RBC Global Asset Management

Market Update

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Tighter financial conditions cool inflation, threaten maturing expansion

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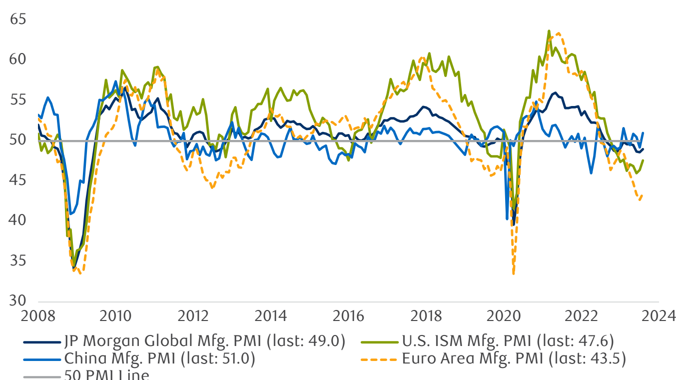
A variety of signals suggest that the economic expansion is mature, and that growth will likely continue slowing. Leading indicators of economic growth for most major economies slipped into contraction in late 2022 and have deteriorated further into 2023, with readings in Europe having dropped to levels consistent with the onset of recession (Exhibit 1). In China, the economic recovery from last year's abandonment of its zero-COVID policy has fizzled even as policymakers deployed measures to support economic activity. Although labour markets remain robust and economic data has been resilient thus far, hiring has slowed and job losses have nudged slightly higher in the past several months. Moreover, higher borrowing costs in general, and financial stress from the U.S. regional banking crisis in the spring has dinged the availability of credit as well as the demand from consumers and businesses to take loans. Taken together, we continue to think economies are likely to fall into recession at some point over the next several quarters and our growth forecasts remain below the consensus.

Inflation cooled rapidly, but further progress will prove more difficult

Moderating demand has helped cool consumer-price increases and a variety of indicators suggest that price pressures are likely to continue cooling. Money supply growth is now contracting, pandemic-induced supply chain challenges have largely been resolved and commodity prices are well off their recent highs. The result is that U.S. CPI inflation has declined to 3.2% from a high of 9.1% in June of 2022 and inflation trends have been favourable in other countries (Exhibit 2). We believe that inflation will continue falling over the medium term, but also recognize that further

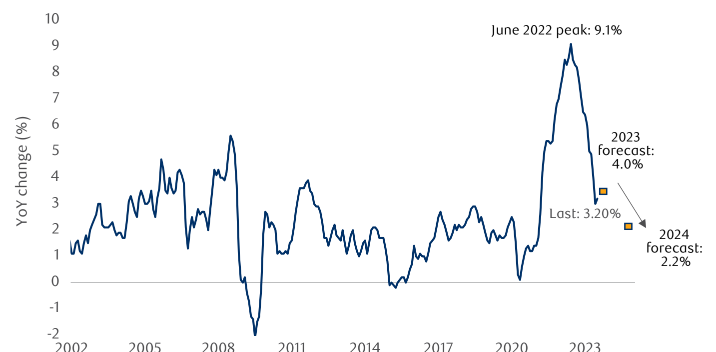
Exhibit 1: Global purchasing managers' indices



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

Exhibit 2: U.S. Consumer Price Inflation

CPI Index Y/Y % change



Note: CPI data as of July 31, 2023, forecast as of August 31, 2023.
Source: Bloomberg, RBC GAM

improvements will likely take longer to materialize as most of the extreme inflation readings from late 2021/early 2022 have rolled out of the 1-year calculation (Exhibit 3).

End of interest-rate tightening cycle is drawing closer

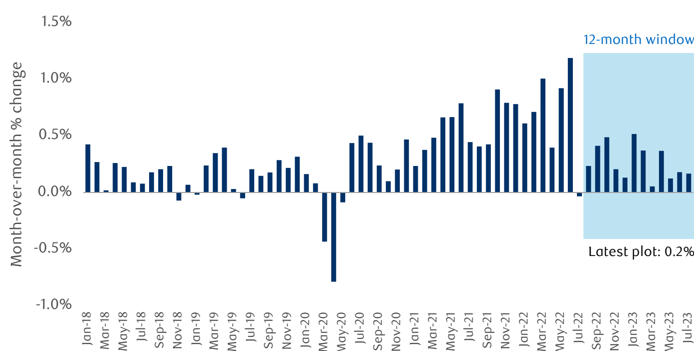
In this environment, central banks likely don't need to raise interest rates much further, if at all. Policy rates in Europe, Canada and the U.S. are at their highest levels in two decades and are now sufficiently in restrictive territory and these levels are unlikely to be sustained according to our models. Although a bit more tightening is a possibility, unless inflation were to reassert itself in a meaningful way, the tightening cycle is likely approaching an end. In fact, the futures market is pricing in interest rate cuts in the U.S. beginning in early 2024 in line with our own view (Exhibit 4).

