# GLOBAL Insight

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

January 2023

## Slow growth stasis?

The developed world faces a long stretch of slow growth. We look at the reasons for the downshift, and how it could impact equity investing.

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GLOBAL
# Insight
*January 2023*

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All values in U.S. dollars and priced as of market close, Dec. 31, 2022, unless otherwise stated.

RBC® Wealth Management

RBC'S INVESTMENT
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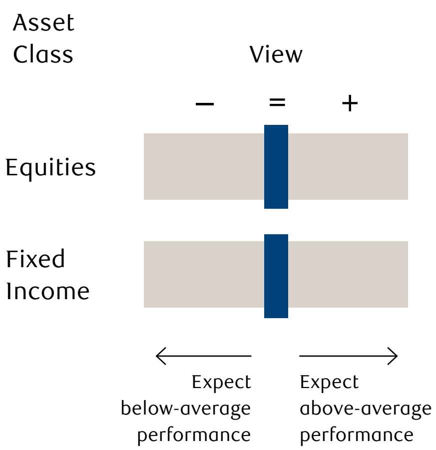


(+/=/–) represents the Global Portfolio Advisory Committee's (GPAC) view over a 12-month investment time horizon.

**+ 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

- Some regions' equity markets have bounced back recently, notably in Asia and Europe. The promise of a reopening in China and moderating inflation in Europe enabled extreme negative investor sentiment to lift.
- This trend may well continue, particularly given these regions' cheap valuations, but several reliable leading indicators are pointing to a broad-based economic decline in the U.S. in 2023. A U.S. recession, probably arriving around midyear, in our view, would likely determine the direction of global equity markets. Typically, U.S. recessions have been bearish for this asset class, and thus any rally could give way to a selloff.
- Yet investors should remember that stock markets tend to turn higher before recessions end and that economic contractions tend to be short, some two quarters on average. Therefore, we would remain invested, but lean more heavily toward quality and sustainable dividends.

## Fixed income

- Government bond yields have leveled out over the past three months, though volatility remains elevated. The average yield on the Bloomberg US Treasury Index sits at 4.07%, compared to the 4.17% three-month average and 2022 high of 4.56%. Though central banks largely remain hawkish, we continue to believe that rate hike cycles for many major global central banks will come to an end in H1 2023, meaning that sovereign yields—at least further out on the yield curve—have likely already peaked, leading us to lock in yields where possible.
- We remain Market Weight U.S. fixed income with yields at multiyear highs in addition to the positive outlook for bank-issued preferred shares on the attractive yields and defensive nature of bank balance sheets. We also maintain U.S. credit at Market Weight as yields remain near 20-year highs, with dollar prices on bonds still historically low—offering a cushion should recession and default risks materialize.
- We maintain our Market Weight in global fixed income, with a Market Weight allocation to credit.

MONTHLY

# Focus

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# Slow growth stasis?

The developed world is faced with the prospect of a long stretch of slower economic growth than what prevailed over the decade following the global financial crisis. We examine the factors that are likely to lead to this period of unusually slow growth. Such a pronounced growth slowdown leads us to some important conclusions for equity investing.

### Key points

- **Working-age populations are falling or slowing in most major economies, pointing to a prolonged stretch of slower GDP growth.**
- **Intense corporate competition and increasing protectionism are likely outcomes in a world where the economic pie is not growing as fast as it has been.**
- **Selecting for an ability to increase sales and earnings in a growth-constrained world should be the prime focus of the equity investor.**

The decade beyond 2023 is likely to feature unusually slow economic growth across the developed world. This is a theme we laid out in our Global Insight 2022 Outlook a year ago back in December 2021. In our view, it holds important ramifications for investors ranging from the prospects for earnings and dividend growth, to average share price performance, to the relative attractiveness/unattractiveness of various sectors, and to the comparative valuations of individual stocks within sectors.

The nonpartisan Congressional Budget Office (CBO), the federal agency charged with analyzing the U.S. economy and budget for the U.S. Congress and regarded by many as the best long-term forecaster of the U.S. economy, looks for the decade following 2023 to feature the slowest pace of GDP growth since the end of WWII. Forecasts for the rest of the developed world including China, by the Organization for Economic Cooperation and Development, reveal a similar pervasive trend—even slower growth than what prevailed over the decade following the global financial crisis.

Why so slow? We believe the chief culprit behind this growth downshift is the fact that working-age populations (15–64) are falling or about to be falling in almost all developed countries. This is the unavoidable result of a decades-long decline in birth rates (see top exhibit on the next page), which have reached levels well below the replacement rate and are showing no signs of reversing.

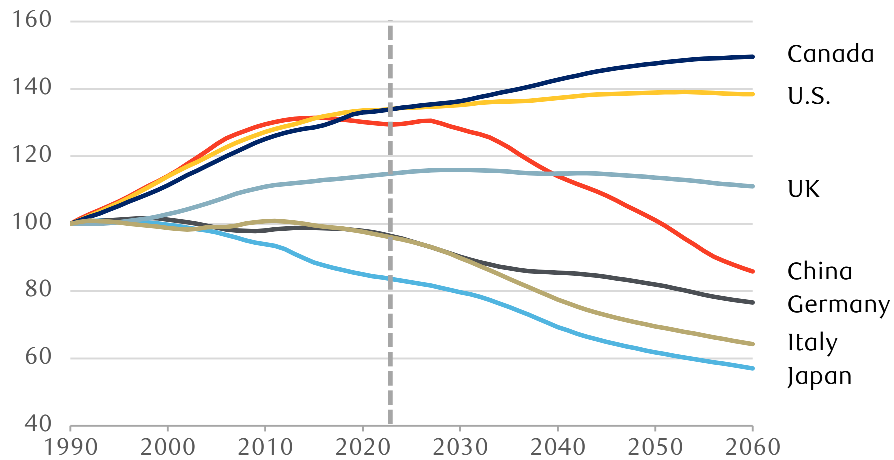
This projected decline in the workforce is important because GDP growth for most countries is mostly explained by a combination of growth in the number of people employed each year plus the growth in output produced by each employee (productivity).

MONTHLY FOCUS

*Slow growth stasis?*

### Working-age populations will grow more slowly—or continue to shrink

Populations aged 15–64 (all series indexed to 100 in 1990)



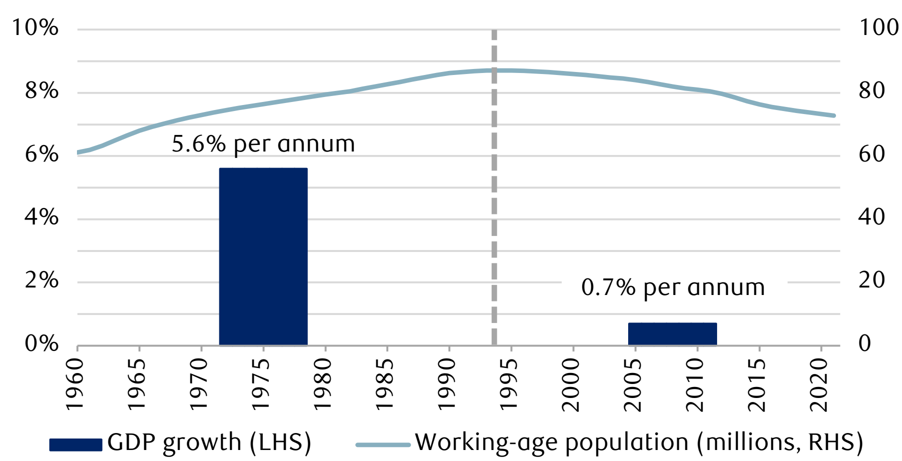

Source - United Nations Department of Economic and Social Affairs

## Japan: Canary in the coal mine?

Japan provides a case in point. From 1960 until 1990 that country's working-age population grew steadily and its GDP advanced by 5.6 percent per annum, consistently much faster than the U.S. economy (3.5 percent per annum over the same period). Many observers thought Japan would replace the U.S. as the world's largest economy by the turn of the century.

