RBC Global Asset Management

Market Update

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U.S. equities rally to fresh record as Trump victory boosts investor enthusiasm

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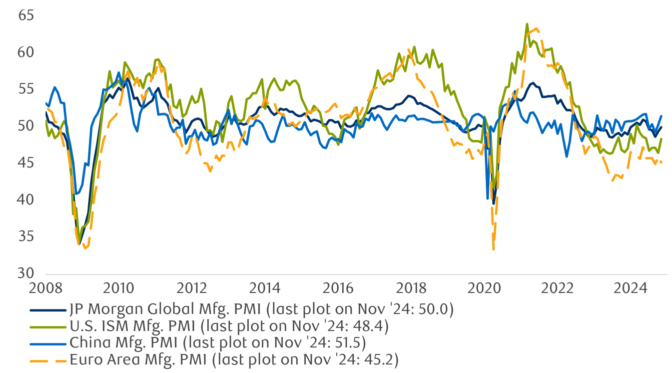
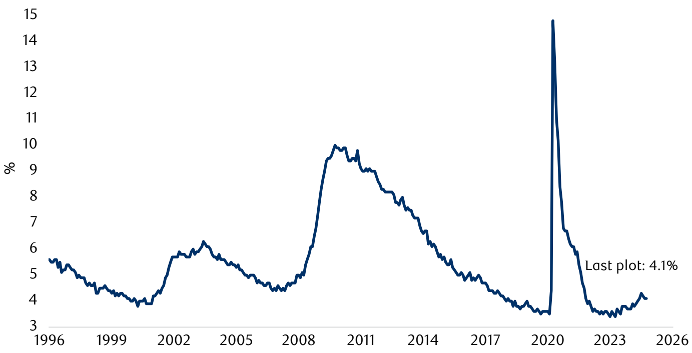
The global economy has been resilient in the last few years despite headwinds from higher interest rates but, with inflation now closing in on central bank targets, the backdrop has shifted to one of monetary accommodation which should bolster economic activity. Although Trump's agenda remains highly uncertain at this point, we know the president-elect favours American-centric economic growth, less taxes and more deregulation, a combination which could re-ignite confidence and re-charge animal spirits. In our view, the odds of recession have diminished over the past several months amid better-than-expected economic data, stabilizing leading indicators and a resilient labour market (exhibits 1 and 2). In this environment, we expect only a 25% chance of a mild economic downturn, and a much greater 75% chance that economies will manage a soft landing and continue expanding over our one-year forecast horizon.

Exhibit 1: Global purchasing managers' indices



Source: Macrobond, RBC GAM

Exhibit 2: U.S. unemployment rate



Note: As of October 2024. Source: Bloomberg, RBC GAM

We acknowledge that the range of potential outcomes around our benign base case scenario is relatively large due to a variety of risks. Geopolitical tensions have intensified in the Middle East as well as between Russia and Ukraine. China's growth remains a concern especially given its highly indebted economy, and until we get more details from the new U.S. administration on policies related to trade, immigration and fiscal spending, it will be challenging to quantify the potential economic impact.

Inflation has made meaningful progress, but tariffs could complicate the outlook

One of the favourable outcomes from higher interest rates is that inflation has made significant progress toward 2%. U.S. headline CPI inflation has fallen to 2.6% from a high of 9.1% in mid-2022 and we continue to expect price pressures to diminish over the year ahead, allowing central banks to continue dialing back monetary restriction (Exhibit 3). Complicating the inflation outlook, however, is that progress may slow or be temporarily reversed if Trump enacts significant tariffs, as companies may opt to pass higher import costs through to their customers. In theory, the inflation impact from tariffs should be temporary, but even a short-lived spike could have a meaningful influence on central bank policy.

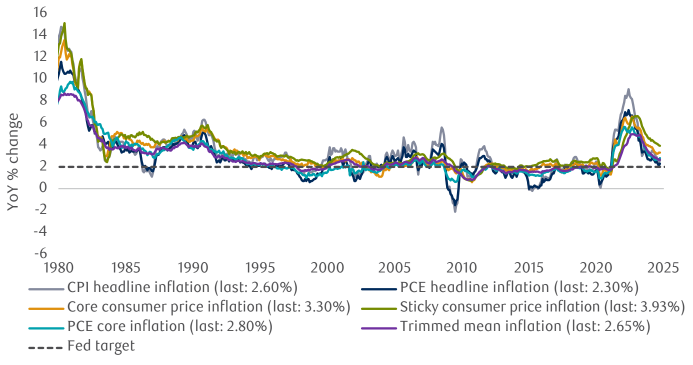
Investors dial back expectations for future rate cuts

