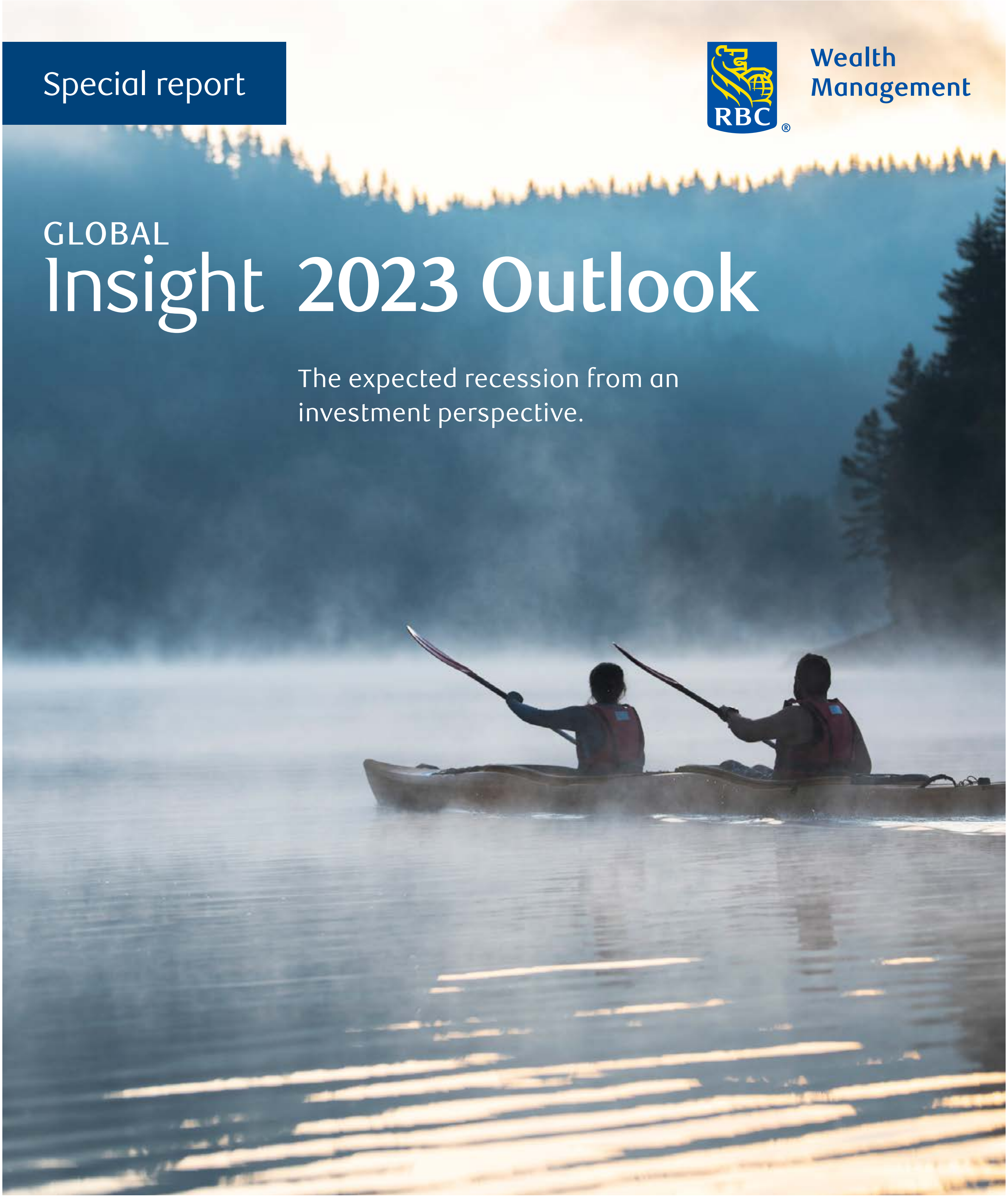
Special report

Wealth Management

GLOBAL Insight 2023 Outlook

The expected recession from an investment perspective.



For important and required non-U.S. analyst disclosures, see page 38.

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Global Insight 2023 Outlook

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All values in U.S. dollars and priced as of market close, Nov. 22, 2022, unless otherwise stated.

We are the hedgehog

Jim Allworth
Vancouver, Canada

"The fox knows many things, but the hedgehog knows one big thing" is an aphorism with roots in an ancient Greek parable resurrected from time to time to argue for the superiority or usefulness of thinking one way or the other. Like most people, in the long run, we think it would be more interesting to be the fox. But right here, right now, we feel more like the hedgehog … we know one big thing that is going to shape the investment landscape over the coming 12–18 months.

The Biggest Thing: A U.S. recession is on the way

First, it's worth pointing out the U.S. is not yet in recession. The National Bureau of Economic Research (NBER) needs to see "a significant decline in economic activity that is spread across the economy and that lasts more than a few months." No such decline has been in evidence yet. However, there are several factors at play that suggest to us such a broad-based economic decline will most probably arrive in the coming year:

1. History says so. The most historically reliable leading recession indicator—the position of short-term interest rates compared with that of long-term rates, also known as the "shape of the yield curve"—signaled back in July that a U.S. recession was on the way when the one-year Treasury yield rose above the yield on the 10-year note. Whenever such an "inversion" has occurred in the past a recession has eventually followed, usually about a year later.

The Conference Board's Leading Economic Index—also sporting a "perfect" track record—fell below where it had been a year ago back in September. A recession has always followed such a signal, on average some two to three quarters later.

All but one of the other five leading indicators of recession we follow are all still in positive territory but are sliding (slowly) toward giving a negative signal for the U.S. economy in the coming months.

2. "Tight money" has arrived. With just two exceptions (the post-WWII downturn and the two-month-long 2020 pandemic recession) U.S. recessions have always been preceded by the arrival of tight money, i.e., prohibitively high interest rates accompanied by a growing reluctance of banks to lend.

The inversion of the yield curve in July, noted above, indicated credit conditions were heading in that restrictive direction. Certainly, interest rates have become prohibitively high for many borrowers as a result of the accelerated pace of tightening on the part of the Fed and most other important central banks. One result is that sharply higher mortgage rates have squashed the demand for both new and existing homes. Housing permits have fallen sharply, a strong indication to us that residential construction activity will sag in the coming months.

And loans are becoming harder to get too. The last three Senior Loan Officer Opinion Surveys (published every three months by the Fed) have shown that more and more U.S. banks are now raising lending standards (i.e., becoming more choosy about who they lend to) for almost all categories of consumer and business loans.

3. The consumer will be a waning force in 2023. At some 70 percent of GDP the direction of consumer spending is all-important. While there are still excess savings sitting in bank accounts and wages are rising, high inflation has pushed real incomes below where they were a year ago. Despite that, real personal spending has continued to climb. Additional borrowing is bridging the gap. Credit card debt is up by 20 percent over the past 18 months.

A lot of future demand for goods was pulled forward into 2020 and 2021 as many services were not available due to pandemic shutdowns while consumer incomes remained high boosted by government support programs, which have now mostly ended. Meanwhile, much of the pent-up demand for services such as travel and dining out has been fulfilled in 2022, and the elevated pace of services spending will likely ease in the coming year.

The consumer is also very downbeat about future prospects, as are CEOs. Consumer and business confidence readings are already at recession-like lows.

What would the arrival of a U.S. recession in 2023 mean for investors?

On the interest rate front, we expect 2023 will be a year of trend transition that sees rates rising somewhat further in the first half before falling in the second.

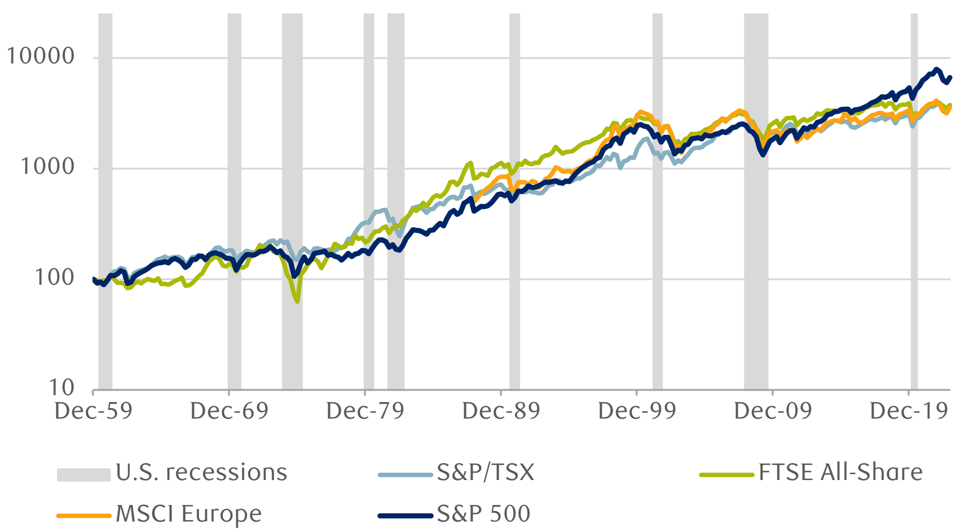
Over the past 70 years, the Fed has usually stopped raising rates and begun cutting even before the recession started. The notable exceptions were in the inflationary '70s and early '80s when rate cuts didn't begin until well into the recession. Over the same time span, 10-year Treasury yields mostly peaked and started falling before the recession began and before Fed rate cutting got underway. Again, the recessions of the 1970s were the exceptions.

Given today's inflation concerns, the Fed has made a point of emphasizing the dangers of cutting rates too soon. Further improvement in the inflation data may allow policymakers to scale back the pace of future rate hikes, maybe even to pause for a while. However, outright rate cutting is unlikely to be on the table, in our view, until there is some marked worsening in the economic data, particularly on the employment front. The second half of 2023 should see the window open for Fed rate cuts designed to soften the impact of the recession which we expect will be underway by midyear.

To the extent that other developed countries will also be seeing some moderation in inflation readings, we think Fed cutting will give their central banks cover to lower rates in response to their own recessions, which, at least in the case of Europe and the UK, are likely to be comparatively deeper and more painful.

10-year bond yields may have already peaked or be in the process of doing so. However, we believe they are unlikely to fall back by very much from today's levels until inflation is clearly on a downward path and until central bank rate cutting is clearly in sight, probably in the second half of 2023.

