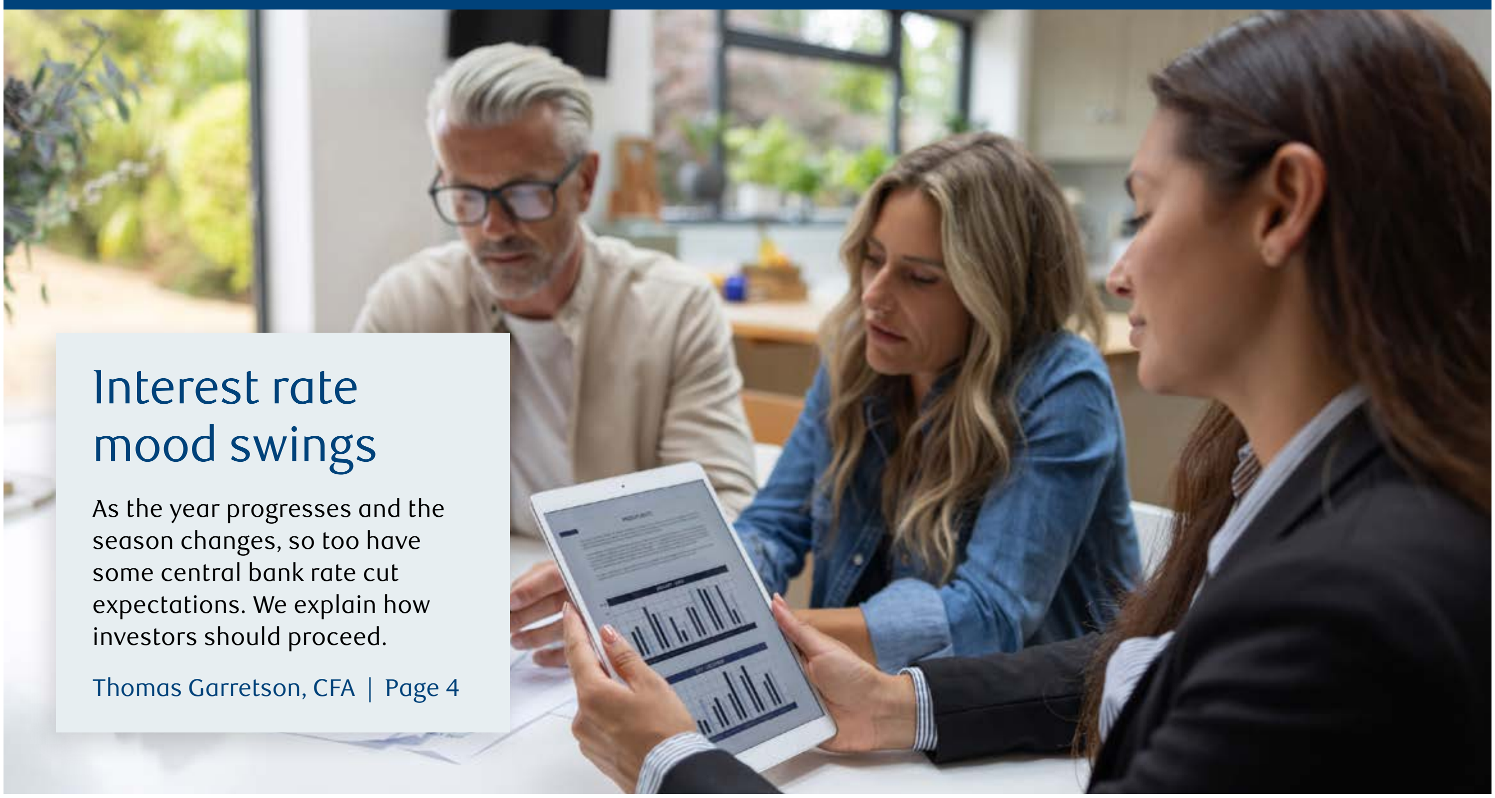
GLOBAL Insight

Perspectives from the Global Portfolio Advisory Committee

May 2024



Interest rate mood swings

As the year progresses and the season changes, so too have some central bank rate cut expectations. We explain how investors should proceed.

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GLOBAL
Insight
May 2024

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All values in U.S. dollars and priced as of market close, April 30, 2024, unless otherwise stated.

