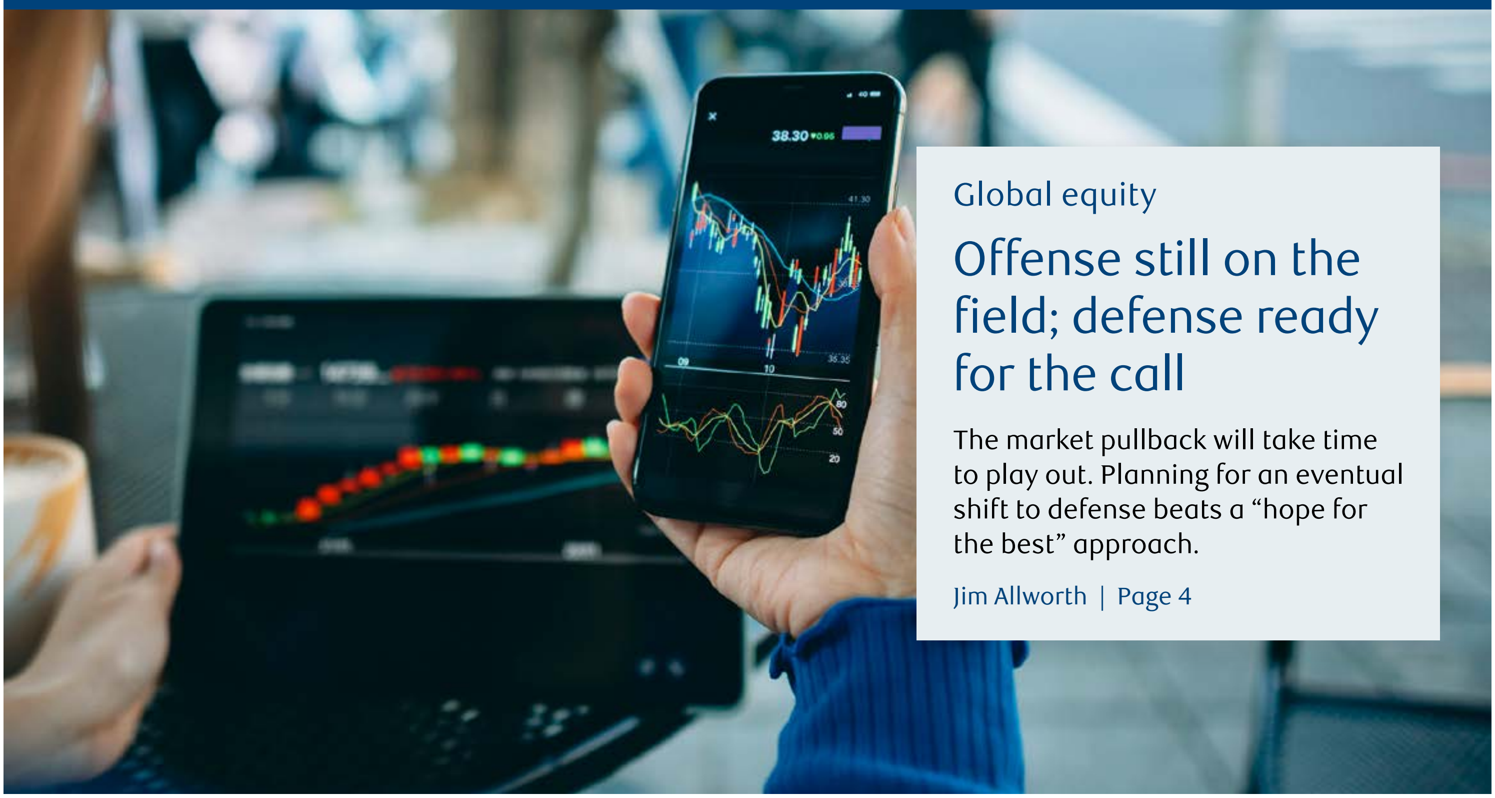
GLOBAL
Insight

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

August 2024



Global equity

Offense still on the field; defense ready for the call

The market pullback will take time to play out. Planning for an eventual shift to defense beats a "hope for the best" approach.