U.S. recessions and equity bear markets go hand in hand



Source - Standard & Poor's, Toronto Stock Exchange, FactSet; quarterly data through 10/31/22, shown on a logarithmic scale, indexed to December 1959 = 100

From a stock investor's standpoint, U.S. recessions have typically been associated with global equity bear markets. Media commentary over the past nine months has assumed that a bear market has already begun. That may be the case. However, wherever the stock market is headed over the next couple of quarters it's unlikely to go there in a straight line, in our opinion.

Starting a couple of weeks before the U.S. midterm elections in early November, most major equity markets began a rally that appeared to have better underpinnings than any prior countertrend upswing in 2022. Outside the U.S., some of the worst underperforming markets of this past year—notably Europe, China, and Hong Kong—led the way higher.

So far, this move has been almost universally labeled as no more than a "bear market rally." Of course, it may prove to be just that. However, several factors persuade us that this current advance could have legs into the new year: moderating inflation data, which raises the possibility of a slowdown in Fed rate hikes; the intensely negative investor sentiment around the market lows in October that was the opposite of the complacent optimism that prevailed back at the market's peak in January; and the fact that the S&P 500 has almost always delivered strong, positive returns for a number of months following the U.S. midterms.

Whether any unfolding equity rally is something more than simply an upside interlude in a longer-term downtrend remains to be seen, in our view.

That said, a 2023 recession, probably arriving around midyear, is now strongly indicated by our most reliable leading indicators. Since every U.S. recession has been associated with an equity bear market (not just in the U.S. but in every major equity market), we expect that any rally in equity prices over the next few weeks or months will, at some point, give way to another period of falling share prices reflecting declining expectations for earnings and eroding confidence in the future that typically comes with a period of economic retrenchment.

How much does the arrival of a recession and accompanying equity bear market matter to the investment outlook?

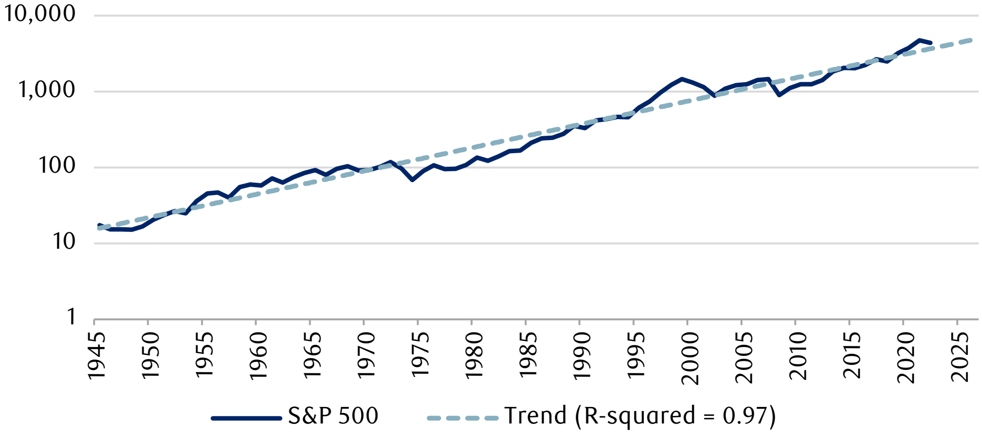
We see at least two answers to this question. During the period when a recession and the accompanying equity bear market are unfolding, investor optimism typically turns, over the course of several months, into extreme pessimism as earnings estimates are revised downward, corporate problems that were manageable in a growing economy become less fixable in a shrinking one, and unforeseen crises come to the surface. As months go by and business conditions worsen, investors may lose confidence that the problems, which they are only belatedly becoming fully aware of, can ever be fully resolved.

At the worst point, investors may come to believe the recession has much further to run than it actually does. That (mistaken) belief makes them highly skeptical when the stock market turns higher, as it always has, well before the recession ends—usually three to five months before.

But if one stands back and looks at a longer stretch of economic and market history, a much less chaotic and much more constructive view emerges. The first chart on the following page reveals that, with bear markets included, the S&P 500 has climbed within in a remarkably steady uptrend over the 77 years from the end of WWII to today. The appreciation of the index over that interval works out to 7.3 percent per annum. Of course, the investor also received dividends along the way equal to roughly two percent per annum, which were not assumed to be reinvested in this example but paid out each year. So the total return for owning 500 of arguably among the largest, most seasoned businesses in the U.S. was more than nine percent per annum, pretty consistently delivered over a span of almost four generations.

Since 1945, the S&P 500 has advanced in a well-defined uptrend

S&P 500 performance

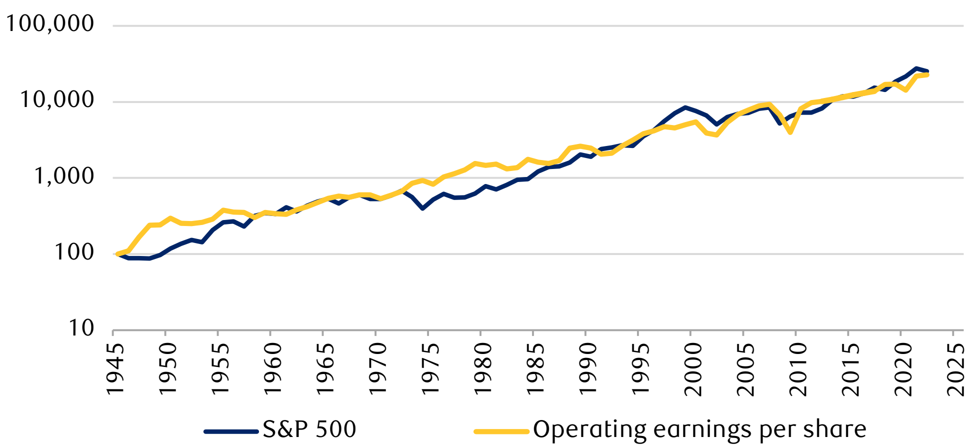


Source - Standard & Poor's; annual data shown on a logarithmic scale

Importantly, as revealed in the chart below, just because the index went from a low value in 1945 to a very high value today doesn't mean it went from "cheap" to "expensive." Rather, it appreciated in value exactly as fast as the earnings of those 500 companies grew—it was a "dead heat" with both the value of the S&P 500 itself and the earnings per share of the index advancing at a rate of 7.3 percent per annum over those 77 years.

Share prices have risen with earnings...

S&P 500 Index performance vs. operating earnings per share



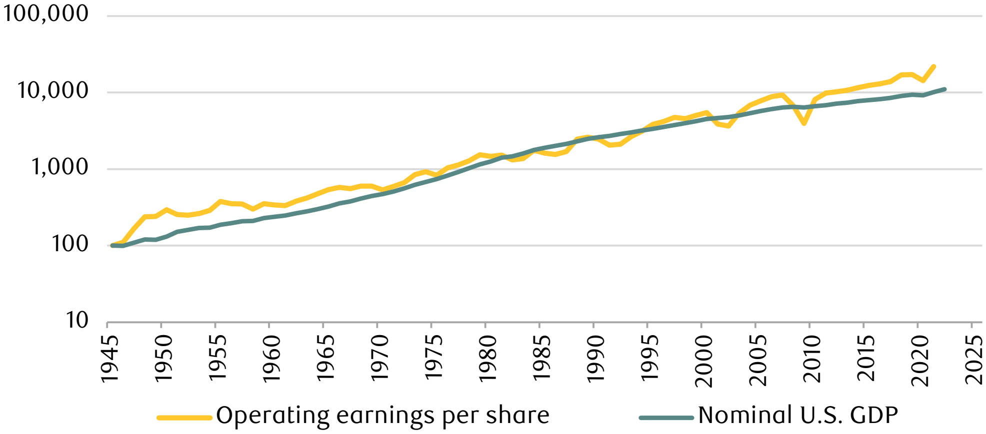
Since 1945, both stocks and earnings have risen by an average of 7.3% per annum.

Source - RBC Wealth Management, Standard & Poor's; annual data shown on a logarithmic scale

And it is also reassuring to discover, as the final chart on the following page shows, that 7.3 percent per annum is not some "magic" number that one has to accept on faith. Instead, it is a rate of growth almost entirely governed by the growth of the U.S. economy over that time. The growth of so-called "nominal GDP" averaged 6.4 percent per annum from 1945 to the present. (Nominal GDP is GDP without adjusting for inflation, which we use here because neither the S&P 500 nor earnings are inflation-adjusted.) In our

... and earnings have risen somewhat faster than the economy has grown

Operating earnings per share vs. nominal U.S. GDP



Since 1945, nominal U.S. GDP has risen by 6.4% per annum, while earnings have risen by 7.3% per annum on average.

Source - RBC Wealth Management, Standard & Poor's, U.S. Federal Reserve; annual data shown on a logarithmic scale

opinion, the best explanation for why earnings and average share values were able to grow almost one percentage point per annum faster than the economy is that an increasing proportion of the firms in the index were successfully growing their businesses outside the U.S., as well as inside, over those years.

So this longer-term view reveals that the economy and businesses are constantly adapting to changing conditions. Sometimes that adaptation is painful. But if recessions are the painful periods, then they are typically very short. Over the 77-year time span we are looking at, the economy was in recession for a total amount of time equivalent to 12 years or about 15 percent of the time. This minority of time spent in recession is underscored in the chart above. If you look closely at the line representing GDP, you can just about make out six very shallow dimples that coincide with periods of recession. But there were a total of 13 recessions over that stretch, so six are barely visible while seven are not visible at all.

Making big portfolio asset allocation decisions based on the premise that the economy and already successful businesses are going to lose this ability to adapt, or that the challenging periods are going to last much longer than they have seems out of proportion to the historical record, in our opinion.

On the other hand, leaning more heavily toward quality and sustainable dividends and away from individual company risks that may come home to roost in a recession looks to us like a good approach as we enter 2023.

Global Insight 2023 Outlook

The United States

U.S. markets could change course more quickly, and in different ways, than investors might assume. Even if the economy succumbs to recession in 2023, if history is a guide, the equity market would likely begin a new bull market cycle before the recession ends. In fixed income, we think the window to put money to work is now open, but could close sooner than expected. In our view, it's time to bring portfolio asset allocations in line with long-term strategic recommendations.

