RBC Global Asset Management

Market Update

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Boosting allocation to bonds as yields surge

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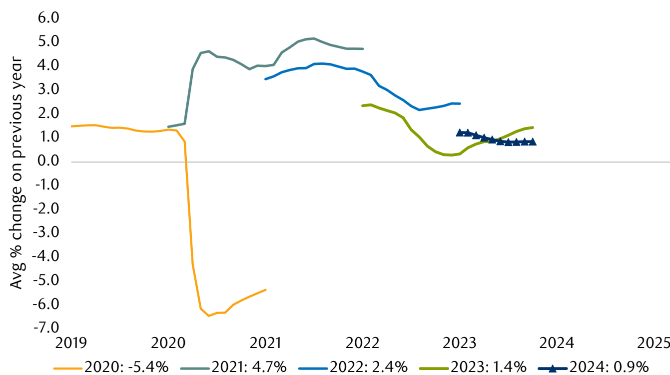
Underlying economic strength and stubborn price pressures are testing the patience of central banks and causing some to question whether financial conditions are restrictive enough. While it is possible that economies are less sensitive to higher interest rates than they were in prior cycles, it is more likely that the headwind from surging interest rates over the past 19 months will hit the economy with a significant lag. Not only will the sharp rise in borrowing costs weigh on consumer spending and business investment, but a variety of other risks have also been added to the mix. In the U.S., large-scale autoworker strikes, the resumption of student-loan repayments and a looming U.S. government shutdown are all factors that are adding to uncertainty and stress in the economy. Furthermore, geopolitical tensions have flared with the recent attacks in the Middle East, a situation that is evolving rapidly and contributing to financial-market volatility. All things considered, the outlook is increasingly murky and we continue to forecast a mild economic recession over the next several quarters. Our forecasts for growth and inflation are below the consensus (exhibits 1 and 2).

Exhibit 1: Weighted average consensus real GDP

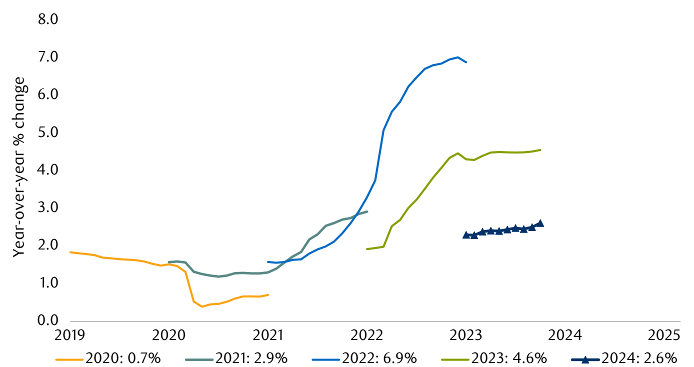
Growth estimates for major developed nations



Note: As of Oct 2023. Source: Consensus Economics

Exhibit 2: Weighted average consensus CPI

Inflation estimates for major OECD nations



Note: As of Oct 2023. Source: Consensus Economics

Economic data has been better than expected...

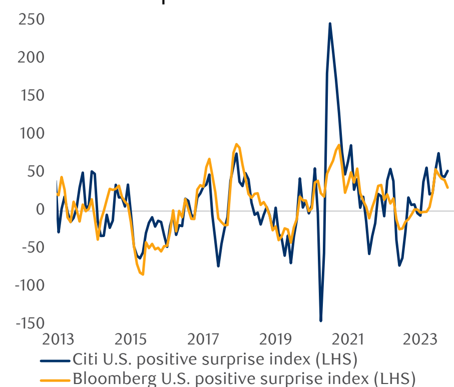
The U.S. economy has been surprisingly strong and there is evidence that growth could even be picking up. Data surprise indices by Citigroup and Bloomberg are well into positive territory, suggesting that economic data has been decidedly better than expected (Exhibit 3). Moreover, U.S. GDP growth hastened to 4.9% in the third quarter of 2023, more than double last quarter's 2.1% rate, and in line with the Atlanta Fed's real-time GDP tracker (Exhibit 4). Consumer spending has also been robust with retail sales accelerating since the spring (Exhibit 5).

...but the pain from higher rates is starting to show

Higher borrowing costs, however, are making things more difficult for interest-sensitive segments of the economy. Housing affordability has been severely hindered as mortgage rates have nearly tripled in the past three years and climbed above 8% for the first since early 2000 (Exhibit 6). Against this backdrop, sales of existing homes have fallen to their lowest level since the global financial crisis, weighing on home-builder sentiment (Exhibit 7). Another indication that some consumers could be feeling the pinch from higher rates and rising costs is that credit-card delinquency rates have been rising steadily, especially for customers of smaller banks (Exhibit 8). The softness in these areas is manageable for now, but continued weakness in housing and further increases in consumer defaults could lead to bigger problems for the broader economy.

