

Special report



Wealth
Management

GLOBAL Insight 2023 Midyear Outlook



Rallies, recessions,
and realistic thinking

For important and required non-U.S. analyst disclosures, see [page 24](#).

Produced: June 26, 2023 5:27 pm ET; Disseminated: June 27, 2023 10:30 am ET

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10 U.S. Recession Scorecard: On the path to a U.S. recession

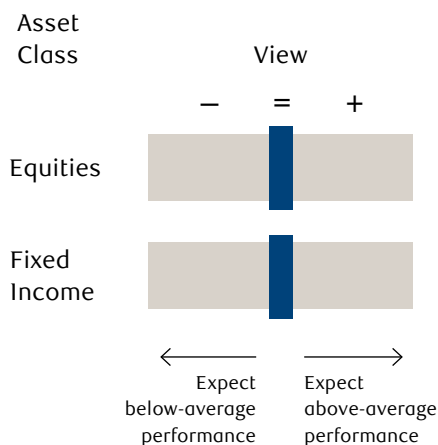
The strong May payrolls report did not stop the unemployment rate from surging to its highest point in this cycle. Our overall analysis of leading economic indicators continues to suggest a recession is approaching.

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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

- With the S&P 500 up 20% from its October 2022 lows, some headlines have reported a new bull market is underway and are predicting a soft landing for the U.S. economy.
- We are not so sure. It would be unusual for a new bull market to start before the Fed stops hiking rates and a recession starts. Moreover, most reliable leading indicators of recession have been giving increasingly negative readings.
- Nevertheless, buoyed by investors' fear of missing out, equities may have further to run, in our opinion. We maintain our Market Weight recommended exposure for equities in a global balanced portfolio. But as this feels much more like the last leg of the market upturn, we would use any strength to increase our existing bias toward high-quality defensive businesses.

FIXED INCOME

- Fixed income market volatility remains elevated as traders weigh the next steps from all of the major central banks. The average yield on the Bloomberg Global-Aggregate Bond Index sits at 3.8%, nearing its 2022 high of 4.0%, which remains the high-water mark for global bond yields since 2008. Though central banks largely remain hawkish, there is a growing divergence in their paths forward. In our view, the Fed will likely pause after one more rate hike next month, while at the other end of the spectrum the Bank of England could be on the cusp of multiple rate hikes through the rest of 2023.
- We remain Market Weight U.S. fixed income with yields again nearing multi-year highs and hold a positive outlook for large-cap U.S. bank-issued preferred shares following recent selling pressures. We stay Market Weight on high-yield corporate debt despite a cloudy outlook for the U.S. economy. We maintain a positive outlook for U.S. government debt on attractive yields and downside protection should a recession materialize later in the year.
- We maintain our Market Weight in global fixed income, with a Market Weight allocation to credit.

MIDYEAR OUTLOOK Focus



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Rallies, recessions, and realistic thinking

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

Key points

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

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

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

Enter the rally

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

MIDYEAR OUTLOOK FOCUS

Rallies, recessions, and realistic thinking

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

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

New bull or last gasp

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

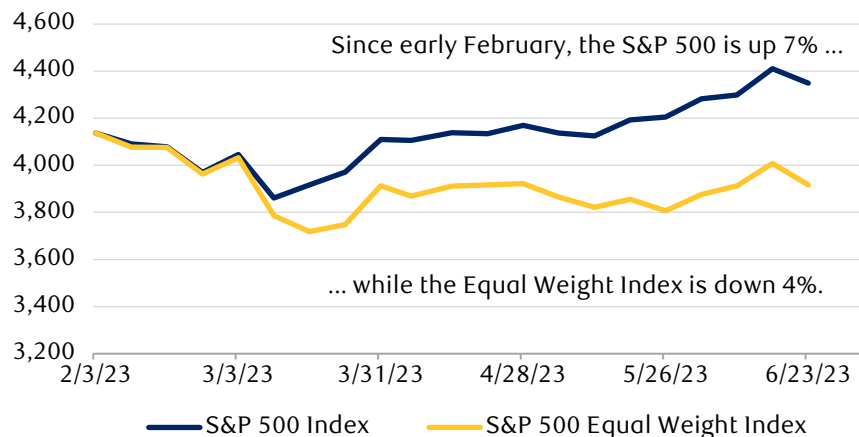
Since then, everything has been turned pretty much topsy-turvy. The U.S. equity market has gone up for nine months instead of down, and the S&P 500 is edging closer to new all-time highs. P/E multiples are back above a rich 20x. And, as noted above, sentiment readings have roared higher, getting closer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

Don’t fight the economy

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

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

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



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

MIDYEAR OUTLOOK FOCUS

Rallies, recessions, and realistic thinking

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

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

Only resilient stocks need apply

We continue to recommend Market Weight equity exposure for a global balanced portfolio because we think this advance has further to go into the summer months. However, we increasingly think individual stock selections should be restricted to companies that an investor would be content to own through a recession. For us, that means high-quality businesses with resilient balance sheets, sustainable dividends, and business models that are not intensely sensitive to the economic cycle.

MIDYEAR OUTLOOK Focus



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The “year of the bond” hasn’t been much of a year at all

What was supposed to have been the great bond rally of 2023 instead has been a lukewarm performance. Yet bond yields have rarely appeared more attractive, in our view, while at the same time they should provide strong capital appreciation potential for portfolios should bond prices rally if and when central banks pivot back toward rate cuts.

Key points

- **The banner year for bonds that we expected in 2023 after a dismal performance in 2022 hasn’t materialized thus far, but we continue to expect bonds to post steady gains as rate hike cycles near their end points.**
- **Inflation remains elevated globally, but we now have sufficient data in hand to suggest that the tide has indeed turned lower. Central banks will stay on high alert, but a more cautious policy approach should limit economic risks.**
- **We expect yields to fall in the back half of the year, but only modestly so as resilient economies are unlikely to see tight central bank policy give way to rate cuts—extending the window for investors to put money to work at historically high yields.**

With 2022 marking one of the worst years on record for bond markets as the Bloomberg Global-Aggregate Index fell over 16%, we expected bonds to bounce back and then some in 2023. But through the first six months of the year that same index has clawed back ... just 2%.

