

JULY 21, 2022

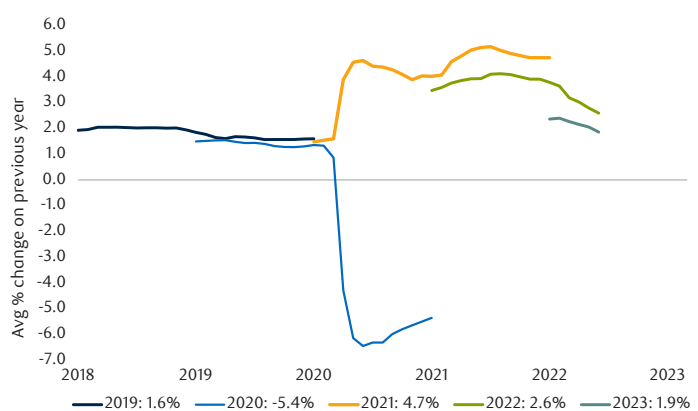
Inflation fears ease, but recession concerns intensify

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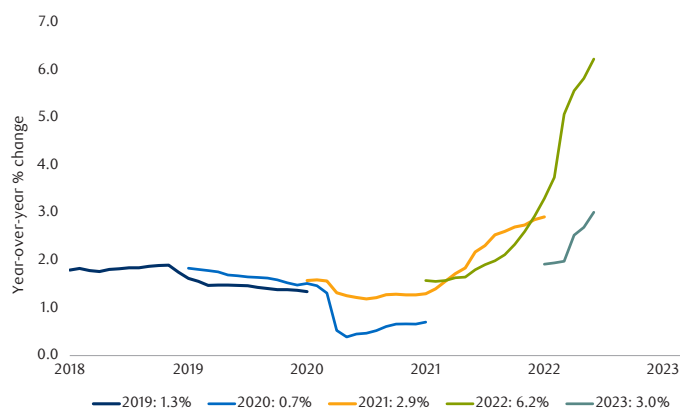
One of the biggest challenges for economies and markets this year has been the sudden surge in inflation, but there is mounting evidence that it could soon be peaking. Supply-chain troubles are being gradually resolved, shipping rates and commodity prices have declined, inventories are increasing and demand is falling in the face of higher costs. Helping to curb price increases is the fact that central-bank tightening is now well underway and fiscal support is fading. In recent weeks, risk assets have responded fairly well to the notion that perhaps the worst of the inflation fears may be behind us. But as inflationary pressures appear to be easing, signs of recession are intensifying. Consumer and business confidence have waned, economic activity is slowing and challenges related to the Ukraine war, the coronavirus and energy shortages remain. We continue to believe that the risk of a recession is elevated but if one does occur, we expect a contraction of middling size. Our forecasts are below the consensus for growth and above consensus for inflation (exhibits 1 and 2).

Exhibit 1: Growth estimates for major developed nations – Growth estimates for major developed nations



Note: As of July 2022. Source: Consensus Economics

Exhibit 2: Weighted average consensus CPI
Inflation estimates for major OECD nations



Note: As of July 2022. Source: Consensus Economics

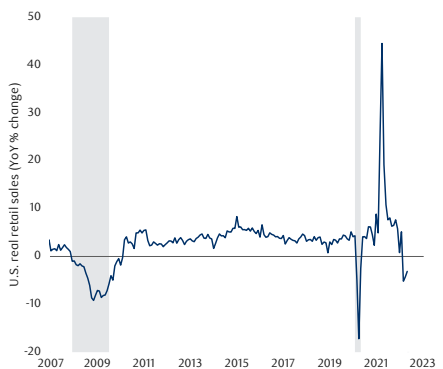
Economic data softens

Since the start of the year, investors and consumers have been growing increasingly pessimistic about the outlook for the economy, and in the past quarter we have started to see concrete evidence that the economy is indeed slowing. U.S. retail sales, on a real or after-inflation basis, are now contracting compared with a year ago, and declining consumer spending is atypical outside of recessions (Exhibit 3). Rising

borrowing costs are also posing a headwind to the economy, but could be especially problematic for the interest-rate-sensitive real estate market where home sales have been falling for almost a year and at an accelerating pace since the start of 2022 (Exhibit 4). Economic data, in general, has been relatively disappointing since May 2022 as evidenced by the fall in economic surprise indices to their lowest readings since the early days of the pandemic (Exhibit 5).

