RBC Global Asset Management

JANUARY 2023

Navigating the path forward in 2023

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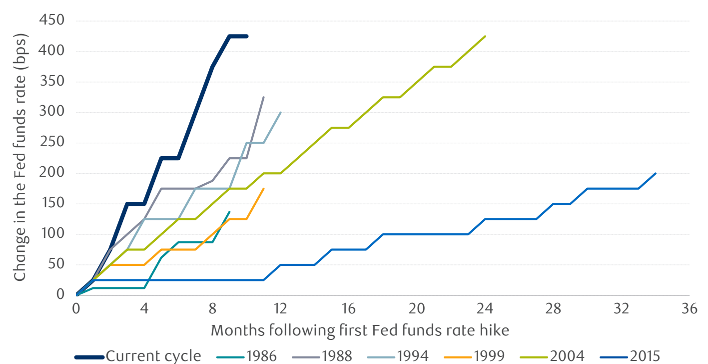
Financial markets just came through one of their most challenging periods on record, with both fixed income and equity markets simultaneously posting double-digit declines, driving the traditional 60/40 balanced portfolio to its worst result since 1939. While investors and economists generally acknowledged the risks related to extraordinarily low interest rates and elevated equity-market valuations in late 2021/early 2022, the biggest challenge for markets was the speed and scale of change in the macro-economic environment. So where do we go from here? We believe that the key for investors as we begin 2023 is to focus on where markets are going, not on where they have been.

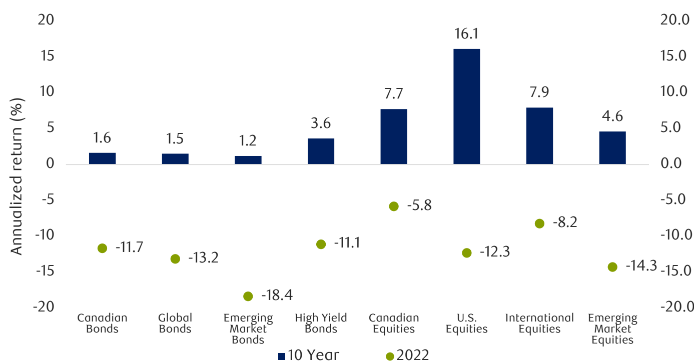
The global economy enjoyed an extraordinary recovery after the pandemic-induced recession and the world was on track to getting back to a state of normalcy. However, that backdrop swiftly changed at the beginning of 2022 as central banks acknowledged the need for tighter monetary conditions to combat problematically high inflation. Unprecedented fiscal stimulus and extremely accommodative monetary policy, pent-up demand from pandemic lockdowns and disruptions in global supply chains and the spike in energy prices caused by Russia's invasion of Ukraine all contributed to unacceptably higher prices. As a result, many central banks embarked on their most aggressive tightening cycle in four decades (Exhibit 1). Financial markets became extremely volatile as they adjusted to high inflation and rising interest rates, resulting in a drastic reset in valuations across many asset classes (Exhibit 2).

Exhibit 1: The most aggressive Fed hiking cycle in decades – Path of the Fed funds rate following first rate hike



Note: As of January 16, 2023. Source: RBC GAM

Exhibit 2: A great reset of returns in 2022
10-year returns vs. 2022



Note: As of December 31, 2022. Canadian Bonds = FTSE Canada Universe Bond Index, Global Bonds = FTSE WGBI (Hedged to CAD), Emerging Market Bonds = JP Morgan EMBI Global Diversified (Hedged to CAD), High Yield Bonds = ICE BofA BB-BUS High Yield Index (CAD Hedged), Canadian equities= S&P/TSX Composite Index, US equities = S&P 500 Index, International equities = MSCI EAFE TR Index, Emerging Market equities = MSCI Emerging Market Index. All returns in CAD and do not reflect transaction costs, investment management fees or taxes. Past performance is not a guarantee of future results. Source: RBC GAM

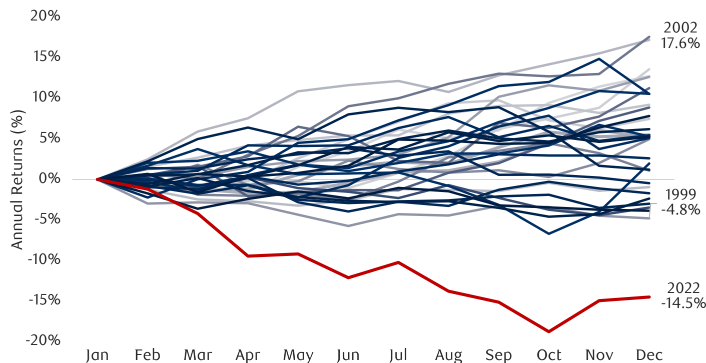
While the past year has certainly been a painful period for many investors, we believe that valuations in both stocks and bonds were pulled down to more reasonable levels in 2022, providing a relatively more attractive starting point as we navigate the path forward in 2023.

