Global Asset Management

For more on our current view and outlook, consult **The Global Investment Outlook**.

Investment Outlook – Spring 2017

Leading economic indicators are at their best levels in several years, economic surprises have been overwhelmingly positive and corporate earnings continue to recover from their prior stumbles. Taken together, global economic signals remain quite strong by post-crisis standards. As a result, risk assets such as equities and corporate credit have performed well.

The biggest question on the minds of global investors relates to what the Trump administration will do in the next four years. There is still enormous uncertainty around precisely how U.S. public policy will play out. So far, optimists would appear to outnumber pessimists: equities have soared, the U.S. dollar has risen, bond yields have gone up and credit spreads have narrowed. It's important to recognize that this bout of market enthusiasm actually began well in advance of the election, but the political outcome provided a further springboard.

Faster economic growth, but we are not abandoning our "slow-growth" view just yet

Economic growth has improved in both developed and emerging markets, with most countries managing some improvement in recent months. Weighing the available evidence, we choose to celebrate this period of faster growth, but we assume that the current episode represents a fluctuation toward the high end of the post-crisis growth range rather than a permanent escape from the "slow-growth" environment. We continue to see a plethora of factors that will constrain economic growth going forward. We have moderately upgraded our 2017 growth forecasts this quarter but assume that some portion of the recent vigour will be shed into the second half of the year and into 2018.

Downside risks manageable

Risks to our outlook include the aging business and credit cycles, rising populist movements, higher interest rates, elevated Chinese debt loads and an ever-evolving and uncertain political landscape in the U.S. and Europe. We expect that the global economy will be able to move beyond these risks and continue to grow and possibly even accelerate, though still running at a pace below long-term historical norms.

U.S. dollar bull market keeps going

Six years into the U.S. dollar bull market, prospects for the greenback still look relatively bright. Many long-term factors are still supportive, while the other major currencies remain hampered by weaker growth profiles, less attractive interest rates and/or political uncertainty. Our forecast of single-digit gains for the U.S. dollar are tempered by what is likely the late stage of the bull market, but proposed Republican policies in the U.S could represent a shot in the arm for the greenback and further extend this period of dollar strength.

Trend to higher inflation continues

There is now clear evidence that the trend towards higher inflation is well afoot as the negative commodity shock has ended, thus removing a profound deflationary pressure. If economic growth is better than expected, inflation should logically rise even more quickly. Our inflation forecasts tend to be above the consensus, with some countries set to drift above their target levels.

All eyes on the Fed

Globally, many central banks are still focused on delivering prior quantitative-easing commitments. The one exception is the U.S. Federal Reserve which continues to press forward with its plan to nudge the fed funds rate higher. Improving U.S. economic conditions, firming inflation and a strengthening labour market suggest a decreasing need for the extremely accommodative monetary policy that has been in place in the U.S. since the financial crisis. The Fed appears to be onboard with this logic, having raised its projections in December for the number of rates hikes in 2017 to three from the two forecast in September.

A popular topic of discussion in financial markets has been an expected shift from monetary stimulus to fiscal stimulus. A gradual decline in monetary stimulus is likely playing out, but there appears to be less new fiscal stimulus coming than popularly imagined. A key implication of these findings is to recognize that total government stimulus – monetary and fiscal policy combined – may actually be in slight decline. This is a reason to be cautious about expecting accelerating economic growth over the next few years.

Near-term pause in bond yields, but long-term direction is higher

The yield on U.S. 10-year Treasuries peaked at 2.65% in December and has been trading in a narrow range since then. Bond yields followed a similar pattern in other major regions, but to a lesser extent. The fact that yields have risen so rapidly since last summer has greatly reduced the valuation risk and, therefore, the need for a further near-term adjustment.

However, our fixed-income models continue to suggest that the long-term direction for yields is higher. The financial crisis has depressed real rates of interest to levels that are not likely to persist. The combination of both a bit more inflation and a higher real rate of interest would act as a headwind to fixed-income returns in general and pose a risk to sovereign-bond investors, in particular.

Stocks extend gains, earnings outlook brightens

Surprisingly strong economic data, surging consumer and business confidence, and better-than-expected earnings propelled stocks higher in the past quarter, with most major indexes delivering gains in the mid to high single digits. Emerging markets, European and U.S. equities rose the most, while gains for Japanese and Canadian stocks lagged. Although stocks have enjoyed a solid rally, we don't think that valuations are as stretched as some investors believe. Traditional price-to-earnings ratios, in particular, do not factor in interest rates and therefore may appear elevated when compared to history. Our own RBC GAM multi-factor model, which incorporates current levels of inflation, interest rates and corporate profitability, suggests U.S. stocks are actually a bit below fair value. However, we do recognize that stocks are not as cheap as they were, so a continued improvement in earnings is needed to fuel further equity gains. Fortunately, a recovery in profits is well underway. In fact, S&P 500 earnings exceeded analysts' forecasts in the fourth quarter and now appear to be accelerating. While there are risks that some of Trump's protectionist policies could have a negative impact on earnings, significant gains are also possible if large-scale corporate-tax cuts materialize and the economy accelerates.

Style rotation could be cause for concern in the near term

While our long-term view on equities remains positive, there are some current trends in the market that may be signalling near-term caution. The massive rotation in investment style leadership of 2016 has stalled so far this year. Since the start of 2017, growth has outperformed value and large caps have outperformed small caps, representing a lack of follow-through in 2016's style shift and, perhaps, a moderation in the positive outlook that rotation represented. Of course, this situation may simply indicate a pause within a longer-term move, or it could also be cause for concern if the trend deteriorates further. A sustained shift toward large-cap and growth leadership may foreshadow a slowdown in the economy and/or corporate profits in the quarters ahead.

Equity exposure slightly reduced

Our models continue to suggest that equities will outperform fixed income through the forecast horizon as well as over the longer term. A starting point of low yields, combined with our expectation that yields will rise, results in low or potentially negative returns over the years ahead. Prospective returns for equities are much more attractive. As a result, we have maintained our long-standing overweight exposure to equities and underweight position in bonds. That said, we have slightly reduced our exposure to stocks and allocated the proceeds to cash due to the uncertainty surrounding U.S. public policy and a variety of style and technical factors. For a balanced, global investor, we currently recommend an asset mix of 60% equities (strategic neutral position: 55%) and 38% fixed income (strategic neutral position: 43%), with the balance in cash.

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