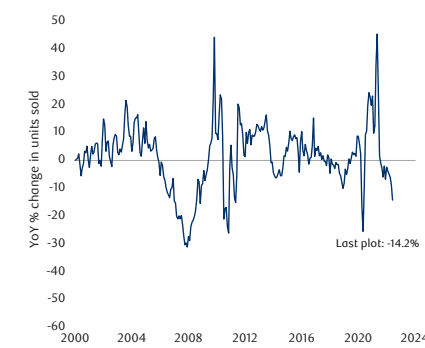
Exhibit 3: U.S. real retail sales

Year-over-year % change



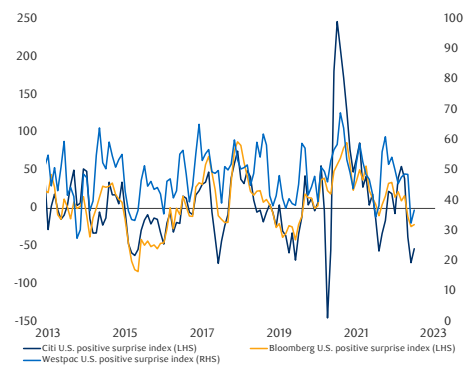
Note: As of May 2022. Shaded area represents recession. Source: BEA, Macrobond, RBC GAM

Exhibit 4: U.S. housing – sales of existing homes – Total existing home sales



Note: As of June 30, 2022. Source: National Association of Realtors

Exhibit 5: United States Economic surprise indices



Note: As of July 20, 2022. Source: Bloomberg, RBC GAM

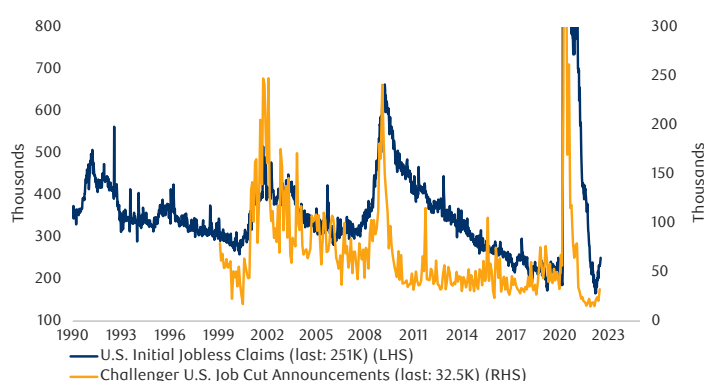
Labour market weakening from a strong position

The incredibly hot labour market that has been a feature of the current economic cycle is showing signs of cooling. Unemployment claims and job-cut announcements have been inching higher since the spring and these trends, while at historically low levels, can be difficult to reverse once established (Exhibit 6). In just the past few weeks, several large U.S. companies have announced their intentions to curtail hiring. Moreover, the NFIB U.S. small-business survey

reveals that even though small companies intend to expand their workforces, they have scaled back their hiring plans and revenue expectations (Exhibit 7). The labour market is in fairly solid shape at the moment, but its resilience could be tested in an environment where more and more companies become worried about the outlook for the broader economy and their own businesses, potentially leading to widespread hiring freezes and/or outright job cuts.

