RBC Global Asset Management

Market Update

MARCH 02, 2023

Nudging asset mix closer to neutral as expansion matures

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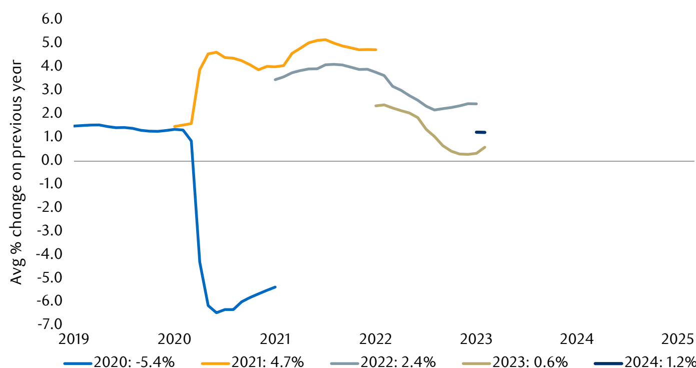
The global economy has benefited from several positive macro developments in the past quarter that have diminished the possibility of a severely negative outcome. An unusually warm winter has averted a full-blown energy crisis in Europe, the abandonment of China's zero-COVID policy allowed for a faster and more widespread re-opening than was expected, and inflation, while still too high, is now on a downward trajectory. Overall, economic data has been better than expected throughout most of the world and, in the U.S. in particular, consumer spending has been resilient and the labour market is robust. That said, a number of challenges threaten the expansion. We are starting to see significant weakness in loan demand and deterioration in the housing market, both hindered by the surge in interest rates, and leading indicators of economic growth are in contraction territory in most major regions. We continue to expect economies to fall into recession over our one-year forecast horizon, but because of the tailwinds in the near term, we don't expect recession to occur until the second half of 2023 (Exhibit 1).

Inflation pressures are calming

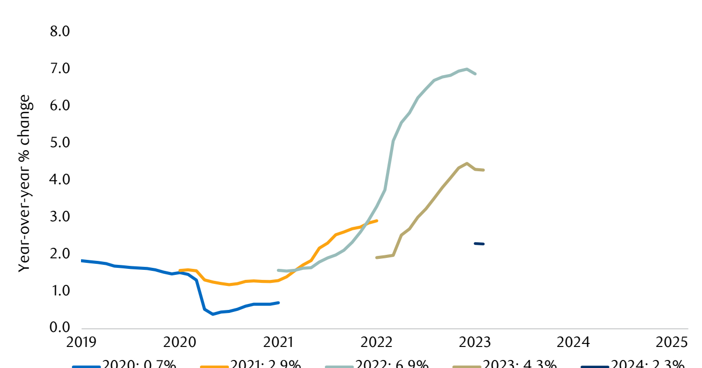
Although inflation remains unacceptably high, there are a variety of signs suggesting that price pressures are cooling and that the data is moving in a favourable direction. Energy and other commodity prices have declined meaningfully from their highs, house and rent prices are off their highs, supply chains have improved, and used car prices have stabilized. As a result, U.S. CPI inflation peaked at 9.1% in mid-2022 and has fallen to 6.4%. Although the path to lower inflation is likely to be a bumpy one, our expectation is that U.S. inflation falls to 3.3% in 2023 and to 2.4% in 2024 (Exhibit 2).

Exhibit 1: Weighted average real GDP
Growth estimates for major developed nations



Note: As of February 2023. Source: Consensus Economics

Exhibit 2: Weighted average consensus CPI
Inflation estimates for major OECD nations



Note: As of February 2023. Source: Consensus Economics

Central bank tightening set to wind down

Helping to curtail inflationary pressures is the fact that central banks have raised interest rates at their most aggressive pace since the 1970s. The U.S. Federal Reserve increased short-term interest rates by 450 basis points in the past 12 months with intentions to continue raising rates a little bit more. Importantly, the amount of expected tightening from here is likely to be less meaningful compared to what has already been delivered and, with inflation moving lower, central banks could be nearing the end of their tightening cycles (Exhibit 3). In fact, the Bank of Canada announced it will pause hiking to allow time for the higher rates to impact the economy and inflation. Outright cutting of rates, we think, will likely require inflation moving more decidedly toward the 2% level targeted by most central banks, which may not occur until beyond our one-year forecast horizon.

