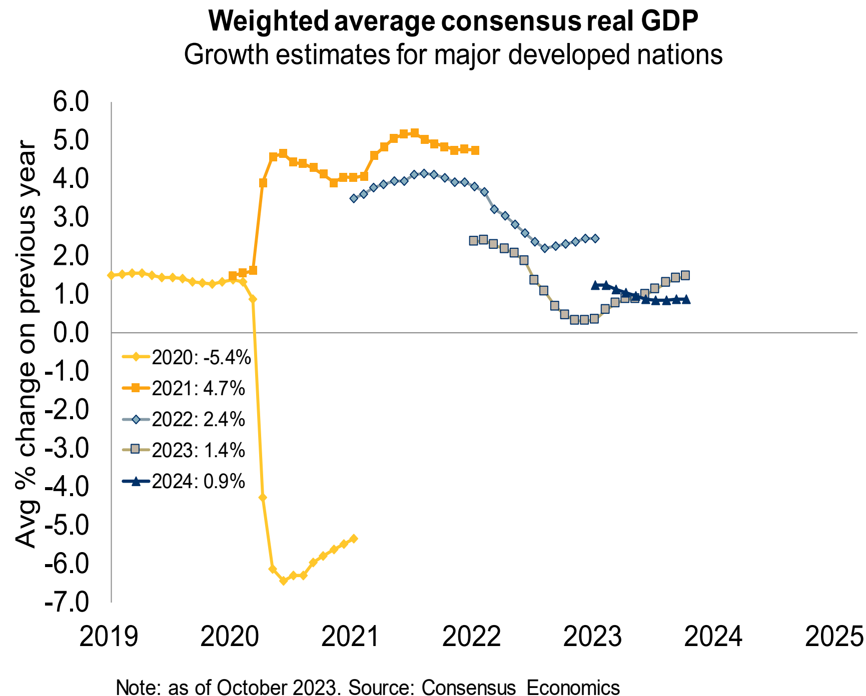
RBC Global Asset Management

Capital markets update

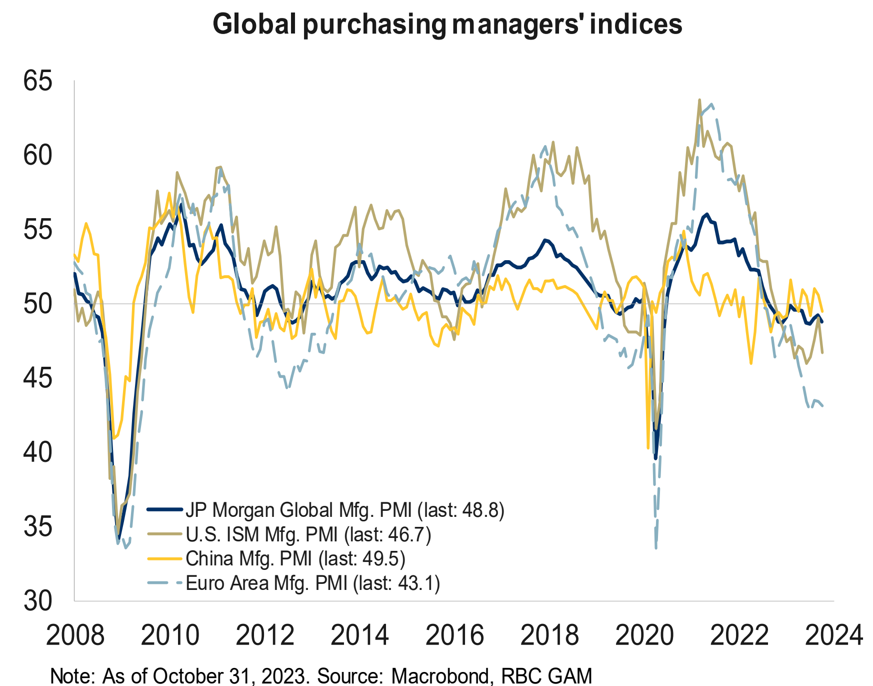
November 2023

The economy

- Underlying economic strength and stubborn price pressures are testing the patience of central banks and causing some to question whether financial conditions are restrictive enough. While it is possible that economies are less sensitive to higher interest rates than they were in prior cycles, it is more likely that the headwind from surging interest rates over the past 19 months will hit the economy with a significant lag. Not only will the sharp rise in borrowing costs weigh on consumer spending and business investment, but a variety of other risks have also been added to the mix.
