RBC Global Asset Management

Economic outlook

FALL 2023

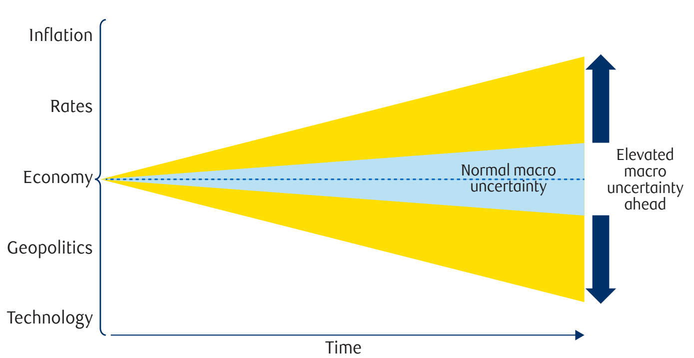
Where’s the recession?

Eric Lascelles
Chief Economist
RBC Global Asset Management Inc.

We remain in a period of elevated uncertainty. Not to the absurd degree of 2020 when a pandemic took over the world for the first time in a century, nor to the extent of 2022, when inflation exploded amid booming demand and a supply-chain crunch. But even absent those extraordinary forces, uncertainty is still high today. There are a variety of plausible directions for inflation, interest rates, the economy, geopolitics and even the rate of technological advancement from here (Exhibit 1). As a result, no guarantees can be made in good conscience with regard to the path forward for these key macroeconomic variables.

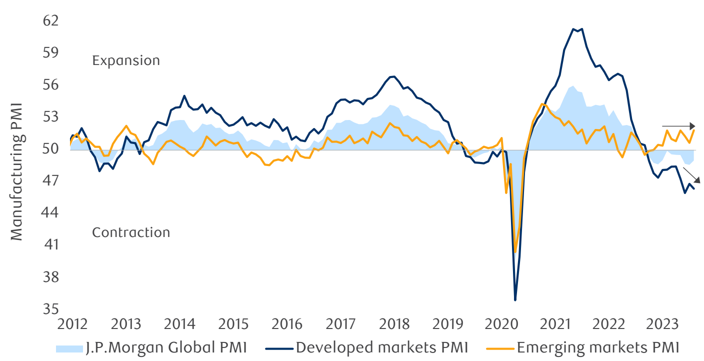
However, among several viable scenarios, a near-term recession remains most likely. This is mainly because rate hikes have been sufficiently large to induce the expected contraction. History also supports this argument: a number of key signals have been tripped that are consistent with a coming recession. There are also now ripples of economic stress forming. Hiring is decelerating, some borrowers are experiencing distress, and manufacturers in the developed world report worsening conditions (Exhibit 2).

Exhibit 1: Unusually high macro uncertainty right now



Note: As at 06/02/2023. Source: RBC GAM

Exhibit 2: U.S. housing metrics show signs of softening



Note: As of Aug 2023. PMI refers to Purchasing Managers Index for manufacturing sector, a measure for economic activity. Source: Haver Analytics, RBC GAM

As a result, we continue to maintain an asset allocation that, while technically neutral, is in practice considerably below the usual degree of risk-taking deployed. This is to say, the recommended equity allocation is lower than the norm, while the fixed-income allocation is higher. Motivating this, the risk premium available in the stock market is smaller than usual relative to bonds, and we anticipate equity underperformance during the year ahead. Patience is advisable: contrary to the popular imagination, the recession and its assorted implications are not actually behind schedule.

Growth survives, for now

Most economies continued to expand across the first three quarters of 2023. In attempting to understand this resilience, a key aspect is surely that a number of serious problems have become less concerning over the past several quarters.

Prominently, inflation isn't nearly as high as it once was, diminishing its direct corrosive effect on growth. Providing particular assistance, energy prices, for both oil and natural gas, are much lower than they were at the onset of the Ukraine war.

Supply-chain problems were already improving a year ago, but have now completely normalized in many sectors.

China was substantially locked down last year, whereas today it is not.

Banking stress in the U.S. has also eased since the spring, though it has not completely normalized (Exhibit 3).

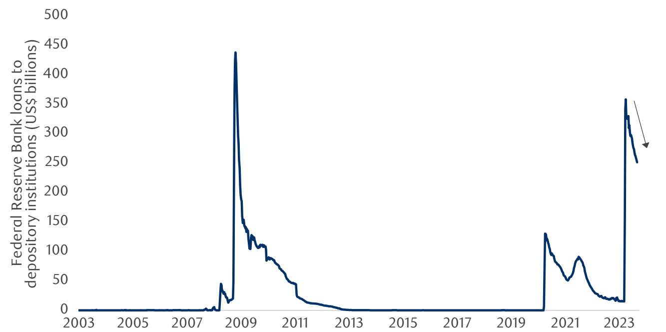
The U.S. fiscal environment has become more supportive as the uptake for previously announced government initiatives exceeds expectations (Exhibit 4). There has been a particular boom in the construction of manufacturing facilities, primarily for the electronics industry (Exhibit 5).

The North American housing market also rebounded in the spring after a difficult prior year.

Finally, the stock market and risk assets have been stronger – a reflection of these developments, but also a boost to consumer spending via a positive wealth effect.

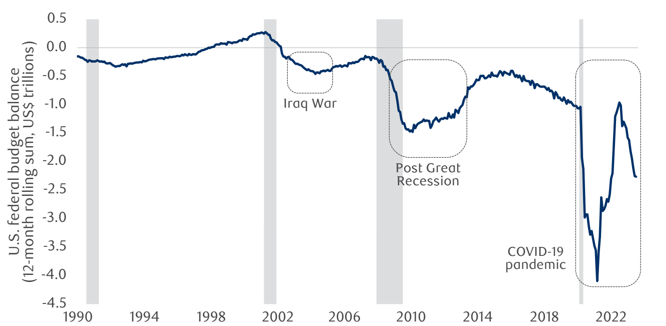
It is therefore fair to say that the macro situation on quite a number of fronts is less perilous than it was a year ago.

Exhibit 3: Emergency lending to banks by Fed starting to decline



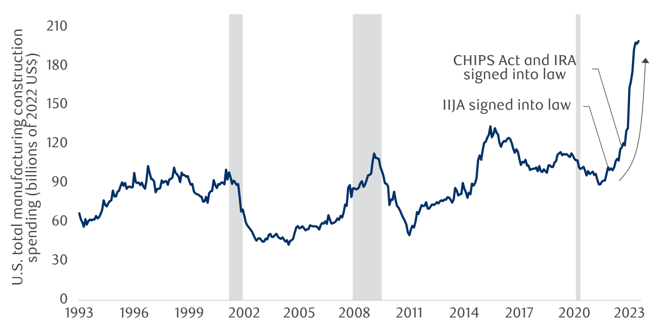
Note: As of the week ending 08/30/2023. Source: Federal Reserve Bank, Macrobond, RBC GAM

Exhibit 4: U.S. fiscal deficit has expanded again



Note: As of Jul 2023. Source: Macrobond, RBC GAM

Exhibit 5 : U.S. spending on manufacturing construction soared due to legislative support



Note: As of Jul 2023. Total private manufacturing construction spending deflated by Producer Price Index for Intermediate Demand, Materials and Components for Construction. Shaded area represents recession. Source: Census Bureau, BLS, Macrobond, RBC GAM

But headwinds still dominate

However, a few big things have not gone according to plan and/or constitute sizeable headwinds, and these are at least as important as the raft of good news.

