GLOBAL Insight

Perspectives from the Global Portfolio Advisory Committee

August 2023

A runaway rally

Stock markets have kept climbing off their 2022 lows for longer than expected. Is it time to consider repositioning equity portfolios?

Jim Allworth | Page 4

Also in this issue

GLOBAL FIXED INCOME

As temperatures rise, so too do yields

U.S. RECESSION SCORECARD

Status quo

Produced: Aug. 2, 2023 2:41 pm ET; Disseminated: Aug. 2, 2023 3:50 pm ET

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GLOBAL
Insight
August 2023

Contents

In the markets

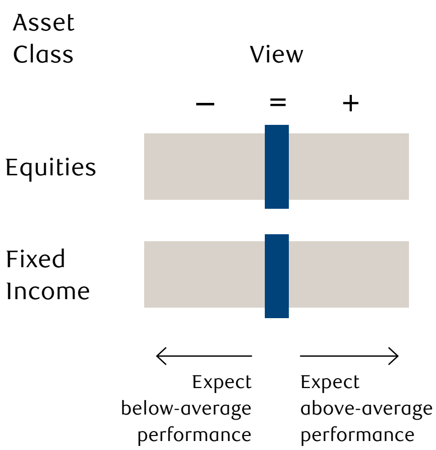
All values in U.S. dollars and priced as of market close, July 31, 2023, unless otherwise stated.

Wealth Management

RBC'S INVESTMENT

Stance

Global asset class views



(+/=/–) represents the Global Portfolio Advisory Committee's (GPAC) view over a 12-month investment time horizon.

+ Overweight implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

= Market Weight implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

– Underweight implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

Source - RBC Wealth Management

Equities

- The global equity rally that began last October persisted in July on the back of resilient U.S. economic data and sentiment that the Fed either has already ended or could soon end its historic rate hike campaign.
- Our position since this rally began has been to leave equity portfolios invested up to the level that is typical for long-term investors (i.e., the strategic recommended level, or a Market Weight position). We maintain this view, as we think the rally could have further to run due to optimism about the U.S. economy and the impact of the "fear of missing out" (FOMO), which often tempts institutional investors to chase the rally as the market unexpectedly marches higher than they were positioned for.
- But, in our view, it would take more than FOMO to put the equity advance on a sustainable footing. It would take an avoidance of a U.S. recession and some reacceleration of growth in the world's largest economy. While a soft landing is possible, we still see many factors pointing toward a recession later this year or next. We increasingly think investors should focus individual stock selections on high-quality businesses with resilient balance sheets, sustainable dividends, and business models that are not intensely sensitive to the economic cycle.

Fixed income

- Fixed income market volatility has subsided as traders weigh the next steps from all of the major central banks. The average yield on the Bloomberg Global Aggregate Bond Index sits at 3.8%, remaining near its 2022 high of 4.0%, the high-water mark for global bond yields since 2008. Though central banks largely remain hawkish, after rate hikes in July both the Federal Reserve and European Central Bank are likely on hold for the rest of the year, while at the other end of the spectrum the Bank of England could be on the cusp of multiple rate hikes through the rest of 2023.
- We remain Market Weight U.S. fixed income with yields again nearing multi-year highs. We stay Market Weight on high yield corporate debt as a cloudy outlook for the U.S. and global economies may dissipate further. We remain Overweight U.S. government debt on attractive yields and downside protection should recession risks reemerge on a 12-month horizon.
- We maintain our Market Weight in global fixed income, with a Market Weight allocation to corporate credit.

