GLOBAL Insight

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

October 2023

New normal, old normal, or no normal?

As global interest rates reach levels not seen in more than a decade, we explore what may be in store for the future of monetary policy.

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GLOBAL

Insight

October 2023

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All values in U.S. dollars and priced as of market close, Sept. 30, 2023, unless otherwise stated.

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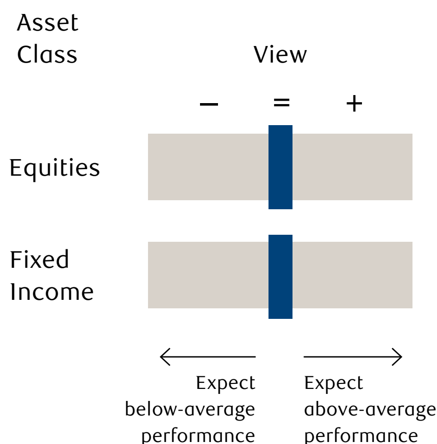
RBC'S INVESTMENT
Stance

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

- We continue to recommend a Market Weight position in global equities for now. We believe the S&P 500 and perhaps other developed markets may be able to reach new highs in the next few months if faith in an economic soft landing for the U.S. can be supported by some plausible rationale.
- However, we note that below the surface, U.S. consumers' spending power and confidence appear to be under pressure, compressed by depleted savings, high interest rates, a growing reluctance of banks to lend, and rising energy costs.
- We think 2024 is likely to feature a more challenging landscape for the economy and equity markets.

Fixed income

- Global yields again achieved fresh highs in September with the average yield on the Bloomberg Global Aggregate Bond Index peaking at 4.3%, the highest level since 2008. This comes at a time when most central banks are likely at, or near, the end of their respective rate hike cycles as policymakers attempt to balance the economic risks of doing too much against the inflationary risks of doing too little. We think the policy prescription will be to keep rates steady, but elevated, while convincing markets that rate cuts are nowhere on the horizon. As a result, the window to put money to work at attractive levels may be open for longer.
- We remain Market Weight U.S. fixed income with yields remaining near multi-year highs. While economic risks have subsided in the U.S., global recession risks remain elevated. Therefore, we broadly remain Underweight corporate credit with a slight bias toward government bonds.

MONTHLY
Focus

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New normal, old normal, or no normal?

With global interest rates achieving levels not seen in over a decade, some investors are beginning to wonder whether the era of zero and negative interest rates has ended. We explore what may be in store for the future of monetary policy.

Key points:

- **The theory of a "neutral" rate of interest for economies, one that neither boosts nor restricts economic activity, has long guided central bank policy.**
- **Neutral rates have been in a state of decline for decades, and while there are reasons to think they have moved higher as global economies change and adjust to a post-pandemic world, we continue to believe the longer-term drivers of lower interest rates will ultimately prevail.**
- **Rates are likely to remain at historically high levels for an extended stretch, but if and when central banks need to turn back to stimulus measures, low rates are likely to remain the primary tool in their toolkits.**

The idea of a new normal in the aftermath of the Global Financial Crisis 15 years ago was a common theme amongst market participants. The Great Moderation of the mid-1980s to 2007 was highlighted by long and sustained economic expansions with stable inflation that could hardly have done less to prepare investors for what was to follow.

Deleveraging by U.S. consumers following the housing bubble paired with an anemic government fiscal policy response meant that monetary policy was left to do the bulk of the heavy lifting as subpar economic growth gave way to a stretch where too-low, rather than too-high, inflation was the primary problem facing central banks. The net result was the first 0% policy rate from the Federal Reserve and other global central banks, not to mention negative policy rates later employed by others, on top of new and alternative policy tools such as large-scale asset purchase programs.

Now it seems as though those issues have reversed. The U.S. fiscal response to the pandemic went above and beyond, economic growth has been persistently above long-term trend levels, and inflation is—of course—well above target levels. As a result, the Fed has hiked rates to levels not seen in over 20 years, with similar outcomes for most major global central banks.

After a decade of investors navigating through zero and even negative-interest-rate policy regimes, what might the next five, 10, and 15 years look like for central bank policy, and more importantly, have we actually left the era of low interest rates behind?

NEW NORMAL, OLD NORMAL, OR NO NORMAL?

The stars are the landmarks of the universe

"As is often the case, we are navigating by the stars under cloudy skies." That was Fed Chair Jerome Powell in an August speech referring to the stars that guide the Fed, and the uncertainty under which it is operating. In Fed parlance, the "stars" policymakers are navigating by are the natural rates of interest, or r* (pronounced r-star) and the natural rate of unemployment, or u*.

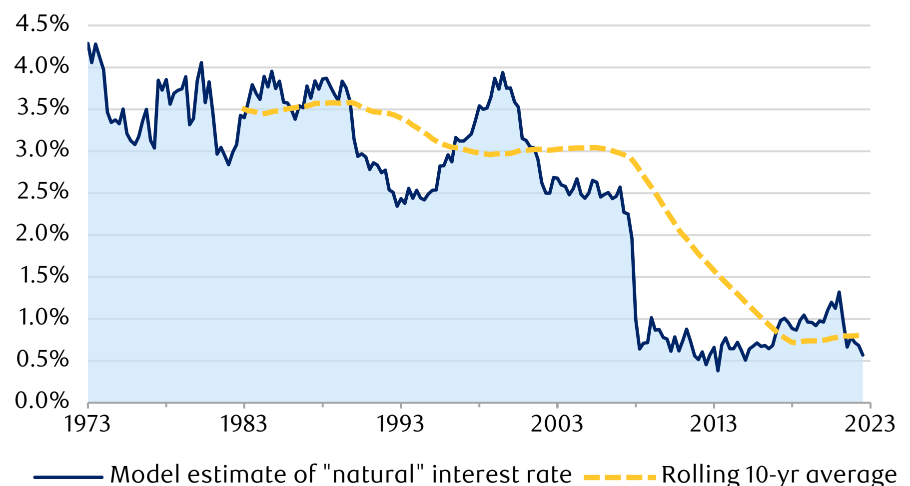
And while perhaps rather poetic for a Fed chair, the theme of celestial navigation is one he has discussed at numerous points during his tenure and could give us an idea of what it means for the near-term policy outlook and perhaps what lies beyond.

To be clear, these theoretical natural rates of interest and unemployment—or the levels that should prevail at times of price stability and full employment—are just that: theoretical. But there are numerous models that attempt to estimate these celestial beings.

The first chart shows one of the most common models co-created by current New York Fed President John Williams to estimate the prevailing real natural interest rate, which is adjusted for inflation. This natural level still sits at just 0.56% on a real basis, or 2.56% when adding the Fed's 2% inflation target.

Why might this be? Interest rates have been in a state of steady decline since the Great Inflation of the 1970s and 1980s, while other research has suggested interest rate levels have been in a steady state of decline over the past 700 years. The key drivers of this so-called natural rate of interest are rather simple, in our opinion. Global potential growth has naturally slowed over time as economies have matured. The biggest driver, demographics, remains firmly in favor of lower natural rates as the global population ages, continuing to fuel excess savings and demand for

One estimate of the "natural" interest rate suggests we're still in the era of low rates



Note: Model based on the Holston-Laubach-Williams estimate of the real (inflation-adjusted) natural rate of interest.

Source - RBC Wealth Management, Bloomberg

what are perceived to be safe assets. Risk aversion, particularly after the economic and psychological harm of the financial crisis, is also perhaps another factor anchoring natural interest rates lower.

