RBC Global Asset Management

Market Update

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Markets enjoy strong start to 2023

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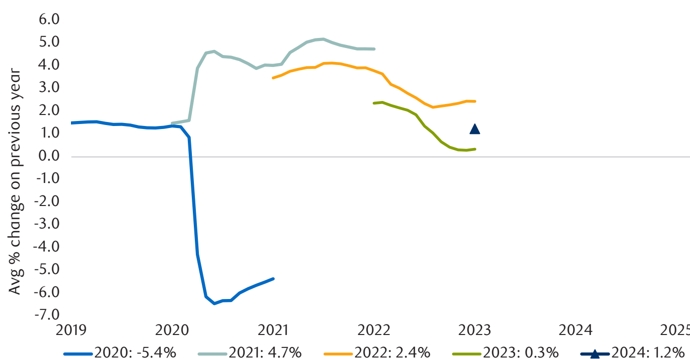
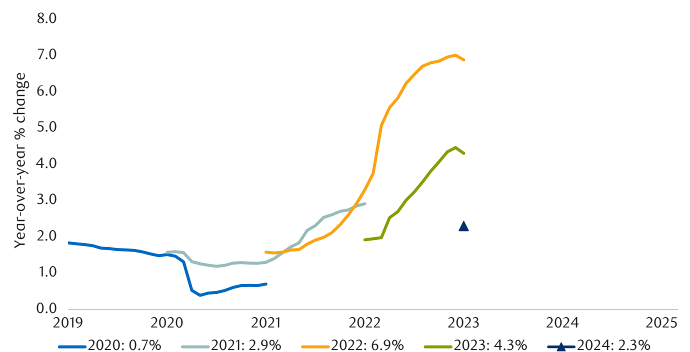
The New Year has brought welcome change for investors as both stocks and bonds rallied in the first few weeks of the year. This bounce extended gains from late 2022 and started from a point of extreme pessimism and relatively attractive asset prices, propelled by several positive developments that took hold over the past three months. The mild winter in Europe has largely alleviated fears of a full-blown energy crisis, China's abandonment of its zero-COVID policy will allow for a rapid revival of the economy and the U.S. labour market has remained especially resilient. Moreover, inflation's decided turn lower suggests that the end of the current monetary tightening cycle is coming into view. That said, growth is still slowing and a variety of risks remain including the delayed economic impact of higher interest rates, structural headwinds in China and the ongoing war in Ukraine. We continue to expect major world economies, including the U.S., to fall into recession sometime over the next year, but the positive changes in the past few months indicate that any downturn may not be as severe as we had imagined. Our own forecasts for global growth remain below the consensus, but have been upgraded relative to a quarter ago. Our forecasts for inflation are below the consensus – a good thing (exhibits 1 and 2).

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



Note: as of January 2023. Source: Consensus Economics

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

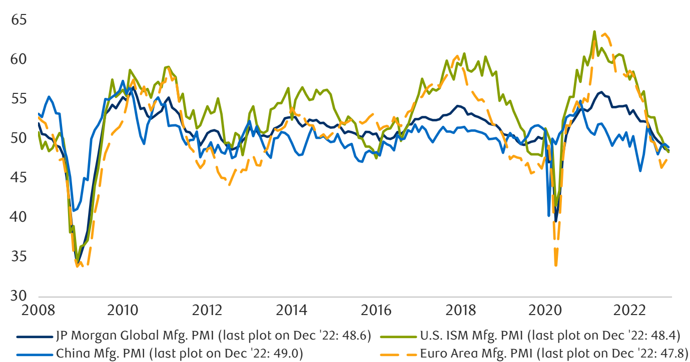


Note: as of January 2023. Source: Consensus Economics

Economic data is soft, but tentatively rebounding internationally

Supporting the notion that global growth is slowing is the fact that leading indicators are weak almost everywhere, but there are some interesting differences between regions at the margin. Exhibit 3 plots the global purchasing managers' indices (PMIs) for major regions and, although they are all below the 50 level, the PMIs in Europe and China appear to be rebounding from low readings. The increase in PMIs is noteworthy, and consistent with the view that those economies are no longer deteriorating to the extent they once were. Consistent with this, recent economic data in Europe has been incrementally less weak than expected since the fall of last year, whereas data in the U.S. has been generally close to or slightly worse than expectations (Exhibit 4). The divergence between Europe and U.S. economic data surprise indices became apparent in November 2022 and has been widening gradually since then. These nuances are important because investors tend to price assets based on expectations, so that even if data is poor, but turns out to be not as poor as expected, then the scope for a positive market response opens up.

