RBC Global Asset Management

Executive summary

NEW YEAR 2023

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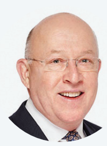

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Global growth faces a variety of challenges including rising interest rates, high inflation and a struggling Chinese economy. Uncertainty is elevated and financial markets have been extremely volatile, but the significant adjustment in asset prices this year has diminished valuation risk and boosted return potential for investors as we enter 2023.

Economic growth continues to slow, recession likely

A year ago, the impressive recovery from the pandemic-induced recession pushed the economy into a position of excess demand. But the backdrop is changing and headwinds have intensified as a result of tighter monetary policy and reduced fiscal stimulus. We continue to look for a deceleration in growth in 2023, with economies likely slipping into recession in the developed world. While emerging-market economies rarely contract, we expect most of them to slow in 2023. Taken together, our growth forecasts are mostly below consensus. We anticipate that global GDP will expand by 2.1% in 2023, which is less than a third of the figure in 2021, and about half the expected 2022 rate. That said, economic indicators have shown more resilience in the past few months, suggesting that the probability and expected depth of recession might be lower than initially feared. Should a recession materialize, we expect it to be of middling depth in most regions. A 1.75% peak-to-trough decline in output persisting no more than three quarters is our presumption, with a moderate recovery likely taking hold toward the end of 2023.

Inflation has started to calm from extremely high levels

The four main drivers that pushed inflation to multi-decade highs are all reversing course. Supply-chain problems have faded, commodity prices have declined, monetary stimulus has turned to tightening and fiscal stimulus has been reduced. For these reasons, we expect inflation to continue to soften and have below-consensus inflation forecasts for 2023. We recognize, however, that other factors may slow its descent. Labour markets remain especially tight, the breadth of the inflation shock may make high prices stickier, and the shelter component of CPI changes with long lags. It could take even longer for inflation in the eurozone and U.K. to come down given the region's unique challenges, mainly weaker currencies and energy shortages.

U.S. dollar may have peaked

The U.S. dollar extended its 12-year-old bull market through October as the allure of higher U.S. bond yields and economic challenges abroad continued to overshadow longer-term issues facing the greenback. However, the rise in the ever buoyant dollar came to an abrupt halt in early November, leading investors to question whether the greenback's period of dominance is finally coming to an end. With valuations stretched, it's clear to us that the currency's bull market is mature and that a major turning point is near. Such peaks are tough to call, but we have greater conviction that a softening in the greenback is in store and that it will herald the start of a multi-year decline.

Central banks approach tightening finish line

The quantity of monetary tightening delivered to tame extremely high inflation has been massive across the world. North American policy rates are already around 4 percentage points higher after less than a year of increases. But the rate-hiking cycle is starting to slow outside North America and Europe as inflation begins to ease. Some emerging-market countries have ended their rate hikes and the pace of tightening is mostly decelerating elsewhere. The U.S. fed funds rate is expected to peak near 5%, compared with a starting point of about 0% at the start of this year, and double the neutral policy rate – that which neither stimulates nor restricts growth. But most of the hard work has been done and there is a possibility that policy rates in developed markets start to decline over the second half of 2023 if inflation cooperates and growth slows.

Bond market finds support

As investors warm to the idea that inflation may have peaked and that the pace of tightening is slowing, yields on 10-year government bonds have fallen 50 to 130 basis points from their September/October highs. This rally in bonds started from a point where technical indicators signaled that the bond market had been oversold and our own valuation models suggested that yields had reached relatively appealing levels. Although real, or after-inflation, interest rates have room to move a little higher, we continue to expect that they will be anchored at levels between 0.5% and 1.0%. Structural forces such as aging populations and an increased preference for saving versus spending should ultimately limit how high real interest rates can go. Over the near term, however, inflation will likely be the factor dominating the trajectory for bond yields. If inflation falls as we expect, our modelled estimate for the U.S. 10-year Treasury yield today of 5.3% falls to 4.5% a year from now and to 3.4% in five years' time.