Prominently, while China has reopened, its economy is nevertheless struggling significantly. China normally generates more than a quarter of global economic growth, so this misfire is quite problematic.

But most importantly, and constituting a more than offsetting counterpoint to the earlier list of happy trends, interest rates have continued to rise and are now quite high by the standards of the 21st century. This represents a major economic headwind, and one that has traditionally proven sufficient to bring on a recession all by itself.

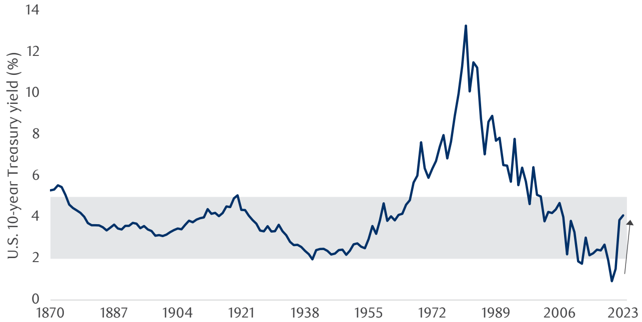
Not only have many developed-world central banks tacked on about half percentage point of additional rate hikes relative to their prior plans last spring, but bond yields have increased by even more for other reasons. The term premium has increased palpably due to a combination of quantitative tightening, persistently large fiscal deficits, especially heavy bond issuance in the U.S. following the debt-ceiling showdown, the U.S. debt downgrade, rising Japanese bond yields (which attract capital from other sovereign-debt markets) and even China's efforts to defend its currency (which involve selling foreign bonds to buy Chinese assets).

Interest rates have now increased to the point that they have gone from being extraordinarily low to fairly high, even when examined through a multi-century lens (Exhibit 6). Higher interest rates impede economic growth by increasing the cost of borrowing, discouraging investments and reducing financial-market valuations.

Furthermore, and crucially, there is a significant lag between the moment when interest rates rise and the peak damage that they inflict on the economy. Our own large-scale econometric model argues that the drag from higher rates is continuing to mount. Historically, the lag from a first U.S. rate hike to recession has averaged around two years, and a key literature review encapsulating 67 studies finds that the average transmission lag from monetary policy to inflation is a whopping two to four years. For context, it has been less than two years since most developed-world central banks began their tightening campaigns. Thus, the window for a recession is far from closing. At a minimum, it is still open, and one could even argue that it is just beginning to open.

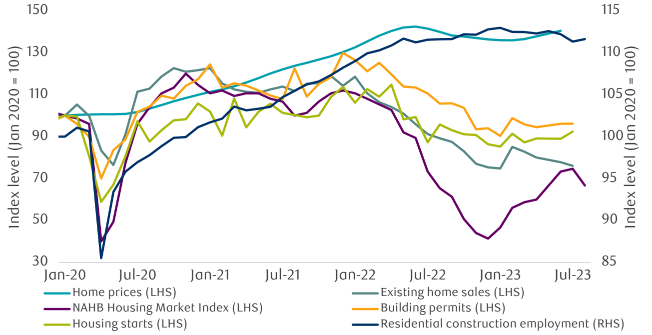
There is evidence of some tentative economic weakness in a range of countries. This trend is more visible in countries such as Germany and the U.K. But even the U.S. evinces a bit of tentative wilting. After a spring resurgence, U.S. housing – the most interest-rate sensitive sector of an economy – is beginning to cool again (Exhibit 7). It is not a coincidence that the U.S. 30-year mortgage rate is now above 7%.

Exhibit 6: U.S. 10-year Treasury yields are approaching the upper bound of normal range



Note: As of 08/31/2023. Source: RBC CM, RBC GAM

Exhibit 7: U.S. housing metrics show signs of softening



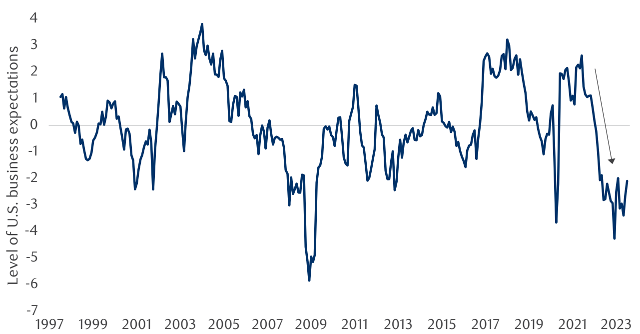
Note: S&P CoreLogic Case-Shiller Home Price Index as of Jun 2023; building permits, housing starts, and existing home sales as of Jul 2023; employment and NAHB HMI as of Aug 2023. Source: BLS, Census Bureau, NAHB, NAR, S&P, Macrobond, RBC GAM

Business expectations remain quite sour and are consistent with contracting demand (Exhibit 8).

Consumers have generally proven more resilient, but points of vulnerability are becoming apparent. Consumer-facing companies including Disney, Foot Locker and Lego are noting softer demand for discretionary purchases. As accumulated pandemic savings wane, credit cards are providing a temporary crutch (Exhibit 9). But the rapid growth in credit-card use cannot be sustained indefinitely. The credit-card delinquency rate is rising significantly and is now at its highest point in over a decade (Exhibit 10). Nearly US$2 trillion of U.S. student loans must start being repaid in October, pinching 44 million Americans.

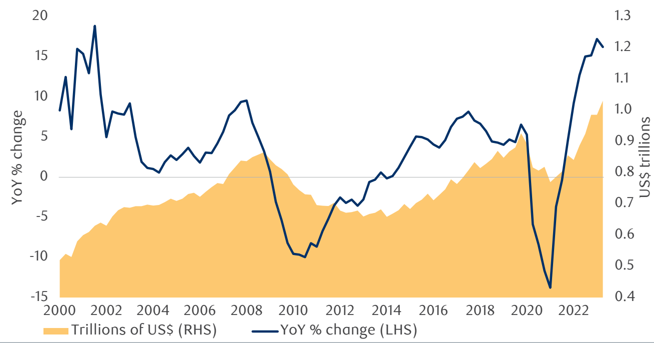
Hiring is also beginning to slow, and temporary employment, a classic leading indicator of the labour market, is in persistent decline (Exhibit 11).

