RBC Global Asset Management

Market outlook

SPRING 2025

Tariff uncertainty rattles markets

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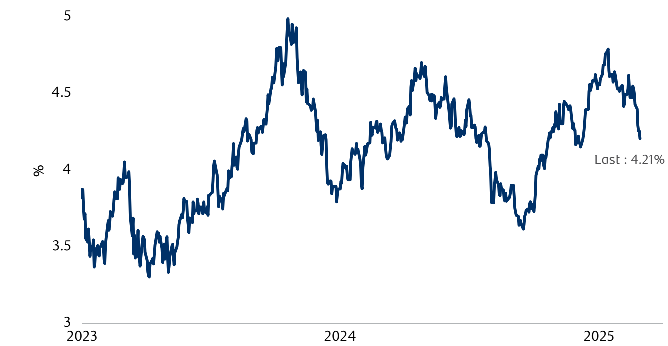
A trade war triggered by the U.S. president has injected significant uncertainty into the macro outlook, widening the range of possible outcomes and causing turbulence in financial markets. The lack of clarity and highly fluid situation on tariffs makes for an especially challenging forecasting environment and, while we continue to forecast growth in most major economies for the year ahead, we recognize that downside risks have intensified and that a variety of scenarios are possible. Should tariffs prove a temporary negotiation tactic, the impact may be less severe, but if tariffs are in place for a prolonged period, GDP, corporate profit growth and valuations could face meaningful headwinds. In any event, the tariffs, threats and changing narratives day-to-day and week-to-week are causing instability for businesses and policymakers alike. For investors, markets are likely to remain volatile as long as a trade war persists, and we stress that maintaining a diversified portfolio is critical in this environment.

Other risks to the outlook include the war in Ukraine, tensions in the Middle East and China's highly indebted economy, although there have been some positive developments, at the margin, on all these fronts. Ceasefire negotiations are taking place between Ukraine and Russia, a tentative ceasefire now exists in the Middle East, and China's economy is showing some signs of recovery following sizeable stimulus efforts by the government. All of these key risks are constantly in flux and could be added sources of volatility for financial markets over the months and quarters ahead.

In fixed income markets, 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 in light of tariff threats and their likely negative impact on the economy (Exhibit 1). The key threat to fixed income investors would be an upside surprise to inflation caused by unfavourable trade policies,

Exhibit 1: U.S. 10-year T-bond
Yield to maturity



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

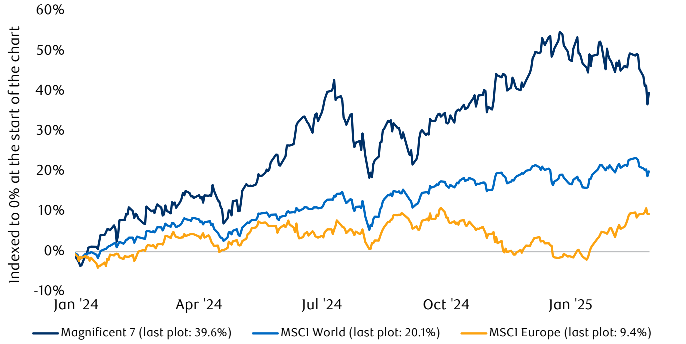
but that upward pressure could be offset by weaker growth conditions. From current levels, our models suggest the U.S. 10-year T-bond is reasonably priced and that it offers decent return potential with only modest valuation risk as long as inflation continues to fall toward the 2% target.

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, initially due to fading enthusiasm around American artificial intelligence (AI) companies following news of some impressive AI advances in China. The selling ultimately extended to other areas of the stock market as tariff threats intensified. Meanwhile in Europe, where valuations are more appealing, stocks have delivered solid gains so far this year, bucking the trend observed in the U.S. (Exhibit 2). According to our models, U.S. large-cap equities remain expensive, while other regions are more attractively priced, and our return estimates range from mid- to high-single digits over the year ahead depending on the region. We would note, however, that large error bands exist around our central forecasts, and that return potential generally improves as prices and valuations decline.

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. In an environment where central banks continue to reduce interest rates, bonds offer appealing return potential and, at current yields, offer a valuable cushion against equity market volatility. We have been especially 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, as bonds offered compelling return potential and downside protection. We reversed this trade in late February after the latest rally recognizing that even though U.S. 10-year bonds still are still appealing, they are slightly less so than earlier in the quarter. For stocks, we are maintaining a neutral allocation 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% equities (strategic: “neutral”: 60.0%), 38.0% bonds (strategic “neutral”: 38.0%) and 2.0% cash.

Exhibit 2: Magnificent 7 return comparison

Cumulative price returns indices in USD



Note: As of February 28, 2025. Price returns computed in USD.
Source: Bloomberg, RBC GAM

Central banks face tricky environment

In this environment, the job of central bankers is especially difficult given their mandates to ensure price stability in a world rife with uncertainty due to shifting trade policies. The U.S. Federal Reserve (Fed) has made it clear that its interest-rate decisions are a function of the data and, at the moment, U.S. unemployment remains near historic lows (Exhibit 3) and inflation is only slightly above the Fed's 2% objective (Exhibit 4). While the monthly inflation data have started to inch higher in the past six months (Exhibit 5), these datapoints don't suggest any immediate need for rate cuts, supporting the Fed's latest decision to keep interest rates on hold.

