RBC Global Asset Management

Market Update

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Bank stress takes centre stage

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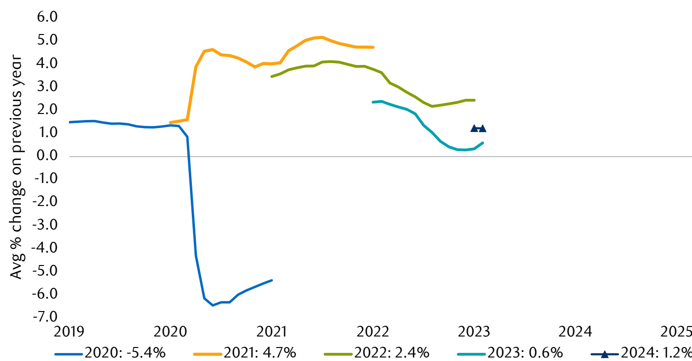
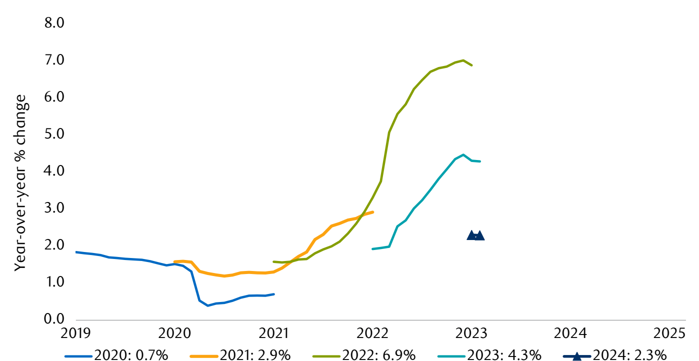
Cracks in the financial system have started to appear and investors are concerned that challenges in the banking system could be a sign of worse things to come for the broader economy. The troubles began several weeks ago when losses on fixed-income investments at Silicon Valley Bank (SVB) triggered a run on deposits and worries about the health of other regionals banks. The focus then shifted to Europe, where doubts about the health of Credit Suisse fanned financial-market volatility. Investor fears calmed somewhat after Swiss regulators demanded Credit Suisse's acquisition by UBS, and central banks stepped in to offer ample liquidity for banks and depositors. While the immediate problems have so far been dealt with, the strain on the financial system has prompted us to budget for further economic weakness. We think the macroeconomic backdrop has become increasingly uncertain and that events over the past few weeks serve as a reminder of the negative, and lagged, impact of the past year's massive interest-rate increases, which could weigh on the economy over the next year. In our view, caution remains warranted and we continue to expect developed-world economies to fall into recession over the next year. Our forecasts for growth and inflation both remain below the consensus (exhibits 1 and 2).

Exhibit 1: Weighted average real GDP
Growth estimates for major developed nations



Note: As of March 2023. Source: Consensus Economics

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



Note: As of March 2023. Source: Consensus Economics

Policymakers provide ample liquidity

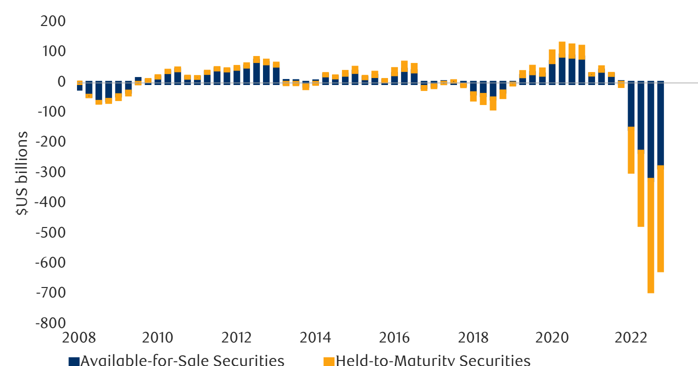
A major factor causing stress in the financial system has been the significant decline in values of government fixed-income investments – often those considered the very safest - on the back of rapidly rising interest rates. U.S. banks are sitting on nearly US$700 billion of unrealized investment losses and, while Treasuries that were purchased at lower yields would still return their full value at maturity, forced selling of bonds before maturity at higher interest rates would crystalize losses (Exhibit 3). To the extent that these assets were earmarked against deposits represents a threat if depositors suddenly decide to withdraw their money in large quantities, as was the case in the days leading up to the collapse of SVB.

