

JUNE 2, 2023

# Inflation cools while higher rates and banking stress threaten growth



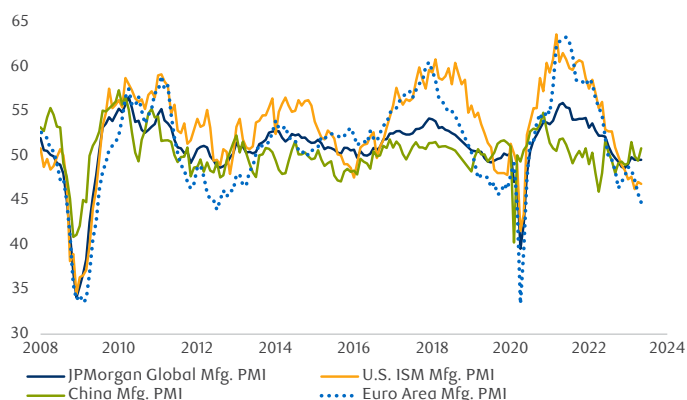
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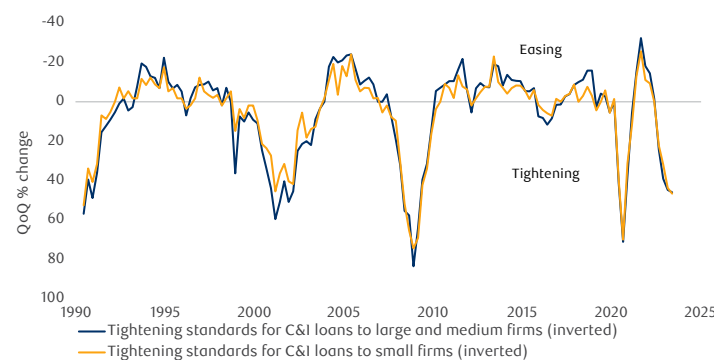
The global economy has been resilient, benefitting from pandemic-related stimulus and substantial pent-up demand. But the rapid and massive increase in interest rates since early 2022 is starting to bite, and signs of softness are surfacing. Leading indicators of economic growth are pointing to contraction in most of the world's major economies (Exhibit 1), consumer confidence has faltered, job gains slowed and unemployment claims are inching higher. Moreover, financial conditions have tightened significantly, and stress emerged in the financial system particularly among U.S. regional banks, presenting new challenges for lending conditions, credit creation and broader economic activity (Exhibit 2).

**Exhibit 1: Global purchasing managers' indices**



Note: as of May 31, 2023. Source: Macrobond, RBC GAM

**Exhibit 2: 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

### Inflation moderates from extremely high readings

A positive development from higher interest rates and slowing economic growth, however, is that they are helping cool inflation from its highest level in four decades. U.S. headline CPI inflation has declined to 4.9% from a high of 9.1% in June 2022, and a variety of factors suggest further progress toward the Fed's 2.0% target is likely (Exhibit 3). Money supply is no longer growing, supply chains have largely resumed normal operation, European energy costs have fully retraced their post-war spike and rent increases have moderated. Considering all these factors, we forecast inflation to continue falling into the end of this year and to fall even further into next year, although we assume inflation does not return all the way to 2.0% in the near term.

### Monetary tightening cycle is likely drawing near a close

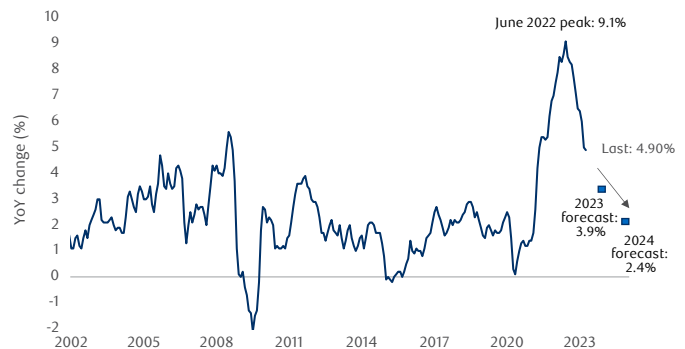
With inflation moderating and cracks starting to appear in the labour market, further aggressive tightening by central banks is becoming less warranted. Many central banks have slowed their pace of interest-rate increases while others have paused hikes altogether. Incoming data will be critical in guiding central-bank actions, but it is worth noting that the U.S. Federal Reserve has already raised short-term interest rates by 500 basis points since March 2022 and that the effects of monetary policy changes usually impact the economy with long and variable lags. The futures market is pricing in just one more 25-basis-point hike in the fed funds rate by July, followed by interest-rate cuts by the end of the year continuing into 2024 (Exhibit 4).