GLOBAL
Equity

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A runaway rally

- **The stock market rally off the washed-out lows of early last fall has run further and for longer than most had expected. U.S. large-cap outperformance has been largely powered by a handful of surging Tech and tech-related stocks, whose outsized weight in the benchmark index has left many fund managers running to avoid being left behind.**
- **The strong stock market and some better-than-forecast economic data have once again raised hopes that the U.S. economy could experience a "soft landing" without a recession. While such a benign outcome can't be ruled out, several headwinds already suggest the going is about to get tougher as the full impact of the Fed's historic series of rate increases is yet to be felt in the economy.**
- **Notwithstanding all the above, and though the compelling valuations of last autumn are long gone, we think this rally has some time left to run. But with recession still the most probable outcome, investors should adopt a focused approach to individual stock selections.**

The equity rally from the lows of early autumn 2022 continued through July 2023—that is to say, for much longer than most had thought likely until recently. Japan's TOPIX and the U.S. S&P 500 have led the way. It has been a much more anaemic affair for U.S. small caps, as well as for Canada's TSX and the UK FTSE All-Share. And the going has been downright soggy for the Korean KOSPI, which we mention here because it is viewed in some quarters as a leading indicator of the future direction of the U.S. economy and stock market due to South Korea's role as a major exporter of computer chips, smart phones, industrial goods, and consumer durables into the U.S.

The comparatively energetic advance of the S&P 500 is largely attributable to the much-reported-upon performance leadership of a handful of mega-cap Technology and tech-related stocks, which together account for more than 25% of the index by weight; the unweighted index presents a less dynamic picture. None of those high-flying mega-cap stocks are included in the more sedately performing indexes outside the U.S.

Our position since this rally unfolded has been to leave equity portfolios invested up to the recommended levels for their long-term strategic asset allocation. Our view has been that the washed-out market momentum, significant P/E retrenchment (from 22x trailing-12-month earnings at the peak of the market in January 2022, to just 16x at the early autumn low), and intensely negative investor sentiment that prevailed back in September and October would give way to a stretch in which all those markers reversed direction. Whether any rally would be robust enough to set new market highs has been far from clear, but staying invested long enough to find out has seemed the right approach.

Equity views

Region	Current
Global	=
United States	=
Canada	=
Continental Europe	–
United Kingdom	–
Asia (ex Japan)	=
Japan	+

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

Many are now attributing the longevity and strength of the stock market advance to the growing belief that the U.S. economy will enjoy a soft landing and avoid recession. This view is supported by the fact that—so far—the economy is still growing,

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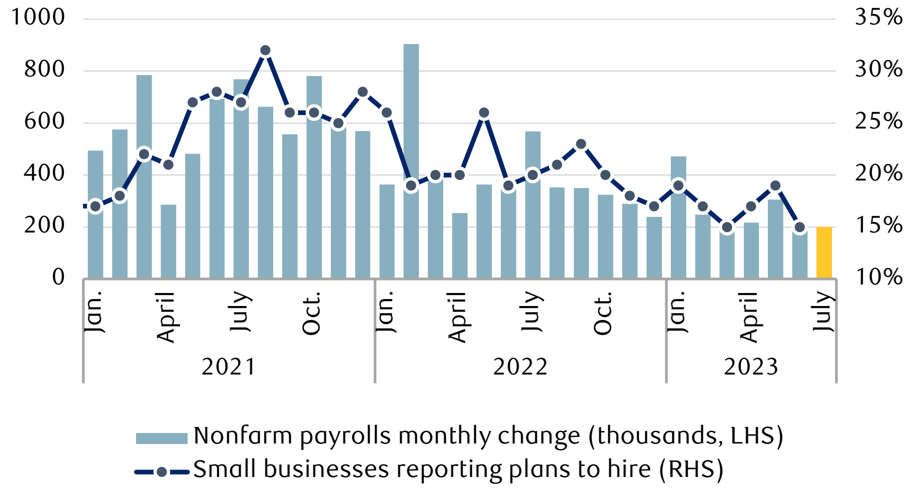
Monthly hiring pace set to reach multiyear low



Source - U.S. Bureau of Labor Statistics, National Federation of Independent Business; data through 7/31/23

while the employment picture is almost unanimously characterised as "resilient" in light of a high (but declining) number of unfilled jobs and a very low unemployment rate. The view that "the stock market is moving higher because the U.S. economy is stronger than expected" often gets turned around by the same speaker to "the market's rise is telling us the U.S. economy is about to improve further"—which sounds like circular reasoning to us.