Exhibit 8: U.S. business expectations remain weak



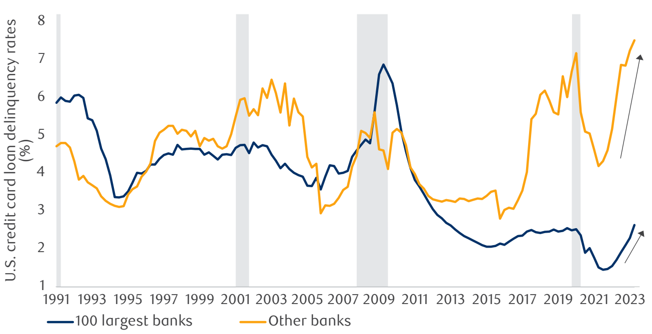
Note: As of Jul 2023. Principal component analysis using NFIB optimism and business conditions outlook, ISM Manufacturing and Services new orders, and The Conference Board CEO expectations for economy. Source: The Conference Board, ISM, NFIB, Macrobond, RBC GAM

Exhibit 9: U.S. credit-card balance is rising rapidly



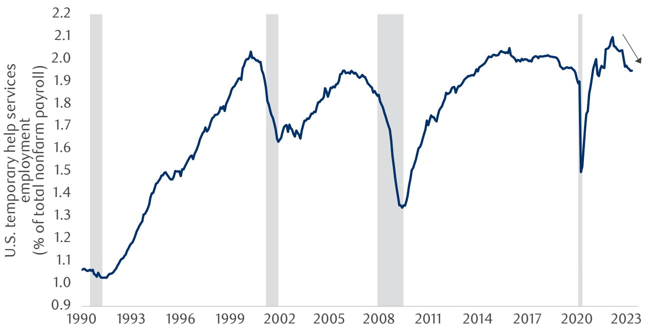
Note: As of Q2 2023. Source: Federal Reserve Bank of New York, Macrobond, RBC GAM

Exhibit 10: Credit-card delinquency rates surging



Note: As of Q2 2023. Shaded area represents recession. Source: Federal Reserve Board, Macrobond, RBC GAM

Exhibit 11: Falling U.S. temporary employment usually leads recession



Note: As of Aug 2023. Shaded area represents recession. Source: BLS, Macrobond, RBC GAM

Recession call tweaked but intact

Calling for a recession is admittedly falling out of fashion, with third-party forecasters assigning a diminishing likelihood for a number of countries (Exhibit 12).

Nevertheless, in light of the economic headwinds that remain, we continue to anticipate a recession spanning most of the developed world. It is not just the cost of borrowing that is rising, but the availability of loans that is falling: Lending standards have tightened, particularly with regard to the willingness of banks to lend to U.S. businesses (Exhibit 13).

Granted, the recession probability we now assign is somewhat lower than in quarters past, with a 65% likelihood for the bellwether U.S. economy, down from 80% before.

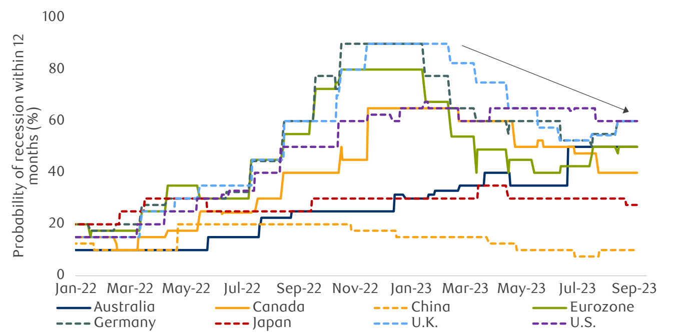
We have pushed back the anticipated onset of the recession to the fourth quarter of this year, with the chance that this drifts further into the future, given the vagaries of recession timing.

But a recession is still likely. The effect of higher interest rates arrives with a considerable, if variable, lag, the window for economic damage remains wide open, and three critical recession criteria in our toolkit continue to be met.

First, our most sophisticated econometric forecasting model continues to anticipate a recession based on the increase in interest rates.

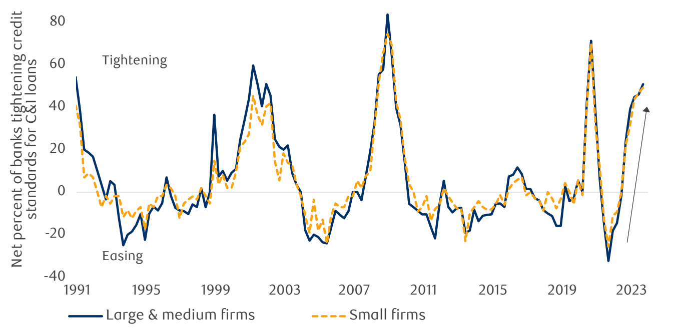
Second, our collection of recession heuristics – rules of thumb that have previously anticipated recessions – continues to indicate that a recession is more likely than not (Exhibit 14). These signals include an inverted yield curve and a large inflation spike.

Exhibit 12: Probability of recession for some countries has come down



Note: As of 09/04/2023. Median probability of recession based on latest forecasts submitted to surveys conducted by Bloomberg. Source: Bloomberg, RBC GAM

Exhibit 13: U.S. business-lending standards tightening



Note: July 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices. Source: Federal Reserve Board, Macrobond, RBC GAM

Exhibit 14: Recession signals point mostly to "yes" or "likely": we estimate 65% chance over the next year

Signal	Indicating U.S. recession?
2yr-10yr curve inverts	Yes
3m-10yr curve inverts	Yes
Fed short-term curve inverts	Yes
Inflation spike	Yes
Duncan leading indicator falls	Yes
Financial conditions tighten	Yes
Monetary tightening cycle	Likely
Google "recession" news trend	Maybe
RBC GAM recession model	Maybe
Oil price spike	Maybe
Jobless claims jump	Maybe
Unemployment increase	No, but trending sideways

Note: As at 07/24/2023. Analysis for U.S. economy. Source: RBC GAM

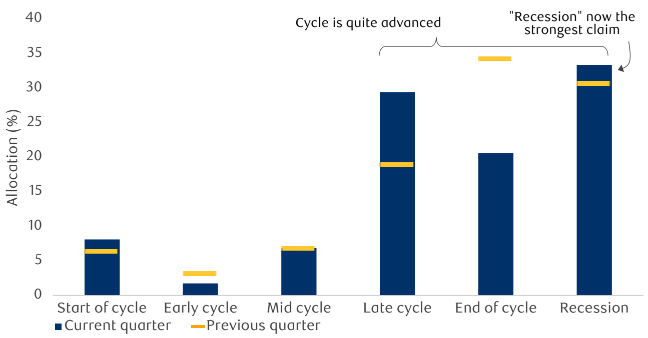
Finally, our business-cycle scorecard postulates with increasing conviction that this is quite a late point in the business cycle, to the point of now being consistent with an imminent recession (Exhibit 15). At a bare minimum, the economy is looking sclerotic and fragile, where just a few years ago it was young and vibrant.

Any recession that arrives can probably be fairly mild in depth, short in duration, and followed by a solid multi-year recovery (Exhibit 16). Job losses should be more muted than the average recession given the difficulty many businesses had securing sufficient workers in recent years.

