RBC Global Asset Management

Market Update

APRIL 25, 2023

Earnings in focus while investors digest regional banking stress

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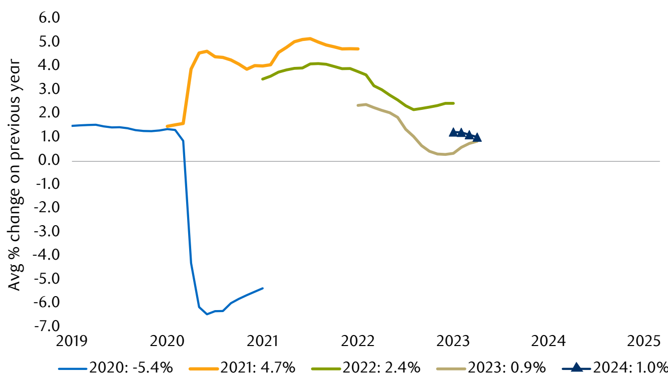
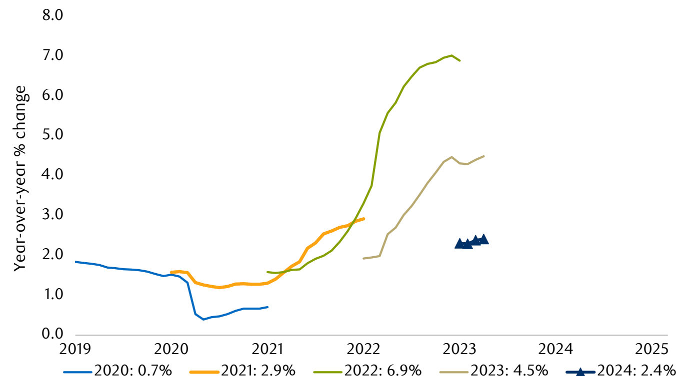
Stock markets were volatile in recent months but ultimately resolved higher as troubles in U.S. regional banks were met with massive liquidity support from central banks. The measures taken by central banks have, for the time being, helped establish financial stability and prevented widespread contagion within banks and to other areas of the economy. Stocks may also have been bolstered by the idea that interest-rate increases, which had been a headwind to equity valuations since the beginning of 2022, may be less necessary going forward. That said, it seems likely that the stress we've seen in the banking system will have some degree of negative impact on the broader economy and corporate profits, as tighter lending conditions should reduce the amount of credit available for consumers and businesses. Even if interest rates don't rise much further or at all, we continue to expect the economy to fall into recession over the year ahead due in large part to the delayed impacts of the sudden and massive interest-rate increases that have been delivered over the past year. Against this backdrop, our forecasts for both growth and inflation are below the consensus (exhibits 1 and 2).

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



Note: as of April 2023. Source: Consensus Economics

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



Note: as of April 2023. Source: Consensus Economics

Economic data has been mixed

The housing market is one area of the economy that has been particularly challenged by rapidly rising interest rates. In just one year, U.S. 30-year fixed mortgage rates more than doubled to their highest level in two decades (Exhibit 3). The U.S. housing supply began to rise in mid-2022 as borrowing costs surged and buying activity plummeted at its fastest pace since the collapse of the 2007/2008 housing crash (exhibits 4 and 5). But there has been a bit of a turn in these metrics since late 2022. Mortgage rates have eased from their highs and housing supply started shrinking again as sales activity picked up in 2023.

We remain skeptical that the improvement in housing data is the start of a durable turnaround in residential real estate and the broader economy because other leading indicators have continued to soften. Purchasing managers' indices have been trending lower since early 2021 and are below 50 in many major regions, indicating that economic activity is contracting (Exhibit 6). Moreover, while the labour market has been

> "The risk remains, however, that a rapid reduction in deposits could force the banks to sell assets at a loss to meet customer withdrawals..."

Exhibit 3: U.S. 30-year fixed mortgage rates

Bankrate.com national average

Note: as of April 24, 2023. Source: Bankrate.com, RBC GAM

Exhibit 4: U.S. housing – month's supply of homes on the market – Existing single family homes

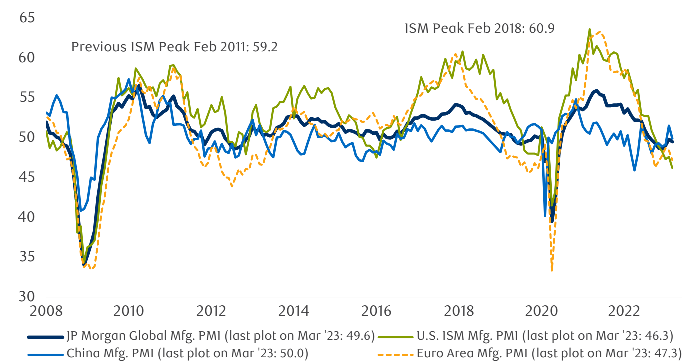
Note: as of March 31, 2023. Source: National Association of Realtors

