



The other side of the wall

Joseph Wu, CFA – Toronto

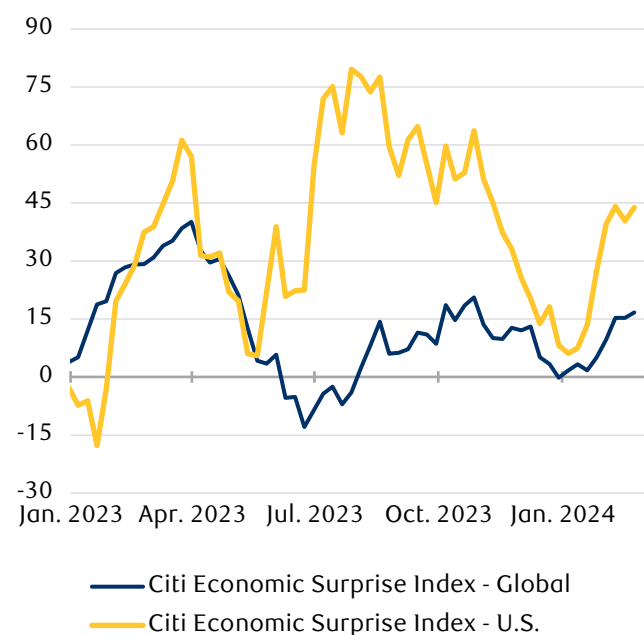
Despite the usual “wall of worry,” markets are currently inclined to embrace a risk-on bias, reassured by ongoing U.S. economic strength. Improving corporate fundamentals can lend support to risk-bearing assets, though valuations may already reflect a high degree of optimism that could restrain near-term upside potential.

Global growth has picked up some momentum to start the year. The J.P. Morgan Global Composite Purchasing Managers’ Index (PMI), a survey-based indicator that sheds light on business conditions in both the manufacturing and services sectors, came in at 51.8 in January, up from 51.0 in December and the highest reading since June 2023. A look beneath the surface, however, reveals a widening divergence in the growth patterns of major economies.

U.S. exceptionalism

Persistent strength in the labour market has helped position the U.S. economy on a firmer base relative to peers. The U.S. has added nearly 1.5 million net new jobs over the past six months, with the unemployment rate near multi-decade lows at 3.7 percent and real (i.e., inflation-adjusted) wage gains finally making meaningful strides as inflation subsides. Another recent tailwind has come in the form of productivity growth—workers doing more per hour worked. Measured in output per hour, U.S. labour productivity rose at a 3.2 percent annualized rate in Q4 2023. This marked the third consecutive notable improvement in productivity, following increases of 4.9 percent and 3.6 percent in the previous two quarters.

U.S. economic outperformance continues



Note: Surprise indexes measure how economic data compares with consensus expectations.

Source - RBC Wealth Management, Bloomberg; data through 2/23/23

For perspectives on the week from our regional analysts, please see [pages 4–5](#).

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Priced (in USD) as of 2/28/24 market close (unless otherwise stated). Produced: 2/29/24 1:16 pm ET; Disseminated: 2/29/24 1:30 pm ET

These factors suggest consumer spending—a pillar of the U.S. economy, accounting for around 70 percent of GDP—is likely to remain a steady growth contributor in the near term. Projections from the Atlanta Fed’s GDPNow model suggest U.S. real GDP could expand by roughly three percent quarter-over-quarter in Q1 2024, in line with its three percent average growth rate in the second half of 2023 and meaningfully above consensus expectations of 0.1 percent for the eurozone, 0.5 percent for Canada and Japan, and 1.3 percent for China.