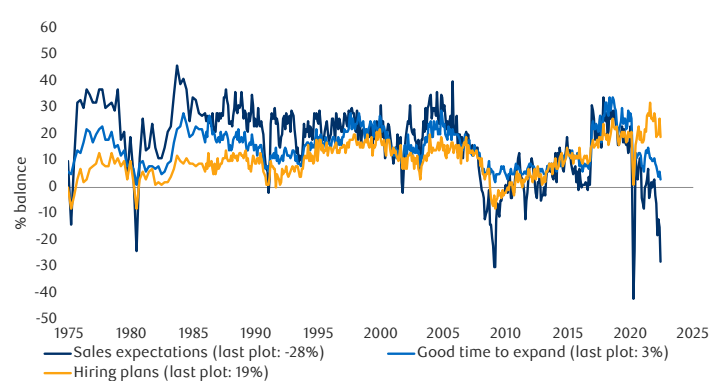
Exhibit 6: U.S. labour market

Unemployment claims and job cuts



Note: As of July 21, 2022. Source: Bloomberg, RBC GAM

Exhibit 7: U.S. small business survey



Note: As of June 30, 2022. Source: NFIB, BCA Research, Bloomberg, RBC GAM

Inflation could be peaking

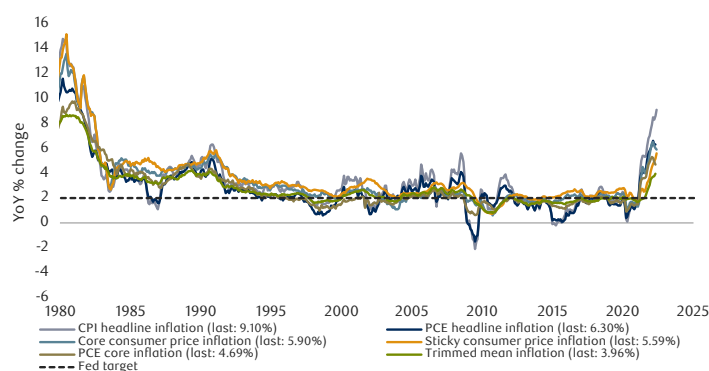
There are a variety of reasons why we could expect U.S. headline CPI inflation to decline from the 40-year high of 9.1% reached in June. For one, we do not expect consumer prices to continue rising at the blistering pace that they have over the past year. While a variety of inflation metrics have been trending higher in recent months, the core measures which exclude food and energy from their calculations have already been trending down gradually since February/March of this year (Exhibit 8). There have also been some fairly large drops in commodity prices and shipping costs. Exhibit 9 plots the Baltic Dry Freight Index and copper spot prices, which dropped 63% and 34% from their respective highs. Oil prices are down about 20% from their recent peak and the cost of lumber has declined 60% as the surge in construction demand during the pandemic has wound down. All of these

recent declines has resulted in a recalibration of inflation expectations. The expected average inflation rate over the next 10 years based on pricing in the fixed-income market is now 2.40%, down from slightly over 3.00% in the spring, and the 2-year inflation number has dropped to 3.25% from a high of nearly 5% in March (Exhibit 10). Although these reduced inflation expectations are still above the U.S. Federal Reserve's 2% target, they are much more manageable.

Central banks push ahead with aggressive rate hikes

Short-term interest rates are still well below the levels that many models suggest they should be even considering that inflation could be peaking. Our own model suggests 5.00% is the appropriate level for the fed funds rate today and this estimate falls to 3.1% in five years' time as the near-term inflation spike ultimately subsides (Exhibit 11). But the

Exhibit 8: U.S. inflation measures



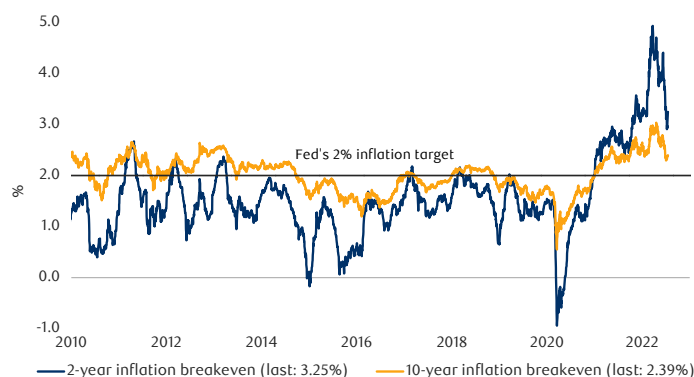
Note: As of June 30, 2022. Source: Bloomberg, RBC GAM