Instead, in 1989, Japan endured a massive collapse of real estate and the stock market, crippling its banking system. A decade later Japan's economy had regained its footing but its growth "mojo" had deserted it. In the early 1990s, its working-age population had begun declining, and that drop

### Japan's working-age population and two very different eras of GDP growth




As Japan's working-age population grew steadily from 1960 to 1994, so too did its economy. Real GDP grew at a compound annual rate of 5.6% per annum over that period, much faster than the 3.5% posted by the U.S.

But once Japan's working-age population started falling after 1994, the country's GDP growth rate crumbled to just 0.7% per annum; meanwhile, the U.S. grew more than three times faster at 2.4% per annum.

Source - United Nations Department of Economic and Social Affairs and the World Bank

MONTHLY FOCUS

*Slow growth stasis?*

accelerated over the next 30 years. Over the interval 1991 to 2021 Japan's GDP grew by less than one percent per annum.

It's worth remembering that Japan is considered by many to be the most industrially sophisticated, advanced economy in the world with more technology imbedded in it and developed by it than any other. It has a well-educated, motivated workforce, universally admired and emulated management skills, together with more than a century of successfully exporting its goods and services. But despite all these strengths Japan's GDP growth has been mired at something less than one percent per annum for three decades and counting.

Given Japan's experience, it's hard to look at the demographic projections and make a case for even average GDP growth for most of the developed countries including China. For the U.S. and Canada there may still be a modest addition to growth from some (slow) workforce growth but not enough by itself to make one confident of predicting a robust upward trajectory for GDP.

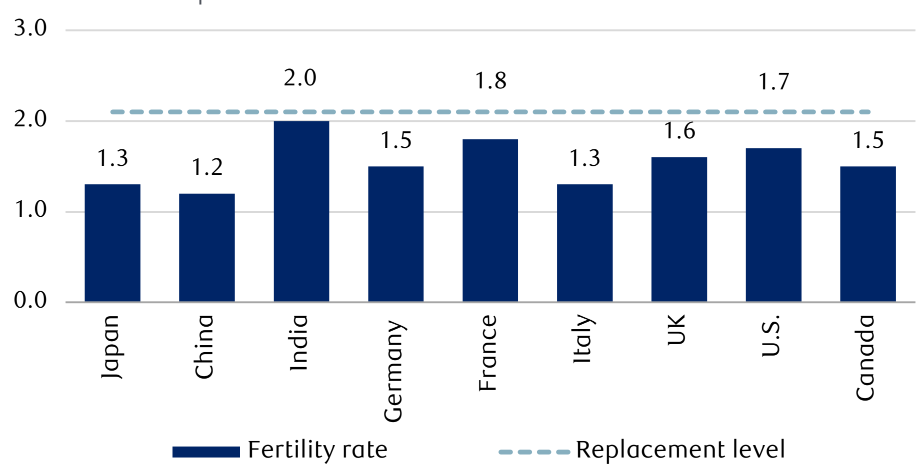
## Is the working-age population decline inevitable?

An individual country could conceivably offset the labor force deficit brought about by low rates through immigration. But of the developed countries noted above, Japan remains effectively closed, China has shown no interest in welcoming foreigners, and the European electorate has been shaken by the migrant crisis into increasingly voting for anti-immigration candidates or for outright restrictions (Brexit).

While the U.S. remains theoretically open to newcomers, the combined effects of the Patriot Act and efforts to tighten the southern border have reduced the flow of newcomers considerably over the past 20 years. Canada is one of the few countries where immigration policies, already selective, have not become restrictive.

### Fertility rates below the replacement level in developed economies

Number of births per woman




Note: The replacement birth rate, below which a country's population tends to decline, is generally considered to be 2.1.

Source - United Nations Department of Economic and Social Affairs

MONTHLY FOCUS

*Slow growth stasis?*

## It’s all up to productivity

As employment growth slows or goes into reverse under the influence of these trends in most developed economies, then it is our view what GDP growth there is will have to increasingly come by way of productivity gains.

Productivity is difficult to measure and has rarely been produced by intentional government policy. Rather, the starting point is usually the arrival of an important invention which, a decade or more down the road, provokes several rounds of innovation (and much skepticism). Many of these innovations fail, but some go on to have a transformative effect on the economy over many decades: think the steam engine, the telegraph, antiseptics, the internal combustion engine, electrification, antibiotics, telecommunications, large computers, the computer chip, the personal computer, and the internet.

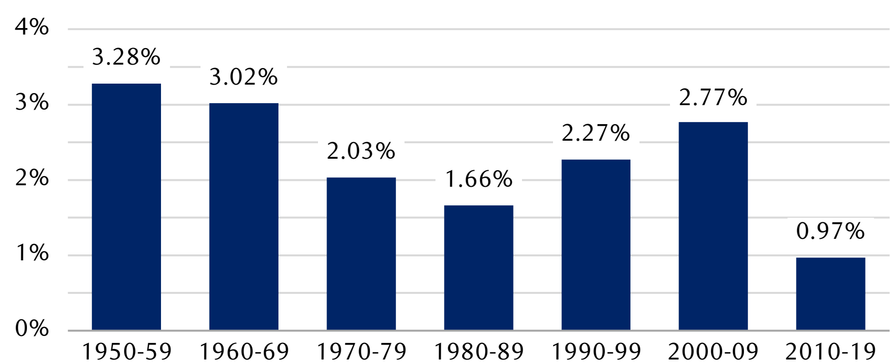
What will be the next important driver of innovation and productivity gains? Although there are plenty of candidates touted as the next big thing—artificial intelligence, big data, self-driving vehicles, genetic engineering, 3D printing—it is difficult to have absolute conviction about any of them in terms of how much they will actually increase productivity.

It is worth remembering that 2010–2019 was the **slowest decade by far** for U.S. productivity growth in the last 70 years, despite being an interval over which the smartphone went from a standing start to being ubiquitous over much of the world even as the device itself was going from being comparatively “dumb” to startlingly powerful. Meanwhile, over that stretch, online capacity increased by several orders of magnitude; businesses digitized at a rapid pace; and capital spending grew at more than twice the rate of the overall economy. And yet productivity did no better than creep higher at less than one percent per annum.

If the working-age population in the U.S. is growing at just the 0.3 percent per annum forecast by the United Nations and productivity gains are limited to something close to the 1.3 percent per annum average that has prevailed since the global financial crisis, then the combined result would be slower overall GDP growth—probably less than two percent per annum,

### Of the past seven decades, 2010-19 delivered by far the slowest productivity gains

Average productivity increase per annum




Source - U.S. Bureau of Labor Statistics right in line with the CBO's forecast of 1.5 percent to 1.8 percent per annum for the decade.

Europe and China will be contending with similar "slow growth" dynamics. We think such a pronounced growth slowdown leads to some important conclusions for equity investing.

## Selection rules

The first would be even greater intensity of corporate competition: when the total economic pie is growing more slowly than it has been, then each individual business has to work that much harder to maintain its share of the pie let alone gain share. In such a scrap the biggest and strongest will likely come out on top, but the second- and third-tier competitors are not going to simply lie there and accept their fate. We see another big wave of tech spending by businesses as the most obvious consequence of a long stretch of intense competition.

