RBC Global Asset Management

Market Update

JULY 6, 2023

Tech darlings carried stocks higher amid slowing growth, higher rates

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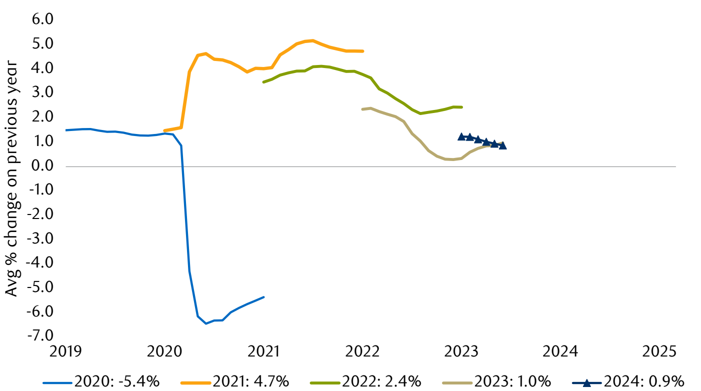
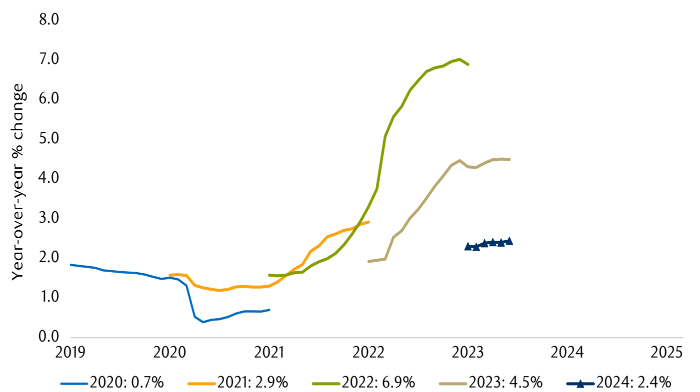
Global equity markets recently rose to their highest levels in over a year, signifying a belief among investors that the economy can achieve a soft landing. The expansion has indeed demonstrated impressive resilience in the face of the most aggressive monetary-tightening cycle since the 1970s, but our view is that the economy is likely to stumble as the impact of rising interest rates is usually felt on a lagged basis. The massive interest-rate increases that have been delivered over the past year are likely to cause economic weakness in the coming quarters and some signs of stress are already starting to surface. While inflation is coming down, central banks have been vocal about their intentions to keep interest rates higher for longer, which would weigh on economic activity and lead to a less friendly macroeconomic environment for risk-taking. We are maintaining our view that developed economies are likely to fall into recession over the next year and that inflation will head lower, though not quite reaching the 2% level targeted by most central banks. Our forecasts for both growth and inflation are below the consensus (exhibits 1 and 2).

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



Note: As of Jun 2023. Source: Consensus Economics

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



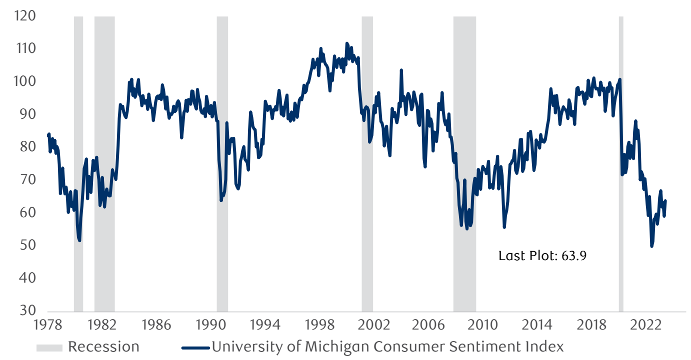
Note: As of Jun 2023. Source: Consensus Economics

Economic data has been mixed

Although we continue to think the economy will soften, there are some indicators pointing to improvement, suggesting the economy could be less fragile than we think. The University of Michigan Consumer Sentiment Index bottomed in June 2022, and while it remains relatively weak, it has been gradually rising in a sign that perhaps consumers' most intense feelings of pessimism are behind (Exhibit 3). A similar trend is occurring in the housing market. Measures of homebuilder and home-buyer sentiment are well off their lows and now indicate that housing-market conditions are more favourable (Exhibit 4). Corroborating this sentiment is the fact that the number of new housing units being built has jumped to its highest rate since April 2022 after declining steadily for more than a year (Exhibit 5).

