JANUARY 2024

Looking back at 2023 and what to expect over the year ahead

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Balanced portfolios experienced a particularly strong year in 2023 as the economy sidestepped a feared recession and bonds delivered their first annual gains since 2020. In this article, we look at what happened in 2023, how it impacted portfolio returns, and share our perspective on what lies ahead.

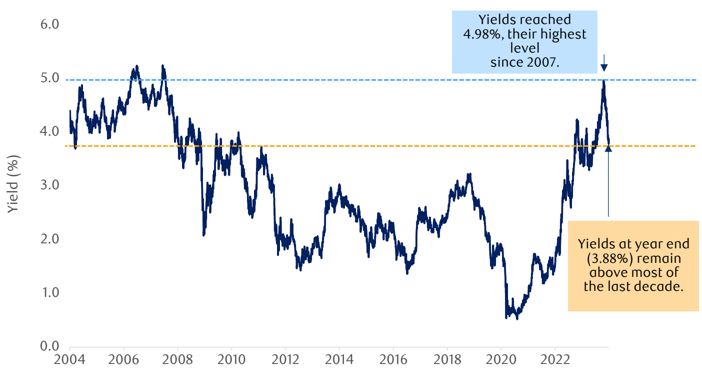
Among the key themes in 2023 were distress among a handful of U.S. regional banks, the recession that never came (at least not yet), the continuation of central-bank rate hikes and speculation about what monetary policymakers would do next. We also experienced continued worries about inflation and intensifying geopolitical frictions.

Offsetting some of the negatives was the fact that many of the economic headwinds that have impeded growth over the past few years faded significantly. Supply-chain problems were largely resolved, inflationary pressures quickly came down, and China's pandemic-related lockdowns ended. The resolution of these issues meant that most developed-world economies managed to avoid contraction in 2023.

Bond yields climbed to the highest level in 16 years

Bond prices rallied in late 2023, leading to a positive year for the asset class. The U.S. Federal Reserve Open Market Committee ("the Fed") delivered four additional rate hikes for a total of 100 basis points in 2023, boosting the benchmark federal funds rate from a range of 4.25%-4.50% at the beginning of the year to a range of 5.25%-5.50% by July. Furthermore, U.S. 10-year Treasury bond yields rose to a peak of 4.98% in October, their highest level since 2007 (Exhibit 1). However, yields later declined as investors grew more confident that central banks had finished hiking rates, and the 10-year Treasury bond yield ended the year at 3.88% – near their starting point in 2023 of 3.79%. Although yields fell from their October peak, the levels at year-end were above that which had prevailed for most of the past decade.

Exhibit 1: U.S. 10-year T-bond yield

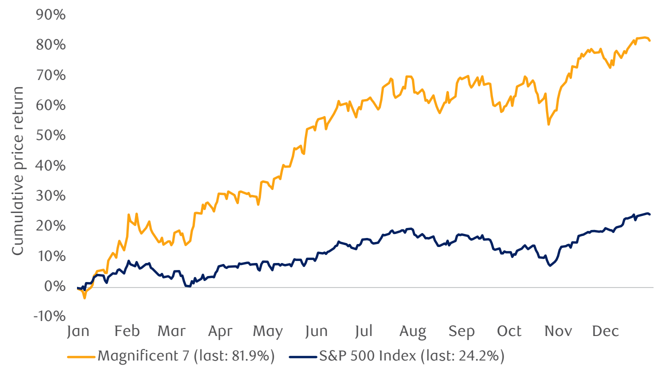


Note: Data from January 1, 2004 to December 31, 2023. Source: Federal Reserve Bank of St. Louis

