RBC BlueBay Asset Management

Navigating volatility in the wake of U.S. policy shocks

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Although volatility has been trending lower, it would be dangerous to assume markets are now comfortable with White House plans and the communication of its program. The president seems to want to conduct policy formation and execution in ways that create maximum surprise. We should be prepared for more of the same as the administration attempts to address fiscal pressures and to change trade, defence and other policies that have progressively shaped the post-war world order, and do all of that quickly.

In our view, the past quarter of "shock and awe" from the White House reveals a consistent basis to policy. Decisions made by this administration reflect a world view anchored in four key beliefs. These animate the changes that the president and his cabinet hope to implement, and they embrace them so completely that collateral damage seems well down their list of concerns.

1. The U.S. has a fiscal problem which, left uncorrected, will compromise its future.
It's hard to argue with that. The fiscal deficit is expected to be 6.2% of GDP this year, adding to the national debt which has already bulged to 121% of GDP. Among the major economies, only Japan and Italy have weaker balance sheets (Exhibit 1).

"The president seems to want to conduct policy formation and execution in ways that create maximum surprise".

Exhibit 1: Global gross Debt/GDP ratios with IMF forecasts

	United States	Canada	France	Germany	Italy	Japan	United Kingdom
2010	95.2	84.0	85.2	80.4	118.7	205.9	75.9
2015	104.7	92.0	95.5	70.6	134.7	228.3	87.9
2020	131.8	118.2	114.6	67.9	154.1	258.4	105.8
2021	124.5	113.5	112.6	67.9	145.5	253.7	105.1
2022	118.6	107.4	111.1	64.8	138.1	256.3	99.6
2023	118.7	107.5	109.9	62.7	134.6	249.7	100.0
2024	121.0	106.1	112.3	62.7	136.9	251.2	101.8
2025	124.1	103.2	115.3	62.1	138.7	248.7	103.8
2026	126.6	101.2	117.6	60.9	140.2	246.9	104.9
2027	128.4	99.5	119.8	59.9	141.4	245.7	106.1
2028	130.2	97.9	121.9	59.0	142.0	244.8	107.3
2029	131.7	96.3	124.1	57.8	142.3	245.0	108.3
Pre-COVID peak	108.8	100.2	98.4	80.4	134.7	236.4	87.9
Anticipated Deficit/GDP ratio for 2025	-6.5	-1.9	-3.0	-5.5	-3.3	-2.9	-4.4

Note: anticipated peak. Source: IMF.

A bigger problem, though, is the Treasury's lack of flexibility with entitlements claiming 61% of expenditures, interest charges eating up another 14%, and national defence at 12% of outlays. Taken together, 87 cents of every dollar of federal government spending is committed. So (1) budget savings, at least in the near term, need to be found in less than 15% of outlays and (2) sensitivity to fixed income markets is acute. Rising yields will place even greater stress on the U.S. fiscal position as the Treasury refunds the national debt. That is, of course, absent a plan to raise revenues through the income tax or a VAT, both of which the White House has come out solidly against.

2. At some point, in the White House's version of economic history, the U.S. became a loser in globalization.
Manufacturing moved offshore, the U.S. middle class suffered from the loss of high-paying jobs, and the country became increasingly dependent on other nations, some of them unfriendly, for manufactured goods.