- In the U.S., large-scale autoworker strikes, the resumption of student-loan repayments and a looming U.S. government shutdown are all factors that are adding to uncertainty and stress in the economy. Furthermore, geopolitical tensions have flared with the recent attacks in the Middle East, a situation that is evolving rapidly and contributing to financial-market volatility. All things considered, the outlook is increasingly murky and we continue to forecast a mild economic recession over the next several quarters. Our forecasts for growth and inflation are below the consensus.



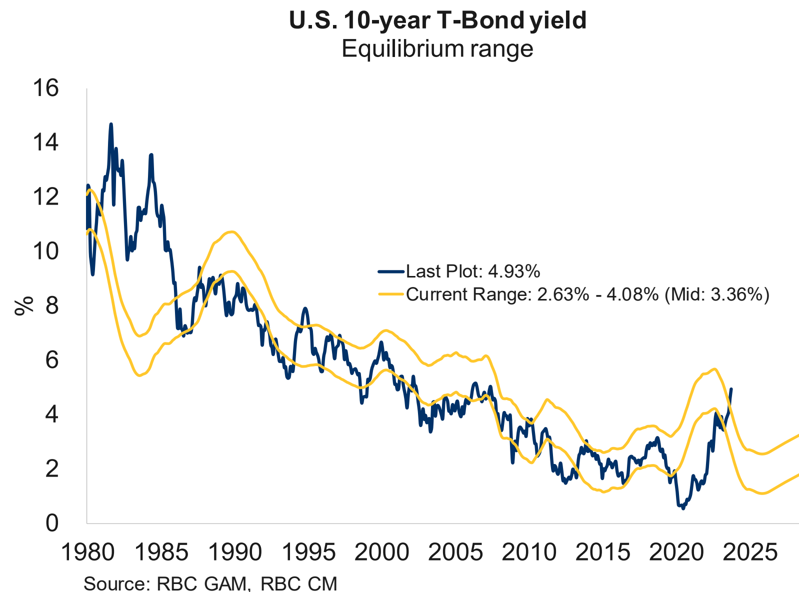
Note: as of October 2023. Source: Consensus Economics



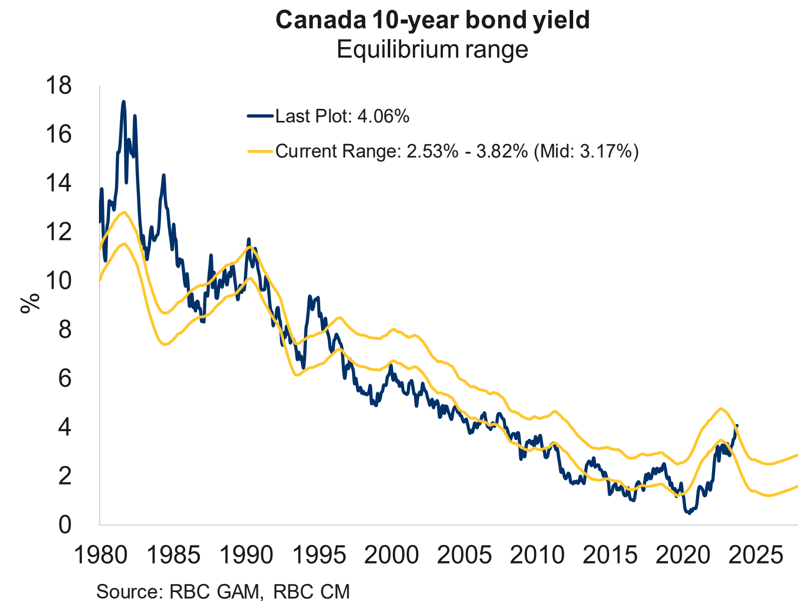
Note: As of October 31, 2023. Source: Macrobond, RBC GAM