Updated growth forecasts

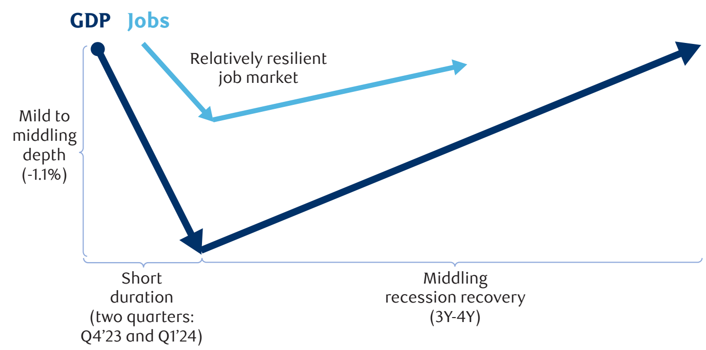
Our GDP growth forecasts have mostly been upgraded for 2023 and downgraded for 2024. This primarily reflects the continued resilience of economic growth across the summer of 2023, paired with the deferment of the anticipated recession onset from the third quarter of 2023 to the fourth quarter (Exhibit 17).

Exhibit 15: U.S. business-cycle score



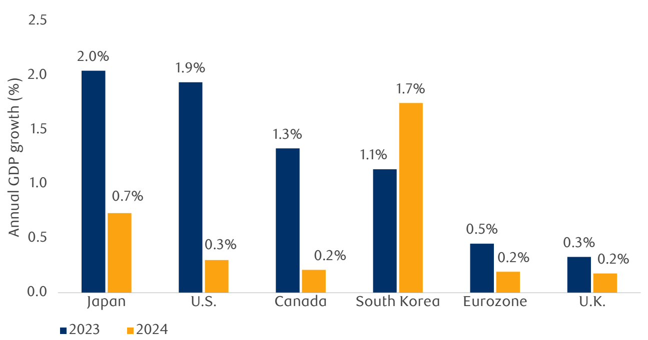
Note: As at 07/28/2023. Calculated via scorecard technique by RBC GAM. Source: RBC GAM

Exhibit 16: Recession is likely to be mild and short



Note: As at 07/19/2023. Source: RBC GAM

Exhibit 17: RBC GAM GDP forecast for developed markets



Note: As of 08/24/2023. Source: RBC GAM

> "Our GDP growth forecasts have mostly been upgraded for 2023 and downgraded for 2024."

The story is somewhat more varied for emerging-market countries. The Chinese outlook for 2023 was downgraded in response to further economic woes, whereas most other countries enjoyed the same upgrade as developed nations. Growth forecasts have been pared in many emerging markets, reflecting spillover effects from the anticipated recession in the developed world. India is set to be the fastest growing country among those we forecast in both 2023 and 2024 (Exhibit 18).

Even after these adjustments, we retain mostly below-consensus growth forecasts for 2024, paired with below-consensus inflation forecasts (Exhibit 19). This helps to explain our more cautious stock-market positioning and more favourable fixed-income stance relative to the past decade.

The U.S. economy is less rate-sensitive than most due to a combination of household deleveraging over the past 15 years and unusually long mortgage terms. This puts it in relatively good stead versus most countries, and indeed informs an expected slight outperformance in both 2023 and 2024 relative to peers such as the eurozone, the U.K. and Canada.

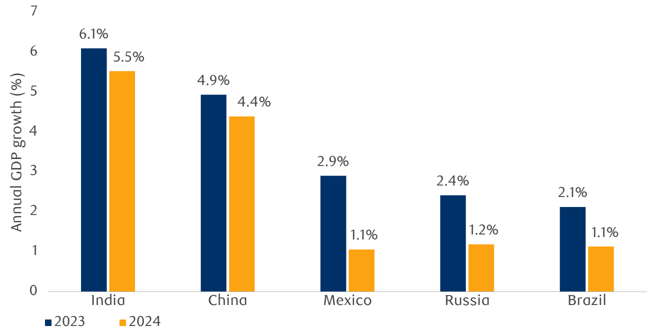
But this advantage must not be overstated. In the U.S., some of the economic pain from higher rates has simply shifted from the sheltered American mortgage holders to the parties that made those now below-market loans. It is not entirely a coincidence that U.S. banks have experienced more stress than other financial systems this year. The U.S. also faces the challenge of a large quantity of student loan debt for which payments soon recommence.

Canada and the U.S. enjoyed larger-than-average growth upgrades for 2023 for an additional reason: immigration is running unexpectedly strongly in both countries, adding to the economy's capacity and to its demand.

Conversely, the U.K. economy remains challenged due to especially high inflation that has demanded additional monetary tightening, plus the chronic economic ache resulting from Brexit adjustments and particularly high levels of labour discontent.

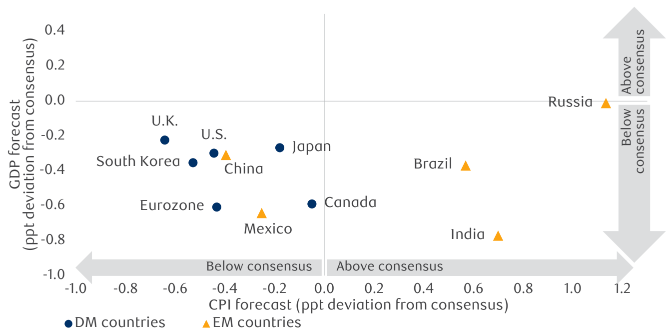
The eurozone shares some common challenges with the U.K. such as lost access to Russian energy that is depressing activity to a greater extent than in North America (Exhibit 20).

Exhibit 18: RBC GAM GDP forecast for emerging markets



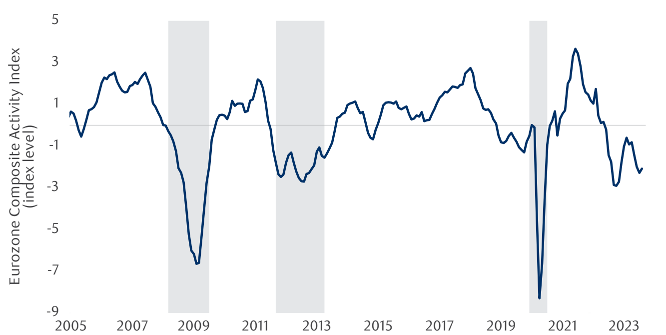
Note: As of 08/24/2023. Source: RBC GAM

Exhibit 19: RBC GAM forecasts vs. consensus for 2024



Note: Deviation measured as difference between RBC GAM forecast (08/24/2023) and consensus forecast (Aug 2023). Source: Consensus Economics, RBC GAM

Exhibit 20: Eurozone economy continues to struggle



Note: As of Aug 2023. Index reflects the first principal component from PCA analysis on select indicators of eurozone economic activity. Shaded area represents recession. Source: CEPR, ZEW, Deutsche Bundesbank, IHS Markit, Macrobond, RBC GAM

Germany has suffered through three consecutive quarters without economic growth, in part due to its greater exposure to a wobbling Chinese economy (Exhibit 21).

