RBC Global Asset Management

Economic outlook

NEW YEAR 2025

Surveying the post-election landscape

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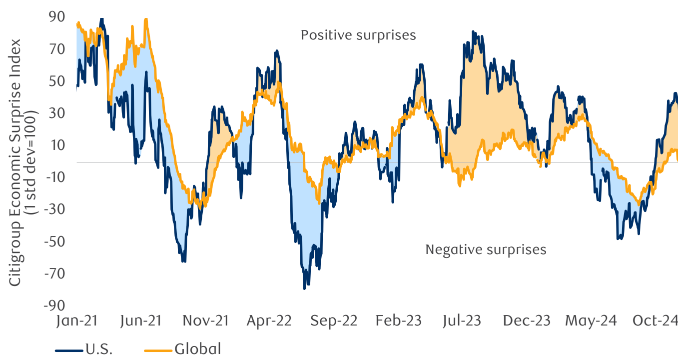
It is a time of transition for the global economy. Inflation is no longer the dominant concern, having descended to the point that central banks are now able to remove the monetary restraints that they introduced in 2022 and 2023. When ameliorating inflation is combined with economic growth that is now seemingly reviving after a period of weakness (Exhibit 1), the risk of a recession in the year ahead has declined substantially.

A major event risk has also been resolved in the form of the U.S. election, which yielded a Republican victory not merely in the race for the White House but also in Congress. The question that remains is the degree to which President-elect Trump's unorthodox campaign ideas will be translated into action. We assume that his proposed tariff and immigration policies will be significantly tempered, which then allows for the growth-enhancing effects of tax cuts, deregulation and rising animal spirits to dominate, moderately boosting the near-term U.S. growth outlook.

Exhibit 1: Economic surprises rebounded from negative readings



Note: As of 12/02/2024. Source: Citigroup, Bloomberg, RBC GAM

From a market perspective, we maintain a neutral asset mix. This attempts to balance the theoretically superior return potential in the stock market with the fact that U.S. equity valuations are now elevated after an impressive rally. Simultaneously, the bond market offers not just reasonably attractive returns in its own right, but helpful ballast for the broader investment portfolio.

Election aftermath

After one of the most memorable election campaigns in history – one that included a mid-stream change in the Democratic Party's candidate and betting markets that gyrated between the two candidates – the election ultimately resolved with a victory for Donald Trump, the Republican

nominee and former president. Congress also tilted to the right, handing majorities to the Republican Party in both chambers.

Naturally, the resolution of the race reduces the scale of U.S. policy uncertainty. However, questions remain regarding the extent to which Trump will deliver on his unorthodox campaign proposals.

For our part, we budget for a significant reduction in U.S. immigration and an increase in the outflow of undocumented residents, but nothing approaching the full removal of the country's 11 million-15 million undocumented residents.

Similarly, we expect additional tariffs, but not the full 60% tariff on China and 10% blanket tariff on the rest of the world that Trump has threatened. These are instead best interpreted as the opening offer from the U.S., with scope for affected countries to negotiate their particular exposure downward via concessions elsewhere. Areas of potential concessions include other countries' trade barriers, border security, alignment with the U.S. on key international issues and military budgets.

Some economic drag should nevertheless result from U.S. immigration and trade policy, but we still budget for slightly faster growth in the near-term under a Trump presidency. The extra growth comes from deregulation, additional domestic oil production, anticipated tax cuts (and the avoidance of tax rates that are currently scheduled to leap higher at the end of 2025) and an already-visible revival of animal spirits (Exhibit 2).

This advantage is then assumed to fade somewhat over the medium run as the cost of servicing additional debt mounts (part of the faster growth in the short run is presumed to be deficit-financed) and as the tailwind from other actions such as deregulation, tax cuts and animal spirits begins to slacken.

Why do we expect a moderation in some of the more damaging Trump policy ideas? His Congressional majority is fairly small, limiting some unconventional actions. Trump famously used the stock market as a yardstick for the success of his first-term presidency and so is unlikely to take actions that significantly undermine the health of the economy. Similarly, his administration is flanked by a significant number of business executives who will similarly endeavour

Exhibit 2: Macro implications from U.S. election

Trump policy expectations

Policy	Short-term economy	Medium-term economy	Inflation (+ is higher)	Equities	Bond yields
Overall effect	+	neutral	+	+ +	+
Tariffs	– –	–	+ +	– –	+
Immigration	– –	– –	neutral	–	neutral
Regulations	+ +	+	neutral	+ + +	neutral
Oil policy	+	+	–	+	–
Taxes	+ +	+	+	+ + +	+
Animal spirits	+ +	+	+	+ +	+
Gov't spending	–	neutral	–	neutral	neutral
Debt servicing	n/a	–	n/a	–	+

Additional thoughts

- Uncertainty is reduced but still substantial
- Republican sweep increases scope for action
- Don't expect most extreme version of ideas to be enacted
- Steadying guidance to come from C-suite advisors, SP500, yields
- Trump victory is probably negative for rest of world growth

Note: Estimated impacts using updated assumption of Republican sweep as at 11/06/2024. +/- indicate positive/negative impact on variable at top of column.
Source: RBC GAM

to steer White House policy away from bad economic outcomes. More generally, Trump had similar tariff and anti-immigration plans during his first term, yet the outcomes were more moderate, with the economy growing and the stock market rising.

