RBC Global Asset Management

Executive summary

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The war in Iran has injected significant uncertainty into the outlook and widened the range of potential outcomes for the economy and financial markets. While risks have intensified, our base case scenario still sees the economy continuing to grow amid a variety of existing tailwinds, allowing stocks to outperform bonds, particularly in non-U.S. regions where valuations are relatively appealing.

Economic backdrop solid amid the arrival of new risks

New macroeconomic concerns relating to the war in Iran and the downside risks emanating from artificial intelligence (AI) are unlikely to be killer blows: oil prices should drop back in the coming months, and there are positive AI scenarios to weigh against the negative ones. Economic momentum has been good, and the outlook remains reasonably constructive given tailwinds including support from last year's interest-rate cuts, fiscal support, and AI capital expenditures and productivity gains. The business cycle could persist for another few years. In turn, our economic-growth forecasts for 2026 are mostly above consensus.

Progress on inflation delayed by surge in energy costs

Inflation had been settling down in recent months, reflecting factors including ebbing tariff pressures, easing shelter costs, AI-related deflation and falling oil prices. However, the recent surge in energy costs should cause headline inflation to leap by between 0.5 and 1.5 percentage point. This temporary phenomenon should unwind as energy resumes flowing normally through the Strait of Hormuz, the key petroleum chokepoint in the Middle East.

Cyclical and structural factors argue for another leg down in the U.S. dollar

Over the past year, the U.S. dollar has fallen by roughly 10% on a trade-weighted basis with declines against both emerging- and developed-market currencies. While Iran-related risk aversion has temporarily put a pause to the trend, we think these moves represent the first phase of the dollar's descent. History suggests that another leg of U.S.-dollar weakness is coming, and that another 10% decline over the next few years is needed to drop the overvalued greenback to levels more in line with its purchasing power. Supporting this view are cyclical and structural factors including a reduced U.S. yield advantage, greater global competition for capital, geopolitical tensions and the threat of coordinated currency intervention.

Fed expected to resume rate cutting in the second half of 2026

The U.S. Federal Reserve (Fed) is on pause again for now as the two pieces of its dual mandate – ensuring maximum employment and price stability – are moving in opposite directions. Slowing job gains suggest more rate cuts, while inflation above target, due in part to the war-linked rise in energy prices, undermines the case for further easing. Accordingly, the Fed under new Chair Kevin Warsh will likely wait until later this year to resume rate cuts. The futures market supports this view and is pricing in 25 to 50 basis points in Fed cuts over the year ahead, roughly in line with our forecast for 50 basis points of cuts.

Limited return potential in sovereign and corporate bonds

Yields climbed toward the upper end of a 3.94%- to-4.30% range in early March as investors worried that the war in Iran could accelerate inflation. At current levels, yields are above our modelled estimates of equilibrium and indicate only modest valuation risk. We expect yields to move sideways to slightly up over the year ahead, as the energy-price shock and ballooning government deficits counterbalance the modelled assumptions for declining inflation and lower real (after-inflation) yields. In this environment, we forecast low-single digit returns.

The reward for taking on the added risk of corporate bonds vis-à-vis government bonds has rarely been smaller. As a result, investors are accepting below-normal risk-adjusted returns given possible corporate defaults. Tight spreads can persist for some time, though, since corporate balance sheets are healthy, default risk is low, and the all-in yield for high-yield bonds remains appealing versus the ultra-low levels experienced during the pandemic.

Better relative value exists outside of U.S. mega-cap stocks amid strong earnings outlook

Strong equity-market gains backed by robust economic growth and a surge in AI-related spending have pushed our global composite of stock valuations to its highest level since early 2022. U.S. large caps remain the most richly valued, and other markets, especially Europe and emerging markets, offer better return prospects.

High valuations can be supported if corporate profits are rising fast enough to justify the premium multiples being paid by investors. Importantly, these estimates have been frequently raised over the past year as profits consistently exceeded expectations and profit-margin expansion continued. Strong earnings growth is expected almost everywhere over the next two years, but indexes outside the U.S. large-cap space may offer access to that earnings growth at a cheaper price. On a regional basis, investors have shifted their preference away from U.S. large-cap stocks to other regions, but it remains to be seen whether the leadership in non-U.S. stocks can be sustained.