Growing optimism about the U.S. economic trajectory is probably part of the story of why this rally has had legs. But we believe a less-welcome phenomenon is in play, in which investor rationality is being overtaken by FOMO ("fear of missing out"). Many individual investors aren't exposed to the mega-cap stocks that have been driving the market higher, as they have been unwilling to pay valuation multiples that always look too high. With the seven biggest S&P 500 stocks by market capitalization totaling 27% of the index, even fund managers who do have exposure to this handful of high-flying stocks usually don't have enough to let their portfolios keep pace with the index benchmark. Hedge fund reporting suggests many of these tactically driven funds were not positioned by late spring for a market that was going to keep on moving higher, let alone accelerate as it has done since mid-May.

We believe FOMO can feed on itself, driving markets to climb longer, and reach higher levels, than anyone thinks is reasonable. Investors who have been selling or planning to sell stocks they regarded as overvalued, only to see them move appreciably higher, stop selling. Fund managers, most of whom are losing ground against their benchmarks, are buying in desperation.

In our view, this dynamic could keep the U.S. large-cap market advancing further for some weeks or months yet. Beyond the small group of leaders, the rest of the market, including other developed-economy stock markets, are likely to be pulled higher too—for a while. In our view, though, it will take more than FOMO to put this market advance on a sustainable footing; at the very least, the U.S. will have to avoid recession and experience some reacceleration in economic growth.

Is a soft landing possible?

Of course it is. And there's nothing wrong with hoping for the best. However, planning for it is another matter—especially when most of the reliable leading indicators of U.S. recession, which have been consistently right over many decades,

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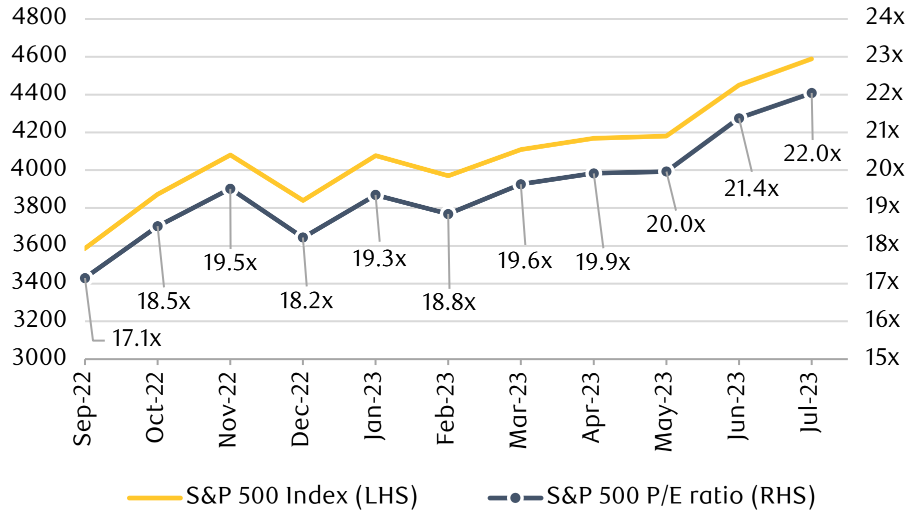
S&P 500 Index vs. P/E ratio

Gains since September 2022 are due entirely to the rising P/E ratio, with earnings flat to down



Source - Thomson Reuters, Bloomberg; data through 7/31/23

are giving progressively more negative readings about where the U.S. economy is headed.

In addition to the signals coming from macro indicators, there are identifiable headwinds to growth facing the U.S. economy. Chief among them is the increasing tightness of credit. Changes in monetary policy are generally thought to take about a year to show up in the economy; from that perspective, the first half of this year is only showing the effects of the first 125 basis points of Fed rate hiking that took place over the first six months of 2022, while the second half of this year will reflect the further 275 basis points piled on from July to December 2022. Assuming the Fed wraps up its tightening program with the policy interest rate at 5.50%, this means another 1.50% will be layered onto the accumulated cost-of-borrowing burden through the first six months of next year.

