RBC Global Asset Management

# The Global Investment Outlook

## RBC GAM Investment Strategy Committee

SPRING 2024

# The RBC GAM Investment Strategy Committee

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The RBC GAM Investment Strategy Committee  consists of senior investment professionals drawn from all areas of RBC Global Asset Management. The Committee regularly receives economic and capital markets related input from internal and external sources. Important guidance is provided by the Committee's regional equity advisors (North America, Europe, Asia, Emerging Markets) and from the Global Fixed Income & Currencies sub-committee. From this, the Committee builds a detailed global investment forecast looking one year forward.

The Committee's view includes an assessment of global fiscal and monetary conditions, projected economic growth and inflation, as well as the expected course of interest rates, major currencies, corporate profits and stock prices.

From this global forecast, the RBC GAM Investment Strategy Committee develops specific guidelines that can be used to manage portfolios.

## These include:

The recommended mix of cash, fixed income instruments, and equities.

The recommended global exposure of fixed income and equity portfolios.

The optimal term structure for fixed income investments.

The suggested sector and geographic make-up within equity portfolios.

The preferred exposure to major currencies.

Results of the Committee's deliberations are published quarterly in *The Global Investment Outlook*.

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# Executive summary

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Economic data has been resilient, recession risks have diminished, and inflation has cooled sufficiently for central banks to consider cutting policy rates at some point this year. In this environment, sovereign bonds are appealing, and while stocks have surged as investors embraced the improved odds of an economic soft landing, demanding valuations in U.S. large-cap stocks may limit upside potential.

## Upgrading our economic outlook

A variety of factors have motivated us to upgrade the likelihood of a soft landing for the U.S. economy to 60% from 40% last quarter, and we now look for modest growth in the first half of 2024 instead of recession. We have also boosted our 2024 forecast for real U.S. GDP growth to 2.4% from 0.3% and project further moderate growth in 2025 that could be even stronger if central-bank rate cuts unfold. Our 2024 growth forecasts are now roughly in line with the consensus for most countries, and even slightly above for the U.S. and Canada. For emerging markets, our growth forecasts have also been raised slightly to reflect the positive effect of healthier developed-world economies. Although the soft-landing scenario is now the most probable outcome, we recognize that a recession remains possible given that higher rates represent an economic headwind, mostly affecting regions outside of the U.S., and several important recession signals remain in place.

## Further improvement on inflation will likely be slower

Inflation has fallen significantly from its 2022 peak as the commodity shock faded, supply-chain challenges were resolved, and extraordinary central-bank stimulus was removed. While there has been tremendous progress so far, the journey from the current range of 2.75%-3.50% down to the 2.00% level targeted by most major central banks will be more difficult. Consumer prices could be supported by elevated fiscal deficits and the economy's general resilience. Given that our base case forecast no longer incorporates a recession, we have increased inflation forecasts from last quarter, and these forecasts are no longer below the consensus. We still believe that inflation is more likely to fall than rise over the next year, as wage pressures gradually abate, goods inflation subsides and service inflation, which is still too high, declines. Shelter costs, the largest driver of inflation today, may also be set to decline, and the range of products and services affected by high inflation is narrowing.

## U.S. dollar continues to face longer-term challenges

We remain bearish on the U.S. dollar, with our outlook premised on long-term headwinds. A combination of major factors should cause the dollar to decline over the next several years: the currency's overvaluation, a reversal of capital inflows and the erosion of U.S. fiscal credibility. We expect the early beneficiaries of such dollar weakness to be the euro and the Canadian dollar, while the yen and British pound will likely lag. Emerging-market currencies may initially be held back by central-bank rate cuts, but will eventually be buoyed by widespread weakness in the greenback.

## Central banks signal likelihood of rate cuts ahead

The period of aggressive central-bank rate hikes ended last year, with a small but growing number of central banks, all of them in emerging markets, starting to ease monetary conditions. Major developed-world central banks are now in a position to do so for several reasons. Inflation has dropped significantly and most major economies have recorded uncomfortably slow growth over the past year. We forecast five 25-basis-point policy-rate cuts in the U.S. over the next year, although we recognize that the timing and pace of monetary-policy adjustments will ultimately be guided by the path of the economy and inflation.

## Bonds are close to their most appealing levels in nearly two decades

Bonds are near their most attractive levels in two decades after selling off from a state of overvaluation that had not been seen in 150 years. The fixed-income bear market of 2020-2023 rapidly pulled yields above 5% for the first time since 2007 and erased all of the overvaluation that had built up since the 1980s, which was accentuated by the pandemic. While the U.S. 10-year yield has declined from its October 2023 peak, at 4.25% it remains near the upper end of the historical range excluding the 1970s and 1980s, a period that featured extreme inflation. Our models confirm that sovereign bonds are attractive, with yields well above their equilibrium levels in major markets excluding Japan, where interest rates are still subject to central-bank efforts to suppress yields. Taking everything together, our models suggest that the appropriate level for bond yields is lower, as long as inflation continues to fall as we expect. In addition to the positive fundamental backdrop, there are a variety of bullish technical measures that suggest a solid outlook for bonds. Our own forecast is for a 4.00% yield on the U.S. 10-year bond a year from now, which would result in mid-to high single-digit returns over the year ahead and, importantly, with little valuation risk.

## Stocks extend gains to new records, valuations are increasingly demanding

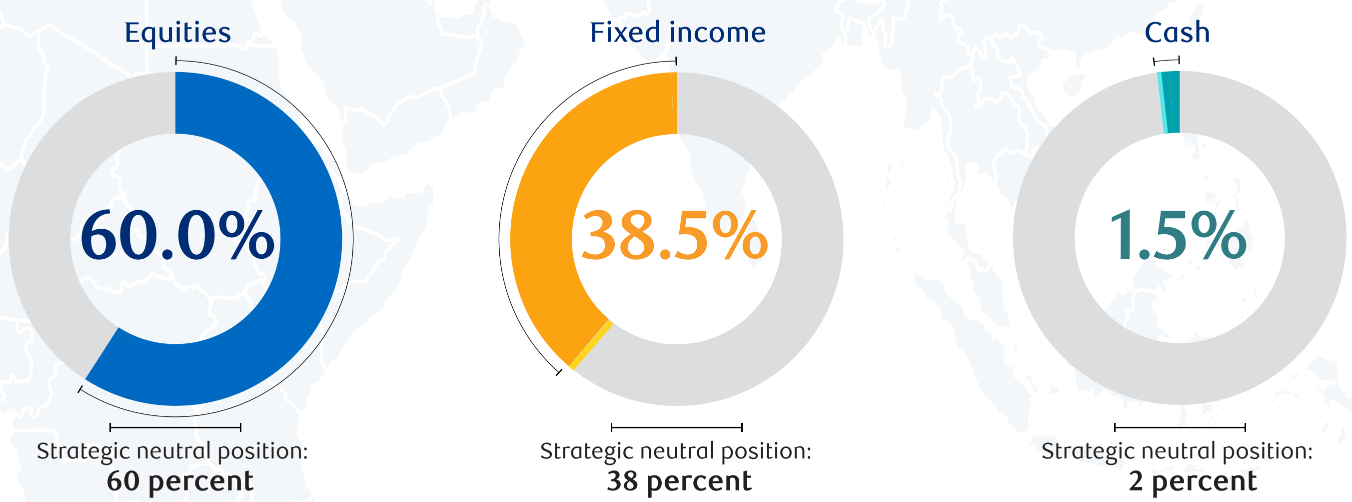
Global equities have enjoyed a powerful rally in the past quarter, with many major markets reaching record highs. Most of the recent gains, however, have been delivered by a narrow set of mega-cap technology stocks. The "Magnificent 7" in the U.S. was up 82% last year and has risen another 10% so far this year. The equal-weighted S&P 500 Index, which neutralizes the impact of these seven stocks, was up only 11.6% in 2023 and 3% this year, which is more consistent with returns in the rest of the world. Given more moderate returns, most major equity markets outside of the U.S. are trading at attractive levels relative to our modelled fair value. With respect to the U.S., many investors are concerned that the "Magnificent 7" is in a bubble given the group's extraordinary gains. We note that these stocks are benefiting from trends in artificial intelligence and are not necessarily overpriced, as long as their earnings can continue to grow at a fast pace. Our work suggests that the "Magnificent 7" would have to grow their aggregate earnings by 23% each year for the next 15 years to justify their current valuation premium versus the rest of the market. Elevated valuations in U.S. large-cap stocks in general means that achieving decent returns on the S&P 500 will now require that solid earnings growth and heightened investor confidence be sustained.

### Asset mix – maintaining asset mix close to neutral, with a bias to fixed income

Balancing the risks and rewards, we are maintaining an asset mix close to our neutral allocation, with a bias to fixed income. Our base case expectation is for the U.S. economy to continue to expand at a moderate pace and for inflation to continue falling at a rate that will allow central banks to cut interest rates at some point this year. Falling interest rates should be supportive of fixed-income assets and, importantly, at higher yield levels, bonds provide greater ballast against equity-market volatility within a balanced portfolio. For these reasons, we have added to our fixed-income allocation over the past several quarters as yields rose, closing our prior underweight position and ultimately moving to a slight overweight as the U.S. 10-year yield approached 5% in the fall of 2023. While we remain constructive on stocks over the longer term, we recognize that in the near term, sentiment is extremely optimistic and valuations are demanding such that investors are not being sufficiently compensated for the risk of an adverse outcome. As a result, we are maintaining a neutral allocation to stocks. For a balanced global investor, we currently recommend an asset mix of 60.0 percent equities (strategic neutral position: 60.0 percent) and 38.5 percent fixed income (strategic neutral position: 38.0 percent), with the balance in cash.

### Recommended asset mix

RBC GAM Investment Strategy Committee




Note: As of February 29, 2024. Source: RBC GAM

# Economic & capital markets forecasts

## Economic forecast (RBC GAM Investment Strategy Committee)

| | United States | | Canada | | Europe | | United Kingdom | | Japan | | China | | Emerging markets* | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Spring 2024 | Change from New Year 2024 | Spring 2024 | Change from New Year 2024 | Spring 2024 | Change from New Year 2024 | Spring 2024 | Change from New Year 2024 | Spring 2024 | Change from New Year 2024 | Spring 2024 | Change from New Year 2024 | Spring 2024 | Change from New Year 2024 |
| **Real GDP** | | | | | | | | | | | | | | |
| 2023A[1] | 2.54% | | 1.11% | | 0.51% | | 0.14% | | 1.87% | | 5.54% | | 5.36% | |
| 2024E | 2.40% | 2.10 | 0.90% | 1.30 | 0.30% | 0.60 | 0.10% | 0.60 | 0.40% | N/C | 4.60% | (0.40) | 4.60% | 0.50 |
| 2025E | 1.70% | N/C | 1.80% | N/C | 1.80% | N/C | 1.80% | N/C | 1.40% | N/C | 4.10% | N/C | 4.30% | N/C |
| **CPI** | | | | | | | | | | | | | | |
| 2023A | 4.12% | | 3.88% | | 5.42% | | 7.30% | | 3.25% | | 0.33% | | 2.59% | |
| 2024E | 2.80% | 0.30 | 2.50% | 0.10 | 2.30% | (0.40) | 2.70% | (0.20) | 2.40% | 1.00 | 0.30% | (0.90) | 2.40% | (0.20) |
| 2025E | 2.30% | N/C | 2.30% | N/C | 2.20% | N/C | 2.40% | N/C | 1.50% | N/C | 1.80% | N/C | 3.00% | N/C |

A = Actual E = Estimate *GDP Weighted Average of China, India, South Korea, Brazil, Mexico and Russia. [1]2023 GDP for Canada, India, Brazil and Russia are not yet available so listed GDP for Canada and Emerging Markets represent the most recent consensus estimates for 2023.

## Targets (RBC GAM Investment Strategy Committee)

| | February 2024 | Forecast February 2025 | Change from New Year 2024 | 1-year total return estimate* (%) |
|---|---|---|---|---|
| **Currency markets against USD** | | | | |
| CAD (USD–CAD) | 1.36 | 1.27 | N/C | 6.6 |
| EUR (EUR–USD) | 1.08 | 1.21 | N/C | 10.3 |
| JPY (USD–JPY) | 149.97 | 135.00 | 5.00 | 5.7 |
| GBP (GBP–USD) | 1.26 | 1.31 | N/C | 3.7 |
| **Fixed income markets** | | | | |
| U.S. Fed Funds Rate (upper bound) | 5.50 | 4.25 | (0.50) | |
| U.S. 10-Year Bond | 4.25 | 4.00 | N/C | 6.3 |
| Canada Overnight Rate | 5.00 | 4.00 | N/C | |
| Canada 10-Year Bond | 3.49 | 3.50 | 0.50 | 3.4 |
| Eurozone Deposit Facility Rate | 4.00 | 2.25 | (0.75) | |
| Germany 10-Year Bund | 2.41 | 2.35 | (0.15) | 2.9 |
| U.K. Base Rate | 5.25 | 4.25 | (0.25) | |
| U.K. 10-Year Gilt | 4.12 | 4.00 | N/C | 5.2 |
| Japan Overnight Call Rate | (0.01) | 0.10 | N/C | |
| Japan 10-Year Bond | 0.71 | 1.00 | N/C | (2.1) |
| **Equity markets** | | | | |
| S&P 500 | 5096 | 5200 | 700 | 3.5 |
| S&P/TSX Composite | 21364 | 22000 | 1450 | 6.4 |
| MSCI Europe | 166 | 175 | 17 | 8.9 |
| FTSE 100 | 7630 | 7925 | 375 | 7.7 |
| Nikkei | 39166 | 41450 | 6700 | 7.5 |
| MSCI Emerging Markets | 1021 | 1085 | 70 | 9.5 |

*Total returns are expressed in local currencies with the exception of MSCI Emerging Markets whose return is expressed in USD. Source: RBC GAM

# Recommended asset mix

Asset mix – the allocation within portfolios to stocks, bonds and cash – should include both strategic and tactical elements. Strategic asset mix addresses the blend of the major asset classes offering the risk/return tradeoff best suited to an investor's profile. It can be considered to be the benchmark investment plan that anchors a portfolio through many business and investment cycles, independent of a near-term view of the prospects for the economy and related expectations for capital markets. Tactical asset allocation refers to fine tuning around the strategic setting in an effort to add value by taking advantage of shorter-term fluctuations in markets.

Every individual has differing return expectations and tolerances for volatility, so there is no "one size fits all" strategic asset mix. Based on a 40-year study of historical returns[1] and the volatility[2] of returns (the range around the average return within which shorter-term results tend to fall), we have developed five broad profiles and assigned a benchmark strategic asset mix for each. These profiles range from very conservative through balanced to aggressive growth. It goes without saying that as investors accept increasing levels of volatility, and therefore greater risk that the actual experience will depart from the longer-term norm, the potential for returns rises. The five profiles presented below may assist investors in selecting a strategic asset mix best aligned to their investment goals.

Each quarter, the RBC GAM Investment Strategy Committee publishes a recommended asset mix based on our current view of the economy and return expectations for the major asset classes. These weights are further divided into recommended exposures to the variety of global fixed income and equity markets. Our recommendation is targeted at the Balanced profile where the benchmark (strategic neutral) setting is 60% equities, 38% fixed income, and 2% cash.

A tactical range of +/- 15% around the benchmark position allows us to raise or lower exposure to specific asset classes with a goal of tilting portfolios toward those markets that offer comparatively attractive near-term prospects.

This tactical recommendation for the Balanced profile can serve as a guide for movement within the ranges allowed for all other profiles.

The value-added of tactical strategies is, of course, dependent on the degree to which the expected scenario unfolds.

Regular reviews of portfolio weights are essential to the ultimate success of an investment plan as they ensure current exposures are aligned with levels of long-term returns and risk tolerances best suited to individual investors.

Anchoring portfolios with a suitable strategic asset mix, and placing boundaries defining the allowed range for tactical positioning, imposes discipline that can limit damage caused by swings in emotion that inevitably accompany both bull and bear markets.

[1]**Average return**: The average total return produced by the asset class over the period 1984 – 2024, based on monthly results.
[2]**Volatility**: The standard deviation of returns. Standard deviation is a statistical measure that indicates the range around the average return within which 2/3 of results will fall into, assuming a normal distribution around the long-term average.

## Global asset mix

| | Benchmark policy | Allowable range | Spring 2023 | Summer 2023 | Fall 2023 | New Year 2024 | **Spring 2024** |
|---|---|---|---|---|---|---|---|
| Cash | 2.0% | 0.0% – 15.0% | 1.5% | 2.0% | 2.0% | 1.5% | **1.5%** |
| Bonds | 38.0% | 23.0% – 53.0% | 37.5% | 38.0% | 38.0% | 38.5% | **38.5%** |
| Stocks | 60.0% | 45.0% – 75.0% | 61.0% | 60.0% | 60.0% | 60.0% | **60.0%** |

Note: Effective June 1, 2020, we reset our strategic neutral positions to reflect long-lasting changes in economy and capital markets' dynamics. Boosting strategic neutral equity exposure by 5% and reducing fixed income by same amount in our reference balanced portfolio.

## Regional allocation

| Global bonds | WGBI* February 2024 | Allowable range | Spring 2023 | Summer 2023 | Fall 2023 | New Year 2024 | **Spring 2024** |
|---|---|---|---|---|---|---|---|
| North America | 44.5% | 34.5% – 54.5% | 49.0% | 42.7% | 40.3% | 47.7% | **47.0%** |
| Europe | 34.6% | 24.6% – 44.6% | 31.2% | 37.1% | 39.8% | 34.4% | **34.6%** |
| Asia | 20.9% | 10.9% – 30.9% | 19.8% | 20.3% | 20.0% | 18.0% | **18.4%** |

| Global equities | MSCI** February 2024 | Allowable range | Spring 2023 | Summer 2023 | Fall 2023 | New Year 2024 | **Spring 2024** |
|---|---|---|---|---|---|---|---|
| North America | 71.1% | 61.1% – 81.1% | 68.0% | 67.7% | 69.3% | 69.8% | **70.6%** |
| Europe | 13.6% | 3.6% – 23.6% | 15.5% | 15.8% | 14.5% | 14.1% | **13.8%** |
| Asia | 7.0% | 0.0% – 17.0% | 8.2% | 8.4% | 8.2% | 8.1% | **7.5%** |
| Emerging markets | 8.3% | 0.0% – 18.3% | 8.4% | 8.1% | 8.1% | 8.1% | **8.1%** |

Our asset mix is reported as at the end of each quarter. The mix is fluid and may be adjusted within each quarter, although we do not always report on shifts as they occur. The weights in the table should be considered a snapshot of our asset mix at the date of release of the Global Investment Outlook.

## Global equity sector allocation

| | MSCI** February 2024 | RBC GAM ISC New Year 2024 | **RBC GAM ISC Spring 2024** | Change from New Year 2024 | Weight vs. benchmark |
|---|---|---|---|---|---|
| Energy | 4.29% | 6.72% | 4.29% | (2.43) | 100.0% |
| Materials | 3.83% | 2.48% | 2.23% | (0.24) | 58.3% |
| Industrials | 10.94% | 12.11% | 12.94% | 0.83 | 118.3% |
| Consumer discretionary | 10.75% | 10.83% | 10.75% | (0.08) | 100.0% |
| Consumer staples | 6.77% | 5.67% | 5.17% | (0.49) | 76.4% |
| Health care | 12.16% | 12.42% | 13.66% | 1.24 | 112.3% |
| Financials | 14.97% | 14.96% | 14.97% | 0.00 | 100.0% |
| Information technology | 23.92% | 24.45% | 25.92% | 1.47 | 108.4% |
| Communication services | 7.61% | 8.28% | 7.61% | (0.66) | 100.0% |
| Utilities | 2.45% | 0.71% | 1.15% | 0.44 | 46.9% |
| Real estate | 2.31% | 1.38% | 1.31% | (0.06) | 56.7% |

*FTSE World Government Bond Index. **MSCI World Index. Source: RBC GAM Investment Strategy Committee

At RBC GAM, we have a team dedicated to setting and reviewing the strategic asset mix for all of our multi-asset solutions. With an emphasis on consistency of returns, risk management and capital preservation, we have developed a strategic asset allocation framework for five client risk profiles that correspond to broad investor objectives and risk preferences. These five profiles range from Very Conservative through Balanced to Aggressive Growth.

## Very Conservative

| Asset class | Bench-mark | Range | Last quarter | Current recommendation |
|---|---|---|---|---|
| Cash & Cash Equivalents | 2% | 0-15% | 1.5% | 1.5% |
| Fixed Income | 73% | 68-88% | 73.5% | 73.5% |
| Total Cash & Fixed Income | 75% | 60-90% | 75.0% | 75.0% |
| Canadian Equities | 10% | 0-20% | 9.9% | 10.0% |
| U.S. Equities | 8% | 0-18% | 7.9% | 7.8% |
| International Equities | 7% | 0-17% | 7.2% | 7.2% |
| Emerging Markets | 0% | 0% | 0.0% | 0.0% |
| Total Equities | 25% | 10-40% | 25.0% | 25.0% |

| | Return | Volatility |
|---|---|---|
| 40-year average | 7.5% | 4.9% |
| Last 12 months | 7.0% | 7.0% |

**Very Conservative** investors will seek income with maximum capital preservation and the potential for modest capital growth, and be comfortable with small fluctuations in the value of their investments. This portfolio will invest primarily in fixed-income securities, and a small amount of equities, to generate income while providing some protection against inflation. Investors who fit this profile generally plan to hold their investment for the medium to long term.

## Conservative

| Asset class | Bench-mark | Range | Last quarter | Current recommendation |
|---|---|---|---|---|
| Cash & Cash Equivalents | 2% | 0-15% | 1.5% | 1.5% |
| Fixed Income | 58% | 43-83% | 58.5% | 58.5% |
| Total Cash & Fixed Income | 60% | 45-75% | 60.0% | 60.0% |
| Canadian Equities | 13% | 3-23% | 12.9% | 13.0% |
| U.S. Equities | 15% | 5-25% | 14.9% | 14.8% |
| International Equities | 12% | 2-22% | 12.2% | 12.2% |
| Emerging Markets | 0% | 0% | 0.0% | 0.0% |
| Total Equities | 40% | 25-55% | 40.0% | 40.0% |

| | Return | Volatility |
|---|---|---|
| 40-year average | 8.0% | 6.2% |
| Last 12 months | 9.5% | 7.2% |

**Conservative** investors will pursue modest income and capital growth with reasonable capital preservation, and be comfortable with moderate fluctuations in the value of their investments. The portfolio will invest primarily in fixed-income securities, with some equities, to achieve more consistent performance and provide a reasonable amount of safety. The profile is suitable for investors who plan to hold their investment over the medium to long term.

## Balanced

| Asset class | Bench-mark | Range | Last quarter | Current recommendation |
|---|---|---|---|---|
| Cash & Cash Equivalents | 2% | 0-15% | 1.5% | 1.5% |
| Fixed Income | 38% | 23-53% | 38.5% | 38.5% |
| Total Cash & Fixed Income | 40% | 25-55% | 40.0% | 40.0% |
| Canadian Equities | 15% | 5-25% | 14.8% | 15.0% |
| U.S. Equities | 25% | 15-35% | 24.8% | 24.7% |
| International Equities | 15% | 5-25% | 15.5% | 15.4% |
| Emerging Markets | 5% | 0-15% | 4.9% | 4.9% |
| Total Equities | 60% | 45-75% | 60.0% | 60.0% |

| | Return | Volatility |
|---|---|---|
| 40-year average | 8.5% | 7.7% |
| Last 12 months | 12.6% | 7.7% |

The **Balanced** portfolio is appropriate for investors seeking balance between long-term capital growth and capital preservation, with a secondary focus on modest income, and who are comfortable with moderate fluctuations in the value of their investments. More than half the portfolio will usually be invested in a diversified mix of Canadian, U.S. and global equities. This profile is suitable for investors who plan to hold their investment for the medium to long term.

## Growth

| Asset class | Bench-mark | Range | Last quarter | Current recommendation |
|---|---|---|---|---|
| Cash & Cash Equivalents | 2% | 0-15% | 1.5% | 1.5% |
| Fixed Income | 23% | 8-38% | 23.5% | 23.5% |
| Total Cash & Fixed Income | 25% | 10-40% | 25.0% | 25.0% |
| Canadian Equities | 18% | 8-28% | 17.8% | 18.0% |
| U.S. Equities | 30% | 20-40% | 29.8% | 29.6% |
| International Equities | 19% | 9-29% | 19.6% | 19.5% |
| Emerging Markets | 8% | 0-18% | 7.8% | 7.9% |
| Total Equities | 75% | 60-90% | 75.0% | 75.0% |

| | Return | Volatility |
|---|---|---|
| 40-year average | 8.7% | 9.6% |
| Last 12 months | 14.7% | 8.3% |

Investors who fit the **Growth** profile will seek long-term growth over capital preservation and regular income, and be comfortable with considerable fluctuations in the value of their investments. This portfolio primarily holds a diversified mix of Canadian, U.S. and global equities and is suitable for investors who plan to invest for the long term.

## Aggressive Growth

| Asset class | Bench-mark | Range | Last quarter | Current recommendation |
|---|---|---|---|---|
| Cash & Cash Equivalents | 2% | 0-15% | 2.0% | 2.0% |
| Fixed Income | 0% | 0-15% | 0.0% | 0.0% |
| Total Cash & Fixed Income | 2% | 0-17% | 2.0% | 2.0% |
| Canadian Equities | 29% | 19-39% | 28.8% | 29.0% |
| U.S. Equities | 38% | 28-48% | 37.8% | 37.5% |
| International Equities | 20% | 10-30% | 20.7% | 20.7% |
| Emerging Markets | 11% | 1-21% | 10.7% | 10.8% |
| Total Equities | 98% | 83-100% | 98.0% | 98.0% |

| | Return | Volatility |
|---|---|---|
| 40-year average | 9.1% | 12.0% |
| Last 12 months | 17.6% | 9.5% |

**Aggressive Growth** investors seek maximum long-term growth over capital preservation and regular income, and are comfortable with significant fluctuations in the value of their investments. The portfolio is almost entirely invested in stocks and emphasizes exposure to global equities. This investment profile is suitable only for investors with a high risk tolerance and who plan to hold their investments for the long term.

# Capital markets performance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The U.S. dollar was relatively flat against other major currencies in the three months ended February 29, 2024. It was up 1.1% against the Japanese yen and 0.7% versus the euro and essentially unchanged against the Canadian dollar and the British pound. The resilience of the U.S. economy and diminished rate-cut expectations buoyed the greenback even as the dollar remains overvalued and the country continues to run current-account and fiscal deficits. The large policy-rate difference between Japan and most other countries is a persistent drag on the yen as Japanese investors shun their currency for better returns elsewhere. In contrast with the U.S., the economies of Japan, Europe, Canada and the UK have slowed considerably or contracted in the past few quarters, but there have been signs of stabilization in some regions. Over the one-year period, the U.S. dollar was up 10.1% against the yen but down 4.7% against sterling, 2.1% against the euro and 0.5% against the loonie.

Global fixed income recorded mixed results in the latest quarter. Bond prices rose and yields fell during the period on investors' assumption that interest rates had peaked, and that interest-rate cuts would soon be appropriate following a series of encouraging inflation readings. Some of those gains have been reversed since January, when rate-cut expectations were pared on surprisingly strong economic data and firmer-than-expected inflation. The yield on the U.S. 10-year bond fell to 3.79% on December 27, 2023, from 4.93% at the end of October of last year, before grinding higher to end the three-month period at 4.25%. U.S. bonds outperformed, with the FTSE U.S. Government Bond Index returning 2.1%, and European bonds lagged as the FTSE European Government Bond Index registered a 1.2% loss. Over the 12-month period, the FTSE Canada Universe Bond Index performed best, up 4.4%, while declines of 10.3% for the FTSE Japanese Government Bond Index and 10.2% for the FTSE European Government Bond Index ranked last, measured in U.S.-dollar terms.