### Sovereign-bond valuation risk is limited according to our models

Bond yields were range-bound in most regions over the past quarter as investors weighed the impact of banking stress, inflation and economic growth on the course for interest rates. Yields initially declined following the failure of Silicon Valley Bank, but rebounded toward the end of the quarter as economic data held up relatively well and inflation proved sticky, causing investors to abandon their view that interest-rate cuts were imminent. The U.S. 10-year yield fluctuated between 4.1% and 3.3%, ending the quarter toward the middle of that range. Our models suggest that valuation risk in sovereign bonds is now limited, and that total return potential has improved assuming our view on the economy and inflation proves correct (Exhibit 5).

#### Exhibit 3: Consumer Price Inflation

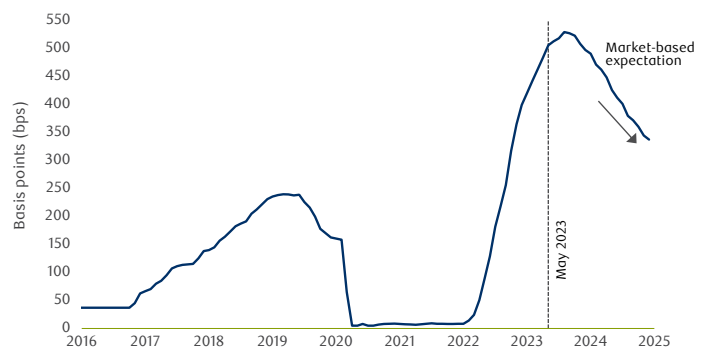
CPI Index Y/Y % change



Note: CPI data as of April 30, 2023, forecast as of May 31, 2023.  
Source: Bloomberg, RBC GAM

#### Exhibit 4: Implied fed funds rate

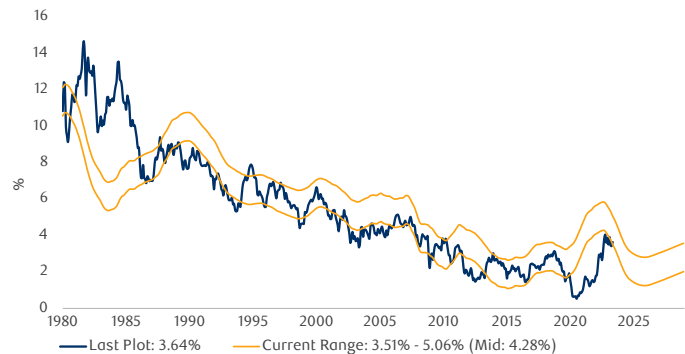
12-months futures contracts as of May 31, 2023



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

#### Exhibit 5: U.S. 10-year T-Bond yield

Equilibrium range

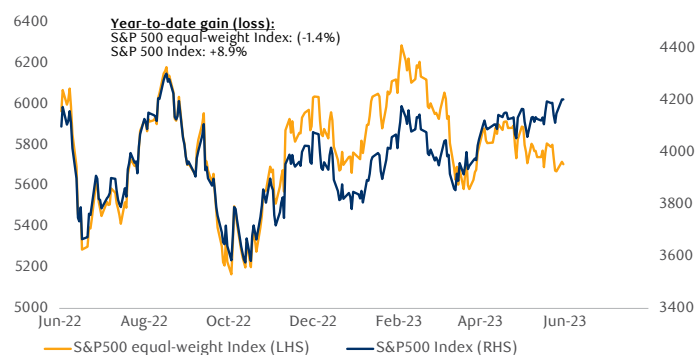


Note: as of May 31, 2023. Source: RBC GAM

## Stocks extend gains, but breadth is especially narrow in U.S. equities

Global equity markets extended gains, although investors' experience has been highly varied across regions and within individual markets. Japanese equities are in a bull market, up double digits year-to-date and having broken out to their highest level since 1990. Emerging market equities, however, are flat so far this year as China's recovery has waned. While breadth has been relatively strong in developed equity markets across the globe, it has been especially narrow in the U.S. where performance of the S&P 500 has been dominated by only a handful of mega-cap technology names. The S&P 500 cap-weighted index is up 8.9% year-to-date, but the S&P 500 equal-weight index is down 1.4% over the same period, suggesting a healthy correction could be taking place beneath the surface (Exhibit 6).