Fixed income outlook

- Fixed income markets extended their sell-off in October as yields on longer-dated government bonds rapidly rose to new cycle highs. Contributing to the increase was the hawkish tone by central banks, as well as an increased supply of Treasuries issued by the U.S. government to fund ever growing deficits and an increased risk premium for the uncertainty of investing in longer-duration securities.
- At current levels, we think government bonds are the most appealing they've been in at least a decade. The real (after-inflation) yield on 10-year Treasuries has climbed to 2.5%, the highest since before the global financial crisis and a significant improvement from the low or often negative real rates endured for much of the past 15 years. Moreover, nominal yields near 5% situate the 10-year yield above the upper boundary of our equilibrium model, suggesting that valuation risk is minimal and that total-return potential has improved. Also worth noting is that the equilibrium band in our bond-yield model tracks lower over the year ahead given our assumptions that inflation will continue to cool and that growth will moderate. If we are right, then fixed-income investors would not only collect attractive coupon income, but also benefit from rising bond prices as yields fall, generating high single-digit or even double-digit returns over the next 12 months.



Source: RBC GAM, RBC CM



Source: RBC GAM, RBC CM

As of October 2023

Fixed income forecasts

Policy Rates	Current October 2023	Forecast August 2024
U.S	5.50	4.50
Canada	5.00	4.25
Europe	4.00	3.75
United Kingdom	5.25	5.25
Japan	-0.02	0.00

Source: RBC GAM
Rate definitions: U.S.= Fed Funds rate; Canada= Overnight rate; Europe = Eurozone policy rate; United Kingdom= Base rate; Japan= Overnight call rate.

Long-term interest rate	Current October 2023	Forecast August 2024
U.S. 10-Year Bond	4.93	3.50
Canada 10-Year Bond	4.06	3.00
Germany 10-Year Bond	2.80	2.60
United Kingdom Gilt	4.51	4.25
Japan 10-Year Bond	0.94	0.75

Source: RBC GAM.

