RBC Dominion Securities Inc.

Volume 31 | July 2023

Scott Sandler
Senior Portfolio Manager
scott.sandler@rbc.com
416-842-6684

Ronan Clohissey, CIM
Senior Portfolio Manager
ronan.clohissey@rbc.com
416-842-6683

Michelle Noel-Smith
Associate Advisor
michelle.noelsmith@rbc.com
416-842-8675

Brendan Hollis, CFA
Associate Investment Advisor
brendan.hollis@rbc.com
416-842-8673

Steve James
Associate
steve.james@rbc.com
416-842-8674

Gary Tsang, MBA, CFA
Associate Advisor
gary.h.tsang@rbc.com
416-842-8672

Joshua Orr
Associate
joshua.orr@rbc.com
416-842-8676

Alisa Christian
Administrative Assistant
alisa.christian@rbc.com
416-842-6677

Please visit us at:
www.SandlerWealth.ca

"It's tough to make predictions, especially about the future" – Yogi Berra

KEY INSIGHTS

- Inflation in Canada and US falls to a manageable level
- An end to rate hikes approaches as central bank policy takes effect
- Equities positive year to day with broad market participation starting to emerge
- Higher rates welcomed by savers as risk free yields exceed 5%
- The path forward remains uncertain with a wide range of outcome to navigate

The most talked about and anticipated recession of all time continues to be a likelihood but has proved elusive so far. Inflation has declined to manageable levels and in doing so, should signal that we are nearing the end of interest rate increases. Equity markets were positive for the first half; the TSX and Dow up a little under 4% each and the tech dominated S&P500 is up over 15%! On the back of a resilient corporate earnings outlook, major indices have continued to climb in July with broader participation beyond the tech giants.

Is current investor optimism the start of a new bull market, or the last leg of a rally that began last October at the lows? The economy will likely set the market's path and many key indicators point to recession; RBC remains in that camp, but the trend is moving away from recession and towards soft landing. The Wall Street Journal's survey of 69 business and academic economists showed them cutting the consensus probability of a downturn over the next 12 months to 54% from 61%. In a poll of 143 CEOs conducted by Fortune-Deloitte, only 38% said they had a pessimistic outlook for the global economy for the next 12 months, down from 76% last October. In a separate poll, JPMorgan showed only 45% of midsize business leaders expected a recession before year-end, down from 65% six months ago.

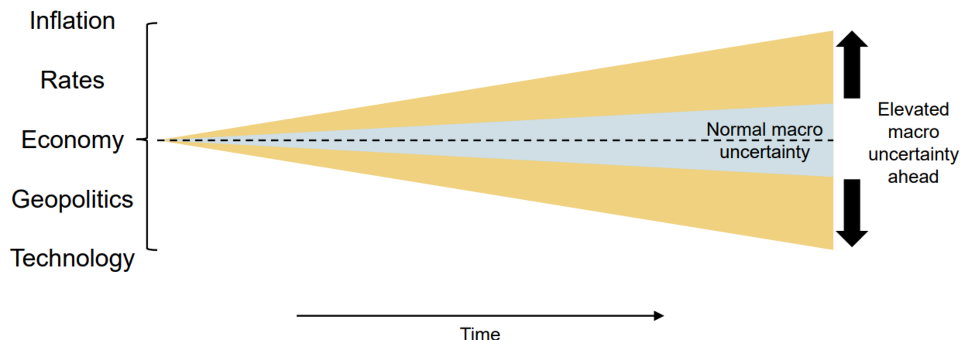


***Figure 1**: Rising macro uncertainty over time (Source: RBC)*

Quarterly Review

Q2 2023

All this to say that the jury is still out and is likely to remain that way for the rest of the summer (see *Figure 1*). As always, there are a range of outcomes for the markets and economy, and it is our job to navigate the uncertainty. Positioning a portfolio for one particular outcome is not dissimilar to timing the market and is fraught with risk. Staying the course and adhering to an appropriate asset allocation, a diverse basket of equities and a laddered range of bond maturities will deliver more predictable long-term returns with lower volatility.