Equity investors were rewarded with tremendous returns in many markets over the three-month period. Several indexes soared to all-time highs, including the S&P 500 Index, the Dow Jones Industrial Average, Europe's Stoxx 600 Index and even Japan's Nikkei Index, which finally topped its high from 35 years ago. The rally in stocks that began in late October was initially led by a handful of U.S. mega-cap technology stocks but has broadened to more areas. Equity returns ranged from 3.2% for the MSCI UK Index to 12.5% for the MSCI Japan Index, with most of the broad market indexes posting high single-digit to low double-digit gains. Although the UK and Japan are both in technical recessions – defined as two consecutive quarters of GDP contraction – the outlook for the two countries differs. The British economy is still contending with high inflation of 4% and weakness in the housing market and domestic investment. In Japan, inflation is near the central bank's 2% target after a two-decade-long battle with deflation and real wages are likely to rise, which would boost domestic consumption. Over the one-year period, the MSCI UK was the worst performer with a 5.5% gain, and the S&P 500 was the best with a 30.5% return, both in U.S.-dollar terms.

Stocks of U.S. companies of all sizes delivered solid returns in the latest quarter, led by the 13.2% gain for the mid-cap S&P 400 Index, which outperformed the small-cap index by 1.3 percentage points. Investors poured money into stocks of growth companies that will likely benefit most from advances in artificial intelligence (AI), pacing the Russell 3000 Growth Index to a 14.5% gain versus the 9.6% increase for the Russell 3000 Value Index. All global equity sectors but one posted gains. Information Technology, which contains many AI and growth-oriented issues, was the best performing sector with a 15.1% return while the defensive Utilities sector came in last, with a loss of 1.5%. This sector performance is congruent with the increased probability of an economic soft landing. Over the 12-month time frame, Information Technology was the best performing sector with a 53.8% return, and Utilities worst with a 0.4% gain.

**Exchange rates**
Periods ending February 29, 2024

| | Current USD | 3 months (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) |
|---|---|---|---|---|---|---|
| USD–CAD | 1.3572 | 0.01 | 2.42 | (0.54) | 2.17 | 0.62 |
| USD–EUR | 0.9252 | 0.71 | 2.14 | (2.14) | 3.74 | 1.03 |
| USD–GBP | 0.7922 | 0.01 | 0.98 | (4.71) | 3.34 | 0.99 |
| USD–JPY | 149.9200 | 1.12 | 6.33 | 10.11 | 12.04 | 6.11 |

Note: all changes above are expressed in US dollar terms

**Canada fixed income markets**
Periods ending February 29, 2024

| | USD | | | | | CAD | | |
|---|---|---|---|---|---|---|---|---|
| Fixed income markets: Total return | 3 months (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) | 3 months (%) | 1 year (%) | 3 years (%) |
| FTSE Canada Univ. Bond Index TR | 1.65 | (4.03) | 4.36 | (4.24) | 0.03 | 1.66 | 3.79 | (2.17) |

**U.S. fixed income markets**
Periods ending February 29, 2024

| | USD | | | | | CAD | | |
|---|---|---|---|---|---|---|---|---|
| Fixed income markets: Total return | 3 months (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) | 3 months (%) | 1 year (%) | 3 years (%) |
| FTSE U.S. Government TR | **2.12** | **(1.68)** | **3.31** | **(3.18)** | **0.58** | **2.14** | **2.75** | **(1.08)** |
| BBg U.S. Agg. Bond Index TR[1] | **2.08** | **(1.68)** | **3.33** | **(3.16)** | **0.56** | **2.09** | **2.77** | **(1.06)** |

**Global fixed income markets**
Periods ending February 29, 2024

| | USD | | | | | CAD | | |
|---|---|---|---|---|---|---|---|---|
| Fixed income markets: Total return | 3 months (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) | 3 months (%) | 1 year (%) | 3 years (%) |
| FTSE WGBI TR | 1.56 | (2.54) | 3.68 | (5.76) | (1.16) | 1.57 | 3.12 | (3.72) |
| FTSE European Government TR | (1.22) | (6.32) | (10.16) | (14.80) | (6.54) | (1.21) | (10.64) | (13.98) |
| FTSE Japanese Government TR | (1.11) | (6.46) | (10.35) | (13.09) | (7.45) | (1.09) | (10.83) | (12.29) |

**Canada equity markets**
Periods ending February 29, 2024

| | USD | | | | | CAD | | |
|---|---|---|---|---|---|---|---|---|
| Equity markets: Total return | 3 months (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) | 3 months (%) | 1 year (%) | 3 years (%) |
| S&P/TSX Composite | 6.37 | (0.04) | 9.79 | 6.70 | 8.62 | 6.39 | 9.19 | 9.01 |
| S&P/TSX 60 | 6.64 | 0.07 | 10.39 | 7.45 | 9.07 | 6.65 | 9.79 | 9.78 |
| S&P/TSX Small Cap | 4.16 | (1.97) | 0.80 | (0.71) | 5.39 | 4.18 | 0.26 | 1.44 |

**U.S. equity markets**
Periods ending February 29, 2024

| | USD | | | | | CAD | | |
|---|---|---|---|---|---|---|---|---|
| Equity markets: Total return | 3 months (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) | 3 months (%) | 1 year (%) | 3 years (%) |
| S&P 500 TR | 11.98 | 7.11 | 30.45 | 11.91 | 14.76 | 11.99 | 29.75 | 14.34 |
| S&P 400 TR | 13.20 | 4.13 | 13.05 | 6.65 | 10.38 | 13.22 | 12.38 | 8.94 |
| S&P 600 TR | 11.94 | (0.75) | 6.50 | 2.31 | 7.72 | 11.96 | 5.93 | 2.79 |
| Russell 3000 Value TR | 9.62 | 3.48 | 13.51 | 8.03 | 9.20 | 9.63 | 12.84 | 10.36 |
| Russell 3000 Growth TR | 14.46 | 9.25 | 43.97 | 11.37 | 17.98 | 14.48 | 43.12 | 13.77 |
| NASDAQ Composite Index TR | 13.32 | 7.33 | 41.63 | 7.69 | 17.38 | 13.33 | 40.86 | 10.02 |

Note: All rates of return presented for periods longer than 1 year are annualized. [1] Bloomberg U.S. Agg. Bond Index TR. Source: RBC GAM

## Global equity markets
Periods ending February 29, 2024

| | USD | | | | | CAD | | |
|---|---|---|---|---|---|---|---|---|
| Equity markets: Total return | 3 months (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) | 3 months (%) | 1 year (%) | 3 years (%) |
| MSCI World TR * | 10.67 | 5.49 | 24.96 | 8.64 | 11.66 | 10.71 | 24.49 | 11.17 |
| MSCI EAFE TR * | 7.86 | 2.42 | 14.41 | 4.45 | 6.77 | 7.90 | 13.98 | 6.88 |
| MSCI Europe TR * | 6.51 | 1.44 | 12.60 | 5.97 | 7.30 | 6.54 | 12.18 | 8.43 |
| MSCI Pacific TR * | 10.27 | 4.14 | 17.76 | 1.83 | 5.82 | 10.31 | 17.32 | 4.19 |
| MSCI UK TR * | 3.15 | (1.31) | 5.45 | 7.10 | 4.44 | 3.19 | 5.06 | 9.59 |
| MSCI France TR * | 7.47 | 2.70 | 12.20 | 8.27 | 8.92 | 7.51 | 11.78 | 10.79 |
| MSCI Germany TR * | 7.65 | 3.11 | 14.98 | 1.18 | 5.20 | 7.69 | 14.55 | 3.53 |
| MSCI Japan TR * | 12.46 | 7.75 | 26.93 | 3.03 | 7.25 | 12.50 | 26.46 | 5.42 |
| MSCI Emerging Markets TR * | 3.80 | (0.11) | 8.73 | (6.30) | 1.89 | 3.84 | 8.32 | (4.12) |

## Global equity sectors
Periods ending February 29, 2024

| | USD | | | | | CAD | | |
|---|---|---|---|---|---|---|---|---|
| Sector: Total return | 3 months (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) | 3 months (%) | 1 year (%) | 3 years (%) |
| Energy TR * | 0.53 | 0.58 | 4.99 | 21.01 | 7.30 | 0.57 | 4.60 | 23.82 |
| Materials TR * | 3.74 | (2.96) | 6.62 | 4.21 | 9.06 | 3.77 | 6.22 | 6.63 |
| Industrials TR * | 13.58 | 5.58 | 23.90 | 9.00 | 10.36 | 13.62 | 23.44 | 11.53 |
| Consumer discretionary TR * | 11.52 | 5.90 | 27.58 | 3.92 | 11.97 | 11.57 | 27.10 | 6.34 |
| Consumer staples TR * | 3.71 | 0.99 | 4.68 | 5.52 | 6.21 | 3.75 | 4.29 | 7.97 |
| Health care TR * | 9.64 | 5.00 | 14.32 | 7.88 | 10.00 | 9.69 | 13.89 | 10.39 |
| Financials TR * | 11.48 | 5.25 | 14.58 | 9.04 | 8.98 | 11.52 | 14.15 | 11.58 |
| Information technology TR * | 15.14 | 10.42 | 53.78 | 14.76 | 22.99 | 15.19 | 53.21 | 17.42 |
| Communication services TR* | 14.19 | 9.00 | 46.48 | 2.92 | 10.37 | 14.23 | 45.93 | 5.31 |
| Utilities TR * | (1.45) | (4.29) | 0.37 | 2.56 | 3.68 | (1.42) | (0.00) | 4.94 |
| Real estate TR * | 5.36 | (3.05) | 3.44 | 0.43 | 1.58 | 5.40 | 3.05 | 2.77 |

* Net of taxes. Note: all rates of return presented for periods longer than 1 year are annualized. Source: Bloomberg/MSCI

# Economic outlook
## Spotlight on a soft landing

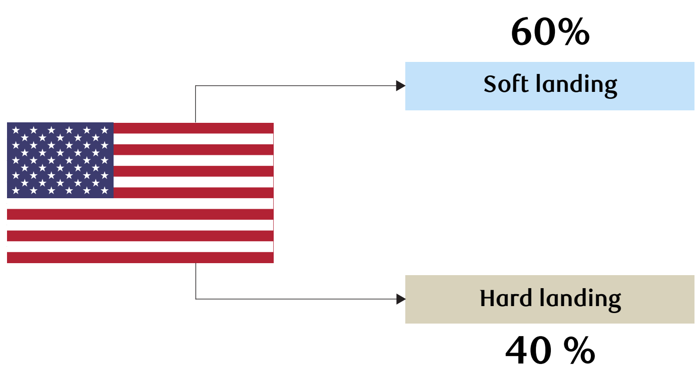
**Eric Lascelles**
Managing Director & Chief Economist
RBC Global Asset Management Inc.

The likelihood of a soft landing – of the economy continuing to grow in the face of adversity – continues to mount, now constituting a 60% probability for the U.S. (Exhibit 1). This scenario has now become more likely than a recession. Inspiring this pivot, economic data has remained resilient – exceeding expectations, and a number of historically compelling recession signals have begun to reverse.

However, we must not make too much of this newfound optimism.

First, the transformation is more incremental than it looks. There have long been, and continue to be, multiple vying economic scenarios. The odds of a soft landing were already considerable last quarter, and the probability of a hard landing – while diminishing – still leaves a very real 40% chance of a recession. A variety of classic recession signals continue to point in that direction, though they constitute a shrinking fraction of the total (Exhibit 2).

### Exhibit 1: Two vying macro scenarios for 2024




Source: RBC GAM

### Exhibit 2: Recession signals significant but declining

| Signal | Predicting U.S. recession? |
|---|---|
| 2yr-10yr curve inverts | Yes |
| 3m-10yr curve inverts | Yes |
| Fed short-term curve inverts | Yes |
| Inflation spike | Yes |
| Volume of global trade falls | Yes |
| Monetary tightening cycle | Likely |
| RBC GAM recession model | Likely |
| Google "recession" news trend | Maybe |
| Duncan leading indicator falls | Maybe |
| Unemployment increase | Maybe |
| Jobless claims jump | No |
| Lending standards tighten | No |
| Oil price spike | No |

Note: As at 02/07/2024. Analysis for U.S. economy. Source: RBC GAM

Second, the divide between a soft landing and a hard landing, while significant, is smaller than it first appears. We expect only modest to moderate economic growth in the soft-landing scenario, versus just a mild decline in the hard-landing scenario. The risk of a deep recession is now small.

The prognosis for other developed markets has also improved but remains less promising than for the U.S., with a recession probability in the realm of 50% over the coming year.

From a financial-market perspective, these developments have not triggered a major asset-allocation rethink. While greater economic optimism argues, all else equal, for more risk taking, market valuations already assume a positive outcome, and leave little room for a negative scenario. Furthermore, fixed income continues to offer more attractive valuations than most risk assets.

## Soft-landing odds rising

Several developments have motivated the upgrade to a 60% probability of a soft landing for the U.S. economy.

First, U.S. economic growth has continued to defy expectations for a slowdown (Exhibit 3). The rate of growth over the past two quarters was outright remarkable and has been good for 18 months. While economic theory makes clear that a sharp increase in interest rates is supposed to hurt growth, the reality has been only minor damage. When the economic data deviates from theory for a quarter or two, the best practice is arguably to stick to one's forecast. But when the data exceeds expectations over and over – and with no particular evidence of an imminent deceleration – the best practice is instead to recognize that the economy possesses a buoyancy that, while poorly understood, is entirely real.

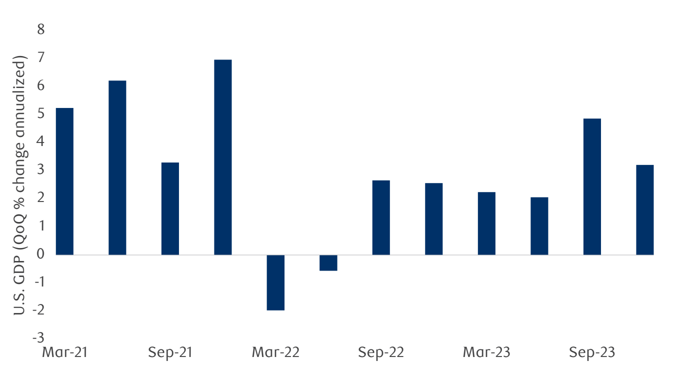
Second, inflation has retreated from the extraordinary highs of 2022, greatly reducing its corrosive effect on the economy. It is difficult for businesses, households and governments to plan for the future and operate efficiently when prices are rising rapidly, but that problem has now mostly faded.

Third, the U.S. Federal Reserve (Fed) and other central banks have stopped rate hikes and are now talking about reversing course at a pace that supports growth without fanning inflation. Monetary policy should become somewhat less restrictive over the coming year, nibbling away at the central argument for a hard landing (Exhibit 4).

Fourth, a number of recession signals have unwound, reducing the likelihood of a recession:

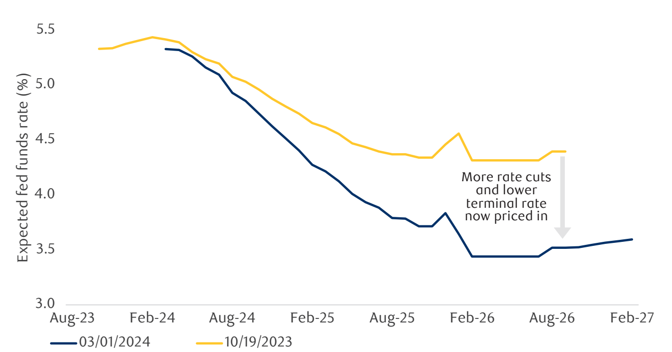
- A recession occurred the prior four times that the U.S. Senior Loan Officer Survey tightened as much as it did in 2023. However, lending conditions are now starting to loosen, arguing that a recession may be avoided this time (Exhibit 5).
- A recession happened the last five times U.S. households sharply scaled back their intentions to purchase durable household goods. But these intentions are now rising again, arguing that the moment of maximum recession risk is behind us (Exhibit 6).

### Exhibit 3: U.S. economy has been stubbornly resilient




Note: As of Q4 2023. Source: Bureau of Economic Analysis, Macrobond, RBC GAM

### Exhibit 4: Market now expects significant rate cutting




Note: As of 03/01/2024. Source: Bloomberg, RBC GAM

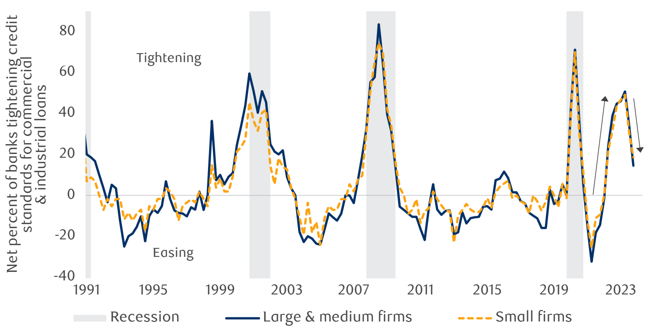
- A recession happened the last four times S&P 500 Index profit margins tumbled significantly. Profit margins again fell sharply over the past few years, but they have now begun to tentatively revive without the arrival of a recession (Exhibit 7).
- While the ISM Manufacturing Index and its new-orders component never quite descended to levels consistent with a recession, they did fall well below normal, to levels consistent with a contracting manufacturing sector. But, in recent months, the trend has begun to tentatively reverse (Exhibit 8).

## Upgraded growth forecasts

With a soft landing now probable, our base case growth forecasts have increased. Instead of a recession in the first half of 2024, we now expect modest growth.

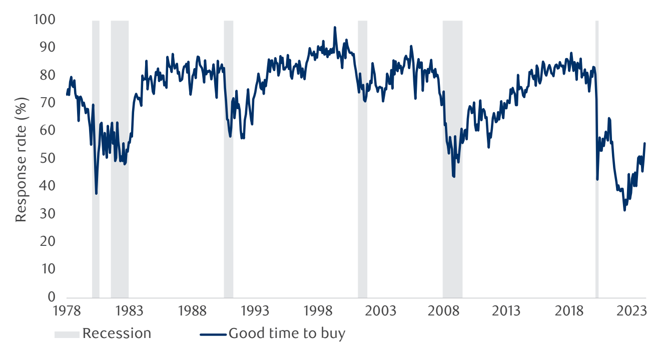
Across the developed world, our upgrades to the 2024 GDP growth forecast range from 0.7 percentage point for the eurozone and UK to a whopping 2.1 percentage points for the U.S., where an exceptionally strong handoff from 2023 and fast start to 2024 have further boosted the forecast. (Japan is an exception to these upgrades, with a roughly unchanged forecast after an improved outlook for the first half of 2024 was neutralized by a poor handoff from 2023).

### Exhibit 5: U.S. business-lending standards have become less tight



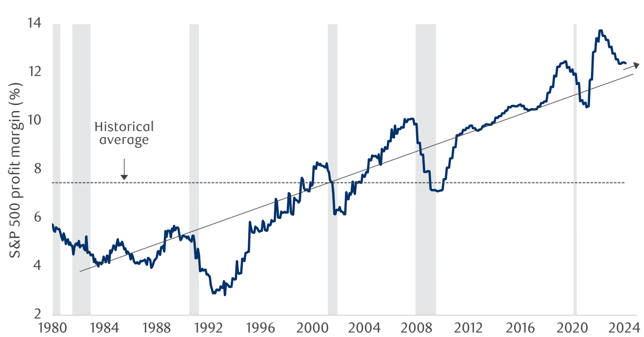

Note: January 2024 Senior Loan Officer Opinion Survey on Bank Lending Practices. Source: Federal Reserve Board, Macrobond, RBC GAM

### Exhibit 6: More consumers think it's a good time to buy large durable household goods



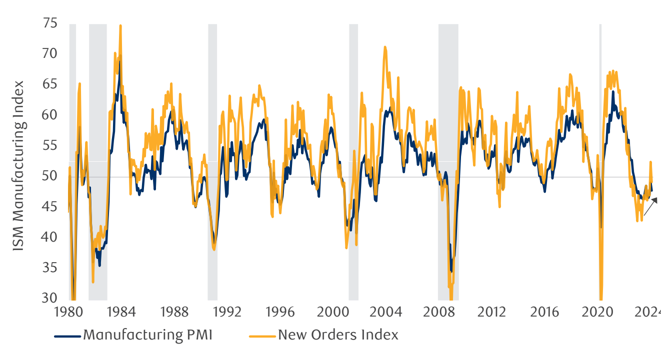

Note: As of Jan 2024. Source: University of Michigan, Macrobond, RBC GAM

### Exhibit 7: S&P 500 profit margins stabilize




Note: As of Feb 2024. Shaded area represents recession. Source: RBC Capital Markets, Bloomberg, RBC GAM

### Exhibit 8: U.S. manufacturing activity has bounced off floor




Note: As of Feb 2024. Shaded area represents recession. Source: ISM, Haver Analytics, RBC GAM

The upgraded 2024 growth forecasts mean we are now roughly in line with the consensus outlook for most countries, and even slightly above the consensus for the U.S. and Canada (Exhibit 9). We forecast 2.4% GDP growth for the U.S. in 2024, which is well ahead of Canada at 0.9%, and small growth forecasts for Japan, the eurozone and the UK.

The 2025 outlook presumes further moderate growth, with economies managing a slight acceleration as central-bank rates decline.

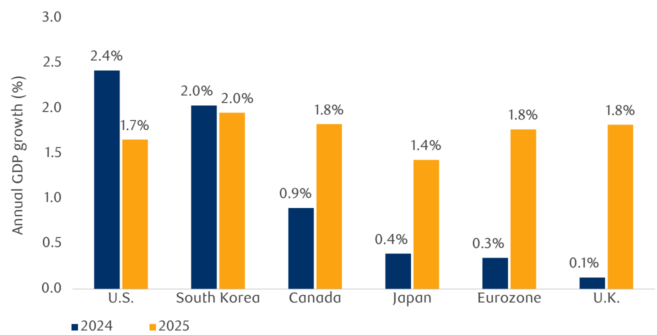
Emerging-market growth forecasts have also been raised modestly, primarily reflecting spillover effects from healthier developed-world economies (Exhibit 10).

## Hard landing still in play

The soft-landing scenario merits most of our attention, but it falls short of a guaranteed outcome. A recession remains possible, with a 40% likelihood.

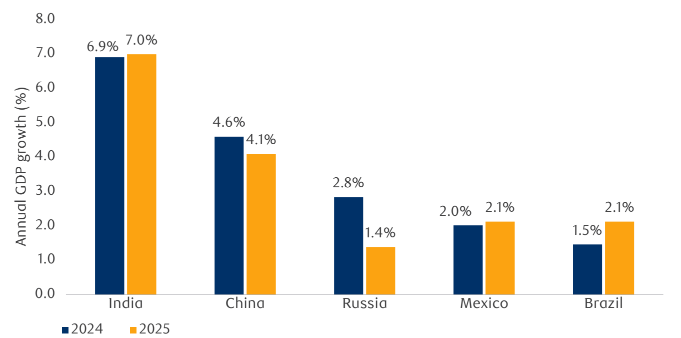
Interest rates have increased massively over the past several years, theoretically imparting a profound economic drag (Exhibit 11). This drag usually peaks a few years after rate hikes begin, making 2024 a year worth watching especially closely (Exhibit 12).

### Exhibit 9: RBC GAM GDP forecast for developed markets



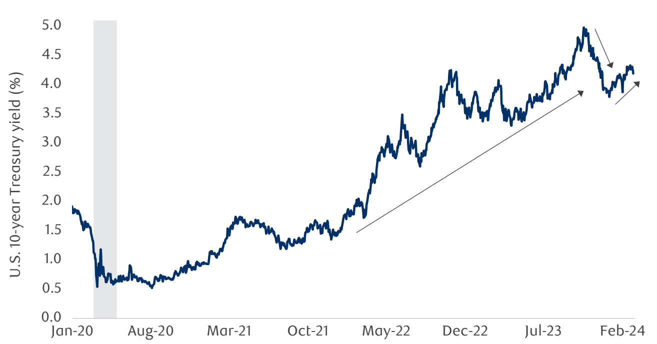

Note: As of 02/23/2024. Source: RBC GAM

### Exhibit 10: RBC GAM GDP forecast for emerging markets



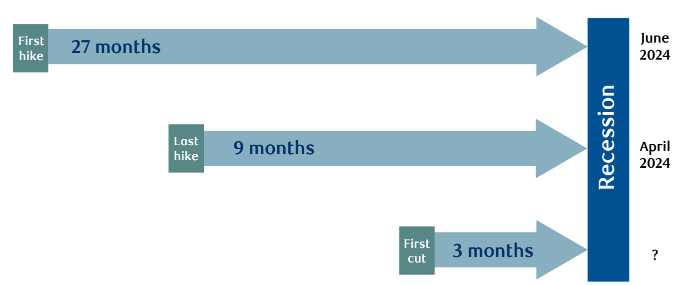

Note: As of 02/23/2024. Source: RBC GAM

### Exhibit 11: Bond yields fell on rate cut bets, but now rising on strong economic data




Note: As of 03/01/2024. Shaded area represents recession. Source: U.S. Treasury, Macrobond, RBC GAM

### Exhibit 12: Historical U.S. monetary cycles argue recession window is still open




Note: As at 02/09/2024. Analysis for U.S. economy. Source: RBC GAM

The pain of higher interest rates may be minimal thus far in the U.S, but it is clearly being felt elsewhere in the developed world. As an example, eurozone economic data remains materially weaker than the U.S. (Exhibit 13).

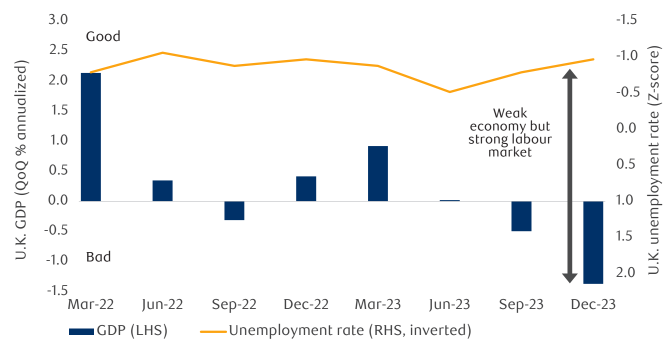
The British, German and Japanese economies have all just registered two consecutive quarters of declining GDP (Exhibit 14). This is conventionally called a “technical recession.” We would argue that a proper recession also requires labour-market weakness, which has yet to happen in those markets. It is more accurate to say that developed economies aside from the U.S. are struggling but not collapsing. While the risk of a recession is higher outside the U.S., the U.S. cannot expect to be completely immune to the effect of higher interest rates when other countries have so clearly succumbed to its gravitational pull.

In the U.S., two of the factors that drove the economy in 2023 were enthusiastic consumers and fiscal spending. These may become less helpful over the coming year. Some households are beginning to struggle under the weight of higher interest rates (Exhibit 15). The IMF and OECD both project a fiscal drag for the U.S. in 2024 (Exhibit 16), though election-year considerations could induce additional fiscal support.