U.S. equities

Kelly Bogdanova
San Francisco, United States

We're not there yet, but we are getting closer

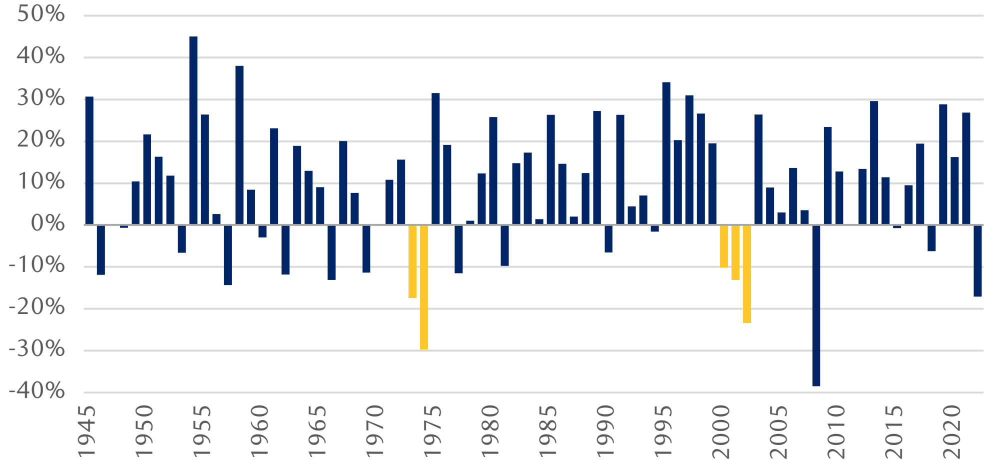
"Are we there yet?" This classic question that parents and grandparents are often asked on long road trips was posed by our U.S. Investment Committee in June 2022. At that point, we noted there were orange cones along the roadside and there was a need for more economic data for better visibility. Some months later, our answer now is, "We're not there yet, but we are getting closer."

First, it would be rare for the S&P 500 to deliver back-to-back negative return years. They have occurred only twice in the post-WWII era. The market has already absorbed significant blows, including one of the Fed's fastest and biggest tightening cycles in history. On the former, we think the Fed will slow the pace of rate hikes, maybe as soon as the December 2022 meeting; and on the latter, we think the rate hike cycle is poised to end in 2023.

Second, the corporate earnings outlook is "less bad" than in previous periods of economic stress. If 2023 S&P 500 earnings end up flat compared to 2022 at roughly $220 per share—a scenario we think is possible—most institutional investors would likely breathe a sigh of relief. Even if a recession materializes and brings with it deeper cuts to consensus earnings estimates,

Only two periods of back-to-back negative U.S. equity returns in the post-WWII era

S&P 500 annual returns 1945–2022 (excluding dividends)



Source - RBC Wealth Management, Bloomberg; 2022 represents preliminary year-to-date data through 11/21/22

we think household spending would be relatively more resilient than in recent economic contractions. Household balance sheets appear to be in better shape due to sturdier employment trends and high savings levels when this period began.

Third, equity market sentiment could benefit from declining inflation in 2023. Price trends for commodities and goods are already pointing in this direction.

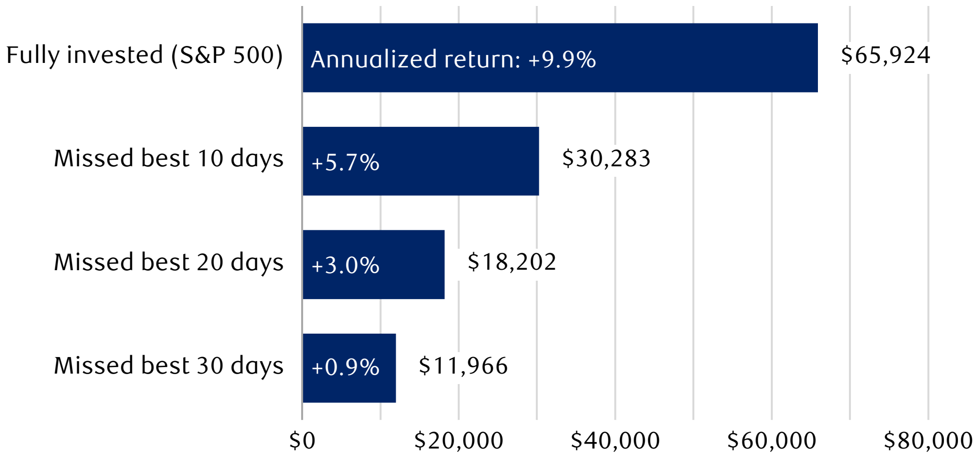
But don't misunderstand—we're not Pollyannaish about the market's prospects for 2023. There are reasons to remain vigilant. The economy is still at risk of succumbing to a recession. If S&P 500 earnings come in around $220 per share or less, this below-average growth rate would leave little room for price-to-earnings valuation expansion and profit margins could come under pressure. And while we anticipate inflation will decline, there is an open question as to how fast and to what degree. This can impact the market's valuation. Generally, elevated inflation and interest rates over the medium term result in lower equity market valuations, and vice versa.

We think the most important objective for investors is to review portfolios and bring them in line with long-term strategic allocation recommendations. Allocations naturally get out of whack during corrections, and there is industry evidence that large cash positions have piled up in portfolios. We think attempting to time the market is a precarious exercise. There is no bell that rings when a new bull market cycle begins. Missing the biggest rally days can have detrimental long-term performance consequences, and such rallies often occur unpredictably before all of the obstacles are out of the road.

Once allocations are brought back into balance, we would keep an eye out for opportunities as the economic, interest rate, and earnings pictures start to become clearer.

Missing the best days in the market can have detrimental portfolio implications

Dollar value of $10,000 invested in the S&P 500 from November 2002 through November 2022 (including dividends)



Source - RBC Wealth Management, FactSet; data through 11/21/22

Currently, we favor the small-capitalization and midcap segments of the U.S. equity market. Their valuations are relatively inexpensive compared to large caps and their own historical averages. This should provide a cushion as earnings estimates adjust further. When the U.S. economy works through challenging periods, these more economically-sensitive segments often lead the early stages of the next bull market phase.

Within the large-cap S&P 500, we continue to favor the Energy sector. Consensus earnings revisions are holding up better than most sectors. Tight energy commodity supplies are unlikely to be fully resolved in the near or medium term due to many years of capital underinvestment. This should help support commodity prices and Energy company earnings to a greater degree than in typical periods of economic weakness.

U.S. fixed income

Thomas Garretson, CFA
Minneapolis, United States

2023 to see the Federal Reserve embark on its third act

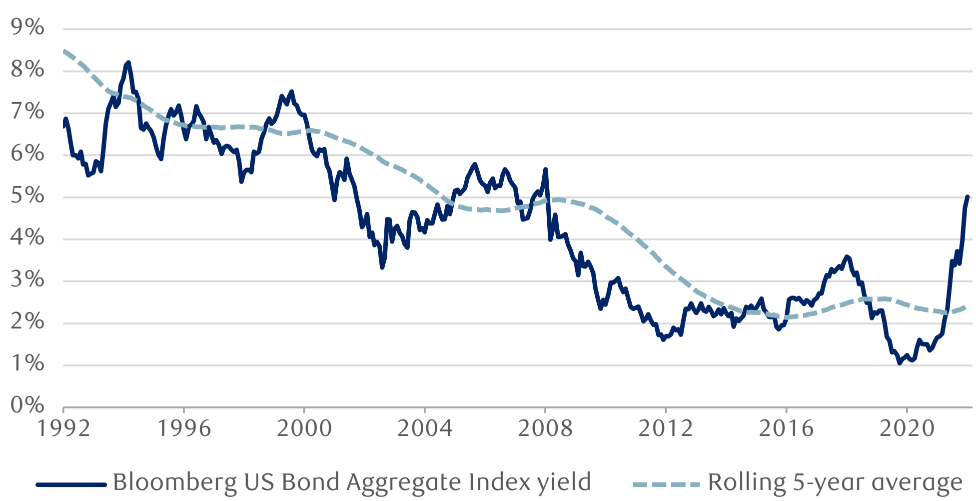
A dual mandate. In 2021, the Fed's sole focus was returning U.S. labor markets to "full employment," the first side of its congressionally-given dual mandate, and long-judged by the Fed to be around 4.0%. Unemployment fell to 3.9% in December 2021 and has remained at and even below the target level since. In 2022, the Fed became hyper-focused on returning the economy to "price stability," the second side of its mandate and defined as prices rising 2% annually on average through any given business cycle. While it will take time for the inflation to get there, the aggressive action from the Fed in 2022 has laid the foundation for it to return to target in due course, in our view.

Financial stability in focus. That now sets the stage for the Fed to turn its focus in 2023 to its unofficial third mandate—financial stability. The historically aggressive tightening campaigns by the Fed and many other global central banks will likely necessitate a far more cautious approach from policymakers, and a heightened focus on—and consideration of—domestic and global financial vulnerabilities that may come as a result of higher interest rates, particularly from the strength of the dollar. This could mean the Fed soon places the blunt tool of rate hikes back in the toolbox and employs more surgical, macroprudential measures that help to ensure the soundness of, and liquidity within, the financial system.

Interest rates to peak in early 2023. We anticipate the Fed's likely 50 basis point rate hike at the Dec. 13–14 meeting will bring short-term rates to a 4.25%–4.50% range and will mark the last of the jumbo-sized moves. Any further rate hikes in 2023 should continue at 25 basis point increments, and only if justified by the incoming data, while attaining a level no higher than 5.00% by Q1 2023, in our view. Then, as the generally assumed 12– to 18–month lagged impact of rate hikes that began in March 2022 begin to significantly weigh on economic activity by the middle of 2023, we foresee the Fed delivering a series of modest rate cuts over the course of the back half of the year as it works to engineer some semblance of an economic soft landing.

Yields to fall. Markets, forward looking as they are, may already be in the process of pricing in such a scenario as recent soft consumer and producer price data have driven Treasury yields sharply lower from this year's highs. We believe the sharp rise in yields across the fixed income landscape that played out over the course of 2022 will give way to the opposite in 2023. For example, the benchmark 10-year Treasury yield could fall below 3.5% by the end of the year, from levels close to 4.0% currently, based on RBC Capital Markets' forecast.

