RBC Global Asset Management

Market Update

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Maintaining asset mix near neutral given demanding stock-market valuations and minimal equity risk premium versus sovereign bonds


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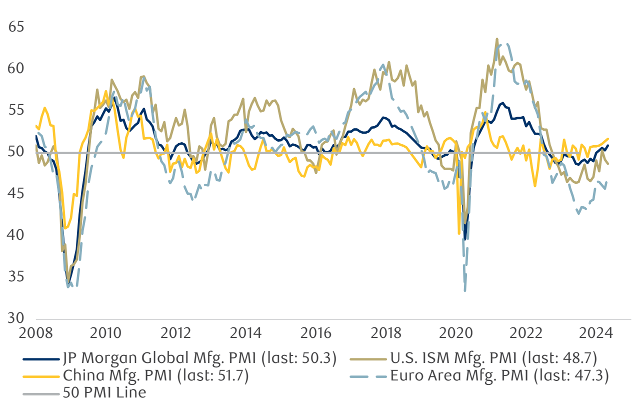
Leading indicators of the global economy have been in a gradual upward trend since late 2022/early 2023 and have recently reached levels consistent with modest growth, suggesting the expansion is likely to continue (Exhibit 1). European economies have been holding up reasonably well and growth in the eurozone has been accelerating in early 2024 after a slowdown in late 2023. In the U.S., consumer spending remains moderate, the labour market is healthy, and households have shown impressive resilience in the face of higher interest rates as many American homeowners are still benefitting from record-low long-term fixed-rate mortgages obtained during the pandemic. That said, there are some signs, at the margin, that the U.S. economy is slowing. The excess household savings accumulated during the pandemic have now been fully depleted, delinquency rates on credit cards and auto loans have been climbing, and wage growth has been moderating. While these trends represent headwinds, we don't believe they are acute enough to push economies into recession over our 1-year forecast horizon and, as a result, we place greater odds of the economy achieving a soft landing, particularly if central banks begin to deliver monetary easing in the months and quarters ahead.

Exhibit 1: Global purchasing managers' indices



Note: As of May 31, 2024. Source: Macrobond, RBC GAM

One of the key risks to our favourable economic outlook is that, should inflation pressures persist, high borrowing costs could be sustained and weigh further on economic activity. Other sources of uncertainty include geopolitical tensions in the Middle East and the upcoming U.S. election in November for its potential impact on taxes, business regulations and tariffs with China.

Progress on inflation continues, albeit at slowing pace

U.S. consumer-price inflation has been hovering just over 3% since June of last year and, although inflation has been a bit more stubborn than many had expected, a variety of signals suggest that disinflationary forces remain in place. Money supply growth has slowed meaningfully, several major retailers have announced price cuts and gasoline prices have been edging lower since early April. Any moderation in U.S. economic growth should further help to cool inflation pressures, particularly in the service sector which remains a source of support for consumer prices. We recognize, however, that significant progress has already been made since U.S. CPI inflation peaked at 9.1% in 2022, and we expect inflation to ultimately achieve the 2% level targeted by most major central bankers, but the latter part of the journey toward lower inflation readings from here may be a slow one (Exhibit 2).

Central banks have been hesitant, but the door for rate cuts is now opening

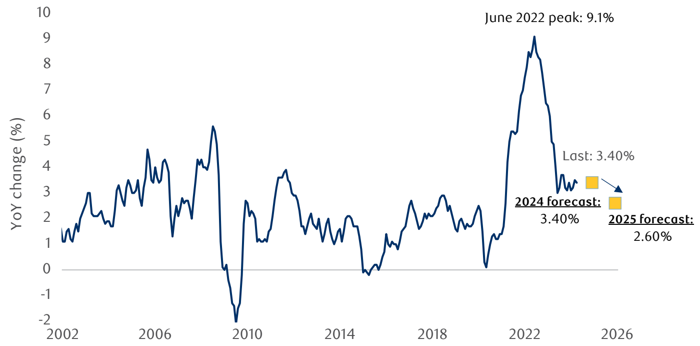
Against this backdrop, most developed world central banks have held short-term interest rates steady since the summer of 2023 and have been reluctant to lower interest rates until obtaining further confidence that inflation was headed sustainably toward the 2% objective. A recurring theme so far this year has been the trimming of rate cut expectations as better-than-expected economic data and firm inflation alleviated the need for imminent and aggressive rate cuts. The futures market is now pricing in only one U.S. rate cut in 2024 toward the end of this year, compared to an expectation of 6 rate cuts in 2024 when the year began (Exhibit 3). Other countries whose economies are more sensitive to interest rates than the U.S. may be inclined to cut rates earlier than the Fed. Market pricing suggests the likelihood of rate cuts by the European Central Bank (ECB) and Bank of Canada (BOC) as early as June or July. We forecast three rate cuts by the Fed, six by the ECB, and four by the BOC over the next 12 months.