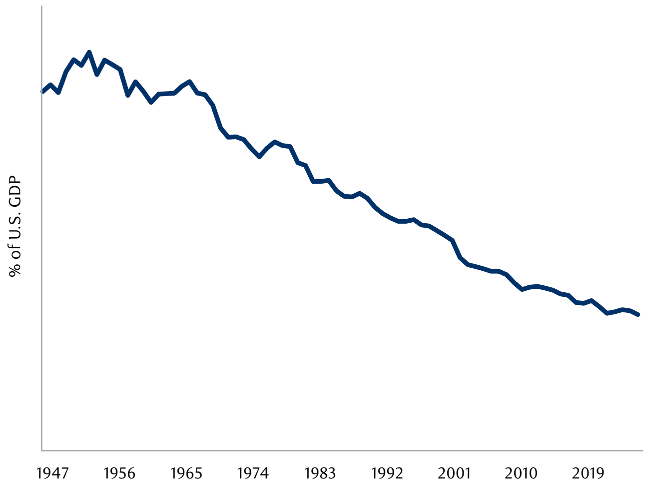
China's ascension to the WTO in 2001 is frequently cited as a tipping point, but the trend was in place long before that. As the U.S. assumed global economic leadership following the Second World War, manufacturing as a share of domestic GDP began a slide from 28% to 10% today, a reduction of about two thirds (Exhibit 2). This narrative also fails to consider the benefits enjoyed by U.S. consumers as production moved to low-cost regions.

> "As the U.S. assumed global economic leadership following the Second World War, manufacturing as a share of domestic GDP began a slide from 28% to 10% today, a reduction of about two thirds."

3. The U.S. cannot afford, and will not pay for, a disproportionate share of defence among its allies.
In this view, for too long too many nations continued to enjoy a peace dividend which many claim was an illusion in the first place. The administration believes that it's unfair and no longer sustainable to rely on the U.S. military to keep global peace.

4. Secure the border
While the first three issues have emerged as signature policy initiatives of the second Trump presidency, border security is a holdover from the first term. While still a threat to growth and inflation, especially with a backdrop of low unemployment, this particular policy is already familiar to markets and therefore unlikely holds the same potential for surprise as the others.

Exhibit 2: U.S. manufacturing as a share of GDP



Note: as of Q4 2024. Source: BEA, RBC GAM.

Implementation challenges

The White House wants to progress quickly on all fronts and seems prepared to accept imperfect solutions if they are at least moving in the desired direction. Tariffs, for example, are clearly a flawed fix for the trade imbalance, but they do raise some revenues and will almost certainly force some reshoring which brings with it new U.S. jobs in manufacturing. The cost in terms of inflation, inefficiency and the loss of global cohesion do not seem to be factored in.

It's possible that all of these goals could be achieved given appropriate time for the movement of people and capital, and with sufficient and sustained support from U.S. voters. The fiscal plan could be rebalanced, manufacturers could return at least some of their production to the U.S., and America's allies could reimagine their own defence and invest more in it. However, what we are seeing is the short run colliding with the long run. In the cross section of this is the economy and markets:

- Tariffs will drive inflation higher. Rather than settling toward 2.0-2.5% as we expected, we now look for U.S. inflation to approach 4% over the year ahead before falling back toward 3% later in 2026 should the White House succeed in implementing its current plans.

- U.S. growth will slow to about 1.3% in 2025 from the 2.02.5% we were looking for on Inauguration Day, with only a modest lift in 2026. Economies with the fiscal room to lean in (Germany) will best avoid the pressure.

- While recession fears are again stirring, driving rate expectations lower, we think the Fed and other central banks will be focused on inflation at least until a rowth accident moves into view with some degree of certainty. Currently the consensus looks for three cuts of 25 basis points to the fed funds rate during 2025. That seems a bit aggressive to us.

- Bond yields have moved higher, and we forecast a range of 4.0% – 4.7% for the 10-year T-bond, barring an unraveling of growth. Fixed income markets, though, are exceptionally vulnerable to a loss of faith should the president press ahead with his threats to remove Jay Powell as Fed Chair and thereby compromise the independence and inflationfighting credentials of the Federal Reserve Board. While the president surely wants lower rates to offset pain from tariffs, the spike in yields that would almost certainly follow tampering with Fed independence (as we saw on April 21), could prove far more damaging to the U.S. fiscal position and the White House's ability to effect fundamental change while avoiding recession. The April 9 delay in tariff implementation shocked markets, but it followed a nearly 50-basis-point rise in T-bond yields over the preceding five days. The White House appears to be ignoring most institutions as it pursues its aggressive goals, but the bond market vigilantes are still a powerful force against radical change.