Stock returns were concentrated in just a few names

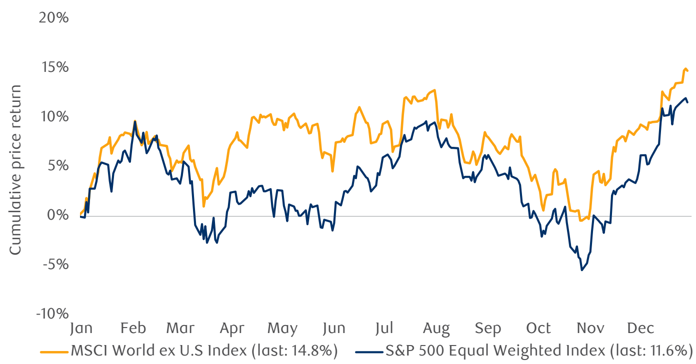
The equity story of 2023 was the lack of breadth in the U.S. market, with a small group of mega-cap technology stocks (the "Magnificent 7") providing the bulk of returns (Exhibit 2) Aside from the Magnificent 7, the broader U.S. equity market (as measured by the S&P 500 Equal Weighted Index) and global equities in general had a far more muted year (Exhibit 3). On a positive note, this bifurcation in returns means that global equity valuations are now generally reasonable, with regions outside of the U.S. trading at particularly attractive discounts to their fair value (Exhibit 4).

Exhibit 2: Magnificent 7 vs S&P 500 Index performance



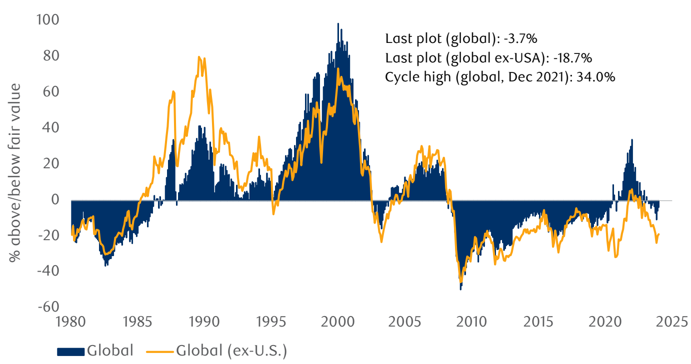
Note: Data as of December 31, 2023. Magnificent 7 is an equal-dollar weighted index consisting of a fixed basket of seven stocks: Apple Inc, Amazon, Microsoft, Meta Platforms, Tesla, Nvidia and Alphabet Inc. Performance indexed to 100. Source: RBC GAM, Bloomberg

Exhibit 3: Global equity performance vs S&P 500 Equal Weighted Index – Indexed at 0% since the start of 2023



Note: As of December 31, 2023. Source: Bloomberg, RBC GAM

Exhibit 4: Global stocks trading at a discount to fair value – Equity market indexes relative to equilibrium



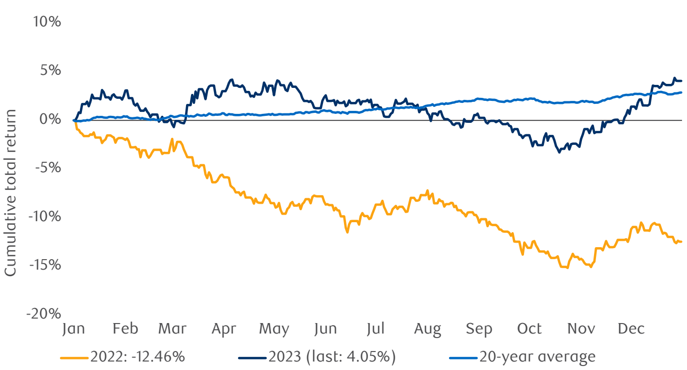
Note: As of December 31, 2023. Source: RBC GAM

> "Global equity valuations are now generally reasonable, with regions outside of the U.S. trading at particularly attractive discounts to their fair value. "

A better environment for balanced portfolios

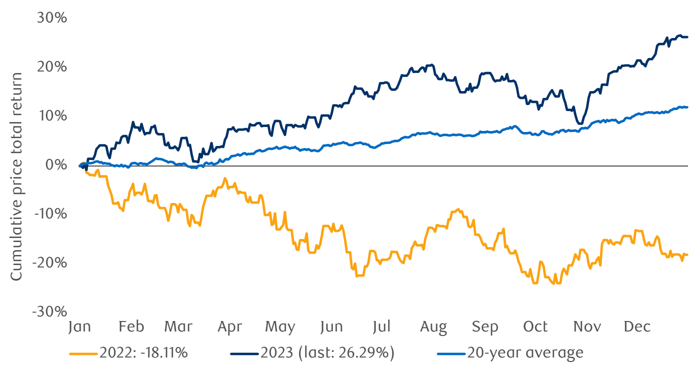
Fixed income and equity performance significantly improved in 2023 versus 2022. Using the Bloomberg US Treasury Index as the proxy, fixed income returns were 4.05% and equity returns were 26.29% in 2023, compared with -12.46% and -18.11%, respectively, in 2022 (Exhibits 5 & 6). These asset class returns led to a 14.30% gain for a balanced portfolio in 2023, up from -12.43% in 2022 (Exhibit 7). This strong positive return placed it in the top quintile of balanced fund returns over the past 15 years (Exhibit 8) and was more than double the 6.94% average during that time frame. By comparison, 2022 was the second-worst balanced fund performance in the past 15 years.

