would be unappealing, with the S&P 500 declining slightly next year and ending up flat by the end of 2023. But if the market manages to trade at a P/E slightly above equilibrium, say 0.5 to 1.0 standard deviation above, the S&P 500 could trade in a range between 4700-5300 in 2022 and 5000-5700 in 2023, resulting in total returns of 5% to 13% annualized over the next two years. Moreover, it is worth considering that continued strong nominal GDP growth could result in materially higher earnings than indicated by the consensus. While stocks are in a vulnerable position should confidence fade or the outlook deteriorate, investors may want to acknowledge that in an environment of still-low interest rates, and where inflation could transition back to normal levels alongside strong growth in corporate profits, the equity market could continue to deliver mid-single-digit to low-double-digit gains over the next few years.

Exhibit 29: Relative style performance



Note: As of November 30, 2021. Source: Bloomberg, RBC GAM

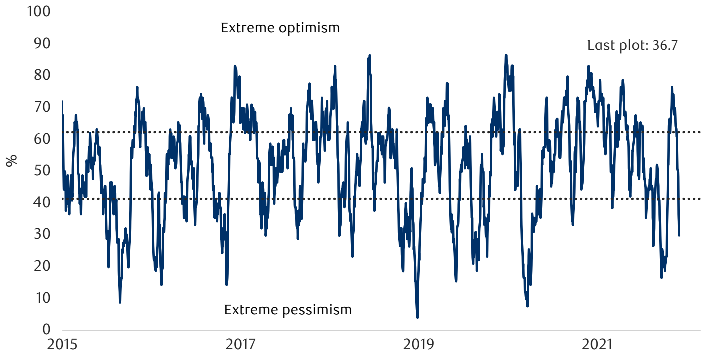
What's in style? Large-cap growth

The style leadership that has been in place since spring of 2021 has been somewhat of a concern, and we have yet to see any significant shift back to the leaders that were in place during the economic reopening. Large-cap growth stocks extended their gains relative to small-cap value stocks as the year progressed and the initial enthusiasm over economic reopening and vaccines faded. By the end of November, value stocks fell to a new all-time low relative to growth stocks, and small caps completely erased their earlier gains versus large caps for the year (Exhibit 29). Although the pandemic prompted a brief and powerful rotation into value and small-cap stocks earlier in the economic recovery, style preferences have shifted back to large-cap growth stocks, signaling that investors may be concerned about the sustainability of the expansion. We have not seen any re-emergence of value and/or small cap leadership, but if we did, and it were sustained, such a shift would represent a strong signal from investors that the economy is strong enough to generate the broad-based profit growth required to fuel a new leg up in equities.

Investor confidence and market breadth wane, often contrarian signals

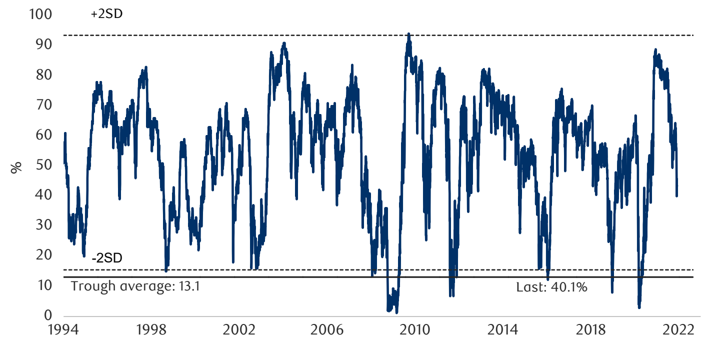
Consistent with style leadership shifting to a more cautious stance, measures of investor sentiment and market breadth peaked in the summer of 2021 and most have been declining since then. Importantly, some of these metrics could already be approaching encouraging levels. Exhibit 30 plots a composite of daily trading sentiment indicators compiled by Ned Davis Research. These indicators suggest that sentiment had climbed to extremely optimistic levels in the summer, but that it has since backed off and is now at a more neutral reading. Measures of price momentum have displayed similar patterns, with the percentage of stocks trading above their 200-day moving average and the percentage of stocks in rising monthly price trends having both come off of extremely positive readings (exhibits 31 and 32). Equities are generally vulnerable to correction when these indicators are falling, but it is also worth noting that they have traversed a significant distance, and that lows on these charts tend to be associated with a definitive bottom.

