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COVID-19 outbreak shocks economy and markets

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The COVID-19 virus outbreak represents a significant challenge to global economic activity through its disruption of global supply chains and its detrimental impact on travel and investor confidence. Although the bulk of confirmed cases are in China, the spread to South Korea, Europe and North America indicates a much larger potential fallout (Exhibit 1). We have shaved 0.4 percentage points off our 2020 global growth forecast. Should the outbreak continue to gain traction and fail to be contained, the economic outlook would further deteriorate. As with past health scares (i.e. SARS, Swine Flu, Avian Flu, Ebola), however, we expect the economic shock to be short-lived. Importantly, daily new cases of the virus are in a declining trend in China and its local economy is gradually resuming full operation.

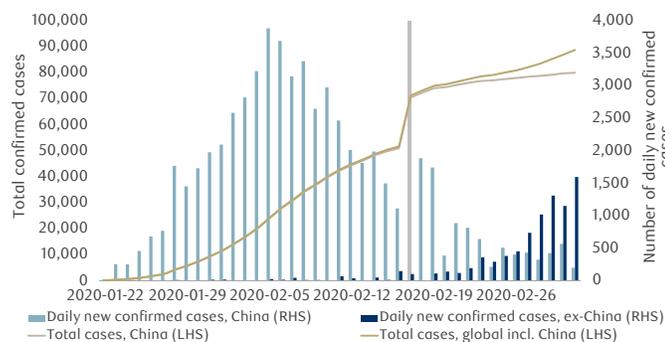
Although the virus outbreak has likely taken centre stage in investors' minds, other risks exist. The U.S. presidential election is now in full swing, Brexit is still evolving, and the U.S.-China trade negotiations continue, all presenting sources of potential uncertainty for the economy and financial markets.

Monetary accommodation in full force

Sluggish growth and concerns of potential recession late last year caused most major central banks to deliver significant monetary stimulus. In particular, the Fed lowered interest rates three times in 2019 and has been buying treasuries at a pace of US\$60 billion per month. In the fall of 2019, the European Central Bank lowered interest rates further into negative territory and restarted its QE program buying 20 billion euros worth of bonds per month. Investors had been

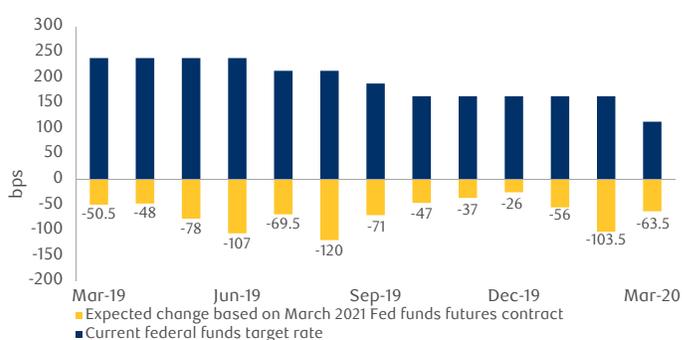
pricing in the expectation of additional easing in the near term and the Fed delivered on those expectations by cutting rates 50 basis points on March 3 – the first rate cut outside of a scheduled FOMC meeting since the financial crisis (Exhibit 2). The inter-meeting rate cut was a response to the COVID-19 outbreak to provide support for the economy and financial markets. Market pricing suggests another 50 basis points of rate cuts in the U.S. may follow by the end of the year.

Exhibit 1: Covid-19 confirmed cases globally
Cumulative total and daily change



Note: As of 3/2/2020. Spike on 2/17/2020 due to change in reporting methodology. Source: WHO, RBC GAM

Exhibit 2: Fed funds rate and implied expectations
12-month futures contract



Note: As of March 3, 2020. Source: RBC GAM

Government bond yields plunge

Investors have flocked to safe-haven assets in recent weeks as it became increasingly apparent the virus outbreak was causing real economic harm. The U.S. 10-year yield fell to a new record below 1.20% and the yield curve, as measured by the spread between 3-month and 10-year maturities, had once again inverted, signaling heightened risk of recession. In addition to near-term pressures from the virus outbreak, a number of structural factors (demographics, shifting savings versus spending preferences and slower economic growth) continue to depress real interest rates. Taking all of these into account, our models still suggest that bond yields are unsustainably low (Exhibit 3). Valuation risk in bonds is acute and, should economies avoid recession, the outlook for bond returns is especially unattractive.