U.S. bond yields hit 5%, double the recent average



Note: The Bloomberg US Aggregate Bond Index comprises investment-grade government and corporate bonds.

Source - RBC Wealth Management, Bloomberg

Lock in high yields. The net result for fixed income investors is that the window to put money to work is open, and it could close sooner than expected. Based on Bloomberg bond indexes, Treasuries yielded 4.2%, investment-grade corporate bonds 5.4%, and tax-exempt municipals 3.7% as of November 22. Should yields on offer fade over the course of 2023, as we broadly expect, that could introduce heightened reinvestment risk for short-maturity securities. We continue to favor a strategy of locking in historically-high yields in intermediate and longer-dated bonds to maintain income, and to benefit from capital appreciation should bond prices move higher, and yields lower, due to recession risks in 2023 and the potential for Fed rate cuts as a result.

Global Insight 2023 Outlook

Canada

The Canadian economy is likely to slip into recession in 2023, but markets are starting to look past this threat. The equity market, including bank stocks, is already pricing in a modest economic contraction and housing market retrenchment. In our view, the recent surge in fixed income yields has returned the Canadian bond market to an environment where investors can achieve reasonable levels of income, including from historically lower-risk investments.

Canadian equities

Sunny Singh, CFA
Toronto, Canada

Recession likely in 2023; household debt and housing in focus

Tighter monetary policy and its impact on financial conditions throughout the Canadian economy have meaningfully slowed economic growth expectations, as household consumption begins to feel the pressure of higher interest rates and elevated inflation. As a result, RBC Economics is expecting Canada to slip into a recession in early 2023.

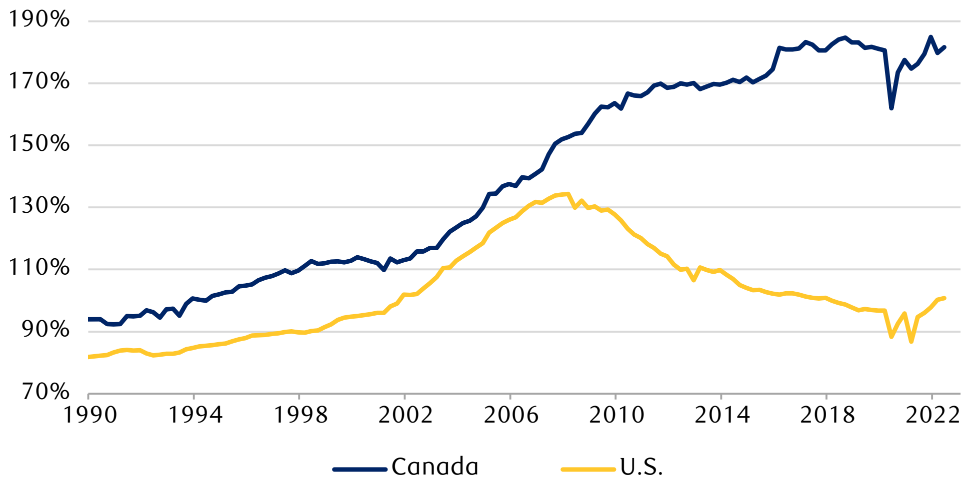
It can be argued that at current valuations the S&P/TSX Composite Index is already pricing in a modest recession. The index trades at an approximate 25% valuation discount to its longer-term averages. However, Canada has the idiosyncratic risks of elevated household debt levels coupled with an outsized economic contribution from housing that we believe warrant additional consideration.

At this time last year, we pointed to the Canadian housing market as the single largest risk to the Canadian economy heading into 2022. However, identifying a catalyst that could have shifted the positive momentum remained a challenge. We clearly found that catalyst this year in dramatically higher interest rates.

According to RBC Economics, Canadians amassed CA$3.9 trillion in net wealth during the pandemic, largely due to a real estate boom. As of Q2 2022, roughly

Elevated household debt levels a key risk to the Canadian economy

Household debt-to-income ratios



Source - Statistics Canada

CA$900 billion of that had been lost as housing markets retrenched under the weight of rising interest rates, with further losses expected through 2023. The dramatic decline in net wealth, combined with high inflation and elevated interest rates, is expected by RBC Economics to cut roughly CA$15 billion from household spending in 2023.

How much of the housing- and recession-related doom and gloom is already accounted for in Canadian bank valuations? We would argue a reasonable level. Canadian banks as a group trade roughly in line with the valuations that prevailed at the tail end of the 2014–2016 oil collapse, and at a mid-teens discount to the average over the past decade. That said, current valuations are approximately 20%–25% higher than those at the worst of the 2008–2009 global financial crisis and the pandemic in early 2020. We would argue that the group is already capturing a moderate recession in its valuation. Typically, we would favour buying Canadian banks when credit losses peak rather than at the early stages of a credit cycle where we are today. However, for those with an income focus who can see through the valley of the upcoming recession, we believe the Canadian bank group provides an interesting opportunity.

Energy was the best-performing sector in the S&P/TSX Composite in 2021, and that has continued in 2022. Although West Texas Intermediate crude oil prices have weakened from their peak earlier this year, Canadian energy equities have held up well. In our view, the underinvestment in oil development over the past decade has resulted in a supply outlook that is expected to remain tight, underpinning our positive multiyear outlook on the commodity. We think the solid commodity outlook paired with attractive free cash flow generation and the potential for favourable capital allocation decisions (increasing dividends, share repurchases, debt reduction) support maintaining allocations to the industry. With respect to base metals, we believe caution is warranted heading into a slowing global growth environment in 2023. That said, given near-term physical supply tightness in base metals such as copper and positive longer-term fundamentals, we believe opportunities could emerge in this sector in the new year.

Canadian fixed income

Ryan Harder, CFA
Toronto, Canada

Returning income to Canadian fixed income

2022: Government bond yields surge, credit spreads widen. Canadian fixed income was by no means spared from historically poor performance across asset classes in 2022, with elevated inflation forcing the Bank of Canada (BoC) to rapidly withdraw monetary stimulus and hike rates substantially faster than markets initially expected.

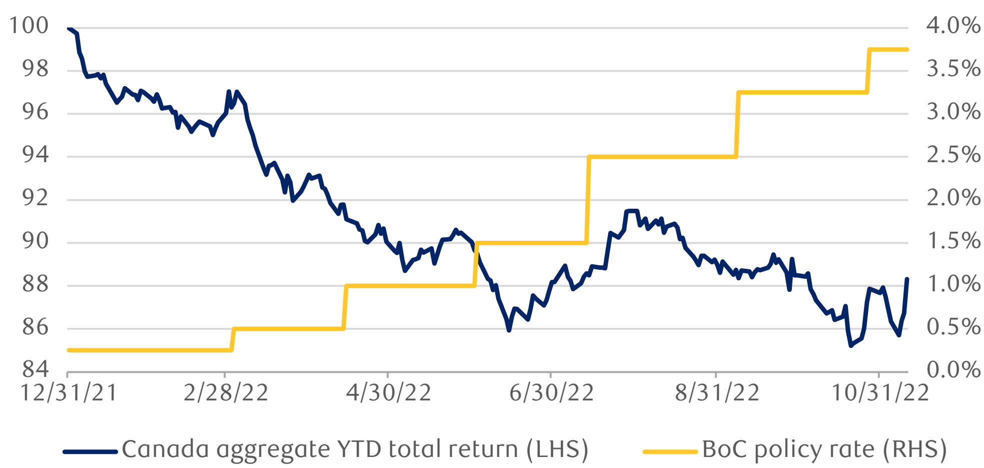
In previous years, government bond yields typically fell when equities and other risk assets sold off—this decline in yields often partially or completely offset losses in corporate bonds. That correlation did not materialize in 2022, with government bond yields surging while credit spreads—which measure the additional yield demanded by investors to assume credit risk—widened to multiyear highs. The result of the breakdown in this historical relationship was that every major part of the Canadian fixed income market saw meaningful declines in 2022.

Return expectations improve. Bonds that do not default must eventually reach par value on maturity, so poor trailing performance has led to improved return expectations going forward. For investors whose investment horizon is longer than the average term of their bond portfolio, this past year's price declines are likely to result in higher total-return figures over that investment period.

The sharp repricing of Canadian bonds is particularly apparent when looking at corporate bond yields. The yield on the average BBB-rated Canadian bond

Hiking with haste

Faster-than-expected rate hikes led to historically poor bond performance in 2022



Source - Bloomberg

Income returns to fixed income

Average yield on investment-grade Canadian corporate bonds

Source - Bloomberg; data through 11/11/22; yield represented by Bloomberg Canada Aggregate Index

nearly doubled in 2022, and now pays investors more than at any point since the global financial crisis. This surge in yields has returned the Canadian bond market to an environment where investors can achieve reasonable levels of income, in our view, even from historically lower-risk investments.

Another advantage for Canadian bonds, in our opinion, is that the average issue now trades at a significant discount to par. Bonds source yield from two places: fixed cash coupon payments and a built-in capital gain or loss as the price of the bond approaches par value at maturity. For this reason, taxable investors can benefit from discount bonds since they receive more of their yield in the form of a capital gain (this feature does not apply to strips, Treasury bills, or other zero-coupon securities that were issued at a discount).

Opportunities in 2023. We see three-to-seven-year investment-grade corporate bonds as particularly attractive heading into 2023, with yields that offer a reasonable level of income while keeping both credit and interest rate risk modest. This is also where many of the most tax-efficient discount bonds can be found, which further informs our conviction on high-quality intermediate-term corporate bonds.

Rate-reset preferred shares also look relatively inexpensive, in our view, given prices have declined significantly over the past year despite a substantial increase to the 5-year yield they are reset off of. In contrast, fixed-dividend preferred share valuations look somewhat rich to us, and we think long-duration positioning would be better expressed through bonds rather than fixed-dividend preferred shares. For both rate-reset and fixed-dividend preferred shares, we expect volatility to remain elevated in the coming quarters, and believe investors should only allocate to this space if they are willing to assume equity-like risk.

High inflation remains the key risk. We believe the primary risk to fixed income in 2023 ultimately comes from the same source that drove asset prices lower in 2022—high inflation. Although goods inflation has shown signs of moderating substantially, prices for services have remained stickier and present the risk of further repricing in bonds should the BoC need to keep rates high for a longer period than markets expect. Given an unusually wide range of potential economic outcomes in the near term, we see the balance of risks as favouring intermediate-term bonds that lock in improved yields today, but without taking on excessive interest rate risk should inflation prove to be more persistent than expected.

