RBC Global Asset Management

# Market Update

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# Tariffs inject uncertainty and volatility into outlook and financial markets

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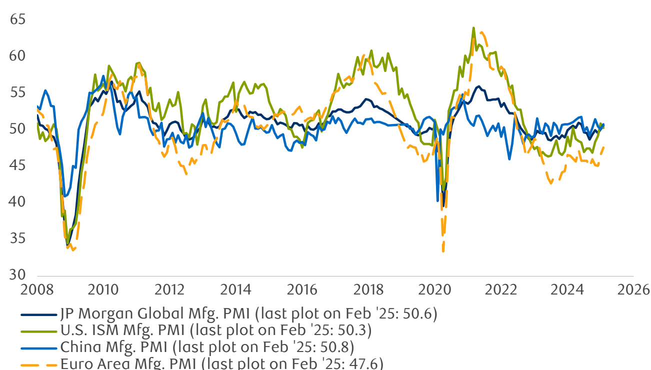
U.S. President Trump's tariff threats widened the range of possible outcomes for the economy and injected volatility into financial markets as investors contemplate a variety of scenarios. The worst-case situation would be large-scale tariffs applied to America's most important trading partners with commensurate retaliation by those countries, which would likely result in higher prices, reduced economic activity and higher unemployment. That said, negotiations are ongoing, and the ultimate impact of tariffs will depend on their scope, size, and how long they are in effect. Our base case is one where only part of the proposed tariffs are applied and for some of them to be in place for a temporary period while others may persist. In this scenario, economies would face a slight headwind but not enough to tip the global economy into recession. But in a scenario where the full scope of tariffs remains for an extended period, economies could encounter more trouble.

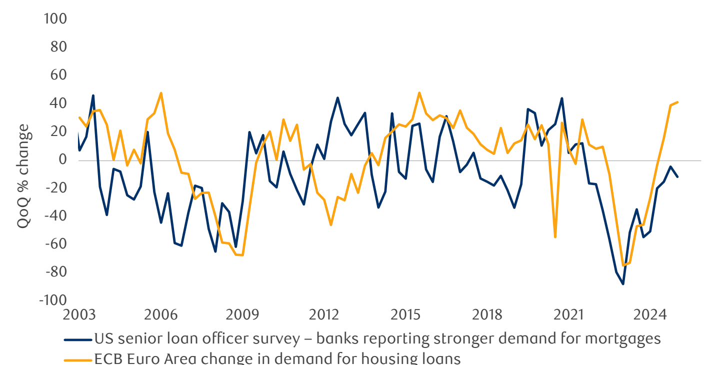
That said, a variety of positive factors lead us to believe growth will prevail at a moderate clip. Global leading economic indicators have been improving since the fall of last year and are consistent with modestly expanding economic activity (Exhibit 1). Despite some recent tentative softness, the U.S. labour market is healthy and business sentiment is reasonably supportive. Moreover, falling interest rates since mid-to-late 2024 in the world's major economies should be supportive of activity over the year ahead, and both the availability and demand for loans has already improved in the U.S. and especially in Europe (Exhibit 2).

### Exhibit 1: Global purchasing managers' indices




Source: Macrobond, RBC GAM

### Exhibit 2: Change in demand for mortgages




Note: As of Q1 2025. Source: Federal Reserve, European Central Bank, Macrobond

## Other risks include China and geopolitical challenges

Aside from tariffs which could weigh on business and consumer confidence, other risks include China's highly indebted economy, as well as geopolitical challenges in the Middle East and in Ukraine/Russia. That said, progress could be taking place. China's property-market slump appears to be stabilizing, a ceasefire is tentatively in place in Gaza, and peace negotiations could begin between Russia and Ukraine. All these developments remain highly fluid and represent sources of uncertainty for the economy and markets.

## Central bank easing may slow as inflation's descent has moderated, though tariffs add uncertainty

Global central banks are likely to continue lowering interest rates against this backdrop, but the pace of rate cuts is likely to slow going forward. In the U.S., the Fed's latest decision has been to pause interest rate cuts and await further evidence that inflation is coming down, particularly given the last several prints have pointed to a slight acceleration in price increases and given the inflationary effect of tariffs (Exhibit 3). With the economy currently on solid footing and inflation still above the 2.0% target, there seems no immediate need to continue aggressive rate cuts, and central banks can be more patient. But if tariffs persist, their negative impact on growth could nudge central banks to provide more accommodation.