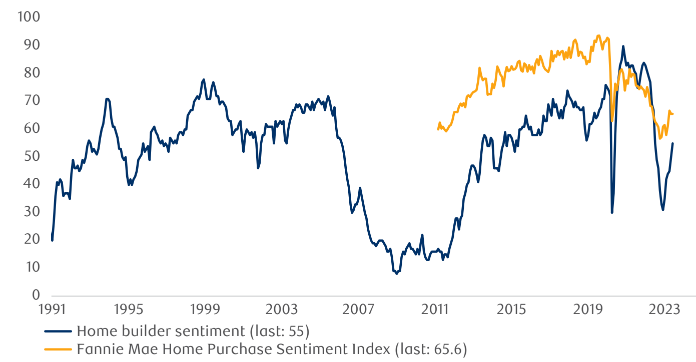
However, other indicators suggest that the economic backdrop remains precarious. Leading indicators of the economy have extended their declines, with manufacturing purchasing managers' indices pointing to contraction in most of the world's major economies (Exhibit 6). Moreover, the labour market is starting to show signs of stress. The number of initial unemployment claims has been inching higher since the second half of 2022 and, while the figure remains below its long-term norm, past instances of sustained increases

Exhibit 3: University of Michigan Consumer Sentiment Index



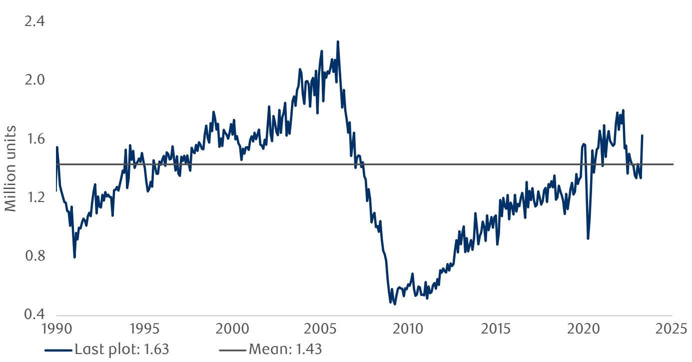
Note: As of June 30, 2023. Source: Bloomberg, RBC GAM

Exhibit 4: U.S. housing market sentiment



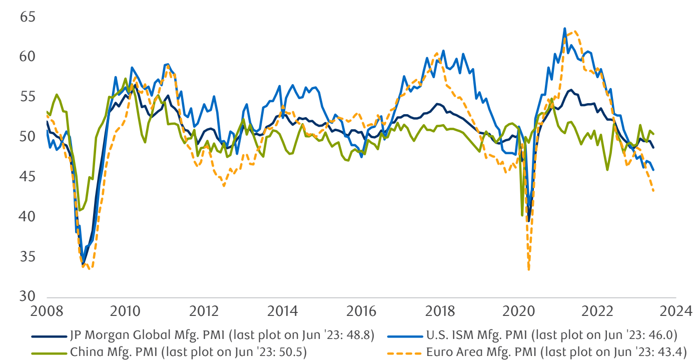
Note: As of June 2023. Source: Bloomberg, RBC GAM

Exhibit 5: U.S. housing - new private housing units started – Total starts including farm housing (SAAR)