To prevent SVB's collapse from causing ripple effects in the broader financial markets, the U.S. Federal Reserve (Fed) stepped in to provide as much liquidity as needed to ensure the continued and smooth operation of the financial system. The Fed opened up an emergency lending facility that enabled banks to borrow up to the par value of their bonds rather than their current depressed market values. More than US$300 billion of this facility has been tapped in just the past two weeks, more than double the amount used during the initial COVID-19 crisis and three quarters of what was taken up during the 2008 financial crisis (Exhibit 4). The use of this lending facility seems so far to have addressed the demand for immediate liquidity that is critical for upholding the confidence of investors, individuals and businesses that their hard-earned savings and working capital is safe and accessible. The Bank of England (BOE) and European Central Bank (ECB) have also expressed a willingness to provide liquidity to European banks, and U.S. Treasury Secretary Janet Yellen has floated the idea that the government could back uninsured deposits if required.

Inflation remains unacceptably high

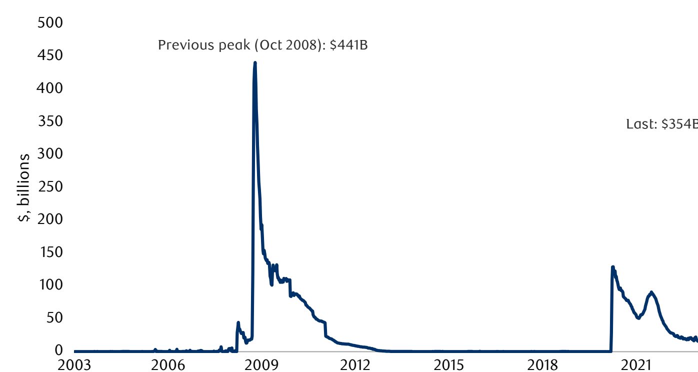
Ample liquidity is being provided to appease financial-system stresses, but central banks have made it clear they don't want to lose sight of their fight against inflation. Inflation remains unacceptably high at as much as two to three times the Fed's 2.0% targeted level (Exhibit 5) depending on which measure is being observed. Moreover, the resilience of the labour market has been impressive, suggesting that demand could remain elevated and that price pressures will be more difficult to suppress. The U.S. unemployment rate remains near its lowest level in history and, although job gains have slowed over the past year, the monthly pace of job creation has

Exhibit 3: Bank unrealized gains (losses) on investment securities



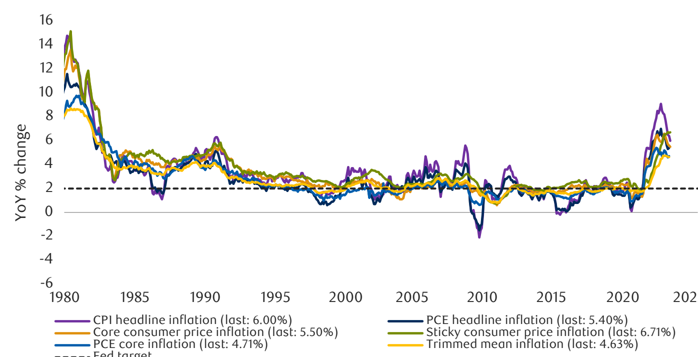
Note: As of September 30, 2022. Source: FDIC, Macrobond, RBC GAM

Exhibit 4: Total loans provided by the Federal Reserve



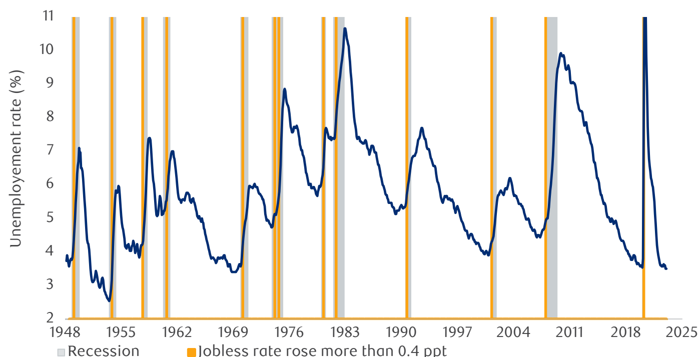
Note: As of March 22, 2023. Source: Federal Reserve, Bloomberg, RBC GAM