Exhibit 30: Ned Davis Research Daily Trading Sentiment Composite – Percent bulls



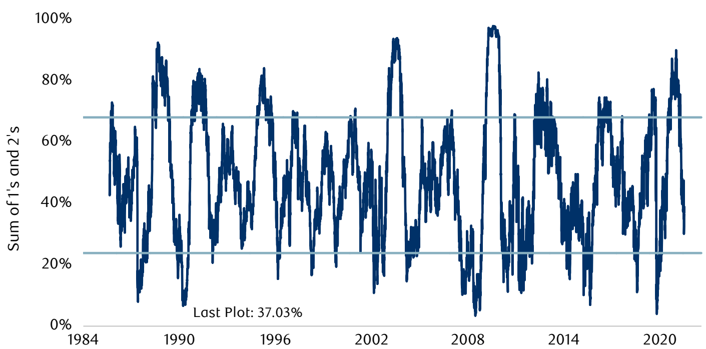
Note: As of December 1, 2021. Source: Ned Davis Research, RBC GAM

Exhibit 31: New York Stock Exchange Composite Index – % of stocks above their 200-day moving average



Note: As of December 1, 2021. Source: Bloomberg, RBC GAM

Exhibit 32: S&P 500 Index
Monthly price momentum

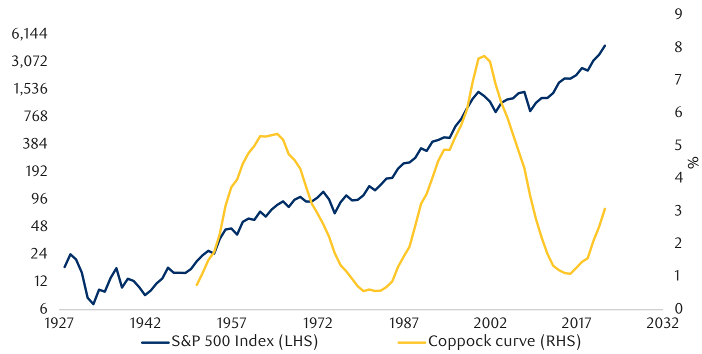


Note: As of December 3, 2021. Source: RBC GAM

Stocks remain in a long-term rising trend

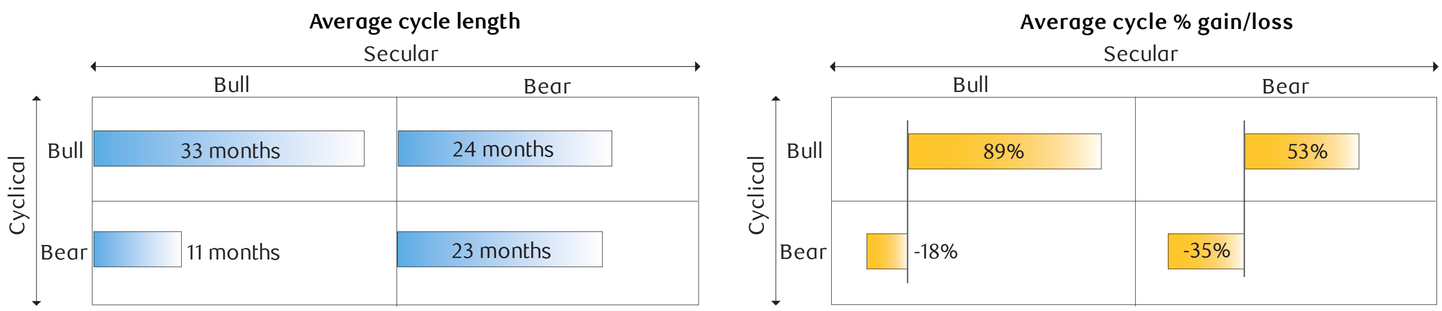
The recent volatility in stocks hardly registered on a very long-term chart of the S&P 500, and this bigger-picture view informs our thinking on where equities may be headed in the short term. Exhibit 33 plots the S&P 500 back to the 1920s, and overlaid on the chart is our supercycle price momentum indicator. While the equity market has experienced extended periods of sideways movement, these phases have tended to be followed by sustained and powerful advances that can be measured in decades. This supercycle indicator turned higher in 2016 and suggests that we are currently in a supercycle bull market. The last time we had a turn higher in this indicator was in the early 1980s followed by a nearly 20-year-long bull market.