Stock markets correct, easing valuation concerns

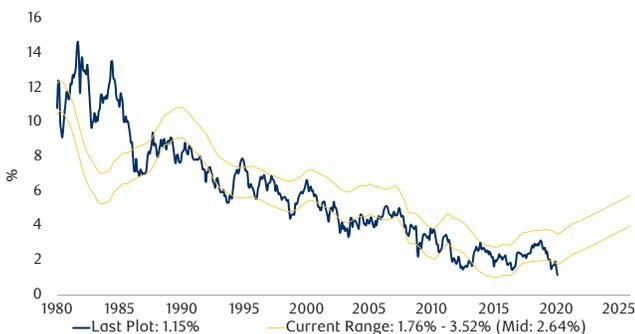
The recent sell-off in global equities erased earlier gains for the year as fear surrounding COVID-19 impacted investor

confidence. Many major stock-market indices declined as much as 10% in just the last week of February. Prior to the sell-off, investors were highly optimistic and valuations had become somewhat stretched based on certain measures. The latest correction has restored U.S. stocks closer to their fair value, and equity markets elsewhere are at relatively attractive levels (Exhibit 4).

Covid-19 likely dings corporate profits in the near term

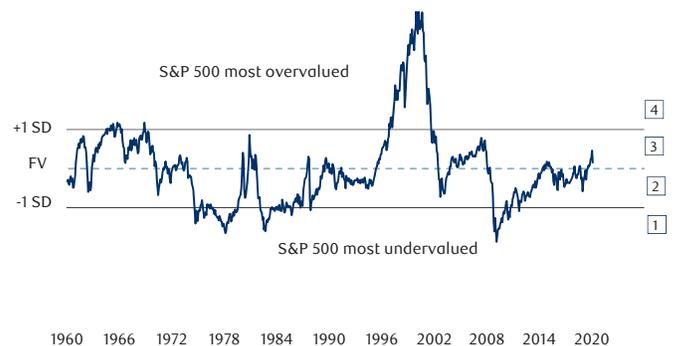
Valuation risk in equities has been reduced as a result of the latest sell off but the profit outlook is now highly uncertain. S&P 500 companies generate 30% of their sales and 40% of their earnings offshore (exhibits 5 to 6). Profit growth is likely to undershoot the 8% projected by analysts for 2020 at the start of the year. The damage to earnings will ultimately depend on how long the virus lingers and the breadth of its impact. Although a wider range of potential outcomes are possible in the near term, we believe the longer-term impact on corporate profits should be minimal.

Exhibit 3: U.S. 10-year T-Bond yield Equilibrium range



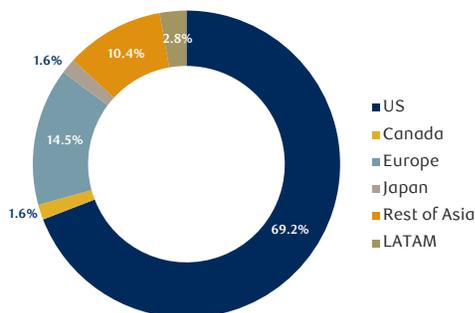
Note: As of February 28, 2020. Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM, RBC CM

Exhibit 4: Standardized S&P 500 fair value bands



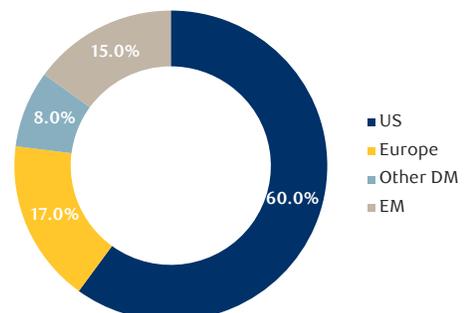
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Exhibit 5: S&P 500 sales by region



Note: As of December 31, 2017. Source: Deutsche Bank

Exhibit 6: S&P 500 profits by region

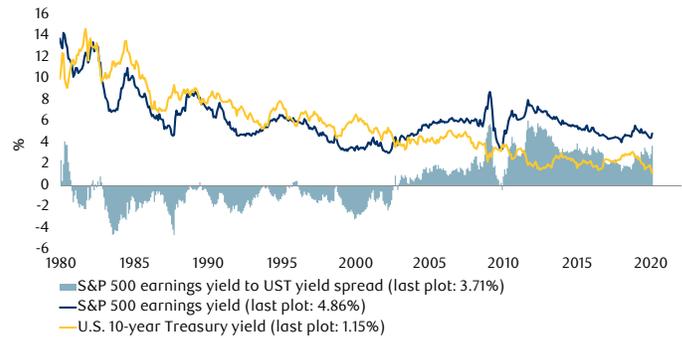


Note: As of December 31, 2017. Source: Deutsche Bank

Asset mix – reversing prior ‘trim’ in equities

In our view, the negative impulse on the economy from COVID-19 is material but will likely be short-lived and not enough to send the global economy into recession. Central banks are responding with additional monetary stimulus in this environment and governments have also started providing support. Before the outbreak gained traction, risk assets were priced such that there was little margin for error. Since then, the plunge in equity prices and bond yields has boosted the equity risk premium and, while near-term volatility is likely to be elevated as headlines from COVID-19 flood news outlets, stocks offer superior return potential to bonds over the longer term, especially after the latest correction (Exhibit 7).

Exhibit 7: S&P 500 earnings yield
12-month trailing earnings/index level



Note: As of February 28, 2020. Source: RBC GAM, RBC CM

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