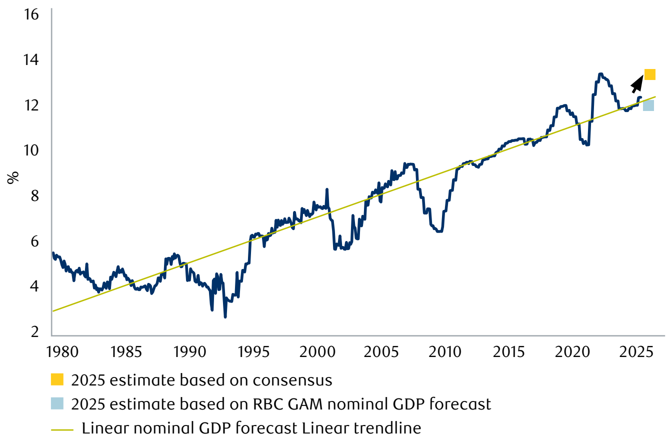
> **"While the president surely wants lower rates to offset pain from tariffs, the spike in yields that would almost certainly follow tampering with Fed independence."**

- The U.S. stock market, until quite recently highly valued, is now challenged for both earnings and valuations. Slower growth means the S&P 500 earnings initially forecast for 2025 won't be produced until 2026 at the earliest as profit margins succumb to the twin burden of tariffs and weakened consumers. Exhibit 3 reminds us that margins have been on a rising trend for three decades, so earnings forecasts likely embed more of the same. However, data assembled by Empirical Research (Exhibit 4) suggests that the trend may now be threatened as only 12% of margin improvement since 2000 resulted from management skill, with the balance delivered by offshoring production, lower interest rates and global tax shelters – all now at risk of reversal.

  U.S. equity market valuations, too, are suddenly challenged, and from a point where the MAG-7 had dragged the U.S stock market almost two standard deviations above its fair value price/earnings ratio (Exhibit 5). Our model reflects the historical relationship between the stock market's P/E ratio and it's determining factors: interest rates, inflation and corporate profitability. Another bout of inflation and higher yields will take a toll on the market's valuation level directly, and also indirectly as a result of dampened investor confidence in an environment of extreme change. Just returning the market P/E to its equilibrium at the midpoint of the band would shave another three to four points off the multiple.

Exhibit 3: S&P 500 Index

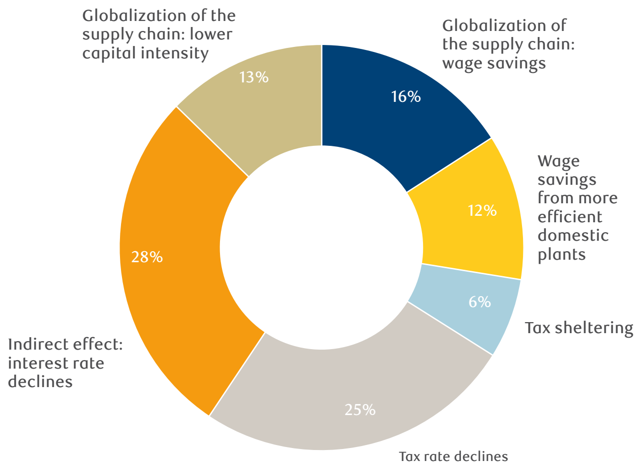
Net margin



Note: as of April 2025. Source: Bloomberg, RBC GAM.