Exhibit 3: United States

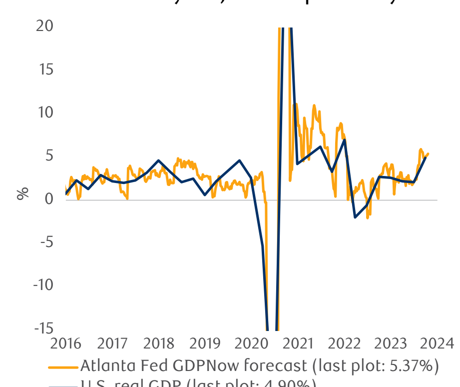
Economic surprise indices



Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

Exhibit 4: U.S. GDP

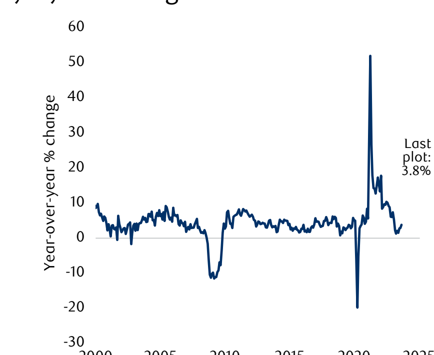
Real seasonally adjusted quarterly data



Note: as of October 20, 2023. Source: Bureau of Economic Analysis, Federal Reserve Bank of Atlanta, RBC GAM

Exhibit 5: U.S. retail sales

Adjusted retail & food services sales yr./yr. % change

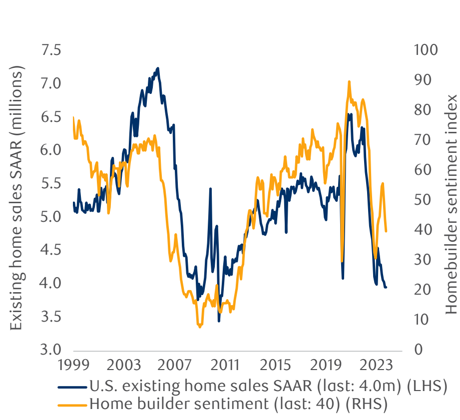


Note: as of September 30, 2023. Source: U.S. Census Bureau, Conference Board, Haver Analytics, RBC GAM

Exhibit 6: U.S. 30-year fixed mortgage rates – Bankrate.com national average

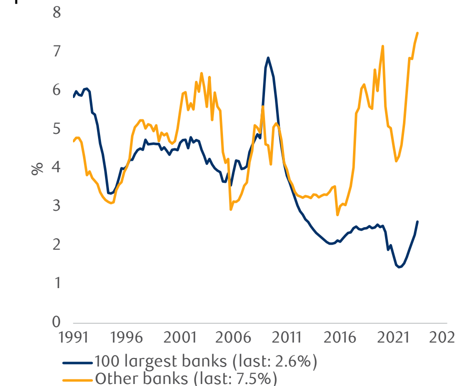
Note: as of October 20, 2023. Source: Bankrate.com, RBC GAM

Exhibit 7: United States housing market



Note: As of October 2023. Source Bloomberg, RBC GAM

Exhibit 8: U.S. credit-card delinquency rates – At least 30 days past due



Note: as of Q2, 2023. Source: Bloomberg, Federal Reserve, RBC GAM

The path to lower inflation is bumpy

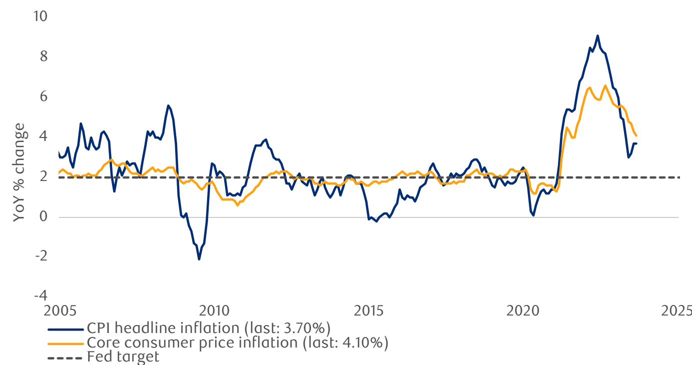
There is a positive impact from higher interest rates: they are successfully cooling inflation. U.S. headline inflation has fallen to 3.7% from a high of 9.1% last year (Exhibit 9). And, although inflation readings were a bit higher in recent months, a key contributor to the increase was the 20% rebound in oil prices since July (Exhibit 10). We don't think the recent slight increase in the headline Consumer Price Index (CPI) means that inflation has returned to an accelerating trajectory and looking at core inflation, which excludes effects from volatile energy and food prices, the trend remains down. In our view, price pressures should continue to moderate, especially as central banks maintain a restrictive stance and the U.S. Federal Reserve (Fed) shrinks its balance sheet, and given that pandemic-related distortions such as supply-chain disruptions have been mostly resolved.

Moreover, pricing in inflation-protected bonds suggests that inflation expectations remain well anchored just above the 2% level (Exhibit 11). So while there could be some volatility in the inflation data in the months ahead, particularly as it relates to energy prices, we continue to believe that the path over the medium term remains down.