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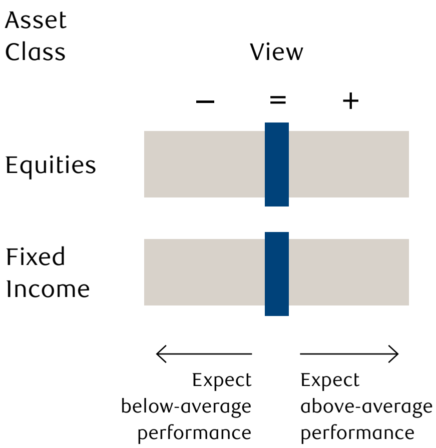

(+/=/–) represents the Global Portfolio Advisory Committee's (GPAC) view over a 12-month investment time horizon.

+ 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

- Calibrating equity exposure in portfolios remains a balancing act. On the one hand, we see upside potential for major equity markets due to favorable consensus earnings growth forecasts for most sectors. Even though U.S. large-cap equity valuations are elevated, some of the usual precursors of bear markets—very high investor sentiment and declining market breadth—are not yet in evidence.
- Yet we think portfolio exposure should factor in the economic risks that stem from this unique period. Developed economies are still adjusting to central bank rate hikes that followed a mountain of pandemic-related stimulus. Stronger-than-expected U.S. inflation and weaker GDP growth in Q1 are reminders that headwinds continue to blow. Some of our leading economic indicators are still flashing yellow or red.
- We recommend maintaining Market Weight exposure to U.S. and global equities in order to balance the risks against the potential that the U.S. economy could prove to be resilient. We would tilt portfolios toward higher-quality equities.

Fixed income

- Global bond yields have been volatile so far in 2024, with the average yield on the Bloomberg Global Aggregate Bond Index trading to a fresh 2024 high of 4.0%, but that remains below the 4.4% peak in 2023. Global inflationary pressures continue to improve, but concerns that progress has stalled of late have caused markets to price out near-term rate cuts; however, modest cuts from most major central banks are still widely expected this summer with the Fed following later in the year. Though yields have dropped dramatically from the late 2023 highs, they remain well above the averages of the past 20 years and continue to present relatively attractive entry points, in our opinion. Still, we continue to exercise caution and patience over the near term as yields could retrace higher until the timing and magnitude of central bank policy easing come into greater focus.
- We stay Market Weight U.S. fixed income with yields remaining above multi-decade averages. While economic risks have subsided in the U.S. and globally, recession risks remain somewhat elevated and credit valuations are still too rich, in our view. Therefore, we broadly remain Underweight corporate credit with a slight bias toward government bonds.

MONTHLY
Focus

Interest rate mood swings

April brought the usual spring showers, but it also brought some adjusted central bank rate cut expectations. We examine the what and why of the revisions and explain how investors should proceed.

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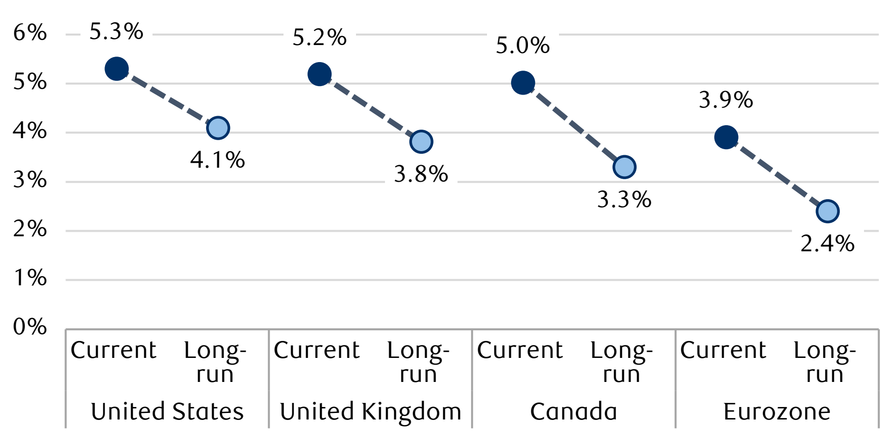
Key points

- **Markets have swung from expecting a large number of central bank rate cuts at the beginning of the year to much fewer, and with a growing divergence seen between major global central banks.**
- **The Federal Reserve has likely shifted from leader to laggard, as it could be the last to ease policy rates. We think that will have its own ramifications—domestically and globally.**
- **While the rate cut outlook remains volatile, a resumption of rate hike cycles remains highly unlikely. But the recent repricing of the outlook could present another opportunity for bond investors.**

Of the four major central banks, [the Federal Reserve (Fed), European Central Bank (ECB), Bank of England (BoE), and Bank of Canada (BoC)], the last to raise rates was the ECB in September 2023. The others have been on hold since this past summer. But given another sharp rise in bond yields, investors would perhaps be forgiven if they believed we were still deep in the midst of central bank rate hike cycles.