Exhibit 5: U.S. housing – sales of existing homes

Total existing home sales

Note: as of March 31, 2023. Source: National Association of Realtors

Exhibit 6: Global purchasing managers' indices



Note: as of March 31, 2023. Source: Haver Analytics, RBC GAM

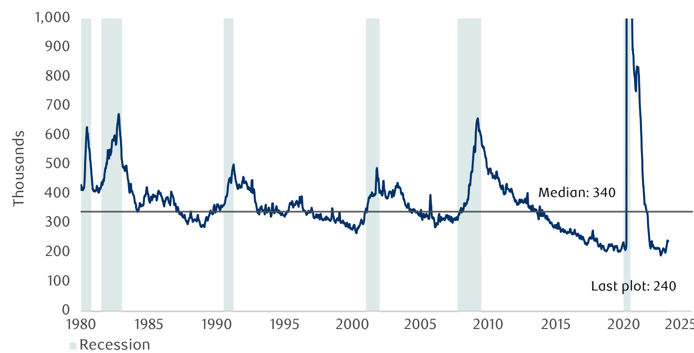
resilient, cracks are starting to show. Layoff announcements and jobless claims have been trending up since the start of the year (Exhibit 7) and the U.S. Senior Loan Officer Survey, which tracks a variety of metrics related to borrowing conditions, suggests that bank-lending standards have tightened meaningfully (Exhibit 8). While lending conditions were already deteriorating, recent issues with regional banks could further challenge the ability of businesses and consumers to access financing, opening the scope for potential economic downside.

Banking crisis seemingly contained, but stress remains

The most intense fears surrounding the banking system have calmed since Silicon Valley Bank (SVB) went into receivership and UBS acquired Credit Suisse. It appears that, at least at this time, a widespread banking crisis has been averted. But stress in the system has not disappeared. Deposits at U.S. banks declined US$495 billion, or 2.8%, in March and, while the pace of decline has slowed, deposits have declined another US$15 billion so far in April (Exhibit 9). Against the total base of deposits, these figures are relatively small, and deposits are still up 27% to US$3.8 trillion since the start of the pandemic. The risk remains, however, that a rapid reduction in deposits could force the banks to sell assets at a loss to meet customer withdrawals, as was the case with SVB. To prevent further forced asset liquidations, the Fed's emergency lending facility has been made available to all U.S. banks, and its usage surged to as much as US$354 billion in March (Exhibit 10). This figure has since dropped to US$325 billion, representing around three-quarters of peak

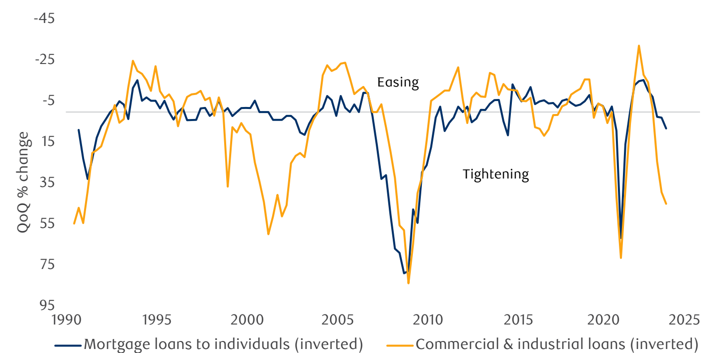
Exhibit 7: U.S. initial unemployment claims filed

Four week moving average



Note: as of April 14, 2023. Source: BLS, Haver Analytics, Bloomberg

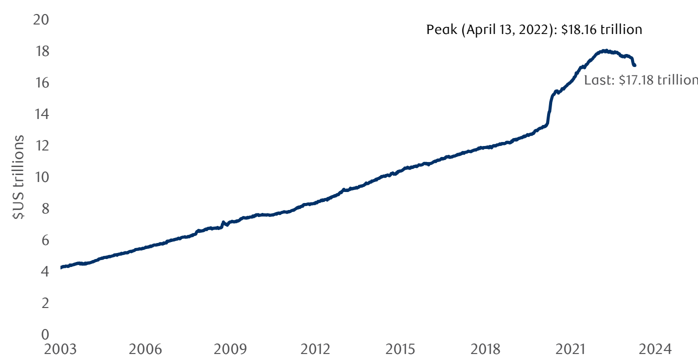
Exhibit 8: Senior loan officer survey on bank lending practices – Loan officers reporting tightening standards



