RBC Global Asset Management

Market Update

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Cooling inflation and moderating growth prompt interest-rate relief

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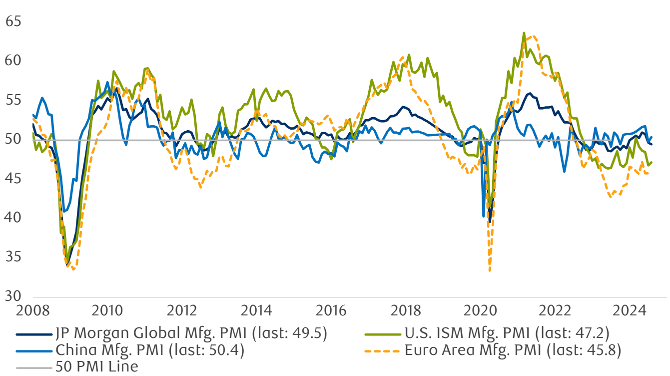
Leading indicators of economic growth suggest the economy is decelerating but the outlook still tilts towards a soft landing rather than recession. Manufacturing purchasing managers indices (PMIs) are only slightly below 50 in most major regions and, above the low 40's that appear with recession, and service PMIs are above 50 and rising (exhibits 1 and 2). The moderation in growth experienced over the past couple years was consistent with rapidly rising interest rates. The economy is now set to feel relief as the pressure from prior restrictive monetary conditions rolls off and as policy rates fall over the months and quarters ahead. Lending conditions are already improving as borrowing costs have started to decline. Banks are more willing to extend loans and demand for borrowing has picked up among businesses, consumers, and home buyers. U.S. consumer spending has held up relatively well in the face of higher interest rates, helped by strong household balance sheets and protection from surging rates on long-term fixed-rate mortgages. Pockets of financial pain do exist, particularly outside the United States where mortgage loan durations are shorter, as the excess savings from the pandemic have largely been wound down, delinquency rates have been rising and unemployment rates have been ticking higher. We recognize the possibility that some of these metrics could worsen over the months and quarters ahead and as a result we place a 40% chance of recession over the next 12 months with Europe, the United Kingdom and then Canada most vulnerable. But the more likely outcome, in our view, is that the U.S. and global economy will continue in moderate expansion, particularly as the interest-rate backdrop becomes more supportive.

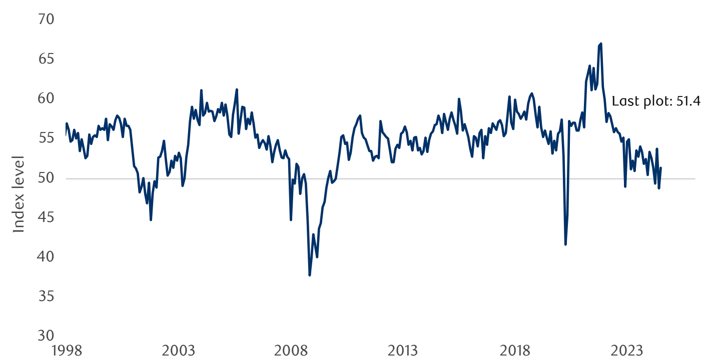
Exhibit 1: Global purchasing managers' indices



Note: As of August 31, 2024. Source: Macrobond, RBC GAM

Exhibit 2: U.S. ISM Services PMI

ISM Non-Manufacturing Index



Note: As of July 31, 2024. Source: Institute for Supply Management, RBC GAM

A variety of risks complicate the outlook. Escalating tensions in the Middle East threaten geopolitical stability, with potential impacts on the price of oil and ultimately inflation. In the U.S., the presidential election in November is a key risk given that the race is likely to be tight, and the two leading candidates have massively different platforms related to taxation, spending initiatives, global trade and immigration policy. Looking further ahead, significant fiscal stimulus during the pandemic stretched sovereign debt loads to levels likely to weigh on future growth potential. All these factors are sources of uncertainty and volatility for both the economy and capital markets.

