GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

January 4, 2024

The 2023 story: Elements of surprise

Kelly Bogdanova – San Francisco

When 2023 started, investors steeled themselves for what many took to be a year of pain for equity markets. But a funny thing happened. The expected pain became gain. We look back at the five key catalysts that turned the U.S. investment environment on its head, leading us to be cautiously constructive in 2024.

The mantra was "recession, recession, recession" when 2023 began. Following a difficult year in 2022 when the S&P 500 declined 18 percent, many economists forecast the U.S. economy would succumb to recession in 2023 due to the Fed's very aggressive rate hike cycle, and market strategists thought this could prolong the pain for stocks.

A recession has yet to pan out, large technology stocks took off, and the S&P 500 ended up posting strong 24.2 percent gains for the year (26.3 percent including dividends)—well above the 10.3 percent average annual price return since 1980.

2023 was a volatile yet strong year for the S&P 500 Index

Source - RBC Wealth Management, Bloomberg; daily data through 12/31/23. 24.2% return does not include dividends; return with dividends is 26.3%.

But we think there's more to the 2023 story than recession avoidance. Five catalysts pushed U.S. stocks higher, and some interesting details can be found in our charts.

The "Big 7" AI-themed stocks dominated, but performance broadened out in Q4

The group of stocks commonly referred to as the "Magnificent 7" or "Big 7" trounced the rest of the U.S. equity market in 2023, rising 105 percent on average. This group includes Apple, Microsoft, Alphabet, Amazon.com, NVIDIA, Tesla, and Meta Platforms.

These are very different companies, but they all have benefited

For perspectives on the week from our regional analysts, please see pages 4–5.

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Priced (in USD) as of 1/3/24 market close (unless otherwise stated). Produced: 1/4/24 5:07 pm ET; Disseminated: 1/4/24 5:25 pm ET

from artificial intelligence (AI) trends (and hype), a transformative technology they incorporate into their business models in one way or another. (For more on AI, see this article.)

During the first nine months of the year, the Big 7 stocks accounted for about 75 percent of the S&P 500's gains. They represent 26 percent of S&P 500 market capitalization, so whether they trade up or down is a major factor in shaping this large-cap index's performance.

The Big 7's outsized gains are also a key reason why the Nasdaq Composite rallied 43.4 percent in 2023 (44.6 percent including dividends), as these stocks trade on the Nasdaq exchange.

The good news is that market performance began to broaden out beyond the Big 7 in Q4. In addition to the Information Technology sector, the Real Estate, Consumer Discretionary, Financials, and Industrials sectors outperformed the S&P 500 on a total-return basis from late October to year end.

The Fed's pivot played a key role

The Fed's dramatic change in stance—pivoting from one of the most aggressive rate hike cycles in history to forecasting multiple rate cuts for 2024—boosted the equity market in Q4 and we think it was one of the key reasons that sector performance broadened out.

Not only did other large-cap sectors participate, but small-cap and midcap indexes also rallied strongly in late 2023. The S&P Small Cap 600 and S&P MidCap 400 surged 23.9 percent and 20.0 percent, respectively, from late October to year end. Even dividend growth stocks, which had lagged badly for much of 2023, rose 14.1 percent during the same period as measured by the S&P 500 Dividend Aristocrats Total Return Index.

Declining inflation and Treasury yields, stronger-than-expected GDP, and soft-landing sentiment helped