Note: as of March 31, 2023. Source: Federal Reserve, Haver Analytics

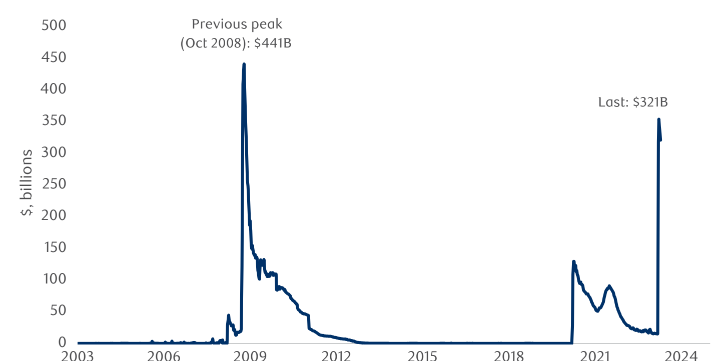
Exhibit 9: U.S. commercial bank liabilities

Total deposits



Note: as of April 12, 2023. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 10: Total loans provided by the Federal Reserve



Note: as of April 12, 2023. Source: Federal Reserve, Bloomberg, RBC GAM

emergency-loan usage during the 2008/2009 financial crisis. While it appears that the current crisis is not worsening, the stress is far from gone.

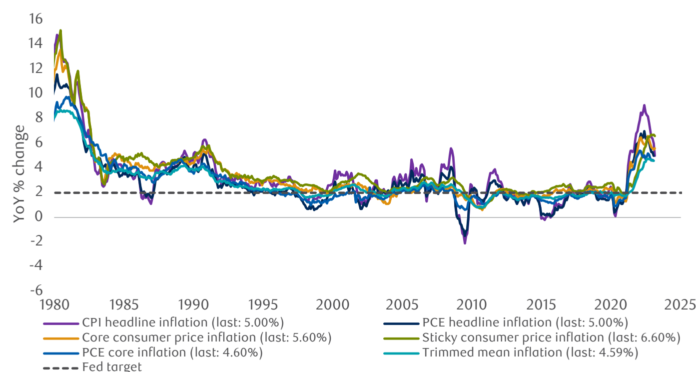
More progress on the fight against inflation

U.S. headline inflation slowed on a year-over-year basis to 5.0% in March from 6.0% in February and is now more than halfway toward the Fed's 2% target from the 9.1% peak in June 2022 (Exhibit 11). Moreover, the major drivers that pushed inflation higher in 2021/2022 are turning or about to turn. Exhibit 12 plots a breakdown of the categories that cumulatively determine headline inflation. Notice from the chart that problem categories such as motor fuel and transportation have already turned lower, food inflation has stabilized and housing inflation is expected to begin falling in the middle of this year as the delayed impact of lower shelter costs kicks in. As a result, investors' inflation expectations remain well anchored at levels just above the Fed's 2% target (Exhibit 13).

The case for further rate hikes is becoming less obvious

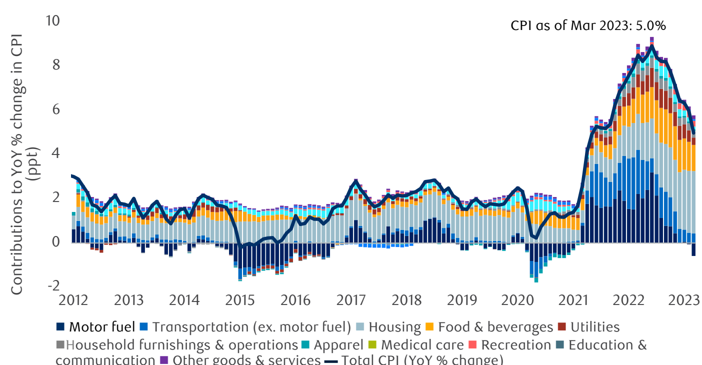
Central banks likely don't need to raise interest rates much further given that inflation is coming down and that bank stress is posing an additional headwind to the economy. That doesn't mean that the Fed will soon need to cut interest rates. The U.S. central bank appears so far to have addressed the financial-instability concerns with its emergency-loan facility rather than through rate cuts, as the futures market suggests investors have dialed back their expectation that reductions would be needed to address the banking crisis (Exhibit 14). The chart plots the expected fed funds rate as implied by

