GLOBAL

Insight

Midyear outlook focus

July 2023

Rallies, recessions, and realistic thinking

The S&P 500's surge over the past nine months doesn't feel to us like the start of a new bull market, but rather like the last leg of the current rally.

Jim Allworth

For important and required non-U.S. analyst disclosures, see page 6.

All values in U.S. dollars and priced as of market close, June 23, 2023 unless otherwise stated.

Produced: June 26, 2023 4:40 pm ET; Disseminated: June 27, 2023 10:30 am ET

MIDYEAR OUTLOOK

Focus

Jim Allworth
Vancouver, Canada
jim.allworth@rbc.com

Rallies, recessions, and realistic thinking

While the S&P 500's surge over the past nine months has rekindled investor optimism, it doesn't feel to us much like the start of a new bull market, but rather much more like the last leg of the current rally. Whichever it is, the market is certainly in a different place today. While this advance should have further to go into the summer, the economy will likely set the market's path for the coming 12 months.

Key points

- **The market rally from the September lows has gone far enough to turn many sceptics into believers. Joining other major markets in new high ground this summer is not out of the question for North American averages.**
- **"Fear of missing out" has been propelling the North American averages higher and could go on doing so for some months yet. But the attractive valuations of last September are giving way to loftier price-to-earnings ratios that we believe will need the economy to cooperate to be justified.**
- **Reliable leading indicators of U.S. recession continue to worsen, suggesting to us that this latest advance in share prices will eventually give way to a more challenging period for equity investors.**

A year ago, our 2022 Midyear Outlook was looking at an equity market landscape that was mostly the opposite of today's:

- Central banks, including the Fed, had started 2022 prepared to be somewhat tolerant of a pick-up in inflation but changed their tune as prices rose much faster than policymakers expected in the early months of the year. Mid-2022 would mark the opening stages of what would come to be the steepest series of rate hikes ever. Still to come for the Fed would be an unprecedented run of four successive 75 basis point (bps) jumps, followed by four more subdued increases totalling an additional 125 bps.
- Also at this time last year, the stock market's price-to-earnings (P/E) multiples had already been pressured lower by the sharp rise in bond yields that came with Fed tightening. The S&P 500 Index was down by 27 percent from its January 2022 peak while the Nasdaq was a whopping 38 percent off its high-water mark set in November 2021. Both had been heavily burdened by the big decline in P/E ratios among the previously high-flying mega-cap growth stocks. The six largest such stocks constituted more than 25 percent of the value of the S&P 500 at the peak of the market in early January last year.

Enter the rally

Most global equity indexes went on losing some more ground into last September before turning higher into a new up-leg. That rally from September has continued up to the present day. From September until May this was viewed by most as no better than a bear market rally that would eventually peter out. But as the S&P 500 moved convincingly above its trading range over

MIDYEAR OUTLOOK FOCUS

Rallies, recessions and realistic thinking

the past six weeks it has rekindled investor optimism. Market sentiment gauges have soared as "fear of missing out" (FOMO) has replaced caution.

For our part, we think this equity market up-leg has further to run. The UK's FTSE All-Share Index, the EURO STOXX 50, and Japan's TOPIX have all posted new highs for this cycle. Before the rally is over, we expect the S&P 500 and Canada's S&P/TSX Composite will do the same.

New bull or last gasp

However, this doesn't feel to us much like the start of a new bull market, but rather much more like the last leg of the current bull run. Whichever it is, the market is certainly in a different place than it was back at the September lows. At that point, most indexes had been falling steeply for nine months, some even longer. The P/E ratio for the S&P 500, an extravagantly overvalued 23.1x at the peak of the market in early January 2022, in our view, had fallen to a much more palatable, slightly undervalued 15.9x by September. This downswing in the index and in valuations occurred even as reported earnings were rising—the running 12 months earnings per share had risen from $208 to $219. Meanwhile, over the same interval, investor sentiment followed the market lower, sinking all the way from unsustainably bullish readings at the top in January to equally unsustainable bearish ones at the bottom in late September.

