

GLOBAL Equity



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A fresh look at the U.S. recession scorecard

Equity investors are contending with a confluence of several economically significant developments: war in Ukraine, surging energy and commodity prices, worrying inflation data, central banks intent on tightening, and bond yields rapidly climbing above pre-pandemic levels. All these, and more, have raised concerns about the potential for broad economic weakness down the road. Those concerns have already produced a pullback in equities, and although markets appear to have regained their footing for now, more events of this kind cannot be ruled out as the year progresses. With the exception of the Ukraine tragedy, these crosscurrents seem to us part and parcel of a global economy transitioning from the high growth rates that usually accompany the first year or so of recovery from recession to the less-dynamic “middle innings” of an economic expansion. In that phase, we would expect GDP growth to remain positive (although Europe looks to be headed for some challenging quarters) while corporate

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

earnings and share prices are likely to advance further.

So long as the U.S. economy can avoid recession, we believe global investors should remain committed to equities. Our U.S. recession scorecard continues to give the economy a green light, although some of our seven indicators are now “less green” than others. Below, we outline the arithmetic of each with an assessment of how vulnerable each might be to turning negative.

U.S. recession scorecard

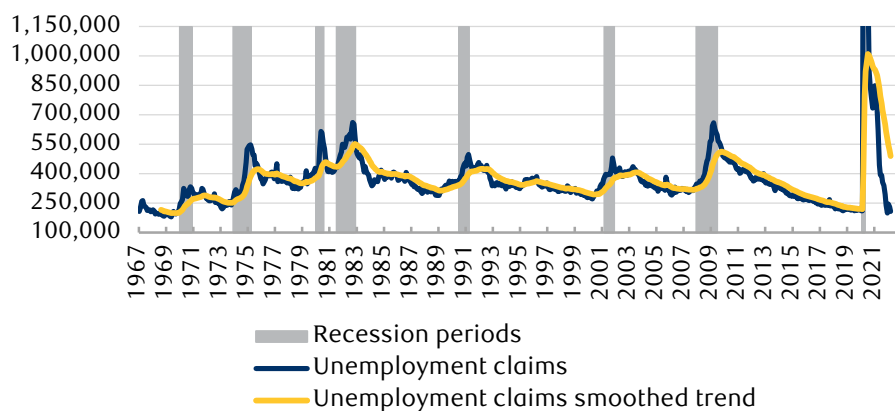
Indicator	Status		
	Expansionary	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)	✓		
Unemployment claims	✓		
Unemployment rate	✓		
Conference Board Leading Economic Index	✓		
Free cash flow of non-financial corporate business	✓		
ISM New Orders minus Inventories	✓		
Fed funds rate vs. nominal GDP growth	✓		

Source - RBC Wealth Management

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Strong labor market

U.S. unemployment insurance claims



Note: Shaded areas indicate recessions

Source - RBC Wealth Management, Federal Reserve Bank of St. Louis (FRED); data through 3/1/22

Unemployment rate and unemployment benefit claims

These two indicators should be looked at together. The smoothed trend of the unemployment rate has usually turned upward at the start of a recession, or immediately before. It is an unusually timely indicator, as it is reported within a week after the end of each month. Although it gives very little in the way of early warning, its signals have always been visible right at the start of the economic downturn rather than months into it. This is especially useful because the start date of a recession is usually only announced definitively by the National Bureau of Economic Research about a year down the road.

The smoothed trend of the monthly average of unemployment claims has typically turned higher two to six months ahead of the unemployment rate's upward turn, giving fair warning of an approaching recession some months in advance. It has produced occasional false signals, but none of those were subsequently confirmed by the unemployment rate. It is available very close to the end of each month.

Both the unemployment rate and the number of claims would have to double from current levels over the next several months to turn their

trends higher. Both are at or close to multi-decade lows, but could go even lower, in our view.

