RBC Global Asset Management

The Global Investment Outlook

RBC GAM Investment Strategy Committee

FALL 2023

The RBC GAM Investment Strategy Committee

Dan Chornous, CFA (Chair)
Chief Investment Officer

Soo Boo Cheah, MBA, CFA
Senior Portfolio Manager

Dagmara Fijalkowski, MBA, CFA
Head, Fixed income and Currencies

Stu Kedwell, CFA
Co-Head, Senior V.P. & Senior Portfolio Manager North-American Equities

Eric Lascelles
Chief Economist

Scott Lysakowski, CFA
Vice President and Senior Portfolio Manager Head, Canadian Equities (Vancouver)

Hanif Mamdani
Head, Alternative Investments

Bryan Mascoe, CFA
Senior Portfolio Manager Co-Head, Fixed Income (Vancouver)

Sarah Riopelle, CFA
Vice President and Senior Portfolio Manager Portfolio Solutions

Martin Paleczny, CFA
Vice President and Senior Portfolio Manager

Kristian Sawkins, CFA
Vice President and Senior Portfolio Manager Co-Head, Fixed Income (Vancouver)

Jaco Van der Walt, DCom
Vice President and Global Head, Quantitative Research & Investments

Milos Vukovic, CFA
Vice President and Head, Investment Policy

Brad Willock, CFA
Vice President and Senior Portfolio Manager

The RBC GAM Investment Strategy Committee consists of senior investment professionals drawn from all areas of RBC Global Asset Management. The Committee regularly receives economic and capital markets related input from internal and external sources. Important guidance is provided by the Committee's regional equity advisors (North America, Europe, Asia, Emerging Markets) and from the Global Fixed Income & Currencies sub-committee. From this, the Committee builds a detailed global investment forecast looking one year forward.

The Committee's view includes an assessment of global fiscal and monetary conditions, projected economic growth and inflation, as well as the expected course of interest rates, major currencies, corporate profits and stock prices.

From this global forecast, the RBC GAM Investment Strategy Committee develops specific guidelines that can be used to manage portfolios.

These include:

The recommended mix of cash, fixed income instruments, and equities.

The recommended global exposure of fixed income and equity portfolios.

The optimal term structure for fixed income investments.

The suggested sector and geographic make-up within equity portfolios.

The preferred exposure to major currencies.

Results of the Committee's deliberations are published quarterly in *The Global Investment Outlook*.

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Executive summary

Eric Savoie, MBA, CFA, CMT
Investment Strategist
RBC Global Asset Management Inc.

Daniel E. Chornous, CFA
Chief Investment Officer
RBC Global Asset Management Inc.

The global economy has been resilient and a variety of challenges stemming from the pandemic have become less severe. But the lagged impact of aggressive monetary tightening, in our view, is still likely to eventually push the economy into recession and, in an environment of heightened macroeconomic uncertainty, substantial risk taking is unwarranted and patience is critical.

Growth remains positive for now, but headwinds are likely to dominate

Most major economies have continued to expand so far this year and some of the key risks to growth have diminished. Inflation has moderated from an extreme, stress in the U.S. regional-banking system has eased, risk assets have rallied and North America's housing market rebounded in the spring. But offsetting this long list of positives is the fact that the most critical headwinds have intensified. China's economic rebound from late last year is fizzling as the world's second-largest economy struggles despite attempts by policymakers to stimulate growth. Moreover, short-term interest rates have risen even further than previously anticipated in the developed world and are now at decidedly restrictive levels not experienced in over two decades. The full effect of tightening monetary conditions typically slows the economy with a significant lag, with the implication that the window for a recession may just now be starting to open. As a result, we continue to expect a recession in most of the developed world over the year ahead, though its contours should be mild in depth and short in duration. Our GDP growth forecasts have mostly been raised for 2023 and lowered for 2024, reflecting better-than-expected economic data during the summer and the deferral of the start of the anticipated recession from the third quarter of 2023 to the fourth quarter. Our 2024 growth forecasts remain below the consensus.

Inflation trend remains favourable

U.S. consumer inflation peaked at 9% in mid-2022 and has since cooled toward 3% as the four main drivers of high inflation have all turned. The commodity-price surge following Russia's invasion of Ukraine has reversed, supply-chain problems have mostly been resolved, monetary policy has moved from extreme accommodation to a restrictive stance and fiscal policy has become far less stimulative. While inflation has declined relatively quickly during the past year, further material improvements toward the 2.0% target will prove more difficult in the near term as gasoline prices have rebounded in recent months and base effects will be less favourable. Nevertheless, we remain optimistic with regard to the medium-term inflation outlook and believe that inflation can fall faster than the consensus expectation, aided in part by weaker economic conditions, to just above 2.0% by next year.

Dollar detour: how short-term factors have interrupted the cyclical decline

The U.S.-dollar downtrend remains intact and we continue to expect significant U.S.-dollar weakness over the coming years. However, the long-term cyclical decline embedded in our outlook has run into a few shorter-term roadblocks, and so its progress has been slower than we had anticipated. While the dollar sits roughly 7% below its September 2022 peak, the currency is unchanged since the start of 2023. Higher U.S. interest rates and disappointing economic growth abroad have interrupted the dollar's slide in 2023. Still, emerging-market currencies as a whole have fared impressively – a few even managing double-digit returns so far this year – and the euro, Canadian dollar and British pound have also outperformed the U.S. dollar. We remain optimistic on most emerging- and developed-market currencies over the next 12 months, as we expect the U.S. dollar to decline broadly.

Rate-hiking cycle is drawing to a close, and cuts are likely over the year ahead

Central banks are now near or already across the finish line in their monetary-tightening journeys. Emerging-market central banks have been leading the way, raising rates before the developed world during this cycle, and some have now pivoted to delivering rate cuts. It is not unreasonable to think that central banks in the developed world may follow suit within the next year. Our model suggests the neutral U.S. fed funds rate is currently 3.4%, but if inflation continues to decline in line with our forecast, that neutral reading falls to around 2% in 12 months. As a result, and in combination with our recession forecast, it seems unlikely that the fed funds rate will remain at an elevated 5.5% for an extended period. This view is in line with pricing in the futures market, which flags the possibility of one more 25-basis-point hike by the end of this year, followed by the start of an interest-rate cutting cycle beginning in early 2024.

Sovereign bonds offer attractive return potential, minimal valuation risk

Government-bond yields have climbed to their highest levels since just before the 2008/2009 global financial crisis and at this point represent attractive value. According to our models, much of the acute valuation risk that so worried us in 2020 and 2021 has dissipated with last year's painful bond sell-off. With bond yields now at a much higher starting point, the economy likely to weaken and inflation pressures capable of moderating further over the coming year, we believe the risk of capital losses in sovereign bonds is minimal and forecast lower bond yields and thus higher bond prices ahead. As a result, sovereign fixed-income assets are the most appealing they have been in many years and we expect that government bonds will deliver returns in the mid to high single digits over the year ahead, with some regions even capable of low double-digit returns.

Equity-market gains have been dominated by U.S. mega-cap technology

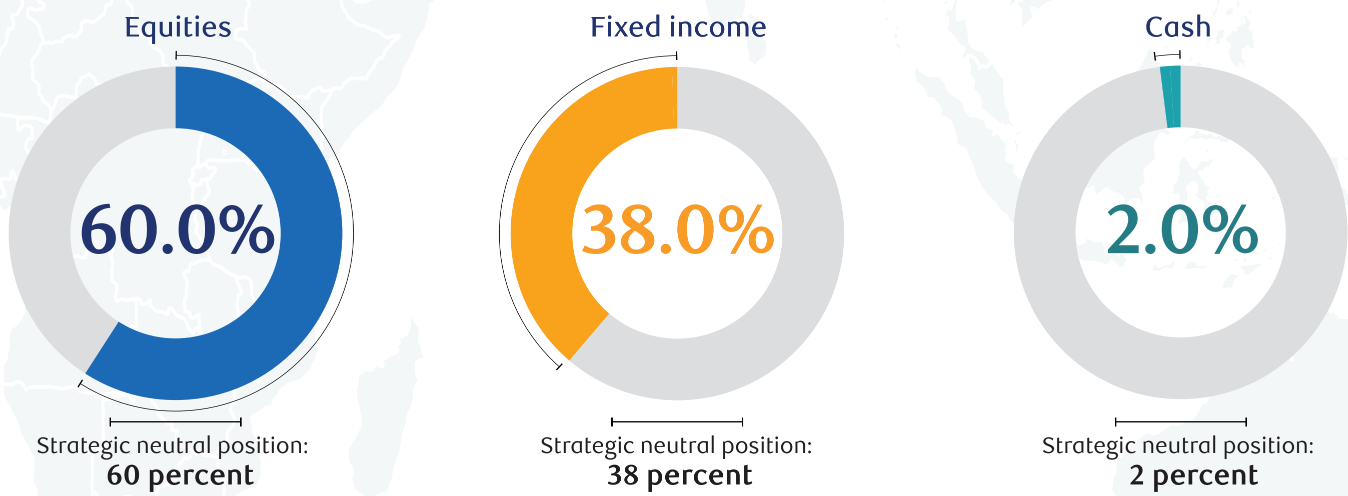
Global stocks extended their gains in the past quarter, but their performance so far this year has been increasingly concentrated to just a handful of names. The "Magnificent 7" – the largest U.S. publicly listed companies – have benefited tremendously from emerging trends in artificial intelligence (AI), which have propelled valuations of these stocks to especially demanding levels. The group now makes up over a quarter of the S&P 500 Index's market capitalization and has delivered outsized gains of 70% so far this year, contributing to almost three quarters of the S&P 500's 17% gain over that period. Returns offered by the rest of the market, however, pale in comparison. The equal-weighted S&P 500, a better representation of how the average stock has performed, is up just 5.8%. As a result, the performance of the S&P 500 is masking the fact that underlying market breadth has been relatively poor – often an indication that the economy is struggling or set to weaken. Although global equity-market valuations are not unreasonable, earnings are vulnerable to a contraction in economic activity, which limits the potential upside in stocks. In this late-cycle environment, we are looking for low-to-mid-single-digit returns for stocks, with relatively worse outcomes from U.S. equities due to their higher valuations and the influence of expensive mega-cap technology names that could falter if the economy entered a downturn.

Asset mix – maintaining neutral allocation

Assuming we are correct in our view that the economy is likely to enter recession over the next 12 months, interest rates, bond yields and stock prices could all be closing in on near-term peaks. While there are pathways to a positive outcome for the economy and markets if an economic soft landing is achieved, we think the reward for taking substantial risk in this environment is not as appealing as it would have been at earlier points in the cycle. Further supporting this view is the fact that the premium offered on stocks versus bonds is at its lowest level in nearly two decades. As a result, we have been gradually dialing down the equity overweight position in our asset mix over the past 18 months, balancing these near-term risks with the asset class's long-term upside potential. We have used those proceeds to narrow our prior underweight in fixed income as rising yields boosted the appeal of sovereign bonds, whose current elevated yields should provide a better ballast against any downturn in equities. Last quarter, we completed the process of fully closing our tactical risk exposures. This quarter, we maintain that neutral stance relative to our benchmark weights. For a balanced global investor, we currently recommend an asset mix of 60% equities (strategic neutral position: 60%) and 38% fixed income (strategic neutral position: 38%), with the balance in cash. Actual fund or client portfolio positioning may differ depending on individual investment policies.

Recommended asset mix

RBC GAM Investment Strategy Committee



Note: as of August 31, 2023. Source: RBC GAM

Economic & capital markets forecasts

Economic forecast (RBC GAM Investment Strategy Committee)

	United States		Canada		Europe		United Kingdom		Japan		China		Emerging markets*	
	Fall 2023	Change from Summer 2023	Fall 2023	Change from Summer 2023	Fall 2023	Change from Summer 2023	Fall 2023	Change from Summer 2023	Fall 2023	Change from Summer 2023	Fall 2023	Change from Summer 2023	Fall 2023	Change from Summer 2023
Real GDP														
2022A	2.06%		3.44%		3.41%		4.10%		1.01%		3.17%		3.49%	
2023E	1.90%	0.90	1.30%	0.70	0.50%	0.40	0.30%	0.50	2.00%	1.40	4.90%	(0.90)	4.70%	0.60
2024E	0.30%	(0.30)	0.20%	(0.50)	0.20%	(0.50)	0.20%	(0.40)	0.70%	(0.40)	4.40%	0.10	4.00%	(0.20)
CPI														
2022A	8.00%		6.80%		8.38%		9.07%		2.50%		1.87%		4.86%	
2023E	4.00%	0.10	3.70%	0.50	5.40%	(0.20)	7.40%	1.20	3.10%	0.60	0.50%	(0.20)	2.80%	(2.60)
2024E	2.20%	(0.20)	2.30%	0.10	2.10%	(0.40)	2.40%	N/C	1.50%	0.10	1.60%	(0.50)	3.10%	(2.50)

A = Actual E = Estimate *GDP Weighted Average of China, India, South Korea, Brazil, Mexico and Russia.

Targets (RBC GAM Investment Strategy Committee)

	August 2023	Forecast August 2024	Change from Summer 2023	1-year total return estimate* (%)
Currency markets against USD				
CAD (USD–CAD)	1.35	1.24	(0.02)	9.0
EUR (EUR–USD)	1.08	1.21	0.01	10.0
JPY (USD–JPY)	145.54	120.00	4.00	15.0
GBP (GBP–USD)	1.27	1.33	0.03	4.1
Fixed income markets				
U.S. Fed Funds Rate (upper bound)	5.50	4.50	(0.25)	0.0
U.S. 10-Year Bond	4.11	3.50	0.25	9.2
Canada Overnight Rate	5.00	4.25	0.25	0.0
Canada 10-Year Bond	3.56	3.00	0.25	8.4
Eurozone Deposit Facility Rate	3.75	3.25	(0.25)	0.0
Germany 10-Year Bund	2.47	2.60	0.35	1.3
U.K. Base Rate	5.25	5.25	0.50	0.0
U.K. 10-Year Gilt	4.36	4.25	0.50	5.3
Japan Overnight Call Rate	(0.06)	0.10	0.10	0.0
Japan 10-Year Bond	0.65	0.75	N/C	(0.3)
Equity markets				
S&P 500	4508	4400	275	(0.8)
S&P/TSX Composite	20293	20700	700	5.6
MSCI Europe	154	154	(6)	3.7
FTSE 100	7439	7500	(200)	5.0
Nikkei	32619	33100	600	3.4
MSCI Emerging Markets	980	1000	(10)	5.0

*Total returns are expressed in local currencies with the exception of MSCI Emerging Markets whose return is expressed in USD. Source: RBC GAM

Recommended asset mix

Asset mix – the allocation within portfolios to stocks, bonds and cash – should include both strategic and tactical elements. Strategic asset mix addresses the blend of the major asset classes offering the risk/return tradeoff best suited to an investor's profile. It can be considered to be the benchmark investment plan that anchors a portfolio through many business and investment cycles, independent of a near-term view of the prospects for the economy and related expectations for capital markets. Tactical asset allocation refers to fine tuning around the strategic setting in an effort to add value by taking advantage of shorter-term fluctuations in markets.

Every individual has differing return expectations and tolerances for volatility, so there is no "one size fits all" strategic asset mix. Based on a 40-year study of historical returns[1] and the volatility[2] of returns (the range around the average return within which shorter-term results tend to fall), we have developed five broad profiles and assigned a benchmark strategic asset mix for each. These profiles range from very conservative through balanced to aggressive growth. It goes without saying that as investors accept increasing levels of volatility, and therefore greater risk that the actual experience will depart from the longer-term norm, the potential for returns rises. The five profiles presented below may assist investors in selecting a strategic asset mix best aligned to their investment goals.

Each quarter, the RBC GAM Investment Strategy Committee publishes a recommended asset mix based on our current view of the economy and return expectations for the major asset classes. These weights are further divided into recommended exposures to the variety of global fixed income and equity markets. Our recommendation is targeted at the Balanced profile where the benchmark (strategic neutral) setting is 60% equities, 38% fixed income, and 2% cash.

A tactical range of +/- 15% around the benchmark position allows us to raise or lower exposure to specific asset classes with a goal of tilting portfolios toward those markets that offer comparatively attractive near-term prospects.

This tactical recommendation for the Balanced profile can serve as a guide for movement within the ranges allowed for all other profiles.

The value-added of tactical strategies is, of course, dependent on the degree to which the expected scenario unfolds.

Regular reviews of portfolio weights are essential to the ultimate success of an investment plan as they ensure current exposures are aligned with levels of long-term returns and risk tolerances best suited to individual investors.

Anchoring portfolios with a suitable strategic asset mix, and placing boundaries defining the allowed range for tactical positioning, imposes discipline that can limit damage caused by swings in emotion that inevitably accompany both bull and bear markets.

[1]**Average return**: The average total return produced by the asset class over the period 1983 – 2023, based on monthly results.
[2]**Volatility**: The standard deviation of returns. Standard deviation is a statistical measure that indicates the range around the average return within which 2/3 of results will fall into, assuming a normal distribution around the long-term average.

Global asset mix

	Benchmark policy	Allowable range	Fall 2022	New Year 2023	Spring 2023	Summer 2023	**Fall 2023**
Cash	**2.0%**	0.0% – 15.0%	1.0%	1.0%	1.5%	2.0%	**2.0%**
Bonds	**38.0%**	23.0% – 53.0%	37.5%	37.0%	37.5%	38.0%	**38.0%**
Stocks	**60.0%**	45.0% – 75.0%	61.5%	62.0%	61.0%	60.0%	**60.0%**

Note: Effective June 1, 2020, we reset our strategic neutral positions to reflect long-lasting changes in economy and capital markets' dynamics. Boosting strategic neutral equity exposure by 5% and reducing fixed income by same amount in our reference balanced portfolio.

Regional allocation

Global bonds	**WGBI* August 2023**	Allowable range	Fall 2022	New Year 2023	Spring 2023	Summer 2023	**Fall 2023**
North America	**45.2%**	35.2% – 55.2%	45.2%	51.8%	49.0%	42.7%	**40.3%**
Europe	**34.8%**	24.8% – 44.8%	40.2%	30.7%	31.2%	37.1%	**39.8%**
Asia	**20.0%**	10.0% – 30.0%	14.6%	17.6%	19.8%	20.3%	**20.0%**

Global equities	**MSCI** August 2023**	Allowable range	Fall 2022	New Year 2023	Spring 2023	Summer 2023	**Fall 2023**
North America	**69.8%**	59.8% – 79.8%	70.0%	71.0%	68.0%	67.7%	**69.3%**
Europe	**14.5%**	4.5% – 24.5%	14.0%	13.6%	15.5%	15.8%	**14.5%**
Asia	**7.4%**	0.0% – 17.4%	8.1%	7.4%	8.2%	8.4%	**8.2%**
Emerging markets	**8.3%**	0.0% – 18.3%	7.9%	8.1%	8.4%	8.1%	**8.1%**

Our asset mix is reported as at the end of each quarter. The mix is fluid and may be adjusted within each quarter, although we do not always report on shifts as they occur. The weights in the table should be considered a snapshot of our asset mix at the date of release of the Global Investment Outlook.

Global equity sector allocation

	MSCI August 2023**	RBC GAM ISC Summer 2023	RBC GAM ISC Fall 2023	Change from Summer 2023	**Weight vs. benchmark**
Energy	4.62%	5.09%	5.12%	0.03	110.8%
Materials	4.17%	4.33%	5.17%	0.85	124.0%
Industrials	10.97%	10.54%	12.97%	2.43	118.2%
Consumer discretionary	11.02%	10.64%	11.02%	0.38	100.0%
Consumer staples	7.33%	8.78%	7.33%	(1.45)	100.0%
Health care	12.58%	15.59%	12.58%	(3.01)	100.0%
Financials	14.88%	12.19%	13.58%	1.39	91.3%
Information technology	22.09%	23.02%	23.89%	0.86	108.1%
Communication services	7.21%	7.01%	7.21%	0.20	100.0%
Utilities	2.74%	1.31%	0.74%	(0.57)	27.0%
Real estate	2.40%	1.50%	0.40%	(1.10)	16.7%

*FTSE World Government Bond Index. **MSCI World Index. Source: RBC GAM Investment Strategy Committee

At RBC GAM, we have a team dedicated to setting and reviewing the strategic asset mix for all of our multi-asset solutions. With an emphasis on consistency of returns, risk management and capital preservation, we have developed a strategic asset allocation framework for five client risk profiles that correspond to broad investor objectives and risk preferences. These five profiles range from Very Conservative through Balanced to Aggressive Growth.

Very Conservative

Asset class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0-15%	2.0%	2.0%
Fixed Income	73%	68-88%	73.0%	73.0%
Total Cash & Fixed Income	75%	60-90%	75.0%	75.0%
Canadian Equities	10%	0-20%	9.9%	9.9%
U.S. Equities	8%	0-18%	7.9%	7.9%
International Equities	7%	0-17%	7.2%	7.2%
Emerging Markets	0%	0%	0.0%	0.0%
Total Equities	25%	10-40%	25.0%	25.0%

	Return	Volatility
40-year average	7.5%	4.8%
Last 12 months	4.3%	6.8%

Very Conservative investors will seek income with maximum capital preservation and the potential for modest capital growth, and be comfortable with small fluctuations in the value of their investments. This portfolio will invest primarily in fixed-income securities, and a small amount of equities, to generate income while providing some protection against inflation. Investors who fit this profile generally plan to hold their investment for the medium to long term.

Conservative

Asset class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0-15%	2.0%	2.0%
Fixed Income	58%	43-83%	58.0%	58.0%
Total Cash & Fixed Income	60%	45-75%	60.0%	60.0%
Canadian Equities	13%	3-23%	12.9%	12.9%
U.S. Equities	15%	5-25%	14.9%	14.9%
International Equities	12%	2-22%	12.2%	12.2%
Emerging Markets	0%	0%	0.0%	0.0%
Total Equities	40%	25-55%	40.0%	40.0%

	Return	Volatility
40-year average	8.0%	6.1%
Last 12 months	6.7%	7.7%

Conservative investors will pursue modest income and capital growth with reasonable capital preservation, and be comfortable with moderate fluctuations in the value of their investments. The portfolio will invest primarily in fixed-income securities, with some equities, to achieve more consistent performance and provide a reasonable amount of safety. The profile is suitable for investors who plan to hold their investment over the medium to long term.

Balanced

Asset class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0-15%	2.0%	2.0%
Fixed Income	38%	23-53%	38.0%	38.0%
Total Cash & Fixed Income	40%	25-55%	40.0%	40.0%
Canadian Equities	15%	5-25%	14.8%	14.8%
U.S. Equities	25%	15-35%	24.8%	24.8%
International Equities	15%	5-25%	15.5%	15.5%
Emerging Markets	5%	0-15%	4.9%	4.9%
Total Equities	60%	45-75%	60.0%	60.0%

	Return	Volatility
40-year average	8.4%	7.7%
Last 12 months	9.5%	9.1%

The **Balanced** portfolio is appropriate for investors seeking balance between long-term capital growth and capital preservation, with a secondary focus on modest income, and who are comfortable with moderate fluctuations in the value of their investments. More than half the portfolio will usually be invested in a diversified mix of Canadian, U.S. and global equities. This profile is suitable for investors who plan to hold their investment for the medium to long term.

Growth

Asset class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0-15%	2.0%	2.0%
Fixed Income	23%	8-38%	23.0%	23.0%
Total Cash & Fixed Income	25%	10-40%	25.0%	25.0%
Canadian Equities	18%	8-28%	17.8%	17.8%
U.S. Equities	30%	20-40%	29.8%	29.8%
International Equities	19%	9-29%	19.6%	19.6%
Emerging Markets	8%	0-18%	7.8%	7.8%
Total Equities	75%	60-90%	75.0%	75.0%

	Return	Volatility
40-year average	8.6%	9.5%
Last 12 months	11.6%	10.4%

Investors who fit the **Growth** profile will seek long-term growth over capital preservation and regular income, and be comfortable with considerable fluctuations in the value of their investments. This portfolio primarily holds a diversified mix of Canadian, U.S. and global equities and is suitable for investors who plan to invest for the long term.

Aggressive Growth

Asset class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0-15%	2.0%	2.0%
Fixed Income	0%	0-15%	0.0%	0.0%
Total Cash & Fixed Income	2%	0-17%	2.0%	2.0%
Canadian Equities	29%	19-39%	28.8%	28.8%
U.S. Equities	38%	28-48%	37.8%	37.8%
International Equities	20%	10-30%	20.7%	20.7%
Emerging Markets	11%	1-21%	10.7%	10.7%
Total Equities	98%	83-100%	98.0%	98.0%

	Return	Volatility
40-year average	8.9%	12.0%
Last 12 months	14.3%	12.3%

Aggressive Growth investors seek maximum long-term growth over capital preservation and regular income, and are comfortable with significant fluctuations in the value of their investments. The portfolio is almost entirely invested in stocks and emphasizes exposure to global equities. This investment profile is suitable only for investors with a high risk tolerance and who plan to hold their investments for the long term.

Capital markets performance

Milos Vukovic, MBA, CFA
V.P. & Head of Investment Policy
RBC Global Asset Management Inc.

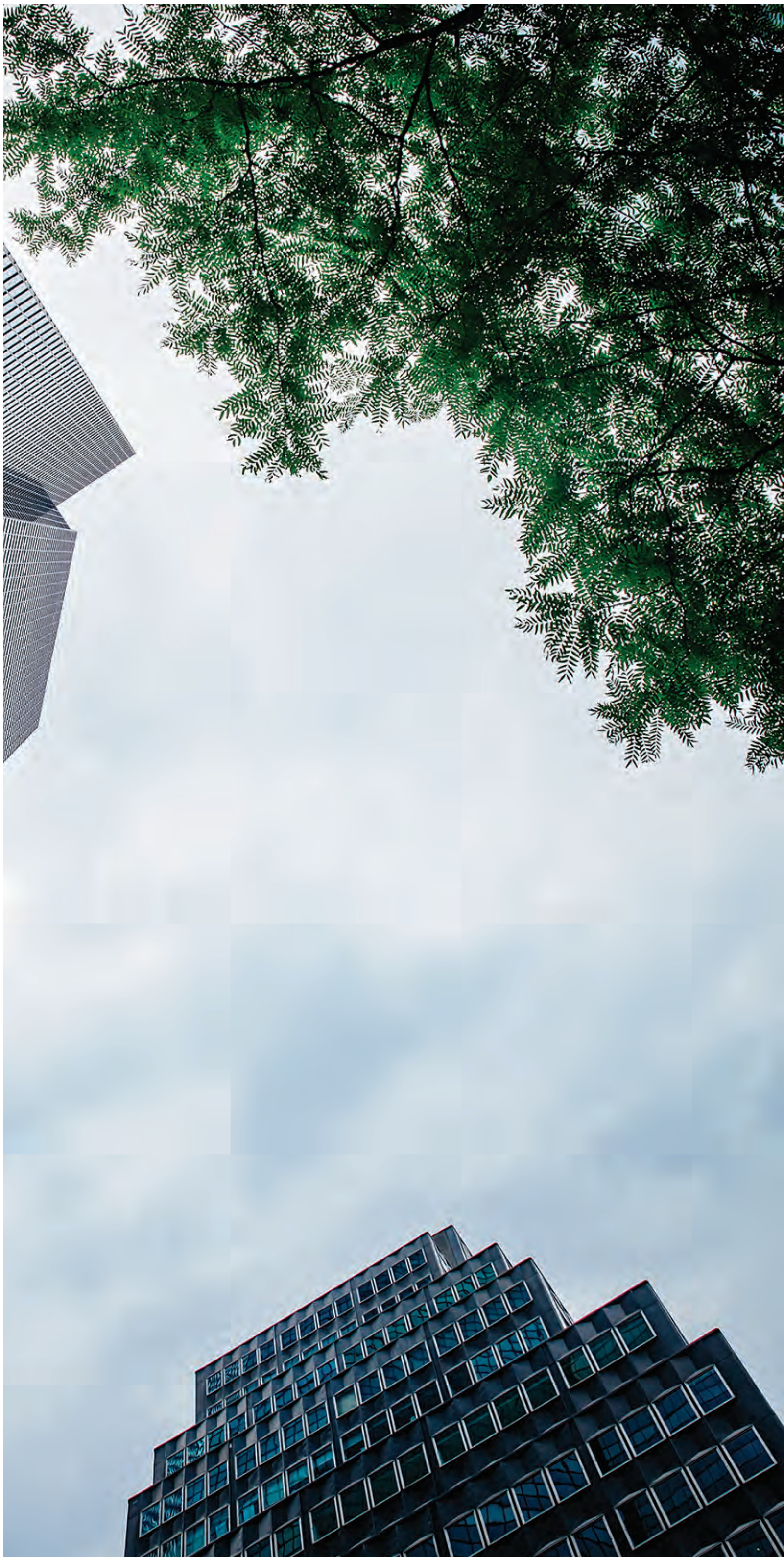
Aaron Ma, MBA, CFA
Senior Analyst, Investment Strategy
RBC Global Asset Management Inc.

The U.S. dollar depreciated against the British pound, euro and Canadian dollar but appreciated against the Japanese yen in the quarter ended August 31, 2023. The overvalued greenback was weakened by vulnerability in the American banking sector, credit-rating downgrades and the country's growing twin deficits. The U.S. dollar declined 1.8% against sterling, 1.4% against the euro and 0.5% against the loonie. The British pound and the euro were supported by hawkish central banks in the U.K. and Europe, which have further to go on interest-rate increases to cool rapid inflation. The Canadian dollar was helped by stronger oil prices and better U.S. economic data. The yen was the notable exception to the overall decline for the U.S. dollar, which gained 4.4% versus the Japanese currency. The U.S. interest-rate advantage stayed wide as the Bank of Japan (BOJ) remained committed to a seven-year-old policy that has held Japanese interest rates near zero. Over the one-year period, the U.S. dollar was up 4.7% against the yen and 2.9% against the loonie but down 8.3% against sterling and 7.3% against the euro.

Major fixed-income markets experienced losses in the latest quarter in U.S.-dollar terms as bond yields rose across the key regions. During the period, central banks remained determined to bring down inflation to their targets, economic activity proved resilient, the BOJ relaxed its cap on interest rates, the U.S. credit rating was downgraded by Fitch and the U.S. Treasury announced increased debt issuance. As a result, the yield on the U.S. 10-year Treasury bond climbed to 4.33% during the quarter, its highest level since before the 2008/2009 global financial crisis. The FTSE World Government Bond Index (WGBI) outperformed with a 0.5% decline followed by the 1.1% decline in U.S. bonds recorded by the Barclays Capital Aggregate Bond Index and the FTSE US Government Bond Index. The FTSE Japanese Government Bond Index and the FTSE European Government Bond Index had the worst declines, falling 7.2% and 7.0%. Over the 12-month period, all major fixed-income benchmarks recorded losses except for the FTSE WGBI, which was essentially flat. The FTSE European Government Bond Index's 9.6% drop and the 9.3% decline in the FTSE Japanese Government Bond Index were the worst in U.S.-dollar terms.

Global equity markets continued their ascent over the quarter as inflation moderated, economic activity remained surprisingly buoyant and developed-market central banks appeared to be approaching the end of their interest-rate hiking campaigns. Returns for the broad indexes in U.S.-dollars ranged from 3.1% for the MSCI UK Index to 8.3% for the S&P 500 Index, with most major overseas markets in the 3%-5% range. Although European stocks outperformed in late 2022 and early 2023, they lagged in the latest quarter due to slowing economic activity on the continent, with Germany's economy contracting for two straight quarters. Likewise, China's economy stalled due in part to a deepening real estate crisis after optimism faded that last year's lifting of pandemic restrictions would spur growth in the country. The "Magnificent 7," a group of U.S. mega-cap technology stocks deemed the leaders in artificial-intelligence technology, helped to drive the outperformance of the S&P 500 as they account for over a quarter of the index's market capitalization. Over the one-year period, the MSCI Emerging Markets Index's 1.3% gain was the worst return and the MSCI Germany Index's 31.4% return was the best, both in U.S.-dollar terms.