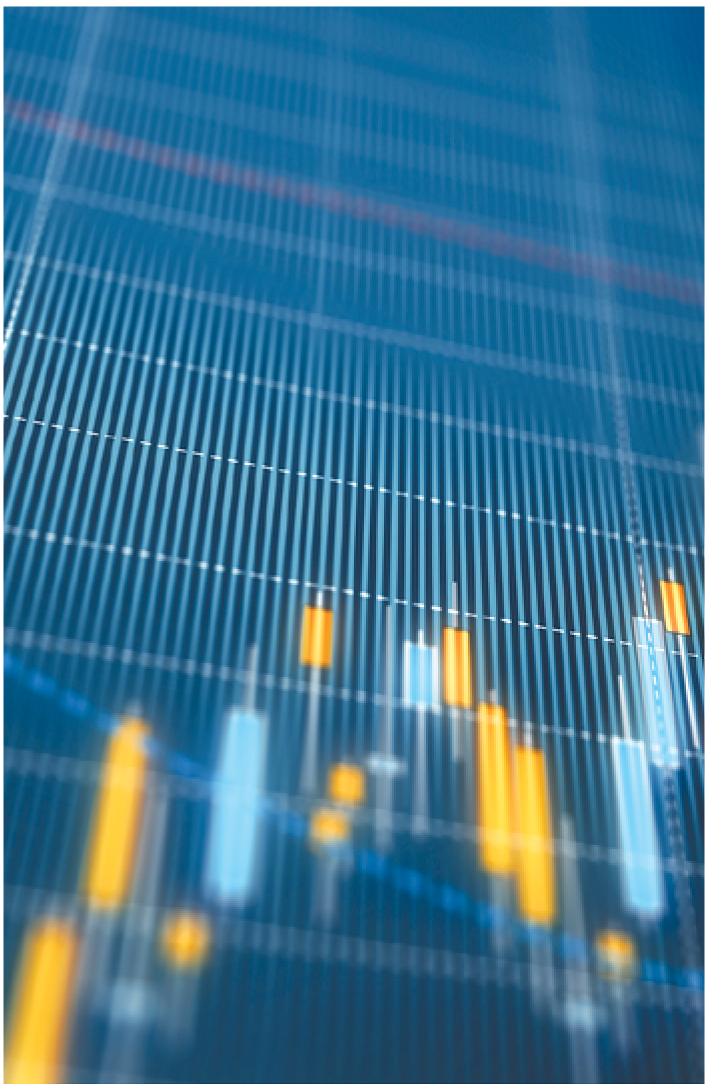
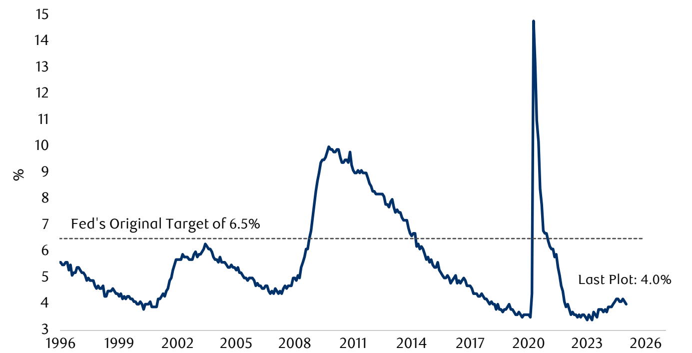


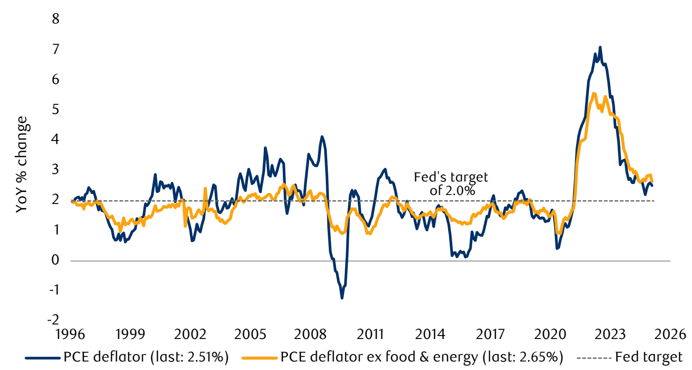
Exhibit 3: U.S. unemployment rate



Note: As of January 2025. Source: Bloomberg,RBC GAM

Exhibit 4: U.S. inflation

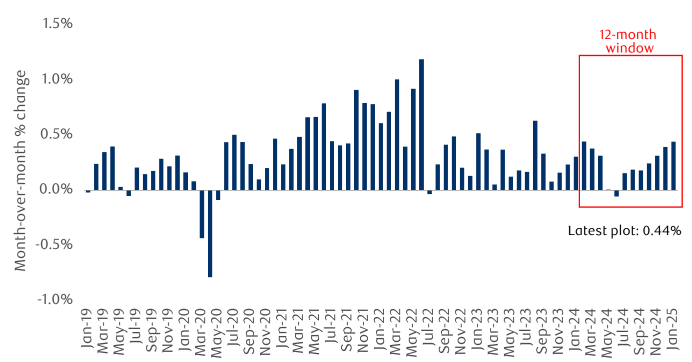
Personal Consumption Expenditures Price Index



Note: As of January 2025. Source: Bloomberg, RBC GAM

Exhibit 5: U.S. CPI Inflation

Month-over-month % change



Note: As of January 31, 2025. Source: Bloomberg, RBC GAM

However, if the growth outlook were to worsen, the scope for further easing would open up. Our federal funds rate model suggests there is ample room to lower rates from here, with the current policy rate of 4.50% still in restrictive territory compared to a neutral rate between 2% and 3% (Exhibit 6). Although the Fed has voiced its willingness to be patient, financial markets have started to anticipate interest-rate cuts, with three 25-basis point cuts priced in by the end of 2025 (Exhibit 7). These interest-rate expectations have been highly volatile in recent months as illustrated in the chart, and we stress that the ultimate path for interest rates will depend on inflation and employment data. That said, pricing in markets suggests an increasing chance of a negative economic outcome that could nudge the Fed to act.

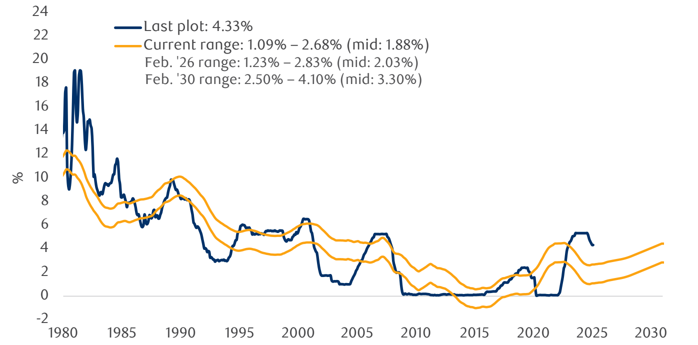
Bond yield movements diverge

Government bond markets have been highly volatile over the past quarter with significant divergences between regions. The U.S. 10-year yield fell to 4.21% at the end of February, fully reversing the increase to 4.80% in January, to end the quarter almost unchanged. In Canada, 10-year yields also rose part-way through the quarter, but they ended the period 20 basis points lower, reflecting a weakening economic backdrop as tariffs will likely hurt Canada more than the U.S. In fact, the spread between 10-year yields in the U.S. and Canada widened to its largest reading in four decades (Exhibit 8). In both Germany and Japan, yields rose through the quarter amid better-than-expected economic data in Europe and given the fact that the Bank of Japan remains in monetary tightening mode. Aside from Japan, where yields remain well below equilibrium, our models suggest that sovereign bonds around the world offer decent return potential with only modest valuation risk, as long as inflation continues to fall toward the 2% level targeted by most major central banks (page 12).