Historic sell-off in bonds has moved yields to more sustainable levels

Historically, bonds have provided ballast in a multi-asset portfolio, acting as a safe-haven asset during periods of equity market volatility. That changed in 2022 as bonds endured their worst sell-off in 40 years over a short period of time (Exhibit 3). This past year feels even worse when you consider that bond investors have benefited from strong returns over the last several decades.

The silver lining is that bond investors now face a different scenario than they had at the beginning of 2022 as bonds are no longer considered expensive and the outlook for returns is much more appealing (Exhibit 4). Central bankers have done a good job of getting interest rates to levels needed to temper inflation and our models now suggest the distance between where interest rates are and where they should be has narrowed significantly. That said, there is still uncertainty around inflation and the plan for central bank rate hikes so some caution is still warranted.

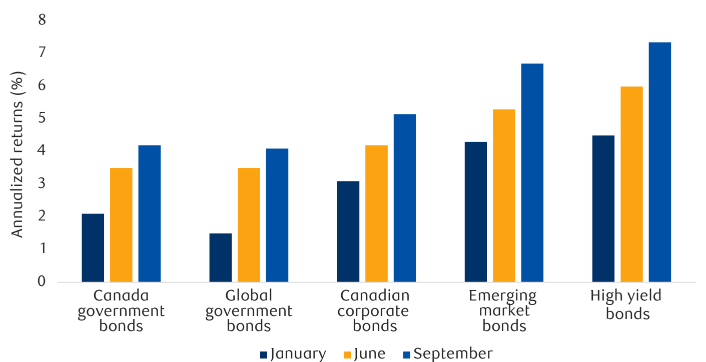
Exhibit 3: Bonds endured a historic selloff in 2022
Calendar-year returns



Note: As of December 31, 2022. Calendar year returns for the Bloomberg Global Aggregate Bonds Index ($CAD) as of Jan 1, 1990. Source: RBC, Bloomberg.

The good news is that the need for further significant tightening appears to be receding and there are a variety of indicators suggesting that inflation is calming and likely to trend lower. Our own fixed income models suggest that if

Exhibit 4: Improved return expectations for bonds
10-year expected returns



Note: As of September 30, 2022. Returns are annualized. 10-year expected returns are RBC GAM 10-year expected return forecasts. The above does not reflect transaction costs, investment management fees or taxes. Past performance is not a guarantee of future results. Source: RBC GAM

inflation calms as we expect, the equilibrium level for the U.S. 10-year yield could fall to 3.4% in five years. With this in mind and following the surge in yields over the last year, we believe that sovereign bonds now offer their most compelling return potential since the onset of the global financial crisis.

At today's higher levels of yields, bonds also now offer greater protection against falling stock prices in the event of an economic downturn. As a result, we are maintaining larger allocations to fixed income than we have in the past, but remain slightly underweight against our strategic neutral weight given our view that stocks offer superior return potential over the longer term. We recognize, however, that if inflation does not recede as we expect, the potential for higher yields remains a possibility in the near term.

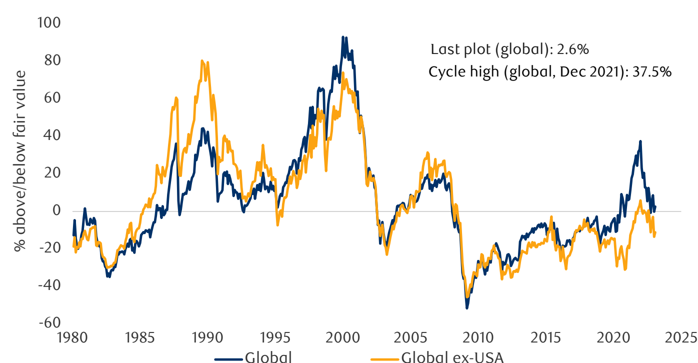
Valuation risk moderates in equities, though vulnerability in earnings remains

Equity markets also encountered tremendous volatility throughout 2022 with many entering bear markets during the summer after reaching new highs in late 2021. Earlier in the year, we de-risked our portfolios by reducing our overweight to equities, positioning our equity weight much closer to our neutral position than we have had at earlier stages of the expansion. That said, we shifted our stance slightly in early October and added back 50 basis points to our equity allocation at a time when stocks had slipped to cycle lows and technical indicators suggested they were oversold.