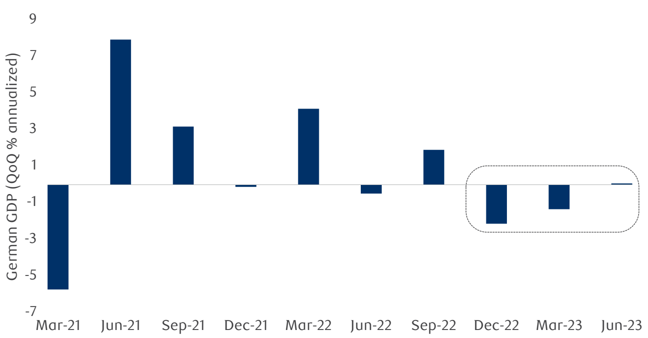
Gazing beyond the next year, a potential economic drag over the medium term for quite a number of countries is the enormous fiscal deficits they continue to run despite some of the lowest unemployment rates in decades (Exhibit 22). These will have to be reduced as the burden of higher interest rates hits debt-servicing costs and as the bond market becomes pickier with regard to who it wishes to fund.

The long-run growth outlook features an assortment of headwinds. These include not just the burden of high public-debt loads, but the effects of a multi-polar world and de-globalization, a challenging demographic environment and the harmful consequences of climate change. On the other hand, we remain hopeful that productivity growth will rise somewhat more quickly than normal, in part due to a range of exciting new technologies. Some of the best positioned countries to harness this wave are those that invest the most in research and development (Exhibit 23).

Inflation improving

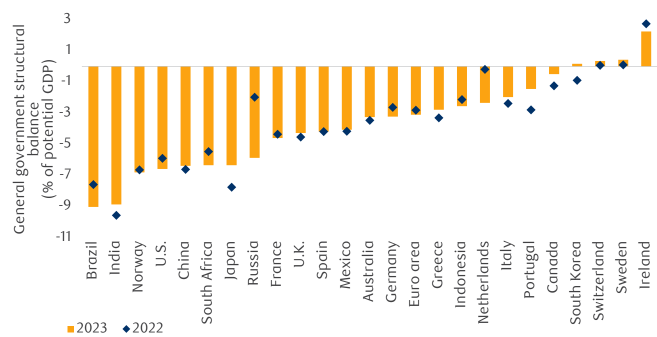
The inflation trend remains favourable. Consumer inflation peaked in the 8%-10% range in the second half of 2022 and has since retreated significantly (Exhibit 24). In the U.S., the annual headline CPI rate has fallen all the way from 9% to 3%.

Exhibit 21: Germany's economy stalls after falling into technical recession



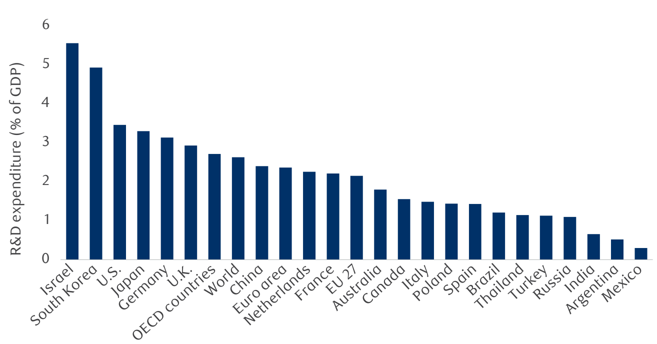
Note: As of Q2 2023. Source: Statistisches Bundesamt, Macrobond, RBC GAM

Exhibit 22: Significant structural fiscal deficits persist



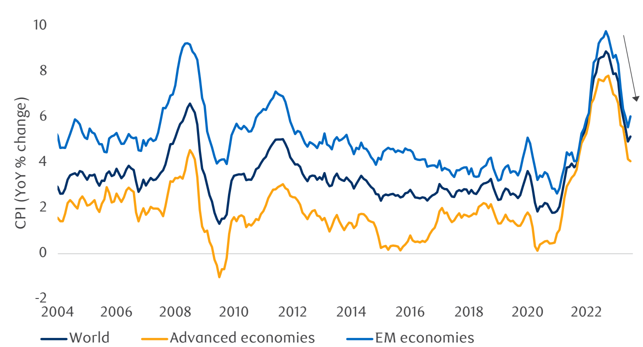
Note: IMF projections for year 2023. Source: IMF WEO, April 2023, Macrobond, RBC GAM

Exhibit 23: R&D has a positive impact on productivity and economic growth



Note: Based on latest data available, ranging from 2018 to 2022. Source: OECD, World Bank, Macrobond, RBG GAM

Exhibit 24: Global inflation has declined while remaining elevated



Note: As of Jul 2023. Source: Haver Analytics, Macrobond, RBC GAM

The four main original drivers of high inflation have all turned around to varying degrees. The commodity shock has been significantly reversed, supply-chain problems have mostly vanished, central banks have pivoted from extreme stimulus to unusual restraint, and fiscal policy has gone from being extraordinarily stimulative to far less so. In short, the supply-and-demand pressures that joined forces to create the biggest inflation problem in more than a generation have mostly normalized, permitting inflation to settle back down. The expected weakening of the global economy should provide additional assistance in taming inflation.

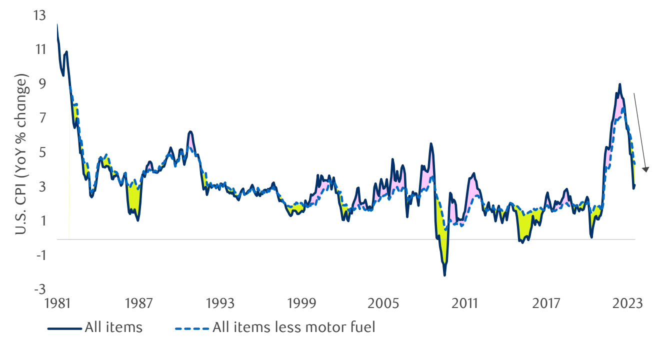
Annual inflation will struggle to improve materially from current levels over the next few months given a recent resurgence in gasoline prices and less friendly base effects (there are no longer big monthly price increases from a year ago falling out of the equation with each release).

It is important to appreciate that while overall consumer inflation has decelerated to just over 3% over the past year, this probably exaggerates the extent of the genuine improvement in inflation on the path toward the 2.0% target. Falling gasoline prices have provided an important but unsustainable helping hand. The U.S. Consumer Price Index (CPI) excluding gasoline is still rising by 4.1% annually (Exhibit 25). Core inflation is still 4.7% year over year and median CPI is still rising at a big 6.1% year over year. Service-sector inflation is also proving sticky (Exhibit 26). There is still work to be done.

But some of the work is unquestionably being done. To illustrate, the three alternate measures of inflation in the previous paragraph have decelerated such that their three-month change at an annualized pace are a more muted 2.6%, 3.1% and 3.8%, respectively. Put differently, inflation may not be within a percentage point of normal as the headline metric claims, but it is probably within two percentage points of normal.