Stocks of U.S. companies of all sizes delivered solid returns in the latest quarter, with the mid-cap S&P 400 Index performing best at 10.4%. The Russell 3000 Growth Index outperformed with a 9.3% return, versus 7.6% for the Russell 3000 Value Index. All global equity sectors but one posted a gain in the quarter. The Energy sector led the way with a 15.4% return on a significant rebound in the price of oil, and the Utilities sector declined 1.4% because of its sensitivity to higher interest rates. Over a one-year time frame, Information Technology was the best performing sector with a 29.5% return, while Real Estate was the worst with a 7.6% loss.



Exchange rates
Periods ending August 31, 2023

	Current USD	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
USD–CAD	1.3512	(0.46)	(0.21)	2.88	1.18	0.70
USD–EUR	0.9222	(1.42)	(1.28)	(7.32)	3.24	1.37
USD–GBP	0.7894	(1.80)	(4.57)	(8.30)	1.81	0.46
USD–JPY	145.4950	4.43	10.86	4.73	11.16	5.54

Note: all changes above are expressed in US dollar terms

Canada fixed income markets
Periods ending August 31, 2023

	USD					CAD		
Fixed income markets: Total return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
FTSE Canada Univ. Bond Index TR	(0.79)	1.40	(2.07)	(5.32)	(0.31)	(1.25)	0.76	(4.20)

U.S. fixed income markets
Periods ending August 31, 2023

	USD					CAD		
Fixed income markets: Total return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
FTSE U.S. Government TR	(1.05)	1.41	(1.24)	(4.47)	0.49	(1.51)	1.60	(3.34)
BBg U.S. Agg. Bond Index TR[1]	(1.06)	1.37	(1.19)	(4.41)	0.49	(1.52)	1.65	(3.28)

Global fixed income markets
Periods ending August 31, 2023

	USD					CAD		
Fixed income markets: Total return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
FTSE WGBI TR	(0.48)	1.49	0.22	(6.58)	(1.37)	(0.94)	3.11	(5.48)
FTSE European Government TR	(7.03)	(9.06)	(9.64)	(13.60)	(5.91)	(7.46)	(10.28)	(13.61)
FTSE Japanese Government TR	(7.23)	(9.49)	(9.34)	(12.60)	(6.48)	(7.66)	(10.08)	(12.64)

Canada equity markets
Periods ending August 31, 2023

	USD					CAD		
Equity markets: Total return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
S&P/TSX Composite	5.05	7.16	5.45	9.07	7.06	4.57	8.49	10.36
S&P/TSX 60	4.75	6.65	4.95	9.23	7.42	4.26	7.97	10.52
S&P/TSX Small Cap	5.81	4.57	2.17	9.00	3.96	5.31	5.11	10.29

U.S. equity markets
Periods ending August 31, 2023

	USD					CAD		
Equity markets: Total return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
S&P 500 TR	8.28	18.73	15.94	10.52	11.12	7.78	19.29	11.83
S&P 400 TR	10.38	10.06	10.71	12.83	6.97	9.86	13.84	14.15
S&P 600 TR	9.47	7.24	5.53	12.61	3.82	8.96	3.23	12.04
Russell 3000 Value TR	7.59	5.83	8.21	11.71	6.83	7.09	11.27	13.02
Russell 3000 Growth TR	9.35	30.97	21.03	7.89	13.04	8.84	24.45	9.15
NASDAQ Composite Index TR	8.72	34.88	19.85	6.85	12.58	8.22	23.30	8.12

Note: All rates of return presented for periods longer than 1 year are annualized. [1] Bloomberg U.S. Agg. Bond Index TR. Source: RBC GAM

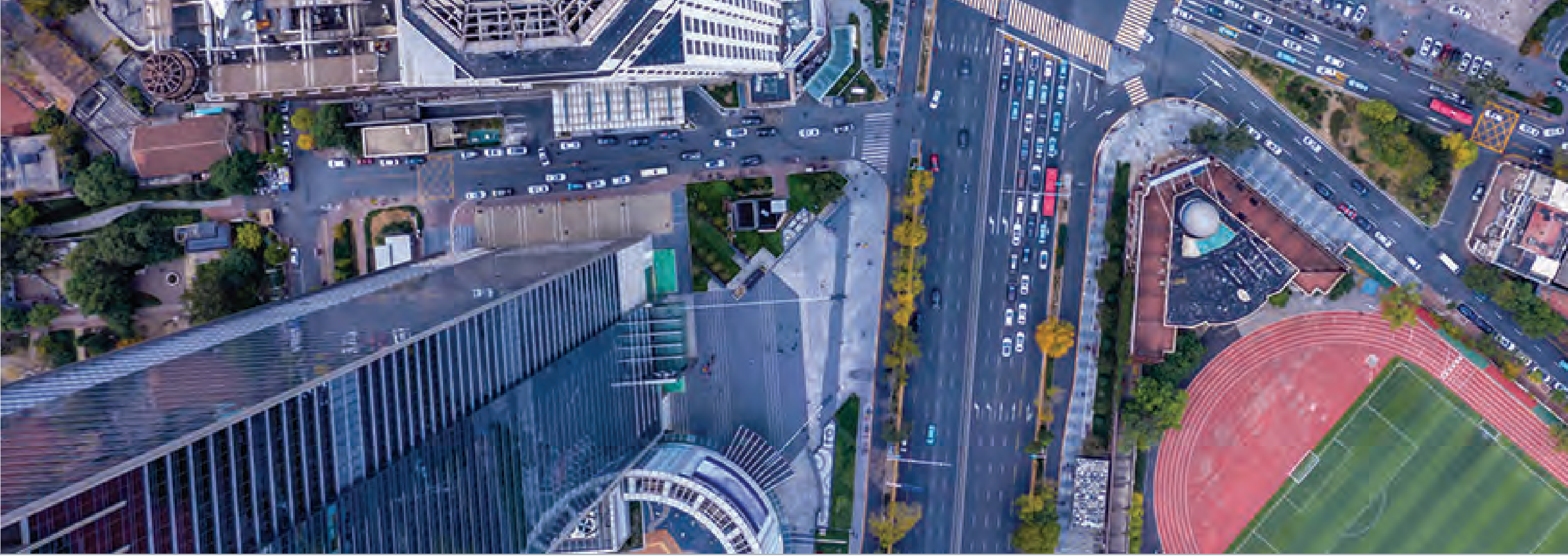
Global equity markets
Periods ending August 31, 2023

	USD					CAD		
Equity markets: Total return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
MSCI World TR *	6.99	16.11	15.60	8.41	8.33	6.49	19.43	9.78
MSCI EAFE TR *	3.80	10.87	17.92	6.05	4.14	3.31	21.82	7.39
MSCI Europe TR *	3.72	12.43	22.51	7.47	4.88	3.23	26.56	8.83
MSCI Pacific TR *	3.89	8.12	10.49	3.61	2.86	3.41	14.15	4.92
MSCI UK TR *	3.12	7.67	14.82	10.49	3.39	2.64	18.62	11.89
MSCI France TR *	4.70	16.21	29.83	11.41	6.25	4.21	34.13	12.82
MSCI Germany TR *	3.27	15.62	31.37	0.74	1.15	2.79	35.72	2.01
MSCI Japan TR *	4.64	13.59	15.30	3.88	3.11	4.15	19.11	5.19
MSCI Emerging Markets TR *	3.47	4.55	1.25	(1.39)	0.98	2.98	4.60	(0.14)

Global equity sectors
Periods ending August 31, 2023

	USD					CAD		
Sector: Total return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
Energy TR *	15.37	4.11	12.78	32.46	5.57	14.83	16.51	34.13
Materials TR *	8.17	5.99	13.95	8.13	7.15	7.66	17.72	9.50
Industrials TR *	8.81	14.01	20.53	9.77	6.96	8.30	24.52	11.16
Consumer discretionary TR *	10.27	28.53	14.08	4.21	8.46	9.75	17.85	5.53
Consumer staples TR *	1.61	2.21	5.27	4.45	6.06	1.14	8.75	5.77
Health care TR *	3.71	1.30	10.09	6.54	8.21	3.23	13.74	7.89
Financials TR *	8.12	4.84	11.46	12.15	4.70	7.62	15.15	13.56
Information technology TR *	6.98	39.93	29.53	10.68	16.94	6.48	33.82	12.08
Communication services TR*	7.48	35.45	19.97	2.23	7.83	6.98	23.94	3.52
Utilities TR *	(1.42)	(3.88)	(5.59)	3.04	5.27	(1.88)	(2.46)	4.34
Real estate TR *	3.26	0.35	(7.63)	0.66	1.02	2.78	(4.58)	1.93

* Net of taxes. Note: all rates of return presented for periods longer than 1 year are annualized. Source: Bloomberg/MSCI



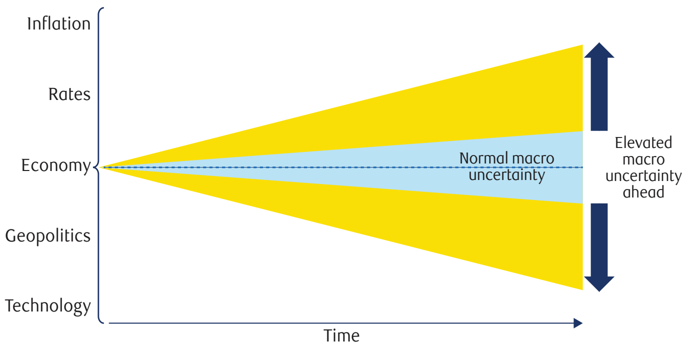
Economic outlook
Where's the recession?

Eric Lascelles
Chief Economist
RBC Global Asset Management Inc.

We remain in a period of elevated uncertainty. Not to the absurd degree of 2020 when a pandemic took over the world for the first time in a century, nor to the extent of 2022, when inflation exploded amid booming demand and a supply-chain crunch. But even absent those extraordinary forces, uncertainty is still high today. There are a variety of plausible directions for inflation, interest rates, the economy, geopolitics and even the rate of technological advancement from here (Exhibit 1). As a result, no guarantees can be made in good conscience with regard to the path forward for these key macroeconomic variables.

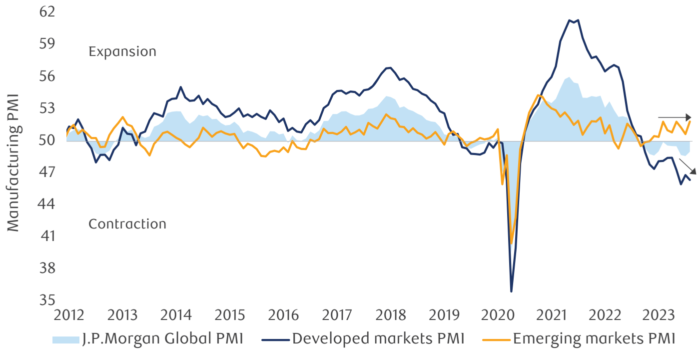
However, among several viable scenarios, a near-term recession remains most likely. This is mainly because rate hikes have been sufficiently large to induce the expected contraction. History also supports this argument: a number of key signals have been tripped that are consistent with a coming recession. There are also now ripples of economic stress forming. Hiring is decelerating, some borrowers are experiencing distress, and manufacturers in the developed world report worsening conditions (Exhibit 2).

Exhibit 1: Unusually high macro uncertainty right now



Note: As at 06/02/2023. Source: RBC GAM

Exhibit 2: U.S. housing metrics show signs of softening



Note: As of Aug 2023. PMI refers to Purchasing Managers Index for manufacturing sector, a measure for economic activity. Source: Haver Analytics, RBC GAM

As a result, we continue to maintain an asset allocation that, while technically neutral, is in practice considerably below the usual degree of risk-taking deployed. This is to say, the recommended equity allocation is lower than the norm, while the fixed-income allocation is higher. Motivating this, the risk premium available in the stock market is smaller than usual relative to bonds, and we anticipate equity underperformance during the year ahead. Patience is advisable: contrary to the popular imagination, the recession and its assorted implications are not actually behind schedule.

Growth survives, for now

Most economies continued to expand across the first three quarters of 2023. In attempting to understand this resilience, a key aspect is surely that a number of serious problems have become less concerning over the past several quarters.

Prominently, inflation isn't nearly as high as it once was, diminishing its direct corrosive effect on growth. Providing particular assistance, energy prices, for both oil and natural gas, are much lower than they were at the onset of the Ukraine war.

Supply-chain problems were already improving a year ago, but have now completely normalized in many sectors.

China was substantially locked down last year, whereas today it is not.

Banking stress in the U.S. has also eased since the spring, though it has not completely normalized (Exhibit 3).

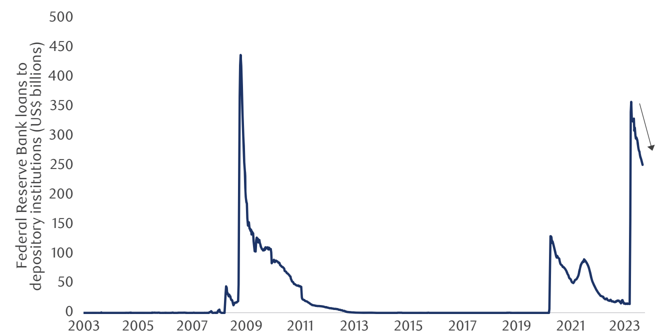
The U.S. fiscal environment has become more supportive as the uptake for previously announced government initiatives exceeds expectations (Exhibit 4). There has been a particular boom in the construction of manufacturing facilities, primarily for the electronics industry (Exhibit 5).

The North American housing market also rebounded in the spring after a difficult prior year.

Finally, the stock market and risk assets have been stronger – a reflection of these developments, but also a boost to consumer spending via a positive wealth effect.

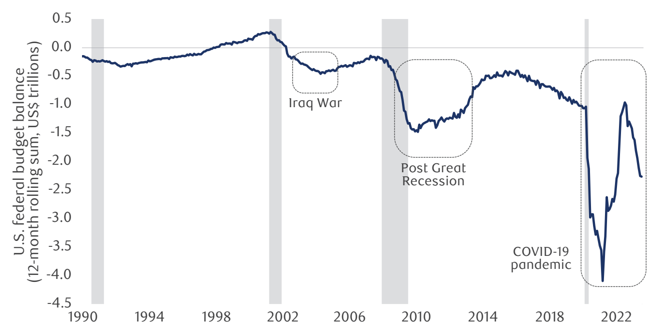
It is therefore fair to say that the macro situation on quite a number of fronts is less perilous than it was a year ago.

Exhibit 3: Emergency lending to banks by Fed starting to decline



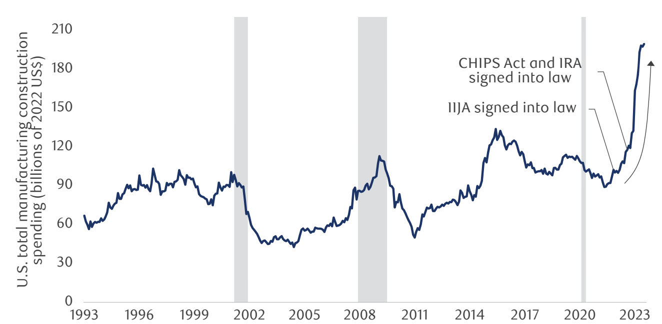
Note: As of the week ending 08/30/2023. Source: Federal Reserve Bank, Macrobond, RBC GAM

Exhibit 4: U.S. fiscal deficit has expanded again



Note: As of Jul 2023. Source: Macrobond, RBC GAM

Exhibit 5 : U.S. spending on manufacturing construction soared due to legislative support



Note: As of Jul 2023. Total private manufacturing construction spending deflated by Producer Price Index for Intermediate Demand, Materials and Components for Construction. Shaded area represents recession. Source: Census Bureau, BLS, Macrobond, RBC GAM

But headwinds still dominate

However, a few big things have not gone according to plan and/or constitute sizeable headwinds, and these are at least as important as the raft of good news.

Prominently, while China has reopened, its economy is nevertheless struggling significantly. China normally generates more than a quarter of global economic growth, so this misfire is quite problematic.

But most importantly, and constituting a more than offsetting counterpoint to the earlier list of happy trends, interest rates have continued to rise and are now quite high by the standards of the 21st century. This represents a major economic headwind, and one that has traditionally proven sufficient to bring on a recession all by itself.

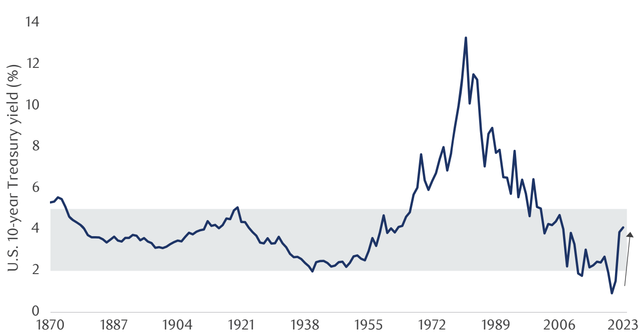
Not only have many developed-world central banks tacked on about half percentage point of additional rate hikes relative to their prior plans last spring, but bond yields have increased by even more for other reasons. The term premium has increased palpably due to a combination of quantitative tightening, persistently large fiscal deficits, especially heavy bond issuance in the U.S. following the debt-ceiling showdown, the U.S. debt downgrade, rising Japanese bond yields (which attract capital from other sovereign-debt markets) and even China's efforts to defend its currency (which involve selling foreign bonds to buy Chinese assets).

Interest rates have now increased to the point that they have gone from being extraordinarily low to fairly high, even when examined through a multi-century lens (Exhibit 6). Higher interest rates impede economic growth by increasing the cost of borrowing, discouraging investments and reducing financial-market valuations.

Furthermore, and crucially, there is a significant lag between the moment when interest rates rise and the peak damage that they inflict on the economy. Our own large-scale econometric model argues that the drag from higher rates is continuing to mount. Historically, the lag from a first U.S. rate hike to recession has averaged around two years, and a key literature review encapsulating 67 studies finds that the average transmission lag from monetary policy to inflation is a whopping two to four years. For context, it has been less than two years since most developed-world central banks began their tightening campaigns. Thus, the window for a recession is far from closing. At a minimum, it is still open, and one could even argue that it is just beginning to open.

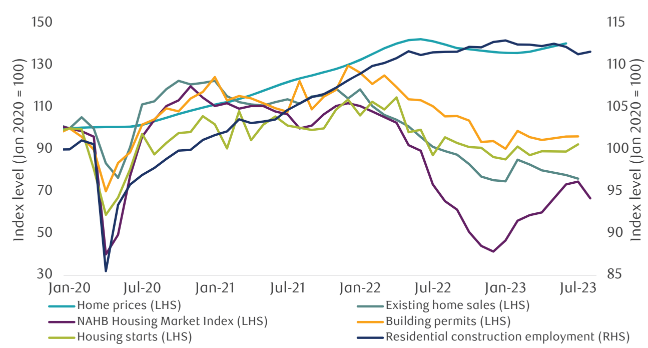
There is evidence of some tentative economic weakness in a range of countries. This trend is more visible in countries such as Germany and the U.K. But even the U.S. evinces a bit of tentative wilting. After a spring resurgence, U.S. housing – the most interest-rate sensitive sector of an economy – is beginning to cool again (Exhibit 7). It is not a coincidence that the U.S. 30-year mortgage rate is now above 7%.

Exhibit 6: U.S. 10-year Treasury yields are approaching the upper bound of normal range



Note: As of 08/31/2023. Source: RBC CM, RBC GAM

Exhibit 7: U.S. housing metrics show signs of softening



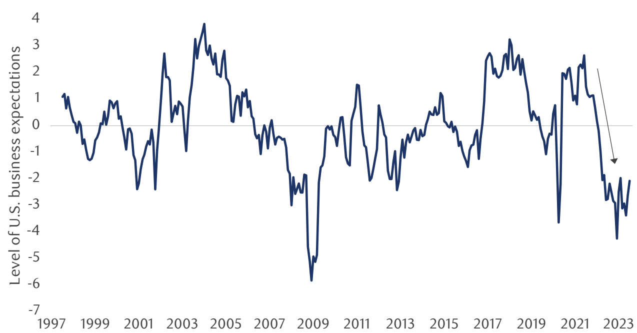
Note: S&P CoreLogic Case-Shiller Home Price Index as of Jun 2023; building permits, housing starts, and existing home sales as of Jul 2023; employment and NAHB HMI as of Aug 2023. Source: BLS, Census Bureau, NAHB, NAR, S&P, Macrobond, RBC GAM

Business expectations remain quite sour and are consistent with contracting demand (Exhibit 8).

Consumers have generally proven more resilient, but points of vulnerability are becoming apparent. Consumer-facing companies including Disney, Foot Locker and Lego are noting softer demand for discretionary purchases. As accumulated pandemic savings wane, credit cards are providing a temporary crutch (Exhibit 9). But the rapid growth in credit-card use cannot be sustained indefinitely. The credit-card delinquency rate is rising significantly and is now at its highest point in over a decade (Exhibit 10). Nearly US$2 trillion of U.S. student loans must start being repaid in October, pinching 44 million Americans.

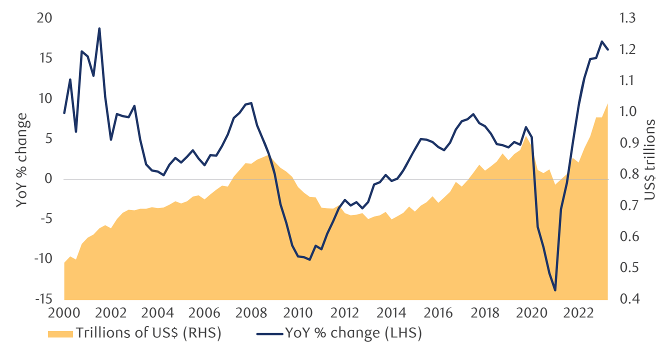
Hiring is also beginning to slow, and temporary employment, a classic leading indicator of the labour market, is in persistent decline (Exhibit 11).

Exhibit 8: U.S. business expectations remain weak



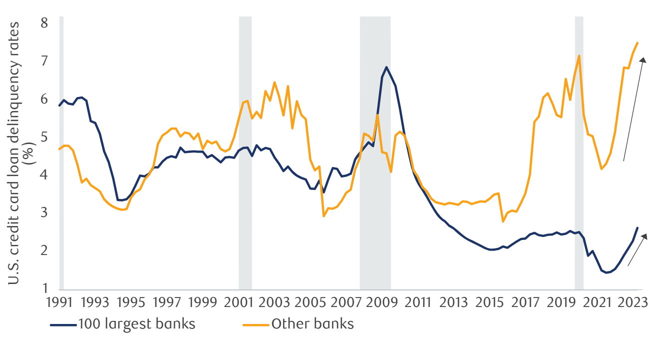
Note: As of Jul 2023. Principal component analysis using NFIB optimism and business conditions outlook, ISM Manufacturing and Services new orders, and The Conference Board CEO expectations for economy. Source: The Conference Board, ISM, NFIB, Macrobond, RBC GAM

Exhibit 9: U.S. credit-card balance is rising rapidly



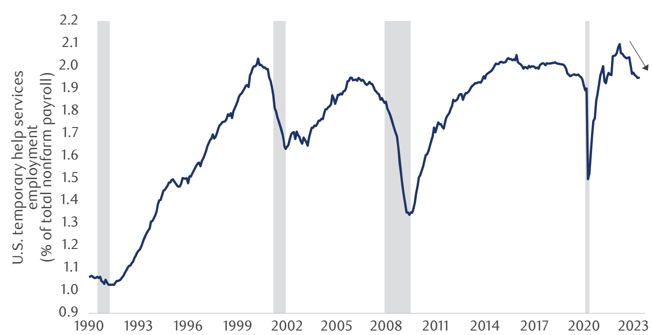
Note: As of Q2 2023. Source: Federal Reserve Bank of New York, Macrobond, RBC GAM

Exhibit 10: Credit-card delinquency rates surging



Note: As of Q2 2023. Shaded area represents recession. Source: Federal Reserve Board, Macrobond, RBC GAM

Exhibit 11: Falling U.S. temporary employment usually leads recession



Note: As of Aug 2023. Shaded area represents recession. Source: BLS, Macrobond, RBC GAM

Recession call tweaked but intact

Calling for a recession is admittedly falling out of fashion, with third-party forecasters assigning a diminishing likelihood for a number of countries (Exhibit 12).

Nevertheless, in light of the economic headwinds that remain, we continue to anticipate a recession spanning most of the developed world. It is not just the cost of borrowing that is rising, but the availability of loans that is falling: Lending standards have tightened, particularly with regard to the willingness of banks to lend to U.S. businesses (Exhibit 13).

Granted, the recession probability we now assign is somewhat lower than in quarters past, with a 65% likelihood for the bellwether U.S. economy, down from 80% before.

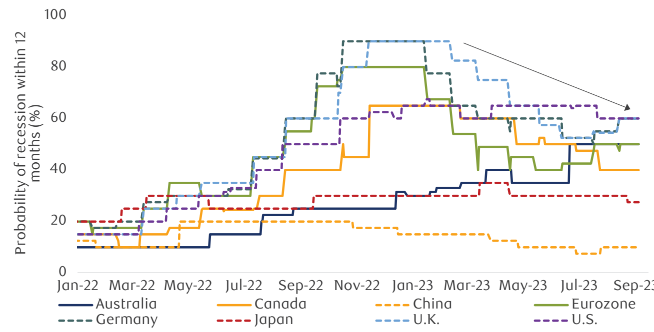
We have pushed back the anticipated onset of the recession to the fourth quarter of this year, with the chance that this drifts further into the future, given the vagaries of recession timing.

But a recession is still likely. The effect of higher interest rates arrives with a considerable, if variable, lag, the window for economic damage remains wide open, and three critical recession criteria in our toolkit continue to be met.

First, our most sophisticated econometric forecasting model continues to anticipate a recession based on the increase in interest rates.

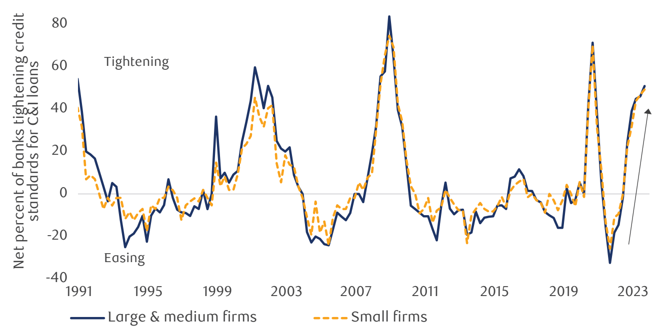
Second, our collection of recession heuristics – rules of thumb that have previously anticipated recessions – continues to indicate that a recession is more likely than not (Exhibit 14). These signals include an inverted yield curve and a large inflation spike.

Exhibit 12: Probability of recession for some countries has come down



Note: As of 09/04/2023. Median probability of recession based on latest forecasts submitted to surveys conducted by Bloomberg. Source: Bloomberg, RBC GAM

Exhibit 13: U.S. business-lending standards tightening



Note: July 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices. Source: Federal Reserve Board, Macrobond, RBC GAM

Exhibit 14: Recession signals point mostly to "yes" or "likely": we estimate 65% chance over the next year

Signal	Indicating U.S. recession?
2yr-10yr curve inverts	Yes
3m-10yr curve inverts	Yes
Fed short-term curve inverts	Yes
Inflation spike	Yes
Duncan leading indicator falls	Yes
Financial conditions tighten	Yes
Monetary tightening cycle	Likely
Google "recession" news trend	Maybe
RBC GAM recession model	Maybe
Oil price spike	Maybe
Jobless claims jump	Maybe
Unemployment increase	No, but trending sideways

Note: As at 07/24/2023. Analysis for U.S. economy. Source: RBC GAM

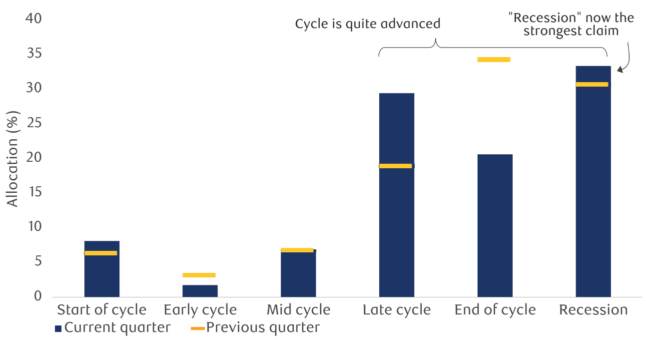
Finally, our business-cycle scorecard postulates with increasing conviction that this is quite a late point in the business cycle, to the point of now being consistent with an imminent recession (Exhibit 15). At a bare minimum, the economy is looking sclerotic and fragile, where just a few years ago it was young and vibrant.

Any recession that arrives can probably be fairly mild in depth, short in duration, and followed by a solid multi-year recovery (Exhibit 16). Job losses should be more muted than the average recession given the difficulty many businesses had securing sufficient workers in recent years.

Updated growth forecasts

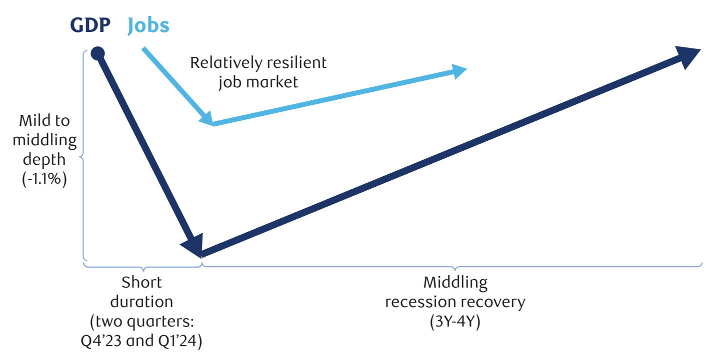
Our GDP growth forecasts have mostly been upgraded for 2023 and downgraded for 2024. This primarily reflects the continued resilience of economic growth across the summer of 2023, paired with the deferment of the anticipated recession onset from the third quarter of 2023 to the fourth quarter (Exhibit 17).

Exhibit 15: U.S. business-cycle score



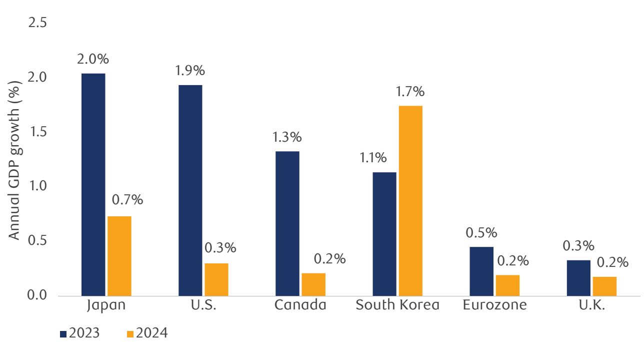
Note: As at 07/28/2023. Calculated via scorecard technique by RBC GAM. Source: RBC GAM

Exhibit 16: Recession is likely to be mild and short



Note: As at 07/19/2023. Source: RBC GAM

Exhibit 17: RBC GAM GDP forecast for developed markets



Note: As of 08/24/2023. Source: RBC GAM

> "Our GDP growth forecasts have mostly been upgraded for 2023 and downgraded for 2024."

The story is somewhat more varied for emerging-market countries. The Chinese outlook for 2023 was downgraded in response to further economic woes, whereas most other countries enjoyed the same upgrade as developed nations. Growth forecasts have been pared in many emerging markets, reflecting spillover effects from the anticipated recession in the developed world. India is set to be the fastest growing country among those we forecast in both 2023 and 2024 (Exhibit 18).

Even after these adjustments, we retain mostly below-consensus growth forecasts for 2024, paired with below-consensus inflation forecasts (Exhibit 19). This helps to explain our more cautious stock-market positioning and more favourable fixed-income stance relative to the past decade.

The U.S. economy is less rate-sensitive than most due to a combination of household deleveraging over the past 15 years and unusually long mortgage terms. This puts it in relatively good stead versus most countries, and indeed informs an expected slight outperformance in both 2023 and 2024 relative to peers such as the eurozone, the U.K. and Canada.