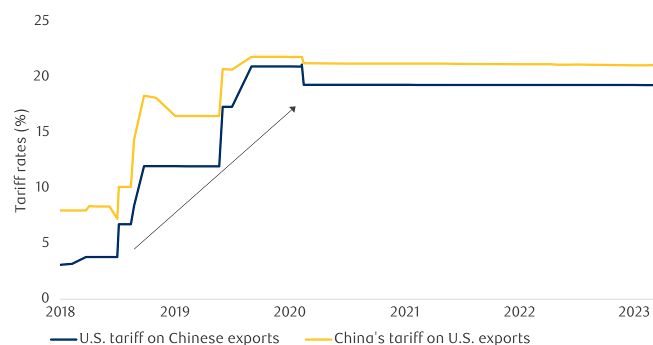
While the U.S. economy may be in a position to grow somewhat more quickly in the short run, the rest of the world faces the opposite prospect. Higher tariffs – even if tempered – should hurt growth. The potential impact is most visible in two sets of countries: those, like China and Mexico that may be targeted disproportionately (Exhibit 3); and those, like Mexico, Vietnam and Canada that have an enormous trade connection with the U.S. (Exhibit 4).

U.S. tax cuts and deregulation also render other countries comparatively less competitive. Greater geopolitical uncertainty (with some countries forced to reallocate government spending toward their militaries) also challenges rest-of-world growth. The overall effect is unlikely to be huge, with most countries experiencing less than a half-percentage-point hit to their 2025 growth outlook.

The Trump win should also be moderately inflationary. Higher tariffs constitute a tax that partially lands on consumers, increasing prices. The prospect of faster economic growth than otherwise is also incrementally inflationary. Conversely, looser oil policy is theoretically deflationary, with the price of oil potentially $3-$4 per barrel cheaper than otherwise as U.S. drillers ramp up. Overall, we budget for a bit more inflation and have upgraded our U.S. inflation outlook for 2025 by about a third of a percentage point. The effect would have been larger, but the Fed now has cause to cut by slightly less, which provides a partial offset.

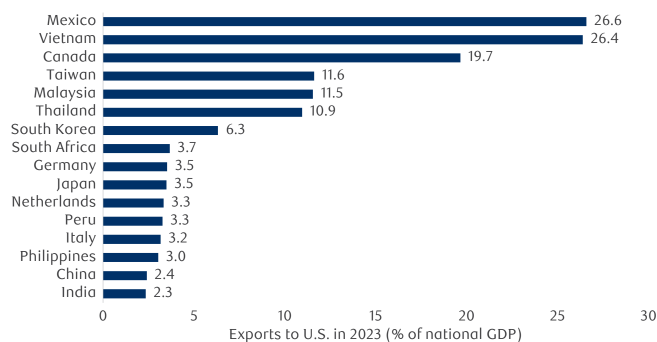
The so-called "Trump trade" is a stronger stock market, higher bond yields and a mightier U.S. dollar. This is precisely how markets have responded since election night. The prospect of deregulation plus tax cuts is like catnip for the stock market. Bond yields have increased due to the prospect of more short-term growth, higher inflation and possibly more public debt. The dollar rises in part on growth prospects, in part because the Fed is now in a position to cut less decisively than other central banks, and in part because a country imposing tariffs tends to experience a compensatory increase in its exchange rate.

Exhibit 3: U.S.-China tariff rates rose under first Trump administration



Note: As of 04/01/2023. Source: PIIE, RBC GAM

Exhibit 4: Exports to U.S. are significant for some countries



Source: IMF, Macrobond, RBC GAM

> "Higher tariffs constitute a tax that partially lands on consumers, increasing prices."

Stabilizing growth

After years of fretting about economic growth in the face of high inflation and then high interest rates, followed by a particularly concerning slump in the summer of 2024 when it had tentatively appeared that growth might finally be stalling out, the economy has seemingly stabilized in recent months.

Supporting this rosier impression, economic surprises have bounced from negative to positive, and economic news is about as positive as it has been at any point since the pandemic (Exhibit 5). Global purchasing managers' indices are admittedly softer (Exhibit 6), reflecting a chronically lagging manufacturing sector and U.S. exceptionalism (the U.S. economy is again materially outperforming its peers). But even purchasing managers' indices aren't any worse than at other points over the past few years.

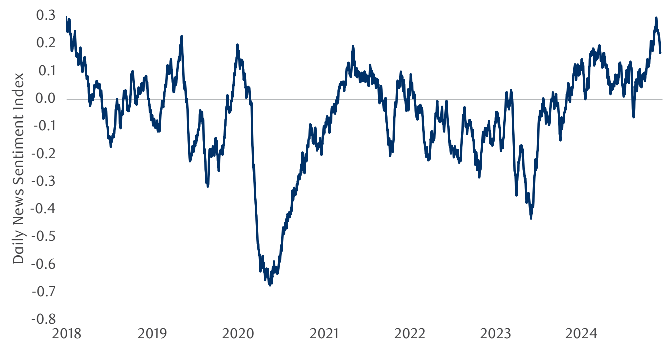
Given that economies showed sufficient buoyancy to avoid recession even when interest rate and inflation headwinds were blowing fiercely, it is entirely reasonable to anticipate further growth in the quarters ahead now that inflation has decelerated and central banks are cutting rates.

The consumer outlook is decent. After a period of pain from high interest rates that has pushed household loan-delinquency rates higher (Exhibit 7), we believe there is scope for a gradual pickup in spending growth starting within the next year as the burden of servicing debt declines. Consumer confidence appears to be improving, unemployment has stabilized at a relatively low level and wage growth remains solid. Outside of the U.S., household-savings rates are elevated, pointing to the potential for spending growth to outpace income growth in the years ahead.

The outlook for capital expenditures is pretty good, especially in the U.S.: spending on artificial intelligence and other new technologies is likely to remain robust, and in the U.S. the combination of lower taxes, deregulation and optimistic businesses is likely to support such activity.

