RBC Global Asset Management

Economic outlook

NEW YEAR 2023

Incremental positives in a challenged world

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The main macroeconomic themes remain familiar: inflation is still much too high, central banks continue to drive interest rates upward, and the economy is not only slowing (Exhibit 1) but is likely to downshift into recession.

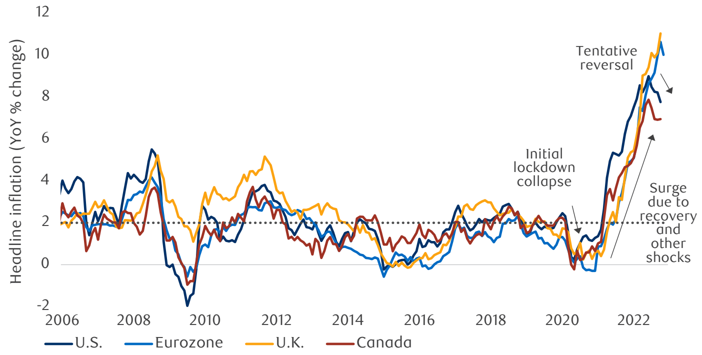
However, there have been several important if subtle shifts in the narrative. All are positive.

Of greatest significance, inflation appears to have peaked (Exhibit 2) as the forces that initially drove it higher now reverse course. Inflation is unlikely to decline rapidly or smoothly, but it should constitute a diminished threat in six months and a significantly vanquished force in a year. Central banks, in turn, are feeling slightly less pressure to drive interest rates ever higher. There is still some distance left to travel, but the end is arguably in sight.

Exhibit 1: Global economic growth has been deteriorating

Note: As of 12/2/2022. Shaded area represents U.S. recession. Source: Citigroup, Bloomberg, RBC GAM

Exhibit 2: Inflation remains elevated in major economies



Note: Canada, U.K., and U.S. as of Oct 2022, Eurozone as of Nov 2022. Source: Bureau of Labor Statistics, Office for National Statistics, Statistics Canada, Statistical Office of the European Communities, Haver Analytics, RBC GAM

Finally, while a recession remains likely, there has been a smattering of recent good news. The U.S. economy has held up better than expected in recent quarters. In Europe, natural-gas prices have retreated sufficiently that the anticipated recession no longer has to be quite as deep. China's recent lightening of COVID restrictions should ease some of the extreme economic pain that country has been suffering.

Despite these incremental improvements to the economy, we retain below-consensus growth forecasts for the year ahead. It would be exceedingly unusual for a recession to be avoided given the headwinds imposed by rising borrowing costs, elevated inflation and myriad other forces.

Whether markets opt to dwell on slowing growth or declining inflation, the bond market is capable of delivering strong returns. The question is how the stock market fares. Declining inflation is a major positive, potentially aiding equity valuations. But a weak economy is clearly a negative, capable of damaging earnings.

Given the skewed risk-reward between bonds and stocks, we retain a greater weight toward fixed income than a year ago. But once central banks conclude their tightening cycle and economic growth begins to rebound, the stock market has a good chance of becoming the stronger performer. With a medium-term investment horizon, it is a rare treat that the outlook for stocks and bonds are both good given depressed starting points.

Peaking inflation

Inflation remains nearly four times higher than normal. This is problematic in two ways. First, inflation itself is doing serious damage to the economy through diminished purchasing power and via distorted spending and investment decisions.

Second, central banks, in their zeal to restore inflation to normal levels, have been tightening monetary policy at a frantic pace that is damaging short-term economic growth.

Why did inflation suddenly explode to such problematic readings after decades of slumber? There wasn't any one cause. Indeed, it is difficult to imagine a single force exerting enough pressure to create an inflation problem of this magnitude all by itself.

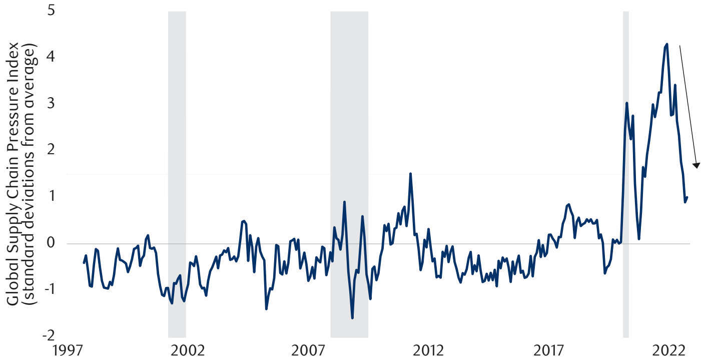
Instead, the catalyst was several forces all applying significant upward pressure at the same time. The four main factors that supercharged inflation were massive supply-chain problems, a commodity shock, too much monetary stimulus and too much fiscal stimulus.

Fortunately, all four of those drivers have since reversed course. In turn, inflation is beginning to recede and should continue to do so.

Supply-chain problems were the original inflation driver, as altered demand preferences and hobbled production capabilities combined to limit the availability and increase the cost of a wide range of goods. Fortunately, those forces have now mostly gone into reverse (Exhibit 3). The cost of shipping is plummeting; there are no longer such large backlogs of ships waiting to unload at port; warehouse utilization rates are falling; the ratio of demand-to-supply for trucks has greatly declined; and the cost of previously scarce computer chips is falling. A slowing economy should further resolve most lingering supply-chain issues.

The commodity shock had two points of origin. One part came from the rapidity of the economic recovery as pandemic restrictions eased – a revival that resource producers had not anticipated. The other part was Russia's attack on Ukraine, which hobbled Ukraine's resource-rich economy and prompted wide-ranging sanctions on Russia that supercharged a host of commodity prices, most prominently those of natural gas and oil.

Exhibit 3: Global supply-chain pressure has significantly eased



Note: As of Oct 2022. Shaded area represents U.S. recession. Source: Gianluca Benigno, Julian di Giovanni, Jan J. J. Groen, and Adam I. Noble,"A New Barometer of Global Supply Chain Pressures," Federal Reserve Bank of New York Liberty Street Economics; Macrobond, RBC GAM

Fortunately, commodity prices have since begun to retreat (Exhibit 4). This is partially as demand growth has cooled, partially as resource producers have had time to catch up, and partially as some Russian and Ukrainian resources have found their way to market despite initial fears. This decline should contribute to lower inflation.

Keep in mind that all that is needed for commodity prices to cease exerting an upward force on inflation is for them to remain roughly flat – it is not necessary that they fully unwind to pre-pandemic levels. Forecasting commodities is notoriously difficult, but the most likely scenario in the short run is that most commodity prices continue to decline as the economy softens.

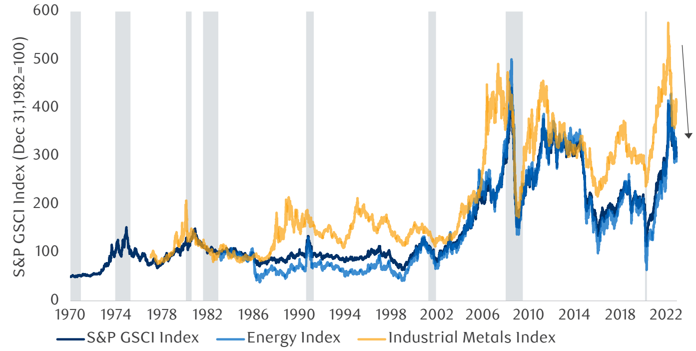
Policymakers, both monetary and fiscal, are also partially to blame for high inflation. Central banks arguably kept interest rates too low and their balance sheets too large for too long, inflating the supply of money. While it took some time for central bankers to recognize this misstep, they have since responded with a level of determination unseen in a generation. North American policy rates have raced from near-zero levels to well above neutral, with the implication that monetary policy has gone from spurring inflation to suffocating it.