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August 2024

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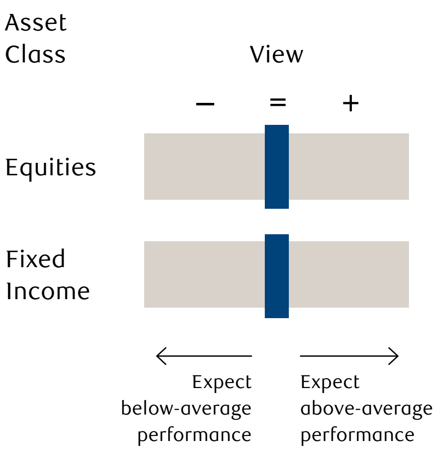

(+/=/–) represents the Global Portfolio Advisory Committee's (GPAC) view over a 12-month investment time horizon.

+ 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

- Market volatility jumped and a selloff transpired following weak U.S. economic data, growing concern that the U.S. Federal Reserve may have fallen behind the curve in cutting interest rates, and disappointing earnings reports from some technology and consumer firms. Also, the Bank of Japan's rate hike and hawkish stance upended currency markets and leveraged trades, which added pressure on equities globally.
- In our view, there are factors that support the idea that this will play out as a pullback or correction rather than the start of a bear market. Most notably, market breadth has not yet triggered a negative signal, and overall S&P 500 earnings trends and consensus earnings growth forecasts remain relatively stable. But there are factors that bear watching: U.S. employment metrics are weakening; Fed rate cuts may not prove to be a panacea; and investor sentiment remains elevated.
- We would hold no higher than a Market Weight position in U.S. and global equities and continue to recommend a defensive posture within equity portfolios, with an emphasis on high-quality dividend-paying shares. While we don't think there is enough evidence to conclude that a U.S. recession is a fait accompli, core equity holdings should be confined to stocks that can better withstand further economic deterioration or a recession, with valuations supported by prospects for earnings growth, in our view.

Fixed income

- Global bond yields have trended lower to open the second half of the year as the average yield on the Bloomberg Global Aggregate Bond Index fell to around 3.7% in late July after reaching a 2024 high of 4.1% in April. However, that decline gathered steam in the last few trading sessions of the month as yields dropped all the way to 3.4% on the back of global volatility, marking the lowest level since April 2023.
- Global inflationary pressures continue to improve, after a brief uptick to start the year. Both the Bank of Canada and the European Central Bank have now delivered multiple rate cuts, with the U.S. Federal Reserve likely to follow with a rate cut in September, in our view. But at a time when many central banks are easing, the Bank of Japan's surprise July 31 rate hike was one contributing factor to the bout of global volatility that rattled markets to close out the month. Regardless, ahead of the Fed joining the global rate easing cycle, we continue to recommend that investors look to extend duration, but after the recent sharp drop in yields, some patience may be called for.
- We remain Market Weight U.S. fixed income with yields remaining above multi-decade averages. In July, we exited short-term Treasury Bills in favor of 7- to 10-year Treasuries. Globally, we continue to broadly favor sovereign debt over corporate bonds at this juncture, as U.S. and global economic risks remain moderately elevated.

GLOBAL
Equity

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Offense still on the field; defense ready for the call

Equity markets backed off sharply in less than a week. The spark that ignited this was a much weaker-than-consensus U.S. employment report. At the least it would appear the market is in a correction that probably has weeks or months to run. At the worst, this may be the opening frame of an outright bear market. There are arguments that support both outcomes. However, what seems most probable is that the relentless march to new highs is over for now.

The most compelling factor supporting the idea that this will play out as a correction rather than the start of a bear market has been market breadth—the majority of stocks in most major global equity indexes have been moving in sync with their respective indexes. That is to say, to take the S&P 500 as an example, when the index has been moving higher, measures of breadth have also been rising. Both have also moved in tandem when the market was pulling back. The turning points, whenever the trend changed, have been within a couple of days of each other.

Breadth is an important market factor to monitor because measures such as advance-decline lines and unweighted indexes usually break down and start moving lower several months before the more closely watched capitalisation-weighted indexes, such as the S&P 500, set their final peak for the cycle. So far, no such negative divergence has appeared, suggesting that once this correction has played out the bull market could have further to run.

Earnings are also on the positive side of the ledger. So far, the consensus estimate for this year's S&P 500 earnings has hovered around $242 per share with next year's at $277, as measured by FactSet. The current-year estimate usually erodes from the beginning of the year through the first half and further into the fourth quarter. However, uncharacteristically, it has risen slightly since the start of the year. Historically, investors would have expected a drop of about 3% in estimated 2024 earnings over that stretch.