This mounting cost of borrowing will likely be visited on an economy that is decidedly less robust than it was last year. Here are a few of the factors in play:

- **Excess savings in the U.S. are gone, or soon will be.** (They remain at elevated levels in most other developed economies including Canada, China, and Europe.) At the peak of the government's pandemic assistance efforts in mid-2021, many recipients used assistance payments to bulk up household savings by an estimated $2.2 trillion over and above what would have been accumulated had the economy remained open. Those balances have declined rapidly. One study undertaken by the San Francisco Fed calculates that only $500 billion remained unspent by April of this year, and that the remainder would likely be gone by December. Another study, using a somewhat different methodology and commissioned by the Federal Reserve itself, argues that these excess savings had already been more than fully drawn down by the end of Q1.

- **Credit card balances are rising.** Large banks' credit card balances jumped by 32% in the two years ending in Q1. The payment delinquency rate recently started moving higher after a multiyear decline. Interest rates on credit card loans have risen from 14% to 21% in a year and a half. And auto loans have been declining since last fall, partly in response to sharply higher borrowing rates—up from 4.5% to almost 8% over the 15 months ended in May. Lender refusals of auto loan applications also jumped from 2% of

GLOBAL EQUITY

all applications to 14% over the same period, the highest refusal rate in years.

- **Financial stress at the corporate level is unusually elevated.** Our colleagues at RBC Brewin Dolphin in the UK recently highlighted a June Fed staff note that calculated the proportion of non-financial firms in financial distress, at 37%, had reached a level higher than during most previous Fed tightening episodes since the 1970s. The analysis reveals that, historically, there has been a bigger decline in business investment among distressed firms than among healthy firms in response to monetary tightening shocks. The same has been true with regards to employment. Putting the two together, the note's authors conclude that with a high proportion of firms in financial distress, policy tightening is likely to have stronger negative effects on economic growth this cycle than in most tightening cycles since the early 1970s. And the financial sector is not immune from this stress, as shown by the recent failures of three U.S. domestic banks, the travails of the regional banking sector, and the forced sale of international giant Credit Suisse.

- **Mortgage refinancing has become much more problematic.** A typical new U.S. 30-year mortgage now sports an interest rate of 6.78%—more than double the 3% that prevailed two years ago. Understandably, the number of households applying to refinance has plummeted over the same interval, from 27% of those with outstanding mortgages to just 5%. But of the much smaller number now seeking to refinance, fully 21% saw their applications rejected in June.

- **Profit margins are getting squeezed.** Total revenues of all U.S. manufacturing and distribution businesses have declined by about 2.5% since last June, while Employment Cost Index data suggests worker compensation has risen by more than 5%. Recent high-profile wage settlements suggest that large corporate labor cost increases aren't going away soon. With productivity declining, job cuts are likely to be one response.

Plan for it

The factors mentioned above do not, singly or collectively, preclude the possibility of a soft landing for the U.S. economy. Neither do the increasingly negative readings from our U.S. Recession Scorecard. However, historical probabilities inform our expectations that a U.S. recession should arrive later this year or possibly early next year, that actual S&P 500 earnings will come in below current estimates, and that share prices will go through a challenging period during which investors' unrealistic optimism eventually gives way to unrealistic pessimism.

In the meantime, we continue to recommend Market Weight equity exposure for global balanced portfolios because we think the current advance from early fall of 2022 has further to run. However, we believe investors should limit individual stock selections to companies they would be content to own through a recession. For us, that means high-quality businesses with resilient balance sheets, sustainable dividends, and business models that are not intensely sensitive to the economic cycle.

GLOBAL

Fixed income

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As temperatures rise, so too do yields

As the summer temperatures rise, global inflationary pressures continue to cool, precipitating in July what may prove to be the last of major global central bank rate hikes for this cycle.