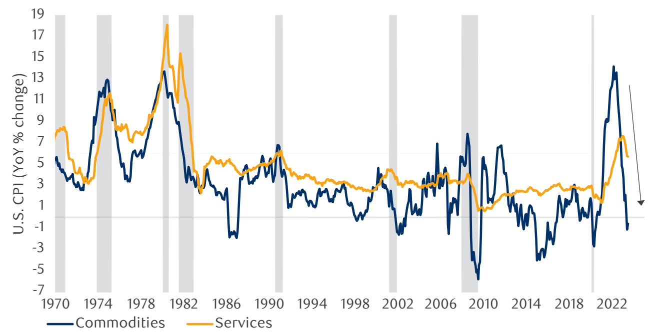
An important metric in gauging the progress made is the breadth of inflation as measured by the extent to which prices are rising quickly across a wide swath of the price basket. This has shown heroic improvement in recent months (Exhibit 27). Putting this into numbers, the portion of the U.S. price basket suffering from price increases of 10% per year or greater has plummeted from a third to just 4% today.

Exhibit 25: U.S. gasoline inflation cooled down much faster than for other goods and services



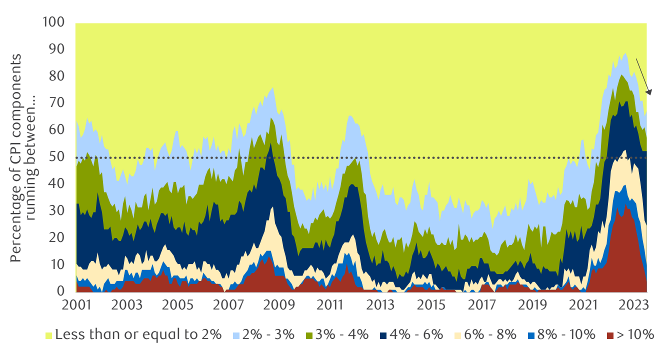
Note: As of Jul 2023. Shaded area represents recession. Source: BLS, Haver Analytics, Macrobond, RBC GAM

Exhibit 26: U.S. goods inflation has declined sharply, services inflation starting to retreat



Note: As of Jul 2023. Shaded area represents recession. Source: BLS, Macrobond, RBC GAM

Exhibit 27: Prices for most items rising more slowly



Note: As of Jul 2023. Share of CPI components with year-over-year % change falling within the ranges specified. Source: Haver Analytics, RBC GAM

Shelter inflation famously moves with a long lag and is finally beginning to ease. Food inflation is also slowing, though we flag upside risks that include the possibility that it will become harder to access Ukrainian agricultural exports now that Russia has abandoned an earlier Black Sea pact, paired with extreme heat in recent months and an El Nino weather pattern in the months ahead.

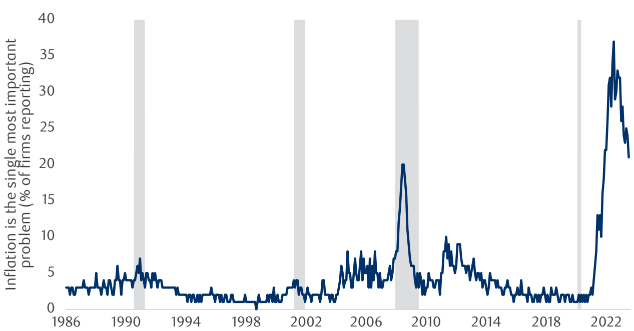
Promisingly, small businesses report a diminishing level of concern about inflation, though attitudes are not yet entirely back to normal (Exhibit 28). Businesses report that they're again considering moderate price increases after a lull, casting some doubt over whether inflation can completely normalize in the near term (Exhibit 29).

Ultimately, we remain optimistic on the inflation outlook. We believe inflation can fall incrementally more quickly than expected by financial markets, achieving readings mostly just above the 2.0% target next year (Exhibit 30). We believe U.K. inflation may continue to run somewhat hotter than elsewhere, in part because wage growth there continues to accelerate in contrast to downward trends in most other countries (Exhibit 31).

Central banks near sustained peak

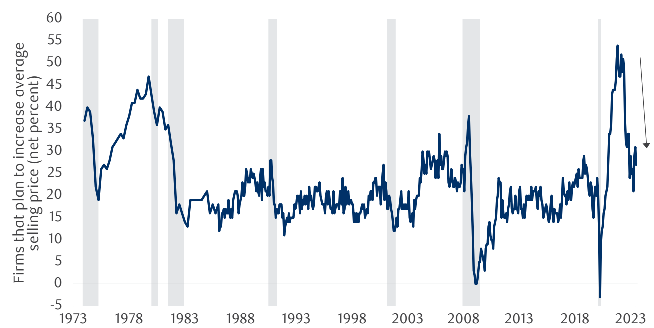
Central bankers have delivered the most aggressive monetary tightening in decades over the past two years (Exhibit 32). In the process, monetary policy has pivoted from extreme stimulus to substantial restraint.

Exhibit 28: Inflation is one of the biggest problems for small businesses



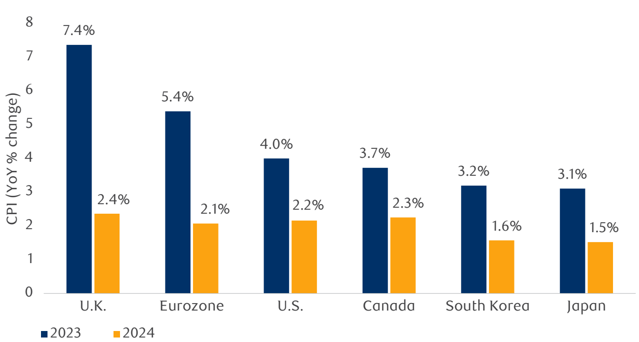
Note: As of Jul 2023. Shaded area represents recession. Source: NFIB Small Business Economic Survey, Macrobond, RBC GAM

Exhibit 29: Fraction of U.S. businesses planning to raise prices has declined



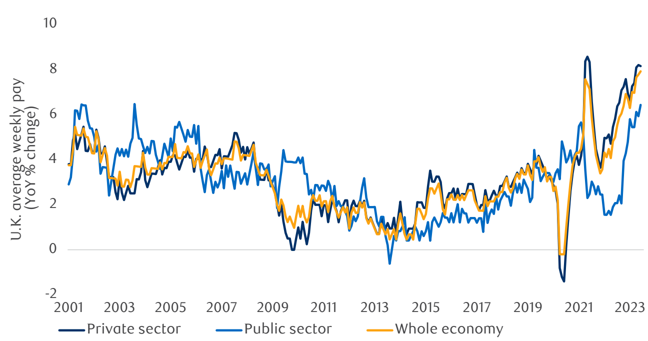
Note: As of Jul 2023. Shaded area represents recession. Source: NFIB Small Business Economic Survey, Macrobond, RBC GAM

Exhibit 30: RBC GAM CPI forecast for developed markets



Note: As of 08/24/2023. Source: RBC GAM

Exhibit 31: U.K. wage growth soaring



Note: As of Jun 2023. Source: U.K. Office of National Statistics, Macrobond, RBC GAM

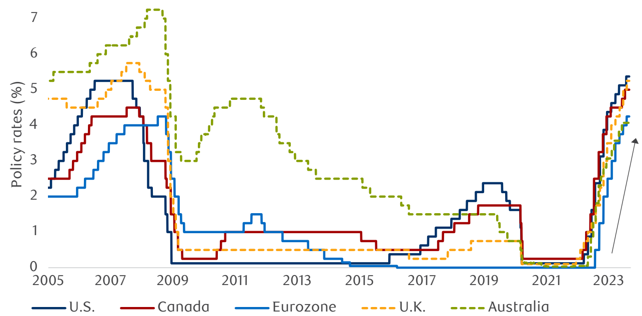
Even as developed-world central banks now near the finish line – some may already be done and several are within a small rate hike or two of completion – the inflation-adjusted fed funds rate will continue to rise as inflation falls (Exhibit 33). Further, and as highlighted earlier, the full economic impact of the rate hikes has not yet been felt given the lags involved.