Global Insight 2023 Outlook

The United Kingdom

A crippling cost of living, austerity measures, and the Bank of England tightening monetary policy will all conspire to create a prolonged recession in the UK, in our view. We advocate an Underweight position in UK equities, although we are mindful that depressed valuations may produce interesting dividend income opportunities. We have a negative outlook on UK sovereign debt, as increased government debt issuance and the Bank of England proceeding to sell its Gilts portfolio will likely create a Gilt supply glut.

UK equities

Frédérique Carrier
London, UK

Thomas McGarrity, CFA
London, UK

Prolonged recession risks, strong bias to international companies

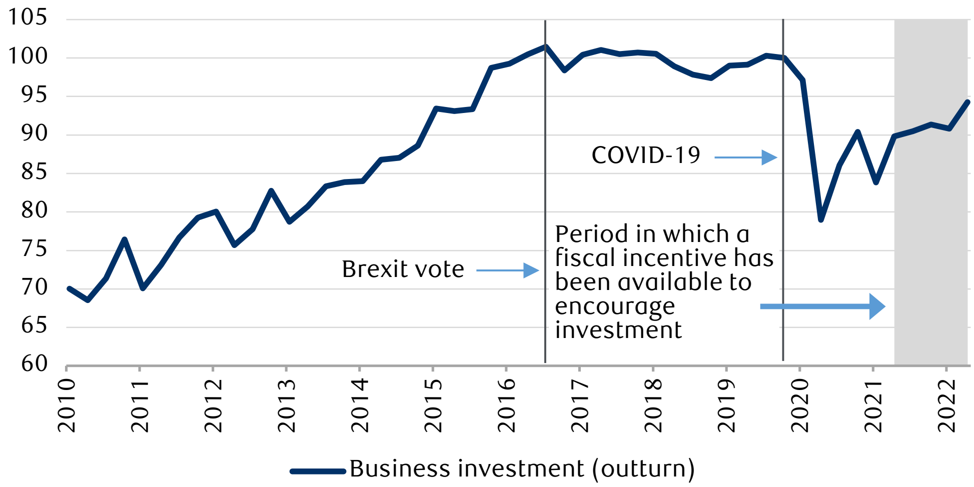
Austerity even as recession bites. Having contended with the economic shocks of Brexit, the COVID-19 pandemic, and this year's energy crisis, the UK is the only G7 economy still languishing below its pre-pandemic output levels. It is now being subjected to sweeping tax increases and spending cuts totaling almost 2% of GDP even as the Bank of England tightens monetary policy and a recession starts.

Newly appointed Prime Minister Rishi Sunak is imposing austerity in an effort to restore credibility after his predecessor's fiscal recklessness increased UK assets' risk premium and nearly caused a financial crisis. Sunak aims to get the nation's debt-to-GDP ratio, roughly 103% as of the end of 2021, falling by a comfortable margin.

This is being done even as economic activity has significantly slowed due to a crippling cost-of-living crisis, with inflation of some 11%. The Bank of England (BoE), the first major central bank to embark on a tightening cycle back in 2021, has lifted interest rates to 3% so far. With a more prudent fiscal policy in place, the BoE will likely be less aggressive going forward, mindful of the impact of higher rates on the housing market. Some 30% of mortgages are

UK business investment struggles

UK business investment (Q4 2019 = 100)



Source - UK Office for National Statistics, RBC Capital Markets, RBC Wealth Management

fixed for two years and will be coming up for refinancing at much higher rates. A more cautious monetary policy will mean tolerating sticky inflation and a weaker pound, in our view.

We believe the Bank Rate will reach 4.0% at the end of the current tightening cycle. This is in contrast with markets, which are discounting a peak interest rate of 4.6% by mid-2023.

Overall, the result of all this will likely be a long, drawn-out recession, which we think could last well into 2024.

Consensus economic forecasts for the UK point to a 0.75% contraction in 2023, but we believe risk may be to the downside as the impact of austerity gets further incorporated into forecasts.

Decisions taken by policymakers (fiscal recklessness, then austerity) and society at large (Brexit) have put the UK economy on a shaky growth path. The economy should ultimately recover, but a change of direction would likely help achieve this sooner.

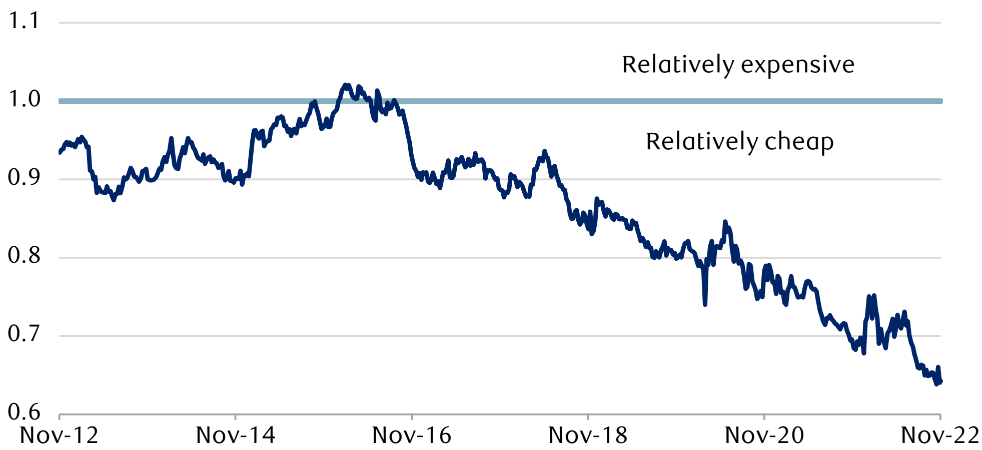
What could change this cautious thesis? Lower natural gas prices and inflation receding faster than currently envisaged would enable the BoE to end its interest rate hiking cycle earlier. Moreover, a warmer relationship with the UK's major trading partner, the EU, would go some way towards reducing the Brexit uncertainty which contributes to holding back growth.

Low valuations, high dividends. Following a period of outperforming other major regions, we downgraded UK equities to Underweight in September 2022 as we were worried about the fiscal policies being entertained by then new Prime Minister Liz Truss. With austerity worsening economic conditions, we maintain this rating.

Yet we think attractive opportunities remain for UK equities, which trade at a historically large valuation discount to other markets, even accounting for the different sector composition. For income-seeking investors, UK equities offer

The FTSE All-Share Index hasn't been this cheap in 10 years

FTSE All-Share Index 12-month forward price-to-earnings valuation relative to FTSE World Index



Source - Bloomberg

interesting opportunities, in our view, given the FTSE All-Share Index has the highest dividend yield among the major equity regional markets, at over 4%.

Within UK equities, we maintain our strong bias for internationally oriented companies. Across the market, the valuation multiples of many global leading UK-listed companies are at notable discounts to their peers listed in other markets. The UK market is also well endowed with Energy companies which, despite strong outperformance in 2022, remain attractively valued given the prospect for higher-for-longer oil and gas prices, in our opinion. We would continue to be selective towards domestically focused UK stocks given our cautious stance on household spending due to the cost-of-living crisis. Though still too early, in our view, we believe there will be a point this year to begin allocating towards UK small-caps and midcaps.

UK fixed income

Rufaro Chiriseri, CFA
London, UK

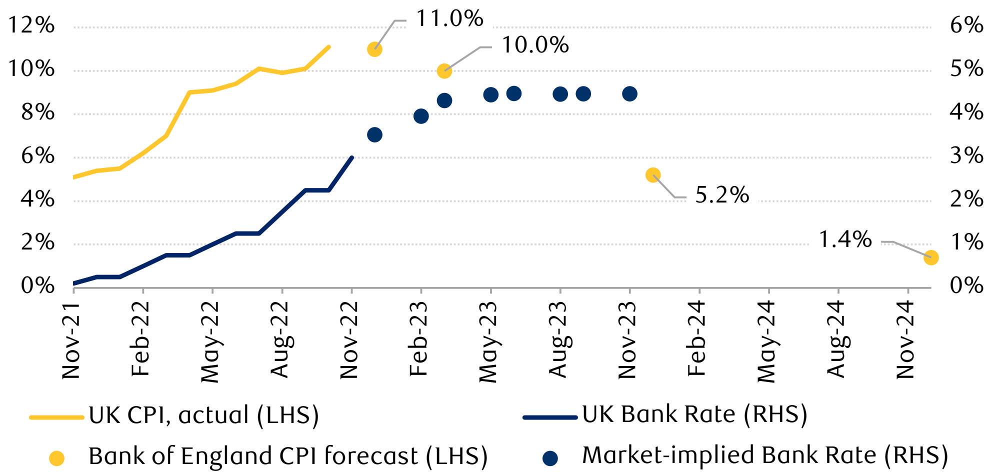
Higher government debt issuance, quantitative tightening create Gilt supply glut

A downbeat outlook. We expect the Bank of England (BoE) to continue raising rates, albeit at a slower pace going forward, to reach a 4% terminal rate in 2023, below the 4.6% market expectation. Price pressures are widely expected to peak in 2022. Furthermore, the recent austerity measures and the upcoming recession will reduce the likelihood for the BoE to hike aggressively from here, in our view.

The BoE's economic expectations for the UK are downbeat. It forecast a two-year recession resulting in a cumulative 2.9% loss of output, leaving GDP running 10% below pre pandemic levels. In addition, the BoE stated, "CPI inflation is projected to fall sharply to some way below the 2% target"

Has inflation peaked in the UK?

UK Consumer Price Index inflation and Bank Rate



Source - Bloomberg, Bank of England; data as of 11/16/22, 09:35 GMT

over the forecast two-year period. The very bearish BoE forecasts from the November Monetary Policy Report (MPR) came with a significant caveat—they were based on a market-implied terminal Bank rate of 5.25%, a level the BoE deemed excessive. Nevertheless, such cautious predictions for the UK's GDP further support our view that current market pricing, even at 4.6%, still seems excessive.

Labour market dynamics present a risk to our view that the terminal rate will reach 4%, as the BoE will be particularly concerned about wage growth running around 6% and above consensus. This raises the risk of a wage-price spiral that further stokes inflation, which could warrant further policy tightening policy above our 4% forecast.