Exhibit 3: Global purchasing managers' indices



Note: as of December 31, 2022. Source: Haver Analytics, RBC GAM

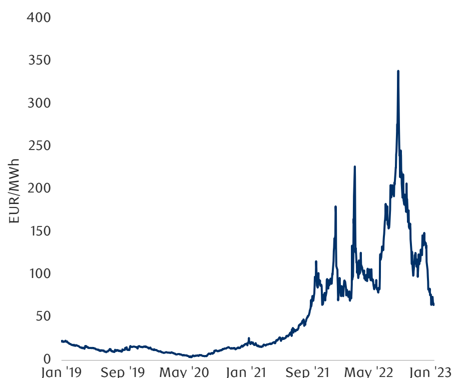
Exhibit 4: Citi Economic Surprise Index

Note: as of January 20, 2023. Source: Citigroup Global Markets Inc., RBC GAM

Inflation is rapidly cooling

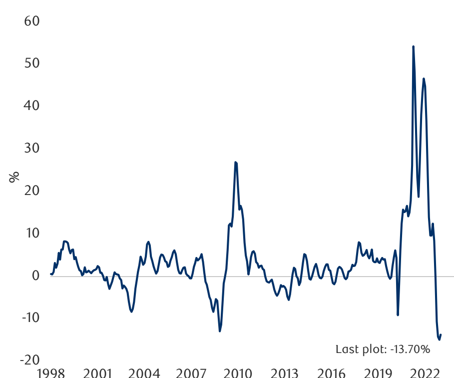
Europeans are getting some relief from plunging energy prices, and price pressures are cooling more broadly. Natural-gas prices have plummeted 80% from their peak, helped by a warmer-than-expected winter (Exhibit 5). In the U.S., used-car prices, which surged in the post-pandemic era, have rolled over and are now declining at a double-digit rate year over year (Exhibit 6). Furthermore, there has been a marked decline in the number of businesses planning to raise prices over the next several months (Exhibit 7). While price pressures still exist in parts of the economy, these examples demonstrate the massive declines in what had been critical drivers of inflation.

Exhibit 5: Dutch TTF natural gas one month forward price



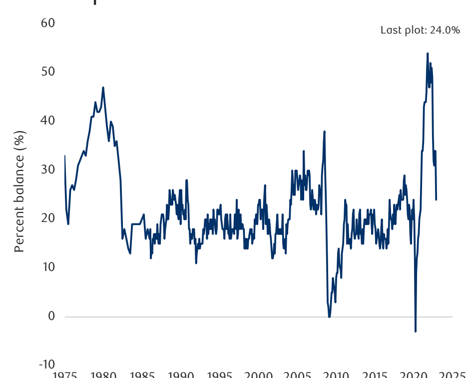
Note: as of January 9, 2023. Source: Macrobond, RBC GAM

Exhibit 6: Manheim Used Vehicle Value YoY Index



Note: as of January 2023. Source: Bloomberg, RBC GAM

Exhibit 7: U.S. small business survey – Companies with plans to raise prices over the next 3 months



Note: as of December 31, 2022. Source: NFIB, BCA Research, Bloomberg, RBC GAM

U.S. consumer-price inflation has already fallen meaningfully to a 6.5% annual rate from its 9.1% peak and is likely to continue decreasing in the months ahead. The trend in the monthly data allows us to more clearly see the shift in the trend that has taken place over the past year (Exhibit 8). The past six months of data suggest inflation is tracking close to a 2% yearly rate, whereas inflation in the six months prior (i.e. January 2022 to June 2022) was tracking closer to a 10% rate. As the one-year data window moves forward with new inflation releases over the coming months, the year-over-year measure will gradually drop off the period of very high inflation from early 2022. Exhibit 9 plots several hypothetical paths for the year-over-year measure under different inflation assumptions. Assuming new inflation data comes in around 0.2% on a month-over-month basis, which is consistent with what we have seen in the past six months, inflation could fall to between 2% and 4% by May of this year and could even drop close to 2% by year-end. This outcome appears widely accepted by investors as inflation expectations embedded in the pricing of inflation-protected bonds appear well-anchored near the 2% level (Exhibit 10).

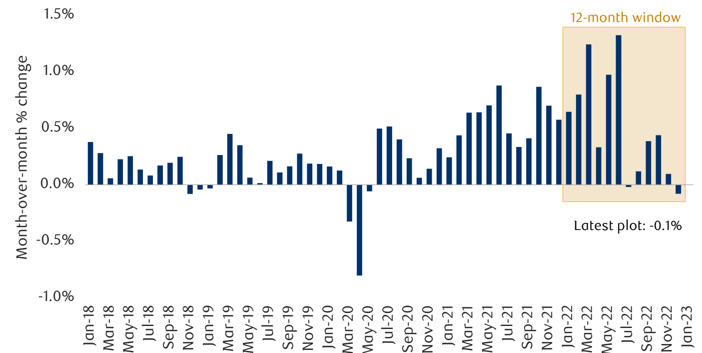
The need for further monetary tightening is becoming less apparent

