RBC Global Asset Management

Executive summary

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The economy has been resilient, and it has been this very strength, combined with inflationary pressures, that has pushed central banks to raise interest rates aggressively over the past year. The sudden and massive rise in interest rates, though, will likely push economies into recession. Although valuations are no longer at extremes, we recognize that risk assets could still be vulnerable should corporate profits falter and/or macro risks intensify.

Pressure on economy grows, recession risk rises

The macroeconomic picture has improved in recent months and our growth forecasts have been upgraded, although we continue to expect a recession over our one-year forecast horizon. Economic tailwinds exist from the strong labour market, buoyant consumer spending and, until very recently, a slight easing of financial conditions. China's reopening and Europe's resilience in the face of an energy shock have also benefitted the global economy, but investors may have become too optimistic regarding the outlook. In our view, the massive and sudden surge in interest rates over the past year is almost certain to cause economic pain. Weakness is already being seen in the housing market, rising goods inventories, diminished business confidence and scaled-back capital spending. Moreover, troubles have surfaced in a handful of U.S. regional banks. While policymakers have enacted measures to prevent widespread financial distress, the failure of Silicon Valley Bank exposes the vulnerabilities that exist for leveraged entities. We assign a 70% chance to a recession materializing and expect that it will occur in the second half of this year. That said, our GDP forecasts have been mostly upgraded for 2023, mainly due to the year's better-than-expected start, plus the fact we have pushed our expected timing of recession to the second half of 2023 from the middle of the year. The anticipated recession's depth, duration and the speed of the subsequent recovery are similar to our prior assumptions, and remain a bit more pessimistic than the consensus. For emerging markets, the expected trajectory of the economy is similar, but without an outright contraction in output.

Inflation is on a downward trajectory

The main drivers that were initially responsible for the inflation surge have all reversed. The massive commodity shock has calmed, supply-chain problems continue to improve markedly and excessive monetary and fiscal stimulus have been ratcheted down. Moreover, businesses' pricing power may be fading and home prices have begun to fall. Given these conditions, we forecast inflation to fall faster than the market anticipates, although a variety of offsetting forces could hold it uncomfortably above the Fed's 2.0% target. For one thing, the labour market is tight and inflation pressures have become widespread, affecting almost all goods and services. Service-based inflation is proving the last to turn, in part because it is at the very end of the chain of pricing decisions, and in part because people continue to embrace activities that were denied to them during pandemic lockdowns. Although we think our base-case inflation forecasts are reasonable, we acknowledge that there is an unusually wide range of possible outcomes. These range from inflation remaining too hot to, alternatively, inflation abruptly converting to temporary deflation.

U.S.-dollar weakness likely lies ahead

The tide is finally turning against the U.S. dollar. A reversal of the greenback's gains has been overdue for some time, and we have warned for several quarters that the currency's strength in 2022 had pushed it from already rich to levels of extreme overvaluation. As the dollar starts to retreat, and with a multitude of factors turning against it, we are growing increasingly confident that a multiyear period of U.S.-dollar weakness lies ahead. We expect most G10 and emerging-market currencies to benefit from this powerful cyclical shift.

Further significant central-bank tightening is becoming less warranted.

Central banks continue to raise their policy rates in response to unacceptably high inflation. Some central banks, such as the Bank of Canada, believe they have reached the finish line after considerable effort, while the Fed, the European Central Bank and the Bank of England are signaling that modestly to moderately more tightening is to come. As inflation ebbs, though, central banks will eventually be in a position to take their foot off the brake. A neutral policy rate in North America is approximately 2.50%, around half the current policy setting. Interest rates are unlikely to return to prior lows, but it makes sense that a structurally low interest-rate environment gradually reasserts itself given elevated global debt levels, demographics, and a low speed limit for economic growth. More generally, the recent increase in interest rates highlights certain vulnerabilities. Countries with elevated public-debt levels such as Japan, Greece and Italy must now grapple with sharply higher debt-servicing costs. Japan merits close attention in particular because its debt burden is so much greater than its peers and because of the extraordinary actions the country took to depress borrowing costs.

