

Debunking debt disaster

Myths may be important to folklore, but they're not helpful in finance. We look at the facts behind some of the common myths surrounding the U.S. national debt.

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KEY FORECASTS

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Given the majority of stocks are moving in sync with the broad averages, supported by expectations for solid earnings growth, we think an investment portfolio should stay put (for now) with a commitment to equities at or near its long-term target weight relative to fixed income.

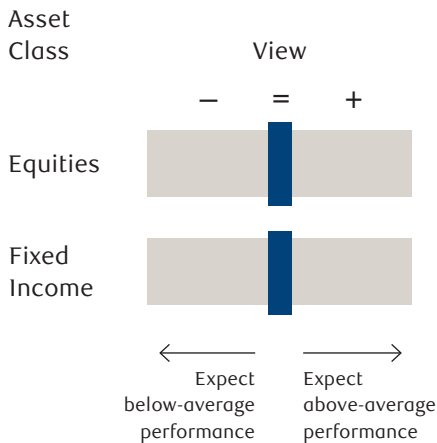
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Central banks have continued their rate-cutting cycles, some at a faster pace than planned. However, markets are keeping a close eye on Federal Reserve action or inaction.

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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

- The S&P 500 and Canada's TSX posted new all-time highs in October, while European, UK, and Japanese markets have done no better than tread water since the spring. Favorable economic data, including upward revisions to jobs growth and solid retail sales, increased the probability of the U.S. economy achieving a soft landing. A resilient U.S. earnings outlook, global central banks embarking on their rate-cutting cycle, and a majority of stocks participating in the advance of most broad averages continue to leave a Market Weight position in global equities as the most appropriate positioning for the coming year.
- A much more aggressive stance may not be warranted, in our view. Investor sentiment shows signs of complacency while lofty equity valuations in the U.S. suggest the market is pricing in a continuation of above-average earnings growth. While we are constructive on global equities, we believe a watchful approach is called for. We would focus on companies with a resilient business, manageable balance sheets, and strong cash flows which enable them to pay and grow dividends.

Fixed income

- Global bond yields have recovered from the lowest levels of the year in September. The average yield on the Bloomberg Global Aggregate Bond Index has risen to 3.6% but remains lower than the April high of 4.1%. While many central banks continued with rate cuts in October, markets have pared back what were deep rate cut expectations in September for the Federal Reserve. We continue to anticipate further rate cuts from most major central banks this year, but that the Fed may proceed more cautiously than the rest.
- Global inflationary pressures continue to improve after a brief uptick to start the year, allowing central banks' focus to shift to economic growth and labor market concerns from inflation. After turning cautious on yields and extending duration due to the drop in yields in September, we believe the recent rise in yields provides another opportunity for investors to put money to work. In the U.S., however, we think there may be some modest upside risk remaining for yields through November due to the elections, so some patience may be warranted.
- We reiterate our Market Weight stance on U.S. fixed income with yields remaining above multi-decade averages. Globally, we favor sovereign bonds over corporate bonds as we think valuations in the latter remain relatively rich.

MONTHLY
Focus



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Debunking debt disaster

Myths may be important to folklore, but they're not helpful in finance. We look at the facts behind some of the common myths surrounding the U.S. national debt.

The U.S. government has an incomprehensible amount of debt. The number is so large—\$35 trillion and counting—that we think it has lost any meaning. We find it incredible that Treasury debt to other U.S. government agencies—if broken out as a standalone—would itself be the third-most indebted nation on Earth, after the U.S. and Japan. Interest on the debt will soon be a trillion-dollar expense, larger than U.S. government spending on veteran benefits, education, and transportation combined.

The magnitude of these numbers has created a cottage industry of doom forecasting, with plenty of hyperbole but little analysis. We have previously [discussed](#) what we see as the realities of the U.S. national debt, but we think it's helpful to take another look at some of the more pernicious and persistent debt myths.