At one point in January of this year, markets had priced in a view that the Fed would be cutting rates nearly seven times in 2024, thereby taking rates all the way down to 3.75 percent from 5.50 percent. It was a similar story globally as deep rate cuts were expected. In a sharp reversal, markets have repriced expectations which now suggest just two rate cuts from the Fed

As central banks edge closer to rate cuts, markets expect a shallow rate cut path in coming years



Note: Long-run market-implied policy rate based on three-year forward contract data.
Source - RBC Wealth Management, Bloomberg; data as of 4/16/24

INTEREST RATE MOOD SWINGS

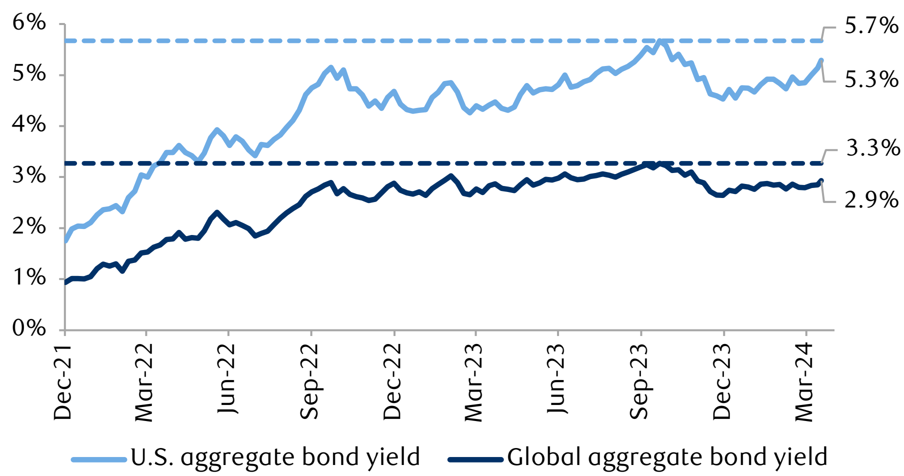
this year, and that at no point over at least the next three years will the Fed cut rates below 4.00 percent.

As the chart on the previous page shows, this idea that any rate cut cycle will be a shallow one has permeated across the central bank landscape. Seemingly gone are the days of zero—or even negative—interest rate policies in the years ahead.

Such are the mood swings of markets.

Inflation, unsurprisingly, is at the heart of the matter. Fading inflationary pressures in the back half of 2023, both in the U.S. and globally, paired with dovish commentary out of central banks, drove bond yields sharply lower. But with the inflation data broadly failing to show further improvement thus far in 2024, particularly in the U.S., sentiment has reversed. As the second chart shows, after falling to multi-month lows this past December, bond yields are now potentially on the cusp of re-testing the decade-plus highs achieved last fall.

U.S. and global bond yields could retest multiyear highs



Source - RBC Wealth Management, Bloomberg U.S. Aggregate Bond Index, Bloomberg Global Aggregate ex USD Bond Index; data through 4/16/24

Rethinking the outlook

Traders aren't the only ones reconsidering the path forward for rates, analysts are as well. To wit, RBC Capital Markets made numerous changes to its rate projections over the course of April. Whereby the Fed was previously seen as the first mover, it may now be the laggard.

Federal Reserve (Current policy rate range: 5.25 percent to 5.50 percent)

- **Previous RBC Capital Markets projection:** Three rate cuts this year to a rate in the 4.50 percent to 4.75 percent range beginning in June and two more in 2025 in the 4.00 percent to 4.25 percent range.
- **Updated projection:** Just one rate cut this year to a rate in the 5.00 percent to 5.25 percent range in December and two more in 2025 to a rate in the 4.50 percent to 4.75 percent range.

INTEREST RATE MOOD SWINGS

- **Why the change?** Recent inflation data has been stronger than expected which likely won't give the Fed the "greater confidence" that inflation remains on track toward two percent to begin rate cuts by June or July. But while RBC Capital Markets doesn't expect a material reacceleration in inflation, it's the presidential election this fall that could give the Fed pause and reason to avoid starting a rate cut process at its September or November meetings, effectively leaving December as the only option for a cut.