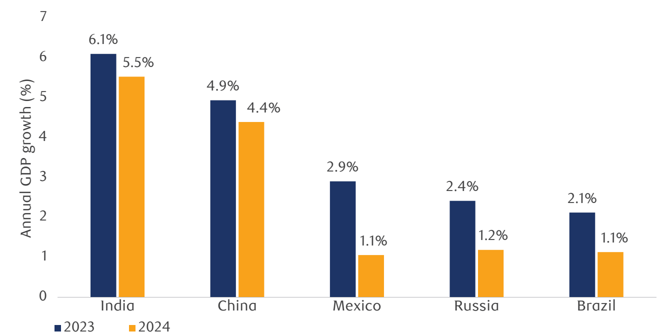
But this advantage must not be overstated. In the U.S., some of the economic pain from higher rates has simply shifted from the sheltered American mortgage holders to the parties that made those now below-market loans. It is not entirely a coincidence that U.S. banks have experienced more stress than other financial systems this year. The U.S. also faces the challenge of a large quantity of student loan debt for which payments soon recommence.

Canada and the U.S. enjoyed larger-than-average growth upgrades for 2023 for an additional reason: immigration is running unexpectedly strongly in both countries, adding to the economy's capacity and to its demand.

Conversely, the U.K. economy remains challenged due to especially high inflation that has demanded additional monetary tightening, plus the chronic economic ache resulting from Brexit adjustments and particularly high levels of labour discontent.

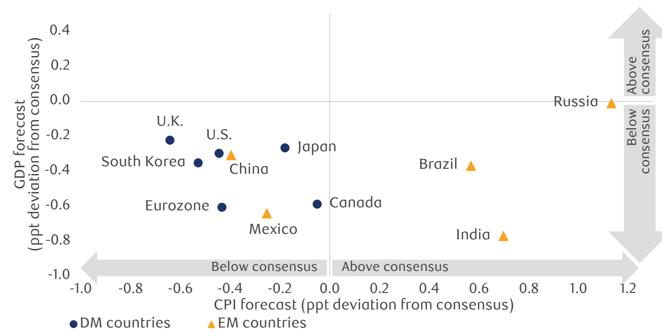
The eurozone shares some common challenges with the U.K. such as lost access to Russian energy that is depressing activity to a greater extent than in North America (Exhibit 20).

Exhibit 18: RBC GAM GDP forecast for emerging markets



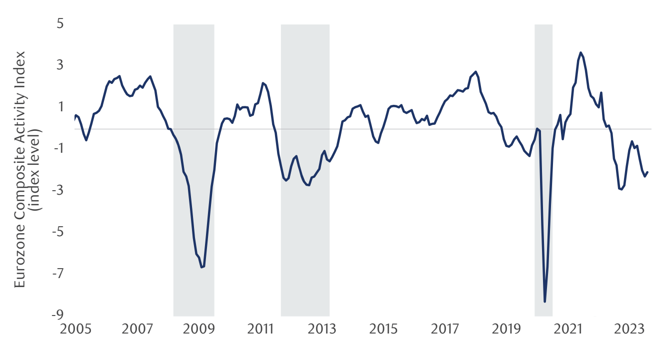
Note: As of 08/24/2023. Source: RBC GAM

Exhibit 19: RBC GAM forecasts vs. consensus for 2024



Note: Deviation measured as difference between RBC GAM forecast (08/24/2023) and consensus forecast (Aug 2023). Source: Consensus Economics, RBC GAM

Exhibit 20: Eurozone economy continues to struggle



Note: As of Aug 2023. Index reflects the first principal component from PCA analysis on select indicators of eurozone economic activity. Shaded area represents recession. Source: CEPR, ZEW, Deutsche Bundesbank, IHS Markit, Macrobond, RBC GAM

Germany has suffered through three consecutive quarters without economic growth, in part due to its greater exposure to a wobbling Chinese economy (Exhibit 21).

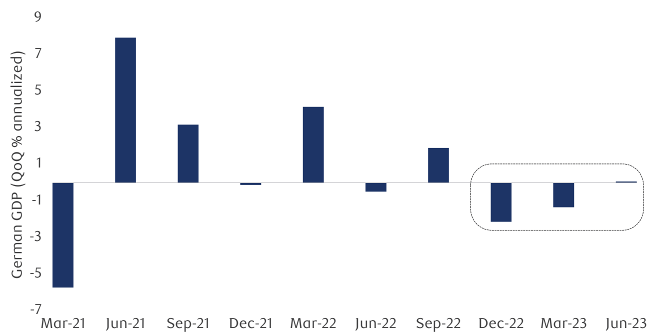
Gazing beyond the next year, a potential economic drag over the medium term for quite a number of countries is the enormous fiscal deficits they continue to run despite some of the lowest unemployment rates in decades (Exhibit 22). These will have to be reduced as the burden of higher interest rates hits debt-servicing costs and as the bond market becomes pickier with regard to who it wishes to fund.

The long-run growth outlook features an assortment of headwinds. These include not just the burden of high public-debt loads, but the effects of a multi-polar world and de-globalization, a challenging demographic environment and the harmful consequences of climate change. On the other hand, we remain hopeful that productivity growth will rise somewhat more quickly than normal, in part due to a range of exciting new technologies. Some of the best positioned countries to harness this wave are those that invest the most in research and development (Exhibit 23).

Inflation improving

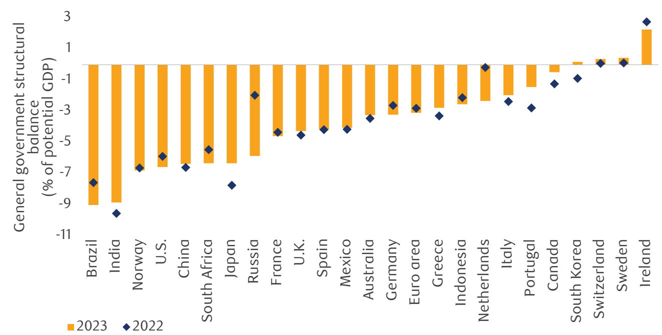
The inflation trend remains favourable. Consumer inflation peaked in the 8%-10% range in the second half of 2022 and has since retreated significantly (Exhibit 24). In the U.S., the annual headline CPI rate has fallen all the way from 9% to 3%.

Exhibit 21: Germany's economy stalls after falling into technical recession



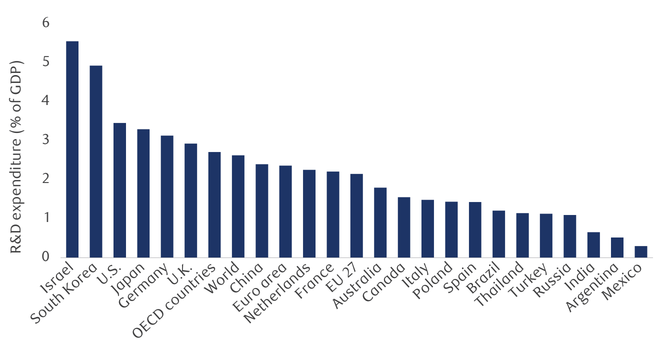
Note: As of Q2 2023. Source: Statistisches Bundesamt, Macrobond, RBC GAM

Exhibit 22: Significant structural fiscal deficits persist



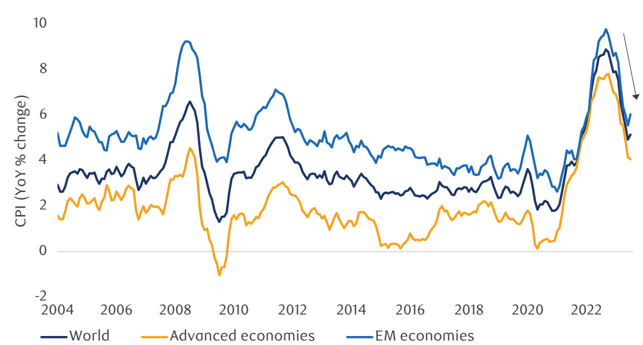
Note: IMF projections for year 2023. Source: IMF WEO, April 2023, Macrobond, RBC GAM

Exhibit 23: R&D has a positive impact on productivity and economic growth



Note: Based on latest data available, ranging from 2018 to 2022. Source: OECD, World Bank, Macrobond, RBG GAM

Exhibit 24: Global inflation has declined while remaining elevated



Note: As of Jul 2023. Source: Haver Analytics, Macrobond, RBC GAM

The four main original drivers of high inflation have all turned around to varying degrees. The commodity shock has been significantly reversed, supply-chain problems have mostly vanished, central banks have pivoted from extreme stimulus to unusual restraint, and fiscal policy has gone from being extraordinarily stimulative to far less so. In short, the supply-and-demand pressures that joined forces to create the biggest inflation problem in more than a generation have mostly normalized, permitting inflation to settle back down. The expected weakening of the global economy should provide additional assistance in taming inflation.

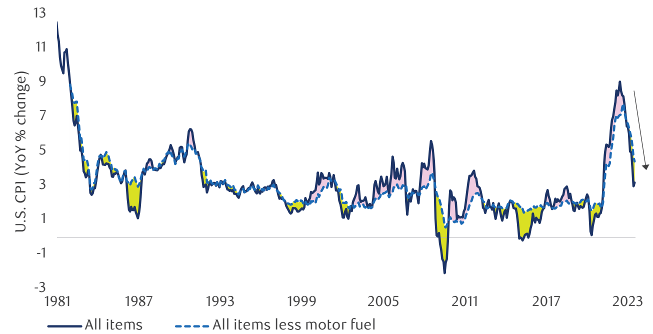
Annual inflation will struggle to improve materially from current levels over the next few months given a recent resurgence in gasoline prices and less friendly base effects (there are no longer big monthly price increases from a year ago falling out of the equation with each release).

It is important to appreciate that while overall consumer inflation has decelerated to just over 3% over the past year, this probably exaggerates the extent of the genuine improvement in inflation on the path toward the 2.0% target. Falling gasoline prices have provided an important but unsustainable helping hand. The U.S. Consumer Price Index (CPI) excluding gasoline is still rising by 4.1% annually (Exhibit 25). Core inflation is still 4.7% year over year and median CPI is still rising at a big 6.1% year over year. Service-sector inflation is also proving sticky (Exhibit 26). There is still work to be done.

But some of the work is unquestionably being done. To illustrate, the three alternate measures of inflation in the previous paragraph have decelerated such that their three-month change at an annualized pace are a more muted 2.6%, 3.1% and 3.8%, respectively. Put differently, inflation may not be within a percentage point of normal as the headline metric claims, but it is probably within two percentage points of normal.

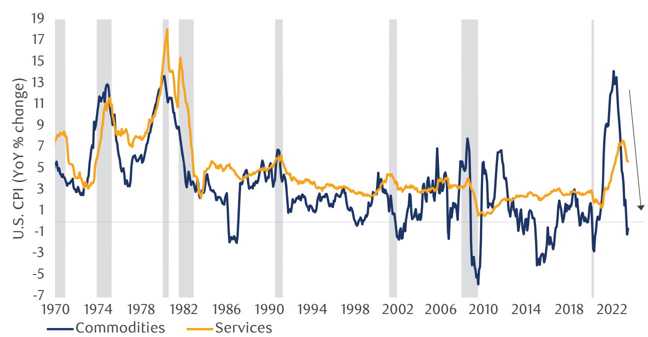
An important metric in gauging the progress made is the breadth of inflation as measured by the extent to which prices are rising quickly across a wide swath of the price basket. This has shown heroic improvement in recent months (Exhibit 27). Putting this into numbers, the portion of the U.S. price basket suffering from price increases of 10% per year or greater has plummeted from a third to just 4% today.

Exhibit 25: U.S. gasoline inflation cooled down much faster than for other goods and services



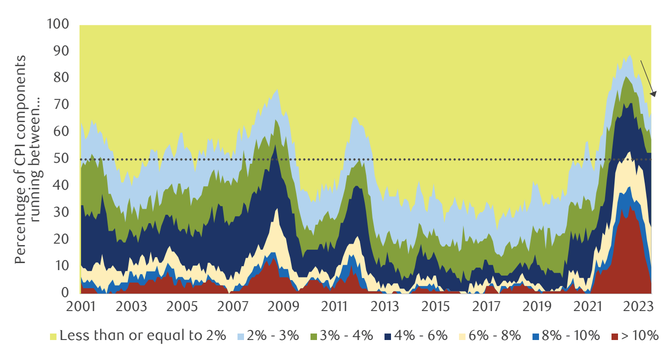
Note: As of Jul 2023. Shaded area represents recession. Source: BLS, Haver Analytics, Macrobond, RBC GAM

Exhibit 26: U.S. goods inflation has declined sharply, services inflation starting to retreat



Note: As of Jul 2023. Shaded area represents recession. Source: BLS, Macrobond, RBC GAM

Exhibit 27: Prices for most items rising more slowly



Note: As of Jul 2023. Share of CPI components with year-over-year % change falling within the ranges specified. Source: Haver Analytics, RBC GAM

Shelter inflation famously moves with a long lag and is finally beginning to ease. Food inflation is also slowing, though we flag upside risks that include the possibility that it will become harder to access Ukrainian agricultural exports now that Russia has abandoned an earlier Black Sea pact, paired with extreme heat in recent months and an El Nino weather pattern in the months ahead.

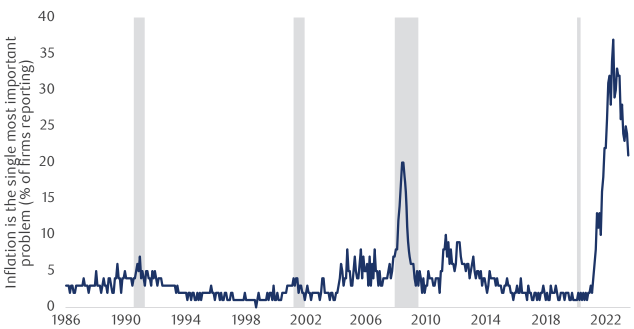
Promisingly, small businesses report a diminishing level of concern about inflation, though attitudes are not yet entirely back to normal (Exhibit 28). Businesses report that they're again considering moderate price increases after a lull, casting some doubt over whether inflation can completely normalize in the near term (Exhibit 29).

Ultimately, we remain optimistic on the inflation outlook. We believe inflation can fall incrementally more quickly than expected by financial markets, achieving readings mostly just above the 2.0% target next year (Exhibit 30). We believe U.K. inflation may continue to run somewhat hotter than elsewhere, in part because wage growth there continues to accelerate in contrast to downward trends in most other countries (Exhibit 31).

Central banks near sustained peak

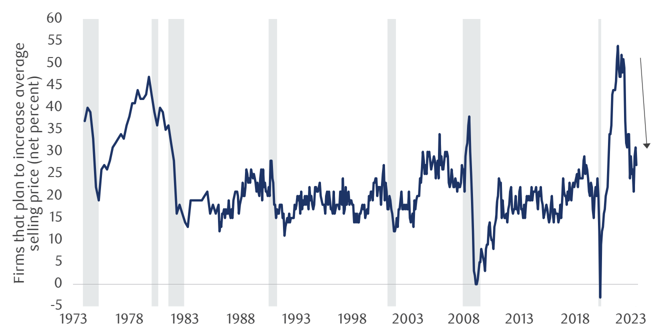
Central bankers have delivered the most aggressive monetary tightening in decades over the past two years (Exhibit 32). In the process, monetary policy has pivoted from extreme stimulus to substantial restraint.

Exhibit 28: Inflation is one of the biggest problems for small businesses



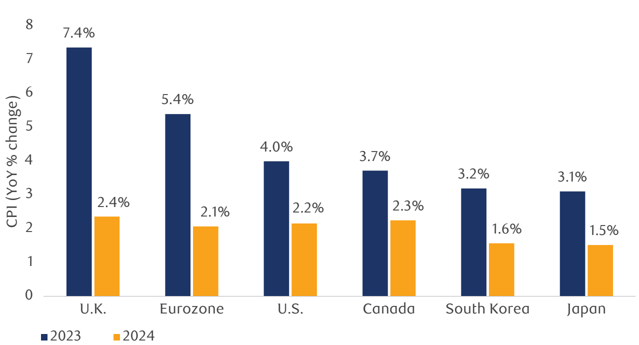
Note: As of Jul 2023. Shaded area represents recession. Source: NFIB Small Business Economic Survey, Macrobond, RBC GAM

Exhibit 29: Fraction of U.S. businesses planning to raise prices has declined



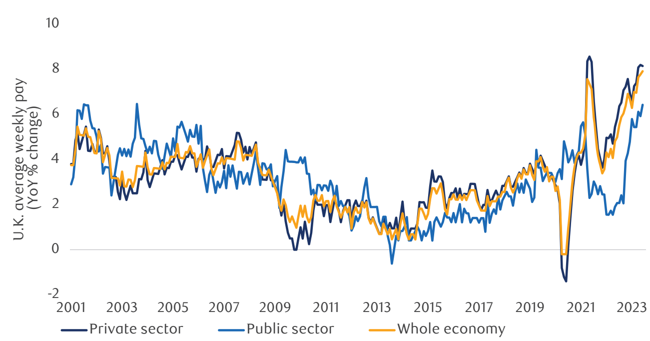
Note: As of Jul 2023. Shaded area represents recession. Source: NFIB Small Business Economic Survey, Macrobond, RBC GAM

Exhibit 30: RBC GAM CPI forecast for developed markets



Note: As of 08/24/2023. Source: RBC GAM

Exhibit 31: U.K. wage growth soaring



Note: As of Jun 2023. Source: U.K. Office of National Statistics, Macrobond, RBC GAM

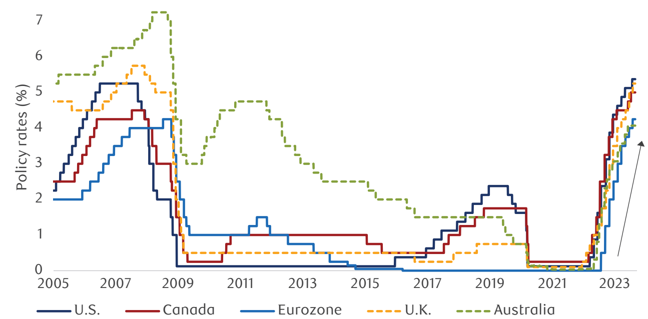
Even as developed-world central banks now near the finish line – some may already be done and several are within a small rate hike or two of completion – the inflation-adjusted fed funds rate will continue to rise as inflation falls (Exhibit 33). Further, and as highlighted earlier, the full economic impact of the rate hikes has not yet been felt given the lags involved.

Emerging-market central banks have acted as bellwethers across this monetary cycle, and some are now pivoting to rate cuts. It is not unreasonable to think that many developed-world central banks will follow suit over the next year, though this does not appear imminent for most based on recent comments from monetary authorities. Developed-world central banks recognize the imprecise impact of rate increases, and the uncertain timing of this effect. Policymakers will therefore be hesitant to reverse course quickly, leading to the conclusion that policy rates could remain elevated for a significant length of time. Lower-than-forecast growth and inflation would presumably motivate rate cuts, but the evidence would have to be decisive to convince central banks that they were not repeating the premature monetary easing that plagued central banks in the 1970s and early 1980s.

The Bank of Japan has belatedly joined the tightening cycle by allowing the country's 10-year yield to rise further (Exhibit 34). The central bank is attempting to limit the already massive depreciation of the yen and appears to believe that inflation has now been high for long enough to jolt economic actors out of their long-standing deflationary mindset.

On August 1, the U.S. sovereign-debt rating was downgraded from AAA to AA+ by Fitch Ratings. This was entirely justified due to the country's large and growing debt load, its ample deficit in the face of low unemployment rates, and a challenging political environment that nearly culminated in a technical default in the spring. The result of the action is that a small risk premium has been added to U.S. bond yields, contributing to the increase in bond yields in recent months. But the U.S. is hardly in a desperate fiscal position, and its debt rating continues to compare favourably with many perfectly viable major nations (Exhibit 35).

Exhibit 32: Central bankers raised policy rates to fight inflation



Note: As of 09/01/2023. Source: Haver Analytics, RBC GAM

Exhibit 33: U.S. real fed funds rate rises quickly as Fed hikes aggressively and inflation falls

Note: As of 08/31/2023. Shaded area represents recession. Source: Federal Reserve Board, Macrobond, RBC GAM

Exhibit 34: BoJ tweaks yield-curve-control policy as inflation rises

Note: As of 09/01/2023. Source: Bloomberg, RBC GAM

Chinese economic woes

After repeated pandemic lockdowns, China's economy was supposed to enjoy a solid economic rebound in 2023. The scenario initially appeared to be happening, but it has since given way to a face plant. Economic data has arrived consistently below consensus expectations (Exhibit 36).

There are several reasons for this weakness. A sizeable part is that Chinese exports are significantly down from a year ago (Exhibit 37). For an economy oriented toward manufacturing and trade, this is bad news. Some of the weakness is the result of more tepid global demand, some reflects a rebalancing of that demand back from goods to services, and some may reflect geopolitical tensions that are motivating many companies to diversify their international production away from China.

Domestic demand within China is also soft. The housing market continues to sputter, with home prices and home sales declining significantly. The housing market was long a bastion of Chinese economic strength. While the softness is welcome in a structural sense – China's economy had become far too reliant on housing, and home prices were bid up to undesirable heights – it is nevertheless proving enormously painful in the short run. The consequences have extended well beyond housing: Chinese consumers are proving stingy, at least in part because the majority of their wealth is tied up in real estate that is now depreciating.

Over the long run, China's economic prospects also look less bright than in decades past. Housing is unlikely to return as the major driver that it once was. The demographic picture is incredibly challenging for the foreseeable future. Geopolitical frictions with the U.S. are likely to cast a chill over China (and, to a lesser extent, the world) for an extended period of time. Finally, from an ideological standpoint, China is drifting away from market forces and back toward top-down control – a potential impediment to productivity growth. Accordingly, we now assume that "normal" annualized economic growth in China is merely 3%-4%, materially less than before the pandemic, let alone earlier decades. Among large nations, India is set to claim the mantle of fastest growing country (Exhibit 38).

Exhibit 35: Global sovereign-debt ratings

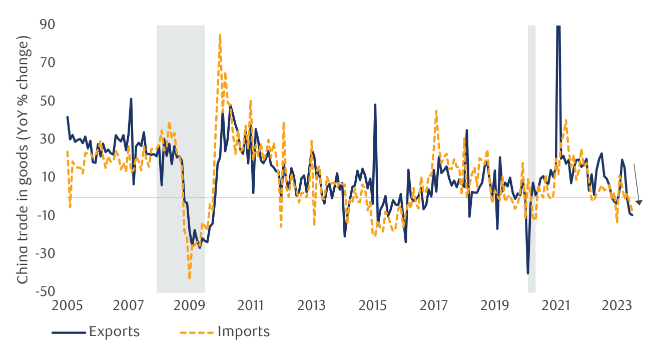
	Sovereign rating		
Country	Moody's	S&P	Fitch
Germany	Aaa	AAA	AAA
Canada	Aaa	AAA	AA+
U.S.	Aaa	AA+	AA+
France	Aa2	AA	AA-
South Korea	Aa2	AA	AA-
U.K.	Aa3	AA	AA-
China	A1	A+	A+
Japan	A1	A+	A
Mexico	Baa2	BBB+	BBB-
Italy	Baa3	BBB	BBB
India	Baa3	BBB-	BBB-
Brazil	Ba2	BB-	BB

Note: As of 08/17/2023. Sovereign ratings for foreign and local currency long-term debt. Source: Fitch Ratings, Moody's Investors Services, S&P Global, Bloomberg, RBC GAM

Exhibit 36: China's reopening boom fizzled

Note: As of 09/01/2023. Source: Citigroup, Bloomberg, RBC GAM

Exhibit 37: Chinese trade falters



Note: As of Jul 2023. Trade in goods in renminbi. Shaded area represents U.S. recession. Source: Macrobond, RBC GAM

But for all of this genuine bad news, pessimism about China is probably overblown right now. Growth averaging 3%-4% still handily outpaces the entirety of the developed world, and the country is so massive that it will remain the largest single contributor to global economic growth for the foreseeable future. Chinese policymakers have also not been entirely idle in response to recent cyclical weakness. Stimulative forces include interest-rate cuts, a weaker currency, loosened rules for the housing market, tax cuts for small businesses and a bailout plan for indebted local governments.

Canada's population boom

The Canadian economy is beginning to slow and remains likely to enter a mild recession in line with its peers. Interest rates have risen sharply in Canada, and the country's high level of interest-rate sensitivity renders it more vulnerable than the U.S.

While Canada's housing market revived somewhat in the spring, we budget for a return to malaise ahead (Exhibit 39). Affordability is somewhat improved from its worst point thanks to falling home prices in 2022, but it is still quite poor relative to pre-pandemic levels, let alone historical norms (Exhibit 40). Past developed-world housing busts have lasted a median 6.6 years, arguing that weakness is likely to persist well into the future.

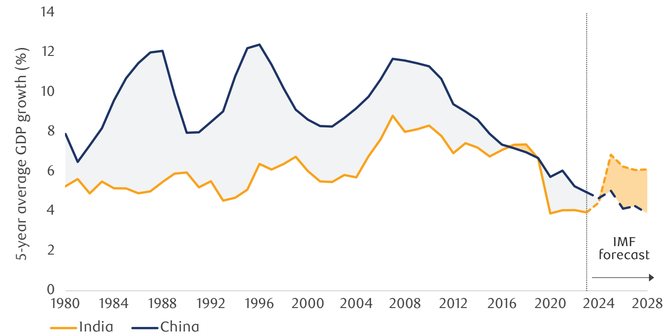
The Canadian economy has also recently been challenged by a series of temporary shocks that include a major port strike on the west coast and a series of major wildfires.

On the other hand, Canada's financial institutions have seemingly side-stepped the problems that recently beset a number of prominent American regional banks.

Furthermore, Canada is experiencing an enormous population boom that has added more than 1 million people over the past year (Exhibit 41). This has thrust the overall population past 40 million, and recent research indicates the true count may be closer to 41 million. The point is that Canada has experienced massive population growth, stoking demand for goods and services and making the economy inclined to grow more quickly.

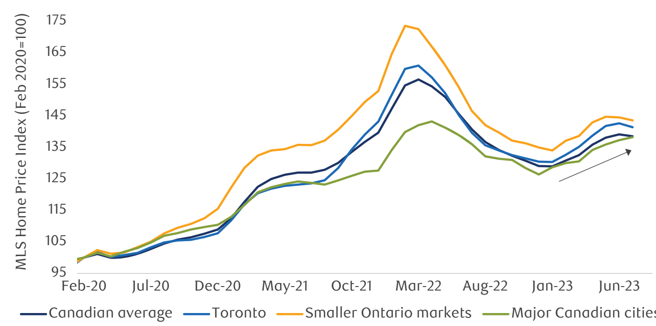
There is a chance this remarkable demographic development prevents Canada from falling into a recession. But we are inclined to believe a recession north of the 49th parallel is still

Exhibit 38: Economic growth: India to outpace China going forward



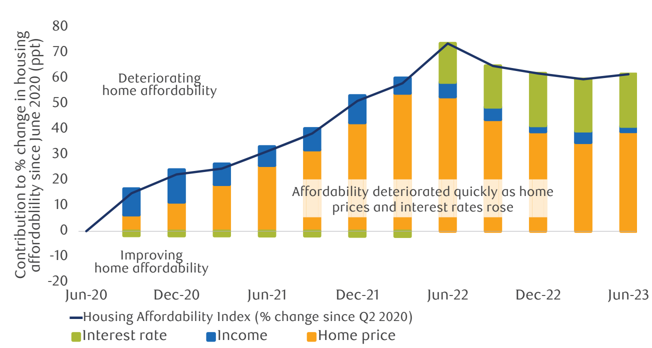
Source: IMF World Economic Outlook, April 2023, Macrobond, RBC GAM

Exhibit 39: Canadian home prices stall again



Note: As of Jul 2023. Source: CREA, Macrobond, RBC GAM

Exhibit 40: Drivers of changing Canadian housing affordability



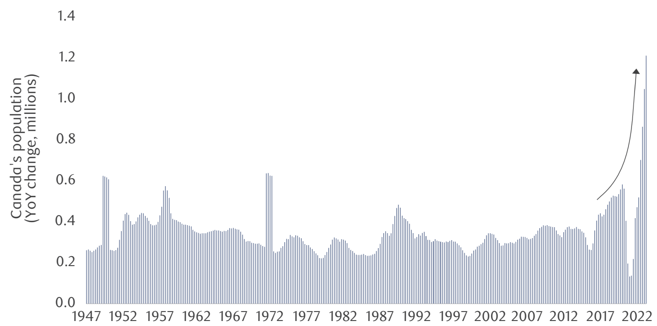
Note: As of Q2 2023. Housing Affordability Index measures the current carrying cost of a home versus the historical norm. Source: Haver Analytics, RBC GAM more likely than not, in part because the population boom should soon slow as the country catches up to its pre-pandemic immigration targets and given that the bulk of foreign students and foreign temporary workers have already returned.

Bottom line

This is a moment in time that demands patience. It is tempting to abandon the longstanding recession call after a year of resilient economic growth and rebounding risk assets. But history shows that recessions usually arrive with a significant lag to monetary tightening, and our recession scorecard and business-cycle scorecard still prophesize a sour outcome. The window thus remains wide open for a recession. Falling inflation is welcome, but it is not yet tame enough to instill central bankers with enough confidence to start cutting interest rates.

As such, we maintain an equity allocation that is technically neutral, but from a practical standpoint is more cautious than at any point in the past decade. This is with an eye to taking advantage of more depressed valuations should a recession arrive. And, in an alternative scenario in which it doesn't, we can take solace in owning fixed-income investments that pay some of the highest yields in decades, and with the potential for capital appreciation in a variety of scenarios.

Exhibit 41: Canada's record population growth fueled by immigration



Note: As of Q2 2023. Source: Statistics Canada, Macrobond, RBC GAM

Market outlook

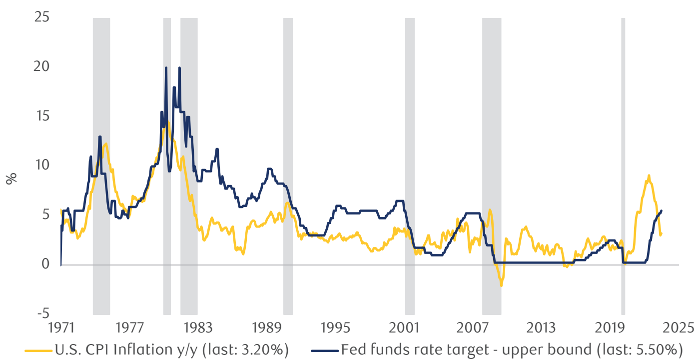
Two-tiered market

Eric Savoie, MBA, CFA, CMT
Investment Strategist
RBC Global Asset Management Inc.

Daniel E. Chornous, CFA
Chief Investment Officer
RBC Global Asset Management Inc.

A little more than three years after the pandemic began, the economy and capital markets have undergone significant change and a variety of economic and financial metrics have reached readings not seen in decades. Unprecedented stimulus delivered by governments and central banks during the pandemic fuelled a surge in inflation to its highest level in 40 years. While price increases were initially deemed transitory, the persistence of rising consumer prices into 2022 led to the most aggressive monetary-tightening cycle since the 1970s. Just 18 months ago, the U.S. federal funds rate was near zero. Now it's at 5.5% and short-term interest rates are at their highest level since the early 2000s (Exhibit 1).

Exhibit 1: U.S. federal funds rate
Target rate – upper bound



Note: As of August 31, 2023. Shaded areas represent U.S. recessions.
Source: Bloomberg, RBC GAM

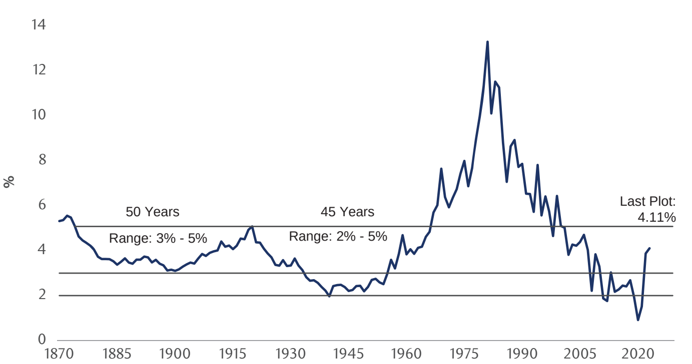
So far, the rapid tightening in monetary conditions appears to be working. Inflation is coming down and although it is not yet at the 2% level targeted by central banks, the meaningful improvement has been a welcome development for investors. After last year's bear market in stocks, risk assets have recovered much of their losses as the economy continued to grow and inflation cooled from extremes. That said, we think it may be premature to conclude that the economy has managed a soft landing or that the window for a recession driven by rising interest rates is closing. In fact, our analysis suggests that the recession window may just now be opening and that the maximum risk to the economy and stocks still lies ahead.