Sovereign bonds offer attractive return potential and minimal valuation risk

Global sovereign bonds sold off in the past quarter as investors embraced the narrative that interest rates could remain higher for longer or that the expected decline in short-term interest rates once central banks begin easing could be more gradual and less deep than previously anticipated. The U.S. 10-year yield climbed 35 basis points in the past three months to 4.60% and is now situated at a substantial distance above our modelled equilibrium level (Exhibit 4). As a result, our model suggests that valuation risk is minimal and total return potential is especially appealing should inflation continue falling as we expect. However, we recognize that our model could be understating the appropriate level of real, after-inflation, yields. The substantially negative real rates encountered during the pandemic remain embedded in our model's adaptive expectations approach and will only gradually roll out of the model's forecast. If instead we assume positive real interest rates going forward, supported

Exhibit 2: U.S. Consumer Price Inflation

CPI Index Y/Y % change



Note: CPI data as of April 30, 2024. RBC GAM forecasts as of May 31, 2024. Source: Bloomberg, RBC GAM

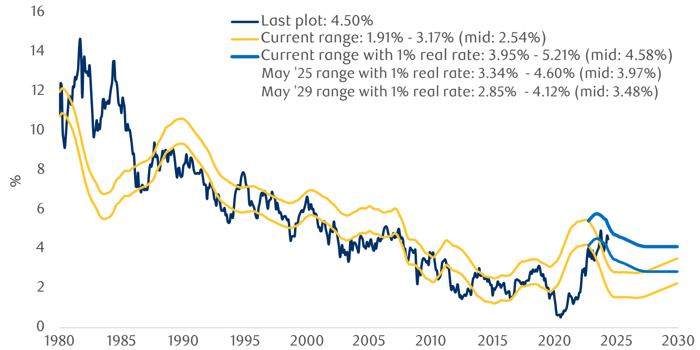
Exhibit 3: Fed funds implied expectations rate based on futures – Based on 12-month futures contracts

Date		25bps cuts priced in for 2024	U.S. 10-yr yield
31-Jul-2023		4.5 cuts	3.96%
31-Aug-2023		4.4 cuts	4.11%
30-Sep-2023		2.8 cuts	4.57%
31-Oct-2023		2.6 cuts	4.93%
30-Nov-2023		4.5 cuts	4.33%
31-Dec-2023	"Powell pivot" Dec. 13, 2023	6.3 cuts	3.88%
31-Jan-2024		5.8 cuts	3.91%
29-Feb-2024		3.4 cuts	4.25%
31-Mar-2024		2.7 cuts	4.20%
30-Apr-2024		1.1 cuts	4.68%
31-May-2024		1.4 cuts	4.50%