So has the “year of the bond” been canceled, or has it simply been delayed?

As we see it, the singular thing still standing in the way of higher bond prices—and therefore lower yields, which move inversely to prices—has been hawkish central banks remaining firm in their resolve to bring inflation down via still-rising policy rates.

And before bonds can begin the kind of rally that we have been anticipating, inflation will need to be well and truly on its way back toward target levels, in our view.

Public enemy No. 1

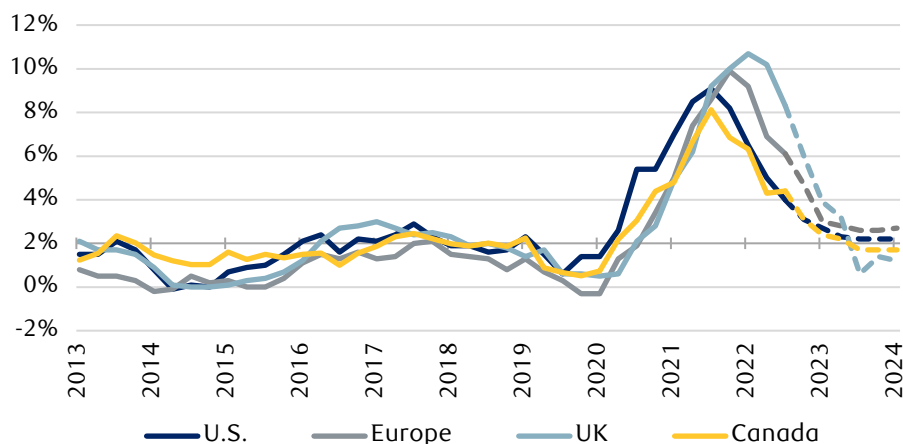
Has inflation been arrested yet? While no major central bank has yet been confident enough to declare it has the suspect in custody, most have cautiously suggested that they believe to have the perp surrounded.

As with any standoff, the last thing those in charge want to risk is escalating the situation. The Bank of Canada most recently provided other major central banks with an example of perhaps what not to do. Its rate hike pause early this year lasted for just two policy meetings until an uptick in inflation and economic activity spurred policymakers back into action with another rate hike in June.

MIDYEAR OUTLOOK FOCUS

The “year of the bond” hasn’t been much of a year at all

Inflation seen returning to near target levels by early 2024



Note: Dashed lines show RBC Capital Markets quarterly forecasts.

Source - RBC Wealth Management, Bloomberg

But as it is clear to us that the worst of the post-pandemic inflation breakout is almost certainly in the rearview mirror, the question now is how long it will take to fall all the way back to target levels. RBC Capital Markets expects that most major economies will see inflation back toward more normal levels by early 2024, which we think should keep any potential central bank rate cuts at bay until roughly the same time.

Performance recap & outlook

While the total returns delivered by bonds this year have been middling at best, just +2.0% for the Bloomberg Global-Aggregate Bond Index, and +2.4% for the Bloomberg US Aggregate Bond Index, we continue to expect steady performance.

In the U.S., we have dialed back our return expectations somewhat from high single digits to something in the 4% to 6% range as we see bonds as likely to deliver little more than the coupons paid for the year. This is largely a function of the anticipated first rate cuts from the Fed being pushed back to Q1 of 2024 from Q4 of this year previously. At the same time, economic risks have perhaps eased as markets are once again pricing in a soft landing for the U.S. economy.

As the table below shows, RBC Capital Markets projects the 10-year Treasury yield—which is sensitive to economic growth and inflation expectations—to end this year relatively unchanged from current levels at 3.60%. RBC Capital Markets previously forecast a year-end level of just 3.2%, but as recession risks have faded, so too, in our opinion, have the downside potential for longer-term bond yields and chances of a “flight to safety” in bonds were a deep recession to materialize.

Year-end forecasts for key policy rates and sovereign yield levels

	United States			Europe			United Kingdom			Canada		
	Fed policy rate	2Y	10Y	ECB policy rate	2Y	10Y	BoE policy rate	2Y	10Y	BoC policy rate	2Y	10Y
Current	5.25%	4.70%	3.74%	3.50%	3.09%	2.40%	5.00%	4.92%	4.33%	4.75%	4.58%	3.34%
Year-end forecast	5.50%	4.15%	3.60%	4.00%	3.05%	2.55%	5.50%	3.50%	3.65%	5.00%	4.15%	3.00%

Note: Europe sovereign yields reflect German Bund yields and forecasts.

Source - RBC Capital Markets, Bloomberg; data as of 6/23/23

MIDYEAR OUTLOOK FOCUS

The “year of the bond” hasn’t been much of a year at all

Globally it’s a similar story for all major economies except the UK. Inflation there has proved more persistent, which has fueled further rate hike expectations to a peak of 5.50%, with more upside risk to that number, based on RBC Capital Markets’ forecasts. But as the Bank of England is forced to do more with respect to rate hikes, we believe that increases the risks of a policy mistake and the economic jeopardy as a result.

A longer investment window

But for bond investors who don’t often worry about total-return potential but rather the income provided by their capital allocations to bonds—the outlook could hardly be better, in our view.

For much of the past year, the market’s primary concern has been with respect to central bank terminal policy rates—or the peak levels that would be needed to tame inflation. But as the end of rate hike cycles comes further into focus, the debate is shifting to how long policy rates will need to remain at elevated levels to keep inflation from surging back.

The Bloomberg Global-Aggregate Bond Index now yields 3.8%, well above its 20-year average of 2.5% and the highest since 2007 when it peaked at 4.8%. In fact, investors have only been able to invest at yields greater than current levels 15% of the time since 2003.

The Fed recently achieved its goal of convincing markets that rate cuts aren’t on the table this year. In May, markets had priced in nearly five 25 basis point rate cuts this year; following recent Fed decisions and communications, markets no longer expect any.