Exhibit 33: S&P 500 Index
Supercycle price momentum



Note: Coppock curve based on yearly data as of December 1, 2021.
Source: Bloomberg, RBC CM, RBC GAM

Exhibit 34: U.S. equity-market cycle statistics



Note: Uses Robert Shiller's historical U.S. stock market data since january 1870. Data based on monthly closing prices. Source: RBC GAM

The secular backdrop provides useful context for what to expect during correction or rally phases. Rally phases during supercycle bull markets average almost 40% longer and two thirds greater in magnitude than that of supercycle bear markets (Exhibit 34). And corrections have historically been half as long and about one third less damaging in supercycle bull markets versus bear markets. If we are right in thinking that we are in a supercycle bull market, then we should expect corrections to be shallow and short-lived and anticipate advances to be long and powerful.

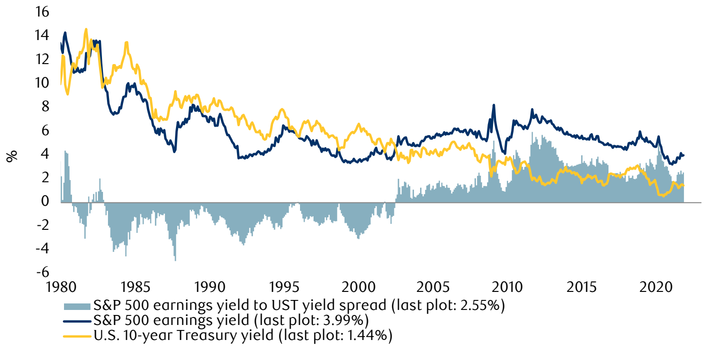
Asset mix – a second modest trim to our equity overweight

Our base case scenario sees the economy continuing to grow at a rapid yet slowing rate as the recovery matures. Much of the economic damage from the pandemic has been repaired and the expansion has moved into the middling stage of the business cycle. At this point, central banks are starting to dial back monetary accommodation and, although conditions fully justify the need for tightening, we recognize that financial markets will, at the margin, be receiving less support. Other risks to our outlook include the ebb and flow of the pandemic, challenges in China's property sector and inflation. That said, there is a possibility that all of these risks prove less harmful than initially feared, resulting in an even better outlook for economies and risk assets than we've budgeted.

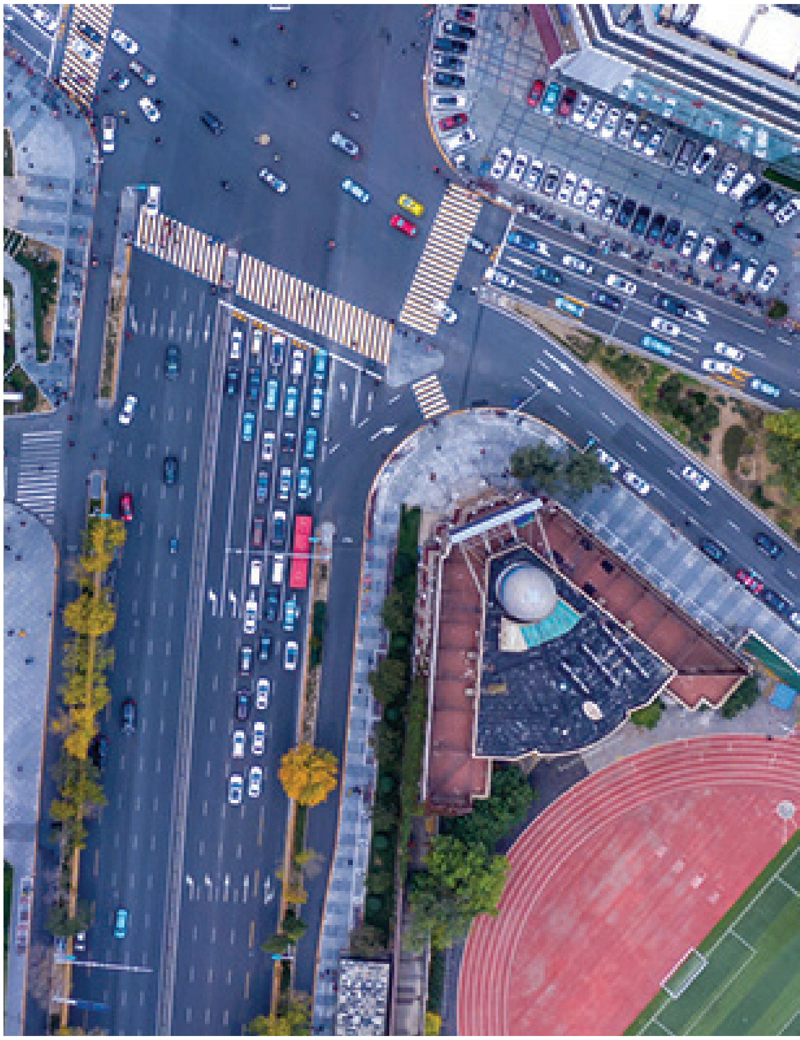
Against this backdrop, sovereign bonds look particularly unappealing. As the economy continues on its bumpy path to normalization, we expect interest rates to rise at a gradual pace. Any meaningful increase in yields from today's extremely low levels would result in low or potentially negative returns for sovereign bonds and, as a result, we remain underweight fixed income in our asset mix.