Bond yields move higher, reducing valuation risk in fixed income

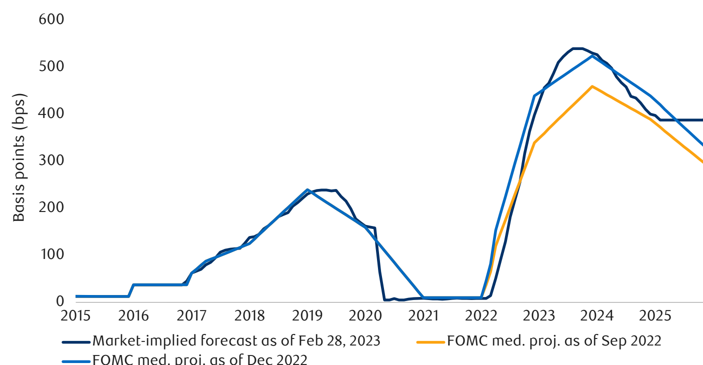
Global bond yields resumed their rise in the past quarter as investors abandoned prior views that rate cuts would be imminent. The U.S. 10-year yield climbed back toward 4%, the German 10-year yield rose to a new cycle-high of 2.7% and Canada's 10-year yield inched closer to its late-2022 peak of 3.5%. It's worth recognizing that, although these yields are well above their extreme lows of the past couple years, the current levels are now more in line with levels seen before the 2008-2009 global financial crisis. Moreover the acute valuation risk that existed in bonds has been greatly reduced. If our inflation forecast is correct, our equilibrium model for U.S. 10-year Treasuries suggests that any further rise in yields is likely limited and that the appropriate level for 10-year Treasuries is slightly lower from here a year from now (Exhibit 4).

Equity rally from the 2022 lows featured shift in leadership

Major stock-market indices extended gains from late last year reflecting reduced pessimism on the economic front and increased optimism that inflation pressures are being promptly addressed (Exhibit 5). The rally began from a point of relatively attractive valuations and oversold conditions after last year's bear market pulled global stocks slightly below our estimate of fair value, with regions outside the U.S. having slumped to especially attractive discounts to their respective fair values (Exhibit 6). Interestingly, the rebound in stock prices featured a different kind of leadership than investors had grown used to for the better part of the post-financial-crisis era. U.S. large-cap growth stocks lagged, while

Exhibit 3: Implied fed funds rate

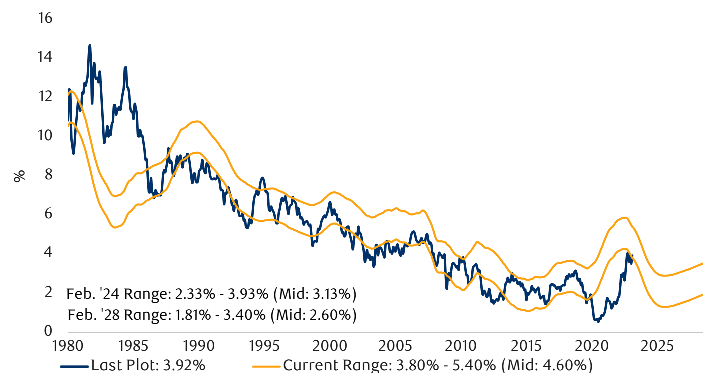
12-months futures contracts



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

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

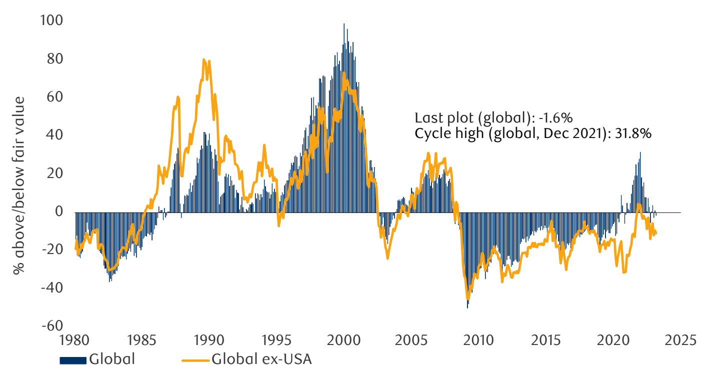
Equilibrium range



Note: As of February 28, 2023. Source: RBC GAM

Exhibit 5: Global stock market composite

Equity market indexes relative to equilibrium

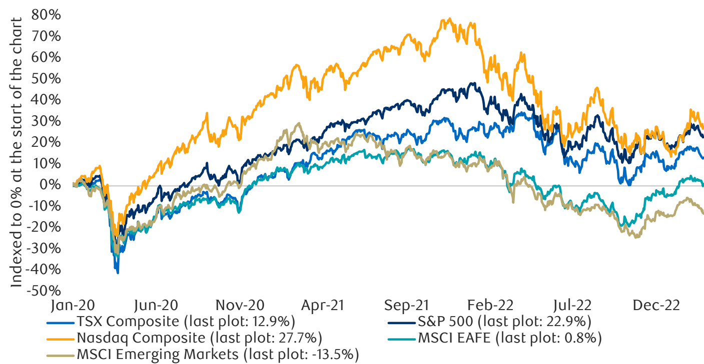


Note: As of February 28, 2023. Source: RBC GAM

international and emerging-market equities, as well as small and mid-cap stocks, value and cyclically-sensitive sectors emerged as leaders in the latest rally.