## Exhibit 13: Economic growth gap between eurozone and U.S.

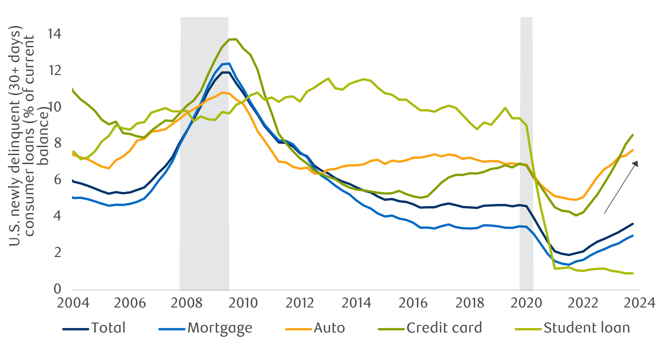

Note: As of 03/01/2024. Source: Citigroup, Bloomberg, RBC GAM

## Exhibit 14: UK economy-employment disconnect



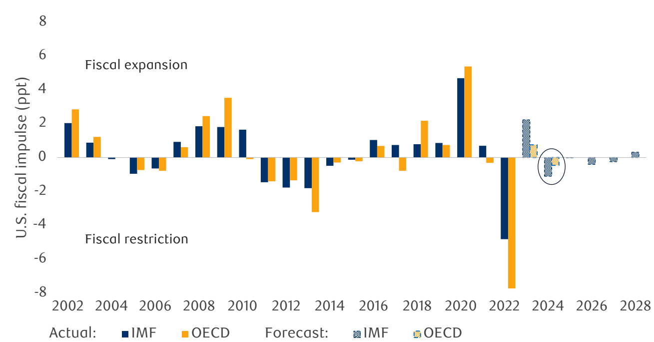

Note: GDP as of Q4 2023, unemployment as of Nov 2023. Unemployment rate normalized over the last decade and plotted on an inverted axis to display good economic data in the same direction. Source: U.K. ONS, Macronond, RBC GAM

## Exhibit 15: U.S. consumer-loan delinquencies are now rising




Note: As of Q4 2023. Shaded area represents recession. Source: FRBNY, Macrobond, RBC GAM

## Exhibit 16: U.S. fiscal policy to become a drag on growth in 2024

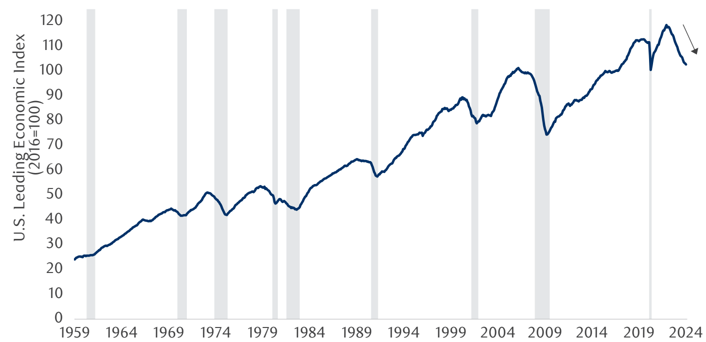



Note: Fiscal impulse is defined as the change in general government structural balance as percentage of potential GDP from the previous year multiplied by minus one. Source: IMF WEO October 2023, OECD Global Economic Outlook, November 2023, Macrobond, RBC GAM

Standing in opposition to the earlier list of recession signals that have now reversed course are several that remain steadfast in their gloominess:

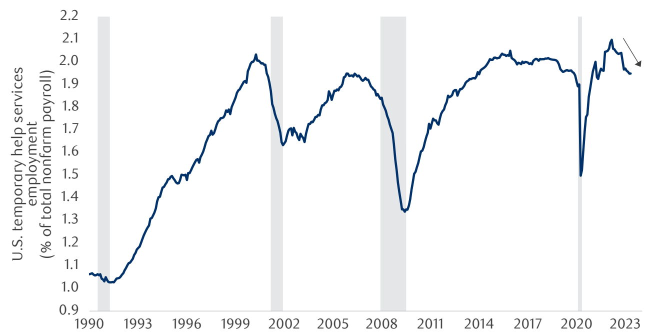
- The yield curve remains inverted – a classic recession precursor, if one that has now been crying wolf for an unusually long time.
- The U.S. Conference Board's leading economic indicator continues to fall – historically, a failsafe recession signal (Exhibit 17).
- Global trade on an inflation-adjusted basis continues to decline – this has been a reliable recession indicator. However, trade may be starting to stabilize.
- Temporary employment in the U.S. is falling, a historically reliable precursor to recession (Exhibit 18). That said, the signal may be flawed this time as companies aren't so much getting rid of temporary workers as converting them into full-time staff in a tight labour market.
- Finally, although Sahm's Law (a 0.5 percentage point increase in the 3-month moving average of the U.S. unemployment rate) has not yet delivered its definitive recession signal, the U.S. unemployment rate appears to have bottomed, and has tentatively increased off that bottom. Historically, such reversals have been closely followed by a rising unemployment rate and recession (Exhibit 19).

### Exhibit 17: U.S. leading economic indicator continues to fall



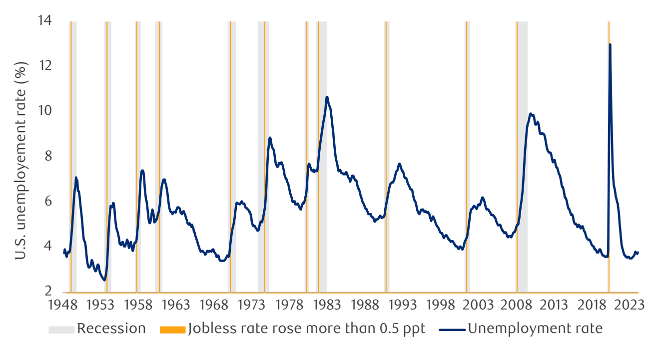

Note: As of Jan 2024. Shaded area represents recession. Source: The Conference Board, Macrobond, RBC GAM

### Exhibit 18: Falling U.S. temporary employment usually leads recession




Note: As of Jan 2024. Shaded area represents recession. Source: BLS, Macrobond, RBC GAM

### Exhibit 19: Not much room for cooling the economy without triggering a recession




Note: As of Feb 2024. Unemployment rate is 3-month moving average. Source: Bureau of Labor Statistics, NBER, Macrobond, RBC GAM

The evident problem is that there are compelling arguments on both sides of the soft landing-hard landing debate. Our business-cycle scorecard embodies this confusion (Exhibit 20). While the majority of the inputs still favour the view that the business cycle is old and thus vulnerable to a downturn, a significant and rising share now claim this is the start of a new cycle.

## Inflation falls less reliably

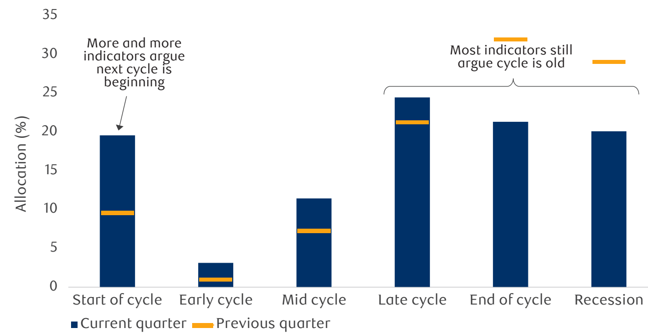
Inflation has fallen significantly from its 2022 apex (Exhibit 21). Three of the four main contributors to ultra-high inflation have been vanquished. The commodity shock has faded, supply chains have resolved their pandemic-era problems and central banks have removed their extraordinary stimulus. The one inflation driver that has not yet fully reversed is fiscal policy: some governments – the U.S. prominently among them – are still running large deficits that do not aid the pursuit of lower inflation.

> "The journey for inflation from the present range of 2.75%—3.50% down to the 2.00% target will be more difficult: slower, bumpier and ultimately less certain."

The improvement in the rate of inflation has slowed and been much choppier over the past few quarters. In the U.S., some of this relates to the economy's resilience – a complication that will persist if the soft-landing scenario continues to play out. Conversely, a recession would neatly – if painfully – arrest wage growth and undermine corporate pricing power in a way that would more swiftly tame the remaining inflation demons.

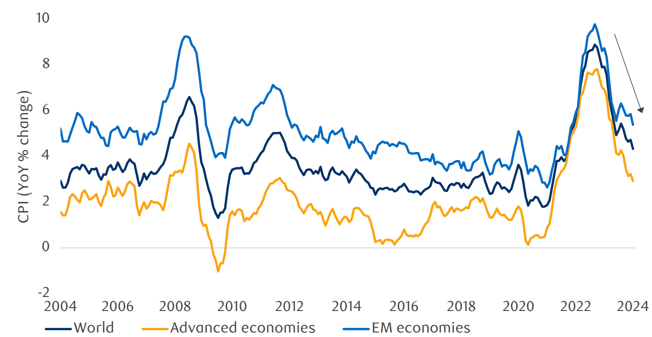
Given that our base case forecast no longer incorporates a recession, we have increased our inflation forecasts relative to a quarter ago, and these forecasts are no longer reliably below the consensus (Exhibit 22). The journey for inflation from the present range of 2.75%-3.50% down to the 2.00% target will be more difficult: slower, bumpier and ultimately less certain.

### Exhibit 20: U.S. business cycle score



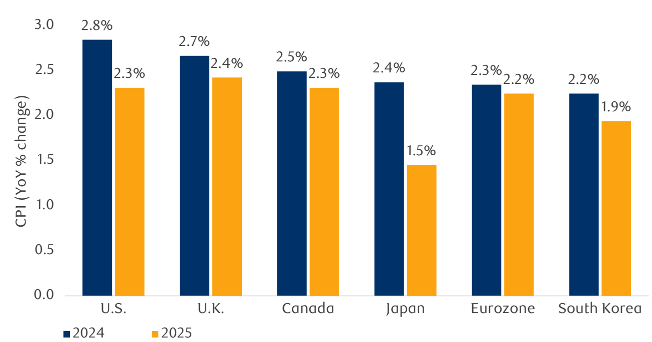

Note: As at 02/02/2024. Calculated via scorecard technique by RBC GAM. Source: RBC GAM

### Exhibit 21: Global inflation has declined but remains elevated




Note: As of Jan 2024. Source: Haver Analytics, Macrobond, RBC GAM

### Exhibit 22: RBC GAM CPI forecast for developed markets

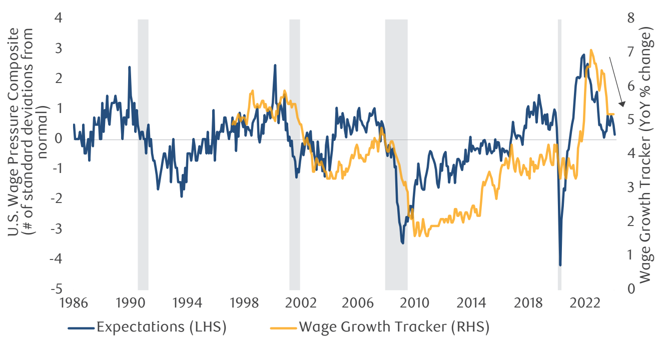



Note: As of 02/23/2024. Source: RBC GAM

But we still believe inflation is more likely to fall than rise from here. Wage pressures are gradually abating despite low unemployment (Exhibit 23).

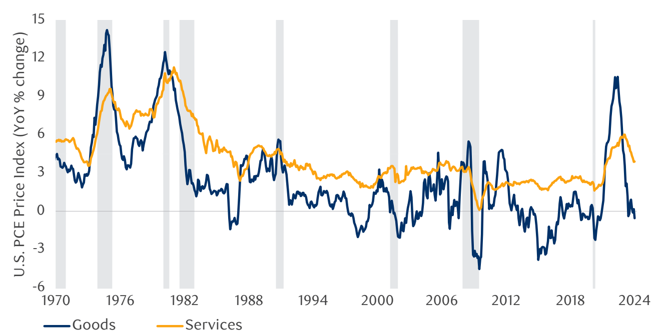
Goods inflation has already vanished. While service inflation remains too high, it is also clearly declining (Exhibit 24). The largest driver of high inflation today comes from shelter costs (Exhibit 25). But these should decline, too. In the U.S., the cost of rent has already slowed importantly, and recent improvements will appear in the CPI index with a lag. The breadth of high inflation is also now narrowing helpfully, clarifying that it is not merely big components such as gasoline and new-car prices that have ceased their rapid ascent, but a spectrum of smaller components (Exhibit 26).

## Exhibit 23: Wage pressure in U.S. has eased



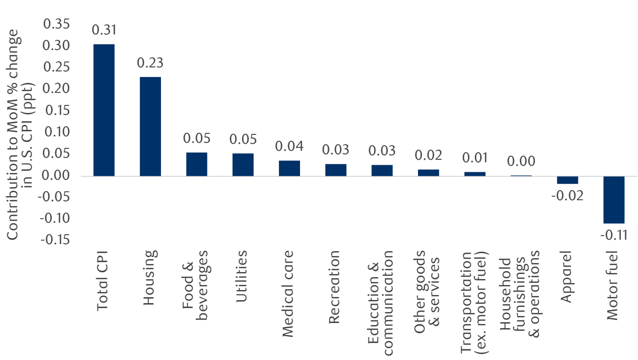

Note: Atlanta Fed Wage Growth Tracker as of Jan 2024, wage expectations as of Feb 2024. Wage Pressure Composite constructed using business intentions to raise wages. Shaded area represents recession. Source: Macrobond, RBC GAM

## Exhibit 24: Both goods and services inflation are now falling



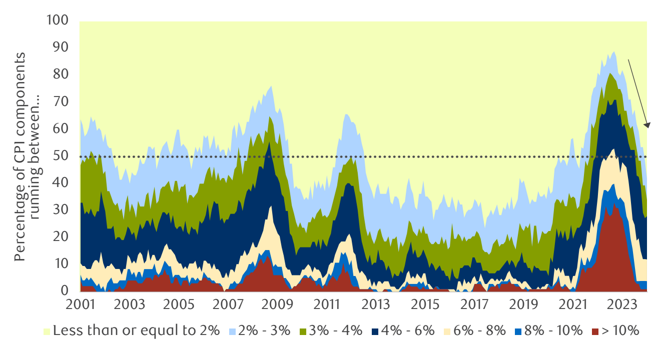

Note: As of Jan 2024. Shaded area represents recession. Source: BEA, Macrobond, RBC GAM

## Exhibit 25: Contribution to latest U.S. monthly inflation rate




Note: As of Jan 2024. Source: U.S. BLS, Macrobond, RBC GAM

## Exhibit 26: High inflation in the U.S. is no longer broad




Note: As of Jan 2024. Share of CPI components with year-over-year % change falling within the ranges specified. Source: Haver Analytics, RBC GAM

## Central banks pivot

The era of central-bank rate hikes came to an end last year, with a small but growing number of central banks now beginning the process of removing that restraint (Exhibit 27). So far, rates have fallen exclusively in emerging markets – countries where inflation, exchange rates and capital flows tend to be more volatile. But the trend is worth watching as it was emerging-market central banks that led the way upward during the period of monetary tightening.

Major developed-world central banks are now signaling rate cuts in 2024. Their motivation is derived from three things. First, inflation has dropped significantly, and can reasonably be expected to fall somewhat further. Second, most of these countries have recorded uncomfortably slow growth over the past year, and so are looking to stabilize their economies. Third, policy rates are unquestionably restrictive and so there is a natural inclination toward lower rates over time.

The U.S. is the distinct exception on the economic front, with an economy that has continued to perform admirably over the past year, in part due to lower interest-rate sensitivity and in part because of particularly strong consumer spending and fiscal support. While the Fed should therefore be less inclined to cut rates, the U.S. central bank has actually communicated its intention to decrease rates more forcefully than many of its peers. Some of this can be chalked up to a more transparent communications strategy, and some presumably reflects the fact that high rates have begun to impose pain even on the U.S. economy, as evidenced by rising consumer-loan delinquency rates, commercial real estate worries and patches of distress among banks.

If the soft-landing scenario continues to play out, rate cuts may take longer to arrive and be more incremental in their magnitude than the market imagines. We budget for five 25-basis-point rate cuts in the U.S. over the next year. Of course, if a recession arrives, central banks are capable of moving much more aggressively, with several hundred percentage points of easing possible.

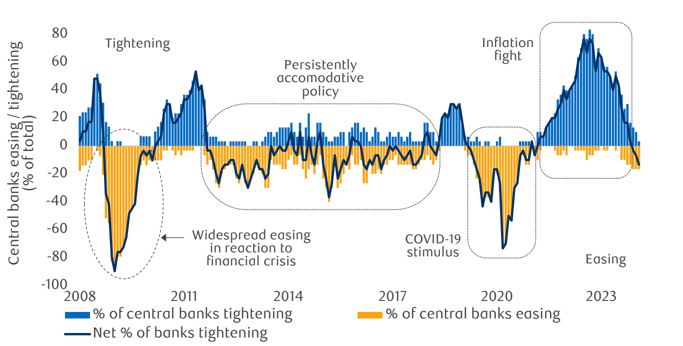
## Key risks

A variety of risks bracket the base case outlook. As a starting point, there is more uncertainty than usual across a range of variables, including the trajectory for the economy, inflation, interest rates, geopolitics and the rate of technological progress (Exhibit 28).

The geopolitical environment remains complex and challenging. The war in Ukraine continues, with Russia managing incremental gains and international support for Ukraine wavering. This is potentially consequential for the European economy and the global price of energy.

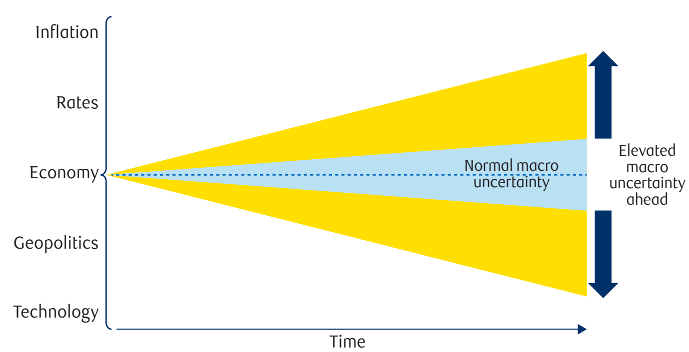
The Middle East remains in a state of turmoil, with ongoing fighting in Gaza and bursts of violence in Israel, the West Bank, Lebanon, Syria, Jordan, Iraq, Iran, Yemen and even extending to an air strike directed by Iran into Pakistan. From a narrow economic perspective, the conflict has the potential to interact with the global economy in two main ways – via the price of oil and the capacity to ship goods through the

### Exhibit 27: Central banks are pivoting to rate cuts




Note: As of 02/29/2024. Based on policy rates for 30 countries. Source: Haver Analytics, RBC GAM

### Exhibit 28: Still fairly high macro uncertainty




Note: As at 03/04/2024. Source: RBC GAM

region. Oil prices have so far not been greatly affected, but supply chains have been tangled by missile strikes on ships attempting to transit the Red Sea via the Suez Canal, with shipping costs rising and European inflation in particular slightly boosted (Exhibit 29).

U.S.-China relations are still frosty, and while they have lately been slightly more harmonious than in recent years, a significant easing of friction is unlikely. As a result, downside risks on this front abound, including the possibility of large additional tariffs levied on China in the event of a Trump presidency, or if China more actively pursued its claims over Taiwan.

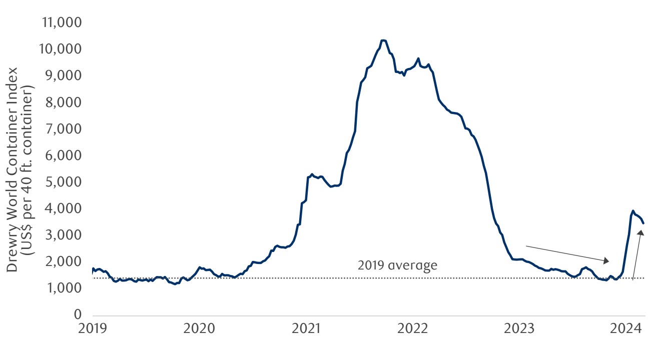
There is also considerable uncertainty in the context of the U.S. election in November. At this juncture, it seems that the vote will be a reprise of 2020, with President Biden pitted against former President Trump. Polls and betting markets suggest it will be a close contest, with Trump slightly favoured (Exhibit 30). While both candidates have no qualms about running deficits and share an aversion toward China, there are also major differences in their platforms. Biden is the more environmentally friendly of the two, while Trump is friendlier toward business, with proposals for corporate-tax cuts and deregulation that are likely to be embraced by markets. Conversely, Trump's tariff proposals and desire to pare immigration constitute economic negatives. His isolationist tendencies are likely to reduce global stability while creating winners and losers internationally. Above all, political uncertainty rises with a Trump presidency.

Perhaps the one major source of macroeconomic uncertainty for which the risks tilt profoundly in a positive direction is technological change. This is a time of particularly impressive progress, with generative artificial intelligence (AI) set to continue making great leaps forward, alongside advances in computer sensing and robotics, and a variety of innovations in health care. These developments should boost capital investment in the short run and productivity over the medium and long run. We have budgeted for a moderate acceleration in productivity growth, but there is an upside scenario in which AI constitutes the world's next general-purpose technology and comes to affect practically every facet of everyday life. The implication is that productivity growth could accelerate more profoundly than we have assumed and remain elevated over a period of a decade or longer. This would have massively positive ramifications for economic prosperity and the stock market, and potentially push inflation lower and inflation-adjusted bond yields higher.

## Challenged China

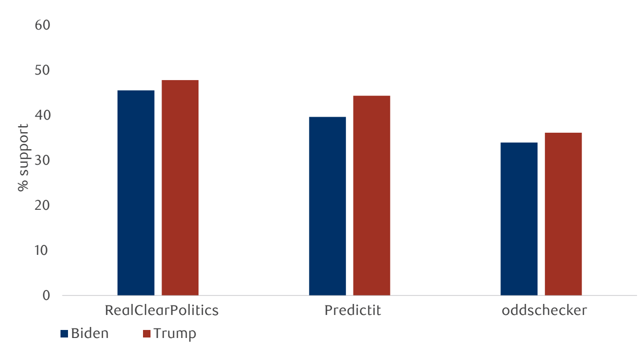
China's economy remains constrained by housing-market weakness. The combination of falling home sales, declining prices and insolvent builders has broad ramifications for the country's economy given that home building constitutes a remarkable one-quarter of GDP. Local-government finances

### Exhibit 29: Shipping costs rose on tensions in Red Sea




Note: As of the week ending 03/03/2024. Source: Drewry Supply Chain Advisors, Macrobond, RBC GAM

### Exhibit 30: 2024 U.S. presidential election: Biden vs. Trump




Note: RealClearPolitics (RCP) (03/03/2024) poll averages for Biden vs. Trump matchups only. Others acknowledge possibility of other candidates contesting the election. Predictit (03/04/2024) probability of winning derived from prediction markets data. oddschecker (03/04/2024) probability of winning derived from median daily betting odds. Source: oddschecker, Predictit, RCP, Macrobond, RBC GAM are also adversely affected due to their reliance on land sales to plug revenue gaps, the large amount of local government debt at risk, and the detrimental effect that weak home prices have on retail sales given that the bulk of Chinese household wealth is stored in real estate. These is a risk that these issues will lead to financial instability, though it is not our base case expectation.

Still, in the context of relentless pessimism about China's economy and its near-term prospects, it must be said that the country is hardly collapsing. Industrial production is advancing at a reasonable clip and China is managing to partially offset declining trade with the U.S. by deepening its ties with developing nations. Ultimately Chinese GDP is on track to grow by a respectable 4.6% in 2024 (Exhibit 31).

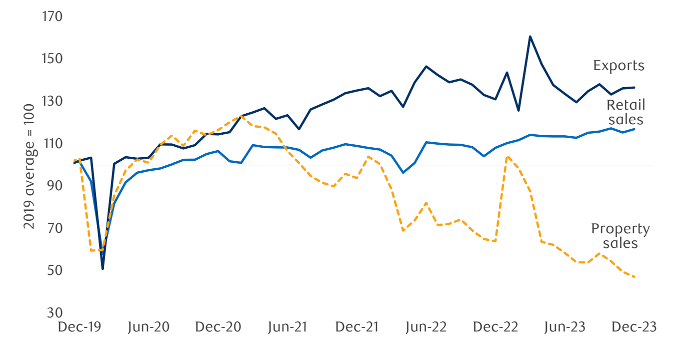
To be sure, China's housing market is unlikely to stage a rapid revival given structural problems, and nor can the country's geopolitical frictions with the West be discounted. China's shrinking population is a challenge, as are decisions that have prioritized the state over the private sector. We budget for 3%-4% real GDP growth once the country has completed its pandemic recovery, materially less than the 6%-plus growth regularly achieved in the 2010s. But even in this diminished state, China should comfortably remain the single most important driver of global economic growth. Incidentally, India is set to claim second place on the list, ahead of the U.S. Emerging-market countries should collectively generate more than 80% of the world's economic growth over the next five years.

## Canadian quandaries

Thus far, the Canadian economy has underperformed the U.S. while managing to slightly outperform the UK and the eurozone. Genuine economic weakness is visible both in several quarters of stagnant GDP and in weak business expectations (Exhibit 32).

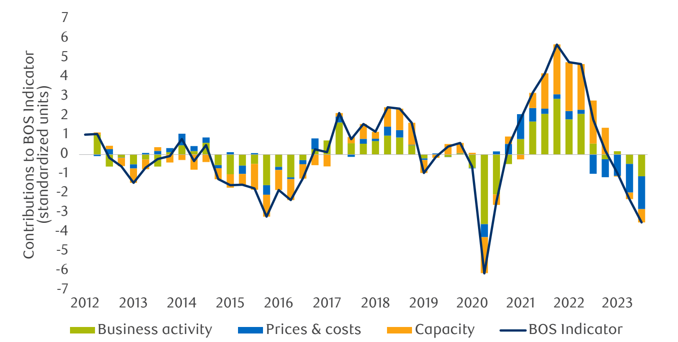
Several Canada-specific issues are worth examining. The country has a high sensitivity to interest rates due to elevated household debt and poor housing affordability. When paired with higher interest rates, this materially explains Canada's recent economic struggles. We anticipate that home prices will remain roughly flat over the next few years as fixed-rate mortgages continue to roll into higher rates (Exhibit 33).

### Exhibit 31: Monthly economic indicators for China point to mediocre growth



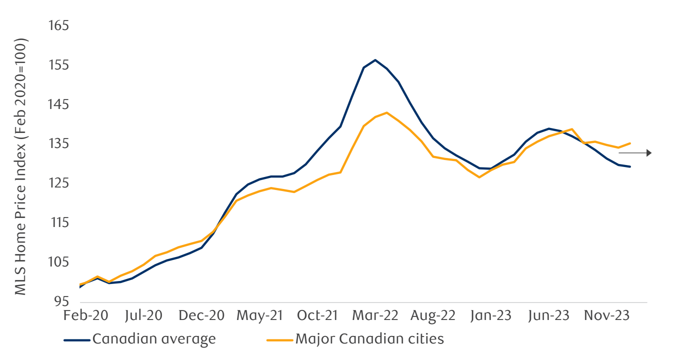

Note: As of Dec 2023. Average of 2019 levels indexed to 100. Source: Haver Analytics, RBC GAM

### Exhibit 32: Canadian Business Outlook Survey Indicator falling further




Note: As of Q4 2023. Source: Bank of Canada Business Outlook Survey, Macrobond, RBC GAM

### Exhibit 33: Canadian home prices to remain soft




Note: As of Jan 2024. Source: CREA, Macrobond, RBC GAM

Canada's rate of population growth has led the developed world in recent years, with more than 1.25 million residents added in 2023 alone (Exhibit 34). The underlying drivers of the rapid immigration have probably peaked now that the government is cracking down on temporary visas, with the result that population growth should be rapid but slowing in 2024 and then merely robust thereafter. This expansion of the population base has added to Canada's overall economic growth rate via increased demand, but with adverse consequences that include diminished productivity and a housing shortage.

Conversely, Canadian productivity has been atrocious, declining outright over the past year and now pitifully resting at the same level as eight years ago – a remarkable failure given that productivity normally rises over time (Exhibit 35). The blame extends in several directions: the immigration surge, lingering post-pandemic distortions, inadequate business investment, insufficient inducements for entrepreneurs and excessive red tape. The first few of these problems should fade with time, but the country has been on a relatively slow productivity train for decades. Canada's failure to address its productivity problem threatens the country's prosperity and corporate profits.

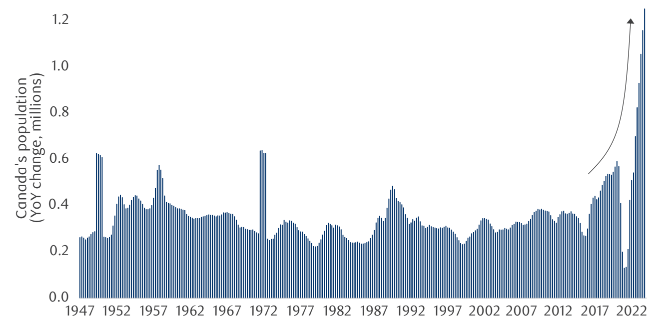
Canada's inferior economic performance would normally prompt the Bank of Canada (BOC) to cut rates well before the U.S., but the poor productivity growth alongside sticky rent and mortgage-interest costs have limited progress on inflation. Ultimately, the Fed and BOC could follow a fairly similar trajectory downward on rates.