U.S. 10-year Treasuries are reasonably priced

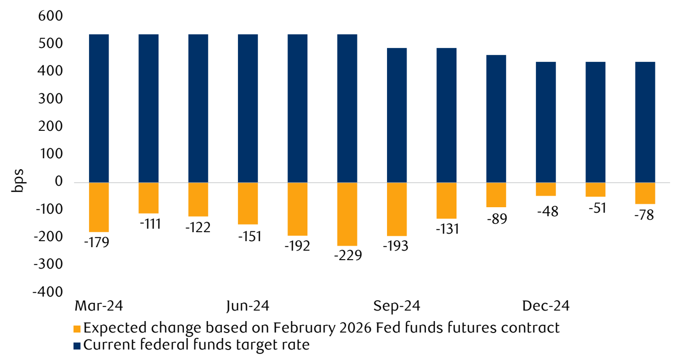
A closer look at our bond model leads us to conclude that, after the significant fluctuations throughout the quarter, the U.S. 10-year yield ended the period at a reasonable level. Exhibit 9 plots the components of our model, which combines an inflation premium with a real, or after-inflation, yield. Inflation has settled nicely after the shock in 2022, and the inflation premium is now close to our modelled level and has been relatively stable for the past several

Exhibit 6: U.S. fed funds rate
Equilibrium range



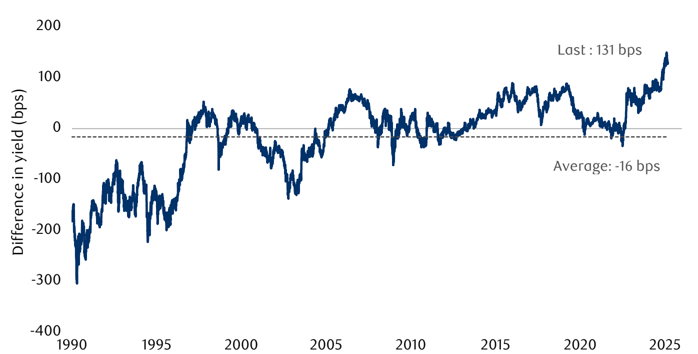
Note: As of February 28, 2025. Source: RBC GAM

Exhibit 7: Fed funds rate and implied expectations
12-month futures contract



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

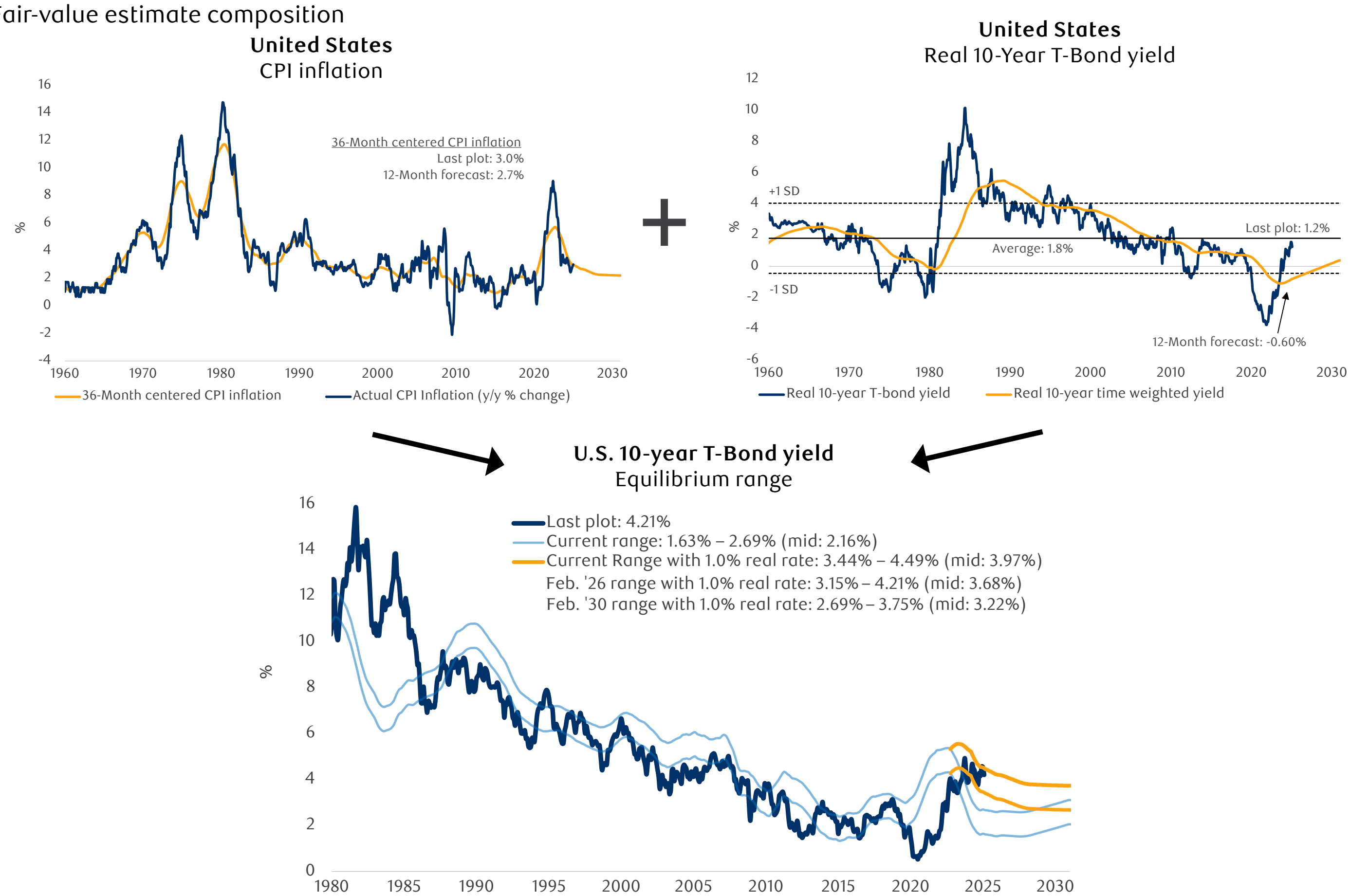
Exhibit 8: U.S. 10-year yield minus Canada 10-year yield



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

Exhibit 9: U.S. 10-year bond yield

Fair-value estimate composition



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

quarters. Most of the increase in the U.S. 10-year yield since the fall of 2024 was delivered through a rise in real interest rates amid an improving macro backdrop and a sense that Trump's administration would be positive for U.S. economic growth. But that increase was much greater than our model would suggest is appropriate based on a variety of structural factors such as demographics and potential long-term economic growth rates. As a result, 10-year yields pushed above the upper boundary of our model's equilibrium band in January, offering fixed-income investors improved return potential and, critically, a bigger cushion against any broader financial-market volatility. After the rally later in the quarter, the 10-year yield fell back within the range to 4.21%. Our expected range for the U.S. 10-year is between 3.50% and 4.50% and we have been using these bands when managing our tactical exposures in fixed income.

Equity markets sell off, led by mega-cap technology stocks

2025 began with global equity markets near record levels as investors were highly optimistic about the outlook. But as Trump began threatening and imposing tariffs on other major economies, stocks encountered significant volatility, erasing earlier gains. Over the three-month period ending February 28, 2025, the S&P 500 declined 1.3%, the tech-heavy NASDAQ fell 2.9% and Canada's TSX Composite fell 4.0%, all in U.S. dollar terms (Exhibit 10). Investors fell out of love with the Magnificent 7 (Mag-7) – a group of mega-cap technology stocks in the U.S. – which rose 56% last year but is now down 4.6% so far this year. Meanwhile, Europe has done especially well, up 11% so far this year to a new all-time high (Exhibit 11). Overall, it appears that investors are rotating away from more expensive areas of the market to cheaper ones.

