RBC Global Asset Management

Executive summary

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Economic headwinds continue to mount, inflation remains problematically high and financial conditions are tightening. Asset prices have experienced a sharp decline in the face of rapidly rising interest rates, slowing growth and greater uncertainty in the macro outlook than usual.

Downgrading growth forecasts as headwinds intensify

Our GDP forecasts have been below consensus for several quarters as we anticipated deceleration in economic growth for 2022. This quarter we have further reduced our forecast and now expect growth to be particularly weak in 2023. The key headwinds to the economy include unacceptably high inflation, aggressive central-bank tightening, a global commodity shock, the continuation of supply-chain challenges and damage from China's zero-tolerance COVID-19 policy. Because of this combination of headwinds, we gauge that the risk of recession is heightened over the next two years. For the developed world, this outlook translates to a forecast of 2.5% GDP growth in 2022, less than half the 5.2% rate achieved in 2021, followed by just 1.2% growth in 2023. With the exception of 2020's pandemic shock, the 2023 forecast would represent the weakest annual performance in more than a decade. We have also downgraded our emerging-market growth outlook and are now anticipating overall growth of just 3.3% in 2022 and 3.7% in 2023 for developing nations. The acceleration from one year to the next in large part reflects Russia's economic collapse in 2022. These growth rates remain well below historical levels for emerging markets.

Unacceptably high inflation persists

Inflation sitting at multi-decade highs is the dominant challenge for this economic cycle. Our own inflation forecasts are above the consensus and we expect pricing pressures to remain elevated in the short to medium term before eventually falling back toward longer-term norms. In the short term, high commodity prices, supply-chain challenges, a housing boom and lingering tailwinds from monetary and fiscal stimulus are likely to keep inflation hot. We look for inflation of 6% to 8% in 2022 across most of the developed world and expect it to remain above normal in 2023, albeit meaningfully lower. Inflation pressures are broadly based but we expect them to calm as monetary and fiscal stimulus are being dialed back, commodity prices are unlikely to continue rising at the pace that they have over the past year and as housing prices feel the weight of higher interest rates. Over the longer term, we expect inflation to continue falling as long-term structural factors such as demographics limit consumer price pressures. But we also recognize that forces such as climate change, a partial reversal of globalization and a rebalancing of powers between employers and employees may provide offsets. As a result, we expect that inflation may ultimately settle a bit higher than 2% over the long term, versus slightly below 2% over the decade prior to the pandemic.

U.S. dollar has benefited from risk aversion, weakness likely to materialize

The greenback has benefited from risk aversion amid Russia's invasion of Ukraine, as well as from expectations that the U.S. Federal Reserve (Fed) will hike interest rates faster than its peers. Although we have pushed back the timing for when we think U.S.-dollar weakness might return, we still expect the greenback to decline in the medium to longer term given that the dollar is meaningfully above its purchasing power parity with other world currencies and that much of the Fed hawkishness and expected economic weakness abroad are already priced in. Key markers that would strengthen our conviction that the U.S. dollar may have peaked include a slowdown in U.S. economic activity, a hawkish shift in tone from the European Central Bank, signs that Asian policymakers may step in to support their currencies and/or a de-escalation of the war in Ukraine. Our forecasts are for the U.S. dollar to depreciate against a basket of major developed-world currencies over the year ahead.

Interest rates are on the rise, quickly

With inflation elevated and economic conditions tight, central banks have been forced to act urgently. They started tightening earlier than initially planned and are raising rates in 50-basis-point increments instead of the usual 25. Market expectations and central-bank guidance point to significantly more monetary tightening ahead, with policy rates in North America reaching neutral levels and potentially a bit beyond. With central banks highly focused on taming inflation, they will be reluctant to turn to monetary easing even if the economy encounters a downturn. Other central-bank priorities such as creating conditions for full employment, ensuring financial-market stability, reducing inequality and limiting climate change do not appear to be a focus at this time. Pricing in futures markets suggests investors expect the fed funds rate to rise to 2.80% one year from now, which would require at least two more 50-basis-point hikes followed by several 25-point hikes. Our own forecast is in line with market pricing as we look for a 2.75% fed funds rate one year from now.

Bond yields surge, valuation risk has been greatly alleviated

The rapid and significant re-alignment of interest-rate expectations caused a fixed-income sell-off of historic proportions over the past year. As the U.S. 10-year yield soared above 3.0% from 1.5%, broad U.S. bond benchmarks lost more than 10% for the largest decline since the early 1980s. The speed and depth of the decline was highly unusual and we do not expect a similar experience to be repeated going forward. Valuation risk has been significantly reduced and yields are now at much more reasonable levels, according to our models, which suggests that once the near-term distortions related to inflation pass, there is little need for yields to rise much beyond current levels. We have also noted that in past tightening cycles the U.S. 10-year yield has peaked around the same level as the fed funds rate. Investors are currently anticipating that the fed funds rate will peak around 3%, which matches recent levels in the 10-year Treasury. For this reason, we have been increasingly comfortable adding to sovereign fixed-income positions and especially as 10-year Treasury bond yields trade above 3%. Although yields could continue to rise if extremely high inflation persists, our base case that inflation ultimately moderates means that the bulk of the needed adjustment in yields has already occurred. We forecast 2.75% for the 10-year Treasury yield 12 months from now, which would mean no further sustained capital losses for bond holders over the year ahead.