## Longer-term themes

Several longer-term themes merit mention because they will play important roles in the medium- and long-run economic and inflation outlooks. The role of potentially accelerating technological change has already been addressed, with the possibility of faster economic growth and lower inflation. Others include deteriorating demographics (negative for growth, negative for inflation) and the effects of climate change (negative for growth, positive for inflation).

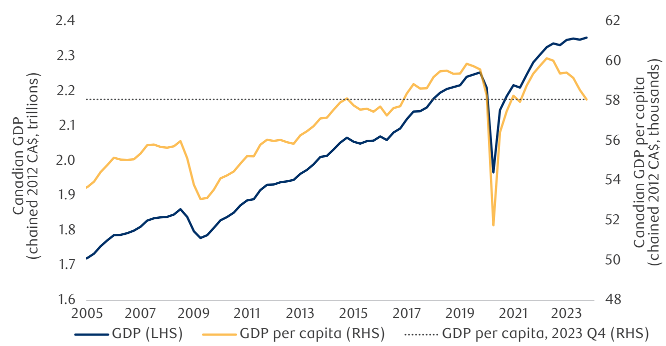
Deglobalization is also now underway, in part as frictions mount between global powers such as the U.S., Russia and China, and more generally as trade barriers rise around the world (Exhibit 36). The resulting deglobalization will be fairly

### Exhibit 34: Canada's record population growth fueled by immigration



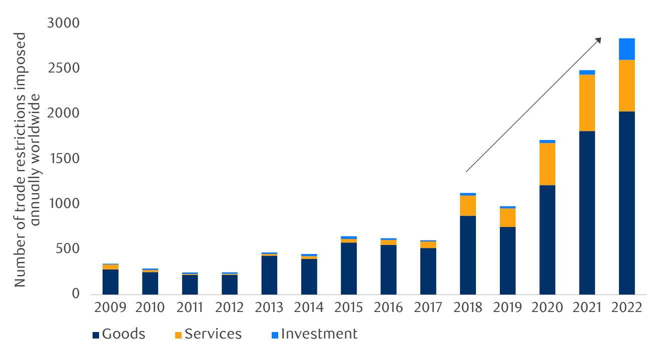

Note: As of Q4 2023. Source: Statistics Canada, Macrobond, RBC GAM

### Exhibit 35: Canadian GDP per capita has been shrinking




Note: As of Q4 2023. Source: Statistics Canada, Macrobond, RBC GAM

### Exhibit 36: Global trade restrictions ballooned in recent years




Note: As of 2022. Source: Global Trade Alert, IMF, fDi Intelligence, RBC GAM modest, but nevertheless constitute a reversal of a previously favourable trend. We believe that deglobalization will, over time, subtract slightly from global economic growth and add slightly to inflation.

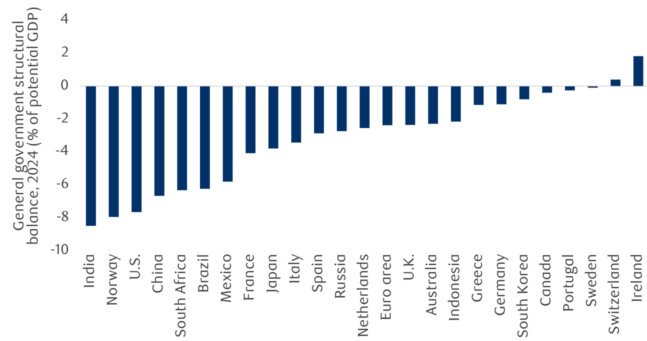
A final thematic consideration is the substantial fiscal deficits that continue to be run across a sizeable fraction of world's major economies (Exhibit 37). Such overspending may have been affordable when interest rates were very low. But the financial burden is mounting as borrowing costs rise, and the bond market is likely to rebel should a measure of fiscal austerity not be delivered within the next few years. This threatens to suppress economic growth over that time frame.

## Bottom line

The main macroeconomic takeaway is that the odds of a soft landing have been materially upgraded, now amounting to a 60% likelihood. This shift is welcome news and supports risk assets. However, faster-than-expect growth also complicates the inflation-normalization process and slows the clip at which central banks can remove monetary restraints. We still believe that inflation can fall further and that central banks will be able to cut rates later this year, but in a soft-landing scenario progress may be more fitful.

At the same time, it is important to appreciate that the risk of a recession has not vanished. Many recession indicators continue to blink red, even as others have turned to amber or green, and geopolitics risks abound. Conversely, technological change could prove more helpful than many imagine. But above all, it remains a time of elevated uncertainty, which contributes to our decision to maintain a roughly neutral asset allocation.

### Exhibit 37: Significant structural fiscal deficits persist




Note: IMF projections for year 2024. Source: IMF WEO, October 2023, Macrobond, RBC GAM

# Market outlook
## Investors embrace improved odds of soft landing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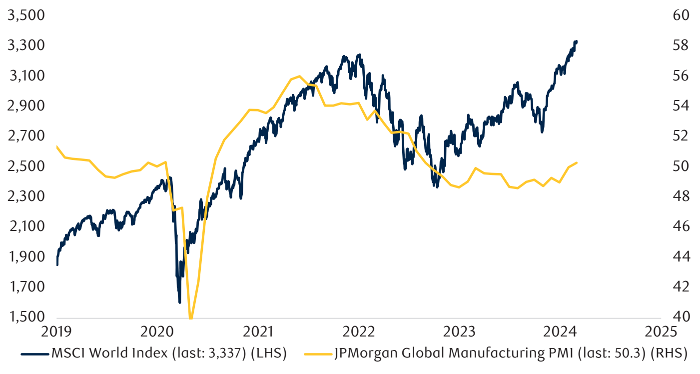
Economic data and financial markets are lining up in a way that suggests a soft-landing outcome for the global economy. In recent months, consumer spending and employment have been robust and the U.S. economy in particular has shown impressive resilience in the face of higher interest rates. Economic data has generally been better than expected, inflation continues to move in a favourable direction after falling meaningfully from prior extremes, and investors are encouraged by the idea that interest rates have likely peaked and that a period of monetary easing may lie ahead. Stocks enjoyed a powerful rally in the past quarter, with the MSCI World Index climbing to a record high as leading economic indicators of global growth began turning up after a year of consolidation (Exhibit 1). Although the debate over recession versus soft landing is ongoing and risks remain, we believe that the odds of a truly severe economic downturn have diminished, even if economies were to contract.

**Exhibit 1: MSCI World Index – U.S. dollars**



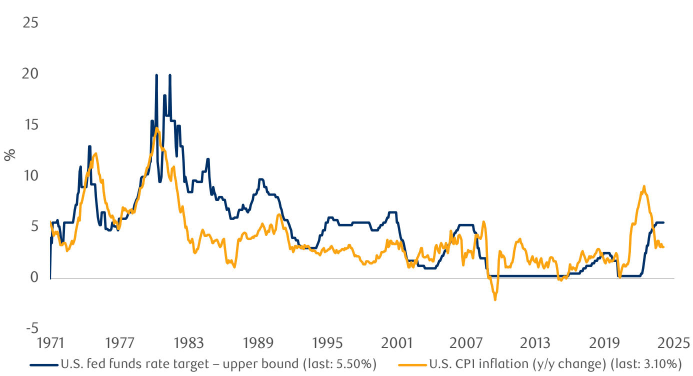

Note: MSCI World Index in U.S. dollars. As of February 29, 2024.
Source: Bloomberg, RBC GAM

Alleviating the risk of a poor outcome for the economy is the fact that inflation has declined to reasonable levels after the injection of a significant amount of monetary tightening into the economy, prompting central banks to stop raising interest rates. The U.S. Federal Reserve (Fed) has held its overnight lending rate steady at 5.25%-5.50% since July 2023 amid increasing evidence that the fight against extremely high inflation is being won (Exhibit 2). Moreover, most developed-world central bankers have signaled that interest-rate cuts would be appropriate at some point this year should the data confirm that inflation is headed toward the Fed's 2% target.

In this environment, fixed-income investments are the most appealing they've been in many years. At 4.25%, the yield on 10-year Treasuries is close to its highest in the past two decades and, although it is below the recent October highs, it could have further room to fall. Bond yields tend to peak at the same level and time as short-term policy rates, setting up the possibility of a period of stable to lower yields over the medium term (Exhibit 3). As a result, sovereign-bond valuations remain attractive and total-return potential is decent, assuming that we are correct in our view that inflation will continue to moderate over 2024 and beyond.

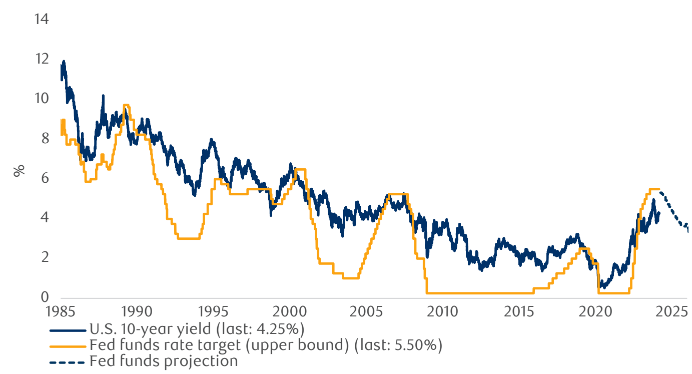
With respect to stocks, investors are extremely optimistic and are willing to pay a high price to participate in the potential upside of continued economic growth against a backdrop of falling interest rates (Exhibit 4). That said, lofty valuations could mean that stocks are vulnerable to disappointment. The "Magnificent 7," a group of U.S. mega-cap technology stocks that have benefited greatly from recent trends in artificial intelligence (AI), is richly valued and trades at a significant premium to the rest of the market (Exhibit 5). Although valuations outside of U.S. mega-caps are still reasonable, the need for a combination of sustained confidence, elevated price-to-earnings multiples and high earnings growth to sustain current prices is becoming more critical than at earlier points in the cycle.

### Exhibit 2: U.S. federal funds rate and inflation




Note: As of February 29, 2024. Source: Bloomberg, RBC GAM

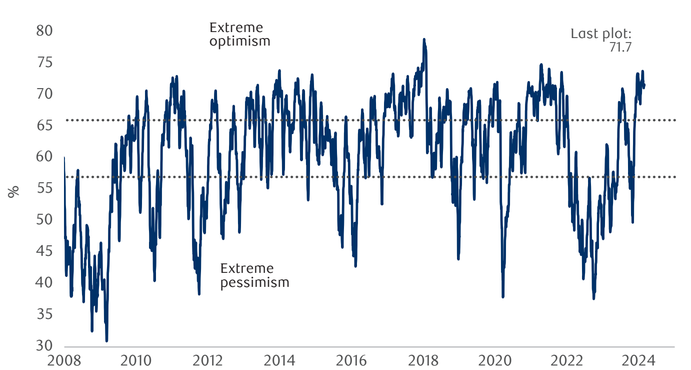
### Exhibit 3: U.S. 10-year yield and federal funds rate




Note: As of February 29, 2023. Source: Bloomberg, RBC GAM

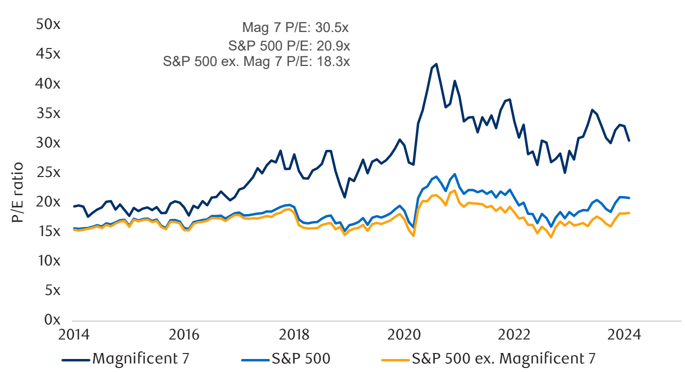
### Exhibit 4: Ned Davis Research Crowd Sentiment Poll

Percent bulls




Note: As of February 27, 2024. Source: Ned Davis Research, RBC GAM

### Exhibit 5: 'Magnificent 7' forward P/E ratio




Note: Magnificent 7 includes Apple, Microsoft, Google, Amazon, Nvidia, Tesla and Meta. Tesla was added in Dec 2020 when it was included in the S&P 500. As of February 29, 2024. Source: RBC GAM

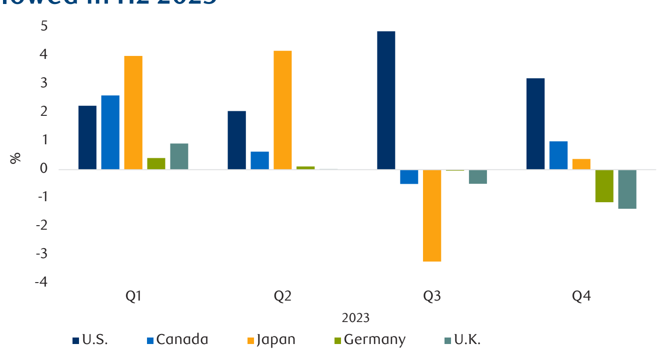
Balancing the risks and opportunities and considering near-term and longer-term time horizons, we are maintaining an asset mix close to our neutral setting. In our base case scenario, 1-year return forecasts for cash, bonds and stocks are not substantially different from each other in the mid to high-single digits. Uncertainty remains elevated, however, and there is a wide range of potential outcomes. Should economic or corporate-profit growth disappoint, stock markets could be vulnerable to correction and government bonds, at these higher yield levels, would likely act as ballast against an equity-market downturn. We have added to our fixed-income allocation over the past several quarters as yields rose, eliminating our prior underweight and ultimately moving to a slight overweight position as the U.S. 10-year yield approached 5%. Over the longer term, we expect stocks to outperform bonds, but recognize that equity investors are not currently being sufficiently compensated for the risk of a downturn. As a result, we are keeping our stock allocation at neutral. For a global balanced investor, our current recommended asset mix is 60.0% equities (strategic: “neutral”: 60.0%), 38.5% bonds (strategic “neutral”: 38.0%) and 1.5% cash.

## U.S. economic exceptionalism

The U.S. economy has held up particularly well over the past year despite all of the monetary tightening, a regional banking crisis in early 2023 and a war in the Middle East. Non-U.S. economies have struggled more in this environment, as was evidenced by slowing growth in most major regions over 2023. Canada’s GDP flat-lined in the second half of last year, while the economies of Japan, Germany and the UK fell into technical recessions, which are defined as two consecutive quarters of declining real GDP (Exhibit 6). The U.S economy managed to continue expanding at a healthy pace throughout last year and even accelerated in the second half of 2023.

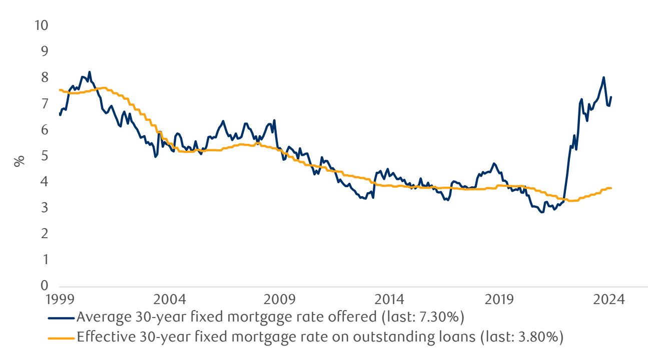
One of the main reasons that the U.S. has weathered high interest rates better than most other economies is that homeowners in America enjoy the stability of fixed-rate mortgage debt with much longer terms than is generally the case in other countries. The traditional mortgage term in the U.S. is 30 years, compared with five to 10 years in most other developed-world nations. U.S. mortgages rates surged to as high as 8% in the fall of 2023 from as low as 2.8% in early 2021, but most mortgage holders were not affected by the spike in borrowing costs – the effective rate being paid on outstanding U.S. mortgage debt now standing at just 3.8% (Exhibit 7). Mortgage borrowers were able to take advantage of the historically low interest rates available during the pandemic and it could take many years for the effective mortgage-interest rate to move meaningfully higher.

### Exhibit 6: U.S. economy accelerated while others slowed in H2 2023




Note: Annualized QoQ growth rates. As of 2023 Q4. Source: U.S. Bureau of Economic Analysis (BEA), Statistics Canada, German Federal Statistics Office (Statistisches Bundesamt), U.K. Office for National Statistics (ONS), Japanese Cabinet Office (CAO), Macrobond, RBC GAM

### Exhibit 7: U.S. 30-year fixed mortgage rates




Note: As of February 29, 2024. Source: Bankrate.com, RBC GAM

Like consumers and home buyers, many businesses also took advantage of low borrowing costs during the pandemic, and the longer interest rates remain elevated, the more damage they can inflict. This is particularly true for corporate debt, where terms generally range between five and seven years. The threat of higher interest expenses for companies becomes more acute over the next several years as the value of debts needing to be re-financed rises to US$700 billion in 2028 from US$100 billion this year and US$300 billion next year (Exhibit 8). We believe that if the U.S. economy is to avoid suffering from a broader global slowdown, it will be imperative for interest rates to come down in a timely manner. Assuming interest rates do come down promptly, the potential pain of steeply higher borrowing costs could go largely unrealized.

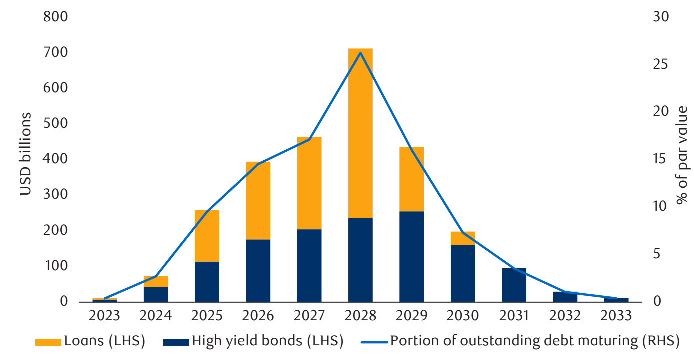
> "The inflation forecasts for 2024 and 2025 are currently straddling the Fed's 2% target."

## Inflation trajectory remains favourable

After the biggest inflation miss in recent forecasting history, economists are now more confident that inflation is headed toward 2% over the next few years. Exhibit 9 plots the range of economists' forecasts going back two decades, with the diamond on the chart representing where inflation finished the year. In 2022, expectations were initially close to the 2% level, but inflation came in above 8%! Many of the pandemic-related distortions have since faded and the range of inflation forecasts narrowed for 2023 and beyond. The forecasts for 2024 and 2025 are currently straddling the Fed's 2% target, if skewed only slightly above that level. Moreover, market-based measures of inflation expectations as determined by pricing in inflation-linked bonds suggest expectations remain well-anchored around 2% across North America and in Europe (Exhibit 10).

**Exhibit 8: U.S. high-yield bonds and leveraged loans**

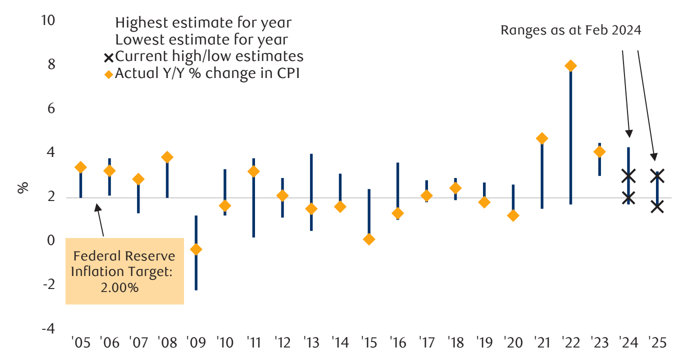
Upcoming maturities




Note: As of August 31, 2023. Source: BofA Global Research, ICE Data Indices LLC, RBC GAM

**Exhibit 9: United States**

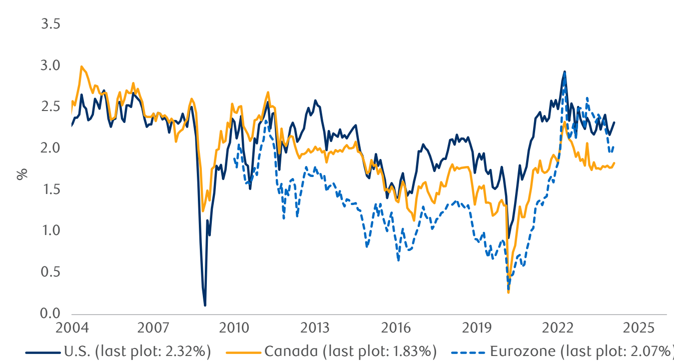
Inflation estimate dispersion




Source: Consensus Economics, RBC GAM

**Exhibit 10: Implied long-term inflation premium**

Breakeven inflation rate: nominal vs 10-year real-return bond




Note: As of February 2024. Eurozone represents GDP-weighted breakeven inflation of Germany, France and Italy. Source: Bloomberg, RBC CM, RBC GAM

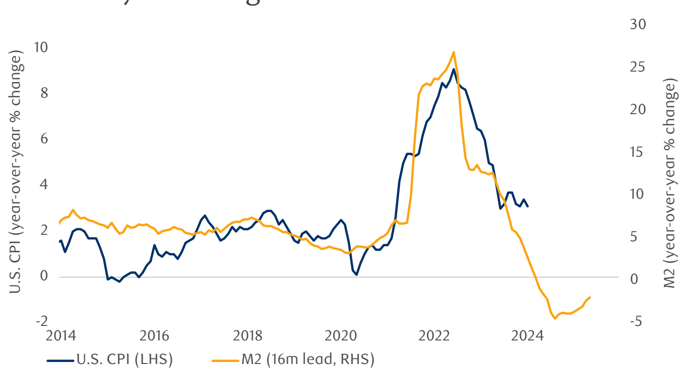
Our confidence in inflation's downward trajectory is reinforced by indicators that have been most useful at explaining the recent surge and subsequent diminishment of price pressures. Exhibit 11 plots U.S. CPI inflation alongside money-supply growth advanced by 16 months. The two lines on the chart move closely together, which suggests that changes in money-supply growth foreshadow inflation by 16 months. If the relationship holds, the current contraction in the money supply should continue to weigh on price pressures into next year. Indicators such as used-car prices and residential rents, which were a major source of rising costs, have moderated significantly. Used-car prices are now declining and rent increases have stabilized near the 3% level, where they had been for most of the pre-pandemic era (exhibits 12 and 13). Although the near-term path could be volatile, these developments give us confidence that inflation is likely to remain subdued over the medium term.

## Gauging the path ahead: cycle road maps

Although the risks of an economic downturn have diminished, they have not disappeared and if a recession does unfold, we believe that the roadmap in Exhibit 14 offers a good guide for what investors could expect. The chart plots the median experience of the S&P 500 Index through 29 recessions dating back to 1882, where t=0 along the horizontal axis is the date a recession begins. Important milestones are indicated with the arrows annotated on the chart. It's worth noting that interest-rate hikes have begun a median of almost two years before a recession, and that in the several months before a recession, we tend to see a peak in interest rates, bond yields and

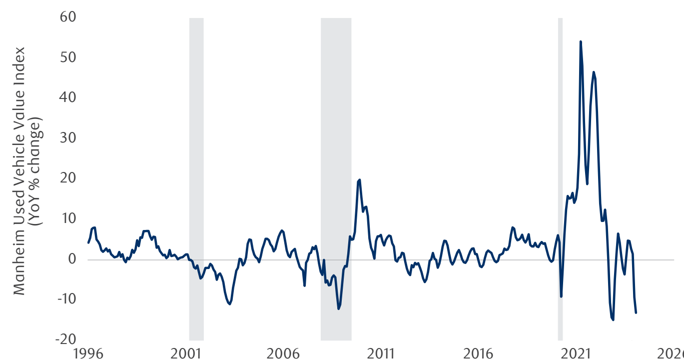
### Exhibit 11: U.S. inflation and money supply

Year-over-year changes in CPI and M2




Note: As of January 31, 2024. Source: Bloomberg, RBC GAM

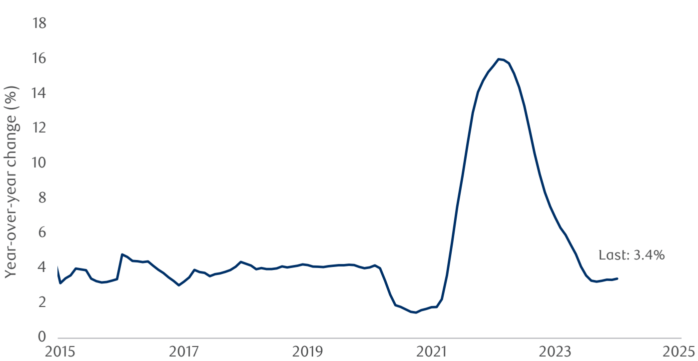
### Exhibit 12: Manheim Used Vehicle Value YoY Index




Note: As of February 2024. Shaded area represents recession. Source: Manheim Consulting, Bloomberg, RBC GAM

### Exhibit 13: U.S. Zillow Rent Index

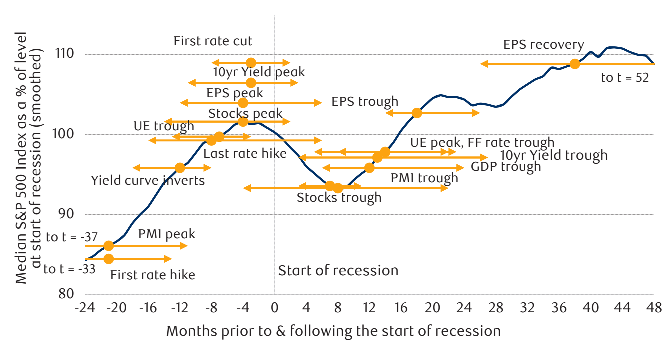
All homes year-over-year % change




Note: As of January 31, 2024. Source: Zillow Inc., Bloomberg, RBC GAM

### Exhibit 14: S&P 500 and recessions

Median of 29 recessions since 1882




Note: Markers represent median timing and ranges are one standard deviation from the mean. Source: Bloomberg, RBC GAM corporate profits. The timing of these milestones are aligned with a difficult period for the economy in late 2023/early 2024, which would be consistent with a sell-off in stocks at some point in late 2024.

But our base case is that there is no recession so stocks and bonds are likely to follow different paths. Exhibits 15 and 16 provide similar roadmaps for the U.S. 10-year Treasury yield and S&P 500, respectively. On these charts, t=0 along the horizontal axis is the date of the last Fed hike and the cycles are grouped based on whether the economy fell into recession or achieved a soft landing (i.e. no recession). For bonds, yields remain flat to slightly down, on median, during non-recessionary outcomes (eight of 15 tightening cycles observed), whereas the decline in yields is more pronounced during recessionary periods.

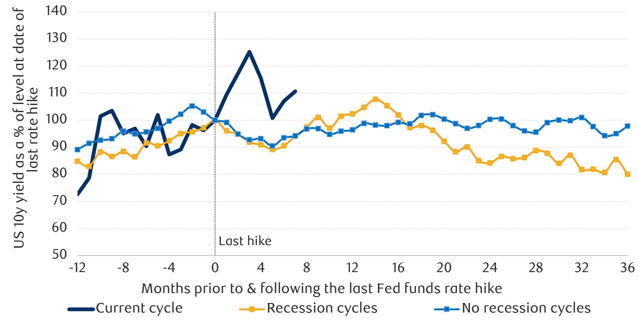
For stocks, we looked at 17 cycles since 1955, where nine cycles led to recession and eight were soft landings. In instances where the economy slipped into recession, stocks corrected after the last hike and took over 12 months to reclaim their prior highs. Through the summer of last year, stocks were on the track consistent with recession. But since late October, economic and inflation data quickly reassured investors that a soft landing was becoming a greater possibility, and the sharp rally in stocks put them right back on the no-recession track of our roadmap. As a result, equities are confirming the soft-landing view. Importantly, in instances where the economy continues to grow and recession risks fade, the stock market tends to continue higher for as many as two years following the last rate hike. Bond yields, meanwhile, are likely to be flat to lower regardless of the economy, as long as central banks are definitively done raising rates.

