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## Economy at risk as inflation becomes top priority for central banks

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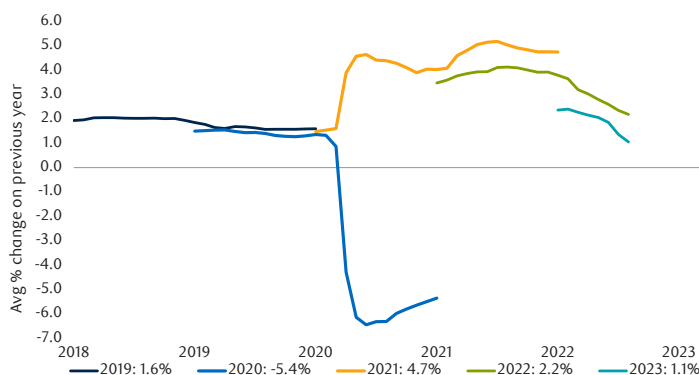
After posting an impressive recovery from the pandemic, the global expansion is mature and the risk of recession is elevated. Leading indicators of the economy have fallen meaningfully from their peaks in late 2020/early 2021, consumer confidence has plummeted and businesses have curtailed plans for hiring and/or capital spending. Although there are paths to a positive outcome, the outlook is highly uncertain given the ongoing war in Ukraine and associated energy crisis in Europe, remaining challenges from COVID-19, unacceptably high inflation and aggressive central-bank tightening. Estimates for growth have been gradually lowered throughout the year and we think that if recession materializes, it will most likely appear in late 2022 or early 2023 (Exhibit 1).

### Inflation is problematically high, but tentatively peaking

Consumer prices have risen at their fastest pace in 40 years and, while inflation is arguably the biggest threat to the expansion, a number of the forces causing surging prices may now be fading. Prices of oil and other commodities plummeted since the spring as demand destruction became evident.

Borrowing costs have surged, fiscal stimulus has diminished and supply challenges are being resolved. U.S. headline inflation declined to 8.5% in July from a high of 9.1% in June and, although there is still a long way to go and the path forward may not be smooth, we see inflation now on a favourable trajectory toward 3.5% by the end of 2023 (Exhibit 2).

**Exhibit 1: Growth estimates for major developed nations** – Growth estimates for major developed nations



Note: As of August 2022. Source: Consensus Economics

**Exhibit 2: U.S. Consumer Price Inflation** CPI Index Y/Y % change



Note: CPI data as of July 31, 2022, forecast as of August 31, 2022. Source: Bloomberg, RBC GAM

### Central banks need more clarity that inflation is under control before backing down

To maintain the credibility built over the last several decades, central banks want to be confident that inflation is headed down and that a stagflation scenario (high inflation amid stagnant growth) is avoided before lowering their guard. Jumbo-sized interest rate hikes in quick succession have been a feature of the current tightening cycle and more hikes are expected throughout the developed world. Since March, the U.S. Federal Reserve raised short-term rates by 225 basis points and pricing in the futures market looks for approximately another 150 basis points by early 2023, reaching a cycle high of nearly 4.0% (Exhibit 3). Although pricing in the futures market suggests rate cuts may occur sometime in 2023, Powell’s speech in Jackson Hole on August 26 reaffirmed that interest rates would remain elevated until the inflation threat is without doubt put to rest, even if that means the economy will endure pain. Starting from a point of great strength in the labour market affords the Fed the ability to remain hawkish for the time being.

### Bond yields continue upward march, valuation risk reduced

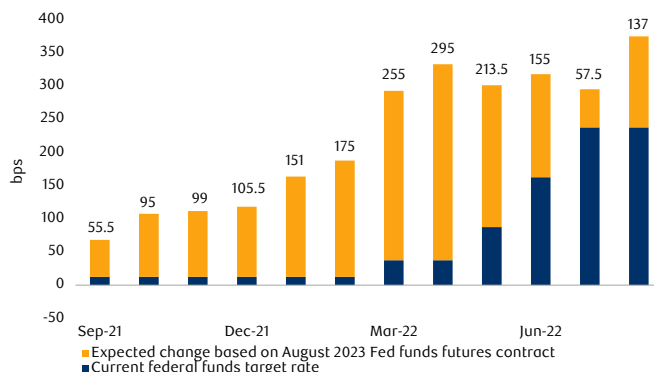
In this environment, fixed income markets have been extremely volatile and bonds endured their worst sell-off since the early 1980s. The U.S. 10-year yield rose as high as 3.5% earlier in the quarter from 1.5% at the start of the year (Exhibit 4). Valuation risk has been significantly reduced as a result. Not surprisingly, our models indicate that if we are proven wrong and inflation remains persistently high, yields will have further to rise. But if the recent surge in inflation proves transitory, yields are likely close to where we would expect them to settle over the medium to longer term.