With inflation on its way down and expectations well anchored around 2%, central banks may be able to raise interest rates at a slower pace or even pause rate hikes altogether. In fact, after delivering a 25-basis-point hike on January 25, the Bank of Canada signaled that rates would remain steady at the current 4.50% level to allow the significant tightening already delivered time to work its way into the economy. The U.S. may soon adopt a similar strategy after having already delivered 425 basis points of rate increases since March 2022. Our own model suggests the Fed was well behind the curve early last year, but that they did a good job catching up to where rates needed to be

> "Unless inflation surprises meaningfully to the upside, the severe pain that bond investors experienced in 2022 is unlikely to be repeated..."

Exhibit 8: U.S. CPI Inflation

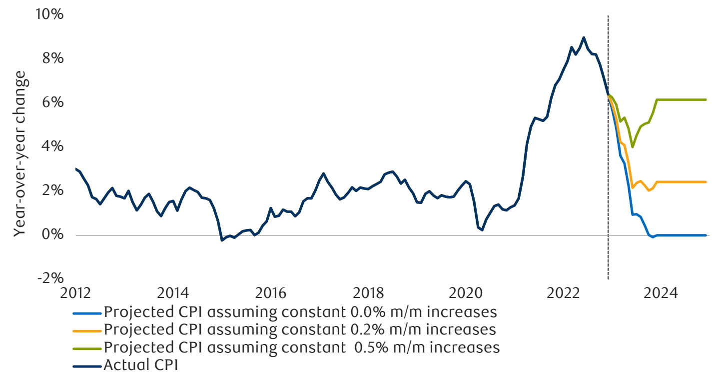
Month-over-month % change



Note: as of December 31, 2022. Source: Bloomberg, RBC GAM

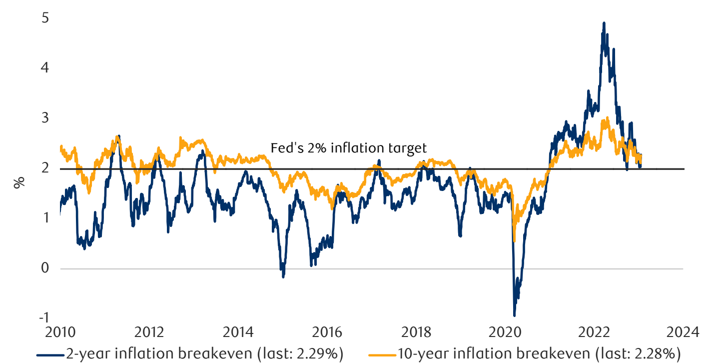
Exhibit 9: U.S. CPI Inflation

Hypothetical projections in y/y % change



Note: as of December 31, 2022. Source: Bloomberg, RBC GAM

Exhibit 10: U.S. Treasuries inflation breakevens



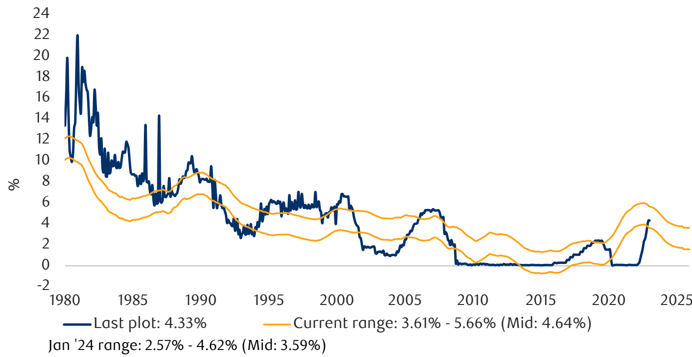
Note: as of January 23, 2023. Source: Bloomberg, RBC GAM

given the state of inflation and economic growth (Exhibit 11). But our model also suggests that outright rate cuts could be warranted over the next year. Pricing in futures markets is consistent with the view that the fed funds rate will peak at 5% after two more 25-basis-point hikes, and hold there until the Fed begins cutting rates later in the year (Exhibit 12).

While financial markets have been buoyed by the prospect of falling interest rates, it is worth noting that both investors and our own model suggest interest rates are unlikely to fall all the way back to zero. As a result, investors will likely still need to get used to higher rates than they had grown accustomed following the financial crisis of 2008-2009.