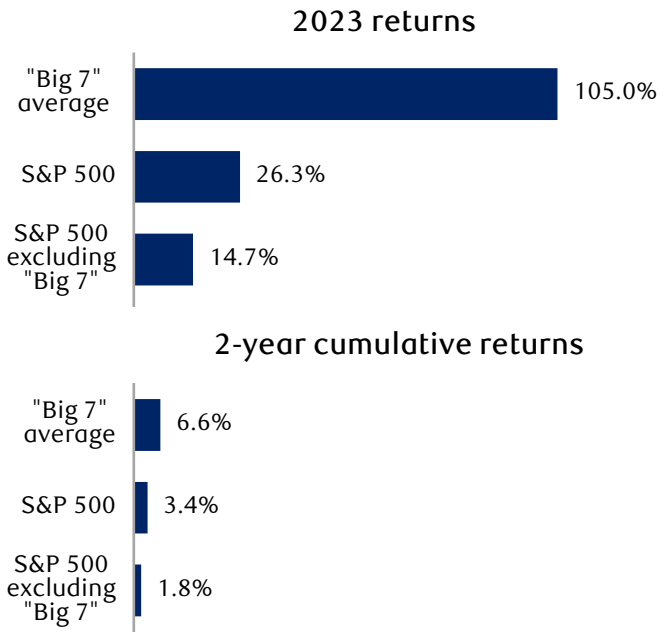
The consumer inflation rate dropped from 7.5 percent at the start of the year to 3.1 percent in November (December data will be released soon). Treasury yields surged midyear with the 10-year yield peaking at 4.99 percent in October, but it quickly fell back to 3.88 percent by year end—just slightly above where it started the year—as the Fed became more dovish and additional rate cuts were factored into bond market expectations. And economists' consensus forecast for 2023 GDP growth rose from just 0.3 percent in January 2023 to 2.40 percent by year end.

These major changes, combined with the labor market's resiliency, led market participants to become more optimistic that a soft landing is possible.

The market surged despite low earnings growth

S&P 500 earnings for the first three quarters of 2023 declined 1.6 percent compared to the first three quarters

"Big 7" not so big on a 2-year basis

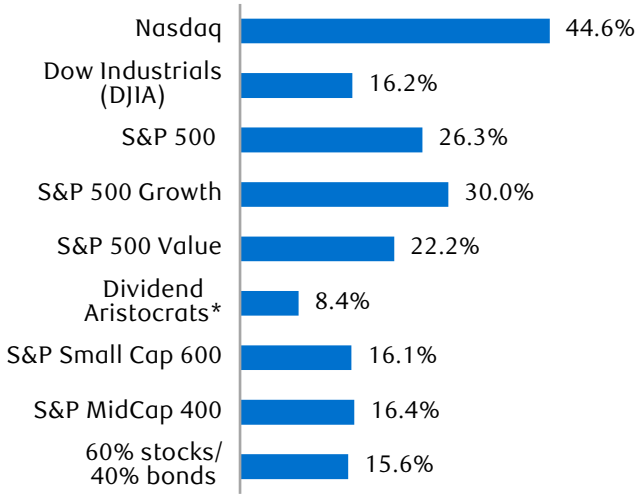


Note: "Big 7" stocks represent Apple, Microsoft, Alphabet, Amazon.com, NVIDIA, Tesla, and Meta Platforms.

Source - RBC Wealth Management, FactSet; data through 12/31/23, data represents total returns (includes dividends)

Most U.S. major indexes and styles posted above-average returns in 2023

Full-year total returns of key indexes and styles (includes dividends)



* S&P 500 Dividend Aristocrats Index (total return)

Source - RBC Wealth Management, Bloomberg; data through 12/31/23

of 2022. While Q4 earnings have yet to be reported, the consensus forecast is for growth to exceed the year-ago period handily, and if it does, we think full-year 2023 earnings growth will rise at least 4.0 percent year over year once the earnings surprises are factored in.

How could the market rally so strongly in 2023 amid tepid, below-average earnings growth? Typically over short periods of time, the magnitude of market gains and earnings growth are not tightly correlated. But over the long term, the relationship between the two is tighter.

We think market participants began to look ahead in anticipation of stronger earnings gains in 2024, which is another reason the broader market rallied toward year end. For this stronger earnings scenario to play out, the economy would need to deliver some decent growth with a healthy soft landing, in our view.

The regional bank crisis came and went

The collapse of Silicon Valley Bank and other troubled regional banks sparked a crisis in March, capturing the attention of investors worldwide. But the crisis came and went, and as the regional banking system stabilized, this group of stocks slowly stabilized and then improved.

And as the Fed pivoted toward a dovish stance and soft-landing sentiment rose, the S&P 500 Regional Banks Index rallied 34.9 percent from late October through year end, clawing back part of the year's losses.