Equity views

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

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

On the momentum front, our proprietary weekly Quadrant Balance measure that tracks the percentage of S&P 500 stocks with rising momentum looks to have peaked and is coming down but is nowhere yet near levels that would rate as oversold.

There are a number of factors that bear watching:

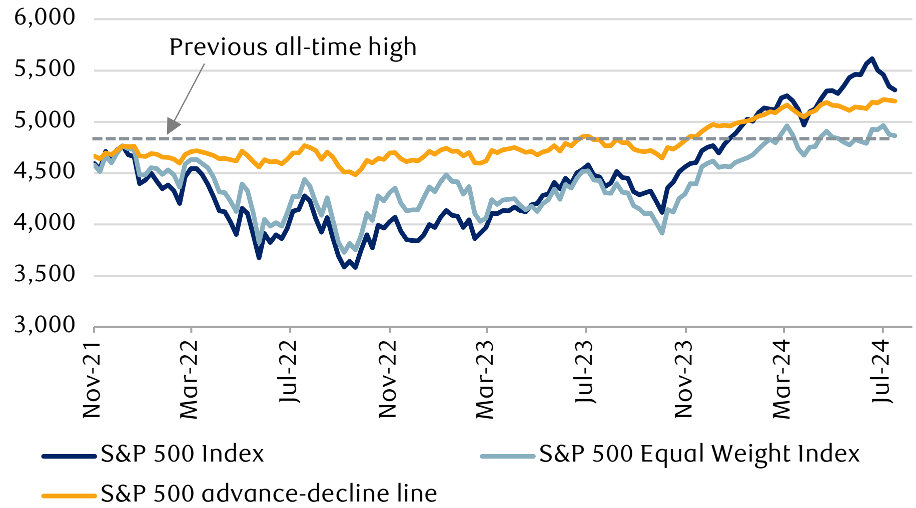
Weakening employment metrics: While employment data has been repeatedly characterised as "stronger-than-expected" and "resilient," a closer look reveals a picture that has steadily weakened over the past 18 months.

The nonfarm payroll report has repeatedly been the source of employment optimism, but almost every month's data has been revised lower the following month. That picture looks even softer when government is excluded to give just the jobs added in the private sector.

GLOBAL EQUITY

All together now

It's not just the "Magnificent 7"; the majority of the stocks in the S&P 500 were moving higher for most of the past 21 months. This broad-based advance is not yet showing any internal signs of weakness.



Source - RBC Wealth Management, FactSet, Bloomberg; data through 8/6/24

And when one looks at the Business Employment Dynamics data prepared by the Bureau of Labor Statistics (BLS), with a six-month lag, which adds in the jobs created by newly formed businesses after deducting those lost to business closures, "strong" is no longer the correct adjective to use. By the BLS' estimate, the private sector added about 850,000 fewer jobs in 2023 than the 2.3 million that the monthly payroll data suggested.

And the household survey, which includes the self-employed, has consistently tracked lower than the nonfarm payroll data. Meanwhile, monthly unemployment claims have risen three of the past four months. The unemployment rate is up five of the past six and now sits at 4.3% for the first time since October 2021.

The number of unemployed persons in the U.S. is now 21% higher than it was 12 months ago. Rising unemployment goes beyond the loss of spending power for those who have lost jobs. The larger impact comes from the increase in precautionary savings on the part of employed people who take the worsening unemployment rate as a signal to prepare for a rainy day.

Federal Reserve cuts may not prove to be a panacea: For several quarters, investors have been expecting the first Fed rate cut to be just around the corner. September is now viewed as the most likely kick-off month. At its peak just a few weeks ago the S&P 500 was up a startling 38% from the fall lows. Even the less tech-supercharged Equal-Weighted version of the index was ahead by 33%. It would seem the market had prepaid for that hoped-for rate cut, perhaps more than once.

What happens when the rate cut arrives? There is always the possibility investors will greet the Fed cut enthusiastically and push share prices higher in anticipation of more rate cuts to come. However, in our view, there is a greater chance that investors will decide the glass is more than half empty and that the Fed is cutting because it sees economic and, therefore, earnings weakness looming ahead. History favours the second interpretation: in eight of the past 10 recessions the first Fed rate cut arrived before or just as the economic downturn was getting underway. An equity bull should be hoping the expected Fed rate cut comes off the table because the economy turns out to be too strong to permit one.