Exhibit 11: U.S. fed funds rate

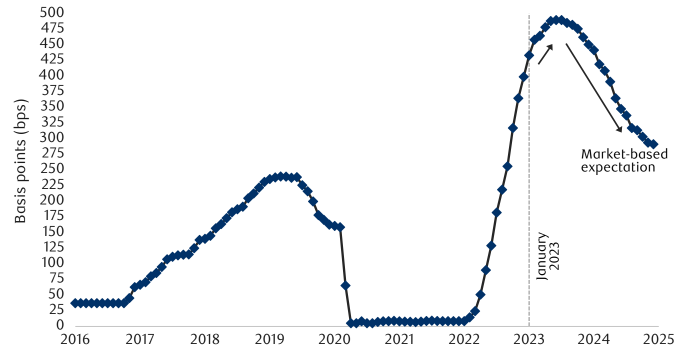
Equilibrium range



Note: as of January 23, 2023. Source: Federal Reserve, RBC GAM

Exhibit 12: Implied fed funds rate

12-months futures contracts as of January 20, 2023

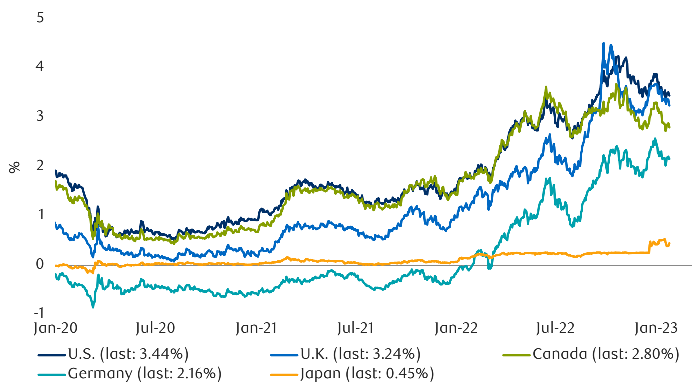


Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Bonds stabilized after historic sell-off

After one of their worst performing periods on record, sovereign bonds rebounded late last year and into 2023 as inflation fears subsided and investors weighed the possibility of a recession. Government-bond yields declined in almost all major regions that we track (Exhibit 13) with the exception of Japan, whose central bank raised the top end of its targeted trading band for the Japanese 10-year yield to 50 basis points from 25 basis points. Japanese 10-year yields immediately rose to the upper limit and have briefly breached it on several occasions since then. In the U.S., 10-year Treasury yields have fallen to 3.50% from October's high of 4.25%. Although the yield is currently well below our modelled equilibrium band, our falling inflation assumption pulls the band lower over time and suggests yields in the range of 3% to 4% would be an appropriate level over the next several years (Exhibit 14). Unless inflation surprises meaningfully to the upside, the severe pain that bond investors experienced in 2022 is unlikely to be repeated, particularly as yields are no longer at extreme lows.

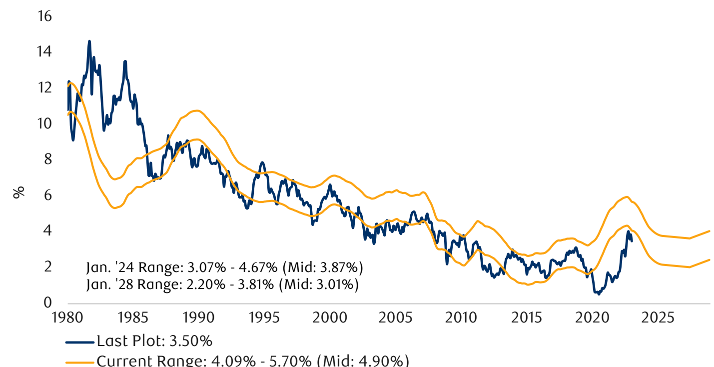
Exhibit 13: 10-year government bond yields



Note: as of January 25, 2023. Source: Bloomberg, RBC GAM

Exhibit 14: U.S. 10-year T-Bond yield

Equilibrium range



Note: as of January 22, 2023. Source: RBC GAM

Yield curve is signaling recession

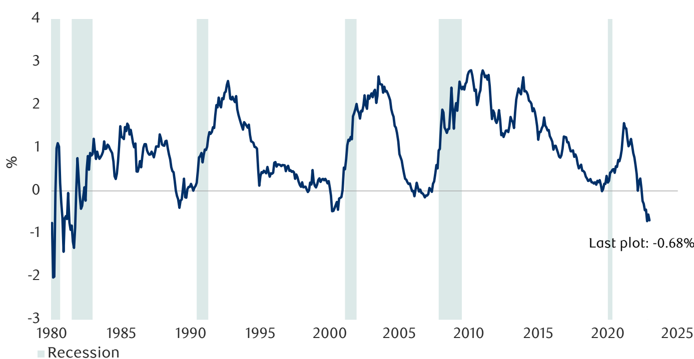
One aspect of the bond market that may be concerning to investors is that short-term interest rates are now much higher than long-term bond yields. An inverted yield curve is a relatively rare occurrence, but it has been a reliable predictor of recessions given that inversions have preceded every economic contraction since the 1980s (exhibits 15 and 16). Historically, inversions in the spread between 2-year and 10-year Treasury yields have occurred an average of 18 months before recessions, and inversions between 3-month and 10-year Treasury yields occurred an average of 11 months before recessions. The 2-year and 3-month curves inverted in July 2022 and October 2022, respectively and, based on the average lead times, both point to September 2023 as the likely beginning of the next recession. While yield-curve inversions are not foolproof predictors of recession, their track record is good enough to suggest they are worth paying attention to.