Hold your ground

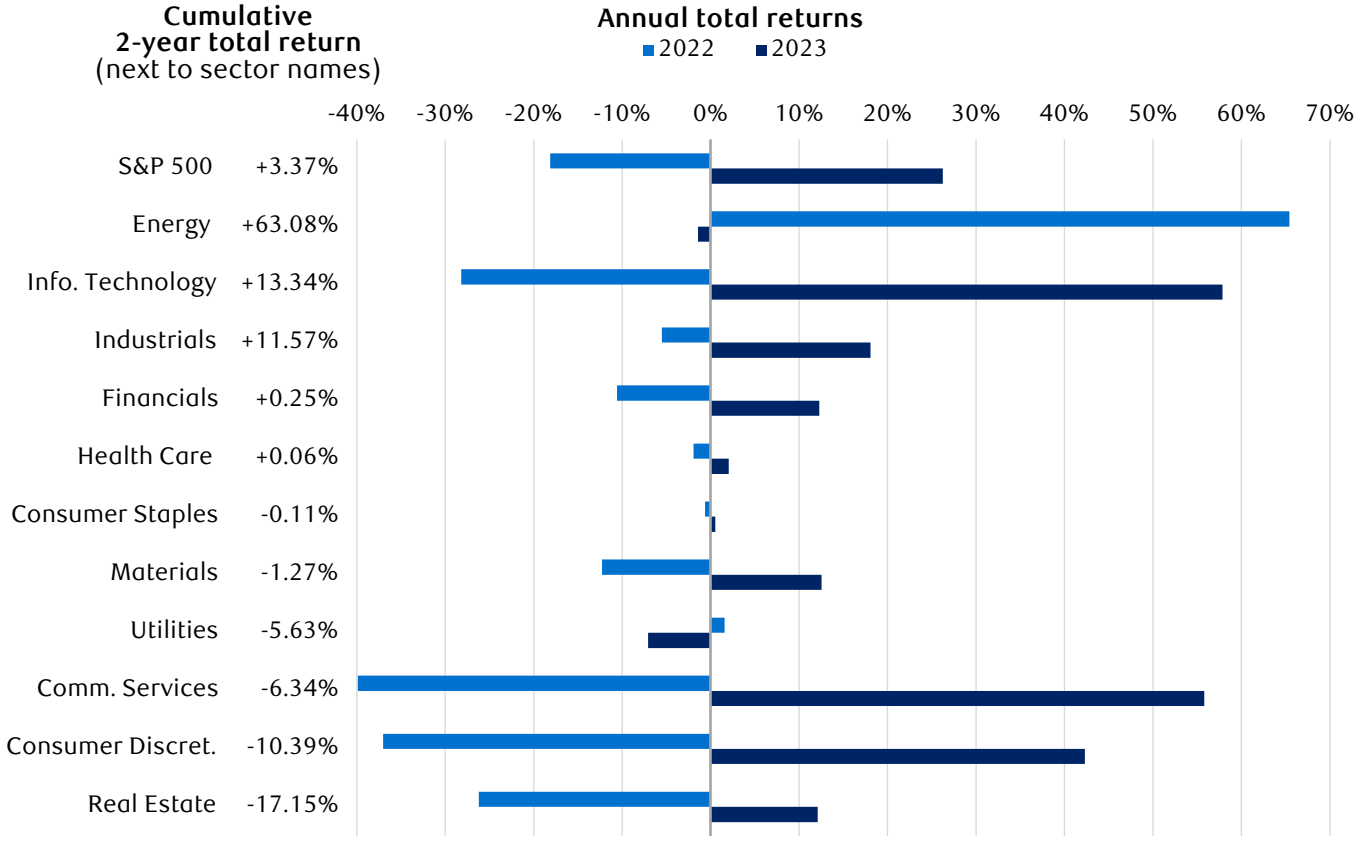
Some of our charts clearly illustrate that 2023 was largely a reversal of poor 2022 performance (see top chart on page 2 and the chart on this page).

We think equity returns in 2024 will mainly depend on whether the U.S. economy succumbs to recession or achieves a much-coveted soft landing. The year-end rally seems to be indicating the latter scenario, but we believe there are lingering risks that the lagged effect of the Fed's aggressive rate hike campaign could at the very least dampen U.S. consumer spending and GDP growth in the quarters ahead.

We would maintain Market Weight positioning in equities overall, which attempts to balance the risks of a U.S. recession against the possibility that one may again be averted. We recommend tilting portfolios toward higher-quality segments of the equity market, including those companies with resilient balance sheets, sustainable dividends, and reliable cash flow generation.