## Bonds offer decent return potential, albeit slightly less after latest rally

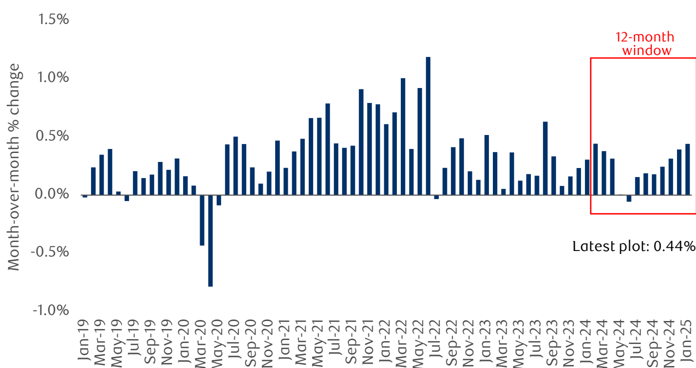
Government bond yields have been highly volatile over the past quarter as investors weighed the impact of the new U.S. administration on economic growth, inflation, and fiscal stability. The U.S. 10-year yield rose to 4.80% in January 2025 from a low of 3.61% in September and then fell to 4.21% in February. Our equilibrium model suggests the appropriate yield for U.S. 10-year ranges between 3.4% and 4.5% and we have used these ranges as a guide for tactical asset allocation decisions (Exhibit 4). At current levels, our model suggests sovereign bonds offer decent return potential, although less so after the recent rally, with only modest valuation risk if inflation continues to fall toward central bankers' 2% targets over the medium term.

## U.S. mega-cap technology stocks lead latest sell-off, while European equities shine

After a strong run in 2024, stocks have encountered a relatively turbulent start to 2025 where leadership may be transitioning away from last year's winners to markets with relatively attractive valuations. The S&P 500 generated a 23.3% return last year, led by the Magnificent-7 – a group of mega-cap technology companies – which gained 56.0% in 2024. As a result of these outsized gains, the S&P 500 reached

### Exhibit 3: U.S. CPI Inflation

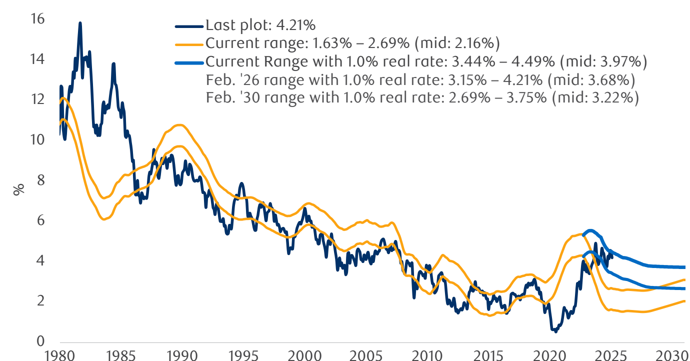
Month-over-month % change




Note: As of January 31, 2025. Source: Bloomberg, RBC GAM

### Exhibit 4: U.S. 10-year T-bond yield

Equilibrium range




Note: As of February 28, 2025. Source: RBC GAM

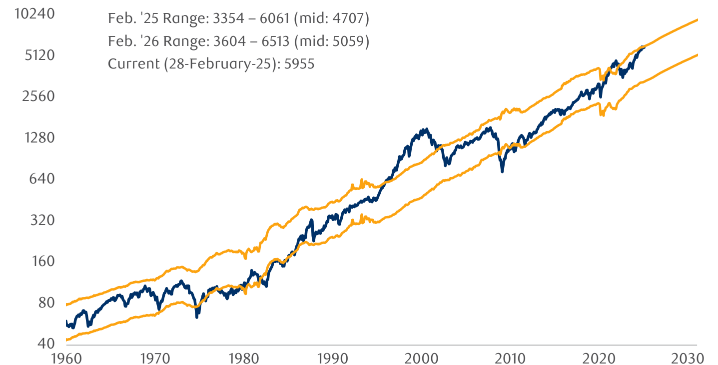
more than one standard deviation above our modelled estimate of fair value which suggests further upside will likely be limited. But other regions such as Europe and emerging markets continue to trade at attractive distances below their fair values (exhibits 5 and 6). So far this year, the richly valued S&P 500 has gained just 1.2% and the even more expensive Magnificent 7 is down 4.6%, but the European Stoxx 600 gained 11% and the MSCI Emerging Markets Index returned 2.0%, all in U.S. dollar terms (Exhibit 7). While it remains to be seen if these trends will persist, a broadening in the equity-market rally beyond U.S. mega-cap technology stocks could be a welcome sign that breathes new life into the bull market.

