RBC Global Asset Management

Executive summary

NEW YEAR 2024

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Progress against inflation has ignited both bonds and stocks as the need for additional tightening of monetary policy is removed. While the threat of recession in early 2024 remains as the full force of prior rate hikes feeds through, the next cycle is moving into view. We believe that capital markets are transitioning to reflect a return to optimal inflation and firming growth later next year, and doing so with a backdrop of generally attractive valuation levels.

Economy avoids recession in 2023, but challenges still lie ahead for first half of 2024

While a recession has been avoided so far in 2023, the economy will likely slow through the first half of 2024 before recovering later in the year. Savings that were built up during the pandemic are being depleted, government spending is set to slow and geopolitical frictions are intense. The main headwind to the global economy, though, is that interest rates surged to their highest level in 16 years by mid-2023 and, if they remain elevated, higher borrowing costs could discourage business and consumer spending while making debt-servicing more difficult. There are signs that economic data is now feeling the pressure of higher interest rates. Global trade is contracting, business expectations are soft, housing activity has plummeted and the labour market is starting to lose momentum, albeit gradually. Although pathways to an economic soft landing are evident and the odds of such an outcome are improving as inflation moderates, we continue to look for mild contraction in the U.S., Canada, the UK and eurozone during the first half of 2024.

We expect inflation to continue moderating

Inflation has fallen sharply from its multi-decade peak in the middle of 2022, and we see further scope for decline. The four original drivers of the inflation spike have all turned meaningfully. The commodity shock has faded, supply-chain bottlenecks have eased, central banks have pivoted from massive ease to restraint, and fiscal stimulus is significantly diminished. At its worst, high inflation was broad-based, with the majority of the spending basket rising at an unusual clip, but that breadth is now fading quickly. Goods inflation has vanished. Service-sector inflation remains elevated, but it too is past its peak and a weaker economy should provide further relief. Shelter costs, the biggest remaining inflation driver, are likely to soften, in part because home prices are forecast to decline and because the shelter component of CPI is lagged in a way that should capture weakness over the coming months. For all these reasons, we think that inflation can continue moving back toward the central bank's 2% target, although it may not reach that level by the end of next year. Our inflation forecasts are modestly below the consensus.

U.S. dollar has been resilient, but tailwinds are fading

The U.S. dollar has remained elevated for longer than we had expected. Elements that were supportive of the greenback are starting to fade, however, and there are signs that fiscal concerns and a slowing economy have started to weigh on the currency, which sits more than 20% above fair value. As this process unfolds, we forecast that the dollar will weaken against major currencies such as the euro and Japanese yen. We are relatively more cautious on emerging-market currencies in the short term, although as a group they are likely to benefit over the longer term from a persistent decline in the U.S. dollar.

Short-term interest rates may be peaking

Policy rates in developed markets have stabilized at an elevated level in the range of 5% following a rapid and unusually large response to the inflation shock. Further rate increases are not impossible if inflation were to be sustained at levels above 3%. That said, the data increasingly tilts toward rate cuts in 2024 – likely sooner rather than later, and more cuts rather than fewer. Policy rates are now restrictive, and they are unlikely to be maintained at current levels if the economy enters a downturn and/or inflation remains on its current path toward the 2% target.

Sovereign bonds stage impressive rally, starting from attractive valuations, as investors anticipate end of tightening

With yields surging over the past couple of years, the bulk of the adjustment needed to restore a proper level of compensation for fixed-income investors is largely complete. The scope for lower yields opened up with yields on 10-year Treasury bonds rising toward 5% during the fall, setting up one of the most attractive entry points for bond investors in a long time. Bond markets rallied in November as investors entertained the potential end of tightening and possible easing next year. The U.S. 10-year yield fell to 4.33% in November and then pierced 4.00% in December from a high of 5.02% in October, and sovereign bonds in Canada and Europe rallied by similar degrees. The rally began with yields generally positioned at undervalued levels relative to our equilibrium models, a situation that has appeared only a handful of times over the past 40 years including the global financial crisis and a brief spike in 2013. Looking ahead, our models indicated yields on 10-year Treasury bonds could settle between 3.50% and 4.00%, or perhaps even lower, over the longer term assuming an inflation premium around 2.0%-2.5%, real rates of 0% to 1% and a term premium of around 100-150 basis points. Such an outcome would deliver mid-to-high single digit total returns over the year ahead as investors receive attractive coupon income in addition to capital gains as yields continue to move lower.