Exhibit 11: U.S. inflation measures



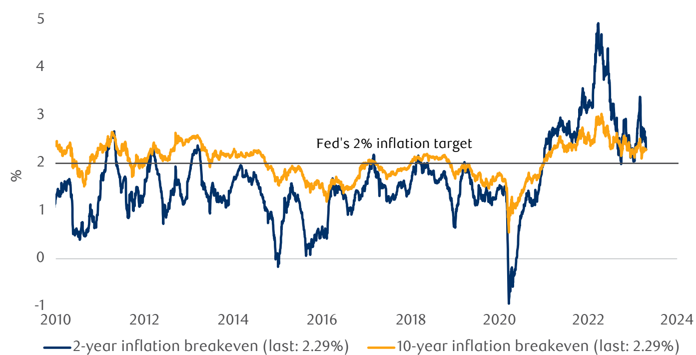
Note: as of March 31, 2023. Source: Bloomberg, RBC GAM

Exhibit 12: Housing, food, energy, and transportation are driving U.S. inflation



Note: as of March 2023. Source: U.S. BLS, Macrobond, RBC GAM

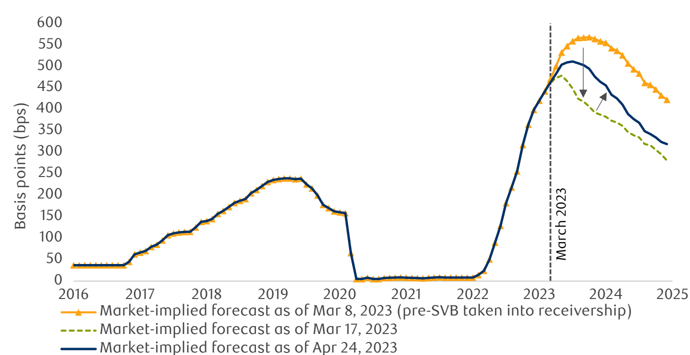
Exhibit 13: U.S. Treasuries inflation breakevens



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

Exhibit 14: Implied fed funds rate

12-months futures contracts



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

pricing in the futures market, which represents a probability-weighted average of all possibilities that investors consider. At this point, the balance of these outcomes suggests another 25-basis-point fed funds hike to 5.25% in early May, before a fall in the benchmark rate to 4.25% by January of next year. Rates may not come down at all, however, if a recession is avoided, and they would likely drop below the January expectation were the economy to contract significantly.

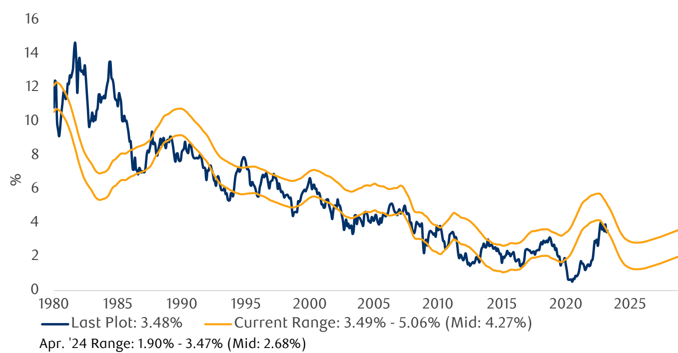
Bond market has stabilized; valuation risk is minimal if inflation keeps falling

The U.S. 10-year Treasury yield has steadied near 3.50% and is trading toward the lower end of its trading range of the past seven months. Our equilibrium model suggests that yields have the scope for further declines if inflation keeps falling as we expect (Exhibit 15). Moreover, the yield curve, as proxied by the spread between 2-year and 10-year Treasury yields, has become less inverted and could be further confirmation that a recession is imminent (Exhibit 16). The change in the yield curve has been a result of a bull steepening effect, where yields on 2-year Treasuries have fallen faster than those on 10-year Treasuries yields. This phenomenon tends to occur just before a recession as it suggests interest-rate relief from the Fed is near. In the current environment of falling inflation and increasing threat of recession, we think that a sustained increase in yields is unlikely and that valuation risk is minimal.