But whether it's a 40- or 700-year trend, those are powerful forces to contend with, suggesting that this current episode of historically high policy rates in the U.S. and globally is perhaps more likely an aberration rather than a break from the post-financial crisis era. In fact, Williams has maintained at numerous points this year that he sees little reason to think the natural rate of interest has moved higher.

That said, there may be some reasons to think that natural interest rates could indeed begin to trend higher in the years ahead.

The Fed's North Star

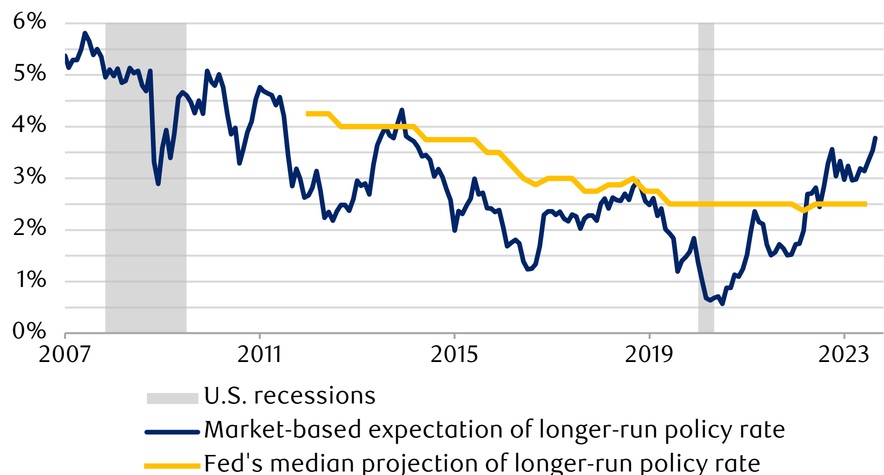
There's one more star the Fed navigates by, but this one is easy to observe and has remained constant for some time: the natural rate of inflation, or π*, which has been formally 2% since 2012.

As the below chart shows, Fed policymakers also broadly agree with the view that the longer-run natural interest rate is around 2.50%, a real level of 0.50% plus the 2% inflation target, though at the margins this has begun to shift higher with some at the Fed seeing it around 3.3% following the Sept. 19–20 policy meeting.

The market may also be entertaining the idea that natural rates could shift higher as gauged by an index that captures what the market expects overnight rates to average over five years, beginning five years from now. It too has consistently trended lower since 2007 only to reverse to nearly 4% recently.

In our view, there are perhaps two key reasons why, and maybe one ancillary one. The first likely stems from the strong policy response to

As markets price a higher natural rate, will the Fed projection follow?



Note: Market-based expectations based on 5-year, 5-years-forward Overnight Index Swap rate; Fed projection based on Federal Open Market Committee target.

Source - RBC Wealth Management, Bloomberg

NEW NORMAL, OLD NORMAL, OR NO NORMAL?

the pandemic that sparked a brisk recovery and an environment where inflation is modestly more structural than it has been in some time.

The second relates to the Fed's North Star—the 2% inflation target. Powell has also highlighted in recent years the challenges posed by low natural rates which is essentially that during economic downturns or times of stress the Fed only has a small window between 2.5% and 0.0% within which to cut rates in order to provide economic stimulus. After the effective lower bound of 0.0% is reached, the Fed has to revert to other alternative tools beyond the policy rate.

If real natural rates are indeed likely to remain historically low and near 0.0%, then the only way to create a larger window to manage policy rates is to raise the inflation target. This has been a regular point of discussion in recent years, and though the Fed would never broach the topic at a time when inflation remains entirely too high, we see a decent chance the Fed could begin to publicly explore the idea as early as 2025.

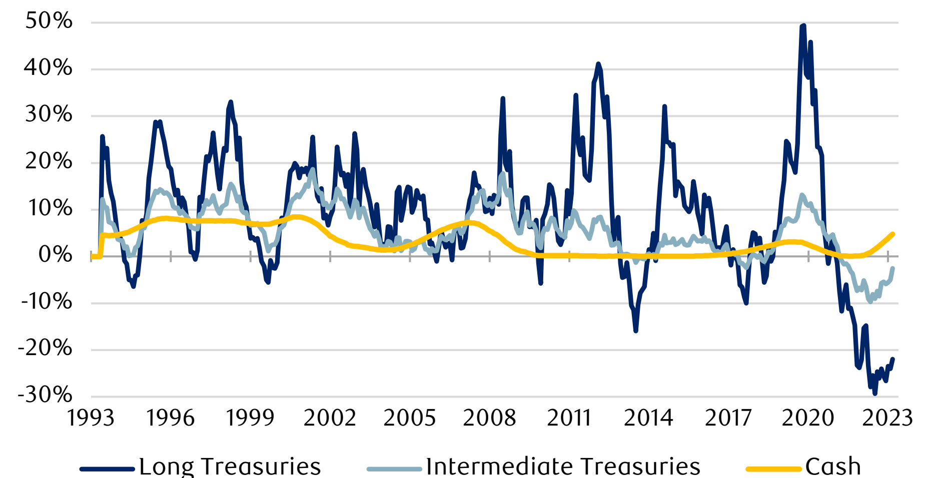
Lastly, there's the issue of artificial intelligence (AI), though admittedly it is a relative unknown as it relates to natural rates, that could be an underlying longer-term dynamic that has investors reassessing the future interest rate levels. But low productivity has long been a drag on potential economic growth rates. Should AI deliver on its rosiest of promises, then perhaps markets may be starting to price in the chance that AI fuels a productivity boom and, therefore, higher potential growth, though this is surely a longer-term issue.

The normal verdict

What does all of this mean for investors? Our base case is that the long-term trend of lower rates will remain largely in place. On the issue of a new

The outperformance of cash may have run its course

Rolling 15-month total returns



Note: Cash represented by Bloomberg US Treasury Bills 1–3 Month Index, intermediate Treasuries by Bloomberg US Intermediate Treasury (1–10 year) Index, long Treasuries by Bloomberg US 10+ Year Treasury Bond Index.

Source - RBC Wealth Management, Bloomberg

NEW NORMAL, OLD NORMAL, OR NO NORMAL?

normal, or a reversion to some old normal, we maintain a view that there really is no normal. Monetary policy and central bank toolkits will continue to evolve with each business cycle and perceived economic era.

Within that framework then, it's likely the case that the current yield environment presents a smorgasbord of opportunities for investors. As the final chart shows, cash has had its day in the sun since the Fed began raising rates in March 2022 delivering total returns of nearly 5% based on 1–3 month Treasury bills, while longer-dated Treasuries are still down by over 20%, one of the biggest performance gaps on record. But the tide may already be shifting, as longer-dated bonds are already clawing back returns with central banks appearing to be at or near peak rate levels.

But attempting to time the market is only likely to mean that an investor will miss it altogether. So, we would simply employ a strategy in coming months and quarters of gradually moving out of cash and short-dated bonds in a higher for longer, but maybe not forever, rate environment.

GLOBAL

Equity

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A narrowing path

- **There continues to be a (diminishing) possibility the S&P 500 and perhaps other developed markets could post new highs in the next few months. As long as faith in a so-called soft landing for the U.S. economy can be supported by some plausible rationale, we think an ever-narrowing path to higher ground will remain open.**
- **However, beneath the surface the spending power and confidence of the U.S. consumer are under pressure, compressed by depleted savings, high and rising interest rates, a growing unwillingness of banks to lend, and rising energy costs. Next year is likely to feature a more challenging landscape for both the economy and equity markets.**

After a rewarding 10-month upward advance into July, the S&P 500 Index, as well as European and Japanese markets, entered a correction/ consolidation phase that has been playing out into the often seasonally weak fall period. These markets appear increasingly oversold. A rebound rally is likely to develop in the coming weeks, in our view, and the possibility of the S&P 500 putting in a new high can't be ruled out.

