RBC Global Asset Management

Market Update

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# Central banks hint at slowing pace of rate hikes as inflation moderates and economy softens

**Eric Savoie, MBA, CFA**
Investment Strategist, RBC Global Asset Management Inc.

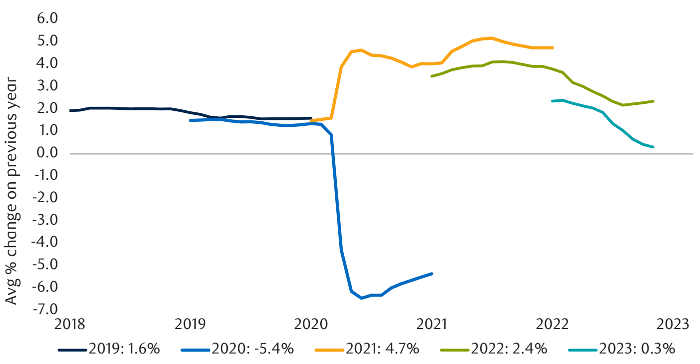
**Daniel E. Chornous, CFA**
Chief Investment Officer, RBC Global Asset Management Inc.

Leading economic indicators have extended their declines and suggest that global growth is softening. A number of macro headwinds are weighing on the outlook, including a significant tightening of financial conditions, China's ongoing battle with COVID, the war in Ukraine and the ensuing energy crisis in Europe. Importantly, though, economies have proved relatively resilient in this environment. The labour market remains strong and data more broadly has been less bad than initially feared. We have lowered our economic growth forecasts versus a quarter ago and we continue to expect a recession of middling size over our one-year forecast horizon, but our pessimism has moderated somewhat over the past couple months (Exhibit 1).

## Inflation has begun turning down

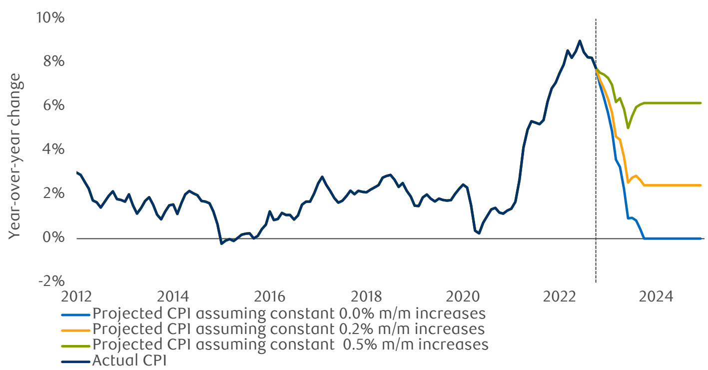
After reaching its highest levels in four decades, inflation may finally be starting to head lower as many of the forces that caused consumer prices to surge are now reversing course. Supply chain challenges have improved, monetary policy is tightening, fiscal policy is acting as a slight drag versus a year ago and commodity prices have retraced meaningfully from their recent highs. We expect inflation to cool decidedly over the next year and our forecasts are below the consensus, though still above the Fed's 2% target. Monthly inflation datapoints will be especially critical in gauging whether consumer price pressures are trending in the right direction and at a pace that is deemed acceptable by central banks (Exhibit 2).

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




Note: As of December 2022. Source: Consensus Economics

**Exhibit 2: U.S. CPI Inflation**
Hypothetical projections in y/y % change




Note: As of October 31, 2022. Source: Bloomberg, RBC GAM

## Central banks could soon slow pace of rate hikes

So far it seems that the monetary tightening delivered by central banks is working but it is hard to say whether enough has been done given long and variable lags of changes in interest rates on the economy. Featuring several jumbo-sized rate hikes, the Fed raised short-term interest rates by 375 basis points in just 8 months, marking the most aggressive tightening cycle since the 1970s, and interest rates could still have further to rise. Pricing in the futures market suggests another 100 basis points in hikes (one 50-basis-point hike followed by two 25-basis-point increases) by early 2023, boosting the rate to a peak at 5.0% (Exhibit 3). Importantly, the market is now anticipating the Fed will begin easing later next year, pricing in a 4.5% fed funds rate by year-end 2023. It is worth acknowledging that the course for monetary policy is flexible and will likely adjust depending how the data evolves.