We believe that a second inevitable consequence of an extended stretch of much slower growth would be more protectionism. We saw that trend emerge in the last half of the prior decade. Now a growing list of countries and companies, shaken by the unexpected fragility of global supply chains, are moving toward mandating and building out greater domestic capacity for everything from vaccines and other biotechnologies to computer chips and defense procurements.

Building more domestic capacity may be good for capital spending for a few years, but the tit-for-tat response of trading partners to any restrictive trade barriers could take a toll on the sales and foreign earnings of exporters and multinationals.

In our view, a prolonged period of elevated competition will produce even greater corporate concentration. We think equity portfolios should lean toward companies that are likely to be in this dominant group at the end of the next decade. Selecting for a company's ability to grow sales, earnings, and dividends as fast as, or faster than, the economy expands should permit a portfolio to deliver above-average returns and demonstrate more resilience in periods of economic downturn.

U.S. RECESSION

# Scorecard

# Pointing toward a downturn getting underway late in H1

Three of our seven leading indicators of U.S. recession continue to signal an economic downturn is on the way. Three others are still firmly in expansionary territory but are moving (slowly) in the wrong direction, and the last—the unemployment rate—is sitting at a 53-year low with no immediate prospect of generating a negative signal.

The indicators that have flipped to recessionary status so far, together with the most recent low in unemployment claims (March 2022), point toward a recession getting underway by Q2 2023, in our view.

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

The position of short-term interest rates relative to long-term rates—a.k.a. the shape of the yield curve—has been the most reliable leading indicator of a U.S. recession. Before the start of every recession for the past 75 years, the 1-year Treasury yield has risen above the 10-year yield, indicative of the arrival of tighter credit conditions. About a year after this crossing occurs, on average, a recession begins.

The 1-year yield rose above the 10-year yield decisively last July. The negative gap widened further in October and November before narrowing somewhat in December. Thus, history suggests the U.S. economy will be in recession by summer 2023.

A majority of U.S. banks have begun raising lending standards, corroborating the yield curve's signal that credit conditions are becoming more restrictive. However, loan payment delinquencies and default rates remain very low; therefore, credit could remain accessible, albeit more expensive, for some time yet.

### ISM New Orders minus Inventories

The difference between the New Orders and the 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

U.S. recession scorecard

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

Source - RBC Wealth Management

## U.S. RECESSION SCORECARD

15% of the U.S. economy) and is derived from a survey rather than hard data. Therefore, we view this as a corroborative indicator—one to pay attention to if other longer-term indicators are implying a recession is on the way. It has been negative since May 2022.

### Conference Board Leading Economic Index

Historically, this series 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 negative in Q3 2022, shifting it to the red column on our scorecard. It indicates a U.S. recession will likely be underway by Q2 2023.

### Unemployment claims

This series set its low, so far, for this cycle back in March 2022 at 178,000. The cycle low for claims has typically been registered about 12 months before the start of the next recession. So, if no lower reading is posted in the coming months, its history would suggest a recession could get underway by spring of this year.

After setting that low in March, the number of claims rose steadily to a peak of 241,000 in July. Since then, new monthly claims have fallen all the way back to around 220,000. A new low for the cycle in the coming months can't be entirely ruled out, in our view, but does not appear likely.

### Unemployment rate

The unemployment rate ticked back down to equal a multi-decade low of 3.5% last month. In our view, a move above 4.0% would signal a recession is on the way. Once that signal is given, on average it has been eight to nine months from the lowest monthly reading until a recession gets underway, although there have been several instances where the time gap was only two to three months.

### As for the rest …

Neither the **free cash flow of non-financial corporate business** nor the **federal funds rate vs. nominal GDP growth** appear close to crossing the threshold into a recessionary reading, although in both cases the positive gap is narrowing.

Weighing up the current positioning of all seven indicators and projecting their likely paths over the next couple of quarters continues to point to a growing probability the U.S. will enter recession sometime late in the first half of 2023, in our view.

GLOBAL
# Equity

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## Status quo

There is no change to the "challenged" outlook for global equity markets over the coming 12 months. Of primary concern is the growing certainty that a U.S. recession will arrive around midyear 2023. If it does, it would be very unusual for Canada not to suffer the same fate. High energy costs in Europe and the UK look set to produce a downturn there—new orders are already weak, and the knock-on effects of production slowdowns have not yet been fully felt.

Meanwhile, China brings a mixed message. The re-opening should add to domestic activity and to imports of foreign goods but may also produce a surge in commodity prices, exacerbating the inflation outlook for central banks.

Over the past 70 years, the Fed has usually stopped raising interest rates and begun cutting even before the associated recession started. However, given today's inflation concerns, the Fed and other central banks have made a point of emphasizing the dangers of cutting rates too soon. Improving inflation data has already allowed the Fed to dial down the size of individual rate hikes; further moderation of price increases, especially if accompanied by weaker labour market readings, may even persuade the Fed to pause. However, outright cutting, in our view, is unlikely to begin until there is some marked worsening in economic data, most likely not before H2 2023 with a recession underway.

Happily, bear markets typically end some months before the associated U.S. recession ends—but not before the recession has started and not before the Fed has started cutting. So it appears the necessary conditions for a sustained upturn in share prices are unlikely to be in place until later in the second half of this year. That said, the path from here to there for equity markets is unlikely to follow a straight line.

### Equity views

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

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

So far, markets have remained above their October lows although the price action of some has resembled "treading water" more than an uptrend. But investor sentiment in the U.S. remains resigned and depressed (usually a good contrary indicator) while tax-loss selling has ended. We think a rally, propelled by better inflation data, could extend the gains made since October for a number of weeks or months into the new year before the bearish forces of the coming recession take control again.

On balance, we think leaning more heavily toward quality and sustainable dividends and away from specific individual company risks that may come home to roost in a recession looks to us like the right approach as 2023 gets underway.

REGIONAL EQUITY

# Regional highlights

## United States

Following the S&P 500's 19.4% decline in 2022, there are reasons to remain vigilant. The domestic economy is still at risk of succumbing to a recession, and the question of how fast and by what magnitude inflation will retreat remains to be answered. Furthermore, if S&P 500 earnings end up roughly flat this year, at $220 per share or less, this below-average growth rate would leave little room for price-to-earnings valuation expansion.

That being said, investors should not assume that 2023 will be a repeat of 2022. Importantly, the consensus earnings outlook is "less bad" than in previous periods of economic stress. Even if a recession materializes, we think household spending and corporate earnings would be relatively more resilient than in recent economic contractions. Also, the market has already absorbed significant blows, including hefty Fed rate hikes. It would be rare for the S&P 500 to deliver back-to-back negative return years; that has occurred only twice in the post-WWII era.

We think the most important objective is to bring portfolio allocations in line with long-term strategic recommendations. Attempting to time the market is a precarious exercise, and missing the biggest rally days can have detrimental long-term performance consequences.

We would also keep an eye out for opportunities. Currently, we favor the small-capitalization and midcap segments of the U.S. equity market, and the large-cap Energy sector.