Credit markets recover after Credit Suisse, suggesting benign outlook

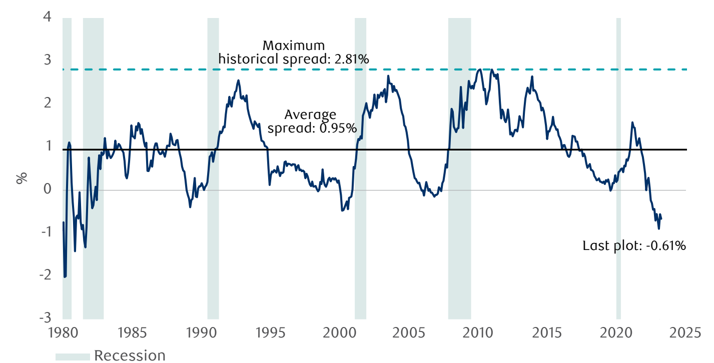
Within credit markets, stress in the banking system caused spikes in the cost to insure the debt of European prime brokers, but there was little sign of concern across the U.S. corporate-bond market. In March, prices of Credit Suisse

Exhibit 15: U.S. 10-year T-Bond yield
Equilibrium range



Note: as of April 24, 2023. Source: RBC GAM

Exhibit 16: U.S. Treasury yield curve – Spread between yield on 10-year and 2-year maturities



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

credit default swaps (CDS), a measure of the financial stress afflicting the Swiss bank, surged to its highest level on record, more than quadruple the levels seen at the height of the financial crisis and the 2010/2011 European debt crisis (Exhibit 17). The financial instability caused by Credit Suisse forced the bank to sell itself to rival UBS, and the cost of insuring against defaults by European banks subsequently plummeted.

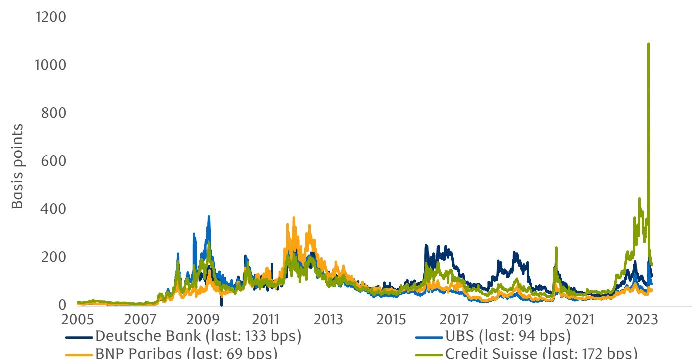
In the U.S., spreads for high-yield corporate bonds widened less than 100 basis points and have since retraced the entire move (Exhibit 18). Moreover, the distressed ratio – the percentage of bond issues with spreads greater than 1,000 basis points – remains far below levels we would normally associate with a crisis. During times of extreme stress, the distressed ratio typically climbs to 25% or higher but it is currently situated at 10%. It is possible that the next credit cycle may feature less defaults given the extent to which corporations have repaired their balance sheets since the pandemic. Overall, the indicators we watch suggest that investors have selectively identified key problem areas within the market, rather than attributing heightened risks to bonds across the board. That said, with U.S. high-yield credit spreads below their long-term average, corporate bonds are expensive and investors are not necessarily being adequately compensated for economic uncertainty.

Stocks rebound, valuations remain reasonable

The impact of bank stress on major equity-market indices was relatively short-lived, and stocks rallied on the assumption that the troubles were isolated and being appropriately managed. Global stocks are up anywhere from the low to high single digits from the March bottom depending on the index, with international markets as measured by the MSCI EAFE having risen to 52-week highs (Exhibit 19). U.S. bank shares, however, have lagged. While the S&P 500 Index has been approaching its recent February high, the relative strength of the KBW Bank Index versus the S&P 500 remains at its lowest in two decades (Exhibit 20). This relationship is evidence that the banking industry has suffered real damage from the recent stress in the financial system, but that investors are betting that the damage is contained and not a systemic issue. Overall, stock markets appear reasonably priced as suggested by our global equilibrium model, which is trading 2% below fair value, and as much as 13% below fair value if we exclude the more expensive U.S. market (Exhibit 21).