Exhibit 5: U.S. inflation measures



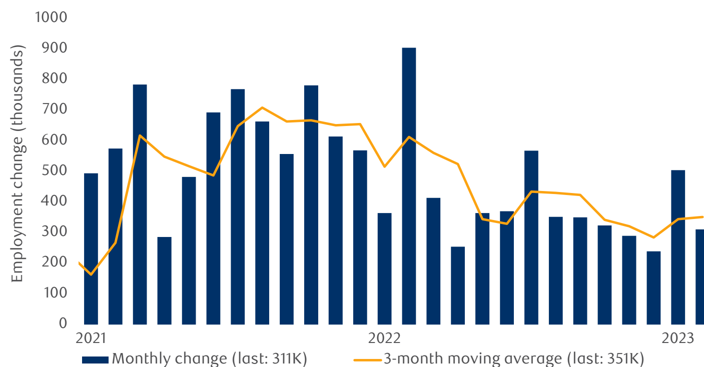
Note: As of February 28, 2023. Source: Bloomberg, RBC GAM

Exhibit 6: U.S. unemployment rate
3-month moving average



Note: As of February 2023. Unemployment rate is 3-month moving average.
Source: Bureau of Labor Statistics, NBER, Macrobond, RBC GAM

Exhibit 7: U.S. labour market



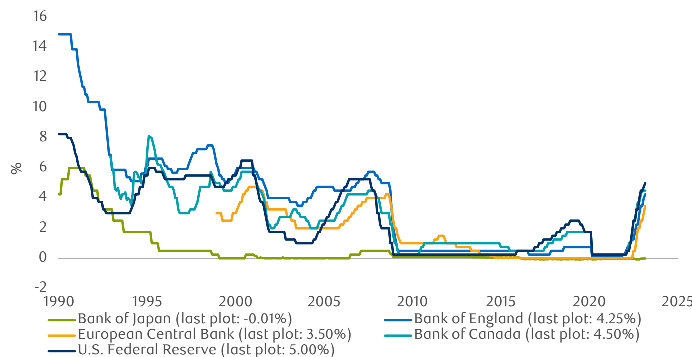
Note: As of February 28, 2023. Source: Bureau of Labor Statistics, RBC GAM

accelerated in the past three months (exhibits 6 and 7). Given the underlying strength of the labour market and the fact that inflation remains elevated, the risk is that central banks will let their feet off the brakes too soon and in doing so fail to bring inflation back to target in a reasonable timeframe.

Central banks deliver more rate hikes, nearing end of tightening cycle

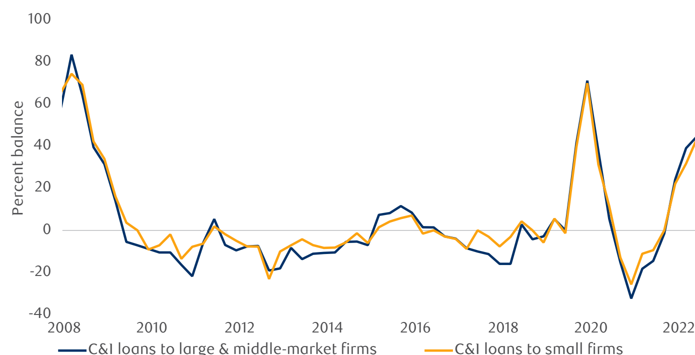
Central banks have pushed ahead with planned interest-rate increases, but investors are skeptical that further tightening is necessary and even expect rate cuts in the near term. Last week, the ECB raised interest rates by 50 basis points, and the BOE and the Fed each delivered 25-basis-point hikes, bringing short-term interest rates to their highest in 15 years (Exhibit 8). However, interest rates could be nearing their peak in the cycle, especially given that SVB-related stress in the banking system will elicit added regulatory scrutiny and effectively operate as a form of monetary tightening (Exhibit 9). Powell has acknowledged that the recent events related to SVB could equate to some amount of rate hikes but has not assigned a number to it. The market is hazarding a guess, though, and in the week following SVB's collapse, expectations for the fed

Exhibit 8: Short-term interest rates
Central bank key lending rates



Note: As of March 24, 2023. Source: Bloomberg, RBC GAM

Exhibit 9: Senior loan officer survey on bank lending practices – Loan officers reporting tightening lending standards



Note: As of December 31, 2022. C&I stands for to Commercial and Industrial.
Source: Federal Reserve, Macrobond, RBC GAM

funds rate were ratcheted lower by approximately 150 basis points over the year ahead (Exhibit 10). That is to say that the fed funds rate has, in the view of investors, already peaked, and that they anticipate an interest-rate cut by this summer.