Emerging-market central banks have acted as bellwethers across this monetary cycle, and some are now pivoting to rate cuts. It is not unreasonable to think that many developed-world central banks will follow suit over the next year, though this does not appear imminent for most based on recent comments from monetary authorities. Developed-world central banks recognize the imprecise impact of rate increases, and the uncertain timing of this effect. Policymakers will therefore be hesitant to reverse course quickly, leading to the conclusion that policy rates could remain elevated for a significant length of time. Lower-than-forecast growth and inflation would presumably motivate rate cuts, but the evidence would have to be decisive to convince central banks that they were not repeating the premature monetary easing that plagued central banks in the 1970s and early 1980s.

The Bank of Japan has belatedly joined the tightening cycle by allowing the country's 10-year yield to rise further (Exhibit 34). The central bank is attempting to limit the already massive depreciation of the yen and appears to believe that inflation has now been high for long enough to jolt economic actors out of their long-standing deflationary mindset.

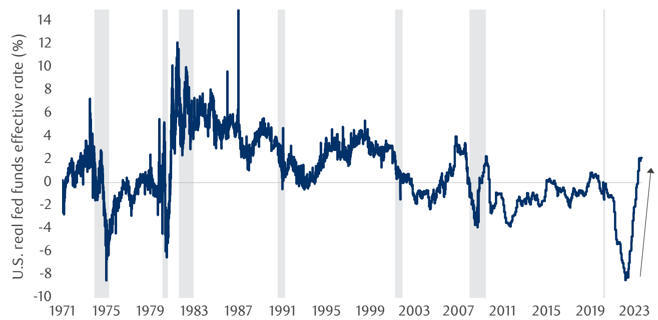
On August 1, the U.S. sovereign-debt rating was downgraded from AAA to AA+ by Fitch Ratings. This was entirely justified due to the country's large and growing debt load, its ample deficit in the face of low unemployment rates, and a challenging political environment that nearly culminated in a technical default in the spring. The result of the action is that a small risk premium has been added to U.S. bond yields, contributing to the increase in bond yields in recent months. But the U.S. is hardly in a desperate fiscal position, and its debt rating continues to compare favourably with many perfectly viable major nations (Exhibit 35).

Exhibit 32: Central bankers raised policy rates to fight inflation



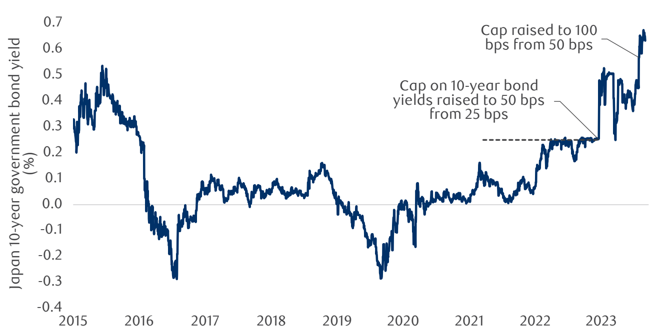
Note: As of 09/01/2023. Source: Haver Analytics, RBC GAM

Exhibit 33: U.S. real fed funds rate rises quickly as Fed hikes aggressively and inflation falls



Note: As of 08/31/2023. Shaded area represents recession. Source: Federal Reserve Board, Macrobond, RBC GAM

Exhibit 34: BoJ tweaks yield-curve-control policy as inflation rises



Note: As of 09/01/2023. Source: Bloomberg, RBC GAM

Chinese economic woes

After repeated pandemic lockdowns, China's economy was supposed to enjoy a solid economic rebound in 2023. The scenario initially appeared to be happening, but it has since given way to a face plant. Economic data has arrived consistently below consensus expectations (Exhibit 36).

There are several reasons for this weakness. A sizeable part is that Chinese exports are significantly down from a year ago (Exhibit 37). For an economy oriented toward manufacturing and trade, this is bad news. Some of the weakness is the result of more tepid global demand, some reflects a rebalancing of that demand back from goods to services, and some may reflect geopolitical tensions that are motivating many companies to diversify their international production away from China.

Domestic demand within China is also soft. The housing market continues to sputter, with home prices and home sales declining significantly. The housing market was long a bastion of Chinese economic strength. While the softness is welcome in a structural sense – China's economy had become far too reliant on housing, and home prices were bid up to undesirable heights – it is nevertheless proving enormously painful in the short run. The consequences have extended well beyond housing: Chinese consumers are proving stingy, at least in part because the majority of their wealth is tied up in real estate that is now depreciating.

Over the long run, China's economic prospects also look less bright than in decades past. Housing is unlikely to return as the major driver that it once was. The demographic picture is incredibly challenging for the foreseeable future. Geopolitical frictions with the U.S. are likely to cast a chill over China (and, to a lesser extent, the world) for an extended period of time. Finally, from an ideological standpoint, China is drifting away from market forces and back toward top-down control – a potential impediment to productivity growth. Accordingly, we now assume that "normal" annualized economic growth in China is merely 3%-4%, materially less than before the pandemic, let alone earlier decades. Among large nations, India is set to claim the mantle of fastest growing country (Exhibit 38).

Exhibit 35: Global sovereign-debt ratings

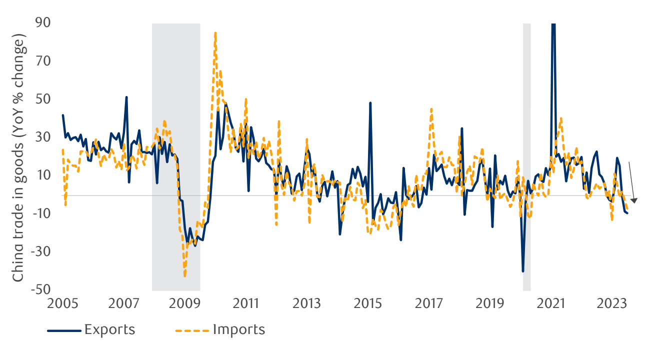
	Sovereign rating		
Country	Moody's	S&P	Fitch
Germany	Aaa	AAA	AAA
Canada	Aaa	AAA	AA+
U.S.	Aaa	AA+	AA+
France	Aa2	AA	AA-
South Korea	Aa2	AA	AA-
U.K.	Aa3	AA	AA-
China	A1	A+	A+
Japan	A1	A+	A
Mexico	Baa2	BBB+	BBB-
Italy	Baa3	BBB	BBB
India	Baa3	BBB-	BBB-
Brazil	Ba2	BB-	BB