RBC's call for only two rate cuts to follow in 2025 is, by our own admission, highly uncertain, but predicated on the idea that if the U.S. economy is still humming along by this December, as it has been thus far, then the case for multiple "insurance cuts" could be a tricky one to make.

European Central Bank (Current policy rate: 4.00 percent)

- **Unchanged RBC Capital Markets projection:** First cut in June, two more this year to 3.25 percent, and three more in 2025 to 2.50 percent
- **Why is there no change?** The ECB has given the clearest signals that it continues to move toward a rate cut in June. While inflation has stayed sticky in recent months, economic growth momentum has been slowing while moderating wage pressures should soon begin to drag inflation lower.

Bank of England (Current policy rate: 5.25 percent)

- **Previous RBC Capital Markets projection:** First cut in August, three more this year to 4.25 percent, and two more in 2025 to 3.75 percent
- **Updated projection:** First cut in August, but only one more this year to 4.75 percent, and two more in 2025 to 4.25 percent
- **Why the change?** While policymaker rhetoric continues to guide toward rate cuts, recent data has shown the economy is recovering both earlier and more strongly than expected by both the BoE and RBC Capital Markets, likely justifying a shallower path for rate cuts this year.

Bank of Canada (Current policy rate: 5.00 percent)

- **Unchanged RBC Capital Markets projection:** First cut in June, three more this year to 4.00 percent, and four more in 2025 to 3.00 percent
- **Why is there no change?** We think the BoC has the easiest rate-cut case to make amid a murky economic outlook and an ongoing deterioration in labor market conditions, where the unemployment rate is up 1.3 percentage points from the post-pandemic low.

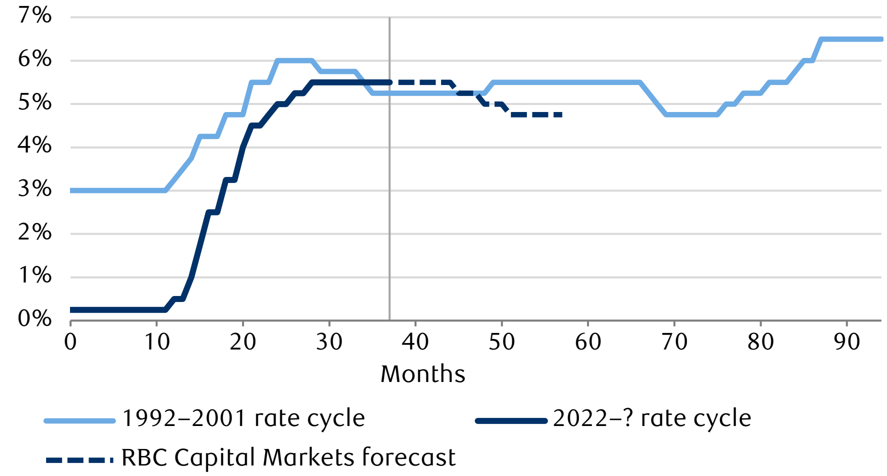
That '90s Show

One key factor behind RBC Capital Markets' revised Fed outlook is simply the economic experience of the 1990s. That period has long been held up as the gold standard of Fed policy setting. After a flurry of rate hikes to rein in inflation in the early part of the decade, the Fed simply delivered a handful of insurance cuts in the middle part and the economy continued to run into the early 2000s, a run largely fueled by a tech boom, which should sound familiar.

INTEREST RATE MOOD SWINGS

As the next chart shows, RBC Capital Markets' outlook reflects a similar 75 basis points of policy easing ahead. But whether it also gives way to a resumption of rate hikes in the years ahead remains to be seen. It would be an exceedingly rare example of the Fed actually engineering a soft economic landing—that is to say, raising rates aggressively without inducing a recession.

RBC's revised Fed outlook reflects similarities to the 1990s economic cycle



Note: Chart starts 12 months before the first increase of each interest rate cycle.

Source - RBC Wealth Management, Bloomberg; data through 4/16/24

What, why, and how?

So, that's the what and the why of a revised central bank outlook, but how should investors proceed? Another round of rising yields has investors and traders wondering again where the selling stops, and when they should step in and buy. In our view, we are nearing that point. Markets, as they can be prone to do, may have potentially moved from one extreme to another, or from far too many rate cuts priced in at the start of the year, to too few now.