Bond yields plunge on risk aversion, reduced rate outlook

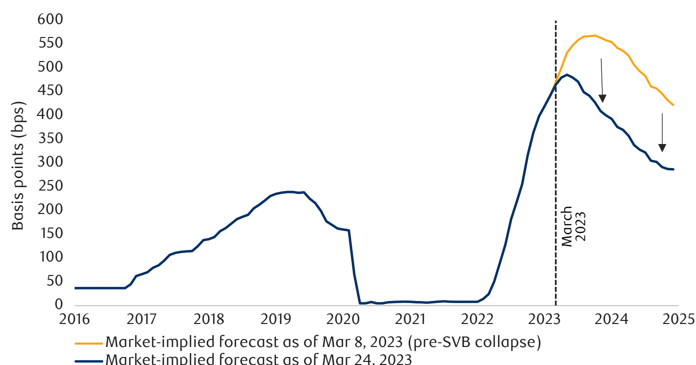
The slump in government-bond yields that occurred in March, particularly at the short end of the yield curve, reflects less confidence in central-bank ability to raise rates amid slowing growth and heightened uncertainty. The U.S. 10-year yield fell to 3.37% from 4.05% earlier this month, and our equilibrium model suggests that yields could have further to fall if inflation continues to decline as we expect (Exhibit 11).

Moreover, volatility in yields has been extreme. The 2-year Treasury yield fell to 3.79% from 5.07% at the start of March, with wild intra-day swings spanning more than 50 basis points since SVB's collapse (Exhibit 12). As a result, the yield curve experienced a "bull steepening," which occurs when shorter-term yields fall faster than those on longer-term bonds, a phenomenon that typically occurs when investors anticipate a recession and imminent rate cuts (Exhibit 13).

Signs of stress in credit markets appear isolated so far

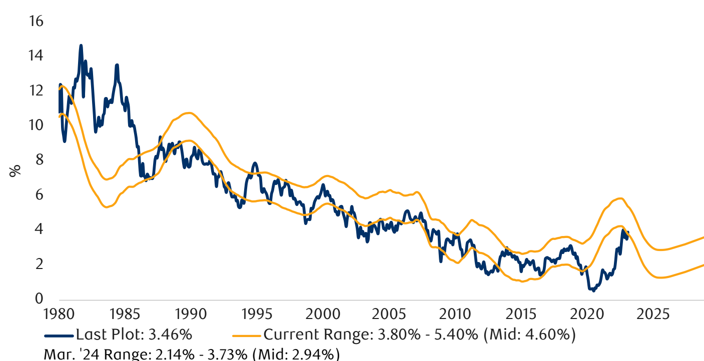
Even with banks encountering trouble, signs of stress in credit markets appear fairly tame and isolated in companies that have problems unique to them. Spreads on U.S. high-

Exhibit 10: Implied fed funds rate
12-months futures contracts



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

Exhibit 11: U.S. 10-year T-Bond yield
Equilibrium range

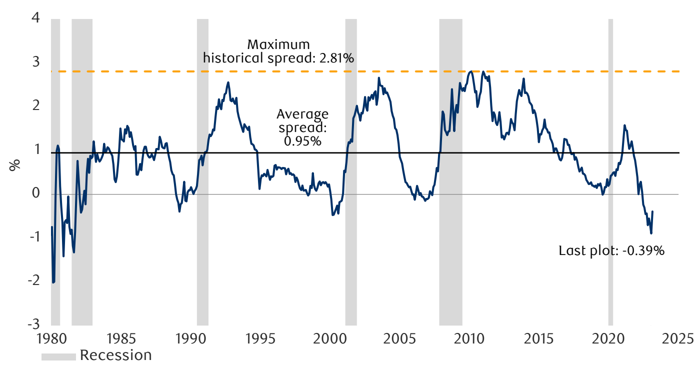


Note: As of March 27, 2023. Source: RBC GAM

Exhibit 12: U.S. 2-year yield
Daily candlestick chart

Note: As of March 24, 2023. Candlesticks represent daily open/high/low/close for the U.S. 2-year yield. Source: Bloomberg, RBC GAM.