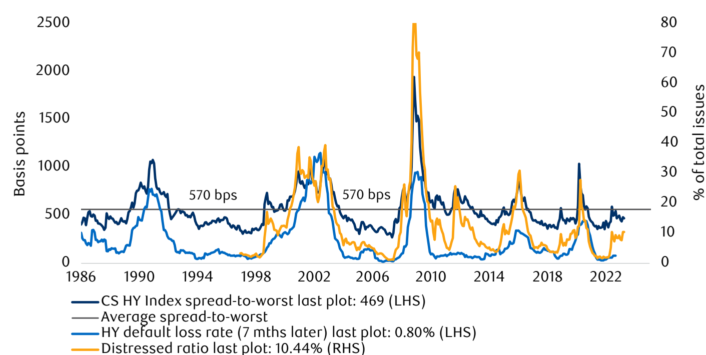
Exhibit 17: European prime brokers

5-year CDS spreads



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

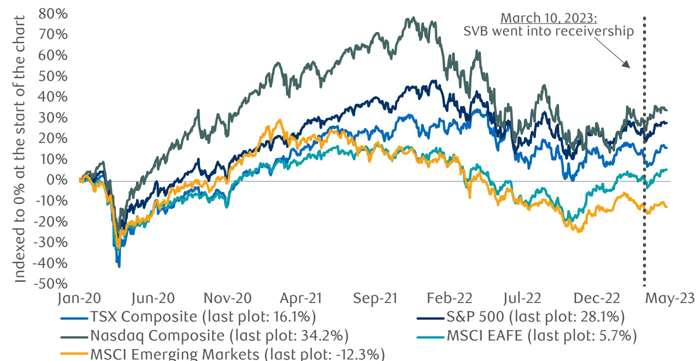
Exhibit 18: High yield bond spread



Note: as of April 21, 2023. Source: BofAML, Credit Suisse, RBC GAM

Exhibit 19: Major equity market indices

Cumulative price returns indices in USD

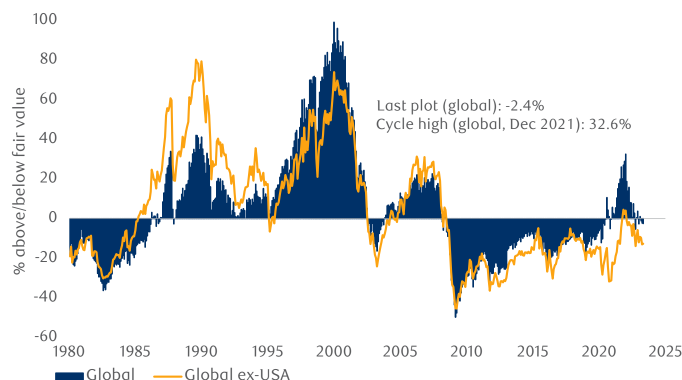


Note: as of April 24, 2023. Price returns computed in USD. Source: Bloomberg, RBC GAM

Exhibit 20: Relative strength
Philadelphia (KBW) Bank Index relative to S&P 500

Note: as of April 21, 2023. Source: RBC GAM, RBC CM

Exhibit 21: Global stock market composite
Equity market indexes relative to equilibrium



Note: as of April 21, 2023. Source: RBC GAM

Risk for stocks lies with earnings in the face of probable recession

The major risk to equity markets these days lies not in valuations but rather the negative impact that a probable recession would have on earnings. An analysis of S&P 500 corporate profits during the 11 recessions dating back to 1953 reveals that earnings declined in each one by at least double digits (Exhibit 22). The table differentiates between recessions that were shallow (highlighted in white) and deep (highlighted in blue), and what we observe is that while earnings tend to decline less during shallow recessions, the difference is relatively small. The median earnings decline during shallow recessions is 18%, whereas profits fell a median of 23% during a deep recession. Analyst estimates have been gradually lowered over the past year, but the projections are calling for zero growth in 2023 followed by a

Exhibit 22: S&P 500 earnings per share
Recession statistics

Recession start date	Earnings peak date	Earnings trough date	Earnings reclaim prior peak date	Earnings decline duration (months)	Earnings peak ($)	Earnings trough ($)	EPS change peak to trough	Months before earnings reclaim prior peak
July 1953	Dec-50	Jun-52	May-55	17	2.8	2.3	-17.6%	53
August 1957	Feb-56	Mar-59	Jun-62	37	3.6	2.8	-23.4%	76
April 1960	Jun-60	Jun-61	Jun-62	12	3.6	3.0	-14.6%	24
December 1969	Feb-70	Jul-71	Dec-72	17	6.2	5.0	-18.4%	34
November 1973	Jan-75	Feb-76	Dec-76	12	9.6	7.6	-21.6%	23
January 1980	Jul-80	Aug-81	Jan-82	13	15.6	13.7	-11.9%	18
July 1981	Aug-82	Jul-83	Oct-84	11	16.3	12.1	-25.8%	26
July 1990	Aug-89	Apr-93	Mar-95	43	25.7	13.6	-46.9%	67
March 2001	Nov-00	Jun-02	May-04	19	56.2	40.1	-28.7%	42
December 2007	Aug-07	Nov-09	Aug-11	26	94.3	61.5	-34.8%	47
February 2020	Aug-19	Feb-21	Aug-21	12	165.7	139.1	-16.0%	24