### Interest rates are likely to start coming down soon

Developed-world central banks have indicated that interest rates could come down at some point this year as inflation and economic activity cool. Our own model confirms this view, situating the current fed funds rate of 5.3%, well above the mid-point of our modelled equilibrium band which rests at 2.5% today and falls to 1.75% a year from now (Exhibit 17). The timing and degree of rate cuts will depend on economic data. At one point, financial markets were pricing in more than 180 basis points in cuts over the year ahead, with the

### Exhibit 15: U.S. 10-year yield road map

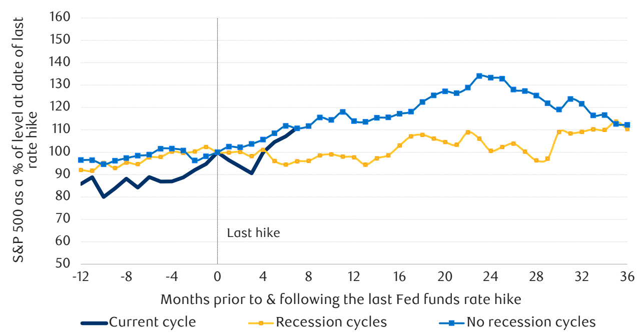
Implications for current cycle, following last rate hike




Note: As of February 29, 2024. Source: RBC GAM

### Exhibit 16: S&P 500 road map

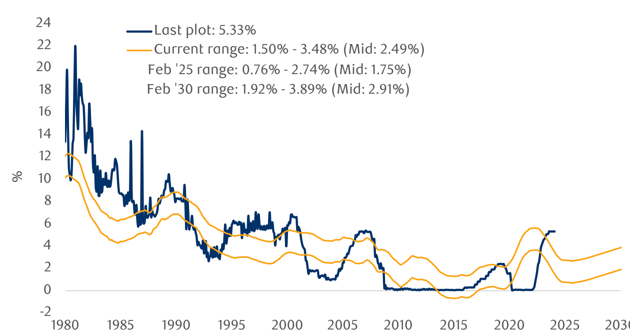
Implications for current cycle, following last rate hike




Note: As of February 29, 2024. Source: RBC GAM

### Exhibit 17: U.S. fed funds rate

Equilibrium range




Note: As of February 29, 2024. Source: Federal Reserve, RBC GAM first cut expected in March (Exhibit 18). The enthusiasm for rate cuts has been dialed back, with the latest market pricing suggesting 100 basis points of cuts over the next 12 months. This indicator is in line with the Federal Open Market Committee's (FOMC) projections (Exhibit 19) and not far from our own forecast of 125 basis points of monetary easing over the next 12 months.

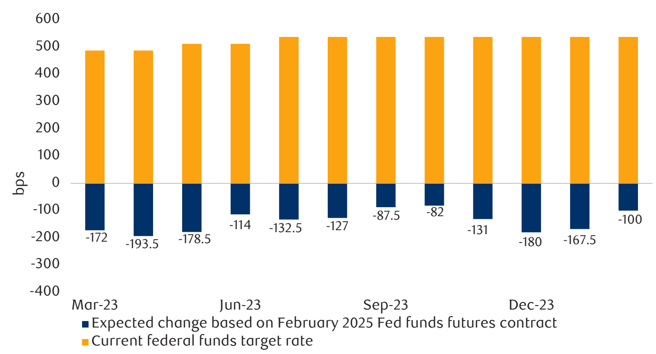
It is worth noting that any rate-cutting cycle could be highly stimulative for the economy and capital markets because of the massive amounts of cash sitting on the sidelines. U.S. money-market accounts climbed to a record of just over US$6 trillion in February, an increase of more than US$1.5 trillion in the past two years (Exhibit 20). While investors have been drawn to attractive 5.25%-5.50% risk-free rates of return on their cash, these elevated rates are unlikely to be available for much longer. Should central banks begin cutting rates later this year and into 2025, the incentives for holding cash would diminish and perhaps motivate savers to move funds to stocks, bonds and alternatives that generally offer higher returns.

## Sovereign bonds offer attractive return potential with minimal valuation risk

Bonds are near their most attractive levels in two decades after selling off from a state of overvaluation that had not been seen in 150 years. The fixed-income bear market of 2020-2023 rapidly pulled yields above 5% for the first time since 2007 and erased all of the overvaluation that had built up since the 1980s, which was accentuated by the pandemic

### Exhibit 18: Fed funds rate and implied expectations

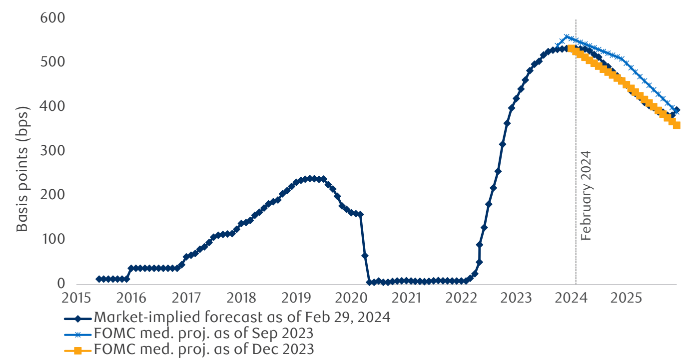
12-month futures contract




Note: As of Feb 29, 2024. Source: RBC GAM

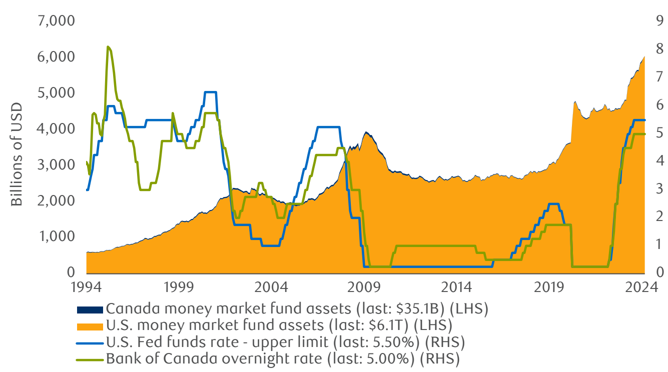
### Exhibit 19: Implied fed funds rate

12-months futures contracts




Source: Bloomberg, U.S. Federal Reserve, RBC GAM

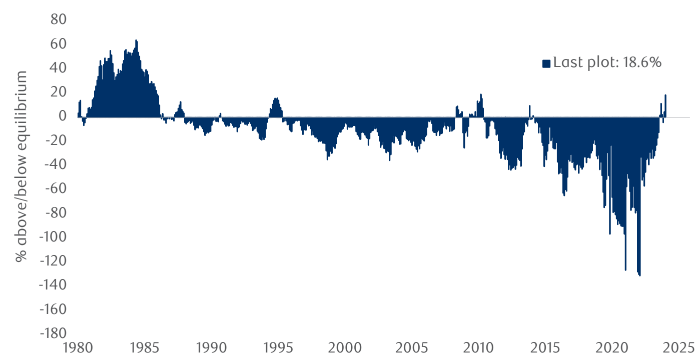
### Exhibit 20: U.S. and Canada money-market fund assets




Note: As of February 29, 2024. Source: ICI, Bank of Canada, RBC GAM

### Exhibit 21: Global bond-market composite

10-year government-bond yields relative to equilibrium



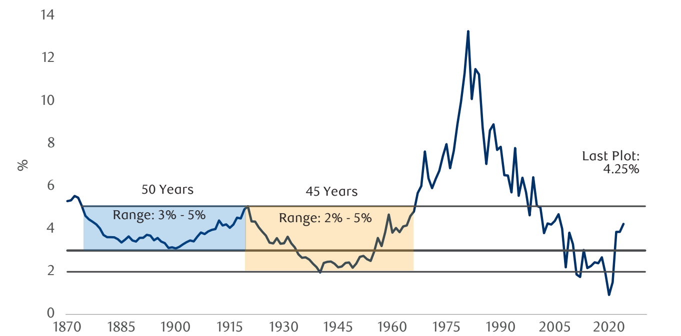

Note: As of February 29, 2024. Source: RBC GAM

(Exhibit 21). While the U.S. 10-year yield has declined from its October 2023 peak, at 4.25% it remains near the upper end of the historical range excluding the 1970s and 1980s, a period that featured extreme inflation (Exhibit 22). Our models indicate that sovereign bonds are attractive, with yields well above their equilibrium levels in major markets excluding Japan where interest rates are still subject to central-bank efforts to suppress yields (page 43).

Our models project that yields are likely to move lower over the medium term based on the assumption that inflation will continue to decline. Exhibit 23 plots the components of our U.S. 10-year Treasury bond model, which is the sum of an inflation premium and a real yield. The significant fluctuations in the band are being driven by the massive spike

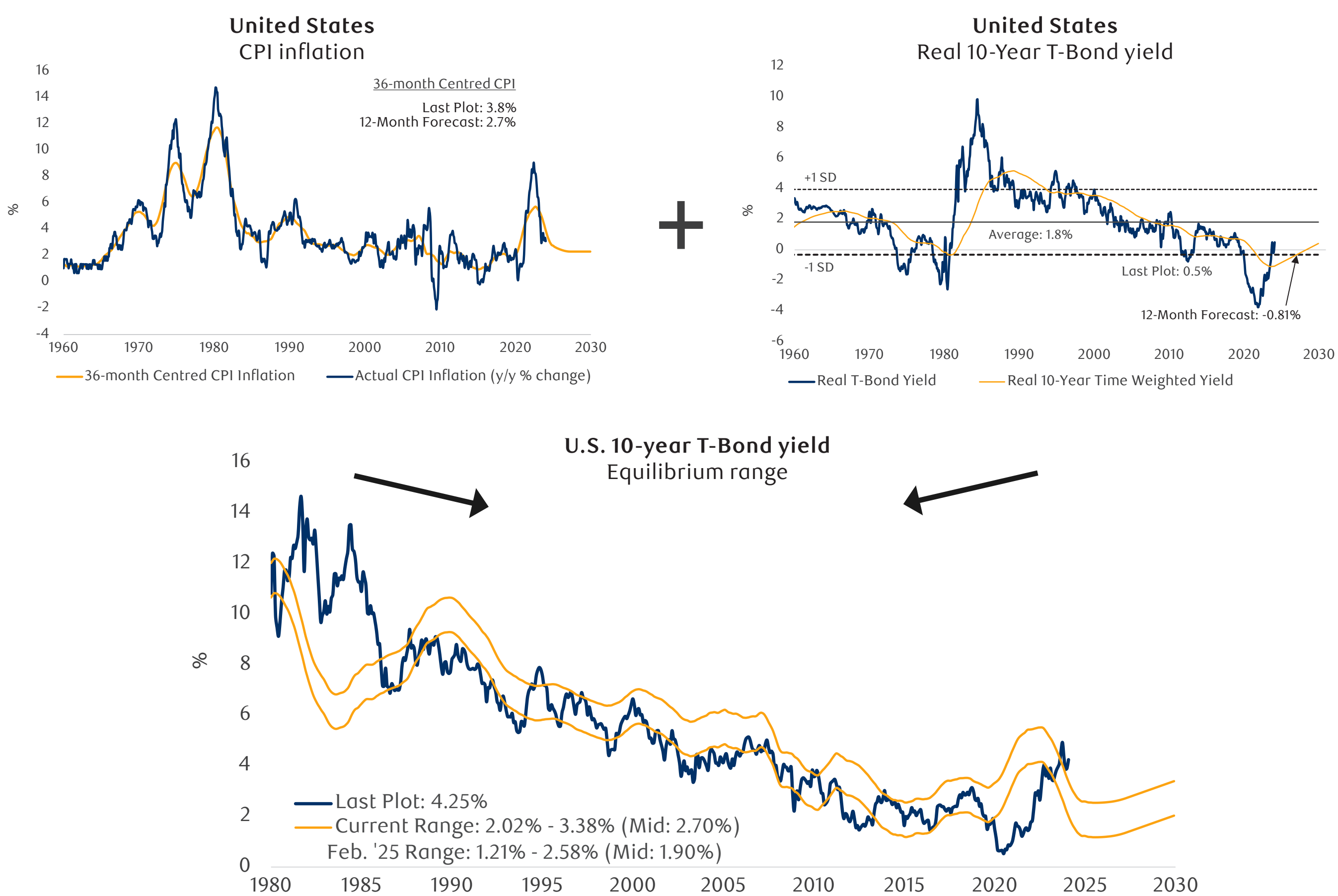
### Exhibit 22: U.S. 10-year bond yield

Monthly data back to 1870




Note: As of February 29, 2024. Source: RBC GAM

### Exhibit 23: U.S. 10-year bond yield




Note: As of February 29, 2024. Source: RBC GAM

in inflation during 2021/2022 as well as its rapid subsequent decline. The other component of the model, real or after-inflation yields, fell into deeply negative territory during the pandemic due to the significant inflation spike. Real rates are positive once again, although the model forecasts a gradual climb to between 50 and 100 basis points over the long term. In our view, investors should receive a positive real return for saving, although that reward will likely be limited over the longer term by structural factors such as slowing potential growth rates and aging populations. Taking everything together, our model suggests that the appropriate U.S. 10-year yield is closer to 3% today and 2% a year from now, although we think the model's swings are exaggerated due to the recent outsized moves in inflation and real interest rates during the pandemic. Our own forecast is 4.00% for the U.S. 10-year yield a year from now, which would result in mid-to high single digit returns over the year ahead and, importantly, with little valuation risk.

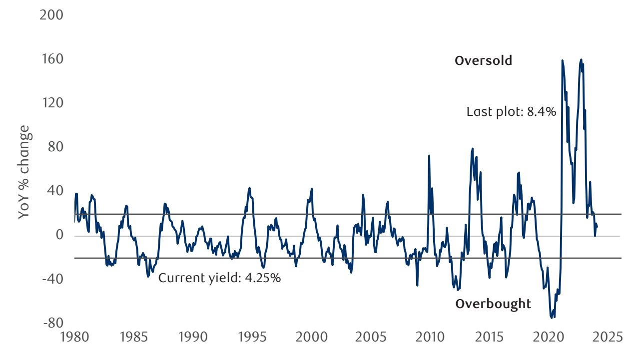
## Technical underpinnings are encouraging for bond investors

In addition to the positive fundamental backdrop, there are a variety of bullish technical measures that suggest a solid outlook for bonds. We have found that the rate of change in bond yields over 12-month periods is a reliable cue for generating buy and sell signals (Exhibit 24). A fall below 20% in the 12-month rate of change in yields following an oversold reading also triggers a buy signal, and this last occurred in November 2023. Moreover, sentiment on bonds has moved to extreme bearish levels not seen since 2000, establishing the contrarian mindset that could propel a bull market (Exhibit 25). And, lastly, our measure of long-term price momentum suggests a trend of sustainably lower yields in the months and quarters ahead, which would be a tailwind for fixed-income returns (Exhibit 26).

## Stocks extend gains as outlook improves

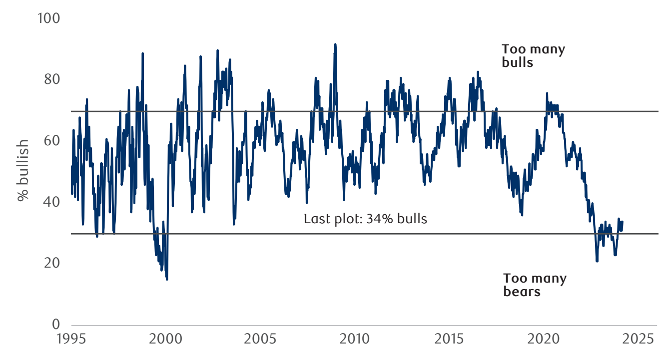
Better odds of a soft landing and increasing confidence that rates are likely to come down soon bolstered equity prices in the past quarter. The S&P 500 rose 12% in the three-month period ended February 29, 2024, extending the gain since late October to about 23%. The MSCI EAFE Index also delivered strong returns, up 8% as Japanese equities rose to a new high for the first time in 35 years. Canada's S&P/TSX Composite Index, with less exposure to technology, was

### Exhibit 24: U.S. 10-year T-bond yields
Rate of change



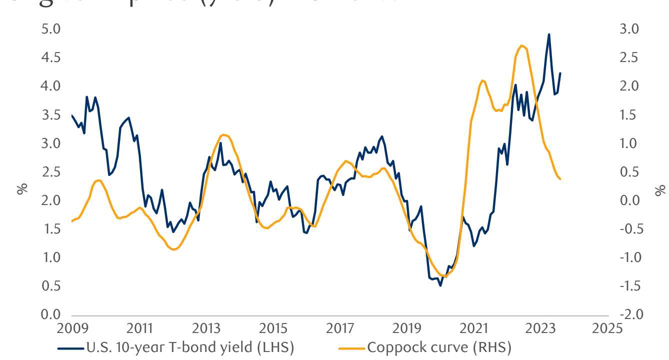

Note: As of February 29, 2024. Source: Bloomberg, RBC GAM

### Exhibit 25: U.S. 10-year T-bond bullish consensus




Note: As of March 3, 2024. Source: Market Vane, RBC GAM

### Exhibit 26: U.S. 10-year T-bond yield
Long-term price (yield) momentum




Note: Coppock curve based on monthly data. As of February 29, 2024. Source: Bloomberg, RBC GAM up only 6% and emerging markets were up only 3% given troubles in China's economy. All figures are in U.S. dollar terms. Given more moderate returns in regions outside of the U.S., our GDP-weighted global composite of equity markets remains reasonably valued if the U.S. is excluded (Exhibit 27). Aside from the U.S. and Japan, equity markets are trading at attractive distances below their fair values and offer decent return potential if valuations revert to historical norms (page 44).

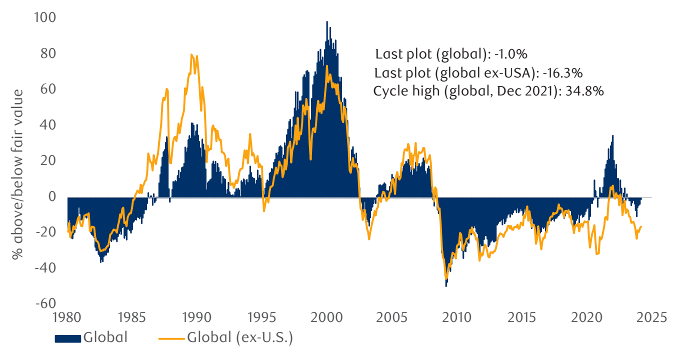
The reason global markets remain attractively priced is that most of the equity gains since early 2023 have been concentrated in a small group of mega-cap technology stocks. Last year, the "Magnificent 7" was up 82% and is up another 10% so far this year. The equal-weighted S&P 500, though, was up only 11.6% in 2023 and just 3% this year, which is more consistent with returns in the rest of the world (Exhibit 28).

### "Magnificent 7" valuations are extremely demanding

Many investors are concerned that the "Magnificent 7" is in a bubble given the group's outsized gains since the pandemic. But those stocks are not necessarily overpriced, as long as their earnings can grow at rates that justify current valuations. The "Magnificent 7" as a group has increased its earnings an average of 22% over the past four years, far

**Exhibit 27: Global stock-market composite**

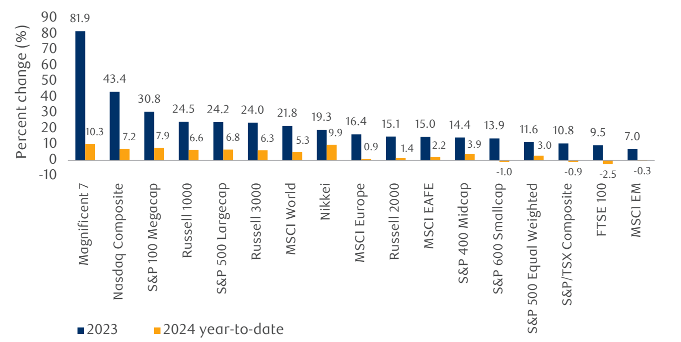
Equity-market indexes relative to equilibrium




Note: As of February 29, 2024. Source: RBC GAM

**Exhibit 28: Major indices' price change in USD**

2023 and YTD 2024




Note: As of February 29, 2024. Magnificent 7 includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Source: Bloomberg, RBC GAM

above the typical mid-single-digit earnings-growth rate of the S&P 500 excluding mega-cap technology. So, these top technology stocks deserve a hefty premium, assuming they can sustain their unusually fast growth rates.

For an investor with a 10-year time horizon, earnings for the “Magnificent 7” would have to increase 32% each year for a decade to justify current valuations (Exhibit 29). This conclusion assumes that the broad stock market (excluding the “Magnificent 7”) would grow at the historical trend rate of 6.2% per year, answering the question of how fast would the “Magnificent 7” need to grow their earnings in order to break even with the broad market on a net-present-value computation. If an investor has a 5-year time horizon, the break-even growth rate is 60% per year, and if the horizon is stretched to 15 years, then 23% per year is needed, roughly in line with the most recent rate of growth for the “Magnificent 7”. Maintaining that high rate of growth consistently for 15 years is a tall order, especially for companies of this size. That said, these figures are not impossible and if AI truly revolutionizes our lives, these growth rates could be achieved.

### Exhibit 29: Mag 7 versus S&P 500 ex. Mag 7 breakeven analysis

#### Mag 7 versus S&P 500 ex. Mag 7 breakeven analysis: assumptions

As of February 29, 2024

| | S&P 500 ex. Mag 7 | Magnificent 7 |
|---|---|---|
| **Price** | 100.00 | 100.00 |
| **P/E** | 18.33 | 30.55 |
| **Trendline EPS** | $195.80 | $48.51 |
| **Trendline earnings growth** | 6.19% | 17.93% |
| **Discount rate** | 6.35% | 6.35% |

#### Earnings growth required to justify Mag 7 premium

As of February 29, 2024

| Years | S&P 500 ex. Mag 7 earnings | Cumulative earnings | Present value of cumulative earnings (S&P 500 ex. Mag 7) | Earnings growth required for Mag 7 to catch up to rest of S&P 500 (annualized) |
|---|---|---|---|---|
| 0 | $195.80 | | | |
| 1 | $207.93 | $207.93 | $195.51 | 328.6% |
| 2 | $220.81 | $428.73 | $390.74 | 153.3% |
| 3 | $234.49 | $663.22 | $585.68 | 100.0% |
| 4 | $249.01 | $912.23 | $780.33 | 74.8% |
| 5 | $264.44 | $1,176.67 | $974.71 | 60.1% |
| 6 | $280.82 | $1,457.48 | $1,168.79 | 50.6% |
| 7 | $298.21 | $1,755.70 | $1,362.60 | 44.0% |
| 8 | $316.69 | $2,072.38 | $1,556.12 | 39.0% |
| 9 | $336.31 | $2,408.69 | $1,749.36 | 35.2% |
| 10 | $357.14 | $2,765.83 | $1,942.32 | 32.2% |
| 11 | $379.26 | $3,145.09 | $2,135.00 | 29.7% |
| 12 | $402.76 | $3,547.85 | $2,327.39 | 27.7% |
| 13 | $427.71 | $3,975.56 | $2,519.50 | 26.0% |
| 14 | $454.20 | $4,429.76 | $2,711.34 | 24.6% |

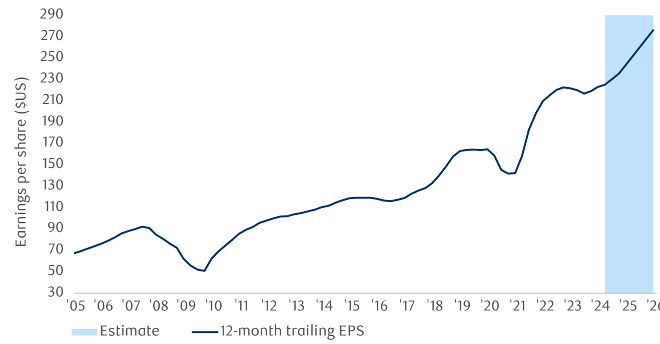
Note: As of February 29, 2024. Source: Bloomberg, RBC GAM

## Analysts look for earnings growth to accelerate

Looking at the market as a whole, the consensus of analysts' estimates is for earnings to re-accelerate rapidly over the next few years. Aggregate S&P 500 earnings came in at US$223 last year and are expected to rise 9% to US$243 this year and 14% to US$276 in 2025 (Exhibit 30). These numbers initially seem challenging to achieve given our forecast for economic growth as profit margins would likely need to return to record levels and even beyond. Exhibit 31 suggests a tight relationship between corporate revenues and nominal GDP. Should our forecasts prove accurate, S&P 500 revenues would grow approximately 5.2% and 4.0% in 2024 and 2025, respectively. If we accept these figures, then the only way to achieve the earnings estimates baked into the consensus is for profit margins to rise 100 basis points this year, back to their prior record, and then climb by another 100 basis points along the trend that has been in place for the past four decades (Exhibit 32).

### Exhibit 30: S&P 500 Index

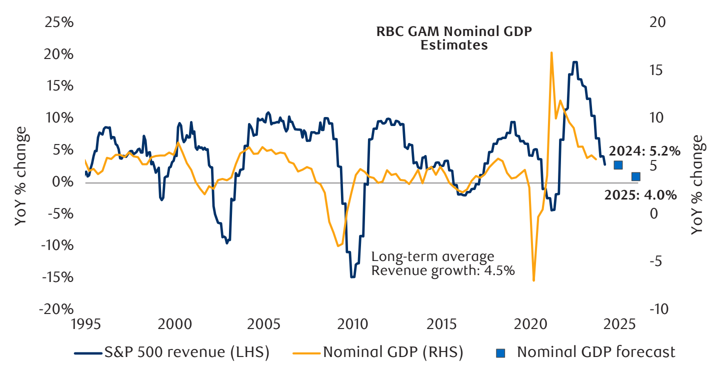
12-month trailing earnings per share




Note: As of March 1, 2024. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, RBC GAM

### Exhibit 31: United States

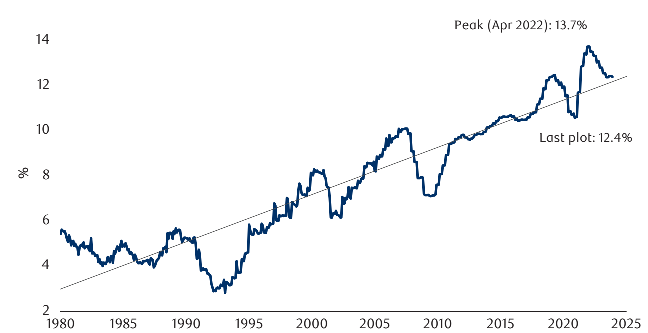
S&P 500 revenue and nominal GDP




Note: As of February 29, 2024. Source: RBC CM, RBC GAM

### Exhibit 32: S&P 500

Net Margin



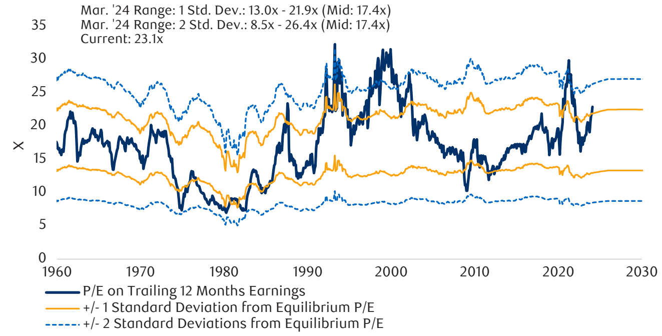

Note: As of February 29, 2024. Source : Bloomberg, RBC GAM

## Scenario analysis reveals limited upside for the S&P 500

Assuming the earnings projected by the consensus can be achieved, the upside still appears limited considering current valuations. The S&P 500 is trading slightly more than one standard deviation above our modelled equilibrium price-to-earnings ratio – i.e. the level consistent with current and expected interest rates and inflation (Exhibit 33). Should valuations revert to equilibrium, stocks would likely suffer. But if they manage to hold at least 0.5 standard deviation above our modelled equilibrium, as they did for many years before the pandemic, then U.S. large-cap stocks could generate low single-digit annualized gains through the end of 2025.