With businesses of all sizes in virtually every sector concerned by labour shortages, and with 11.3 million jobs on offer versus 6.3 million persons unemployed, we think most employers would be reluctant to lay anyone off in the near term. Even if the economy were to slow from here, we believe most businesses would go on hiring if they could find qualified applicants.

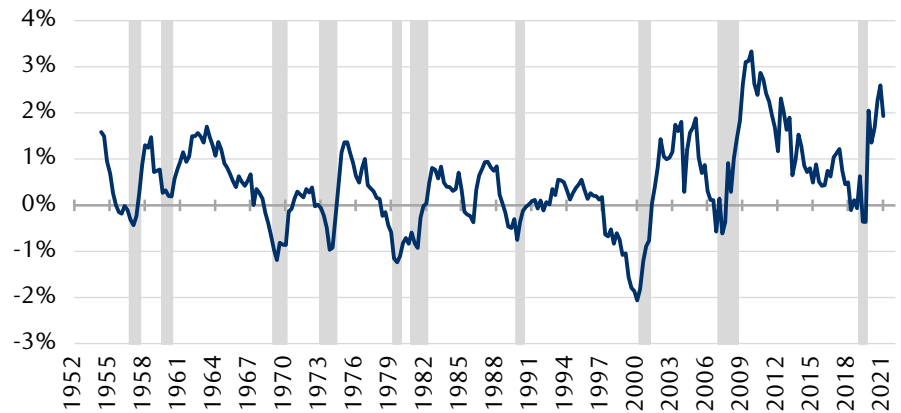
Free cash flow of non-financial corporate businesses

This indicator measures the cash generated by non-financial corporate businesses as a percentage of GDP. It is derived from the Federal Reserve's quarterly Financial Accounts of the United States, and has given only one false positive signal in more than 65 years. In all other cases when this indicator has fallen below zero, a recession has followed—typically, two to three quarters later. More particularly, shrinking corporate cash flows have most often signaled an upcoming period of weaker capital spending, a highly cyclical component of GDP. Today, this indicator looks to be in no danger of signaling an approaching recession any time soon.

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Robust corporate health

U.S. nonfinancial corporate sector: Free cash flow as % of GDP (including foreign earnings retained abroad)



Note: Shaded areas indicate recessions

Source - RBC Wealth Management, Federal Reserve Bank of St. Louis (FRED); data through 10/31/21

Conference Board Leading Economic Index (LEI)

This indicator signals a recession is on the way when it falls below where it was a year ago. It has always done so at least three months before the start of a recession (the pandemic downturn being the only exception), often six months before, and occasionally earlier. The LEI may have peaked for this economic cycle in Q2 of last year, but it remains a long way above where it was a year ago. Arithmetically, we don't think this indicator could turn negative on a 12-month basis until at least late Q2 of this year, or more likely Q3—and then only if the economy were to

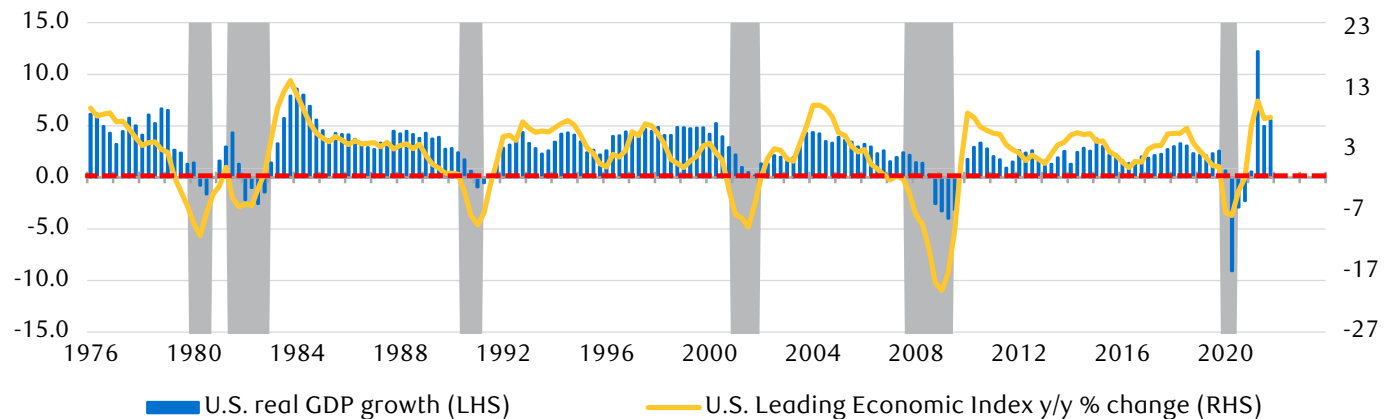
deteriorate swiftly in the intervening months. It is one of the strongest of the recession indicators we follow, and we think it is a long way from giving a negative signal.

