MARCH 4, 2024

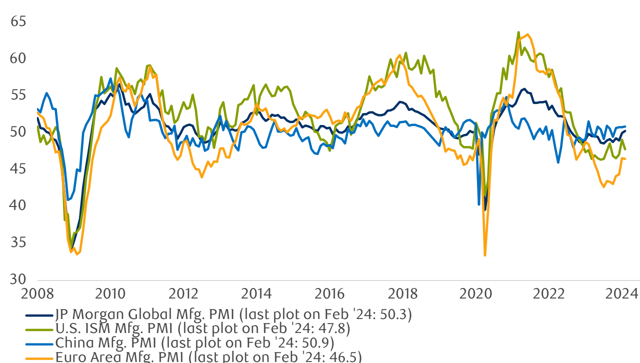
Peaking interest rates, moderating inflation pressures and diminishing recession risks boost investor confidence, lifting equity valuations to demanding levels

Eric Savoie, MBA, CFA, CMT
Investment Strategist
RBC Global Asset Management Inc.

Daniel E. Chornous, CFA
Chief Investment Officer
RBC Global Asset Management Inc.

The rapid and globally synchronized tightening of monetary conditions since the start of 2022 has come to a halt and central banks are actively considering interest rate cuts at some point this year if inflation continues to fall. Against this backdrop, the risk of a severe economic downturn is diminishing, and confidence among consumers and businesses is being revived. While several countries outside the U.S. are technically in recession, the degree of contraction in these economies has been relatively benign thus far, and leading indicators of economic growth have been rebounding across most major regions in recent quarters (Exhibit 1). In contrast to the rest of the world, the U.S. economy has been impressively resilient in the face of higher interest rates, helped by historically low 30-year fixed-rate mortgages and gigantic cash-rich corporations. The U.S. labour market remains strong, lending conditions have improved, and housing activity has picked up since mid-2023. All things considered, we believe the odds of a soft landing for the economy have increased and, importantly, even if a global recession materialized, we think it would be mild and short lived.

Exhibit 1: Global purchasing managers' indices



Note: As of February 29, 2024. Source: Macrobond, RBC GAM

There are still a variety of risks that could upset the outlook. The key risks include intensifying geopolitical tensions particularly with respect to military conflicts in the Middle East, China's slowing growth, the lagged impact of higher interest rates and related challenges in U.S. commercial real estate, as well as a U.S. presidential election in November. These developments all represent potential sources of volatility for the economy and markets over the year ahead.

Inflation remains on a favourable trajectory

On the inflation front, we remain optimistic that consumer-price pressures can continue falling. U.S. CPI inflation has so far declined to 3.1% from a high of 9.1% 2022 and leading indicators of inflation continue to suggest a downward trajectory ahead. The U.S. Federal Reserve continues to engage in quantitative tightening, reducing its balance sheet

and shrinking the money supply. Used car prices are now falling and growth in residential rents has moderated to low single digits, or even outright declines in some areas. Moreover, commodity prices, including energy, have been moving sideways to slightly lower over the past several quarters. We recognize that significant progress has already been made, and that the remaining distance to the Fed's 2.0% target will be more difficult to attain. As a result, we forecast developed-world inflation to continue falling at a gradual pace toward the 2% targeted by most central banks over the course of 2024 and into 2025 (Exhibit 2).

Central banks signal rate cuts ahead

If inflation continues to fall as expected, the tight monetary stance currently employed by many central banks may no longer be necessary and rate cuts will become increasingly likely over the year ahead. Our own model situates the neutral level for the U.S. fed funds rate closer to 2.50%, which suggests the current 5.25% overnight lending rate is highly restrictive and unlikely to be sustained. The key questions at this point surround the timing of any monetary-policy easing and how quickly interest rates might decline once central banks begin cutting. We look for three 25-basis point cuts by the Fed over the next 12 months, with the first cut by the late spring/early summer. This view is roughly in line with pricing in the futures market, which suggests between three and four by January 2025. That said, expectations can be volatile, and we recognize the path for rates will largely depend on incoming data on the economy and inflation (Exhibit 3).

Sovereign bonds offer attractive return potential, minimal valuation risk

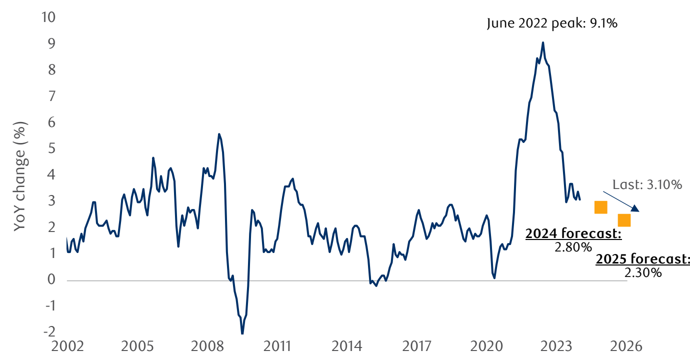
Bondholders enjoyed a powerful rally since October 2023 as investors became increasingly confident that interest rates have peaked and that inflation is headed lower. The U.S. 10-year yield climbed to a cycle high of at 5.02% in the fall, then plunged to 3.79% in late December before rebounding back above 4% in 2024. Our models continue to suggest that yields are well above their equilibrium levels in most regions and that, if inflation continues to subside as we expect, yields have scope to continue moving lower over the years ahead. At this point, with sovereign bond yields still among the highest we've seen in almost two decades, we believe that valuation risk in fixed income markets is minimal and that total return potential is attractive (Exhibit 4).