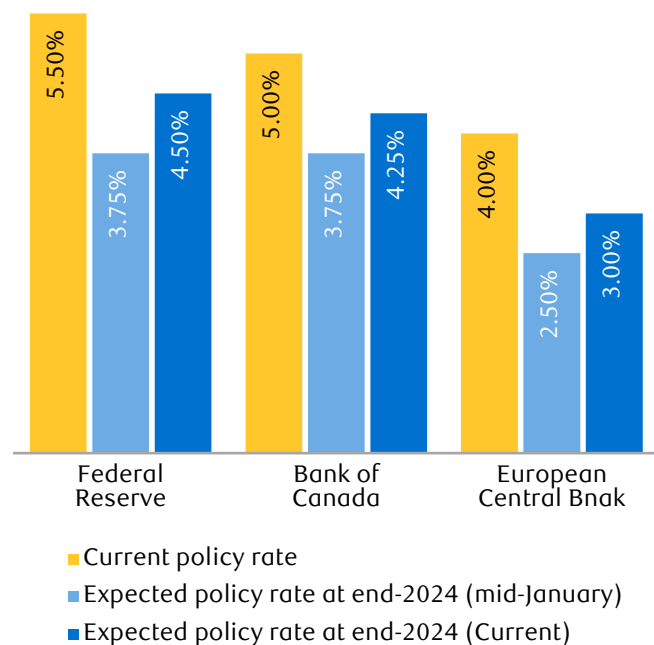
In our view, much of this divergence can be attributed to variations in global economies’ sensitivity to interest rates and global trade conditions. Compared with its economic peers, the U.S. is less sensitive to higher borrowing costs; the ratio of U.S. household debt to disposable income, at 97.3 percent, is near the lowest levels since the early 2000s, and the bulk of this household debt comprises mortgages locked into 30-year fixed rates under five percent. The U.S. is also more insulated against adverse developments in global trade, as exports make up only 11 percent of its economy.

Rate cuts can wait

As inflation has retreated in major economies, their central banks have begun to lay the groundwork for an eventual pivot to monetary easing. But both the magnitude and the timing of potential interest rate cuts remain highly uncertain. Much will depend, we believe, on the inflation and labour market data that policymakers monitor most closely: services prices and wage growth.

Interest rate expectations have been pushed back

Market-implied policy rate expectations



Source - RBC Wealth Management, Bloomberg; data through 2/23/23

In the U.S., Federal Reserve policymakers have been pushing back against aggressive market expectations for rate cuts, expressing skepticism that conditions are in place for a sustainable return to two percent inflation. This, together with the recent string of stronger-than-expected economic and inflation data, have prompted markets to revise their interest rate expectations, as the chart below left shows.

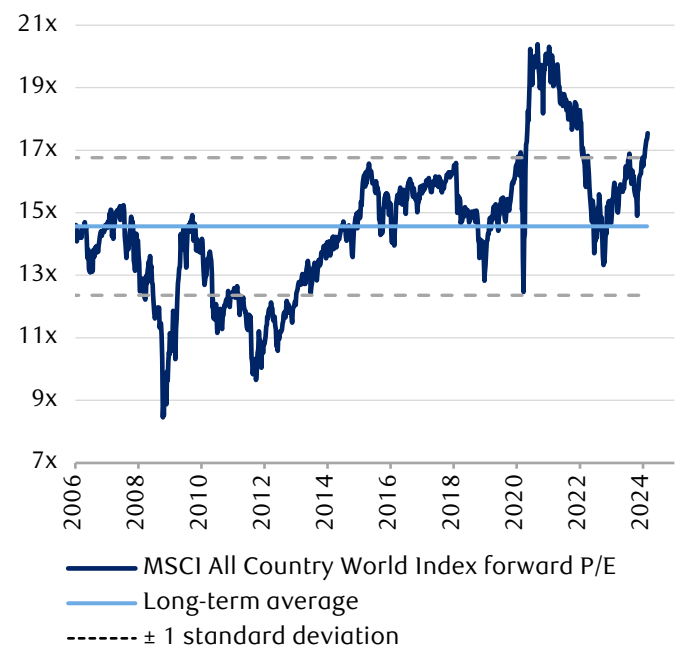
As recently as mid-January, futures pricing showed that markets expected the Fed to trim its policy rate to 3.75 percent from 5.50 percent by year’s end, via a series of seven cuts starting in March. Futures markets now anticipate the first Fed rate cut in June, and the benchmark rate ending the year around 4.50 percent. Over the past 30 years, the average time from the last Fed rate increase to the first cut has been 10 months; assuming the July 2023 rate hike was the last one for this cycle, May and June are both in play if this pattern holds. Considering the renewed strength in the labour market, we believe the risks are currently skewed towards fewer cuts and a later start to the easing cycle.