Myth #1: The U.S. economy is dangerously overleveraged

The biggest source of confusion that we see on the U.S. debt is that the number tells us something important. It doesn't—at least not by itself. That's because the government is only a small part of the U.S. economy. What matters for macroeconomic purposes is how much all stakeholders, public and private, have borrowed. And when we layer in household and corporate borrowing, it's apparent that the U.S. debt picture is relatively benign. Canadians, for instance, have leveraged more of their future production than Americans have, and U.S. borrowing is on par with Sweden and the UK.

Worrying about government debt is analogous to someone claiming to be debt free because they paid off last month's credit card bill. That's a tough argument if the person still has a mortgage, car loan, or student debt. Whether at the household or the national level, we're unlikely to reach the right conclusion if we only look at one slice of the pie.

Myth #2: Investors need to prepare for an upcoming U.S. default

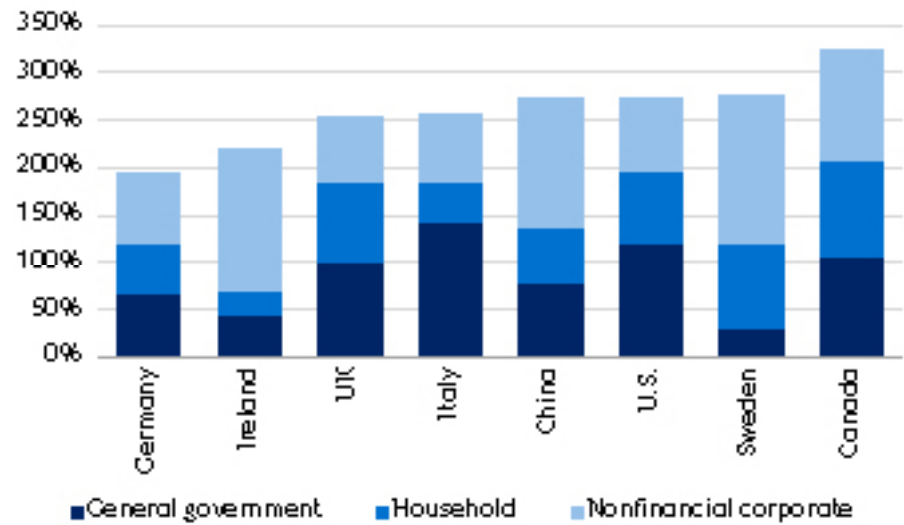
Defaults generally occur when borrowers lack the resources to fulfill their promises. That's not likely to happen for the U.S. government, since the Treasury has only promised to give investors a set number of dollars at specified future dates. By happy coincidence, the U.S. government can manufacture dollars at the push of a button. In those circumstances, it would be an active choice for the U.S. to fail to meet its obligations. And given the lifespan of political careers after a sovereign default, we think it's a choice U.S. leadership is not going to make.

As we've discussed [before](#), the legitimate concern around excess borrowing is not default but inflation. The dollars will be paid as promised, but investors won't be able to buy as much with the proceeds. This is a

DEBUNKING DEBT DISASTER

Not so very different after all: A broader measure of indebtedness shows the U.S. is fairly typical

Debt as percentage of 2022 national GDP



Source - International Monetary Fund; percentage of 2022 GDP including bonds, loans, and debt securities

genuine risk. But it's a much different concern than default. Sovereign defaults are economic catastrophes for most strata of society and tend to precede years of slow growth. Inflation is a serious problem, but it's easier to deal with and usually orders of magnitude less severe than defaults.

Myth #3: Blame the politicians, they're the ones in control

The prevailing narrative is that profligacy created our debts. Whether its crazy spending programs or unfunded tax cuts, debt is just a result of poor political leadership.

To be fair, there's an element of truth to that view. Raising taxes is a political no-go, and there are certain programs that must be funded. Unfortunately, the uncuttable program costs exceed the un-raiseable tax proceeds. That's a structural political issue, and it's likely here to stay for the foreseeable future.