Note: Recession severity is classified based on peak to trough decline in real GDP (shallow: up to 2.5% decline, deep: greater than 2.5% decline). Source: National Bureau of Economic Research (NBER), U.S. Bureau of Economic Analysis (BEA), RBC GAM

Aggregate statistics	Earnings decline duration (months)	EPS change peak to trough	Months before earnings reclaim prior peak
Shallow recession median (7 observations)	17	-18.4%	34
Deep recession median (4 observations)	19	-22.5%	36

Note: as of April 21, 2023. Source: Bloomberg, RBC GAM

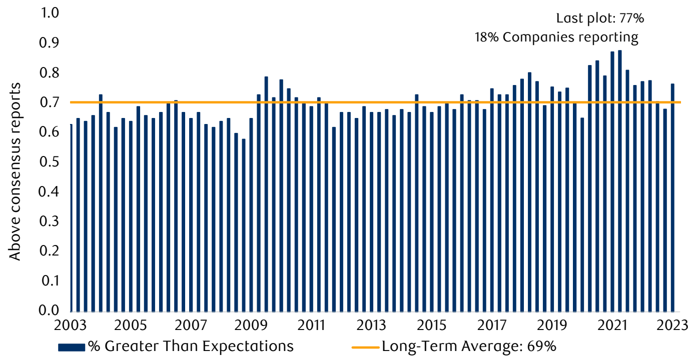
10% increase in 2024 (Exhibit 23). We think these estimates are too optimistic and vulnerable to further downgrades should the economy fall into recession.

We will get further clarity on the earnings outlook in the coming weeks as reporting for the first quarter of 2023 is underway. So far about one-fifth of S&P 500 companies have reported, and 77% of them have beaten expectations (Exhibit 24). Revenue growth has been resilient, but profit margins are under pressure given that costs in many cases are rising even more (Exhibit 25). Margins have fallen from the record levels recorded in the wake of the pandemic but remain well above the long-term trend, suggesting there could be more room for them to fall. Declining profit margins could limit the sustainability of the latest stock-market rally, especially if revenues start to falter in light of weakening economic growth.

Pessimism is not uncommon

There are a variety of reasons to be pessimistic on the economic outlook, and there is no shortage of investors willing to bet against the stock market. Exhibit 26 plots net investor positions in S&P 500 futures over time, taking the difference between the number of long and short contracts outstanding. The line shows that short positions outnumber long positions to a degree reached only a handful of times over the past 20 years. Except for the period preceding the global financial crisis, extreme negative readings in this indicator have signaled good buying opportunities for stocks (fall 2011, late 2015/early 2016, spring 2020). If the economy and/or corporate profits turn out better than expected, investors with short positions may look to cover their positions, further stoking any rally that takes place.

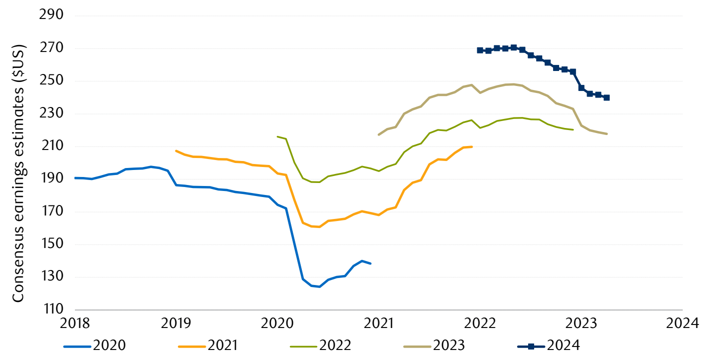
Exhibit 23: Companies reporting results above consensus forecasts