The evolving investment landscape

The world economy is navigating a landscape marked by an evolving mix of resilience and challenges. But according to current Bloomberg consensus expectations, 2024 should be a better year than 2023, with 7.5 percent earnings growth forecasted for the MSCI All Country World Index. An expanding economy should allow corporate profits to rise over the coming quarters and

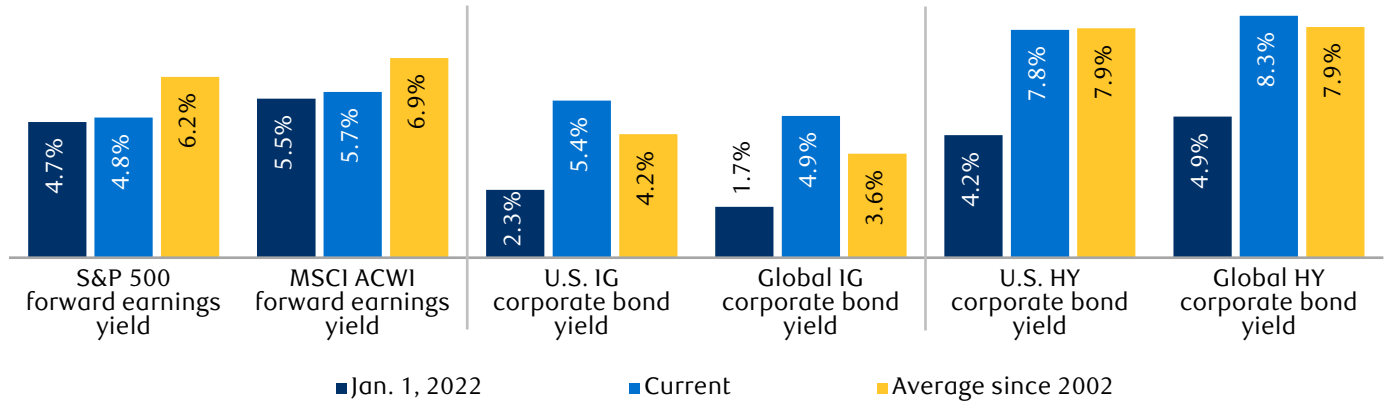
Do valuations have room to rise?

MSCI All Country World Index forward price-to-earnings ratio



Source - RBC Wealth Management, Bloomberg; data through 2/23/23

Valuations across major asset classes



* Earnings yield is the inverse of the forward price-to-earnings ratio. Bond yield refers to yield to worst for the Bloomberg U.S. Corporate Index, the Bloomberg Global Agg Credit Index, the Bloomberg U.S. Corporate High Yield Index, and the Bloomberg Global Corporate High Yield Index. IG = investment-grade rated, HY = high-yield rated.

Source - RBC Wealth Management, Bloomberg; data through 2/23/23

support equity markets—although we would note that the sharp rally since last October, and the attendant higher valuations, may have anticipated this sanguine outlook. In addition to earnings delivery, the potential for equities to generate above-average gains over the next 12 months also hinges, in our view, on whether elevated valuation multiples can be maintained or ascend further.

Meanwhile, we continue to see opportunities in fixed income markets. Entry points matter a great deal for bonds, because history has shown that starting yields are

strongly correlated with subsequent returns. The broad uplift in yields year to date has moderately improved the risk-reward profile for many bond markets, in our view. While all-in yields remain at levels that may allow bonds to serve as an adequate source of returns in portfolios over the medium term (see chart above), we believe investors should consider a selective approach to corporate bond exposure in light of the mediocre compensation for taking credit risk.

UNITED STATES

Tyler Frawley, CFA – Minneapolis

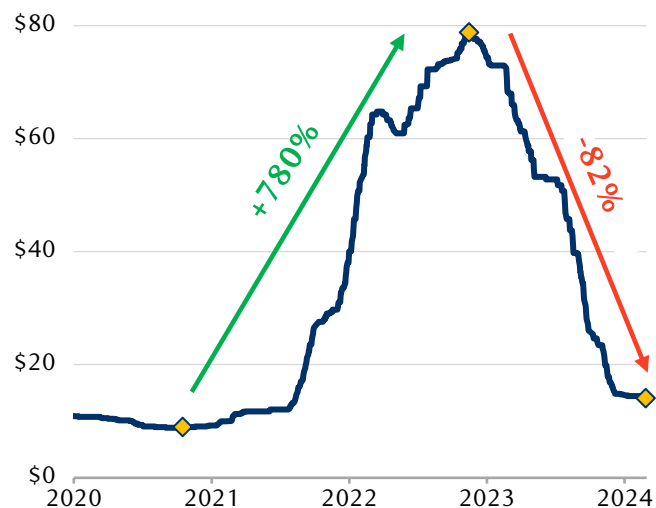
■ U.S. equities are on track for mixed results on the week, as investors take a breather following a strong start to 2024 that has seen the S&P 500 rise over 6.3% YTD. Of the major indexes, the Nasdaq Composite has been the best relative performer, rising 0.18%. The S&P 500 has outperformed the Dow Jones Industrial Average, but both are lower, down 0.08% and 0.39%, respectively. Sector leadership is evident in Consumer Discretionary, which has returned 1.17%. Health Care has lagged, falling 1.72%.