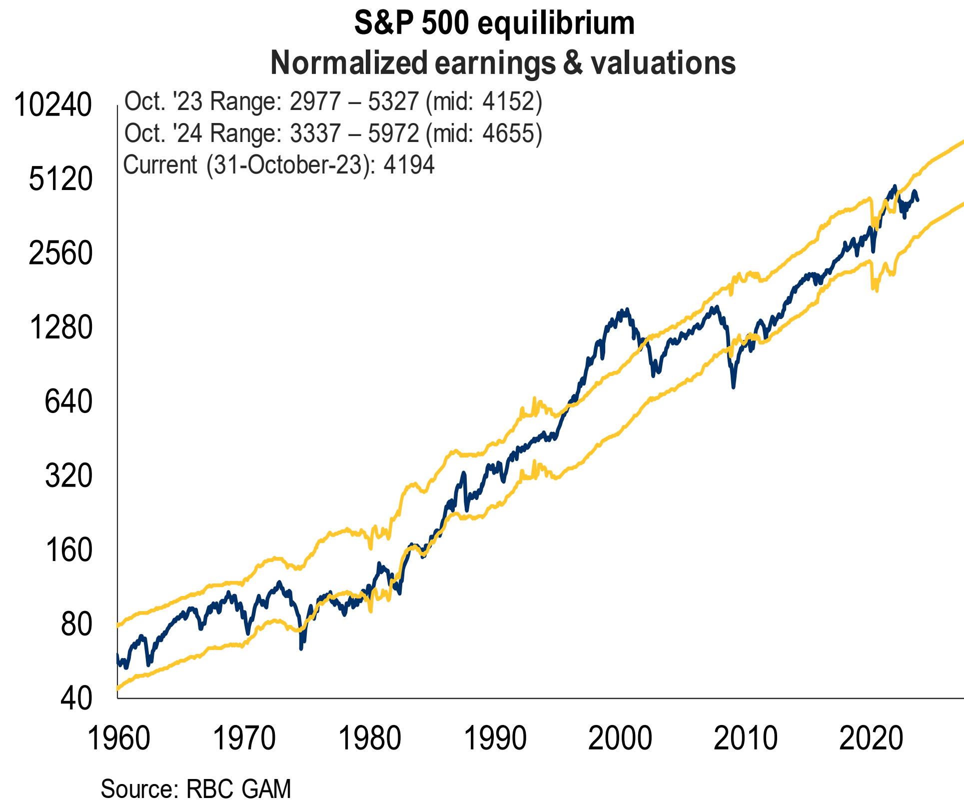
Equity markets

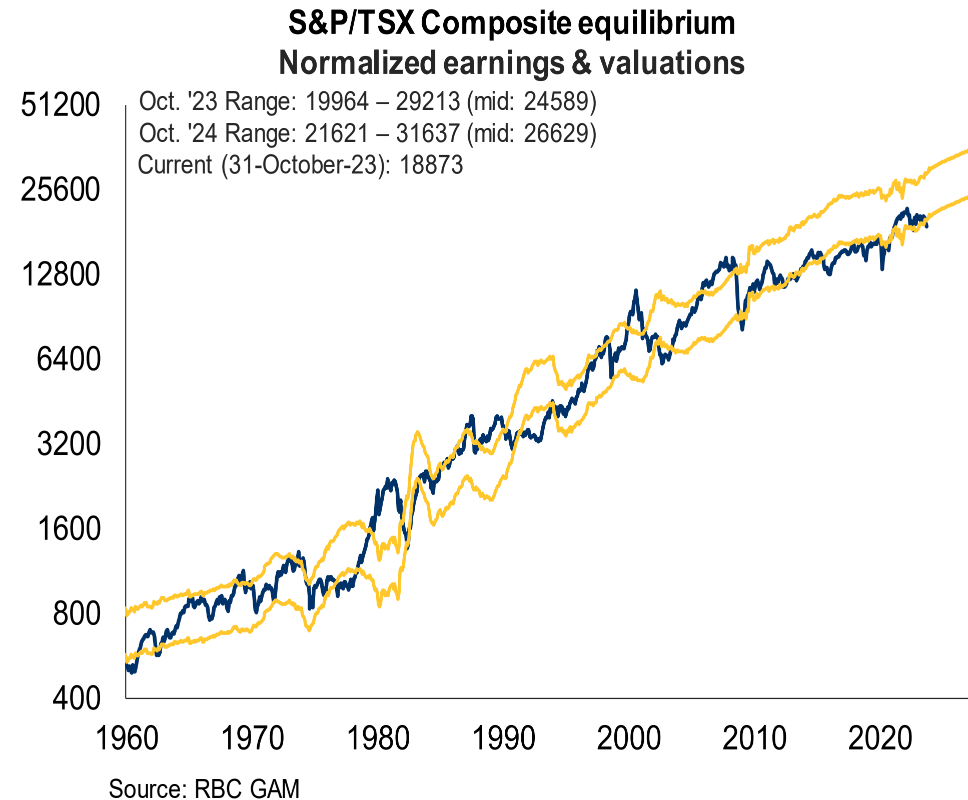
- Global equity markets have turned lower since the summer and extended their declines in October. Higher interest rates continue to weigh on equities, and the addition of intensifying geopolitical risks is also having an impact. With the latest pullback in stocks, many major markets are flat to slightly down so far this year. The one major outlier, however, is the Magnificent Seven, a group of seven U.S. mega-cap technology stocks that have risen 60% so far this year and masked weakness in the broad U.S. equity market. Aside from these seven tech stocks, global equities are not unreasonably valued and many markets are trading at substantial discounts to their fair value. Our equity-market composite suggests that global stocks are 6% below fair value. If we remove the U.S. – the most expensive market –stocks are 16% below fair value according to our models.
- The biggest risk to the broader equity markets has to do with the fact that earnings expectations are still too optimistic given our view that the economy is likely headed for recession. The consensus of analyst estimates projects 11% growth in S&P 500 Index profits next year, and that number has increased in recent months. Investors are paying a relatively high price-to-earnings multiple at 19 times earnings compared with our modelled equilibrium of 17 times based on current interest rates and inflation. In past recessions, earnings have fallen an average of 24% so there is a substantial gap between what analysts are expecting and what could materialize if a recession doe take hold. As a result, we think that current earnings estimates will fall and that process appears to have started. Further declines in earnings estimates will likely limit stock returns in the near term.