Bond yields reset to long-term norms

After last year's sudden adjustment in Fed policy ravaged bond markets, yields are now situated at levels that are closer to normal in the context of history. Back in December 2021, interest rates were at extreme lows with the yield on cash at 0.1%, U.S. 10-year Treasury yields of 1.5%, investment-grade credit yielding 2.4% (i.e. a spread of 90 basis point) and high-yield bonds at 4.9% (i.e. a spread of 340 basis points). But after the massive adjustments of 2022, these numbers at the end of February were 4.6% for cash, 3.9% for the U.S. 10-year bond, 5.8% for investment-grade credit (i.e. a 166-basis-point spread) and 8.7% for high-yield bonds (i.e. a 465-basis-point spread). Remarkably, even though fixed-income markets have suffered massive losses over the past year, the adjustment in markets represented a move away from extreme lows and back to something closer to the averages of the past three decades. At current levels, our bond models suggest valuation risk has greatly diminished and the prospect for future returns has improved considerably, especially if we are right in our view that inflation will continue to moderate.

Equity valuations are reasonable, risk sits with the corporate-profit outlook

Last year's bear market in stocks addressed excessive valuations, boosting return potential according to our models. Our global composite equilibrium measure indicates that stocks are now 2% below fair value, down from a 32% overvaluation at the time of their late 2021 peak. Importantly, valuations range widely across markets, with the U.S. being the most expensive while others, especially emerging markets, are trading at compelling discounts to fair value. Given that stock market valuations have been reset and now appear consistent with the current and expected level of interest rates and inflation, we think the bigger risk to markets has to do with corporate profits. Earnings estimates have been gradually lowered over the past year amid slowing growth and rising costs, and the latest consensus of analysts' projections anticipates no growth in 2023 profits versus 2022. However, we remain concerned that earnings estimates are not fully pricing in even a mild recession.

Shifts in market leadership worth noting

Beneath the surface, several themes and trends have emerged from October 2022 to February 2023 that we think could influence financial markets for many years. Some of the big shifts that we have observed are that the U.S. dollar has started to weaken; international equities have been outperforming U.S. stocks; cyclical sectors have been leading; small and mid-cap stocks have moved ahead of large caps; and value stocks have been winning against growth stocks. More evidence is required to convince us of a wholesale and durable shift in market leadership, but this bears watching. Some of these emerging trends have stalled amid the recent troubles within the U.S. regional banking sector, but we remain open to the possibility that the next bull market, whenever it takes hold, might not be led by the key themes that dominated for the better part of the past decade.

Asset mix – trimming equities and moving allocation closer to neutral

Balancing the risks and rewards as well as weighing long-term versus nearby considerations, we remain cautiously positioned and moved our tactical positioning closer to neutral this quarter. Although we continue to expect equities to outperform bonds over the longer term, the rally in stocks from October 2022 to February 2023 diminished the risk-reward profile in equities in the near term, especially since corporate profits are vulnerable in an economic downturn. Our view has recently been modified yet again with the failure of Silicon Valley Bank and associated strain on the financial system in the United States. We were already expecting some weakness in the economic backdrop, but these recent events, we think, open the scope for further deterioration and, at the margin, reduce the odds of an optimistic outcome. As a result, early in the quarter we trimmed our equity allocation by 100 basis points, placing half the proceeds in bonds and the other half in cash. With yields at their highest level in a decade, sovereign bonds should act as ballast against any downturn in stocks within a balanced portfolio. Moreover, cash has become a more suitable holding at today's higher interest rates, providing a cushion to the portfolio in the event that inflation surprises to the upside and triggers simultaneous declines in both stocks and bonds. Reflecting heightened uncertainty in the macroeconomic backdrop and an unusually wide range of potential outcomes, our asset mix is now the closest to neutral that it has been in several years. For a balanced global investor, we currently recommend an asset mix of 61 percent equities (strategic neutral position: 60 percent) and 37.5 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

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