Exhibit 5: Calendar year performance in U.S. Treasuries – 2022 vs 2023



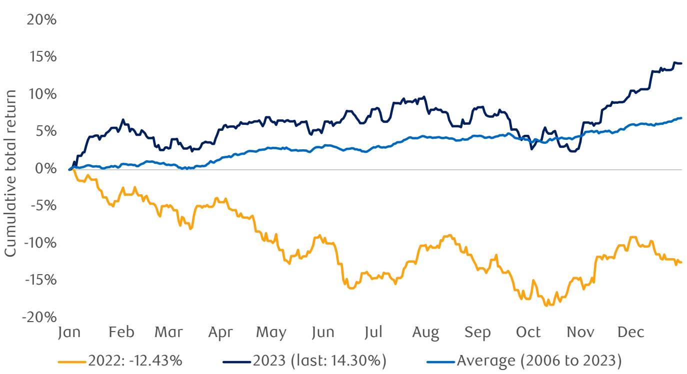
Note: As of December 31 2023. Index shown is the Bloomberg US Treasury Index. Source: Bloomberg, RBC GAM

Exhibit 6: Calendar year performance in S&P 500 Index – 2022 vs 2023



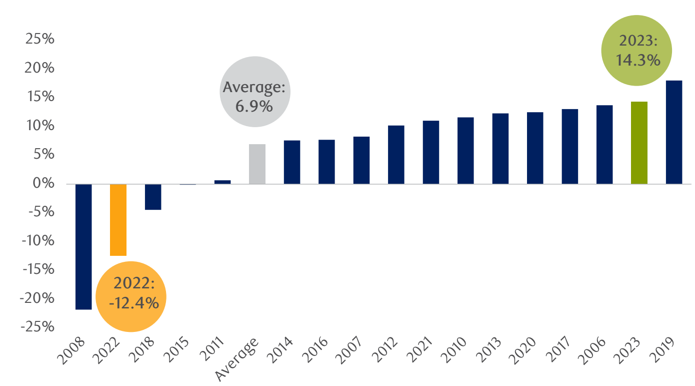
Note: As of December 31, 2023. Source: Bloomberg, RBC GAM

Exhibit 7: Calendar year performance for a balanced portfolio – 2022 vs 2023



Note: As of December 31, 2023. Sample balanced fund is 2% FTSE Canada 30-day T-Bill Index, 38% FTSE Canada Universe Bond Index, 15% S&P/TSX Composite Index, 25% S&P 500 Index, 15% MSCI EAFE Index and 5% MSCI Emerging Markets Index. All returns are total returns in Canadian dollars, unless otherwise noted. Index returns do not reflect deduction of expenses associated with investments. If such expenses were reflected, returns would be lower. An investment cannot be made directly in an index. Source: Bloomberg, RBC GAM

Exhibit 8: Calendar year performance for a balanced portfolio – Ranked worst to best from 2008 to 2023



Note: Balanced Portfolio annual returns from 2008-2023. Sample balanced fund is 2% FTSE Canada 30-day T-Bill Index, 38% FTSE Canada Universe Bond Index, 15% S&P/TSX Composite Index, 25% S&P 500 Index, 15% MSCI EAFE Index and 5% MSCI Emerging Markets Index. All returns are total returns in Canadian dollars, unless otherwise noted. Index returns do not reflect deduction of expenses associated with investments. If such expenses were reflected, returns would be lower. An investment cannot be made directly in an index. Source: Bloomberg, RBC GAM

Constantly evolving our portfolios

A core tenet of our philosophy is to constantly evolve and innovate. The latest example of this is the addition of the newly launched RBC Global Infrastructure Fund LP to our portfolio solutions in 2023. This addition gave the portfolios exposure to infrastructure assets such as airports, toll roads, mobile-phone towers and other opportunities that support economic activity and daily life. By continuing to expand our investment universe, we can access new opportunities as markets change.