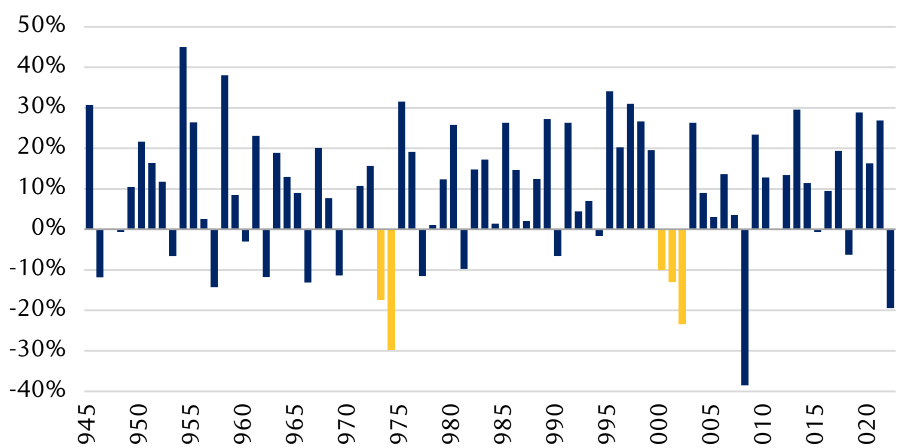
## Canada

Tighter monetary policy and its impact on financial conditions throughout the Canadian economy have meaningfully slowed economic growth expectations, as household consumption feels the pressure from higher interest rates and elevated inflation. As a result, RBC Economics is expecting Canada to slip into a recession early this year.

We think the S&P/TSX Composite Index is pricing in a modest recession, trading at an approximate 20% discount to its longer-term average. However, Canada has the idiosyncratic risk of elevated household debt coupled with an outsized economic contribution from housing that we believe warrants additional consideration.

### Only two periods of back-to-back negative U.S. equity returns in the post-WWII era

S&P 500 annual returns 1945–2022 (excluding dividends)




Source - RBC Wealth Management, Bloomberg; 2022 represents preliminary year-to-date data through 12/31/22

REGIONAL EQUITY

The Canadian banks trade roughly in line with valuations that prevailed at the tail end of the 2014–2016 oil collapse, but remain significantly above valuations at the worst of the 2008–2009 global financial crisis and the COVID-19 pandemic. Thus, we believe the group is already capturing a mild recession in its valuation, but further weakness is possible if Canada experiences a deeper-than-expected recession.

Canadian energy equities have held up well despite crude oil prices weakening from their peak last year. In our view, the underinvestment in oil development over the past decade has resulted in a tight supply outlook, underpinning our positive multiyear projection regarding the commodity. We believe the solid commodity forecast paired with attractive free cash flow generation and the potential for favourable capital allocation decisions support maintaining allocations to the industry.

### Continental Europe

The EU faces a challenging winter. The uncertainty of higher natural gas prices and possible energy shortages have dragged consumer and business confidence to multi-decade lows. Double-digit inflation has pushed the European Central Bank into its most aggressive hiking cycle in its history. Leading indicators point to an economic slowdown.

After the winter, once the anxiety of potential energy shortages lifts, economic activity could pick up as consumption resumes and businesses adapt their supply chains and improve energy efficiency. Exports should benefit from China's eventual reopening, and the ultimate stabilization and improvement of the U.S. economy.

There remain several "known unknowns," including energy shortages and worsening geopolitics, that represent potential downside risks to the region's economic growth outlook. For now, we continue to recommend an Underweight position in European equities, but we acknowledge the discounted valuations with the MSCI Europe ex UK Index trading on 13.2x 2023 consensus earnings estimates.

We maintain our bias for quality, globally diversified companies that possess strong pricing power, and we see opportunities within the pharmaceuticals, technology, luxury, and capital goods industries. Moreover, we believe long-term investment opportunities exist in companies that are well-positioned for the prospect of a strong industrial capital expenditure cycle ahead in areas such as decarbonization, infrastructure, automation, and digitalization.

### United Kingdom

Having contended with the economic shocks of Brexit, the COVID-19 pandemic, and the ongoing energy crisis, the UK economy is now being subjected to sweeping tax increases and spending cuts totaling almost 2% of GDP even as the Bank of England (BoE) tightens monetary policy and a recession starts.

Consensus economic forecasts for the UK point to a 0.95% GDP contraction in 2023, and a meek bounceback of 0.9% in 2024.

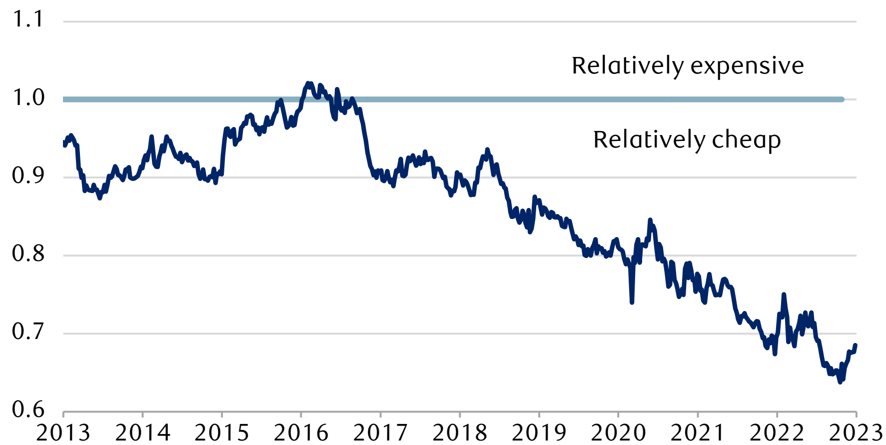
Decisions taken by policymakers (austerity) and society at large (Brexit) have put the UK economy on a shaky growth path. The economy should ultimately recover, but a change of direction would likely help achieve this sooner.

This scenario could prove too cautious were natural gas prices and inflation to recede faster than currently envisaged, enabling the BoE to end its interest rate hiking cycle earlier. Moreover, a warmer relationship with the UK's major trading partner, the EU, would go some way towards reducing the Brexit uncertainty which contributes to holding back growth.

## REGIONAL EQUITY

**The FTSE All-Share Index hasn't been this cheap in 10 years**

FTSE All-Share Index 12-month forward price-to-earnings valuation relative to FTSE World Index




Source - Bloomberg

With austerity worsening economic conditions, we maintain our Underweight rating on UK equities.

Yet we think attractive opportunities remain for UK equities, which trade at a historically large valuation discount to other markets, even accounting for the different sector composition. For income-seeking investors, UK equities offer interesting opportunities, in our view, given the FTSE All-Share Index has the highest dividend yield among the major regional equity markets, at over 4%.

Within UK equities, we maintain our strong bias for internationally oriented companies. Moreover, energy companies remain attractively valued given the prospect for higher-for-longer oil and gas prices, in our opinion, and trade at a substantial discount to global peers.

### Asia Pacific

China's accelerated reopening has led to a surge in COVID-19 cases. Top Chinese health experts think this round of the pandemic will likely peak during China's New Year festivities later this month and the situation could stabilize in three months. Therefore, we expect the sharp surge in cases to add pressure on the economy in Q1 2023 and lead to market volatility. However, last month's Central Economic Work Conference, which sets the national agenda for the Chinese economy and its financial sector, adopted a pro-growth tone for 2023 including a proactive fiscal policy, forceful monetary policy, and support for high-quality development. We think the Chinese economy could gradually pick up in Q2 2023 thanks to policy stimulus and as infections stabilize.

The Bank of Japan announced a change to its Yield Curve Control (YCC) policy earlier than widely expected. We believe the policy change indicates an improvement in the economy, with the return of inflation, and inflation expectations rising. We note that Japanese stocks rose following the past two YCC changes in 2018 and 2021.

We maintain our positive stance on Japan equities, relative to other developed markets. This is supported by a likely economic recovery, the reopening of Japan's borders to overseas tourists, a still relatively weak yen, our view that the increase in Japanese interest rates will lag other developed markets, and the end of deflation as corporations increasingly hike prices to reflect higher input costs. We view the latter as a positive structural factor for Japan equities as it would reflect a sea change in corporate pricing behavior.