However, the probability of reaching a new high is diminishing, in our opinion, and depends more on technical market factors than on fundamentals. In particular, the advance-decline (A/D) line for the S&P 500, a measure of market breadth and participation, touched a new all-time high in the summer. Often, but not always, the S&P 500 itself could be expected to join the A/D line in new high ground. But that would require a strengthening of the soft landing (i.e., no recession) case for the U.S. economy.

Faith that the post-pandemic economic expansion has further to run in the U.S. has been the fuel that has driven most markets higher, periodic pullbacks notwithstanding. Ever since the Fed began raising interest rates and dismantling quantitative easing programmes, the forecasting community has been grouped into one expecting a soft landing and another looking for a hard one.

Equity views

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

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

The debate continues. The soft landing proponents have recently been taking heart from some moderately better-than-expected economic data, including employment conditions that have refused so far to weaken.

There is also a line of thinking which argues that the fact the U.S. economy is apparently still growing means that it is not about to fall into recession. This group points to the respectable 2.1% annualised real GDP growth posted in Q2, and if more comfort is needed, to the 4.9% estimate for Q3 generated by the Atlanta Fed's widely watched GDPNow model. This model is useful, but pinpoint accuracy is not intended to be one of its features—the average error of its predictions is +/- 1.2 percentage points.

It's also worth noting that the Atlanta Fed's process is not finished yet for

GLOBAL EQUITY

this quarter and won't be until the September data releases have all been reported through late October. And there are, in fact, two other regional Fed banks which publish "nowcasting" forecasts (i.e., using current data, including big data, to predict economic trends as they happen): the St Louis Fed's estimate for Q3 growth currently stands at 1.6% while the New York Fed's is at 2.1%. Average the three models and you're looking at 2.9%.

The real GDP growth rates in each of the quarters positioned just prior to the onset of every recession back through to the 1950s ranged between +9.3% and -2.9%. The average was +2.4%, but we find no compelling central tendency in evidence. It would seem that the growth rate in one quarter has very little useful to say about the likelihood of a recession arriving in the next.

We are more persuaded by the historical record, which reveals that the progressive tightening of credit conditions by way of a long succession of Fed rate hikes accompanied by a multi-quarter boosting of bank lending standards has never been a recipe for avoiding a recession. Rather, those factors have always preceded or been part of a hard landing.

Those restrictive conditions are present and have been building for more than a year. We expect their effect to be more keenly felt by the economy and stock market through some extended part of next year. Of course, there can always be a first time, but planning on being let off easy when the historical probabilities point toward a more challenging outcome doesn't seem like the prudent course to us.

For now, we recommend remaining sufficiently committed to stocks to take advantage of what we regard as a diminishing possibility of reaching a new high in the coming few months. However, we believe investors should consider limiting individual stock selections to companies they would be content to own through a recession, which, in our view, is the most probable economic outcome in the coming quarters. 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.

Perhaps the most compelling reason for focusing on resilient, high-quality businesses is that the headwinds which appear to be gathering will, in our view, run their course and probably fully dissipate later next year. Equity markets typically have anticipated the start of a new economic expansion several months before it gets underway. In our opinion, portfolios that have held their value to a better-than-average degree will be best-equipped to take advantage of the opportunities that are bound to present themselves at that positive turning point when it arrives.

Regional equity perspectives

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United States

- After strong gains in the first half of the year, momentum has stalled and major U.S. equity indexes have pulled back. The continued rise in the 10-year Treasury yield and hawkish signals from the Fed dampened enthusiasm for equities. For years the U.S. stock market had an advantage over U.S. bonds because the latter's yields were unusually low; more money flowed into stocks than would have otherwise. Now the bond market appears to be back, offering yields much higher than the S&P 500 dividend yield. We think this is causing a greater proportion of incremental cash to flow into bonds instead of stocks.

- While many institutional investors are focused on the economy's resiliency, our leading indicators are still signaling that a recession can't be ruled out within the next 12 months. If one materializes, we think S&P 500 earnings would fall short of the 2024 consensus forecast of $247 per share.

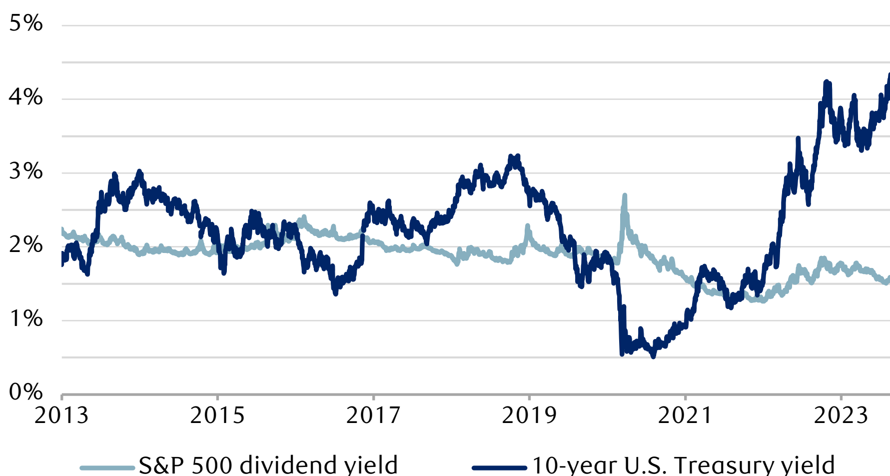
- We recommend holding no more than Market Weight exposure to U.S. equities and would tilt toward high-quality companies—those with reliable cash flow generation, sustainable and growing dividends, lower debt levels, and strong management teams. In our view, valuations look pricey for the seven large technology-oriented stocks that have done the heavy lifting so far this year, representing the bulk of the S&P 500's 11.7% gains. We prefer the S&P 500 Equal Weight Index to the capitalization-weighted S&P 500 Index, which is much more exposed to those tech-oriented stocks.

Canada

- Canada's economy surprised to the downside in Q2 as GDP contracted relative to the prior quarter, suggesting higher interest rates are constraining activity. Consumer spending advanced at its slowest pace since Q2 2021, and residential investment fell for a fifth straight quarter. We remain conscious that the full impact of the Bank of Canada's tightening campaign has yet to be felt across an economy that is particularly sensitive to interest rates due to elevated household debt and housing's outsized economic contribution.

- Several Canadian banks recently cited the risk of "higher for longer" rates when provisioning for future credit losses. Bank valuations continue to reflect the uncertain environment with the group trading at a steep discount relative to its long-term average and close to "non-crisis" troughs. While it is hard to

The U.S. 10-year Treasury yield has surged while the S&P 500 dividend yield has drifted lower



Source - RBC Wealth Management, Bloomberg; data through 9/22/23

REGIONAL EQUITY PERSPECTIVES

identify a catalyst for why valuations should improve at this point in the credit cycle, we believe income-oriented investors with a long-term view can find opportunities.

■ We expect energy sector performance will be largely influenced by commodity prices. We would highlight Energy investors' ability to reap meaningful cash returns via share buybacks and dividends in a constructive economic outcome, while companies are better equipped to navigate a more challenging macro backdrop via fortified balance sheets and what we see as reasonable capital expenditure needs.

Continental Europe

■ European equities have markedly lagged the S&P 500 Index over the past six months owing to the sharp deterioration in the region's relative economic momentum. The main culprits for this backdrop are softening global demand for Europe's manufactured goods, particularly in China, and the European Central Bank's aggressive interest rate hiking cycle. Moreover, compared to other regions, the MSCI Europe ex UK Index has lower exposure to growth stocks, and to Technology stocks in particular, which have outperformed in recent months amid the surge in interest around artificial intelligence.