What is the path forward for equites in 2023? Much like bonds, stocks are now much more reasonably priced compared to late 2021/early 2022. Our composite of global equity valuations fell below fair value in late 2022 for the first time since March 2020 (Exhibit 5). Although the S&P 500 remains above fair value, albeit only slightly so, stocks outside of the U.S. have reached especially attractive discounts to their respective fair values.

Our current view is that the bulk of the inflation adjustment and resulting correction to valuations has worked its way through equity markets, but questions remain about the potential impact that a recession could have on earnings. Weaker economic growth has historically not been supportive for corporate profits. Given that earnings are still above their long-term trend and companies are facing headwinds from rising costs and slowing economic activity, earnings estimates are vulnerable to further downside in the near term. While stocks rose toward the end of the fourth quarter, we believe that clarity on earnings is needed before stocks can move meaningfully higher from here.

Exhibit 5: Global stock market composite
Equity market indexes relative to equilibrium



Note: As of January 17, 2023. Source: RBC GAM

Periods like these have been rare

The past year has been a difficult period for investors. The speed and magnitude of changes to markets was unprecedented, and both stocks and bonds fell in tandem, making this period particularly challenging for balanced investors.

> "Even though the past year has been challenging and the path forward remains uncertain, our return expectations are much more favourable than they were at this time last year. "

Exhibit 6: Years where stocks and bonds have both fallen are rare

Annual returns since 1950

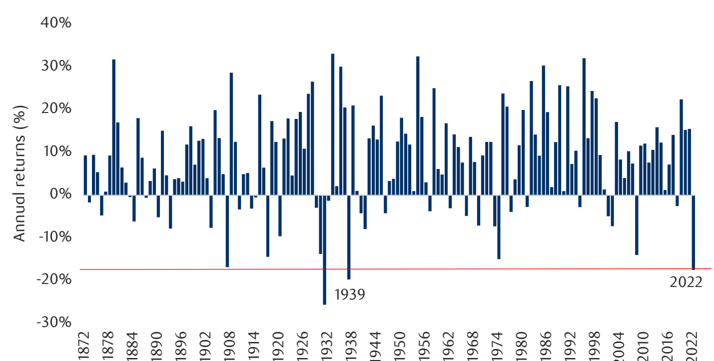
	U.S. 10-year Treasuries	S&P 500 Index		U.S. 10-year Treasuries	S&P 500 Index		U.S. 10-year Treasuries	S&P 500 Index
1950	0.5%	29.9%	1974	2.5%	-26.6%	1998	14.4%	28.2%
1951	-0.2%	24.1%	1975	3.9%	37.1%	1999	-7.7%	20.8%
1952	2.3%	18.3%	1976	16.5%	23.5%	2000	17.2%	-9.2%
1953	4.3%	-1.2%	1977	1.5%	-7.5%	2001	5.6%	-11.9%
1954	3.1%	52.1%	1978	-0.1%	6.2%	2002	15.0%	-22.1%
1955	-1.1%	31.3%	1979	2.1%	18.1%	2003	0.0%	28.6%
1956	-2.2%	6.5%	1980	1.9%	32.0%	2004	4.6%	10.9%
1957	7.0%	-10.9%	1981	0.9%	-5.2%	2005	2.8%	4.9%
1958	-2.2%	43.2%	1982	34.9%	21.3%	2006	2.2%	15.7%
1959	-2.4%	11.8%	1983	2.0%	22.3%	2007	10.4%	5.4%
1960	11.5%	0.4%	1984	14.1%	6.0%	2008	20.6%	-37.0%
1961	2.1%	26.7%	1985	28.6%	31.5%	2009	-10.3%	26.3%
1962	5.7%	-8.8%	1986	20.9%	18.5%	2010	7.8%	15.0%
1963	1.8%	22.6%	1987	-2.9%	5.1%	2011	16.2%	2.0%
1964	3.8%	16.3%	1988	6.7%	16.3%	2012	2.8%	15.8%
1965	0.7%	12.3%	1989	17.4%	31.3%	2013	-8.6%	32.2%
1966	3.1%	-10.2%	1990	7.4%	-3.3%	2014	10.4%	13.6%
1967	-1.6%	23.8%	1991	18.3%	30.3%	2015	1.1%	1.4%
1968	3.1%	10.9%	1992	7.0%	7.6%	2016	0.1%	11.9%
1969	-5.0%	-8.5%	1993	12.1%	9.3%	2017	2.7%	21.7%
1970	17.4%	3.9%	1994	-7.8%	0.6%	2018	0.4%	-4.4%
1971	9.8%	14.3%	1995	25.2%	36.7%	2019	9.2%	31.3%
1972	3.0%	18.9%	1996	0.0%	22.3%	2020	10.5%	18.4%
1973	4.0%	-14.8%	1997	11.8%	32.8%	2021	-4.2%	28.6%
						2022	-16.4%	-18.1%