GLOBAL

# Fixed income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## End in sight

The year 2022 was not lacking in surprises for investors. The last was the Bank of Japan (BoJ) delivering a decision that injected further volatility into global fixed income markets. The move was subtle—a simple doubling of its 10-year sovereign yield target to 0.50%, while leaving the official policy rate at -0.10%—but unexpected nonetheless with markets viewing it as laying the groundwork for a formal exit from the negative policy rate era in H1 2023.

As a result, one of the biggest policy oddities of the past decade—negative interest rates—looks to be nearing an end as the global stock of debt trading to negative yields has nearly completed a round trip back to zero. But as central banks step back from extraordinary measures, we think their impact on markets will be no less significant in 2023.

While the BoJ may only be just on the cusp of removing policy accommodation, and last in line to do so, markets remain keenly focused on when other major central banks plan to stop.

In the U.S., the Federal Reserve continues to stand strong in the face of a market that continues to anticipate—wrongly, in our view—the long-awaited pause from the Fed. Policymakers indicated at the December meeting that rates could reach as high as 5.00%–5.25% this year, following the latest rate hike to a 4.25%–4.50% range. We think that suggests rate hikes in 25 basis point increments in February, March, and May before pausing at the June meeting. However, recent signs of sharply decelerating inflationary pressures could cause policymakers to pause as early as March at a 4.75%–5.00% policy rate.

A similar timeline holds for the central banks of Europe, England, and Canada, in that the aggressive rate hike campaigns that dominated 2022 will likely come to an end in H1

### Fixed income views

| Region | Gov't bonds | Corp. credit | Duration |
|---|---|---|---|
| Global | = | = | 5–7 yr |
| United States | = | = | 7–10 yr |
| Canada | + | + | 5–7 yr |
| Continental Europe | = | = | 5–7 yr |
| United Kingdom | = | = | 5–7 yr |

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

### A decade of negative-yielding debt nears an end

Global aggregate negative-yielding debt market value in U.S. dollars


Source - RBC Wealth Management, Bloomberg; data through 12/31/22

## REGIONAL FIXED INCOME

2023 with policy rates seen peaking at 3.00%, 4.00%, and 4.25%, respectively.

Although central-bank-driven market volatility will likely remain elevated over the near term as a result, we continue think it will pale in comparison to what investors have had to weather of late and will fade over the course of the year.

## Regional highlights

### United States

Interest rates are likely to peak in early 2023. We think December's 50 basis point rate hike, which brought short-term rates to a 4.25%–4.50% range, will be the Fed's last jumbo-sized move. Any further rate increases this year should continue in more traditional increments of 25 basis points, and only if justified by the incoming data, while attaining a level around 5.00% by Q1 2023, in our view. We foresee the Fed delivering a series of modest rate cuts over the back half of the year as it works to engineer some semblance of an economic soft landing.

Yields appear set to fall. We believe the sharp rise in yields across the fixed income landscape that played out over the course of 2022 will reverse in 2023. For example, the benchmark 10-year Treasury yield could fall below 3.5% by the end of the year, from 3.9% at the close of 2022.

We see this as a good time to lock in high yields. The net result for fixed income investors is that the window to put money to work is open, and it could close sooner than expected. Based on Bloomberg bond indexes, Treasuries yielded 4.2%, investment-grade corporate bonds 5.4%, and tax-exempt municipals 3.5% as of December 30. Should yields on offer fade over the course of 2023, as we broadly expect, that could introduce heightened reinvestment risk for short-maturity securities. We continue to favor a strategy of locking in historically high yields in intermediate-term and longer-dated bonds to maintain income, as well as to benefit from capital appreciation should bond prices move higher (and yields lower) due to recession risks in 2023 and the potential for Fed rate cuts as a result.

### Canada

Canadian fixed income was by no means spared from the historically poor performance across asset classes in 2022. Elevated inflation forced the Bank of Canada to rapidly withdraw monetary stimulus and

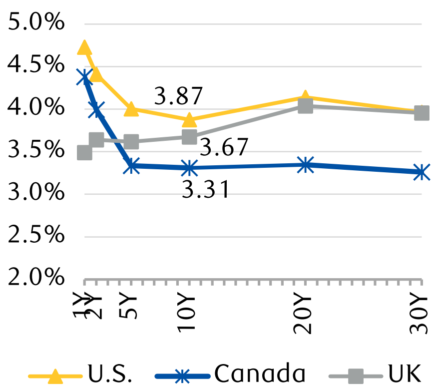
**Income returns to fixed income**

Average yield on investment-grade Canadian corporate bonds


Source - Bloomberg; data through 1/4/23; yield represented by Bloomberg Canada Aggregate Index

## REGIONAL FIXED INCOME

### Sovereign yield curves




Source - Bloomberg; data through 12/31/22

raise interest rates more aggressively than markets initially expected, resulting in surging bond yields.

In previous years, government bond yields typically fell when risk assets sold off, allowing bonds to partially preserve capital in diversified portfolios; however, this negative correlation between bonds and equities did not materialize in 2022. The sharp repricing of Canadian bonds is particularly apparent when looking at corporate debt: Canadian BBB-rated bonds saw average yields nearly double in 2022, and are now paying investors more than at any point since 2008.

Although painful, this historic surge in yields has also meant that investors are not required to take on nearly as much risk to be compensated relatively well, allowing us to comfortably deploy capital into the Canadian bond universe. That being said, we believe the primary risk to fixed income in 2023 comes from the same source that drove asset prices lower in 2022: high inflation. Given an unusually wide range of potential economic outcomes in the near term, we see the balance of risks as favouring intermediate-term investment-grade bonds that lock in improved yields today without taking on excessive interest rate risk should inflation prove more persistent than expected.

### Continental Europe

We have raised our peak interest rate forecast for 2023 to 3% in light of the surprisingly hawkish stance taken by the European Central Bank (ECB) at its December meeting. ECB President Christine Lagarde stated it was "obvious to expect" further 50 basis point hikes at the next two meetings. Markets look for rates to peak even higher, at 3.3%.

December's ECB staff forecasts reinforced the hawkish forward guidance from the central bank's governing council. The forecasts show inflation at 2.3% as late as 2025, indicating that further policy tightening may be warranted. The ECB expects a recession in Q4 2022, albeit one that is more "short lived and shallow" than previously anticipated.

In line with our expectations, the ECB has announced it will start to reduce its balance sheet in March. This process, known as quantitative tightening (QT), will initially involve the cessation of reinvestment; further guidance regarding the bank's bond portfolio sales will be provided after Q2. As the central bank shifts to QT, we have a bias against sovereign debt from Portugal, Italy, and Greece, as these countries' bonds have been among those receiving the greatest support from ECB purchases.

European corporate credit looks attractive to us, as investors are now receiving higher yields that we believe should more than compensate for interest rate risk as we approach peak policy levels. We prefer investment-grade over high-yield credit at current corporate spread levels. We also favour senior-ranking bonds issued by banks, as well as bonds from commodity and telecoms issuers.

### United Kingdom

Following the dovish rate hike at the December Bank of England (BoE) meeting, we expect future interest rate increases to proceed at a slower pace towards a 4% terminal rate in 2023, below the 4.6% market expectation. Market-implied measures of inflation suggest a sharp fall in 2023, as it appears likely that inflation has peaked. Furthermore, the widely expected recession will reduce the likelihood that the BoE could hike aggressively from here, in our view.