■ Following their bout of underperformance, we think European equities have a particularly attractive valuation, both in a historical context and relative to the U.S. Even taking into account differences in sector exposure, the MSCI Europe ex UK Index trades at a historical discount to the S&P 500.

■ We continue to recommend an Underweight position in European equities as we think weakening macro and earnings momentum will remain headwinds to the region's ability to outperform. Economic momentum has stalled since the spring, but this does not appear to be fully reflected in earnings expectations. Given the more muted economic environment, we think consensus earnings forecasts are at risk of being downgraded.

■ Against this backdrop, we would remain selective. For the patient investor, some attractive opportunities may be emerging in sectors which have sold off heavily, such as luxury stocks that suffered due to their China exposure.

United Kingdom

■ UK equity performance has been disappointing this year. Given the FTSE All-Share Index's relatively large exposure to defensive sectors (e.g., Health Care and Consumer Staples) and value sectors (e.g., Financials and Energy), it tends to suffer when growth stocks are in vogue. Moreover, the pound's appreciation versus the U.S. dollar until midsummer proved to be a powerful headwind given companies in the index derive the majority of their revenues abroad. UK equity valuations appear undemanding, with almost every sector trading on an abnormally high discount relative to history.

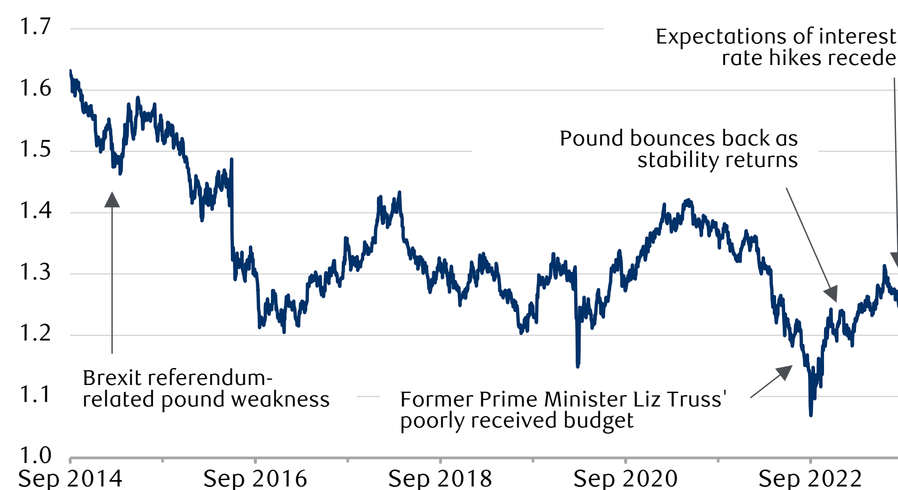
■ Prospects may be improving. Investors are hoping that the Bank of England's recent decision to pause rate hikes could be a positive catalyst. The pound has been weakening as a result of the pause, mitigating an important headwind for equities. Moreover, the UK's blue-chip equity index, the FTSE 100, typically outperforms when value stocks outperform growth stocks given the index's bias to "old economy" industries such as Energy, Mining, and Banks. This dynamic has been supportive recently, with rising oil prices helping to buoy the Energy sector.

■ As a result, we are upgrading UK equities to Market Weight from Underweight. We acknowledge the challenging domestic economic prospects and remain cautious on domestic stocks. But we would be alert to opportunities in the Energy sector, as well as in leading globally

REGIONAL EQUITY PERSPECTIVES

The pound weakens again

GBP/USD currency pair



Source - RBC Wealth Management, Bloomberg

diversified, high-quality businesses whose valuations remain at a notable discount versus international peers listed in other markets.

Asia Pacific

- Chinese economic data showed signs of improvement in August. We believe there is room for additional stimulus in Q4, which could help revive the economy. Investors may monitor the macro data and corporate earnings for a few more months to judge if the economy is indeed improving. Therefore, we believe the Chinese equity market could remain somewhat volatile in the short term. Because we sense that investor sentiment is leaning towards pessimism, it would be unreasonable, in our view, for investors to adopt an even more bearish stance. We think the recent advancements in the Chinese semiconductor industry could help alleviate some concerns regarding U.S. tech restrictions, potentially paving the way towards equity market stabilization.

- The recent reaction of the Japanese equity market to the prospect of an early move away from the country's negative interest rates suggests momentum remains healthy. Some market observers expect the Bank of Japan to further relax its yield curve control policy in early 2024, and to lift negative interest rates in H2 2024. We continue to favor Japanese equities for the following reasons: the deflation era seems to be coming to an end; companies are expanding shareholder returns; domestic demand is likely to remain strong; there is heightened interest in the market as a proxy investment for Chinese stocks; Chinese tourists are returning in H2 2023 with the lifting of group travel bans; there is heightened interest in the potential value in the market due to Warren Buffett's recently disclosed investments in five Japanese companies; the country's relatively easy monetary policy; increasing foreign fund inflows; and what we consider to be undemanding valuations.

GLOBAL

Fixed income

It may be autumn, but yields won’t fall

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Even as global central banks have ostensibly reached the end of rate hike cycles, at least for the time being, sovereign bond yields have continued to rise sharply as traders dial back expectations that rate cuts are anywhere on the horizon.

Over the course of Q3, the U.S. benchmark 10-year Treasury yield added 70 basis points (bps) to reach a fresh 15-year-plus high of 4.54%, even as the Federal Reserve only raised its overnight policy rate once by 25 bps during the quarter (at its July meeting) to a 5.25%–5.50% level.

So, it’s not rate hikes that are driving yields higher, but rather fading prospects of rate cuts. At one point last summer, markets had priced a scenario that the Fed would be cutting rates down to 3.75% by the end of next year. That expectation has risen to nearly 4.75% as policymakers have pledged their commitment to keeping rates higher for longer in order to bring inflation down to the 2.0% target.

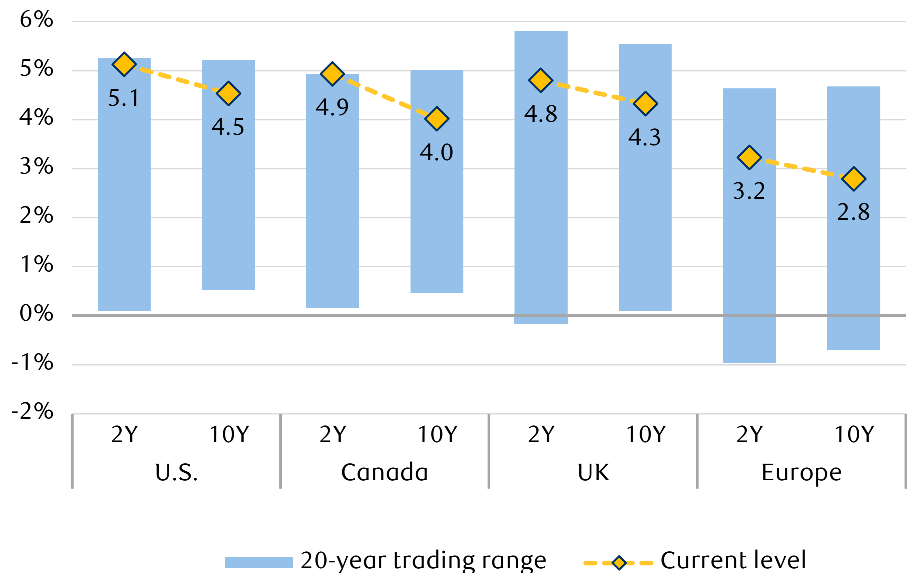
Fixed income views

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

It’s a similar story globally. While anticipated economic downturns have seemingly been delayed, risks haven’t dissipated entirely. Central banks have settled into the idea that holding rates at elevated levels for an extended stretch is the preferred strategy rather than pushing forward with rate hikes until something potentially breaks.