The Federal Reserve's policy meeting on July 26 came and went without much commotion despite a 25 basis point rate hike following the rate hike "skip" at the June meeting, a move that brought the policy rate to a target range of 5.25% to 5.50%, its highest level since 2001.

While Fed Chair Jerome Powell took great pains to stress that all options remain on the table including further rate hikes, what the Fed does next, in our view, will entirely boil down to the two Consumer Price Index readings and the two jobs reports that are scheduled to be released before the next Fed decision on September 20. Though each could spark some market volatility, enough leading indicators suggest to us that the data will continue to move in the right direction and that the Fed will be ready to formally pause its rate hike cycle by then.

Fixed income views

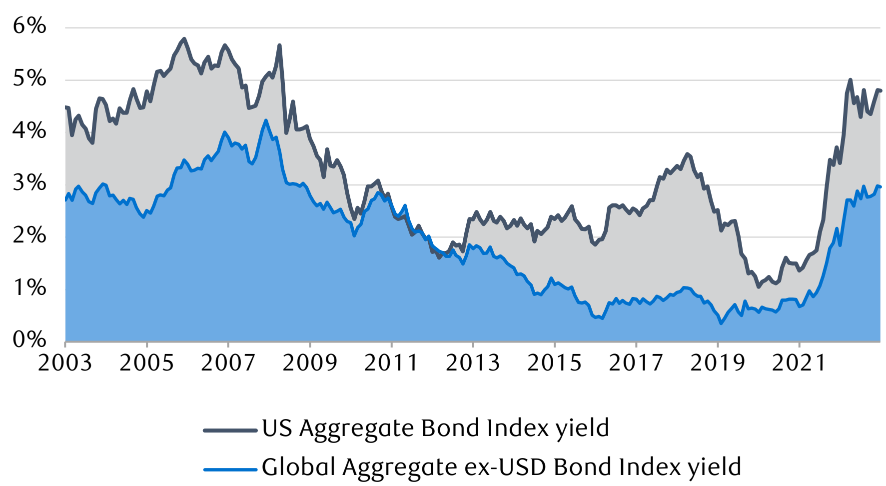
Region	Gov't bonds	Corp. credit	Duration
Global	+	–	5–7 yr
United States	+	–	3–10 yr
Canada	=	+	3–7 yr
Continental Europe	=	–	5–10 yr
United Kingdom	=	–	5–10 yr

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

Though an air of mystery may hang over the Fed's next move given a U.S. economy that remains remarkably strong, the European Central Bank (ECB) may have been more explicit in its forward guidance for markets.

The ECB removed language from its policy statement that previously suggested further policy tightening ahead, while ECB President Christine Lagarde said the central bank now has an "open mind" about what to do in September, with the burden falling on the data to justify another

Investment-grade bond yields again approach multi-decade highs



Source - RBC Wealth Management, Bloomberg investment-grade aggregate bond indexes

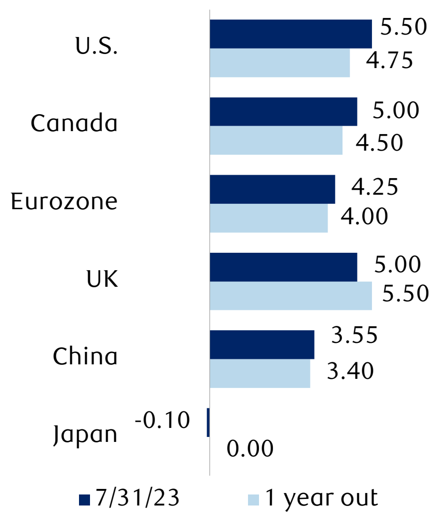
GLOBAL FIXED INCOME

rate hike. For its part, RBC Capital Markets revised its forecasts and no longer sees one more 25 bps rate hike in September, with the ECB now seen on hold through the entire forecast horizon.