Stocks extend gains on soft-landing optimism

Global equity markets extended their gains from late last year into early 2024 and, although last year featured highly concentrated gains in U.S. mega-cap technology stocks, the

Exhibit 2: U.S. Consumer Price Inflation

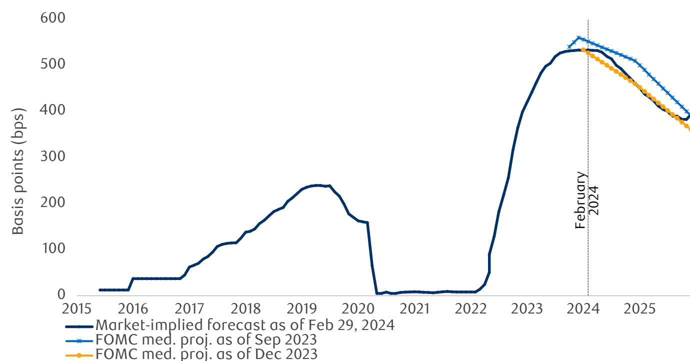
CPI Index Y/Y % change



Note: CPI data as of January 31, 2024. RBC GAM forecasts as of February 29, 2024. Source: Bloomberg, RBC GAM

Exhibit 3: Implied fed funds rate

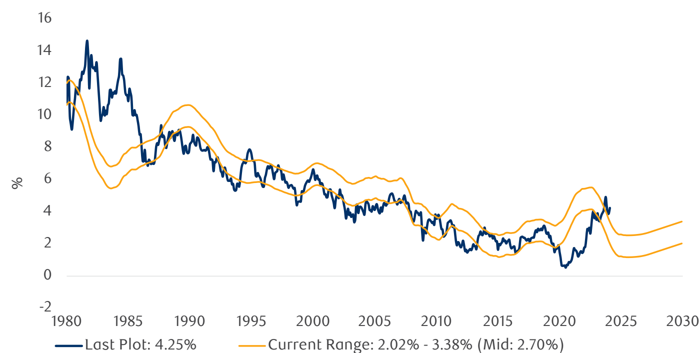
12-months futures contracts



Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 4: U.S. 10-year T-bond yield

Equilibrium range



Note: As of February 29, 2024. Source: RBC GAM

rally so far this year has been more broad-based. New record highs were reached by the S&P 500 Index, the Dow Jones Industrial Average Index, Europe's Stoxx 600 Index and even Japan's Nikkei Index, which surpassed its previous high set 35 years ago. At current levels, our composite of global stock markets suggests valuations are reasonable in aggregate, but there are significant variations between regions. U.S. large-cap and Japanese equities are trading above their modelled fair values, whereas stocks in Europe, Canada, and emerging markets are trading at attractive discounts relative to their own history (Exhibit 5).

Earnings are widely expected to re-accelerate

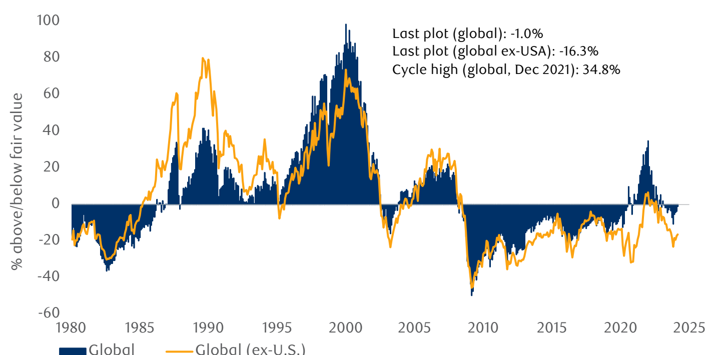
The recent enthusiasm for stocks can be justified if earnings achieve the optimistic estimates reflected in the consensus. S&P 500 earnings per share is expected to climb 9% to $243 by the end of 2024 and rise by an additional 13% to $276 by the end of 2025 (Exhibit 6). Our analysis suggests these figures are achievable if the U.S. economy avoids recession and companies manage to expand their profit margins. However, should the economy encounter difficulty, or if companies incur higher-than-expected costs, these earnings estimates would likely be vulnerable to downgrades. While achieving these optimistic earnings projections is not impossible, elevated valuations mean that robust and uninterrupted earnings growth is becoming increasingly necessary to sustain the bull market.