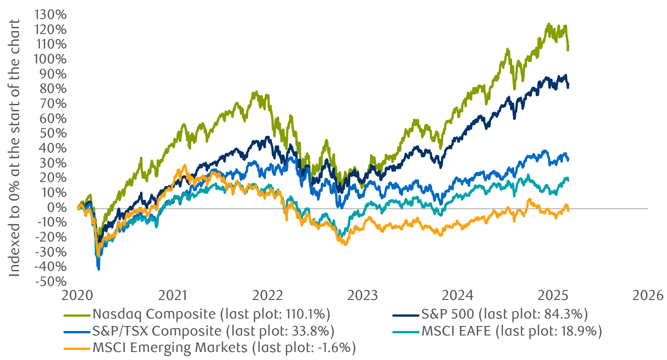
Our analysis suggests the global stock market, in aggregate, is not expensive, particularly if the U.S. is excluded from the mix. Exhibit 12 plots the stock market's distance from fair value based on a GDP-weighted composite of global equity indices. The chart shows that stocks are reasonably priced at just 7% above fair value. But most of the overvaluation is due to the expensive U.S. large-cap market (driven by the Mag-7). If we exclude the U.S. from the calculation, global stocks (ex-USA) are 12% below fair value. In some instances, the valuation difference between the U.S. and other regions is extreme. Stocks in emerging markets, the U.K. and Europe are trading close to or more than one standard deviation below fair value, whereas the S&P 500 is trading at one standard deviation above fair value (page 38).

S&P 500 Index is highly concentrated and lacking diversification

One of the major challenges with the U.S. large-cap market is that it is highly concentrated in just a small number of companies. As of the end of February, the largest 10 stocks in the S&P 500 accounted for 35% of the index weight, a figure that has climbed meaningfully from around 18% a decade

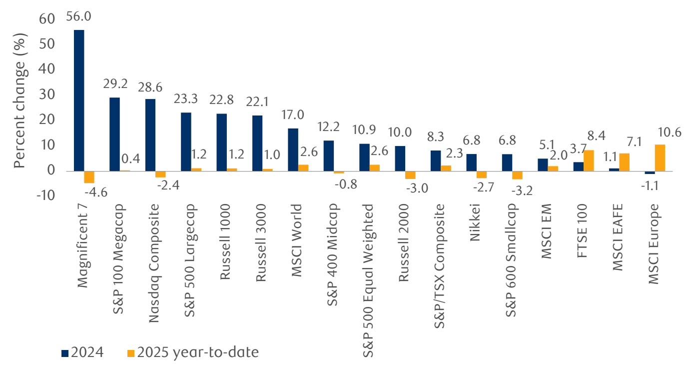
Exhibit 10: Major equity market indices

Cumulative price returns indices in USD



Note: As of February 28, 2025. Price returns computed in USD. Source: Bloomberg, RBC GAM

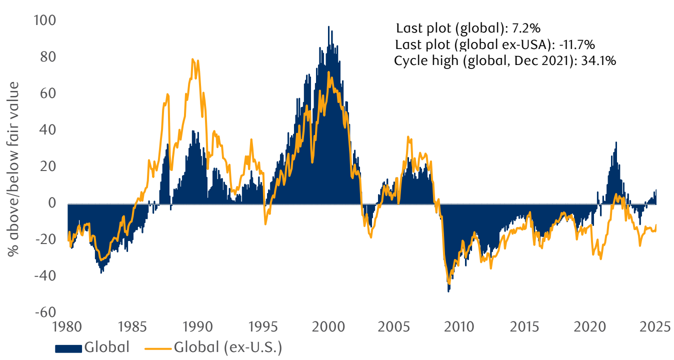
Exhibit 11: Major indices' price change in USD 2024 and YTD 2025



Note: As of February 28, 2025. Magnificent 7 includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Source: Bloomberg, RBC GAM

Exhibit 12: Global stock market composite

Equity market indexes relative to equilibrium



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

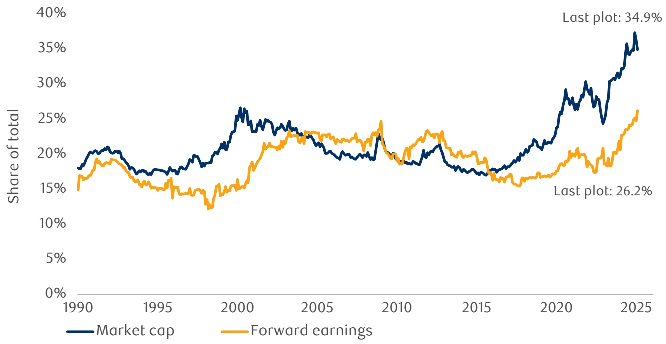
> "If we exclude the U.S. from the calculation, global stocks (ex-USA) are 12% below fair value."

ago (Exhibit 13). As a result, this small group of successful companies has been delivering a disproportionate share of the index return. In 2023, the top 10 stocks contributed almost two thirds of the S&P 500's 24% price-return (Exhibit 14). And in 2024, those 10 stocks delivered roughly half the market's return, with the other 490 stocks making up the other half. Valuation concerns largely stem from this small group of expensive companies, whereas the equal-weighted version of the S&P 500 is trading close to our modelled estimate of fair value, suggesting that the average stock in the S&P 500 is more reasonably priced (Exhibit 15). Profit growth required to sustain current valuations is substantially more demanding for the small group of current leaders than for the rest of the index.

Earnings estimates could be vulnerable to downgrades

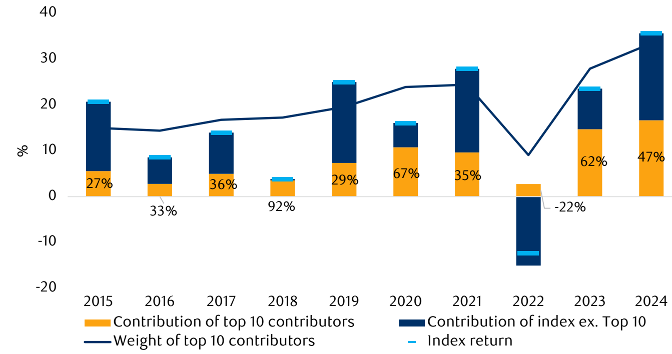
The outlook for corporate profits was rosy going into 2025 as the odds of an economic soft-landing had improved, interest rates were falling, and economic data was robust. But tariff uncertainty is clouding the path ahead, leaving earnings estimates vulnerable to downgrades if the economy falters. Analysts were looking for double digit earnings growth in the U.S. in both 2025 and 2026 (Exhibit 16). In an environment of