Fixed-income valuation risk has diminished as bond yields climbed to new cycle highs

Global sovereign bonds are the most appealing they've been in many years as yields climbed to levels not seen since before the 2008/2009 global financial crisis. The U.S. 10-year yield reached as high as 4.33% during the quarter, up approximately 100 basis points since the spring. At this point, yields in most regions are near the upper range of our modelled equilibrium bands, representing improved total return potential and minimal valuation risk (Exhibit 5). Even a modest decline in yields from current levels could lead to high single digit or even low double digit returns in government bonds over the year ahead.

Exhibit 3: U.S. CPI Inflation

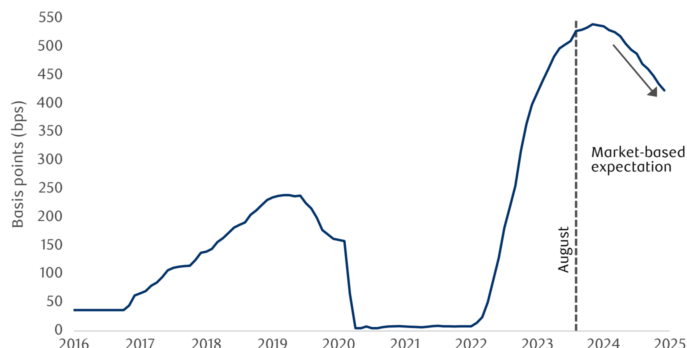
Month-over-month % change



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

Exhibit 4: Implied fed funds rate

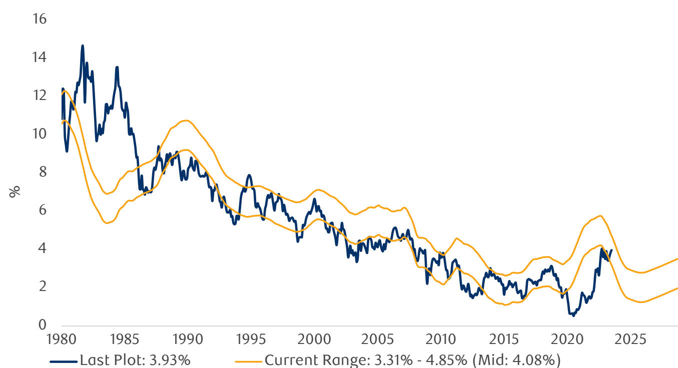
12-months futures contracts as of August 31, 2023



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

Exhibit 5: U.S. 10-year T-Bond yield

Equilibrium range



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

> "Yields in most regions are near the upper range of our modelled equilibrium bands, representing improved total return potential and minimal valuation risk."

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

Stocks extended their gains over the quarter, but breadth was relatively narrow as returns were dominated by a handful of U.S. mega-cap technology stocks (Exhibit 6). The "Magnificent 7" – a group of the largest U.S. technology stocks that also stand to benefit from trends in artificial intelligence – has returned just over 60% year-to-date, lifting the NASDAQ as much as 30% and the S&P 500 by 13%. These impressive stocks have grown so large in market capitalization that the "Magnificent-7" makes up more than a quarter of the S&P 500's weighting, and the U.S. equity market is now the most concentrated it's ever been. In contrast, the equal-weight S&P 500 is up only 4% year-to-date and small/mid caps as well as non-U.S. equities have registered mid- to low-single digit gains so far this year. As a result of this two-tiered market, equity valuations outside of the U.S. large-cap space are reasonable or even attractive relative to their fair value but the valuations of these crowded mega-cap tech stocks are highly demanding (Exhibit 7).

Benign corporate-profit outlook would be vulnerable should recession materialize

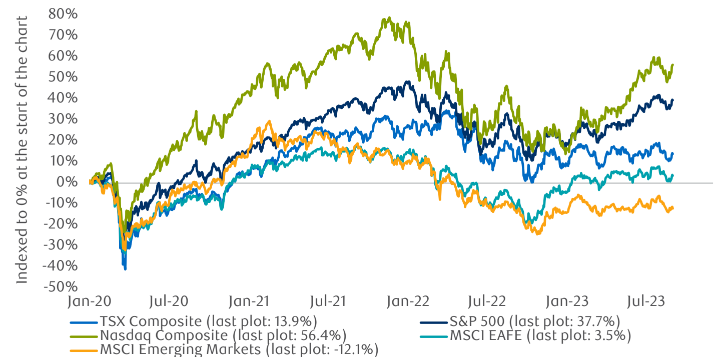
The more critical threat to stocks, in our view, is the sustainability of corporate profits in the face of a probable slowdown in the economy. Rising costs has weighed on profit margins and earnings growth so far this year has been subdued (Exhibit 8). We are open to the possibility that profits could fall meaningfully if the economy entered a downturn. In past recessions, S&P profits have fallen an average of 24%. But analyst estimates suggest a benign outlook. While the consensus looks for just 1% profit growth in 2023, analysts are projecting 11% earnings growth in 2024 followed by another 12% gain in 2025. We think these estimates are too optimistic and not factoring in a high chance of recession.