At such a time of elevated uncertainty, it's important to step back and take a look at the bigger picture. The article that follows from our Global Portfolio Advisory Committee echoes our thoughts and does so more efficiently than we likely can. Following that we include the latest sobering thoughts from Chief Strategist Jim Allworth. Jim remains in the recession camp and advises that while this market has room to run (he wrote the article a month ago and has been right so far), investors should be upgrading the quality of their portfolios. To him this means "companies that an investor would be content to own through a recession…….high-quality businesses with resilient balance sheets, sustainable dividends, and business models that are not intensely sensitive to the economic cycle." We agree with Jim's investment selection criteria in theory and in practice!

Scott Sandler
Senior Portfolio Manager

Ronan Clohissey, CIM
Senior Portfolio Manager

	Q1	1 Year
Indices		
S&P/TSX	3.69%	-8.18%
Dow Jones	0.38%	-4.05%
S&P 500	7.03%	-9.29%
Nasdaq	16.77%	-14.05%
Euro Stoxx	13.74%	10.57%
Japan Nikkei	-2.61%	0.79%
India Sensex	-3.04%	0.72%
VIX (Volatility)	-13.71%	-9.05%
Commodities		
Gold	7.96%	1.64%
Silver	0.60%	-2.80%
Copper	7.64%	-13.16%
Oil	-5.72%	-24.54%
Natural Gas	-40.34%	-61.75%
Currency		
CAD	0.27%	-7.47%
EUR	1.25%	-2.06%
JPY	-1.31%	-8.40%
AUD	-1.88%	-10.65%
GBP	2.10%	-6.10%

Values as of March 31st, 2023

Wealth Management
Dominion Securities

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The strategies and advice in this report are provided for general guidance. Readers should consult their own Investment Advisor when planning to implement a strategy. Interest rates, market conditions, special offers, tax rulings, and other investment factors are subject to change. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ® / TM Trademark(s) of Royal Bank of Canada. Used under licence. © 2020 RBC Dominion Securities Inc. All rights reserved.

MIDYEAR OUTLOOK
Focus

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

Rallies, recessions, and realistic thinking

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

Key points

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

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

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

Enter the rally

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

MIDYEAR OUTLOOK FOCUS

Rallies, recessions, and realistic thinking

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

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

New bull or last gasp

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

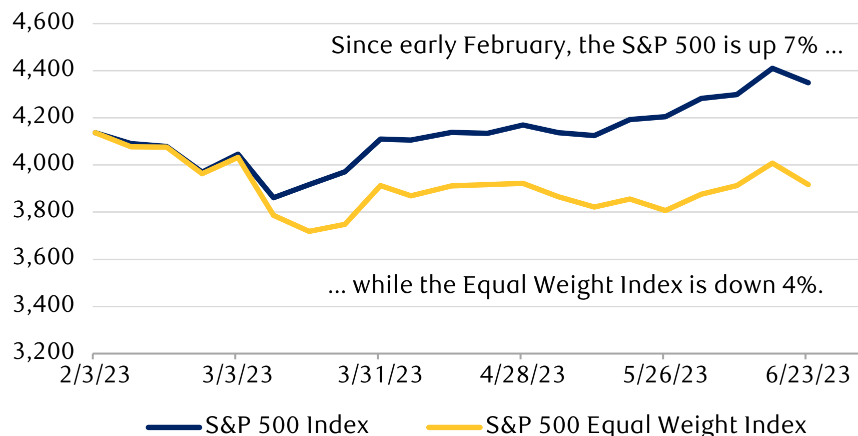
Since then, everything has been turned pretty much topsy-turvy. The U.S. equity market has gone up for nine months instead of down, and the S&P 500 is edging closer to new all-time highs. P/E multiples are back above a rich 20x. And, as noted above, sentiment readings have roared higher, getting closer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

Don't fight the economy

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

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

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



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

MIDYEAR OUTLOOK FOCUS

Rallies, recessions, and realistic thinking

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

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

Only resilient stocks need apply

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

GLOBAL
Insight
WEEKLY

Wealth
Management

Perspectives from the Global Portfolio Advisory Committee

June 29, 2023

A wide-angle lens

The Global Portfolio Advisory Committee

While the equity and fixed income investment environments in coming months will likely be tethered to the U.S. economy's fate, we think a broader perspective is called for. Our Midyear Outlook argues for patience while financial markets work through persistent challenges.