Exhibit 4: S&P 500 Index manufacturers

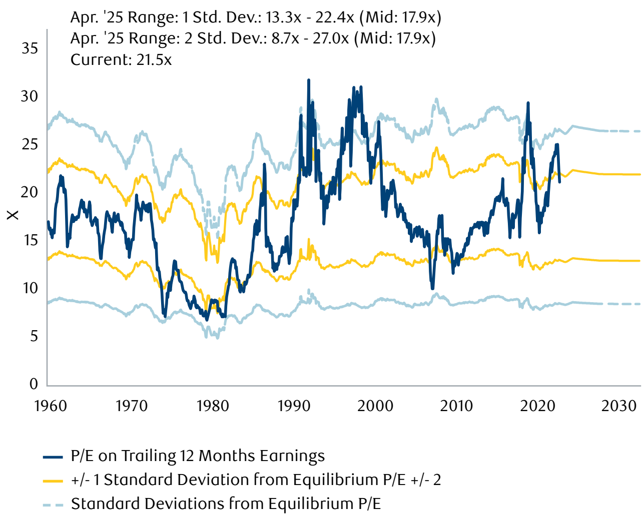
Sources of profit margin improvement since 2000



Source: Empirical Research Partners.

Exhibit 5: S&P 500 Index

Normalized (Equilibrium) Price/Earnings Ratio



Note: as of April 17, 2025. Source: RBC GAM.

- "U.S. exceptionalism" has been a defining feature of global capital markets since the recovery from the Financial Crisis began. The American economy's dynamism contrasted sharply with European and UK sclerosis at the same time as China dealt with debt and demographics and Japan struggled to leave 30 years of stagnation and lost growth behind. Over the past decade the S&P 500 has outperformed EAFE (MSCI Europe, Australia, Far East equity index) by 121% (or 8.3% annualized) (Exhibit 6), boosting the U.S. market's share of the MSCI World Index from 50% to 70% (Exhibit 7).

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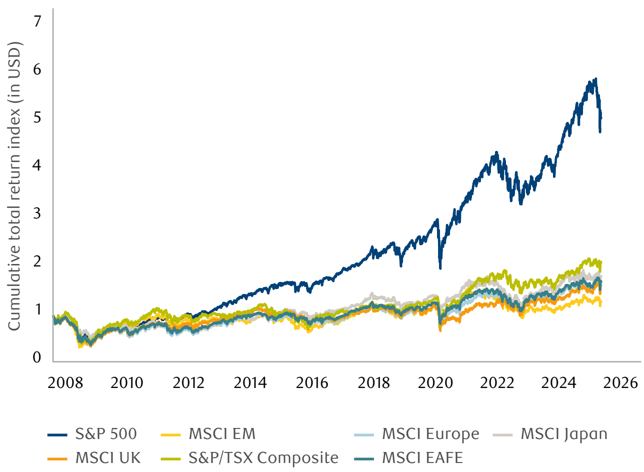
Similarly, the U.S. Dollar Index soared 36% from 2009 to 2024. U.S. assets, including stocks, bonds and the currency sucked in huge amounts of foreign capital as investors. chased performance in an otherwise fractious, slowgrowing world.

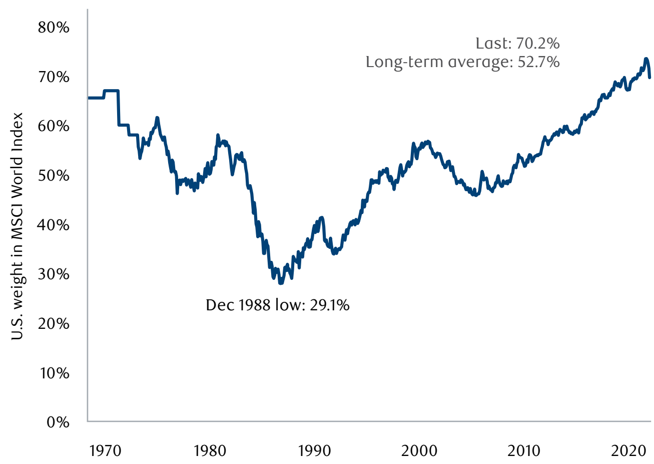
Markets are now testing U.S. exceptionalism, and there are signs of leadership transferring away. Exhibit 8 plots yearto-date performance for the U.S. and a variety of global stock markets. Led by Europe, the U.K., and Canada, most major markets outside the U.S. are now flat to up since the new year while the S&P 500 is down 12% and the tech-heavy NASDAQ has shed 18%. The U.S. dollar has also struggled, now off 9% since the beginning of the year, and, like stocks, this correction began from a position of significant overvaluation relative to others (Exhibit 9).