Short-term interest rates are now falling and further reductions are expected although central bankers remain highly data dependent. Fed chair Jerome Powell acknowledged that interest rates will likely keep falling, but he suggested that central banks can be patient against a backdrop of strong economic data. Investors have taken note, evidenced by the big shift in interest rate expectations since September. Pricing in the futures market now implies a fed funds rate around 3.75% by end of 2025, up from the 2.75% level that was priced in mid-September (Exhibit 4). Compared to just a couple months ago, investors expect a slower pace of easing and, ultimately, a higher terminal rate for the current easing cycle.

Rebound in sovereign bond yields boosts return potential, reduces valuation risk

There has also been a major shift in the fixed income market, as yields rose to reflect an environment of stronger growth, limited downside for inflation, and less need for aggressive rate cuts. The U.S. 10-year yield jumped more than 80 basis points from its September low to briefly just over 4.40%, its highest reading since July. At this level, the 10-year yield is slightly above our modelled equilibrium estimate but within

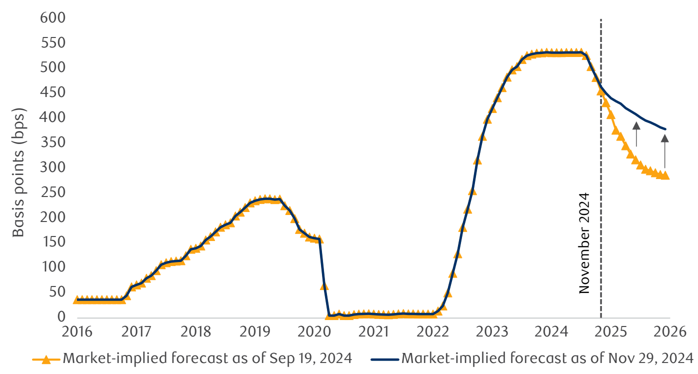
Exhibit 3: U.S. inflation measures



Note: As of October 31, 2024. Source: Bloomberg, RBC GAM

Exhibit 4: Implied fed funds rate

12-months futures contracts



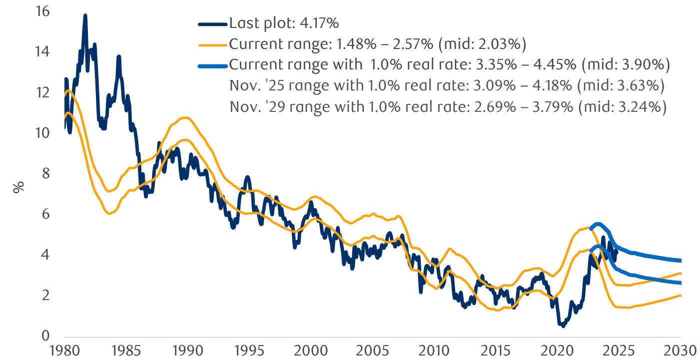
Source: Bloomberg, U.S. Federal Reserve, RBC GAM the range our model would deem as reasonable given the economic backdrop (Exhibit 5). As a result of the latest sell off, return potential has improved, valuation risk has diminished and, importantly, bonds offer reasonable ballast against equity-market volatility in the context of a balanced portfolio.

Stocks extend gains to new records

Global stocks extended their impressive gains through the fall but returns have been highly varied between regions and styles. The S&P 500 has risen over 26% so far this year and while gains had been concentrated in a small group of mega-cap technology stocks in the first half of the year, the rally broadened out since the summer and other parts of the market have come alive. For example, the S&P 500 equal weight index is up over 18% year to date, the S&P 600 Small Cap Index is up 16%, the S&P 400 Mid Cap Index up 21% and the TSX Composite up 16%, all in U.S. dollars (Exhibit 6). Gains offshore, however, have been less impressive and Trump's protectionist inclinations could pose a headwind to international and emerging markets. The MSCI Emerging Markets Index is up just 5% year to date, and the MSCI EAFE Index has gained a mere 4%. The varied performance also means that when observing our valuation models, U.S. large-cap equities are especially expensive, particularly among mega-cap technology stocks, but other areas of the global equity market are much more reasonably priced, suggesting relatively attractive return potential (Exhibit 7).