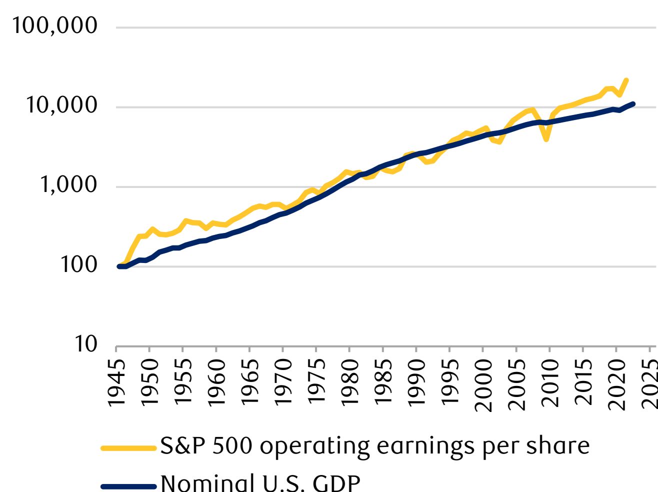
Over the near term, we continue to anticipate that market returns will be largely shaped by whether the U.S. economy succumbs to recession and the related central bank policies. While the long-term outlook still looks bright to us and we don't recommend major changes to portfolio positioning at this stage, we think the lingering uncertainties require more patience from investors and a wider perspective.

Recessions are normally the difficult periods for equity markets, but those periods do not dominate the investment landscape. Since 1945, the U.S. economy was in recession for only 15 percent of the time, meaning that it expanded during the other 85 percent of the time. Looking at the long-term GDP chart, the economic pullbacks associated with recessions are either barely noticeable or not at all visible.

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

Following is a brief summary of the key takeaways from our Global Insight 2023 Midyear Outlook, which provides investment guidance for the next 6–12 months.

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

For perspectives on the week from our regional analysts, please see pages 3–4.

Investment and insurance products offered through RBC Wealth Management are not insured by the FDIC or any other federal government agency, are not deposits or other obligations of, or guaranteed by, a bank or any bank affiliate, and are subject to investment risks, including possible loss of the principal amount invested.

For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

Priced (in USD) as of 6/28/23 market close (unless otherwise stated). Produced: 6/29/23 5:40 pm ET; Disseminated: 6/29/23 5:45 pm ET

Equities: Rallies, recessions, and realistic thinking

The market rally from the September lows has moved far enough to turn many skeptics 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.

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.

Portfolio positioning by market:

- **U.S. –** 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. We would tilt portfolios slightly toward defensive sectors and dividend growers.
- **Canada –** We remain constructive on the energy complex, including the Canadian oil majors, as we think oil supply tightness points to higher prices through the cycle. Despite the multiple headwinds facing Canadian banks, we believe income-oriented investors with a long-term view can discover opportunities.
- **Continental Europe –** We favor leading semiconductor equipment manufacturers, electrical equipment providers that are supplying infrastructure for generative artificial intelligence data centers, luxury stocks, and select European Industrials stocks tied to decarbonization, automation, and onshoring trends.
- **UK –** We maintain our bias toward defensive, quality UK companies that generate a high proportion of revenue internationally and trade at a steep discount to international peers. Our preferred defensive sector remains Health Care, but Consumer Staples is becoming more appealing to us given cheaper valuations.
- **Asia Pacific –** Japan remains our preferred developed market in Asia partly due to positive structural changes underway. Going forward, we expect greater foreign interest to be another support for the equity market. For the Chinese market, we favor owning some defensive and high-dividend-yield stocks for downside protection and income.

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

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 steady gains as rate hike cycles near their end points.

While inflation remains elevated globally, we now have sufficient data in hand to suggest that the tide has indeed turned lower. Central banks will stay on high alert, and we believe a more cautious policy approach should limit economic risks. 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.

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.

In the U.S., we have dialed back our return expectations somewhat from high single digits to something in the four percent to six percent range as we see bonds as likely to deliver little more than the coupons paid for the year.

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.

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. From our vantage point, bond yields have rarely appeared more attractive, while at the same time bonds should provide strong capital appreciation potential for portfolios should prices rally if and when central banks pivot back toward rate cuts as economic growth and inflation eventually cool.

Midyear musings

For more details on the investment views and opportunities, as well as guidance for regional fixed income markets and forecasts for commodities and currencies, please take a look at our complete Global Insight 2023 Midyear Outlook. The individual feature articles are also available separately: “Rallies, recessions, and realistic thinking” and “The ‘year of the bond’ hasn’t been much of a year at all.”