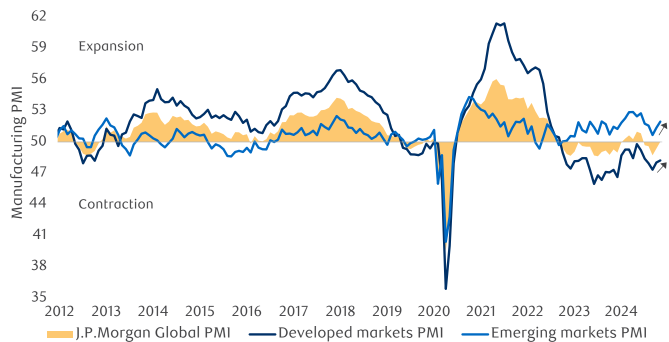
The U.S. economy continues to grapple with hurricane-related distortions in the October and November data, but by all appearances growth is healthy once those factors are accounted for.

Exhibit 5: U.S. economic news sentiment has been upbeat



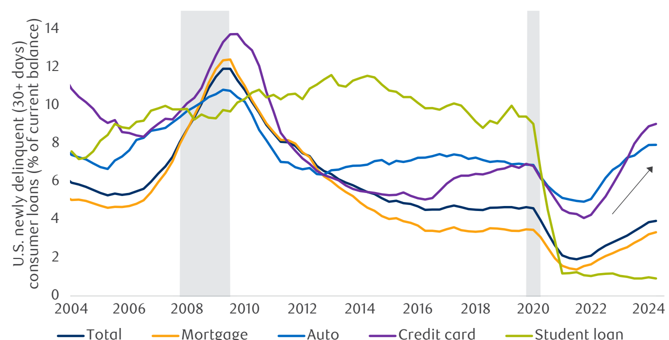
Note: As of 12/01/2024. Source: Federal Reserve Bank of San Francisco, Macrobond, RBC GAM

Exhibit 6: Global PMI reviving tentatively



Note: As of Nov 2024. PMI refers to Purchasing Managers Index for manufacturing sector, a measure for economic activity. Source: Haver Analytics, RBC GAM

Exhibit 7: U.S. consumer loan delinquency has been rising



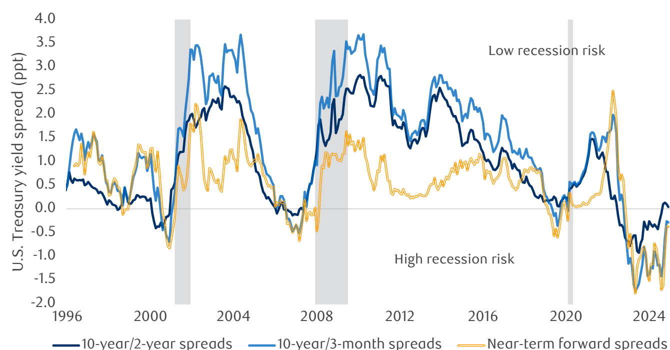
Note: As of Q3 2024. Shaded area represents recession. Source: FRBNY, Macrobond, RBC GAM

We continue to monitor the risk of a recession, but this appears to have declined further, such that there is just a 25% risk in the U.S. over the next year. A soft landing is by far the most likely outcome. The risk of recession is less trivial outside of the U.S. given more muted growth and fewer fiscal tailwinds.

A few recession signals admittedly still blink red for the U.S., including inverted yield curves that have historically presaged trouble (Exhibit 8). But we believe these are less sinister than they first look as interest rates are merely descending from high to normal levels, rather than from normal to low levels as often occurs in the build-up to a recession. Unemployment rates have also increased – another classic recession signal – but these now look to have stabilized in defiance of the usual uninterrupted upward trajectory into a recession.

Conversely, quite a number of recession indicators that previously signaled danger have normalized (Exhibit 9). This includes lending standards that are now easing (Exhibit 10). On aggregate, the risk of recession has declined and further economic growth appears likely.

Exhibit 8: Yield spreads rising across all three measures



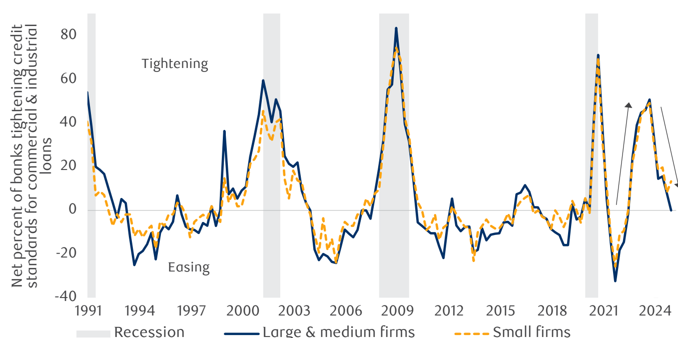
Note: As of 12/05/2024. Near-term forward spread measured as forward rate of 3-month Treasury bill six quarters from now minus spot 3-month Treasury yield. Shaded area represents recession. Source: Engstrom and Sharpe (2018), FEDS Notes, Washington: Board of Governors of the Federal Reserve System; Bloomberg; Haver Analytics; RBC GAM

Exhibit 9: Recession risk declining, but still higher than normal

Signal	Predicting U.S. recession?
2yr-10yr curve inverted / bull rallies out of inversion	Yes
3m-10yr curve inverted / bull rallies out of inversion	Yes
Fed short-term curve inverted / bull rallies out of inversion	Yes
Conference Board leading indicator falling	Yes
Unemployment increase	Yes
RBC GAM recession model	Maybe
Google "recession" news trend	Maybe
Inflation spike	Maybe
Monetary tightening cycle	Maybe
Jobless claims jump	No
Duncan leading indicator falls	No
Volume of global trade falls	No
S&P 500 profit margins fall	No
Lending standards tighten	No
Oil price spike	No

Note: As at 11/01/2024. Analysis for U.S. economy. Source: RBC GAM

Exhibit 10: U.S. business lending standards are reversing helpfully



Note: October 2024 Senior Loan Officer Opinion Survey on Bank Lending Practices. Source: Federal Reserve Board, Macrobond, RBC GAM

> "On aggregate, the risk of recession has declined and further economic growth appears likely."