Exhibit 5: U.S. 10-year T-bond yield

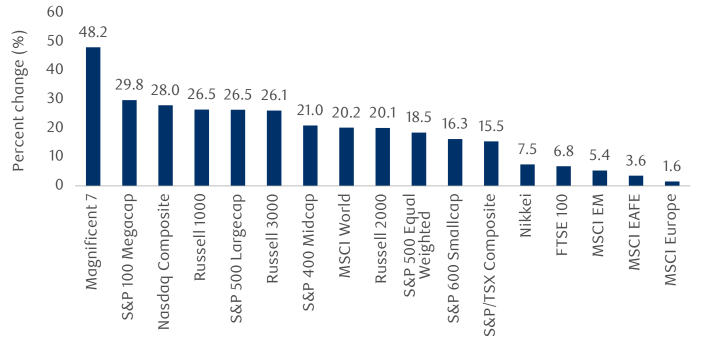
Equilibrium range



Note: As of November 30, 2024. Source: RBC GAM

Exhibit 6: Major indices' price change in USD

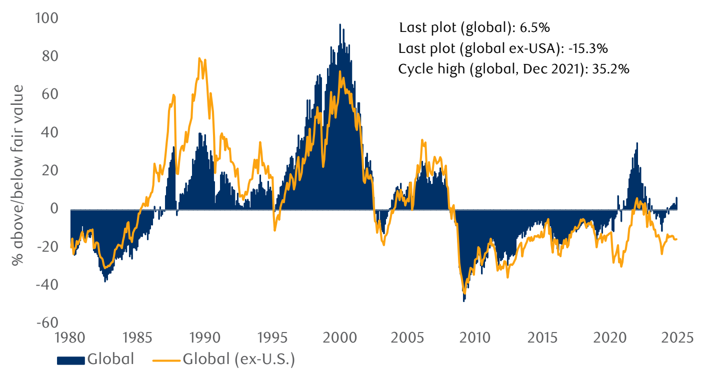
December 29, 2023 to November 29, 2024



Note: Magnificent 7 includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Source: Bloomberg, RBC GAM

Exhibit 7: Global stock market composite

Equity market indexes relative to equilibrium



Note: As of November 29, 2024. Source: RBC GAM

Exhibit 8: Major stock-market indices

Consensus earnings outlook

	Current			2023	2024			2025			2026		
Index	Index level	EPS	P/E	EPS	EPS estimate	EPS Growth	Implied P/E	EPS estimate	EPS Growth	Implied P/E	EPS estimate	EPS Growth	Implied P/E
S&P 600 Small Cap	1533	81.16	18.9	89.7	81.16	-9.5%	18.9	93.78	15.5%	16.3	109.93	17.2%	13.9
S&P 500	6032	238.61	25.3	221.2	238.61	7.8%	25.3	272.67	14.3%	22.1	304.26	11.6%	19.8
Russell Mid-Cap	3807	178.94	21.3	165.9	178.94	7.9%	21.3	206.66	15.5%	18.4	227.56	10.1%	16.7
S&P/TSX Composite	25648	1437.31	17.8	1448.2	1437.31	-0.8%	17.8	1638.88	14.0%	15.6	1781.75	8.7%	14.4
S&P 400 Mid Cap	3366	178.59	18.8	175.7	178.59	1.6%	18.8	199.11	11.5%	16.9	232.70	16.9%	14.5
S&P 500 Equal Weighted	7590	383.86	19.8	371.3	383.86	3.4%	19.8	425.90	11.0%	17.8	472.41	10.9%	16.1
MSCI World	3810	179.39	21.2	167.2	179.39	7.3%	21.2	195.32	8.9%	19.5	216.34	10.8%	17.6
MSCI Emerging Markets	1079	85.09	12.7	73.0	85.09	16.5%	12.7	92.50	8.7%	11.7	104.59	13.1%	10.3
MSCI China	63	6.03	10.5	5.4	6.03	11.9%	10.5	6.55	8.5%	9.6	7.31	11.6%	8.6
STOXX 600	510	35.81	14.2	36.5	35.81	-1.9%	14.2	38.03	6.2%	13.4	41.57	9.3%	12.3
MSCI UK	2365	193.59	12.2	212.7	193.59	-9.0%	12.2	203.73	5.2%	11.6	218.21	7.1%	10.8
MSCI Europe	171	11.93	14.3	12.2	11.932	-2.2%	14.3	12.54	5.1%	13.6	13.708	9.3%	12.5
MSCI Japan	1647	108.34	15.2	90.4	108.34	19.8%	15.2	109.83	1.4%	15.0	124.06	13.0%	13.3