### Equity valuations under pressure from rising interest rates, high inflation

Global equities slipped into bear markets in the first half of the year as fears over rising rates and high inflation intensified. The S&P 500 fell as much as 23.5% from its all-time high before retracing half of that by mid-August as inflation showed signs of peaking. The bulk of the fluctuations in equity markets so far this year can be explained by shifting valuations related to changing interest rates and investor confidence, which affected high-growth technology stocks in particular. The S&P 500 remains slightly above our modelled estimate of fair value and, although a wide range of outcomes exist, the more positive scenarios for stocks hinge on both corporate profits remaining strong and inflation and interest rates peaking (Exhibit 5).

### Exhibit 3: Fed funds rate and implied expectations

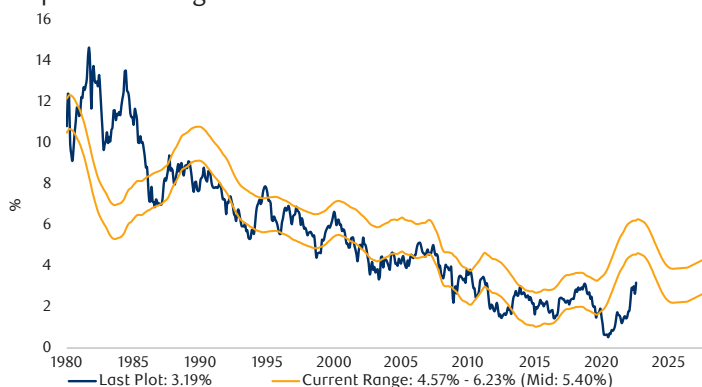
12-month futures contract



Note: As of August 26, 2022. Source: RBC GAM

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

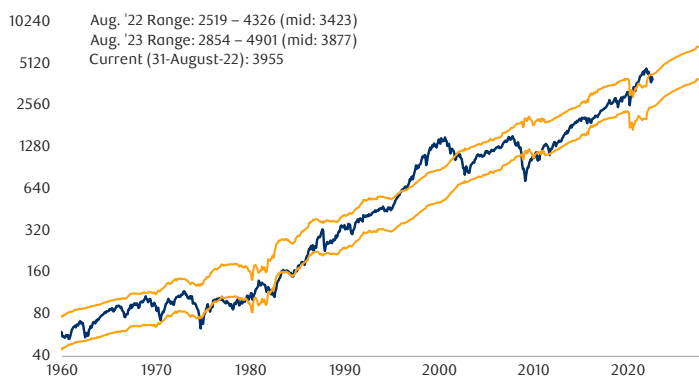
Equilibrium range



Note: As of August 31, 2022. Source: RBC GAM

### Exhibit 5: S&P 500 equilibrium

Normalized earnings & valuations

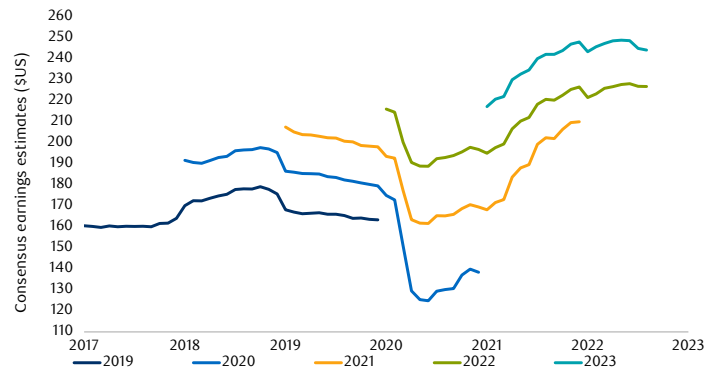


Source: RBC GAM

### Earnings outlook challenged by potential recession scenario

While financial markets have been volatile, the outlook for earnings has held up reasonably well. Companies have demonstrated pricing power, raising revenues even as costs have increased, maintaining margins and growing their earnings in this environment as a result. Although estimates are now being revised slightly lower, analysts still look for 8% profit growth for the S&P 500 in 2022 and another 8% in 2023 (Exhibit 6). These estimates, we think, are still optimistic given that profits have declined an average of 25% during recessions. If the economy is actually headed for recession, earnings will be vulnerable to significant downgrades opening further downside for equity markets.