Stocks extend rally from late 2022, leadership shifts away from U.S. large caps

While the bond market signals economic weakness ahead, the stock market is reflecting a more optimistic view. Global equities have rebounded from their lows late last year, with some indices recording gains exceeding 20%. The MSCI EAFE Index has gained 28% from its low and the MSCI Emerging Markets Index is up 24%. Canada's TSX Composite has risen by 17% and the S&P 500 Index by 12%, all in U.S.-dollar terms (Exhibit 17). U.S. equities lagged due to their heavy weighting in large-cap technology stocks, which underperformed. More broadly, part of the reason stocks may have rebounded was that last year's bear market made stock valuations reasonable, or even particularly attractive, depending on the region. Our composite of global stock-market valuations fell below fair value in September 2022 for the first time since March 2020, compared with readings of as much as 37% above fair value in December 2021 (Exhibit 18). Moreover, excluding the more highly valued U.S. market, stocks register at more than 10% below fair value.

Exhibit 15: U.S. Treasury yield curve

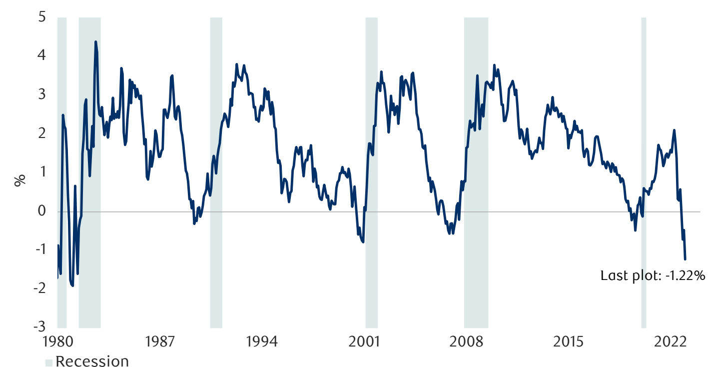
Spread between yield on 10-year and 2-year maturities



Note: as of January 25, 2023. Source: Bloomberg, RBC GAM

Exhibit 16: U.S. Treasury yield curve

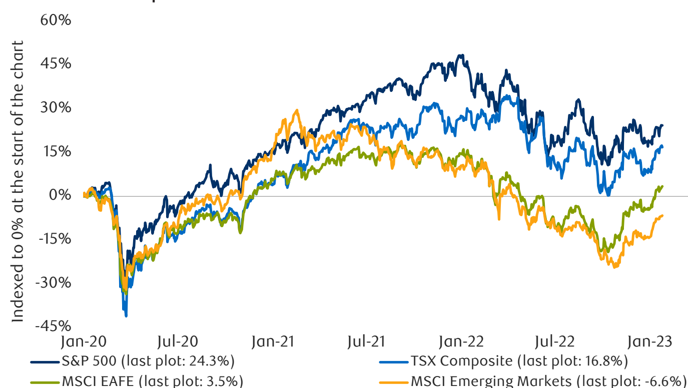
Spread between yield on 10-year and 3-month maturities



Note: as of January 25, 2023. Source: Bloomberg, RBC GAM

Exhibit 17: Major equity market indices

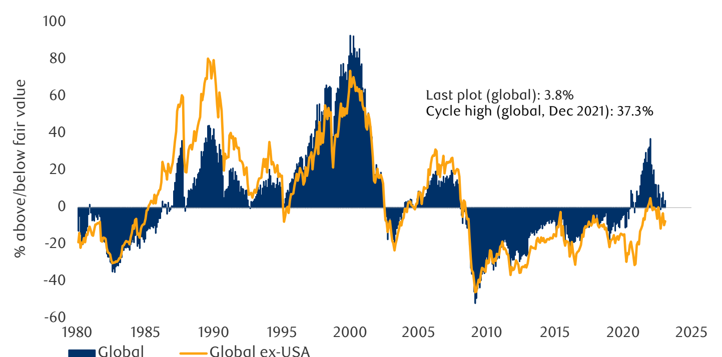
Cumulative price returns indices in USD



Note: as of January 25, 2023. Price returns computed in USD.
Source: Bloomberg, RBC GAM