## High equity-market valuations demand strong earnings growth to deliver decent returns

For U.S. large-cap stocks to deliver further gains from currently elevated valuations, delivering strong earnings growth and maintaining elevated investor confidence are both becoming critical. Analysts are projecting S&P 500 earnings per share to rise 10% in 2025 to $270.46 followed by another 14% gain in 2026 to $308.38. These figures are optimistic but even if they are achieved, the S&P 500 only delivers reasonable gains if valuations remain elevated.

### Exhibit 5: S&P 500 equilibrium

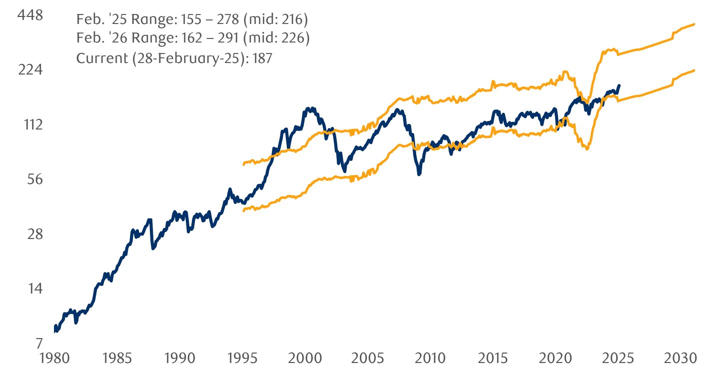
Normalized earnings & valuations




Note: As of February 28, 2025. Source: RBC GAM

### Exhibit 6: MSCI Europe equilibrium

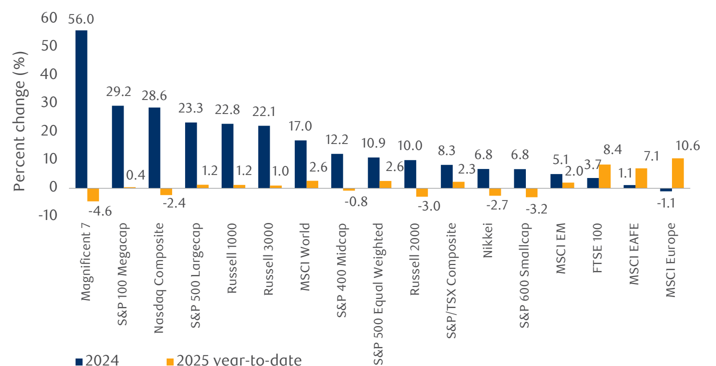
Normalized earnings & valuations




Note: As of February 28, 2025. Source: RBC GAM

### Exhibit 7: Major indices' price change in USD

2024 and year-to-date 2025




Note: As of February 28, 2025. Magnificent 7 includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Source: Bloomberg, RBC GAM

### Exhibit 8: Earnings estimates and alternative scenarios for valuations and outcomes for the S&P 500

| | | Consensus | Total return | | Consensus | Annualized total return |
|---|---|---|---|---|---|---|
| | | 2025 | 2025 | | 2026 | 2026 |
| | P/E | $270.5 | | P/E | $308.4 | |
| +2 Standard Deviation | 26.6 | 7203.5 | 22% | 27.1 | 8347.5 | 21% |
| +1 Standard Deviation | 22.1 | 5981.3 | 2% | 22.5 | 6931.1 | 10% |
| +0.5 Standard Deviation | 19.9 | 5370.2 | -9% | 20.2 | 6222.9 | 4% |
| Equilibrium | 17.6 | 4759.0 | -19% | 17.9 | 5514.8 | -3% |
| -0.5 Standard Deviation | 15.3 | 4147.9 | -29% | 15.6 | 4806.6 | -10% |
| -1 Standard Deviation | 13.1 | 3536.8 | -39% | 13.3 | 4098.4 | -17% |
| -2 Standard Deviation | 8.6 | 2314.5 | -60% | 8.7 | 2682.1 | -33% |