The rise in long-term bond yields over the past few years has made sovereign fixed income particularly appealing. While last year was among the most painful in decades for bond investors, yields on 10-year Treasuries are now near the upper end of their normal range of the past 150 years (Exhibit 2). According to our models, much of the acute valuation risk that had us concerned in 2020 and 2021 has dissipated, particularly given our view that the economy is likely to enter a downturn over our one-year forecast horizon and that inflation pressures will continue to moderate – two factors that are likely to result in lower bond yields and higher bond prices. As a result, we expect sovereign bonds to deliver returns in the mid to high single digits, or even low double digits over the year ahead, depending on the region.

Equities, in our view, offer less upside potential than bonds in the near term and, although stock indexes have performed well so far this year, the bulk of the gains have been delivered by a handful of companies. Emerging trends in artificial intelligence (AI) have propelled the valuations of America's biggest technology stocks – known as the "Magnificent 7" – such that they now make up just over a quarter of the weight in the S&P 500 Index. This group, whose valuations range from hundreds of billions to multi-trillion dollars, is up 70% so far this year accounting for almost three quarters of the S&P 500's 17% gain over the same period. By comparison, the equal-weighted S&P 500, a better representation of how the average stock has performed, is up 5.8% (Exhibit 3). The strong performance of the capitalization-weighted S&P 500 is masking the fact that underlying market breadth has been relatively poor – often a precursor of a meaningful correction in stocks. In this environment, our stock-market return forecasts are consistent with a view that we are late in the economic cycle. We are looking for low-to-mid-single-digit returns for stocks, with relatively worse outcomes from U.S. equities due to their higher valuations and the influence of expensive mega-cap technology names.

Assuming we are correct in our view that the economy will enter recession over the next 12 months, interest rates, bond yields and stock prices could all be closing in on a near-term peak. While there are pathways to a positive outcome if an economic soft landing is achieved, we think the reward for taking excessive risk in this environment is not as appealing as it would have been at earlier points in the cycle. As a result, we have been gradually dialing down the equity overweight position in our asset mix over the past 18 months. We have used those proceeds to narrow our prior underweight in fixed income as rising yields boosted the appeal of sovereign bonds, and current elevated yield levels should provide a better ballast against any downturn in equities. As of last quarter, we had fully closed our tactical risk exposures and are maintaining a neutral stance relative to our benchmark weights again this quarter. For a balanced global investor, we currently recommend an asset mix of 60% equities (strategic neutral position: 60%) and 38% fixed income (strategic neutral position: 38%), with the balance in cash. Actual fund or client portfolio positioning may differ depending on individual investment policies.

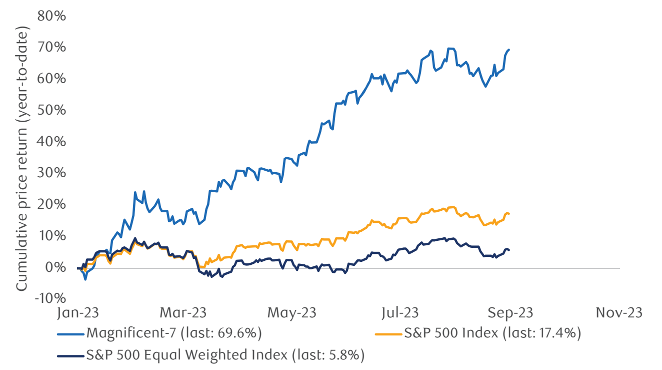
Exhibit 2: U.S. 10-year bond yield



Note: As of August 31, 2023. Source: RBC GAM

Exhibit 3: U.S. equity indices

Cumulative price returns, year-to-date



Note: As of August 31, 2023. Magnificent-7 is a cap-weighted index which includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Source: Bloomberg, RBC GAM

Recession road map

One tool that we have found helpful in assessing where we might be in the context of the broader economic and market cycles is a roadmap of the typical experience for stocks in recessions. Exhibit 4 plots the median of the U.S. equity market's progression through 29 recessions since the late 1880s. T=0 on the chart represents the start of the recession in any given cycle and the chart plots 24 months leading into that point and 48 months afterward. The blue line on the chart indicates that U.S. equities tend to rise into recessions, peaking a median of four months before the economy begins to contract, and troughing a median of eight months after a recession begins.

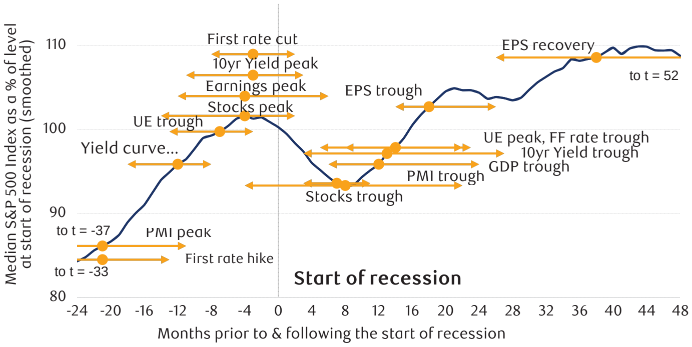
The chart is busy and contains a variety of key milestones that tend to occur leading up to and following recessions. Some of these occur well in advance of economic downturns. Purchasing managers indices (PMIs) tend to peak and short-term interest rates start to rise 21 months before the recession begins, based on the median outcome. The yield curve, based on the spread between 3-month and 10-year Treasury yields, also tends to invert 12 months before a recession. These milestones have all occurred in this cycle, and the timing of each measure lines up relatively closely to what we might expect. PMIs peaked 29 months ago, the first U.S. rate hike was 18 months ago and the yield curve inverted 10 months ago. The unemployment rate troughed seven months ago, close to the median experience of eight months before recession, although it is only marginally off its low. If our forecast for a recession later this year proves correct, then according to this chart, we may be nearing, or could already have seen, a peak in interest rates, yields and stock prices. This scenario suggested by the roadmap is somewhat at odds with the view of many investors that the economy has managed to avoid recession given buoyant consumer spending and a rally in stocks so far this year. A period of heightened market volatility could lie ahead as the economy feels the weight of central-bank efforts to severely tighten monetary conditions over the past 18 months.

Lagged impact from rising rates is beginning to show

After 18 months of monetary tightening and more than 500 basis points of short-term rate hikes, we are beginning to see economic headwinds surface. Bank-lending standards have been become progressively more challenging since mid-2022 and are still tightening at an accelerating pace, exacerbated by the U.S. regional-bank crisis earlier this year (Exhibit 5). As a result, both the availability and demand for credit are reduced, ultimately limiting capital available for consumer spending and business investment.

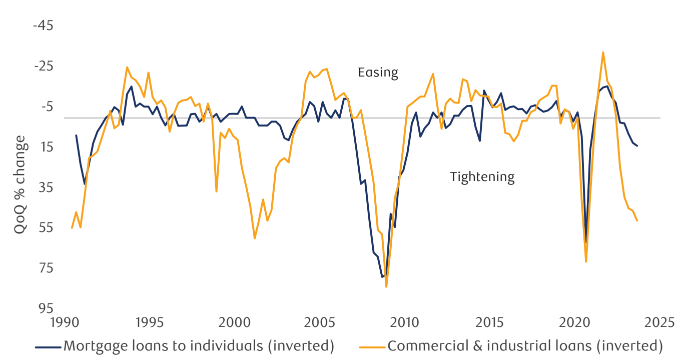
A meaningful tightening of monetary conditions typically effects a slowdown in economic activity and employment growth 12 to 18 months later. We are now seeing this relationship play out as employment growth and PMIs begin to soften following their usual lags to hikes in interest rates (exhibits 6 and 7).

Exhibit 4: S&P 500 and recessions – Median of 29 recessions since 1882



Note: Markers represent median timing and ranges are one standard deviation from the mean. Source: Bloomberg, RBC GAM

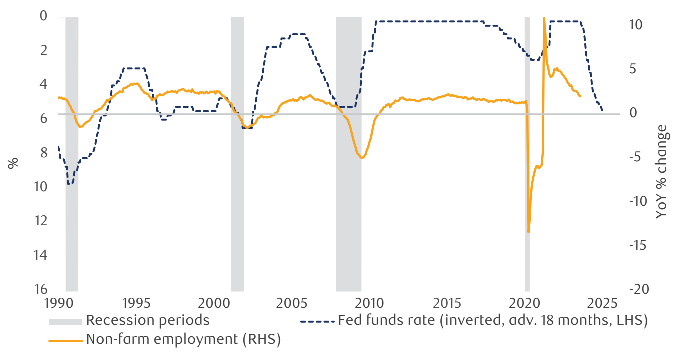
Exhibit 5: Senior loan officer survey on bank lending practices – Loan officers reporting tightening standards



Note: As of Q3 2023. Source: Federal Reserve, Macrobond

Exhibit 6: United States

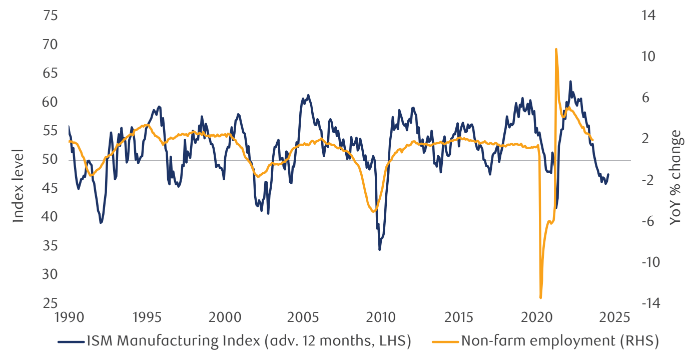
Non-farm employment and the fed funds rate



Note: As of August 31, 2023. Source: Evercore ISI

Exhibit 7: United States

ISM Manufacturing Index and non-farm employment



Note: As of August 31, 2023. Source: Institute for Supply Management, BLS

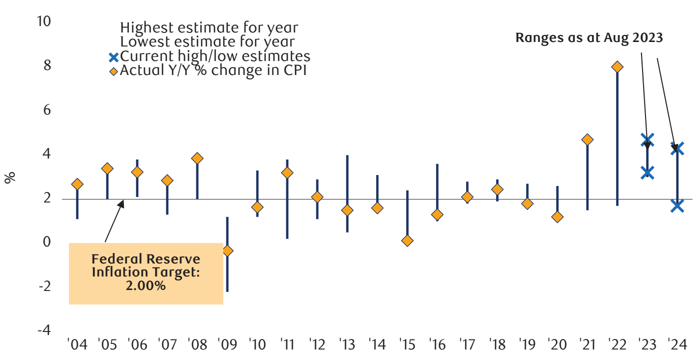
Long-term inflation expectations remain well-anchored as price pressures cool

The main benefit of slowing the economy is that extreme inflation levels appear to have subsided and inflation expectations are now near central-bank targets. The consensus of economists' U.S. inflation forecasts for 2023 is close to 4%, which is less than half of last year's 9.1% peak, and projections are for inflation to moderate further into 2024 while remaining slightly above the U.S. Federal Reserve's (Fed) 2% target (Exhibit 8). It is possible that the aggressive central-bank tightening already delivered is exactly the response needed to arrest inflation pressures: market-based measures of inflation expectations in the U.S., Canada and Europe are all not far from the 2% target (Exhibit 9).

Supporting our view that inflation is likely to continue cooling is evidence that a variety of factors that contributed to rising consumer prices during the pandemic are no longer as problematic. Money supply growth has in the past been highly correlated to inflation. It's been falling for 30 months, leading inflation lower following the usual lag (Exhibit 10). The surge in money-supply growth in the early days of the pandemic preceded the subsequent spike in inflation from 2021 to 2022, after which slowing money-supply growth

Exhibit 8: United States

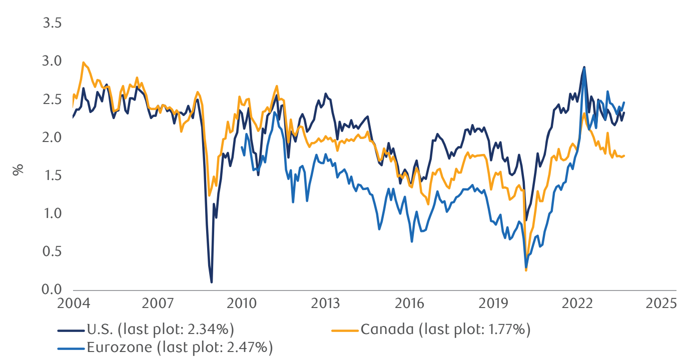
Inflation estimate dispersion



Source: Consensus Economics, RBC GAM

Exhibit 9: Implied long-term inflation premium

Breakeven inflation rate: nominal vs 10-year real return bond



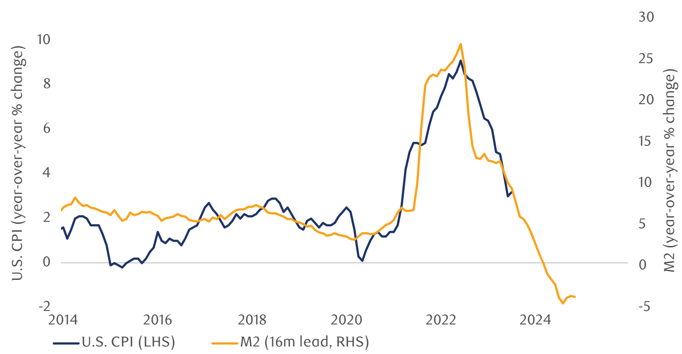
Note: As of August 31, 2023. Eurozone represents GDP-weighted breakeven inflation of Germany, France and Italy. Source: Bloomberg, RBC CM, RBC GAM correctly foreshadowed a moderation. The fact that the money supply is now contracting suggests that inflation could continue cooling over the next year and a half. Other measures signifying a possible improvement in inflation are used-car prices, which are no longer rising, and rents, which are now only rising at levels in the low single digits (exhibits 11 and 12). For these reasons, we expect that inflation will continue moderating over the medium term, though we also recognize that price pressures have already decreased meaningfully from their peak and that further progress toward the Fed's 2% target will be more difficult.

Interest-rate hiking cycle is nearing the finish line, with cuts expected next year

With the economy softening and inflation moving in the right direction, the need for further interest-rate increases is becoming less apparent, and interest-rate cuts could be warranted in the year ahead. According to our fair-value model, the fed funds rate is currently highly restrictive at more than half a standard deviation above our modelled estimate of equilibrium as defined by the band running along the chart (Exhibit 13). Our model suggests the neutral fed funds rate – the mid-point of the band – is currently 3.4%, but

Exhibit 10: U.S. inflation and money supply

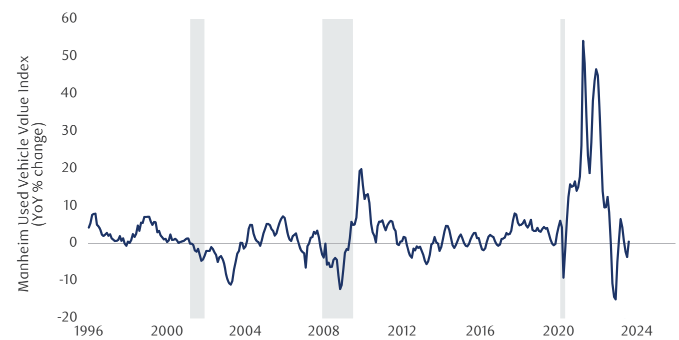
Year-over-year changes in CPI and M2



Note: As of July 31, 2023. Source: Bloomberg, RBC GAM

Exhibit 11: Manheim Used Vehicle Value Index

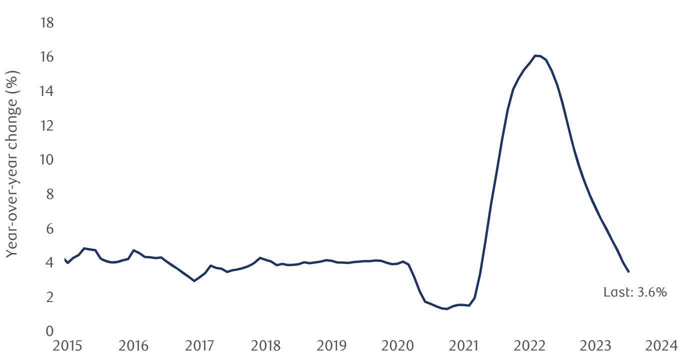
Year over year



Note: As of August 2023. Shaded area represents recession. Source: Manheim Consulting, Bloomberg, RBC GAM

Exhibit 12: U.S. Zillow Rent Index

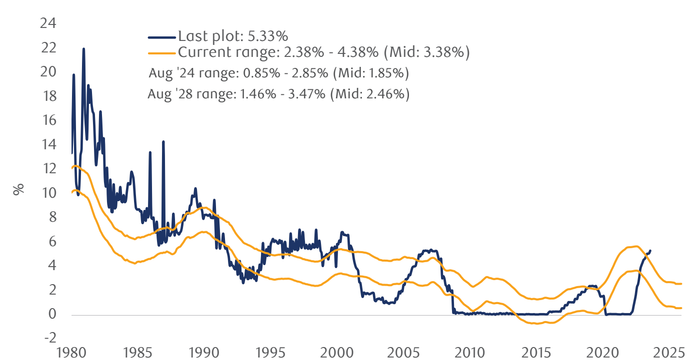
All homes year-over-year % change



Note: As of July 31, 2023. Source: Zillow Inc., Bloomberg, RBC GAM

Exhibit 13: U.S. fed funds rate

Equilibrium range



Note: As of August 31, 2023. Source: Federal Reserve, RBC GAM if inflation continues to decline in line with our forecast, the neutral reading falls to around 2% in 12 months' time. As a result, the fed funds rate is likely to fall from 5.5% sometime in the the first half of next year. Our view is in line with pricing in the futures market, which suggests a possibility of one more 25-basis-point hike by the end of the year, followed by the start of an interest-rate cutting cycle beginning in early 2024 (Exhibit 14).

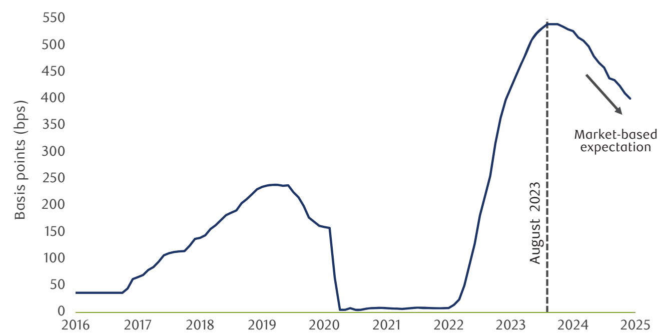
Sovereign bonds are appealing; return potential is high and valuation risk is minimal

The possibility that interest rates will fall over the next year means that government bonds, whose yields have climbed to their highest levels since just before the 2008/2009 global financial crisis, offer attractive value at these levels. Exhibit 15 lists the total returns that would be realized by 10-year government bonds in various major regions should yields move to either our forecast level or our modelled equilibrium rate over the next year. Negative returns are expected in only one region, Japan, where yields remain extraordinarily low but are expected to rise as the Bank of Japan relaxes its mechanism to suppress interest rates (i.e. yield curve control). In the other regions, projected returns range from low to high single digits should yields achieve our forecast levels, but those results rise closer to 20% if yields were to move to our modelled equilibrium levels over the year ahead. In our view, bond investors' return potential has improved and the risk of capital losses is limited should yields moderate alongside risks to the global economy (page 44).

A closer look at our bond model for U.S. 10-year Treasuries reveals that yields were vulnerable to a sharp correction last year because they were far below the equilibrium band in 2020 and 2021. That situation has almost completely reversed (Exhibit 16). As yields rose rapidly over the past 18 months, they moved into the band and are now flirting with its upper boundary. The equilibrium band is a modelled estimate of the appropriate nominal bond yield, which is the result of combining an inflation premium with a real (or after-inflation) yield. Inflation began to spike in 2021, pushing the band higher and yields eventually caught up to government inflation readings by late 2022/early 2023. With inflation's peak seemingly behind and price pressures cooling rapidly, the scope for lower bond yields has opened. The less obvious change revealed by the model is the significant upward adjustment in real interest rates. Our model shows that the real rate of interest on the 10-year Treasury has risen to

Exhibit 14: Implied fed funds rate

12-months futures contracts as of August 31, 2023



Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 15: 10-year government bond yields

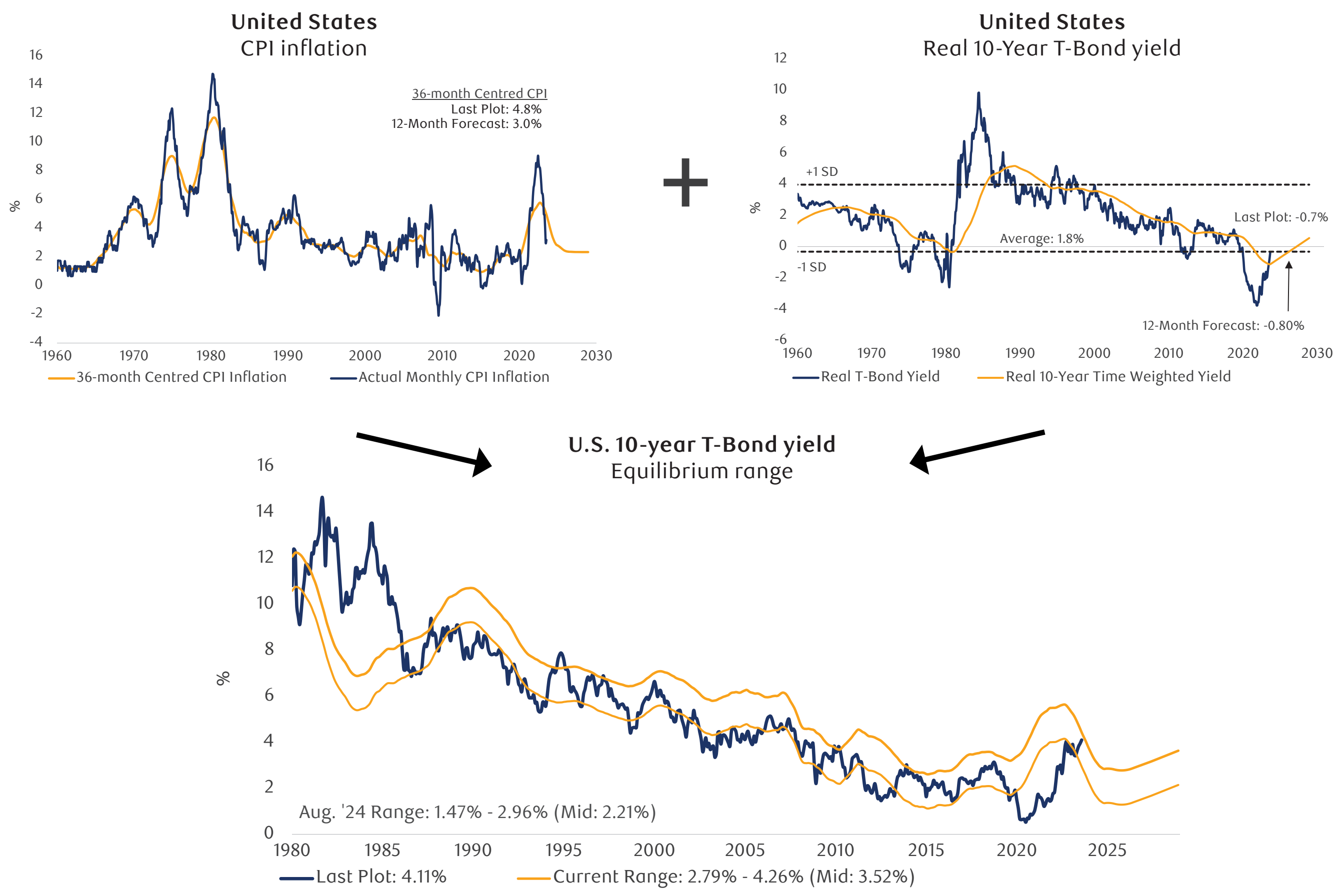
RBC GAM forecasts and equilibrium levels

	Current (%)	RBC Global Asset Management Forecast (%)		Equilibrium Level Forecast (%)	
	Yield Aug. 2023	Forecast Aug. 2024	Total Return (Local curr.)	Equilibrium Aug. 2024	Return (Local curr.)
United States	4.11	3.50	9.2	2.21	21.0
Canada	3.56	3.00	8.4	1.99	17.8
Germany	2.47	2.60	1.3	2.61	1.2
U.K.	4.36	4.25	5.3	2.36	22.1
Japan	0.65	0.75	-0.3	1.19	-4.4

Note: Table indicates hypothetical total returns for 10-year government bonds over the next year should yields fall to either RBC GAM's forecast level or to our bond models' equilibrium levels. Source: RBC GAM

negative 0.70% from negative 3.75% in late 2021. We continue to think real rates are unlikely to return to their post-World War II average of 2% due to aging populations and other structural economic headwinds such as lower long-term potential growth rates. Rather, we think real rates can settle somewhere between 0% and 1% on a sustained basis, which is still a bit above where they are at the time of this writing. Taking these factors into account, the equilibrium band in our model falls quite sharply into 2024 and 2025, with the mid-point falling from 3.70% to 2.21% a year from now. As a result, the outlook for sovereign fixed income is encouraging if inflation follows the trajectory we expect, and real interest rates hold between the 0% to 1% range that we forecast.

Exhibit 16: U.S. 10-year bond yield



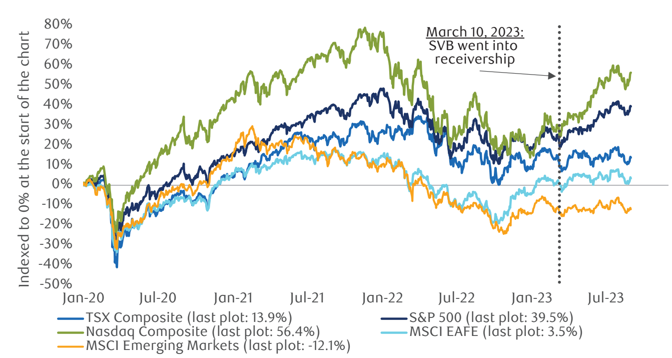
Note: As of August 31, 2023. Source: RBC GAM

Equities are reasonably valued outside of U.S. mega-cap technology

Global stocks extended their gains in the past quarter, led predominantly by mega-cap technology stocks. So far this year, the NASDAQ rose 34% while non-U.S. markets, measured in U.S. dollars, have moved mostly sideways since stress in U.S. regional banks surfaced in early March (Exhibit 17). Outside of the indices that have a large weighting to the "Magnificent 7," most major equity indices are up far less, with several posting low-to-mid-single-digit gains year-to-date (Exhibit 18). The stark difference in performance between the seven largest companies in the U.S. and the rest of the global markets is evidence of a two-tier market so far in 2023.

Exhibit 17: Major equity-market indices

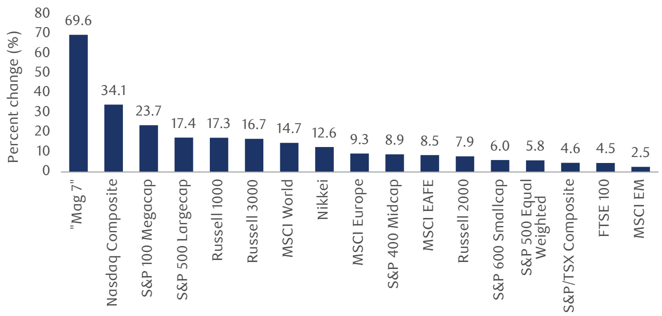
Cumulative price returns indices in USD



Note: As of August 31, 2023. Price returns computed in USD.
Source: Bloomberg, RBC GAM

Exhibit 18: Major indices' price change in USD

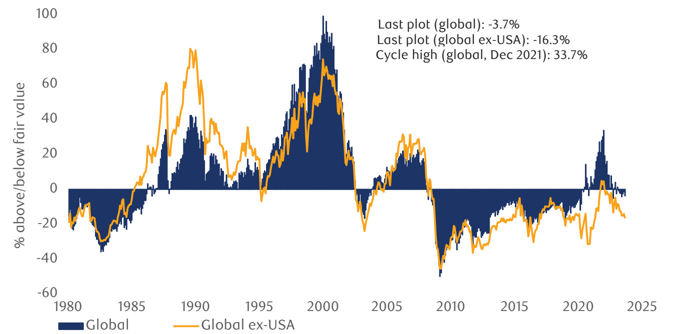
December 30, 2022 to August 31, 2023



Note: Mag 7 includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Source: Bloomberg, RBC GAM

Exhibit 19: Global stock-market composite

Equity-market indexes relative to equilibrium



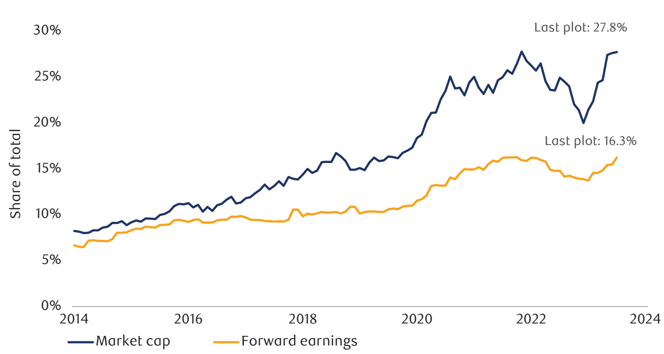
Note: As of August 31, 2023. Source: RBC GAM

Valuations for global stocks are reasonable relative to their own histories and especially on a relative basis compared with the U.S. Our GDP-weighted composite of global equity markets suggests that stocks are appropriately valued or, in some cases, even slightly below fair value (Exhibit 19). And if we remove the U.S. from the calculation, global equities would be situated at 17% below fair value. Note that this composite had been as much as 34% above fair value in late 2021, so there has been a meaningful improvement in valuations over the past 18 months, with most of that adjustment taking place outside of the U.S. large-cap space. Among major markets, the S&P 500 is the most expensive at almost half a standard deviation above fair value, while markets in other regions are either slightly or significantly below their fair value estimate (page 45).

Magnificent 7 occupies significant market share and has demanding valuations

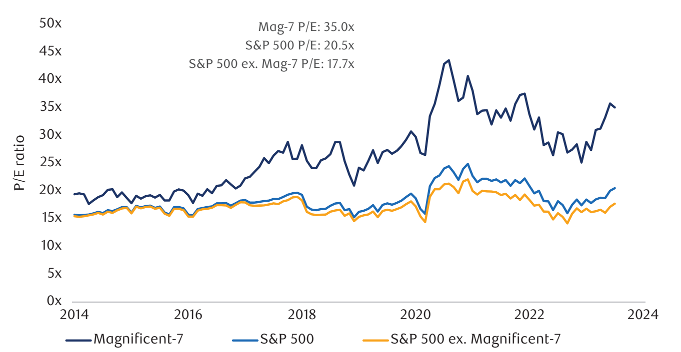
A closer look at the "Magnificent 7" is warranted because of its influence on the world's most popular and most valuable equity index. These seven largest U.S. publicly listed companies make up 28% of the S&P 500 weighting, a share that has almost tripled over the past decade (Exhibit 20). What is somewhat concerning is that these companies contribute a much smaller portion – just 16% – of the S&P 500's earnings pool. The forward price-to-earnings ratio of the Magnificent 7 stands at 35.0 versus the S&P 500 at 20.5, while the S&P 500 excluding these stocks (i.e. the remaining 493 companies) is 17.7 – almost 3 full points cheaper (Exhibit 21).