Exhibit 13: Top 10 stocks as a share of S&P 500 Index



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

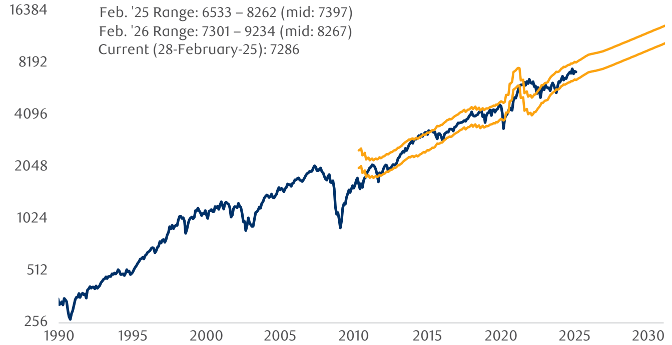
Exhibit 14: S&P 500 Top 10 contributors by calendar year



Note: As of December 31, 2024. Data labels show percentage of index return from the top 10 contributors. Source: RBC GAM

Exhibit 15: S&P 500 Equal Weighted equilibrium

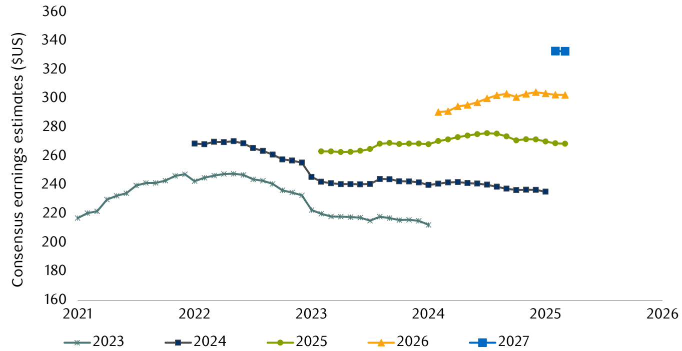
Normalized earnings & valuations



Source: RBC GAM

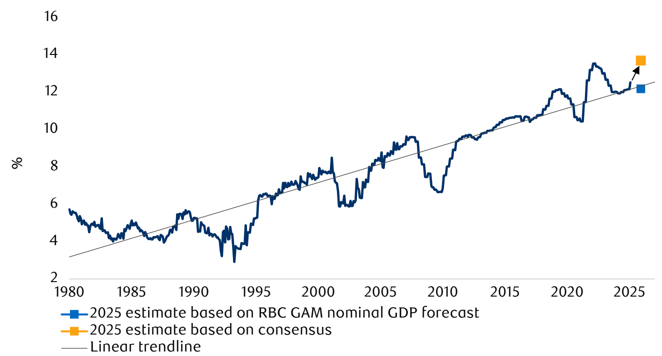
Exhibit 16: S&P 500 Index

Consensus earnings estimates



Note: As of March 7, 2025. Source: Bloomberg, RBC GAM moderate economic growth that produces low-single digit revenue growth, profit margins would need to recover to record levels in order to achieve the consensus earnings forecasts (Exhibit 17). While it is not impossible for margins to continue to expand, we would likely need to see further calming in inflation, reductions in interest rates and/or improved operating efficiencies. However, in a world where tariffs stick around for an extended period and companies are motivated to onshore production, the resulting increase in production costs would weigh on margins. As a result, analysts have become a bit more skeptical and earnings estimates have been revised lower over the past few months, although only slightly thus far.

Exhibit 17: S&P 500 – Net margins



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

Scenarios for S&P 500 suggest valuations are demanding

With the S&P 500 at an elevated valuation, the earnings growth penciled into the consensus estimates is more of a "need-to-have" than a "nice-to-have" in order to drive further gains in the U.S. large cap market. Exhibit 18 outlines a variety of combinations for the S&P 500 based on a variety of earnings estimates and price-to-earnings ratios (P/E). If the S&P 500 traded at a P/E of 17.6 – our modelled equilibrium level based on today's interest rates, inflation and corporate profitability – and earnings per share came in at $270.50 (the current 2025 consensus), then the index would trade at 4759 by the end of this year, representing a 19% decline from the close on February 28, 2025. That same math produces 5514 by the end of 2026 which would still be a slight loss over the next 22 months. Better results are possible, though, if investor confidence remains elevated. If the S&P 500 manages to trade at a P/E of one standard deviation above equilibrium (22.1) for 2025 and 22.5 for 2026, then the S&P 500 would trade at 5981 by the end of this year and 6931 by the end of next year for gains of 2% and 10% annualized, respectively. What these numbers show is that achieving decent returns for the S&P 500 require both solid earnings growth and heightened investor confidence, which is possible if tariffs prove only temporary. But if the economy encounters lasting challenges,

Exhibit 18: Earnings estimates and alternative scenarios for valuations and outcomes for the S&P 500

		Consensus 2025	Total Return 2025		Consensus 2026	Total Return 2026
	P/E	$270.5		P/E	$308.4	
+2 Standard Deviation	26.6	7203.5	22%	27.1	8347.5	21%
+1 Standard Deviation	22.1	5981.3	2%	22.5	6931.1	10%
+0.5 Standard Deviation	19.9	5370.2	-9%	20.2	6222.9	4%
Equilibrium	17.6	4759.0	-19%	17.9	5514.8	-3%
-0.5 Standard Deviation	15.3	4147.9	-29%	15.6	4806.6	-10%
-1 Standard Deviation	13.1	3536.8	-39%	13.3	4098.4	-17%
-2 Standard Deviation	8.6	2314.5	-60%	8.7	2682.1	-33%

Note: As of February 28, 2025. Total returns for 2026 are annualized. Source: LSEG I/B/E/S, RBC GAM investors become pessimistic and earnings downgrades accelerate, stocks could be vulnerable to further downside.

Themes: capital spending in AI expected to moderate

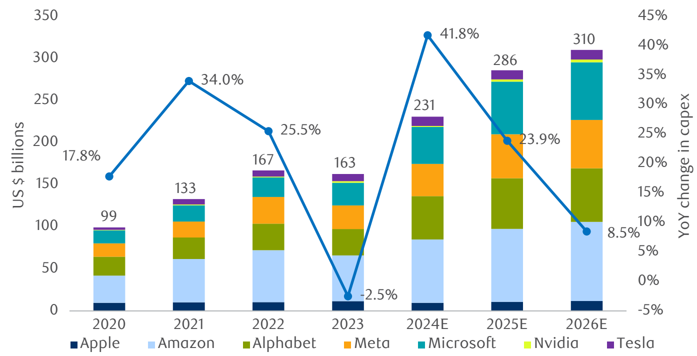
One of the more topical themes that served as a tremendous tailwind for U.S. equities has been the rapid growth in AI and related capital spending. The investment in AI software and infrastructure could be set to slow over the next couple of years. Exhibit 19 plots the yearly capital expenditures (CAPEX) by the Mag-7 and, while the numbers are impressive in the hundreds of billions, the growth rate overlaid on the chart is expected to decelerate from 42% in 2024 to 24% in 2025 and 9% in 2026. The expected slowdown in CAPEX, combined with the fact that China's generative AI company DeepSeek was able to deliver successful results with relatively little investment, presents headwinds for AI-related spending. As a result, stocks related to AI themes (i.e. software, data centres, energy) have recently sold off anywhere from 10% to 20% (Exhibit 20). If the peak in AI spending growth is behind, the market leadership of the AI-related names that has been in place for nearly a decade could be tested.

