RBC Global Asset Management

The Global Investment Outlook

RBC GAM Investment Strategy Committee

NEW YEAR 2021

The RBC GAM Investment Strategy Committee

The RBC GAM Investment Strategy Committee consists of senior investment professionals drawn from all areas of RBC GAM. The Committee regularly receives economic and capital markets related input from internal and external sources. Important guidance is provided by the Committee's regional equity advisors (North America, Europe, Asia, Emerging Markets) and from the Global Fixed Income & Currencies sub-committee. From this, the Committee builds a detailed global investment forecast looking one year forward.

The Committee's view includes an assessment of global fiscal and monetary conditions, projected economic growth and inflation, as well as the expected course of interest rates, major currencies, corporate profits and stock prices.

From this global forecast, the RBC GAM Investment Strategy Committee develops specific guidelines that can be used to manage portfolios.

These include:

- the recommended mix of cash, fixed income instruments, and equities
- the recommended global exposure of fixed income and equity portfolios
- the optimal term structure for fixed income investments
- the suggested sector and geographic make-up within equity portfolios
- the preferred exposure to major currencies

Results of the Committee's deliberations are published quarterly in *The Global Investment Outlook*.

Executive Summary

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Buoyed by ultra-low interest rates and fiscal stimulus, financial markets calmed and stocks rose to record levels as economic normalization drew closer and the recovery progressed.

Looking past COVID-19 to an improving outlook for 2021

The pandemic remains the key challenge for economies as we approach the New Year, with case counts and fatalities reaching near record levels. But the transmission rate is starting to slow and, while countries including the U.S. and Canada are battling a second wave, many European countries appear to be emerging from theirs. Tighter restrictions to combat the virus may lead to some economic slippage at the end of 2020, but there are reasons to be optimistic. The economic recovery has been exceeding expectations, vaccine developments are promising and markets have responded positively to the outcome of the U.S. presidential election. Although the economy may encounter hurdles in the very near term, our growth forecasts for 2021 have featured more upgrades than downgrades and are now situated modestly above the consensus.

A variety of risks threaten our base case, but upside surprises are also possible

We think the risks to our benign base case scenario are slightly skewed to the downside. The virus is still spreading and colder winter weather in the northern hemisphere could worsen the situation. It is also possible that a third wave of infections emerges in the spring as happened in the 1918 flu pandemic. Moreover, sentiment around vaccines is extremely positive, but a return to normal could be delayed should they cause unexpected side-effects or prove less effective than hoped, or should distribution complications slow the pace of inoculations. While we expect inflation to remain low, there is the potential for prices to rise faster than our forecasts, and an environment of too much inflation would be worse than not enough. Note that it is normal for the balance of risks to lean toward the downside as there are usually more ways for the economy to stumble than to outperform meaningfully. We should, though, also consider the possibilities for better-than-expected outcomes. The virus could retreat on its own or vaccines could be administered flawlessly. Other sources of uncertainty include the amount and timing of U.S. fiscal stimulus, Brexit and structural themes related to demographics, high debt loads and globalization.

Inflation gains traction but not to problematic levels

Our thinking about inflation has evolved over the past quarter. We correctly predicted inflation would be low amid the pandemic, with falling oil prices and plunging demand. More recently, though, inflation has begun to stabilize as economic conditions have normalized. Our forecasts for inflation in 2020 and 2021 point to slightly higher inflation and we recognize that a weaker U.S. dollar and the outperformance of the U.S. economy may support faster price increases in the U.S. versus elsewhere. Over the longer term, potential upside risks to inflation exist. Massive monetary stimulus, higher inflation targeting by the U.S. Federal Reserve (Fed), elevated government-debt loads and a push to support sales of American-made products are all elements that could push inflation higher than we would have thought before the pandemic. That said, we don't think inflation will rise to problematic levels as a number of structural forces such as demographics will continue to weigh on inflation pressures. All in all, any faster inflation that we do encounter is likely to be simply a return to more normal readings after decades of subdued price increases.

U.S. dollar weakness ahead

We expect a sustained U.S.-dollar decline in 2021 as structural headwinds take precedence over short-term factors that have slowed the decline of the greenback over the past year. U.S. twin deficits and the Fed's intention to boost inflation, coupled with economic and political improvements and extraordinarily easy financial conditions, should cement the U.S.-dollar downtrend. Emerging-market currencies are likely to finally shine next year, and the euro, yen and loonie should outperform the British pound.

Bond yields hover around historic lows, scope for increase is limited

Central bankers have expressed a commitment to keeping short-term interest rates extremely low to stimulate economies and financial markets even as the recovery gains traction. Longer-term bond yields have a bit more room to rise, but the scope for increases is limited by secular pressures such as aging demographics, slowing population growth and an increased desire for saving versus spending. All of these factors have contributed to declines in real interest rates (i.e. the after-inflation interest rate) and these trends are unlikely to change anytime soon. We have evolved our modelling to incorporate these elements into our real-interest-rate projections. As a result, we now look for a more gradual and ultimately smaller rise in real rates of interest. Our new modelling suggests that sovereign bond yields everywhere will drift just slightly higher over the next year, acting as a modest headwind to total returns for bondholders.

Global equities soar to new highs and vaccines trigger style rotation

Stocks surged from their March lows due to a combination of massive stimulus, a gradual reopening of economies and, more recently, the promise of imminent vaccines. The latest rally pushed the S&P 500 Index to a new record and many other markets are also showing gains this year. We recognize that optimism is elevated and, while stocks may be expensive by some measures, investors are paying up for a recovery in earnings that is just beginning. In fact, outside of U.S. large-cap stocks, markets remain attractively positioned with many below the mid-point of our fair value bands. The equity-market rally has broadened from a handful of U.S. mega-cap technology stocks to a much larger base of companies, industries and regions that are more economically sensitive, including value, small- and mid-cap stocks, as well as segments that were hardest hit by COVID-19 such as airlines, hotels, casinos and energy.

Asset mix – boosting equity overweight, sourced from fixed income

With the economy entering a period of normalization supported by low interest rates and ample fiscal stimulus, stocks continue to offer superior return potential versus fixed income. Our forecasts look for mid-single to potentially low-double digit returns from stocks over the year ahead versus low single-digit or potentially negative returns from sovereign bonds. Moreover, extremely low bond yields mean that fixed-income markets may not provide as much protection against stock declines as they have in recent decades. In our opinion, traditional views on optimal asset mix should be reconsidered to reflect the impact of structural change in the global economy on returns, correlations and risk mitigation within the universe of investment options. For many, one option may be to invest over longer time horizons and add more equities to portfolios.

Supporting our positive view on stocks is long-term price momentum, which suggests equities could be in a long lasting bull market. We continue to position our portfolios with an overweight in stocks and underweight in fixed income. This quarter, we were further encouraged by the style rotation into value from growth, the increasing breadth in small- and mid-cap stocks, international equity outperformance, the steepening yield curve and the weakening U.S. dollar, all of which are frequently in evidence in the early stages of bull markets. As a result, we added 2.5 percentage points to our equity allocation during the quarter, sourced from fixed income. For a balanced, global investor, we currently recommend an asset mix of 64.5 percent equities (strategic neutral position: 60 percent) and 34.5 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.