Meanwhile, fiscal policy also remained too generous for too long, with governments ploughing money into the economy even after the unemployment rate had largely normalized and the threat of widespread business failures had passed.

Although governments continue to spend significant sums in absolute terms, the more important fact is that fiscal deficits have shrunk massively over the past year, constituting a net drag on the economy (Exhibit 5). Given that fiscal impulses work with a lag, that drag should persist into 2023. In the U.S., the fiscal deficit has shrunk from an unprecedented US$4 trillion during the worst of the pandemic to around US$1 trillion today.

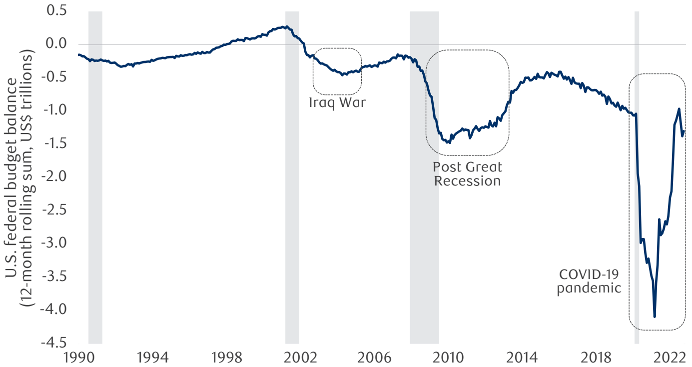
So why is inflation unlikely to snap back to 2% overnight, let alone descend into negative territory, even as the main drivers have reversed direction? The answer is that there are a handful of new inflationary pressures that may retard a decline in inflation.

Exhibit 4: Commodity prices weighed down by recession concerns



Note: As of 12/01/2022. Shaded area represents recession. Source: S&P, Macrobond, RBC GAM

Exhibit 5: U.S. fiscal deficit has shrunk significantly



Note: As of Oct 2022. Source: Macrobond, RBC GAM

> "In short, inflation should fall from here, but the decline is unlikely to be complete in the short run."

Nominal wage growth is now rising at a brisk pace due to exceptionally tight labour markets. While a full-blown wage-price spiral is unlikely, higher pay may keep inflation from descending quite as quickly as it would have.

The fact that inflationary pressures are no longer merely the result of a handful of expensive products is another complication. Inflation has now trickled into nearly every crevice of the consumer-spending basket as first-order impacts (such as higher energy prices) bring second-order consequences (such as more expensive transportation costs), and so on (Exhibit 6). It will take extra time for these cascading impacts to unwind.

Finally, the recent inflation spike was sufficiently large and traumatizing that some households and businesses will have been scarred by the experience and so assume that inflation remains high, making it harder for actual inflation to fully unwind.

Lags must also be considered. Even as home prices and rental costs have begun to decline, the famously lagged shelter component of U.S. CPI has remained red hot. This particular inflation pressure – and it has recently been responsible for as much as half of recent price increases – may not significantly turn until well into 2023.

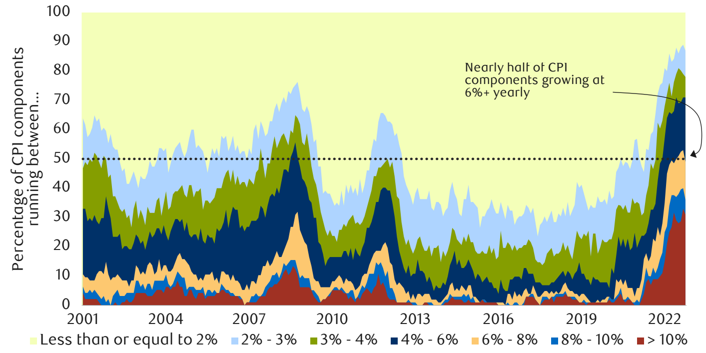
It is reassuring that, in addition to strong theoretical arguments that inflation should ease, there is also empirical evidence that businesses are altering their pricing behavior. The fraction of American firms planning to raise prices has plummeted in recent months (Exhibit 7).

Slightly over half of the variables tracked in our inflation turning scorecard are behaving in a manner consistent with declining inflation, with another 40% of the variables showing tentative evidence of a decline. Just 10% are refusing to cooperate altogether. This is a promising mix.

In short, inflation should fall from here, but the decline is unlikely to be complete in the short run. We possess below-consensus inflation forecasts for 2023, signaling that we are more optimistic than the market about this pivot (Exhibit 8).

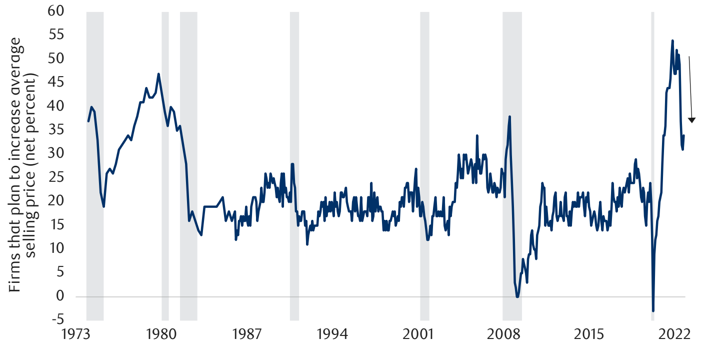
It should take longer for inflation in the eurozone and U.K. to come down by virtue of the region's unique challenges, mainly weaker currencies and energy shortages, but a peak may also now be forming.

Exhibit 6: Inflation in the U.S. is quite broad



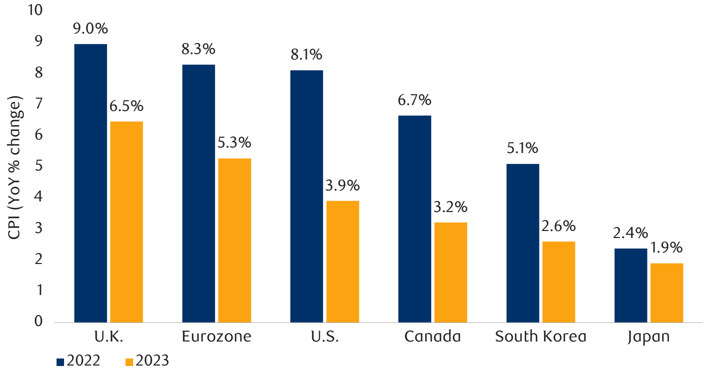
Note: As of Oct 2022. Share of CPI components with year-over-year % change falling within the ranges specified. Source: Haver Analytics, RBC GAM

Exhibit 7: Fraction of U.S. businesses planning to raise prices falling precipitously