The outlier remains the Bank of England, but having finally seen some progress on inflation, the extent of rate hikes has been dialed back. Last month, markets were pricing a peak policy rate this year of at least 6.50% compared to the current level of 5.00%, but the ultimate level is now seen falling somewhere below 6.00% based on current market pricing.

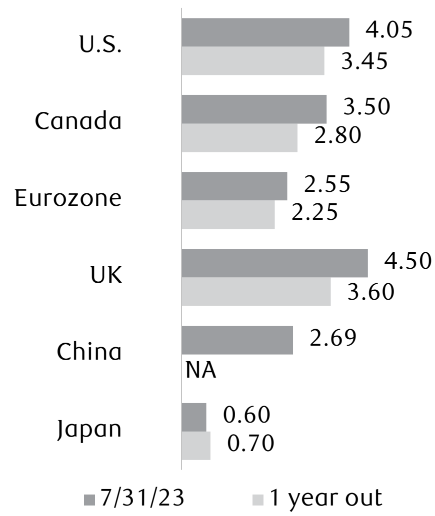
The net result of rate hikes to this point amid easing inflationary pressures and the subsequent fading of near-term recession risks is that global bond yields are again on the ascent, extending the window within which investors can put money to work at yields that have eluded them for much of the past decade.

Central bank rates (%)



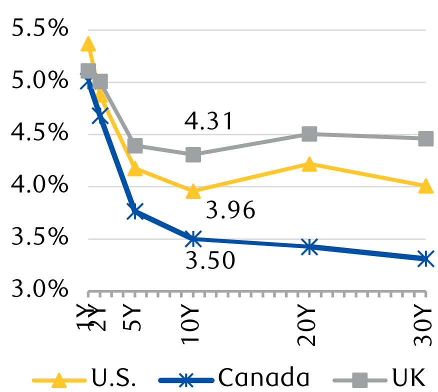
Source - RBC Investment Strategy Committee, RBC Capital Markets forecasts, Global Portfolio Advisory Committee, RBC Global Asset Management

10-year rates (%)



Note: Eurozone utilizes German Bunds.
Source - RBC Investment Strategy Committee, Global Portfolio Advisory Committee, RBC Global Asset Management

Sovereign yield curves



Source - Bloomberg; data through 7/31/23

U.S. RECESSION
Scorecard

Status quo

There have been no changes to the Recession Scorecard indicators so far this summer. Three of the seven remain in the negative red column, meaning each has passed a threshold value beyond which, historically, a recession typically has arrived within a measurable time horizon. Two others were moved into the cautionary yellow column in the spring because they were close to giving an outright negative signal and seemed likely to do so within a few months; one all but did so in July. The last two indicators, still green, continue to suggest there is some way further to go in the economic expansion.

The average time gap from giving a negative signal to the onset of recession for those three indicators that are rated as outright negative so far point toward a recession getting underway this summer, in our view. However, all three have histories with instances of much longer signal-to-recession intervals. **Please note, the official start date of any recession may not be announced until many months or quarters after the fact.**

Yield curve (10-year to 1-year Treasuries)

The 1-year Treasury yield rose above the 10-year yield decisively in July 2022, and the negative gap has widened over the past year. **The average experience of this indicator after crossing into negative territory suggested the U.S. economy would be in recession by this summer.**

The Fed's most recent Senior Loan Officer Survey (released on July 31) further extended the five-quarter-long trend of a majority of U.S. banks raising lending standards on almost every category of business and consumer loan including commercial and industrial loans for businesses of all sizes, credit card loans, consumer installment loans, mortgage loans, and commercial real estate loans.

The same survey also revealed that most banks are reporting reduced demand for commercial and industrial loans, as well as indicating a reduced willingness to make such loans. Most are also requiring higher credit scores for consumer loans and larger down payments for car loans as well as increasing the premium charged for loans to riskier businesses.