One source of fresh concern is that long-term bond yields have lately risen, undermining some of the benefit of central-bank rate cuts. But short-term borrowing is still considerably cheaper than it was, long-term borrowing is still less expensive than it was at its peak, and overall financial conditions are only slightly tighter than a few months ago, and remain materially improved over the past few years (Exhibit 11).

Diverging forecasts

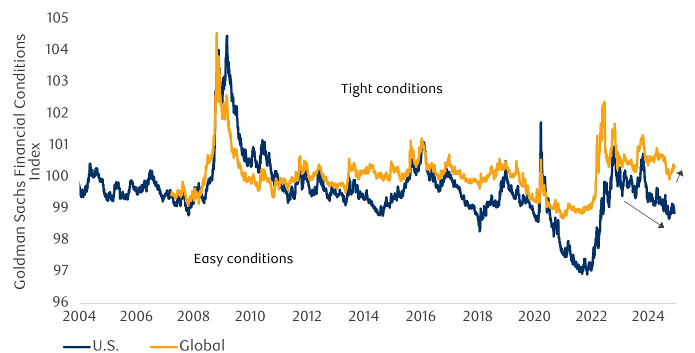
Our GDP forecasts continue to anticipate further economic growth, mostly at a modest to moderate clip over the first half of 2025 before the pace picks up somewhat later in the year. Beyond this common theme, however, forecasts have diverged somewhat along geographic lines. The U.S. growth outlook for 2025 has improved over the past quarter, from 1.7% to 2.3%. In contrast, other developed-world forecasts are mostly flat to lower, and their expected growth rates remain slower than the U.S. (Exhibit 12).

Some of this international gap is structural, reflecting lower economic speed limits outside of the U.S. due to a combination of more challenging demographics and structurally slower productivity growth. But the U.S. is also disproportionately buoyed by an expected boost from the fiscal arena. This advantage could start to shrink after 2025.

European growth appears set to remain unusually bifurcated, with southern countries such as Spain, Italy and Greece in a position to continue outpacing northern ones such as Germany. While Germany has failed to reliably grow over the past few years (Exhibit 13) and faces challenges competing with China's high-value industrial outputs, Germany's unemployment rate is only a percentage point higher than the post-pandemic low. The level of suffering in the economy therefore cannot be said to be unbearably high. It has been a similar situation in other countries that have sputtered in recent years: while certainly undesirable, the level of pain has not been in line with traditional recessions.

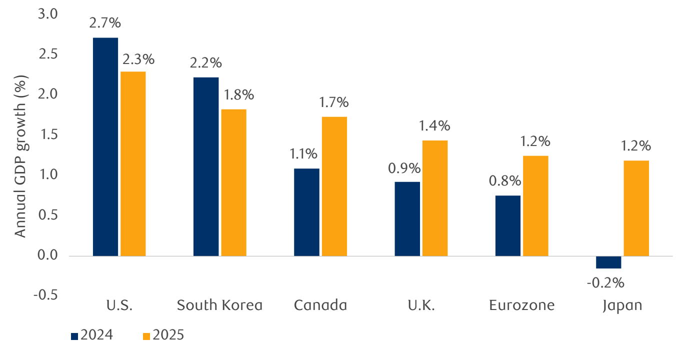
The U.S. growth forecast is somewhat ahead of the consensus, while most other developed nations hover around the consensus. Still, rest-of-world growth is on track to accelerate slightly in 2025 versus 2024 as the pain of high interest rates fades. The UK is in a position to grow somewhat more quickly in 2025, in part due to lower rates and partially

Exhibit 11: Financial conditions eased, but slight uptick lately



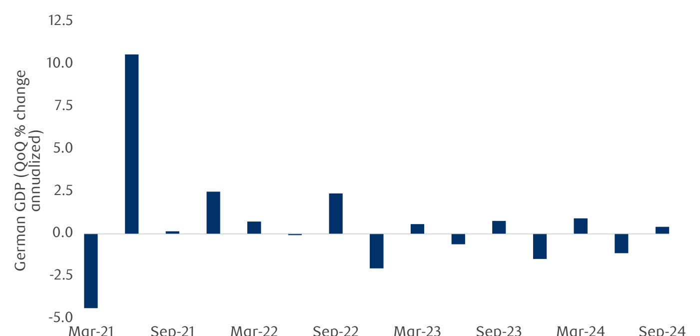
Note: As of 12/02/2024. Source: Goldman Sachs, Bloomberg, RBC GAM

Exhibit 12: RBC GAM GDP forecast for developed markets



Note: As of 11/06/2024. Source: RBC GAM

Exhibit 13: Germany's economy teetering on the brink of recession



Note: As of Q3 2024. Source: Statistisches Bundesamt, Macrobond, RBC GAM

as the government delivers additional fiscal support (Exhibit 14).

