Investment UPDATE

Summer 2022 edition

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A long-term view of diversification

Diversification plays a role in many aspects of life. As children, we take a wide range of courses in grade school. In our working years, we often diversify our skill set. When we travel across Canada, we're able to enjoy the incredible biodiversity – oceans, lakes, mountains and more.

For investors, diversification means building a portfolio that holds different types of investments. This quarter we explore portfolio diversification, including the roles of cash, fixed income and equities. We also look at how a diversified portfolio has performed in times of rising interest rates and relative to long-term inflation.

3 reasons to diversify

Different investments have different return and risk profiles. Additionally, when market conditions change, some investments might go up in value, while others go down. How can a diversified investor benefit from factors like these?

1. **The potential for smoother returns while generating strong long-term growth**
2. **The opportunity to build a portfolio aligned with short-, medium- and long-term goals**
3. **The ability to direct new investment dollars into the opportunities best aligned with your goals**

How can diversification help smooth your investment journey?

This diversified portfolio delivered strong returns, but without the same degree of ups and downs as equity markets.

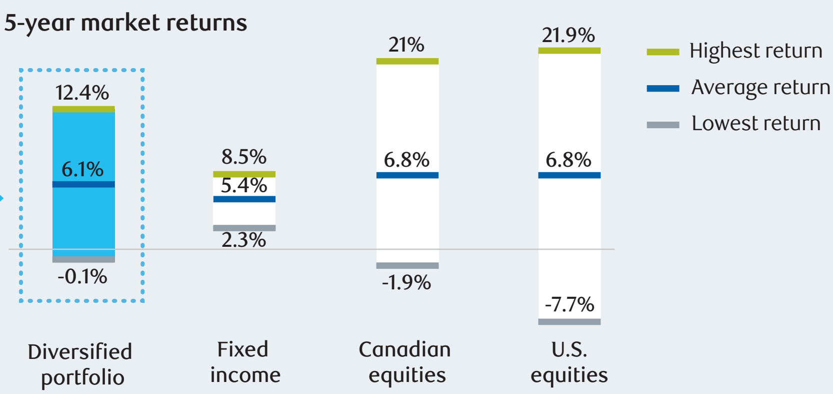

Chart source: Bloomberg, RBC GAM. 25-year period ended December 31, 2021. Based on five-year rolling returns, which means a new five-year return period starts each month. Please see footnote 1 on page 2 for additional details and disclosure on market returns and the Diversified portfolio.

A long-term view of diversification

On their own, cash, fixed income and equities play different roles

Cash and equivalents

Key benefits: Stability, liquidity and modest income

Typical goals: Shorter-term goals or an emergency fund

Fixed income

Key benefits: Steady income, relative stability and an income boost over cash

Typical goals: A mix of different bond types can help meet numerous short- and long-term goals

Equities

Key benefits: Potential long-term growth, income growth and inflation protection

Typical goals: Maximizing growth to meet longer-term goals

Together, fixed income and equities can help reduce portfolio ups and downs

In general, fixed income performs well when equities pull back. The reverse is also true.

5.8%
Average fixed income returns in years Canadian equities had negative returns

17.4%
Average Canadian equity returns in years fixed income had negative returns

Source: Bloomberg, RBC GAM. Based on calendar year returns from 1991-2021. Over this period, fixed income had negative returns in four years and Canadian equities had negative returns in 11 years. See footnote 1 for additional details on market returns.

The importance of taking a long-term view

As we have seen this year, there are times when both fixed income and equities struggle, putting a diversified portfolio to the test. While not uncommon on a monthly basis, a longer-term view can provide a more complete picture of the value of diversification.

For example, since 1991:

- 14% of monthly periods saw negative returns for both fixed income and Canadian equity markets – an average of about once every seven months.
- Only 1.4% of one-year periods saw both markets decline.
- There were ZERO three-year periods when both markets were negative.

Source: Bloomberg, RBC GAM. January 1991 – April 2022. One-year and three-year periods are based on rolling monthly returns, which means a new return period starts each month. See footnote 1 for additional details on market returns.