Given that the RBC Global Infrastructure Fund is newly launched, performance reporting is not yet available. However, the EDHEC Infra300 Equal Weight Index, which tracks global infrastructure performance, returned 17.5% for the year, as of November 30, 2023 (Exhibit 9).

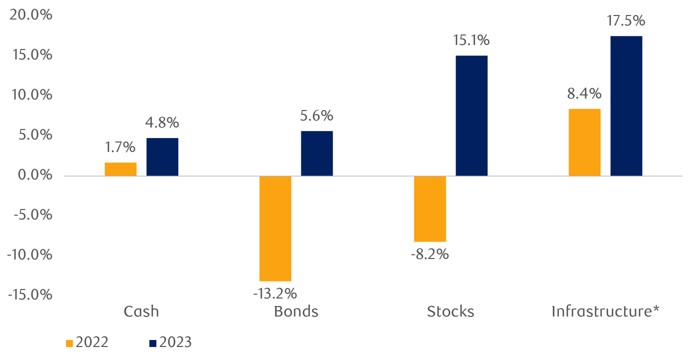
A focus on tactical asset allocation remains key

Over the course of 2022 and 2023, we made several changes to the tactical asset mix of the Portfolios with the general theme being to gradually move to a neutral asset mix. The key development in 2023 was our shift to an overweight position in bonds, a position we have not been in for over two decades (Exhibit 10).

In April, we executed the last trade to remove our overweight equity position and move to neutral. Historically, we have maintained at least a mild tilt towards stocks to capture the attractive equity risk premium that has persisted over the long term. However, we believe that the risk premium offered on stocks relative to bonds was not properly compensating investors for the risk of an economic downturn.

Since January 2022, we have raised our bond position by a total of 500 basis points in the balanced profile. Although most of the individual increases were made in 2022, our latest allocation to fixed income in 2023 brought our portfolios to an overweight position for the first time in 20 years. Allocations to our bond position this year were driven by the attractiveness of bonds thanks to their much-improved real yields, minimal valuation risk and better total return potential, with our most recent shift occurring as yields peaked last October.

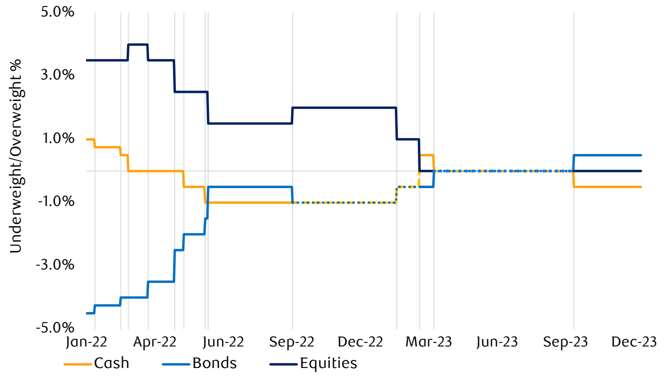
Exhibit 9: Performance by asset class – 2022 vs. 2023



Note: *Infrastructure data for period January 1, 2022 to November 30, 2023. Cash, bonds, and stocks performance for period January 1, 2022 to December 31, 2023. Cash = FTSE Canada 30 Day TBill Index, Bonds = FTSE WGBI (hedged to CAD), Stocks = MSCI World Total Return Net Index (CAD), Infrastructure = EDHEC Infra300 EW Index (returns in CAD). Source: Bloomberg RBC GAM

Exhibit 10: Tactical asset mix changes

January 1, 2022 to December 31, 2023



Note: As of December 31, 2023. Changes shown for RBC Select Balanced Portfolio. Yellow line = cash weight relative to neutral, light blue line = fixed income weight relative to neutral, dark blue line = equity weight relative to neutral.
Source: RBC GAM

Where do we go from here?

We have come through an extraordinary period of adjustment in markets over the past two years. We believe that the economy will slow over the next few quarters before recovering later in the year. There are a variety of risks that will bear watching as 2024 progresses, including rising borrowing costs, a contraction in global trade, slowing business expectations, falling housing activity and a softening labour market.