Within markets, AI has virtually taken over as the determiner of stock-market returns as investors piled into companies that have benefited from the immense capital spending and shunned ones deemed vulnerable to AI disruption.

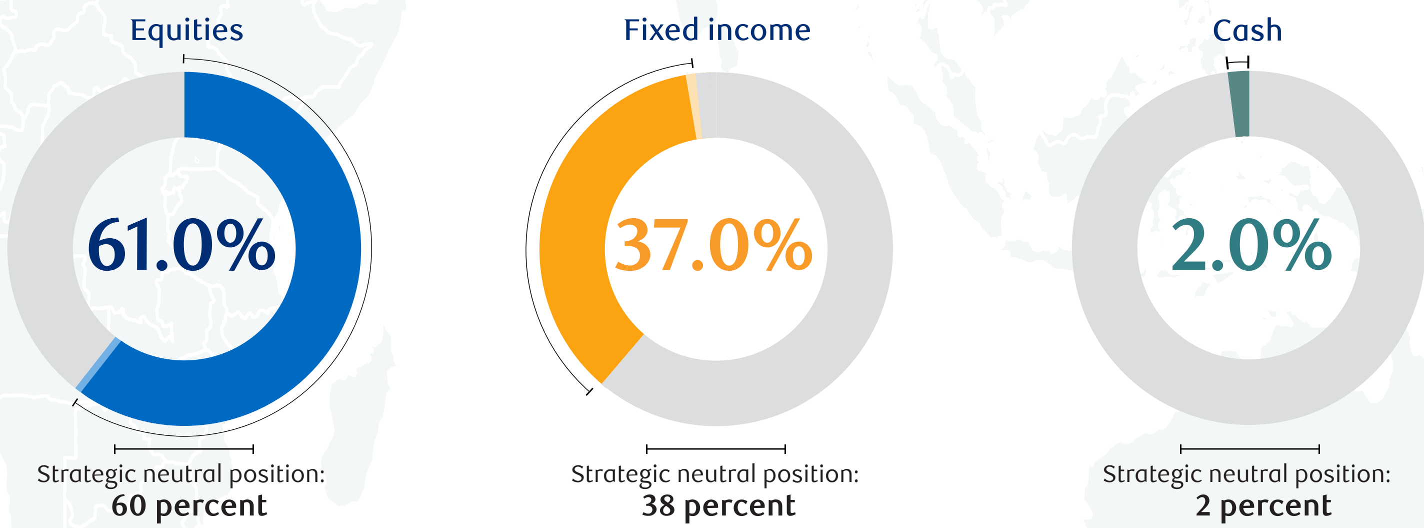
Asset mix – maintaining slight overweight in equities and expanding tilt to non-U.S. regions

Due to a variety of risks related to geopolitics, AI disruption and elevated government debts, combined with the fact that equity valuations are elevated in some regions, we believe only modest risk taking is appropriate. Historically prescient indicators of the current yield-to-maturity for sovereign-bond returns and Shiller's cyclically adjusted P/E for equity returns suggest no advantage to overweighting stocks in the current environment. As a result, we have left our top-level asset allocation unchanged from the prior quarter, with only a small overweight position in stocks versus bonds.

We did, however, make a change to our regional equity positions. Assuming continued economic growth and a near-term de-escalation to the Iran war, we expect non-U.S. equities to outperform. Accordingly, this quarter we increased our overweight exposure in Canada, European, Japanese and emerging-market equities, and expanded our underweight position in U.S. equities. For a balanced global investor, our current recommended asset mix is 61.0% equities (strategic: "neutral": 60.0%), 37.0% bonds (strategic "neutral": 38.0%) and 2.0% cash.

Recommended asset mix

RBC GAM Investment Strategy Committee



Note: As of March 2026. Source: RBC GAM

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