Exhibit 6: Equity index performance since 2008



Note: as of April 21, 2025. Source: Bloomberg, RBC GAM.

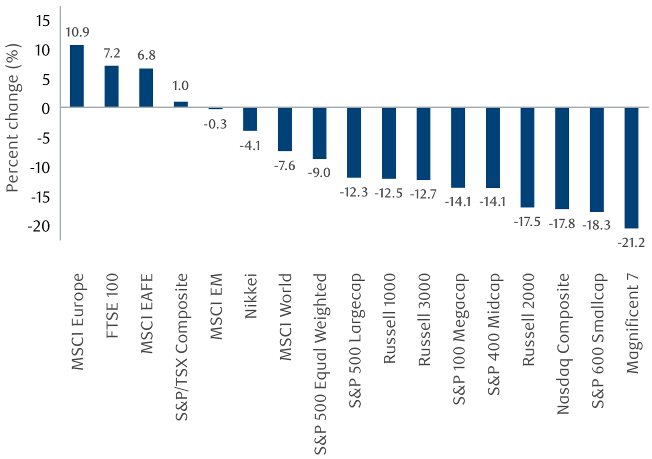
Exhibit 7: U.S. weight in MSCI World Index



Note: as of April 21, 2025. Source: RIMES.

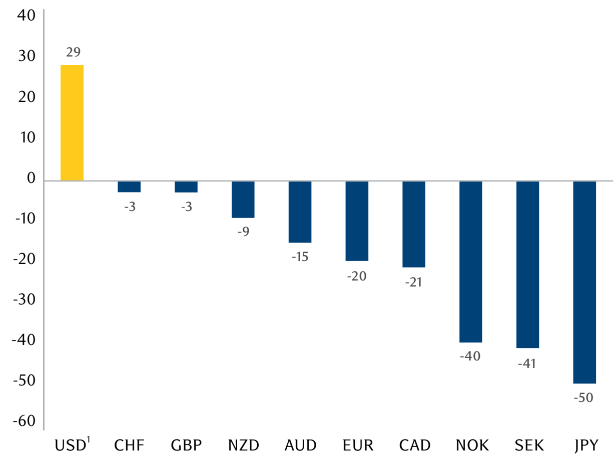
Exhibit 8: Major indices' price change in USD

2025 year-to-date



Note: as of April 21, 2025. Magnificent 7 includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla.
Source: Bloomberg, RBC GAM.

Exhibit 9: Purchasing power parity currency valuation



Note: as of January 2025. [1]Calculated relative to other countries using weights from the US trade-weighted Advanced Foreign Economies (AFE) Dollar Index. Source: Deutsche Bank FX Research, RBC GAM.

Perhaps most striking, though, has been the simultaneous decline of stocks, bonds and the dollar over recent days, and especially on days with severe market volatility. Although the White House says there are no signs of foreign capital leaving the U.S., that action suggests otherwise.

Looking ahead...

The administration hardly seems inclined to reverse course in policy or change its style of delivery, although the president has modified his initial proposals on s everal occasions as goals have been partially achieved or the pressure from markets proved severe. We should expect a continuation of frequent shocks, an elevated level of volatility and the lingering threat of weaker growth, rising inflation, higher bond yields and lower stock prices as the costs to the domestic and global economy are scoped.