Sovereign yields trading at or near 20-year highs in many regions



Source - RBC Wealth Management, Bloomberg; Europe represented by German sovereign yields; data as of 9/25/23

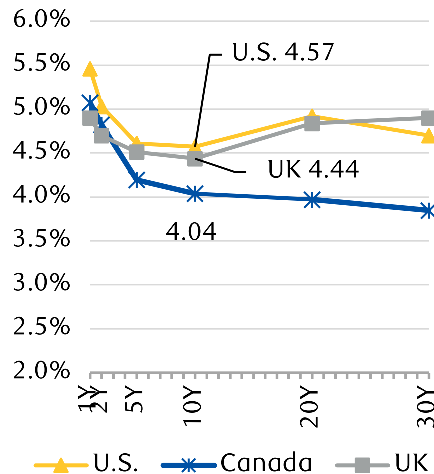
GLOBAL FIXED INCOME

Higher yields—which push bond prices lower—continue to weigh on bond market performance. Returns on the Bloomberg US Aggregate Bond Index have turned negative once again, now down 1.0% year to date, while the Bloomberg Global Aggregate Ex-USD Bond Index is down 3.0%.

But with global sovereign yields at historically attractive levels across most regions, and the end of rate hikes at the doorstep, the risk-reward setup for fixed income investors has rarely been better, in our view. For example, while Treasury performance remains negative this year, the U.S. 10-year yield would have to rise to 5.2% over the next year for the price decline to completely offset coupons earned over that stretch. Alternatively, should the 10-year yield fall back below 4.0%, the combination of coupons and bond price appreciation in that scenario would deliver U.S. investors returns of nearly 10%, with similar dynamics likely globally.

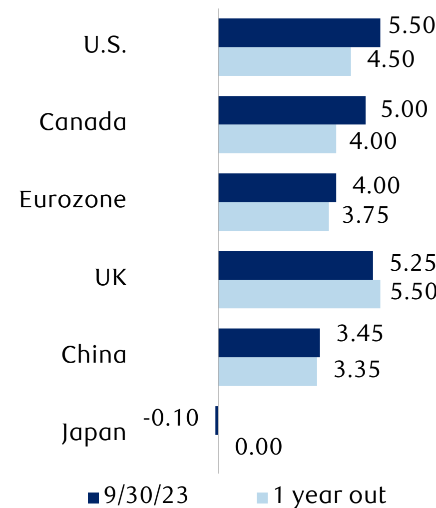
At this stage of peak central bank rates and what could be a return of economic fears in Q4, we now hold a more positive outlook for sovereign debt performance relative to corporate bonds.

Sovereign yield curves



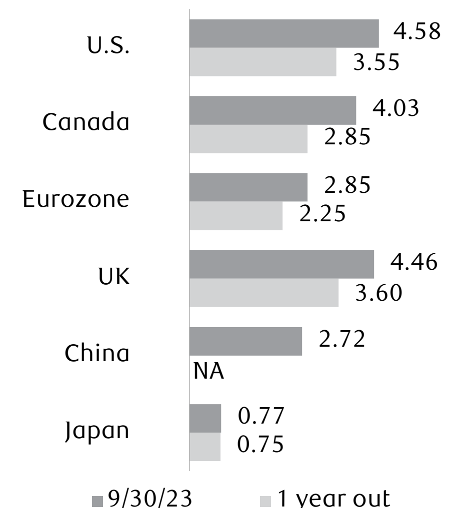
Source - Bloomberg; data through 9/30/23

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

Regional fixed income perspectives

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United States

- The Federal Reserve has ostensibly reached the end of its rate hike cycle, though policymakers are essentially split as to whether one more hike to a target range of 5.50% to 5.75% is forthcoming by the end of the year. The path of inflation, of course, will dictate the Fed's decision. Current market pricing has the year-over-year pace of the Consumer Price Index falling under 3% by November, which would be the lowest level since March 2021. Ultimately, we think the Fed will hold rates steady for the balance of the year.

- The benchmark 10-year Treasury note yield traded as high as 4.51% in Q3, marking the highest level since 2007 when it peaked at 5.32%. With the Fed aiming to keep policy rates north of 5.00% throughout 2024, we see scope for the 10-year yield to breach that level as well, though that is not our base case. As Treasury yields continue to rise, bond prices—which move in the opposite direction to yields—continue to fall. As a result, Treasuries appear on track to deliver yet another down year for investors.

- As recession risks have faded amid a resilient U.S. economy, credit markets have repriced a more benign default outlook. Credit spreads—which capture the yield compensation over comparable Treasury yields for underlying default risks—have declined to just +1.2% (total index yield is 6.0%) for investment-grade corporate bonds, and to +3.8% (total index yield is 8.7%) for speculative-grade. Those levels are historically low relative to what are still elevated chances of a recession in 2024. While all-in yields look historically attractive, we remain cautious with respect to both sectors.

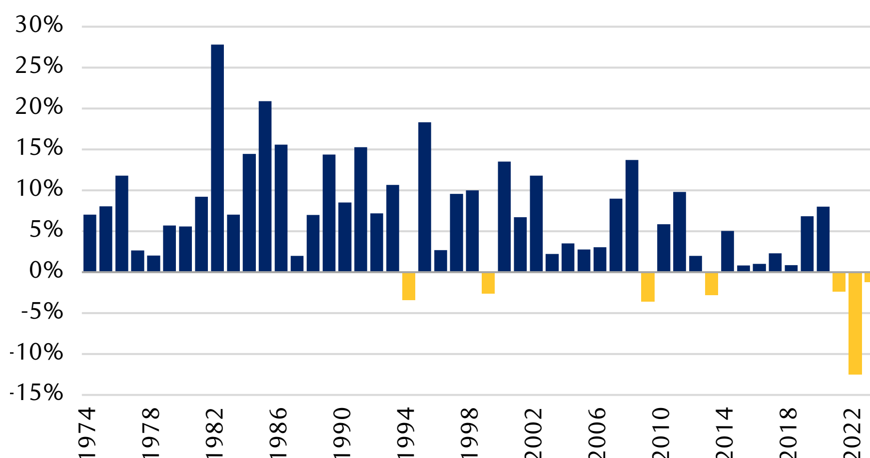
Canada

- Canadian interest rates maintained an upward bias in Q3, as Government of Canada bond yields moved 30 to 60 basis points higher across various maturities. Despite having likely reached the final innings of the most aggressive Bank of Canada (BoC) rate hiking campaign since the 1980s, we view the prospects of rate cuts as a distant event. In fact, the BoC has expressed continued commitment to the inflation fight with limited patience for upward surprises, leaving the door wide open for additional rate hikes if necessary.

- Following a sharp deceleration from its mid-2022 peak, Canada's headline inflation reaccelerated in Q3, coming in at 4.0% y/y in August on the back of a sharp rise in energy prices. Growing price pressures extended

U.S. Treasuries are on track for an unprecedented third year of negative returns as rising yields push bond prices lower

Bloomberg US Treasury Total Return Index



Source - RBC Wealth Management, Bloomberg US Treasury Bond Index; 2023 year-to-date return of -1.2% through 9/29/23

REGIONAL FIXED INCOME PERSPECTIVES

beyond just the energy category, as key core inflation metrics, or those excluding the historically volatile food and energy categories, are still running at a pace nearly twice as high as pre-pandemic levels. Meanwhile, wage growth continues to move at a pace consistent with above-target inflation.