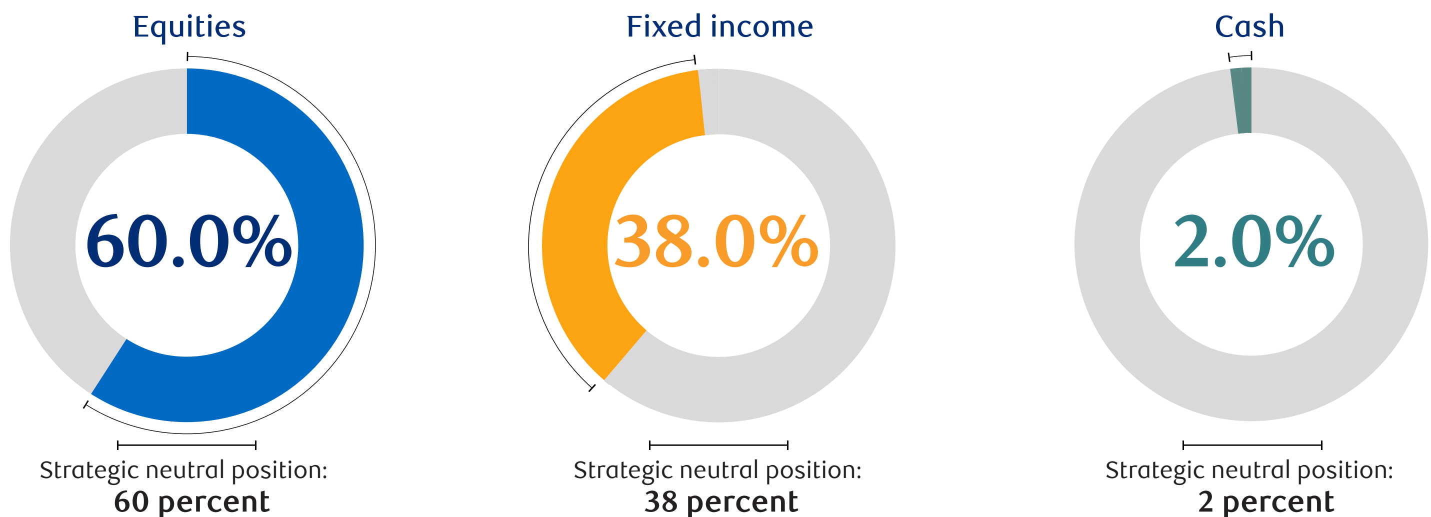
Note: As of February 28, 2025. Total returns for 2026 are annualized. Source: LSEG I/B/E/S, RBC GAM

Should the S&P 500 trade at a price-to-earnings multiple of 20x – about 0.5 standard deviations above equilibrium – the Index would reach 5370 by the end of this year (a drop of 9%), and 6223 by the end of next year (a gain of 3.7% over 22 months) (Exhibit 8). Double digit returns can be achieved, but doing so would require lots of positives all coming to fruition such as moderate economic growth translating to decent revenue growth, rising corporate profit margins to fuel elevated corporate profit growth, and investor sentiment remaining highly optimistic to sustain above-average valuations.

### Asset mix: maintaining neutral asset mix with preference for less expensive equities

Balancing the near-term risks with the longer-term opportunities, we are maintaining a relatively cautious positioning in our asset mix. Our base case is for the economy to continue growing at a moderate pace, though we recognize that the uncertainty around tariffs means the outlook is cloudy and subject to large deviations from our central scenario. We expect central banks to continue lowering interest rates and, in this environment, bonds offer decent return potential with only modest valuation risk. That said, we have been active in tactically managing our fixed income exposures given the large swings in yields more recently. Earlier in the quarter, we added 50 basis points to our fixed income allocation, sourced from cash, moving to a slight overweight as U.S. 10-year yields surged beyond 4.60%. But as yields fell sharply back below 4.30% a month later, we reversed that trade moving our position back to neutral. In equities, we are maintaining a neutral allocation given our concerns about elevated valuations in U.S. large-cap growth stocks. But we have adjusted the regional tilts within our stock allocation this past quarter, reducing exposure to North American equities in favour of international and emerging market equities where valuations are relatively 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 March 4, 2025. Source: RBC GAM

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