RBC Global Asset Management

Executive summary

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Uncertainty around U.S. tariffs remains, but the worst-case scenario has largely been ruled out as progress toward trade deals is being made. In our base case scenario, economic growth should slow, but not stop, and any rise in inflation should prove temporary. Stocks can perform well against this backdrop if policy, earnings and investor sentiment cooperate, and bonds offer decent return potential with only moderate valuation risk.

Tariff slump in economic growth expected this year

The impact of repeated waves of unorthodox U.S. public policy is washing over the global economy and financial markets and, while some policy guardrails are starting to appear, there remains substantial uncertainty. In our view, tariffs are set to exert a substantial drag on economic growth over the second half of 2025, but probably not to the extent of causing a global recession. Expected U.S. tax cuts are likely to boost economic growth but reducing immigration and withholding resources from universities and other research institutions may have a negative effect. GDP growth in 2025 is forecast to be modest at sub-2% across the developed world. A mild 2025 slump triggered by tariffs is also expected for most emerging markets. Next year should be somewhat better with the worst of the tariff adjustment complete and U.S. tax cuts acting as a tailwind.

Inflation has massively improved, but tariff impact awaits

Inflation still hasn't quite returned to normal following the post-pandemic inflation shock of 2021-2023, but a new inflation challenge already looms in the form of tariffs. Tariffs are taxes that are levied on importers, who in turn may pass a portion of their higher costs on to consumers in the form of higher prices. As a result of the tariff impact, we have budgeted for a substantial rise in U.S. prices, with annual inflation rates of 3.0% in both 2025 and 2026 and a projected peak of 3.5% in late autumn. Inflation has been tame since the tariffs were implemented, as inventory stockpiling has delayed the impact, but price pressures should become more visible, especially in the U.S., given that other countries have not levied such high tariffs on U.S. imports.

Beginning of multi-year U.S.-dollar decline

The U.S. dollar is one of the worst performing currencies since Donald Trump's inauguration in late January. The president's second term may well come to mark the beginning of a multi-year dollar decline and a momentous shift for foreign-exchange markets, impacting the broader investment landscape.

The U.S. dollar's 10% decline this year is especially noteworthy since the greenback tends to appreciate during times of heightened financial-market stress. But this time, the dollar did not offer protection, perhaps reflecting investor doubts around U.S. exceptionalism and whether the U.S. dollar is truly a safe haven. Moreover, the weakness in the U.S. dollar has exacerbated the underperformance of U.S. assets relative to global assets. Note that the sell-off in the greenback began from a point of extreme overvaluation, and that the declines could still have a long way to go should the magnitude of currency movements from past cycles be repeated.

Central banks are taking a measured approach

Central banks are proceeding with considerable caution for two sets of reasons. The first is that it is unclear where tariffs will go from here. Central bankers are therefore forced to delay monetary adjustments as they wait to see what kind of White House policies get implemented. The second complication for central banks is that tariffs give contradictory signals. They simultaneously increase prices and decrease economic output, with the former arguing for rate hikes and the latter for rate cuts. In practice, it is the economic damage that usually takes precedence because the damage to the level of output is enduring, whereas inflation's deviation is short-lived. As such, rate cuts can be expected, but of a more cautious nature.

We anticipate economic conditions will allow U.S. interest-rate relief to resume later this year, and we forecast three 25-basis-point cuts to the fed funds rate over the year ahead. Other central banks have less of a conflict to grapple with, as the primary damage to their economies is through slower growth rather than high inflation. In turn, they are well positioned to continue easing interest rates to levels that are low enough to stimulate the economy.

Sovereign bonds offer decent return potential with only modest valuation risk

The U.S. 30-year yield climbed to above 5% in May 2025, the highest since late 2023, on fiscal concerns. Shorter-term yields have not risen as much. Consequently, the spread between 2-year and 30-year U.S. T-bonds grew to its widest since early 2022. With inflation relatively stable, the increase in yields was mostly from rising real interest rates. The higher real yield reflects a better economic backdrop but also embeds an increasing risk premium due to growing anxiety about U.S. debt levels. However, further increases in real rates are likely limited over the long term due to structural factors such as an aging population and reduced growth potential as developing economies bow under the burden of much higher debt. As a result, the U.S. 10-year yield at 4.40% is appealing, situated slightly above the upper boundary of our model's estimate of equilibrium. We forecast that the U.S. 10-year yield will decline marginally to 4.25% over the year ahead, delivering mid-single digit returns with modest valuation risk.