Exhibit 13: U.S. Treasury yield curve
Spread between yield on 10-year and 2-year maturities



Note: As of March 24, 2023. Source: Bloomberg, RBC GAM

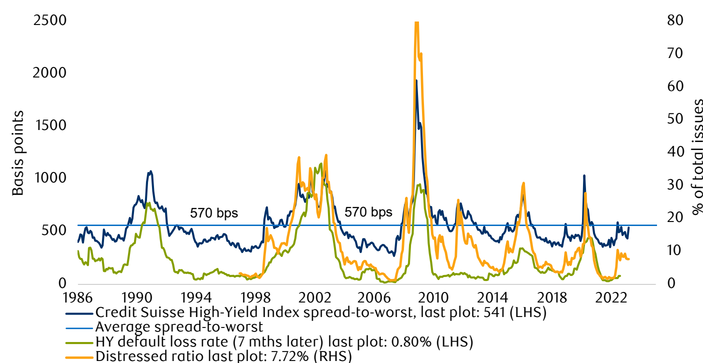
yield bonds have inched a bit higher but remain below their long-term average, suggesting that investors are not overly concerned with the ability of most companies to service their debts (Exhibit 14). This relatively calm behaviour in credit markets has not been the case in Europe, though the stress was most predominantly observed with regards to Credit Suisse. The cost of insuring against a default by Credit Suisse, as measured by credit-default swap spreads (CDS spreads), soared to record levels on March 16 at more than quadruple the peaks seen during the global financial crisis and the European debt crisis two years later (Exhibit 15). As demands for deposit withdrawals intensified at Credit Suisse, and given the importance of this bank to the global financial system, the Swiss National Bank provided emergency liquidity of over US$50 billion to Credit Suisse, ultimately leading to the UBS takeover.

Under the UBS purchase agreement, Credit Suisse shareholders received about US$3.2 billion and holders of US$17 billion of Credit Suisse contingent convertible bonds (i.e. “CoCos”) were written down to zero, spurring concerns over the riskiness of instruments that emerged as popular capital-raising tools from the debris of the 2008 financial crisis. Also known as Additional Tier 1 capital (AT1), CoCos are fixed-income securities that can get converted to equity or, as was the unique case with Swiss banks, canceled to shore up bank balance sheets in the event that their capital ratios fall below key thresholds.

The write-off has caused significant concern for the broader US$275 billion AT1 market because while holders of Credit Suisse’s AT1 bonds received nothing in the UBS transaction, Credit Suisse equity holders received some consideration for their stock (Exhibit 16) – a capital allocation that appeared to flip the calculus that debt investors should get seniority

> “Estimates for S&P 500 earnings have declined gradually month by month and analysts now expect zero profit growth in 2023 versus 2022.”