But the upside for investors of a drawn-out inflation fight by central banks is that the window to put money to work at elevated yields will likely be extended.

While we think central banks will take a more cautious approach going forward after a year of brute force, bond investors are in a unique—and privileged—position. Bond yields have rarely appeared more attractive, in our view, while at the same time they should provide strong capital appreciation potential for portfolios should bond prices rally if and when central banks pivot back toward rate cuts as economic growth and inflation eventually cool.

U.S. RECESSION Scorecard

On the path to a U.S. recession

There have been no changes to the Recession Scorecard in the past month. Three of the seven indicators remain in the negative red column, meaning each has passed a threshold value beyond which, historically, a recession typically has arrived within a measurable time horizon. Two others were recently moved into the cautionary yellow column because they were close to giving an outright negative signal and seemed likely to do so within a few months. The last two indicators, still rated green, continue to suggest there is some way further to go in the economic expansion—but it should be noted that both are less decidedly positive than they were a month ago.

Those indicators that have flipped to recessionary status so far point toward a recession getting underway by late Q2 or in Q3 2023, in our view.

It is worth remembering that the official start date of any recession may not be announced until many months or quarters after the fact.

Yield curve (10-year to 1-year Treasuries)

The 1-year Treasury yield rose above the 10-year yield decisively last July, and the negative gap has widened

over the past 11 months. **The history of this indicator after crossing into negative territory suggested the U.S. economy would be in recession by summer 2023.**

Adding weight to the “tight money” message coming from the yield curve, the Fed’s most recent Senior Loan Officer Survey (released in May) further extended the year-long trend of a majority of U.S. banks raising lending standards on almost every category of business and consumer loan.

The same survey also revealed that a majority of banks are reporting reduced demand for commercial and industrial loans, as well as a reduced willingness to make such loans. A growing majority are also requiring higher credit scores for consumer loans and larger down payments for car loans.

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

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

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. That being said, **this measure has never before reached its current depth 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. The latest reading, for April, indicated a further deepening of its negative message. Its past record strongly suggests a U.S. recession will be underway sometime in Q2 or Q3 2023.

Unemployment claims

The monthly low for this cycle occurred in September. 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 this fall.**

Claims have recently bumped up well above that September low, suggesting the smoothed trend may indeed be reversing from down to up. The fact that both temporary employment and job openings are falling on a year-over-year basis adds to the likelihood that the tide is turning for unemployment claims. While we wait either for that shift to be confirmed or for claims to subside once again, this ambiguity warranted shifting the indicator's status to yellow back in April.

Unemployment rate

The unemployment rate posted its biggest monthly increase of this economic cycle in May, after revisiting January's five-decade low in April. Despite a robust 330,000 jobs added in the May payrolls report, unemployment (measured by the Bureau of Labor Statistics' household survey) surged to 3.7% from 3.4% the previous month. A move above 4.0% in the next couple of 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 reading 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, as has a recession. This number dipped slightly in Q4 2022 but remained elevated, and still appears some way from giving a negative signal. The Q2 reading will be released in early September.

Fed funds rate vs. nominal GDP growth

The federal funds rate has risen above the six-month annualized run rate of nominal GDP either before or at the very start of every recession in the last 70 years. (Nominal GDP is GDP not adjusted for inflation.) That run rate has been declining since its reopening high of 23% in Q4 2020. By the end of last year it had slowed to 7.2% but was still well above the federal funds rate, which at the time had risen to 4%. Now the fed funds rate is up to 5.25% and Q1 GDP data shows the six-month run rate of

U.S. RECESSION SCORECARD

nominal GDP growth slowing to just 6.0%. We expect nominal GDP to slow further, and by Q2 or Q3 of this year will likely fall to or below 5%, meeting that historical precondition of recession.

Given that the gap between the fed funds rate and the economic growth rate has narrowed to such a degree, and our view that a negative crossing point likely will be reached within the next few months, we shifted this indicator from green to yellow back in April.

Bottom line

Weighing up the current positioning of all seven indicators, and projecting their likely paths over the next couple of quarters, continues to point to a growing probability the U.S. will enter a recession sometime late in the first half or in Q3 of 2023, in our view.

REGIONAL Equity

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United States

■ The U.S. equity market’s ability to hold its recently achieved outsized gains and, better yet, build on them during the second half of the year will largely depend on whether the economy succumbs to recession, in our view.

■ Despite the Fed’s aggressive interest rate hikes, economic data and earnings growth have been relatively sturdy thus far in 2023, which helped push the S&P 500 higher by 13.3% on a year-to-date basis through late June. However, our [leading economic indicators](#) continue to point to heightened recession risks. If a recession materializes in the months ahead, we think corporate earnings would stumble and [earnings estimates would come down](#). The consensus forecast is for S&P 500 earnings of \$220 per share in 2023, slightly ahead of last year, and for \$246 per share in 2024. To us, the market’s above-average 18.8x 12-month forward price-to-earnings valuation seems like it is baking in a lot of good news—an economic soft landing, continued declines in

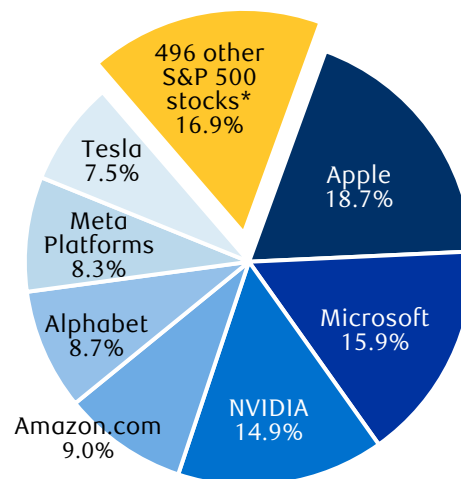
inflation, the Fed pivoting to rate cuts later this year, and strong earnings growth in 2024—leaving little wiggle room for disappointments.

