RBC Global Asset Management

Executive summary

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Extremely high inflation is jeopardizing four decades of central-bank credibility, and aggressive monetary tightening featuring jumbo-sized rate hikes has triggered broad-based declines in asset prices. Meanwhile, the global economy is slowing, and the path forward for the economy and markets hinges largely on whether/when price stability will be restored.

Downgrading economic forecasts again, risk of recession is elevated

The global economy is grappling with a variety of challenges. Central banks are hiking interest rates aggressively, inflation is extremely high and geopolitical tensions have led to an energy crisis in Europe. Other risks include China's troubled real-estate market, U.S. politics and the lingering effects of the pandemic. Extending the pattern of the past several quarters, the economy continues to slow and we have further downgraded our growth forecasts for the year ahead. We estimate the odds of recession at 70% in North America, with an even greater likelihood in the U.K and Eurozone. Should a recession materialize, we expect it to be of middling size and duration in the U.S. and for the economy to recover at a moderate pace thereafter. The situation is expected to be meaningfully worse in Europe and the U.K. as both regions face a spike in natural-gas prices due to Russia's war on Ukraine. For the developed world, we now forecast moderate economic growth of 2.3% in 2022, followed by just 0.3% in 2023. In emerging markets, we look for 2.8% growth in 2022 followed by an improvement to 3.8% in 2023. These figures are relatively weak by emerging-market standards and the recovery in 2023 would occur because headwinds to China's growth are expected to fade somewhat by next year.

Unacceptably high inflation appears to have peaked

There are a variety of reasons to think that inflation may have peaked and be headed toward meaningfully lower readings. Over the past year, there have been four major contributors to inflation and all of these have begun to turn. Supply-chain challenges are being resolved, commodity prices have slipped, fiscal stimulus has faded and monetary policy has flipped from easing to aggressive tightening. Moreover, our inflation-peaking scorecard reveals that the majority of inputs and signals have now reversed, suggesting inflation probably crested in June. Although there are risks that inflation could reassert itself if the pandemic flares or geopolitical tensions intensify, we anticipate substantially lower inflation in 2023. We look for U.S. inflation to fall to 3.5% by the end of 2023, while readings in the U.K. could remain more problematic given particularly high natural-gas prices and surging wage demands that have led to a wave of strikes.

U.S. dollar is extremely expensive, temporarily supported by extraordinary factors

The U.S. dollar has rallied strongly this year, gaining broadly against both developed- and emerging-market currencies. A relatively hawkish U.S. central bank, the uncertain financial-market outlook and softening global economic growth have all played roles in driving both a stronger greenback and foreign-exchange markets in general. The greenback now stands above its March 2020 highs and is extremely overvalued by most measures. In our view, the currency should weaken over the medium term, but extraordinary factors may lend further support for the rest of this year. On a 12-month horizon, we remain more constructive on the Canadian dollar and Japanese yen than we are on the euro, pound or U.S. dollar.

Central banks are committed to fighting inflation, even at the expense of the economy

While there is good reason to think inflation is already headed lower, the unpredictable nature of inflation in the post-pandemic era suggests it may be difficult for the U.S. Federal Reserve (Fed) to claim victory until inflation actually starts falling decidedly toward the 2% target. With the labour market in solid shape, the Fed can afford to be aggressive with monetary tightening. Our models suggest that the fed funds rate could rise as high as 6% from the current 2.25%-2.50% given conditions for growth, inflation and the labour market. As a result, the pressure will likely remain to the upside on rates and pricing in the futures market suggests that short-term rates could rise to 4% sometime in the first half of 2023.

Bonds extend sell-off, valuation risk diminishes

Rapidly rising interest rates have caused further declines in global government-bond prices, but we believe that any further losses will likely be limited. The World Government Bond Index (WGBI) hedged to U.S. dollars lost 10.1% between January and August, or 13% from its peak in 2020, and has erased all of the gains generated since late 2018. With the massive increase in bond yields so far this year, the acute valuation risk that existed across major developed-world sovereign-bond markets has been greatly alleviated. Our model for 10-year Treasuries suggests that government bonds have likely priced in much, or even most, of what is needed to properly reflect current and expected inflation and real interest rates. Assuming that the inflation spike subsides as we forecast, our model suggests the U.S. 10-year yield should be positioned near 3.5% in five years, not far from where it is at the time of writing. We therefore think that bond investors are more likely to keep their coupons and that the risk of fixed-income capital losses has meaningfully diminished since the start of the year.