But the reality is the big run-up in government borrowing hasn't been a result of political will. The biggest increases are from the global financial crisis and the pandemic. Without those two events, the U.S. debt-to-GDP ratio would likely be around 40 points lower. It's difficult to argue, in our view, that politicians really had a choice when COVID struck or when the banking system veered toward collapse.

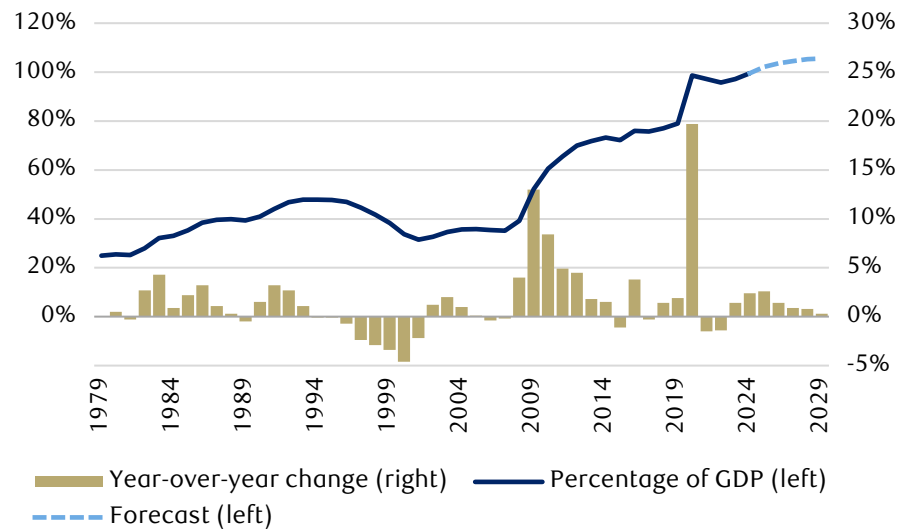
This again highlights the point that the government is only a relatively small part of the economy. If we look back to the last U.S. budget surplus in the 1990s, there were movements to control spending and raise taxes, but a major driver of the surplus was the rise of the internet and the concurrent economic growth.

Debt reduction is less about annual fiscal budget tightening than about avoiding catastrophes and reaping the fruits of innovation.

DEBUNKING DEBT DISASTER

U.S. debt rise is driven by crisis response

Federal debt held by the public



Source - RBC Wealth Management, Bloomberg; 2024 and later represents Bloomberg consensus forecast

Myth #4: Reducing debt will make everything better right away

The old adage to “be careful what you wish for since you just might get it” is particularly apt when it comes to investors and government debt reduction.

The rise in U.S. government debt has been accompanied by solid investment returns across most—if not all—asset classes. Debt-funded government spending played a real role in those results. At its core, debt is about moving demand through time; borrowing adds to today’s demand and repayment reduces today’s demand. If the U.S. were to shift to debt reduction, it’s very likely that economic growth—and by extension corporate earnings—would decline, at least in the short term. Investor optimism around lower debt could help offset some of the effects of slower growth, but there is little empirical support for that idea.

Reality check

Despite the scary and oft-repeated headlines around U.S. debt, we struggle to see what keeps the fear going. Equity markets are at or near all-time highs; borrowing costs across the economy are largely manageable; and economic growth is strong with inflation declining. This has largely been the case for the U.S. for most of the past four decades, a period marked by rising government debt.

Is every dollar of U.S. government spending efficient? Of course not. Could tax policy be made more rational and do a better job of fomenting growth? Absolutely. But it’s a far cry from saying the world is not ideal to saying that we are on the verge of an economic apocalypse. To us, that leap, like much of the discussion on the U.S. debt, is better suited to economic mythology than financial reality.

GLOBAL
Equity

Watchful and cautious, but invested



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Three horses have dropped out of the global equity market race, at least for now, as the MSCI Europe, MSCI UK, and (Japan) TOPIX indexes all last posted new highs in the spring. European and UK markets have slowed to a walk ever since, while Japan looks to have slipped into a downtrend.