■ The knock on the market’s recent rally is that it has been unusually imbalanced and narrow. Stocks leveraged to earnings growth prospects associated with the artificial intelligence theme have done an overwhelming proportion of the heavy lifting, representing roughly 83% of the year-to-date gains, as the chart illustrates. A study by RBC Capital Markets found that performance following similarly imbalanced periods since 1990 did not have a consistent pattern—sometimes the market rallied and at other times it sold off. Here again, for this cycle, we think performance will hinge on whether a recession unfolds, causing earnings to retreat.

■ We recommend maintaining Market Weight exposure to U.S. equities, an allocation that attempts to balance the heightened economic risks against the typical opportunities associated with a Fed policy shift. At this stage, we would tilt portfolios

“Big 7” stocks represent the overwhelming proportion of returns so far in 2023

Proportion of year-to-date returns within the S&P 500 including dividends, by Big 7 stocks versus the other 496 stocks*



The S&P 500’s YTD total return is 14.2%. Apple represents 18.7% of that return, Microsoft 15.9%, and so forth. The Big 7 collectively represents 83.1% of the index’s total return.

* There are currently 503 stocks in the S&P 500 Index

Source - RBC Wealth Management, FactSet; data through 6/23/23

REGIONAL EQUITY

Equity views

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

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

slightly toward defensive sectors and dividend growers.

Canada

■ Resilient remains a good descriptor of Canadian economic activity as Q1 gross domestic product growth came in ahead of consensus expectations, while Q2 growth is looking solid thus far. However, despite these stronger-than-expected growth metrics, we remain cautious on the outlook as the full impact of central bank tightening has yet to be fully felt across the economy and our forward-looking indicators continue to suggest a recession is on the horizon.

■ We remain ever mindful that the Canadian economy is particularly sensitive to higher rates given elevated household leverage and a high proportion of economic activity tied to housing. Following a turbulent year for the Canadian housing market, conditions appear to have stabilized over recent months with sales activity and prices trending higher. However, the recent restart of Bank of Canada interest rate increases should further deteriorate already stretched affordability and potentially stem the housing recovery before it gains further steam.

■ Canadian banks are trading at historically discounted valuations, which we believe offers reasonable compensation for an earnings outlook that is clouded by multiple headwinds including slowing loan growth, contracting margins, regulatory pressures, and the potential for higher credit losses. While it is hard to 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 discover opportunities.

■ Global recession concerns continue to weigh on energy prices as the near-term outlook for oil demand remains cloudy. However, we remain constructive on the energy complex as we believe oil supply tightness points to higher prices through the

cycle. In conjunction with the solid free cash flow generation profiles and, in our view, favourable capital allocation decisions (increasing dividends, share repurchases, debt reduction) of the Canadian oil majors, we would maintain an allocation to the industry.

Continental Europe

■ The eurozone is in a technical recession as GDP contracted by 0.1% in two consecutive quarters (Q4 2022 and Q1 2023). Q2 2023 is off to a slow start. Economic activity in service sectors is holding up well, but it is not enough to offset the manufacturing slump.

■ Yet, one should not be too pessimistic about the situation. Remarkably, unemployment at 6.5% is the lowest level in more than 20 years. Moreover, fiscal stimulus, while much less generous than in recent years, will still underpin the economy. Consensus expectations are for growth of 0.6% this year, according to Bloomberg.

■ As activity levels deteriorated, the MSCI Europe ex UK Index gave back some of its outperformance accumulated between August 2022 and March 2023. Despite valuations which are again inexpensive relative to the U.S., we continue to suggest an Underweight position in the region that has historically underperformed when global activity levels weaken.

■ Yet, we believe there are compelling opportunities for investors. A popular narrative is that Europe has a low exposure to the Technology sector and is thus at a disadvantage, particularly now given the buzz around generative artificial intelligence (GAI). While it is true that European indexes have a substantially lower weighting in Tech, there are opportunities connected to the infrastructure build required for GAI. We believe leading semiconductor equipment manufacturers are particularly well-positioned, as are select electrical equipment providers reflecting that

REGIONAL EQUITY

datacenters will have higher power and cooling requirements, and a stronger need for smarter power management systems.

- We continue to like luxury stocks that combine strong growth, brand and operational momentum, and reasonable valuations. We see potential for higher dispersion in share price performance within the sector, however, given the bumpy China recovery.

- Finally, we remain positive on the long-term prospects for several European Industrials stocks that we believe are well-placed to benefit from capital expenditure connected to decarbonization, automation, and onshoring trends.

United Kingdom

- In the UK, with the current Conservative government struggling in the polls, attention is turning to the next election due by January 2025 but widely expected to be held next year.

- The Labour Party will likely focus on the message to “make Brexit work,” possibly striving to eventually remove trade frictions. It is also targeting a much greater role for renewables, pledging to eradicate barriers currently in the way of green projects.

- Should it win the next election, Labour will inherit a country with deep scars, not only from Brexit

but also from the Bank of England’s fastest tightening spree in three decades.

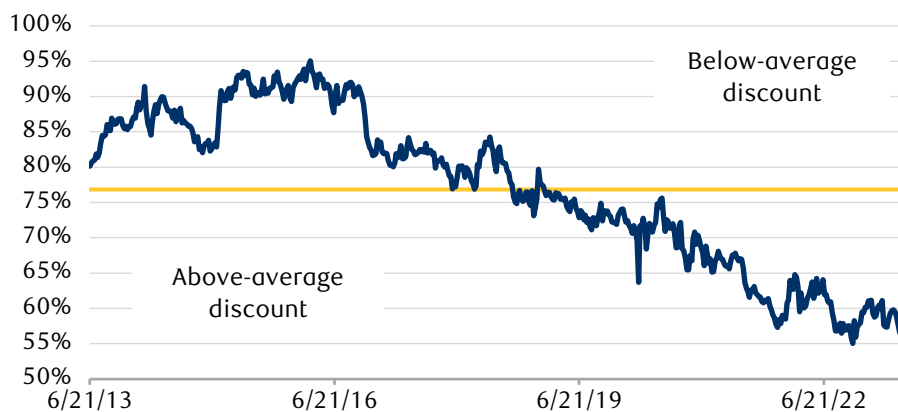
- We maintain our Underweight recommendation for UK equities, but we acknowledge there are opportunities despite the projection for a subdued domestic economic outlook. Most companies in the FTSE 100 derive the bulk of their revenues (close to 80%) outside the UK. We note the attractive valuations of the wider index, the FTSE All-Share, at just under 10x forward consensus earnings estimates, an “abnormal discount” according to our national research correspondent. Dividends are attractive, with a yield of more than 4%, and are well covered. Historically, this index has performed relatively well when global activity levels wane, as we expect will be the case in the second half of the year.

