RBC Global Asset Management

Executive summary

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Uncertainty abounds as the trade war threatens economic growth, complicates the outlook on inflation, and stokes financial-market volatility, causing investors to weigh a wide range of possible outcomes. In this environment, stocks are under pressure as investors shun expensive U.S. large-cap growth stocks in favour of those with more reasonable valuations.

Tariff uncertainty threatens growth

It is a time of high uncertainty for U.S. public policy including concerns around trade, immigration, and taxation. The heightened activity and lack of clarity threatens to temporarily slow economic growth as businesses and households opt to delay key decisions. With business and consumer sentiment fading and tariffs being applied, recession risk is now substantial for Canada and Mexico, and has mounted a bit even for the U.S. where the probability of recession has jumped to 25% or more from 15%. Our developed-world growth forecasts have been nearly universally downgraded for 2025 and now rest somewhat below the consensus. U.S. growth is now expected to be just 1.9% for the year, down from 2.3% a quarter ago. 2026 should be better for global growth, with forecasts that are broadly on or slightly above the consensus. Beyond Mexico, emerging-market growth forecasts have been steadier. Notably, the China 2025 growth outlook has been upgraded by a few tenths to 4.6%. Risks to these growth forecasts extend in both directions. On the optimistic side, perhaps large tariffs can be avoided after all. On the negative side, perhaps the trade war will be even greater than feared. Another downside risk is the potential for greater geopolitical tension as the U.S. seemingly pulls away from its traditional allies, forcing a rethink of international alliances and creating a window of opportunity for bad actors.

Raising inflation forecasts

We have increased the 2025 inflation outlook for two reasons: tariffs are inflationary in the short run and inflation in the U.S. has proven sticky of late. U.S. inflation is stuck near 3.0%, while other countries have wrangled inflation rates down to the 2.0% to 2.5% range. All told, we look for U.S. inflation to increase outright in 2025, from 2.9% in 2024 to 3.3%. Other countries are also expected to experience inflation upticks. As with our growth forecasts, these land on the undesirable side of the consensus (i.e. above).

Direction of U.S.-dollar remains key driver of FX markets

The U.S. dollar is overvalued by the most it has been in almost four decades versus the currencies of its main trading partners and the most ever against the Canadian dollar. The U.S. dollar's direction has been one of the primary drivers in FX markets as investors toggled their focus between U.S. interest rates and U.S. elections. This was evident in the way that developed-market exchange rates have become increasingly synchronized since the fall of 2024. We expect that the greenback will weaken in the longer-term, but we put our bearish outlook on pause last quarter following the elections in the U.S. owing to trade measures that would be tough on U.S. trade partners. A steeper decline of a larger magnitude would likely require investor enthusiasm for allocating money outside of the U.S., tentative signs of which have recently materialized.

Central banks expected to continue easing policy in the face of tariffs

Central banks have been in rate cutting mode for the past year with some further easing likely in 2025. The Fed kept its key policy rate unchanged in January and looks likely to remain on hold on March 19 barring a sharp slowdown in economic activity. The target range for the fed funds rate is currently situated between 4.25% and 4.50%, higher than what the Fed and investors consider a neutral level – i.e. neither stimulative nor restrictive for economic growth and consumer prices.

Should tariffs remain in place for an extended period, the headwind to economic growth, rather than the tailwind on inflation, will likely be the key factor nudging central banks to cut rates. Any inflation caused by tariffs would represent a one-time price level shock and the inflation rate should rapidly return to normal afterward, whereas any related economic damage would be enduring. In turn, there is room for material further monetary easing for a number of countries, with the U.S. a potential exception due to its relatively more robust economy and higher inflation readings compared to other countries.

Return potential in sovereign bonds remains decent despite recent rally

U.S. Treasuries have so far this year acted as a ballast against broader financial market volatility. The U.S. 10-year yield rallied to 4.21% at the end of February from a high of 4.80% earlier in the year as investors sought safe-haven assets amid tariff threats and the potential negative impact on the economy. The key threat to fixed income investors would be an upside surprise to inflation caused by unfavourable trade policies, but that upward pressure could be offset by weaker growth conditions. From current levels, our models suggest the U.S. 10-year T-bond is reasonably priced and that it offers decent return potential with only modest valuation risk if inflation continues to moderate. We expect bonds to deliver at least coupon-like returns somewhere in the low-to-mid single digits over the year ahead, but with greater divergence across bond markets, reflecting their disparate economic outlooks.