However, the BoE is likely to be particularly concerned about wage growth, currently running around 6%. This raises the risk of a wage-price spiral that stokes inflation, which could warrant further policy tightening that would take interest rates above our 4% forecast.

Not only is the government set to issue record amounts of debt in 2023, but the supply of Gilts should also increase as the BoE proceeds with the selling of its Gilts portfolio at the same time, in a process known as quantitative tightening (QT). According to RBC Capital Markets' forecasts for the 2023–2024 tax year, net Gilt issuance will reach nearly £255 billion, nearly double the previous record in 2010–2011. The key question, in our view, will be whether demand for Gilts can soak up the supply deluge. We have a negative outlook for Gilts in the second half of 2023.

As for credit markets, corporate default rates remain low and we note that credit spreads tend to peak at the beginning of recessions. However, we remain cautious and would avoid indiscriminately adding meaningful duration, UK-centric issuers, or lower-quality credit.

## Asia Pacific

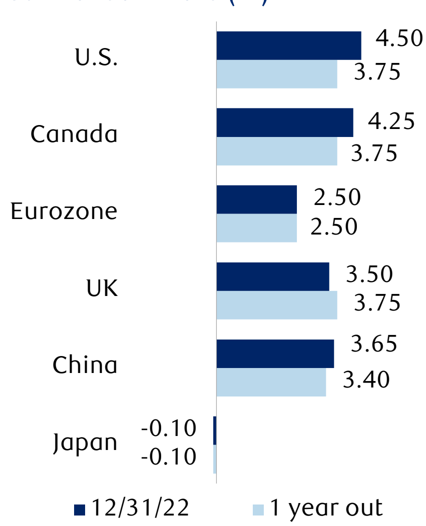
Asian local currency bonds suffered outflows in 2022, reflecting investors' underweight exposure to Asian fixed income. We expect a reversal to net buying in 2023, but believe foreign investor demand is likely to remain weak over the medium term until global rates volatility and foreign exchange markets stabilize.

In China, high-yield credit enjoyed a strong relief rally in the final weeks of 2022 thanks to the announcement of the relaxation of COVID-19 control measures, news of the country's reopening, and an extensive support plan to rescue the ailing property sector.

While the recent measures have been positive for sentiment around property developer bonds, there is a risk that this newfound optimism may be short-lived. First, an increasing focus among investors on limiting sector and geography exposures (in China) could drive outflows. Furthermore, it might take a long time for effects of the measures to be felt. Lastly, full-year property sales declined by 42% for the top 100 Chinese property developers compared to the previous year. A wider economic slowdown in China and the lack of property sales recovery might offset the government's support for the sector, with cash flow still tight for many developers.

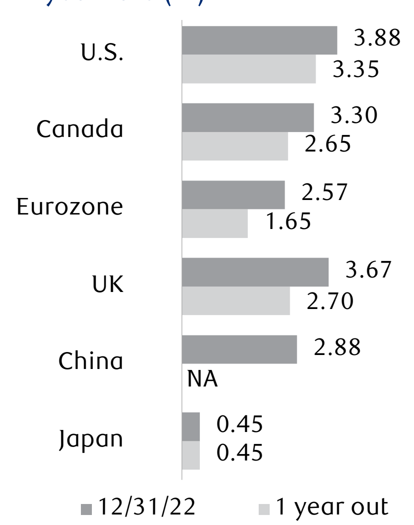
Outside China, we continue to favor investment-grade bonds issued by what we see as quality Asian corporates with conservative balance sheets and government-linked companies that may benefit from implicit government support.

**Central bank rate (%)**




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

**10-year rate (%)**




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

# Commodities

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### Commodity forecasts

| Commodity | 2023E | 2024E |
|---|---|---|
| Oil (WTI $/bbl) | $92.06 | $98.46 |
| Natural gas ($/MMBtu) | $4.75 | $4.25 |
| Gold ($/oz) | $1795 | $1725 |
| Copper ($/lb) | $3.75 | $3.75 |
| Soybeans ($/bu) | $13.00 | $12.50 |
| Wheat ($/bu) | $7.35 | $7.70 |

Source - RBC Capital Markets forecasts (oil, natural gas, gold, and copper), Bloomberg consensus forecasts (soybeans and wheat); data as of 12/22/22

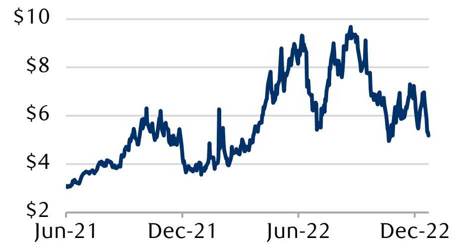
Chart source - RBC Wealth Management, Bloomberg; date range: 6/1/21–12/22/22

### Crude oil: Balanced

While the softer economic outlook could weigh on global oil prices, RBC Capital Markets expects global supply and demand to remain mostly in balance through the first half of the year. Thereafter, we expect a supply deficit to build in the second half. Additionally, the combination of OPEC+ production curtailments and looser Chinese pandemic policies should support higher oil prices, in our view.

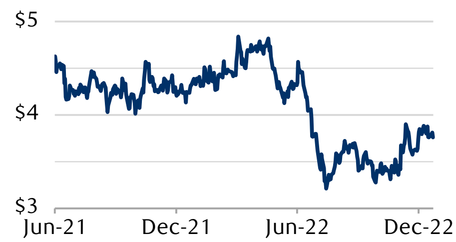

### Natural gas: Volatile

Following the surge in natural gas prices last year, RBC Capital Markets is calling for a more balanced U.S. market in 2023. The U.S. Energy Information Administration believes prices will ease in the second half of the year. However, we believe Russia remains a key swing factor, one which could leave natural gas prices prone to volatility throughout 2023.




### Copper: Surplus

In our view, the copper outlook is a combination of two scenarios that may overlap: short-term demand will likely be restrained by the slowing economic backdrop, while global decarbonization efforts should sustain long-term demand. Overall, we believe upside potential may be limited over the medium term as recessionary risks rise. RBC Capital Markets is forecasting a supply surplus through 2025.

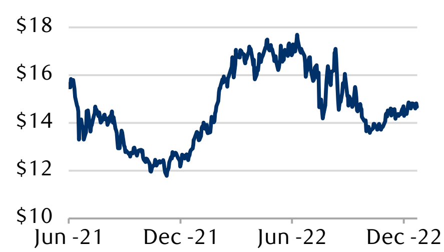



### Gold: Challenging

Gold lost about two percent of its value in 2022 as a function of rising real rates and the strength of the U.S. dollar. Heading into 2023, we believe gold will remain range-bound in the first half of the year before seeing greater upside potential in the second half on the expectation of a slowdown in interest rate hikes.


### Soybeans: China

For 2023, the U.S. Department of Agriculture (USDA) is forecasting increased global production offset by higher global consumption. The USDA expects U.S. exports to grow by approximately 10 percent in 2023, driven in part by a step-up in Chinese demand. A reduction in COVID-19-related restrictions in China would be a key catalyst, in our view.




### Wheat: Tight

Global consumption is expected to remain healthy in 2023 despite rising costs, according to the USDA, driven by continued demand for wheat-related products. Global demand and supply balances should remain relatively tight, in our view, with any excess demand supported by a drawdown in existing inventories. Additional escalations in the Russia-Ukraine conflict could push prices higher.

