GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee December 8, 2022

The one big thing

The Global Portfolio Advisory Committee

With a U.S. recession looming in the distance, what are the consequences for investors? Our 2023 Outlook examines the issues and opportunities facing markets and asset classes in 2023.

Market overview: We are the hedgehog

"The fox knows many things, but the hedgehog knows one big thing" is an aphorism which argues for the usefulness of thinking one way or the other. Right now, we feel more like the hedgehog ... we know one big thing—the arrival of a U.S. recession in 2023—that should shape the investment landscape over the coming year.

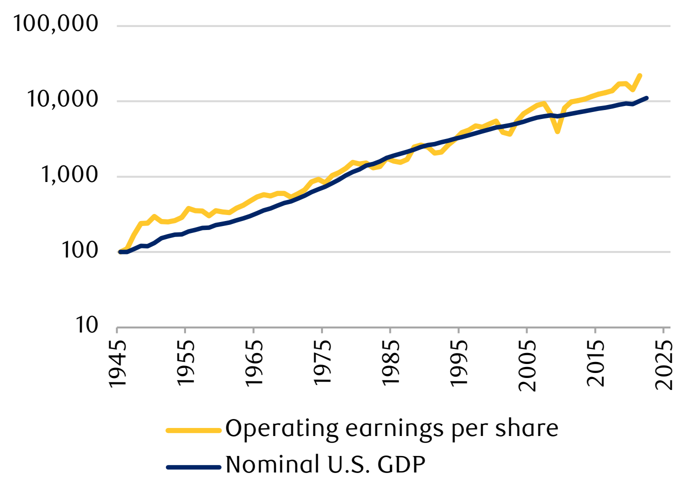
Several leading indicators, including short-term interest rates being higher than long-term rates, point to a recession. Moreover, interest rates are now prohibitively high while banks are increasingly reluctant to lend. We expect rates will rise somewhat further in the first half of 2023 before falling in the second.

The arrival of a recession would have consequences for investors. U.S. recessions have typically been associated with global equity bear markets. So we believe any equity market rally 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 the eroding confidence in the future that typically comes with a period of economic retrenchment.

Yet investors should keep in mind that the stock market has always turned higher well before the recession ends, usually three to five months before. Moreover, recessions typically are short-lived and already successful companies should have the ability to adapt to new circumstances. Looking at the chart above, the 13 U.S. recessions since 1945 are barely visible on the nominal GDP line, while operating earnings per share always have ultimately recovered.

Corporate earnings have outpaced economic growth

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.

Priced (in USD) as of 12/7/22 market close (unless otherwise stated). Produced: 12/8/22 2:27 pm ET; Disseminated: 12/8/22 3:00 pm ET
For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

Against this backdrop, as we enter 2023, we would lean more heavily toward quality and sustainable dividends, and away from individual company risks that may come home to roost in a recession.

U.S.: Swift change of direction possible

We expect 2023 will be punctuated by a markedly slower economy, and the end of the Fed rate hike cycle.

Against this backdrop, several factors suggest 2023 should be better for equity investors than 2022. Back-to-back negative return years are rare, while equity market sentiment could benefit from declining inflation in 2023.

Yet investors should remain vigilant, in our view. If S&P 500 earnings come in flat next year around $220 per share or less, this would leave little room for valuation expansion. Ensuring portfolios are in line with long-term strategic allocation recommendations and being alert to opportunities which may appear as the macroeconomic situation becomes clearer will be key, in our opinion.

Small caps and midcaps are relatively inexpensive and tend to lead early stages of bull markets, while we favour the Energy sector within large caps.

In fixed income, with the economy likely to slow around midyear and the Fed potentially to start cutting rates in the latter part of the year, the benchmark 10-year Treasury yield has already dropped below 3.50 percent in anticipation of this, and could face further downside pressure into 2023. We would thus lock in historically high yields in intermediate and longer-dated bonds to maintain income and to benefit from capital appreciation if recession risks and the potential for Fed rate cuts push yields lower, and bond prices higher.