Maintaining cautious stance on asset mix, with slight overweight in fixed income

Balancing the risks and opportunities over the near-term and longer-term horizons, we are maintaining a recommended asset mix close to our neutral setting. The macroeconomic outlook remains highly uncertain and, although the odds of

Exhibit 5: Global stock market composite

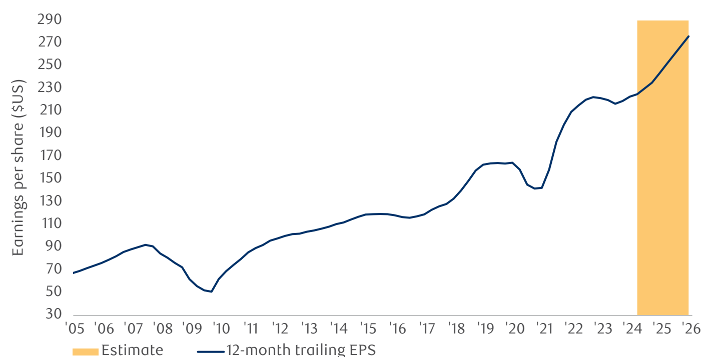
Equity market indexes relative to equilibrium



Note: As of February 29, 2024. Source: RBC GAM

Exhibit 6: S&P 500 Index

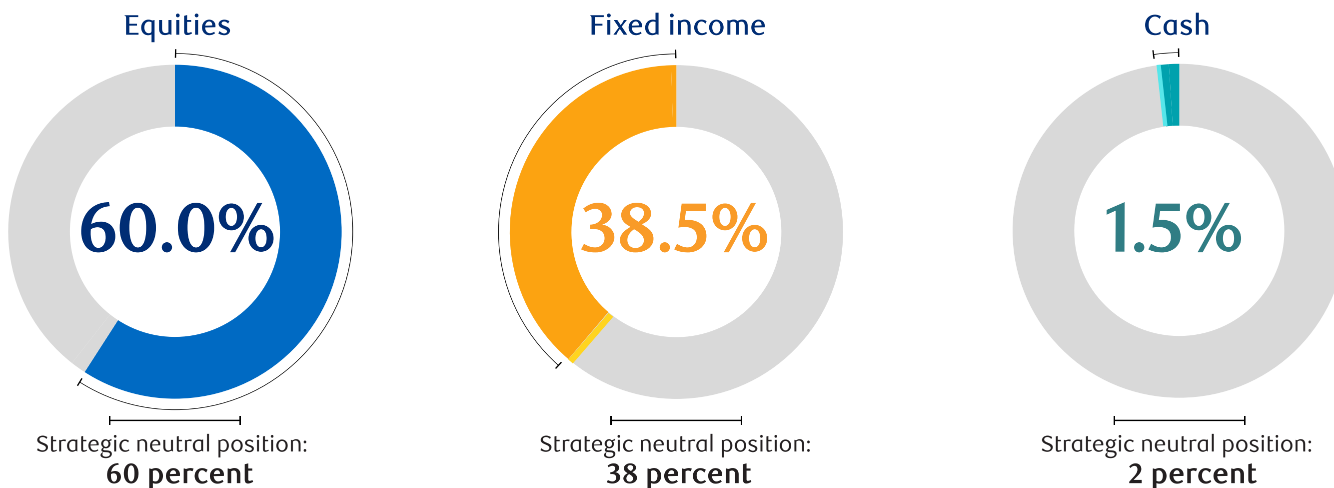
12-month trailing earnings per share



Note: estimate is based on a consensus of industry analysts' bottom-up expectations. Note: As of March 1, 2024. Source: Thomson Reuters, RBC GAM

a soft landing have improved, the risk of a downturn in the economy remains higher than usual. For many years, and especially following the pandemic when interest rates were at historic lows, we had been running large underweight positions within fixed income in our balanced portfolios given that bonds offered little return potential, minimal diversification benefit and significant valuation risk. We have been adding to our fixed income allocations regularly over the past two years as interest rates rose, moving to a slight overweight position in fixed income for the first time in two decades during the fall of 2023. At this point, we think there is a high likelihood that interest rates have peaked and inflation remains on a downward trajectory and so we remain comfortable holding a larger allocation to fixed income than we have held over the past decade, especially given the improved portfolio diversification benefits offered by bonds at higher yields. With respect to equities, we continue to expect stocks to outperform bonds over the longer term. However, we recognize that the near-term upside for equities is limited by current valuations in some markets and, as a result, the premium associated with holding stocks relative to fixed income is lower than it was at earlier points in the cycle and perhaps is not adequately compensating investors for the risk of an economic downturn. As a result, our current recommended asset mix for a global balanced investor is 60.0% equities (strategic: "neutral": 60%), 38.5% bonds (strategic "neutral": 38%) and 1.5% in cash (Exhibit 7). Actual fund or client portfolio positioning may differ depending on that portfolio's investment policies.

Exhibit 7: Recommended asset mix
RBC GAM Investment Strategy Committee



Note: As of February 29, 2024. Source: RBC GAM

Disclosure

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to people in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited and RBC Global Asset Management (Asia) Limited, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

Additional information about RBC GAM may be found at www.rbcgam.com.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the above-listed entities in their respective jurisdictions.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions.

RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

® / ™ Trademark(s) of Royal Bank of Canada. Used under licence.
© RBC Global Asset Management Inc. 2024

Publication date: March 4, 2024