Stocks tumble as trade war unfolds

Stocks began to fall toward the end of February after reaching record levels earlier in the quarter as investors shied away from risk taking amid heightened uncertainty. The sell-off was concentrated in the most expensive U.S. stocks, whereas other markets which are more attractively priced, such as European equities, have delivered impressive gains so far this year. According to our models, U.S. large-cap equities remain expensive and require continued strong earnings growth to support further gains. The consensus of analysts estimates looks for double digit earnings growth this year and next, although those estimates may be subject to downward revisions should tariffs remain in place for an extended period, leaving stocks vulnerable given their elevated starting point.

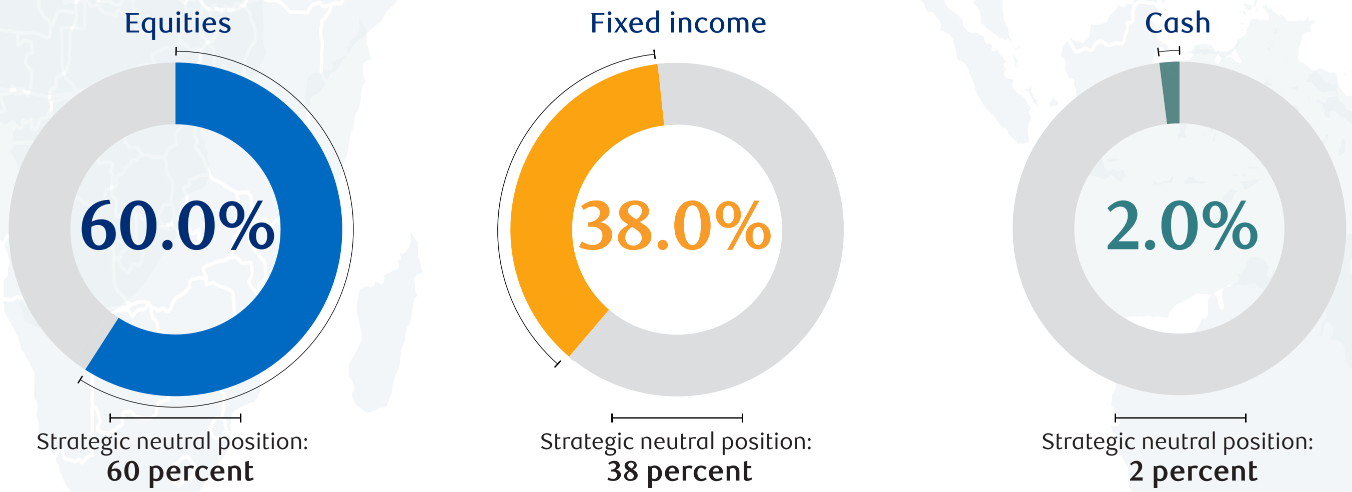
Our return estimates range from mid- to high-single digit returns over the year ahead depending on the region, but large error bands exist around our central forecasts.

Asset mix – maintaining positioning at strategic neutral

Balancing the risks and rewards in our asset mix, we are maintaining a relatively cautious stance with our recommended allocation in line with our strategic neutral positioning. Our base case is for the economy to grow at a modest pace, though we recognize that large deviations are possible given the uncertainty around tariffs. Bonds offer decent return potential and an important ballast against equity-market volatility and that diversification benefit is especially important in this environment. We have been active in tactically managing our fixed income exposures. As the U.S. 10-year yield climbed over 4.60% earlier in the year, we added 50 basis points to bonds, sourced from cash. We reversed that trade after the latest rally, recognizing that even though U.S. 10-year bonds are still appealing, they are slightly less so than earlier in the quarter. Stocks continue to offer superior long-term return potential. However, because valuations remain elevated, the premium between stocks and bonds is unusually low at the moment, particularly in U.S. equities. As such, we are more cautious on stocks in the near-term and are maintaining a neutral allocation in equities overall, but have adjusted our regional tilts. This quarter we reduced exposure to North American equities in favour of international and emerging market stocks. For a balanced global investor, our current recommended asset mix is 60.0 percent equities (strategic neutral position: 60 percent), 38.0 percent fixed income (strategic neutral position: 38.0 percent), with the balance in cash.

Recommended asset mix

RBC GAM Investment Strategy Committee



Note: As of February 28, 2025. Source: RBC GAM

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