- Furthermore, the pound peaking should remove a headwind. The currency, which moved to 1.27 now from 1.06 at the height of former Prime Minister Liz Truss’s troubles, acted as a headwind to equities. The pound should stabilize going forward given consensus interest rate hike expectations are already aggressive and UK fundamentals are weak.

- We maintain our bias to defensive, quality international revenue generators which trade at a steep discount to international peers.

The FTSE All-Share Index discount to the S&P 500 is unduly high

UK vs. U.S. equities relative 12-month forward P/E



Source - RBC Wealth Management, Bloomberg; data through 6/21/23

REGIONAL EQUITY

- Our preferred defensive sector remains Health Care, although Consumer Staples is becoming more appealing given cheaper valuations after a period of underperformance and given the prospect of better margins in the second half of the year.

- China surprising markets by unveiling a larger-than-anticipated stimulus package geared toward infrastructure would be positive for UK equities, in our opinion, as commodities constitute almost 20% of the FTSE All-Share Index.

Asia-Pacific

- Japan's equity market has been one of the better-performing developed markets year to date, in local currency terms. We believe the recent share price gains have been driven by the end of the deflation era; companies' higher return on equity (ROE) and ability to expand shareholder returns; relative attractiveness of Japanese stocks amid a consensus for coming recessions in the U.S. and Europe; heightened interest as a proxy investment for Chinese stocks; heightened interest as the type of investment advocated by Warren Buffett; and relatively easy monetary policy.

- Going forward, we expect greater foreign interest to be another support for the equity market. We remain positive on Japanese equities as domestic demand should remain strong; Chinese tourists are likely to return; Tokyo Stock Exchange restructuring should drive higher ROE; and valuations still seem undemanding as the market's forward price-to-earnings ratio is below its 20-year average. While we think Japanese equities would face headwinds in H2 2023 if the global economy were to enter a recession, given the positive structural changes underway, we think any such share price declines would likely be relatively small. Japan remains our preferred developed market in Asia.

- For Chinese equities, we believe the status of the economic recovery, stimulus, and geopolitics will be the key drivers of the market. RBC Global Asset Management Inc. Chief Economist Eric Lascelles pointed out that there may be "too much pessimism about the Chinese economic outlook." He still expects a moderate economic recovery and 5%-plus economic growth for China in 2023. The country has plenty of room to deliver monetary and/or fiscal stimulus given the low inflation environment. However, we get the sense that market participants think the recent easing measures, such as the policy rate cut, are not enough. We believe the timing and magnitude of stimulus are important. The government needs to show its commitment to support the economy as soon as possible, in our assessment. U.S.-China relations are showing some signs of stabilization following U.S. Secretary of State Antony Blinken's recent visit to China.

- Before seeing material improvement of the three key drivers noted above, Chinese equities are likely to remain range-bound. But we believe the market still provides opportunities in terms of sectors and individual stocks. We favour owning some defensive and high-dividend-yield stocks for downside protection and income. We would also hold some short-term trading positions in higher-beta stocks (i.e., those that are more volatile than the broader market), such as quality Chinese tech names, to take advantage of potential market volatility.

REGIONAL Fixed income

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■ The Federal Reserve “skipped” its first rate hike in over a year at its June meeting, but its updated rate projections suggest more rate hikes remain in the pipeline than markets had expected. While Fed policymakers see rates ultimately achieving a 5.75% level before hikes are paused, we expect a lower 5.50% endpoint by either the July or September meeting.

■ We think the next battle between markets and the Fed will be over the timing of the first rate cut. The Fed has strongly maintained that cuts are not on the table this year, but the Fed is also now truly “data dependent.” If the economy stays resilient and inflation progress slows, then rate cuts should be a 2024 event. But markets have been oscillating around the idea that cooler economic activity and inflation could spur the Fed to deliver one or two “insurance” rate cuts later in 2023.

■ Credit markets continue to trade as though any recession (if there is one) on the horizon will be mild. The average yield advantage over Treasuries to compensate for default risks sits at just 1.3% for investment-grade bonds; historically that number is greater than 2.0% when recession risks are material. Given that, we maintain a slight preference for government debt over

corporate debt based on valuations and the countercyclical benefits of government debt should recession fears come roaring back. Preferred shares have lagged this year following the bank collapses in March and April, but the sector continues to claw its way back, and we still see value in the space.

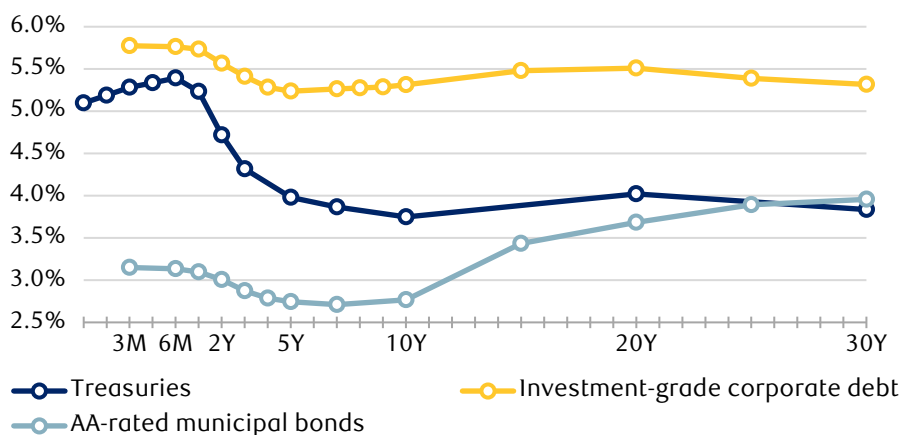
■ Municipal bond valuations remain rich with yields at historically low levels relative to Treasury yields as the demand for bonds far outstrips the new supply in the market. We think investors still need to look beyond 15-year maturities to find value. Short of that option, better opportunities may be found in other sectors of the U.S. bond market for investors in all but the highest tax brackets, in our opinion.