Stocks continue to offer superior potential, especially relative to fixed income. Exhibit 35, which plots the earnings yield of the S&P 500 versus the U.S. 10-year bond yield, continues to suggest that stocks are attractive relative to bonds. That said, we recognize that the cycle is advancing, valuations are elevated and the market is vulnerable to correction should risks mount, investor confidence wane and/or the economic outlook deteriorates. We reduced our equity allocation by 50 basis points in the summer in recognition of the maturing of the recovery. Since then, narrowing market breadth, slowing growth, a lack of leadership outside U.S. large-cap equities and the threat of the new Omicron virus variant have motivated us to reduce our equity weight by another 50 basis points this quarter, placing the proceeds into cash. This leaves us with a modest risk-on position with 63.5% in equities versus our strategic neutral of 60.0%, reflecting our continued preference for stocks, but also an acknowledgement that the opportunity set is less attractive than it was at earlier points in the recovery. We are maintaining a modest of a cash buffer to be deployed should opportunities arise or if technical conditions were to improve. For a balanced global investor, we currently recommend an asset mix of 63.5 percent equities (strategic neutral position: 60 percent) and 33.5 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

Exhibit 35: S&P 500 earnings yield
12-month trailing earnings/index level

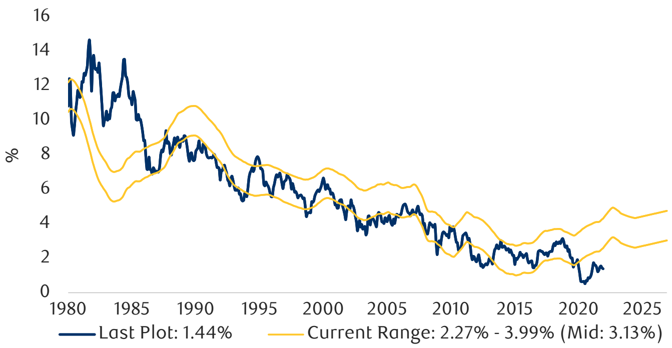


Note: As of November 30, 2021. Source: RBC GAM, RBC CM



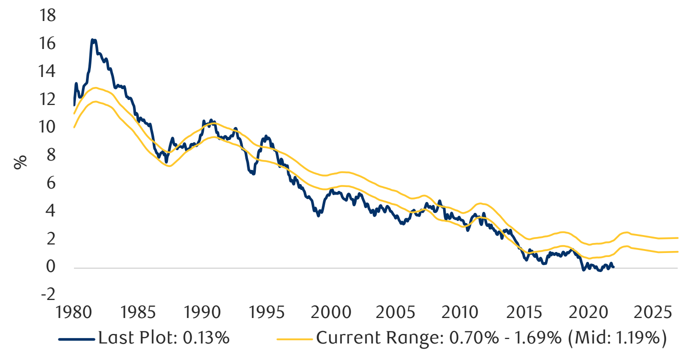
Global fixed income markets

U.S. 10-Year T-Bond Yield
Equilibrium range



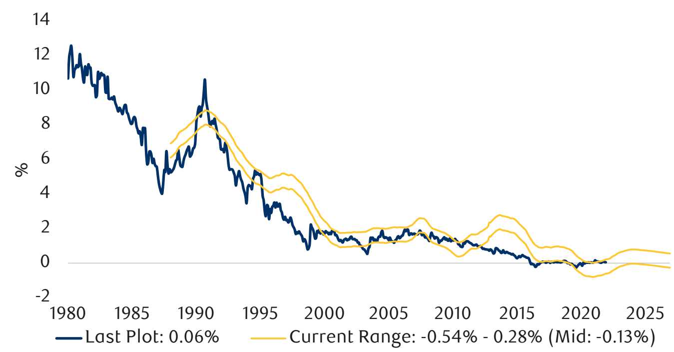
Note: As of November 30, 2021. Source: RBC GAM, RBC CM

Eurozone 10-Year Bond Yield
Equilibrium range



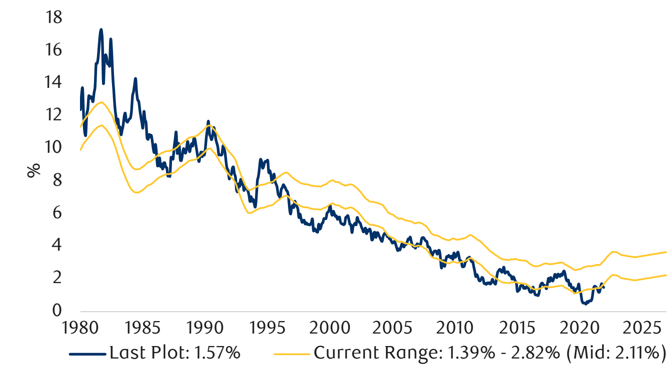
Note: As of November 30, 2021. Source: RBC GAM, RBC CM

Japan 10-Year Bond Yield
Equilibrium range



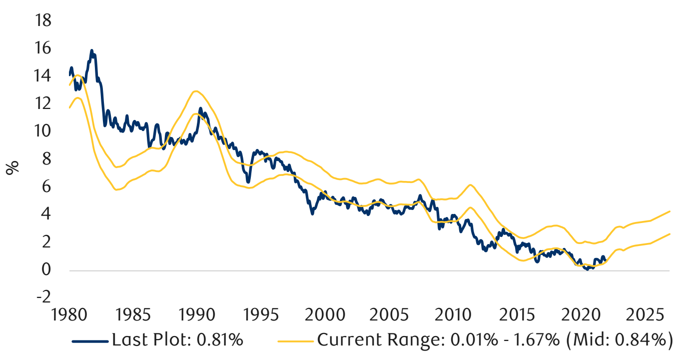
Note: As of November 30, 2021. Source: RBC GAM, RBC CM

Canada 10-Year Bond Yield
Equilibrium range



Note: As of November 30, 2021. Source: RBC GAM, RBC CM

U.K. 10-Year Gilt
Equilibrium range



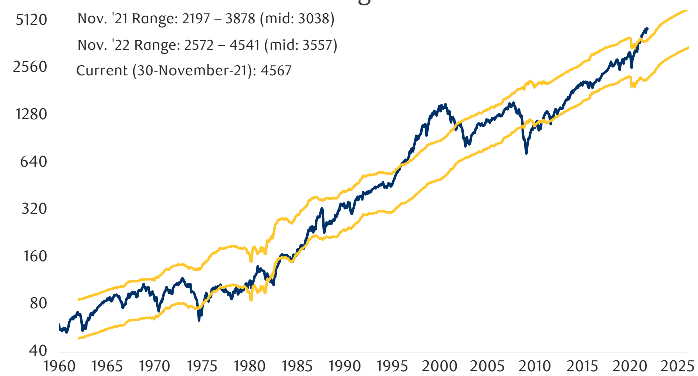
Note: As of November 30, 2021. Source: RBC GAM, RBC CM

> "Global bond yields climbed over the course of the year but encountered significant fluctuations, and they remain well below where our models would deem appropriate."