GLOBAL EQUITY

That is not how some other central banks are feeling. The Bank of Canada just implemented its second cut and telegraphed a third for September because inflation is falling while the Canadian economy is threatening to weaken further. The European Central Bank looks like it may be on a similar path for similar reasons.

Investors have been expecting higher share prices: Investor sentiment prior to the pullback was ranging between euphoric and merely bullish. Complacency may be justified if the consensus earnings outlook—$242 per share for the S&P 500 this year and $277 for next—holds together. So far, with most of Q2 reported, this year's estimate looks makeable. But we would find it easier to be constructive about the market's near-term ability to shake off the current downturn if investor sentiment readings were much more pessimistic. Worthwhile market uplegs that carry the indexes sustainably into new high ground usually begin from deeply depressed readings for both momentum and sentiment. We are not there yet.

Committed, but…

Corrections can and do arrive unannounced from time to time—we've already had two notable ones come and go since the 2020 pandemic market low. A price-to-earnings multiple north of 20x, monetary and fiscal policy uncertainty, and dramatic political curve balls are just some of the potential catalysts that could trigger a further pullback. So too could collateral damage from yen volatility or any Q3 corporate pre-announcements which pointed to a weakening U.S. consumer spending outlook.

It's already the case, in our view, that the steady rise in the unemployment rate, at a time when consumer confidence is low and the excess household savings built up during COVID fully depleted, removes important bricks from the wall that had been supporting the idea of a "soft landing" for the U.S. economy.

We continue to recommend a defensive posture in equity portfolios, with an emphasis on high-quality dividend-paying shares. While we don't think there is enough evidence to conclude that a recession is a fait accompli, we think core equity holdings should be confined to stocks that can better withstand further economic deterioration or a recession, with valuations supported by prospects for earnings growth.

We are closely monitoring market breadth and sentiment for any signs that a more defensive posture should be considered. Until then, we think a watchful commitment to equities in a global balanced portfolio is called for.

GLOBAL

Fixed income

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What a difference a difference makes

Interest rate differentials. They're one of the key drivers of currency exchange rates between countries and are simply the gap between interest rates—those nations with higher rates tend to see their currencies appreciate, those with lower rates the opposite. But hedge funds, traders, and others can also borrow in the low-rate country and invest where expected rates of return are higher—the so-called "carry trade" that has captured headlines.

Like many things, this usually works. Right up until the point that it doesn't.

That, very simply, is the dynamic behind the most recent bout of global market turmoil, in our view. As the chart below shows, the first half of the year was characterized by global bond yields rising in unison as investors came to realize that central bank rate cuts would likely be both delayed and fewer in number.

But after a favorable run of inflation data in many developed economies which reignited rate cut hopes, at a time when the Bank of Japan was guiding toward rate hikes, the gap began to grow. As a result, after a long stretch of weakness the yen began to strengthen in July, whereupon the Bank of Japan delivered a surprise rate hike on July 31. The surprisingly soft U.S. labor market report which followed sparked a "flight to safety" that drove global sovereign yields down by historically large degrees.

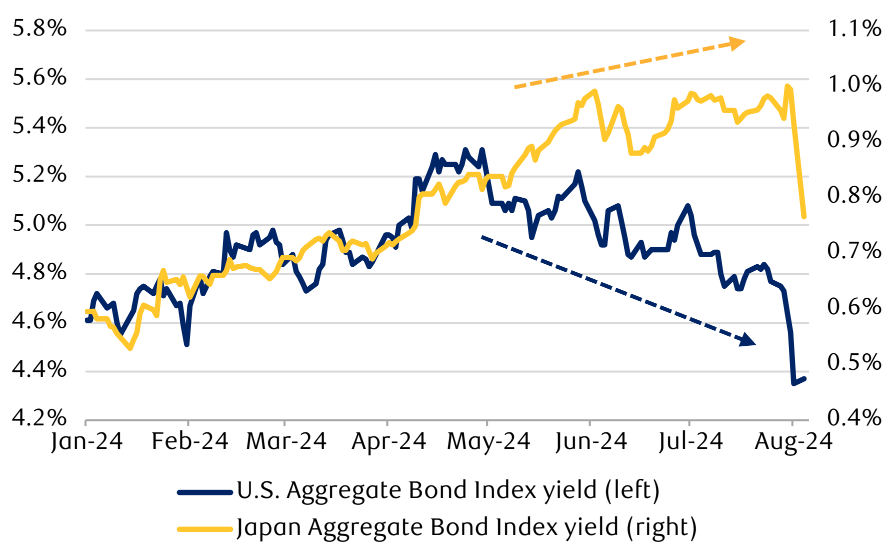
Though it remains too early to tell whether this is a simple unwinding of trading positions that will cause