Note: as of December 31, 2022. Data since January 1950. Source: Robert J. Shiller, RBC CM, RBC GAM

It is worth noting that periods like the one we have just been through are rare. Since 1950, there has been only one other instance (1969) where stocks and bonds were both down over a calendar year (Exhibit 6). Going back even further, the drawdowns exhibited by both bonds and stocks in 2022 contributed to the worst year for a traditional 60/40 balanced portfolio since 1939 (Exhibit 7).

What does all of this mean for a long-term balanced investor? Even though the past year has been challenging and the path forward remains uncertain, our return expectations are much more favourable than they were at this time last year. Given the lower starting point for both stocks and

Exhibit 7: Annual returns for a Balanced Portfolio



Note: as of December 31, 2022. Sample portfolio consists of 60% U.S. Equites, 40% Treasuries with no rebalancing. Source: Robert J. Shiller, RBC GAM

bonds, our forecast annualized return over the next decade for a balanced portfolio has risen to 7.0% (Exhibit 8), an improvement from the 4.9% that we had penciled in at the start of last year, though still slightly below its long-term average of 7.4%. We are also seeing an improvement in the return expectations for our more conservative profiles, where our return expectation for a very conservative portfolio has improved to 5.5% from 3.4% at the beginning of 2022.

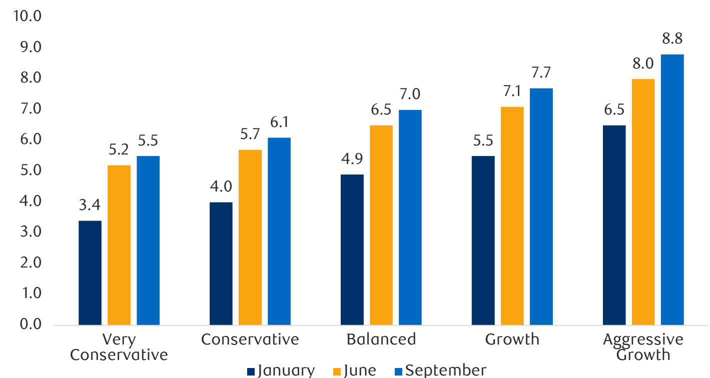
Navigating the path forward in 2023 and beyond

Looking forward, the macro environment remains highly uncertain. While we are optimistic for the future and there are a variety of positive scenarios for investors, we believe a cautious approach to risk-taking in the near-term remains appropriate and this is reflected in our asset mix.

We continue to reflect a fairly neutral stance in our portfolio positioning. The global economy continues to slow and we think that recession is more likely than not at some point over our one-year forecast horizon. That said, economic indicators have shown more resilience in the past few months suggesting that the expected depth of recession may be shallower than initially feared.

Over the longer term, we expect that stocks will continue to offer superior return potential versus fixed income and we remain slightly overweight stocks and underweight bonds as a result. Our moderate tilt towards risk allows us flexibility to take advantage of volatility and opportunities as they arise in 2023 and beyond.

Exhibit 8: 10-year annualized expected returns by profile



Note: as of September 30, 2022. Returns are annualized. 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 Total Return Index, U.S. equities = S&P 500 Total Return Index (CAD), European equities = MSCI Europe Total Return Net Index (CAD), Asia Pacific ex-Japan equities = MSCI AC Asia Pacific ex Japan Total Return Net Index (CAD), Japanese equities = MSCI Japan Total Return Net Index (CAD), Emerging Market equities = MSCI Emerging Markets Total Return Net Index (CAD). 10-year expected returns are RBC GAM 10-year expected return forecasts. The above does not reflect transaction costs, investment management fees or taxes. Past performance is not a guarantee of future results. Source: RBC GAM

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Publication date: January 19, 2023

(01/2023)

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