The yield curve

This very reliable indicator laboured in obscurity for decades, but is now followed minute-by-minute by a financial press that apparently needs something to obsess about 24/7. A yield curve inversion—that is, short-term interest rates higher than long-term rates—has preceded the start of every recession for the past 75 years,

More growth ahead

Conference Board Leading Economic Index for the U.S.



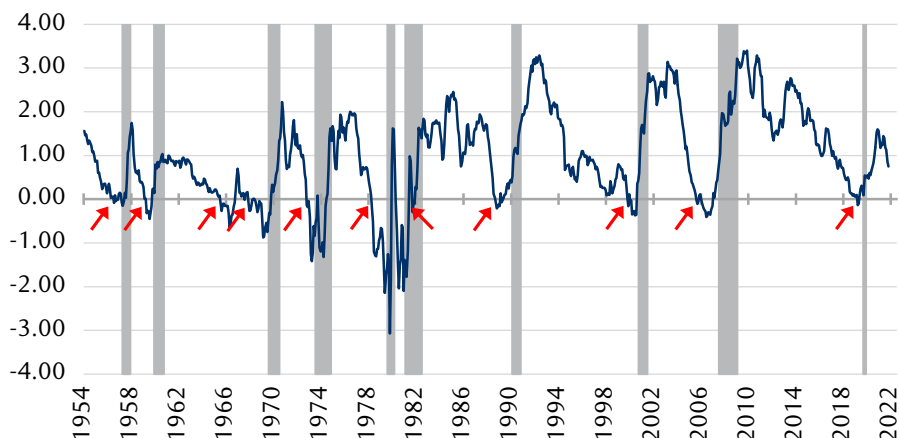
Note: Shaded areas indicate recessions

Source - The Conference Board, U.S. Department of Commerce, RBC Wealth Management; data through Q4 2021

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Consistent with sustained growth

Yield differential between the U.S. 10-year Treasury Note and the 1-year Note



Note: Shaded areas indicate recessions and arrows indicate where yield curve inverts
 Source - RBC Wealth Management, Federal Reserve Bank of St. Louis (FRED); data through 3/1/22

with an average lead time of roughly 11 months.

Bond trading desks typically focus on the relationship between 2-year and 10-year Treasury yields. The Fed, when it comments on this topic, typically refers to the 90-day T-Bill yield versus the 10-year. We use the 1-year Treasury yield, a quieter maturity on the curve, as our short-term component.

Yield curve inversions have occasionally occurred after stock market peaks, but never more than a month or two later, and well before the associated bear markets reached the stage of serious declines. On average, the 1-year/10-year Treasury yield curve has inverted about six months prior to the peak of the stock market.

Today, the 10-year Treasury yield is still roughly 75 basis points higher than the 1-year yield. Inversion, were it to occur, would flip this indicator to red—but as things stand, we think that possibility is a long way off. A narrowing to something under 30 basis points would induce us to shift to a more cautionary yellow (neutral) rating.