Note: As of May 2023. Source: Bloomberg

Exhibit 6: Global purchasing managers' indices



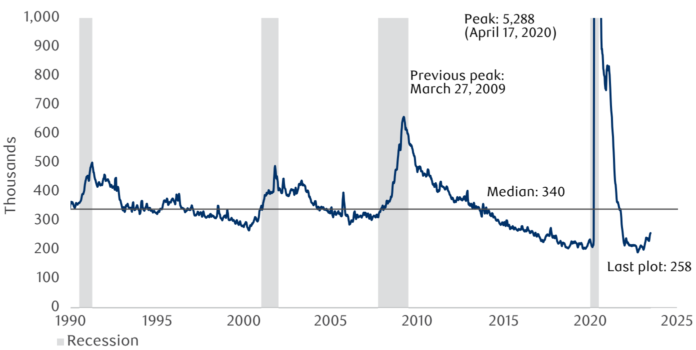
Source: Haver Analytics, RBC GAM

in jobless claims have often preceded recessions (Exhibit 7). Finally, rapidly rising interest rates and the troubles in U.S. regional banks that surfaced this spring have caused significant tightening in lending standards, making it more difficult for consumers and businesses to obtain loans that would bolster economic activity (Exhibit 8). While consumer spending and the housing market have been resilient so far, we ultimately think that the headwinds facing the economy will dominate in the second half of this year.

Inflation pressures have moderated

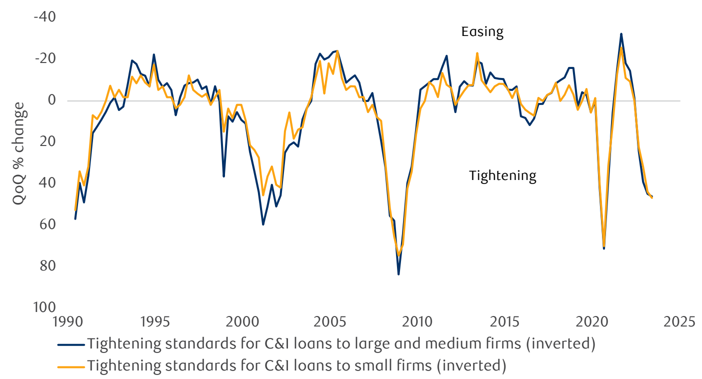
A major benefit of the slowing economy is that inflationary pressures are cooling. U.S. CPI declined to 4.0% in May of this year from a high of 9.1% in June 2022, and a variety of indicators suggests inflation will likely continue trending lower over the year ahead. One indicator that has been particularly good at foreshadowing the direction of inflation has been U.S. money-supply growth, with a 16-month lead (Exhibit 9). The initial surge in money supply during the pandemic pointed to much higher levels of inflation in 2021 through to mid-2022 and then began reversing. The fact that money-supply growth is now contracting suggests inflation is likely to continue falling until the end of 2024. Investors largely agree with this view, as prices of inflation-protected bonds indicate that inflation expectations remain well anchored around the 2% level targeted by most developed-world central bankers (Exhibit 10). Should inflation continue falling as expected, central banks will ultimately be able to scale back monetary tightening and perhaps even begin easing at some point over our one-year forecast horizon.

Exhibit 7: U.S. initial unemployment claims filed
Four week moving average



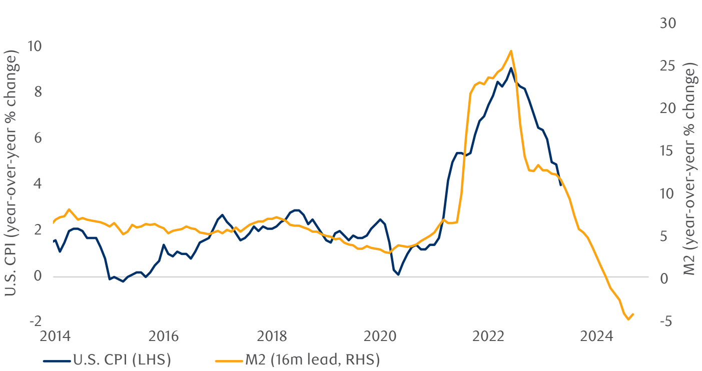
Note: As of June 23, 2023. Source: BLS, Macrobond, Bloomberg