Styles and geographies: prior leaders take a breather, while Europe outperforms

Shortly after the U.S. election, investors bid up U.S. stocks, in particular small caps, over international equities on the notion that the Trump administration favoured domestic economic growth at the expense of foreign economies. That trade has since fizzled out as tariffs could destabilize the global economy and act as a drag on American consumption. From a style perspective within the U.S. market, small-cap stocks have been the worst performer so far this year, with growth stocks underperforming value stocks, and the large-cap value bucket being the only broad style delivering gains (Exhibit 21). These moves suggest that investors are shying away from smaller companies, higher-momentum stocks and expensive names in this highly uncertain environment, and favouring larger, higher quality and less expensive stocks.

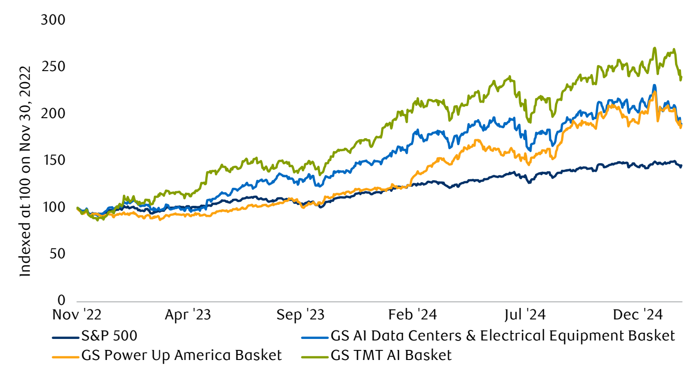
Investors have also adjusted their geographical preferences, favouring non-U.S. markets so far this year. While the S&P 500 Index declined slightly year-to-date, the MSCI Europe Index rose 11% and the MSCI Emerging Markets Index rose 2%. This period of outperformance from non-U.S. regions comes after more than a decade of U.S. equity leadership. Exhibits 22

Exhibit 19: Magnificent 7 capital expenditures



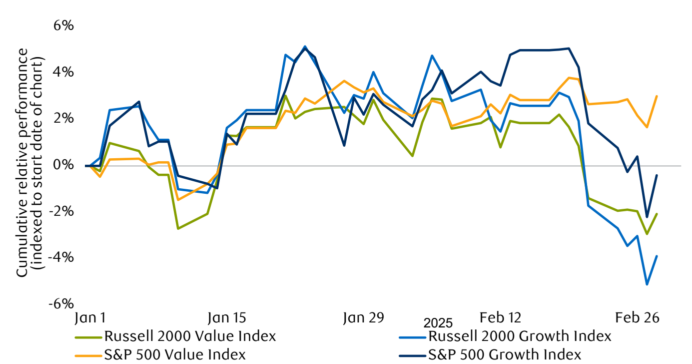
Note: As of March 3, 2025. Source: Bloomberg, RBC GAM

Exhibit 20: AI baskets performance since launch of Chat-GPT



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

Exhibit 21: U.S. large cap/small cap value vs. growth performance



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

and 23 plot the MSCI Europe and MSCI Emerging Markets, respectively, in the top panel of each chart, along with their performance relative to the S&P 500 in the bottom panel of the charts. There have been many instances in the past where European and emerging market equities outperformed for a brief period, only for U.S. leadership to resume, so it remains to be seen whether the recent shift in these trends can be sustained. If we do get a durable rotation into parts of the market outside of U.S. mega-cap tech, it could inject new life into the bull market, fueled by areas that have underperformed for many years.

> "Considering both the short-term risks and long-term return potential, we are maintaining an asset mix in line with our strategic neutral this quarter."

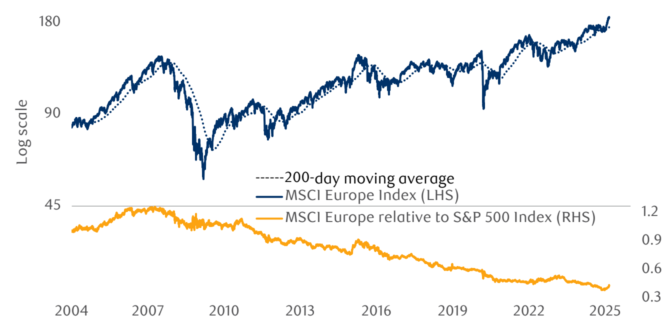
Asset mix – maintaining neutral allocation, but shifting regional equity tilts

Given the rapidly changing situation on tariffs imposed by the U.S. as well as retaliatory efforts by other countries, the near-term outlook is filled with uncertainty. With so much near-term murkiness, taking a step back to look at the potential returns over the longer term is especially useful.

A good estimate for the return that fixed income investors will receive on bonds over the long-term is the current yield to maturity. Exhibit 24 plots the relationship between the U.S. 10-year yield and the actual returns realized over the subsequent decade. The correlation between the two lines is almost perfect, suggesting that most of the returns generated by a 10-year bond over a 10-year period are explained by the starting yield. As a result, the 4.2% yield on 10-year Treasuries at the end of February establishes a reliable forecast for what bond investors may earn over the coming 10 years.

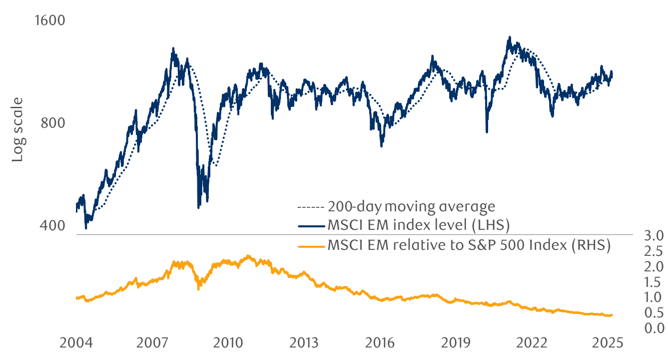
Stocks continue to offer superior long-term return potential. However, because valuations remain elevated, the premium between stocks and bonds is unusually low at the moment, particularly in U.S. equities. It is more elevated in other regions where valuations are relatively more appealing.