Equity valuations are reasonable outside U.S. mega caps, but earnings growth will be critical to sustaining the rally

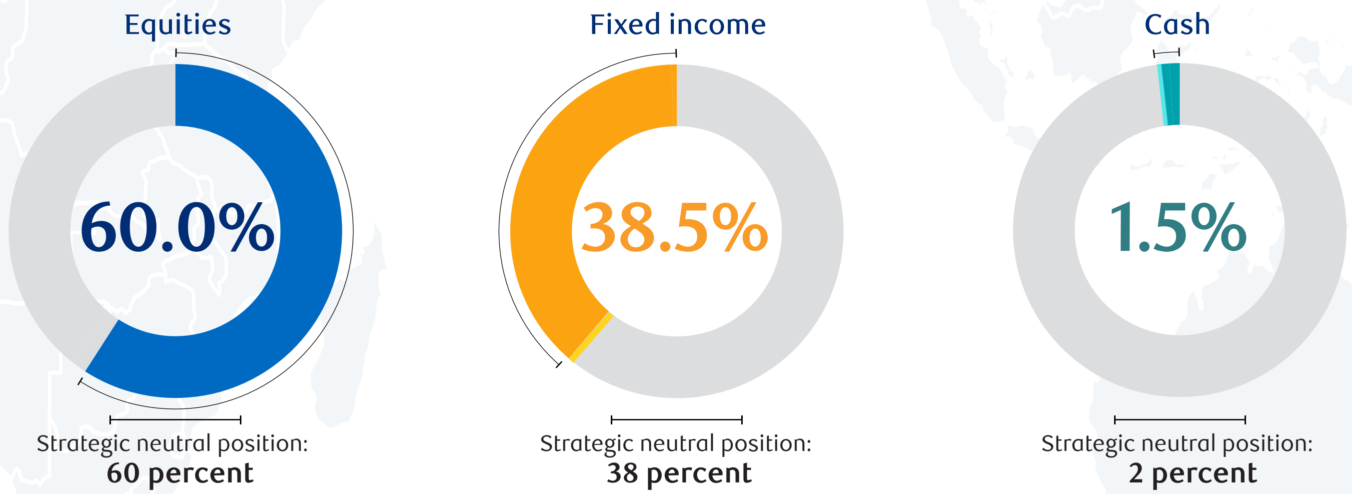
A distinguishing characteristic of the 2023 stock-market rally was the narrowness of the advance as investors priced in a challenging economic backdrop for the bulk of listed companies. In this environment, the "Magnificent 7," the seven largest stocks in the S&P 500 by market value and characterized as high-quality growth stocks, were up 76% as of November 30, pulling the technology-laden Nasdaq up 36% and the S&P 500 up 18%, accounting for fully 29% and 15% of these gains, respectively. Most stocks lagged the capitalization-weighted index returns significantly. The Equal Weight S&P 500 Index, a better reflection of the average stock's performance, was up only 5% during this period, and many other global indexes such as the UK's FTSE 100, Canada's S&P/TSX Composite, the emerging-markets benchmark and even U.S. small-cap indexes produced only low single digits returns over the period. As a result, apart from the capitalization-weighted and Magnificent 7-dominated S&P 500, global equities are not all that expensive, with regions outside the U.S. trading at particularly attractive discounts to their fair value. Given that valuations are generally reasonable, the biggest risk to the stock market, in our view, is the near-term path for corporate profits. Analysts' estimates reflect a re-acceleration in earnings growth to 11% for the S&P 500 in 2024, up from 2% this year. But in our view, these expectations would be vulnerable if the U.S. and global economies fell into at least a mild recession. To the extent that a soft landing for the U.S. and global economy has increasing visibility, stocks could extend their gains. Should the outlook for growth improve and the threat of earnings shortfalls diminish, the rally could broaden out and leadership could shift to non-U.S. regions, value stocks and small/mid-caps as investors look to the most attractive valuations in an environment of a broad-based increase in corporate profits beyond the first half of 2024.

Asset mix – raised fixed-income allocation above neutral setting

We acknowledge that uncertainty remains as the prior tightening of monetary policy feeds through the global economy. While our base case is that economies slip into recession over the next several quarters, we recognize there are also pathways to a positive outcome for the economy and risk assets and that these are now rising in probability. With inflation on a favourable trajectory, central banks are unlikely to raise rates any further, and cuts in policy rates will be appropriate at some point over the next year. For sovereign bonds, the risk/reward is particularly appealing given that, at higher yields, safe-haven fixed-income assets can provide ballast against a downturn in equities, and with a diminished risk of significant losses. Although we continue to expect stocks to outperform bonds over the longer term, the premium associated with holding equities, relative to fixed income, is lower than it was at earlier points in the cycle and perhaps not adequately compensating investors for the risk of an economic downturn. We would become more constructive on the outlook for stocks if we saw increasing stock-market breadth, an improvement in economic leading indicators and/or an easing of monetary conditions. Given the balance of risks and opportunities against both short-term and long-term investment horizons, we added to our fixed-income allocation over the past quarter, boosting our bond weight above neutral for the first time in two decades. The 50-basis-point increase in our fixed-income weight was sourced from cash as yields on 10-year Treasuries climbed near 5%. For a balanced global investor, we currently recommend an asset mix of 60.0 percent equities (strategic neutral position: 60.0 percent) and 38.5 percent fixed income (strategic neutral position: 38.0 percent), with the balance in cash. Actual fund or client portfolio positioning may differ depending on individual investment policies.

Recommended asset mix

RBC GAM Investment Strategy Committee



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

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