Exhibit 8: Senior loan officer survey on bank lending practices – Number of banks reporting tightening standards for C & I loans



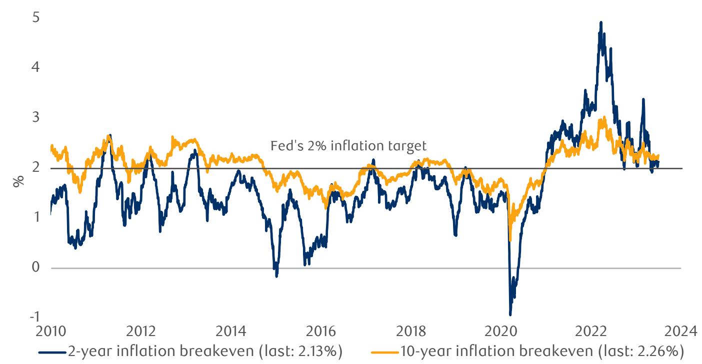
Note: As of Q2 2023. Source: Federal Reserve, Macrobond

Exhibit 9: U.S. inflation and money supply
Year-over-year changes in CPI and M2



Note: As of May 31, 2023. Source: Bloomberg, RBC GAM

Exhibit 10: U.S. Treasuries inflation breakevens



Note: As of Jul 4, 2023. Source: Bloomberg, RBC GAM

Central banks remain hawkish

Even though inflation is moving in the right direction, there is still some distance to the 2% target and central banks are not ready to let their guard down just yet. Most developed-world central banks have hinted that more rate hikes are coming but have dismissed the idea that rate cuts are imminent. The Bank of Canada resumed tightening after a brief pause, the Bank of England accelerated its pace of rate increases and, although the U.S. Federal Reserve (Fed) opted for a pause last month, the Federal Open Market Committee's (FOMC) forecast suggests the likelihood of two more 25-basis-point hikes by the end of the year.

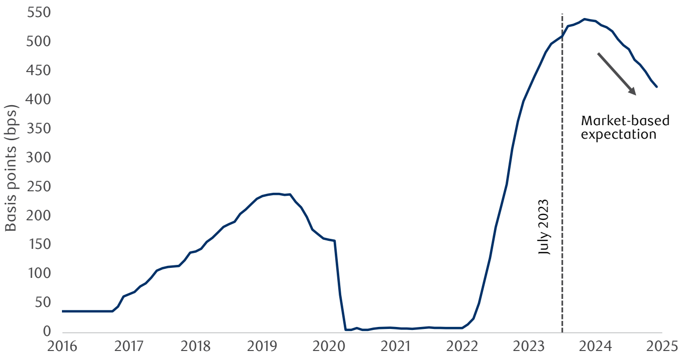
Incoming data will ultimately guide the path for rates and, while central banks are intent on delivering more hikes in the near term, we think the monetary-tightening cycle is ultimately nearing its conclusion. Pricing in the futures market is consistent with 25 to 50 basis points of further hiking in the U.S., followed by eventual cuts in 2024 (Exhibit 11). Our own model, which uses inflation as an input, is consistent with this view. The model suggests interest rates are currently situated well into restrictive territory and, if we are right that inflation will continue falling, they have the scope to come down over the year ahead (Exhibit 12).

Bond yields climb, yield curve inverts further

The prospect of higher central-bank policy rates in the near term and the notion that rate cuts likely won't occur until next year has lifted bond yields, especially for shorter maturities. The U.S. 2-year bond yield climbed more than 50 basis points in the past month and is flirting with the cycle peak that occurred just before the failure of Silicon Valley Bank (Exhibit 13). Longer-term yields have risen too, but not nearly as much, reflecting doubt in the sustainability of high interest rates amid slowing growth and cooling inflation. As a result,