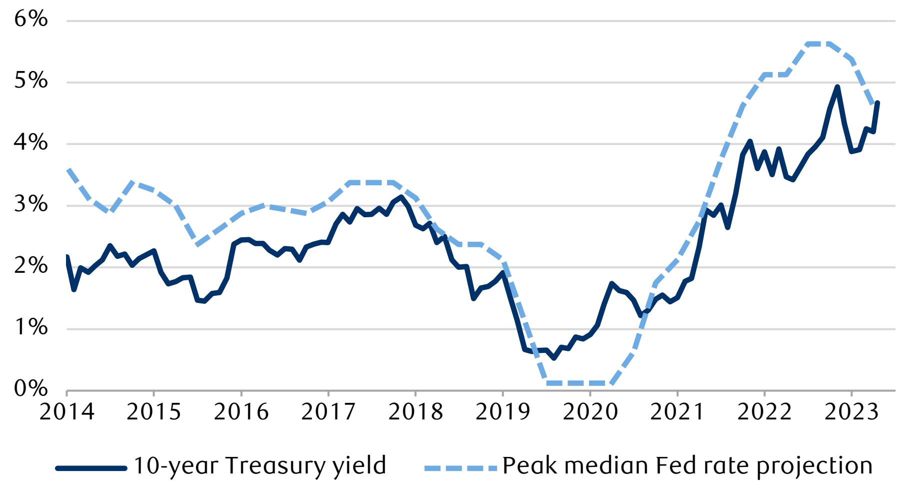
We still see the bar to resume raising rates as being extraordinarily high for the Fed, and certainly for most central banks, and, therefore, the Fed's rate guidance from the March meeting should still serve as a reasonable guidepost for how high yields can rise. The chart on the next page shows the benchmark 10-year Treasury yield relative to where the Fed has projected the peak policy rate over upcoming years, as indicated by its Summary of Economic Projections. After another sharp rise in yields to start 2024, how much higher could they go?

At the Fed's March meeting, the median forecast of policymakers showed three cuts in the fed funds rate to 4.63 percent this year, roughly where the 10-year Treasury yield currently trades. But if RBC Capital Markets is right and the Fed only cuts once to a mid-point of 5.13 percent, the 10-year Treasury yield could potentially trade higher and toward that level. That range—approximately 4.6 percent to 5.1 percent—forms our near-term target level for the 10-year before it begins to fade to 4.30 percent by

INTEREST RATE MOOD SWINGS

Hitting the ceiling?

Ten-year U.S. Treasury yield likely to hold below the Fed's rate guidance



Note: Shows maximum level of the Fed's one-to-three-year interest rate projections.

Source - RBC Wealth Management, Bloomberg, U.S. Federal Reserve; data through 4/16/24

year-end, as RBC Capital Markets currently projects. That framework for thinking about yields relative to central bank policy rate expectations should hold broadly true on a global basis as well.

For U.S. investors, we now recommend gradually moving out of cash and/or short-dated bonds and into longer-dated bonds over the course of 2024, but perhaps at a more expeditious pace for global investors with other central banks set to cut earlier.

GLOBAL
Equity

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Two steps forward, one step back?

Most major equity markets had posted new all-time highs by April 2024, China excepted. After an initial push to a new high, the equity market often checks back to the breakout point as part of its two steps forward, one step back pattern of climbing to new high ground. Such a pause has played out through April and may not be finished yet.

This time, the catalyst for the market retreat was yet another huge change of mind, which arrived late in Q1, about where the U.S. Federal Reserve was headed next, and when. For most of Q1, investors were confidently expecting a first Fed rate cut in May as a prelude to a series of further reductions before year end. But then a few tenths of a percent rise in the March U.S. inflation data and a stronger-than-expected jobs report kicked that scenario into the ditch.

The market pushed its expectation for the first Fed cut out into the second half and dramatically scaled back expectations for follow-up reductions. Some commentators wondered aloud if another hike was needed rather than a cut. The 10-year Treasury yield reversed course and backed up by a market-rattling 75 basis points.

Fast forward just 30 days to the end of April where a jobs report that was weaker than expected by the market, a one-tenth of a percent rise in the unemployment rate, and a couple of words in a Fed press release following the central bank's May meeting have threatened to turn Fed policy expectations back into a "jump ball."

This would mark at least the fourth 180 degree turn in investor hopes for a Fed easing cycle to get underway over the past 12 months. It's difficult to imagine just how much brain power, ink, and screen time have been marshalled over that time to report on, explain, and allegedly analyse all this. Sheets of paper covered with small print and laid end to end circling the globe come to mind.