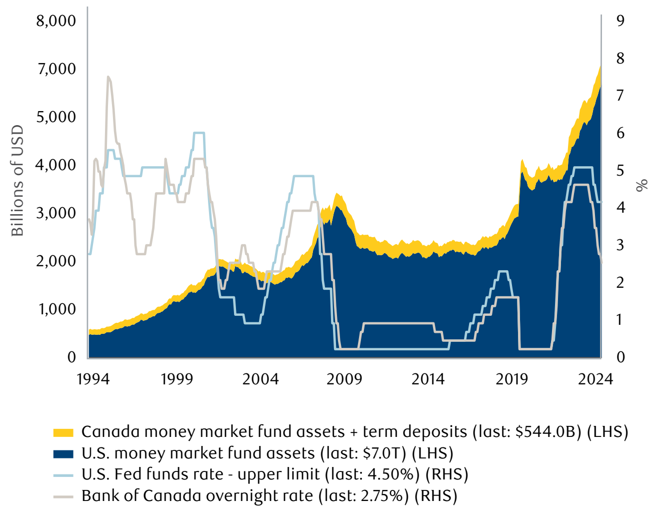
Nevertheless, the correction is opening up opportunities for investors, and with US$7 trillion in cash on the sidelines in the U.S. alone, there is increasing support for both offshore and U.S. stock markets as prices decline (Exhibit 10). Already, our global composite shows markets are 3.5% below aggregate fair value, down from a pre-Liberation Day peak of 6.7% above (Exhibit 11). Moreover, removing the U.S. equity market from the count shows valuations at 18.1% below equilibrium, not far off levels where durable market bottoms have been established in the past.

> **"After leading global indices since the beginning of the recovery from the financial crisis, the U.S. stock market has been among the worst performers since late December 2024 as Europe and others have moved to the front."**

A time-tested technical rule of thumb is that the leaders of the next bull market reveal themselves during the preceding correction. After leading global indices since the beginning of the recovery from the financial crisis, the U.S. stock market has been among the worst performers since late December 2024 as Europe and others have moved to the front.

We can only estimate how and when all of this might end and the scale of damage along the way. If, for example, the S&P 500 were to fall at once to fair value, the index would rest at 4815, down 12% from last night's close (April 24, 2025) (Exhibit 12). Other major market indices, though, are already at attractive valuations, having held beneath their respective fair values since late 2022.

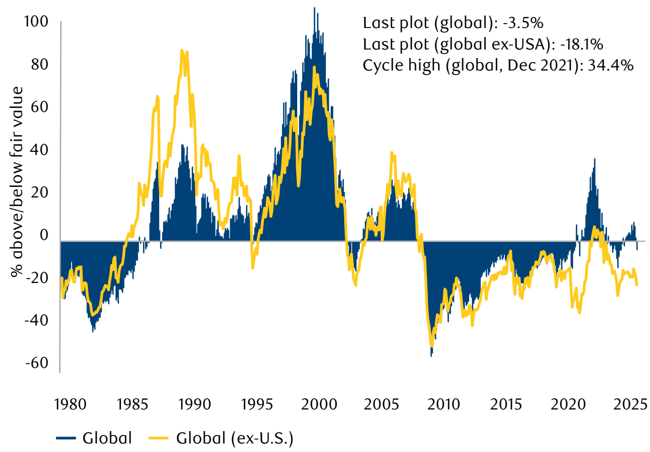
Exhibit 10: U.S. and Canada money market funds and term deposits



Note: as of April 22, 2025. Source: ICI, Bank of Canada, RBC GAM.

Exhibit 11: Global stock market composite

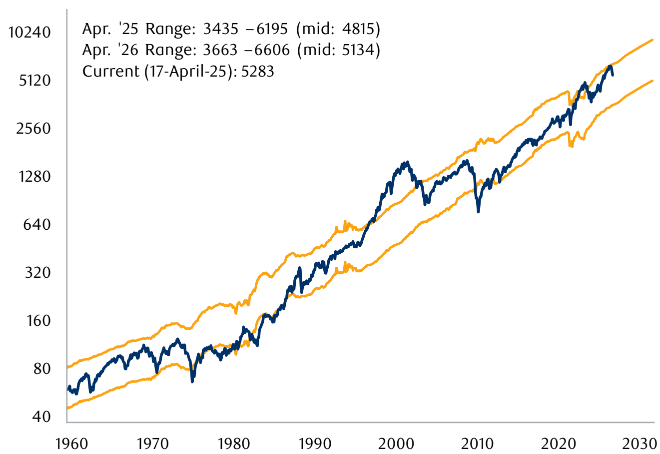
Equity market indexes relative to equilibrium



Note: as of April 21, 2025. Source: RBC GAM.