The war on inflation is being won

Importantly, one of the biggest challenges facing the economy – unanticipated high inflation – has largely been remedied as price pressures continue to decline throughout the developed world. In the U.S., consumer-price inflation slipped to 2.9% in July, well below its 9.1% peak from mid-2022 and other critical inflation measures have followed a similar trajectory. We expect inflation to continue declining toward the 2% level targeted by major central bankers, but we recognize that progress from here may be more gradual. Going forward, the risk of inflation pressures re-igniting appears low given that leading indicators of price pressures appear well contained, and that market-based measures of inflation expectations remain well anchored around the 2% level (Exhibit 3). The war on inflation is being won, opening the door for central banks to loosen their currently restrictive monetary policies in the near term.

Central banks turn to easing

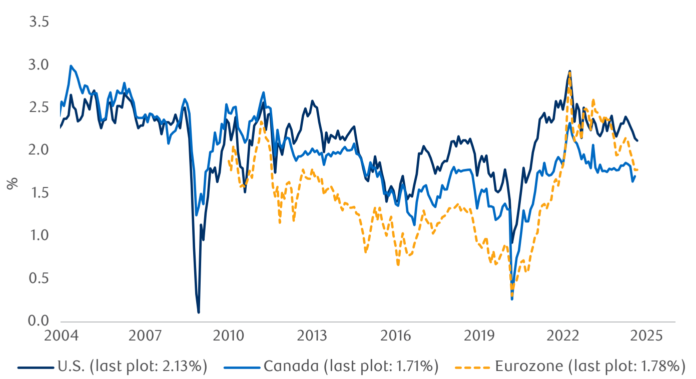
Many central banks have already delivered monetary easing, and the U.S. likely not far behind. During the summer, the Bank of Canada cut rates three times by 25 basis points inclusive of the September 4 policy announcement, and the European Central bank and Bank of England both reduced their key policy rates by 25 basis points. One exception is the Bank of Japan, which is still in the early stages of raising rates from near-zero levels. In the U.S., the Federal Reserve has signaled that easing will begin in September with rates likely to continue falling gradually over the year ahead. Pricing in the futures market suggests 200 basis points in U.S. rate cuts over the next 12 months (Exhibit 4), slightly more than our own forecast of 150 basis points. Our view is aligned with the consensus in terms of direction, but we recognize the actual pace of interest-rate normalization will depend on evolution of inflation and labour-market data.

Rally in sovereign bonds reduces return potential

Sovereign bonds generated solid gains for bond holders in the past quarter as yields declined in most major regions on the back of falling inflation and moderating economic data. The U.S. 10-year yield fell over 50 basis points during the past three months and crossed below 4% for the first time since February. Although our model suggests that yields are likely to continue falling over the longer-term as inflation continues to cool, the near-term downside in yields will be limited if real interest rates are to remain positive. If we consider that the deeply negative real rates from the pandemic were a distortion resulting from extraordinary monetary and fiscal stimulus that is unlikely to be repeated, then our model

Exhibit 3: Implied long-term inflation premium

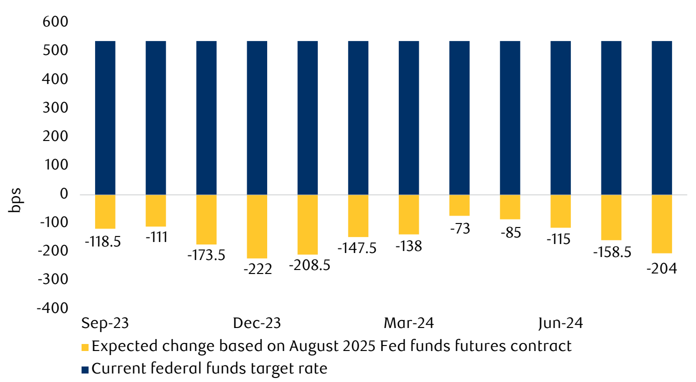
Breakeven inflation rate: nominal vs 10-year real return bond



Note: As of September 2024. Eurozone represents GDP-weighted breakeven inflation of Germany, France and Italy. Source: Bloomberg, RBC CM, RBC GAM