Meanwhile, the S&P 500 and Canada’s TSX posted new highs last month as did the unweighted version of the S&P 500 and the advance-decline lines for both the S&P 500 and the Dow Jones Industrial Average. As long as these latter measures of “market breadth” keep making new highs alongside the capitalization-weighted S&P 500, it’s reasonable to think the uptrend for the U.S. blue-chip index could have further to run.

U.S. equity valuations—never a reliable short-term timing tool—remain rich by historical standards at 24x consensus estimated earnings of \$242 per share and 21x projected 2025 earnings of \$275. They can get richer still, and we think they may do so as long as the 2025 earnings outlook does not fall apart. That will depend on the economy for which there are conflicting expectations.

U.S. consumers split

The U.S. consumer has differing views on the economic outlook depending on income. The top 40%, buoyed by much-better job security, appreciating stock prices, and rising home values have been the main positive force behind solid increases in consumer spending. Roughly speaking, the top 40% account for about 60% of consumer outlays.

The bottom 60% of income earners have been losing confidence in the near-term prospects for the economy since the beginning of the year (although long-term expectations remain mostly positive). That profile

Equity views

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

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

of declining confidence looks very much like the path of the National Federation of Independent Business’ (NFIB) Small Business Optimism Index. Small and medium-sized businesses account almost 60% of private sector jobs in the United States. We think it’s not surprising that the mood of the owners of those businesses looks a lot like the mood of their employees.

So small business optimism (or lack of it) maps onto consumer confidence and onto the (related) willingness of workers to voluntarily quit their jobs in search of a better-paying one: the so-called “quit rate” continues to plunge as employed workers cast a wary eye on the rising unemployment rate and the steady increase in continuing unemployment claims since the beginning of the year.

Rate cutting by the Federal Reserve may eventually improve this confidence picture but so far credit card loan rates and car loan rates remain sky high at 23% and 8.5%, respectively, up dramatically from two years ago. The rate on short-term business loans clocked in at a punishing 10% per annum in the latest NFIB survey.

For the stock market, the all-important earnings outlook has been more or less holding together,

GLOBAL EQUITY

although both the 2024 estimate and the 2025 projection are fractionally off their recent peaks. RBC Capital Markets, LLC Chief U.S. Equity Strategist Lori Calvasina has characterised the Q3 earnings season to date as “underwhelming.”

For our part, we think an investment portfolio should retain a commitment to equities at or near its long-term target weight relative to fixed income. What would persuade us to become more defensively-minded would be the major stock market indexes rising to a succession of further new highs amidst a backdrop of some combination of a breakdown in market breadth, a prolonged stretch of unbridled investor optimism, and/or a shift in policy that fundamentally and materially weakened the prospects for earnings growth.

We remain watchful and cautious, but invested.

GLOBAL
Fixed income



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The beat goes on

Global central bank rate-cut cycles not only continued in October, some banks even accelerated the pace of easing. The European Central Bank (ECB) cut rates for the third time since June, bringing its primary policy rate down to 3.25% from 4.00%. The guidance was equally dovish as ECB President Christine Lagarde continued to downplay further inflationary risks, while highlighting growing economic concerns.

We expect the ECB to continue cutting into H1 2025 as policymakers appear keen to get policy rates back to a more “neutral” setting, and rapidly so, which we judge to be around 2.25%. From there the debate will likely be whether to move rates lower and into an expansionary setting based on the evolution of the economic data.

Not to be outdone, the Bank of Canada upped the pace of its ongoing rate-cutting cycle, delivering an outsized 50 basis points (bps) cut in October, bringing its policy rate down to 3.75%, from the peak level of 5.00% in June. Policymakers highlighted that inflation has fallen below 2%, and while further cuts are likely, they noted that economic growth is expected to improve in 2025.