## Bond yields retrace from highs as inflation concerns fade

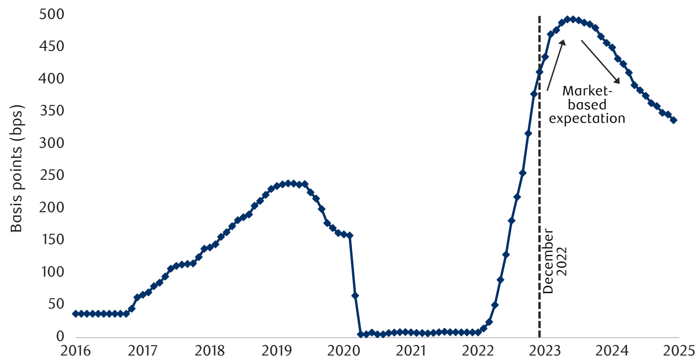
During the quarter, the U.S. 10-year yield reached a high of 4.33% in October and the World Government Bond Index had wiped out all its gains of the past four years. But bond prices have rebounded since then, supported by mounting evidence that inflation has peaked and that global growth is slowing. Our own models suggest that if inflation calms as we expect, and that real (after-inflation) interest rates revert to a range of 0.5%-1.0% consistent with demographics and long-term economic trends, the equilibrium level for the U.S. 10-year yield could ultimately fall to 3.4% in five years' time (Exhibit 4). With this in mind and following the surge in yields so far this year, the risk of significant and sustained further losses in sovereign bonds has been greatly reduced. We recognize, however, that if we are wrong and inflation remains elevated, the path for meaningfully higher yields remains a possibility.

## Equities rebound from deeply oversold conditions, led by cyclicals and international stocks

Stocks encountered tremendous volatility during the quarter and, after touching new lows earlier in the period, the impressive rebound off the bottom had stocks ending the quarter with a slight gain. At its low, the S&P 500 had fallen 26% from its peak, sentiment was extremely pessimistic and a variety of technical indicators deemed global equities oversold at levels consistent with major market bottoms of the past. Our composite of global equity valuations had fallen below fair value for the first time since March 2020 and although the S&P 500 remained above fair value, albeit only slightly so, stocks in other regions reached especially attractive discounts to their respective fair values (Exhibit 5).

### Exhibit 3: Implied fed funds rate

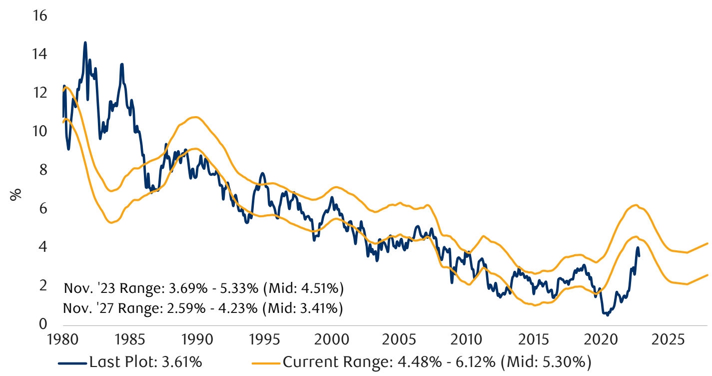
12-months futures contracts as of December 1, 2022




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

### Exhibit 4: U.S. 10-year T-Bond yield

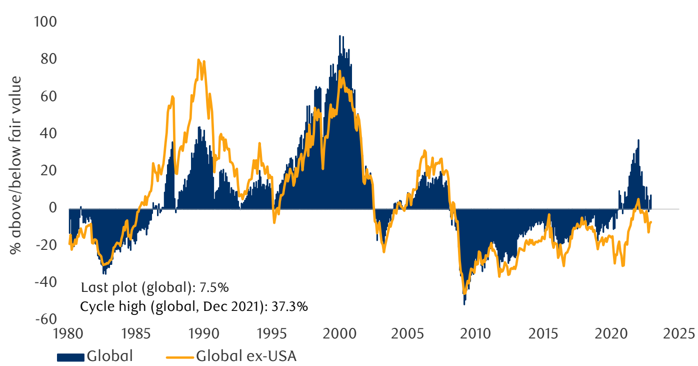
Equilibrium range




Note: As of November 30, 2022. Source: RBC GAM

### Exhibit 5: Global stock market composite

Equity market indexes relative to equilibrium




Note: As of November 30, 2022. Source: RBC GAM

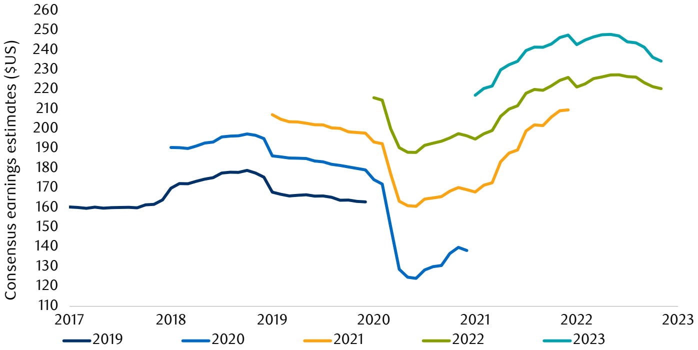
The October 13 U.S. inflation data release, which was better than expected, served as a key catalyst for the turnaround in sentiment, giving investors hope that inflation was now on a downward trajectory, alleviating pressure on the Fed and ultimately valuations. The powerful rally since then has, interestingly, been led by cyclicals, small caps, value and international stocks whereas U.S. mega-cap technology stocks – leaders of the prior bull market – have lagged.