Exhibit 9: Shipping costs and copper price



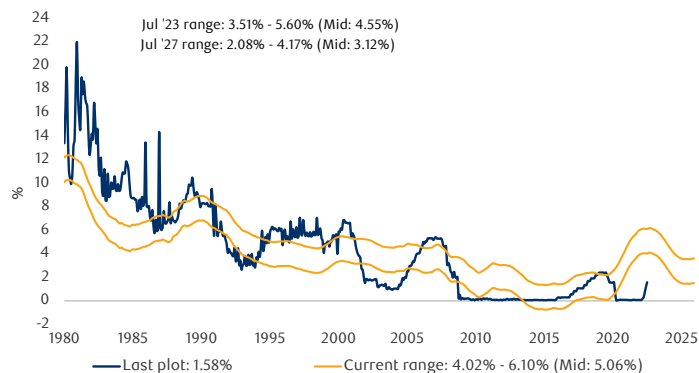
Note: As of July 15, 2022. Source: Bloomberg

Exhibit 10: U.S. Treasuries inflation breakevens



Note: As of Jul 20, 2022. Source: Bloomberg, RBC GAM

**Exhibit 11: U.S. fed funds rate
Equilibrium range**



Note: As of Jul 19, 2022. Source: Federal Reserve, RBC GAM

current fed funds rate is between 1.50% and 1.75%, so it still has a lot further to rise. This view is in line with the market's pricing in of nearly 200 basis points in increases from now until February 2023, which would bring the fed funds rate to around 3.50% (Exhibit 12). More than one 75-basis-point hike is expected and it's not impossible to envision even larger hikes than that, as demonstrated by the Bank of Canada's jumbo-sized 100-basis-point-hike on July 13. The European Central Bank also raised interest rates by 50 basis points on July 21, its first hike in more than a decade and the largest increase in 20 years. While central banks are clearly motivated to raise interest rates rapidly in the near term, what's likely most important for investors is the level at which rates settle over the longer term – i.e. the terminal rate. Interestingly, market pricing suggests that the fed funds rate will top out in early 2023 and eventually decline to around 3.0%, a longer-term expectation that has been relatively stable over the past several months. That said, market pricing can adjust meaningfully as we have seen so far this year, and the ultimate course for interest rates will depend on whether inflation comes down fast enough to reduce the need for further aggressive tightening.