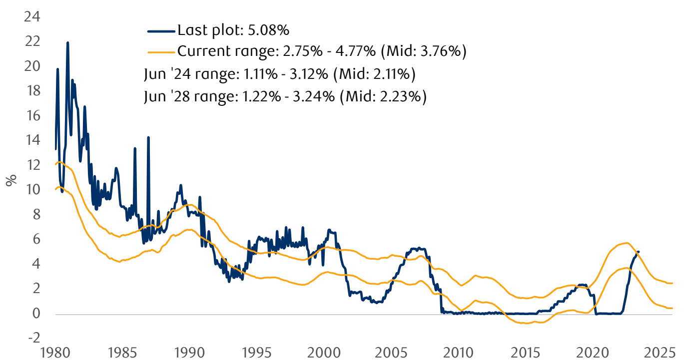
> "An inverted curve has been a reliable predictor of recessions in the past, and we believe this set-up bodes well for fixed-income returns assuming central banks ultimately ease policy in the face of economic weakness."

Exhibit 11: Implied fed funds rate – 12-months futures contracts as of July 3, 2023



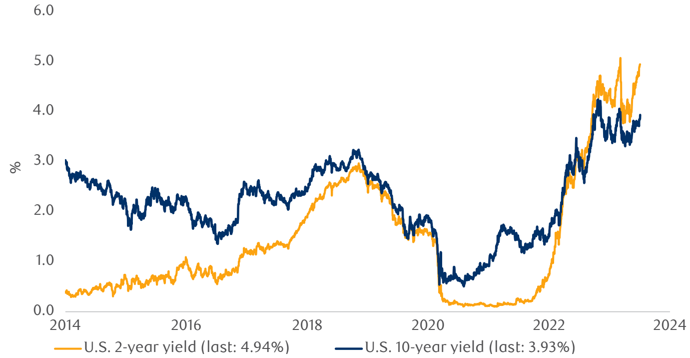
Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 12: U.S. fed funds rate
Equilibrium range



Note: As of Jul 4, 2023. Source: Federal Reserve, RBC GAM

Exhibit 13: U.S. government bond yields

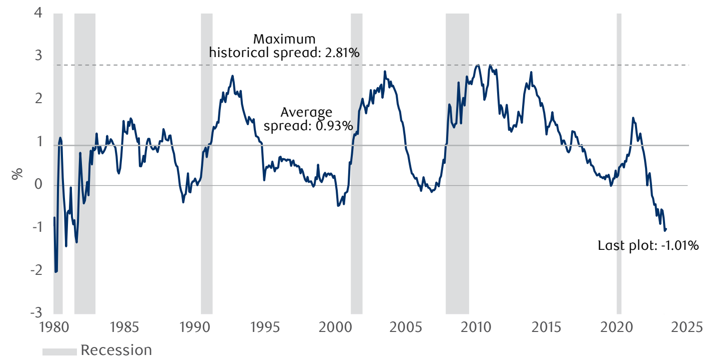


Note: As of July 5, 2023. Source: Bloomberg, RBC GAM the yield curve, as proxied by the spread between 2-year and 10-year yields, reached its most inverted level since the early 1980s (Exhibit 14). An inverted curve has been a reliable predictor of recessions in the past, and we believe this set-up bodes well for fixed-income returns assuming central banks ultimately ease policy in the face of economic weakness. Moreover, our own model projects a declining trend in the equilibrium level for the U.S. 10-year yield over the year ahead, suggesting minimal valuation risk and improved return potential for sovereign bonds (Exhibit 15).