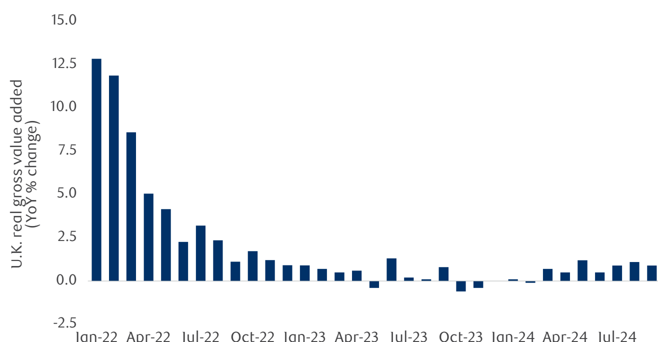
For emerging markets, aggregate economic growth may slow by a hair in 2025 relative to 2024 (Exhibit 15). Chinese growth is set to decline from 4.6% in 2024 to 4.3% in 2025. India could buck that trend, accelerating slightly from a relatively subdued 6.7% in 2024 to 6.9% in 2025.

Inconsistently declining inflation

The key point about inflation is that it is now much lower than the startling heights that were reached a few years ago (Exhibit 16). In turn, it is no longer the world's primary economic problem.

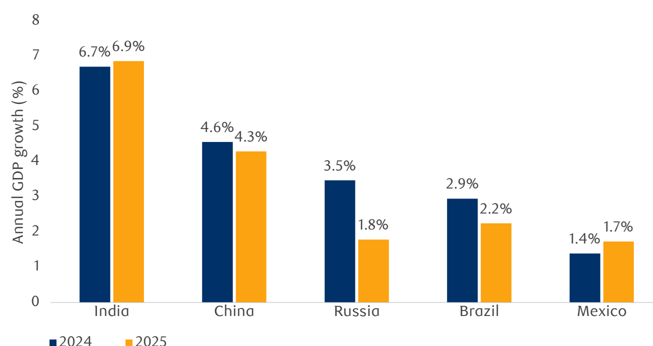
Still, inflation isn't quite all the way back to normal, and its downward path has been somewhat less consistent in recent months (Exhibit 17). The upcoming Trump administration introduces additional inflation pressures via tariffs and faster growth that oblige us to raise our U.S. inflation forecast for 2025 from 2.3% to 2.6%. This nevertheless leaves it a bit lower than the average rate in 2024, supported in part by a lagged decline in shelter inflation and in part by a less dovish Fed.

Exhibit 14: U.K. economy back to growth, albeit modest



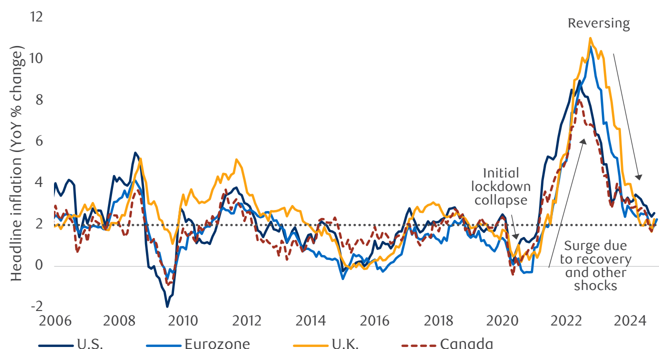
Note: As of Sep 2024. Source: U.K. ONS, Macrobond, RBC GAM

Exhibit 15: RBC GAM GDP forecast for emerging markets



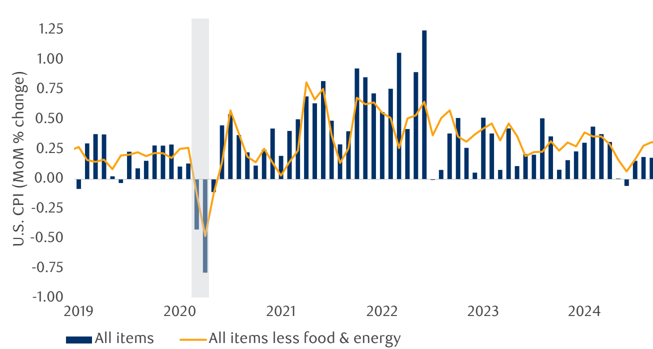
Note: As of 11/06/2024. Source: RBC GAM

Exhibit 16: Inflation has massively improved, but not quite normalized



Note: Canada, U.K., and U.S. as of Oct 2024, Eurozone as of Nov 2024. Source: Bureau of Labor Statistics, Office for National Statistics, Statistics Canada, Statistical Office of the European Communities, Macrobond, RBC GAM

Exhibit 17: Path to 2% inflation has been bumpy



Note: As of Oct 2024. Shaded area represents recession. Source: BLS, Macrobond, RBC GAM

The inflation challenges are less acute in other countries, and we have greater confidence in inflation continuing to converge upon target in most of those markets (Exhibit 18). Fundamentally, economies are less overheated than they were a few years ago, wage growth has moderated and corporate pricing plans are less aggressive (Exhibit 19). It makes sense for inflation to continue descending.

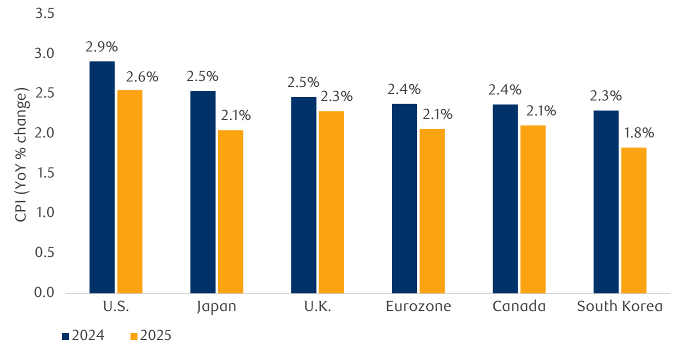
Decelerating rate cuts

The most profound new economic tailwind – or more technically, the removal of a prior economic headwind – is that central banks are beginning to unwind the enormous amount of monetary tightening they delivered in 2022 and 2023 (Exhibit 20). All major developed-world parties other than the Bank of Japan have now begun the journey toward lower rates, including the late-arriving U.S. which managed a splashy 50-basis-point inaugural cut in September, followed by a further 25-basis-point rate cut in November.