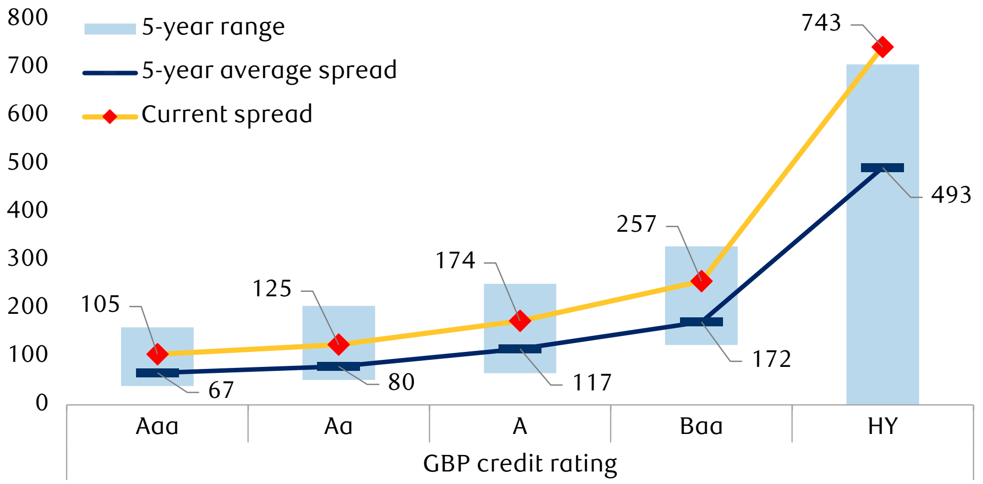
Oversupply darkens Gilt outlook. The Chancellor of the Exchequer's recent spending cuts and tax increases, totalling £55 billion by the end of tax year 2027–2028, significantly reduce the government's debt issuance requirement, which the UK Debt Management Office has reduced by £24.4 billion to £169.5 billion for the current tax year. Still, the net supply of Gilts for the current and subsequent tax years is forecast by RBC Capital Markets to be above record highs—a clear negative for Gilt yields.

Not only will the government issue record amounts of debt, but the supply of Gilts will also increase as the BoE proceeds with the selling of its Gilts portfolio at the same time—in a process known as quantitative tightening (QT). According to RBC Capital Markets' forecasts, the supply glut will continue into the 2023–2024 tax year with a net issuance of nearly £255 billion, close to double the previous record in 2010–2011. The challenge will be whether demand for Gilts can meet the supply deluge. We have a negative outlook for Gilts in H2 2023.

Barbell approach to credit. As for credit markets, we would proceed with caution given high inflation and recession. Yet, the return potential for credit has improved after a challenging 2022, and we think there are pockets of

UK credit spreads are above their 5-year averages

Credit spreads by credit rating



Source - Bloomberg, data as of 11/17/22, 17:35 GMT

opportunity. Corporate default rates remain low and credit spreads tend to peak at the beginning of recessions. However, we remain cautious in adding meaningful duration, UK-centric issuers, or lower-quality credit indiscriminately as there are bound to be periods of volatility as risk assets continue repricing.

We prefer bonds that are trading at attractive spreads relative to company fundamentals and peers. To take advantage of compelling yields and spreads in short-dated, lower-quality investment-grade credit, a barbelled approach looks interesting to us where we balance risks in lower-quality credit with higher-quality credit.

The Financials sector is poised for outperformance, in our view, as it is not held within the BoE's £18.56 billion corporate bond portfolio. Therefore, as the central bank winds down its holdings through QT, sector supply will be unaffected. Moreover, sector fundamentals remain favourable, in our view, as it benefits from higher interest rates.

Global Insight 2023 Outlook

Europe

The energy crisis is likely to cause a mild recession in Europe, which will lead the European Central Bank to tone down its fight against inflation early in 2023, in our view. We would hold an Underweight position in European equities, but we acknowledge downside risks seem to be partly reflected in sharply discounted valuations and we see opportunities in companies that are global leaders. As for fixed income, we would remain selective on sovereign bonds and focus on corporate issuer fundamentals.

European equities

Downside risks partly offset by low valuations and extreme investor caution

Frédérique Carrier
London, UK

Thomas McGarrity, CFA
London, UK

A recession induced by an external shock. The EU will start 2023 in a much different situation than a year ago with a war on its doorstep, an aggressive central bank, and new leaders in Germany and Italy.

The upcoming winter will be challenging, despite most national governments providing support to households and enterprises to soften the blow of soaring energy prices. Annual EU inflation now exceeds 10%. The uncertainty of higher natural gas prices and the possibility of energy shortages during the winter have dragged consumer and business confidence to multi-decade lows. The region eked out 0.2% q/q growth in Q3 2022, but leading indicators point to an economic slowdown.

Double-digit inflation has pushed the European Central Bank (ECB) into its sharpest and most aggressive hiking cycle in its 24-year history, lifting interest rates by a total of 200 basis points (bps) from negative territory, where they had languished for eight years, to 1.5% in just over three months. ECB President Christine Lagarde has warned more hikes are in the offing and the market currently projects interest rates to peak at 3% by July 2023. The ECB

Natural gas prices are now "only" 20 percent higher than they were at the beginning of the year

European natural gas forward prices (EUR/MWh)

Source - Bloomberg

has understood too late, in our view, that even if inflation is driven by supply-side factors, if it remains too elevated for too long, it could drive second-round effects such as higher wage demands.

After the winter, once the anxiety of potential energy shortages lifts, we expect economic activity to pick up, as consumption resumes and businesses adapt their supply chains and improve energy efficiency. Moreover, exports should benefit from China's eventual reopening, which we expect in 2023, and the ultimate stabilization and improvement of the U.S. economy.

The consensus forecast of economists is for a GDP contraction of 0.1% in 2023, but growth of 1.5% in 2024.

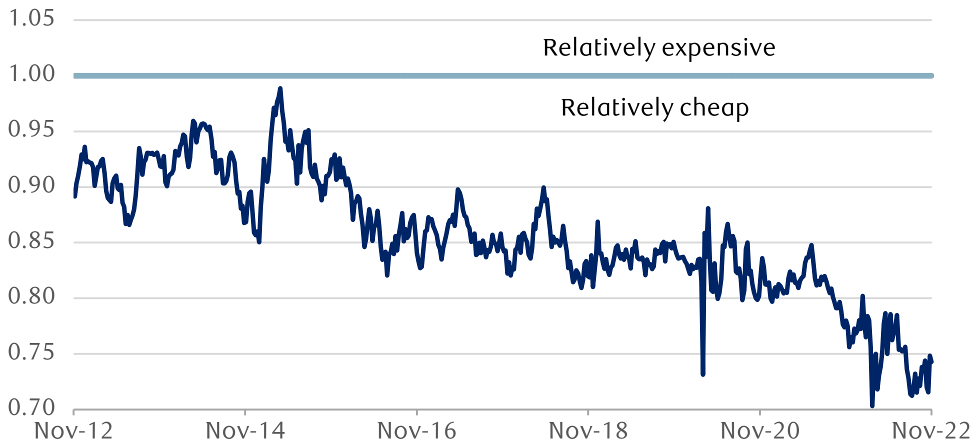
Unusually high uncertainty. A number of potential factors could make our expectations too optimistic: a deterioration in geopolitics, with either a worsening of the Russia-Ukraine conflict or heightened China-Taiwan tensions; a bitterly cold winter in Europe leading to energy rationing for industrial uses; the ECB overcompensating for lagging other central banks in tightening policy by keeping rates too high for too long; a slower reform process in Italy under the new government of Prime Minister Giorgia Meloni that puts the sustainability of Italy's heavy debt load in question; tensions between French President Emmanuel Macron and German Chancellor Olaf Scholz that makes EU policy coordination more challenging and less effective.

Conversely, a number of factors could improve the outlook, including: an earlier reopening of China's economy, to which the euro area, and Germany in particular, is a big exporter; a de-escalation of the war in Ukraine; natural gas prices falling further from current levels; and inflation peaking early that would enable the ECB to ease monetary policy.

Focus on global leaders. We continue to recommend an Underweight position in European equities given the prevailing uncertainties. However, we acknowledge that the long list of downside risks is partly reflected in sharply

European equities have become very cheap compared to U.S. equities

MSCI Europe ex UK Index 12-month forward P/E relative to S&P 500 Index



Source - Bloomberg

discounted valuations and extreme investor caution. Based on a forward 12-month price-to-earnings (P/E) ratio of 12.9x, the MSCI Europe ex UK Index is trading at a discount to its 10-year median of around 14.5x. On a relative basis, the discount to U.S. equities is much steeper than typical, even taking into account sector differences.

We continue to prefer defensive sectors over cyclicals, and maintain our bias for quality, globally diversified companies that possess strong pricing power. In particular, we see opportunities in companies which are global leaders within the pharmaceuticals, technology, luxury, and capital goods industries. We are also beginning to see select opportunities in deeply discounted cyclicals where valuations already appear to price in the prospect of a European recession, particularly in sectors such as Industrials and Materials.

European fixed income

Turning tides, focus on higher-quality issuers and income generation

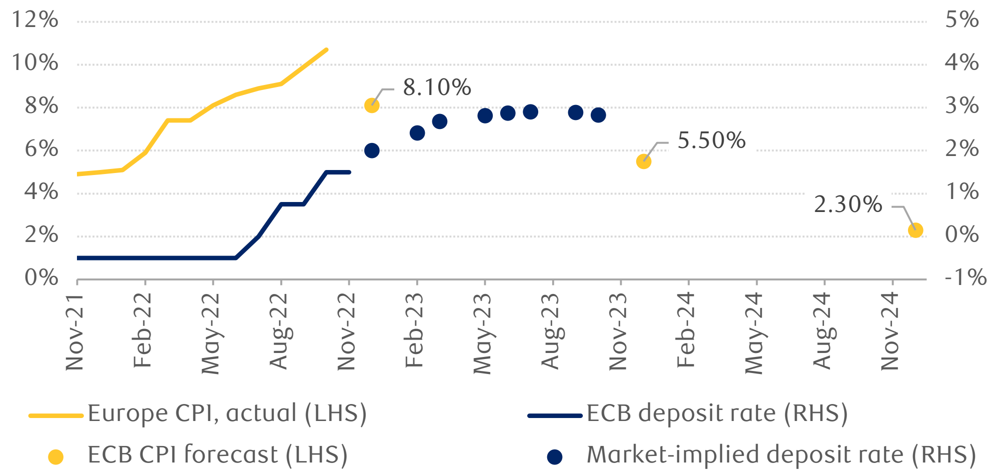
Rufaro Chiriseri, CFA
London, UK

Monetary policy not overly restrictive. European Central Bank (ECB) officials are maintaining that borrowing costs must rise to counter inflation; however, the appetite for jumbo 75 basis point (bps) hikes is waning. The Governing Council judged that “substantial progress in withdrawing monetary policy accommodation” has been made, which hints at a terminal rate that is not overly restrictive. We expect interest rates to peak at 2.50% in 2023, up from 1.5% currently.