Central banks signal interest rates likely to stay higher for longer

Financial conditions have tightened significantly over the past few years, but they are perhaps not yet too tight according to Fed Chair Jerome Powell. Corroborating this idea is an index generated by Goldman Sachs that suggests financial conditions are only slightly tighter than normal (Exhibit 12). Recognizing that the tightness of financial conditions is not at an extreme, the Fed has communicated

Exhibit 9: U.S. inflation measures

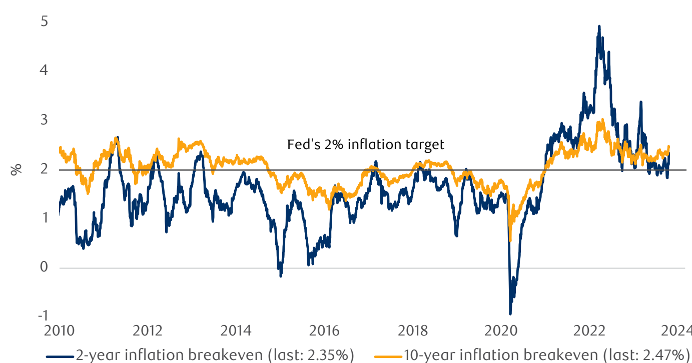


Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

Exhibit 10: WTI Cushing crude-oil spot price

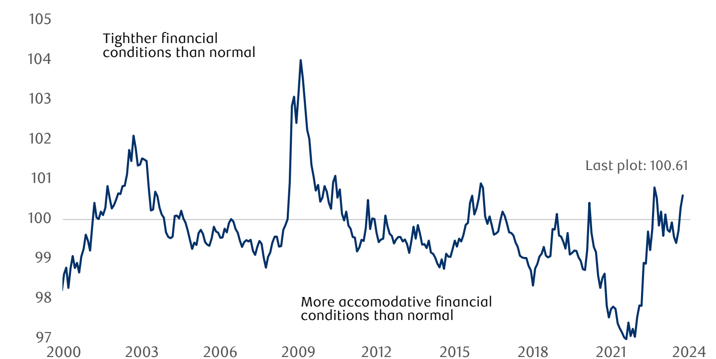
Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

Exhibit 11: U.S. Treasuries inflation breakevens



Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

Exhibit 12: Goldman Sachs U.S. Financial Conditions Index



Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

that interest rates could continue to rise further or at the very least remain at elevated levels for an extended period. The Fed will likely respond based on how the data evolves and, if inflation cools and economic growth contracts as we forecast, the Fed could shift the narrative and reduce rates next year. Pricing in the futures market is in line with this view, suggesting a slim possibility of one more rate hike over the next several months, followed by as many as three 25-basis-point cuts by the end of 2024 (Exhibit 13). The risk to this outlook on rates is that inflation stays hot and the economy remains robust, which would likely push rate cuts further into the future.

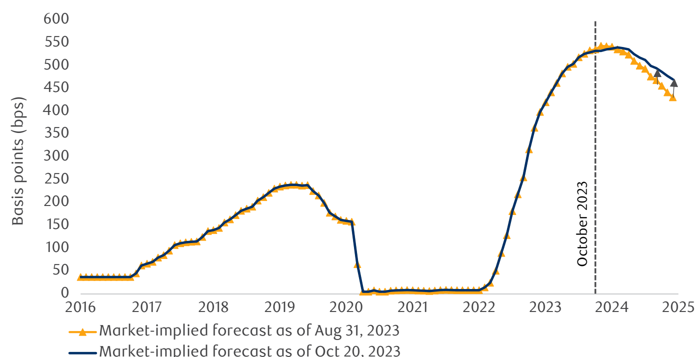
Bond bear market deepens as yields rise to highest levels since 2007

Fixed-income markets extended their sell-off in October as yields on longer-dated government bonds rapidly rose to new cycle highs. Contributing to the increase was the hawkish tone by central banks, as well as an increased supply of Treasuries issued by the U.S. government to fund ever growing deficits and an increased risk premium for the uncertainty of investing in longer-duration securities. As a result, yields on both 10-year and 30-year Treasuries climbed above 5% for the first time since just before the global financial crisis. What's remarkable is the speed at which yields have reached these levels (Exhibit 14) and the intense losses for bondholders that have resulted. A portfolio of 10-year government bonds has lost 26% since the all-time low in U.S. yields in July 2020, and a portfolio of 30-year bonds has lost 51% over that period (Exhibit 15). These numbers are truly massive, especially for what are considered safe-haven instruments, and it means that investors in 10-year or 30-year U.S. government bonds have given back the entirety of the gains that they have accumulated since 2012 – a lost decade in long-dated sovereign fixed income.