Exhibit 34 outlines a variety of scenarios for the S&P 500 based on combinations of valuations and consensus earnings estimates. At our modelled equilibrium price-to-earnings ratio, the S&P 500 would trade at 4300 by the end of 2024, and 4900 by the end of 2025 if earnings grow as the consensus expects. This outcome would generate losses of 14% and 1% to the end of this year and next year, respectively. But if the S&P 500 trades at a typical P/E of at least 0.5 standard deviation above equilibrium and S&P 500 earnings per share achieve the US$276 estimated by the consensus, the market could trade as high as 5550 over the next 22 months, representing an annualized total return of around 6%. At current levels, valuations are demanding and generating decent returns on the S&P 500 from here will require earnings expectations to be achieved or exceeded, and for valuations to sustain elevated levels that are pushing toward the right-tail of the historical valuation distribution.

### Exhibit 33: S&P 500 Index
Normalized (Equilibrium) Price/Earnings Ratio




Note: As of February 29, 2024. Source: RBC GAM

### Exhibit 34: Earnings estimates and alternative scenarios for valuations and outcomes for the S&P 500

| | | Consensus | | | Consensus | | |
|---|---|---|---|---|---|---|---|
| | | 2024 Top Down | 2024 Bottom Up | | 2025 Top Down | 2025 Bottom Up | Recessionary* |
| | P/E | $235.0 | $243.3 | P/E | $274.6 | $276.0 | $167.3 |
| +1 Standard Deviation | 22.2 | 5210.1 | 5394.8 | 22.5 | 6168.6 | 6200.1 | 3757.1 |
| +0.5 Standard Deviation | 19.9 | 4679.1 | 4844.9 | 20.2 | 5539.9 | 5568.2 | 3374.2 |
| Equilibrium | 17.7 | 4148.1 | 4295.1 | 17.9 | 4911.2 | 4936.3 | 2991.3 |
| -0.5 Standard Deviation | 15.4 | 3617.1 | 3745.3 | 15.6 | 4282.5 | 4304.3 | 2608.3 |
| -1 Standard Deviation | 13.1 | 3086.0 | 3195.4 | 13.3 | 3653.8 | 3672.4 | 2225.4 |

Note: *Trailing 12-Month Earnings to February 2024 less 25% (i.e. average decline in earnings through recession). As of February 29, 2024. Source: Bloomberg, Thomson Reuters, RBC GAM

## Investment themes: styles, regions and cap size

Some of the themes that we monitor suggest the bull market is less robust than we would like. We would prefer to see leadership in value stocks versus growth, small-cap versus large-cap, and international versus domestic because these relationships usually suggest that economic growth is broadly accelerating. But the opposite has been happening. The rally since early 2023 has been dominated by a narrow set of mega-cap growth stocks (exhibits 35 to 37). While there have been brief episodes where value, small caps, and/or international stocks outperformed, we are monitoring these themes for signs of sustained rotation into new leadership to confirm a durable bull market lies ahead.

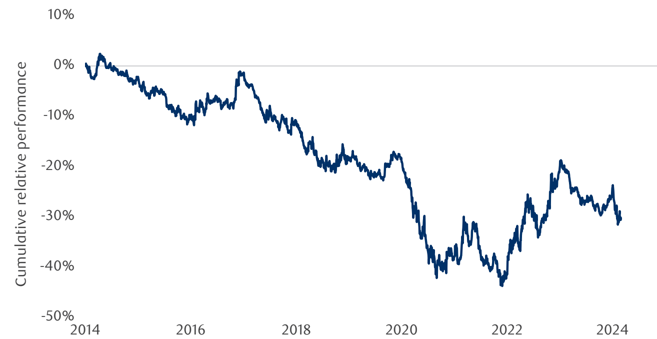
## Maintaining asset mix close to neutral, with slight nudge to fixed income

The odds of an economic soft landing have improved to the point that it is now the more probable outcome in our scenario analysis. Our base-case expectation is for the U.S. economy to continue to expand at a moderate pace and for inflation to continue falling at a rate that will allow central banks to support the economy by cutting interest rates at some point this year. We recognize, however, that the chance of a recession is still higher than usual. The impact of monetary tightening poses a headwind, and other risks include slowing growth in China, heightened geopolitical tensions, especially in the Middle East, and a U.S. presidential election later this year.

Against this backdrop and after the biggest ever bear market in fixed-income assets, long-term return potential in government bonds is close to the highest it has been in two decades. A good estimate for what investors will likely earn on 10-year Treasuries over the next decade is its current yield to maturity which is 4.25% (Exhibit 38). Crucially, a higher starting yield cushions bonds from the possibility of negative returns. It would take a 60-basis-point increase in the yield on the 10-year Treasury to wipe out its coupon income over the next 12 months. That number was less than 10 basis points at one point during 2020. Conversely, if yields were to drop 60 basis points over the year ahead, 10-year Treasuries stand to generate a return of 8.9%. As a result, we think bonds offer decent return potential in this environment with minimal downside risk.

### Exhibit 35: Value to growth relative performance

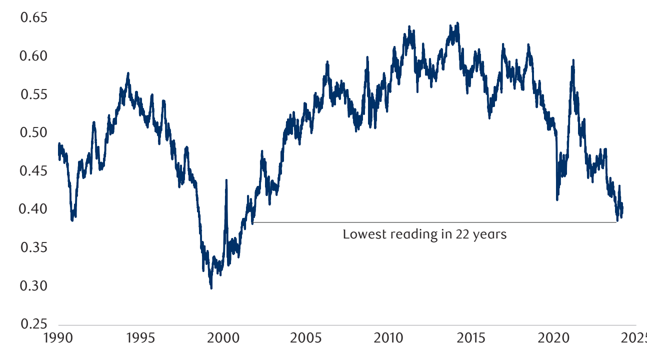
S&P 500 Value Index / S&P 500 Growth Index




Note: As of February 29, 2024. Source: Bloomberg, RBC GAM

### Exhibit 36: U.S. small caps versus large caps

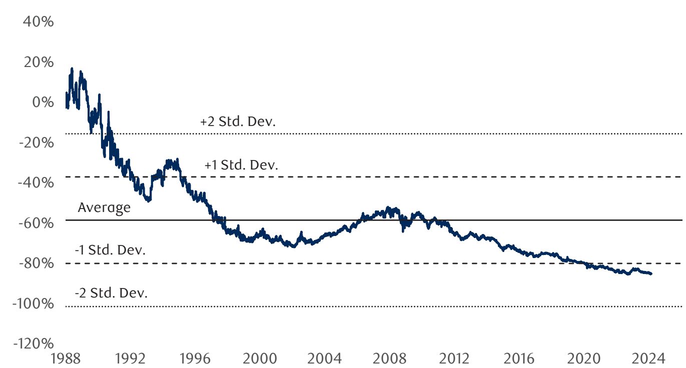
Russell 2000 Index / S&P 500 Index




Note: As of Feb 29, 2024. Source: Bloomberg, RBC GAM

### Exhibit 37: International vs U.S. relative performance

MSFI EAFE TR USD vs S&P 500 TR USD

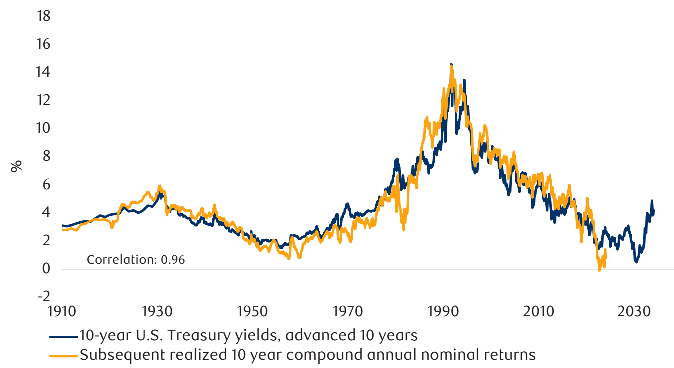



Note: As of February 29, 2024. Source: Bloomberg, RBC GAM

We continue to expect stocks to outperform bonds over the longer term, but the shorter-term potential for equities has been reduced by the recent rally which has driven valuations to demanding levels in some markets. Based on the historical relationship between the Cyclically Adjusted P/E ratio (CAPE) and long-term equity-market returns, the S&P 500 Index is projected to deliver returns of 6.5% per year over the next decade, down from as much as 10% projected in the depths of the 2022 bear market (Exhibit 39). As a result, the premium offered for taking equity-market risk relative to fixed income is not nearly as appealing as it has been at earlier points in the cycle.

Taking everything together, we are maintaining an asset mix close to our neutral allocation, with a bias to fixed income. We added to our fixed-income allocation over the past several quarters as yields rose, closing our prior underweight position and ultimately moving to a slight overweight in October as the U.S. 10-year yield approached 5% in the fall of 2023. Critically, at these higher yields, bonds provide greater ballast against equity market volatility within a balanced portfolio. While we remain constructive on stocks over the longer term, we recognize that in the shorter-term sentiment is extremely optimistic and valuations are demanding such that investors are not being sufficiently compensated for the risk of an adverse outcome. Our current recommended asset mix for a global balanced investor is 60.0% equities (strategic: “neutral”: 60.0%), 38.5% bonds (strategic “neutral”: 38.0%) and 1.5% in cash.

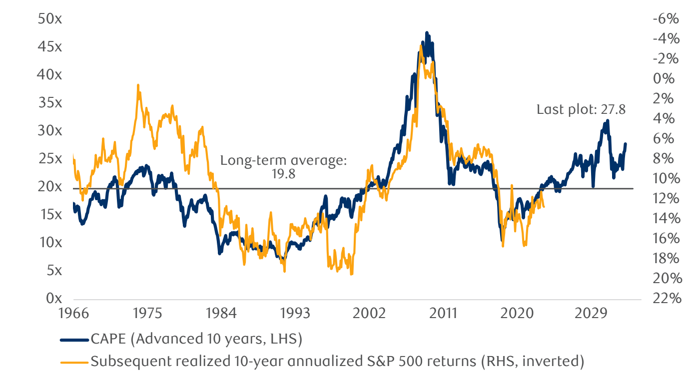
### Exhibit 38: U.S. 10-year Treasury note and returns




Note: As of February 29, 2024. Source: Deutsche Bank, Macrobond, RBC GAM

### Exhibit 39: Shiller’s CAPE

Real S&P 500 Index / 10-year average of real EPS

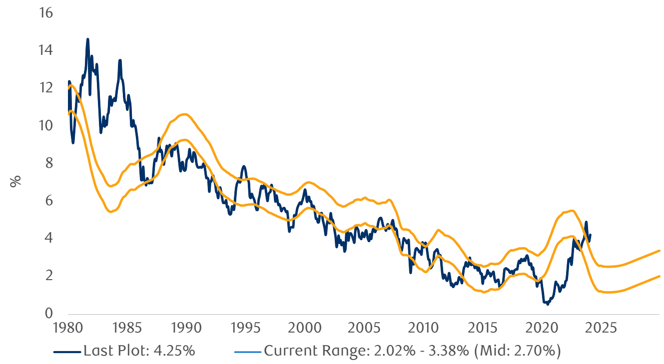



Note: As of Feb 29, 2024. Source: Macrobond, Bloomberg, RBC GAM

## Global fixed income markets

### U.S. 10-Year T-Bond Yield

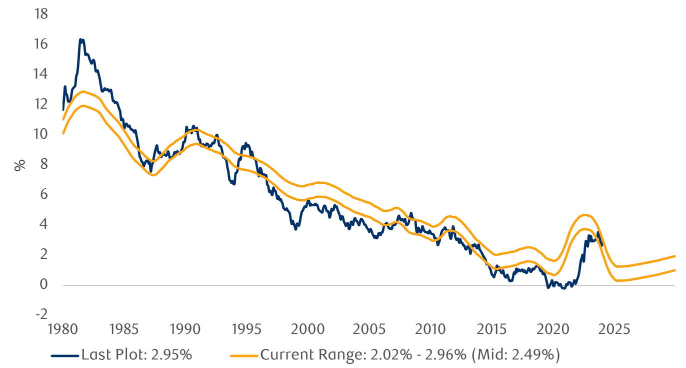
Equilibrium range




Note: As of February 29, 2024. Source: RBC GAM, RBC CM

### Eurozone 10-Year Bond Yield

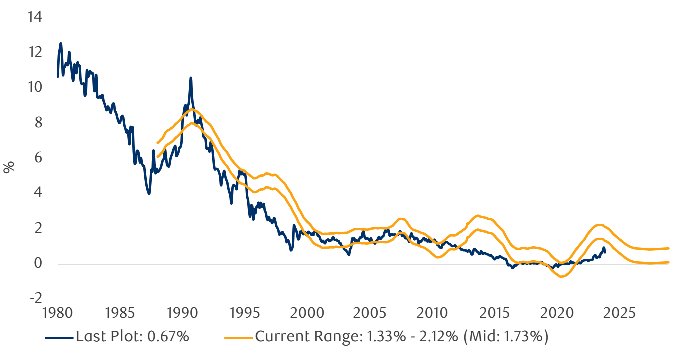
Equilibrium range




Note: As of February 29, 2024. Source: RBC GAM, RBC CM

### Japan 10-Year Bond Yield

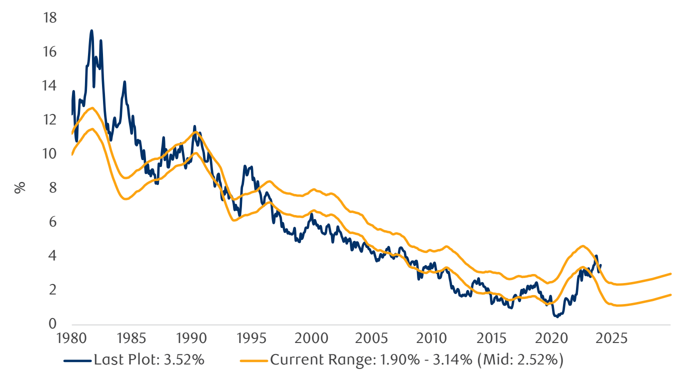
Equilibrium range




Note: As of February 29, 2024. Source: RBC GAM, RBC CM

### Canada 10-Year Bond Yield

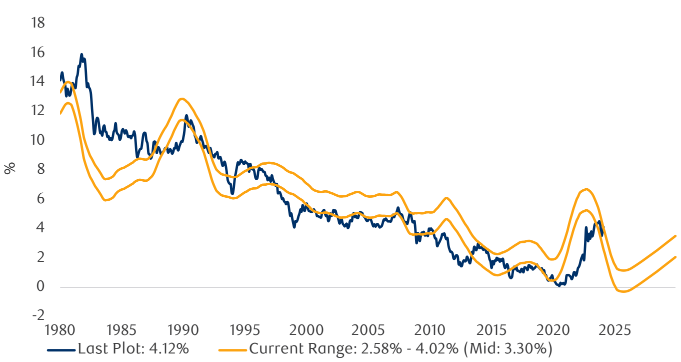
Equilibrium range




Note: As of February 29, 2024. Source: RBC GAM, RBC CM

### U.K. 10-Year Gilt

Equilibrium range

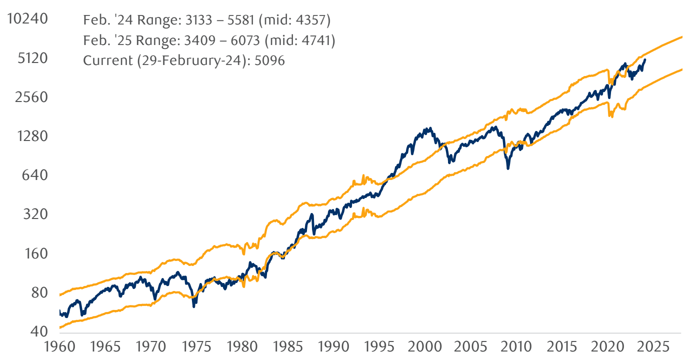



Note: As of February 29, 2024. Source: RBC GAM, RBC CM

> "Except for in Japan, sovereign bond yields in all major regions are situated well above their modelled equilibrium level."

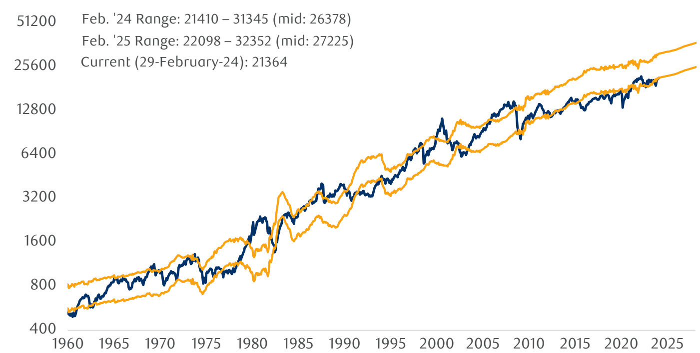
## Global equity markets

### S&P 500 Equilibrium
Normalized earnings and valuations



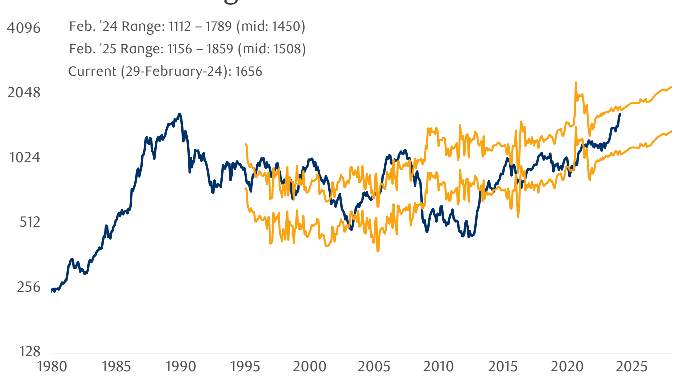

Note: As of February 29, 2024. Source: RBC GAM

### S&P/TSX Composite Equilibrium
Normalized earnings and valuations



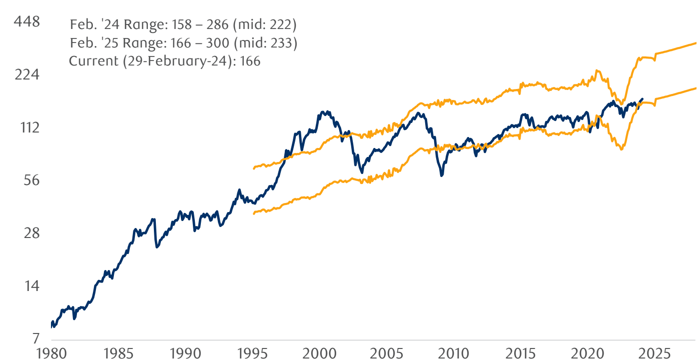

Note: As of February 29, 2024. Source: RBC GAM

### MSCI Japan Index
Normalized earnings and valuations



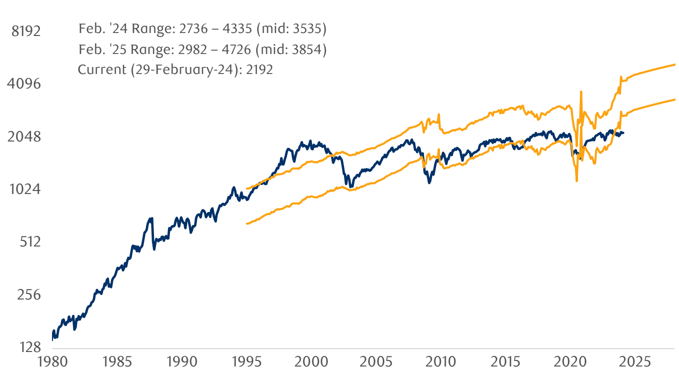

Note: As of February 29, 2024. Source: RBC GAM

### MSCI Europe Index
Normalized earnings and valuations



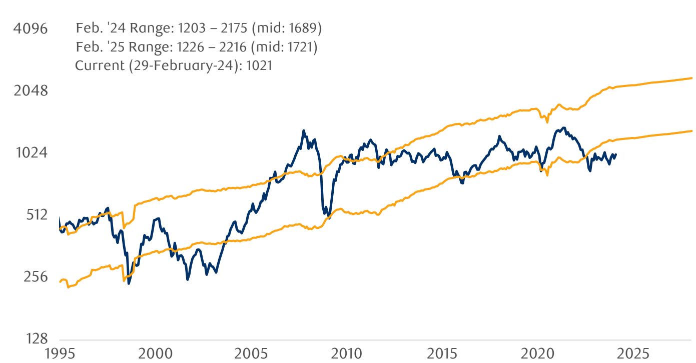

Note: As of February 29, 2024. Source: RBC GAM

### MSCI UK Index
Normalized earnings and valuations




Note: As of February 29, 2024. Source: RBC GAM

### MSCI Emerging Markets Index
Normalized earnings and valuations




Note: As of February 29, 2024. Source: RBC GAM

# Global fixed income markets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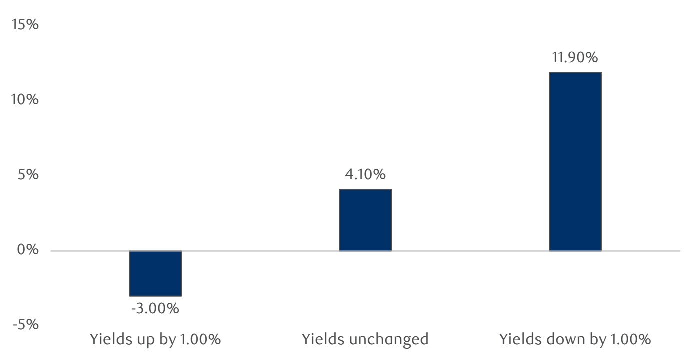
Fixed-income investors have earned strong returns since October, as the market anticipated rate cuts and pushed down bond yields. We agree that policy rates are likely to fall this year but think investors may be expecting too much from central bankers and end up disappointed. While the 4% yield on the 10-year Treasury is attractive, the gains of recent months mean that the prospect of outsize returns has dimmed since the last *Global Investment Outlook*. At that time, we highlighted good odds of mid-to-high single-digit returns for bonds, and a decent chance of double-digit returns. We now expect a mid-single-digit return for holders of government bonds over the next year. Our view is that the slowdown in inflation will likely continue and that looser labour markets will permit some central-bank easing, likely leading to a decline in bond yields over the year ahead.

To be sure, the potential returns from bonds remain compelling. The most important part of this calculus is simply that yields are high, and high yields provide a better jumping-off point for returns. If yields are unchanged a year from now, investors can expect to receive returns of 4.25% on their bond holdings. The higher starting yield provides a cushion if bond prices retreat. For instance, a 1.00% rise in yields would result in losses of 3.0%. They also provide a springboard for returns if yields were to fall: the same 1.00% decline in yields would produce gains of 11.9% (Exhibit 1).

The threat of runaway inflation, which we believe linked bond and stock returns closely since the pandemic, is also much lower, a scenario that tends to favour fixed income. In many economies, the pace of price rises has dropped to levels

**Exhibit 1: Bonds can offer solid returns for investors**

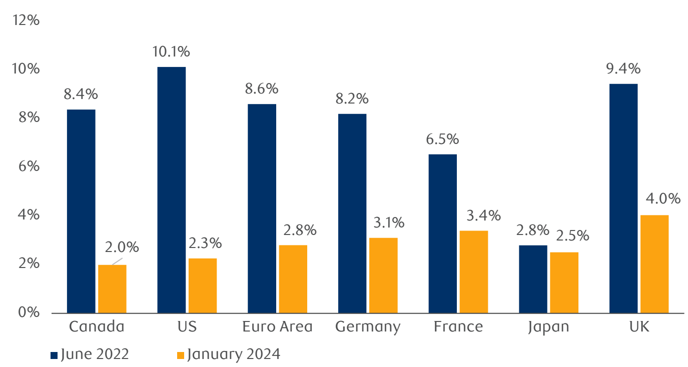



Note: 1-year return for U.S. 10-year government bond from February 29, 2024 to February 28, 2025. Source: Bloomberg, RBC GAM calculations not far from central-bank targets near 2% (Exhibit 2). The global decline in inflation, which in the U.S. was the fastest 12-month drop since 1990, speaks to the degree to which price pressures were likely transitory and tied to supply-chain problems and energy costs rather than excess demand. To be sure, recent attacks on oil tankers in the Red Sea and Russia's control of a significant slice of energy reserves mean there is an elevated risk that energy prices could start rising again. Robust wage growth is also often cited as a reason why inflation could remain higher, but we think current wage demands mostly reflect past inflation rather than expectations of a reacceleration in prices. As inflation cools, so will wages. Against this backdrop, we think central banks have room to cut rates and bond yields could fall.

The biggest risk to our outlook is that the worst of the effects of global monetary tightening are behind us, and that the economy starts to accelerate. In fact, RBC GAM expects only a 40% chance of recession, down from 60% last quarter, and has thus shifted to a base case forecast of modest growth. In this scenario, the U.S. economy remains positive and growth in the economies of America's developed-market peers starts to catch up.

Governments, moreover, continue to keep spending, propelled by increasing budget deficits. Markets haven't seemed perturbed by growing debt aside from a period of about three months starting in August 2023, when fiscal concerns led to a significant bond sell-off. Even with yawning deficits, we think it is unwise to expect a significant curtailment of government spending in 2024 as so many countries face elections, not least the U.S. For now, higher fiscal deficits remain a risk that could exacerbate a sell-off in bonds, rather than a principal cause. Over time, rising debt will cause a greater and greater share of government revenues to be devoted to debt servicing, reducing the flexibility of governments to support spending. We believe this is an issue that will need to be addressed.

### Exhibit 2: Inflation is much lower everywhere




Note: Inflation rates adjusted for regional calculation differences.
Source: Bloomberg, RBC GAM, National statistical offices

We expect U.S. Treasury yields to fall, with the 10-year bond yield declining to 4.00% over the next year from 4.25% at the time of writing.

## United States

The U.S. economy continues to defy expectations of recession. The significant decline in bond yields, rising prices for stocks, cooling inflation, strong government spending and rising wages are a powerful combination supporting economic activity to start 2024. However, we are unconvinced that growth can be sustained at these levels. We believe that a slowdown is likely over the next 12 months given our view that the significant monetary tightening delivered since 2022 will eventually curb the expansion. Moreover, the pent-up savings built during the pandemic and government spending are likely to wane. High interest costs are already weighing on the housing market and business investment, and we believe they could at some point translate into higher unemployment and a recession. While consumer prices rose at a pace modestly above the U.S. Federal Reserve's (Fed) target of 2% over the past year, they are up just 1% during the past three to six months. We think, therefore, that the Fed is keen to ease policy from current levels, which it believes are restrictive for economic activity. Our forecast is that the target range for the fed funds rate will decline to between 4.00% and 4.25% from the current 5.25% to 5.50% over the next 12 months, with cuts beginning in the second half of 2024. We expect U.S. Treasury yields to fall too, with the 10-year bond yield declining to 4.00% over the next year from 4.25% at the time of writing.

German 10-year government bond yields already reflect much of the expected decline in policy rates, and we expect them to be about the same in a year, at 2.35%.

## Eurozone

The eurozone economy, in contrast to the U.S., is barely growing. Over the past year, the single-currency area's GDP has expanded by just 0.1%, its worse annual reading since the depths of the region's sovereign-debt crisis in the early 2010s (excluding COVID). Inflation has been much more persistent than in the U.S., too, leading us to believe that stagflation risks are higher in the eurozone.

The eurozone's economic infirmities, however, disguise important divergences among its member countries. Germany, without a doubt, has struggled with much higher energy costs and muted demand from China. In contrast, Spain and Italy have posted strong growth and their labour markets remain tight. We believe these countries share a similar story with the U.S., where fiscal largesse has bolstered growth. In Europe, though, it has been the EU itself opening the spending taps to fund various Europe-wide projects, rather than central governments. Italy and Spain have received huge sums as a percentage of GDP, while Germany has received little since it is judged to be relatively wealthy. The different needs of the economies it oversees as a central bank raise a perennial problem for the European Central Bank (ECB) and suggest very different policy prescriptions.

Wage growth in Europe has likely peaked but remains much too high at between 4% and 5%. Now that inflation has cooled, we expect demands for higher wages to cool also. With high rates of unionized workers, we know that several high-profile negotiations are taking place this spring. We believe that the ECB is unlikely to cut policy rates without greater confidence that the slowdown in price pressures is also being reflected in wage expectations. Ultimately, we think a cooling economy and slowing inflation will prompt the ECB to begin cutting rates later this year – with the deposit rate falling from 4.00% now to 2.25% in a year's time. German 10-year government-bond yields already reflect much of the expected decline in policy rates, and we expect them to be about the same in a year, at 2.35%.

