RBC Global Asset Management

Executive summary

SUMMER 2023

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The global economy is slowing as higher borrowing costs and tighter financial conditions weigh on activity. At this late stage in the business cycle, short-term interest rates are likely nearing their peak, bonds are more appealing than they've been in a long time, and equity markets could be vulnerable to correction should a recession materialize.

Economies are likely headed for recession

The economy has been resilient so far this year, but the most aggressive monetary-tightening cycle since the 1970s is starting to have an impact. Higher interest rates have increased the cost of borrowing, diminished risk appetite and emerged as the root cause of banking-sector stress. Moreover, business confidence is waning, global trade is beginning to shrink and consumers are increasingly turning to credit to support their spending. Further inhibiting growth will be the U.S. debt-ceiling resolution, which comes with a commitment for reduced government spending over the next two years. All in all, we anticipate that developed-world economies will fall into recession within the next few quarters. We assess the odds of a contraction at 80%, up from 70% last quarter due to the impact of credit tightening in the wake of the short-lived banking crisis earlier this year. That said, we expect any recession to be mild to middling in depth and fairly short at just two to three quarters. Our growth forecasts have been slightly upgraded from a quarter ago, but they are still below the consensus. A mild recession could bring about some positives as it would help cool inflation, prompt central banks to cut interest rates and set the stage for the next durable economic expansion.

Inflation, down from last year's highs, is progressing in the right direction

The four key factors that drove inflation to its highest level in four decades are all turning. Commodity prices are well off their prior peaks, supply-chain problems have mostly abated, monetary policy has become restrictive and fiscal policy is starting to act as a headwind. Other indicators also point to fading inflationary pressures. Chinese producer prices are dropping, companies have reduced plans to raise wages and the share of products subject to rapid price increases has declined. There is, however, still some distance to go before inflation returns to levels targeted by central banks. The path to 3% inflation can likely be traversed in the next several months in North America, but achieving the 2% target could take considerably longer. The biggest barrier to continued significant declines in inflation in the near term is service-sector inflation, which remains hot due to a strong labour market. A recession would likely be needed to cool price pressures in this sector. Taking all of this together, we expect that inflation can continue falling and our inflation estimates are below the consensus.

U.S. dollar takes a breather within a longer-term decline

The U.S. dollar kept to a narrow 4% range in the first five months of 2023 in what we believe will turn out to be a pause in the currency's longer-term sell-off. Recent U.S. regional-bank failures and monetary and fiscal trends support our view that the dollar will weaken, but this outlook has been challenged as the U.S. economy remained more resilient than its global peers. We retain our forecast that the greenback will fall over the next year and expect the declines to be greater than what we had been forecasting last quarter.

The end of central bank rate hikes is coming into view

A massive amount of monetary tightening has already been delivered and policy rates are now restrictive in most major developed economies. As a result, further aggressive rate hikes are becoming less warranted and, while we could see rates inch a bit higher still, we are likely approaching the finish line in the current rate-hiking cycle. The near-term risks to this assumption tilt toward central banks raising rates a bit more than expected should inflation fail to come down and economies avoid recession. But in our view, the pressure to raise rates will continue to diminish and several central banks should be in a position to cut rates, if necessary, over the year ahead as economies weaken and inflation falls. We don't think interest rates will retreat to the historic lows of 2020 or even the average of the post-financial-crisis era, but we do think that they will be suppressed in the years ahead by a combination of high debt, aging populations and structurally slow economic growth.

Bonds offer attractive return potential; valuation risk is minimal

It appears that the relentless increase in bond yields from last year has eased and investors have been conditioned to a higher interest-rate environment. As inflation soared, investors embedded a higher inflation premium into bonds and our models suggest the reverse will be true as inflation moderates. The other piece of our fixed-income model is the real, or after-inflation, interest rate, which has been gradually climbing from negative levels. Over the longer term, we continue to expect real interest rates to rise slightly above zero as savers will ultimately need to be compensated for saving instead of spending. But any increase in real yields will likely be trivial in the near term compared to the significant expected declines in the inflation premium. As a result, we look for the 10-year Treasury-bond yield to fall to 3.25% over the next year, which would generate close to a 7% total return with minimal valuation risk. In addition, a variety of technical signals indicate support for bond prices.