Canada: Looking beyond likely recession

Tighter monetary policy and waning household consumption suggest to us that the economy will slip into recession in 2023.

It can be argued that at current valuations the S&P/TSX Composite Index is already pricing in a modest recession. Canadian banks, in particular, could provide an interesting opportunity for investors who can see through the valley of the expected upcoming economic contraction.

Given the tight supply outlook following years of underinvestment in the oil industry, the solid commodity outlook paired with attractive free cash flow generation support maintaining allocations to energy stocks, in our view.

After a difficult 2022, we see opportunities in 3- to 7-year investment-grade corporate bonds as we believe yields offer a reasonable level of income while keeping both credit and interest rate risk modest. For investors willing to assume equity-like risk, rate-reset preferred shares also look relatively inexpensive, given their significant 2022 price decline despite a substantial increase to the 5-year yield they are reset off.

UK: Austerity during a recession

A crippling cost of living crisis, austerity measures, and the Bank of England tightening monetary policy will all conspire to create a prolonged recession, in our opinion. For equities, we prefer internationally-oriented defensive stocks and cyclicals positioned for long-term structural trends such as decarbonisation. There could be an opportunity later in the year in small caps and midcaps.

We have a negative view on Gilts as government issuance will likely hit a record high even as the Bank of England starts selling its portfolio of Gilts accumulated during the pandemic. It is not clear that there will be demand for this deluge of supply, in our view.

Europe: Hostage to a geopolitical conflict

We expect a mild recession in Europe, though this scenario could prove too optimistic if there are energy shortages this winter or too pessimistic if China reopens swiftly. Discounted equity valuations and severe fund outflows in 2022 reflect investors' concerns. We maintain our bias for quality, globally diversified companies that possess strong pricing power—in particular, global leaders within the pharmaceuticals, technology, luxury, and capital goods industries.

As for fixed income, we see opportunities in corporate credit where yields have significantly increased versus a year ago and should compensate for interest rate risk.

China's new strategic agenda, Japan's inflation

We expect volatility in Chinese equities to persist as long as investors debate the focus of future economic policy, and COVID-19 restrictions continue. Nevertheless, we believe there are opportunities in areas tied to the country's long-term development blueprint such as energy and food security, high-end manufacturing, and new green energy supply chains.

In Japan, the reopening of the economy after the pandemic could lead to above-average GDP growth. Inflation making a return could represent a sea change in corporate pricing behaviour as corporations increasingly hike prices to reflect higher input costs.

On the fixed income front, we prefer Asia ex-China investment-grade bonds, particularly those issued by what we see as quality Asian corporates with conservative balance sheets and government-linked companies that may benefit from implicit government support.

For more details on these views, as well as forecasts for commodities and currencies, please have a look at our complete Global Insight 2023 Outlook or the individual articles: We are the hedgehog (feature article), as well as the regional focus commentaries on the U.S., Canada, the UK, Europe, and Asia.