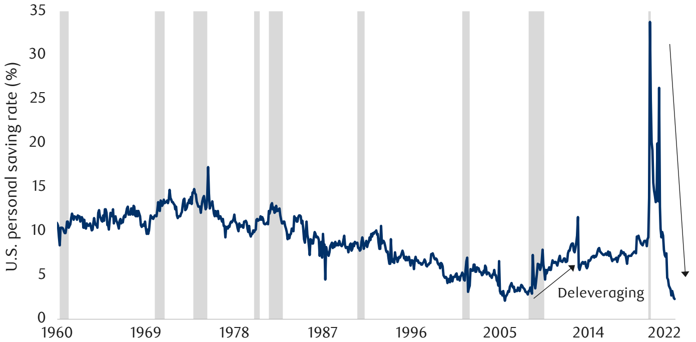
Note: As of Oct 2022. Shaded area represents recession. Source: NFIB Small Business Economic Survey, Macrobond, RBC GAM

Exhibit 8: RBC GAM CPI forecast for developed markets



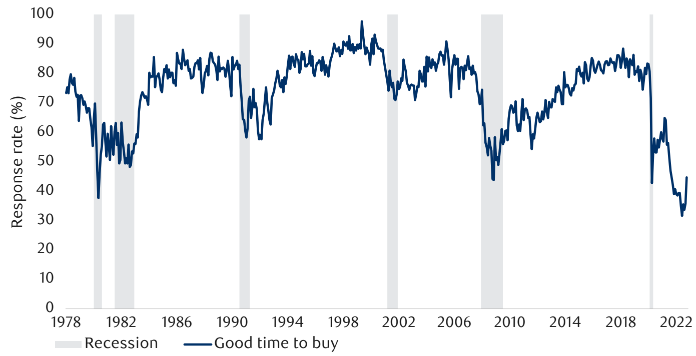
Note: As of 11/23/2022. Source: RBC GAM

Exhibit 9: U.S. personal-savings rate approaching record low



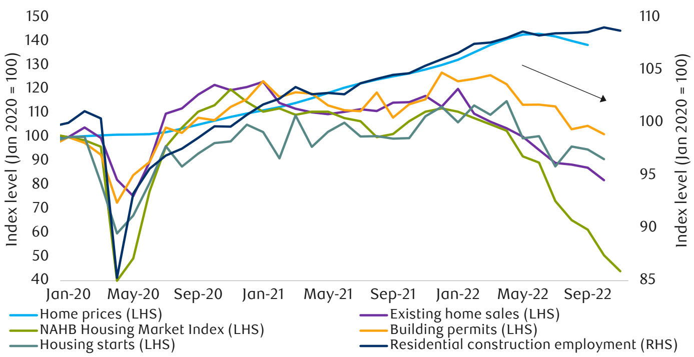
Note: As of Oct 2022. Shaded area represents recession. Source: BEA, Macrobond, RBC GAM

Exhibit 10: U.S. consumers don't think it's a good time to buy large durable household goods



Note: As of Oct 2022. Source: University of Michigan, Macrobond, RBC GAM

Exhibit 11: U.S. housing metrics reveal weakness



Note: Case-Shiller Home Price Index as of Sep 2022; building permits, housing starts, and existing home sales as of Oct 2022; employment and NAHB HMI as of Nov 2022. Source: BLS, Census Bureau, NAHB, NAR, S&P, Macrobond, RBC GAM

State of the economy

The fastest recovery from a recession in history culminated in the global economy boiling over into a position of excess demand a year ago. Economies remain similarly situated today as demonstrated by the persistence of some of the lowest unemployment rates in decades.

However, the economic backdrop is changing significantly. Economic headwinds have mounted as aggressive rate hikes, high prices, tightening financial conditions, a commodity shock, a struggling Chinese economy and fiscal drag join forces.

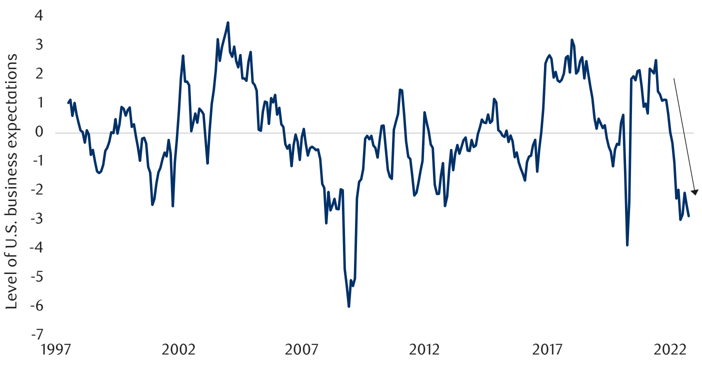
While the U.S. economy, in particular, is holding together better than initially expected, there are nevertheless hints of softness to come. As rising interest rates and high gasoline prices take a bite out of consumer wallets, the personal savings rate has fallen to within a hair of the lowest level on record (Exhibit 9). The drop in savings hints at diminished spending in the future, and indeed most consumers indicate they plan to spend less money in response to high inflation, with the appetite for discretionary and big-ticket items in particular decline (Exhibit 10).

Housing, the most interest-rate-sensitive area of the economy, has swooned across the world (Exhibit 11).

Moreover, business expectations have dimmed considerably, if not quite to levels consistent with a recession (Exhibit 12). The inventory cycle has clearly reversed – usually a signal of economic weakness to come (Exhibit 13).

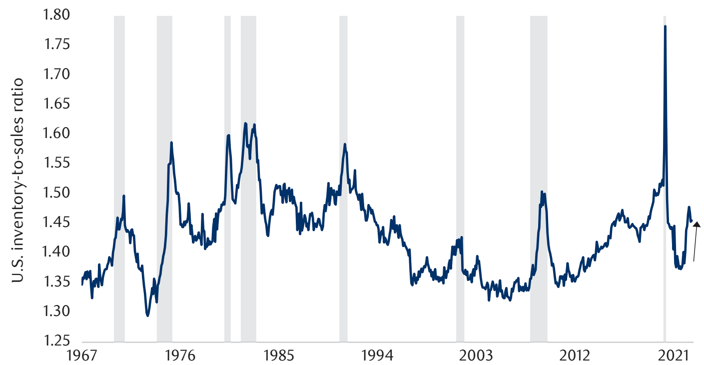
In contrast, labour markets have been stubbornly resilient, with unemployment rates still plumbing the depths and hiring solid. But there are hints of softness to come. Layoffs are rising (Exhibit 14), especially in technology. Job openings have also begun to decline, albeit from a high level (Exhibit 15). Fewer people are voluntarily quitting their jobs in a sign that workers are losing confidence in their ability to find another one. We believe that the jobs market will weaken in 2023, if not on the usual scale, as companies hang onto more workers than usual after having had to fight so hard to recruit them in recent years.