Equity views

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

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

Here's what we know:

The Fed has not yet cut. Monetary conditions are still tight or, in the words of the CEO of one of America's largest banks, "very tight." (The yield curve has now been inverted for 22 months and counting.)

Even if the Fed were to cut in June, the impact on the economy of that cut won't be fully felt before 2025, in our view. Arguably, the U.S. economy and most of the rest of the developed and emerging world are still contending with/digesting the rate increases put in place in the first half of last year.

Does that mean a U.S. recession is inevitable? No. But we think it does mean the period of vulnerability has further to run, even if rate cutting were to start next month. In eight of the past 10 recessions the Fed had already been cutting the funds rate before the recession started.

And a first Fed rate cut, when it comes, likely won't bring any more clarity to the collective expectations for monetary policy. Is it "one and done"? How long until the next cut? How many times will the Fed cut, and by when? Did policymakers wait too long? Did they move too soon? Will

GLOBAL EQUITY

Fed policy be stymied by the U.S. presidential election in November? You get the picture.

What does this extended runway of monetary policy uncertainty mean for equities? First, we think it signifies the pullback/consolidation that began in early April could easily have further to go. The sharp back-up in bond yields appears to have been the chief culprit behind this latest equity market retreat, and a full retest of the 10-year Treasury yield's October 2023 highs at almost 5% can't be ruled out.

That said, we think this pullback will prove to be no more than a temporary respite in the longer-term equity market upleg, which kicked off back in the fall of 2022 and, in our view, has not yet run its course.

We think Q1 index earnings for the S&P 500 were good enough at +4% q/q to make the consensus full-year estimate of $244 (up 10% y/y) look reasonable. At the same time, corporate guidance remained mostly positive among the large-cap contingent, although small-cap business surveys reveal a much less optimistic outlook. Meanwhile, investor enthusiasm for AI continues to put a shiny gloss on expectations for 2025 and beyond.

We continue to look for more new highs in the coming months, but the economic and earnings picture needs to hold together to make that outlook feasible. At its end-of-March peak, trading at 23x latest 12-month earnings and 21.5x this year's consensus estimate, the S&P 500 had already "paid for" at least two Fed rate cuts. New highs from here would imply a willingness to pay for more, in our view.

If a series of Fed rate reductions were to be delivered in response to an inflation rate that was convincingly subsiding towards 2% with the U.S. economy doing no worse than temporarily slowing down, the S&P 500 and other large-cap indexes might go on setting new highs for some time punctuated by occasional corrections/consolidations.

But if, as has so often been the case in past cycles, Fed cutting comes to be seen by investors as an urgent response to a more serious economic downturn, then we think stocks could enter a more challenging market phase.

The fact that market breadth has been rising in sync with the broad large-cap averages persuades us to remain committed to equities for now. But new highs, fuelled in part by price-to-earnings valuations rising from already rich levels, argue for a watchful, cautious approach to portfolio management.

GLOBAL

Fixed income

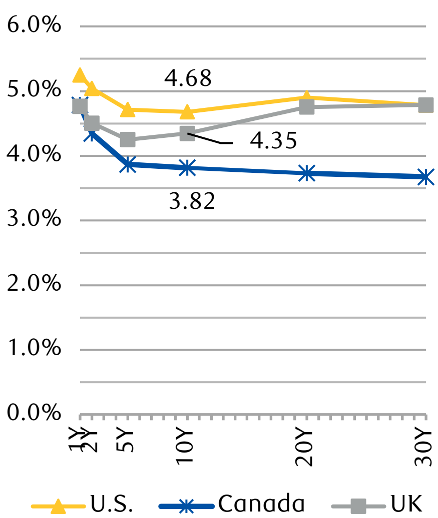
Markets have swung from expecting a large number of central bank rate cuts at the beginning of the year to much fewer, and with a growing divergence seen between major global central banks. While the rate cut outlook remains volatile, a resumption of rate hike cycles remains highly unlikely. But the recent repricing of the outlook could present another opportunity for bond investors. For a full account of our thinking, see this month's focus article, [“Interest rate mood swings.”]