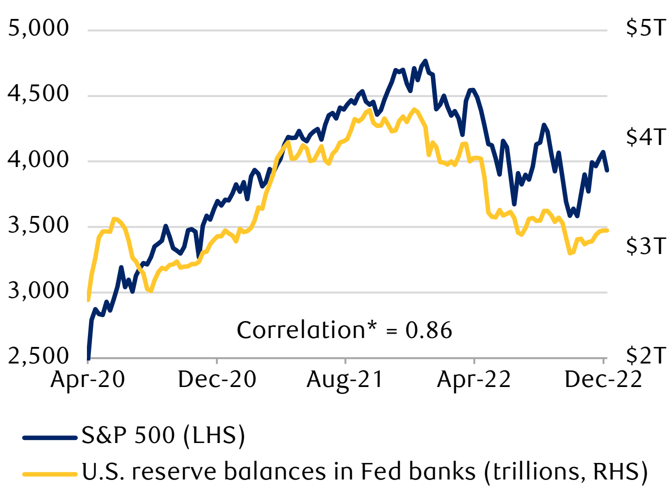
UNITED STATES

Tyler Frawley, CFA – Minneapolis

- **U.S. equities are on track for weekly losses** as increased recession fears have given investors pause, and the market has stalled out at some key technical levels following the strong rally since mid-October. All of the major indexes are lower, with the Dow Jones Industrial Average being the best relative performer but still falling 1.68% on the week. The S&P 500 has outperformed the Nasdaq Composite, but both are lower, having fallen 2.45% and 3.02%, respectively. Utilities is the only sector higher on the week, rising 0.44%. Meanwhile, Energy has lagged, falling 5.73%, as **investors appear unimpressed by the G7 price cap on Russian oil.**

- As the Federal Reserve continues its balance sheet reduction program, excess reserve balances within the U.S. banking system are dwindling. While the central bank's aggressive rate hiking cycle has captured the majority of headlines, **it is the movement in excess reserves within the U.S. banking system that appears to have impacted the direction of markets thus far this cycle**. After ballooning in 2020 and 2021, excess bank reserves peaked at $4.3 trillion back in early December 2021 and have fallen steadily throughout this year, to $3.2 trillion today. When we plot these excess reserve numbers against the S&P 500, on a one-week lag, we can see that correlation between the two is very strong—nearly 0.86 since the beginning of April 2020. Given the strong correlation, and the fact that the Fed's balance sheet projections indicate the reduction program should continue for the foreseeable future, we believe this relationship is worth keeping an eye on over the next several months and quarters, as it could represent a headwind for the equity market.

U.S. reserve balances are dwindling



* Correlation based on a 1-week lag

Source - Bloomberg; data through 12/7/22

- **Economic data have largely come in hotter than expected this week**, fanning concerns that the Fed may have to continue its rate hiking cycle longer than currently anticipated, which could raise recession risks. The ISM Services Purchasing Managers' Index (PMI), which gauges the level of economic activity in non-manufacturing sectors, came in at 56.5, well above the consensus of 53.4, indicating business activity remains strong. Initial jobless claims came in at 230,000, up slightly from last week and in line with the Bloomberg consensus forecast, as **the labor market continues to show surprising resilience**.

CANADA

Sean Killin & Mila Krunic – Toronto

- **The Bank of Canada (BoC) raised its benchmark overnight interest rate by 50 basis points (bps)** to a target rate of 4.25% this week, the latest step in its effort to curb inflationary pressures on the economy. This monetary policy action is larger than the 25 bps rate hike forecast by RBC Economics, and by financial markets via overnight index swaps. RBC Economics noted that the larger-than-expected increase could be due in part to the strong labour market data that has emerged since the BoC's last meeting in October. The central bank has raised its rate at seven consecutive meetings this year, accounting for a cumulative tightening of 400 bps. **BoC Governor Tiff Macklem indicated that he is willing to pause and assess the situation** now that the benchmark interest rate is four percentage points higher than it was at the start of the year. "Looking ahead, the governing council will be considering whether the policy interest rate needs to rise further," the statement said, opening the door to a pause as soon as the next meeting in January, in our view.

- **Canada is stepping up efforts to promote its national interests in its Indo-Pacific Strategy with a renewed focus on trade and foreign investment.** The Canadian government's regional strategic report, released in November, proposes further restrictions on both indirect and direct foreign investment into the country. The decision is building out new powers for ministers to protect Canadian industry and strategic assets from foreign ownership and intervention. The federal government has already begun restricting investment in the critical minerals sector, particularly within the lithium and uranium spaces, as officials ordered three Chinese firms with state connections to divest from projects in early November. Recently enacted U.S. legislation, the Inflation Reduction Act of 2022, directs incentives towards purchasing battery technology from countries without human rights abuses; given these incentives, **Canada's critical minerals sector is one of several where RBC's Multi-Asset Strategy team anticipates growth and investment in the long term.**

EUROPE

Thomas McGarrity, CFA – London

- **RBC Capital Markets expects the Bank of England (BoE) to deliver a 50 basis point (bps) rate hike** at the next Monetary Policy Committee (MPC) meeting on Dec. 15. We expect the BoE to continue raising rates in 2023, albeit at a slower pace, with a terminal rate of 4% in 2023, below current market pricing which sees a peak around 4.5%.