**Exhibit 6: S&P 500 Index**  
Consensus earnings estimates



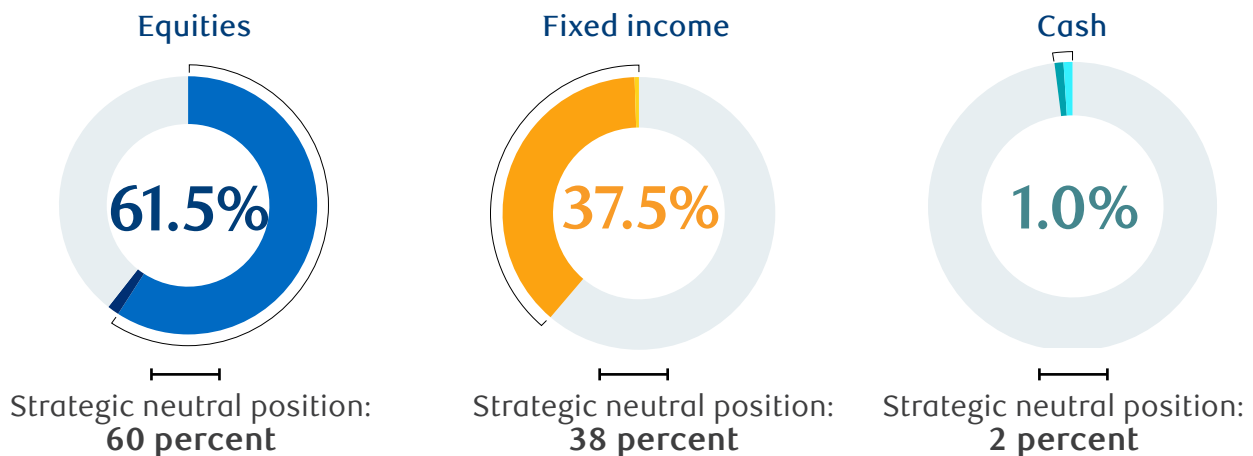
Note: As of August 31, 2022. Source: Thomson Reuters, Bloomberg

### Asset mix – shifting positioning closer to neutral

Balancing the risks and opportunities, our asset mix is closer to neutral than it has been in some time. This positioning reflects our view that the outlook is unusually murky and that the range of potential outcomes is large given that the singular goal for central banks is to arrest inflation, even if that means aggressive monetary tightening will adversely affect economic growth. In our view, bond markets have priced in most of the anticipated central-bank tightening. Higher yields have lessened in fixed income markets and bonds now offer a better ballast against equities in the event of a downturn. As a result, we have taken steps over the past several months to further narrow our bond underweight as yields have risen, sourced from cash and equities. Over the

long term, we continue to expect that stocks offer superior return potential versus bonds and we are maintaining a slight overweight allocation to equities as a result, but that overweight is much lower than we’ve held at prior points in the cycle. We remain somewhat cautious in the near-term with a possible recession on the horizon. For us to be more comfortable dialing up risk exposures, we would like to see further confirming evidence that inflation is headed toward the Fed’s 2% target and/or that earnings estimates adjust to reflect a more conservative outlook than is currently priced in. Our current recommended asset mix for a global balanced investor is 61.5% equities (strategic: “neutral”: 60%), 37.5% bonds (strategic “neutral”: 38%) and 1.0% in cash (Exhibit 7).

**Exhibit 7: Recommended asset mix**



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