■ The Federal Reserve’s preferred inflation gauge, the Personal Consumption Expenditures (PCE) Index, delivered no major surprises in January. Core PCE grew 2.8% year over year, its lowest level since March 2021 and in line with Bloomberg consensus expectations. On a month-over-month basis, core PCE rose 0.4%, up from 0.1% in December, also in line with consensus expectations. This month-over-month increase represents an acceleration in inflation compared to recent months, and is the highest level seen since January 2023. The report comes at a pivotal moment, following a Consumer Price Index report that showed prices increased faster than expected in January, leading investors to push back their interest rate cut expectations.

■ Lithium prices are falling significantly as supply grows and electric vehicle demand cools. The metal’s price rose over 780% from late 2020 through late 2022 as demand from electric vehicle makers increased faster than new production could come online. However, prices have moved sharply lower over the past 15 months, falling 82% since peaking in November 2022, as growth in electric

Lithium carbonate prices plunge amid weak demand and supply glut

\$ per kilogram



Source - RBC Wealth Management, Bloomberg; data through 2/27/24

vehicle sales has waned and a slowdown in the Chinese economy has led to oversupplied conditions. Despite pressures in the near term, the International Energy Agency expects global demand growth for lithium to outstrip supply growth through 2030. This supply/demand mismatch should provide a level of support for lithium prices in the longer term, which could entice new entrants into the market. An example of this is ExxonMobil (XOM), which recently announced plans to start producing lithium by 2027 with the goal of producing enough to supply over one million electric vehicles per year by 2030. We view Exxon’s announcement as an endorsement of the lithium market’s longer-term potential, and believe investors should continue to monitor the space in the coming years.

CANADA

Matt Altro & Jonathan Laser, CFA – Toronto

■ **Housing activity has been picking up steam as home resales within Canada increased for the second month in a row in January** with a 3.7% rise from December 2023. Nevertheless, the MLS Home Price Index continued to fall, with a 1.2% m/m decline in January, and it is down 5% since August 2023. Increased activity was seen nationwide, with the highest gains in the Niagara region and Hamilton, at 18.5% and 12.6%, respectively. We note that this activity increase is coming off of historically low levels, leaving RBC Economics still describing this market as slow. As we look forward through the rest of 2024, any change in the Bank of Canada’s monetary policy stance will likely dictate market movements. While the loss of affordability remains the dominant force weighing on property values, lower interest rates should provide some relief to Canadians and bring further activity to the Canadian housing market, according to RBC Economics.

■ **Canada recorded the fastest population growth rate among developed countries in 2023**, adding 1.25 million net new people. Immigration has been the driving force behind Canada’s population growth, supported by ambitious targets set by the federal government for nearly 500,000 additional permanent residents each year, growth in the international student population of over 250,000 in 2023 alone, and a 300,000 increase in the number of temporary foreign workers in Canada. This level of rapid population growth has helped spur growth in aggregate GDP; however, per-capita GDP remains in decline, and Canada’s housing shortage has been exacerbated. To relieve pressure in the rental market, the federal government has introduced a cap on international student visas, taking effect in 2024, aimed at reducing the number of student visas by 35%. Although this won’t immediately reduce the number of international students in Canada, RBC Global Asset Management Chief Economist Eric Lascelles thinks it is likely Canadian immigration will decline from 2023 levels over the coming years.

