RBC Global Asset Management

Market Update

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Favouring bonds as policy tightening feeds into economy and inflation trends lower

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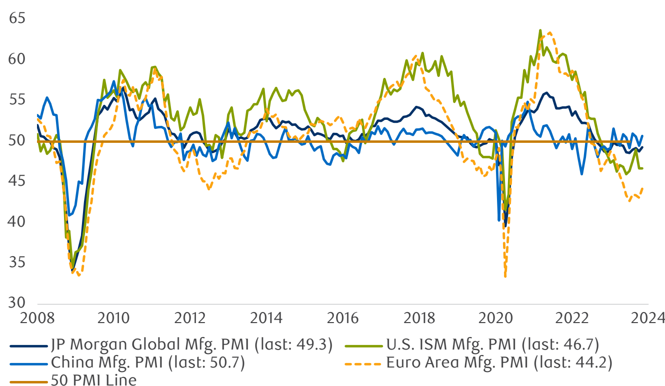
The intense and highly synchronized tightening of global monetary conditions delivered over the past 20 months has started to bite and, the longer interest rates remain elevated, the more economic pain they'll likely inflict. Softness is being seen in leading indicators, which are now pointing to sluggish or outright contraction in growth in many of the world's major regions (Exhibit 1). Canada, the U.K. and several eurozone countries have either fallen into technical recession already or are very close to that. The U.S., however, has so far proven resilient and American consumers may be less sensitive to rising rates after having locked in ultra-low long-term fixed-rate mortgages during the pandemic. But higher borrowing costs are hindering businesses' and consumers' marginal propensity to spend/invest and, as an example, readings of housing market activity have fallen to their lowest levels since the global financial crisis. Other risks to the outlook relate to China's struggling post-pandemic recovery, heightened geopolitical tensions and elevated and growing fiscal deficits. Importantly, given historic lags between the start of monetary tightening and contractions in the economy, the window for significant slowing or recession is just now opening rather than closing. We forecast a mild recession to take hold in the developed world over the next several quarters and our growth estimates are below the consensus.

Exhibit 1: Global purchasing managers' indices



Note: As of November 30, 2023. Source: Macrobond, RBC GAM

> "We expect that inflation will continue moderating to levels not far above 2% by the end of next year."

Progress on inflation continues, expectations remain well-anchored

A positive outcome from tighter financial conditions and slowing economic activity is that inflation continues to cool from prior extremes. U.S. headline CPI inflation has fallen to 3.2% from a high of 9.1% in June 2022 and core CPI has declined to 4.0% from a high of 6.6% in September 2022. Although these figures are not yet ideal, the trend is favourable and, crucially, market-based measures of inflation expectations remain well anchored near the 2% level targeted by most central banks (Exhibit 2). We expect that inflation will continue moderating to levels not far above 2% by the end of next year.

Short-term interest rates may be peaking

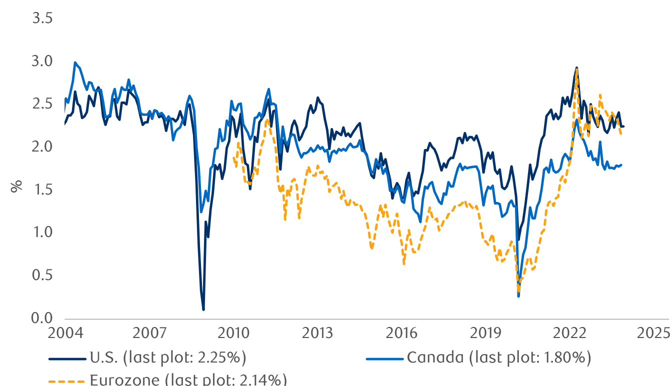
Against this backdrop, it is becoming increasingly apparent that central banks may have already delivered enough monetary tightening to meet their inflation goals. Short-term rates are now decidedly in restrictive territory according to our models and, if inflation continues to decline as we expect, central banks could begin cutting interest rates sooner than the consensus currently reflects. In fact, the futures market is now pricing in no further rate hikes, and for the first U.S. rate cut to occur by the spring, with as much as a 100 basis-point decline in the fed funds rate by the end of next year (Exhibit 3).

Bond yields have scope for further declines

The current setup in capital markets, we think, is appealing for fixed-income investors. Yields on sovereign bonds climbed to their highest levels in 15 years during the past quarter, pushing our GDP-weighted composite of sovereign bonds yields above our modelled estimate of equilibrium for the first time since before the financial crisis except for a brief period in 2023. In particular, the U.S. 10-year yield climbed to a high of 5.02%, far above our modelled equilibrium of 3.16% (Exhibit 4). While recession is our central scenario, it is not a pre-condition for declining yields. Simply restoring inflation to target and maintaining real interest rates near 1% – a level consistent with aging populations and lower economic growth potential – suggests a 3.5% to 4.0% yield on U.S. 10-year T-bonds is not unreasonable. From today's elevated levels, even a modest decline in yields could lead to high single-digit or low double-digit returns for U.S. 10-year T-bonds over the coming year. For these reasons, we believe that government bonds offer attractive return potential with minimal valuation risk.