At current levels, we think government bonds are the most appealing they've been in at least a decade. The real (after-inflation) yield on 10-year Treasuries has climbed to 2.5%,

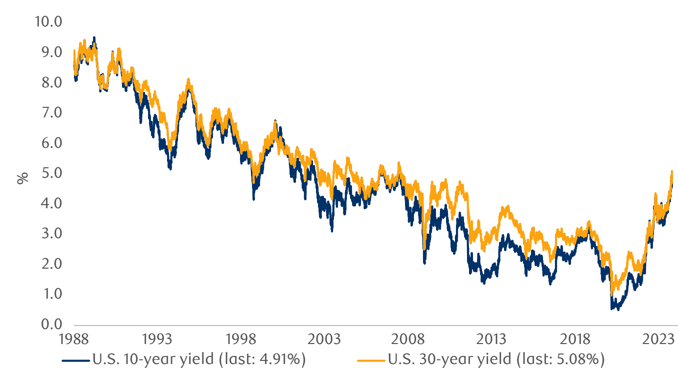
> "Also worth noting is that the equilibrium band in our bond-yield model tracks lower over the year ahead given our assumptions that inflation will continue cooling and that growth will moderate."

Exhibit 13: Implied fed funds rate
12-month futures contracts



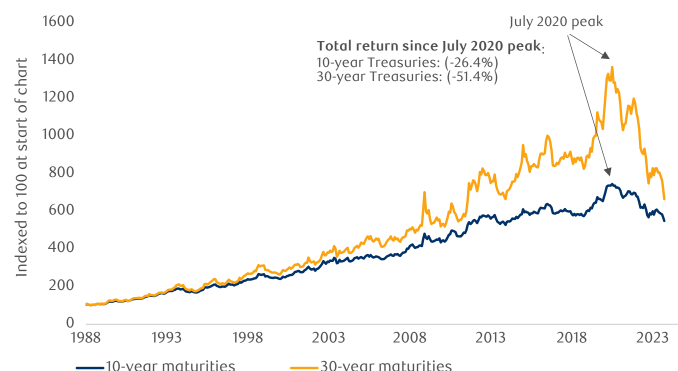
Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 14: U.S. government-bond yields



Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

Exhibit 15: U.S. long-dated T-bonds
Constant maturity cumulative total return indices



Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

the highest since before the global financial crisis and a significant improvement from the low or often negative real rates endured for much of the past 15 years (Exhibit 16). Moreover, nominal yields near 5% situate the 10-year yield above the upper boundary of our equilibrium model, suggesting that valuation risk is minimal and that total-return potential has improved (Exhibit 17). Also worth noting is that the equilibrium band in our bond-yield model tracks lower over the year ahead given our assumptions that inflation will continue to cool and that growth will moderate. If we are right, then fixed-income investors would not only collect attractive coupon income, but also benefit from rising bond prices as yields fall, generating high single-digit or even double-digit returns over the next 12 months. A similar setup is observed in long-dated government bonds in most developed-world countries, as evidenced by the fact that our composite of global bond yields has risen above equilibrium this month for the first time since 2013 (Exhibit 18).

Technicals and sentiment favour bonds

There are other indicators indicating that this could be a good time to add to sovereign bond holdings in investment portfolios. One of the technical indicators that we monitor triggered a buy signal this month as the year-over-year change in 10-year yields has fallen below 20% from an oversold condition (Exhibit 19). On the sentiment front, the percentage of investors who are optimistic about bonds has reached an extreme low seen in only two other periods in the

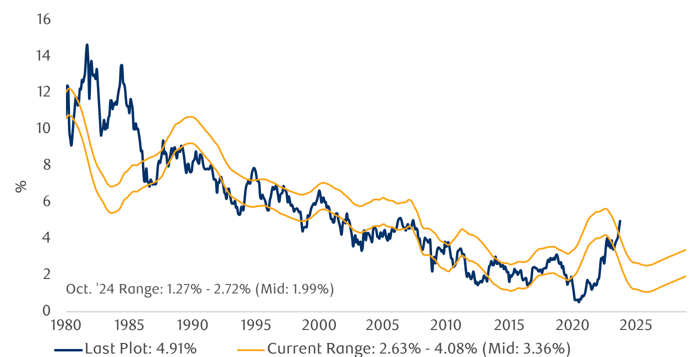
Exhibit 16: U.S. 10-year real yield

Inflation-indexed government bond yield

Note: real yield based on 10-year nominal bond yield minus the 10-year inflation breakeven rate. As of October 20, 2023. Source: Bloomberg, RBC GAM