Exhibit 20: 'Magnificent-7' as a share of S&P 500 Index



Note: Magnificent-7 includes Apple, Microsoft, Google, Amazon, Nvidia, Tesla and Meta. Tesla was added in Dec 2020 when it was included in the S&P 500. As of July 31, 2023. Source: RBC GAM

Exhibit 21: 'Magnificent-7' forward P/E ratio



Note: Magnificent-7 includes Apple, Microsoft, Google, Amazon, Nvidia, Tesla and Meta. Tesla was added in December 2020 when it was included in the S&P 500. As of July 31, 2023. Source: RBC GAM

Exhibit 22: Mag-7 versus S&P 500 ex. Mag-7 break-even analysis

Assumptions for study
As of July 31, 2023

	S&P 500 ex. Mag-7	Magnificent-7
Price	100.00	100.00
P/E	17.71	35.04
Trendline EPS	$187.30	$36.38
Trendline earnings growth	6.19%	17.93%
Discount rate	6.35%	6.35%

Earnings growth required to justify Mag-7 premium
As of July 31, 2023

Years	S&P 500 ex. Mag-7 earnings	Cumulative earnings	Present value of cumulative earnings (S&P 500 ex. Mag-7)	Earnings growth required for Mag-7 to catch up to rest of S&P 500 (annualized)
0	$187.30			
1	$198.90	$198.90	$187.02	446.7%
2	$211.22	$410.12	$373.78	191.8%
3	$224.31	$634.43	$560.25	121.1%
4	$238.20	$872.63	$746.46	88.9%
5	$252.96	$1,125.59	$932.40	70.7%
6	$268.63	$1,394.22	$1,118.06	59.0%
7	$285.27	$1,679.48	$1,303.45	50.8%
8	$302.94	$1,982.42	$1,488.57	44.9%
9	$321.71	$2,304.13	$1,673.42	40.3%
10	$341.64	$2,645.77	$1,858.01	36.7%
11	$362.80	$3,008.57	$2,042.32	33.8%
12	$385.27	$3,393.84	$2,226.36	31.4%
13	$409.14	$3,802.98	$2,410.14	29.3%
14	$434.49	$4,237.47	$2,593.64	27.6%
15	$461.40	$4,698.87	$2,776.88	26.1%

Source: RBC GAM

We ran a break-even analysis to determine how fast these companies would need to grow their earnings in order to justify their premium prices. Exhibit 22 lists the assumptions and results of the analysis, which compares two earnings trends. The first set is the earnings of the S&P 500 excluding the Magnificent 7, which is assumed to grow at its historic trend of 6.2% without the influence of those seven tech darlings. The second set solves for the rate of growth required for Magnificent 7 profits to equal the first set's over a specified number of years, discounted using an appropriate rate. One result is that, over a 10-year period, the Magnificent 7 would have to increase their profits by 36.7% per year – just over double the historic trend for this group – to make up for the premium price being paid for their shares today versus the rest of the S&P 500. The math suggests the bar is set extremely high and these companies could be vulnerable if they were to disappoint investors' lofty expectations, potentially weighing heavily on major equity indices.

Analysts are constructive on the profit outlook...

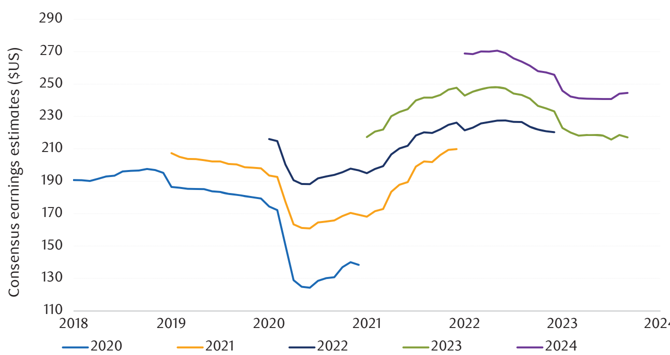
Analysts have been relatively optimistic on the outlook for U.S. corporate profits. Estimates stabilized and even started to rise slightly in recent months as the economy has been holding up better than expected after last year's earnings downgrades (Exhibit 23). Analysts now look for something like 1% growth in S&P 500 earnings in 2023 followed by a re-acceleration to low double-digit growth in 2024 and beyond (Exhibit 24).

...but a slowing/contracting economy should weigh on earnings

In our view, analysts may be too optimistic given that a slowing economy paired with falling profit margins will likely pose further challenges to earnings growth. It is worth acknowledging that revenue growth has been extremely strong and the recovery from the pandemic has been record-setting so far this cycle, both in terms of how fast revenues have recovered and how high they have risen (Exhibit 25). But revenue growth has historically tracked well with nominal GDP growth, which suggests that if the economy slows as we expect, revenue growth will also come down and perhaps even briefly decline (Exhibit 26). Moreover, profit margins have been coming down from record levels toward their long-term trend (Exhibit 27) and could have further to drop based on historical trends. As corporate costs continue to rise and revenue growth slows, profit margins could be further compressed, resulting in lower profits.

Exhibit 23: S&P 500 Index

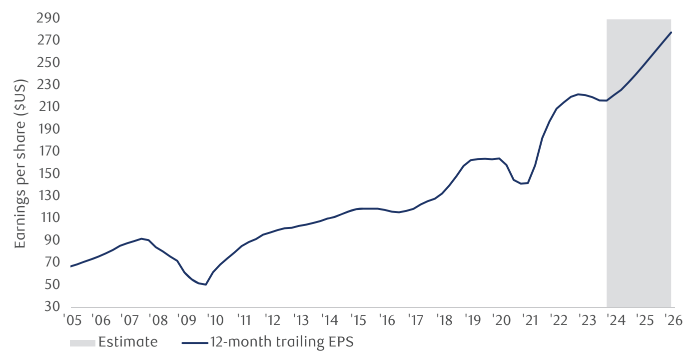
Consensus earnings estimates



Note: As of August 31, 2023. Source: Bloomberg, RBC GAM

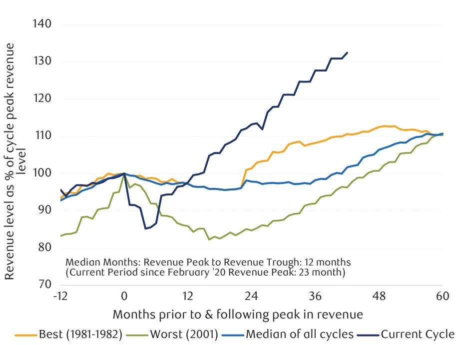
Exhibit 24: S&P 500 Index

12-month trailing earnings per share with estimate



Note: Note: as of August 25, 2023. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, RBC GAM

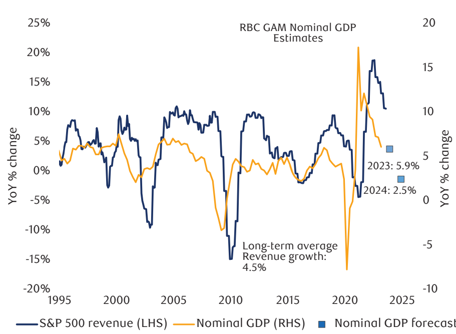
Exhibit 25: S&P 500 revenue



Note: All revenue peaks associated with periods of recession. As of August 31, 2023. Source: RBC GAM

Exhibit 26: United States

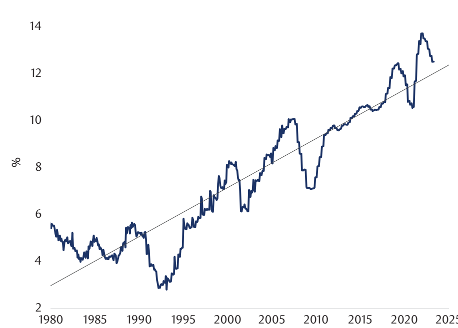
S&P 500 revenue and nominal GDP



Note: As of August 31, 2023. Source: RBC CM, RBC GAM

Exhibit 27: S&P 500

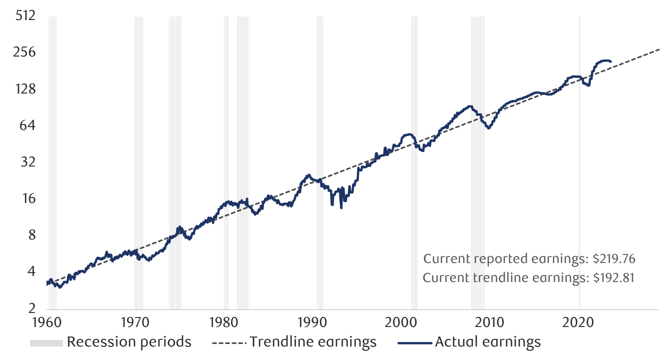
Net margin



Note: as of July 31, 2023. Source : Bloomberg, RBC GAM

S&P 500 earnings are also above their long-term trend and could have much further to drop if we enter a typical recession (Exhibit 28). Simply falling back to the long-term trend would represent a 12% decline from current levels. But during recessions, profits tend to fall below trend. Exhibit 29 shows that S&P 500 profits fell an average of 24% (a minimum drop of 12% to a maximum drop of 50%) in the 11 recessions since the early 1950s. Even the mildest recession would likely limit further gains in stocks given that current earnings estimates would undergo significant reductions.

Exhibit 28: S&P 500 earnings comparison



Note: As of August 31, 2023. Source: RBC GAM

Exhibit 29: S&P 500 earnings per share

Recession statistics

Recession start date	Earnings peak date	Earnings trough date	Earnings reclaim prior peak date	Earnings decline duration (months)	Earnings peak ($)	Earnings trough ($)	EPS change peak to trough	Earnings reclaim duration (months)	Trendline earnings (exponential trend)	Difference between actual EPS and trendline EPS at earnings trough
July 1953	Dec-50	Jun-52	May-55	17	2.8	2.3	-17.6%	53	2.0	17.8%
August 1957	Feb-56	Mar-59	Jun-62	37	3.6	2.8	-23.4%	76	3.1	-9.3%
April 1960	Jun-60	Jun-61	Jun-62	12	3.6	3.0	-14.6%	24	3.5	-14.5%
December 1969	Feb-70	Jul-71	Dec-72	17	6.2	5.0	-18.4%	34	6.8	-25.6%
November 1973	Jan-75	Feb-76	Dec-76	12	9.6	7.6	-21.6%	23	9.1	-17.0%
January 1980	Jul-80	Aug-81	Jan-82	13	15.6	13.7	-11.9%	18	13.0	6.0%
July 1981	Aug-82	Jul-83	Oct-84	11	16.3	12.1	-25.8%	26	14.7	-17.5%
July 1990	Aug-89	Apr-93	Mar-95	43	25.7	13.6	-46.9%	67	27.4	-50.3%
March 2001	Nov-00	Jun-02	May-04	19	56.2	40.1	-28.7%	42	49.4	-19.0%
December 2007	Aug-07	Nov-09	Aug-11	26	94.3	61.5	-34.8%	47	79.7	-22.8%
February 2020	Aug-19	Feb-21	Aug-21	12	165.7	139.1	-16.0%	24	164.2	-15.2%
Aggregate statistics										
Average				20			-23.6%	39		-15.2%
Median				17			-21.6%	34		-17.0%
Max				43			-11.6%	76		17.8%
Min				11			-49.8%	18		-50.3%

Note: As of August 31, 2023. Source: Bloomberg, RBC GAM

Exhibit 30: Earnings estimates and alternative scenarios for valuations and outcomes for the S&P 500

		Consensus				Consensus	
		2023 Top Down	2023 Bottom Up	Recessionary*		2024 Top Down	2024 Bottom Up
	P/E	$213.0	$218.7	$167.3	P/E	$230.0	$243.5
+1 Standard Deviation	21.7	4626.3	4749.2	3632.6	22.6	5203.1	5508.2
+0.5 Standard Deviation	19.5	4153.8	4264.1	3261.6	20.3	4671.6	4945.6
Equilibrium	17.3	3681.3	3779.0	2890.6	18.0	4140.2	4383.0
-0.5 Standard Deviation	15.1	3208.8	3294.0	2519.6	15.7	3608.8	3820.4
-1 Standard Deviation	12.8	2736.3	2808.9	2148.6	13.4	3077.4	3257.9

Note: *Trailing 12-Month Earnings to July 2023 less 25% (i.e. average decline in earnings through recession). As of August 31, 2023. Source: Bloomberg, Thomson Reuters, RBC GAM

Scenario analysis for stocks suggests little appeal from a risk/reward standpoint

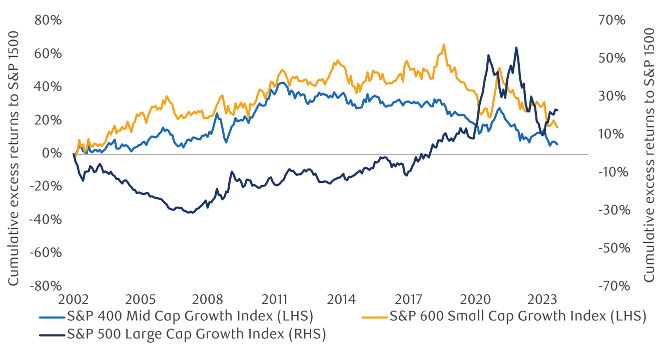
We find it useful to map out a variety of scenarios to gauge the potential downside and upside for stocks under reasonable assumptions. Given where the S&P 500 is trading at the time of writing, the upside appears limited and the potential downside far greater. Exhibit 30 plots various combinations of price-to-earnings levels with earnings to generate possible outcomes for the S&P 500 by the end of this year and in 2024. If the market trades at our modelled equilibrium P/E – the level consistent with current and expected interest rates and inflation – then the S&P 500 is likely to deliver slight losses over the year ahead. But if the market trades at a slight premium of half a standard deviation above equilibrium, where it has tended to trade for much of the past decade, and if earnings achieve the consensus of analysts' estimates, the S&P 500 could trade as high as 5000 by the end of next year for nearly a 13% total return over the next 15 months. This positive scenario, while not inconceivable, would require a number of things to go right, including the economy avoiding recession, inflation coming back down to target, central banks providing some interest-rate relief and investors remaining highly optimistic. On the flip side, should the economy enter a downturn and earnings suffer an average recessionary experience, market declines could reasonably range from 20% to 30%.

Styles: U.S. large-cap growth has dominated so far in 2023

Large-cap growth leadership has re-emerged in a big way so far this year, due mostly to the outsized outperformance of the Magnificent 7. As a result, small and mid-cap stocks have lagged and value stocks of all sizes have trailed the broader market (exhibits 31 and 32). Investors will often favour large-cap growth companies for their stability and proven ability to consistently increase earnings even during periods of heightened macroeconomic uncertainty and a weakening economic outlook, and the Magnificent 7 exhibit these characteristics. That said, we remain cautious regarding the increased market concentration and demanding valuations in large-cap growth stocks. We would prefer to see less reliance on the Magnificent 7 for market gains, and more evidence of broader participation from small- and mid-cap stocks to reassure us that the economy is on solid footing.

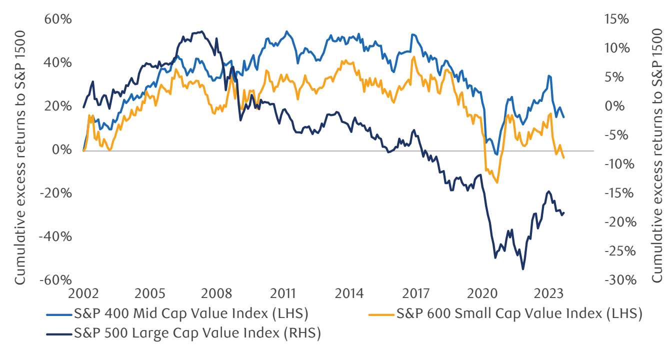
A longer-term consideration from a regional perspective is that U.S. equities have mostly outperformed international markets since the 2009 financial crisis. But U.S. outperformance appears to come and go in cycles over multi-year periods and the relative-strength trends are fairly similar whether we are looking at Canada, emerging markets or Europe relative to the U.S. (exhibits 33 to 35). In the years following the peak of the late 1990s tech bubble, international

Exhibit 31: Returns for growth
S&P growth indices



Note: As of August 31, 2023. Source: S&P Dow Jones Indices, Bloomberg, RBC GAM

Exhibit 32: Returns for value
S&P value indices



Note: As of August 31, 2023. Source: S&P Dow Jones Indices, Bloomberg, RBC GAM

Exhibit 33: Relative performance
S&P/TSX Composite TR USD vs S&P 500 TR USD

Note: As of August 31, 2023. Source: Bloomberg, RBC GAM

Exhibit 34: Relative performance
MSCI Emerging Markets TR USD vs S&P 500 TR USD

Note: As of August 31, 2023. Source: Bloomberg, RBC GAM

Exhibit 35: Relative performance
MSCI Europe TR USD vs S&P 500 TR USD

Note: As of August 31, 2023. Source: Bloomberg, RBC GAM markets outperformed consistently for almost a decade. While it is difficult to time turns in these long-term trends, we could be nearing a point where the tide shifts particularly if the Magnificent 7 were to falter.

Asset mix – maintaining neutral positioning

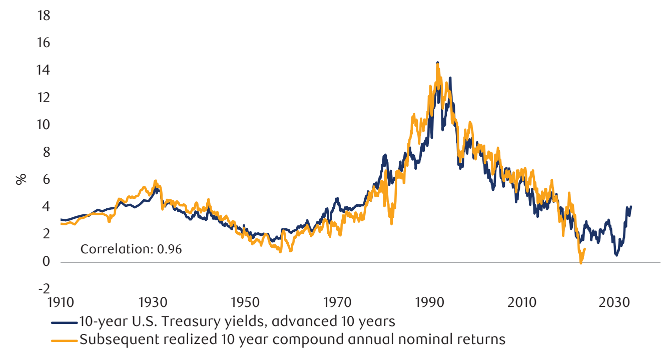
The global economy faces a variety of headwinds, with the rapid tightening of financial conditions being the most prominent. While a wide range of outcomes is possible and there are pathways to a positive outcome, our base case is that the economy falls into recession at some point over our one-year forecast horizon, prompting central banks to start cutting interest rates early next year.

Against this backdrop, prospective returns for fixed-income assets are especially appealing. A reasonable expectation of what an investor can earn on 10-year Treasuries over the long term is the current yield to maturity (Exhibit 36). That number is now 4.1%, up from 1.5% at the start of 2022. This higher starting point in yields means that sovereign bonds should offer greater ballast against equity-market volatility in a balanced portfolio. But it also means that potential returns in the near term could extend to the high single or even low double digits if interest rates fall rapidly in a recession.

Stocks would be vulnerable to an economic downturn in the near term as any declines in corporate profits are likely to weigh on equity prices. While we are more cautious in the near term, we don't want to lose sight of the superior return potential offered by stocks over the longer term. Exhibit 37 plots the relationship between 10-year returns for the S&P 500 and Robert Shiller's cyclically adjusted P/E ratio (CAPE). The chart suggests that current valuations for the S&P 500 are consistent with annual returns of almost 7% over the next decade. This is down from 10% late last year, but remains much greater then the 4% that was expected on this basis in late 2021 and early 2022.

Balancing the risks and opportunities as well as shorter- and longer-term perspectives, we don't think the current environment warrants taking substantial risks in portfolios at this time. The premium offered on stocks versus bonds remains slightly positive but is now at its lowest level in nearly two decades (Exhibit 38). We have dialed back our equity overweight exposures over the past 18 months as

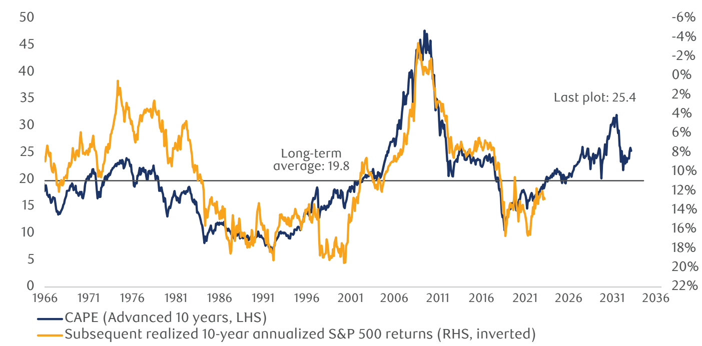
Exhibit 36: U.S. 10-year Treasury note and returns



Note: As of August 31, 2023. Source: Deutsche Bank, Macrobond, RBC GAM

Exhibit 37: Shiller's CAPE

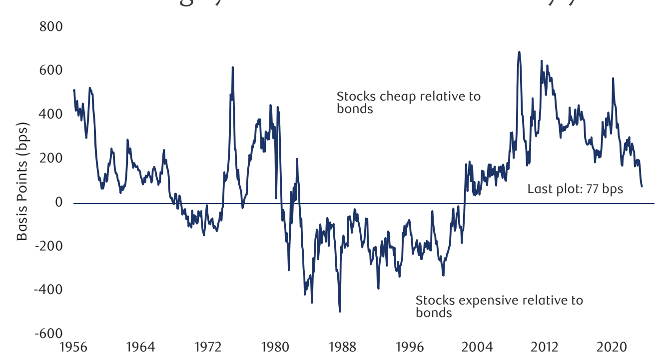
Real S&P 500 Index / 10-year average of real EPS



Note: As of August 31, 2023. Source: Macrobond, Bloomberg, RBC GAM

Exhibit 38: U.S. equity-risk premium

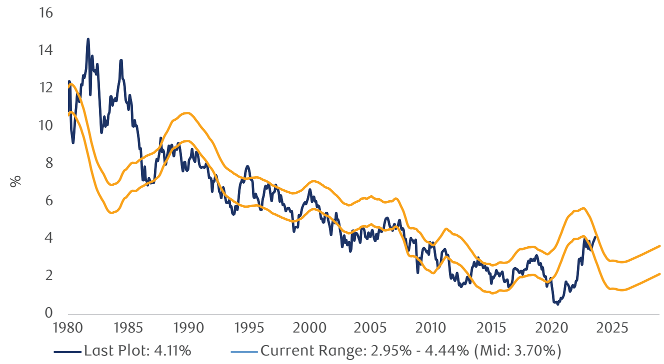
S&P500 earnings yield – U.S. 10-Year Treasury yield



Note: As of August 31, 2023. Source: RBC GAM, RBC CM recession risks mounted and used the proceeds to reduce our underweight allocation to bonds as yields rose. We fully eliminated our tactical risk exposures last quarter, moving the asset mix in line with our strategic neutral. This quarter, we are maintaining that neutral stance. To be more constructive on the macroeconomic outlook and comfortable taking on more risk in the asset mix, we would like to see a broadening in market participation in the equity-market rally, improvement in economic leading indicators, and/or an easing in monetary policy. Currently, our recommended asset weighting for a balanced global investor sits at our strategic neutral positions of 60% in stocks, 38% in bonds, and 2% in cash. Actual fund or client portfolio positioning may differ depending on individual investment policies.

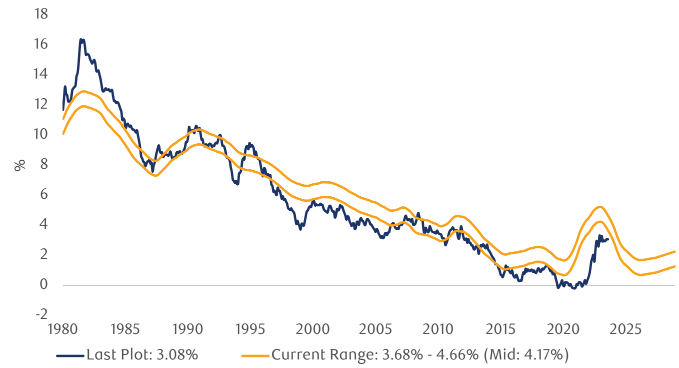
Global fixed income markets

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



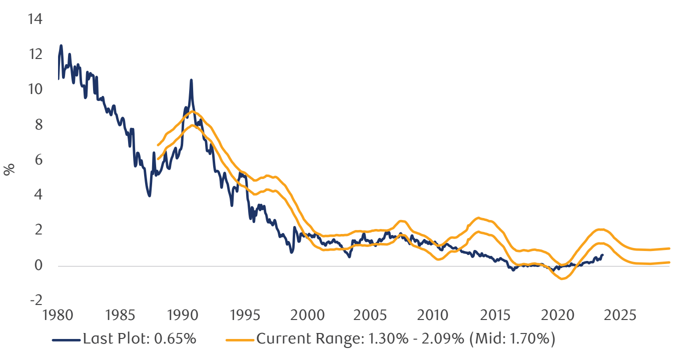
Note: As of August 31, 2023. Source: RBC GAM, RBC CM

Eurozone 10-Year Bond Yield
Equilibrium range



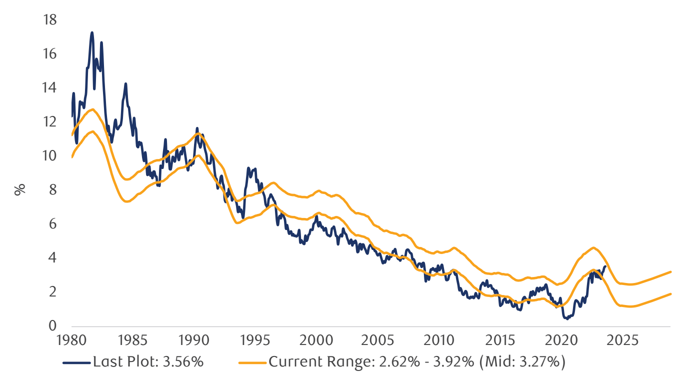
Note: As of August 31, 2023. Source: RBC GAM, RBC CM

Japan 10-Year Bond Yield
Equilibrium range



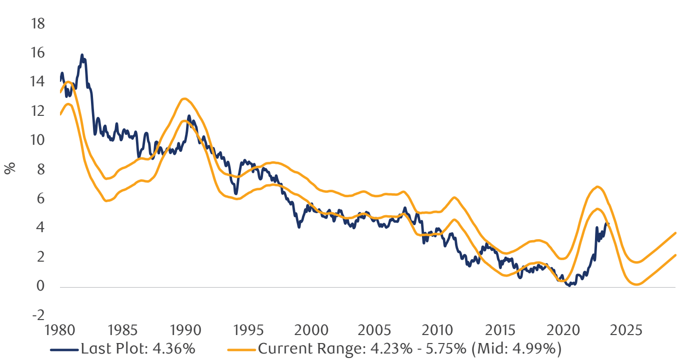
Note: As of August 31, 2023. Source: RBC GAM, RBC CM

Canada 10-Year Bond Yield
Equilibrium range



Note: As of August 31, 2023. Source: RBC GAM, RBC CM

U.K. 10-Year Gilt
Equilibrium range

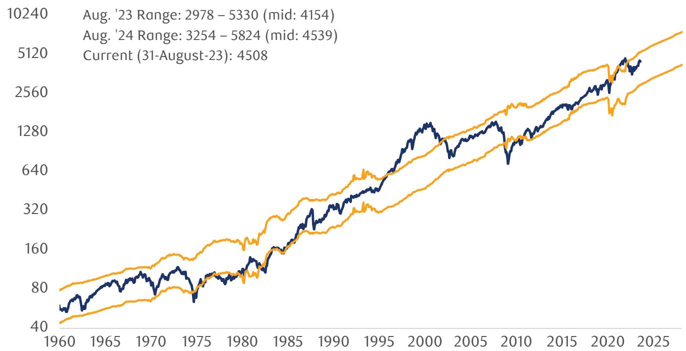


Note: As of August 31, 2023. Source: RBC GAM, RBC CM

> "In our view, bond investors' return potential has improved and the risk of capital losses is limited should yields moderate alongside risks to the global economy."

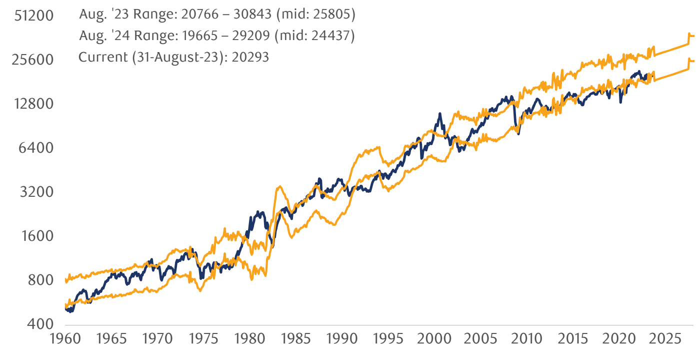
Global equity markets

S&P 500 Equilibrium
Normalized earnings and valuations



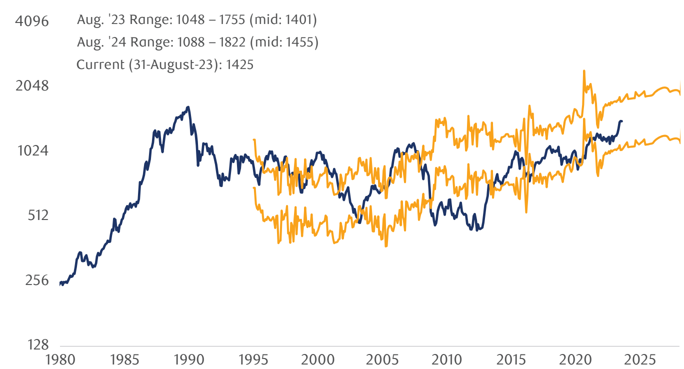
Note: As of August 31, 2023. Source: RBC GAM

S&P/TSX Composite Equilibrium
Normalized earnings and valuations



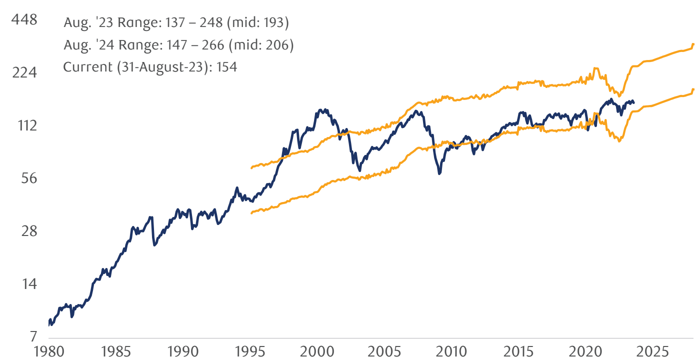
Note: As of August 31, 2023. Source: RBC GAM

MSCI Japan Index
Normalized earnings and valuations



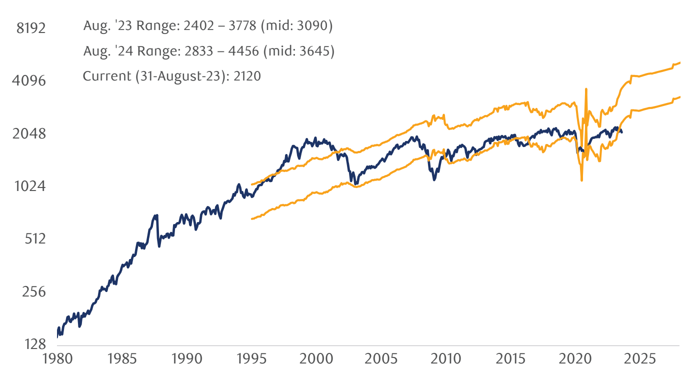
Note: As of August 31, 2023. Source: RBC GAM

MSCI Europe Index
Normalized earnings and valuations



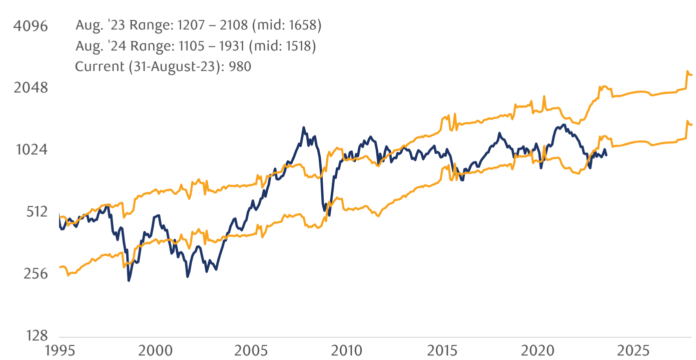
Note: As of August 31, 2023. Source: RBC GAM

MSCI U.K. Index
Normalized earnings and valuations



Note: As of August 31, 2023. Source: RBC GAM

MSCI Emerging Markets Index
Normalized earnings and valuations



Note: As of August 31, 2023. Source: RBC GAM

Global fixed income markets

Soo Boo Cheah, MBA, CFA
Senior Portfolio Manager
RBC Global Asset Management (UK) Limited

Joanne Lee, MFin, CFA
Senior Portfolio Manager
RBC Global Asset Management Inc.