Exhibit 18: Global stock market composite

Equity market indexes relative to equilibrium



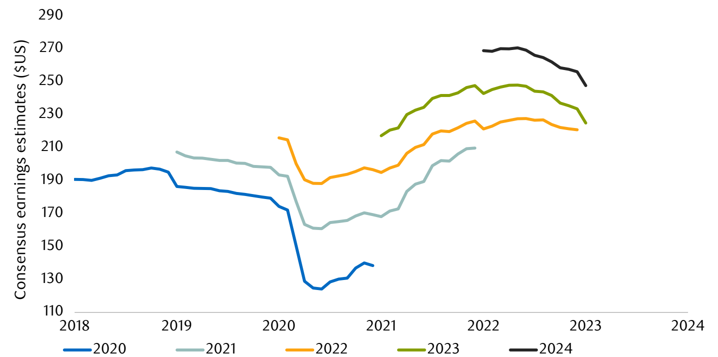
Note: as of January 23, 2023. Source: RBC GAM

Earnings weakness expected to be short lived

One development that could stall the recent stock rally are declines in analysts' earnings expectations. Exhibit 19 plots the month-by-month progression of S&P 500 earnings estimates, which have been gradually decreasing amid slowing economic growth and the negative impact of rising costs on corporate profit margins. Analysts now expect an overall increase in earnings in 2023 of just 3%, down from expectations of 8% a quarter ago. Based on the more granular quarterly estimates, profits are indeed expected to contract during the year but rebound to a double-digit-growth rate by the end of the year (Exhibit 20). Exhibit 21 plots the expected path for S&P 500 earnings based on these estimates, and suggests that a shallow and short-lived downturn in profits will give way to increases that will lead to a new aggregate high of US$251 for 2024. In our view, this projection is overly optimistic given that profits have fallen an average of 25% during past recessionary periods. But we could be wrong in this assessment if the economy encounters a soft landing and/or if companies are able to continue raising prices without sacrificing profits.

Exhibit 19: S&P 500 Index

Consensus earnings estimates



Note: as of January 20, 2023. Source: Thomson Reuters, Bloomberg

Exhibit 20: S&P 500 historical and estimated future earnings growth rates

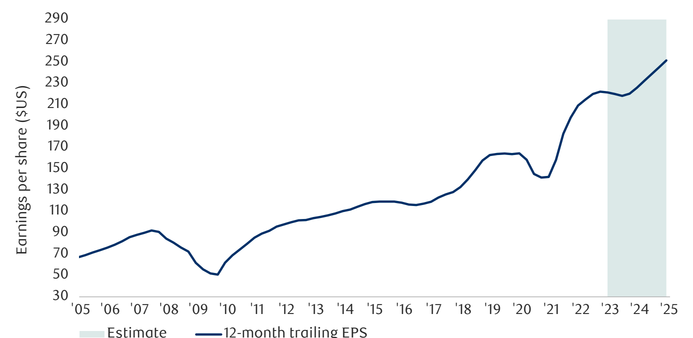
Year-over-year change

	Historical				Estimates				
Sector	**2021 Q4**	**2022 Q1**	**2022 Q2**	**2022 Q3**	**2022 Q4**	**2023 Q1**	**2023 Q2**	**2023 Q3**	**2023 Q4**
Consumer Discretionary	54.1%	-27.9%	-12.1%	13.3%	-16.1%	36.2%	34.5%	18.3%	22.0%
Consumer Staples	7.7%	7.9%	2.2%	1.3%	-2.8%	-0.5%	5.7%	7.7%	9.0%
Energy	12611.0%	269.5%	295.5%	140.9%	61.0%	23.1%	-30.4%	-24.3%	-9.7%
Financials	9.9%	-17.1%	-19.3%	-16.4%	-10.2%	5.8%	10.4%	18.0%	14.7%
Health Care	28.0%	18.3%	8.7%	1.5%	-6.5%	-11.8%	-8.5%	-3.6%	4.8%
Industrials	43.8%	40.5%	31.6%	19.6%	42.3%	25.8%	5.2%	14.6%	6.5%
Materials	64.2%	46.3%	17.5%	-7.8%	-22.3%	-23.1%	-19.7%	-1.1%	6.1%
Real Estate	17.6%	25.5%	13.1%	14.8%	7.0%	-3.8%	-2.1%	-3.6%	8.1%
Technology	24.6%	14.6%	1.5%	-0.2%	-9.1%	-6.9%	0.4%	4.6%	15.1%
Communication Services	16.6%	-2.8%	-20.3%	-26.1%	-22.2%	-7.6%	5.5%	19.4%	18.8%
Utilities	-1.3%	24.6%	-3.7%	-7.0%	1.9%	-10.0%	2.6%	9.9%	32.4%
S&P 500	**32.1%**	**11.4%**	**8.4%**	**4.4%**	**-2.9%**	**0.1%**	**-1.3%**	**4.3%**	**10.5%**
S&P 500 Ex-Energy	23.5%	5.2%	-2.1%	-3.3%	-7.3%	-1.7%	3.0%	8.4%	12.9%