Stocks extend rally, led by mega-cap technology

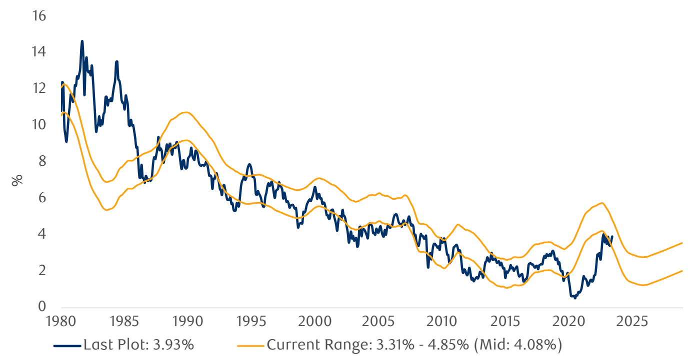
Global equity indexes extended gains in the past month, capping a strong first half of the year. The returns were heavily concentrated in a handful of mega-cap technology stocks, while most other segments of the equity market did not perform nearly as well. The "Fab 7," a basket that comprises the mega-cap U.S. technology stocks deemed most likely to benefit from emerging trends in artificial intelligence, was up an impressive 62% in the first six months of this year (Exhibit 16). In that time period, the tech-heavy NASDAQ was up 32% and the S&P 500 by 16%. The "Fab 7" makes up about 30% of the weighting of the S&P 500 Index, so these companies' stellar stock performance has dominated the broad indexes. In contrast, the S&P 500 equal-weighted index was up only 6% in the first six months and other major indices such as the Russell 2000 small caps, Canada's TSX Composite, the MSCI Emerging Markets and the U.K.'s FTSE 100 gained in the mid-single digits. While global stocks have entered a technical bull market after gaining 20% from their lows, the narrow breadth in the latest advance suggests the rally could lack durability.

Exhibit 14: U.S. Treasury yield curve – Spread between yield on 10-year and 2-year maturities



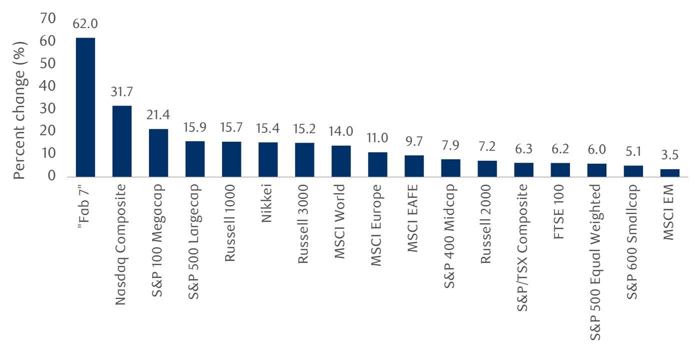
Note: As of July 5, 2023. Source: Bloomberg, RBC GAM

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



Note: As of July 5, 2023. Source: RBC GAM

Exhibit 16: Major indices' price change in USD
December 30, 2022 to June 30, 2023



Note: Fab 7 includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Source: Bloomberg, RBC GAM

Stock valuations are reasonable, especially outside the U.S.

Although a small portion of mega-cap stocks have delivered outsized gains in a short period of time, our broader-based global composite of equity-market valuations suggests that stocks, as a whole, remain fairly priced (Exhibit 17). Within this composite, market attractiveness varies largely by region, and the U.S. is the most expensive of the major markets that we track. If we exclude the U.S. from the GDP-weighted composite, global stock valuations are situated at 14% below our modelled fair value instead of just 1% below. As a result, stocks do offer reasonably attractive return potential in an environment where the economy and corporate profits continue to rise in the absence of unexpectedly large interest-rate increases.

Earnings, above their long-term trend, are vulnerable to recession

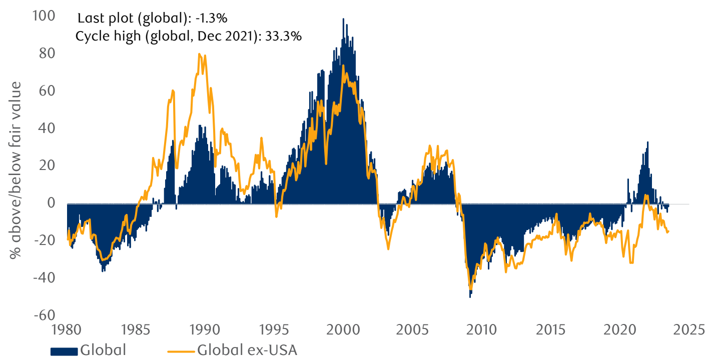
The bigger risk to equity markets is the fact that earnings would likely decline should a recession materialize as we expect. S&P 500 profit gains have stalled so far this year amid slowing economic growth and rising costs, which have weighed on record-high profit margins. Earnings, currently situated above their long-term trend, are vulnerable to correction given they've at least fallen back to their trendline in past recessions (Exhibit 18). That trendline in S&P 500 earnings per share is currently sitting at US$190, which would represent a 15% drop from the current reported earnings of US$223. If a drop in earnings of this magnitude or greater were realized, the latest rally is unlikely to be sustained.