For some sectors, 2022 and 2023 returns were nearly a mirror image of each other

S&P 500 and sector total returns (including dividends)



Source - RBC Wealth Management, Bloomberg; data through 12/31/23

UNITED STATES

Atul Bhatia, CFA – Minneapolis

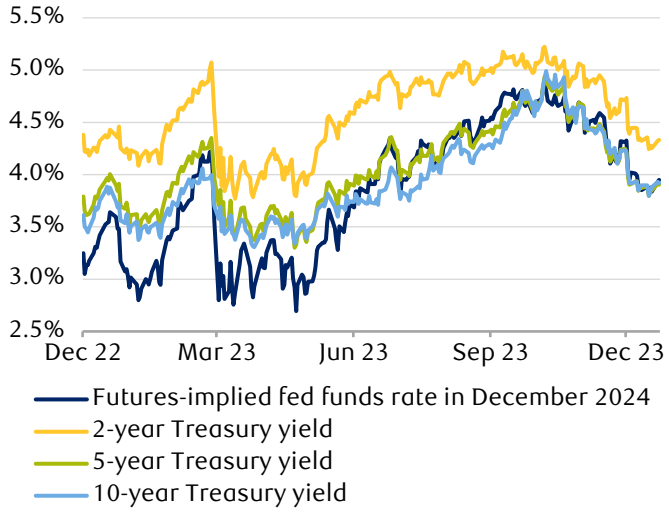
■ Bond markets have started the year on a weak note, with declining prices in the first two trading sessions pushing yields higher by approximately six basis points (bps) on major Treasury maturities. The declines, however, are modest compared to the strong price run-up to end 2023, which saw Treasury yields falling by roughly 40 bps in December. Corporate bonds outperformed their government equivalents as credit spreads—which compensate investors for higher perceived default risk—also fell meaningfully during the month.

■ The primary driver of recent bond market performance, in our view, is investors' ongoing reassessment of the likely path for monetary policy. In the weeks following the Fed's December meeting, investors priced in an aggressive rate-cutting regime. Interest rate futures' prices at one point last month implied a meaningful probability of seven rate cuts in 2024, more than double the number found in the Fed's own projections. Since then, pricing has softened somewhat and now reflects five rate cuts in 2024 with a meaningful chance of a sixth. As the chart below demonstrates, longer-maturity bond performance has closely tracked futures-derived year-end policy rates.

■ The recently released minutes of the latest Fed meeting emphasized the data-dependent nature of future policy moves, with a particular emphasis on inflation. The most recent numbers—including the personal consumption expenditures (PCE) deflator, the Fed's preferred measure of consumer price changes—have been generally supportive of a dovish pivot by the central bank, as price increases seem to be on a path to target levels. The news is not all positive for bond investors, however, as labor market indicators continue to show relatively tight conditions, potentially setting the stage for future inflation.

Bond markets take their cue from the Fed

Key Treasury maturities moving in lockstep with policy expectations



Source - RBC Wealth Management, Bloomberg; data through 1/3/24

CANADA

Sean Killin & Luis Castillo – Toronto

■ **Disinflationary pressures are still intact despite higher-than-expected November data**. Canadian inflation numbers for November surprised to the upside, with headline Consumer Price Index (CPI) inflation at 3.1% y/y, above the consensus estimate of 2.9%. The Bank of Canada's preferred measures of inflation also came in higher than expected, with the trimmed mean core CPI up 3.5% y/y (consensus 3.4%) and median core CPI up 3.4% y/y (consensus 3.3%). Housing costs continued to be a significant contributor to inflationary tailwinds in November, particularly in the core component of CPI, with rising household debt service costs making up a sizeable portion of the consumer price basket. Mortgage interest costs, which are closely tied to the Bank of Canada's interest rate hiking campaign, continued to rise at an elevated rate of 29.7% y/y, but appear to have passed their peak according to RBC Economics. Despite the upside CPI surprise, disinflationary pressures still dominate the consumer price basket—meaning the inflation rate for these categories is declining. Breadth has improved notably over the past six months, and while November CPI and core rates did come in above expectations, the uptick in household debt servicing costs has been the primary factor underpinning sticky price growth.