Note: As of November 30, 2024. Sorted by 2025 EPS growth. Source: Bloomberg, RBC GAM

Favourable earnings outlook reaches beyond the S&P 500

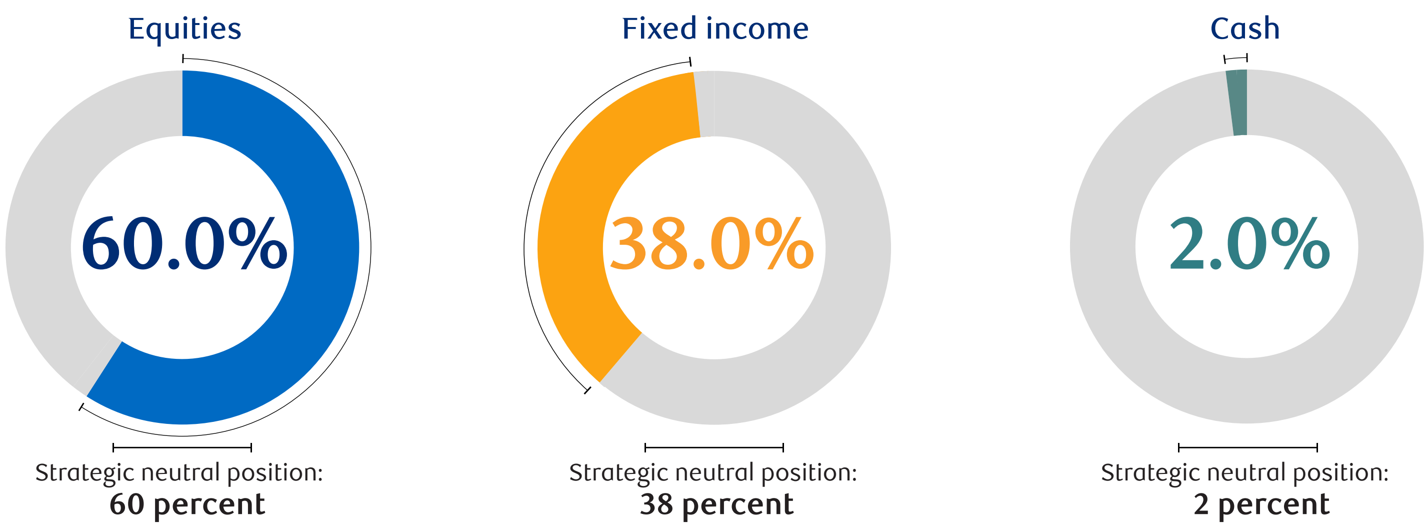
The bull market could be sustained as long as earnings are able to meet analysts' optimistic projections. The consensus looks for S&P 500 earnings per share growth of 8% this year, 14% next year, and 12% in 2026. These numbers are not impossible to achieve if the economy grows at a moderate pace and profit margins expand on the back of increased efficiencies, less taxes and lower interest rates. Importantly, not just the S&P 500 is expected to deliver double digit earnings growth next year but also small caps, mid caps, Canadian equities and emerging markets (Exhibit 8). As a result, investors can access compelling earnings growth at a cheaper price outside of the S&P 500. Nevertheless, as valuations and earnings expectations are elevated, stocks could be vulnerable if profits were to underwhelm.

Asset mix: added to bonds during the quarter, moving asset mix back to neutral setting

In our base case scenario, the economy continues to grow at a moderate pace against a backdrop of progressively more accommodative monetary conditions. Falling short-term interest rates should be supportive of government bonds, and the higher starting point for yields means that fixed income markets offer decent return potential with only moderate valuation risk. As a result, we added one percentage point to our fixed income allocation in the past quarter, eliminating our prior underweight position. We continue to believe that stocks offer superior return potential to fixed income, but we recognize that elevated valuations in U.S. large-cap equities may limit upside. Our equity exposure remains in line with our strategic neutral setting. We would be more comfortable boosting equity exposure if we saw a sustained shift in leadership away from mega-cap technology stocks toward small/mid-cap, value and international equities where valuations are much more appealing. Our current recommended asset mix for a global balanced investor is 60.0% equities (strategic: "neutral": 60%), 38.0% bonds (strategic "neutral": 38%) and 2.0% in cash (Exhibit 9).

Exhibit 9: Recommended asset mix

RBC GAM Investment Strategy Committee



Note: As of November 30, 2024. Source: RBC GAM

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