Fixed income views

Region	Gov't bonds	Corp. credit	Duration
United States	+	–	7–10
Canada	+	=	3–7
Continental Europe	+	=	3–7
United Kingdom	+	=	3–7

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

The divergence between global yields and Japanese yields is partly to blame for recent market volatility



Source - RBC Wealth Management, Bloomberg Aggregate Bond Indexes; data through 8/5/24

GLOBAL FIXED INCOME

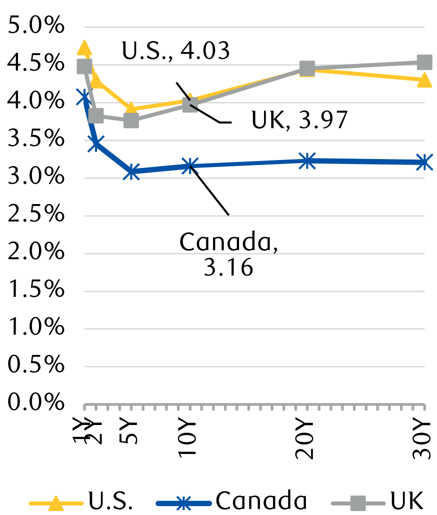
some market consternation but ultimately fade away or if it's simply a big warning about even bigger risks to the global economy, we think it will almost certainly amplify the focus on what central banks do next.

And those market expectations are once again lofty, perhaps exceedingly so. While we had already expected the Fed to deliver the first 25 basis point rate cut of the cycle at its September policy meeting, the ongoing rise in the unemployment rate through July, paired with global volatility, has markets pricing a high prospect of a larger 50 basis point (bps) cut, with another 50 bps of cuts by the end of the year, which would take the policy rate down to 4.25%–4.50% from 5.25%–5.50% currently. For perspective, the Fed projected just one 25 bps rate cut this year as recently as the June meeting.

Our view remains that the Fed will aim to stick with the standard 25 bps cut in September. But whether it's instead 50 bps will depend almost entirely on the next jobs report to be released Sept. 6, as another month of soft labor market data will likely cause the Fed to try and play catchup to a rapidly cooling labor market.

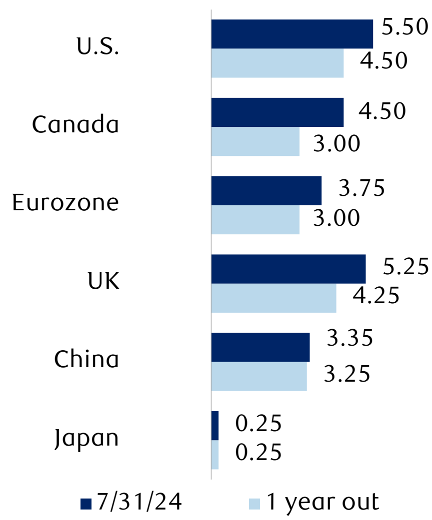
Over the near term, global yields have likely fallen too far, too fast, in our view, but we also don't think they'll move materially higher as global risks—both market and economic—should weigh on the market regardless of how recent developments resolve themselves. Longer term, we still expect global yields to trend lower.

Sovereign yield curves



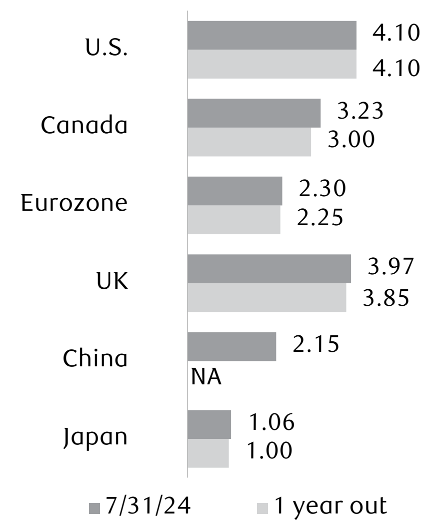
Source - Bloomberg; data through 7/31/24

Central bank rates (%)



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

10-year rates (%)



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

U.S. RECESSION

Scorecard

Four of seven

A bit more than two years ago, the Recession Scorecard was flashing nothing but expansionary green lights for the U.S. economy. Starting in summer 2022 that unequivocally unanimous rating began to deteriorate. First, the Treasury yield curve inverted in July 2022, i.e., the 1-year Treasury yield rose above the 10-year yield, signaling that credit conditions were tightening in a serious way. Every recession in more than 100 years has been preceded by such a yield shift.