Taylor Self, MBA, CFA
Portfolio Manager,
RBC Global Asset Management Inc.

The outlook for bond investors appears to be improving, with the highest yields in 15 years forming a positive backdrop for fixed-income returns over the year ahead.

U.S. government bonds returned just over 3.0% over the past 10 months, a period in which 10-year bond yields were essentially unchanged. Over the next 12 months, we expect returns in the mid-to-high single digits as yields are augmented by rising bond prices in an environment where inflation continues to slow and central bankers appear set to begin cutting interest rates.

Our view is that the threat of a recession, whether or not one materializes, will lead central banks to reduce interest rates within the next year. Moreover, inflation is already falling back toward central bankers' 2% target, bolstering the case for lower policy rates. While we have been predicting a recession since late 2022, the call hasn't materialized due to much-better-than-expected U.S. growth, which buoyed equity markets and kept central banks raising interest rates, even after a brief pause during the spring.

Why has growth been so resilient?

The first reason is that we underestimated the full effect of fiscal stimulus and the impact of the pandemic-related savings accumulated in most of the developed world. Fiscal stimulus has been pared, but spending incentives related to the U.S. Inflation Reduction Act and energy subsidies in the eurozone have bolstered growth much more than we anticipated.

Governments were also much slower to curtail pandemic-related expenditures and consumers much more eager to spend their savings stashes. Typically, consumers would raise their savings rates for a period after a serious economic downturn – reflecting a more cautious outlook on the world. Instead, households have spent their savings, and more. Governments, for their part, have made little effort to scale back their own spending and budget deficits remain remarkably high.

Another reason that a recession has so far been avoided is that the economy seems less sensitive to rising interest rates than has historically been the case. In the U.S., corporations took advantage of low yields to lock in borrowing costs for exceptionally long periods (Exhibit 1), and households typically have very long-maturity borrowings related to mortgages. Even terms on car loans are much longer and now stretch as long as 10 years.

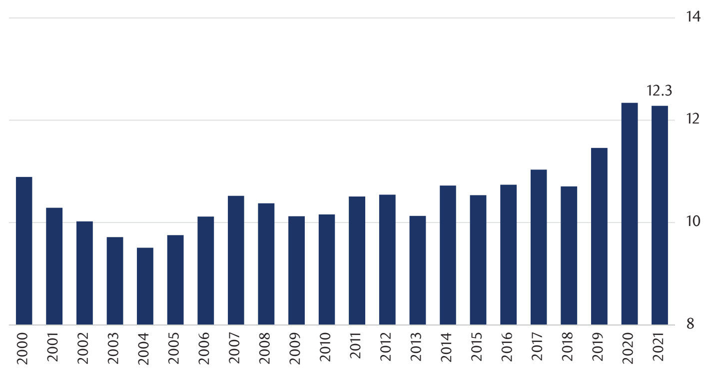
This means that borrowing costs for businesses and households rise much more slowly because a smaller portion of their debt is renewed every year. The impact of interest-rate hikes is therefore spread over a longer period and their effect dulled by earnings growth (for businesses) and income growth (for households). The forbearance of lenders has also been surprising. In Canada, major banks have permitted some mortgage borrowers to extend amortization periods by decades in order to keep payments manageable.

Quantitative easing also reduced the sensitivity of the economy to rate hikes by reducing banks' bond holdings and therefore their exposure to losses linked to rising interest rates. Smaller bond holdings have enabled banks to sustain lending better than if their bond holdings had been more significant. To be sure, the failure of several important U.S. banks indicates that the decline in bond portfolios still had an impact this time around, but absent quantitative easing it would have been much worse.

We still think that the rapid pace and huge scale of interest-rate hikes over the past year and a half will be sufficient to bring inflation back to 2% alongside a cooling of economic activity. As the long lags of policy start to bite, we already see signs that the economy is softening. Inflation has eased substantially, and the risks of overtightening are much higher now.

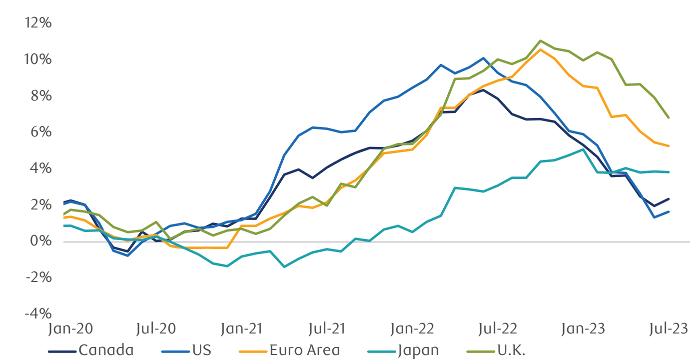
While inflation still exceeds 2%, the pace is down from mid-2022, when prices were rising at the fastest pace since the 1980s (Exhibit 2). Labour-market strength – which central banks have identified as a key contributor to the risk of sustained too-high inflation – has also eased. Consumers and businesses, for their part, are also set to more fully feel the pinch of rate hikes. Payments for Canadian mortgage holders could rise 20% or even more as they renew their loans.

Exhibit 1: Firms issued exceptionally long-maturity debt when yields were low



Note: Data as of December 31, 2021. Bonds, weighted average time to maturity (years). Source: Bloomberg Barclays U.S. Corporate Bond Index

Exhibit 2: Inflation has slowed



Note: Data as of August 30, 2023. Adjusted for country-level differences in inflation calculation methods. Source: National statistical offices

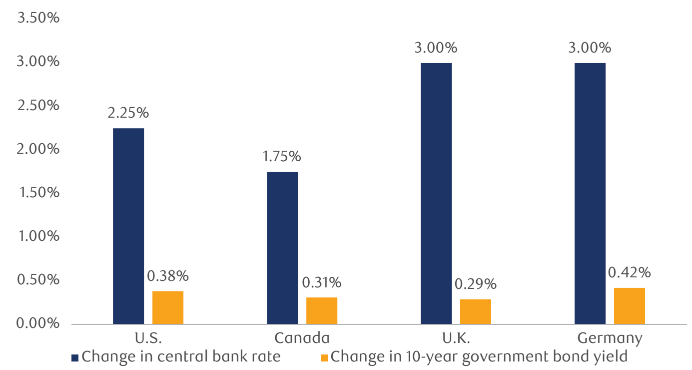
Overall, we believe that the window for continued economic resilience and very high policy rates will close in 2024, and this view is in line with bond-market indicators. The inverted yield curve reflects investors' conviction that an economic downturn is nigh and that high policy rates are unlikely to persist. The extremeness of the inversion is reflected in the fact that, while central banks have raised interest rates hundreds of basis points over the past year, longer-term bond yields are effectively unchanged (Exhibit 3).

Yield-curve inversions, where long-term bond yields are lower than short-term yields, have presaged every U.S. recession since 1945, and it's unlikely that this time will be different. Typically, the yield curve inverts between six months and two years before a recession starts. The yield curve has been inverted since last July, just six months after the first rate hike by the U.S. Federal Reserve (Fed). Based on history, a recession is mostly likely to occur sometime over the next year.

Our view is that we have likely seen the final few rate hikes from most central banks. We think slower price rises and a more balanced labour market will give policymakers the confidence to reduce policy rates from very restrictive levels, bolstering bond returns. Over the next year, the dominant theme in the bond market will likely be peak policy rates and peak bond yields. Bonds are cheap according to most of our valuation metrics, and we expect that returns over the next year will be well supported by coupon income and price gains as central banks start to cut policy rates.

Some investors are legitimately concerned that the long-run impact of poor government finances will be negative for bonds - and that investors will demand higher yields in exchange for higher risk of non-payment. As mentioned above, government deficits remain very large in most countries.

Exhibit 3: Government bond yields have not risen with policy rates – Respective changes since October 2022



Note: Data as of August 30, 2023. Source: Bloomberg

We have been writing about this risk for some time. The fiscal situation in many places looks particularly poor compared to history. In the U.S., for example, government debt relative to the size of the economy is expected to grow quickly through the middle of this century. This trend might prompt investors to draw comparisons to the European debt crisis of the early 2010s. Our view is that the U.S. situation is quite different. The U.S. tax burden is very low, and unlike European countries that faced huge interest costs and were already highly taxed, the U.S. has substantial room to raise revenues and "right-size" its tax base to reflect an expanded government footprint.

Overall, we think that concerns about government deficits in the developed world are overblown. While government debt and deficits are concerning, bond yields are more likely to be affected over the next year by slower inflation and growth than long-run concerns over fiscal probity.

Direction of rates

We expect the fed funds rate target to be between 4.50% and 4.75% in a year's time and the yield on the 10-year U.S. Treasury to fall to 3.50% from about 4.30% now.

United States

The Fed raised its target range for the fed funds rate to 5.25% to 5.50% in July, after keeping rates on hold in June. This Fed's move was in line with our view based on still too-high inflation and a too-tight labour market. We expect just one more hike from policymakers in the current cycle, likely in November. The fall in inflation, despite a remarkably resilient pace of economic growth, means that the risk of tightening too much is now higher. While falling inflation likely removes the need for much further tightening, resilient growth means that the Fed is likely to keep rates at high levels into the middle of next year before the start of rate cuts. At the time of writing, long-term bond yields in the U.S. were rising quickly, reflecting concerns about the poor fiscal outlook in the U.S.

As mentioned above, while the long-run fiscal outlook is poor, we think that the U.S. government has substantial room to raise revenues through tax hikes. Policymakers could, of course, decide to shrink spending back to a level more consistent with pre-pandemic levels. Whenever these adjustments occur, they are likely to depress growth in the short to medium term, pushing down yields and pushing up bond prices. We expect the fed funds rate target to be between 4.50% and 4.75% in a year's time and the yield on the 10-year U.S. Treasury to fall to 3.50% from about 4.30% now.

We expect the ECB will hike just once more to 4.00%, before cutting rates around the middle of next year back to 3.25%.

Eurozone

The European Central Bank (ECB) hiked interest rates by 0.25% at both its June and July meetings to bring the deposit rate to 3.75%. Strong demand for European government debt, especially that of fiscally weaker countries such as Italy, has kept policymakers focused on containing inflation. Inflation remains much too high, but disinflation seems to have taken hold in most of the single-currency area. It appears that the current hiking cycle in Europe might come to an end much sooner than most investors were expecting.

As recently as May, investors thought that long-run policy rates in Europe might rise as high as those in the U.S. We did not think this scenario would play out, as Europe's potential for economic growth is likely much lower than the U.S. and the region requires lower central-bank policy rates as a result. The European economy is also more sensitive to rising borrowing costs than America's, leading us to believe that the economic slowdown might happen faster and be more pronounced. Over the past six months, the German economy has been weak, posting two consecutive quarters of contraction. Manufacturing activity is also remarkably weak, partly reflecting the lack of a hoped-for rebound in Chinese growth, and services activity now appears vulnerable to a slowdown as well. Moreover, fears that high unionization rates in Europe would stoke inflation through big wage deals appear to have been unfounded.

We expect the ECB will hike just once more to 4.00%, before cutting rates back to 3.25% starting around the middle of next year. Against this backdrop, we expect yields on 10-year German government bonds to reach 2.60%.

We expect further tightening of monetary policy over the next year, with the overnight rate rising above 0% for the first time since 2016, to 0.10%.

Japan

The Bank of Japan (BOJ) surprised markets by tightening monetary policy at its July meeting, in line with our expectations for an eventual unwinding of the central bank's exceptionally easy policy stance. Unlike its developed-market peers, which have tightened their policy stances at the most aggressive pace in decades, the BOJ, until July, had refrained from making any material tightening. Also unlike its peers, inflation in Japan has not slowed. In response to the highest and longest period of sustained inflation since the 1990s, inflation expectations are climbing quickly, raising the risk that price rises could become entrenched at a higher rate than the BOJ wants.

The changes to the BOJ's yield-curve control policy, which for the past eight years has kept the gap between short- and long-term rates in a tight range, could have large spillover effects on global bond markets. These adjustments have allowed Japanese interest rates to rise, making overseas bonds less attractive to Japanese investors and potentially removing a large and important buyer of global bonds. Truth be told, Japanese investors had been large sellers of foreign bonds for some time due to punitive currency-hedging costs and a realization that Japanese interest rates couldn't stay near zero forever. We expect further tightening of monetary policy over the next year, with the overnight rate rising above 0% for the first time since 2016, to 0.10%. The yield on the 10-year Japanese government bond should also rise, to about 0.75%, from 0.60% at the time of writing.

We forecast that the policy rate will remain at 5.0% for the rest of 2023. In 2024, we expect the BOC will cut the policy rate to 4.25% by the fall. We expect the Canadian 10-year government bond will yield 3.00% sometime over the next 12 months.

Canada

After pausing rate hikes for five months, the Bank of Canada (BOC) resumed benchmark increases in June and July, lifting the policy rate to 5% for the first time since 2001. Strong demand and sticky inflation, due in large part to strong population growth, prompted the decision. The BOC does not expect inflation to return to its 2% target until mid-2025, about two quarters later than the bank forecast in April. Immigration, strong labour markets and household savings accumulated during the pandemic continue to underpin strong demand and are helping to offset higher inflation and mortgage rates. That said, consumer spending is drifting lower as debt-servicing costs climb and that trend will continue and even accelerate. Tight credit conditions and prospects for slower economic growth are starting to dent business investment. We forecast that the policy rate will remain at 5.0% for the rest of 2023. In 2024, we expect the BOC will cut the policy rate to 4.25% by the fall. We expect the Canadian 10-year government bond will yield 3.00% sometime over the next 12 months.

We expect the UK benchmark interest rate to fall to 5.25% sometime over the next 12 months and the yield on the 10-year gilt to drop to 4.25%.

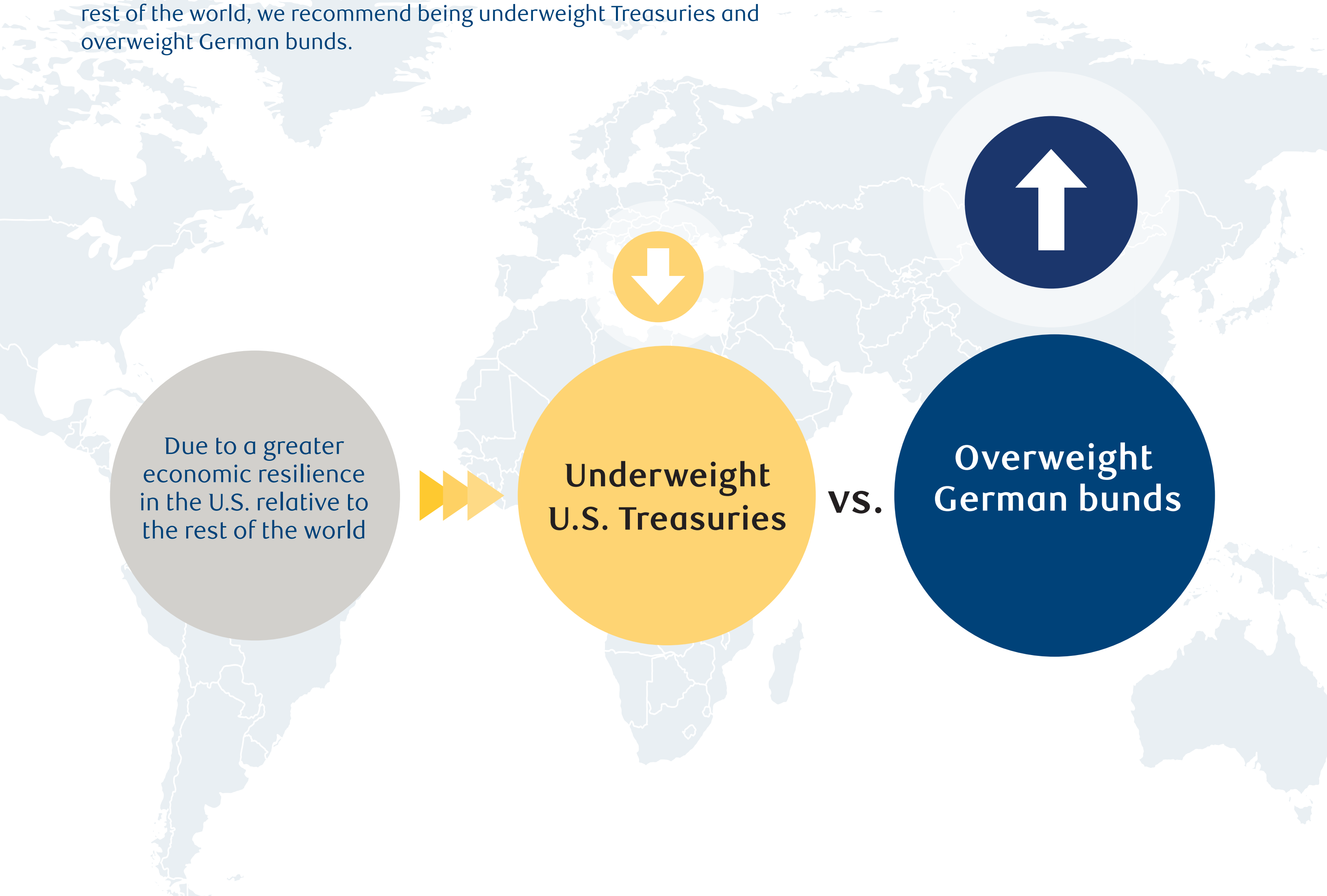
U.K.

We expect the Bank of England (the BOE) to halt policy tightening before the end of this year, with rates peaking at 5.75%. In the coming months, policymakers will shift their attention beyond the peak in rates, and we expect the BOE to cut rates in 2024 as household finances deteriorate due to higher interest costs and slowing economic activity. As the renewal pace of fixed-rate mortgages picks up, household consumption is likely to slow. The impact of higher mortgage rates on borrowers will be dramatic, and some Britons renewing a 25-year mortgage could face a 50% increase in monthly payments. As weak as we expect economic activity to be, inflation remains above the BOE's target, and this fact will tend to underpin rates and keep the BOE from supporting real activity as much as it would like.

The path toward lower yields faces a large hurdle given investors' concern over the credibility of the U.K. Treasury. The government's deteriorating finances and the probability of rising issuance in the coming months may lead investors to demand higher yield premiums. Debt-servicing costs currently stand at 4% of GDP, double the level in 2020 and the highest in 20 years. The surge is particularly large due to inflation compensation paid on government debt whose payments are linked to changes in prices. This issue is particular to the U.K., as a large percentage of the country's government debt is tied to such changes. We expect the U.K. benchmark interest rate to fall to 5.25% sometime over the next 12 months and the yield on the 10-year gilt to drop to 4.25%.

Regional outlook

Reflecting greater economic resilience in the U.S. relative to the rest of the world, we recommend being underweight Treasuries and overweight German bunds.



Interest-rate forecast: 12-month horizon

Total-return calculation: August 31, 2023 – August 31, 2024

U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.50%	4.10%	3.75%	3.50%	3.90%	6.67%
Change to prev. quarter	(0.25%)	0.60%	0.45%	0.25%	0.20%	
High	6.25%	6.00%	5.25%	4.75%	4.90%	0.23%
Low	2.50%	2.60%	2.60%	2.75%	3.50%	10.91%
Expected Total Return US$ hedged: 6.9%						

Germany						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.25%	3.00%	2.75%	2.60%	2.50%	2.45%
Change to prev. quarter	(0.25%)	0.50%	0.35%	0.35%	0.25%	
High	4.50%	4.00%	3.75%	3.50%	3.00%	(2.54%)
Low	2.00%	1.75%	1.75%	1.75%	2.00%	11.90%
Expected Total Return US$ hedged: 6.2%						

Japan						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.10%	0.20%	0.40%	0.75%	1.70%	1.32%
Change to prev. quarter	0.10%	0.00%	0.00%	0.00%	0.15%	
High	0.50%	0.75%	0.90%	1.25%	2.30%	(6.80%)
Low	(0.10%)	0.00%	0.20%	0.35%	1.20%	8.80%
Expected Total Return US$ hedged: 6.7%						

Canada						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.25%	3.75%	3.25%	3.00%	3.10%	6.44%
Change to prev. quarter	0.50%	0.25%	0.25%	0.25%	0.20%	
High	5.75%	5.50%	4.75%	4.25%	4.00%	(0.33%)
Low	2.25%	2.25%	2.25%	2.25%	2.40%	12.21%
Expected Total Return US$ hedged: 6.7%						

U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	5.25%	4.75%	4.50%	4.25%	4.50%	5.78%
Change to prev. quarter	0.50%	1.50%	1.10%	0.50%	0.50%	
High	6.50%	6.00%	5.50%	5.00%	4.80%	0.95%
Low	3.50%	3.00%	3.00%	3.00%	3.75%	15.37%
Expected Total Return US$ hedged: 7.8%						

Source: RBC GAM

Currency markets

Dollar detour: how short-term factors have interrupted the cyclical decline

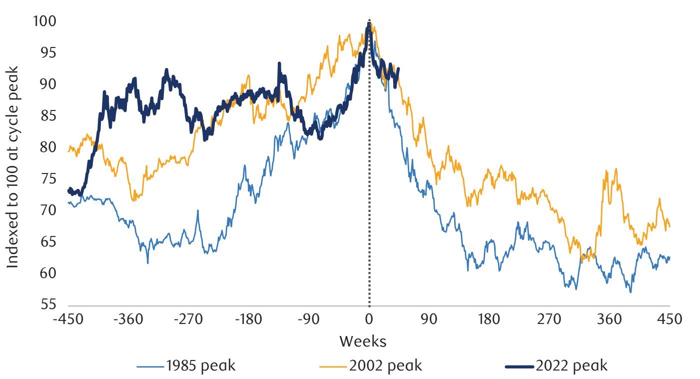
Dagmara Fijalkowski, MBA, CFA
Head, Global Fixed Income & Currencies
RBC Global Asset Management Inc.

Daniel Mitchell, CFA
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

The U.S.-dollar downtrend remains intact and we continue to expect significant weakness over the coming years. However, the long-term cyclical decline embedded in our outlook has run into a few shorter-term roadblocks, and so its progress has been slower than we had anticipated. While the dollar sits roughly 7% below its September 2022 peak, the currency is unchanged since the start of 2023. Higher U.S. interest rates and disappointing economic growth abroad have interrupted the dollar's slide in 2023. Still, emerging-market currencies as a whole have fared impressively – a few even managing to post double-digit returns so far this year – and the euro, Canadian dollar and British pound have also outperformed the U.S. dollar. We remain optimistic on most emerging- and developed-market currencies over the next 12 months, as we expect the U.S. dollar to decline broadly.

The greenback has so far failed to follow through on the significant weakness experienced late last year. A quick 10% decline from October 2022 to January of this year offered a glimpse of what past cyclical declines have entailed (Exhibit 1), but the move stalled early in the year (Exhibit 2). U.S.-dollar strength this summer has caused some investors to question the sustainability of the downtrend. We, on the other hand, remain confident that the long-term trajectory for

Exhibit 1: U.S.-dollar bear market roadmap



Note: As at August 28, 2023. Uses USTWAFE index. Source: Bloomberg, RBC GAM

Exhibit 2: U.S. dollar in tight year-to-date range

Note: As at August 29, 2023. Note: Uses BBDXY index. Source: Bloomberg, RBC GAM the U.S. dollar is lower, and we expect a multi-year period of weakness (Exhibit 3) to exert an important influence on bond, equity, commodity and currency markets.

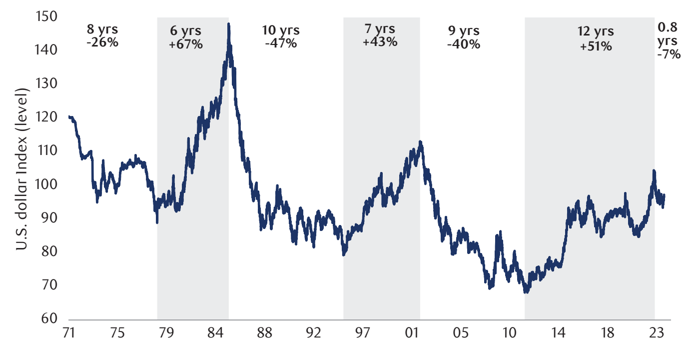
Fundamental factors continue to make the case for a weaker U.S. dollar. Most valuation models indicate that the currency has been expensive for several years, and the purchasing power parity model that we monitor places the dollar at more than 20% rich to its estimated fair value (Exhibit 4). Likewise, few would contest the link between America's deteriorating fiscal and trade deficits and U.S.- dollar movements (Exhibit 5) or the negative U.S. dollar implications from U.S. bank failures, threats of government shutdowns and credit-rating downgrades. As discussed in prior editions of the Global Investment Outlook, the theme of 'dedollarization' – a slow but gradual shift away from using the U.S. dollar for global trade and global investment - has gained traction. The theme will erode support for the dollar over the next decade, especially if the U.S. continues to weaponize the currency by restricting access to payment systems and freezing the foreign-exchange reserves of its enemies. A study[1] published by the IMF in January found that dozens of countries in Europe, the Middle East and Asia have resorted to holding more gold as a reserve asset.

The U.S. dollar's resilience can largely be explained by short-term factors. A persistently hawkish U.S. Federal Reserve (Fed) has done its part in keeping the greenback strong, as higher U.S. rates continue to attract capital away

> "So long as this policy tightening doesn't cause a recession in the U.S. the greenback should depreciate."

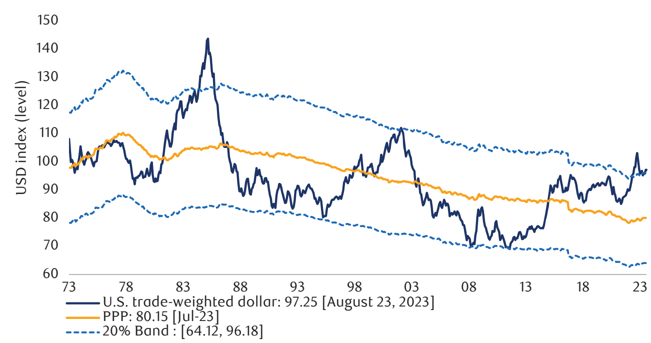
[1] Arslanalp, S., Eichengreen, B. J., & Simpson-Bell, C. (2023). "Gold as International Reserves: A Barbarous Relic No More?" IMF Working Paper No. WP/23/14

Exhibit 3: U.S. trade-weighted dollar



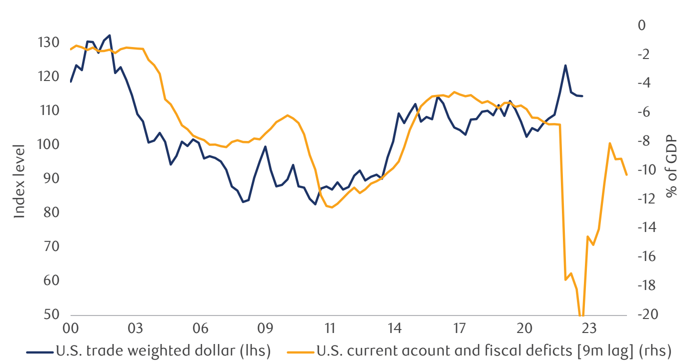
Note: As at August 25, 2023. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 4: U.S. dollar – PPP model



Note: Uses new Fed USD index from Dec 31, 2019 onward (USTWAFE Index). As at August 23, 2023. Source: U.S. Federal Reserve, Bloomberg, RBC GAM

Exhibit 5: U.S. dollar and the American twin deficits

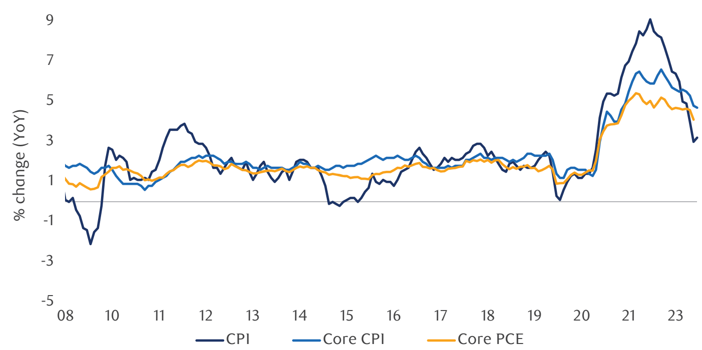


Note: As at March 31, 2023. Source: Bloomberg, RBC GAM from lower-yielding regions such as Japan. For now, the Fed has been steadfast in asserting that monetary policy will be kept tight for as long as it takes to tame inflationary pressures. Exactly when U.S. policymakers will be able to claim victory on this task is up for debate. Overall inflation has declined to about 3% from a high of about 9% (Exhibit 6), which suggests a job nearly finished, although the Fed's preferred measure of price changes (core PCE) has not yet declined sufficiently. With the fed funds rate having risen to 5.50%, the Fed's inflation-adjusted policy rate is positive again and thus more restrictive of economic growth.

So long as this policy tightening doesn't cause a recession in the U.S., the greenback should depreciate as inflation continues to decline because it relieves pressure on the Fed to raise interest rates further and could even prompt the Fed to lower them. It's safe to say that the positive impact of higher yields on the U.S. dollar has largely played out, and that the Fed is either finished or nearly finished with rate hikes.

The other primary factor supporting the greenback is the relatively downbeat economic news in other regions. Europe and China stand out, not only because they are the next two biggest economies after the U.S., but because their economic data have been so disappointing (Exhibit 7). Without the prospect of superior returns luring capital abroad, it's unlikely that the euro and renminbi can make substantial gains. Having said this, sentiment toward these two currencies is extremely poor, telling us that the worst may already be factored in.