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

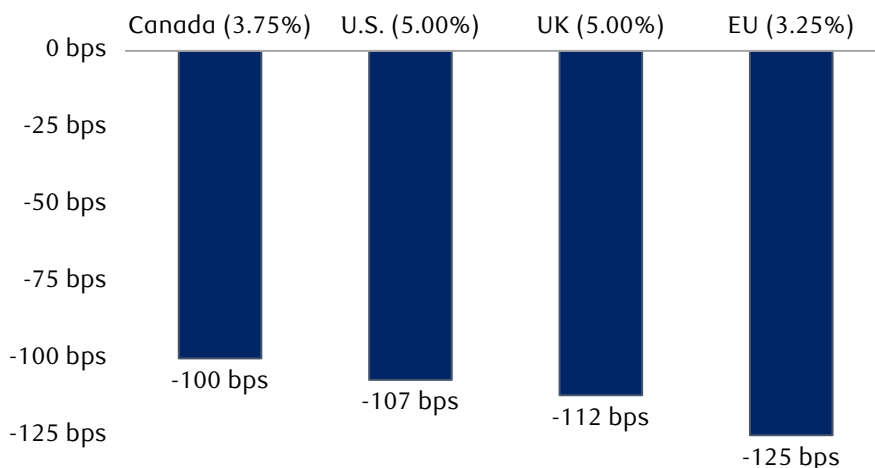
However, RBC Capital Markets isn't so sure. It now expects another 50 bps rate cut in December as urgency is likely to grow over getting rates back to neutral, which it now views as a lower level of 2% from 3% previously, and possibly even lower amid what it expects to be a softer economic backdrop.

But where many global central banks have their feet firmly on the policy-easing accelerator as inflation wanes and growth concerns rise, markets are increasingly thinking the Federal Reserve could tap the brakes after just one rate cut.

After the Fed's September decision to cut rates by a larger-than-expected

Market expectations for rate cuts through June 2025

Based on policy rates as of 10/23/24 (in parentheses)



Source - RBC Wealth Management, Bloomberg

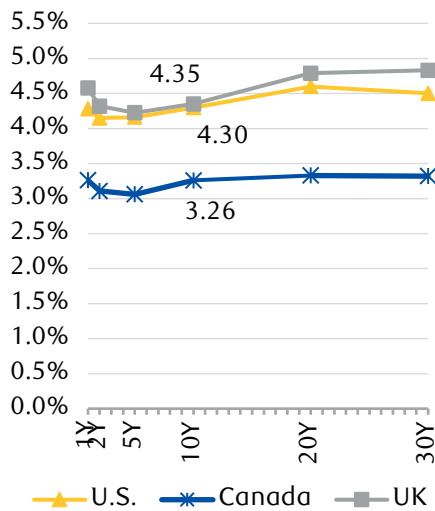
GLOBAL FIXED INCOME

50 bps, markets had priced nearly 200 bps of further reductions through June 2025—that has already been pared back to just 100 bps. Better economic data, and signs that the U.S. economy could actually be gathering steam amid a weaker global backdrop, have been the primary drivers.

We still expect the Fed to cut by another 25 bps this month, but it may take a more cautious approach to further easing from there compared

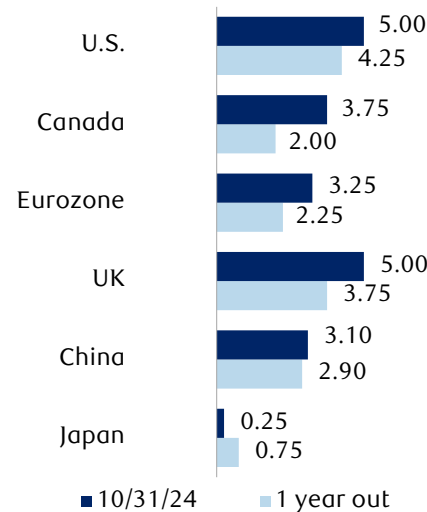
to its global counterparts. While most central banks now appear to be on autopilot with respect to lowering rates to less restrictive levels, continued U.S. economic strength could mean the Fed’s path forward is more nuanced and subject to greater volatility, as markets are left to price “will they, won’t they” scenarios ahead of each upcoming meeting.