Exhibit 17: U.S. 10-year T-bond yield

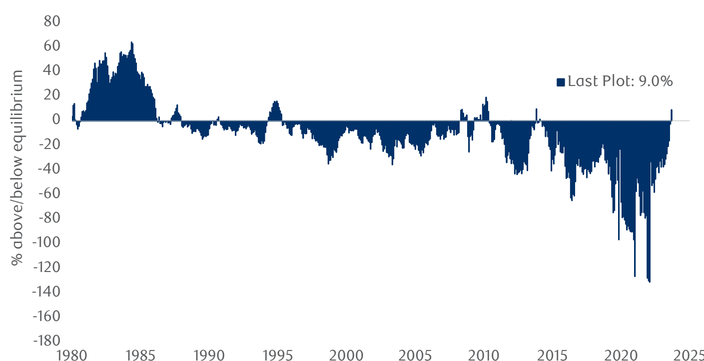
Equilibrium range



Note: as of October 20, 2023. Source: RBC GAM

Exhibit 18: Global bond-market composite

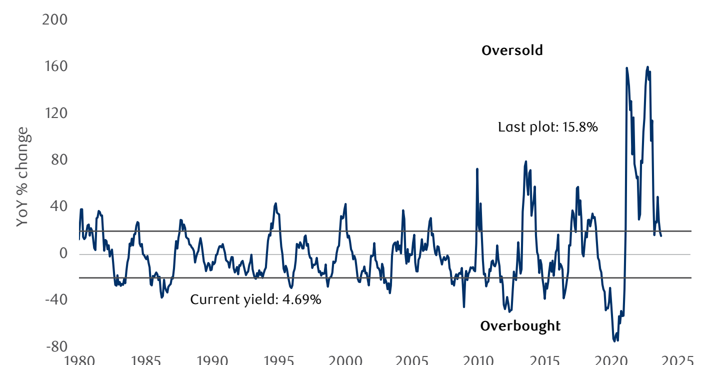
10-year government bond yields relative to equilibrium



Note: as of October 20, 2023. Source: RBC GAM

Exhibit 19: U.S. 10-year T-bond yields

Rate of change



Note: as of October 18, 2023. Source: Bloomberg, RBC GAM

past 23 years – late 2022 and late 1999/early 2000 (Exhibit 20). Extreme pessimism can often be a good counter-indicator, setting up the preconditions for improved total returns going forward.

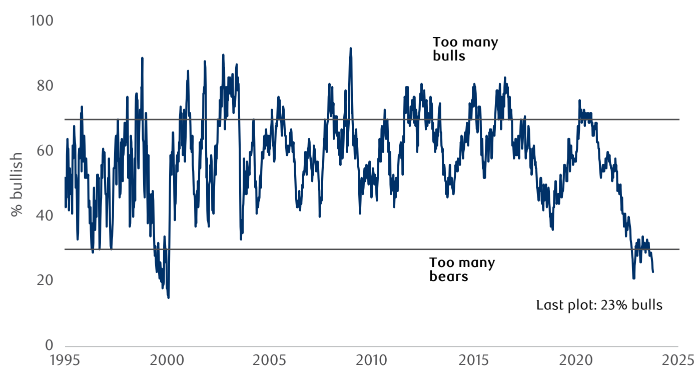
Credit markets appear well-behaved, but debt maturities pose a risk if high-rate environment persists

Moving out the fixed-income risk spectrum to corporate bonds introduces greater risk because companies may start struggling to meet their financial obligations if interest rates remain elevated. Credit spreads (i.e. the compensation investors receive for taking risk above and beyond "risk-free" government bonds) have remained relatively narrow in a sign that there is little concern about the financial health of corporations (Exhibit 21). But default rates have started to rise and, although they are not an immediate concern, companies will eventually need to roll over low-interest debt issued during the pandemic into higher-interest debt in the coming years. Exhibit 22 plots the dollar amount of maturing high-yield debt and leveraged loans over the next several years. The figures increase notably to the hundreds of billions of dollars from 2025 through 2028. Corporate interest expense could balloon over the next several years as increasing amounts of debt reset at higher rates.

Stocks extend losses as macro risks intensify

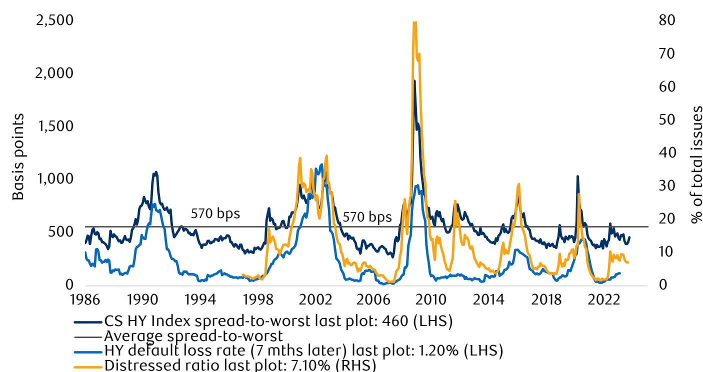
Global equity markets have turned lower since the summer and extended their declines in October (Exhibit 23). As of October 24, the S&P 500 Index is down 8% from this year's high on July 31, and some other markets are down even more. The MSCI Emerging Markets Index has declined 12% and