Canada

■ Canadian bonds had a choppy first half of the year, with yields experiencing two periods of rapid decline and two periods of rapid increase. As a result, rates volatility is hovering near levels not seen since the Global Financial Crisis, and this has resulted in greater price moves than investors have been used to over the past 15 years. The heightened volatility reflects the uncertainty that markets must contend with when assessing the future path of monetary policy.

Hunting for value

Yield curves for key U.S. bond sectors



Source - RBC Wealth Management, Bloomberg; data as of 6/21/23

REGIONAL FIXED INCOME

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

■ A high degree of variability in economic data has made it difficult to determine where interest rates will settle. Those who think rate cuts will soon be a reality can point to softening employment data and a rapidly cooling headline inflation number. However, those who believe more hikes are on the way would counter that the core component of inflation remains above the Bank of Canada's (BoC) target, and unemployment levels remain near record lows even as job creation slows. Complicating the question further is the fact that tighter monetary policy works through the economy with a considerable lag, meaning the BoC must be wary of overtightening.

■ Despite elevated economic uncertainty and the high-profile failures of a number of U.S. regional banks, Canadian economic data were strong enough in the second quarter for Governor Tiff Macklem and the rest of the BoC's governing council to hike rates again in early June, helping to push bond yields close to a 15-year high.

■ Our view is that markets continue to underestimate the underlying strength of core and services inflation, and that a resilient Canadian economy will require more time with higher rates than forward rate expectations are currently expressing. As a result, we prefer to maintain a modestly short duration bias. Nonetheless, we see bond yields as broadly attractive in historical perspective, and higher starting yields provide some cushion against further rate increases. We believe investors who have focused on short-term bonds or GICs would be well served by gradually extending duration to mitigate reinvestment risk.

Continental Europe

■ Despite eurozone interest rates now 400 basis points higher than in June 2022, inflation is still "projected to remain too high for too long," according to the European Central

Bank (ECB). The ECB's June staff forecasts included significant upward revisions to core inflation (excluding food and energy) and, notably, above the central bank's target level at 2.3% y/y in 2025.

■ This, together with ECB President Christine Lagarde's statement that a July rate hike is "very likely," leads us to adjust our peak policy expectations to 4% from 3.75%. Beyond its September meetings, the ECB could decide to forego an October increase in order to evaluate the effects of its monetary policy, resuming hikes later if inflation remains sticky. This is not our base case, but it presents an upside risk to our 4% terminal rate estimate.

■ The ECB is trimming its balance sheet through a process known as quantitative tightening (QT); we view the pace as moderate and unlikely to disrupt the market. We are neutral on sovereign debt and multinational bonds, with a preference for issuances from France, Spain, and the EU that are trading at spread ranges we view as compelling relative to German Bunds.

■ In corporate credit, the ECB still holds around 34% of the €1.13 trillion eligible credit bond universe. We note that supply in the first half of the year has been the second-heaviest on record. Therefore, we think that net supply in the second half of the year, even after QT, may be fairly low based on average annual supply for previous years. This reduces the risk of spreads materially widening, in our view.

■ Having recovered from the March banking sector rout, corporate spreads are near their 12-month lows. Even so, banking sector spreads remain elevated. We view this as an opportunity to allocate to senior-ranking bonds from well-capitalised banks that are trading at compelling yields, in our opinion, relative to other senior-ranking non-financial bonds.

■ Corporate credit default rates remain low, but tighter financing conditions and the possibility of a

REGIONAL FIXED INCOME

global economic slowdown leave high-yield spreads more exposed to widening in the second half of the year. Therefore, on a risk-reward basis, at current yield levels we maintain our preference for higher quality investment-grade bonds over high-yield bonds.

United Kingdom

■ The Bank of England (BoE) appears to be in a no-win situation: the data are strongly in favour of more rate hikes, but there is an increased risk of breaking something along the way. The BoE's May Monetary Policy Report (MPR) identified three areas that would determine its future moves: services inflation, private sector pay, and labour market tightness. With all three above expectations, the central bank has little choice but to raise rates. After a shock 50 basis point hike, we are therefore revising our terminal rate expectation to 5.50%–5.75% from 5.25%, but with upside risk if signs of services inflation persist. Market expectations are much higher, at 6.125%.

■ A possible limiting factor for the Monetary Policy Committee is the sensitivity of the UK housing market to higher interest rates. According to the BoE, around 57% of mortgages due for renewal in 2023 were fixed at an interest rate below 2%; this affects around 1.3 million households.

■ Ten-year UK government debt trading near the October 2022 peak levels of 4.5% and in oversold territory has been an opportunity to allocate to Gilts, in our view. But we maintain a neutral position and have stopped short of turning Overweight for now due to uncertainty concerning the central bank's terminal rate and recent upside surprises in inflation. That being said, yields could trend lower after the recent selloff, and accordingly we would shift to an Overweight position if we continued to see yields trading near the peaks in H1.

■ Given the sensitivity of corporate yields to government bond yields, we are cautious on adding meaningful duration in credit. However, the BoE has nearly exhausted its balance of corporate bonds through active sales (quantitative tightening). As a result, excess supply risk is now in the rear view mirror, and this should limit spread widening in the near term. When looking at the yield compensation for interest rate risks, we see an opportunity in bonds that are trading well above their historic averages. Similar to European credit, we see also opportunities in senior-ranking bonds from banks with robust balance sheets.