Sovereign yield curves



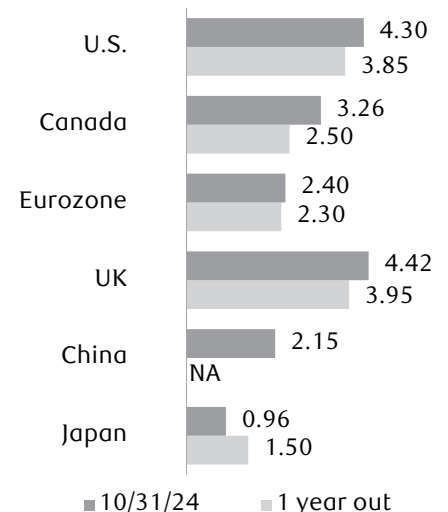
Source - Bloomberg; data through 10/30/24

Central bank rates (%)



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

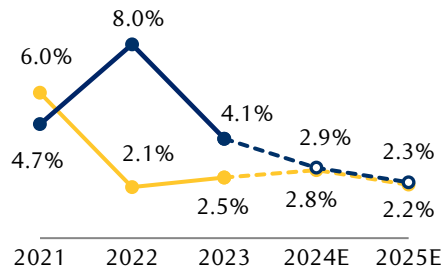
10-year rates (%)



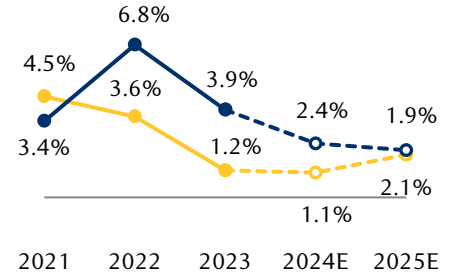
Note: Eurozone utilizes German Bunds. Source - RBC Investment Strategy Committee, Global Portfolio Advisory Committee, RBC Global Asset Management

KEY Forecasts

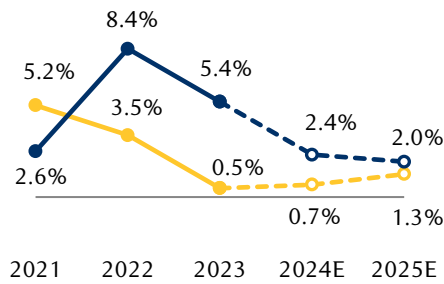
United States



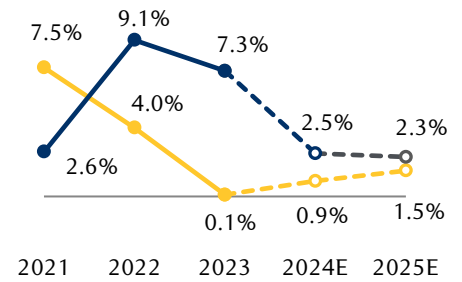
Canada



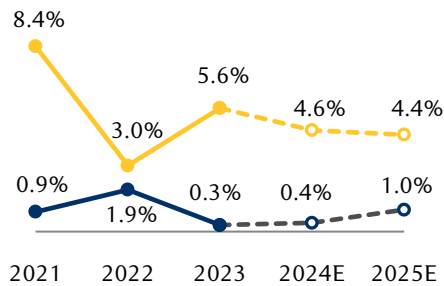
Eurozone



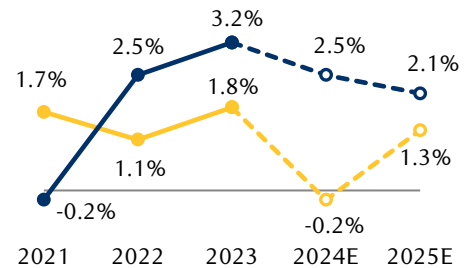
United Kingdom



China



Japan



—●— Real GDP growth

—●— Inflation rate

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

Research resources

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			Count	Percent
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