Sentiment has reached extreme optimism

Investors may be looking beyond any potential near-term weakness in the economy and corporate profits, as sentiment measures suggest optimism is becoming increasingly widespread. A collection of various indicators tracked by Ned Davis indicates that investor sentiment has climbed to levels of extreme optimism for the first time since early 2022, after having reached a reading signifying extreme pessimism in the fall of 2022 (Exhibit 19). These sentiment indicators are good counter-indicators, though they tend to be better at identifying market bottoms than market tops. We also recognize that sentiment can remain in an extremely optimistic state for a sustained period, but it is worth noting that equity-market returns tend to be lower when starting from points of extreme optimism.

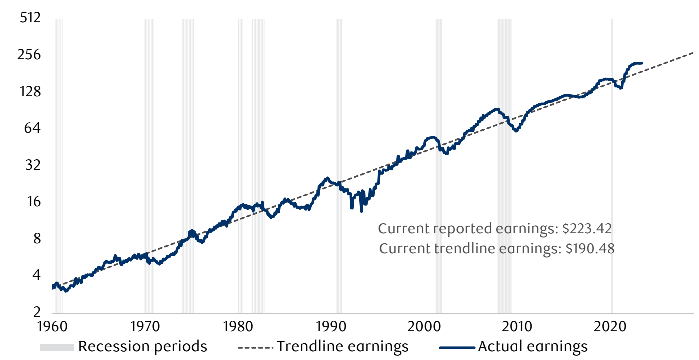
Exhibit 17: Global stock market composite