# Currencies

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### Currency forecasts

| Currency pair | Current rate | Forecast Dec. 2023 | Change |
|---|---|---|---|
| Major currencies | | | |
| USD Index | 104.70 | 110.29 | 5% |
| CAD/USD | 0.73 | 0.74 | 1% |
| USD/CAD | 1.37 | 1.36 | 0% |
| EUR/USD | 1.06 | 1.00 | -5% |
| GBP/USD | 1.20 | 1.11 | -7% |
| USD/CHF | 0.94 | 0.92 | -2% |
| USD/JPY | 130.70 | 143.00 | 9% |
| AUD/USD | 0.67 | 0.65 | -3% |
| NZD/USD | 0.63 | 0.62 | -1% |
| EUR/JPY | 138.00 | 143.00 | 4% |
| EUR/GBP | 0.88 | 0.90 | 3% |
| EUR/CHF | 0.99 | 0.92 | -7% |
| Emerging currencies | | | |
| USD/CNY | 6.90 | 6.60 | -4% |
| USD/INR | 83.00 | 81.00 | -2% |
| USD/SGD | 1.35 | 1.34 | 0% |

Change is defined as the implied appreciation or depreciation of the first currency in the pair quote. Examples of how to interpret currency data can be found in the Market Scorecard.

Source - RBC Capital Markets forecasts, Bloomberg

## U.S. dollar: Downside risks in early part of Q1 2023

Weaker-than-expected U.S. inflation data in November and December has led the dollar to weaken, with the consensus view that U.S. inflation and interest rates have now peaked. RBC Economics sees the dollar overshooting to the downside during Q1 and steadily appreciating for the rest of the year, but notes that its view may evolve with more inflation data.

## Euro: More aggressive ECB rate hikes ahead

The euro should be supported in the short term, in our view, following a notable hawkish shift in tone at the European Central Bank's (ECB) policy meeting in December. Further out, RBC Economics sees the outlook for the euro as being more binary, with European equity outperformance being one of the potential positives, while energy supply risks returning in the winter could weigh on the currency.

## Canadian dollar: Weighed down by recession risks

The softer stance by the Bank of Canada in December and the mounting risk of a recession in Canada in H1 2023 should weigh on the Canadian dollar in early 2023.

RBC Economics expects the economy to begin a slow recovery from a recession in H2 2023 and expects the USD/CAD to end the year around 1.36.

## British pound: Weak fundamentals persist

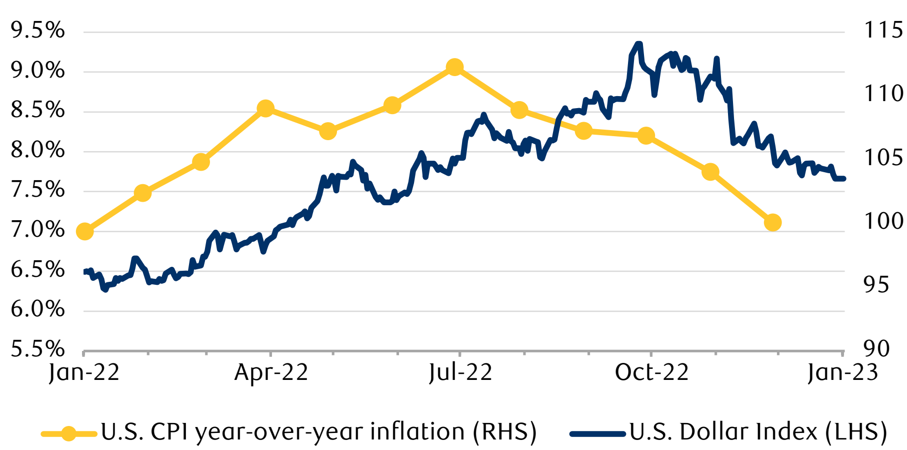
GBP/USD starts 2023 just above 1.20, but the outlook remains bearish, with RBC Economics expecting the Bank of England to be less aggressive on interest rate hikes, compared to what the market is pricing in 2023. With interest rates likely to stay in check, the longer-term expectation is for a cheaper pound to balance the UK's twin deficits (the fiscal deficit and current account deficit).

## Japanese yen: Tentative peak lowered to 143

After weakening as much as 30% in 2022, the yen clawed back almost half of the losses in Q4, following intervention by Japanese officials, a broadly weaker dollar, and the Bank of Japan (BoJ) surprising investors in December by raising the ceiling on 10-year Japanese bond yields. RBC Economics believes that monetary policy divergence between the Fed and the BoJ will reassert itself as the key driver in 2023, but forecasts USD/JPY to peak at 143.

### After rising on inflation-driven Fed rate hikes, the dollar gave up gains late in 2022

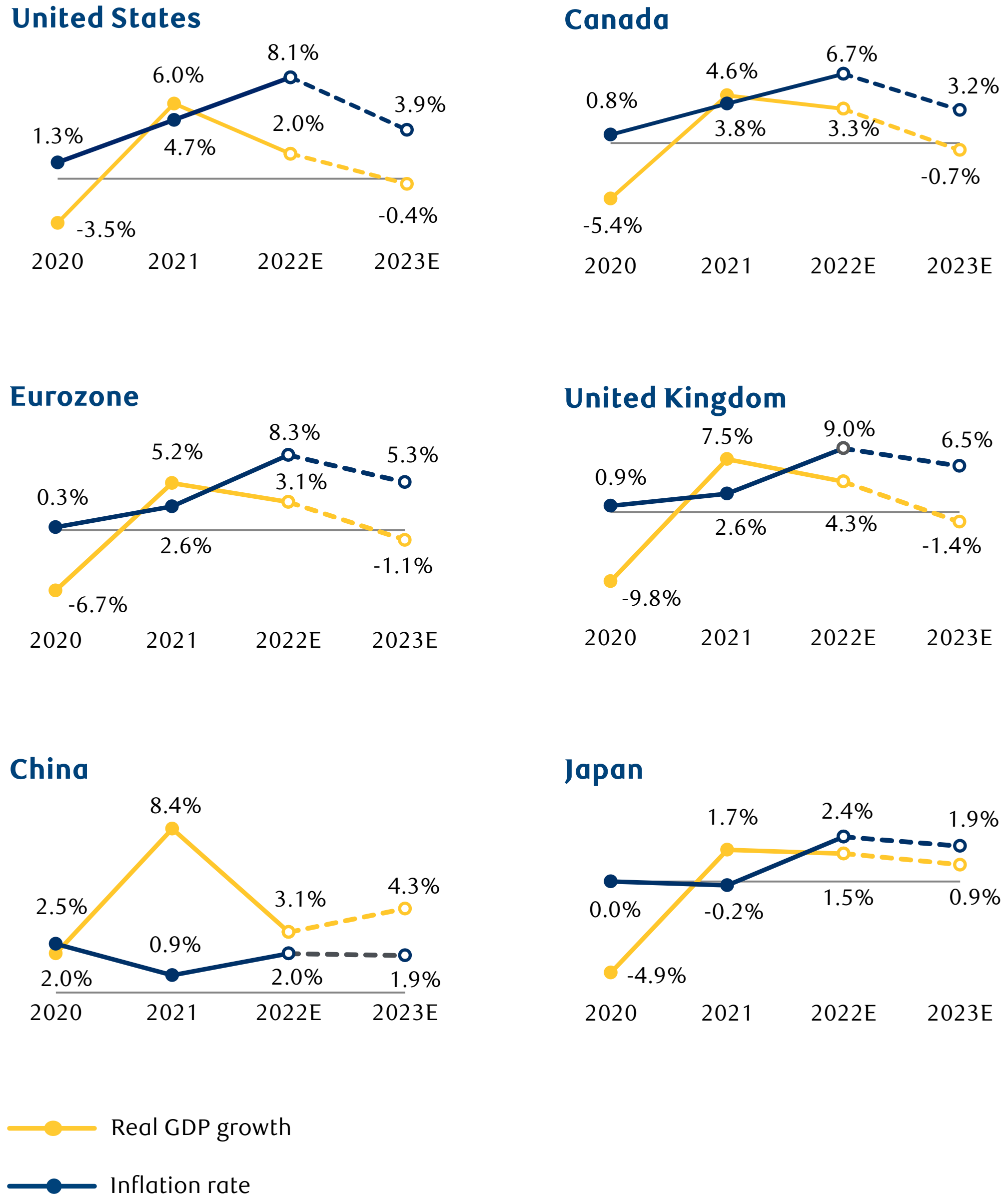
U.S. Dollar Index (DXY) and consumer price inflation




Source - RBC Wealth Management, Bloomberg; data through 1/3/23

KEY

# Forecasts




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

# Market Scorecard

*Data as of December 31, 2022*

### Equities

Global equity markets posted losses in December with the exception of Hong Kong's Hang Seng Index.