Central banks are still in a position to ease further, but with slightly less speed than what was delivered over the fall. This is in part because policy rates are no longer as restrictive as they were, reducing the urgency of further cuts. Equally relevant, the aforementioned inflation has not come in quite as soft in recent months, with U.S. inflation in particular now on a slightly higher trajectory.

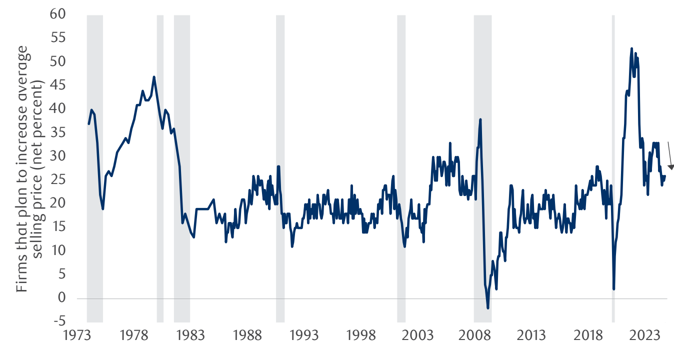
The takeaway is that the Fed can likely still inch its way down to around a 3.5% policy rate by the end of 2025, but this is higher than the 2.8% endpoint imagined by markets as recently as September. Other developed economies have lower neutral rates, meaning their policy rates are capable of descending into the 2%-3% range.

Exhibit 18: RBC GAM CPI forecast for developed markets



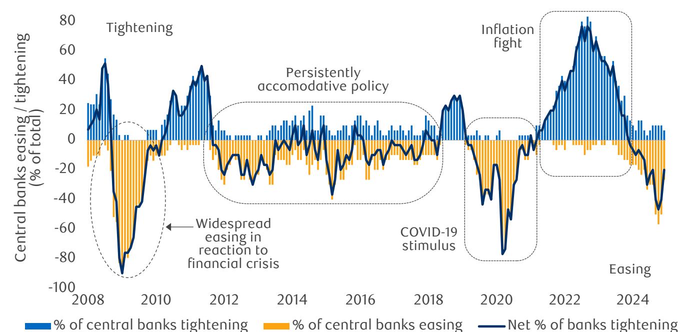
Note: As of 11/06/2024. Source: RBC GAM

Exhibit 19: Fraction of U.S. businesses planning to raise prices approaching pre-pandemic levels



Note: As of Oct 2024. Shaded area represents recession. Source: NFIB Small Business Economic Survey, Macrobond, RBC GAM

Exhibit 20: Central bank rate cutting is tentatively slowing



Note: As of 12/02/2024. Based on policy rates for 30 countries. Source: Haver Analytics, RBC GAM

Chinese stimulus in focus

The Chinese economy has decelerated markedly in recent years due to a mix of worsening demographics, a housing bust, renewed skepticism of the private sector, and geopolitical frictions with the U.S. China is nevertheless on track for 4%-5% growth this year and next thanks to resilient exports (Exhibit 21), but it will probably then decelerate to 3%-4% on a steady-state basis thereafter. This is disappointing for a country that once managed 6%-10% growth, but the new growth profile is still superior to that regularly achieved by developed-world nations.

Given a shrinking population, even that diminished economic clip translates into pretty robust productivity growth, and so China can still be said to be tracking the Japanese and South Korean path toward rich-country status.

It is tempting to think that China will be hit quite hard by U.S. tariffs, and indeed the country is the main target. But a few things should temper the extent of any damage.

A key factor is that only 2% of Chinese output is exported directly to the U.S. If that sounds low, recall that large countries are always primarily oriented toward their domestic market, and that China also has deep trade ties with the rest of Asia, South America, Europe, Africa and Australasia. China is less beholden to U.S. demand than commonly imagined.

China also has space to deliver more economic stimulus. We expect actions that include further rate cuts, support for the property market and local governments, and inducements for additional consumer spending. The country may be delaying some of this support until there is greater clarity around how the U.S. will hit China, and then respond with force in the new year.

Assorted risks

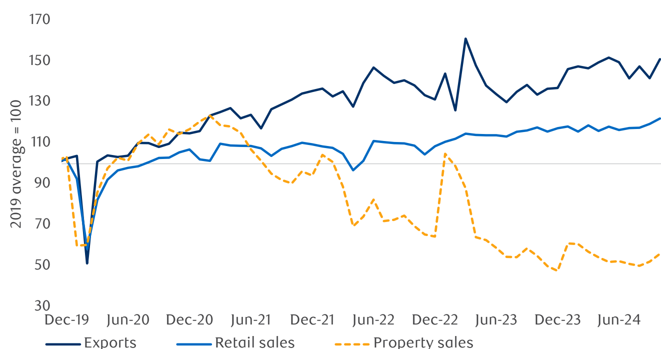
Naturally, there are a variety of risks to our base case outlook. It is the very nature of macroeconomic risks that these tilt more negatively than positively.

Quite a number of the most prominent uncertainties relate to the path forward for U.S. public policy. We have already articulated our view that the economic policies unleashed in certain critical areas will be tempered relative to the campaign rhetoric. But this is far from certain.