Exhibit 20: U.S. 10-year T-bond bullish consensus



Note: as of October 8, 2023. Source: Market Vane, RBC GAM

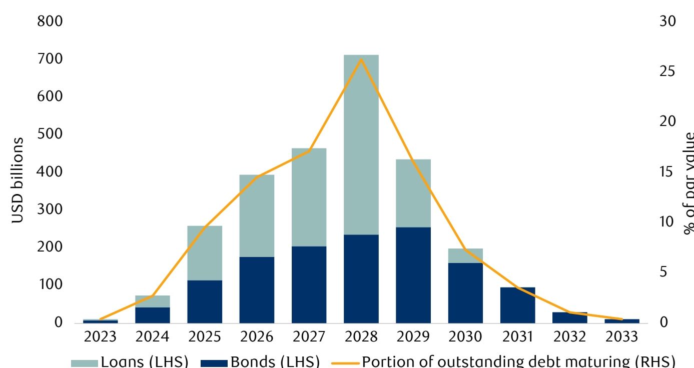
Exhibit 21: High-yield bond spread



Note: as of October 20, 2023. Source: BofAML, Credit Suisse, RBC GAM

Exhibit 22: U.S. high-yield bonds and leveraged loans

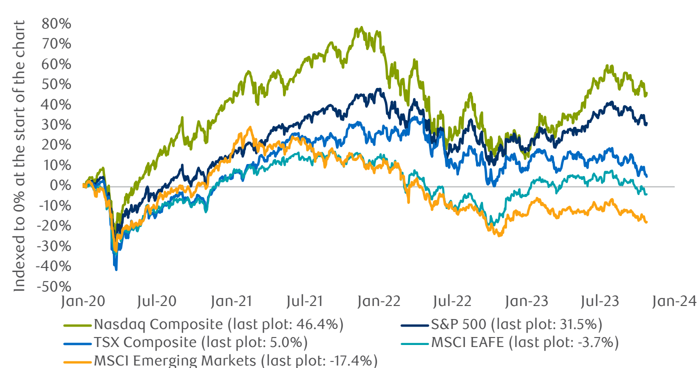
Upcoming maturities



Note: as of August 31, 2023. Source: BofA Global Research, ICE Data Indices LLC, RBC GAM

Exhibit 23: Major equity-market indices

Cumulative price-returns indices in USD



Note: as of October 24, 2023. Price returns computed in USD. Source: Bloomberg, RBC GAM

the Russell 2000 small-cap index 17% over the same period. Higher interest rates continue to weigh on equities, and the addition of intensifying geopolitical risks is also having an impact. With the latest pullback in stocks, many major markets are flat to slightly down so far this year (Exhibit 24). The one major outlier, however, is the Magnificent Seven, a group of seven U.S. mega-cap technology stocks that have risen 60% so far this year and masked weakness in the broad U.S. equity market.

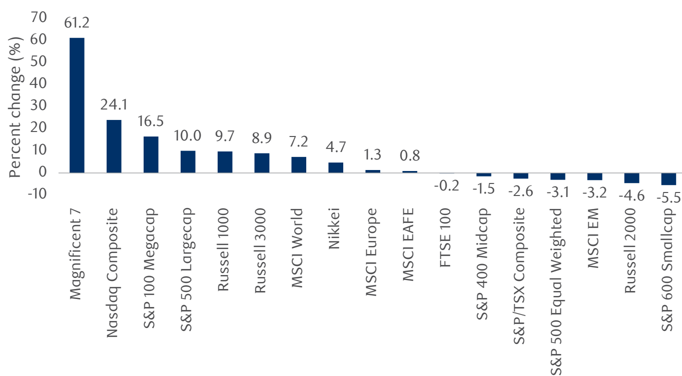
Aside from these seven tech stocks, global equities are not unreasonably valued and many markets are trading at substantial discounts to their fair value. Our equity-market composite suggests that global stocks are 6% below fair value. If we remove the U.S. – the most expensive market – stocks are 16% below fair value according to our models (Exhibit 25).

Rosy earnings outlook is vulnerable to disappointment

The biggest risk to the broader equity markets has to do with the fact that earnings expectations are still too optimistic given our view that the economy is likely headed for recession. The consensus of analyst estimates projects 11% growth in S&P 500 Index profits next year, and that number has increased in recent months (Exhibit 26). Investors are paying a relatively high price-to-earnings multiple at 19 times earnings compared with our modelled equilibrium of 17 times based on current interest rates and inflation (Exhibit 27). In past recessions, earnings have fallen an average of

Exhibit 24: Major indices' price change in USD

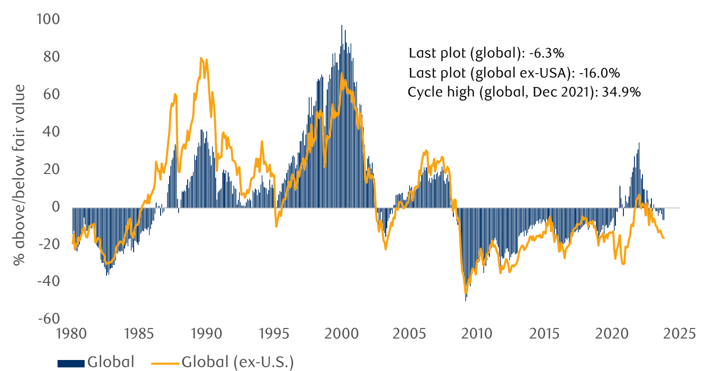
December 30, 2022 to October 20, 2023



Note: Magnificent 7 includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Source: Bloomberg, RBC GAM