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

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

Equilibrium range



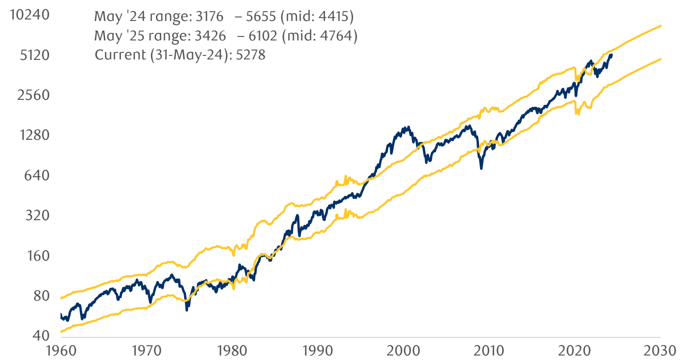
Note: As of May 31, 2024. Source: RBC GAM by rising fiscal deficits and a positive term premium given that central banks are no longer delivering extreme monetary accommodation, then an appropriate U.S. 10-year bond yield could be closer to 4.0% to 4.5% over the next 12 months rather than the 2%-2.5% level projected by our model. In either case and if inflation doesn't surprise to the upside, we expect sovereign bond investors to be able to keep their coupon and enjoy modest capital gains amid a slight decline in yields for mid- to high single digit total returns over the next 12 months.

Equity markets rise, led by U.S. mega-cap technology

Stocks extended their gains and many major equity indices reached new records during the quarter. The S&P 500 climbed above 5300 in May for the first time, lifting its year-to-date gains to just over 10%, and new highs were observed in Japanese, European and Canadian equity markets. Stocks also performed well in emerging markets, up mid single digits in the past quarter aided in particular by stimulus measures announced in China to support their property market. Although gains have been broad-based, outsized gains and market leadership has been increasingly concentrated in a small set of U.S. mega-cap technology stocks that have benefitted predominantly by themes surrounding artificial intelligence (AI). After the powerful rally since late 2023, S&P 500 valuations are around one standard deviation above the level our models deem appropriate given the current interest rate and inflation backdrop (Exhibit 5). On a global basis, though, equity markets are not unreasonably priced and non-U.S. markets offer relatively attractive return potential (Exhibit 6).

Exhibit 5: S&P 500 equilibrium

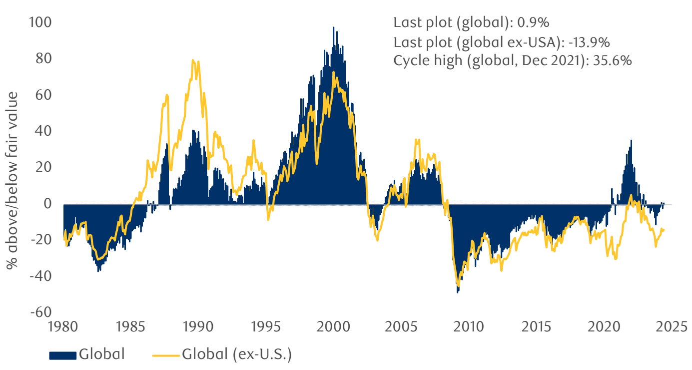
Normalized earnings & valuations



Note: As of May 31, 2024. The fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM

Exhibit 6: Global stock market composite

Equity market indexes relative to equilibrium



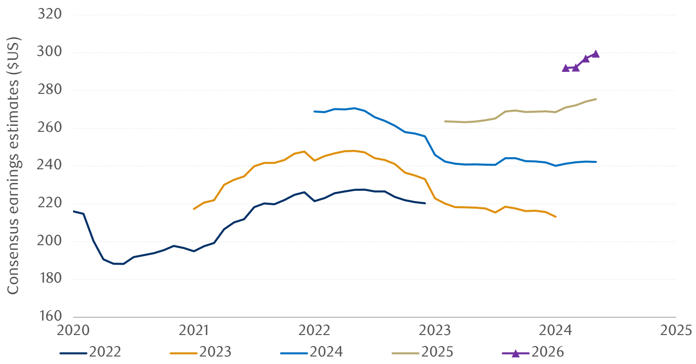
Note: As of May 31, 2024. Source: RBC GAM

Strong profit growth is possible but is now critical to supporting further equity gains

From current elevated valuations in U.S. large caps, further upside is becoming increasingly dependent on corporate profit growth meeting or exceeding analysts' optimistic projections. The consensus looks for 10%, 14%, and 12% growth in S&P 500 earnings in 2024, 2025 and 2026 respectively (Exhibit 7). Achieving these figures would require some combination of better-than-expected economic growth and/or continued increases in corporate profit margins. Our analysis suggests that nominal GDP growth of 5% and an increase of 70 to 100 basis points in profit margins would produce double digit profit gains for the S&P 500. While these figures are not impossible to achieve, they require a favourable macro economic environment, and we recognize that delivering strong corporate profit growth is becoming increasingly critical to sustaining the bull market.