Exhibit 6: All three inflation measures falling

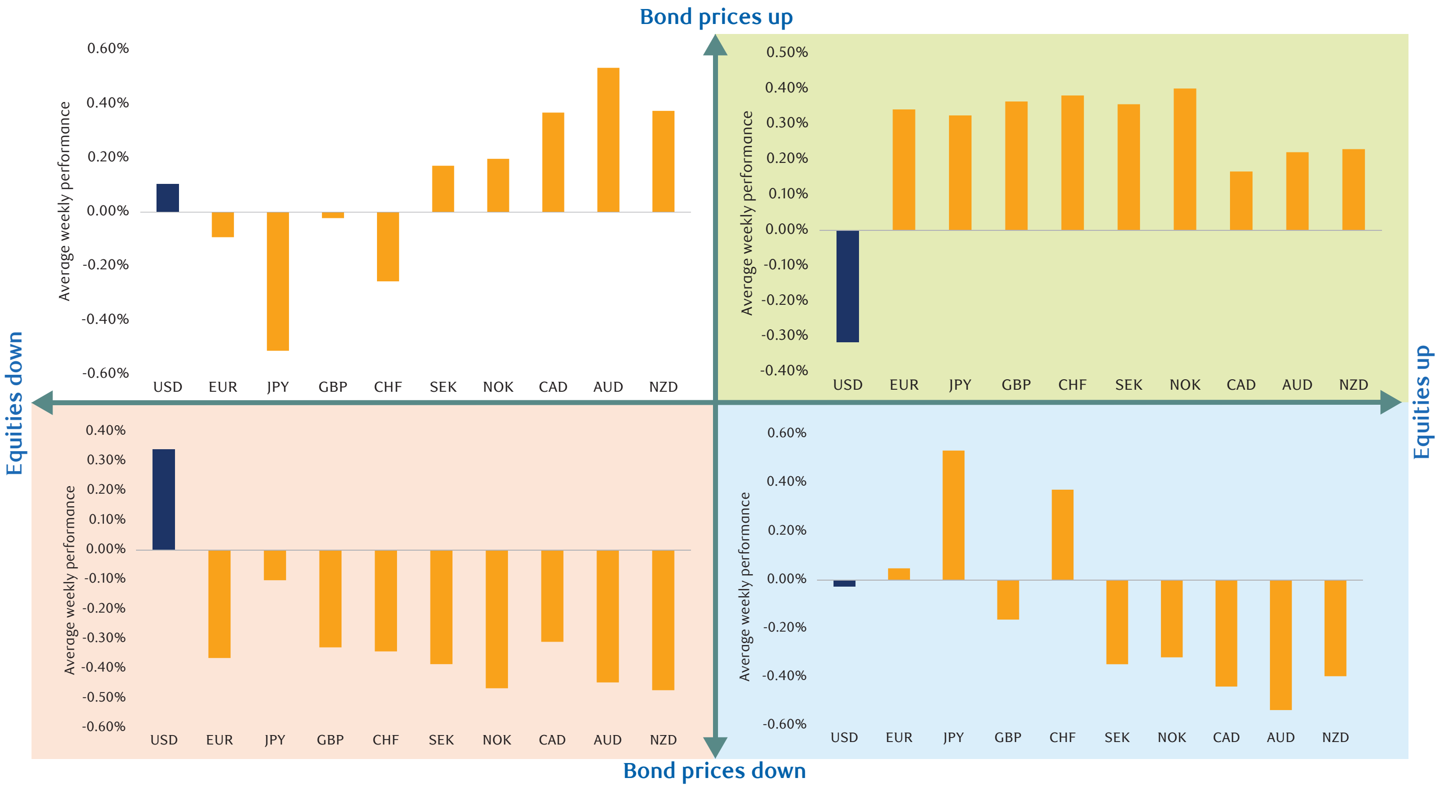


Note: As at August 28, 2023. Source: Bureau of Labour Statistics, Bureau of Economic Analysis, RBC GAM

Exhibit 7: Economic-data surprises by region

Note: As at August 28, 2023. Source: Citi, RBC GAM

Exhibit 8: Currency performance in bond/equity regimes
Weekly data 1980–2023



Note: As at August 25, 2023. Bars show average of weekly data from 1980 – 2003, excluding observations within +/- 0.5 standard deviations.
Source: RBC Capital Markets, RBC GAM

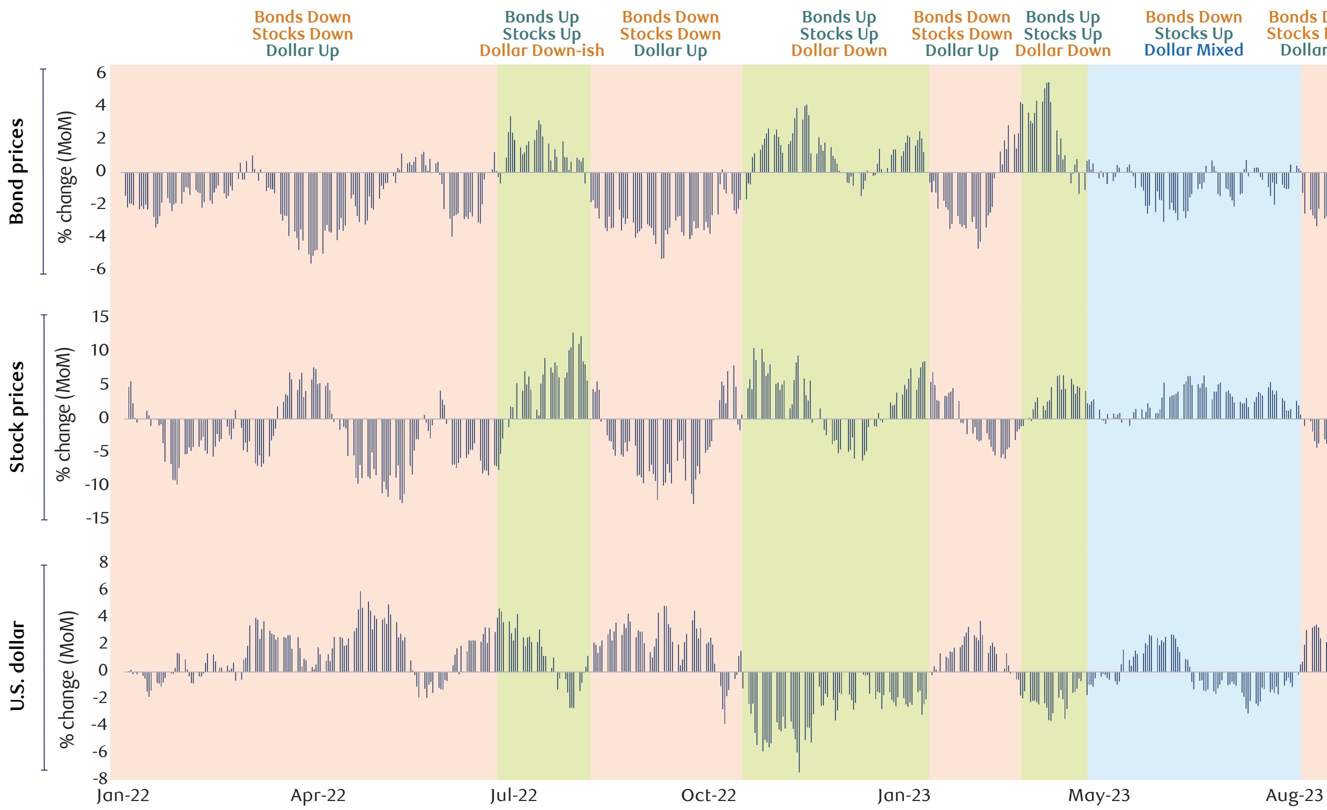
A new regime?

A study of the relationship between financial markets and the U.S. dollar also suggests that the greenback could enter a period of weakness. The four-quadrant framework illustrated in Exhibit 8, devised by Adam Cole and Elsa Lignos at RBC Capital Markets, displays currency returns in different bond/equity environments over the past four decades. As one would expect, a rising greenback correlates most closely with declines in both stocks and bonds (bottom left-hand quadrant) because the dollar benefits from higher yields as bonds weaken and from safe-haven demand when stocks falter. This was the prevailing market environment for much of 2022, and in retrospect the dollar would have served as a good hedge for investors grappling with the very difficult investment landscape at the time. Periods where bonds and stocks fall in unison are fairly rare, however, and are typically characterized by periods when Fed interest-rate hikes threaten to interrupt equity bull markets. As the Fed nears the end of its rate-hiking cycle, we don't expect this difficult environment to persist, and indeed have noticed a weaker link between bonds and stocks (bottom right quadrant) in recent months (Exhibit 9). Provided that a hard economic landing can be avoided, we suspect that bonds and stocks could both experience relief as the Fed pauses rate hikes, an environment in which the dollar would be expected to sell off broadly against its peers.

Emerging markets

Many of the world's best performing currencies over the past year have been emerging-market ones offering much higher interest rates than even the U.S. dollar. A number of emerging-market central banks, including Hungary, Mexico and Brazil, were more aggressive than the Fed about raising rates last year in response to rising inflation, and such policy

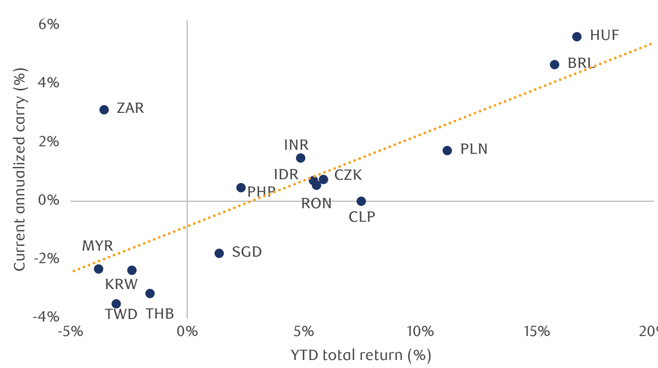
Exhibit 9: Rolling 1-month price returns (bonds, stocks, $)



Note: As at August 25, 2023. Source: RBC GAM

saved these countries from experiencing sudden capital outflows as U.S. rates rose. In fact, the higher yields – double digits in some countries – have led to substantial emerging-market currency total returns (Exhibit 10) comprised of both healthy yields and exchange-rate gains. The success of such yield-seeking strategies has been fueled by low market volatility, strong equity markets and a wide gap in rates between high- and low-yielding currencies. Emerging-market currencies may continue to outperform as the dollar falters, but we are growing more cautious as valuations converge and as some emerging-market central banks, notably those in Brazil and Chile, begin cutting rates. While U.S.-dollar weakness represents a broad-based tailwind for emerging-market currencies, we are likely to be more selective in which emerging markets to own. We look to own currencies of countries with better growth and fiscal profiles while avoiding those with central banks that are cutting interest rates before inflation has subsided.

Exhibit 10: Strong relationship between yield and FX performance



Note: Data as at August 28, 2023. Source: Bloomberg, RBC GAM

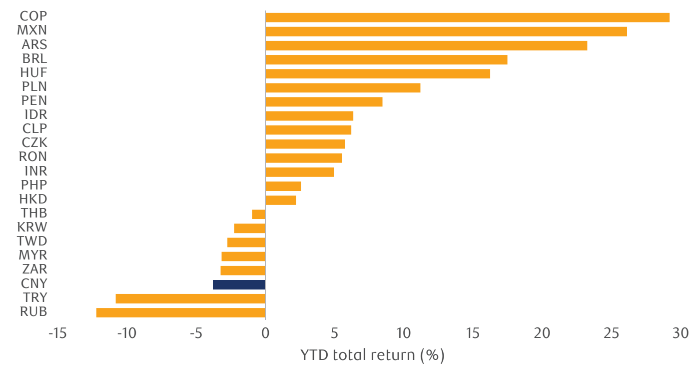
Chinese renminbi

The Chinese renminbi has been one of the worst performing currencies this year, ranking third worst among 25 major emerging markets and just ahead of the Russian ruble and Turkish lira (Exhibit 11). A rebound in economic growth failed to materialize after COVID restrictions were relaxed late last year, and these disappointing results are reflected in currency performance. Moreover, with Chinese interest rates among the lowest in emerging markets and with policy rates being cut twice this summer, the renminbi has been shunned by investors seeking currencies offering higher yields. The softer renminbi and the general ill-health of the Chinese economy has weighed on investor appetite for all emerging-market currencies, but there's hope that this currency headwind may lighten as the Chinese central bank starts to push back against the renminbi's decline. For Chinese policymakers, who prioritize stability and control, the yuan's near-10% fall since January threatens to attract speculation about further declines, a dynamic that could erode confidence in the currency and disrupt efforts to encourage investment. As the currency nears lows not seen since the global financial crisis (Exhibit 12), the People's Bank of China has used many of its tools to support the renminbi.
These include:

- providing guidance through a daily reference rate that is stronger than the prevailing exchange rate,
- engineering higher short-term interest rates aimed at dissuading short positions in the renminbi,
- coercing banks and state-owned exporters to convert their foreign cash holdings and cutting reserve requirements on foreign-exchange dealings to free up more assets for repatriation.

The bank is well-armed with additional and more powerful tools that it has yet to tap, including direct purchases of renminbi. Our view is that the current round of renminbi depreciation is nearly complete and that the bad economic news has been factored into the exchange-rate level. We don't expect the renminbi to rebound sharply, but the absence of further weakness would remove an important negative influence on emerging-market currencies and thus is a negative for the U.S. dollar overall.

Exhibit 11: Renminbi one of the worst EM peformers for the year



Note: As at August 28, 2023. Source: Bloomberg, RBC GAM

Exhibit 12: Renminbi approaching levels not seen since the global financial crisis

Note: As at August 25, 2023. Source: Bloomberg, RBC GAM

Euro

The euro strengthened in early summer, rising above US$1.12 in mid-July from US$1.065 at the beginning of June. The rally was partly attributable to the European Central Bank's (ECB) determined efforts to fight inflation, though it also reflected a broad sell-off in the U.S. dollar at that time. Since then, sentiment toward the single currency has soured because of a trio of factors: (i) disappointing European economic data, (ii) a weak Chinese economy that spends less on European exports and (iii) lower odds of a U.S. recession and a reversal of next year's Fed rate-cut expectations. The pessimism around economic growth outside of the U.S. is already widespread, so there's room for this sentiment to recover. Indeed, the economies of both Europe and China have already begun to show unexpected signs of improvement.

The next several months will offer important insights into the trajectory of monetary policy in all major regions. For now, we can be relatively certain that the Fed has hiked interest rates sufficiently, lessening the support that the dollar receives from higher rates. Many investors think the ECB is almost done with its rate-hike cycle given perceptions that Europe's growth slump will bring inflation down without the need for much in the way of further rate hikes. Unlike the Fed, however, the ECB is not tasked with targeting growth and employment when setting policy rates. Will the ECB's past hikes be enough to bring down the stubbornly high core inflation in Europe? Could China's recent efforts to stimulate growth support the euro? ECB President Lagarde didn't provide her views on these questions in a recent appearance at the Jackson Hole central-banker conference in Wyoming, but her comments did lean more hawkish – a sign that that the ECB isn't yet claiming victory in its fight against rising prices. A recovery in the euro will require more than just a hawkish central bank, however. We expect that the European economy will be on better footing in a year's time and that a weaker U.S. dollar overall will help the euro to strengthen. Our forecast is for the single currency to rise to US$1.21 in 12 months' time.

"Will the ECB's past hikes be enough to bring down the stubbornly high core inflation in Europe?"

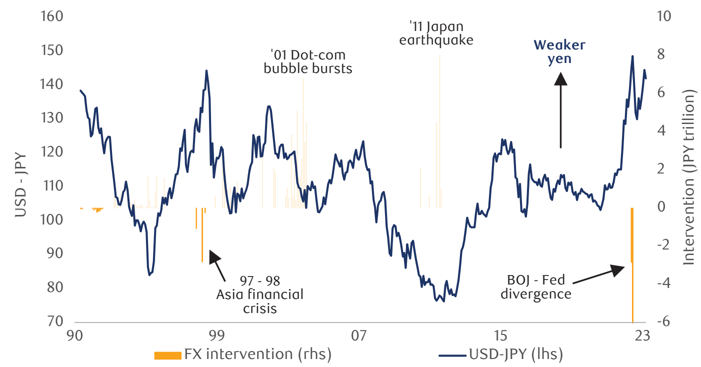
Japanese yen

Japanese authorities last intervened to support the yen in October 2022, and it appears increasingly likely that they may do so again. G20 central banks have generally condoned the practice of tamping down excessive currency volatility but have frowned on targeting specific exchange-rate levels that would result in unfair trade advantages. Japanese authorities intervened by selling U.S. dollars following last year's near-40% decline in the yen (Exhibit 13), and as the Japanese currency weakens back to those intervention levels (140-150 per U.S. dollar), the market is growing more anxious about shorting the yen. The impact of any intervention would probably be fleeting, though, because the government is unlikely to enjoy the coordinated support of other countries and because such actions conflict with Japan's relatively low interest rates – a more powerful influence on exchange rates. A change in the Bank of Japan (BOJ) monetary policy and/or more persistent U.S.-dollar weakness is needed for the yen to rally in earnest.

A change in BOJ policy may soon be on its way. The bank allowed 10-year JGB yields to rise above the +/-50-basis-point range established by its so-called yield curve control (YCC) policy. Initially set at +/- 10 bps around 0%, the policy has been widened a few times since it was introduced in September 2016

(Exhibit 14). With core inflation at a 40-year high of 4.3%, pressure is mounting on the central bank to widen the band further or even to abandon the policy. The bank has bought itself some time by announcing a formal review of monetary policy over the next year, but we suspect that some action will take place within our 12-month forecast horizon. Our 120 yen per US-dollar forecast is built on expectations that the BOJ allows interest rates to fluctuate more freely.

Exhibit 13: BOJ intervention history



Note: As at July 31, 2023. Source: Japan Ministry of Finance, RBC GAM

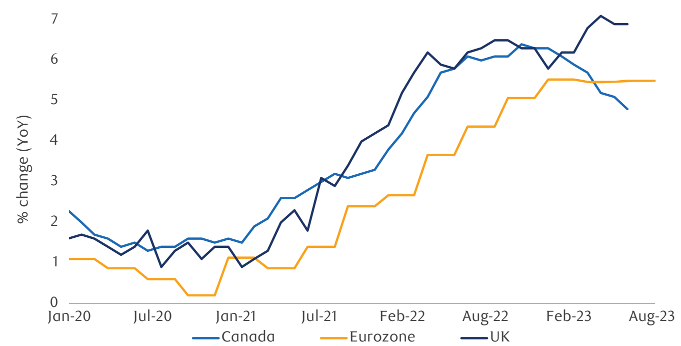
Exhibit 14: 10-year Japanese bond yields and yield-curve-control bands

Note: As at August 29, 2023. Source: Bank of Japan, RBC GAM

British pound

The pound, this year's best performing G10 currency, has been surprisingly resilient as persistently high inflation pushed the Bank of England (BOE) to continue hiking interest rates (Exhibit 15). The increase in policy rates has helped support the pound in the face of concerns about weak consumer spending, trade deficits and the fact that British companies are investing more abroad at the same time that foreign companies are pulling back on their U.K. investments. The BOE is now expected to raise interest rates to almost 6%, 2 full percentage points higher than the market's expectation in March. This looks overdone: Investors, in our view, are too optimistic in their views that the pound will be able to sustain its gains. While sterling may continue to rally against a weak U.S. dollar, we expect the pound to fall versus other major currencies this year. Our view is that the currency will appreciate only modestly to US$1.33.

Exhibit 15: Sticky U.K. inflation



Note: As at July 31, 2023. Source: Macrobond, RBC GAM

Canadian dollar

Until recently, shorting the Canadian dollar was a popular strategy for hedging against scenarios involving a U.S. economic slowdown, owing to the loonie's tight link with oil prices and the U.S. economy. The paring of these short positions alongside better U.S. economic data helped the loonie strengthen toward the lower end of this year's $1.32-$1.40 per U.S.-dollar range before generalized U.S.- dollar gains caused the exchange rate to bounce again (Exhibit 16). As the Canadian dollar nears $1.32 per U.S. dollar, the loonie may have trouble keeping up with gains we expect from the euro and the yen given the persistence of the trading range. Over a 12-month horizon, though, we expect the loonie to strengthen to $1.24 per U.S. dollar as cyclical currencies benefit most from greenback weakness.

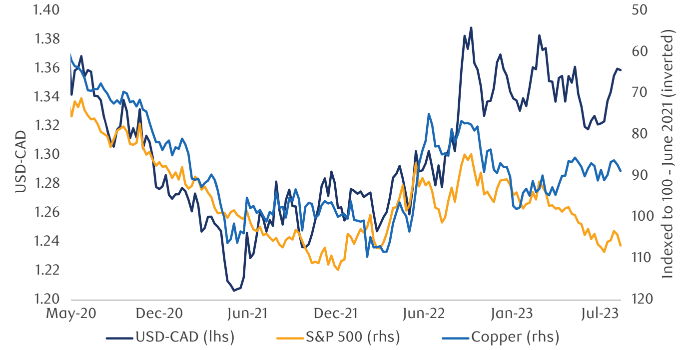
There are plenty of other reasons to be positive on the Canadian dollar. From a longer-term viewpoint, the currency is undervalued, Canada is well endowed with natural resources and the loonie enjoys support from foreign demand for Canadian corporate bonds and from healthy immigration. The country also has a stable political environment and a strong banking system that hasn't

Exhibit 16: USD – CAD range

Note: As at August 29, 2023. Source: Bloomberg, RBC GAM experienced the same kind of deposit flight as in the U.S. Shorter-term factors are mostly supportive as well, with stock-market movements, copper prices and general U.S.-dollar weakness all pointing toward a stronger Canadian dollar (Exhibit 17).

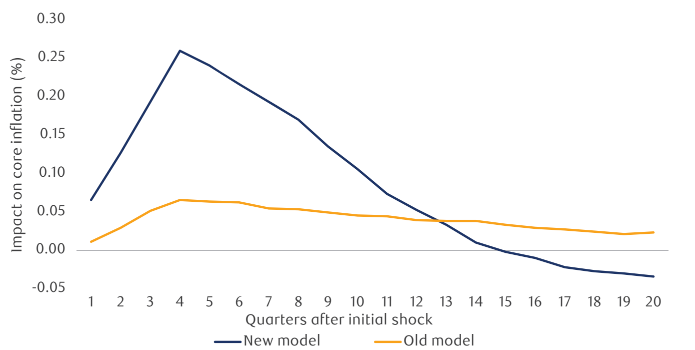
Partly countering these short- and long-term positives are intermediate concerns about how tighter financial conditions might impact household finances. The Bank of Canada (BOC) paused its rate-hiking cycle earlier in the year, only to learn that consumer spending had been surprisingly strong. It's likely that a breakneck pace of immigration and low unemployment rate are responsible for supporting consumer demand and boosting inflation. The BOC noted in July that prices excluding food and energy were higher than it would like, so, while the bank paused in early September, the emphasis remains on further policy tightening. On the other hand, the newest version of the bank's economic model (Exhibit 18) shows that the Canadian dollar has a greater impact on core inflation than previously thought. Given the importance of this model in the BOC's decision making, it's possible that further Canadian dollar strength is seen as a welcome and complementary tool in containing consumer-price gains.

Exhibit 17: Short-term drivers suggest USD-CAD below 1.30



Note: As at August 28, 2023. Source: Bloomberg, RBC GAM

Exhibit 18: Inflation senstivities



Note: As at June 30, 2021. Source: CIBC, Bank of Canada, RBC GAM

Regional outlook – United States

Brad Willock, CFA
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

U.S. stocks, measured by the S&P 500 Index, rebounded to finish the three-month period ended August 31, 2023, up 8.3%. The higher-than-average quarterly gains were driven primarily by better-than-expected economic activity and cooling inflation, and stock-market returns also benefited from a broadening of participation beyond the technology-dominated gains of the previous period. The Energy sector led the way, driven by increases in prices for oil, up 20%, and natural gas, up 14%, as well as solid gains from cyclical areas such as semiconductors, capital goods and retail spending on discretionary items. Defensive industries continued to lag, including telecommunications providers, utility companies, sellers of consumer staples and interest-sensitive REITs. Clearly, the widely held recessionary narrative of late last year has faded, and investors appear to have concluded that an economic soft landing is the most likely outcome. But with both stock prices and interest rates up, risks are up, too.

Let's begin our review with the big picture. The economy has been incredibly resilient, growing at a pace that was above the historical average during the first half of this year, even as policy rates reached their highest in more than two decades. Historically, rising interest rates would deter companies from building factories and buying equipment, but capital spending has been particularly strong thanks to fiscal subsidies and government tax credits aimed at easing the energy transition, especially for battery and electronic-vehicle manufacturing, and the semiconductor industry. Indeed, there is a backlog of over US$500 billion of projects that should continue to support the economy for several years.

In terms of households, rising rates typically depress consumer spending by raising borrowing costs that reduce demand for big-ticket items such as cars and houses. However, this cycle is not typical. During the pandemic in 2020 and 2021, mortgage rates fell below 4% and millions of households refinanced or bought homes at extremely low interest rates. Now, the average rate for a new mortgage is over 7%, while the majority of homeowners carry mortgages around 3.5% and have no incentive to move. The result is that fewer than 1% of existing homes are for sale, a record low and a third of what is normal. Affordability has plummeted, and home turnover has dropped to a rate seen only in past housing busts. Nevertheless, home prices have suffered only a minor correction as inventories remain tight.

The last pieces of the big picture have to do with the U.S. Federal Reserve's (Fed) purview – inflation, labour markets and interest rates. Inflation appears to be ebbing. In goods, supply-chain pressures have reversed and prices are deflating. In services, the labour market remains tight, with the pickup in immigration insufficient to offset the reduced supply of labour from retiring Baby Boomers. Still, wage pressures are moderating, and decreases in aggregate hours

United States – Recommended sector weights

	S&P 500	
Energy	4.5%	0.5%
Materials	2.5%	0.5%
Industrials	8.5%	1.3%
Consumer discretionary	10.5%	-0.5%
Consumer staples	6.5%	-0.5%
Health care	13.2%	0.3%
Financials	12.5%	-1.0%
Information technology	28.2%	1.3%
Communication services	8.7%	0.5%
Utilities	2.4%	-1.2%
Real estate	2.4%	-1.2%

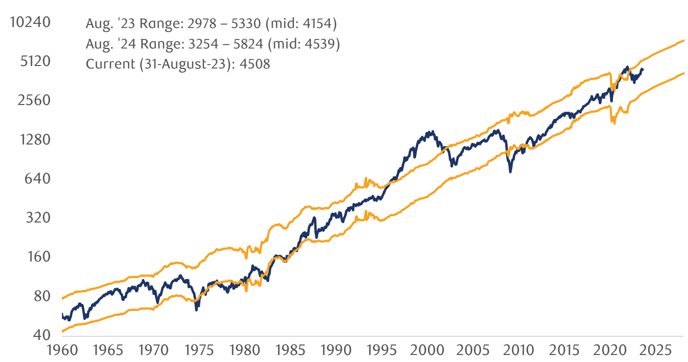
-1.5% -1.0% -0.5% 0.0% 0.5% 1.0% 1.5%

Underweight Overweight

Note: As of August 31, 2023. Source: RBC GAM

> “We believe equity investors are anticipating a soft landing with a decent rebound in earnings later this year and into 2024.”

S&P 500 Equilibrium
Normalized earnings and valuations



Source: RBC GAM

worked and in the use of temporary labour suggest further softening is likely in the months ahead. The Fed has hiked rates 5.25 percentage points in 17 months and financial conditions continue to tighten. In our view, the Fed is done or almost done raising rates for this cycle. If policymakers remain patient, inflation is likely to keep fading as the economy decelerates while households and businesses slowly adapt to the higher cost of money.

Next let's consider the outlook for corporations. The revenues of the S&P 500 grew by just 1% in the first half of the year and its earnings per share declined by 1%. If we exclude the Energy sector from the analysis, revenues were up 4% and earnings per share roughly 2%. Profit margins excluding the Energy and Utilities sectors were up in the latest quarter as raw-materials costs, inventories and growth in capital spending all declined. The drop in inventories and the capital-spending slowdown resulted in a bounce-back in free-cash-flow margins to 11.5%, near the peak of 12% in 2021. Free-cash-flow margins in the Information Technology sector were at a record 25% in the second quarter, while the average for the rest of the market was 9%.

Artificial intelligence (AI) as an investment theme continued to be a significant driver of returns during the period. We believe that the productivity-enhancing potential of the technology is real and that a powerful adoption wave is just beginning. Phase One of this adoption involves investors buying the so-called "picks and shovels" - semiconductor manufacturer Nvidia is the obvious leader of this group that also includes other chipmakers; the cloud providers, Amazon, Microsoft and Google; and leading enterprise software developers such as Adobe, CRM, Intuit and Service Now. The outperformance of these "obvious" AI winners has been substantial and we are on the lookout for signs of excess. While valuations have expanded, many of these companies are generating market-leading amounts of free cash flow. These cash flows help to counterbalance high valuations and extended price momentum. In sum, it's still early, and we don't yet see an investment bubble in this area.

That brings us to where we stand today. At roughly 4500, the S&P 500 is up almost 14% from a year ago and over 25% since early October 2022. The consensus estimate for aggregate S&P 500 earnings for the next 12 months is US$238, implying a valuation of roughly 19 times today versus less than 15 last fall. We believe equity investors are anticipating a soft landing with a decent rebound in earnings later this year and into 2024. But with stock valuations and interest rates at current levels, we have to acknowledge that the risks are rising.

Regional outlook – Canada

Sarah Neilson, CFA
V.P. and Senior Portfolio Manager
RBC Global Asset Management Inc.

Irene Fernando, CFA
V.P. and Senior Portfolio Manager
RBC Global Asset Management Inc.

Canada's stock benchmark, the S&P/TSX Composite Index, gained 4.6% on a total-return basis over the three months ended August 31, 2023. In U.S.-dollar-terms, the S&P/TSX Composite gained 5.1%, lagging the S&P 500 Index, which advanced 8.3%, and the MSCI World Index, which gained 7.0%.

Global equity markets climbed over the past three months given the spectacular performance of a relatively small number of stocks linked to artificial intelligence and optimism that the economy may sidestep a deep recession. Taming persistently high inflation has been the focus of central banks and investors this year. While recent data have indicated that inflation pressures are easing after a rapid rise in interest rates, inflation remains above targets set by central bankers, who continue to force short-term rates higher though at a slower pace. Longer-term interest rates have surged higher in recent months, which could pressure equity valuations lower. While economists continue to expect the economy to slip into a recession due to tighter monetary policy, the magnitude remains up for debate. Equity returns will ultimately depend on the path of interest rates, the severity and length of any recession that materializes, and its impact on corporate-earnings growth. As always, commodity prices will play a significant role in Canadian equity results, given the importance of the Energy and Materials sectors to the index. These will reflect the growth prospects for both developing and emerging markets where growth has been slow to emerge.

Inflation is steadily coming down. The rise in Canadian consumer prices in July, at 3.3%, was down from April's 4.4% increase and as much as 8.1% in June 2022. Energy costs had fallen until recently and food inflation has also slowed, while the cost of housing continues to press higher as mortgage rates and rents rise. In July, the Bank of Canada (BOC) raised its benchmark interest rate to 5%, aiming to drive inflation towards its 2% target rate. The BOC is projecting that inflation will remain close to 3% for the next two years given persistent strength in the economy and tight labour markets. Canada's population-growth rate reached 2.7% this year, the fastest in its peer group, contributing to an increase in consumer spending and housing demand. Economists have boosted their expectations for domestic economic growth with estimates that it will expand 1.5% in 2023, but then slow to 0.8% in 2024. The consensus among forecasters is that the BOC plans to leave its policy rate where it is for the rest of 2023.

Higher interest rates have pushed mortgage rates to levels not seen since 2006, cooling home sales in Canada. Even so, home prices are down just 1.5% from last year as new listings

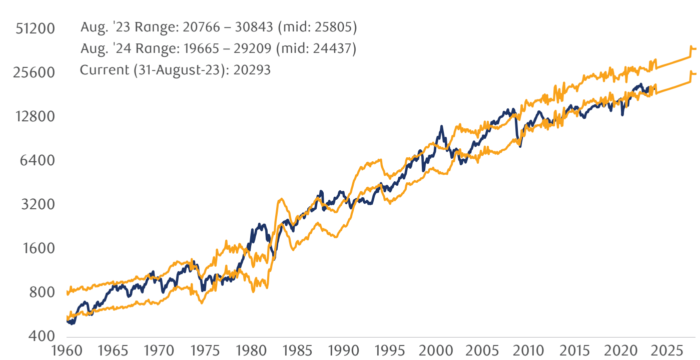
Canada – Recommended sector weights

Sector	S&P/TSX Composite	Underweight / Overweight
Energy	18.1%	1.4%
Materials	11.8%	0.2%
Industrials	13.6%	1.4%
Consumer discretionary	3.7%	-0.7%
Consumer staples	4.2%	0.3%
Health care	0.3%	-0.3%
Financials	30.0%	-1.0%
Information technology	8.0%	0.5%
Communication services	3.8%	-0.6%
Utilities	4.2%	-0.9%
Real estate	2.4%	-0.4%

Note: As of August 31, 2023. Source: RBC GAM

> "Higher interest rates pose significant risks for homeowners whose mortgages come up for renewal, which in turn hurts affordability and discretionary spending."

S&P/TSX Composite Equilibrium
Normalized earnings and valuations



Source: RBC GAM

have been limited, although a recent uptick has led to a more balanced market. Already high Canadian housing prices have been exacerbated by rising rents and interest costs, forcing economists and politicians to seek ways to make homes more affordable while ensuring that homeowners can service their mortgages and consumers can keep spending.

The Energy sector, one of Canada's three biggest, benefited from rising crude-oil prices, while the Real Estate sector, dominated by REITs, had a strong quarter but remains this year's worst-performing sector given higher mortgage rates. The Information Technology sector, led by Shopify, relinquished some of its strong gains as higher interest rates weighed on valuations. The Financials sector, dominated by the big banks, gained slightly over the past three months, as investors remain concerned about the impact of higher interest rates on loan portfolios for housing and businesses. The Utilities sector performed the worst over the past three months, as industries with significant debt levels were hurt as the rise in interest rates led to concerns that those debts would have to be refinanced at significantly higher rates. The Materials sector's performance was slightly positive in a period where prices for gold, metals and lumber were largely unchanged.