Exhibit 2: Implied long-term inflation premium

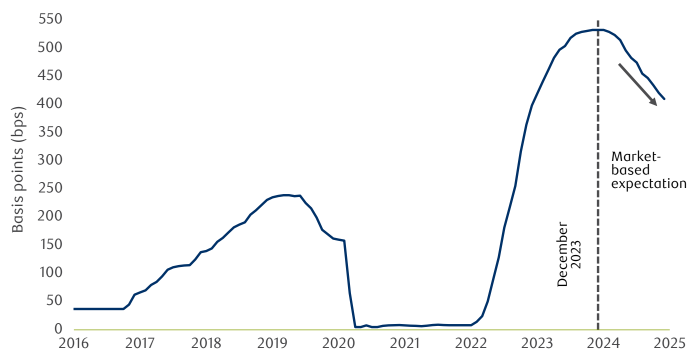
Breakeven inflation rate: nominal vs 10-year real return bond



Note: As of December 2023. Eurozone represents GDP-weighted breakeven inflation of Germany, France and Italy. Source: Bloomberg, RBC CM, RBC GAM

Exhibit 3: Implied fed funds rate

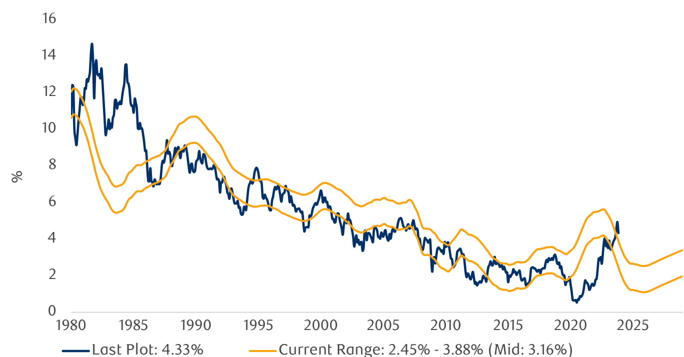
12-months futures contracts as of December 1, 2023



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

Exhibit 4: U.S. 10-year T-Bond yield

Equilibrium range



Note: As of November 30, 2023. Source: RBC GAM

Stocks rebound from summer/fall correction

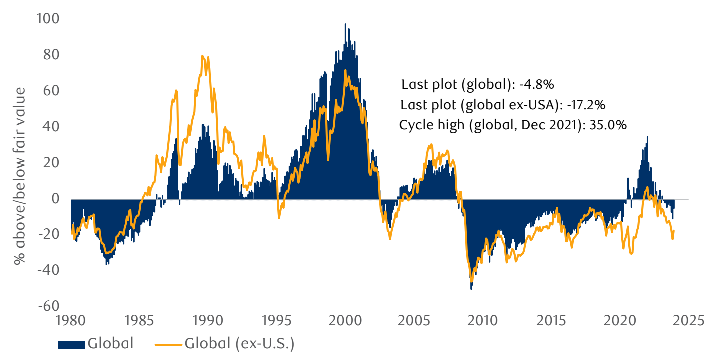
Global stocks suffered a correction of slightly more than 10% earlier in the quarter as yields rose, geopolitical tensions intensified, and investors became increasingly worried about the economy. But the subsequent rally in November reversed most of those earlier losses as yields declined from their recent highs and prospects for a soft landing for the economy improved. That said, most of the gains in global stocks so far this year has to do with just a handful of stocks. The S&P 500 cap-weighted index is up 18% year-to-date, delivered mostly by the "Magnificent 7" with its 76% return. The equal-weighted index, which represents the performance of the average stock, is up only 4%. As a result, even though the S&P 500 is slightly above our modelled estimate of fair value, if we exclude the Magnificent-7 from the U.S. index, or if we look outside of the U.S. large-cap space to small-caps, mid-caps or international equities, stocks are broadly priced below fair value and, in some cases, situated at especially attractive valuations (Exhibit 5).

Earnings estimates are highly optimistic

We think that earnings rather than valuations represent the major risk for equity markets. So far this year, S&P 500 earnings growth has been relatively sluggish and, based on estimates for the remainder of the year, profit increases in 2023 are expected to be just 2% versus 2022. But estimates are much more optimistic for next year, with S&P 500 earnings-per-share expected to rise 11% to $245 by the end of 2024 (Exhibit 6). These estimates, in our view, reflect a fairly benign outcome for the economy where growth remains robust and profit margins stay elevated. If recession or a meaningful downturn in activity were to materialize as we expect, these estimates will be vulnerable to downgrades, likely limiting gains in stocks.