Note: As of 08/17/2023. Sovereign ratings for foreign and local currency long-term debt. Source: Fitch Ratings, Moody's Investors Services, S&P Global, Bloomberg, RBC GAM

Exhibit 36: China's reopening boom fizzled

Note: As of 09/01/2023. Source: Citigroup, Bloomberg, RBC GAM

Exhibit 37: Chinese trade falters



Note: As of Jul 2023. Trade in goods in renminbi. Shaded area represents U.S. recession. Source: Macrobond, RBC GAM

But for all of this genuine bad news, pessimism about China is probably overblown right now. Growth averaging 3%-4% still handily outpaces the entirety of the developed world, and the country is so massive that it will remain the largest single contributor to global economic growth for the foreseeable future. Chinese policymakers have also not been entirely idle in response to recent cyclical weakness. Stimulative forces include interest-rate cuts, a weaker currency, loosened rules for the housing market, tax cuts for small businesses and a bailout plan for indebted local governments.

Canada's population boom

The Canadian economy is beginning to slow and remains likely to enter a mild recession in line with its peers. Interest rates have risen sharply in Canada, and the country's high level of interest-rate sensitivity renders it more vulnerable than the U.S.

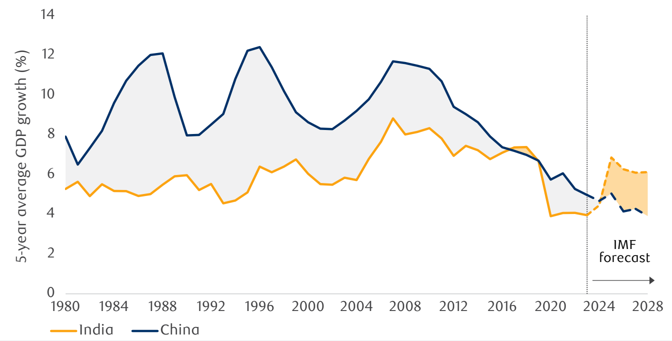
While Canada's housing market revived somewhat in the spring, we budget for a return to malaise ahead (Exhibit 39). Affordability is somewhat improved from its worst point thanks to falling home prices in 2022, but it is still quite poor relative to pre-pandemic levels, let alone historical norms (Exhibit 40). Past developed-world housing busts have lasted a median 6.6 years, arguing that weakness is likely to persist well into the future.

The Canadian economy has also recently been challenged by a series of temporary shocks that include a major port strike on the west coast and a series of major wildfires.

On the other hand, Canada's financial institutions have seemingly side-stepped the problems that recently beset a number of prominent American regional banks.

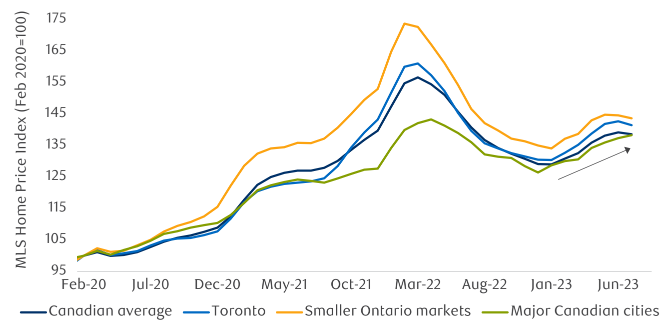
Furthermore, Canada is experiencing an enormous population boom that has added more than 1 million people over the past year (Exhibit 41). This has thrust the overall population past 40 million, and recent research indicates the true count may be closer to 41 million. The point is that Canada has experienced massive population growth, stoking demand for goods and services and making the economy inclined to grow more quickly.

Exhibit 38: Economic growth: India to outpace China going forward



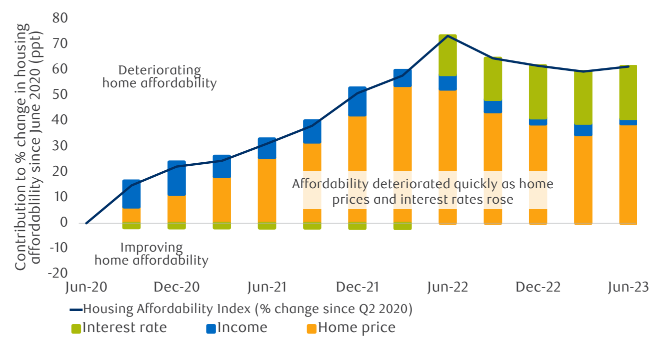
Source: IMF World Economic Outlook, April 2023, Macrobond, RBC GAM

Exhibit 39: Canadian home prices stall again



Note: As of Jul 2023. Source: CREA, Macrobond, RBC GAM

Exhibit 40: Drivers of changing Canadian housing affordability



Note: As of Q2 2023. Housing Affordability Index measures the current carrying cost of a home versus the historical norm. Source: Haver Analytics, RBC GAM

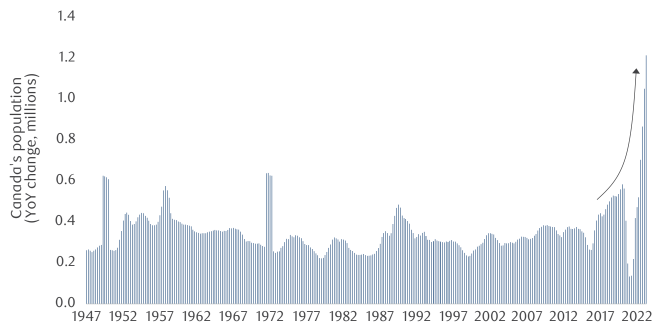
There is a chance this remarkable demographic development prevents Canada from falling into a recession. But we are inclined to believe a recession north of the 49th parallel is still more likely than not, in part because the population boom should soon slow as the country catches up to its pre-pandemic immigration targets and given that the bulk of foreign students and foreign temporary workers have already returned.

Bottom line

This is a moment in time that demands patience. It is tempting to abandon the longstanding recession call after a year of resilient economic growth and rebounding risk assets. But history shows that recessions usually arrive with a significant lag to monetary tightening, and our recession scorecard and business-cycle scorecard still prophesize a sour outcome. The window thus remains wide open for a recession. Falling inflation is welcome, but it is not yet tame enough to instill central bankers with enough confidence to start cutting interest rates.

As such, we maintain an equity allocation that is technically neutral, but from a practical standpoint is more cautious than at any point in the past decade. This is with an eye to taking advantage of more depressed valuations should a recession arrive. And, in an alternative scenario in which it doesn't, we can take solace in owning fixed-income investments that pay some of the highest yields in decades, and with the potential for capital appreciation in a variety of scenarios.

Exhibit 41: Canada's record population growth fueled by immigration



Note: As of Q2 2023. Source: Statistics Canada, Macrobond, RBC GAM

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