RBC Global Asset Management

Executive summary

FALL 2023

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The global economy has been resilient and a variety of challenges stemming from the pandemic have become less severe. But the lagged impact of aggressive monetary tightening, in our view, is still likely to eventually push the economy into recession and, in an environment of heightened macroeconomic uncertainty, substantial risk taking is unwarranted and patience is critical.

Growth remains positive for now, but headwinds are likely to dominate

Most major economies have continued to expand so far this year and some of the key risks to growth have diminished. Inflation has moderated from an extreme, stress in the U.S. regional-banking system has eased, risk assets have rallied and North America's housing market rebounded in the spring. But offsetting this long list of positives is the fact that the most critical headwinds have intensified. China's economic rebound from late last year is fizzling as the world's second-largest economy struggles despite attempts by policymakers to stimulate growth. Moreover, short-term interest rates have risen even further than previously anticipated in the developed world and are now at decidedly restrictive levels not experienced in over two decades. The full effect of tightening monetary conditions typically slows the economy with a significant lag, with the implication that the window for a recession may just now be starting to open. As a result, we continue to expect a recession in most of the developed world over the year ahead, though its contours should be mild in depth and short in duration. Our GDP growth forecasts have mostly been raised for 2023 and lowered for 2024, reflecting better-than-expected economic data during the summer and the deferral of the start of the anticipated recession from the third quarter of 2023 to the fourth quarter. Our 2024 growth forecasts remain below the consensus.

Inflation trend remains favourable

U.S. consumer inflation peaked at 9% in mid-2022 and has since cooled toward 3% as the four main drivers of high inflation have all turned. The commodity-price surge following Russia's invasion of Ukraine has reversed, supply-chain problems have mostly been resolved, monetary policy has moved from extreme accommodation to a restrictive stance and fiscal policy has become far less stimulative. While inflation has declined relatively quickly during the past year, further material improvements toward the 2.0% target will prove more difficult in the near term as gasoline prices have rebounded in recent months and base effects will be less favourable. Nevertheless, we remain optimistic with regard to the medium-term inflation outlook and believe that inflation can fall faster than the consensus expectation, aided in part by weaker economic conditions, to just above 2.0% by next year.

Dollar detour: how short-term factors have interrupted the cyclical decline

The U.S.-dollar downtrend remains intact and we continue to expect significant U.S.-dollar weakness over the coming years. However, the long-term cyclical decline embedded in our outlook has run into a few shorter-term roadblocks, and so its progress has been slower than we had anticipated. While the dollar sits roughly 7% below its September 2022 peak, the currency is unchanged since the start of 2023. Higher U.S. interest rates and disappointing economic growth abroad have interrupted the dollar's slide in 2023. Still, emerging-market currencies as a whole have fared impressively – a few even managing double-digit returns so far this year – and the euro, Canadian dollar and British pound have also outperformed the U.S. dollar. We remain optimistic on most emerging- and developed-market currencies over the next 12 months, as we expect the U.S. dollar to decline broadly.

Rate-hiking cycle is drawing to a close, and cuts are likely over the year ahead

Central banks are now near or already across the finish line in their monetary-tightening journeys. Emerging-market central banks have been leading the way, raising rates before the developed world during this cycle, and some have now pivoted to delivering rate cuts. It is not unreasonable to think that central banks in the developed world may follow suit within the next year. Our model suggests the neutral U.S. fed funds rate is currently 3.4%, but if inflation continues to decline in line with our forecast, that neutral reading falls to around 2% in 12 months. As a result, and in combination with our recession forecast, it seems unlikely that the fed funds rate will remain at an elevated 5.5% for an extended period. This view is in line with pricing in the futures market, which flags the possibility of one more 25-basis-point hike by the end of this year, followed by the start of an interest-rate cutting cycle beginning in early 2024.

Sovereign bonds offer attractive return potential, minimal valuation risk

Government-bond yields have climbed to their highest levels since just before the 2008/2009 global financial crisis and at this point represent attractive value. According to our models, much of the acute valuation risk that so worried us in 2020 and 2021 has dissipated with last year's painful bond sell-off. With bond yields now at a much higher starting point, the economy likely to weaken and inflation pressures capable of moderating further over the coming year, we believe the risk of capital losses in sovereign bonds is minimal and forecast lower bond yields and thus higher bond prices ahead. As a result, sovereign fixed-income assets are the most appealing they have been in many years and we expect that government bonds will deliver returns in the mid to high single digits over the year ahead, with some regions even capable of low double-digit returns.