Exhibit 12: S&P 500 equilibrium

Normalized earnings & valuations



Note: as of April 21, 2025. Source: RBC GAM.

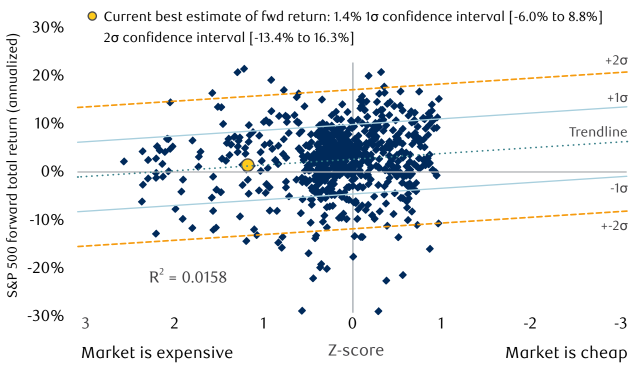
We do, though, know with certainty that returns in equity markets are heavily a function of their valuations at the time of investment. Patience and discipline are critical. Exhibit 13 plots 3-month forward returns (vertical axis) against the S&P 500's distance above or below its then-current fair value (horizontal axis). Although we tend to think of tactical asset management as taking advantage of short term market anomalies, this chart suggests otherwise with the relationship between valuations and returns essentially random in the short-term, evidenced by a correlation coefficient of less than 2%. However, stretch the time horizon to 10 years from the date of investment and the correlation coefficient soars to 65% (Exhibit 14)!

Investors who put money to work six months ago will likely see below normal holding period returns. But those who have dry powder are already looking at returns from current levels in some stock markets at or above historical norms, and these could be padded in an extended correction.

Almost two years ago we began reducing our overweight equity position within our recommended asset mix as we focused on the high hurdles to producing long-term normal returns especially in the leading but richly-valued U.S. stock market. For much of the period since then we declined to take risk relative to our strategic neutral position in stocks, but we began tilting our exposures away from the U.S. and toward much more attractively valued markets in Europe, Asia, Emerging Markets and Canada. At the same time, we aggressively managed our tactical positioning in fixed income as yields moved within a wide range, and minimized holdings in cash. In our latest edition of the *Global Investment Outlook* (Spring 2025 edition), we stuck to that tactical positioning, but are more and more encouraged to take advantage of opportunities that are presented at the new lower valuations for stocks, especially outside the U.S.

Exhibit 13: S&P 500 return versus average valuation metric z-score

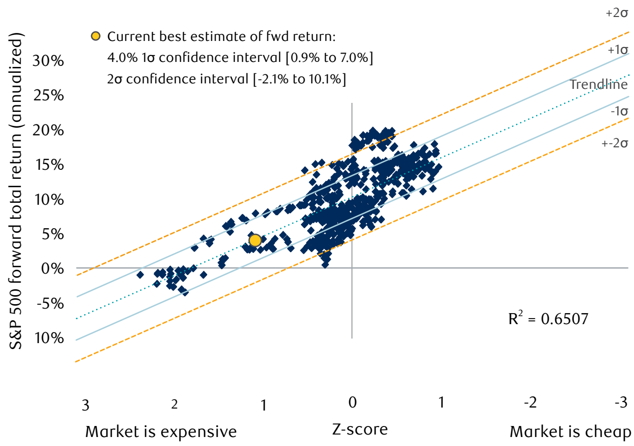
– 3-month forward total returns



Note: as of April 21, 2025. Z-score = number of standard deviations above/ below equilibrium. Source: RBC GAM.

Exhibit 14: S&P 500 return versus average valuation metric z-score

– 10-year forward total returns



Note: as of April 21, 2025. Z-score = number of standard deviations above/ below equilibrium. Source: RBC GAM.

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