Exhibit 12: U.S. business expectations have fallen



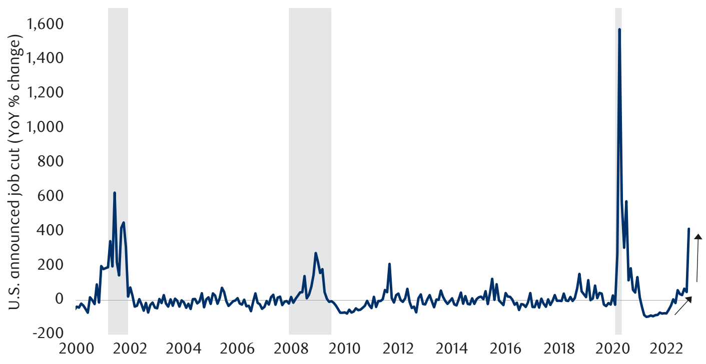
Note: As of Oct 2022. Principal component analysis using NFIB optimism and business conditions outlook, ISM Manufacturing and Services new orders, and The Conference Board CEO expectations for economy. Source: The Conference Board, ISM, NFIB, Macrobond, RBC GAM

Exhibit 13: U.S. inventory-to-sales ratio climbs as inventory builds and sales fall



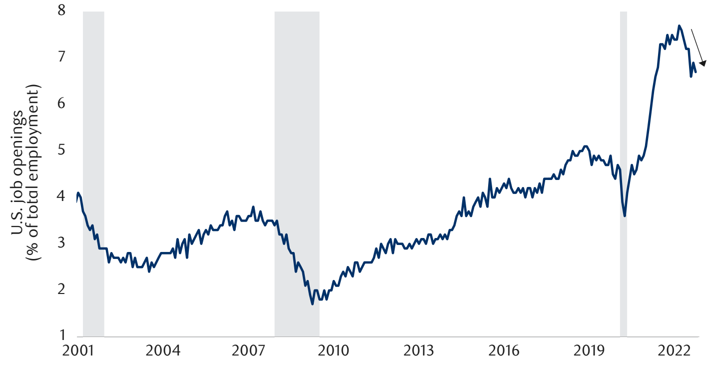
Note: As of Sep 2022. Real inventory-to-sales ratio of all manufacturing and trade industries. Shaded area represents recession. Source: BEA, Haver Analytics, RBC GAM

Exhibit 14: Rise in U.S. job-cut announcements has picked up



Note: As of Nov 2022. Source: Challenger, Gray & Christmas, Inc., Macrobond, RBC GAM

Exhibit 15: U.S. job-openings rate falling from record highs but still elevated



Note: As of Oct 2022. Estimates for all private nonfarm establishments. Shaded area represents recession. Source: BLS, Macrobond, RBC GAM

Overall, most economic indicators are now weakening, even if they remain shy of recessionary thresholds (Exhibit 16).

We continue to look for a further deceleration in growth in 2023, likely all the way into a recession for the developed world (Exhibit 17). While emerging-market economies rarely contract outright, we nevertheless look for most of them to slow in 2023 (Exhibit 18). Altogether, global GDP is on track for just 2.1% growth in 2023 – less than a third of what was managed in 2021 – and just over half the 2022 growth rate.

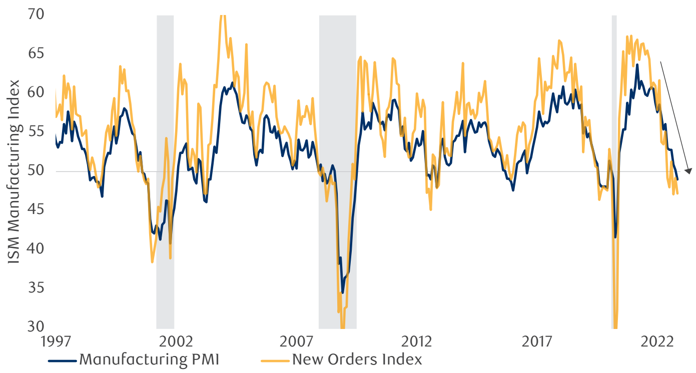
Our growth forecasts are mostly below the consensus, signaling that the economic slowdown will be incrementally worse than investors assume.

Recession expectations

We monitor a dozen simple recession rules of thumb that have historically been triggered in advance of recessions (Exhibit 19). Signals include the inversion of the yield curve, the commencement of a monetary-tightening cycle, and spiking inflation. None is perfect by itself, but collectively they convey useful information about the likelihood of a recession. At present, the majority of the indicators, and a rising share, indicate that a recession is likely coming.

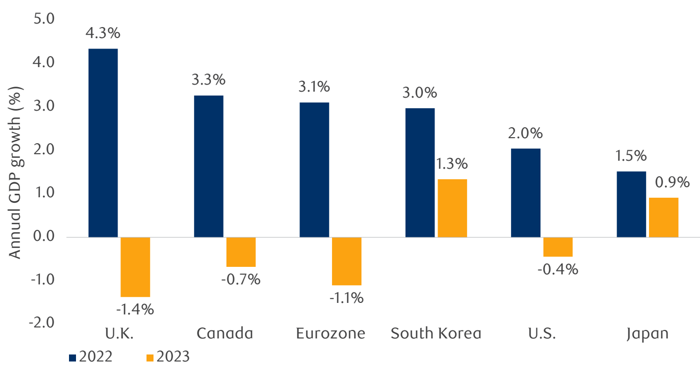
We can also approximate the likelihood of a recession by assessing the state of the business cycle. The idea behind the business cycle is that there are certain repeating patterns across economic expansions, and that an economy with a lot

Exhibit 16: U.S. manufacturing activity deteriorating



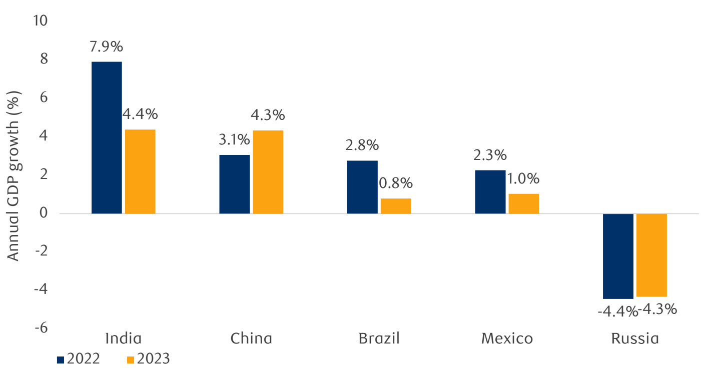
Note: As of Nov 2022. Shaded area represents recession. Source: ISM, Haver Analytics, RBC GAM

Exhibit 17: RBC GAM GDP forecast for developed markets



Note: As of 11/23/2022. Source: RBC GAM

Exhibit 18: RBC GAM GDP forecast for emerging markets



Note: As of 11/23/2022. Source: RBC GAM

Exhibit 19: Recession signals point mostly to "yes"

Signal	Indicating U.S. recession?
2yr-10yr curve inverts	Yes
3m-10yr curve inverts	Yes
Fed short-term curve inverts	Yes
Inflation spike	Yes
Oil shock	Yes
Financial conditions tighten	Yes
Jobless claims jump	Yes
Monetary tightening cycle	Likely
Google "recession" news trend	Likely
RBC GAM recession model	Maybe
Duncan Leading Indicator falls	Maybe
Unemployment increase	No, but may be turning

Note: As at 11/15/2022. Analysis for U.S. economy. Source: RBC GAM of room to expand usually looks quite different from one that is about to falter. Our business-cycle scorecard concludes that the U.S. economy is most likely at an "end of cycle" moment (Exhibit 20) – a position that usually precedes a recession by no more than several quarters.

In conclusion, a recession continues to appear significantly more likely than not. The likelihood is in the realm of 80% for the U.S. and Canada, and higher for the eurozone and the U.K. In fact, a recession may have already started in the U.K.