If U.S. public policy is instead delivered with greater fealty to the Trump campaign's platform, one might imagine materially less economic growth due to a significant drag from large tariffs and a sharply declining U.S. population, and potentially significantly higher inflation due to those same tariffs and the loss of inexpensive undocumented workers. The rest of the world would also be adversely affected by higher tariffs and less U.S. growth leadership.

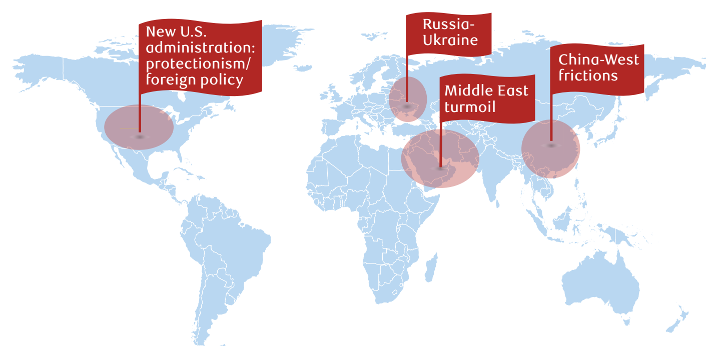
There are also large questions around potential changes to American foreign policy. The outlook for the war in Ukraine, conflict in the Middle East and Chinese frictions with the West are all in play (Exhibit 22). The likelihood of a Ukraine-Russia

Exhibit 21: Exports remain the bright spot in China's growth



Note: As of Oct 2024. Average of 2019 levels indexed to 100. Source: Haver Analytics, RBC GAM

Exhibit 22: Geopolitical inflation risks abound – watch oil, supply chains and tariffs



Note: As at 11/15/2024. Source: RBC GAM

cease-fire has arguably increased, albeit with the potential for significant Ukrainian territory to be ceded to Russia. Both parties are now battling with an increased intensity as they seek to crystalize favourable borders. An alternate scenario is that the war continues but with Europe replacing the U.S. as Ukraine's main benefactor, with uncertain effectiveness. The price of oil, agricultural prices and the availability of natural gas to Europe are all in play.

There is a risk that the conflict in the Middle East intensifies given Trump's greater historical antagonism toward Iran, with conceivable ramifications for the price of oil (Exhibit 23). Conversely, his isolationist instincts cannot be ignored.

A third category of U.S. political risk is that our base case assumption of moderate policies is delivered, but the economy accelerates more than expected in response, preventing inflation from settling and stopping the Fed from cutting rates much (or at all) further. In an extreme form of the scenario, rate hikes might even be necessary.

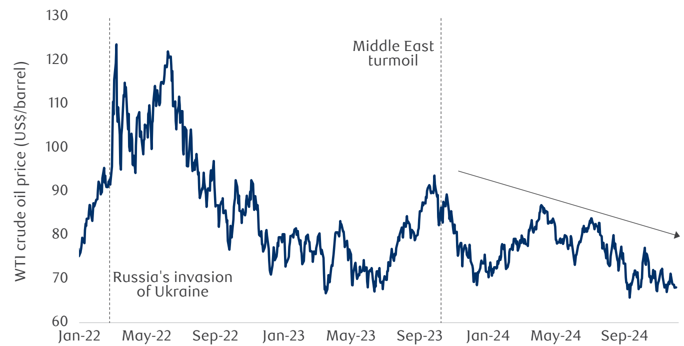
Outside the U.S., a major global risk involves China's slow-motion housing bust – specifically, the possibility that the government ultimately fails to contain the fallout across a network of interconnected parties including builders, homeowners, local governments and Chinese banks. A major blow to Chinese economic growth and financial stability would reverberate around the world given that the country generates nearly a quarter of global growth (Exhibit 24).

Peak Canadian pessimism

The Bank of Canada has been cutting rates with greater ardor than its peers (Exhibit 25), enabled by an inflation rate that has already descended to the country's 2.0% target, an underwhelming economic performance where the unemployment rate has risen by nearly 2 percentage points, and spurred by the large numbers of Canadian households with five-year mortgages that will roll into sharply higher interest rates in 2025 and 2026.

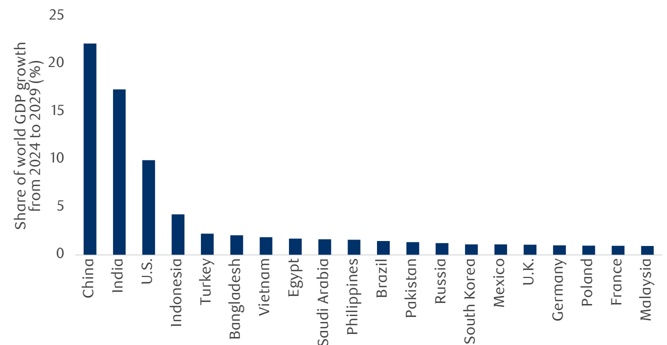
Fortunately, the Canadian outlook is not all negative, and indeed we posit that that attitudes toward the country could begin to improve from their current pessimistic stance over the year ahead. Declining interest rates should be particularly beneficial to a country that is so interest-rate sensitive. An election in the new year could install a more growth-oriented