Exhibit 7: S&P 500 Index

Consensus earnings estimates



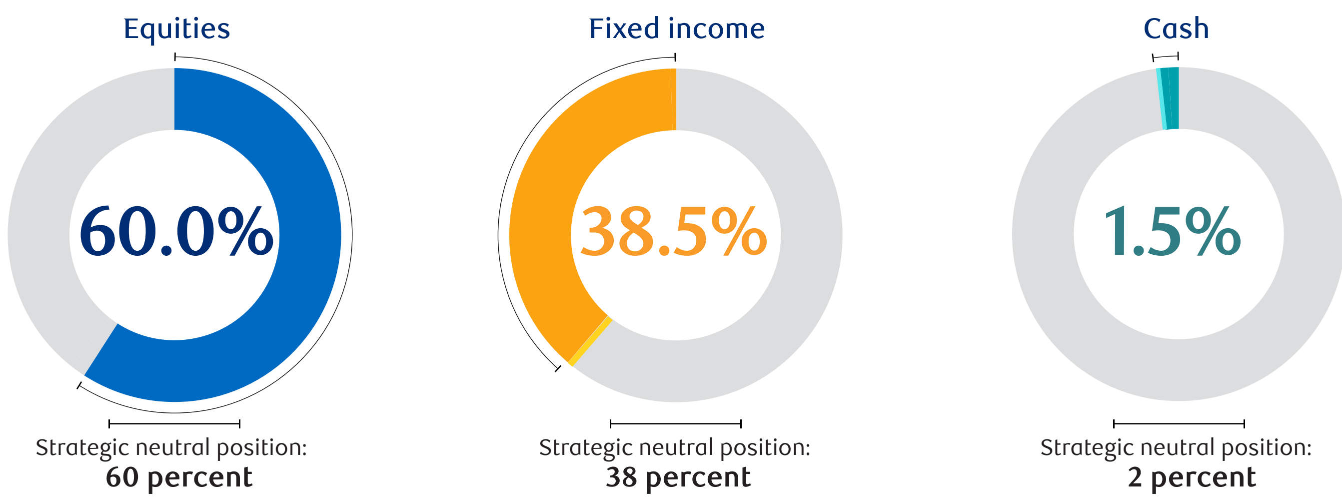
Note: As of May 31, 2024. Source: Bloomberg, RBC GAM

Maintaining close to neutral asset allocation, with slight bias to bonds

Considering the balance of risks and opportunities in the shorter- and longer-term horizons, we are maintaining our asset mix close to a neutral setting, with a slight tilt to fixed income. Our base case has the economy achieving a soft landing where inflation cools sufficiently to allow central banks to begin easing their currently restrictive monetary policies. Falling interest rates would be supportive for fixed income investments and we expect that sovereign bonds can deliver mid to high single digit returns over the year ahead. As a result, we had been adding to our fixed income allocation over the past couple of years as yields climbed. Importantly, higher yields mean that bonds offer improved ballast against a potential downturn in equities should the economy falter. We continue to expect stocks to outperform bonds over the longer term, but elevated valuations in U.S. large-cap stocks in particular and a resulting narrow risk premium versus bonds have us maintaining less equity exposure than we have had at earlier points in the cycle. We would be more encouraged to boost our allocation to equities if we saw a broadening of investment themes beyond artificial intelligence, supported by a rotation in equity-market leadership outside of U.S. mega-cap technology and into small or mid cap, value, international and/or emerging market equities. Our current recommended asset mix for a global balanced investor is 60.0% equities (strategic: "neutral": 60%), 38.5% bonds (strategic "neutral": 38%) and 1.5% in cash (Exhibit 8).

Exhibit 8: Recommended asset mix

RBC GAM Investment Strategy Committee



Note: As of May 31, 2024. Source: RBC GAM

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