- **The European Central Bank (ECB) is also likely to deliver a 50 bps hike** at its Dec. 15 meeting, in our view. We expect interest rates to peak at 2.50% in 2023, which, again, is below current market pricing that sees the ECB increasing its interest rate to around 2.75%.

- **The euro area economy expanded by more than previously thought in Q3**, according to Eurostat data, with GDP growing 0.3% q/q versus the initial estimate of 0.2%. Fixed capital investment drove the slightly better-than-anticipated GDP performance, while households also contributed positively despite high inflation. Net trade was a large drag, weighing on overall output. Despite the better-than-expected Q3 GDP details, our base case remains a mild recession across Q4 2022 and Q1 2023 in the euro area.

- **The shares of pharmaceutical groups GSK and Sanofi were among the best-performing within the STOXX Europe 600 Index during the week.** Their share prices gained 7.5% and 6%, respectively, on Wednesday following the judge ruling in their favour regarding Zantac product litigation in the federal Multi-District Litigation (MDL) in the U.S. The court determined that the plaintiffs' expert testimony and evidence was inadmissible in proving that ranitidine within Zantac increases the risk of cancer. The ruling only applies to the federal MDL, with state court cases ongoing in other jurisdictions, including California where the first bellwether trial related to Zantac product litigation is scheduled for February 2023.

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Investors' sentiment on Chinese and Hong Kong equities has improved as China moves towards reopening.** China's National Health Commission published 10 new measures to further loosen its COVID-19 control policies, covering quarantine requirements, close contact, vaccination, and treatment. Hong Kong equities rallied strongly on Thursday following a local media report that the Hong Kong government is also considering rolling back COVID restrictions. Hong Kong's benchmark Hang Seng Index surged by 3.4% and the Hang Seng Tech Index rallied by 6.6% for the day.

China equities have recovered, but valuations remain relatively low

MSCI China Index price-to-earnings ratio

Source - RBC Wealth Management, Bloomberg; data through 12/7/22

- We believe a confirmed path towards reopening paves the way for earnings improvement and a valuation re-rating for Chinese equities. However, **the path will be bumpy, in our view, with the reopening likely to be a "two steps forward, one step back" process** as it will take some time for the government, citizens, and health care system to figure out a way to "live with COVID."

- Besides, **a recovery in consumption could take a while to play out**, in our opinion. As new cases surge, many people may be hesitant to go out. We believe offline shopping and dining out at restaurants could see a slower pickup, while online retail, telemedicine, and food delivery demand could see stronger momentum—similar to what we observed at the beginning of the pandemic.

- **Japan's GDP was down an annualized 0.8% from July to September, a smaller decline than the early official estimate** for a contraction of 1.2%, and better than economists' consensus forecast of -1.0%. The revised figures showed that slightly stronger exports reduced the negative impact on trade from yen depreciation. Moreover, companies have been increasing their inventories and spending, which should be positive for future GDP growth. However, consumption was dampened by inflation and a surge in COVID cases. Overall, while the data are slightly better than expected, we don't think they are strong enough to eliminate investors' concerns about the recovery of the economy.