Global equity markets

S&P 500 Equilibrium

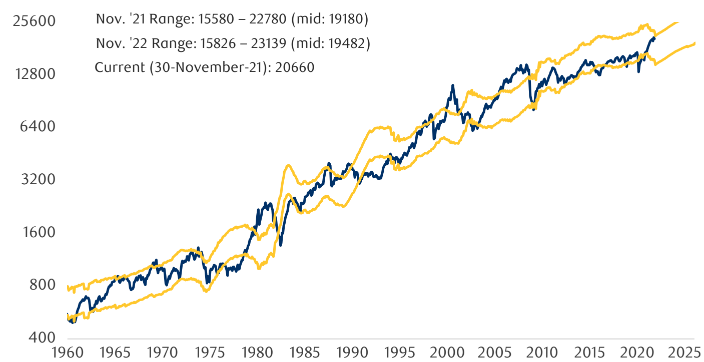
Normalized earnings and valuations



Source: RBC GAM

S&P/TSX Composite Equilibrium

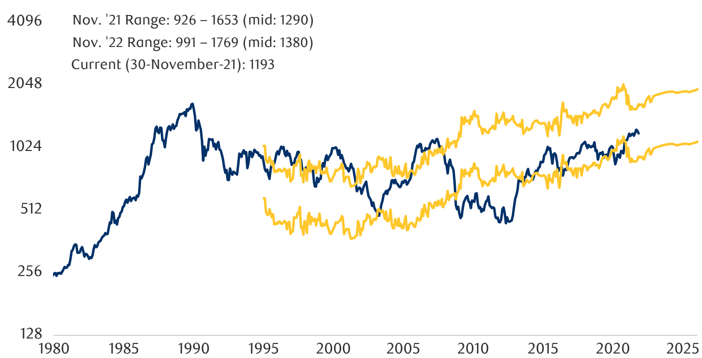
Normalized earnings and valuations



Source: RBC GAM

MSCI Japan Index

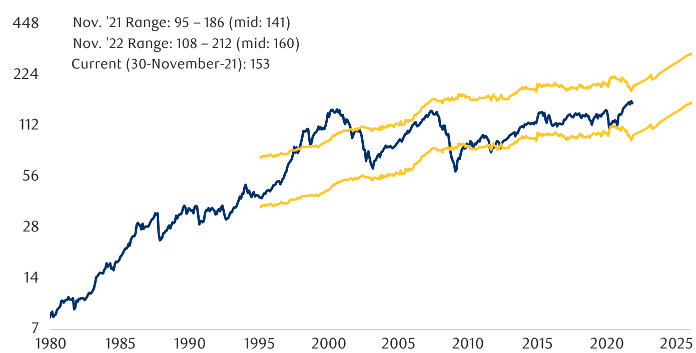
Normalized earnings and valuations



Source: RBC GAM

MSCI Europe Index

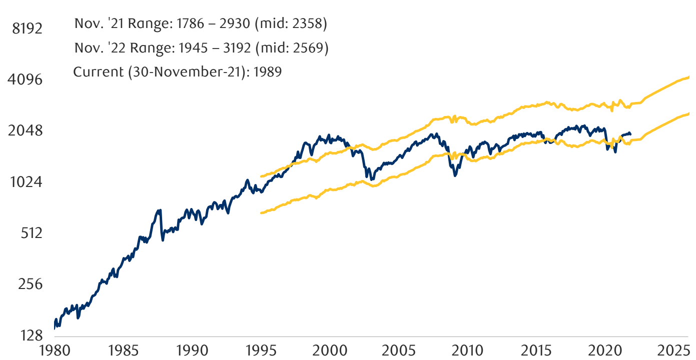
Normalized earnings and valuations



Source: RBC GAM

MSCI U.K. Index

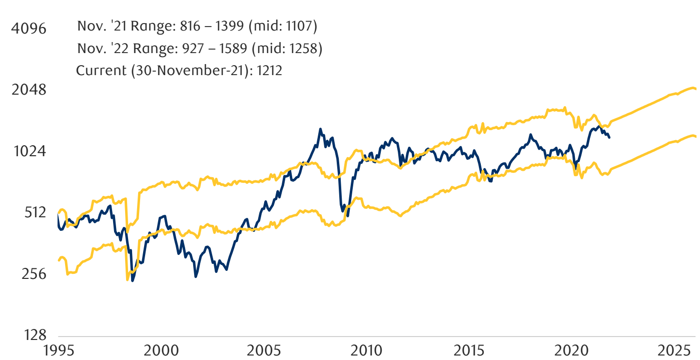
Normalized earnings and valuations



Source: RBC GAM

MSCI Emerging Markets Index

Normalized earnings and valuations



Source: RBC GAM

Note: The fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index.

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