[1] Unless otherwise noted, Cash represented by FTSE Canada 30 DAY T-Bill Index; Fixed income represented by FTSE Canada Universe Bond Index; Canadian Equities represented by S&P/TSX Composite Index; U.S. Equities represented by S&P 500 Index; International Equities represented by MSCI EAFE Index; Emerging Markets Equities represented by MSCI Emerging Markets Index. **Diversified Portfolio** assumes monthly rebalancing as represented by 2% Cash, 38% Fixed Income, 15% Canadian Equities, 25% U.S. Equities, 15% International Equities and 5% Emerging Markets Equities. Past performance is not a guarantee of future results. All returns are total returns in Canadian dollars, unless otherwise noted. Index returns do not reflect deduction of expenses associated with investments. If such expenses were reflected, returns would be lower. An investment cannot be made directly in an index.

Diversification can help when interest rates rise

When rates rise, investors tend to expect bond prices to fall (in line with higher borrowing costs) and stocks to perform well (as rates typically rise when the economy is strong). However, since 1991, in years when the Bank of Canada increased rates, cash, fixed income and equities have all maintained positive average returns.

Average market returns in years rates rose

Average rate increase[2]	Cash	Fixed income	Canadian equities	U.S. equities	Diversified portfolio
1.1%	2.7%	5.5%	4.9%	8.0%	6.4%

Why is this important?

1. Rates rising are not necessarily a good predictor of market performance.
2. Diversification has been an effective way to navigate rising rates.

[2] Total of all rate increases minus decreases during the nine applicable calendar years divided by nine. Source: StatCan, RBC GAM. Based on the nine calendar years in which the Bank of Canada overnight rate was higher at the end of the year than it was at the beginning of the year from 1991-2021. See footnote 1 for additional details on market returns and the Diversified portfolio.

Diversification can help fight inflation

Despite today's higher inflation, the Bank of Canada remains focused on bringing inflation back to its target rate of 2%. From a long-term investment perspective, market returns have outpaced inflation since 1991, when the 2% target was set.

Average inflation and market returns since 1991

Inflation rate	Cash	Fixed income	Canadian equities	U.S. equities	Diversified portfolio
1.8%	2.7%	6.2%	8.8%	11.0%	8.2%

Why is this important?

Over the long term, a diversified portfolio has been an effective way to help build wealth and maintain purchasing power relative to inflation.

Source: StatCan, Bloomberg, RBC GAM. Inflation rate and market returns are annualized from 1991-2021. See footnote 1 for additional details on market returns and the Diversified portfolio.

How can you get the most out of diversification?

As with most investment strategies: take a long-term view, stick to your plan and avoid trying to time markets. Contact your RBC Advisor if you would like to discuss your investments.

One-minute market update

Economy

- This quarter we have reduced our 2022 forecast even further and now expect growth in 2023 to be the weakest in over a decade excluding the 2020 pandemic shock. We gauge that the risk of recession is high over the next two years.
- The key headwinds to the economy include extremely high inflation, aggressive central-bank tightening, a global commodity shock caused by Russian sanctions, supply-chain challenges and damage from China's zero-tolerance COVID-19 policy.
- Inflation pressures are broad-based but we expect them to calm as monetary and fiscal stimulus are dialed back, and commodity and housing price growth slows.
- We forecast 2.5% GDP growth in 2022 for the developed world, less than half the 5.2% rate achieved in 2021, followed by just 1.2% growth in 2023.

Fixed income

- The rapid and significant re-alignment of interest-rate expectations caused a fixed-income sell-off of historic proportions over the past year.
- Valuation risk has been significantly reduced and yields are now at much more reasonable levels, according to our models, which suggests that yields may not need to rise much beyond current levels once near-term inflation distortions pass.
- Our base case is that inflation ultimately moderates which means that the bulk of the needed adjustment in yields has already occurred. We forecast 2.75% on the 10-year yield 12 months from now, which would mean no further sustained capital losses for bond holders over the year ahead.

Equity markets

- Fear of inflation, aggressive monetary tightening and the increased risk of recession sent stocks lower in the past quarter and several major indexes fell into bear markets.
- Equity valuations fell from elevated levels, especially in high-priced technology stocks that were most sensitive to interest rates.
- If consensus estimates for profits come through, inflation pressures subside and investor confidence rebounds from extreme pessimism, stocks could deliver double-digit gains over the year ahead.
- But should a downturn or recession play out, history suggests that earnings could be vulnerable to declines of more than 20%, likely sending stocks lower.

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