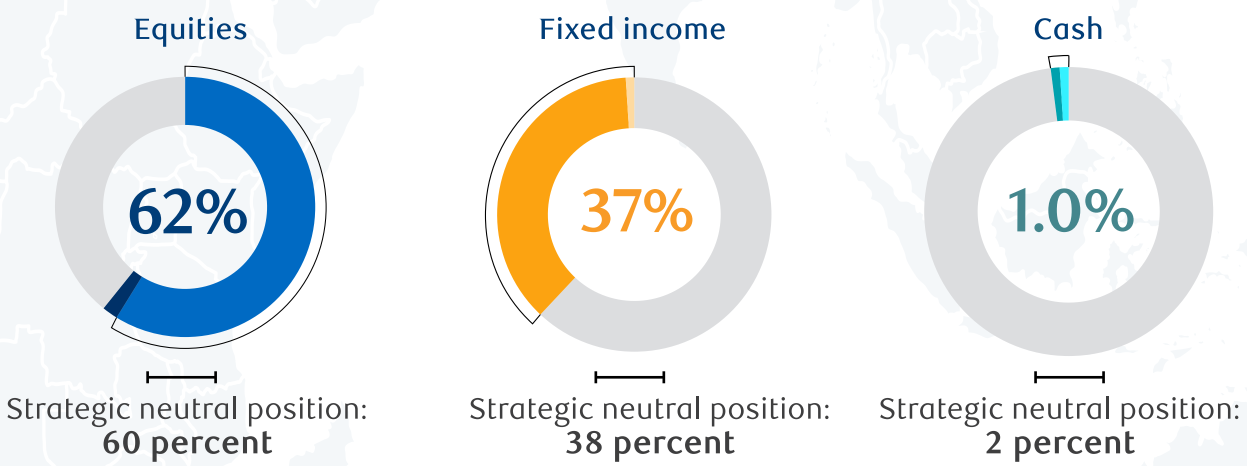
Equity-market valuation risk diminished, but earnings remain vulnerable

Equity markets stabilized in the past quarter but, even with the recent bounce, are still sitting on significant losses for the year. The good news for investors is that stocks are now much more reasonably priced than they were at the start of the year. Our global composite of equity valuations peaked around 40% above fair value at the end of 2021, but the recent bear market pulled the composite slightly below fair value in September/October for the first time since March 2020. While valuation risk has diminished and return potential has increased, stock prices could fall in the event that we enter a recession and earnings decline. Analysts have already begun downgrading their profit forecasts for S&P 500 Index companies ahead of a potential recession, but the downward revisions have been small so far. We think these estimates are vulnerable to further downside given that earnings are still above their long-term trend and companies are facing headwinds from rising costs and slowing economic activity. In this environment, stock gains could be limited in the near term absent evidence that the economy is headed for a soft landing.

Asset mix – maintaining overweight stocks, underweight bonds

We recognize that uncertainty is elevated and that there is a wide range of potential outcomes for the economy and financial markets. That said, the 2022 bear market in both fixed income and equities has meaningfully improved return expectations across all asset classes. We note that bonds, at today's higher yields, offer more ballast in a balanced portfolio should the economy enter a downturn. We believe a cautious approach to risk taking remains appropriate in this environment. Our asset mix is positioned with a small overweight in stocks and slight underweight in fixed income given our view that stocks offer superior return potential over the longer term. But these allocations are closer to our strategic neutral position than they have been at previous points in the cycle, allowing us to take advantage of volatility and opportunities should they present themselves. For example, when stock prices were near their lows earlier in the quarter and technical indicators suggested equities were oversold, we added 50 basis points to our equity allocation, sourced from fixed income. For a balanced global investor, we currently recommend an asset mix of 62 percent equities (strategic neutral position: 60 percent) and 37 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

Recommended asset mix



Note: As of November 30, 2022. Source: RBC GAM

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