Exhibit 5: Global stock market composite

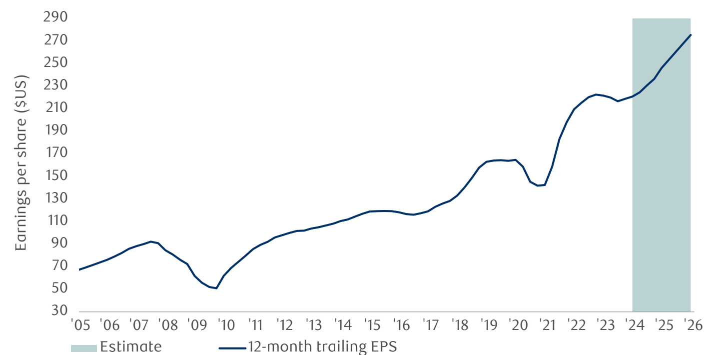
Equity market indexes relative to equilibrium



Note: As of November 30, 2023. Source: RBC GAM

Exhibit 6: S&P 500 Index

12-month trailing earnings per share



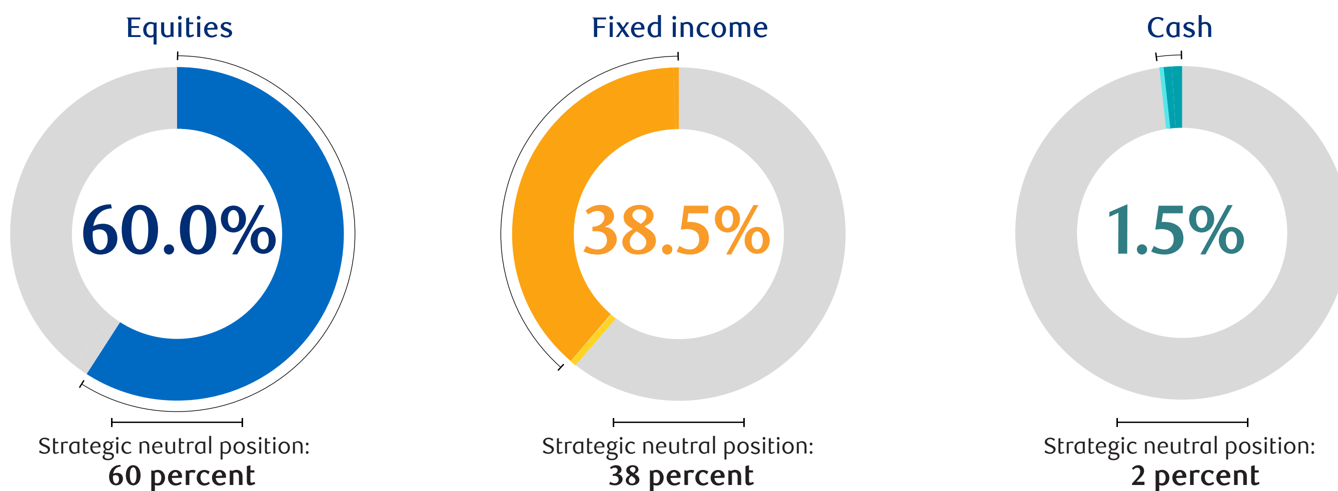
Note: estimate is based on a consensus of industry analysts' bottom-up expectations. Note: as of December 1, 2023. Source: Thomson Reuters, RBC GAM

Asset mix reflects cautious positioning with slight overweight in fixed income

Although the macro backdrop remains highly uncertain, we recognize paths to a positive outcome exist. In our base case scenario, economies enter recession over the next several quarters and inflation continues to cool. Against this backdrop, central banks likely start cutting interest rates and bond yields decline as investors seek higher-yielding safe-haven assets. It's typically at that point in the cycle where longer-duration fixed-income assets tend to outperform. Moreover, at today's higher level for yields, bonds offer greater ballast against equity-market volatility within a balanced portfolio than they have in several years. We still think that stocks offer superior return potential to bonds over the longer term. Nevertheless, our asset mix aims to balance long-term return potential with near-term risks and we recognize that the equity risk premium is now at its narrowest level since just before the global financial crisis. For us to be comfortable increasing our allocation to equities off a neutral stance, we would prefer to see widening stock-market breadth, an easing of financial conditions and/or a recovery in economic leading indicators. As a result, this quarter we added 0.5% to our fixed income allocation, sourced from cash, as the U.S. 10-year yield approached 5%. This move brings our bond allocation to an overweight position for the first time in the RBC GAM Investment Strategy Committee's two-decade history. Our current recommended asset mix for a global balanced investor is 60.0% equities (strategic: "neutral": 60%), 38.5% bonds (strategic "neutral": 38%) and 1.5% in cash (Exhibit 7). Actual fund or client portfolio positioning may differ depending on that portfolio's investment policies.

Exhibit 7: Recommended asset mix

RBC GAM Investment Strategy Committee



Note: As of November 30, 2023. Source: RBC GAM

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