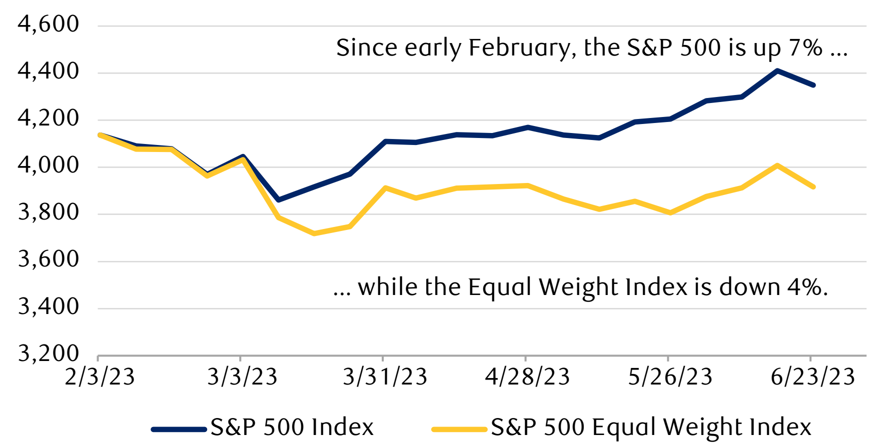
Since then, everything has been turned pretty much topsy-turvy. The U.S. equity market has gone up for nine months instead of down, and the S&P 500 is edging closer to new all-time highs. P/E multiples are back above a rich 20x. And, as noted above, sentiment readings have roared higher, getting closer to (but not yet at) the unsustainable levels that last prevailed at the top of the market a year-and-a-half ago.

Don't fight the economy

This strong upswing in equity index values (mostly contributed once again by a handful of mega-cap Tech and tech-related stocks as well as by a wave of investor interest for anything even remotely related to artificial intelligence) is persuading some market watchers that the U.S. economy will avoid a deeper downturn. However, most reliable leading indicators of recession (see our U.S. Recession Scorecard) have been moving inexorably toward even more negative readings.

S&P 500 Index versus S&P 500 Equal Weight Index

Both series indexed to the S&P 500 Index value on Feb. 3, 2023



Source - Standard & Poor's, FactSet; weekly data through 6/23/23

MIDYEAR OUTLOOK FOCUS

Rallies, recessions and realistic thinking

Of course, even leading indicators of U.S. recession that have been repeatedly and consistently right over the last 70 years or more could be wrong this time. Earnings and GDP growth could conceivably be pulling out of their funk starting right now. And if current consensus earnings estimates for $231 per share a year from now and $246 per share for all of 2024 prove to be correct, then that may be what is happening. That would put today's index value at almost 19x year-ahead earnings—not cheap, but perhaps not overly risky either, in our view.

However, our Recession Scorecard tells us that the underlying economic assumptions needed to bring in those improved earnings are becoming more and more improbable by the week. We expect that a U.S. recession will arrive later this year, that actual earnings will come in lower than current consensus estimates, and that share prices will go through a challenging period during which unrealistic optimism on the part of investors gives way eventually to unrealistic pessimism.

Only resilient stocks need apply

We continue to recommend Market Weight equity exposure for a global balanced portfolio because we think this advance has further to go into the summer months. However, we increasingly think individual stock selections should be restricted to companies that an investor 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.

Research resources

This document is produced by the Global Portfolio Advisory Committee within RBC Wealth Management's Portfolio Advisory Group. The RBC Wealth Management Portfolio Advisory Group provides support related to asset allocation and portfolio construction for the firm's investment advisors / financial advisors who are engaged in assembling portfolios incorporating individual marketable securities.

The Global Portfolio Advisory Committee leverages the broad market outlook as developed by the RBC Investment Strategy Committee (RISC), providing additional tactical and thematic support utilizing research from the RISC, RBC Capital Markets, and third-party resources.