Exhibit 6: Major equity market indices

Cumulative price returns indices in USD



Note: As of February 28, 2023. Price returns computed in USD.
Source: Bloomberg, RBC GAM

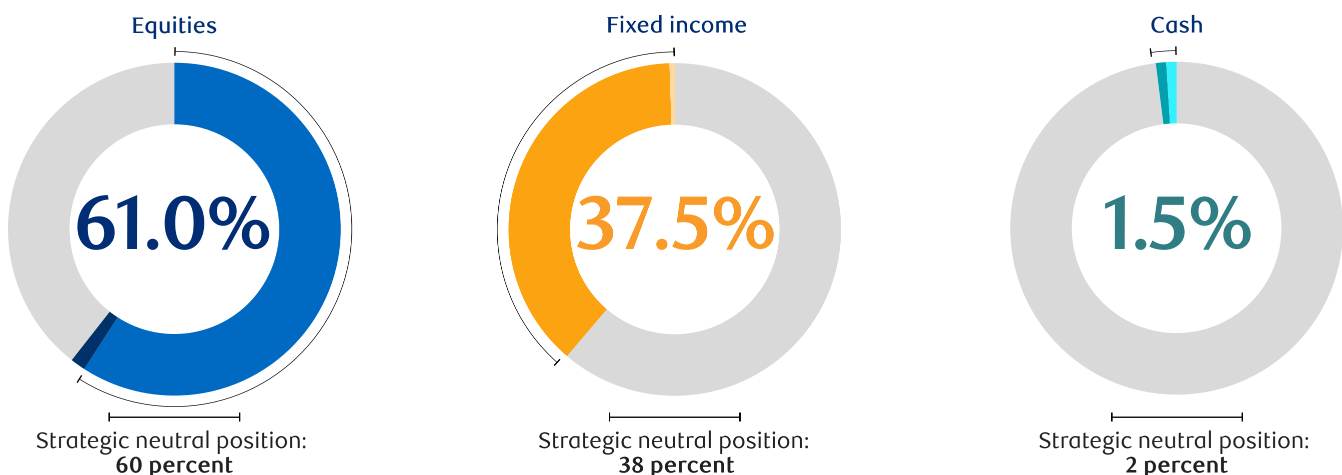
Earnings outlook deteriorates, may limit upside in stocks

We are encouraged by the underlying trends within markets but recognize that earnings will likely play a critical role in the sustainability of the rally, and profit forecasts have been revised lower. The consensus of analysts' estimates now suggests S&P 500 earnings will be flat in 2023 versus 2022, down from an earlier projection of as much as 10% growth (Exhibit 7). Should recession materialize, these profit forecasts could come down even further given that, historically, profits have declined an average of 25% during past economic contractions. While a mild recession could result in slightly less damage to corporate profits compared to history, other factors that could weigh on profits is that they are beginning from a point well above their long-term trend and margins are at historic highs and vulnerable to rising cost pressures.

Asset mix – trimming stocks and moving allocation closer to strategic neutral

Our asset mix seeks to balance the risks and potential opportunities, while recognizing uncertainty remains elevated and that the range of potential outcomes is wider than usual. Although there are paths to a positive outcome, our base case is that a mild recession materializes sometime in the next year. In this environment, short-term interest rates will likely peak sometime this year and central banks could begin talking about the possibility of cutting rates to support growth. With this in mind, and at their current elevated yields, bonds would offer more of a cushion against a downturn in stocks. We continue to expect stocks to outperform bonds over a longer-term horizon, but in the near-term our positioning is more cautious considering that stocks could be vulnerable if the corporate-profit outlook deteriorates further. The latest rally in stocks began pricing in a fairly optimistic scenario for the economy, inflation and interest rates which led to the risk-reward becoming less appealing in our view, given our expectation that recession is likely later in the year. This quarter, we reduced our allocation to stocks by one percentage point and moved 50 basis points of those proceeds to cash and the other 50 basis points to fixed income. Our current recommended asset mix for a global balanced investor is 61.0% equities (strategic: "neutral": 60%), 37.5% bonds (strategic "neutral": 38%) and 1.5% in cash.

Exhibit 7: Recommended asset mix



Note: As of February 28, 2023. Source: RBC GAM

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Publication date: March 03, 2023