Exhibit 22: MSCI Europe Index



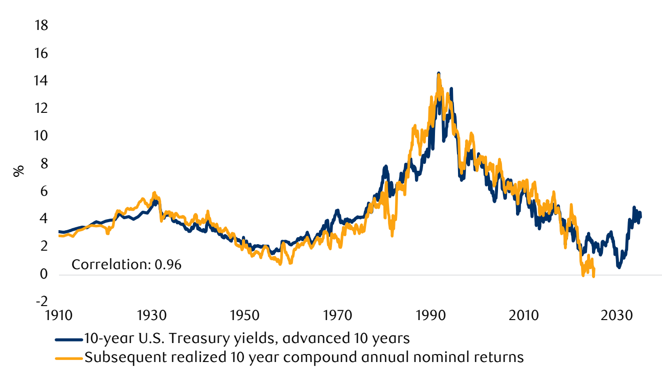
Note: As of February 28, 2025. Source: RBC GAM

Exhibit 23: MSCI Emerging Markets Index



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

Exhibit 24: U.S. 10-year Treasury note and returns



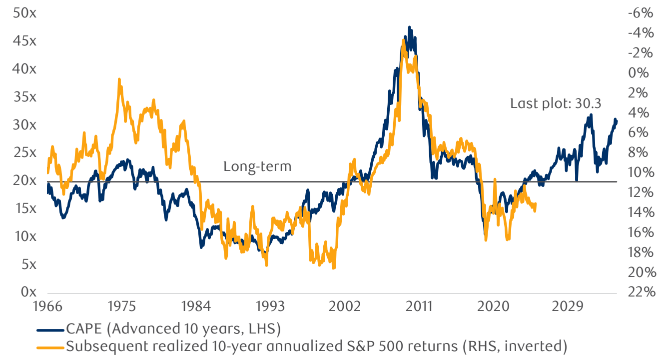
Note: February 28, 2025. Source: Deutsche Bank, Macrobond, RBC GAM

Taking the U.S. as an example, a reliable relationship between valuations and 10-year returns is Shiller's Cyclically Adjusted P/E ratio (CAPE). The relationship shown in Exhibit 25 suggests that higher valuations today correlate to lower returns over the longer term. A CAPE of 30.3 translates to around 5% annual gains over the long term, still better than bonds, but not significantly so. Should the sell-off in stocks intensify and valuations decline, then return potential would improve as a result.

Considering both the short-term risks and long-term return potential, we are maintaining an asset mix in line with our strategic neutral this quarter. This positioning reflects a relatively cautious stance given our concerns around valuations in the U.S. and heightened uncertainty due to tariff threats. Bonds offer decent return potential and an important ballast against equity-market volatility and that diversification benefit is especially important in this environment. Within stocks, however, we have adjusted our regional tilts away from North America toward international and emerging markets where valuations are relatively more appealing. For a balanced global investor, our current recommended asset mix is 60.0% equities (strategic: "neutral": 60.0%), 38.0% bonds (strategic "neutral": 38.0%) and 2.0% cash.

Exhibit 25: Shiller's CAPE

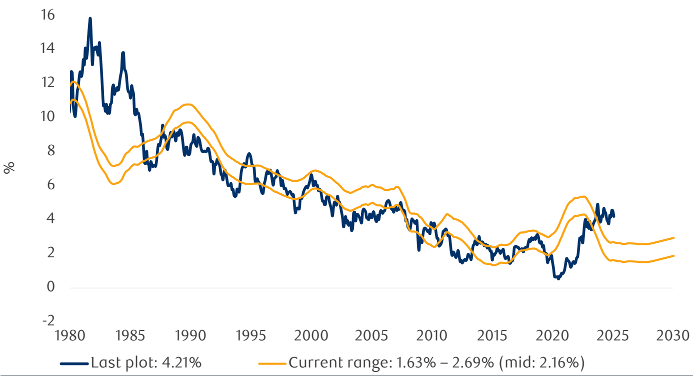
Real S&P 500 Index / 10-year average of real EPS



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

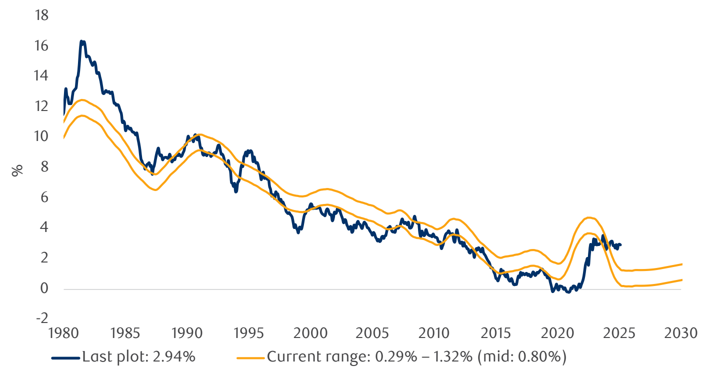
Global fixed income markets

U.S. 10-Year T-Bond Yield
Equilibrium range



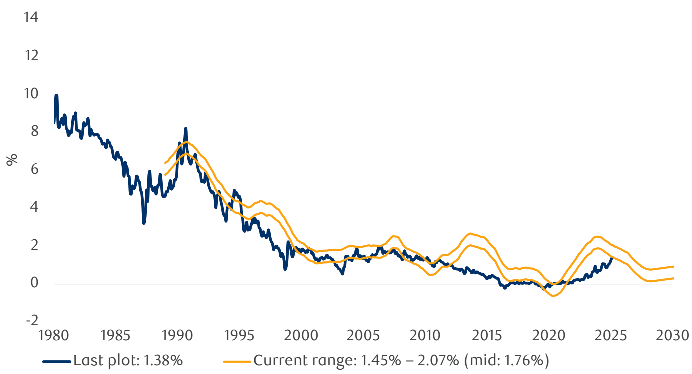
Note: As of February 28, 2025. Source: RBC GAM

Eurozone 10-Year Bond Yield
Equilibrium range



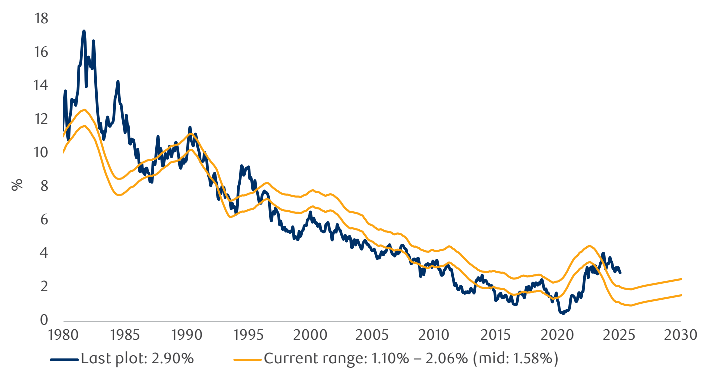
Note: As of February 28, 2025. Source: RBC GAM