Fixed income views

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

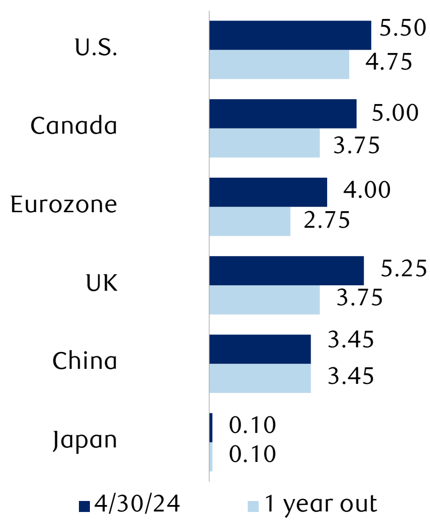
+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

Sovereign yield curves



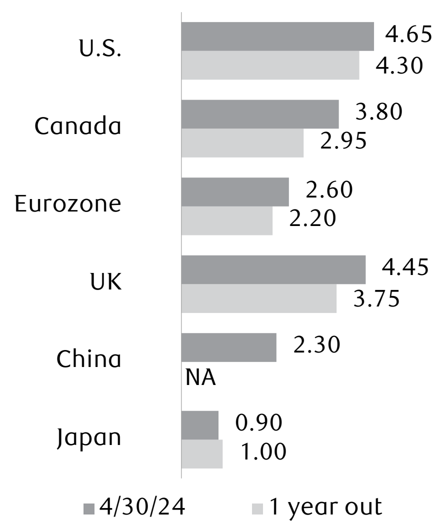
Source - Bloomberg; data through 4/30/24

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

U.S. RECESSION

Scorecard

Discomfort zone?

There have been no changes to our Scorecard ratings for several months; however, one is in the works but not yet confirmed. If the pending change (see "Fed funds rate vs. nominal GDP growth" below) were to be implemented, that would leave the overall rating awkwardly balanced between three arguing a U.S. recession is likely to arrive within a few months, two continuing to give the economic expansion a green light, and two at a neutral setting.

In one sense the "expectations landscape" has arrived at an important timing juncture: On average, recessions have arrived 25 months following the first fed funds rate hike—which, in this case, would be last month, April 2024. However, although the average elapsed time from the "first hike" to recession is slightly more than two years, in more than half the instances measured, the wait time was longer than 25 months.

Our two most reliable leading indicators of U.S. recession are in the outright negative column. While the "average" experience of both pointed to last summer as a recession kick-off date, both have histories with instances of much longer signal-to-recession intervals. Note that the official start date of any recession may not be announced until many months or quarters after the fact, so the soft vs. hard landing debate won't be settled for some considerable time yet.

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, reaching its widest point in June 2023. The average historical experience of this indicator after crossing into negative territory suggests the U.S. economy would have been in recession by late last summer. However, while the average time interval between "inversion" of the yield curve and the onset of recession is 13 months, in four instances the gap was longer than average, with the longest being 23 months.

Yield curve inversion is an unequivocal indication that credit conditions are tightening, a fact underscored by the message delivered consistently for seven consecutive quarters by the Fed's Senior Loan Officer Survey (most recent issue released on Feb. 5). A majority of U.S. banks continue to

U.S. Recession Scorecard

	Status		
Indicator	Expansionary	Neutral	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

raise 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 negative spread between the 1-year yield and the 10-year yield reached its widest point this cycle so far last June at 158 basis points (bps). It has since narrowed dramatically to just 55 bps, strongly suggesting the period of "de-inversion" is underway. The crossover from "inverted" to "normal" tends to occur just as the recession is starting or a few months before.

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 decisively negative in Q3 2022, shifting it to the red column on our Scorecard. As of the April 2024 report, the index had fallen for 22 of the preceding 23 months moving deeply into negative territory, although the rate of year-over-year decline has slowed over the past six 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 (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. It has oscillated around the zero line for three months, prompting us to leave the indicator rating at yellow.

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, so the history of this indicator would suggest a recession could get underway as early as this summer.

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 be turning for unemployment claims. While we wait for that shift to be confirmed or for claims to subside once again, we think this ambiguity warrants leaving the indicator's status at yellow.

Unemployment rate

The unemployment rate jumped to 3.9% in February after setting a cycle low of 3.4% back in April of last year. While it edged gradually higher over the intervening 12 months, it has not yet moved into a decisive uptrend. However, any sustained move above 4.0% in the next few months, in our view, would signal a recession is on the way.

U.S. RECESSION SCORECARD

Free cash flow of non-financial businesses

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 deepening one that is already underway. These cash flows, while well down from their pandemic peak, were nowhere near a negative crossing point as of Q4 2023. There is a long lag time before this data is reported, with the Q1 release not coming until June.