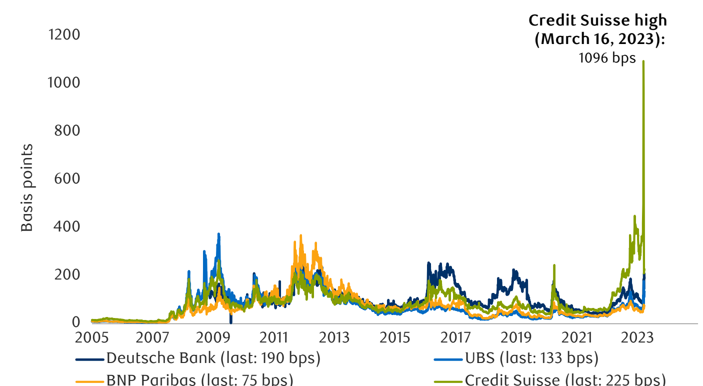
Exhibit 14: High yield bond spread



Note: As of March 17, 2023. Source: BofAML, Credit Suisse, RBC GAM

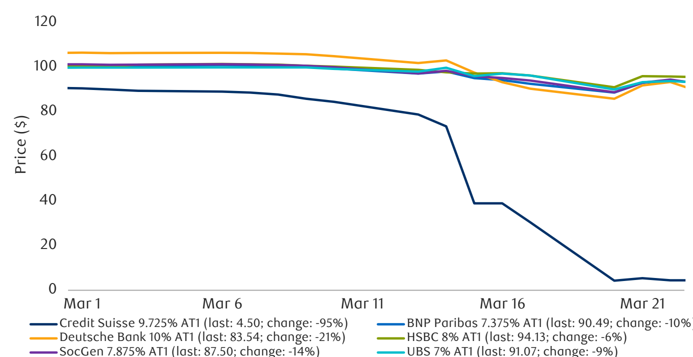
Exhibit 15: European prime brokers

5-year CDS spreads



Note: As of March 23, 2023. Source: BMO, Bloomberg, RBC GAM

Exhibit 16: European bank AT1 bond prices



Note: As of March 24, 2023. Price change calculated using the price as at February 28, 2023. Source: Bloomberg, RBC GAM

over stockholders in a distressed situation. But the ECB and the BOE reiterated that the full write-down of AT1 securities in this instance was exceptional and due to a Swiss provision that was written into terms of the Credit Suisse prospectus. Policymakers in these jurisdictions reassured investors that they could expect AT1 securities to have seniority over equity holders. This message resulted in boost in confidence and rebound in AT1 securities and risk assets more broadly.

Stock-market volatility picked up, but major indices have proven resilient

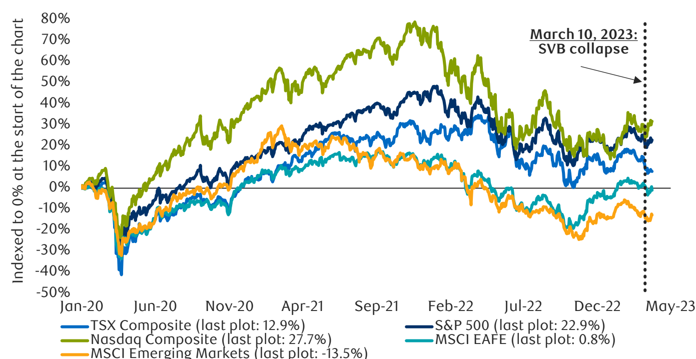
Equity markets have been highly volatile since the troubles surfaced at SVB, but major indices have held up relatively well and are for the most part little changed over the past month. Since the start of March, the S&P 500 is flat, the MSCI EAFE is up 1% and the technology-heavy NASDAQ is up 3% (Exhibit 17). Emerging-market equities are down 2% and the TSX, which is more heavily weighted to financials, has lagged and is down 4% so far in March. The fact that major indices have been resilient suggests that financial-market stress has been contained to the subset of stocks most affected by the financial troubles. Moreover, according to our models, global equities remain reasonably valued and regions outside the U.S. are trading at particularly attractive levels relative to their fair value (exhibits 18 and 19).

Big shifts within equity markets beneath the surface

Although stocks have held up at the index level, much has changed beneath the surface. Many of the market-positive themes that emerged since late 2022 have stalled or reversed. Among sectors, Financials have seriously underperformed, with the KBW Bank Index falling 28% in March, and its relative strength versus the S&P 500 declining to its lowest level on record (Exhibit 20). Investment styles have also experienced

Exhibit 17: Major equity market indices

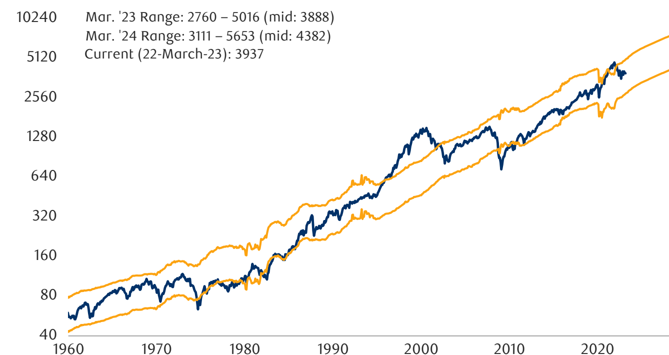
Cumulative price returns indices in USD



Note: As of March 24, 2023. Price returns computed in USD. Source: Bloomberg, RBC GAM