Note: as of April 21, 2023. Source: Refinitiv

Exhibit 24: S&P 500 Index

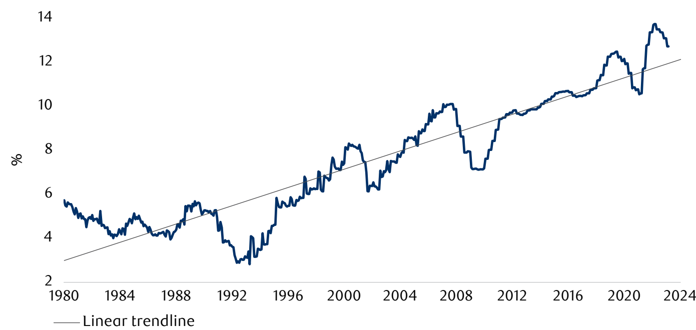
Consensus earnings estimates



Note: as of April 21, 2023. Source: Bloomberg, RBC GAM

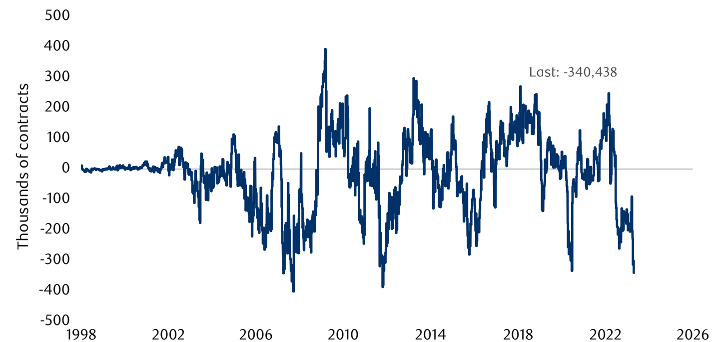
Exhibit 25: S&P 500 Index

Net margin



Note: as of March 31, 2023. Source : Bloomberg, RBC GAM

Exhibit 26: CME E-mini S&P 500 non-commercial net futures positions



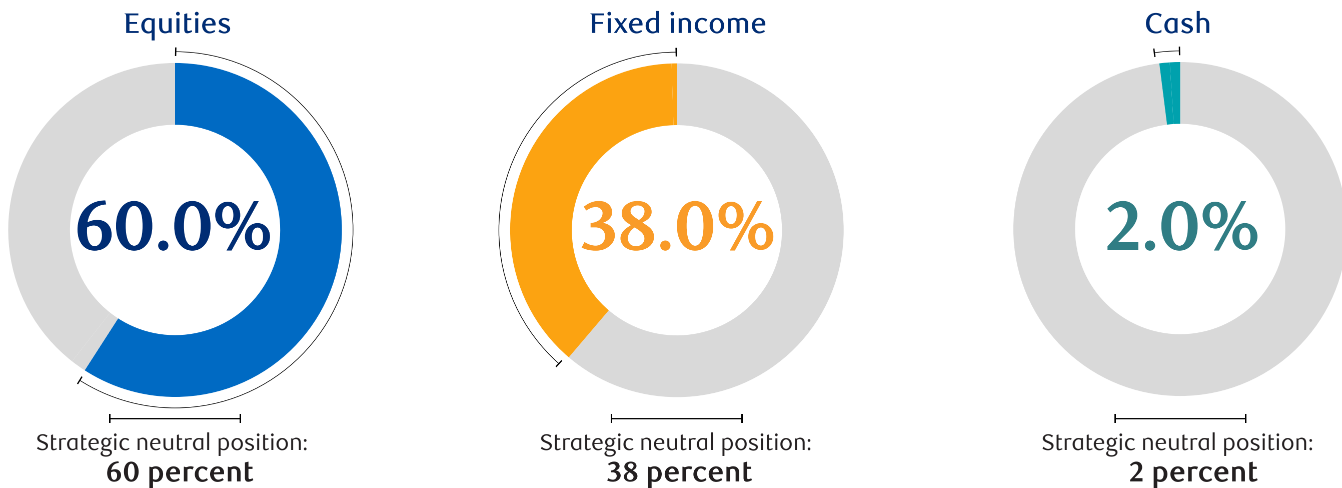
Note: as of Apr 18, 2023. Source: Commodity Futures Trading Commission (CFTC), Macrobond, RBC GAM

Asset mix – maintaining neutral allocation

The macroeconomic environment remains highly uncertain, and our assessment is that the payoff for taking excessive investment risk in the near term is fairly limited. Our base case is that the economy will enter a recession of middling size at some point over the next year, and that the tightening of financial conditions stemming from the recent stress in U.S. regional banks tilts the balance of risks more to the downside. In a recessionary scenario in which inflation is moving back toward the Fed's 2% target, the U.S. central bank would likely cut the fed funds rate and safe-haven government bonds would outperform as yields decline. This scenario has led us over the past year to gradually eliminate both our previously large underweight in fixed income and our equity overweight, as we think stocks would be vulnerable to a deterioration in corporate profits should the economy experience a downturn. We still think that stocks offer superior return potential over the longer term, and we recognize that valuations are reasonable for investors with a long time horizon. To return to a stock overweight would require: 1) stock prices and earnings estimates to reflect a recessionary scenario; or 2) evidence that a soft landing is being achieved through a combination of rising economic leading indicators, improving employment metrics, upgrades to the corporate-profit outlook, an easing of financial conditions and/or a steepening yield curve. Currently, our 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 27).

Exhibit 27: Recommended asset mix

RBC GAM Investment Strategy Committee



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