Fed funds rate vs. nominal GDP growth

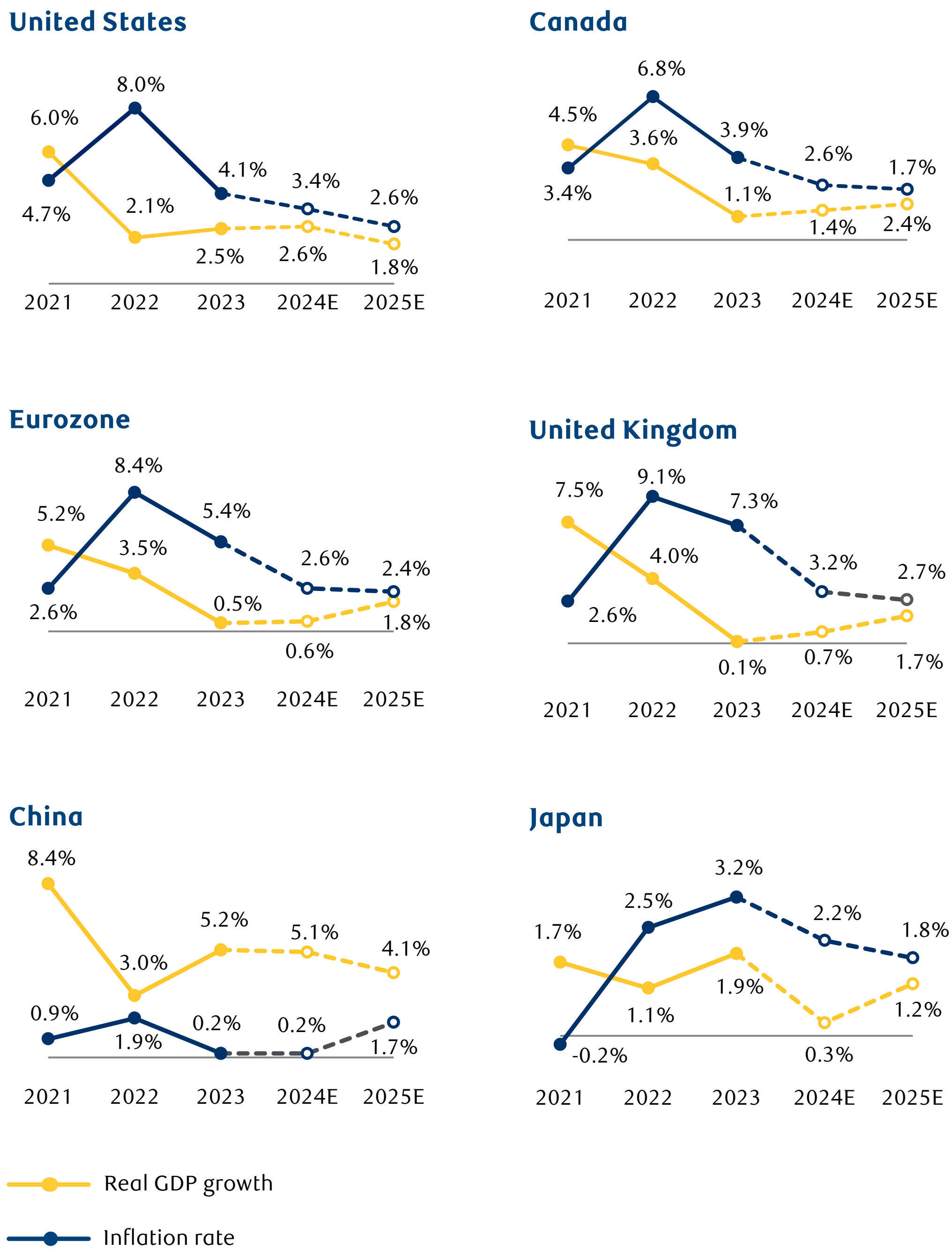
The fed funds rate has risen above the six-month annualized run rate of nominal GDP either before or at the start of every recession in the past 70 years. (Nominal GDP is GDP not adjusted for inflation.) That GDP run rate has been declining since its pandemic reopening high of 23% recorded in Q4 2020. By the end of last year, it had slowed to 6.7%, still above the fed funds rate at 5.50%. Now, however, the preliminary Q1 GDP data release shows the six-month run rate of nominal GDP growth, at 4.9%, has fallen below the fed funds rate, satisfying this historical precondition of a recession. We are waiting for confirmation by the second estimate of Q1 GDP to be released in late May before changing our Scorecard rating.

Clock still ticking

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

KEY

Forecasts



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.

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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As of March 31, 2024

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