■ Despite a "higher for longer" rates narrative gaining traction amongst market participants, leading to a more difficult refinancing environment for corporations, the yield compensation demanded by investors for the risk of default on corporate bonds has continued to shrink. We do expect some degree of negative repricing over the near term, and as such have continued to source corporate credit exposure within the higher-quality, i.e., investment-grade, categories. Nonetheless, we see bond yields as broadly attractive from a historical perspective, with higher starting yields providing some cushion against further rate increases.

Continental Europe

■ This is likely the end of the hiking cycle for the European Central Bank (ECB). We expect the deposit rate to remain at 4%, and markets are now only pricing a cumulative five basis points (bps) worth of hikes for the rest of the year.

■ According to the September ECB staff projections, "growth is projected to stagnate in the third quarter of 2023 and remain subdued in the fourth quarter." We believe the ECB now perceives that current interest rates are consistent with meeting its inflation goal. The ECB lowered its inflation estimate for 2025 and stated that "interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target." Yet ECB voting members have been noncommittal on whether this marks the "plateau" for interest rates. Maintaining hiking optionality is pragmatic for the central bank, in our view, as the risks of upside surprises in inflation data remain.

■ We see compelling opportunities in government bonds as yields are close to peak levels. Current market pricing indicates a "soft landing" economic scenario, but as we expect growth to disappoint, we are biased to add to sovereign positions and duration.

■ Corporate spreads have tightened year to date, but we are loath to chase this rally as higher financing costs are impairing corporate fundamentals. We remain cautious and maintain our Underweight in European credit with a preference for investment-grade over high-yield credit.

United Kingdom

■ Our base case is that the Bank of England (BoE) maintains the Bank Rate at 5.25%, marking the terminal rate for this hiking cycle. Future inflation data could present a risk to that view. According to the latest BoE guidance, additional hikes may be warranted if there are "more persistent inflation pressures." RBC Capital Markets is forecasting inflation at 4.9% by year-end. A higher number may force the BoE's hand, and with inflation so far off the 2% target, we do not expect rate cuts until next year.

■ The central bank has stepped up the pace of its balance sheet reduction in a process known as quantitative tightening (QT) to £100 billion from £80 billion. The £100 billion total is dominated by an increase in Gilts maturing, with the balance from Gilt sales over the next 12 months. The increase in long-end Gilt supply has been well flagged and yields have trended higher. We maintain a neutral position in Gilts given the recent rally, and we see the August peak levels as attractive entry points to increase allocations.

■ Similar to Europe, corporate fundamentals have deteriorated due to tighter financing conditions. Moreover, spreads have narrowed as a result of no further active BoE

REGIONAL FIXED INCOME PERSPECTIVES

corporate bond sales as part of the QT process. While yields are near five-year highs, the compensation for risk present in current spreads is at historical averages. Therefore, we prefer to remain Underweight credit as we think sterling corporate spreads have further room to widen, leading to potential underperformance.

Asia Pacific

- Emerging market bond funds have been experiencing outflows since the start of the year. However, the performance of Asian credit remains well supported by a number of factors, including a better macro backdrop in Asia versus developed markets, a shortage of new bond supply, elevated U.S. Treasury yields resulting in higher coupon rates, and sound investor demand.

- China's property sector remains under stress, as property sales for key Chinese developers in August 2023 fell by 40% y/y. While it's encouraging that Chinese policymakers have rolled out a series of measures to revive the sector, including cutting key interest rates and relaxing purchase requirements for first-time homebuyers in certain cities, we think more funding support measures are needed to help cash-strapped developers before any sales rebound can be deemed sustainable. Nevertheless, we believe the contagion risk to other Asian bonds is diminishing, as the Chinese property bond universe has shrunk considerably with most of the downside risks already priced in.

- We would take core positions in high-quality Asian investment-grade corporate issuers with sound financial profiles to help cushion market volatility. We remain cautious on high-yield corporate bond issuers, which are likely to continue facing heightened refinancing costs in the near term.

U.S. RECESSION

Scorecard

Calm

With some data still to come there have been no sufficient changes this past month necessitating adjustments to the positioning of our seven U.S. recession indicators on the Scorecard.

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

Three are in the "cautionary" yellow column while the other two indicators, still green, continue to suggest there is further to go in the economic expansion.

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 widened further over most of the past year, peaking in June. T**he average historical experience of this indicator after crossing into negative territory suggested the U.S. economy would have been in recession by this summer. However, while the average time interval between "inversion" of the yield curve and the onset of recession is 11 months, in four instances the gap was longer than average.**

Yield curve inversion is an unequivocal indication that credit conditions are tightening, a fact underscored by the message delivered consistently for five consecutive quarters by the Fed's Senior Loan Officer Survey (most recent issue released on July 31). A majority of U.S. banks continue to raise 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

U.S. Recession Scorecard

Indicator	Status		
	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

the premium charged for loans to riskier businesses. Also, in the most recent survey a substantial majority of respondent banks indicated that conditions would remain tight or even be tightened further through the second half.

The negative spread between the 1-year yield and the 10-year yield reached its widest point this cycle so far in June at 158 basis points (bps). It has since narrowed by more than a third, to just 98 bps, strongly suggesting the period of "de-inversion" may have begun. The return trip to "normal" from "inverted" usually gets underway just as the recession is starting or a few months before. There is also a reasonable correlation between how long the total period of inversion runs and how long the ensuing recession lasts. This latest inversion is at 14 months and counting.

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. For those reasons, we look at it as a corroborative indicator rather than a decisive one taken on its own.

After setting its most recent low in September 2022, this series has steadily moved higher and August 2023 data (we use a three-month moving average) has moved back above zero. As a result, we shifted the indicator back to yellow from red last month. However, we note that the New Orders sub-index itself remains in contractionary territory and weakened somewhat last month. If the ISM new orders component by itself were to move up into an expansionary reading in coming months we would upgrade this indicator back to expansionary (green). That being said, this measure has never 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. As of August 2023, the index has fallen for 17 consecutive months moving deeply into 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 as early as this fall**.

Claims surged higher in June but settled back into September. The fact that both temporary employment and job openings are falling on a year-over-year basis adds to the likelihood the tide may be turning for unemployment claims. While we wait 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 to 3.8% in August, its highest posting since February 2022. Monthly net job

U.S. RECESSION SCORECARD

additions have been trending steadily lower since setting a cycle high that same month. Any move above 4.0% in the unemployment rate in the next few 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 underway. This number declined in both Q4 2022 and Q1 of this year before ticking fractionally higher in Q2, and it remains well above a negative crossing point. There is a long lag time before this data is reported with the Q3 release not coming until December.

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 the start of every recession in the past 70 years. (Nominal GDP is GDP not adjusted for inflation.) That GDP run rate has been declining since its pandemic reopening high of 23% recorded 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 4.50%. 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 5.1%, barely meeting that historical precondition of recession. We expect nominal GDP growth to have slowed some more in Q3, which will widen the gap further.

Clock still ticking

Weighing up the current positioning of all seven indicators and projecting their likely paths points to a growing probability the U.S. will enter a recession in the fourth quarter, in our view.