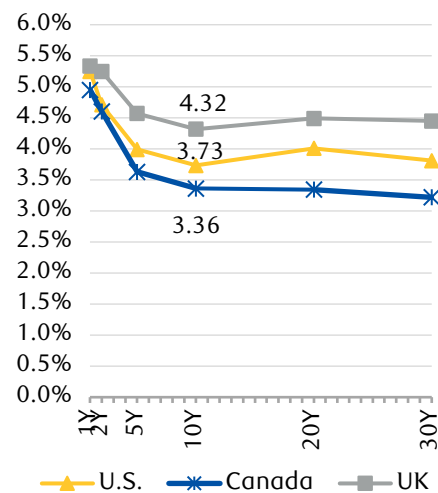
Asia-Pacific

■ Emerging market bond funds experienced outflows for the past four months. Given the highly uncertain macro backdrop, we do not expect bond fund inflows to pick up materially in the near term although they could improve later in the year if the Federal Reserve pauses and on potential further policy easing in China.

■ However, Asia credit performance in H1 2023 has been constructive, despite the market turbulence. The Asia (ex-Japan) USD bond market posted 3.1% total returns, thanks to the compression of Asia credit spreads and U.S. Treasury yields. Another catalyst for this outperformance is the subdued bond issuance in the Asian market so far this year, driven by an uncertain economic outlook and considerable pre-funding in the past two years when yields were low.

■ We think Asia credit remains attractive in total-return terms, backed by robust yield levels which are near the 10-year high. This is creating a strong buffer against market volatility, and we think Asia credit will continue to post positive total returns in the second half of the year. However, we believe this will be driven by further compression of the U.S. Treasury yields rather than spread tightening.

Sovereign yield curves



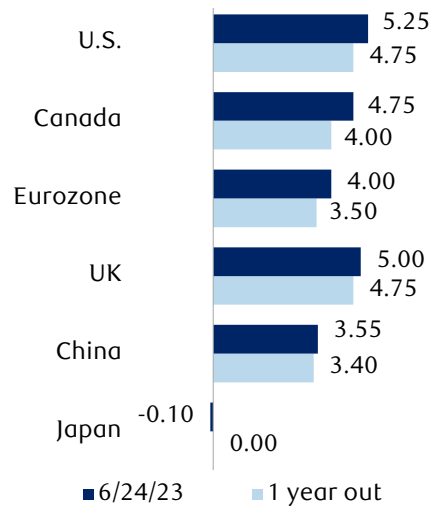
Source - Bloomberg; data through 6/23/23

■ We prefer investment-grade bonds over high-yield bonds in the Asian space, as higher-quality bonds remain in demand due to limited new issuance, whereas demand for lower-quality bonds remains weak. We expect this to persist for the rest of 2023 and prefer positioning in the higher-quality bond space.

■ In China, the post-COVID recovery has been losing steam. Initial optimism around the property sector is fading as growth in property sales for the top 100 Chinese property developers reversed to a fall of 21% y/y in May from a gain of 11% y/y in April. We continue to see challenges for property developers trying to regain access to bond markets. While the government might roll out more support measures for the sector, they might not be sufficient to spark a sustained rebound in property developer bonds.

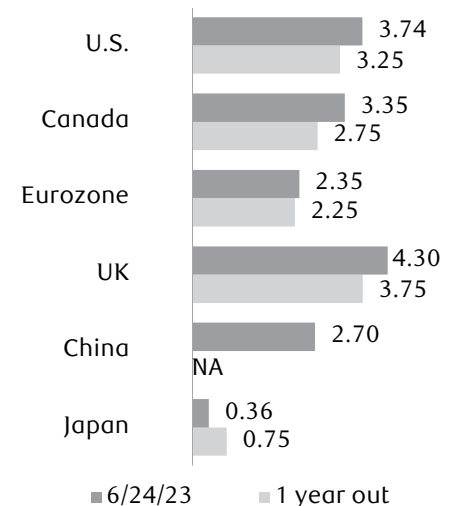
■ Outside China, we see opportunities in investment-grade bonds from Japan and Australia, as the inclusion of the two countries in the soon-to-be-launched JACI Asia Pacific Index should increase demand for Japanese and Australian credits, in our view.

Central bank rate (%)



Source - RBC Investment Strategy Committee, RBC Capital Markets forecasts, Global Portfolio Advisory Committee, RBC Global Asset Management

10-year rate (%)



Note: Eurozone utilizes German Bunds.
 Source - RBC Investment Strategy Committee, Global Portfolio Advisory Committee, RBC Global Asset Management

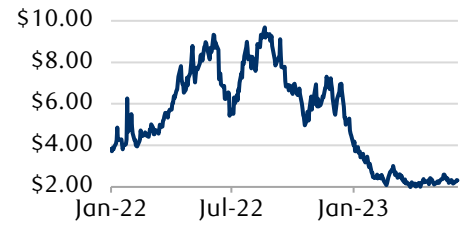
Commodities

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Natural gas: Floor

Natural gas prices are down approximately 50% YTD driven in part by growing production, higher inventories, and muted consumption expectations. Elevated storage likely remains an overhang until LNG export capacity increases next year. However, RBC Capital Markets believes a floor was reached this year and is forecasting an average price of roughly \$3.00/MMBtu in H2 2023.



Crude oil: Disconnect

On paper, global supply/demand balances have remained tight for months and are expected to tighten further in the second half of the year according to RBC Capital Markets. However, crude's year-to-date underperformance suggests there is likely more slack in the physical market than reported inventories are revealing. RBC Capital Markets is projecting higher crude prices through the end of the year as controlled supplies eventually clear the market.



Copper: Overhang

Looking ahead through the back half of the year, we expect the slowing economic environment and excess global inventories will weigh on copper prices. In particular, demand stemming from manufacturing and construction has started to falter and presents downside risk to consumption forecasts, in our view. Until we see improving macroeconomic data, we believe these overhangs will dominate sentiment.



Gold: Sensitive

Gold prices have been pushed higher year to date driven by the combination of increased net purchases from central banks and defensive positioning amongst investors. All else equal, higher real rates should act as a headwind for gold, but RBC Capital Markets believes gold could linger around its high scenario target of \$2012/oz through year end and will likely remain sensitive to key economic releases.