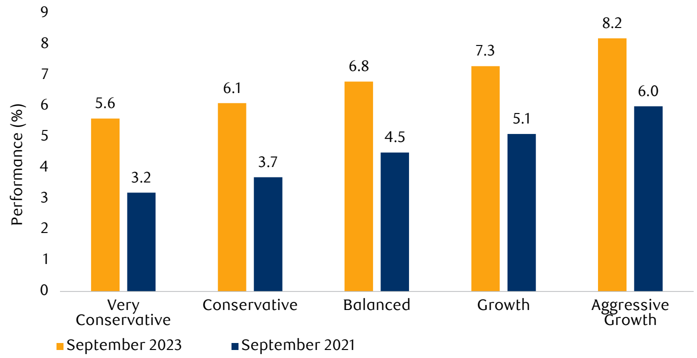
Should economies fall into at least a mild recession as we expect, we believe that analysts' estimates for earnings growth will need to be revised lower. Therefore, corporate profits are vulnerable and this could lead to more muted equity market performance in the first half of 2024.

We believe that sovereign bonds now offer a particularly appealing risk/reward trade-off. At today's higher yield levels, sovereign bonds can provide ballast against a downturn in equities with a lower risk of significant losses. Furthermore, with inflationary pressures subsiding, central banks are unlikely to further raise rates and the focus has shifted to the possibility of rate cuts at some point during 2024.

Given the balance of risks and opportunities for both the short-term and long-term investment horizons, we are positioned with a small overweight in fixed income and neutral position in equities.

Shifting to the longer-term view, the historic sell-off in the bond market since the beginning of 2022 and improved equity valuations outside of the Magnificent 7 have helped boost our forward return expectations (Exhibit 11). With expected returns for a balanced profile rising 230 basis points to 6.8%, we believe investors can enjoy much stronger 10-year performance than we previously forecasted in 2021.

Exhibit 11: Changes in 10-year annualized expected returns by profile



Note: As of September 30, 2023. Returns are annualized. 10-year expected returns are RBC GAM 10-year expected return forecasts. Very Conservative = 2% Cash, 73% Fixed Income, 10% Canadian equities, 8% U.S. equities, 3.5% European equities, 1.6% Asian ex-Japan equities, 1.9% Japanese equities. Conservative = 2% Cash, 58% Fixed Income, 13% Canadian equities, 15% U.S. equities, 6% European equities, 2.75% Asian ex-Japan equities, 3.25% Japanese equities. Balanced = 2% Cash, 38% Fixed Income, 15% Canadian equities, 25% U.S. equities, 7.5% European equities, 3.5% Asian ex-Japan equities, 4% Japanese equities, 5% Emerging Market equities. Growth = 2% Cash, 23% Fixed Income, 18% Canadian equities, 30% U.S. equities, 9.5% European equities, 4.4% Asian ex-Japan equities, 5% Japanese equities, 8% Emerging Market equities. Aggressive Growth/All-Equity = 2% Cash, 29% Canadian equities, 38% U.S. equities, 10% European equities, 4.6% Asian ex-Japan equities, 5.4% Japanese equities, 11% Emerging Market equities. Cash = FTSE Canada 30 Day TBill Index, Fixed Income = FTSE Canada Universe Bond Index, Canadian equities = S&P/TSX Capped Composite TR Index, U.S. equities = S&P 500 TR Index USD, European equities = MSCI Europe ex UK Index (LCL), Asia equities = MSCI AC Asia Pacific Index (LCL), Japanese equities = Nikkei 225 Average PR Index (JPY), Emerging Market equities = MSCI EM Index (USD). The above does not reflect transaction costs, investment management fees or taxes. Source: RBC GAM

Expect more volatility in 2024

So despite continued macro uncertainty, 2023 turned out to be a strong year for both bonds and stocks, leading to impressive returns for balanced portfolios. However, while the economy managed to side-step recession in 2023, the historically long lags between monetary tightening and ultimate weakness in the economy suggest the window for recession may just now be opening. As the business cycle matures, inflation moderates and interest rates peak, we believe that capital markets could be nearing an interesting transition period. While we recognize that there are pathways to a positive outcome and that a soft landing is possible, our base case is that slowing economic growth will act as a headwind to corporate profits. In this environment, equities could be vulnerable but fixed-income investments would likely pull greater weight and offer important diversification benefits in the returns of a balanced portfolio.

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Publication date: January 2024

(01/2024)
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