Exhibit 4: Fed funds rate and implied expectations

12-month futures contract



Note: As of August 30, 2024. Source: RBC GAM indicates that sovereign bond yields are close to or slightly below the mid-point of our equilibrium band. Assuming real rates remain above the zero-bound, the band ranges from 3.5% to 4.6% (Exhibit 5). Return potential in sovereign fixed income markets is diminished with the U.S. 10-year yield around 3.9% at the end of August. Barring a slide in recession, we forecast a move in the U.S. 10-year yield to 3.75% over the next 12 months, resulting in mid single-digit returns for U.S. government bonds and even lower returns in other sovereign markets.

Stocks climbed to records, valuation risk is concentrated in U.S. large-cap growth

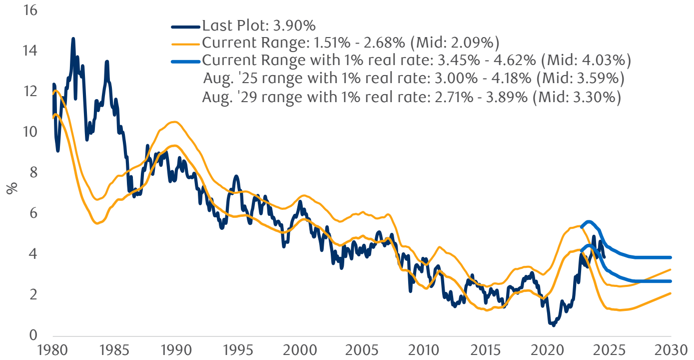
Equity markets encountered significant volatility through the summer, punctuated by the unwinding in the Japanese Yen carry trade, but stocks rebounded to record or near-record highs in most major markets by the end of August. The S&P 500 rose 7% in the past quarter, extending gains to 18% so far this year. While gains earlier in 2024 were driven primarily by mega-cap technology stocks, the rally has broadened to include smaller companies, value stocks and international equities. The S&P 500 Equal Weight Index rose 6% in the past quarter, the TSX Composite climbed 6%, MSCI Emerging Markets rose 5% and the MSCI EAFE Index increased 4%, all in U.S. dollar terms. While the S&P 500 is deemed expensive at close to one standard deviation above our modelled estimate, other markets are much more attractively priced. Most major markets outside U.S. large-cap growth stocks are trading below our modelled estimates of fair value and offer superior return potential as a result (Exhibit 6).

Analysts' optimistic earnings projections, if met, could further fuel equity bull market

The equity bull market can be fundamentally supported as long as corporate profits continue to grow in line with analysts' forecasts. The consensus of analysts' expectations looks for 9% profit growth in 2024 followed by an acceleration to 15% in 2025 (Exhibit 7). Exceptionally fast revenue growth has supported profits since the pandemic even as margins contracted in the past couple years alongside rising costs. Profit margins reverted to their long-term trend but, importantly, they have begun rebounding once again in the past quarter. While analysts' estimates are highly optimistic, an environment of modest economic growth, low inflation and falling interest rates could create the conditions for the lofty earnings expectations penciled into the consensus to be achieved.