## Earnings could still be vulnerable to economic weakness ahead

One element that could test the rally's durability will be how well corporate profits hold up during the expected oncoming period of economic weakness. Analysts have already begun downgrading earnings forecasts for the S&P 500 in light of slowing growth and pressures on margins from increasing costs. But even the lowered estimates are relatively optimistic. The consensus projects S&P 500 earnings growth of 6.5% in 2022 and another 6.3% growth in 2023 (Exhibit 6). In our view, these figures seem inconsistent with the onset of a contraction in the economy, given that history reveals S&P 500 profits have fallen an average of 25% in past periods of economic contraction. Further downward pressure on profit forecasts in the event of continued economic weakness could threaten investor enthusiasm and limit how far stocks can rise from here.

### Exhibit 6: S&P 500 Index

Consensus earnings estimates

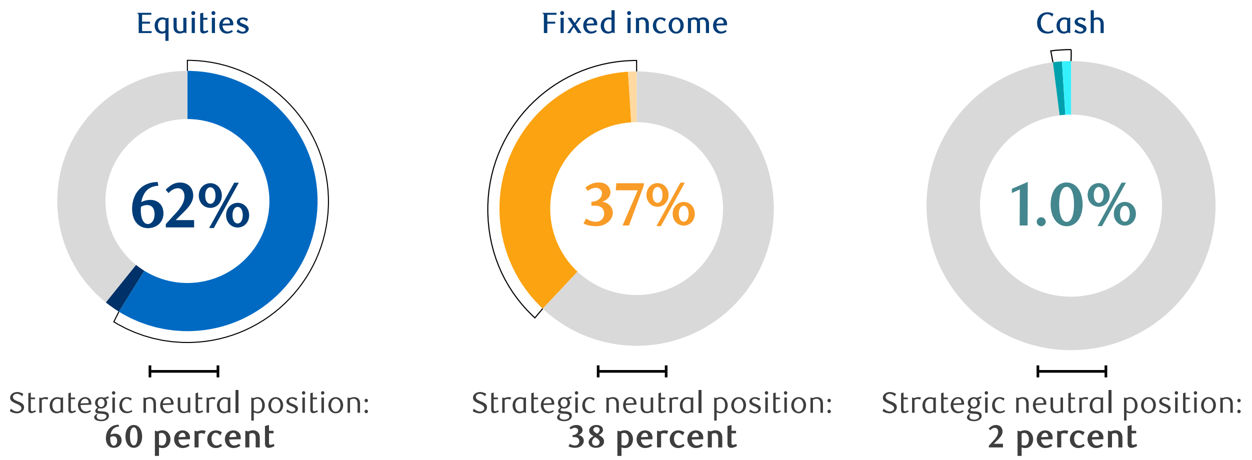



Note: As of November 30, 2022. Source: Thomson Reuters, Bloomberg

## Asset mix – maintaining slight overweight in stocks, underweight in bonds

The macro environment remains highly uncertain and although there are paths to a positive outcome, we believe a cautious approach to risk-taking remains warranted. Central banks have delivered a sizeable amount of monetary tightening into the financial system, the economy is slowing and recession is likely. That said, asset prices have largely adjusted to these expectations. Bond yields surged and stock prices plunged, greatly reducing valuation risk and boosting return potential across most major asset classes. At these higher levels of yields, bonds 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. We had been reducing our equity weight throughout the year as risks intensified, but opted to take a step in the opposite direction this quarter, nudging our equity exposure slightly higher at the end of September. We added 50 basis points to our equity allocation, sourced from fixed income, as global equities fell below our modelled estimate of fair value and investor sentiment reached extremely pessimistic levels, improving the risk/reward ratio among a wide range of potential scenarios. Our current recommended asset mix for a global balanced investor is 62.0% equities (strategic: "neutral": 60%), 37.0% bonds (strategic "neutral": 38%) and 1.0% in cash (Exhibit 7).

### Exhibit 7: Recommended asset mix




Note: As of November 30, 2022. Source: RBC GAM

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