Global equities pared prior losses and leadership in non-U.S. markets emerged

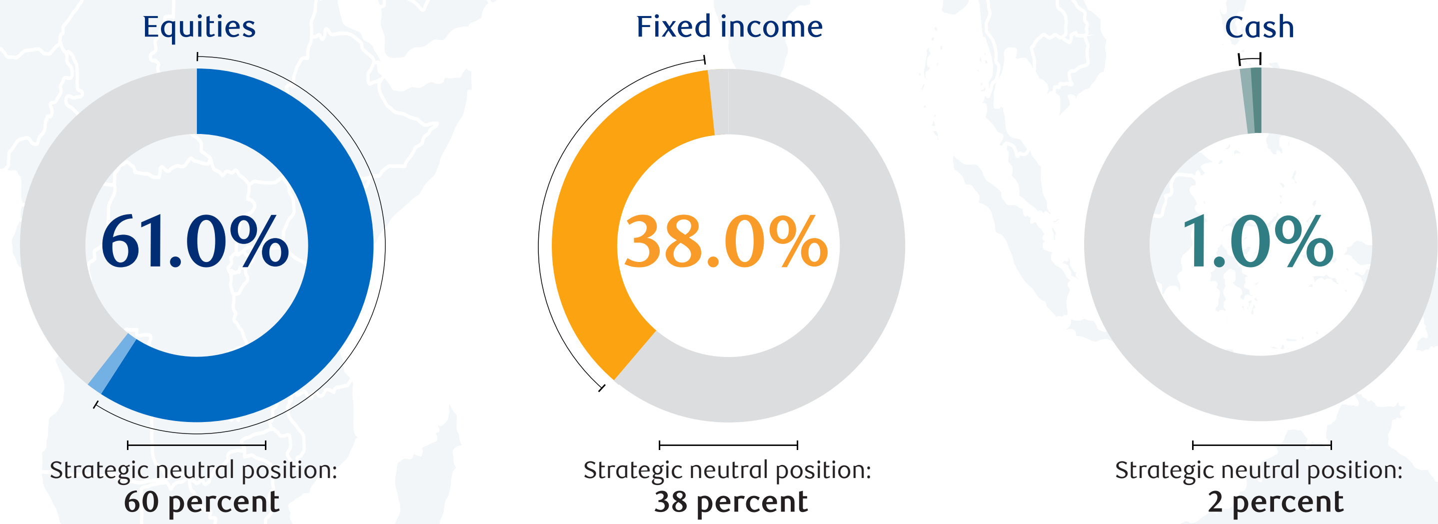
Stocks suffered steep declines followed by an impressive recovery as the narrative on U.S. trade policy shifted wildly. The tariffs sparked an intense sell-off, pushing many of the technical and sentiment indicators that we track to extremes and a shift in leadership away from U.S. stocks toward international markets took place. As tariff delays were announced and progress toward deals made, most markets fully recovered their losses and some, particularly international markets, rose to records. At this point, our models suggest that global equities are fairly priced and offer attractive return potential, especially non-U.S. markets. For the S&P 500, uncertainty around U.S. trade policy has depressed earnings estimates, with analysts now pencilling in 8.5% aggregate profit growth in 2025 and 13.5% in 2026, down from 14% and 15%, respectively, earlier this year. A bull-case scenario for the S&P 500 Index would generate a 9% annualized total return for the index from May 31, 2025, to December 31, 2026. This result likely requires a lot of things to go right, including further progress on trade, Fed accommodation, consumer optimism and strong earnings growth.

Asset mix – added to equities following extremely oversold conditions

Considering the short-term risks and the long-term opportunities, we are maintaining an asset allocation that is relatively close to neutral given heightened uncertainty in the macroeconomic backdrop and our view that the risk premium between stocks and bonds is relatively small. That said, we have made some slight changes this quarter. We added one percentage point to our equity allocation, sourced from cash, as stocks reached extremely oversold conditions typically associated with good long-term buying opportunities. Within our equity regional mix, we have tilted away from expensive U.S. large-cap stocks in favour of equities outside the U.S., particularly in Europe, where valuations are more appealing. For a balanced global investor, our current recommended asset mix is 61.0% equities (strategic: "neutral": 60.0%), 38.0% bonds (strategic "neutral": 38.0%) and 1.0% cash.

Recommended asset mix

RBC GAM Investment Strategy Committee



Note: As of June 3, 2025. Source: RBC GAM

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