Our base-case scenario is based on expectations for inflation to peak in 2022 and start declining in Q1 2023. However, we acknowledge there are risks to that view. On the one hand, with inflation currently at 10.6% y/y and running much above the ECB’s 2022 target, tightening to around 2.75% may be warranted. On the other, a recession and a modest rise in unemployment that

European Central Bank forecasts inflation falling below target in 2024

European Consumer Price Index inflation and European Central Bank (ECB) deposit rate



Source - Bloomberg, European Central Bank; data as of 11/16/22, 09:35 GMT

is easing wage pressures could result in less restrictive policy with interest rates peaking at around 2.25%. Current market expectations are higher than our three scenarios, with a terminal rate close to 2.90% priced in for mid-2023.

A mild recession. RBC Capital Markets forecasts that euro area GDP growth will turn negative in Q4 2022 and Q1 2023 before turning positive for the rest of 2023. Though the euro area is very likely heading into a recession this winter, we expect the recession to be milder than initially feared when the fullness of the energy crisis became clear.

A backstop to prevent material sovereign spread widening. As with other central banks, the ECB will begin the process of reducing the assets on its balance sheet, also known as quantitative tightening (QT). We expect that before selling assets outright, the QT process will likely commence with the ECB merely ceasing reinvestments in Q1. As the central bank shifts to QT and starts to sell sovereign bonds, we would prefer to be positioned in nations with a lower supply glut to minimise the effect of sovereign spreads widening. As such, we have a bias against Portugal, Italy, and Greece as they have been some of the nations most supported by ECB purchases which resulted in tighter spreads. When the ECB transitions to asset sales, we expect spreads to widen and for these most supported sovereign bonds to underperform.

Still, we do not anticipate a disorderly rise in sovereign spreads. We are comfortable with the ECB's ability to limit an unwarranted rise in the premium investors demand to hold lower-rated euro area sovereign bonds. The ECB's measures to limit such an outcome can be used at the Governing Council's discretion with no limitations. Therefore, there is a sufficient backstop to prevent spreads from materially widening, in our view.

Corporate credit opportunities improve after a challenging 2022. Credit yields have risen very sharply from 0.5% to 4% this year alone, which has opened up opportunities in the market. Credit looks compelling to us as investors are now receiving higher yields which we believe should more than compensate for the interest rate risk of their investments. On a risk-reward basis, investment-grade bonds look more attractive relative to high-yield bonds, in our view, due to recession expectations resulting in widening high-yield spreads and the higher cost of borrowing for high-yield issuers.

Corporate bonds appear well cushioned against further spread widening before returns turn negative, in our opinion. However, we believe it is essential for investors to proceed with caution in credit markets during a period of high inflation and slowing growth. The return potential for credit has improved, in our view, after a challenging 2022 and we see pockets of opportunity. We believe the theme for 2023 is to remain selective and focus on issuer fundamentals. In particular, we prefer senior ranking bonds issued by banks, as well as bonds from commodity and telecoms issuers as these industries possess a combination of the most attractive spreads, credit rating upgrade potential, and resilient cash flows, in our view.

European credit yields are significantly higher than a year ago

Bloomberg Euro-Aggregate Corporate Index yield by credit rating

Source - Bloomberg; data as of 11/17/22, 17:35 GMT

Global Insight 2023 Outlook

Asia Pacific

Asian economies and equity markets stand to benefit as the region's powerhouses—China and Japan—loosen COVID-19 restrictions. But investors' perceptions of China's economic growth opportunities over the medium term and the priorities of the country's new leadership team will likely also play a role in shaping the region's equity and fixed income market performance. Heading into 2023, we favor Japan equities and Asia ex-China investment-grade bonds.

Asia Pacific equities

China's growth outlook uncertain; multiple macro factors support Japan equities

Jasmine Duan
Hong Kong, China

Nicholas Gwee, CFA
Singapore

After the 20th National Congress of the Communist Party of China in October, investors have divergent views on the new leadership team and their policy agenda. Interestingly, offshore investors seem concerned about the consolidation of President Xi Jinping's power and the capability of Li Qiang potentially serving as the next premier considering how he handled Shanghai's COVID-19 lockdown. However, onshore investors point to Li Qiang's effective work in China's economic powerhouses of Zhejiang, Jiangsu, and Shanghai, as well as his long-standing support of the private sector.

We think equity market volatility could persist in the short term as investors debate the focus of future policy and look for signs to justify their own interpretation of Party Congress messages. Investors' perceptions toward China's economic growth and policy outlook will likely impact fund flows into the market and asset allocations.

Market participants are increasingly concerned about China's medium-term GDP growth prospects. RBC Global Asset Management Inc. Chief Economist Eric Lascelles pointed out that he is increasingly leaning toward an assumption of sub-4% growth on a steady-state basis going forward. We

China’s era of double-digit growth is coming to an end as the country is facing multiple growth challenges

China real annual GDP (year-over-year % change)

Source - RBC Wealth Management, Bloomberg; annual data through 2024, 2022–2024 data are Bloomberg consensus estimates

believe this slower growth threatens the country’s ability to achieve its societal objectives and also means China may provide less of a tailwind to global growth than in the past.

We think the resumption of a sustainable uptrend in China equities in 2023 depends on whether the government will gradually loosen its COVID-19 restrictions and reopen the economy, and if leaders can demonstrate a pro-growth agenda. Even if the market remains choppy in the short term, we think investors can find opportunities in areas tied to the country’s long-term development blueprint—for example, industries that will benefit from safeguarding energy and food security, high-end manufacturing, and new green energy supply chains.

The state of macro developments in Japan remains relatively positive with the country moving toward endemic COVID-19, out of the pandemic phase. Japan’s household earnings and its labor market remain very resilient, non-manufacturers’ sentiment continues to improve, and the government is finally lifting its in-bound travel restrictions. We expect wage inflation to continue to rise, underpinned by reopening dynamics and likely further labor shortages. We anticipate domestic consumption will bounce strongly in coming quarters. The Bank of Japan (BoJ) forecasts Japan’s real GDP will expand at an above-average rate for the foreseeable future: by 2.0% in fiscal 2022, 1.9% in fiscal 2023, and 1.5% in fiscal 2024 (fiscal years end in March of the following year).

The BoJ maintains that current inflation is transitory and headline inflation will not be sustained above 2% in 2023. We expect the BoJ Yield Curve Control policy to be adjusted upward early in H1 2023, as broadening inflation and a tightening labor market will likely push up wages in the coming quarters. Based on the latest Bloomberg survey, analysts expect the yen to appreciate below the 140 level against the U.S. dollar by the end of 2023.

Support for the year-old government has been sliding, with opinion polls declining to levels even below the previous administration. While Prime

Minister Fumio Kishida does not have to face another general election for more than two years, we think the low level of public support could make it difficult for him to control his party and push ahead with election pledges such as higher defense spending.

Heading into 2023, we maintain our positive stance on Japan equities. This is supported by a likely economic recovery, the reopening of Japan's borders to overseas tourists, a relatively weak yen, our view that the increase in Japanese interest rates will lag other developed markets, and the end of deflation as corporations increasingly hike prices to reflect higher input costs. We view the latter as a positive structural factor for Japan equities as it would reflect a sea change in corporate pricing behavior.

Asia Pacific fixed income

Shawn Sim
Singapore

Positive on Asia ex-China investment-grade credit, but cautious on China

Outflows to reverse. Asian local currency bonds suffered outflows in the first three quarters of 2022, reflecting investors' underweight exposure to Asian fixed income after aggressive unwinding of positions throughout the year. China accounted for most of the outflows, followed by Malaysia, Indonesia, South Korea, and Thailand. We expect outflows to reverse to net buying, reflecting the retracement of global rates and global investors' much lighter exposure to Asian bonds. However, we believe foreign investor demand is likely to remain weak over the medium term until global rates volatility and foreign exchange markets stabilize.

Concerns over China's new strategic direction. The 20th National Congress of the Communist Party of China took center stage in October, with China's leadership appearing to take a new direction by playing down the importance of reform and economic development for future legislation. This adds to investors' concerns that the government is increasingly prioritizing security and ideology over growth. We believe such a domestic policy may further weaken foreign investor sentiment that is already reeling from China's regional geopolitical issues, tough zero-COVID controls, and a housing crisis. Post the Party Congress, credit spreads of U.S. dollar-denominated Chinese investment-grade corporate bonds sharply widened to a much higher premium over U.S. investment-grade credit, reflecting investor worries. We expect these concerns to linger in the medium term, and investors to remain cautious.

China's property market remains challenged. The Chinese property sector bore the brunt of the correction in China credit year to date. The selloff mainly impacted privately owned developers, with some contagion spreading to state-owned developers, and limited access to the capital markets for many developers. Chinese regulators have supported property developers' new bond issues with credit protection or enhancements. However, a wider economic slowdown in China and the lack of strong property sales might offset these efforts, with cash flow still tight for many developers.

We favor Asia ex-China investment-grade bonds. Elsewhere in Asia outside of China, we continue to favor investment-grade bonds issued by what we see as quality Asian corporates with conservative balance sheets and government-linked companies that may benefit from implicit government support. This segment has been relatively resilient year to date, and we expect the strong credit profiles of the aforementioned issuers to see little deterioration despite headwinds of rising borrowing costs and inflationary pressures.

Credit spreads in the U.S.-dollar-denominated Chinese investment-grade bond sector reaching one-year highs

USD China investment-grade Z-spread (basis points)

Note: Z-spread is the difference from the zero-coupon U.S. Treasury yield curve.