Exhibit 25: Global stock-market composite

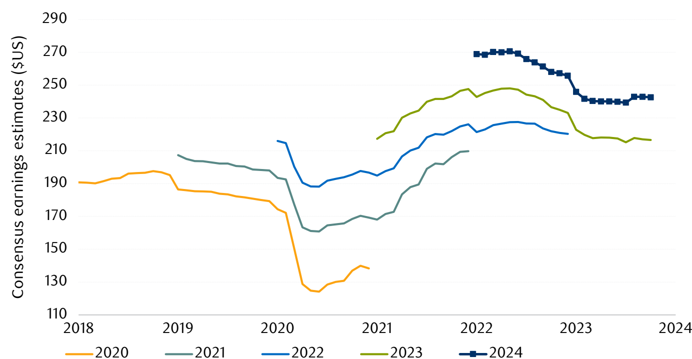
Equity market indexes relative to equilibrium



Note: as of October 20, 2023. Source: RBC GAM

Exhibit 26: S&P 500 Index

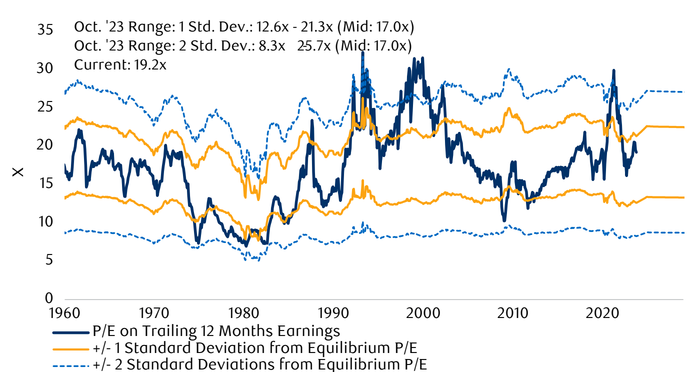
Consensus earnings estimates



Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

Exhibit 27: S&P 500 Index

Normalized (Equilibrium) Price/Earnings Ratio



Note: as of October 13, 2023. Source: RBC GAM

24% so there is a substantial gap between what analysts are expecting and what could materialize if a recession doe take hold. As a result, we think that current earnings estimates will fall and that process appears to have started (Exhibit 28). Further declines in earnings estimates will likely limit stock returns in the near term.

A deeper dive into equity-market breadth

Further to the earlier-mentioned theme of high concentration in U.S. equities, relative-strength charts can be used to illustrate how extremely narrow market breadth has been. Between January 1 of this year and October 24, the S&P 500 equal-weight index has underperformed the S&P 500 cap-weighted index by 13%, erasing the relative gains that the equal-weight index had enjoyed over the past three years (Exhibit 29). The underperformance of small caps versus large caps has reached even greater extremes in the current cycle, with the Russell 2000 small-cap index lagging the S&P 500 by 34% since the start of 2021, and the relative strength between these indices falling to its lowest in 22 years (Exhibit 30). In an environment of heightened uncertainty and weakening economic growth, investors tend to favour large-cap and high-quality stocks given their stable business models and proven ability to generate cashflow. In contrast, smaller-cap stocks are more sensitive to changes in economic conditions and, as a result, we would look for any rebound in equity markets to be accompanied by widening breadth and outperformance of small caps as confirmation that the rally can be sustained.

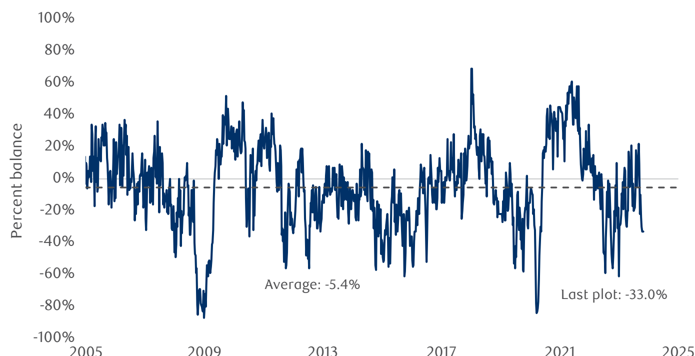
Asset mix – nudging fixed income allocation to slight overweight

Balancing the risks and rewards, we have decided to increase our allocation to fixed income by half a percentage point, sourced from cash. This change has pushed our bond allocation to a slight overweight for the first time in two decades. In our base case scenario, the economy falls into recession at some point over the next several quarters, ultimately prompting central banks to lower interest rates. Given today's higher yields and the fact that inflation is

> "Attractive coupon income and the tendency for sovereign bonds to offer shelter from a downturn in stocks should provide ballast in a balanced portfolio."