### Bond yields

Sovereign bond yields advanced higher across the globe with the largest increase seen in German Bunds.

### Commodities

Commodity markets mostly gained in December, led by silver and gold prices.

### Currencies

While the U.S. dollar lost some ground in December, the greenback ended the year strong against most global currencies.

| Index (local currency) | Level | 1 month | YTD | 12 month |
|---|---|---|---|---|
| S&P 500 | 3,839.50 | -5.9% | -19.4% | -19.4% |
| Dow Industrials (DJIA) | 33,147.25 | -4.2% | -8.8% | -8.8% |
| Nasdaq | 10,466.48 | -8.7% | -33.1% | -33.1% |
| Russell 2000 | 1,761.25 | -6.6% | -21.6% | -21.6% |
| S&P/TSX Comp | 19,384.92 | -5.2% | -8.7% | -8.7% |
| FTSE All-Share | 4,075.13 | -1.6% | -3.2% | -3.2% |
| STOXX Europe 600 | 424.89 | -3.4% | -12.9% | -12.9% |
| EURO STOXX 50 | 3,793.62 | -4.3% | -11.7% | -11.7% |
| Hang Seng | 19,781.41 | 6.4% | -15.5% | -15.5% |
| Shanghai Comp | 3,089.26 | -2.0% | -15.1% | -15.1% |
| Nikkei 225 | 26,094.50 | -6.7% | -9.4% | -9.4% |
| India Sensex | 60,840.74 | -3.6% | 4.4% | 4.4% |
| Singapore Straits Times | 3,251.32 | -1.2% | 4.1% | 4.1% |
| Brazil Ibovespa | 109,734.60 | -2.4% | 4.7% | 4.7% |
| Mexican Bolsa IPC | 48,463.86 | -6.2% | -9.0% | -9.0% |
| **Bond yields** | **12/31/22** | **11/30/22** | **12/31/21** | **12 mo. chg** |
| U.S. 2-Yr Tsy | 4.426% | 4.310% | 0.732% | 3.69% |
| U.S. 10-Yr Tsy | 3.875% | 3.605% | 1.510% | 2.36% |
| Canada 2-Yr | 4.054% | 3.875% | 0.951% | 3.10% |
| Canada 10-Yr | 3.300% | 2.938% | 1.426% | 1.87% |
| UK 2-Yr | 3.576% | 3.297% | 0.687% | 2.89% |
| UK 10-Yr | 3.672% | 3.161% | 0.971% | 2.70% |
| Germany 2-Yr | 2.764% | -0.601% | -0.620% | 3.38% |
| Germany 10-Yr | 2.571% | -0.185% | -0.177% | 2.75% |
| **Commodities (USD)** | **Price** | **1 month** | **YTD** | **12 month** |
| Gold (spot $/oz) | 1,824.02 | 3.1% | -0.3% | -0.3% |
| Silver (spot $/oz) | 23.95 | 7.9% | 2.8% | 2.8% |
| Copper ($/metric ton) | 8,364.76 | 1.7% | -14.1% | -14.1% |
| Oil (WTI spot/bbl) | 80.26 | -0.4% | 4.2% | 4.2% |
| Oil (Brent spot/bbl) | 85.91 | 0.6% | 10.5% | 10.5% |
| Natural Gas ($/mmBtu) | 4.48 | -35.4% | 20.0% | 20.0% |
| Agriculture Index | 470.53 | 1.3% | 5.7% | 5.7% |
| **Currencies** | **Rate** | **1 month** | **YTD** | **12 month** |
| U.S. Dollar Index | 103.5220 | -2.3% | 8.2% | 8.2% |
| CAD/USD | 0.7378 | -1.0% | -6.7% | -6.7% |
| USD/CAD | 1.3554 | 1.1% | 7.3% | 7.3% |
| EUR/USD | 1.0705 | 2.9% | -5.8% | -5.8% |
| GBP/USD | 1.2083 | 0.2% | -10.7% | -10.7% |
| AUD/USD | 0.6813 | 0.4% | -6.2% | -6.2% |
| USD/JPY | 131.1200 | -5.0% | 13.9% | 13.9% |
| EUR/JPY | 140.4100 | -2.3% | 7.3% | 7.3% |
| EUR/GBP | 0.8853 | 2.6% | 5.2% | 5.2% |
| EUR/CHF | 0.9896 | 0.6% | -4.6% | -4.6% |
| USD/SGD | 1.3395 | -1.6% | -0.7% | -0.7% |
| USD/CNY | 6.8986 | -2.7% | 8.5% | 8.5% |
| USD/MXN | 19.4999 | 1.2% | -5.0% | -5.0% |
| USD/BRL | 5.2804 | 1.7% | -5.3% | -5.3% |

Equity returns do not include dividends, except for the Brazilian Ibovespa. Equity performance and bond yields in local currencies. U.S. 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 -6.7% return means the Canadian dollar has fallen 6.7% vs. the U.S. dollar during the past 12 months. USD/JPY 131.12 means 1 U.S. dollar will buy 131.12 yen. USD/JPY 13.9% return means the U.S. dollar has risen 13.9% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 12/31/22

# 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.

The Global Portfolio Advisory Committee leverages the broad market outlook as developed by the RBC Investment Strategy Committee (RISC), providing additional tactical and thematic support utilizing research from the RISC, RBC Capital Markets, and third-party resources.

The RISC consists of senior investment professionals drawn from individual, client-focused business units within RBC, including the Portfolio Advisory Group. The RISC builds a broad global investment outlook and develops specific guidelines that can be used to manage portfolios. The RISC is chaired by Daniel Chornous, CFA, Chief Investment Officer of RBC Global Asset Management Inc.

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# Required disclosures

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References to a Recommended List in the recommendation history chart may include one or more recommended lists or model portfolios maintained by RBC Wealth Management or one of its affiliates. RBC Wealth Management recommended lists include the Guided Portfolio: Prime Income (RL 6), the Guided Portfolio: Dividend Growth (RL 8), the Guided Portfolio: ADR (RL 10), and the Guided Portfolio: All Cap Growth (RL 12). RBC Capital Markets recommended lists include the Strategy Focus List and the Fundamental Equity Weightings (FEW) portfolios. The abbreviation 'RL On' means the date a security was placed on a Recommended List. The abbreviation 'RL Off' means the date a security was removed from a Recommended List.

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**Distribution of ratings – RBC Capital Markets Equity Research**

As of December 31, 2022

| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| Buy [Outperform] | 839 | 56.05 | 225 | 26.82 |
| Hold [Sector Perform] | 603 | 40.28 | 151 | 25.04 |
| Sell [Underperform] | 55 | 3.67 | 3 | 5.45 |

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