**Exhibit 6: S&P500 index and S&P500 equal-weight index – Four week moving average**

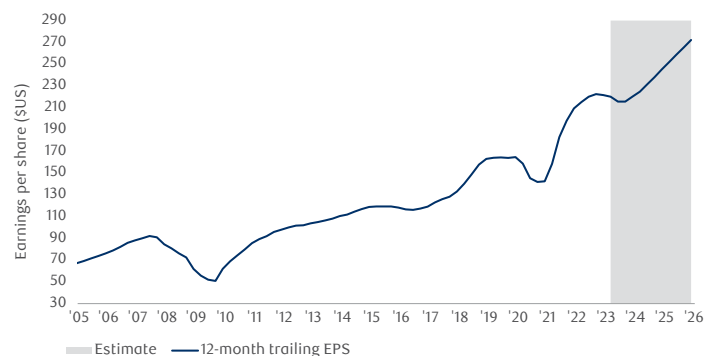


Note: as of 5/31/2023. Source: Bloomberg, RBC GAM

## Benign earnings outlook is vulnerable to recession

Although global equities are reasonably priced according to our fair value models, the outlook for corporate profits will be critical to sustaining further gains in stocks. Challenged by rising costs and slowing growth, profits have contracted for the past two quarters and are expected to fall again next quarter. But after a year of downgrades, earnings estimates may be stabilizing, and analysts look for profits to start rising again in the second half of the year and beyond. The consensus of analyst estimates looks for earnings to be flat in 2023 versus 2022, but for profit growth to accelerate to 11% in 2024 (Exhibit 7). These estimates reflect a benign outcome for the economy, and we think that if a recession were to materialize as we expect, then profit forecasts would be vulnerable to further downgrades.

**Exhibit 7: S&P 500 Index 12-month trailing earnings per share**



Note: as of May 26, 2023. Source: Thomson Reuters, RBC GAM. Estimate is based on a consensus of industry analysts' bottom-up expectations.

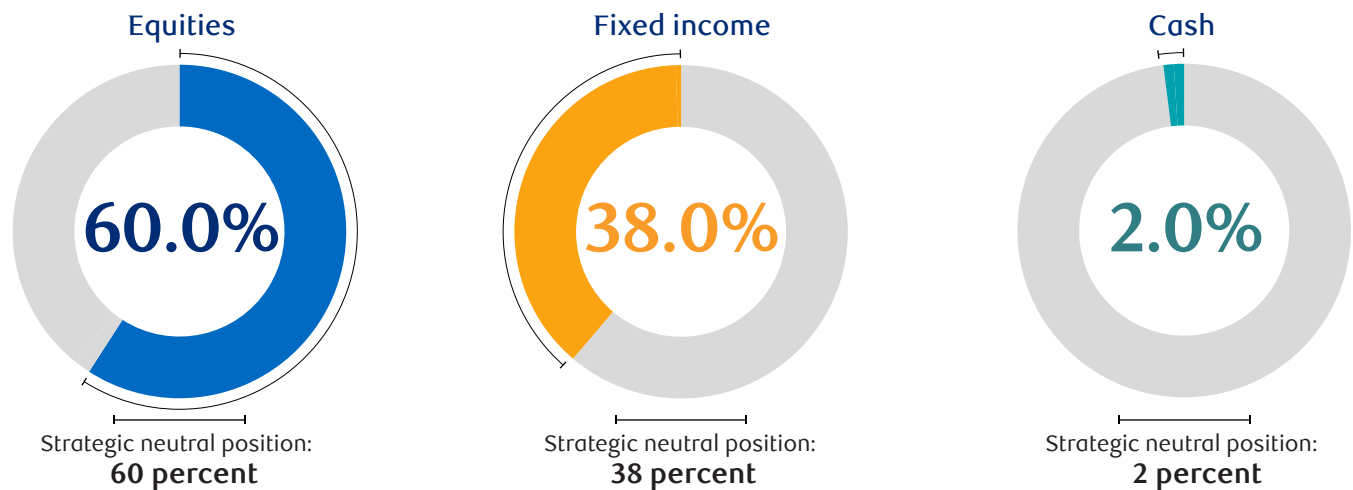


**Asset mix – sitting on neutral positioning amid elevated uncertainty**

In our view, the range of potential scenarios remains unusually wide and the macro backdrop is highly uncertain. Our base case is for economies to fall into recession over the next year and, in this environment, central banks would likely shift from monetary tightening to monetary easing. At current elevated yields, and especially if central banks cut interest rates to support a weakening economy, sovereign bonds offer a worthy ballast against a downturn in equities. The present interest-rate environment also lessens the appeal of taking risk in equities on a relative basis versus fixed income and even cash. As a result, we had been narrowing our underweight in fixed income and adding to our cash position as interest rates rose over the past year. During the

past quarter, we further reduced our equity allocation by 100 basis points, shifting half the proceeds into fixed income and the other half into cash. Our current asset mix rests at a neutral position relative to our strategic neutral. Some of the indicators we are watching that could encourage us to adopt a more constructive outlook and appetite for risk taking are improvement in economic leading indicators, easing of financial conditions, and broadening of equity-market breadth particularly among U.S. equities. Our current 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 8). Actual fund or client portfolio positioning may differ depending on that portfolio’s investment policies.

**Exhibit 8: Recommended asset mix**  
RBC GAM Investment Strategy Committee



Note: as of May 31, 2023. Source: RBC GAM

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