Japan 10-Year Bond Yield
Equilibrium range



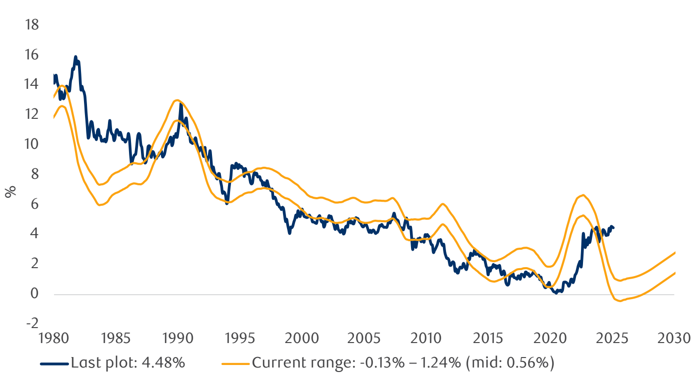
Note: As of February 28, 2025. Source: RBC GAM

Canada 10-Year Bond Yield
Equilibrium range



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

U.K. 10-Year Gilt
Equilibrium range

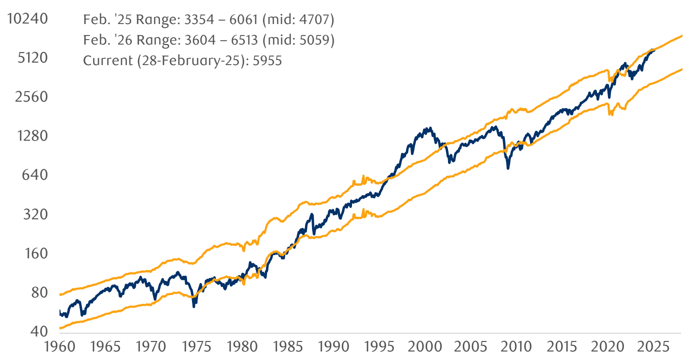


Note: As of February 28, 2025. Source: RBC GAM

> "Our models suggest that sovereign bonds offer decent return potential with only modest valuation risk as long as inflation continues falling toward the 2% level targeted by major central banks."

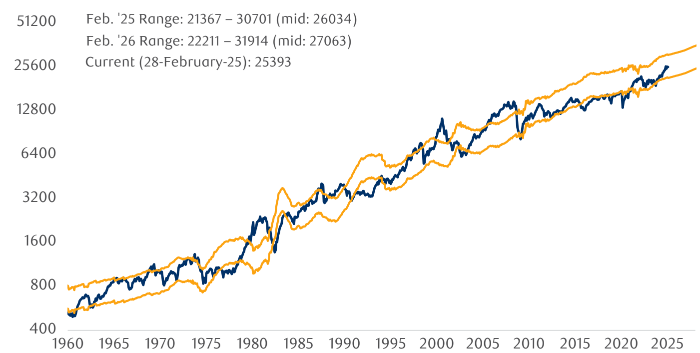
Global equity markets

S&P 500 Equilibrium
Normalized earnings and valuations



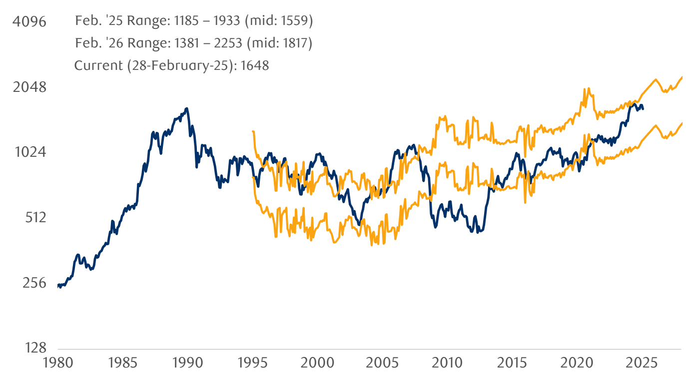
Note: As of February 28, 2025. Source: RBC GAM

S&P/TSX Composite Equilibrium
Normalized earnings and valuations



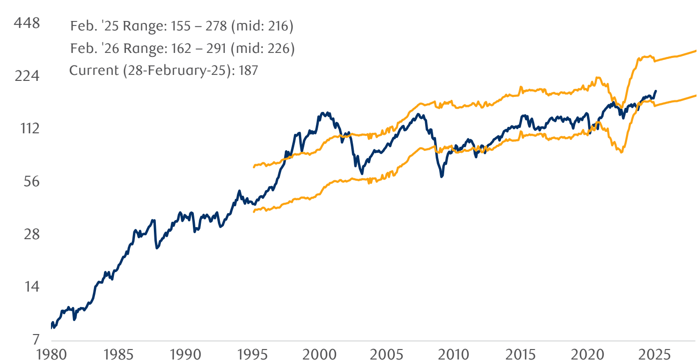
Note: As of February 28, 2025. Source: RBC GAM

MSCI Japan Index
Normalized earnings and valuations



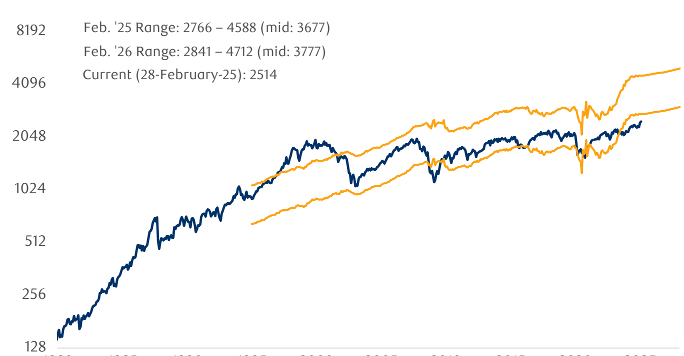
Note: As of February 28, 2025. Source: RBC GAM

MSCI Europe Index
Normalized earnings and valuations



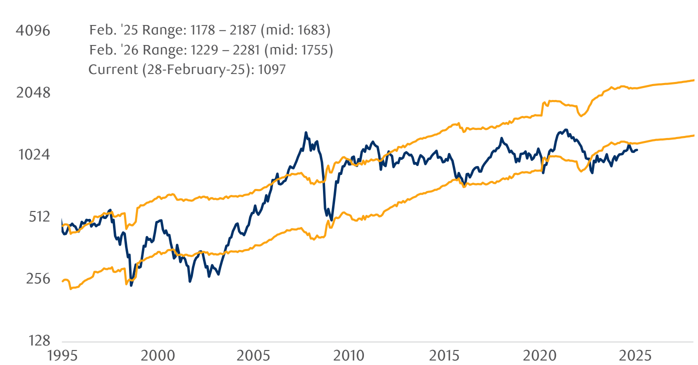
Note: As of February 28, 2025. Source: RBC GAM

MSCI UK Index
Normalized earnings and valuations



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

MSCI Emerging Markets Index
Normalized earnings and valuations



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

Note: The fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index.

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