U.S. recession scorecard

	Status		
Indicator	Expansionary	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)			✓
Unemployment claims		✓	
Unemployment rate	✓		
Conference Board Leading Economic Index			✓
Free cash flow of non-financial corporate business	✓		
ISM New Orders minus Inventories			✓
Fed funds rate vs. nominal GDP growth		✓	

Source - RBC Wealth Management

U.S. RECESSION SCORECARD

ISM New Orders minus Inventories

The difference between the New Orders and Inventories sub-indexes of the ISM Purchasing Managers' Index has turned negative near the start of most U.S. recessions. But it has also registered occasional false positives—signaling a recession was imminent when none subsequently arrived. Moreover, this indicator only relates to activity in the manufacturing sector (some 15% of the U.S. economy) and is derived from a survey rather than hard data. That being said, **this measure has never before reached its most recent low set in deeply negative territory without a recession eventually following.**

Conference Board Leading Economic Index

Historically, this series has given reliable early warnings of recession. When the index has fallen below where it was a year earlier, a recession has always followed—usually two to three quarters later.

This indicator turned decisively negative in Q3 2022, shifting it to the red column on our Scorecard. The latest reading, for June, saw a very small uptick in the year-over-year comparison, but the indicator remains in deeply negative territory. Its past record strongly suggests a U.S. recession will be underway sometime in H2 2023.

Unemployment claims

The monthly low for this cycle occurred in September 2022. The cycle low for claims has typically been registered about 12 months before the start of the next recession. So, **if no lower reading is posted in the coming months, its history would suggest a recession could get underway this fall.**

Claims surged higher in June but settled back in July. The smoothed trend appears to be trying to reverse to up from down but has not yet done so convincingly. The fact that both temporary employment and job openings are falling on a year-over-year basis adds to the likelihood the tide is turning for unemployment claims. While we wait either for that shift to be confirmed or for claims to subside once again, this ambiguity warranted shifting the indicator's status to yellow in April.

Unemployment rate

The unemployment rate jumped by its biggest monthly increase of this economic cycle in May to 3.7%, but it ticked lower again in June. Monthly net job additions have been trending steadily lower since setting a cycle high in February 2022. Any move above 4.0% in the Unemployment Rate in the next few of months would turn the smoothed trend of this indicator higher and, in our view, signal a recession is on the way. Once that signal is given, on average, it has been eight to nine months from the lowest monthly posting (which was 3.4% in April) until a recession gets underway—although there have been several instances when the time gap was only two to three months.

Free cash flow of non-financial businesses

This gives an indication of the ability of such businesses, in aggregate, to internally fund any capital spending they want or need to do. Historically, whenever it has posted a year-over-year negative reading, a decline in corporate capital spending has typically followed, either indicating a recession is coming or deepening one that is already under way. This number declined in both Q4 2022 and Q1 of this year but remained well above a negative crossing point. We expect a further deterioration occurred in the Q2 data which will be released early next month.

Fed funds rate vs. nominal GDP growth

The fed funds rate has risen above the six-month annualized run rate of nominal GDP either before or at

U.S. RECESSION SCORECARD

the start of every recession in the past 70 years. (Nominal GDP is GDP not adjusted for inflation.) That run rate has been declining since its reopening high of 23% in Q4 2020. By the end of last year, it had slowed to 7.2% but was still well above the fed funds rate, which at the time had risen to 4%. Now the fed funds rate is up to 5.50%, and Q2 GDP data shows the six-month run rate of nominal GDP growth slowed to just 5.4%, just barely meeting that historical precondition of recession. We expect nominal GDP growth will slow some more in Q3, which will widen the gap further.

We shifted this indicator to yellow from green in April.

Where things stand

Weighing up the current positioning of all seven indicators, and projecting their likely paths over the next couple of quarters, points to a growing probability the U.S. will enter a recession later this year, in our view.

Research resources

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As of June 30, 2023

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Outperform]	832	57.22	250	30.05
Hold [Sector Perform]	573	39.41	138	24.08
Sell [Underperform]	49	3.37	3	6.12

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