Equity-market gains have been dominated by U.S. mega-cap technology

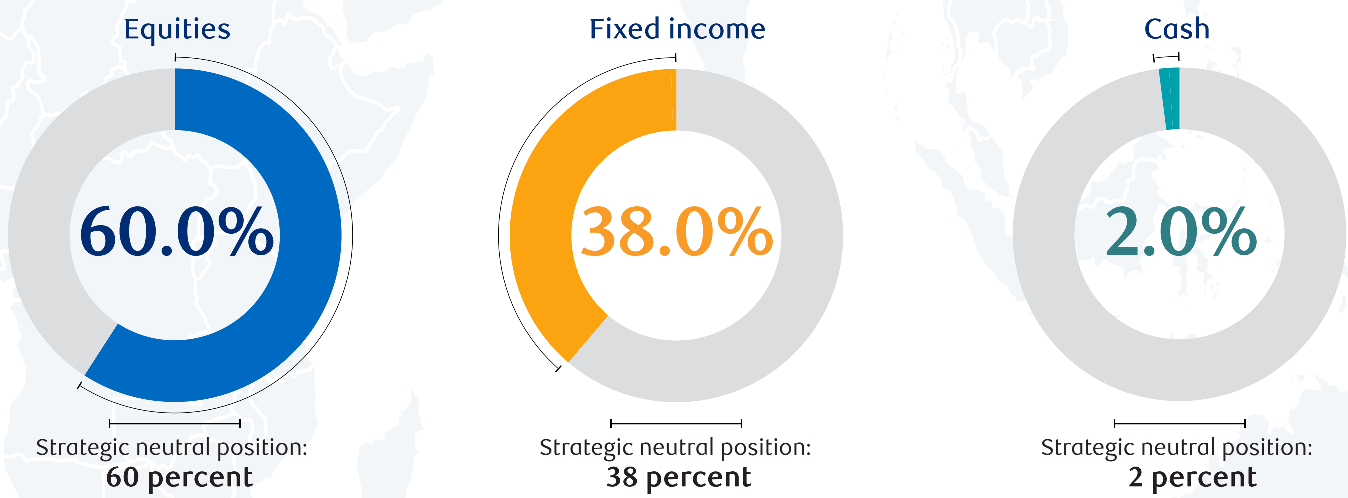
Global stocks extended their gains in the past quarter, but their performance so far this year has been increasingly concentrated to just a handful of names. The "Magnificent 7" – the largest U.S. publicly listed companies – have benefited tremendously from emerging trends in artificial intelligence (AI), which have propelled valuations of these stocks to especially demanding levels. The group now makes up over a quarter of the S&P 500 Index's market capitalization and has delivered outsized gains of 70% so far this year, contributing to almost three quarters of the S&P 500's 17% gain over that period. Returns offered by the rest of the market, however, pale in comparison. The equal-weighted S&P 500, a better representation of how the average stock has performed, is up just 5.8%. As a result, the performance of the S&P 500 is masking the fact that underlying market breadth has been relatively poor – often an indication that the economy is struggling or set to weaken. Although global equity-market valuations are not unreasonable, earnings are vulnerable to a contraction in economic activity, which limits the potential upside in stocks. In this late-cycle environment, we are looking for low-to-mid-single-digit returns for stocks, with relatively worse outcomes from U.S. equities due to their higher valuations and the influence of expensive mega-cap technology names that could falter if the economy entered a downturn.

Asset mix – maintaining neutral allocation

Assuming we are correct in our view that the economy is likely to enter recession over the next 12 months, interest rates, bond yields and stock prices could all be closing in on near-term peaks. While there are pathways to a positive outcome for the economy and markets if an economic soft landing is achieved, we think the reward for taking substantial risk in this environment is not as appealing as it would have been at earlier points in the cycle. Further supporting this view is the fact that the premium offered on stocks versus bonds is at its lowest level in nearly two decades. As a result, we have been gradually dialing down the equity overweight position in our asset mix over the past 18 months, balancing these near-term risks with the asset class's long-term upside potential. We have used those proceeds to narrow our prior underweight in fixed income as rising yields boosted the appeal of sovereign bonds, whose current elevated yields should provide a better ballast against any downturn in equities. Last quarter, we completed the process of fully closing our tactical risk exposures. This quarter, we maintain that neutral stance relative to our benchmark weights. For a balanced global investor, we currently recommend an asset mix of 60% equities (strategic neutral position: 60%) and 38% fixed income (strategic neutral position: 38%), with the balance in cash. Actual fund or client portfolio positioning may differ depending on individual investment policies.

Recommended asset mix

RBC GAM Investment Strategy Committee



Note: as of August 31, 2023. Source: RBC GAM

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