Global equity perspective

May 2022

Running the gauntlet

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Most major markets declined from their year-end levels into early March, then rallied for several weeks before turning down again. U.S. markets fared the worst, recently undercutting the March lows. The S&P 500 has declined by 13 percent year to date while the tech-heavy Nasdaq is off by a much chunkier 26 percent.

Many of the mega-cap tech and tech-related stocks that have taken such a toll on the Nasdaq are also in the S&P 500. But when one looks at the S&P 500 Equal Weight Index, which counts each stock as just 0.2 percent of the index, the market decline from the beginning of the year is a less dramatic nine percent. To make the same point, most other major indexes, which have almost no exposure to the mega-cap tech group, are down by single digits, with war-exposed Europe the worst, down by 10 percent.

There are several factors one can point to that have contributed to this decline, including the potential for further deceleration in global economic growth due to China's renewed COVID-19 lockdowns and the Russia-Ukraine conflict, and the Fed's more accelerated rate hike plans in order to fight inflation.

Dollar signs

One factor that is perhaps the least discussed, the strength of the U.S. dollar, shines some light on the comparatively poorer performance of the U.S. equity indexes. The dollar is up sharply versus the euro and the pound, less so but still up versus the yen and the Canadian dollar. This means that earnings of U.S. multinationals from these sources will be less than they otherwise would be after translation back into the U.S. currency for reporting purposes. Among the largest overseas earners are those same mega-cap tech stocks that have had an outsized negative impact on U.S. equity index performance.

The greenback has been strong largely because of the rapid shift of Fed policy from one tolerant of higher inflation to one intent on reining in inflationary pressures. Capital has been flowing toward decidedly higher U.S. rates—the U.S. 3-year Treasury

Equity views

Region	Current
Global	+
United States	+
Canada	=
Continental Europe	=
United Kingdom	=
Asia (ex Japan)	=
Japan	=

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

For important and required non-U.S. analyst disclosures, see page 4.
All values in U.S. dollars and priced as of market close, April 30, 2022, unless otherwise stated.
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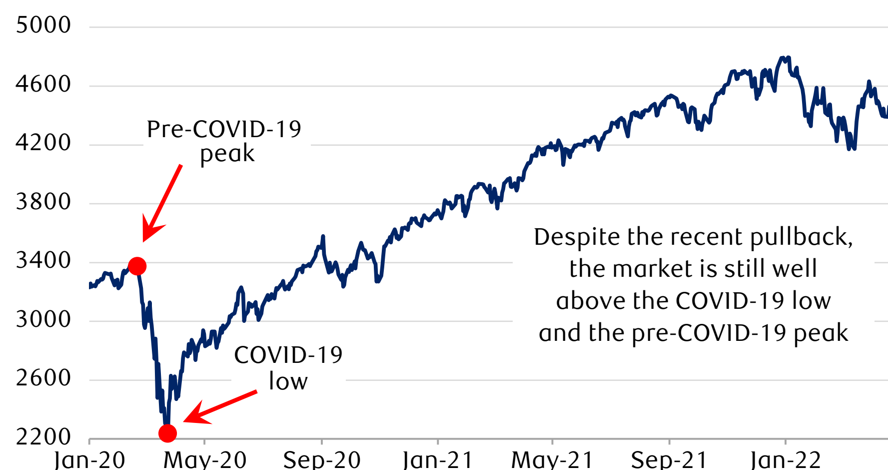


Source - RBC Wealth Management, Bloomberg; data through 4/30/22

yields 2.9 percent versus 1.6 percent for UK Gilts and just 45 basis points on German Bunds. The resultant dollar strength probably won't weaken until the pace of Fed rate hikes slows, which is unlikely before the fall, in our view.

We believe the year-over-year inflation rate has already peaked or could soon. RBC Global Asset Management anticipates headline inflation will decelerate in the second half of this year but will still be "uncomfortably high" at year-end (for more, see "A different kind of inflationary environment," a discussion with RBC Global Asset Management Inc. Chief Economist Eric Lascelles, in the May issue of Global Insight). A clearly marked off-ramp for the Fed's tightening efforts is unlikely to appear before 2023.

Cracks in the foundation?