Exhibit 18: S&P 500 equilibrium

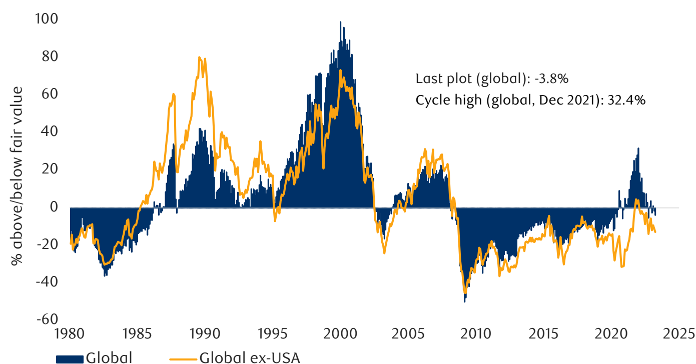
Normalized earnings & valuations



Source: RBC GAM

Exhibit 19: Global stock market composite

Equity market indexes relative to equilibrium



Note: As of March 24, 2023. Source: RBC GAM

Exhibit 20: Relative strength

Philadelphia (KBW) Bank Index relative to S&P 500

Note: As of March 24, 2023. Source: RBC GAM, RBC CM

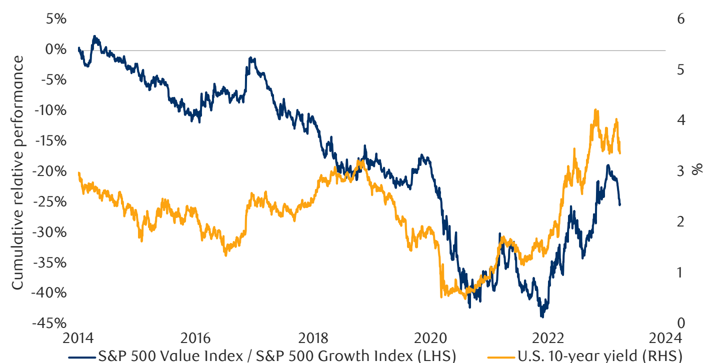
major changes. Value stocks, which led for most of the past year amid rising interest rates, have been underperforming since the start of 2023 and most notably in the past month (Exhibit 21). Smaller-cap stocks have also lost significant ground to large-caps, as evidenced by the S&P 500 Equal Weight Index giving back all gains relative to the S&P 500 cap-weighted index since the start of 2022 (Exhibit 22). These changes in trend, at the margin, could suggest that investors are positioning defensively in favour of large-cap growth stocks that tend to do better in an environment where economic growth is likely to slow.

Corporate profits vulnerable to further downgrades

One reason we think the upside in stocks is limited in the near term is that the corporate-profit outlook has been deteriorating and could worsen even further. Estimates for S&P 500 earnings have declined gradually month by month and analysts now expect zero profit growth in 2023 versus 2022 (Exhibit 23). In our view, these estimates still don't reflect the high probability of a recession and we think that these profit forecasts are vulnerable to further reductions, especially given the troubles that have emerged in the banking system.

Exhibit 21: Value to growth relative performance

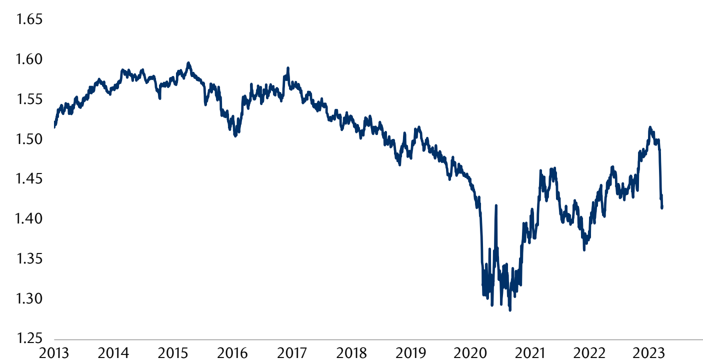
S&P 500 Value Index / S&P 500 Growth Index



Note: As of March 24, 2023. Source: Bloomberg, RBC GAM

Exhibit 22: S&P 500 Index breadth

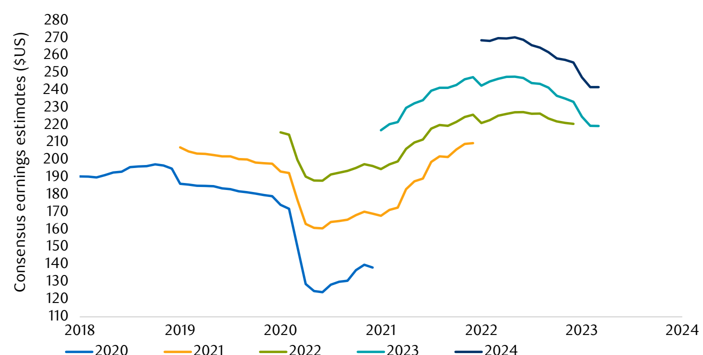
Equal-weighted index / cap-weighted index