Rally in stocks features narrow leadership, upside is limited

The stock-market rebound in late 2022/early 2023 was propelled by diminishing investor concerns regarding inflation and less worry about the sustainability of economic growth. The rally was initially broad-based across regions, but returns in recent months have been concentrated in a narrow set of U.S. mega-cap technology stocks. Apart from the U.S. large-cap market, which has been fueled by excitement about artificial intelligence, most major indices were flat or down for the quarter. In fact, even within the S&P 500 Index, performance has been lacklustre beneath the surface. While the S&P 500 rose 8.9% in the five months ended May 31, 2023, the equal-weighted version, which neutralizes the impact of large technology names, was down 1.4% in that period. We would prefer to see expanding breadth alongside a rising stock-market index to confirm a healthy, durable, bull market.

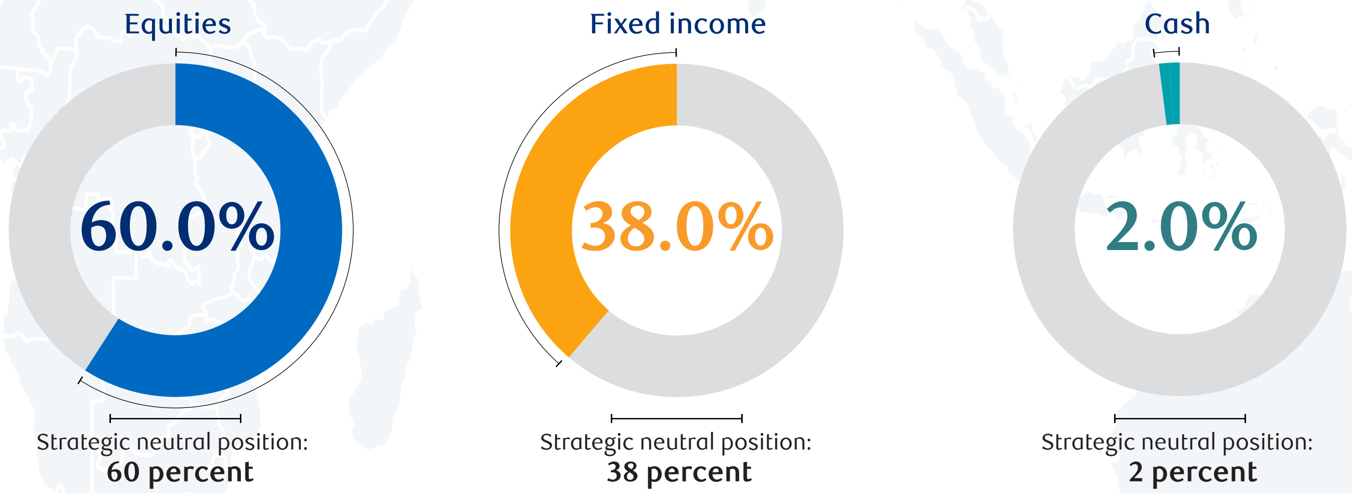
The bigger threat to the stock market is now the sustainability of corporate profits which have been struggling and will be vulnerable if the economy falls into recession. S&P 500 earnings growth has currently stalled as rising costs weigh on profit margins. Moreover, earnings are situated above their long-term trend and we've never seen a contraction in the economy that didn't force profits at least back to their long-term trend line. In a slowdown scenario, S&P 500 profits could fall as much as 15% from their peak, limiting the upside potential for stocks.

Asset mix – neutralizing tactical allocation

Our asset mix seeks to balance the risks and opportunities given a variety of scenarios for the economy and financial markets. We tend to run at least a mild tilt toward stocks to capture the risk premium versus bonds over the long term. But that premium is currently small and, given our base case that the economy is headed for recession over the next year, we are reluctant to hold an overweight position in stocks at this time. As a result, we removed the last of our overweight during the quarter, trimming our stock allocation by 100 basis points, moving half the proceeds into fixed income and half into cash. Our allocations to stocks, bonds and cash are now all in line with our strategic neutral levels. While we no longer have any tactical risk in our asset mix, we can’t ignore the fact that the economy has not yet stumbled and that there are pathways to a soft landing. To add back equity exposure, we would want to see an easing of financial conditions, an improvement in economic leading indicators and expanding equity-market breadth, particularly in the U.S. For a balanced global investor, we currently recommend an asset mix of 60 percent equities (strategic neutral position: 60 percent) and 38 percent fixed income (strategic neutral position: 38 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 May 31, 2023. Source: RBC GAM

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