Exhibit 23: Oil prices are soft, but risk of geopolitical flare-up



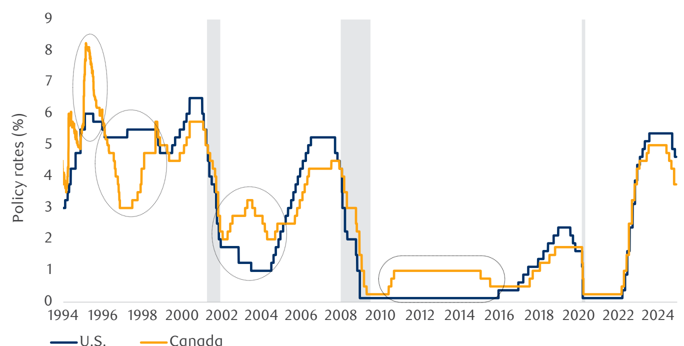
Note: As of 12/02/2024. Source: Macrobond, RBC GAM

Exhibit 24: China to remain the top driver of world growth



Note: Based on IMF forecast from 2025 to 2029. Source: IMF World Economic Outlook, Oct 2024, Macrobond, RBC GAM

Exhibit 25: North American monetary policy now in easing mode



Note: As of 12/02/2024. Shaded area represents U.S. recession. Source: Macrobond, RBC GAM

government. Any tariffs applied by the U.S. against Canada are likely to be quite limited. Business attitudes are starting to become less negative (Exhibit 26). A housing shortage should begin to prompt additional construction, even if poor housing affordability will constrain buyer enthusiasm for some time (Exhibit 27). The elevated household savings rate leaves room for stronger spending growth once the burden of high interest rates starts to fade.

The key Canadian question is how anticipated reversals in population growth and productivity growth will interact. Population growth is set to slow sharply due to tightening immigration rules after an unprecedented surge in recent years (Exhibit 28) – a potentially serious drag on economic growth. In contrast, productivity has been unbelievably weak in recent years, in part due to the indigestion created by the outsized immigration. The demographic reversal should thus allow for some revival in productivity, but it is impossible to say whether productivity will normalize at the precise moment that immigration eases. As such, the quarter-to-quarter growth across 2025 may be unusually choppy as the retreat in one key variable and the revival of another fail to synchronize perfectly.

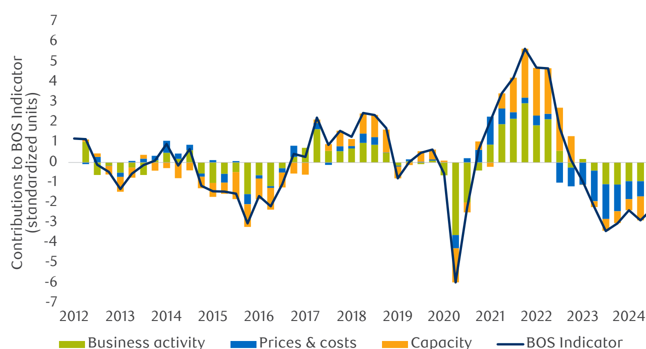
Bottom line

Priorities are shifting for the global economy. Worries have diminished about excessive inflation and the prospect of a recession, and greater clarity has been achieved about the downward path for monetary policy. Now questions about the outlook for U.S. public policy dominate.

Much will be revealed in the coming months, but we mostly budget for a more moderate set of economic policies under Trump than those articulated on the campaign trail. The result will likely be that the U.S. economy can grow a little more quickly in the short run, that inflation runs a bit hotter than otherwise (while still edging lower), and that the rest of the world lives with slightly less growth than otherwise.

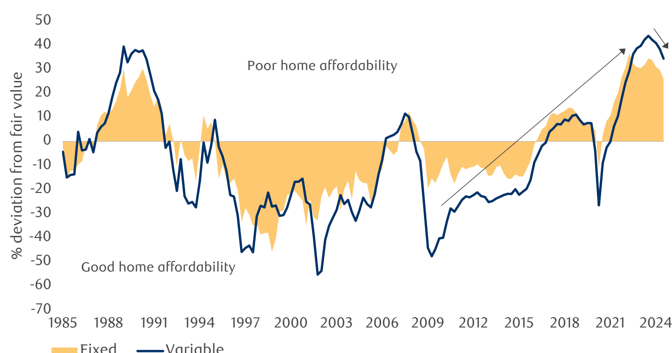
From a market standpoint, a neutral asset mix remains appropriate given reasonably attractive bond yields paired with conflicting stock market signals that include the prospect of solid economic growth (favourable) and high market valuations (unfavourable, at least for the U.S.).

Exhibit 26: Canadian Business Outlook Survey Indicator has become less negative



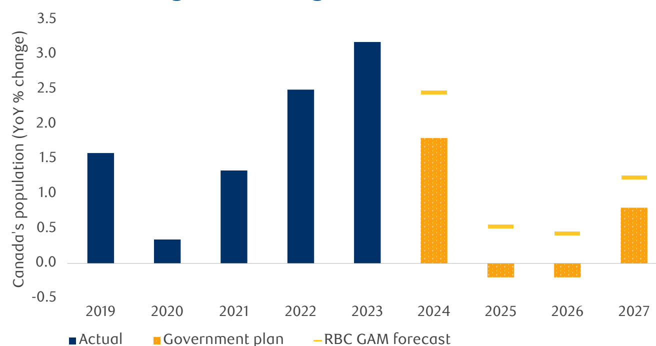
Note: As of Q3 2024. Source: Bank of Canada Business Outlook Survey, Macrobond, RBC GAM

Exhibit 27: Canadian housing affordability is very poor but improving



Note: As of Q3 2024. Current carrying cost of a home versus the historical norm. Source: CREA, Statistics Canada, Haver Analytics, RBC GAM

Exhibit 28: Canadian population growth to slow with reduced immigration targets



Note: As of 10/28/2024. Government plan estimated based on federal government 2025–2027 Immigration Levels Plans released on 10/24/2024. Source: Statistics Canada, Macrobond, RBC GAM

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