We forecast the benchmark interest rate at 0.10% in a year's time. We also expect bond yields to rise, with the yield on the 10-year Japanese government bond reaching 1.00% in the year ahead.

## Japan

We believe that Japan is experiencing the most profound increase in price pressures in several decades. Prices for items that serve as important reference points for consumers, such as that staple bowl of ramen, have risen sharply – after remaining unchanged for years. It is probable that Japanese workers will enjoy the strongest wage growth in the G7 group of developed nations.

The Bank of Japan (BOJ) has signalled its intent to make policy more restrictive by permitting government bond yields to rise, and we think further normalization is likely this year. The BOJ's policy rate could rise above zero for the first time since 2016. We forecast the benchmark interest rate at 0.10% sometime over the next 12 months. Meanwhile, we also expect bond yields to rise, with the yield on the 10-year Japanese government bond reaching 1.00% in the year ahead.

The Bank of Canada (BOC) left its policy rate unchanged at 5.00% in March, marking the fifth consecutive meeting that policymakers kept rates on hold.

## Canada

The Bank of Canada (BOC) left its policy rate unchanged at 5.00% in March, marking the fifth consecutive meeting that policymakers kept rates on hold. The BOC remains hesitant to lower rates, even after the annual pace of inflation fell to 2.9% in January 2024 from as high as 8.1% in June 2022 amid weakening economic growth. Policymakers said they consider policy rates to be sufficiently tight to keep inflation in check, but patience is required as the economy has done better than expected thanks largely to immigration. However, the unemployment rate has risen by 0.8 percentage point since 2022, and Canada's economy is expanding more slowly than the pool of workers is rising. In per-person terms, Canada's economy has shrunk markedly over the past few years, and, in a rare and disconcerting development, Canadian productivity is declining. The BOC has nothing in its arsenal to directly effect structural changes that would boost productivity. Nor does it control immigration, and it can't build houses. In fact, the BOC's efforts to cool inflation via higher policy rates are now the largest contributor to inflation - via soaring mortgage costs and rents. We expect these circumstances to sway the BOC toward earlier rather than later cuts as long as inflation continues to cool towards 2%. If progress toward 2% inflation is better than the BOC expects, policymakers would likely cut interest rates more than our forecast.

We forecast the 10-year gilt yield at 4.00% over the next year, only slightly lower than the 4.10% they are at now.

## United Kingdom

The UK ended 2023 in recession, as the economy shrank in consecutive quarters. Domestic activity was poor, as businesses reckoned with cooling demand from households and rising prices. Inflation is double the Bank of England's (BOE) target of 2%, with consumer prices rising by 4% year over year in January. Inflation in service industries exceeds 6%, reflecting heady wage gains for employees. High rates of inflation mean that the BOE has been slow to consider easing policy rates. At least some of the economy's persistent weakness is related to a hangover from leaving the EU in early 2020, when the UK lost access to its main trading partners, and the resulting malaise is something that monetary policy will be limited in addressing. We think economic conditions will continue to deteriorate over the next year, leading to a weaker labour market and slower wage gains. We believe inflation will cool enough for the BOE to cut its policy rate to 4.25% from the current 5.25% sometime over the next 12 months. We think the UK's long-run economic prospects are among the worst in the developed world, and that the country will likely experience persistently higher inflation and poorer growth than its peers, exacerbated by the questionable competence of its political class. These concerns should keep gilt yields from falling as much as might be expected in an environment of declining policy rates. We forecast the 10-year gilt yield at 4.00% over the next year, only slightly lower than the 4.10% they are at now.

**Interest-rate forecast: 12-month horizon**

Total-return calculation: February 29, 2024 – February 28, 2025

| U.S. | | | | | | |
|---|---|---|---|---|---|---|
| | 3-month | 2-year | 5-year | 10-year | 30-year | Horizon return (local) |
| Base | 4.25% | 3.75% | 3.80% | 4.00% | 4.30% | 5.65% |
| Change to prev. quarter | (0.50%) | (0.25%) | (0.10%) | 0.00% | 0.05% | |
| High | 6.00% | 5.75% | 5.50% | 5.25% | 5.25% | (0.62%) |
| Low | 3.00% | 2.75% | 3.00% | 3.20% | 3.60% | 10.16% |
| **Expected Total Return US$ hedged: 5.9%** | | | | | | |

| Germany | | | | | | |
|---|---|---|---|---|---|---|
| | 3-month | 2-year | 5-year | 10-year | 30-year | Horizon return (local) |
| Base | 2.25% | 1.90% | 2.00% | 2.35% | 2.60% | 3.10% |
| Change to prev. quarter | (0.75%) | (0.60%) | (0.25%) | (0.15%) | (0.25%) | |
| High | 4.00% | 3.50% | 3.30% | 3.25% | 3.25% | (3.13%) |
| Low | 1.75% | 1.50% | 2.00% | 2.00% | 2.50% | 6.74% |
| **Expected Total Return US$ hedged: 4.2%** | | | | | | |

| Japan | | | | | | |
|---|---|---|---|---|---|---|
| | 3-month | 2-year | 5-year | 10-year | 30-year | Horizon return (local) |
| Base | 0.10% | 0.40% | 0.60% | 1.00% | 2.00% | (1.66%) |
| Change to prev. quarter | 0.00% | 0.00% | 0.10% | 0.00% | 0.15% | |
| High | 0.25% | 0.75% | 1.25% | 1.75% | 2.50% | (8.43%) |
| Low | (0.10%) | 0.00% | 0.25% | 0.50% | 1.40% | 6.72% |
| **Expected Total Return US$ hedged: 3.3%** | | | | | | |

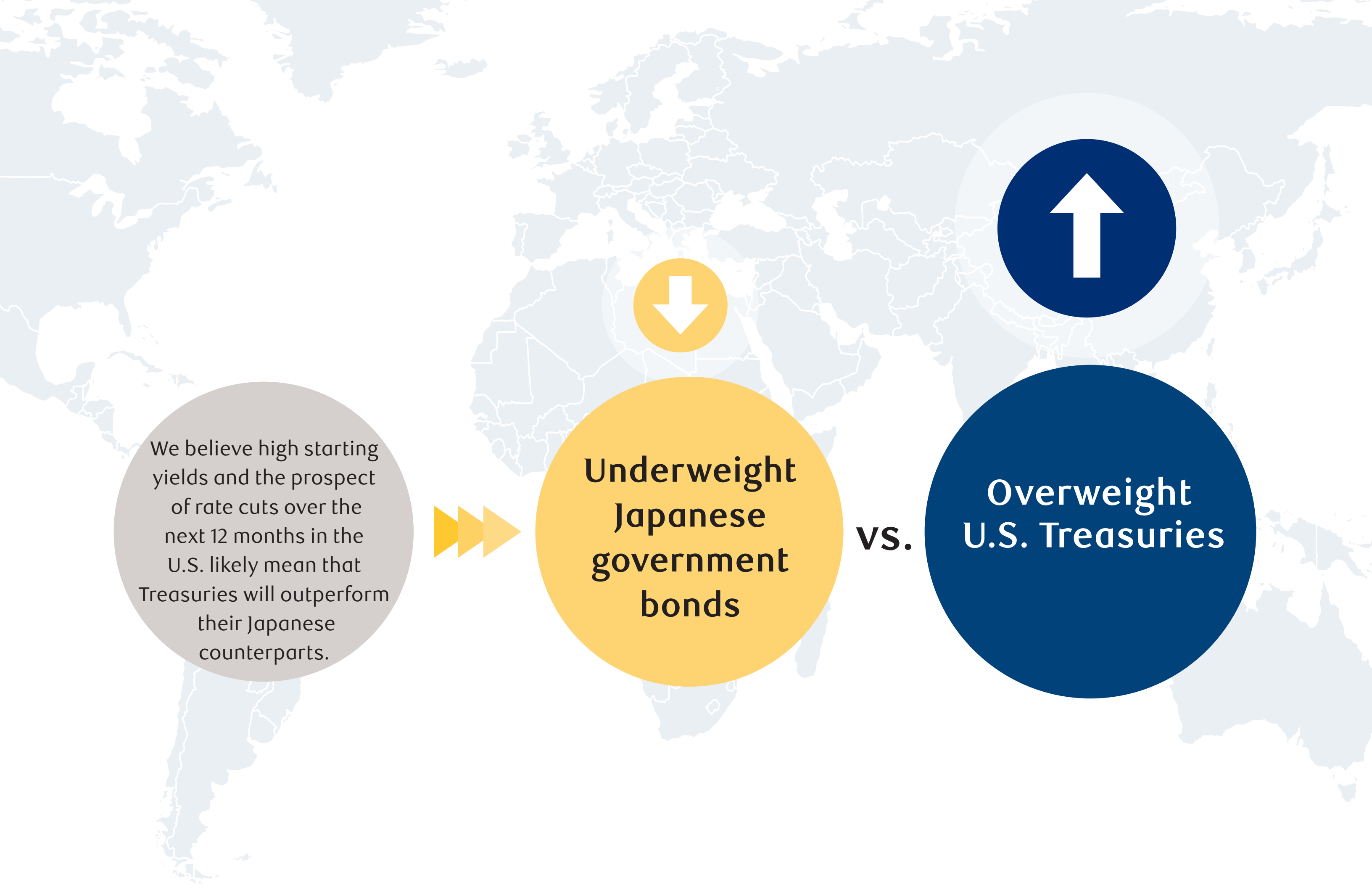
| Canada | | | | | | |
|---|---|---|---|---|---|---|
| | 3-month | 2-year | 5-year | 10-year | 30-year | Horizon return (local) |
| Base | 4.00% | 3.75% | 3.60% | 3.50% | 3.50% | 3.34% |
| Change to prev. quarter | 0.00% | 0.45% | 0.50% | 0.50% | 0.30% | |
| High | 5.50% | 5.25% | 5.00% | 4.75% | 4.50% | (2.91%) |
| Low | 2.50% | 2.25% | 2.50% | 2.75% | 3.00% | 7.93% |
| **Expected Total Return US$ hedged: 3.2%** | | | | | | |

| U.K. | | | | | | |
|---|---|---|---|---|---|---|
| | 3-month | 2-year | 5-year | 10-year | 30-year | Horizon return (local) |
| Base | 4.25% | 3.75% | 3.80% | 4.00% | 4.50% | 5.45% |
| Change to prev. quarter | (0.25%) | (0.25%) | 0.00% | 0.00% | (0.25%) | |
| High | 5.75% | 5.50% | 5.25% | 5.00% | 4.85% | (0.23%) |
| Low | 3.50% | 3.25% | 3.00% | 3.25% | 4.25% | 9.00% |
| **Expected Total Return US$ hedged: 5.3%** | | | | | | |

Source: RBC GAM

**Regional outlook**

We are overweight U.S. government bonds and underweight Japanese government bonds. We believe high starting yields and the prospect of rate cuts over the next 12 months in the U.S. likely mean that Treasuries will outperform their Japanese counterparts. In contrast, we expect policy tightening from the Bank of Japan, likely boosting bond yields and leading to relatively disappointing returns.



# Currency markets

## U.S. dollar stays aloft despite long-term headwinds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We remain bearish on the U.S. dollar, with our outlook premised on long-term headwinds. A combination of major factors should cause the dollar to decline over the next several years: the currency's overvaluation, a reversal of capital inflows and the erosion of U.S. fiscal credibility. We expect the early beneficiaries of such dollar weakness to be the euro and the Canadian dollar, while the yen and British pound lag. Emerging-market currencies may initially be held back by central-bank rate cuts but will eventually be buoyed by widespread weakness in the greenback.

One might have predicted that the U.S. dollar would fluctuate more than it has over the past three months given the emergence of Donald Trump as the front-runner in November's general election, the belief that central banks are done hiking interest rates and an emerging consensus that the global economy will avoid recession. The greenback has, however, traded in a tight range for most of the past year. While the dollar remains roughly 9% below its 2022 peak on a trade-weighted basis (Exhibit 1), the lack of any follow-through, we think, is the result of offsetting factors that have kept the currency pinned in place. Recent developments, including stronger-than-expected economic growth, have supported the greenback, undercut by longer-term factors such as the currency's rich valuation.

**Exhibit 1: U.S. dollar still below 2022 peak**


Note: As at February 29, 2024. Source: Bloomberg, RBC GAM

The U.S. dollar's gains in the aftermath of the pandemic have most models indicating the currency as significantly overvalued. Our preferred measure, purchasing power parity, suggests that the dollar is more overvalued than at any point since the mid-1980s (Exhibit 2), a level unjustified even after accounting for U.S. energy independence and U.S. leadership in technology. We expect this overvaluation to be short-lived because, as with an elastic band that is stretched, resistance grows as the currency deviates from fair value. And when the snapback finally occurs, currencies tend to over-adjust and move from one extreme to the other rather than stopping at fair value.

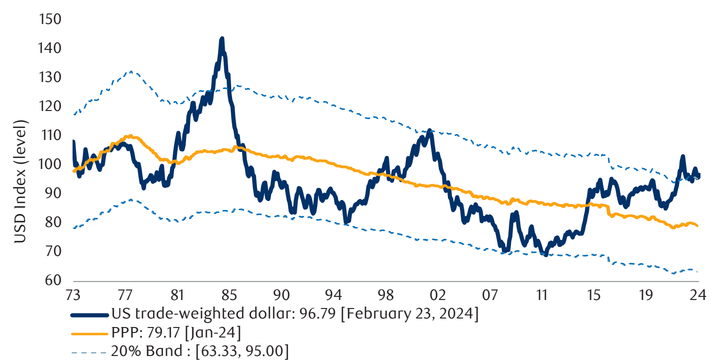
One argument why the dollar could remain overvalued in the short term is that interest rates have risen with expectations that the U.S. Federal Reserve (Fed) will reduce policy rates more slowly than had been expected late last year. The 50-basis-point increase in U.S. 2-year yields seen in February would normally cause the greenback to appreciate had it not been for the fact that German interest rates also rose. So, while U.S. yields are higher than peers', it is the change in relative interest rates that is keeping the dollar within its range.

Investors are now pondering whether the U.S. elections in November could allow the currency to remain strong and resilient in the face of longer-term headwinds. A Trump victory would likely cause the U.S. dollar to appreciate in the short term due to the nature of his policies. For instance, a proposed 10% tariff on all imports would dent the competitiveness of the country's trading partners by raising the price of foreign goods for American consumers. In addition, expansionary fiscal spending, tax cuts and deregulation would perpetuate the U.S.-dollar-supportive economic outperformance experienced over the past year. Trump's disdain for international organizations and his less ardent support for Ukraine may also elevate the greenback because a withdrawal of military support would be negative for European stability.

With that said, the reaction to a Trump victory may be limited to a knee-jerk spike in the dollar similar to the months after he secured the White House in 2016 (Exhibit 3). Republican presidencies have generally been worse for the greenback, with the most negative periods being those in which both houses of Congress and the White House are controlled by the GOP (Exhibit 4).

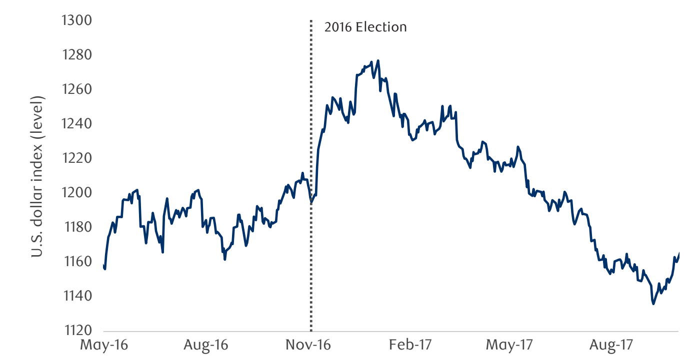
We note that the dollar usually performs poorly when equities rise, and we think Trump's penchant for deregulation and tax cuts would be positive for stock markets. He is also likely

### Exhibit 2: USD – Purchasing Power Parity Valuation




Note: As at February 23, 2024. Uses new Fed USD index (USTWAFE Index) from Dec 31, 2019. Source: U.S. Federal Reserve, Bloomberg, RBC GAM

### Exhibit 3: Post election U.S. dollar rally short-lived




Note: As at February 29, 2024. Source: Bloomberg, RBC GAM

### Exhibit 4: U.S. dollar's performance under different political parties

**Democrat president**

| TW$ (avg. monthly return) | | House | |
|---|---|---|---|
| | | Democrat | Republican |
| Senate | Democrat | -0.06% | 0.19% |
| | Republican | | 0.33% |

**Republican president**

| TW$ (avg. monthly return) | | House | |
|---|---|---|---|
| | | Democrat | Republican |
| Senate | Democrat | -0.04% | -0.12% |
| | Republican | 0.06% | -0.36% |

Note: As at February 29, 2024. Source: Bloomberg, U.S. Federal Reserve, RBC GAM to remove support for the greenback by leaning on the Fed to keep policy rates lower than they would otherwise be, an outcome he can achieve by appointing board members if his efforts to jawbone the central bank are unsuccessful.

It is important to recognize the reasons a Trump presidency could have more bearish *long-term* implications for the dollar. For one, Trump's preference for cutting taxes and keeping interest rates low threatens to further damage U.S. fiscal and monetary credibility. Tax reductions and interest-rate cuts are tools to be used in an economic slowdown, and the U.S. economy is clearly not in need of extra stimulus. A combination of monetary and fiscal easing could stoke additional inflationary pressures which, at a time when inflation is a concern, could erode the value of the greenback relative to other developed-market currencies.

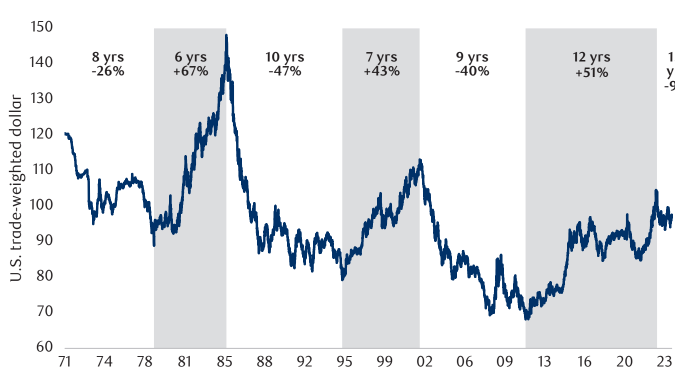
A second long-term concern involves Trump's criticism of trade partners that run surpluses with the U.S. and his willingness to weaponize the currency to exert geopolitical influence. Both Trump and Biden have locked countries out of the dollar-based payment system for failing to comply with international law, and a second Trump term would likely lead to the more frequent use of this approach.

Trump was the first president to extend the use of this tool beyond Cuba, after Iran pursued a nuclear-enrichment program, and Biden has used the same method against Russia following its invasion of Ukraine. Biden went several steps beyond economic sanctions by effectively seizing Russian assets, so it is clear that the practice of weaponizing the dollar is not exclusive to one political party. The increasingly frequent use of the dollar as a political lever is causing holders of significant foreign-exchange reserves to question the safety and security of national savings physically held in the U.S. or denominated in U.S. dollars. The U.S. policies haven't dislodged the greenback as the world's primary reserve currency, but there is certainly a noticeable uptick in the amount of global trade and investment occurring in other currencies, including Russian oil exchanged for Chinese renminbi or Indian rupees.

In any case, the longer-term trajectory of the U.S. dollar tends not to be driven by elections but by persistent factors that can alter the currency's trajectory over longer periods. Valuation is one of these anchors and is well aligned with the six- to nine-year phases between peaks and troughs of U.S.-dollar cycles (Exhibit 5). We believe the dollar is in the early stages of a long-term decline that will result in a plunge of at least 20% over the next several years. A persistent current-account deficit and large fiscal expenditures will reinforce this trend. The gradual shift away from the U.S. dollar in foreign-exchange reserves, even if only a small share of this US$12 trillion pool of capital, will also exert downward pressure on the dollar.

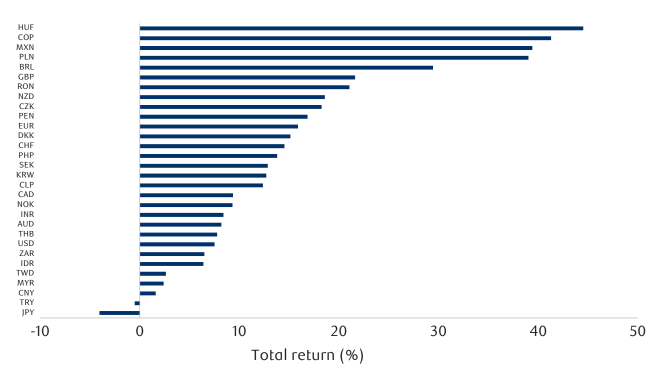
This longer-term backdrop is of critical importance to our outlook as it sets the stage for how other currencies might perform. A falling dollar will be the tide that floats all other boats, as has been the case since the greenback peaked 18 months ago (Exhibit 6). We expect that the initial beneficiary

### Exhibit 5: Long-term cycles in the U.S. trade-weighted dollar




Note: As at February 23, 2024. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

### Exhibit 6: Most currencies stronger since the dollar's peak




Note: Since September 30,2022. As at February 29, 2024. Source: Bloomberg, RBC GAM of this U.S.-dollar weakness will be the euro, as the single currency is the next most important for purposes of global trade and investment, and most often counterbalances the U.S. dollar's fluctuations. Unlike the Canadian dollar, which is likely to keep pace with the euro, we expect the Japanese yen and British pound to strengthen less as the dollar falls.

## Emerging markets

Emerging-market currencies have performed relatively well in recent years. A large yield advantage due to aggressive interest-rate hikes in the fight against inflation has supported emerging-market assets and insulated currencies from rising rates in developed markets.

Now that inflation is moderating globally, some emerging-market central banks have begun to ease monetary policy even as central banks in the developed world remain on hold. The yield gap between the highest- and lowest-yielding currencies (Exhibit 7) has shrunk rapidly as a result – a trend that could limit investors' enthusiasm for emerging-market currencies. Greater exchange-rate volatility may have the same result as it changes the calculus on the amount of risk taken to exploit yield differences across countries. While markets have so far remained calm, forward-looking measures (option prices) suggest greater currency-market fluctuations are in the cards as election jitters play out in the second half of the year (Exhibit 8).

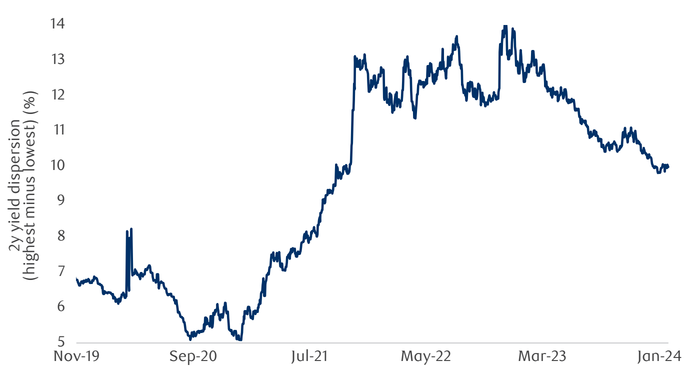
This is not to say that emerging-market currencies must weaken significantly, as they continue to offer higher yields and as the hard-won credibility of central banks in the battle against inflation continues to pay dividends. A big part of this credibility comes alongside a shift toward floating exchange rates, which allow central banks to focus on fighting inflation rather than managing the level of the currency.

We see other signs that should support emerging-market currencies, as these countries progress on the path toward economic development:

- Improved functioning of government and better enforcement of the rule of law.
- Greater inclusion of workers into the formal economy, which raises tax revenue and creates jobs.
- The creation of pension funds that provide a social safety net and encourage retirement savings, a pool of capital that helps governments fund themselves domestically.
- The strengthening of domestic capital markets, which encourages investment by foreigners.

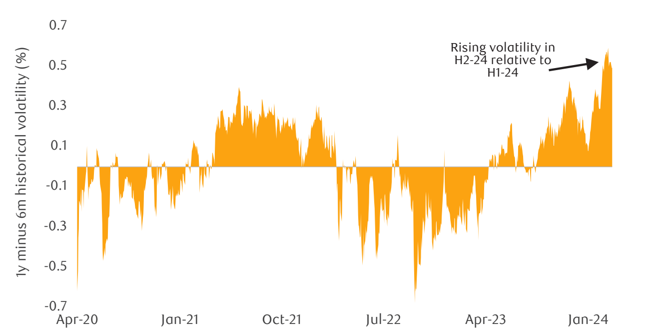
Alongside these socioeconomic advances, the rising share of emerging-market assets in global portfolios has fueled demand for emerging-market currencies. We expect this demand to continue, and for emerging-market currencies to benefit from a broad decline in the U.S. dollar.

### Exhibit 7: Narrowing gap between highest and lowest yielders




Note: As at February 29, 2024. Source: Bloomberg, RBC GAM

### Exhibit 8: Markets pricing greater volatility into U.S. elections



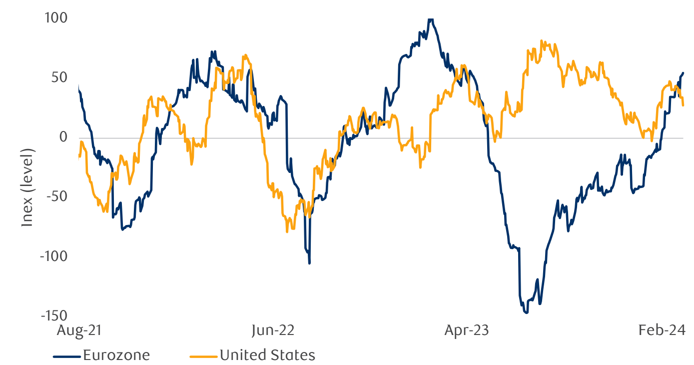

Note: Average of the difference of historical volatilities of G9 currencies. As at March 8, 2024. Source: Bloomberg, RBC GAM

## Euro

Weaker European economic activity is the principal reason the euro has failed to find its footing in recent years. The difference between economic growth on each side of the Atlantic Ocean has been stark, causing capital to leave the eurozone as the prospects for asset returns look brighter elsewhere. A cocktail of lower interest rates, meagre economic growth and geopolitical uncertainty has dented sentiment toward the currency. It can be argued, though, that investors are too bearish on the euro. The bar for economic data is now so low that recent indicators have begun to surpass expectations, and positive surprises in Europe are now outstripping those in the U. S. (Exhibit 9) – a sign that sentiment toward the single currency is due to improve. Upgrades to global growth forecasts tend to have a greater impact on currencies than do changes in U.S. growth expectations, and we expect the euro to benefit from such a shift.

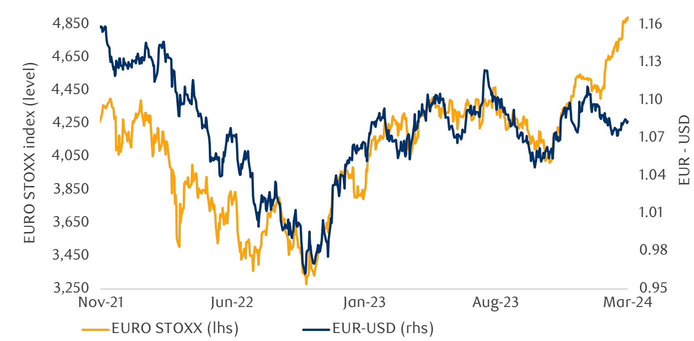
The pessimism embedded in the exchange rate can also be quantified by comparing the euro against some of the factors that determine the exchange rate. Whether we look at the performance of equity markets or the added yield required by investors to hold Italian bonds, the euro's major drivers suggest the currency should be trading in the neighbourhood of US$1.17 (Exhibits 10 & 11). We think the euro can strengthen beyond these levels, and we target an exchange rate of US$1.21 within the next year.