MARKET
Scorecard

Data as of December 7, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,933.92	-3.6%	-17.5%	-16.1%	6.6%
Dow Industrials (DJIA)	33,597.92	-2.9%	-7.5%	-5.9%	11.7%
Nasdaq	10,958.55	-4.4%	-30.0%	-30.1%	-12.5%
Russell 2000	1,806.90	-4.2%	-19.5%	-19.8%	-4.5%
S&P/TSX Comp	19,973.22	-2.3%	-5.9%	-5.6%	13.6%
FTSE All-Share	4,093.68	-1.1%	-2.7%	-2.0%	10.8%
STOXX Europe 600	436.20	-0.9%	-10.6%	-9.2%	11.0%
EURO STOXX 50	3,920.90	-1.1%	-8.8%	-8.3%	11.1%
Hang Seng	18,814.82	1.2%	-19.6%	-21.6%	-29.0%
Shanghai Comp	3,199.62	1.5%	-12.1%	-11.0%	-6.4%
Nikkei 225	27,686.40	-1.0%	-3.8%	-2.7%	4.3%
India Sensex	62,410.68	-1.1%	7.1%	8.3%	37.4%
Singapore Straits Times	3,225.45	-2.0%	3.3%	2.9%	14.2%
Brazil Ibovespa	109,068.55	-3.0%	4.1%	1.4%	-4.0%
Mexican Bolsa IPC	50,725.96	-1.9%	-4.8%	-0.4%	17.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.415%	-19.0	190.5	194.2	249.2
Canada 10-Yr	2.757%	-18.1	133.1	117.5	199.3
UK 10-Yr	3.044%	-11.7	207.3	231.4	276.1
Germany 10-Yr	1.782%	-14.8	195.9	215.7	236.4
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.48%	0.9%	-11.8%	-11.9%	-12.8%
U.S. Investment-Grade Corp	5.18%	1.5%	-14.2%	-14.3%	-14.5%
U.S. High-Yield Corp	8.60%	0.4%	-10.3%	-9.7%	-4.6%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,786.42	1.0%	-2.3%	0.1%	-4.1%
Silver (spot $/oz)	22.73	2.4%	-2.5%	1.0%	-7.2%
Copper ($/metric ton)	8,384.75	1.9%	-13.9%	-12.8%	9.0%
Oil (WTI spot/bbl)	72.01	-10.6%	-6.5%	-0.1%	57.4%
Oil (Brent spot/bbl)	77.53	-9.2%	-0.3%	2.8%	58.9%
Natural Gas ($/mmBtu)	5.80	-16.3%	55.5%	56.4%	141.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	105.1790	-0.7%	9.9%	9.1%	15.8%
CAD/USD	0.7324	-1.8%	-7.4%	-7.4%	-6.2%
USD/CAD	1.3654	1.8%	8.0%	8.0%	6.7%
EUR/USD	1.0508	1.0%	-7.6%	-6.7%	-13.2%
GBP/USD	1.2210	1.3%	-9.8%	-7.8%	-8.7%
AUD/USD	0.6726	-0.9%	-7.4%	-5.5%	-9.4%
USD/JPY	136.5500	-1.1%	18.7%	20.2%	31.2%
EUR/JPY	143.4900	-0.1%	9.6%	12.1%	13.9%
EUR/GBP	0.8606	-0.3%	2.3%	1.2%	-4.9%
EUR/CHF	0.9886	0.5%	-4.7%	-5.1%	-8.3%
USD/SGD	1.3553	-0.4%	0.5%	-0.8%	1.4%
USD/CNY	6.9700	-1.7%	9.7%	9.5%	6.7%
USD/MXN	19.6680	2.1%	-4.2%	-6.5%	-1.1%
USD/BRL	5.2164	0.5%	-6.4%	-7.0%	2.1%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -7.4% return means the Canadian dollar fell 7.4% vs. the U.S. dollar year to date. USD/JPY 136.55 means 1 U.S. dollar will buy 136.55 yen. USD/JPY 18.7% return means the U.S. dollar rose 18.7% vs. the yen year to date.

Source - Bloomberg; data as of 12/7/22

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As of September 30, 2022

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Sell [Underperform]	52	3.52	5	9.62

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