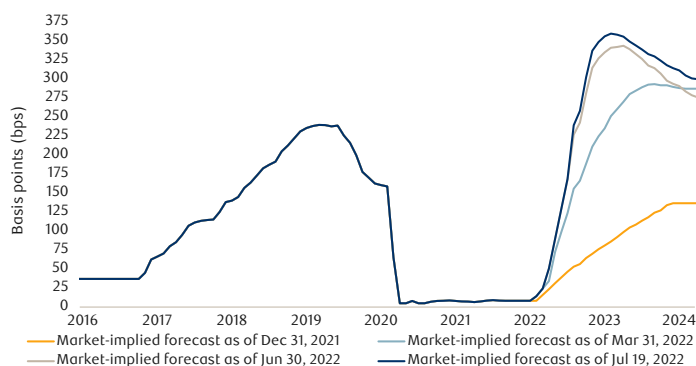
Yield curve inverts once again

The push and pull between inflation pressures and recession concerns has resulted in the yields of longer-dated maturities falling below those of shorter-term maturities. The U.S. 10-year yield peaked at 3.5% in mid-June, but has fallen back toward 3.0% as inflation fears subsided and the threat of recession increased. The U.S. 10-year yield remains below our modelled estimate of equilibrium in the short term, but remains appropriately situated, based on our five-year equilibrium band, once inflation pressures subside. But yields on shorter-term maturities have continued to increase as large rate hikes are being priced in over the near term, with the U.S. 2-year yield rising to 3.2%. As a result, the yield curve, proxied by the spread between 2-year and 10-year Treasuries, has inverted for the second time since April and sits at its most negative reading since 2000 (Exhibit 14). Inversions in the yield curve are worth noting because they've preceded each of the last six recessions back to 1980.

Credit markets rebounded after steep sell-off

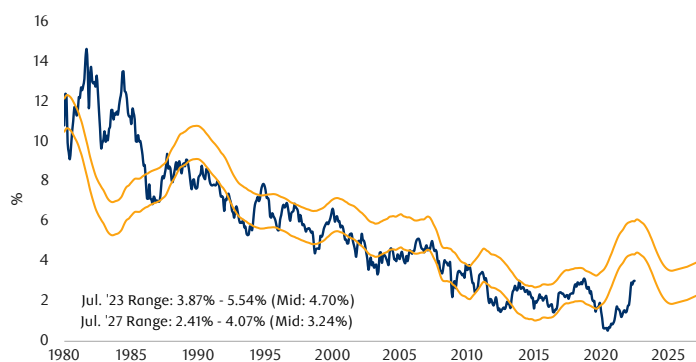
After a significant sell-off in the first half of the year, corporate bonds found support in July as falling inflation expectations enticed investors to take on more risk. Spreads on U.S. high-yield and investment-grade bonds have narrowed to around 100 and 15 basis points, respectively, since the beginning of July and are currently hovering around their long-term averages (Exhibit 15). The health of credit markets can often be used as a signal for equity markets

Exhibit 12: Implied fed funds rate
12-months futures contracts



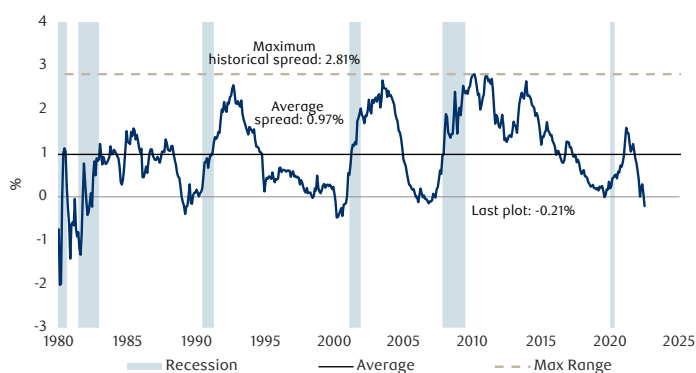
Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 13: U.S. 10-year T-Bond yield
Equilibrium range



Note: As of July 20, 2022. Source: RBC GAM

Exhibit 14: U.S. Treasury yield curve
Spread between yield on 10-year and 2-year maturities



Note: As of July 19, 2022. Source: Bloomberg, RBC GAM

since they are both affected by the outlook for earnings. The rally in corporate bonds, if sustained, could bode well for stocks.

Equity markets find support

Stock prices have stabilized somewhat since mid-June as equities rebounded from oversold conditions. U.S. large-cap growth stocks, in particular, were among the hardest hit groups in the first half of 2022, with the NASDAQ down as much as 34% from its peak before rebounding (Exhibit 16). The S&P 500 has also enjoyed a decent rebound, up 8% from its recent low. Outside of the U.S., however, many markets continue to struggle given the recent weakness in commodity prices and the negative impact of a strong U.S. dollar.