Commodities

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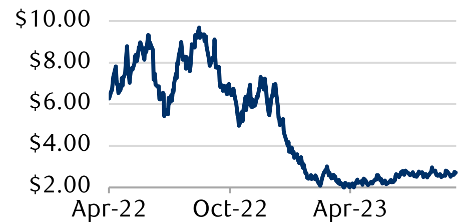
Crude oil: Rebound

Physical inventories tightened over the summer driven by resilient refined product demand. This in conjunction with planned OPEC+ production cuts and stronger-than-expected Chinese imports caused global oil prices to bounce off the year-to-date lows to fresh annual highs. Looking ahead, RBC Capital Markets' commodity strategist believes the market will remain in supply deficit through year-end and is forecasting an average of $86.50/barrel in 2024.

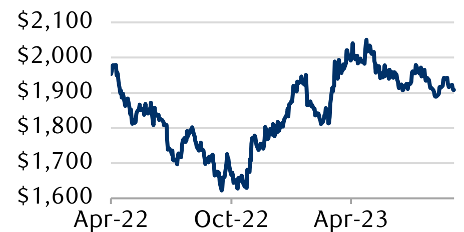
Natural gas: Waning

Natural gas prices remain deeply in the red year to date driven by growing production, above-average storage levels, and waning demand. As a result, we believe inventories will likely have to normalize before we see a recovery in prices. On this note, the U.S. exported record volumes in the first half of the year, which should help to clear balances.



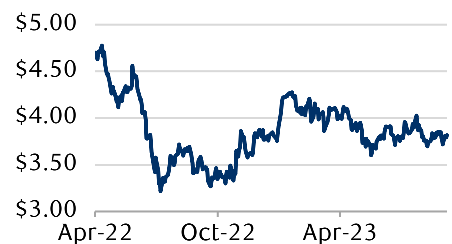
Gold: Surplus

While slowing economic growth is typically viewed as a tailwind amongst gold investors, we would argue that increased global supply and waning demand are difficult to ignore. Weaker jewelry and central bank purchases year over year have been the key culprits, according to RBC Capital Markets. Looking through 2024, the key catalyst for higher prices would likely come in the form of looser monetary policy.



Copper: Softer

Despite the slowing economic outlook, copper prices have been relatively flat year to date. However, RBC Capital Markets estimates new mines will ramp up in 2024, which in turn should add to the global supply surplus. All in, weakening demand and growing supplies will likely pressure near-term upside. Longer-term, a reacceleration in the Chinese economy is likely required before copper prices can rally, in our view.



Soybeans: Pressure

The U.S. Department of Agriculture (USDA) expects global production and ending inventories to advance higher into the 2023/24 season. As a result, we see downward pressure on soybean prices. China also accounts for approximately 60% of global imports, and therefore a reacceleration in economic growth will be the key catalyst for higher soybean prices, in our view.

Wheat: Tight

While wheat prices are near the lower end of the 18-month range, we believe tight global balances could act as a catalyst for higher prices over the medium term. Looking into the 2023/24 season, the USDA believes global demand will remain resilient but expects supply to decline year over year. In turn, ending inventories are expected to finish at the lowest levels since the 2015/16 season.

Chart source - RBC Wealth Management, Bloomberg; data range 4/8/22–9/14/23

Commodity forecasts

Commodity	2023E	2024E
Oil (WTI $/bbl)	$79.25	$86.50
Natural gas ($/MMBtu)	$2.51	$3.50
Gold ($/oz)	$1,921	$1,960
Copper ($/lb)	$3.90	$4.00
Soybeans ($/bu)	$13.00	$12.45
Wheat ($/bu)	$6.71	$6.40

Source - RBC Capital Markets forecasts (oil, natural gas, gold, and copper), Bloomberg consensus forecasts (soybeans and wheat); data as of 9/20/23

Currencies

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U.S. dollar: Extending strength into H1 2024

Having dropped below 100 in July, the U.S. Dollar Index (DXY) staged a 6% rally following a hawkish Federal Reserve meeting in September that reinforced the "higher for longer" narrative, with upward revisions of the median interest rate projections for 2024 and 2025. We look for U.S. dollar strength to persist into H1 2024, driven by outperformance in economic data and the yield advantage that the United States has over global peers.

Euro: Weighed down by soft economic data

Despite its decision to raise interest rates by 25 basis points, the European Central Bank adopted a clearly dovish tone at the September meeting, announcing a downward revision of its growth forecasts following a set of weak economic data in Q3. After touching a high near 1.1275 in July, EUR/USD is currently close to 1.05. We expect the pair to continue trending lower, with RBC Capital Markets targeting 1.02 in Q2 2024.

Canadian dollar: Supported by surging oil prices

The Canadian dollar was among the top-performing G-10 currencies in Q3, helped by surging crude oil prices, with USD/CAD back near 1.35 after reaching almost 1.37 in July. After keeping rates unchanged at 5% in September, RBC Capital Markets expects the Bank of Canada to stay on hold throughout 2023 and forecasts USD/CAD at 1.39 in H1 2024, with a bias towards broad U.S. dollar strength.

British pound: Bank of England stays on hold in September

The British pound has lost more than 7% against the U.S. dollar since July, with a rapid deterioration in Purchasing Managers' Index surveys a key factor behind the Bank of England leaving interest rates unchanged at its September meeting—a decision that surprised markets. We see the next support level for GBP/USD at 1.20, and we look for the pair to remain under pressure on weaker economic fundamentals in the UK.

Japanese yen: Peak USD/JPY pushed to 154

Despite verbal intervention by Bank of Japan officials to prop up the yen, USD/JPY continues to move higher, driven by interest rate differentials between the U.S. and Japan. With the pair currently just below 150, RBC Capital Markets has moved its peak forecast to 154 in H1 2024, from 150 in Q4 2023 previously.

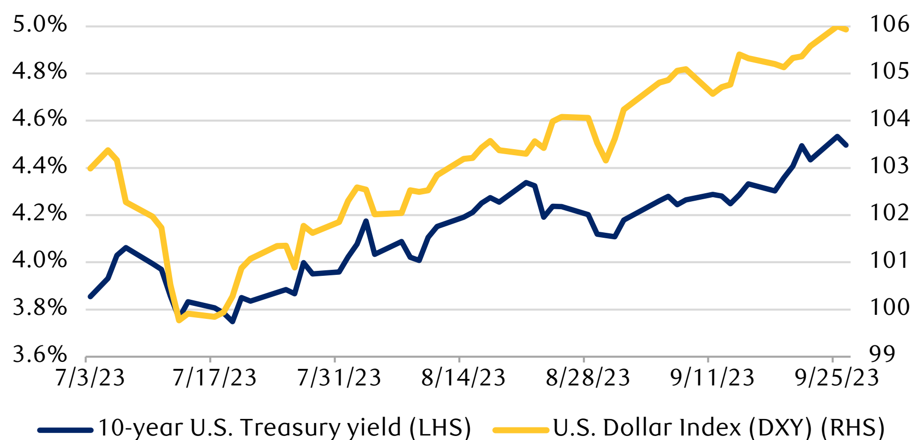
Currency forecasts

Currency pair	Current rate	Forecast Sept. 2024	Change
Major currencies			
USD Index	104.90	107.41	2%
CAD/USD	0.74	0.74	0%
USD/CAD	1.35	1.35	0%
EUR/USD	1.06	1.05	-1%
GBP/USD	1.22	1.15	-6%
USD/CHF	0.91	0.89	-2%
USD/JPY	149.00	150.0	1%
AUD/USD	0.64	0.61	-5%
NZD/USD	0.60	0.57	-4%
EUR/JPY	158.00	149.0	-6%
EUR/GBP	0.87	0.90	3%
EUR/CHF	0.97	0.95	-2%
Emerging currencies			
USD/CNY	7.31	7.40	1%
USD/INR	83.20	83.30	0%
USD/SGD	1.37	1.36	-1%

Change is defined as the implied appreciation or depreciation of the first currency in the pair quote.