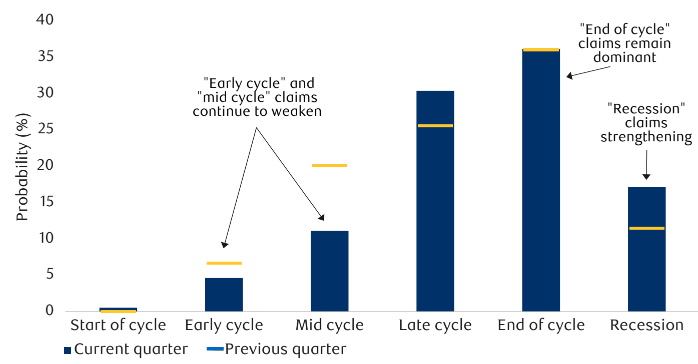
All of that said, the probability and depth of a recession has arguably shrunk slightly over the past few months as economic indicators have shown more resilience than anticipated. Economic surprises have actually been more positive than negative, though most of that shift reflects rock-bottom expectations more than strong economic outcomes (Exhibit 21).

Should a recession transpire, we continue to expect it to be of a middling depth in most jurisdictions – in the realm of a 1.75% peak-to-trough decline in output (Exhibit 22). In contrast, financial markets are pricing in no more than a mild recession. Note that while our forecast is in line with the average recession, it is milder than the past two downturns. While a lack of monetary-policy support argues for a deeper decline, the prospect of a more resilient labour market than usual makes the opposite case.

The period of declining output should persist for no more than three quarters, with a moderate recovery taking hold toward the end of 2023. It is unlikely that policymakers will opt to spur a galloping recovery akin to 2020-2021 given the distortions and excesses that ultimately resulted. But it is also unlikely that the recovery takes as long as it did across the anemic post-financial-crisis years.

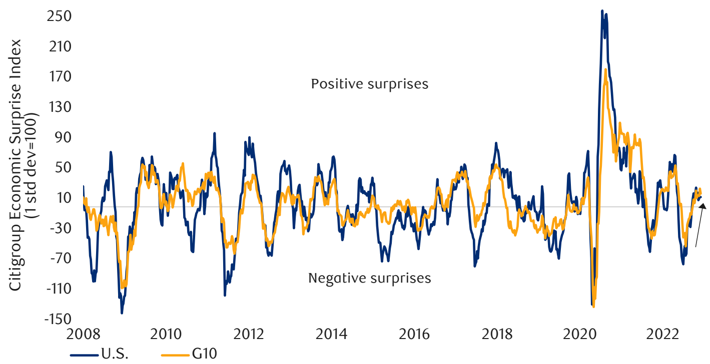
It is worth flagging that even if this recession charts a middling depth, it could feel rather milder. For one thing, if there are fewer job losses, there should be less acute suffering because it is job losses that trigger a cascade of problems such as bankruptcies and sharply curtailed spending. These problems simply don't manifest to the same degree if the same burden of diminished income is instead distributed more evenly.

Exhibit 20: U.S. business-cycle score



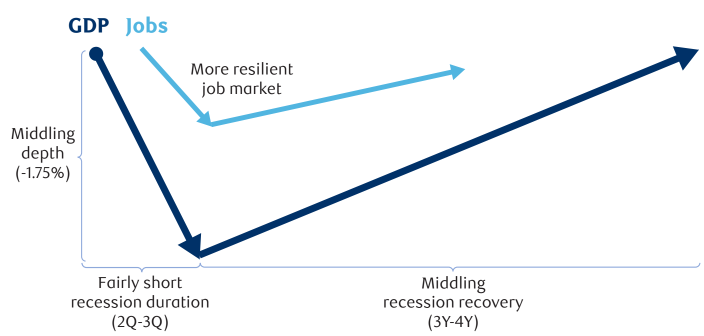
Note: As at 11/15/2022. Calculated via scorecard technique by RBC GAM. Source: RBC GAM

Exhibit 21: Global economic surprises bounce back, now positive



Note: As of 12/2/2022. Source: Citigroup, Bloomberg, RBC GAM

Exhibit 22: Recession scenario assumptions



Note: As at 08/30/2022. Source: RBC GAM

Second, even as real GDP declines, nominal GDP should continue to grow given the buffer of elevated inflation. That is to say, the quantity of things produced should decline, but the amount paid for them and earned from them shouldn't. Nominal wages, corporate earnings and government revenues may not fall as far as in a normal recession. While much of the benefit from this is psychological rather than real, that could nevertheless prevent a vicious circle of mounting pessimism and declining activity from forming to the usual extent.

National variations

While global forces such as rising interest rates and high fuel prices suggest that most countries should experience a broadly similar pattern of decelerating economic activity in 2023, there are important distinctions to make among nations. Consumer-confidence metrics highlight the divide, with U.S. confidence only moderately lower, whereas there have been severe declines in the eurozone and the U.K. (Exhibit 23).

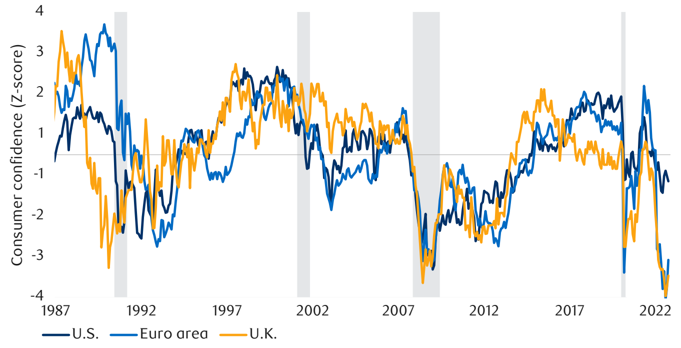
The U.S. economy appears more resilient than most, for several reasons. The country is less interest-rate sensitive given lower household leverage and a mortgage market that shelters borrowers from interest rate swings via 30-year loan terms.

New infrastructure initiatives combined with "Buy American" rules and trepidation about China are encouraging some international manufacturers to expand into the U.S. The American mid-term election yielded a divided Congress, an outcome that financial markets have historically liked despite (or perhaps because of) the gridlock it creates.

Canada is somewhat more vulnerable economically than the U.S., due primarily to its greater household-debt burden (Exhibit 24). The country's home prices are now in clear decline, with the regions that experienced the greatest appreciation over the prior few years now showing the greatest retreat (Exhibit 25). Further depreciation is likely.

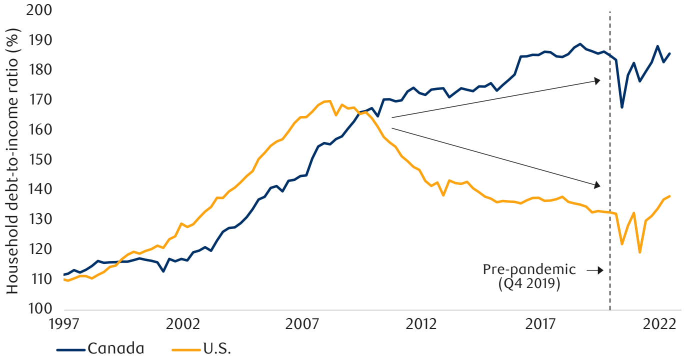
While high commodity prices benefit Canada's resource-intensive economy and the Bank of Canada appears set to alight at a slightly lower peak policy rate than the U.S. Federal Reserve (Exhibit 26), the net result is still for a larger economic decline in Canada.