A couple of months later a second of our seven indicators—the Conference Board's Leading Economic Index—changed to recessionary red by falling below where it had been a year earlier. This has occurred before the onset of every U.S. recession since the late 1950s or for as long as this indicator has been around. In the months that followed, three more of the series tracked by the Scorecard shifted out of the expansionary green zone over to the cautionary yellow rating.

A third indicator in the Scorecard was re-rated to the recessionary red column in June. As of Q1, the growth rate of U.S. nominal GDP had fallen below the fed funds rate. Such a crossing point has occurred either before or just after the start of every recession back to the 1950s. Preliminary Q2 GDP data released in late July confirmed that re-rating.

Now a fourth indicator in our series, the unemployment rate, has been relit as red which brings the majority into that recessionary column.

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

The 1-year Treasury yield rose above the 10-year yield decisively in July 2022, with the negative gap growing further over most of the following year. While the average time interval between "inversion" of the yield curve and the onset of recession is 13 months, the gap was longer than average in four instances, with the longest being 23 months. As of July, this became the longest inversion in more than 100 years.

Yield curve inversion is an unequivocal indication that credit conditions are tight. The Fed's Senior Loan Officer Survey (most recent issue released on August 5) revealed that most U.S. banks continue to raise

U.S. Recession Scorecard

Indicator	Status: Expansionary	Status: Neutral/ Cautionary	Status: Recessionary
Yield curve (10-year to 1-year Treasuries)			✓
Unemployment claims		✓	
Unemployment rate			✓
Conference Board Leading Economic Index			✓
Non-financial corporate cash flows	✓		
ISM New Orders minus Inventories		✓	
Fed funds rate vs. nominal GDP growth			✓

Source - RBC Wealth Management

U.S. RECESSION SCORECARD

lending standards on almost every category of business and consumer loan, including commercial and industrial loans for businesses of all sizes, credit card loans, consumer installment loans, mortgage loans, and commercial real estate loans. The plurality of banks tightening has narrowed in the past three surveys, but the data remains well short of signaling a return to easing of standards.

The negative spread between the 1-year yield and the 10-year yield reached its widest point this cycle so far in June 2023 at 158 basis points (bps). It has since narrowed dramatically to just 31 bps in early August. The crossover from “inverted” back to “normal” has tended to occur just as the recession is starting or a few months before.

Conference Board Leading Economic Index

Historically, this indicator 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 recessionary red column. As of the June 2024 report, the index had fallen for 29 of the preceding 30 months moving deeply into negative territory, although the rate of year-over-year decline has slowed over the past seven months. The indicator has never fallen this deeply without a recession arriving.

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 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. For those reasons, we look at it as a corroborative indicator rather than a decisive one taken on its own.

After setting its most recent low in September 2022, this series rose steadily (we use a three-month moving average) and moved back above zero last summer. After three consecutive months in positive territory, we shifted the rating from recessionary red to neutral/cautionary yellow despite the fact the new orders component by itself remained decisively negative. That new orders reading finally managed to reach expansionary territory in January 2024; however, weak readings in May, June, and July have left this indicator teetering barely above zero.

Unemployment claims

The monthly low for this cycle occurred in September 2022. The cycle low for claims has typically been registered about 12 months before the start of the next recession. So far, no lower reading has been posted in the intervening months, leaving the indicator’s status at yellow. A decisive push in the monthly data above 300,000 claimants would be needed shift this indicator to red. The latest monthly total rose to 238,000.

The fact that temporary employment, job openings, and average hours worked have all been falling on a year-over-year basis adds to the likelihood the tide may have turned for unemployment claims.

Unemployment rate

The unemployment rate rose to 4.3% in July after setting a cycle low of 3.4% in April 2023. While it edged gradually higher over the intervening 14 months, it looks, with the jump in July, to have moved into a decisive uptrend. We have re-rated this indicator to red.

U.S. RECESSION SCORECARD

Non-financial corporate cash flows

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, either indicating a recession is coming or a deepening one is already underway. These cash flows, while well down from their pandemic peak, are still above a negative crossing point as of Q1, which leaves it as the sole indicator still giving the U.S. economy a green light. There is a long lag time before this data is reported with the Q2 release not coming until September.