■ **Credit spreads in both investment-grade and high-yield corporate bonds finished 2023 near their tightest levels since early 2022**. (Credit spreads represent extra yield compensation for the risk of default over government bonds.) Markets seem to be ignoring the potential for a difficult refinancing environment in the coming years, focusing instead on strong fundamentals today and the possibility that central banks could deliver a financial reprieve in the form of aggressive rate cuts sooner than expected. Despite these market-implied tailwinds, we remain cautious. Our investment thesis has been consistent: increase portfolio quality through a larger allocation to core fixed income (i.e., categories with a lower likelihood of balance sheet impairment) at the expense of higher-yielding categories with lower credit ratings. We believe the potential for credit deterioration ahead should not be taken lightly, as weakening economic momentum and a tougher refinancing environment begin to take a bite out of corporate profitability.

EUROPE

Thomas McGarrity, CFA – London

- **Having rallied strongly into the end of 2023, European equities slipped slightly in early 2024 trading**. Under the surface, defensive sectors that lagged in 2023 outperformed, particularly Health Care. As highlighted in the Global Insight 2024 Outlook, Health Care is our preferred defensive sector. After underperforming over the past year, its valuation is relatively inexpensive, in our view, and the sector also shows resilient characteristics, strong balance sheets, and the prospect of robust earnings growth driven by innovation over the coming years.

- Moreover, the underperformance of Health Care (alongside other defensive sectors such as Consumer Staples) relative to cyclicals has been somewhat at odds with weak data from purchasing managers indexes. Accordingly, **we think there could be a degree of rotation into defensive stocks at the start of 2024**.

- **Energy shares gained alongside rising oil prices amid a renewed focus on geopolitics and escalating tensions in the Middle East** after several commercial shipping vessels were attacked by Yemeni Houthi rebels in the Red Sea. Disruption to shipping through the Red Sea sent the shares of Danish shipping firm A.P. Moller-Maersk (Maersk) to the top of the STOXX Europe 600 Index leaderboard, up over 16% in 2024 so far. If container ships traveling from Asia to Europe are forced to avoid the Bab el-Mandeb Strait and take the longer route around Africa, voyage times will be increased by around 10 days. Longer voyage times increase spot freight rates, which have spiked on Asia-to-Europe routes by over 170% since the diversions started in mid-December, according to freight booking and payment platform freightos.com.

- **If the Red Sea disruption persists, the knock-on impact will likely be felt by industries such as clothing retail**, with negative implications for margins due to higher freight costs.

Best and worst performing industry groups within the European equity market in the early days of 2024

	Total return (year to date)
Health Care	2.8%
Telecommunications	2.4%
Personal Care	1.8%
STOXX Europe 600 Index	-0.3%
Consumer Products & Services	-3.6%
Retail	-3.8%
Technology	-4.0%

Source - RBC Wealth Management, Bloomberg; data through 1/4/24

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Asian equities have had a somewhat weak start to the year, with the MSCI Asia ex Japan Index falling over 2% during the first three trading days**. The weakness was influenced in part by the minutes from the Federal Reserve's December policy meeting released Wednesday, which hinted that high interest rates might persist for some time. The fragile sentiment on Chinese equities also didn't help, with the onshore Shanghai Shenzhen CSI 300 Index down for three consecutive days. Japanese equities were somewhat under pressure due to the recent earthquake off the country's northwest coast and the tragic collision involving a Japan Airlines passenger plane and a coast guard aircraft.

- Despite the economic recovery headwinds, **China's tourism data from the New Year holiday indicates a relatively stable recovery in the services sector**. The holiday period saw 135 million domestic tourism trips, marking a 9.4% increase from the same period in 2019 when adjusted for comparability; tourism revenue was reported at RMB 79.7 billion, a 5.6% increase from 2019. However, revenue per tourist was still 3% lower than pre-pandemic levels.

- While tourism from mainland China to Hong Kong has risen since late 2022, the trend has stalled in the past few months. **Tourism flows have shifted, with more Hong Kong residents now traveling to mainland China** for weekends and holidays, reversing the historical trend. During the three-day Christmas holiday, around 900,000 Hong Kong residents crossed the border to travel to Shenzhen, the Chinese city adjacent to Hong Kong, while only 360,000 mainland Chinese tourists visited Hong Kong.