Exhibit 23: Consumer confidence has fallen sharply



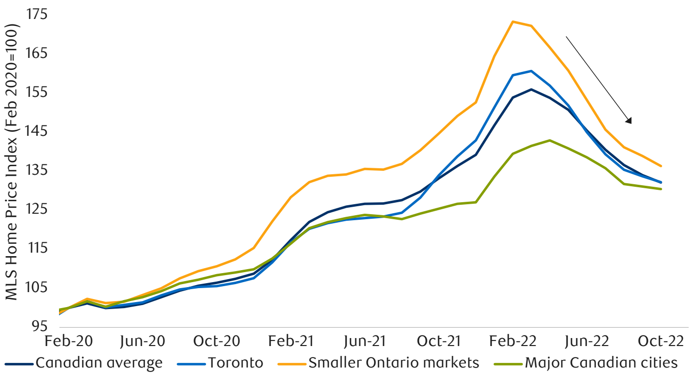
Note: As of Nov 2022. Shaded area represents U.S. recession. Source: The Conference Board, European Commission (DG ECFIN), GfK UK, University of Michigan, Macrobond, RBC GAM

Exhibit 24: Household leverage lower in U.S. than Canada



Note: As of Q2 2022. Source: Haver Analytics, RBC GAM

Exhibit 25: Home prices dropped across Canada



Note: As of Oct 2022. Source: CREA, Macrobond, RBC GAM

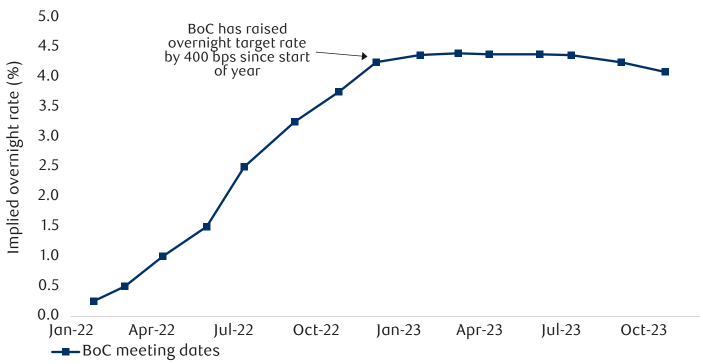
The eurozone and U.K. face more challenging economic conditions than the U.S., in large part due to the region's greater exposure to Russia – both through sanctions imposed on Russia, and Russia's decision to limit its export of natural gas to the continent. Ultra-high energy costs are a heavy burden for households, businesses and government finances (Exhibit 27). While Europe has enough gas in storage to survive this winter and natural-gas prices have retreated, the scramble is likely to resume next summer to secure supplies for the winter of 2023-2024.

The resulting spike in eurozone inflation has forced the European Central Bank to play catch-up after a long period of negative interest rates, further dampening growth (Exhibit 28).

The U.K. faces the same energy challenges, and an even trickier political backdrop than the eurozone. The country has gone through a revolving door of prime ministers, and the bond market almost collapsed in September after an ill-advised (and since shelved) tax-cut plan. The U.K. also continues to reel from the effects of Brexit, which now appear to be inflicting the economic damage that had been prophesied before the referendum. All of this has put the U.K. in the unsustainable position of consuming significantly more than the country produces (Exhibit 29), and so belt-tightening will be necessary.

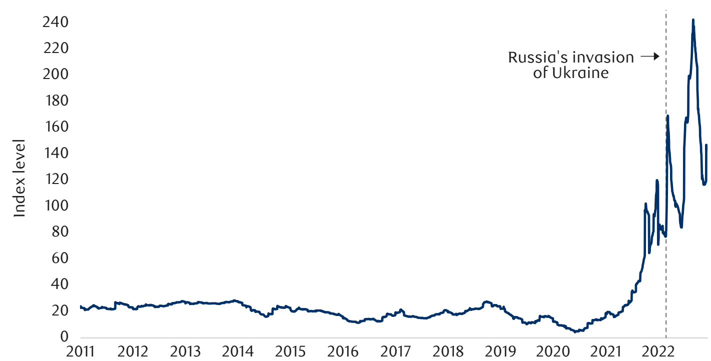
Despite the U.S. economy's relative resilience, the dollar should give up some of its gains over the coming year. The currency is overvalued by any standard, and has benefited

Exhibit 26: Bank of Canada tightened monetary policy aggressively



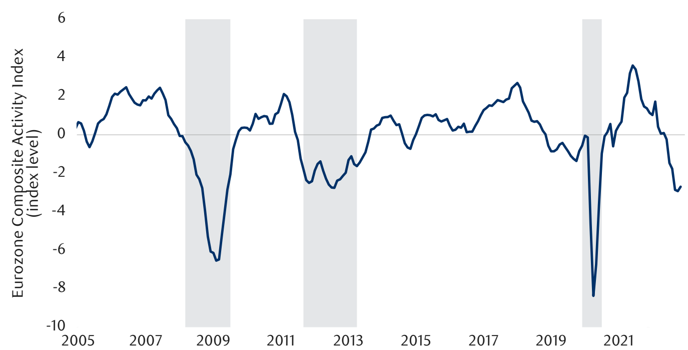
Note: As of 12/07/2022. Source: Bloomberg, RBC GAM

Exhibit 27: Natural-gas prices high but declined from their peak



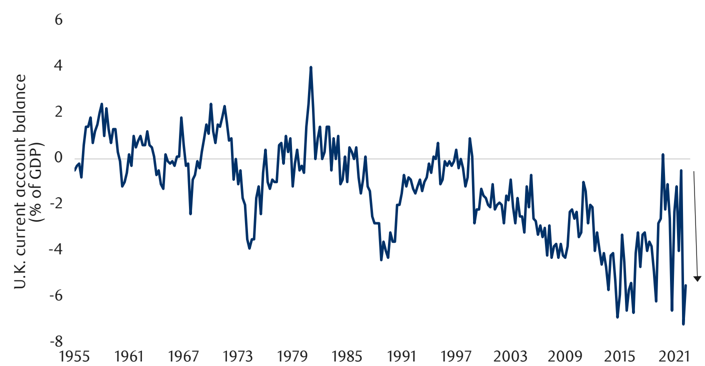
Note: As of 12/01/2022. Source: Intercontinental Exchange, Macrobond, RBC GAM

Exhibit 28: Eurozone economic activity depressed by Russia's invasion and high inflation



Note: As of Nov 2022. Index reflects the first principal component from PCA analysis on select indicators of eurozone economic activity. Shaded area reflects recession. Source: CEPR, ZEW, Deutsche Bundesbank, IHS Markit, Macrobond, RBC GAM

Exhibit 29: U.K. current-account deficit yawns wider



Note: As of Q2 2022. Source: ONS, Macrobond, RBC GAM from a safe-haven bid that won't last as inflation ebbs. This should provide a currency-adjusted tailwind to non-U.S. markets.

Monetary tightening slows

Central banks continue to push interest rates higher as they attempt to remedy the explosion of inflation over the past 18 months. The breadth of policy-rate increases has no precedent in the 21st century (Exhibit 30). The quantity of tightening each country has delivered has also been outsized, with North American policy rates already around 4 percentage points higher after less than a year of increases.