Although the macro environment is highly uncertain, valuation risk has been significantly reduced as a result of the

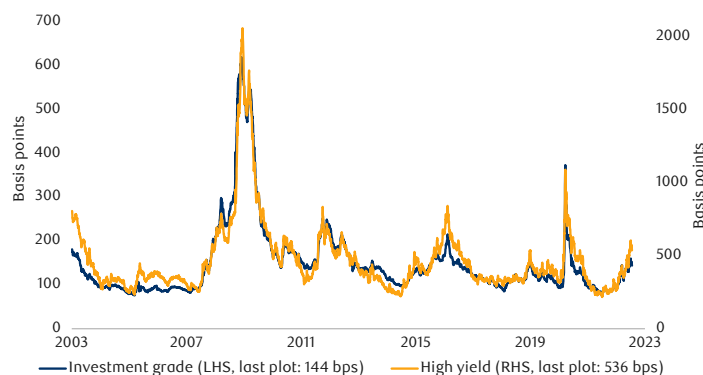
sell-off in the first half of the year, setting up improved return potential going forward. Our composite of global valuations suggests that the entire overvaluation that existed in stocks at the beginning of the year has been erased (Exhibit 17), and if we exclude the S&P 500, valuations in non-U.S. markets now trade at relatively attractive discounts to fair value. At these levels, stocks could well be positioned to deliver attractive returns in the event that inflation calms and investor confidence improves.

Earnings in focus with Q2 reporting underway

S&P 500 companies have begun reporting earnings for the second quarter, and the results have so far been better than expected. As of the time of this writing, 12% of S&P 500 companies have reported second-quarter results and 78% of them have exceeded analysts' estimates (Exhibit 18).

Exhibit 15: U.S. corporate bond spreads

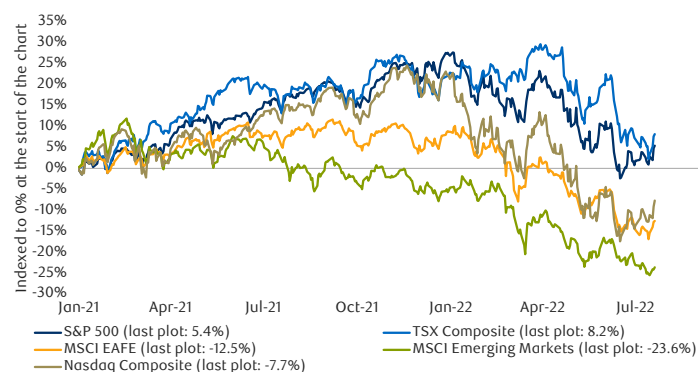
Difference with U.S. 10-year Treasury yield



Note: As of July 19, 2022. Source: Barclays Capital, Bloomberg, RBC GAM

Exhibit 16: Major equity market indices

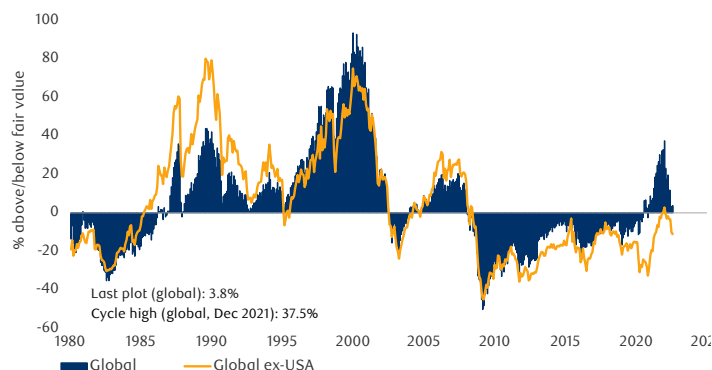
Cumulative price returns indices in USD



Note: As of July 20, 2022. Price returns computed in USD. Source: Bloomberg, RBC GAM