Source - RBC Capital Markets forecasts, Bloomberg

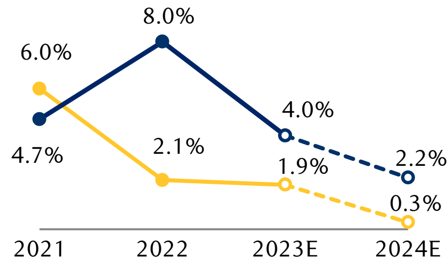
The U.S. Dollar Index has rallied more than 6% after a sharp drop in July, aided by 10-year Treasury yields rising to levels last seen in 2007



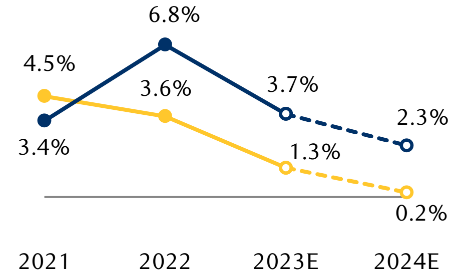
Source - RBC Wealth Management, Bloomberg; data through 9/26/23

KEY
Forecasts

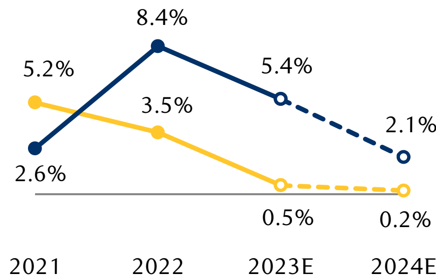
United States



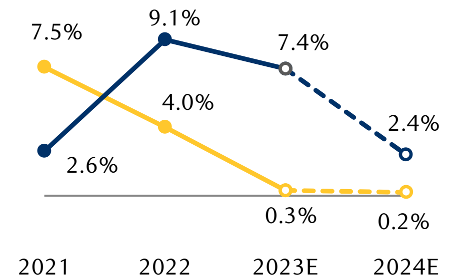
Canada



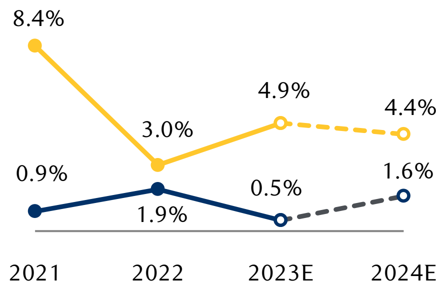
Eurozone



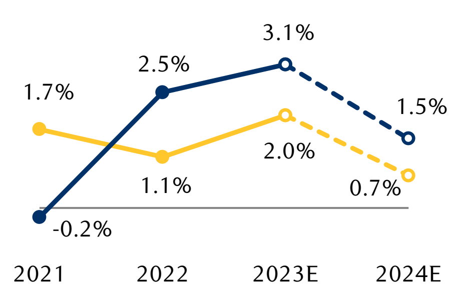
United Kingdom



China



Japan



Real GDP growth

Inflation rate

Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management, Bloomberg consensus estimates

Market scorecard

Data as of September 30, 2023

Equities

The majority of global equity markets sold off during September, while stocks in the Nasdaq and Russell 2000 experienced the majority of selling pressure.

Bond yields

Sovereign bond yields advanced higher in September with the exception of the UK 2-year yield, which ended the month down about 25 basis points.

Commodities

Global commodity prices were mixed between gains and losses in September. Gold and silver sold off sharply, ending the month down 4.7% and 9.3%.

Currencies

The U.S. dollar gained ground against most major currencies, ending September up 2.5%.

Index (local currency)	Level	1 month	YTD	12 month
S&P 500	4,288.05	-4.9%	11.7%	19.6%
Dow Industrials (DJIA)	33,507.50	-3.5%	1.1%	16.6%
Nasdaq	13,219.32	-5.8%	26.3%	25.0%
Russell 2000	1,785.10	-6.0%	1.4%	7.2%
S&P/TSX Comp	19,541.27	-3.7%	0.8%	5.9%
FTSE All-Share	4,127.24	1.7%	1.3%	9.7%
STOXX Europe 600	450.22	-1.7%	6.0%	16.1%
EURO STOXX 50	4,174.66	-2.8%	10.0%	25.8%
Hang Seng	17,809.66	-3.1%	-10.0%	3.4%
Shanghai Comp	3,110.48	-0.3%	0.7%	2.8%
Nikkei 225	31,857.62	-2.3%	22.1%	22.8%
India Sensex	65,828.41	1.5%	8.2%	14.6%
Singapore Straits Times	3,217.41	-0.5%	-1.0%	2.8%
Brazil Ibovespa	116,565.17	0.7%	6.2%	5.9%
Mexican Bolsa IPC	50,874.98	-4.0%	5.0%	14.0%
Bond yields	**9/29/23**	**8/31/23**	**9/30/22**	**12 mo. chg**
U.S. 2-Yr Tsy	5.044%	4.863%	4.279%	0.76%
U.S. 10-Yr Tsy	4.571%	4.108%	3.829%	0.74%
Canada 2-Yr	4.873%	4.645%	3.791%	1.08%
Canada 10-Yr	4.026%	3.564%	3.173%	0.85%
UK 2-Yr	4.904%	5.149%	4.232%	0.67%
UK 10-Yr	4.437%	4.360%	4.093%	0.34%
Germany 2-Yr	3.203%	2.978%	1.759%	1.44%
Germany 10-Yr	2.839%	2.466%	2.108%	0.73%
Commodities (USD)	**Price**	**1 month**	**YTD**	**12 month**
Gold (spot $/oz)	1,848.63	-4.7%	1.3%	11.3%
Silver (spot $/oz)	22.18	-9.3%	-7.4%	16.6%
Copper ($/metric ton)	8,212.50	-2.3%	-1.8%	6.9%
Oil (WTI spot/bbl)	90.79	8.6%	13.1%	14.2%
Oil (Brent spot/bbl)	95.31	9.7%	10.9%	8.4%
Natural Gas ($/mmBtu)	2.93	5.8%	-34.5%	-56.7%
Agriculture Index	385.87	-3.6%	-18.0%	-19.4%
Currencies	**Rate**	**1 month**	**YTD**	**12 month**
U.S. Dollar Index	106.1740	2.5%	2.6%	-5.3%
CAD/USD	0.7365	-0.5%	-0.2%	1.9%
USD/CAD	1.3577	0.5%	0.2%	-1.8%
EUR/USD	1.0573	-2.5%	-1.2%	7.9%
GBP/USD	1.2199	-3.7%	1.0%	9.2%
AUD/USD	0.6435	-0.8%	-5.5%	0.5%
USD/JPY	149.3700	2.6%	13.9%	3.2%
EUR/JPY	157.9500	0.1%	12.5%	11.3%
EUR/GBP	0.8666	1.3%	-2.1%	-1.2%
EUR/CHF	0.9676	1.0%	-2.2%	0.0%
USD/SGD	1.3662	1.1%	2.0%	-4.8%
USD/CNY	7.2980	0.5%	5.8%	2.6%
USD/MXN	17.4227	2.3%	-10.7%	-13.5%
USD/BRL	5.0341	1.6%	-4.7%	-7.0%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Equity performance and bond yields in local currencies. U.S. 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 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD 1.9% return means the Canadian dollar has risen 1.9% vs. the U.S. dollar during the past 12 months. USD/JPY 149.37 means 1 U.S. dollar will buy 149.37 yen. USD/JPY 3.2% return means the U.S. dollar has risen 3.2% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 9/30/23

Research resources

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