The federal funds rate versus the nominal GDP growth rate

Since 1954, the federal funds rate has typically moved above the nominal (i.e., not adjusted for inflation) year-over-year growth rate of GDP prior to the onset of a recession. There have been two exceptions: in 1957 and 2020, the funds rate crossed that threshold one month after the recession began. It is not an ideal timing tool, as there have been several false positive signals, but with the exception of the two “close calls” noted, a fed funds rate in excess of nominal GDP growth has been a precondition of all U.S. recessions.

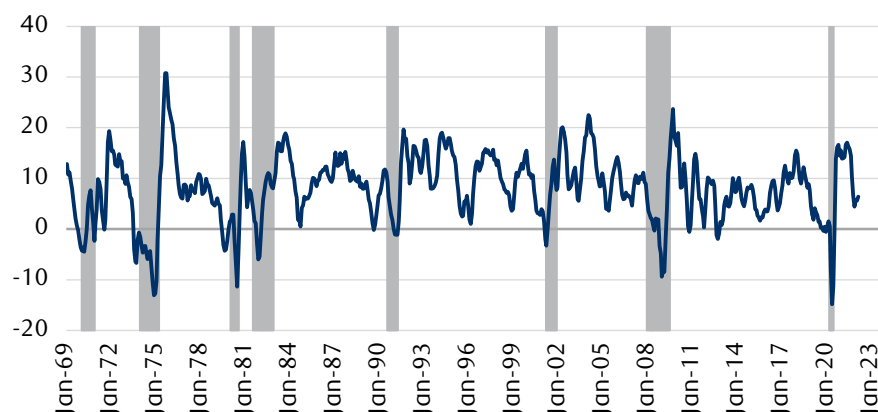
At the end of 2021, the nominal GDP growth rate stood at 10.6%, more than 10 percentage points above the 0.08% fed funds rate. We expect the year-over-year nominal GDP run rate will slow to between 7% and 8% by the end of this year, and decrease further to between 4% and 5% by late 2023.

The Federal Reserve hiked the funds rate by 25 basis points at its March meeting. The market is now pricing in a pair of 50 basis point hikes in April and June, followed by four more quarter-point increases this year and another four next year. That would put the funds rate at 2.25% by the end of 2022, and 3.25% at the end of

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Support waning

ISM Manufacturing New Orders minus Inventories



Note: Shaded areas indicate recessions

Source - RBC Wealth Management; Institute for Supply Management; data through 1/4/22

2023—still well short of the projected GDP run rate, by our reckoning.

(Keep in mind that the market’s forecasts of Fed rate setting are usually wrong, often spectacularly so. For example, through much of last year the market expected no Fed rate hikes in 2022, with perhaps one sneaking in by year’s end.)

The Fed’s own “dot plot” projection (which has a similarly uneven record of predicting rate changes) is somewhat more subdued, with the funds rate hitting 2% by the end of this year and 2.75% next year.

Getting the funds rate above our projections for nominal GDP growth within the next 12 months would require GDP to grow far more slowly than we expect, or the fed funds rate to rise much more quickly. Either would be a tall order, in our view.

ISM New Orders minus Inventories

Two components of the ISM Manufacturing Index, taken together, have a helpful track record of signaling recessions as they begin or shortly before. The difference between the New Orders component and the Inventories component

has turned negative near the start of most U.S. recessions. But it has also registered occasional false positives, signaling that 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. Therefore, we view this as a corroborative indicator—one to pay attention to if other, longer-term indicators are implying a recession is on the way. The spread between New Orders and Inventories has narrowed from its post-pandemic peak of a few months ago, but remains well above zero.

Stay committed to equities

We recommend global portfolios remain moderately Overweight equities. However, we recently [reduced our recommended exposure to Europe](#) to Market Weight from Overweight, acknowledging that the dislocations of the Ukraine war can be expected to take a toll on the EU economy.

Research resources

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			Count	Percent
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Hold [Sector Perform]	569	39.03	172	30.23
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