Commodity forecasts

Commodity	2023E	2024E
Oil (WTI \$/bbl)	\$84.45	\$90.12
Natural gas (\$/mmBtu)	\$2.67	\$3.75
Gold (\$/oz)	\$1807	\$1777
Copper (\$/lb)	\$4.00	\$4.00
Soybeans (\$/bu)	\$13.83	\$13.20
Wheat (\$/bu)	\$6.89	\$7.25

Source - RBC Capital Markets forecasts (oil, natural gas, gold, and copper), Bloomberg consensus forecasts (soybeans and wheat); data as of 6/13/23

Soybeans: Challenging

In our view, the year-to-date pullback in soybean prices is attributable to softer economic data stemming from the Chinese economy. Consensus estimates are calling for China's real GDP to contract to approximately 1.1% by Q4 2023 from 2.2% in Q1 2023. China accounts for roughly 60% of global imports. Therefore, near-term upside will likely remain constrained until the outlook for Chinese consumption improves.



Wheat: Tight

Looking into the 2023–2024 season, the USDA expects global production to come in at approximately 790 million metric tons, relatively in line with the estimate for global consumption. However, tight stocks among major exporters are expected to lead to the lowest ending inventories since 2008–2009 on an ex-China basis. Thus, we see support at current price levels with modest upside through the remainder of the year.



Chart source - RBC Wealth Management, Bloomberg; date range: 1/1/22–6/8/23

Currencies

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Currency forecasts

Currency pair	Current rate	Forecast June 2024	Change
Major currencies			
USD Index	102.90	104.53	2%
CAD/USD	0.75	0.74	-1%
USD/CAD	1.31	1.35	3%
EUR/USD	1.08	1.07	-1%
GBP/USD	1.27	1.19	-6%
USD/CHF	0.89	0.89	0%
USD/JPY	143.70	139.0	-3%
AUD/USD	0.66	0.64	-3%
NZD/USD	0.61	0.62	2%
EUR/JPY	156.66	149.0	-5%
EUR/GBP	0.85	0.90	6%
EUR/CHF	0.97	0.95	-2%
Emerging currencies			
USD/CNY	7.17	7.05	-2%
USD/INR	82.03	81.20	-1%
USD/SGD	1.35	1.33	-1%

Change is defined as the implied appreciation or depreciation of the first currency in the pair quote. Examples of how to interpret currency data can be found in the Market Scorecard.

Source - RBC Capital Markets forecasts, Bloomberg; data as of 6/26/23

U.S. dollar: Mild gains in H2

The U.S. Dollar Index (DXY) recovered in May on firmer U.S. economic data and an upward repricing in Treasury bond yields as worries over banking stress receded. RBC Capital Markets maintains a mild bias toward dollar gains in H2 but expects a wide range on the DXY, similar to what happened in H1. Its base case is for a delayed U.S. recession, which could potentially support the greenback as U.S. interest rates could stay higher for longer, while growth momentum is expected to fade in other parts of the world, notably in Europe and China.

Euro: Stuck in sideways trading

The EUR/USD has traded in a 1.05–1.11 range so far in 2023, and we expect similar ranges to hold throughout the summer. We believe the European Central Bank will likely hike interest rates to 3.75% in July and remain on hold for the rest of the year, similar to the Fed. While higher rates should support the euro, economic growth in H2 could be more downbeat, as evidenced by recent Purchasing Managers' Index readings, and could potentially cap any rallies in the euro.

Canadian dollar: High hurdle for more gains

The USD/CAD level is near the lowest of this year's 1.3200–1.3860 range, with the Canadian dollar outperforming following a surprise rate hike by the

Bank of Canada (BoC) in June. With investors already pricing in about 30 basis points of additional rate hikes from the BoC, the hurdle is high for further loonie gains in H2, in our opinion.

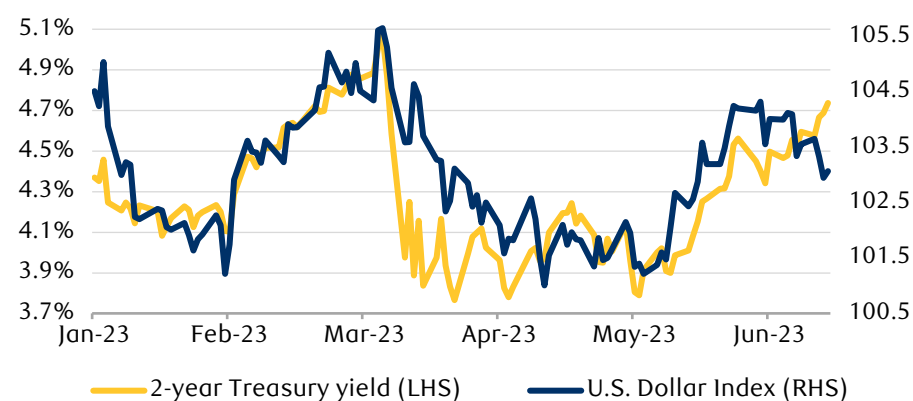
British pound: Staying bearish despite outperformance

The British pound is the top performer among G10 currencies in 2023 so far as it has recovered from year-earlier depressed levels. Strong labour market data in the UK have led investors to expect Bank of England (BoE) policy rates to peak at about 6% by end-2023. We retain a bearish view on the currency as we think the BoE will not be aggressive on interest rate hikes due to households' vulnerability to higher mortgage rates, with RBC Capital Markets expecting policy rates to peak at 5.5%.

Japanese yen: Weaker on yield differentials

The yen rose to 130 against the dollar during the banking stress in March, but the USD/JPY pair has gradually recovered and touched 141 shortly after the Fed's policy meeting in June. RBC Capital Markets has revised its USD/JPY target higher to 145, expecting interest rate differentials between the U.S. and Japan to drive a weaker yen, even if the Bank of Japan ends its yield curve control policy in H2.

Will the dollar's rebound continue in H2 2023?



Source - RBC Wealth Management, Bloomberg; data through 6/15/23

Research resources

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As of March 31, 2023

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

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