Source - Bloomberg; data range 11/10/21–11/9/22

Asian hybrid/perpetual credit a key area. This space has attracted interest, not only because of the yield pick-up during the ultralow rate environment of recent years but also from investors' belief that Asian issuers (particularly financial institutions) will exercise redemptions on the first call date. This belief was to a certain extent justified, in our view, due to Asian financial institutions having traditionally been sensitive to the reputational risks associated with not redeeming their perpetual bonds.

However, when a South Korean insurer announced on Nov. 1, 2022 that it would not redeem a perpetual bond on the first call date, a sharp selloff was triggered across Korean financials sector perpetuals as well as the wider Asian perpetual space due to increased concerns over non-call risk. That decision not to redeem was later reversed in a dramatic U-turn with the issuer citing market stability reasons, and the space retraced higher.

We believe this event may actually serve to reinforce the call likelihood of Asian financials sector perpetuals, especially those issued in jurisdictions where regulators take a more holistic, prudential regulatory approach.

We like the Asian financials sector perpetuals space, but would focus on bonds where yield pick-up and deal-specific features look attractive.

Global Insight 2023 Outlook

Commodities

Richard Tan, CFA
Toronto, Canada

Natural gas: Volatile

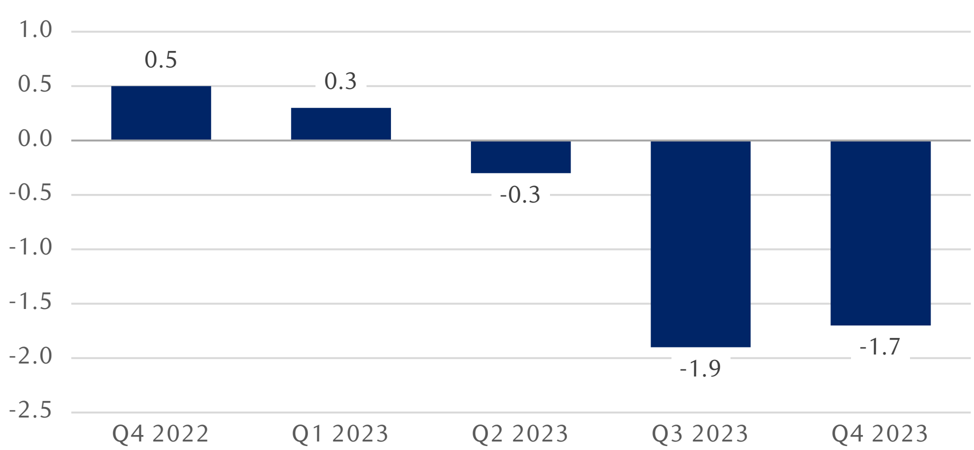
U.S. natural gas prices have spiked by 80 percent year to date, driven by the war between Russia and Ukraine, increased demand for liquefied natural gas, and the global transition towards green energy. Heading into 2023, RBC Capital Markets is forecasting a balanced U.S. market, and the U.S. Energy Information Administration is also calling for some price relief in the second half of the year. That being said, Russia remains a key swing factor, one which could leave natural gas prices prone to volatility through 2023.

Crude oil: Balanced

While the softer economic outlook could weigh on global oil prices, RBC Capital Markets expects global supply and demand to remain mostly in balance through the first half of the coming year. Thereafter, we expect a supply deficit to build in the second half of 2023. Additionally, the combination of OPEC+ production curtailments, a potential rebuild in U.S. reserves, and looser Chinese pandemic policies should support higher oil prices, in our view.

Projected global oil supply & demand balance

Millions of barrels per day



Source - RBC Capital Markets

Copper: Surplus

In our view, the copper outlook is a combination of two scenarios that may overlap: short-term demand will likely be restrained by the slowing economic backdrop, while global decarbonisation efforts should sustain long-term demand. Overall, we believe upside potential may be limited over the medium term as recessionary risks rise. A reacceleration in the Chinese economy would likely be needed as a catalyst for higher prices. RBC Capital Markets is forecasting a supply surplus through 2025.

Gold: Challenging

Despite the risk-off environment and its reputation as a "safe haven", gold has lost about nine percent of its value in 2022. In our view, rising real rates and the strength of the U.S. dollar have been the key drivers of downward pressure. Heading into 2023, we believe U.S. interest rates will tick higher through the first half of the year, albeit at a slower pace. We think gold may experience further price pressure in the first half of the year before seeing some relief in the second half.

Soybeans: China

Soybean prices have moderated in the second half of 2022 but are still up by double digits on a year-over-year basis. As we approach 2023, the U.S. Department of Agriculture (USDA) is forecasting increased global production offset by higher global consumption. The USDA expects U.S. exports to grow by approximately 10 percent in 2023, driven in part by a step-up in Chinese demand. A reduction in COVID-19-related restrictions in China would be a key catalyst, in our view.

Wheat: Tight

Global consumption is expected to remain healthy in 2023 despite rising costs, according to the USDA, driven by continued demand for wheat-related products. The agency also expects global production to edge up modestly, but believes there will be a slight overall deficit. Global demand and supply balances should remain relatively tight, in our view, with any excess demand supported by a drawdown in existing inventories. Additional escalations in the conflict between Russia and Ukraine could push prices higher.

2023 commodities forecasts

Commodities	Price
Natural gas ($/mmBtu)	$4.87
Oil (WTI $/bbl)	$91.25
Copper ($/lb)	$3.75
Gold ($/oz)	$1795
Soybeans ($/bu)	$14.24
Wheat ($/bu)	$8.56

Source - RBC Capital Markets forecasts for oil, natural gas, copper, and gold), Bloomberg consensus forecasts (soybeans and wheat); data as of 11/15/22

Nicolas Wong, CFA
Singapore

U.S. dollar: Peaking with fed funds rate

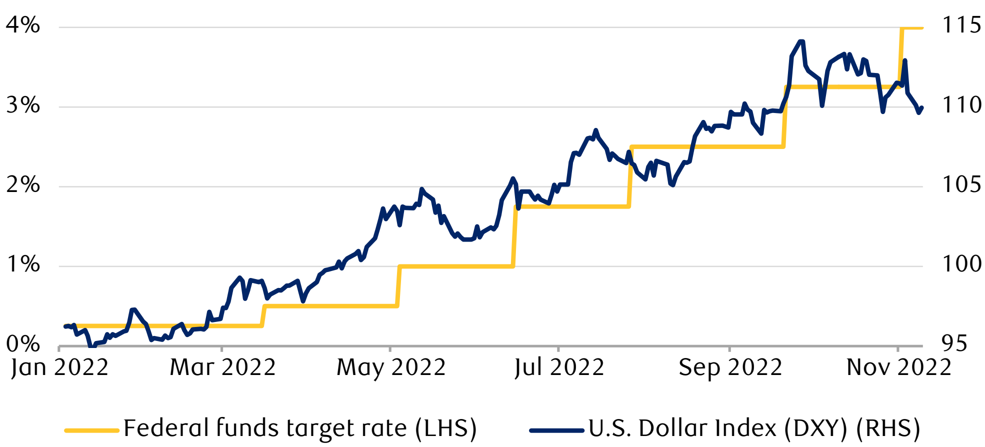
We expect the U.S. dollar strength to fade in H2 2023, coinciding with our expectation that the pace of interest rate hikes by the Federal Reserve will pause and potentially reverse in 2023. With the fed funds rate expected to peak in Q1 2023, consensus forecasts have the dollar trading lower against other major currencies in the G10 for 2023. RBC Economics also expects a weaker dollar in 2023, but not at the pace expected by most, due to the yield advantage the dollar would hold against most other currencies. It also notes that if inflation continues to come in stronger than the market consensus, there is a risk of dollar strength persisting for longer.

Euro: Upside risk from capital flows

It is our view that a lot of the negative news that has caused the euro to lose more than 10% against the U.S. dollar in 2022 has already been priced in. Despite the consensus growth forecast in Europe remaining weak, the outlook

The U.S. Dollar Index had a strong rally in 2022, driven by aggressive Fed rate hikes

We expect the USD to ease in 2023 as the Fed pauses and potentially starts to cut interest rates in the second half of the year



Source - RBC Wealth Management, Bloomberg, data through 11/9/22 for the euro is more neutral in 2023 from a positioning point of view. RBC Economics thinks there could be an underappreciated upside risk for the euro in 2023 coming from capital reallocation to Europe, especially if European equities outperform U.S. equities. Energy prices will also be closely watched and will affect euro performance in 2023, in our opinion.

Canadian dollar: Weighed down by recession risks

The mounting risk of a slowdown or recession in H1 2023 from the more restrictive policy settings by the Bank of Canada (BoC) is expected to weigh on the Canadian dollar in early 2023, according to RBC Economics. Furthermore, it notes that the interest rate differential favours a higher USD/CAD and forecasts a terminal rate of 4% from the BoC vs. 5.25% from the Fed. However, with the expectation of the U.S. dollar peaking broadly in H1 2023, the Canadian dollar should recover in the second half of the year.

British pound: Weak fundamentals persist

With the UK bond market normalizing after a volatile period in September 2022, the outlook for the British pound should revert to the more "conventional" driver of interest rates differentials. RBC Economics expects the Bank of England to be less aggressive on interest rate hikes, compared to what the market is pricing in 2023, noting the squeeze on household real income due to high energy bills and fixed rate mortgages resetting at much higher rates. With interest rates likely to stay in-check, RBC Economics' longer-term expectation is for a cheaper pound to balance the twin deficits (the fiscal deficit and current account deficit) that the UK has.

Japanese yen: Tentative peak at 150

Japanese officials intervened in October when the USD/JPY breached 150, following a more than 20% rally on the pair in 2022. We believe monetary policy divergence between the Fed and the Bank of Japan (BoJ) will remain the key driver in 2023 and while RBC Economics expects the BoJ to be reluctant in raising interest rates, it anticipates the peak in the fed funds rate in Q1 2023, which coincides with its peak USD/JPY forecast.

2023 currencies forecasts

Currencies	Forecast Dec. 2023
U.S. Dollar Index	106.18
EUR/USD	1.05
USD/CAD	1.36
GBP/USD	1.17
USD/JPY	143.00

Source - RBC Capital Markets estimates; data as of 11/10/22

Research resources

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As of September 30, 2022

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