Note: as of January 20, 2023. Figures from 2022 Q4 onward are estimates. Source: I/B/E/S data from Refinitiv, RBC GAM

Exhibit 21: S&P 500 Index

12-month trailing earnings per share



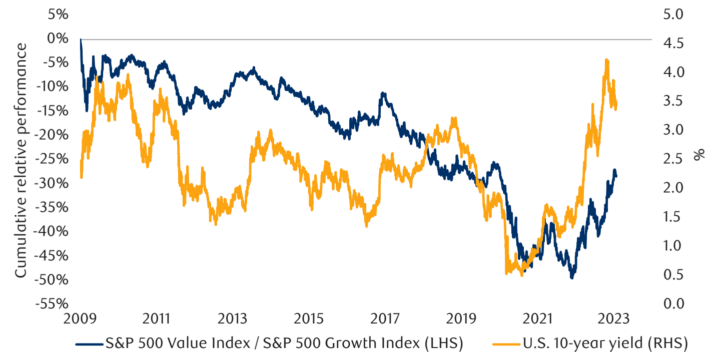
Note: as of January 20, 2023. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, Bloomberg

Constructive trends within markets

There are a number of trends signaling that investors are looking beyond the near-term economic slowdown to a subsequent recovery. We have identified five major shifts in market leadership that began over the past year but which

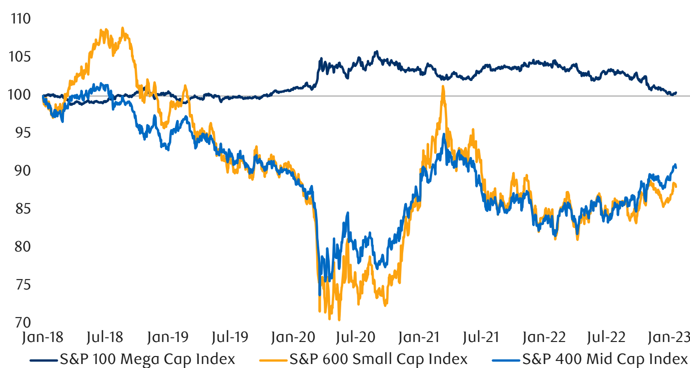
have accelerated in the recent months: 1) small caps are outperforming large caps 2) international stocks are leading U.S. stocks 3) value stocks have been winning against growth stocks 4) industrial stocks have displayed considerable relative strength and 5) the U.S. dollar has been weakening (exhibits 22 to 26). These shifts in leadership are important for two reasons. The first is that they are happening after a decade-long period of U.S. large-cap leadership. The second is that all these shifts tend to occur at the beginning of an expansion or new bull market rather than at the end of an aging cycle. So while there is a lot of pessimism and the macroeconomic backdrop remains highly uncertain, financial markets are giving us signs consistent with a bull-case scenario unfolding in the year ahead.

Exhibit 22: Value to growth relative performance
S&P 500 Value Index / S&P 500 Growth Index



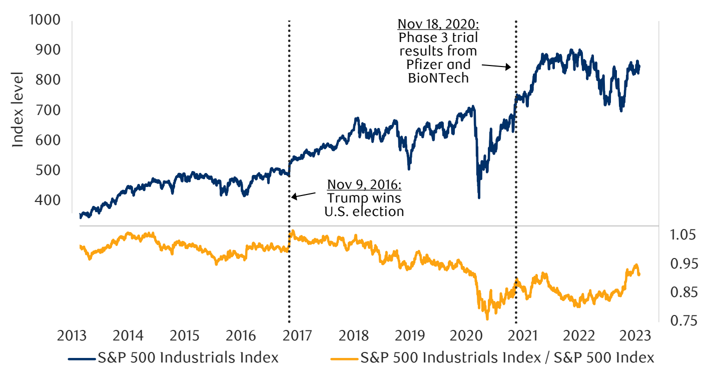
Note: as of January 20, 2023. Source: Thomson Reuters, Bloomberg

Exhibit 23: Returns to cap size relative to S&P 500 Index – Rebased to 100 as of January 1, 2018



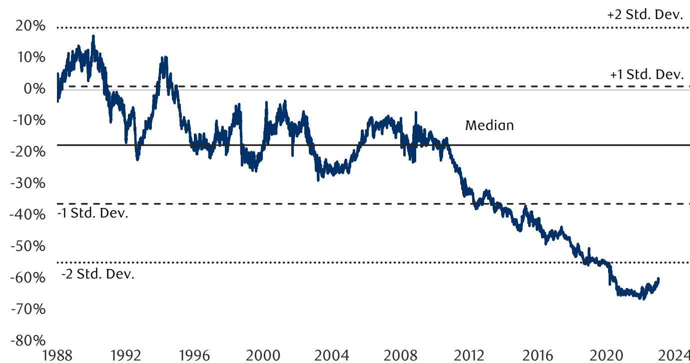
Note: as of January 20, 2023. Source: Haver Analytics, RBC GAM