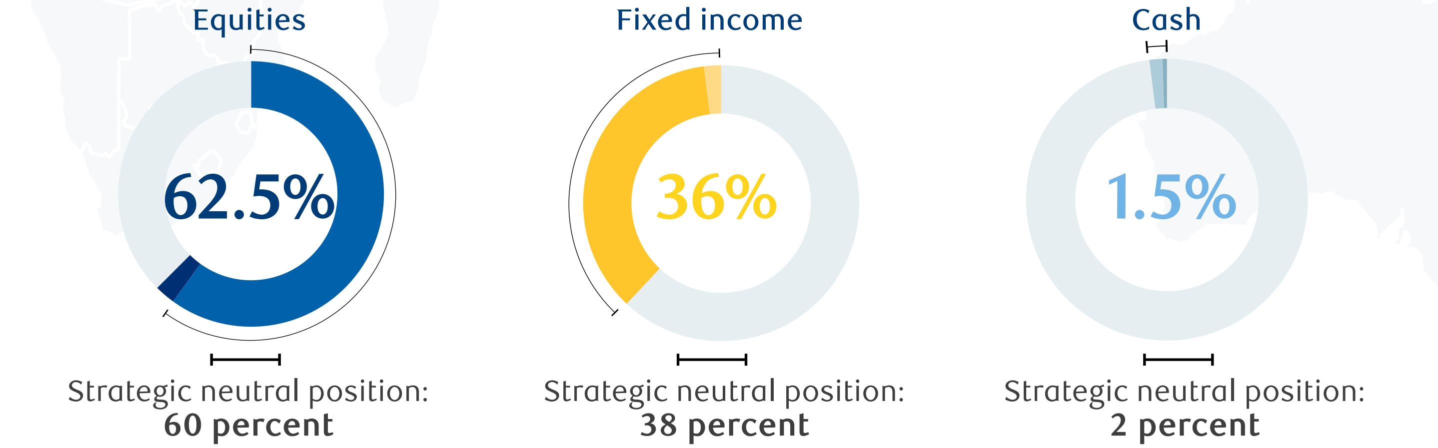
Equity rout deepens and profit outlook is vulnerable amid slowing growth

Fear of inflation, aggressive monetary tightening and the increased risk of recession sent stocks lower in the past quarter, dragging several major indexes into bear markets. The Nasdaq Composite Index, heavily concentrated in technology stocks, fell as much as 36% from its peak and the S&P 500 Index reached 20% below its peak on an intraday basis. Emerging markets were also down nearly 30% from their prior highs. The outperformer has been Canadian equities, helped by heavy weightings in energy and other resource companies that are benefiting from the high-inflation environment. So far, the decline in stocks has been mostly due to a fall in equity valuations that had approached extremes, especially in high-priced technology stocks that were most sensitive to interest rates. With valuation levels having adjusted meaningfully, the focus now is on whether earnings expectations need to be lowered. Consensus estimates are for low double-digit profit gains over the year ahead. In an environment where those profits come through, inflation pressures subside and investor confidence rebounds from extreme pessimism, stocks could be set up to deliver double digit gains over the year ahead. But should a downturn or recession play out, history suggests that earnings could be vulnerable to declines of more than 20%, sending stocks lower still.

Asset mix – shifting allocation closer to neutral given elevated uncertainty, higher yields

Taking into account the risks and opportunities, and balancing the long-term outlook against near-term challenges, we took steps to de-risk the portfolios during the past quarter. We added two percentage points to our fixed-income allocation as yields rose, which boosted return potential for bonds while also providing more cushion to a balanced portfolio in the event of a downturn in risk assets. We also reduced our equity allocation by 1.5 percentage points, recognizing that the risk/reward has diminished in an environment where corporate profits could be vulnerable to a slowdown. These shifts leave our recommended asset mix with a slight overweight in stocks and slight underweight in bonds. Our positioning is much closer to neutral than it had been at earlier points in the cycle, reflecting a higher degree of uncertainty in the outlook and wider range of potential outcomes than usual. For a balanced, global investor, we currently recommend an asset mix of 62.5 percent equities (strategic neutral position: 60 percent) and 36.0 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

Recommended asset mix



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