Note: as of March 24, 2023. Source: Bloomberg, RBC GAM

Exhibit 23: S&P 500 Index earnings estimates

Consensus earnings estimates



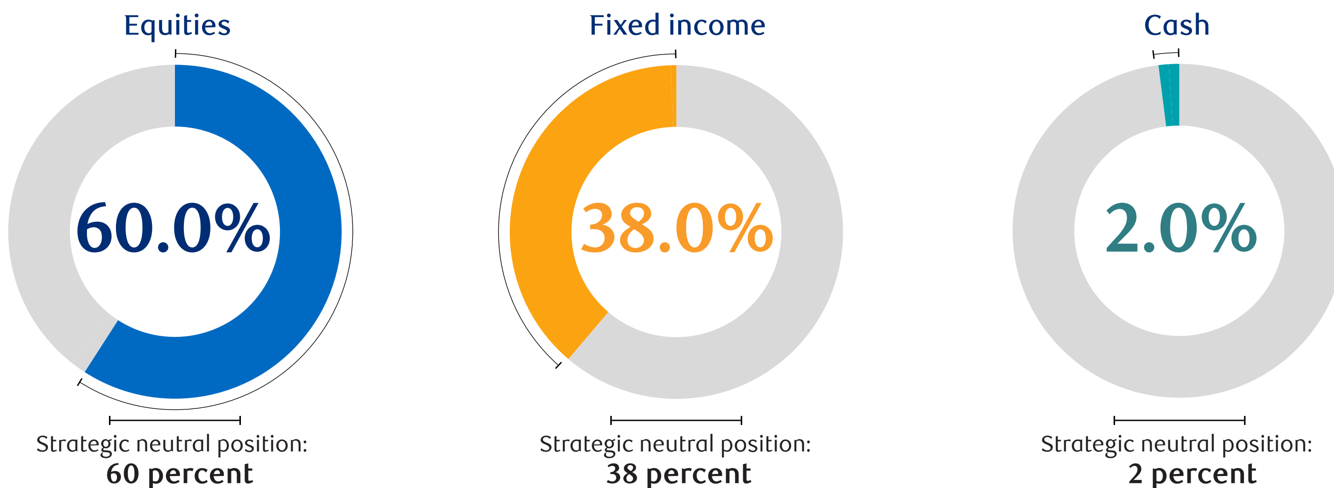
Note: As of March 24, 2023. Source: Thomson Reuters, Bloomberg

Asset mix – closing equity overweight and moving asset mix to neutral

The outlook has become increasingly uncertain and the range of possible outcomes is especially wide. Many decisions that were made during the low-interest-rate environment that persisted in the post-financial-crisis era are being upended by rapid and sudden increase in interest rates over the past year. We had expected the economy to slow, but the recent banking-industry challenges give us greater conviction that a recession is on the horizon. Against this backdrop, we expect central banks to slow the pace of rate hikes and believe that they could even shift to easing over the year ahead. Our view is that today's higher fixed-income yields make bonds more appealing than they have been in many years. As a result, we have been gradually increasing exposure to fixed income, and our bond underweight is less significant than it had been. While we continue to expect stocks to outperform over the longer term, we recognize that the outlook for corporate profits is vulnerable should the economy falter, which could lead to declines in stock prices in the shorter term. We have been dialing down the risk exposures in our asset mix over the past several quarters. This month we decided to trim our allocation to stocks by another 100 basis points, closing our equity overweight and moving half the proceeds to bonds and half to cash. In light of this change, our asset mix is now fully in line with the firm's strategic neutral allocation. Our current recommended asset mix for a global balanced investor is 60.0% equities (strategic: "neutral": 60%), 38.0% bonds (strategic "neutral": 38%) and 2.0% in cash (Exhibit 24).

Exhibit 24: Recommended asset mix

RBC GAM Investment Strategy Committee



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