Asset mix – maintaining neutral allocation as risk/reward for stocks versus bonds is unappealing in the near term

The macro backdrop is highly uncertain and the range of possible outcomes spans an unusually large range. We recognize there are pathways to a soft landing but our base case scenario is one where recession materializes in the next several quarters, prompting central banks to cut interest rates. Against this backdrop and with yields at current levels, sovereign bonds offer attractive return potential, limited downside risk and should act as ballast against equity-market volatility. Although we continue to expect stocks to outperform bonds over the longer term, the compensation

Exhibit 6: Major equity market indices

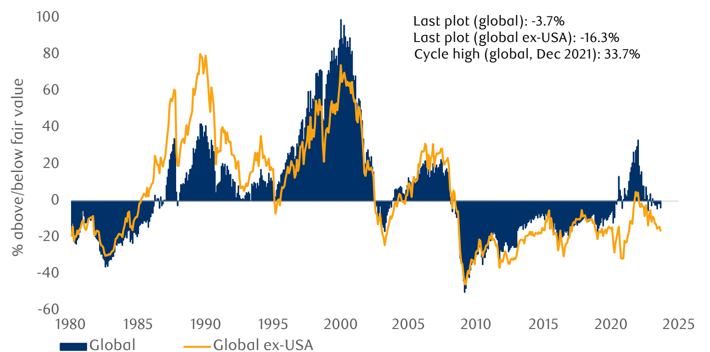
Cumulative price returns indices in USD



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

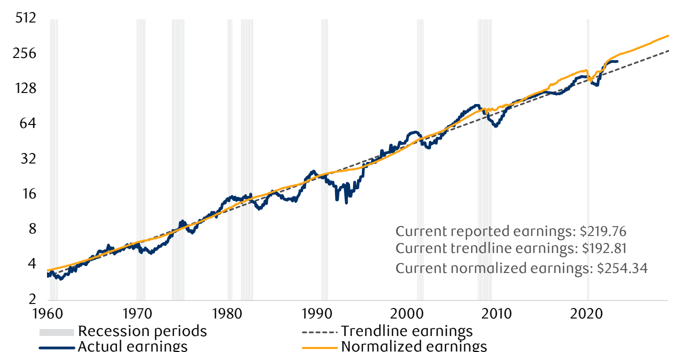
Exhibit 7: Global stock market composite

Equity market indexes relative to equilibrium



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

Exhibit 8: S&P 500 earnings comparison



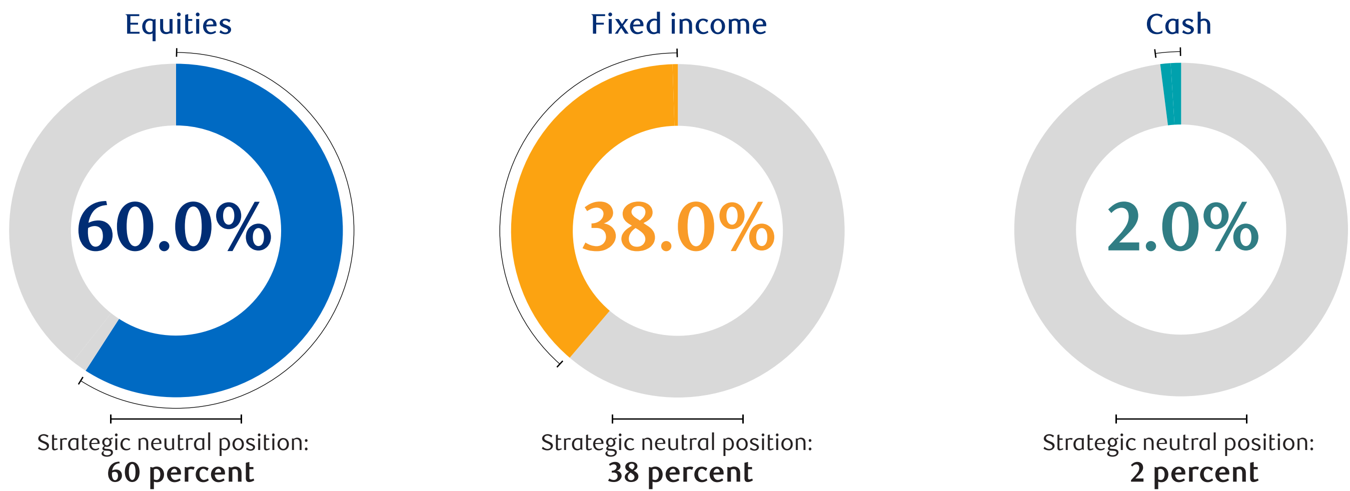
Note: As of August 31, 2023. Source: RBC GAM

for taking additional risk in equities is minimal in the near term. As a result, we have been narrowing our underweight in bonds and overweight in stocks through the cycle as yields rose and the risk of recession intensified. Last quarter we brought our positioning in line with our strategic neutrals, and we are maintaining this neutral positioning again this quarter.

Our current recommended asset mix for a global balanced investor is 60.0% equities (strategic: "neutral": 60%), 38.0% bonds (strategic "neutral": 38%) and 2.0% in cash (Exhibit 9). Actual fund or client portfolio positioning may differ depending on that portfolio's investment policies.

Exhibit 9: Recommended asset mix

RBC GAM Investment Strategy Committee



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