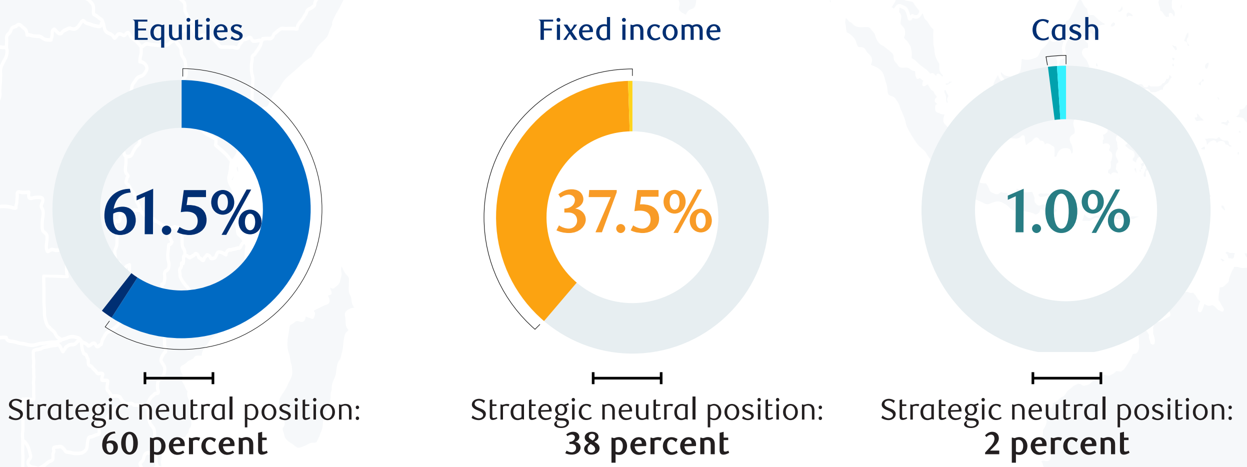
Equities dinged by falling valuations, earnings outlook faces headwinds

Stocks encountered significant volatility during the quarter as the fluctuating outlook for interest rates and inflation impacted valuations and a more challenging outlook for earnings came into view. The S&P 500 Index had fallen as much as 24% from its all-time high in June and almost all of this year's decline in stocks has come from shrinking valuations due to rising inflation and bond yields. As a result of the worldwide drawdown in stocks, the entire excess valuation that existed in our composite of global equity markets has been erased. Within the composite, U.S. equities remain slightly above our estimate of fair value, but stocks in other regions look more appealing. Although stocks are more reasonably priced, the focus is shifting to corporate profits which remain well above their long-term trend and may soon encounter headwinds from slowing economic growth, especially if a recession were to materialize.

Asset mix – positioning closer to a neutral stance

The macroeconomic environment is highly uncertain and we believe that the range of potential outcomes for markets continues to be especially wide. There are pathways to positive outcomes and falling valuations in both stocks and bonds have improved the return potential over the longer term. However, we remain concerned about the short-term outlook as the risk of a recession is elevated and the future path for inflation remains uncertain. The last eight months were especially difficult for balanced investors as both stocks and bonds moved lower. We acknowledge that both asset classes could continue to be adversely affected in the near term by unacceptably high inflation, although this is not our base-case scenario. At today's higher yield levels, bonds offer a much better ballast for stocks in the event of an economic downturn. Last quarter, we took advantage of the rise in U.S. 10-year yields above 3.0% to add 1.5% to our fixed-income position, sourced from both cash and stocks. Over the longer term, we continue to believe that stocks will outperform bonds, so we are maintaining a slight underweight in bonds and overweight in stocks. Reflecting our cautious stance, however, our positions are much closer to a strategic neutral setting than they've been in the past. For a balanced global investor, we currently recommend an asset mix of 61.5 percent equities (strategic neutral position: 60 percent) and 37.5 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

Recommended asset mix



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