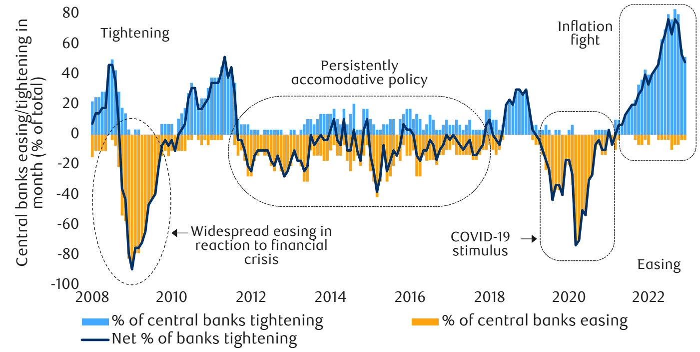
But this monetary tightening is now starting to slow as inflation begins to decline. Some emerging-market countries have already ended their rate hikes, and the pace of tightening is mostly decelerating elsewhere. Central bankers think they are nearing the finish line, with the U.S. fed funds rate now expected to peak at around 5% (Exhibit 31). That is a lofty rate relative to the starting point near 0%, and double the neutral policy rate of around 2.5%. But it is also only around a percentage point higher than the current setting. Most of the hard work has already been done, and there is even the possibility that policy rates start to decline over the second half of 2023 if inflation cooperates and growth slows.

Complicating the analysis, one can simultaneously argue that the present setting of nominal interest rates is extremely restrictive by the standards of the past 15 years, and yet interest rates adjusted for the present rate of inflation are the lowest on record despite all of the recent tightening.

Between high and rising public debt levels, quantitative tightening that is adding to the effective supply of government bonds, and interest rates that are no longer at rock-bottom levels, the cost of servicing public debt is set to rise materially. After decades of ignoring fiscal affairs, bond investors are again paying attention to government spending, as the U.K. discovered to its peril.

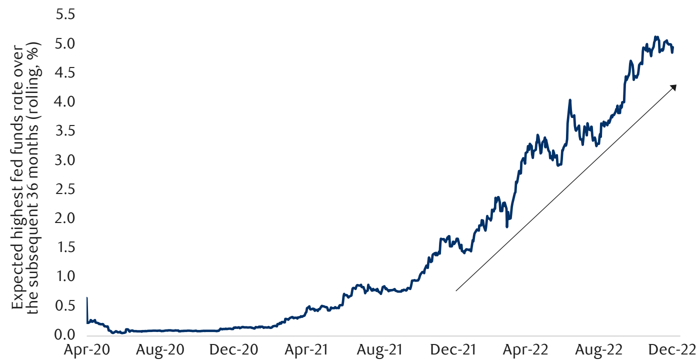
The potential problem isn't confined to a single country. The bulk of the world's large nations continue to run significant structural deficits even though their economies have mounted full recoveries from the pandemic (Exhibit 32). These countries will be under pressure to narrow these deficits over the next few years as debt-servicing costs climb. The timing is

Exhibit 30: Central banks lift rates to fight inflation



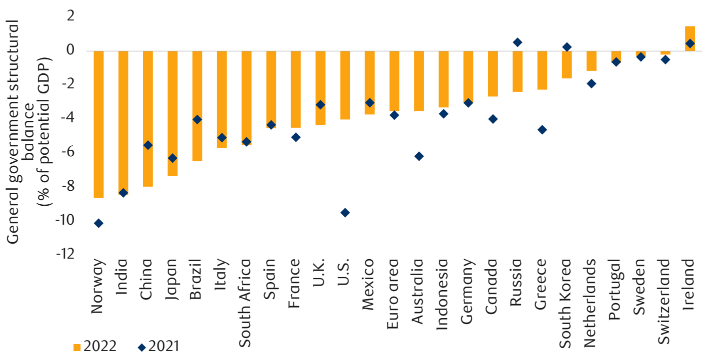
Note: As of 12/02/2022. Based on policy rates for 30 countries. Source: Haver Analytics, RBC GAM

Exhibit 31: Expected peak fed funds rate has increased sharply



Note: As of 12/02/2022. Source: Bloomberg, RBC GAM

Exhibit 32: Significant structural fiscal deficits persist



Note: IMF projections for year 2022. Source: IMF WEO, October 2022, Macrobond, RBC GAM awkward since politicians will want to deliver fiscal stimulus during the next recession, and given rising energy subsidies, military spending, green investments, industrial policies, and expenses related to an aging population.

Lingering pandemic

The COVID-19 virus continues to circulate, but at a diminished intensity relative to 2020 and 2021. Crucially for investors, the pandemic's economic impact has now shrunk considerably, exerting only a small effect outside of China.

New variants continue to emerge, with BQ.1 and BQ.1.1 the latest strains to gain prominence. Although each new generation of the COVID-19 virus is more contagious than the last, the virus is not becoming any more deadly. Recent variants may even be slightly milder than prior iterations, though this claim is difficult to disentangle from the fact that so many people now have some measure of protection via vaccine or prior infection.

It is a considerable consolation that there has not been a surge in global infections even as these new strains have emerged. Still, it remains prudent to assume there will continue to be additional COVID-19 waves in the future, though of limited economic consequence as governments are unlikely to significantly reverse their easing of mobility restrictions (Exhibit 33).

The major exception to this happy narrative is that China is now suffering its greatest outbreak of COVID-19 infections since the pandemic first arose in the central city of Wuhan three years ago (Exhibit 34).

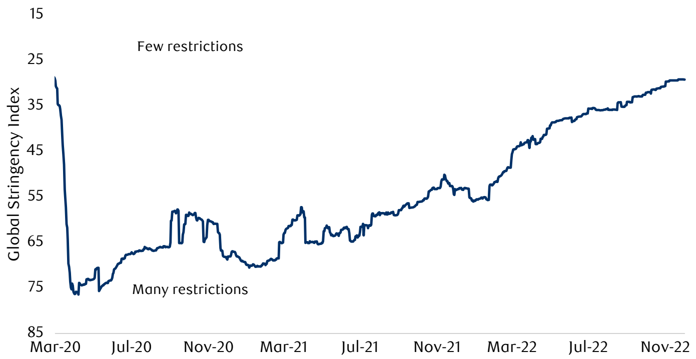
Chinese challenges

The Chinese economy is suffering acutely after the country again locked down a significant swath of its population in response to surging infections.

But the population has reached a breaking point after three years of heavy restrictions, as demonstrated by intense public protests that have prodded the government to significantly change course in recent weeks. Policymakers have abruptly scaled back the most heavy-handed pandemic restrictions, greatly reducing the use of quarantining facilities, abandoning the contact-tracing app, scaling back PCR testing requirements and limiting the scope of lockdowns when outbreaks are detected.

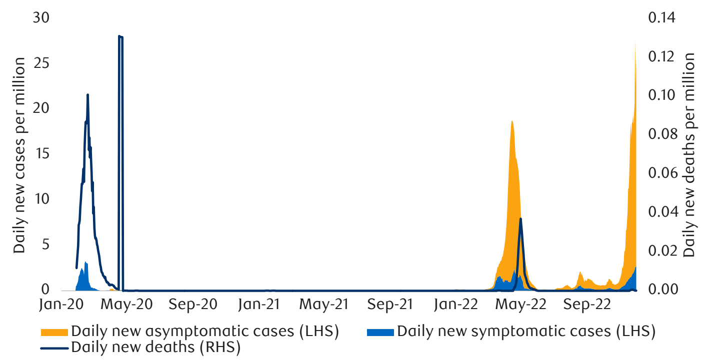
The problem is that China is now likely to be overwhelmed by infections due to its underperforming homegrown vaccine, insufficient vaccination of vulnerable seniors, and a lack of natural immunity in the population. This is quite bad from a public health perspective, though it should allow the economy to revive more quickly than would otherwise be possible.