- **There's also a shift in the spending habits of mainland tourists, who are now more interested in cultural experiences than luxury shopping**. This shift in travel and spending patterns could further impact Hong Kong's retail sales, which in October were at 85% of the 2018 level.

MARKET Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,704.81	-1.4%	-1.4%	23.0%	-1.9%
Dow Industrials (DJIA)	37,430.19	-0.7%	-0.7%	13.0%	2.3%
Nasdaq	14,592.21	-2.8%	-2.8%	40.5%	-7.8%
Russell 2000	1,959.20	-3.3%	-3.3%	11.9%	-13.8%
S&P/TSX Comp	20,818.58	-0.7%	-0.7%	7.1%	-1.9%
FTSE All-Share	4,196.69	-0.8%	-0.8%	1.6%	-0.3%
STOXX Europe 600	474.40	-1.0%	-1.0%	9.3%	-3.2%
EURO STOXX 50	4,448.13	-1.6%	-1.6%	14.6%	2.7%
Hang Seng	16,646.41	-2.4%	-2.4%	-17.4%	-28.5%
Shanghai Comp	2,967.25	-0.3%	-0.3%	-4.8%	-18.5%
Nikkei 225	33,464.17	0.0%	0.0%	28.2%	16.2%
India Sensex	71,356.60	-1.2%	-1.2%	16.4%	20.6%
Singapore Straits Times	3,199.44	-1.3%	-1.3%	-1.4%	2.1%
Brazil Ibovespa	132,833.95	-1.0%	-1.0%	27.5%	27.8%
Mexican Bolsa IPC	55,726.64	-2.9%	-2.9%	13.6%	5.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.916%	3.7	3.7	17.7	228.8
Canada 10-Yr	3.155%	4.5	4.5	-3.4	172.9
UK 10-Yr	3.639%	10.2	10.2	-1.2	266.8
Germany 10-Yr	2.024%	0.0	0.0	-36.5	214.2
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.61%	-0.5%	-0.5%	4.6%	-7.9%
U.S. Investment-Grade Corp	5.15%	-0.6%	-0.6%	7.5%	-8.1%
U.S. High-Yield Corp	7.73%	-0.4%	-0.4%	12.4%	0.4%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	2,041.49	-1.0%	-1.0%	11.0%	13.3%
Silver (spot $/oz)	22.99	-3.4%	-3.4%	-4.2%	0.4%
Copper ($/metric ton)	8,440.50	-0.3%	-0.3%	1.6%	-13.3%
Oil (WTI spot/bbl)	72.70	1.5%	1.5%	-5.5%	-4.4%
Oil (Brent spot/bbl)	78.49	1.9%	1.9%	-4.4%	-0.6%
Natural Gas ($/mmBtu)	2.69	6.8%	6.8%	-32.6%	-29.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	102.4810	1.1%	1.1%	-1.9%	6.5%
CAD/USD	0.7488	-0.8%	-0.8%	2.4%	-4.6%
USD/CAD	1.3355	0.8%	0.8%	-2.3%	4.8%
EUR/USD	1.0923	-1.1%	-1.1%	3.6%	-3.3%
GBP/USD	1.2666	-0.5%	-0.5%	5.8%	-6.0%
AUD/USD	0.6727	-1.2%	-1.2%	0.0%	-6.4%
USD/JPY	143.2600	1.6%	1.6%	9.3%	24.2%
EUR/JPY	156.3900	0.4%	0.4%	13.2%	20.0%
EUR/GBP	0.8622	-0.5%	-0.5%	-2.2%	2.9%
EUR/CHF	0.9275	-0.1%	-0.1%	-6.0%	-10.7%
USD/SGD	1.3291	0.7%	0.7%	-1.2%	-1.8%
USD/CNY	7.1494	0.7%	0.7%	3.4%	12.5%
USD/MXN	17.0185	0.3%	0.3%	-12.3%	-17.1%
USD/BRL	4.9191	1.3%	1.3%	-10.0%	-13.3%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Tuesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -0.8% return means the Canadian dollar fell 0.8% vs. the U.S. dollar year to date. USD/JPY 143.26 means 1 U.S. dollar will buy 143.26 yen. USD/JPY 1.6% return means the U.S. dollar rose 1.6% vs. the yen year to date.

Source - Bloomberg; data as of 1/3/24

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Sell [Underperform]	46	3.17	6	13.04

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