Fed funds rate vs. nominal GDP growth

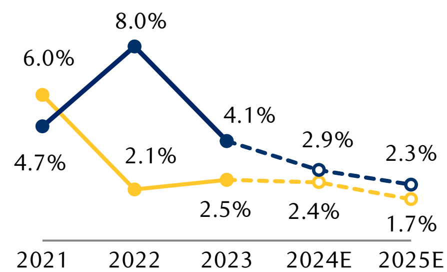
The fed funds rate has risen above the six-month annualized run rate of nominal GDP either before or at the start of every recession in the past 70 years. (Nominal GDP is GDP not adjusted for inflation.) That GDP run rate has been declining since its pandemic reopening high of 23% recorded in Q4 2020. By the end of last year, it had slowed to 6.7%, still above the 5.50% fed funds rate. However, the Q1 GDP data release put that six-month run rate of nominal GDP growth at just 4.9%, below the 5.50% fed funds rate, satisfying this historical precondition of a recession. We shifted this indicator into the recessionary red column in June. Preliminary Q2 GDP data confirmed this re-rating.

Tick, tick, tick...

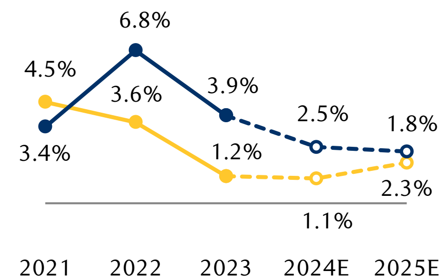
Weighing up the current positioning of the seven indicators and projecting their likely paths points to a growing probability the U.S. will enter a recession in the second half of this year, in our view.

KEY
Forecasts

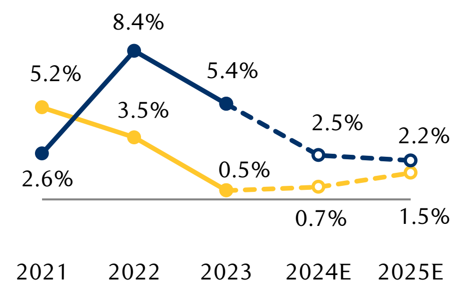
United States



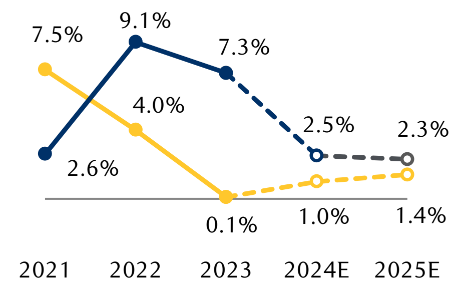
Canada



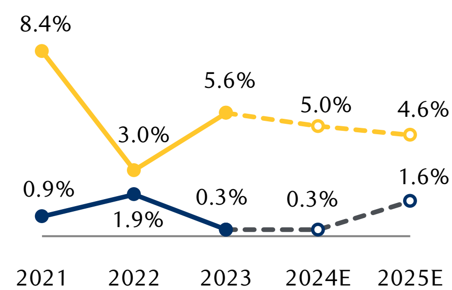
Eurozone



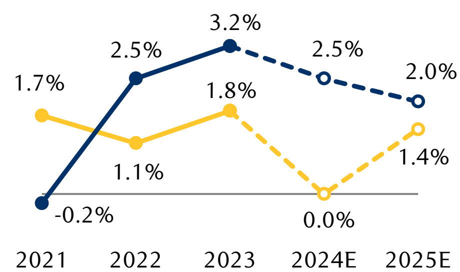
United Kingdom



China



Japan



Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management, Bloomberg consensus estimates

Research resources

This document is produced by the Global Portfolio Advisory Committee within RBC Wealth Management's Portfolio Advisory Group. The RBC Wealth Management Portfolio Advisory Group provides support related to asset allocation and portfolio construction for the firm's investment advisors / financial advisors who are engaged in assembling portfolios incorporating individual marketable securities.

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Distribution of ratings – RBC Capital Markets Equity Research
As of June 30, 2024

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Outperform]	857	57.44	271	31.62
Hold [Sector Perform]	588	39.41	146	24.83
Sell [Underperform]	47	3.15	5	10.64

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