Exhibit 5: U.S. 10-year T-bond yield

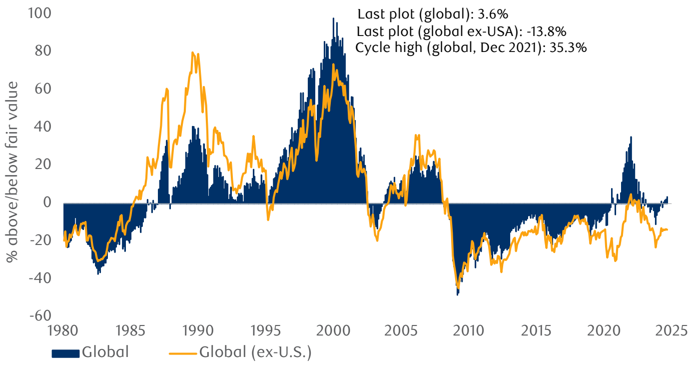
Equilibrium range



Note: As of August 31, 2024. Source: RBC GAM

Exhibit 6: Global stock market composite

Equity market indexes relative to equilibrium



Note: As of August 30, 2024. Source: RBC GAM

Exhibit 7: S&P 500 Index

12-month trailing earnings per share

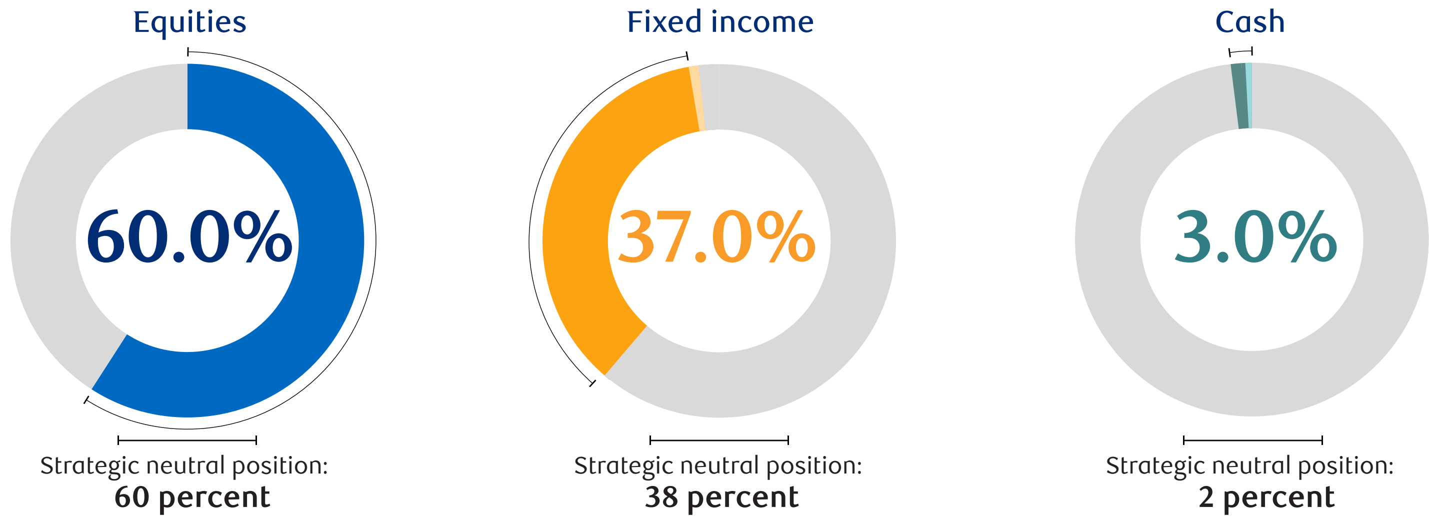
Note: As of August 30, 2024. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, RBC GAM

Asset mix: trimming fixed-income allocation by 150 basis points, placing the proceeds into cash

Our asset mix reflects the balance of risks and opportunities across a range of scenarios. In our base case, the economy achieves a soft landing, inflation continues to cool and corporate profits rise at a reasonable clip. With inflation pressures subsiding, the need for highly restrictive central-bank policies is becoming less evident, and we expect interest-rate cuts to proceed at a gradual pace in most major developed countries except Japan. As of the end of August, however, a meaningful amount of policy accommodation has been priced in to fixed income markets, and further meaningful gains in sovereign bonds would likely require the economy to fall into recession, which is not our central forecast. As a result of the reduced return potential in fixed income due to lower yields, we have trimmed our fixed income allocation by 1.5 percentage points this quarter, placing the proceeds into cash to build a buffer against potential market volatility should any of the aforementioned risks intensify, or to deploy into stocks if we gain further clarity on a soft-landing outcome for the economy. Our current recommended asset mix for a global balanced investor is 60.0% equities (strategic: "neutral": 60%), 37.0% bonds (strategic "neutral": 38%) and 3.0% in cash (Exhibit 8).

Exhibit 8: Recommended asset mix

RBC GAM Investment Strategy Committee



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