Exhibit 24: S&P 500 Industrials Index
Index level and relative strength



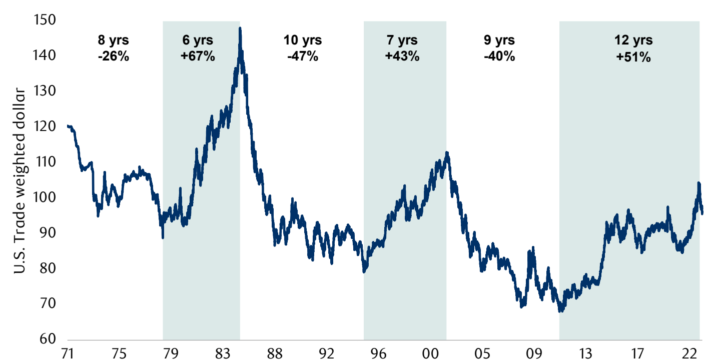
Note: as of January 25, 2023. Source: Bloomberg, RBC GAM

Exhibit 25: Relative Performance
MSCI Europe EUR vs MSCI U.S. USD



Note: as of January 11, 2023. Source: RIMES, RBC GAM

Exhibit 26: U.S. trade-weighted dollar

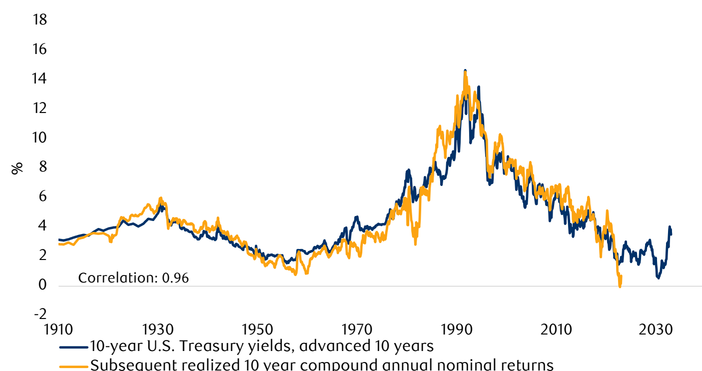


Note: as of January 13, 2023. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Asset mix – remain close to neutral, with slight bias to risk taking

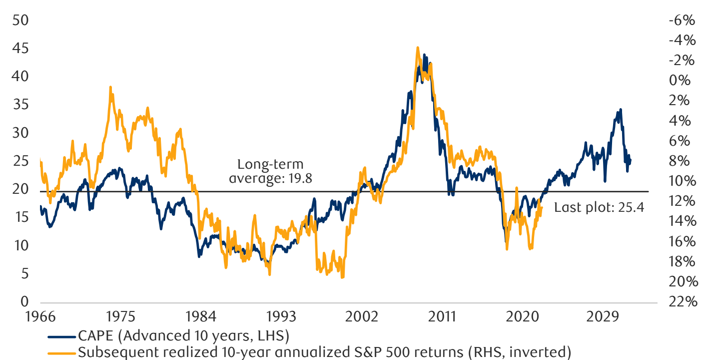
Our asset mix seeks to balance the risks and potential opportunities given a variety of scenarios. We recognize that the odds of recession are elevated and that corporate profits would be vulnerable were the economy to deteriorate, but we also believe that financial markets are much more attractively priced than they were a year ago and that both stocks and bonds therefore offer improved return potential (exhibits 27 and 28). Interest rates have risen meaningfully and are now at levels where bonds should offer greater ballast against a downturn in stocks within a balanced portfolio. Furthermore, cooling inflation and the idea that central banks are nearing a pause in their tightening plans could provide a further boost to government bonds. As a result, our allocation to fixed income is close to neutral, versus the significant underweight positions we had in place when interest rates were near historic lows. We are maintaining a slight overweight position stocks given our view that equities will likely outperform bonds over the longer term. Equities could encounter volatility in the near term if recession concerns intensify or inflation reasserts itself, but we acknowledge that a variety of positive market trends are challenging this view. While it remains unclear as to whether these trends will be sustained, we are open to the possibility that the cycle lows could be behind us. 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 27: U.S. 10-year Treasury note and returns



Note: As of January 23, 2023. Source: Deutsche Bank, Haver Analytics, RBC CM, RBC GAM

Exhibit 28: Shiller's CAPE – Real S&P 500 Index / 10-year average of real EPS



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

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