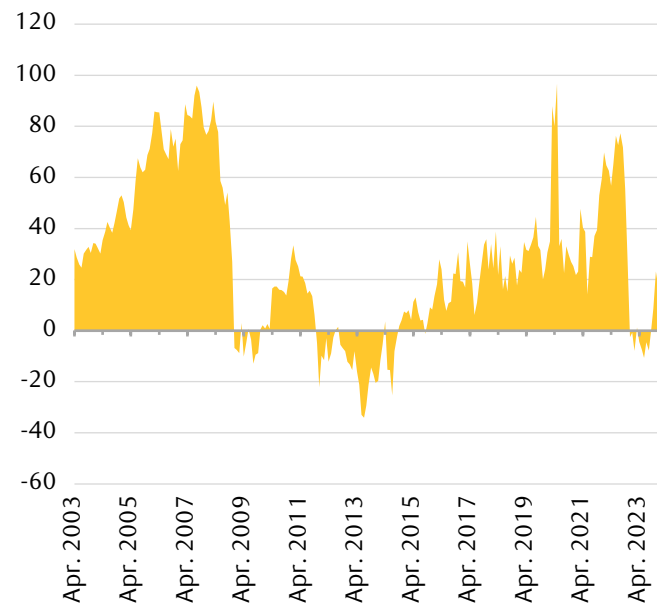
EUROPE

Frédérique Carrier – London

- **The European Central Bank (ECB) wage tracker suggested negotiated pay will again be up around 4.5% in 2024.** With inflation rapidly declining, this means real wages are growing. Stronger real wages and a tight labour market should support consumption which, in turn, would be the main factor to underpin a modest economic recovery in the second half of the year. RBC Capital Markets expects economic growth, currently flat, to inch up 0.1% q/q each quarter, to reach growth of 0.3% by Q4. It is subdued growth, but growth, nevertheless.
- **Should bank lending recover, these estimates could prove too conservative.** Bank lending made a tentative recovery late last year, but fell back in January, perhaps as a one-off. Still, it seems 2023's very severe contraction as a result of the aggressive interest tightening cycle has passed, particularly in the context of a looser monetary policy in H2 2024. Bloomberg consensus expects the ECB to embark on its rate-cutting cycle in June.
- **In the UK, the Chancellor of the Exchequer Jeremy Hunt is scheduled to present the 2024 UK Budget to the House of Commons on March 6.** With the ruling Conservative party facing a 20 percentage point gap to the opposition Labour Party according to recent polls, this is one of the last opportunities the government may have to shore up its popularity ahead of upcoming general elections.

Will lending resume its recovery?

Total bank lending (euro in billions) in the eurozone on a three-month moving average



Source - RBC Wealth Management, RBC Capital Markets, European Central Bank

- **RBC BlueBay estimates that a fiscal giveaway, possibly in the form of personal tax cuts and as large as £20 billion, is likely.** But this fiscal largesse, combined with wage settlements still above 5%, and above-inflation price increases in a wide array of services ranging from broadband to insurance, mean core services inflation could remain suborn.

- **Still, with the energy price cap primed to fall by 12% in April, headline inflation could decline to below 2% by midyear, in our view.** Even if services inflation and wage settlements remain buoyant, such an improvement in the inflation figure would likely put pressure on the Bank of England to embark on its rate-cutting cycle in this coming summer.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets traded mixed during the week with the MSCI All Country Asia Pacific Index hovering near its one-year high.** After a post Chinese New Year rally, greater China equities are taking a breather this week. According to a Bloomberg report, Beijing is looking to restrict and reduce a quantitative trading strategy that some believe may have led to the domestic equity market selloff weeks ago. Chinese regulators are asking fund managers to stop accepting new inflows into the “Direct Market Access” strategy and eventually phase out the product as they believe the gradual exit will help prevent another drastic selloff. We think observers are concerned that the drive to deleverage could lead to another stock slump last seen in January. As part of the quant crackdown, the Shanghai and Shenzhen stock exchanges froze the accounts of major quant fund Ningbo Lingjun Investment Management Partnership for three days earlier this month. The China Financial Futures Exchange also recently banned Shanghai Weiwan Fund Management from opening stock index futures positions for 12 months as the hedge fund used high-frequency trading to circumvent transaction limits on multiple equity index futures.
- **Hong Kong plans to remove all property cooling measures with hopes of an immediate effect according to the latest budget on Wednesday.** Hong Kong's government is hoping that the removal will help to boost its very weak residential market. Financial Secretary Paul Chan noted that the policies are no longer necessary due to the current economic and market conditions, and he signalled there is room to ease policies on property lending. Analysts, however, believe Hong Kong's real estate sector still faces an uphill battle due to weak sentiment, high interest rates, and slow economic growth. Also in the budget, the domestic economy is expected to grow 2.5%–3.5% this year. Economists surveyed by Bloomberg estimated that GDP would moderate to 2.7% in 2024 from 3.2% in 2023.

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			Count	Percent
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