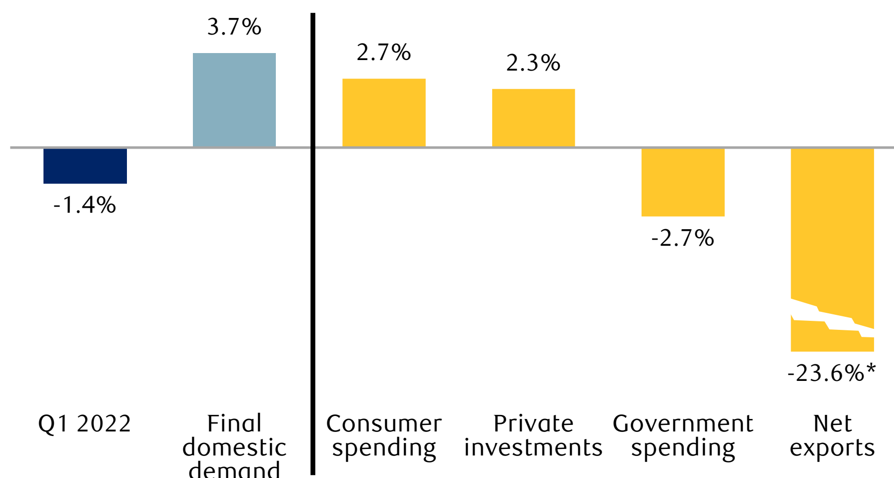
All the foregoing and the surprising decline in U.S. GDP for Q1 have raised concerns that consensus estimates for GDP and corporate earnings for this year and next are both too high.

We say the negative U.S. GDP print was "surprising" but maybe it shouldn't have been. Government spending fell as COVID-related support programs unwound, while the trade deficit widened dramatically due mostly to supply chain distortions and the strong dollar noted above. Yet the far larger parts of the U.S. economy—consumer spending (69 percent of GDP) and fixed asset investment (15 percent)—remain healthy, with those two components up by 2.7 percent and 7.3 percent, respectively.

Moreover, with employment and wages growing, the participation rate advancing, and more than 10 million jobs on offer, we don't see either consumer spending or capital expenditure running out of steam anytime soon. True, the closely watched handoff from goods spending to services has not been smooth and elevated inventories of goods on hand portend further production slowdowns in coming quarters, but the much larger services spend should offset much if not all of that.

While the economy looks to us like it can avoid a recession, the earnings outlook could be prone to a greater degree of downward revision.

There are cracks in the corporate earnings story. The aggregate Q1 results have been good thus far. S&P 500 earnings and revenue growth are pacing at 8.6 percent and 12.5 percent, respectively, with 56 percent of companies having reported results as of May 2. The proportion of companies exceeding earnings forecasts is in line with recent quarters, and the proportion



*Magnitude of the decline for net exports (exports minus imports) is truncated so as to not distort the other data in the chart.

Source - National research correspondent, Bureau of Economic Analysis, Bloomberg

beating revenue estimates is at the upward range of previous periods. The magnitude of beats for both categories are in the range of consensus expectations at the start of earnings season.

However, there have been some notable misses and/or cautious guidance by high-profile firms in a variety of sectors. Also, earnings growth results are bifurcated. The five largest technology-related stocks, which make up a significant part of the S&P 500 market capitalization, have seen earnings per share (EPS) decline 1.4 percent year over year, whereas EPS for the rest of the S&P 500 combined has risen 12.4 percent. But the latter figure is distorted by the Energy sector, which has delivered very strong earnings and margin growth on the back of ultra-high energy prices. When Energy is stripped out of the picture, S&P 500 EPS growth drops back to 4.6 percent.

These factors—combined with the economic, monetary policy, and currency headwinds—raise questions about earnings growth prospects going forward. Currently, the S&P 500 consensus earnings forecast is for $229 per share in 2022, which would represent 10 percent year-over-year growth. We think this estimate is at risk of coming down.

Pulling that consensus back to, for example, $220 per share would leave the S&P 500 trading at about 18.5 times forward 12-month earnings estimates—far from cheap, but only about one multiple above its 30-year average of 17.6x.

It could take time to work things out

Given the lingering supply chain, inflation, growth, and geopolitical risks, there is a wider range of potential outcomes for the global economy and corporate earnings for this year and next than there was just a few months ago. It could take time for the market to work through the uncertainties. Some further pullbacks can’t be ruled out.

We believe the S&P 500 has the potential to be higher than current levels in the next 12 months primarily because U.S. recession risks are no worse than moderate, a number of important economic indicators remain solidly in positive territory, and earnings trends are still generally good. As long as the end result of all the foregoing is an economic “growth scare” instead of a full-blown recession, and Russia and NATO avoid direct clashes, we think any further market downside should be limited.

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