The RISC consists of senior investment professionals drawn from individual, client-focused business units within RBC, including the Portfolio Advisory Group. The RISC builds a broad global investment outlook and develops specific guidelines that can be used to manage portfolios. The RISC is chaired by Daniel Chornous, CFA, Chief Investment Officer of RBC Global Asset Management Inc.

Global Portfolio Advisory Committee members

Jim Allworth – Co-chair
Investment Strategist, RBC Dominion Securities Inc.

Kelly Bogdanova – Co-chair
Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group U.S., RBC Capital Markets, LLC

Frédérique Carrier – Co-chair
Managing Director & Head of Investment Strategies, RBC Europe Limited

Mark Bayko, CFA – Head, Portfolio Management, RBC Dominion Securities Inc.

Rufaro Chiriseri, CFA – Head of Fixed Income – British Isles, RBC Europe Limited

Janet Engels – Head, Portfolio Advisory Group U.S., RBC Wealth Management, RBC Capital Markets, LLC

Thomas Garretson, CFA – Fixed Income Senior Portfolio Strategist, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

Ryan Harder, CFA – Fixed Income Portfolio Advisor, Portfolio Advisory Group, RBC Dominion Securities Inc.

Patrick McAllister, CFA – Manager, Equity Advisory & Portfolio Management, Portfolio Advisory Group, RBC Dominion Securities Inc.

Alan Robinson – Senior Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group – U.S. Equities, RBC Capital Markets, LLC

Michael Schuette, CFA – Multi-Asset Portfolio Strategist, RBC Wealth Management Portfolio Advisory Group – U.S., RBC Capital Markets, LLC

David Storm, CFA, CAIA – Chief Investment Officer, BI & Asia, RBC Europe Limited

Yuh Harn Tan – Head of Discretionary Portfolio Management & UHNW Solutions, Royal Bank of Canada, Singapore Branch

Joseph Wu, CFA – Portfolio Manager, Multi-Asset Strategy, RBC Dominion Securities Inc.

Required disclosures

Analyst Certification

All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.

Important Disclosures

In the U.S., RBC Wealth Management operates as a division of RBC Capital Markets, LLC. In Canada, RBC Wealth Management includes, without limitation, RBC Dominion Securities Inc., which is a foreign affiliate of RBC Capital Markets. This report has been prepared by RBC Capital Markets which is an indirect wholly-owned subsidiary of the Royal Bank of Canada and, as such, is a related issuer of Royal Bank of Canada.

Non-U.S. Analyst Disclosure

One or more research analysts involved in the preparation of this report (i) may not be registered/qualified as research analysts with the NYSE and/or FINRA and (ii) may not be associated persons of the RBC Wealth Management and therefore may not be subject to FINRA Rule 2241 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

In the event that this is a compendium report (covers six or more companies), RBC Wealth Management may choose to provide important disclosure information by reference. To access current disclosures, clients should refer to https://www.rbccm.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?EntityID=2 to view disclosures regarding RBC Wealth Management and its affiliated firms. Such information is also available upon request to RBC Wealth Management Publishing, 250 Nicollet Mall, Suite 1800, Minneapolis, MN 55401-1931.

RBC Capital Markets Distribution of Ratings

For the purpose of ratings distributions, regulatory rules require member firms to assign ratings to one of three rating categories – Buy, Hold/Neutral, or Sell – regardless of a firm's own rating categories. Although RBC Capital Markets' ratings of Outperform (O), Sector Perform (SP), and Underperform (U) most closely correspond to Buy, Hold/Neutral and Sell, respectively, the meanings are not the same because RBC Capital Markets' ratings are determined on a relative basis.

Distribution of ratings – RBC Capital Markets Equity Research

As of March 31 2023

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Outperform]	824	56.05	236	28.64
Hold [Sector Perform]	591	40.20	132	22.34
Sell [Underperform]	55	3.74	4	7.27

Explanation of RBC Capital Markets Equity Rating System

An analyst's "sector" is the universe of companies for which the analyst provides research coverage. Accordingly, the rating assigned to a particular stock represents solely the analyst's view of how that stock will perform over the next 12 months relative to the analyst's sector average.