Exhibit 28: U.S. equities

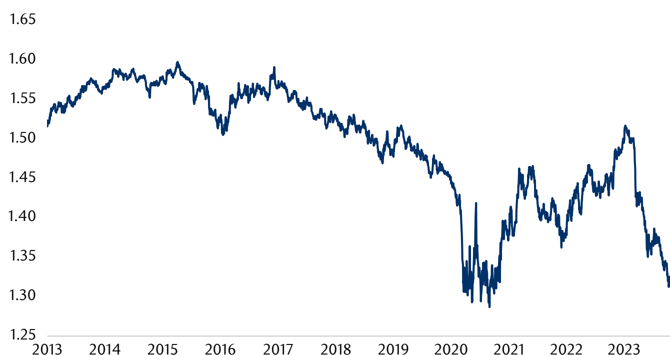
Companies with upward earnings revisions



Note: as of October 20, 2023. Source: Citi, RBC GAM

Exhibit 29: S&P 500 Index

Equal-weighted index / cap-weighted index



Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

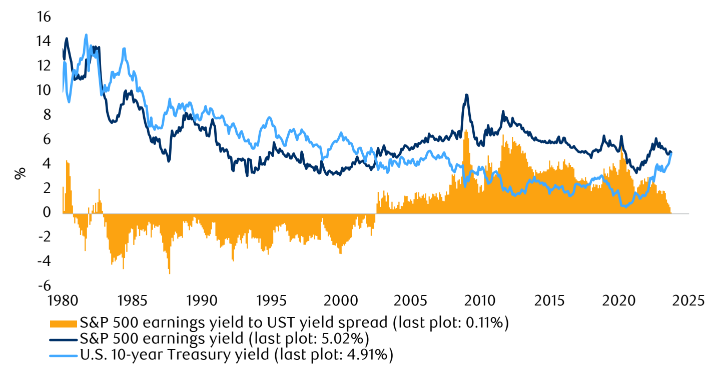
Exhibit 30: U.S. small caps versus large caps

Russell 2000 Index / S&P 500 Index

Note: as of October 20, 2023. Source: Bloomberg, RBC GAM

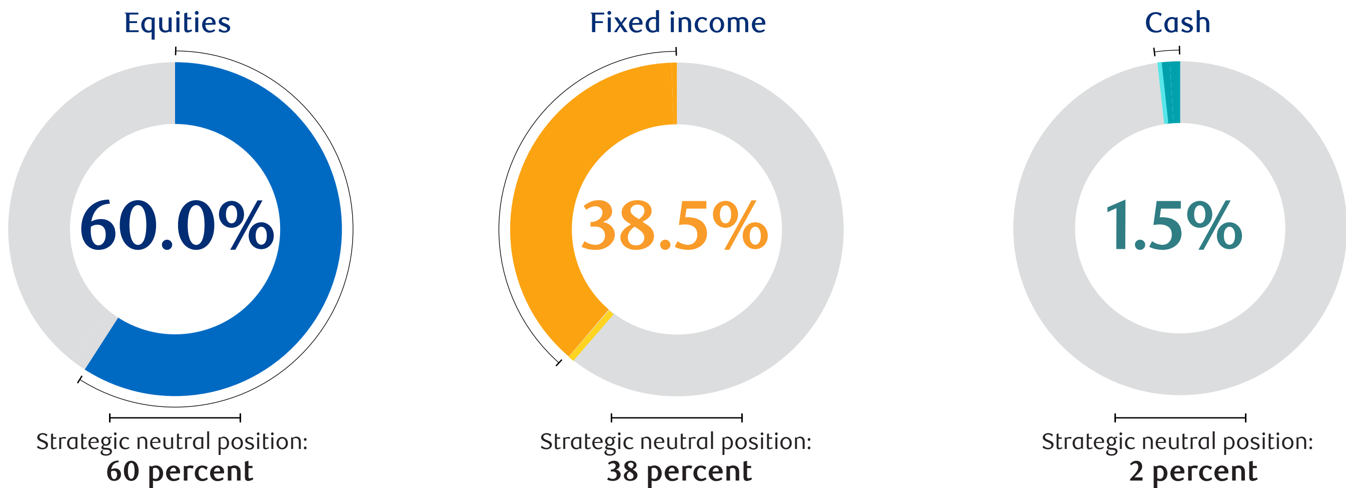
trending lower, bonds offer attractive return potential with minimal valuation risk. Moreover, attractive coupon income and the tendency for sovereign bonds to offer shelter from a downturn in stocks should provide greater ballast in a balanced portfolio. While we continue to expect stocks to outperform bonds over the longer term, we recognize that macroeconomic risks are elevated, corporate profits are vulnerable to an economic slowdown and the equity-risk premium has meaningfully eroded with the recent surge in bond yields (Exhibit 31). As a result, we are maintaining our positioning in stocks in line with our strategic neutral. For a balanced global investor, we currently recommend an asset mix of 60.0 percent equities (strategic neutral position: 60.0 percent) and 38.5 percent fixed income (strategic neutral position: 38.0 percent), with the balance in cash (Exhibit 32). Actual fund or client portfolio positioning may differ depending on individual investment policies.

Exhibit 31: S&P 500 earnings yield
12-month trailing earnings/index level



Note: as of October 20, 2023. Source: RBC GAM

Exhibit 32: Recommended asset mix
RBC GAM Investment Strategy Committee



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