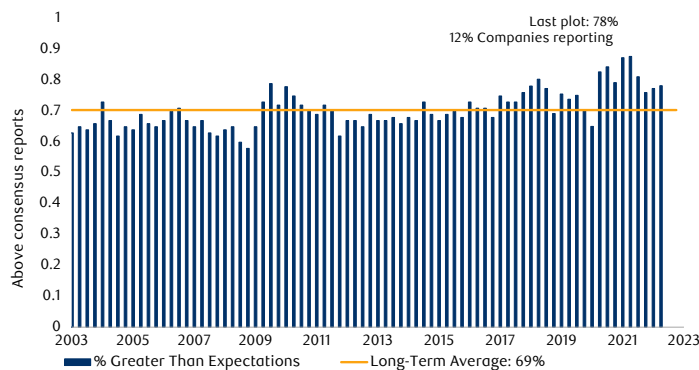
Exhibit 17: Global stock market composite

Equity market indexes relative to equilibrium



Note: As of July 19, 2022. GDP-weighted average of RBC GAM fair value models for a variety of countries. 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 18: Companies reporting results above consensus forecasts



Note: As of July 19, 2022. Source: Refinitiv

However, downward revisions in company earnings forecasts have been much more common and have intensified in the past two months (Exhibit 19). That said, the magnitude of the revisions has been fairly small so far and the overall consensus earnings estimate for the S&P 500 has held up relatively well. Exhibit 20 plots the trajectory for S&P 500 earnings through the end of 2024 based on consensus estimates. Profit growth of 10% is estimated for this year, followed by another 9% next year and 8% in 2024, bringing S&P 500 earnings per share to US\$248 by the end of 2023 and US\$268 by the end of 2024. Although these estimates are encouraging, they seem inconsistent with the challenging economic backdrop and elevated risk of recession. Should a recessionary scenario unfold, our base case would be for profits to decline as much as 25% which is the average earnings decline during past recessions.

Growth stocks extend gains relative to value stocks

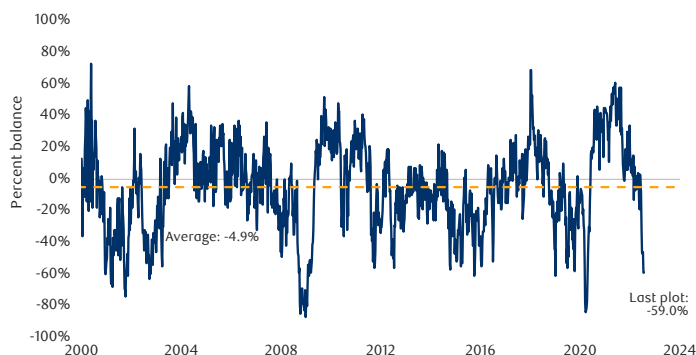
The combination of slowing economic growth and potential peaks in the U.S. dollar, the 10-year yield and inflation offer a good setup for a rotation into growth stocks, especially after they had sold off so much earlier in the year. From December to May, the S&P 500 Growth Index underperformed the S&P 500 Value Index by 24 percentage points as inflation accelerated, bond yields rose and the U.S. dollar gained. Since late May, however, growth stocks have outperformed value stocks by almost nine percentage points (Exhibit 21). Investors may be finding growth stocks more appealing once again after the substantial bear market eased valuation concerns, and yields stopped rising as inflation fears moderated. Moreover, the challenging macro environment could make earnings growth more scarce, which ultimately boosts the attractiveness of growth stocks given their solid track record of increasing profits.

Asset mix – positioning remains close to neutral

The macro backdrop is highly uncertain and the economy is encountering a slowdown as central banks deliver an extremely rapid tightening of monetary conditions to combat the highest inflation in decades. The war in Ukraine, energy shortages and the coronavirus are other potential sources of volatility. We believe that the risk of recession is elevated and, in this environment, think that the range of potential outcomes is unusually large. That said, we recognize that valuations for both stocks and bonds have improved meaningfully as the expectation that central banks would hike aggressively has already largely been priced in. As a result, bond yields have risen to levels that we think offer