Outperform (O): Expected to materially outperform sector average over 12 months. **Sector Perform (SP):** Returns expected to be in line with sector average over 12 months. **Underperform (U):** Returns expected to be materially below sector average over 12 months. **Restricted (R):** RBC policy precludes certain types of communications, including an investment recommendation, when RBC is acting as an advisor in certain merger or other strategic transactions and in certain other circumstances. **Not Rated (NR):** The rating, price targets and estimates have been removed due to applicable legal, regulatory or policy constraints which may include when RBC Capital Markets is acting in an advisory capacity involving the company.

Risk Rating: The Speculative risk rating reflects a security's lower level of financial or operating predictability, illiquid share trading volumes, high balance sheet leverage, or limited operating history that result in a higher expectation of financial and/or stock price volatility.

Valuation and Risks to Rating and Price Target

When RBC Capital Markets assigns a value to a company in a research report, FINRA Rules and NYSE Rules (as incorporated into the FINRA Rulebook) require that the basis for the valuation and the impediments to obtaining that valuation be described. Where applicable, this information is included in the text of our research in the sections entitled "Valuation" and "Risks to Rating and Price Target", respectively.

The analyst(s) responsible for preparing this research report have received (or will receive) compensation that is based upon various factors, including total revenues of RBC Capital Markets, and its affiliates, a portion of which are or have been generated by investment banking activities of RBC Capital Markets and its affiliates.

Other Disclosures

Prepared with the assistance of our national research sources. RBC Wealth Management prepared this report and takes sole responsibility for its content and distribution. The content may have been based, at least in part, on material provided by our third-party correspondent research services. Our third-party correspondent has given RBC Wealth Management general permission to use its research reports as source materials, but has not reviewed or approved this report, nor has it been informed of its publication. Our third-party correspondent may from time to time have long or short positions in, effect transactions in, and make markets in securities referred to herein. Our third-party correspondent may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any company mentioned in this report.

RBC Wealth Management endeavors to make all reasonable efforts to provide research simultaneously to all eligible clients, having regard to local time zones in overseas jurisdictions. In certain investment advisory accounts, RBC Wealth Management or a designated third party will act as overlay manager for our clients and will initiate transactions in the securities referenced herein for those accounts upon receipt of this report. These transactions may occur before or after your receipt of this report and may have a short-term impact on the market price of the securities in which transactions occur. RBC Wealth Management research is posted to our proprietary Web sites to ensure eligible clients receive coverage initiations and changes in rating, targets, and opinions in a timely manner. Additional distribution may be done by sales personnel via e-mail, fax, or regular mail. Clients may also receive our research via third-party vendors. Please contact your RBC Wealth Management Financial Advisor for more information regarding RBC Wealth Management research.

Conflicts Disclosure: RBC Wealth Management is registered with the Securities and Exchange Commission as a broker/dealer and an investment adviser, offering both brokerage and investment advisory services. RBC Wealth Management's Policy for Managing Conflicts of Interest in Relation to Investment Research is available from us on our website at https://www.rbccm.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?EntityID=2. Conflicts of interests related to our investment advisory business can be found in Part 2A Appendix 1 of the Firm's Form ADV or the RBC Advisory Programs Disclosure Document. Copies of any of these documents are available upon request through your Financial Advisor. We reserve the right to amend or supplement this policy, Part 2A Appendix 1 of the Form ADV, or the RBC Advisory Programs Disclosure Document at any time.

The authors are employed by one of the following entities: RBC Wealth Management USA, a division of RBC Capital Markets, LLC, a securities broker-dealer with principal offices located in Minnesota and New York, USA; RBC Dominion Securities Inc., a securities broker-dealer with principal offices located in Toronto, Canada; RBC Investment Services (Asia) Limited, a subsidiary of RBC Dominion Securities Inc., a securities broker-dealer with principal offices located in Hong Kong, China; Royal Bank of Canada, Singapore Branch, a licensed wholesale bank with its principal office located in Singapore; and RBC Europe Limited, a licensed bank with principal offices located in London, United Kingdom.