Equity market indexes relative to equilibrium



Note: As of June 30, 2023. Source: RBC GAM

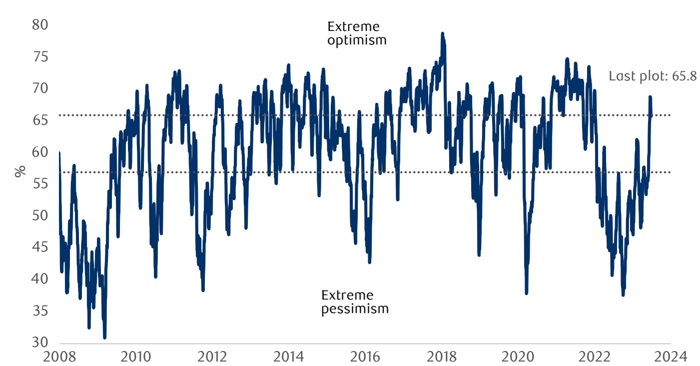
Exhibit 18: S&P 500 earnings comparison



Note: As of June 30, 2023. Source: RBC GAM

Exhibit 19: Ned Davis Research Crowd Sentiment Poll

Percent bulls

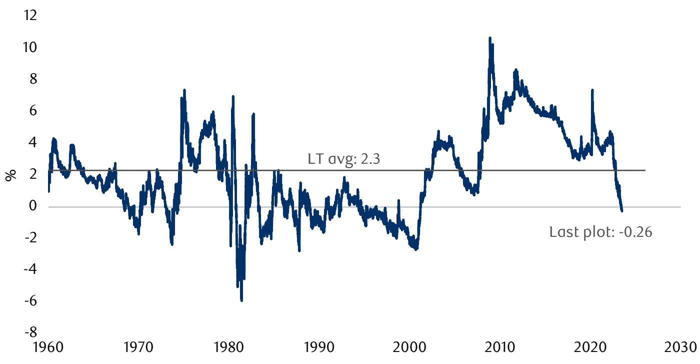


Note: As of June 27, 2023. Source: Ned Davis Research, RBC GAM

Asset mix – maintaining neutral allocation

Balancing the risks and opportunities in the near term and beyond, our asset mix is in line with our strategic neutral allocations. This is a relatively cautious stance for us given that we generally favour running an overweight position in stocks to capture superior return potential over the longer term. But the combination of a rapid rise in interest rates and latest rally in the S&P 500 has made stocks the most unappealing they've been versus cash in two decades (Exhibit 20). Moreover, given our base case that the economy is set to enter recession at some point in the next year, the higher yields offered by safe-haven bonds would provide ballast against a downturn in equities in the event of a risk-off scenario. We recognize that there are pathways to a positive outcome for the economy and equity markets should a soft landing be achieved, but we assess a low probability of this scenario playing out. We could become more constructive on the outlook if we saw some combination of a rebound in economic leading indicators, an easing of financial conditions and/or improving equity-market breadth beyond U.S. large-cap technology stocks. For a balanced global investor, we currently recommend an asset mix of 60 percent equities (strategic neutral position: 60 percent) and 38 percent fixed income (strategic neutral position: 38 percent), with the balance in cash (Exhibit 21). Actual fund or client portfolio positioning may differ depending on individual investment policies.

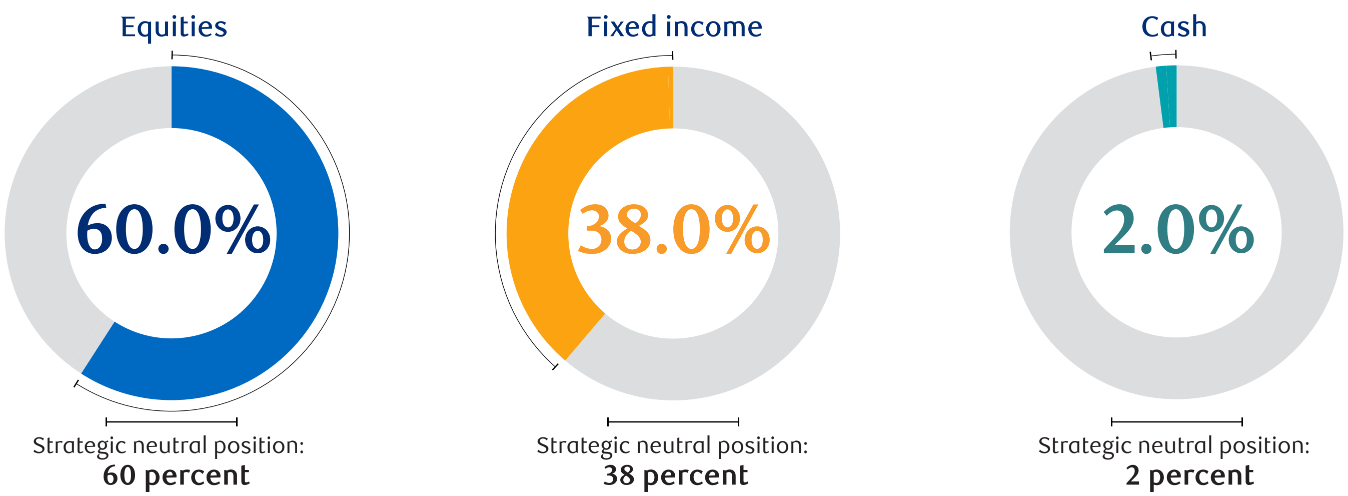
Exhibit 20: S&P 500 equity risk premium to cash



Note: As of Jun 30, 2023. Calculated as earnings yield minus U.S. 3-month yield. Source: Bloomberg, RBC GAM

Exhibit 21: Recommended asset mix

RBC GAM Investment Strategy Committee



Note: As of July 5, 2023. Source: RBC GAM

Disclosure

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