Exhibit 19: U.S. equities

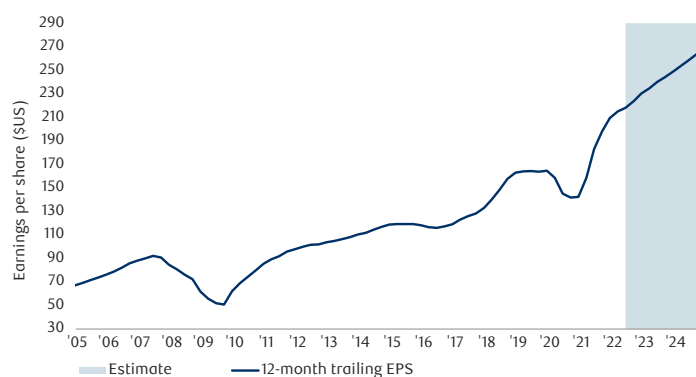
Companies with upward earnings revisions



Note: As of July 19, 2022. Source: Citi, RBC GAM

Exhibit 20: S&P 500 Index

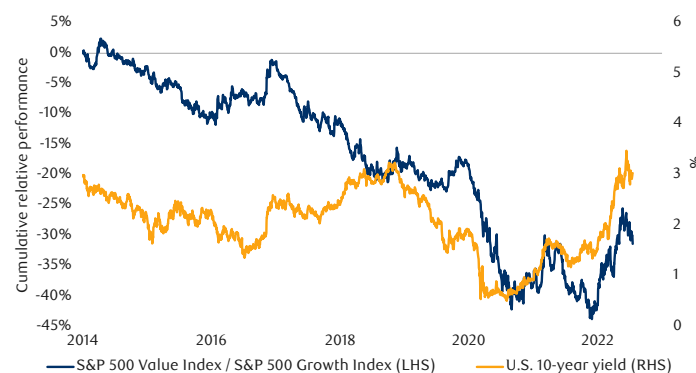
12-month trailing earnings per share



Note: As of July 20, 2022. Estimate is based on a consensus of industry analysts' bottom-up expectations.
Source: Thomson Reuters, RBC GAM

Exhibit 21: Value to growth relative performance

S&P 500 Value Index / S&P 500 Growth Index

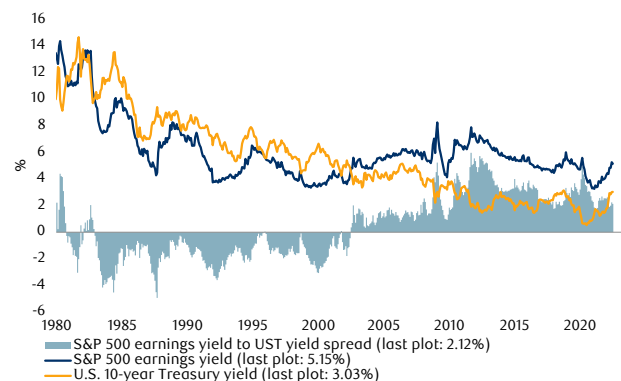


Note: As of July 20, 2022. Source: Bloomberg, RBC GAM

decent return potential and, perhaps more importantly, ballast against equities in the event of a further downturn in stocks. We still believe that stocks will outperform bonds over the longer term given that a risk premium still exists, but that the premium is not as appealing as it was when bond yields were at much lower levels at the start of the year (Exhibit 22). Moreover, we recognize that the corporate-profit outlook embedded in analysts' estimates is highly optimistic and could be vulnerable to significant downgrades should a recession unfold. Balancing these risks and opportunities, we are opting to keep our asset mix closer to neutral, with only a slight bias to risk-taking given the equity risk premium that still exists. Our current recommended asset mix for a global balanced investor is 61.5% equities (strategic: "neutral": 60%), 37.5% bonds (strategic "neutral": 38%) and 1.0% in cash.

Exhibit 22: S&P 500 earnings yield

12-month trailing earnings/index level



Note: As of July 19, 2022. Source: RBC GAM, RBC CM

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