Analysts' earnings expectations for the S&P/TSX have been cut for both 2023 and 2024. Expectations that commodity prices will decline amid slowing growth and higher interest rates have reduced the outlook for earnings, which are forecast to decline by 8% in 2023. Looking ahead to 2024, earnings are expected to rise by 11% for Canadian companies as Financials, Energy and Materials deliver better results. This outlook will likely prove optimistic should a recession materialize. The S&P/TSX trades at 13.3 times forward earnings, below its 14.5 long-term average. The TSX's discount to the S&P 500 remains wide owing in part to the large weighting of banks and cyclical sectors such as Energy and Materials in the Canadian benchmark.

The current consensus is that bank earnings will decline 5% in the fiscal year ending October 2023, and this weakness is reflected in the banks' underperformance versus the S&P/TSX during the period. The six large domestic banks trade at 9.9 times forward earnings, a 11% discount to the longer-term average. Bank-stock valuations reflect concerns about rising odds of a recession and worries about the health of Canadian consumers. Higher interest rates pose significant risks for homeowners whose mortgages come up for renewal, which in turn hurts affordability and discretionary spending. Elevated expense growth driven by inflation, pressure on revenue growth from a weaker U.S. operating environment and higher provisions for credit losses are all contributing to the lackluster earnings outlook. In addition, higher funding costs remain an issue for both Canadian and U.S. banks. Capital remains elevated as banks are facing increases in regulatory capital requirements. In Canada, the Office of the Superintendent of Financial Institutions has raised the Domestic Stability Buffer, a key regulatory requirement, by 50 basis points to 3.5% of total risk-weighted assets, effective November 1, 2023. As a result, banks that were running close to regulatory capital minimum need to preserve and build their capital, which can impede near-term growth. All of this is to say that the outlook for 2024 EPS growth will be soft until business picks up. Until then, the sector should trade at a discount to history.

The Energy sector gained 10% over the three-month period, reflecting the rally in crude-oil prices, as the continued economic resilience has supported demand for oil and natural gas. Since the beginning of the year, North American oil prices have gained 18% and natural gas 13%. The outlook for crude oil is supported by continued solid global demand and limited supply given the additional OPEC production cuts announced earlier this year. Crude prices will likely remain volatile as investors balance the positive force of persistent demand with the potentially negative repercussions of any eventual recession. Canada's energy producers are looking ahead to the completion of two major infrastructure projects on British Columbia's west coast, the LNG Canada export facility and, at exorbitant cost, the Trans Mountain Expansion pipeline. These projects are expected to bring increased demand for the country's petroleum resources starting in mid-2024 and could spur consolidation among producers as they try to lock up resources. One area of potential weakness in the sector is energy infrastructure, where rising interest rates have pressured earnings. Debt reduction and fundraising for projects with the potential for attractive returns will be the key to any improvement in their outlook.

Regional outlook – Europe

Elma de Kuiper
Portfolio Manager
RBC Global Asset Management (UK) Limited

European equities continued this year's strong gains, returning 12.4% in U.S. dollars through August 31, 2023, and 3.7% in the latest three-month period. However, Europe underperformed the world index by just over 3 percentage points during the three-month period, a result that was especially pronounced versus U.S. stocks that benefited from the outsized influence of a handful of large-cap technology issues. Stocks fluctuated on concerns that central bankers would be forced to extend interest-rate hikes, as inflation, while slowing, has not receded as quickly as central bankers had hoped.

Leading indicators for Europe are still painting a bleak picture. Earnings-per-share estimates are falling, but inflation is still the most pressing issue, and it's proving particularly sticky in the U.K. and Germany. There are signs, however, that the situation may improve. While the eurozone entered a short recession with GDP declines in the fourth quarter of 2022 and first quarter of 2023, labour markets have proven more robust than expected.

Several macroeconomic indicators suggest the economy continues to slow. Notably, services declined in June and July from their peak. There are early indications that inflation is slowing but it is too early to call the end to the tightening cycle as oil prices have strengthened recently and inflation is still higher than in recent decades. Housing prices are beginning to fall, although equity markets have proved remarkably resilient considering the dividend yield on the MSCI Europe Index, at 3.4%, is well below the 6% interest rate available on a risk-free bank deposit.

Our style indicators have started flashing 'recession,' which even if it doesn't emerge as a technical one, usually indicates the outperformance of high-quality, large-cap value stocks. It's this part of the market that has indeed posted the best returns in the past few months. Surprisingly, worsening macroeconomic signals have coincided with analysts increasing their earnings estimates for sectors generally associated with faster economic growth, including Energy and Industrials. Earnings have risen faster than prices, pushing down valuations. Earnings at defensive companies appear set to grow faster than those at cyclical companies in the short term.

Inflation and corporate profitability

The return of inflation following the pandemic led to record margins for earnings before interest and taxes as companies were able to push through prices increases that more than covered supply-chain issues, higher wages and skyrocketing energy prices after Russia invaded Ukraine in early 2022. Consumers have arguably borne the brunt of the inflationary pain, and corporate profit margins are at their highest since before the financial crisis of 2008.

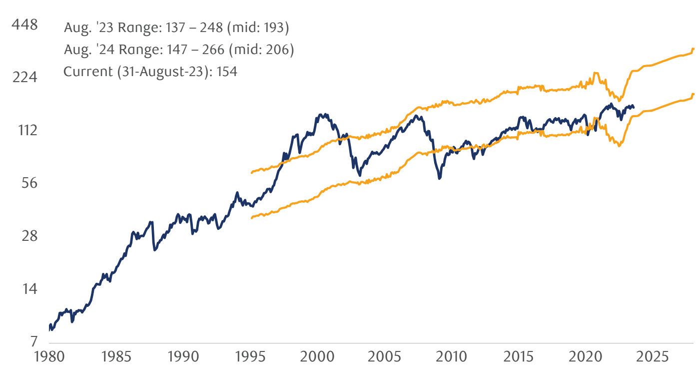
Europe – Recommended sector weights

Sector	MSCI Europe	Underweight / Overweight
Energy	5.9%	-0.4%
Materials	7.0%	0.5%
Industrials	15.0%	1.0%
Consumer discretionary	11.1%	0.1%
Consumer staples	12.4%	0.6%
Health care	16.2%	1.0%
Financials	17.4%	-0.4%
Information technology	6.9%	0.6%
Communication services	3.1%	-1.1%
Utilities	4.2%	-1.2%
Real estate	0.8%	-0.8%

Note: As of August 31, 2023. Source: RBC GAM

> “Corporate balance sheets in Europe are the strongest they’ve been in more than a decade, which should make them more resilient in an environment of still-rising interest rates.”

MSCI Europe Index Equilibrium
Normalized earnings and valuations



Source: RBC GAM

There are signs that this imbalance is starting to turn around. With the pricing lever exploited, consumers have been squeezed from all sides and no longer have the capacity or appetite to absorb further price increases. This change matters especially for sectors that are most exposed to consumer spending. As a result, consensus expectations for European profit margins are for them to fall back – although to levels that are still higher than before the pandemic.

Corporate balance sheets and the rising cost of debt

One positive result of today's wider profit margins is that they have enabled companies to make progress in paying down debt, with ratios of net debt to EBITDA at their lowest in almost 10 years. While the build-up of debt during the pandemic was swift, the ratio of net debt to equity has gradually declined to pre-pandemic levels and is now near the average of the past 20 years. Moreover, cash balances remain healthy at levels exceeding those of the past 15 years as a percentage of assets, and many companies have locked in debt at very low rates for some years to come.

These facts reassure us that companies are in a strong financial position. While interest expenses will increase as rates rise, in aggregate this should be less of a burden or risk than in previous recessions. That's not to say that debt can't rapidly increase from here – during recessionary periods it usually does – but the starting point today is more benign.

The struggle facing European capital markets

European companies continued to move their stock listings to the U.S. in the second quarter, serving as a wake-up call for continental policymakers. The reasons for this shift include better liquidity, lower resistance to high executive compensation, and less onerous disclosure and governance requirements. Executives of biotechnology and software companies have also noticed that their stocks will receive higher valuations when listed on U.S. exchanges. As a result, the value of European listings in 2022 dropped to the lowest in a decade, and just one deal – the 75 billion-euro IPO of Porsche – accounted for 60% of the total amount raised. In the U.K., newly listed companies raised 90% less in 2022 than in 2021.

Companies that have left include Linde, the German industrial company; CRH, the Irish construction company; Flutter, the gambling company; Ryanair; and Abcam, which makes compounds used by pharmaceutical companies toward new-drug discovery. ARM, a chip designer listed in London when it was acquired by SoftBank in 2016, recently filed to list in the U.S. instead of the U.K. Reports said the company could carry a market value of about US$50 billion.

There are signs that changes are being made to address the issue, especially in the U.K., where regulators are changing rules governing accounting for pension funds and rolling back regulations imposed in the wake of the financial crisis.

Conclusion

We are at an interesting juncture for European equities. On the one hand, we have a weak macroeconomic backdrop, with high inflation and a besieged consumer. There are heightened risks in the U.K., where still higher interest rates may be required. In southern Europe, inflation is relatively low, but its economy may be hurt by the higher rates required in northern Europe countries where inflation is relatively high. Inflation has finally started eating into corporate profit margins, and our view is that consensus earnings estimates may not fully reflect this trend. Against this backdrop, the best strategy may be to overweight businesses that are able to raise prices in line with higher costs.

There is also a case for optimism. Corporate balance sheets in Europe are the strongest they've been in more than a decade, which should make them more resilient in an environment of still-rising interest rates. Furthermore, efforts by companies to reduce debt will offset some of the impact of rising rates. While our expectation is that inflation will be stickier in Europe than in the U.S., we see signs that monetary policy is working and that inflation is coming down sharply from last year. It may be too early to call the end of the tightening cycle, but might we tentatively say we are at the "beginning of the end?"

Regional outlook – Asia

Chris Lai
Portfolio Manager
RBC Global Asset Management (Asia) Limited

Asian equities rose modestly in the three months ended August 31, 2023, bolstered by regulatory reform in Japan and firm economic growth outside China. Notable outperformers included Taiwan, Japan and India, while China and Hong Kong underperformed. In Taiwan, information-technology companies performed well given their exposure to artificial intelligence (AI), which has emerged as the driver of semiconductor companies and other AI-related businesses. Japan's outperformance was due in part to efforts by the stock exchange to improve corporate governance and share performance. India benefited from solid economic growth, relatively benign inflation, a pro-business government and ample bank credit. China's 2023 GDP forecasts continued to be cut, most recently to 5% from 5.5%, as Chinese property remains depressed, household confidence weak and business confidence poor.

China's slowdown is a worry for all of Asia because it's unlikely that policy support from Beijing will be sufficient to spur significantly faster economic growth in the short term. Taiwan, Hong Kong, South Korea, Singapore and Malaysia are particularly exposed to China's slowdown via trade, while India is the least affected. We expect more central banks to ease ahead of the U.S. Federal Reserve, with China, Indonesia, South Korea and the Philippines looking to cut rates as inflation has gradually eased.

Japan

The Japanese economy is forecast to expand 1.3% in 2023, up from 1.1% last year. A recent Bank of Japan (BOJ) survey confirmed that corporations are confident about their prospects, especially for services. Small and medium-sized companies have indicated that they plan to maintain or increase capital expenditures given price increases for capital goods and the need to catch up on investments that were put on hold during the pandemic. Personnel shortages are also bolstering capital investments. On the domestic front, we see solid services growth and a continued rebound in foreign tourists.

Inflation is easing, and is forecast to fall to 2.3% in the fourth quarter of this year from 3.3% in the second quarter after peaking near 4% at the end of 2022. A relatively weak yen has spurred the cost of imports this year, as has the impact of labour shortages. The disappearance of deflation since the pandemic has enabled the BOJ to begin abandoning ultra-low interest rates.

Asia – Recommended sector weights

	MSCI Pacific	Underweight / Overweight
Energy	2.9%	-0.2%
Materials	7.3%	1.0%
Industrials	12.5%	1.0%
Consumer discretionary	15.5%	0.8%
Consumer staples	5.3%	0.2%
Health care	6.1%	-1.1%
Financials	19.0%	-1.2%
Information technology	17.9%	1.1%
Communication services	8.1%	0.9%
Utilities	1.9%	-0.7%
Real estate	3.5%	-1.7%

-2.0% -1.0% 0.0% 1.0% 2.0%

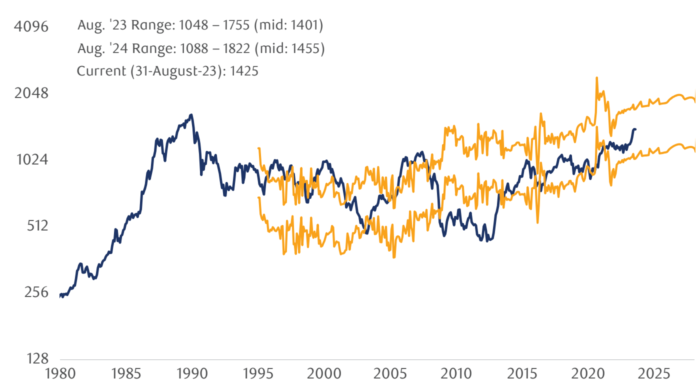
Underweight Overweight

Note: As of August 31, 2023. Source: RBC GAM

> “We believe that widespread economic weakness will prompt Beijing to boost fiscal spending and loosen monetary policy.”

MSCI Japan Index Equilibrium

Normalized earnings and valuations



Source: RBC GAM

Rest of Asia

Chinese domestic activity has been weak with a decline in retail sales amid weak consumer confidence. There are concerns about youth unemployment, which for people between 16 and 24 has risen to 21%. In the Real Estate sector, the number of property transactions is falling along with prices. We believe that widespread economic weakness will prompt Beijing to boost fiscal spending and loosen monetary policy. After recent rate cuts, we expect the People's Bank of China (PBOC) to deliver two more. The Chinese central government will provide support to local governments, speed up infrastructure investment and add measures that encourage bank loans and other forms of lending. We also expect Beijing to allow local governments to roll out additional measures in support of the property industry.

Economists predict that GDP growth in India will slow in 2023 to 6% from 7% last year, while inflation is forecast to decline to 5% from 7% due to weaker growth and lower commodity prices. We believe that declining inflation will enable the central bank to start reducing interest rates and expect them to fall by 50 to 75 basis points by the first quarter of 2024, provided inflation remains under control. The government delivered a budget that was heavy on infrastructure spending, while forecasting a deficit of 6.2% of GDP in the current fiscal year compared with 6.4% in the year-earlier period.

In Indonesia, economic growth remains solid with GDP predictions of 5.1% for the current fiscal year, down from 5.3% last year. Household spending continues to remain robust, and investment spending is expected to moderate heading into the fourth quarter of 2023, reflecting the lagged effect of interest-rate hikes and impact of lower prices for petroleum and minerals on Indonesia's commodity-linked economy. We expect the Bank of Indonesia to prioritize currency stability over economic growth, and so do not expect it to rush into cutting interest rates.

In South Korea, we expect slowing domestic consumption will lead to a mild recession in second half of 2023. Manufacturing is a bright spot, led by strong auto output and a better-than-expected increase in chip production. Inflation has moderated given falling energy prices and moderating domestic demand, leaving room for the Bank of Korea to consider rate cuts in October. We now expect a total of 50 basis points of rate cuts by the of 2023, followed by another 150 basis points cumulatively in 2024. The benchmark rate currently sits at 3.50%.

We expect Australia's economy to slow as inflation running at 5% prompts the central bank to continue boosting interest rates. In this environment, consumption will likely cool and mortgage rates will rise, providing relief to a labour market at its hottest in a generation. Strong population growth due to immigration and higher fiscal spending suggest that inflation could be faster than economists are currently forecasting, especially for services. In this environment, we expect the central bank to raise its benchmark interest rate by another 25 basis points in November.

Regional outlook – Emerging markets

Ashna Yarashi-Shah
Portfolio Manager
RBC Global Asset Management (UK) Limited

Emerging-market equities returned 4.6% in the eight months ended August 31, 2023, underperforming the 16.1% return for developed markets during period. Much of this relative weakness was driven by the poor performance of China, which accounts for 28.6% of the emerging-market equity benchmark. In the three-month period, emerging-market stocks returned 3.5%, underperforming developed markets. All figures are in U.S.-dollar terms.

China's economy has experienced broad weakness following its re-opening from the pandemic in late 2022. High levels of youth unemployment and significant weakness in the residential property market have kept Chinese consumers cautious. We believe that the weak consumption raises the potential for aggressive monetary and fiscal stimulus in the coming months. From a valuation perspective, Chinese stocks trade at 10 times their 12-month forward earnings versus an average of 11.6 since 2006.

Emerging-market equities have experienced four major performance cycles over the past 35 years, each ranging between six and 11 years. The periods when emerging markets have outperformed developed markets share a few characteristics: Emerging-market growth exceeded developed-market growth, and emerging-market price-to-book ratios were below those in developed markets at the same time that earnings per share in emerging markets were accelerating in U.S.-dollar terms. Conversely, slower emerging-market growth in earnings per share has underpinned the underperformance cycles.

During the most recent bear-market cycle, which started in 2010, earnings per share in emerging markets have contracted by 1.1% and emerging-market valuations have fallen by 5.6 percentage points more than those in developed markets. Looking at profitability, we find that emerging-market margins have been lower than in developed markets since July 2013. We expect earnings growth in emerging markets to rise faster than in developed markets over the next two years, mimicking the 2016-2018 trend that coincided with 26 percentage points of outperformance. Looking ahead, we believe that emerging-market earnings growth will be driven by countries such as South Korea and Taiwan, where we see strong prospects for a cyclical profit recovery amid production cuts, leaner inventories and demand for semiconductors linked to the explosion of artificial intelligence.

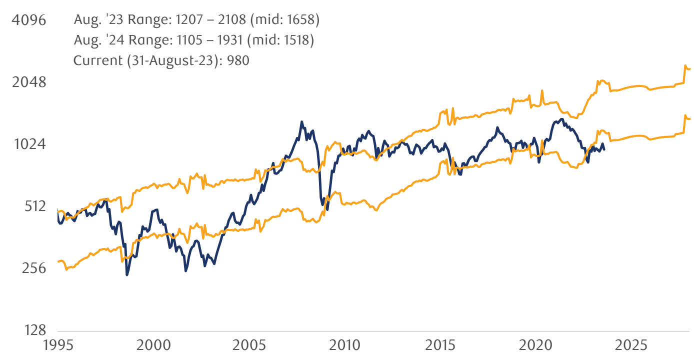
Inflation has been a global phenomenon in recent years, driven by fiscal and monetary responses to the COVID-19 pandemic, supply-chain disruptions and the Russia-Ukraine war's impact on food and commodity prices. One of the reasons for the dramatic surge in inflation in the U.S. and other developed markets may have been due in part to a surge in the money supply triggered by the unprecedented policy response to the pandemic. The response was far more contained in emerging markets than developed markets. For instance, in China and India, the increase in broad money supply between February and December 2020 was significantly less than in the U.S.

A rapid tightening of monetary policies in developed markets, especially the U.S., has historically caused financial stress in emerging markets, forcing them to also tighten policy to defend their currencies and forestall inflation. We have seen in this cycle that central banks in Brazil, Mexico and elsewhere tightened policy at a much faster rate than the U.S., and both emerging and developed markets have experienced a drop in inflation. This deceleration in inflation combined with a moderating outlook on global growth will likely prompt many emerging-market central banks to focus on lowering interest rates rather than increasing them over the next 12 months. We are expecting swift cuts in Brazil and Chile, which serve as a sharp contrast to developed markets, where there is a greater likelihood that central banks will continue hiking rates over the next 12 months.

U.S.-dollar strength has represented a significant challenge for the performance of emerging-market equities in recent years. We see several reasons why this trend may now reverse. First, U.S.-dollar valuations seem extreme on many metrics. On a trade-weighted basis, the U.S. dollar now trades at historically expensive levels. Second, U.S. economic fundamentals are generally worse than they are in emerging markets. In the U.S., there are concerns about the country's current-account and budget deficits and the longer-term sustainability of the country's debt remains uncertain.

On the other hand, many emerging markets have significantly improved their current-account balances through sales of commodities or, in the case of India, via strong demand for computing services and pharmaceuticals. Longer term, we expect emerging-market currencies to rise versus the U.S. dollar. Rising geopolitical tensions have accelerated the recent "de-dollarisation" trend in commodity transactions, with many emerging economies reaching deals to settle trade in their own currencies rather than relying on the U.S. dollar.

MSCI Emerging Markets Index Equilibrium
Normalized earnings and valuations



Source: RBC GAM

We expect a shift in the West's global trade away from China – a trend known as re-globalisation – to provide long-term opportunities for emerging-market exporters. Increasingly, we find global businesses diversifying their supply chains as they face significantly higher geopolitical risks, largely in the form of escalating trade tensions between the U.S. and China. As China's exports to the U.S. have declined, so have they risen to other emerging markets. Since 2018, the percentage of Chinese exports destined for Latin America, Africa, India and Southeast Asia has grown to 36%, while the U.S. share has fallen to 15%.

Economies in Southeast Asia and India continue to be the biggest winners of this shift in supply chains, as they benefit from cost competitiveness, industrial development, linkages to existing manufacturing hubs and rising middle-income consumers. Over the past two years, countries in Southeast Asia have gained from Chinese foreign direct investment and are now increasing orders from U.S. companies abandoning China. In the past decade, U.S. direct investment in Southeast Asia has increased at an average annual rate of 10%, and we expect the Philippines, Indonesia and Thailand to be on the Biden administration's list of "friendly" countries as the U.S. government tries to reconfigure supply chains.

RBC GAM Investment Strategy Committee Members

Daniel E. Chornous, CFA
Chief Investment Officer
RBC Global Asset Management Inc.
Chair, RBC GAM Investment Strategy Committee

Dan Chornous is Chief Investment Officer of RBC Global Asset Management Inc. (RBC GAM), the Royal Bank of Canada's wholly-owned investment management subsidiary. The firm manages assets nearing (CAD) $562 billion for institutional, high net worth and individual investors in fixed income, equity and alternative mandates in Canada and around the world. Since joining RBC GAM in November 2002, Dan has been responsible for the overall direction of investment policy and asset management across the firm's global investment platform. Prior to that, Dan was Managing Director, Capital Markets Research and Chief Strategist at RBC Capital Markets.

Dan joined the RBC Global Asset Management board immediately upon his arrival at the firm. In December 2010, Dan joined the board of BlueBay Asset Management following its merger with RBC GAM. He also sits on the board of RBC Global Asset Management (UK) Ltd., is a member of the RBC Pension Investment Strategy Committee and chairs the RBC GAM Investment Strategy Committee (RISC) among others.For many years, Dan has been active in the Canadian investment community. He served on the board of the Canadian Coalition for Good Governance from 2008 to 2020 and as its chair from 2012 to 2016. In addition, he is a member of CFA Society Toronto Advisory Council, a past member of the Toronto United Way major giving cabinet, a former Director of the Toronto Society of Financial Analysts and of the Winnipeg Society of Financial Analysts.

Dan is a graduate of the University of Manitoba (B. Comm, Honours, 1980) and is a member of The Associates, Asper School of Business. In 1985, Dan was awarded the Chartered Financial Analyst designation..

*AUM in CAD as of August 31, 2023

Soo Boo Cheah, MBA, CFA
Senior Portfolio Manager
RBC Global Asset Management (UK) Limited

Based in the U.K., Soo Boo is responsible for managing global fixed-income allocations. He specializes in assessing the impact of central bank policies and global macroeconomic trends on developed-market bonds. In his role as a senior portfolio manager, he integrates a wide range of investment strategies involving interest rates, currencies, and derivatives. Soo Boo started his career in the investment industry in 2000 and holds an MBA from University of New Brunswick.
Soo Boo has been a CFA charterholder since 2002.

Dagmara Fijalkowski, MBA, CFA
Head, Global Fixed Income & Currencies
RBC Global Asset Management Inc.

As Head of Global Fixed Income and Currencies, Dagmara leads a team of 40+ investment professionals in Toronto, London and Minneapolis with almost $100 billion in assets under management. In her duties as a portfolio manager, Dagmara leads management of several bond funds, including the RBC Bond Fund, and manages foreign-exchange hedging and active overlay programs. She leads the Fixed Income Strategy Committee which determines appropriate level of risk taking given market opportunities. Dagmara is a member of the RBC Investment Policy Committee, which determines the asset mix for balanced products; and the RBC Investment Strategy Committee. In 2016, she was appointed to the RBC GAM Executive Committee. Dagmara, who began her investment career in 1994, holds an MBA from the Richard Ivey School of Business at the Western University in Canada and a Master's degree in economics from the University of Lodz in Poland. Dagmara has been a CFA charterholder since 1997.

Stuart Kedwell, CFA
Senior Vice President and
Senior Portfolio Manager
RBC Global Asset Management Inc.

Stu co-leads the North American Equity team and is a member of the RBC GAM Investment Strategy Committee, which is responsible for establishing the firm-wide global asset mix for mutual funds and for institutional and high net worth private clients. Stu began his career in 1996 with RBC Dominion Securities in the firm's Generalist program, a two-year internship in which participants rotate through different areas of the firm. In 1998, he joined the RBC Investments Portfolio Advisory Group, which provides investment ideas and recommendations to RBC DS Investment Advisors. He was also a member of the RBC DS strategy & focus list committees. Stu has been with the firm since 2002 and is a CFA charterholder.

Eric Lascelles
Chief Economist
RBC Global Asset Management Inc.

Eric is the Chief Economist for RBC Global Asset Management Inc. (RBC GAM) and is responsible for maintaining the firm's global economic forecast and generating macroeconomic research. He is also a member of the RBC GAM Investment Strategy Committee, the group responsible for the firm's global asset-mix recommendations. Eric is a frequent media commentator and makes regular presentations both within and outside RBC GAM. Prior to joining RBC GAM in 2011, Eric led a team of economists and fixed income strategists at another large Canadian financial institution. He began his career as a research economist for a federal government agency.

Scott Lysakowski, CFA
Vice President and Senior Portfolio Manager
Head of Canadian Equities (Vancouver)
RBC Global Asset Management Inc.

Scott is Head of the Vancouver-based Canadian Equity Team. He is primarily responsible for overseeing equity research and portfolio management of the firm's core Canadian equity strategies. Scott also serves as lead manager for the Canadian income strategies. Scott began his investment management career with the firm in 2002 as a senior research analyst and portfolio manager within the Toronto-based Canadian Equity Team. He transitioned to the Vancouver team seven years later and assumed his current leadership role in 2012. During his tenure with the organization, he has conducted research for and managed a broad spectrum of Canadian equity portfolios, specializing in dividend and income mandates.

Hanif Mamdani
Head of Alternative Investments
RBC Global Asset Management Inc.

Hanif Mamdani is Head of both Corporate Bond Investments and Alternative Investments. He is responsible for the portfolio strategy and trading execution of all investment-grade and high-yield corporate bonds. Hanif is Lead Manager of the PH&N High Yield Bond and Alternative strategies, including a multi-strategy hedge fund. He is also a member of the Asset Mix Committee. Prior to joining the firm in 1998, he spent 10 years in New York with two global investment banks working in a variety of roles in Corporate Finance, Capital Markets and Proprietary Trading. Hanif holds a master's degree from Harvard University and a bachelor's degree from the California Institute of Technology.

Bryan Mascoe, CFA
Senior Portfolio Manager
Co-head, Fixed Income (Vancouver)
RBC Global Asset Management Inc.

Bryan is co-Head and a senior portfolio manager on the PH&N Fixed Income Team. He co-manages the investment-grade credit research effort. As part of this role, he manages our dedicated corporate bond portfolios and is responsible for performing credit analysis on investment-grade issuers. He also assists with the strategy and trade execution of corporate bonds held in broader short, universe, and long fixed-income mandates. Bryan has a Bachelor of Commerce degree from the University of British Columbia and is a Leslie Wong Fellow as a graduate of the UBC Portfolio Management Foundation. He has been a CFA charterholder since 2005.

Sarah Riopelle, CFA
Vice President and Senior Portfolio Manager
Investment Solutions
RBC Global Asset Management Inc.

Since 2009, Sarah has managed the entire suite of RBC Portfolio Solutions which totals $180 billion in assets. She is a member of the RBC GAM Investment Strategy Committee, which sets global strategy for the firm, and the RBC GAM Investment Policy Committee, which is responsible for the investment strategy and tactical asset allocation for RBC Funds' balanced products and portfolio solutions. In addition to her fund management role, she works closely with the firm's Chief Investment Officer, ensuring that all aspects of the investment management function at RBC GAM are running smoothly. She is co-chair of the RBC Wealth Management Diversity Leadership Committee – Canada, as well as a member of the Dean's Advisory Board for both the Telfer School of Management at the University of Ottawa and the Faculty of Management at Laurentian University.

Sarah joined RBC Global Asset Management in 2003 and held roles in Investment Strategy and Canadian Equities before assuming her current responsibilities in 2009. Prior to joining RBC GAM, Sarah worked at RBC Capital Markets in both the Quantitative Research and Investment Strategy groups. She began her career in the investment industry in 1996 after graduating from the University of Ottawa with a Bachelor of Commerce degree, majoring in Finance and International Management. She was awarded the Chartered Financial Analyst designation in 2001.

Martin Paleczny, CFA
Vice President and
Senior Portfolio Manager
RBC Global Asset Management Inc.

Martin Paleczny, who has been in the investment industry since 1994, began his career at Royal Bank Investment Management, where he developed an expertise in derivatives management and created a policy and process for the products. He also specializes in technical analysis and uses this background to implement derivatives and hedging strategies for equity, fixed-income, currency and commodity-related funds. Since becoming a portfolio manager, Martin has focused on global allocation strategies for the full range of assets, with an emphasis on using futures, forwards and options. He serves as advisor for technical analysis to the RBC GAM Investment Strategy Committee.

Kristian Sawkins, CFA
Vice President and Senior Portfolio Manager
PH&N Fixed Income
RBC Global Asset Management Inc.

Kristian is co-Head and a senior portfolio manager on the PH&N Fixed Income team, specializing in universe and short-term bond mandates. He is also a member of the PH&N IM Asset Mix Committee. Kristian joined Phillips, Hager & North Investment Management in 2002 as an associate analyst with the Canadian Equities Team and moved to the Fixed Income Team in 2005. Prior to joining the organization, Kristian spent three years at a major investment bank in New York across a few different roles. Kristian has a Bachelor of Commerce degree from the University of British Columbia and is a Leslie Wong Fellow as a graduate of the UBC Portfolio Management Foundation. He has been a CFA charterholder since 2002.

Jaco Van der Walt, DCom
Vice President and
Global Head of Quantitative Research & Investments
RBC Global Asset Management Inc.

As Head of Quantitative Investments, Jaco leads an experienced team that is driven to continually innovate across all its capabilities, including research, portfolio management, data and systems to leverage the combination of human and machine in investment decision-making. He previously held an executive role at one of South Africa's largest financial services companies, leading the Investment Management Office, with experience spanning pensions, insurance, banking and wealth management. As asset owner, he also chaired the boards and investment committees of several of the company's pension plans, promoting investment excellence and driving transformational change to ensure members reach their retirement goals. Jaco began his investment career in 1996 and holds a Master's degree in Economics from the University of Toronto and a Doctorate from the University of Pretoria.

Milos Vukovic, CFA
Vice President, Investment Policy
RBC Global Asset Management Inc.

Milos, who joined RBC in 2003, oversees investment-management activities including new-fund launches, performance analytics and trade-cost analysis. He is also responsible for developing and monitoring investment mandates and implementing tactical asset allocation for the RBC GAM investment solutions. Milos earlier worked for a Big 4 accounting firm and two top-tier securities firms. He earned an MBA at the Schulich School of Business and has held the CFA designation since 2004.

Brad Willock, CFA
Vice President and
Senior Portfolio Manager
RBC Global Asset Management Inc.

Brad Willock joined RBC Global Asset Management in July 2002 and is a Senior Portfolio Manager and CFA charterholder. In his current role, Brad has responsibility for RBC Global Asset Management's core and income-oriented U.S. equity strategies. He joined RBC in May 1996 after receiving a bachelor's of commerce degree with distinction from the University of Calgary. Prior to that, Brad obtained a bachelor's of science degree at the University of British Columbia and represented Canada at the 1992 Barcelona Summer Olympics in volleyball.

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> RBC Global Asset Management Inc.

> **Eric Lascelles**
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