Third-party Disclaimers

The Global Industry Classification Standard ("GICS") was developed by and is the exclusive property and a service mark of MSCI Inc. ("MSCI") and Standard & Poor's Financial Services LLC ("S&P") and is licensed for use by RBC. Neither MSCI, S&P, nor any other party involved in making or compiling the GICS or any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability and fitness for a particular purpose with respect to any of such standard or classification. Without limiting any of the foregoing, in no event shall MSCI, S&P, any of their affiliates or any third party involved in making or compiling the GICS or any GICS classifications have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

Disclaimer

The information contained in this report has been compiled by RBC Wealth Management, a division of RBC Capital Markets, LLC, from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC Wealth Management, its affiliates or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report constitute RBC Wealth Management's judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. Nothing in this report constitutes legal, accounting or tax advice or individually tailored investment advice. This material is prepared for general circulation to clients, including clients who are affiliates of Royal Bank of Canada, and does not have regard to the particular circumstances or needs of any specific person who may read it. The investments or services contained in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about the suitability of such investments or services. To the full extent permitted by law neither Royal Bank of Canada nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct, indirect or consequential loss arising from, or in connection with, any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior written consent of Royal Bank of Canada in each instance. In the U.S., RBC Wealth Management operates as a division of RBC Capital Markets, LLC. In Canada, RBC Wealth Management includes, without limitation, RBC Dominion Securities Inc., which is a foreign affiliate of RBC Capital Markets, LLC. This report has been prepared by RBC Capital Markets, LLC. Additional information is available upon request.

To U.S. Residents: This publication has been approved by RBC Capital Markets, LLC, Member NYSE/FINRA/SIPC, which is a U.S. registered broker-dealer and which accepts responsibility for this report and its dissemination in the United States. RBC Capital Markets, LLC, is an indirect wholly-owned subsidiary of the Royal Bank of Canada and, as such, is a related issuer of Royal Bank of Canada. Any U.S. recipient of this report that is not a registered broker-dealer or a bank acting in a broker or dealer capacity and that wishes further information regarding, or to effect any transaction in, any of the securities discussed in this report, should contact and place orders with RBC Capital Markets, LLC. International investing involves risks not typically associated with U.S. investing, including currency fluctuation, foreign taxation, political instability and different accounting standards.

To Canadian Residents: This publication has been approved by RBC Dominion Securities Inc. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. * Member Canadian Investor Protection Fund. ® Registered trademark of Royal Bank of Canada. Used under license. RBC Wealth Management is a registered trademark of Royal Bank of Canada. Used under license.

RBC Wealth Management (British Isles): This publication is distributed by RBC Europe Limited and Royal Bank of Canada (Channel Islands) Limited. RBC Europe Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority (FCA registration number: 124543). Registered office: 100 Bishopsgate, London, EC2N 4AA, UK. Royal Bank of Canada (Channel Islands) Limited is regulated by the Jersey Financial Services Commission in the conduct of investment business in Jersey. Registered office: Gaspé House, 66-72 Esplanade, St Helier, Jersey JE2 3QT, Channel Islands.

To Hong Kong Residents: This publication is distributed in Hong Kong by Royal Bank of Canada, Hong Kong Branch which is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission ('SFC'), and RBC Investment Services (Asia) Limited, which is regulated by the SFC.

To Singapore Residents: This publication is distributed in Singapore by the Royal Bank of Canada, Singapore Branch, a registered entity licensed by the Monetary Authority of Singapore. This material has been prepared for general circulation and does not take into account the objectives, financial situation, or needs of any recipient. You are advised to seek independent advice from a financial adviser before purchasing any product. If you do not obtain independent advice, you should consider whether the product is suitable for you. Past performance is not indicative of future performance. If you have any questions related to this publication, please contact the Royal Bank of Canada, Singapore Branch. Royal Bank of Canada, Singapore Branch accepts responsibility for this report and its dissemination in Singapore.

Wealth Management