Exhibit 33: COVID-19 restrictions mostly lifted, except in China



Note: As of 12/2/2022. Global Stringency Index measuring the strictness of lockdown policies that restrict mobility, calculated as stringency index of 50 largest economies. Sources: University of Oxford, IMF, Macrobond, RBC GAM

Exhibit 34: China hit hard by Omicron wave



Note: As of 12/1/2022. 7-day moving average of daily new cases and deaths. Source: Johns Hopkins University, Macrobond, RBC GAM

This helping hand for the economy couldn't come at a better time given the horrible state of consumer confidence (Exhibit 35), higher than normal unemployment and crimped retail sales (Exhibit 36).

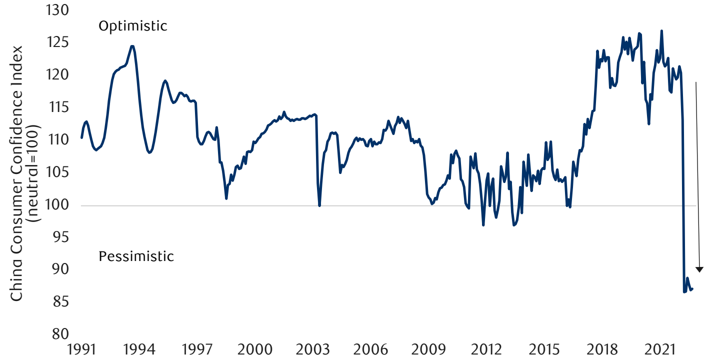
Nevertheless, the Chinese economy still grapples with structural challenges. The property market continues to weaken after decades of excess (Exhibit 37). This is largely by design as the government seeks to reduce the reliance on housing to drive the economy forward. But the scale of the weakness has given policymakers second thoughts about their approach, and so a number of new measures were recently introduced to soften the blow to builders in particular. Still, we do not expect housing to resume its torrid growth.

Challenging demographics will persist, with the country's fertility rate tentatively plummeting even further during the pandemic.

President Xi's recent reappointment to an unprecedented third five-year term is also arguably a growth-negative development, in part because political administrations tend to become stale when they retain power for too long, and in part because the government's priorities are not growth-friendly. The administration's three key goals are political control over the society, pursuing a more assertive foreign policy and returning power from corporations back to the state. The last of these is a particularly significant reversal from the strategy that allowed China's economy to grow so impressively over recent decades. The "animal spirits" that might normally drive productivity growth have been greatly diminished after several crackdowns on technology entrepreneurs.

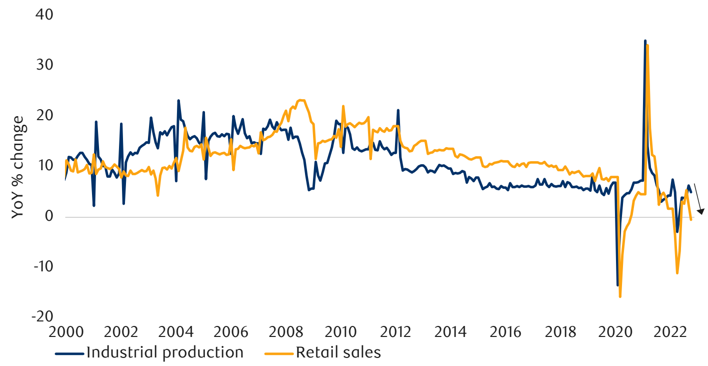
Whereas the Chinese economy once rollicked along at 10%+ annual growth and was still capable of sustaining a 6% rate prior to the pandemic, it is now on track for no more than 3% growth this year and may well have suffered a permanent decline in its potential growth rate to no more than 3% to 4% even after the pandemic restrictions have faded. This clip is not bad in an absolute sense, but will greatly slow the rate at which China approaches developed-world living standards, and also suppress the rate at which the global economy can expand.

Exhibit 35: Chinese consumer sentiment nosedived since Shanghai lockdown



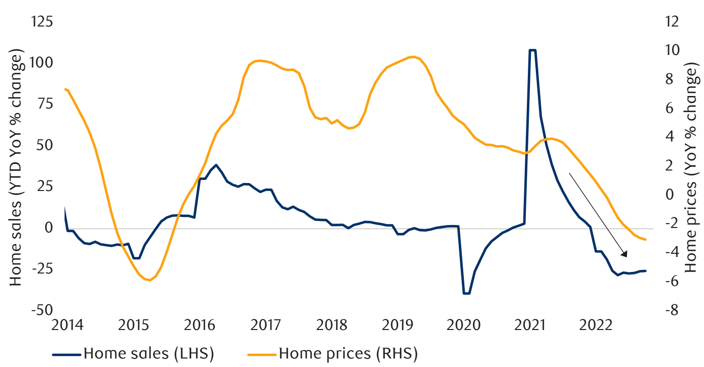
Note: As of Sep 2022. Source: China National Bureau Statistics, Macrobond, RBC GAM

Exhibit 36: Chinese retail sales beaten down by zero-COVID



Note: As of Oct 2022. Source: China National Bureau Statistics, Macrobond, RBC GAM

Exhibit 37: China's property sector hit hard by government crackdown



Note: As of Oct 2022. Home price change is an average of price changes in primary and secondary markets. Source: China National Bureau of Statistics, Macrobond, RBC GAM

Elevated uncertainty

It is undoubtedly a time of elevated uncertainty. Market volatility is an acknowledgement of the large number of powerful economic forces currently playing a vigorous game of tug of war.

There are a number of downside risks that loom large over global markets. We believe the world can avoid returning to a 1970s-esque decade of high inflation, but there is a small chance that a reprise materializes. It seems unlikely and certainly ill-advised that China would attack or lay siege to Taiwan in the short run, but this could happen. We believe the world can avoid a financial crisis, but the recent sharp increase in borrowing costs has already exposed points of vulnerability in a range of leveraged institutions including British pension funds. It is not impossible that further problems could be in store, whether from unravelling cryptocurrency empires, opaque private markets, or somewhere else.

But there are also problems that could work out better than we expect. It is hard to fathom the economic situation in China getting much worse for long, whereas it could get much better if pandemic and economic policies continue to change. A cease-fire between Russia and Ukraine is unlikely but conceivable given the damage being wrought to both parties.

While we have informed opinions on where inflation, the economy and central banks should go, none of these outcomes are assured. There are risks that extend in both positive and negative directions around these key variables. Of particular note, we highlight the chance that inflation declines more quickly than the consensus assumes. While not our base-case forecast, it is distinctly possible that economies continue to hold up better than expected, much as the U.S. has over the second half of 2022. This combination would be catnip for both stocks and bonds.

Bottom line

The global economy remains in a challenging place. Inflation is too high, borrowing costs are rising and growth is slowing. Things are worse in Europe and the U.K. than in North America.

But there is evidence of incremental improvement. Inflation has begun to decline, and we believe the trend can continue. Accordingly, central banks may not have to tighten quite as much, and could even be in a position to partially unwind monetary tightening by the second half of 2023.

We continue to believe a recession is coming, but with slightly less conviction than a few months ago, and with the recognition that a recession with fewer job losses than normal and without a decline in nominal GDP may not feel quite so bad, even if the shrinkage in real output ends up being significant.

While one could be excused for focusing exclusively on the next several quarters given the key developments anticipated, it is also worth gazing out over the next few years with the recognition that economic prospects should improve over that time horizon. Inflation is likely to be significantly lower, an economic recovery should take hold by late 2023 or 2024 – permitting robust growth for several years thereafter, and investment asset classes of almost every description promise superior returns over a multi-year horizon given today's depressed valuations.

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