Equity market	**Current October 2023**	**Forecast August 2024**
S&P 500 Index	4194	4400
S&P/TSX Composite Index	18873	20700
MSCI Europe Index	146	154
FTSE 100 Index	7322	7500
Nikkei Index	30859	33100
MSCI Emerging Markets Index	915	1000

Source: RBC GAM. Please note that the forecasts are updated quarterly. An investment cannot be made directly into an index. The above does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results.

Equity markets





Data as of October 31, 2023. The fair value calculation is the product of the equilibrium price/earnings ratio and the current estimate for normalized earnings. The resulting price level is then standardized by a factor representing the historic relationship of the actual market to its equilibrium level. This generates the "fair value" estimate or mid-point of the band. The bands' boundaries capture one standard deviation of movement above and below this value. Fair value is the minimum price level consistent with mild inflation/low interest rates in a growing economy. Above-average price appreciation remains a possibility in an environment where 'normalcy' is restored. Moreover, opportunity exists as valuations in some big markets still lie below their minimum expected levels. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks, but the outlook for equity market returns is generally superior when stocks lie below fair value at the bands' midpoint. An investment cannot be made directly into an index. The above does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results.

Asset mix

- Balancing the risks and rewards, we have decided to increase our allocation to fixed income by half a percentage point, sourced from cash. This change has pushed our bond allocation to a slight overweight for the first time in two decades. In our base case scenario, the economy falls into recession at some point over the next several quarters, ultimately prompting central banks to lower interest rates. Given today's higher yields and the fact that inflation is trending lower, bonds offer attractive return potential with minimal valuation risk.
- Moreover, attractive coupon income and the tendency for sovereign bonds to offer shelter from a downturn in stocks should provide greater ballast in a balanced portfolio. While we continue to expect stocks to outperform bonds over the longer term, we recognize that macroeconomic risks are elevated, corporate profits are vulnerable to an economic slowdown and the equity-risk premium has meaningfully eroded with the recent surge in bond yields. As a result, we are maintaining our positioning in stocks in line with our strategic neutral.
- For a balanced global investor, we currently recommend an asset mix of 60.0 percent equities (strategic neutral position: 60.0 percent) and 38.5 percent fixed income (strategic neutral position: 38.0 percent), with the balance in cash.

Global Asset Mix	Benchmark	Past Range	New Year 2023	Spring 2023	Summer 2023	Fall 2023	October 2023
Cash	2.0%	1%-16%	1.0%	1.5%	2.0%	2.0%	1.5%
Bonds	38.0%	25%-54%	37.0%	37.5%	38.0%	38.0%	38.5%
Equities	60.0%	36%-65%	62.0%	61.0%	60.0%	60.0%	60.0%

Source: RBC GAM
Actual fund or client portfolio positioning may differ depending on individual investment policies.

Disclosure

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