### Exhibit 9: Economic data surprises



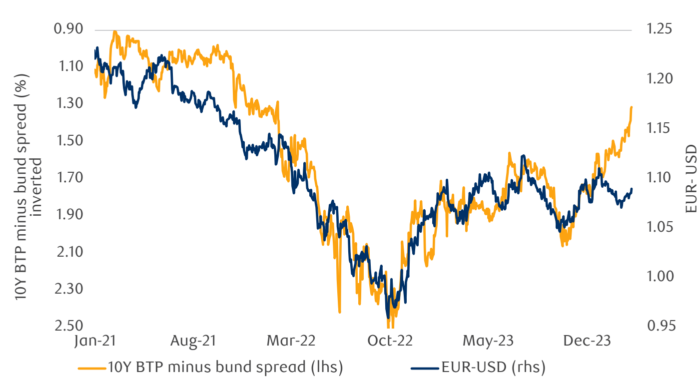

Note: As at March 5, 2024. Source: Citi, RBC GAM

### Exhibit 10: European equities point to a higher euro




Note: As at February 29, 2024. Source: Bloomberg, RBC GAM

### Exhibit 11: Peripheral spreads point to a higher euro




Note: As at March 6, 2024. Source: Bloomberg, RBC GAM

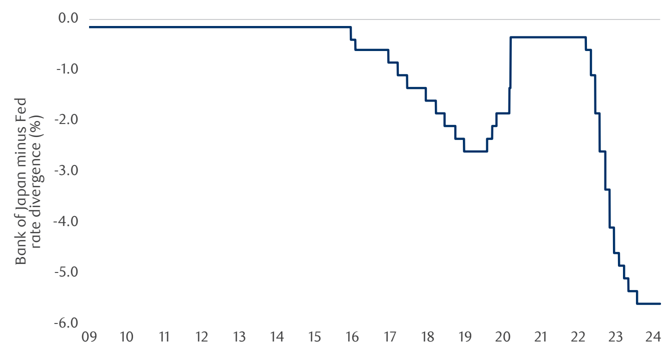
## Yen

The Japanese yen has been the worst-performing developed-market currency over the past year and the second worst globally after the Turkish lira. This performance is largely a symptom of the wide gap between the Bank of Japan's (BOJ) -0.10% policy rate and the Fed's 5.50% setting (Exhibit 12), an opportunity cost that makes it unattractive for Japanese investors to hold their own currency.

Another mark against the yen is the fact that the BOJ is unlikely to resume its currency intervention. The primary motivation in defending the yen late last year was to maintain the effective functioning of Japanese financial markets and to prevent disorderly fluctuations in the exchange rate (Exhibit 13). Barring another sudden depreciation in the yen to 160, we don't think investors can count on the BOJ to limit Japanese yen losses. A broad dollar sell-off is needed in order for the Japanese yen to rally.

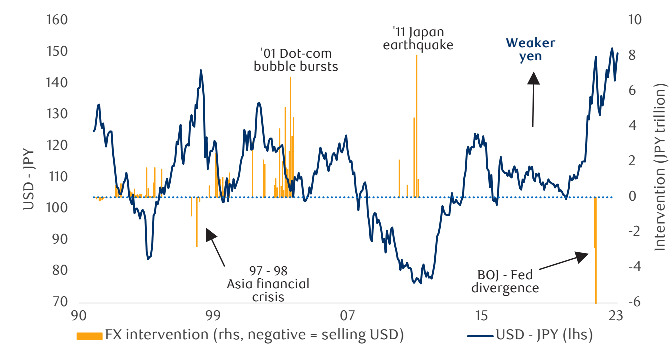
An appreciation in the yen would also require a sustained BOJ pivot away from ultra-easy monetary policy or additional rate cuts by the Fed beyond what is currently expected. We expect both of these developments to eventually materialize, though perhaps not until later this year. A broad equity-market sell-off that reignites safe-haven demand for the Japanese currency could also help. We have trimmed our optimism on the yen and now expect the currency to hit 135 per U.S. dollar within 12 months.

### Exhibit 12: Japanese – U.S. rate differentials at extremes




Note: As at February 29, 2024. Source: Bloomberg, RBC GAM

### Exhibit 13: Bank of Japan intervention history



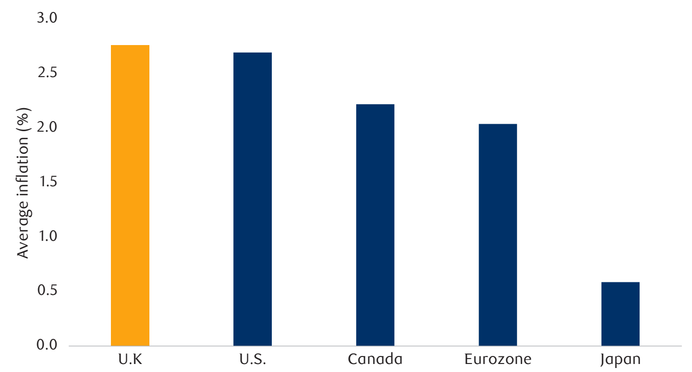

Note: As at January 31, 2024. Source: Japan Ministry of Finance, RBC GAM

## British pound

The UK has experienced faster inflation with slower economic growth than its peers since late 2022. This combination would not seem to be a particularly attractive outcome for currency traders – and yet the pound has managed to consistently outperform most other developed-market peers over the past year. While the longer-term effect of the country's structurally higher inflation (Exhibit 14) will be a gradual erosion of the pound's value, it also means that the currency has been propped up by the Bank of England's reluctance to cut rates.

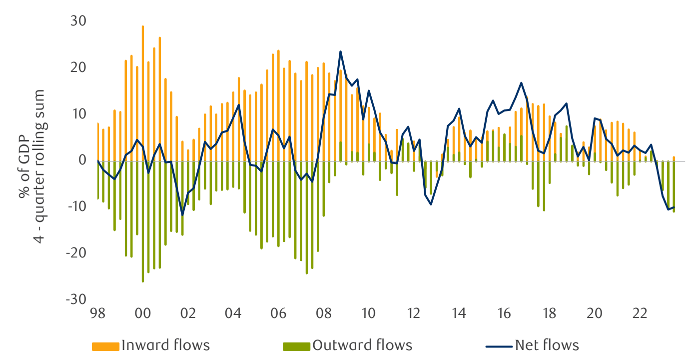
As inflation subsides, we expect the currency to be weighed down by the lingering impact of Brexit, the UK's twin deficits and a soft housing market. A sudden increase in outbound foreign investment is also a concern for investors (Exhibit 15) because it exacerbates the UK's already deteriorating balance of capital flows. Additionally, the country is facing a troubling rise in health-related unemployment, with more than 2.5 million of the UK's 67 million people out of work due to long-term disability (Exhibit 16). We remain long-term bears on the British pound and expect it to appreciate the least of the major currencies versus the dollar. Our current view is that the pound should rise only modestly to US$1.31 over the next 12 months.

### Exhibit 14: UK has structurally high inflation




Note: As at January 31, 2024. Data since 1990. Source: Bloomberg, RBC GAM

### Exhibit 15: UK investment flows




Note: As at September 30, 2023. Source: U.K. ONS, RBC GAM

### Exhibit 16: Large part of the labour pool is out sick


Note: As at November 30, 2023. Source: Bloomberg, RBC GAM

## Canadian dollar

The Canadian dollar has traded between C$1.32 and C$1.40 per U.S. dollar over the past 18 months, partly mirroring broader moves in the U.S. dollar and partly reflecting medium and long-term factors that may be at odds with each other.

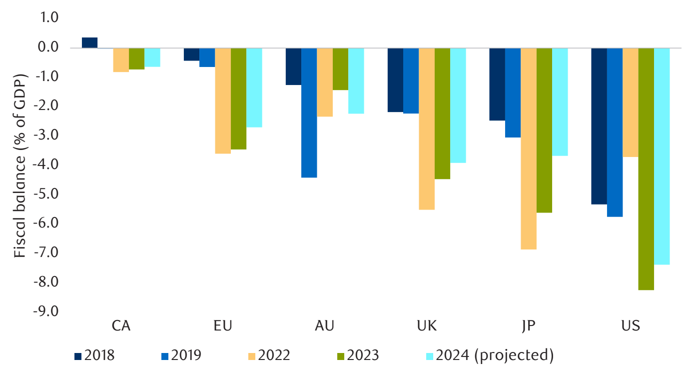
Over longer investment horizons, the loonie has a lot going for it:

- The Canadian dollar is undervalued, based both on short-term and long-term models.
- There is steady foreign demand for Canadian bonds.
- The country has a strong and stable banking system, without the deposit flight or market stress seen in the U.S. last year.
- Fiscally, Canada runs smaller and more sustainable deficits than its peers (Exhibit 17)
- Canada's increasingly well-educated workforce provides opportunity for higher-quality growth (Exhibit 18).
- Strong immigration should boost growth potential in the long term.

We continue to think that the Canadian dollar's positive long-term fundamentals will lead to its appreciation over time, particularly against a falling U.S. dollar. But our optimism has been tempered somewhat over the past year as several developments hurt the currency's prospects. Most notably, rising mortgage payments and rents are weighing on household consumption, an effect that becomes more pronounced each month as mortgage rates are reset higher.

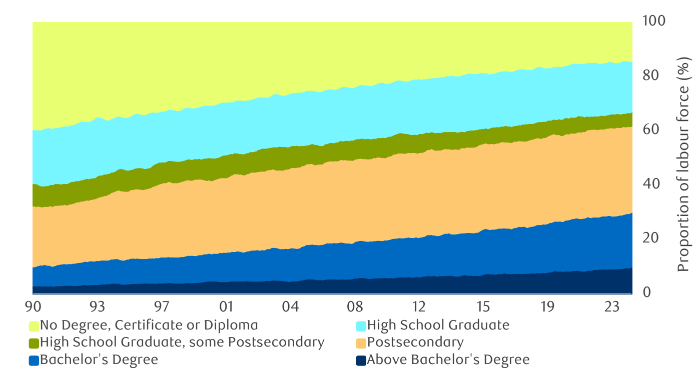
The country's immigration policy has also not delivered the economic benefit that we, alongside many others, had initially celebrated. In fact, even with substantial increases in the labour force, the size of the economy has declined on a per-capita basis, meaning that the standard of living for most Canadians has deteriorated (Exhibit 19). Unhappiness with the government's immigration plan has emerged in response to a shortage of housing, and that opposition will undoubtedly intensify if it also results in a shortage of jobs.

### Exhibit 17: Canada's fiscal balance is healthier than peers



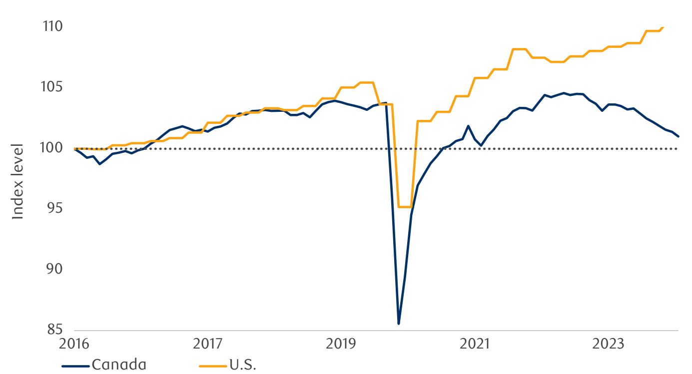

Note: As at December 31, 2023. Source: IMF, RBC GAM

### Exhibit 18: Educational attainment




Note: As at February 29, 2024. Source: Statistics Canada, RBC GAM

### Exhibit 19: Real GDP per capita suggests no improvement in Canadian living standards




Note: As at December 31, 2023. Indexed to 100 on January 2016. Source: Bureau of Economic Analysis, Statistics Canada, RBC GAM

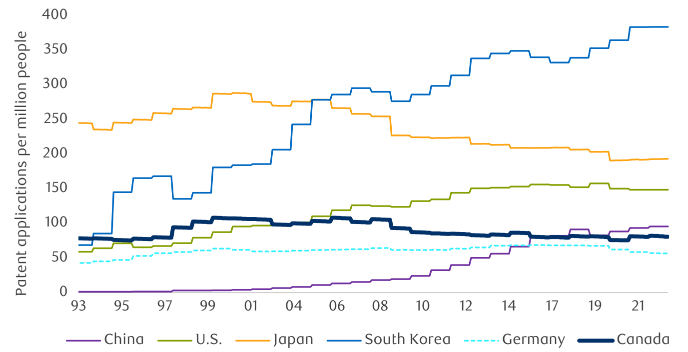
Another explanation for the loonie's recent weakness and the country's ailing per-capita GDP is the reluctance of companies to invest in growth opportunities. Canada lags in key areas of investment, including spending on research and development and creation of intellectual property. Adjusted for population, patent registrations have lagged those in the U.S., China, South Korea and Japan for many years (Exhibit 20), contributing to the country's low productivity.

Canadian companies have shown a reluctance to make capital investments. This is understandable for the oil patch, where politics make the prospects uncertain, but it extends to the large percentage of Canadian firms that are choosing more and more to make capital expenditures outside the country rather than within it (Exhibit 21). Outbound foreign direct investment (FDI) was less of a concern in recent years because Canada's trade deficit was contained during the pandemic. But the current-account balance has again fallen into deficit now that Canadians are travelling abroad and snowbirds are back to wintering in Florida. These steady outflows – both from FDI and from the current account – impose continuous downward pressure on the Canadian dollar.

In the meantime, investors are focused on several shorter-term themes. Canada's sensitivity to slowing U.S. economic growth is one. A U.S. slowdown could cause the Canadian dollar to weaken toward C$1.40 per U.S. dollar, while risks of a bigger economic downturn keep foreign-exchange traders anxious about a more meaningful sell-off in the loonie. The relative stance of central banks is another concern. We suspect that the Bank of Canada is more eager to cut policy rates than the Fed given the country's slower economic growth, higher household debt and greater sensitivity to mortgage resets.

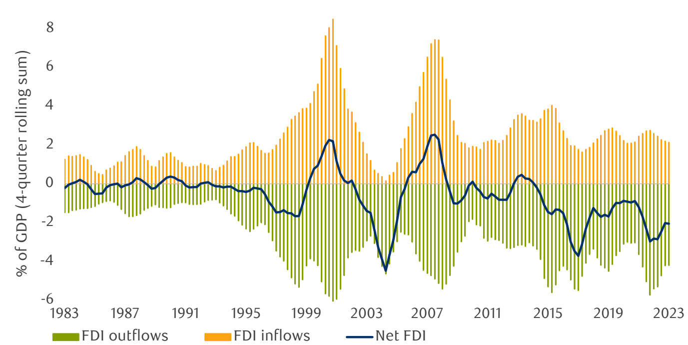
We expect that these short-term factors may weigh on the loonie for a time – not enough to see it weaken beyond its well-established C$1.32-C$1.40 range, but enough for it to underperform the euro. Over the longer term, we expect the Canadian dollar to perform better against the U.S. dollar than its other developed-market currencies as it appreciates to C$1.27 per U.S. dollar over the next 12 months.

## Exhibit 20: Canada lags peers in innovation




Note: As at December 31, 2022. Source: Macrobond, RBC GAM

## Exhibit 21: Foreign direct investment




Note: As at December 31, 2023. Source: Statistics Canada, RBC GAM

# Regional outlook – United States

**Brad Willock, CFA**
Managing Director & Senior Portfolio Manager
RBC Global Asset Management Inc.

U.S. stocks, measured by the S&P 500 Index, rose to all-time highs during the three months ended February 29, 2024, climbing 12.0% for the period on better-than-expected economic growth, continued resilience in employment and solid earnings. Growth-oriented sectors led the way, with Communication Services and Information Technology out front, followed by Industrials, Health Care and Financials. Most defensive sectors continued to lag, including utility companies and sellers of consumer staples. The stock market's surge reflects the fact that an economic soft landing has become the consensus view and that excitement over artificial intelligence (AI) is gaining strength. With the S&P 500 trading over 5000, up roughly 24% from October, investors are beginning to question whether the current AI-fueled rally has gone too far. Many investors are drawing comparisons with the epic melt-up in dot-com stocks in the late 1990s and labeling current market levels a bubble. The performance of stocks over the next year will likely hinge on whether the AI optimism is well-founded.

To determine whether stocks are vulnerable, we came up with a checklist of developments that tend to presage a stock-market bubble. First, is there something to get excited about? Yes, there is. Historically, bubbles have been driven by innovations that are clearly consequential, but whose future value is impossible to ascertain. Generative AI certainly fits this description, and its potential to dramatically improve productivity is driving enormous investment in the infrastructure required to exploit the new technology. In this first stage of adoption, the biggest beneficiaries are manufacturers of advanced semiconductors and suppliers of cloud-computing services. For example, Nvidia, the No. 1 semiconductor maker for chips used in AI, reported earnings of US$12.3 billion in its most recent quarter – up more than eightfold from the year-earlier period. This is completely different from what happened in the dot.com bubble, when many highly touted companies had little or no revenue or earnings.

Another necessary condition for a bubble is easy access to capital. The premise is that cheap capital is necessary to fund the buildout of a new industry or technology. In the late 1990s, the dot.com bubble was financed primarily by a wide-open IPO market. In 1999, 560 companies went public - compared with 154 in 2023. In 1999, investor excitement helped fund the buildout of the internet, but the vast majority of the investments failed. Today, the buildout of AI infrastructure is being led by a handful of massively profitable companies (Amazon, Microsoft, Google, Meta Platforms and Nvidia), while others are financed in part by sovereign-wealth funds. The companies are adding AI features and services to their existing businesses. It is clear that today's boom is taking shape under a very different set of circumstances than did the boom of 1999.

## United States – Recommended sector weights

| | S&P 500 | Underweight / Overweight |
|---|---|---|
| Energy | 3.8% | 0.2% |
| Materials | 2.4% | -0.9% |
| Industrials | 8.7% | 1.0% |
| Consumer discretionary | 10.3% | -0.3% |
| Consumer staples | 6.0% | -1.0% |
| Health care | 12.6% | 0.9% |
| Financials | 13.0% | -0.0% |
| Information technology | 29.8% | 1.2% |
| Communication services | 8.8% | 0.4% |
| Utilities | 2.2% | -0.7% |
| Real estate | 2.4% | -0.9% |

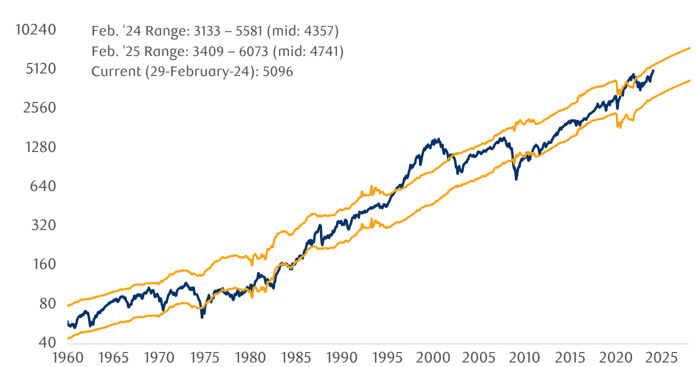
-1.5% -1.0% -0.5% 0.0% 0.5% 1.0% 1.5%

Underweight Overweight

Note: As of february 29, 2024. Source: RBC GAM

> "Over half of S&P 500 companies reported an increase in profit margins, and earnings growth outpaced revenue growth for the second straight quarter."

## S&P 500 Equilibrium
Normalized earnings and valuations




Source: RBC GAM

Another way to judge whether there is a bubble is to evaluate investor behaviour. First, are investors using excessive leverage in financial markets? There is little evidence that this is the case, and recently margin debt on the New York Stock Exchange has fallen significantly to an 18-year low. Second, we can look at technical patterns to see how fast share prices are advancing, under the presumption that the steeper the advance the more likely it is to be a bubble in the making. On that basis, today's rally pales in comparison with the one in 1999. Third, an expensive market can also be a tell as to whether there is a bubble. Today's market is expensive, trading at about 20.5 times earnings over the next 12 months but is not as expensive as it was in 1999, when the multiple was 26. Compared to bonds, stocks are expensive, but also not as expensive as they were in 1999. The bottom line is that stocks are expensive but probably not in a bubble. The rally could continue, particularly were inflation to fall quickly and the U.S. Federal Reserve to cut interest rates in an environment where economic growth is sustained.

Finally, let's consider the outlook for corporate earnings. While changes in valuations can make the prices of stocks and markets gyrate over the short term, earnings will dictate the direction over the long term. Earnings per share for the S&P 500 increased 2% in 2023 (6% excluding Energy) on revenue growth of 4.5%. In the fourth quarter, earnings per share accelerated to 6% (11% excluding Energy) on revenue growth of 5.5%. Analysts anticipate earnings-per-share growth of 8.5% next year, a plausible outcome given what we've seen over the past two quarters and what likely lies ahead. Inventories have risen to levels more in line with history, input costs have fallen significantly, and labour costs are no longer growing faster than revenues. Of note, over half of S&P 500 companies reported an increase in profit margins, and earnings growth outpaced revenue growth for the second straight quarter.

As has been the case all year, the performance of the index has been driven by its seven largest members, the so-called "Magnificent 7." This group, which comprises Microsoft, Apple and Nvidia in the Information Technology sector; Google and Meta Platforms in Communication Services; and Amazon and Tesla in Consumer Discretionary, now comprises almost 30% of the market capitalization of the S&P 500. The group's collective market value has increased 82% over the past year and the stocks trade at about 28 times forward earnings. Meanwhile, the remaining 493 stocks in the S&P 500 as a group have gained 17% and trade at roughly 18 times earnings. Analysts have high expectations for five-year growth of revenue (13%), earnings (17%) and free cash flow (22%) for the Magnificent 7. The bar is high, but over the past 70 years just over 100 large-cap stocks have managed to produce results similar to what is expected of the Magnificent 7. We favour allocating incremental capital to members of the S&P 500 other than the Magnificent 7 given the increased odds of a soft landing for the economy. We have rebalanced our portfolios, adding to the Financials, Real Estate and Energy sectors.

# Regional outlook – Canada


**Sarah Neilson, CFA**
Managing Director &
Senior Portfolio Manager
RBC Global Asset Management Inc.

**Irene Fernando, CFA**
Managing Director &
Senior Portfolio Manager
RBC Global Asset Management Inc.


Canada's stock benchmark, the S&P/TSX Composite Index, gained 6.4% on a total-return basis over the three months ended February 29, 2024. The S&P/TSX lagged the S&P 500 Index, which advanced 12.0%, and the MSCI World Index, which gained 10.7%.

The stock market's performance was supported by a decline in long-term interest rates, resilient economic data and expectations that corporate-earnings growth will regain momentum as the probability of a deep recession has receded. The performance of Canadian stocks continues to lag U.S. equity benchmarks, which have been supported by technology exposed to artificial intelligence and its potential to offer gains in both earnings growth and productivity. For 2023 as a whole, the S&P/TSX returned 11.8%, though it lagged most of its global peers. Many global equity markets recently reached all-time highs, but the S&P/TSX remains 3.3 percentage points shy of its peak in March 2022, when oil prices were closer to US$120 per barrel than today's US$78.

The timing of policy-rate reductions is of great importance to investors. Central banks are likely to reduce the short-term interest rates they control when monetary tightening is judged to have slowed the economy sufficiently to rein in the uncomfortable rise in prices over the past two years. Consumer inflation has dropped to 3.2% in January of this year from 3.4% in December 2023, but still above the Bank of Canada's (BOC) 2% target. Shelter costs, reflected in rising mortgage payments and rents, remain the biggest contributor to Canadian inflation, but slowing wage growth will also be needed before the central bank can be confident that the economy is cooling. That was not the case in January, when the unemployment rate stayed steady at 5.7% and wages rose 5% from a year earlier. With these issues in mind, the BOC earlier this month held its benchmark rate at 5%.

That said, Canada's economy is clearly losing steam, and many economists are expecting a more significant downturn in the second half of this year. Consumer spending has slowed, and rising interest costs on housing and personal debt continue to bite into disposable income. Consensus growth forecasts reflect the impact of tighter financial conditions, with Canada's GDP expected to expand 0.6% in 2024 and then grow 1.7% in 2025. The BOC has lowered its forecast for 2024 GDP growth to 0.8% from 0.9%, pointing to lower household spending and business investment. Equity markets, however, have begun to look past the economic softness and reflect an improving earnings growth outlook on expectations that economic growth will slow sufficiently for central banks to begin relaxing monetary policy sometime later this year.

The Industrials sector led the S&P/TSX to start this year, as economic resilience improved the growth outlook. The Consumer Staples sector had solid results, led by Loblaw and Couche-Tard. The interest-rate-sensitive Utilities and

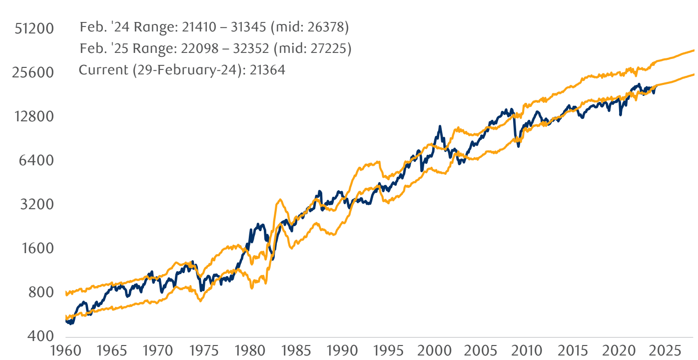
## Canada – Recommended sector weights

| | S&P/TSX Composite | Underweight / Overweight |
|---|---|---|
| Energy | 17.6% | -0.1% |
| Materials | 10.6% | -0.6% |
| Industrials | 14.4% | 1.1% |
| Consumer discretionary | 3.6% | -0.1% |
| Consumer staples | 4.3% | 0.5% |
| Health care | 0.3% | -0.3% |
| Financials | 31.0% | 0.2% |
| Information technology | 8.7% | 0.5% |
| Communication services | 3.4% | -0.4% |
| Utilities | 3.8% | -0.6% |
| Real estate | 2.3% | -0.3% |

Note: As of February 29, 2024. Source: RBC GAM

> “The six major banks currently trade as a group at 10.5 times forward earnings, representing a 5-percentage-point discount to the historical average. ”

### S&P/TSX Composite Equilibrium
Normalized earnings and valuations




Source: RBC GAM

Communications Services sectors underperformed as long-term interest rates recently moved higher. The Materials sector was the biggest drag over the three months. Gold prices were flat, however, as higher costs and execution concerns weighed on gold-miner returns and equity performance.

Aggregate S&P/TSX earnings declined 8.8% in 2023 from the previous year due in large part to falling commodity prices. Forward-looking equity markets rose in anticipation of rebounding earnings growth in 2024 and 2025. The consensus is for 6% earnings growth in 2024, driven by the Financials, Energy and Materials sectors, which in our view may be somewhat optimistic. The S&P/TSX trades at 14.3 times forward earnings, in line with its long-term average but below the comparable valuation for the S&P 500 – one of the widest spreads ever given the impact of technology on the U.S. benchmark.

Canadian bank stocks continue to reflect concerns about the impact of a slowing economy, underperforming the S&P/TSX by 4 percentage points since the beginning of the year. The current financial backdrop continues to be marked by reduced demand from borrowers, higher costs to fund loans and rising provisions for credit losses. These pressures, combined with higher capital requirements, pressured the group's returns on equity to below medium-term targets. Bank executives said at the end of February that they do not expect the growth outlook to improve meaningfully in the near term. The consensus estimate is for a 1% decline in bank earnings for the fiscal year ending October 2024, followed by an 8% increase the following year. The six major banks currently trade as a group at 10.5 times forward earnings, representing a 5-percentage-point discount to the historical average. Bank valuations have improved lately, driven primarily by a lowered earnings outlook.

Canadian consumers have pared discretionary spending in the face of affordability challenges. Banks are seeing an increase in mortgage delinquencies, though not alarming given that the levels are near those before the pandemic. Mortgages originated at low rates in the 2020-2021 timeframe will be coming up for renewal in the next two years. We believe that homeowners will be able to handle the increasingly higher mortgage payments without denting the broader economy too much.

Banks have been focused on complying with higher capital requirements, and we currently feel comfortable with their capital positions. Moreover, banks are communicating that a softer regulatory stance is in the offing. For example, three banks recently ended dividend-reinvestment incentives that had enabled the banks to better manage capital, signaling confidence in current capital levels.

While an economic soft landing has become a consensus call, we are still cautious on the sector in the near term and would like to see analysts start taking a more positive view of bank earnings before becoming more optimistic.

Stocks in Canada's Energy sector were little changed over the three-month period, with supply and demand for crude oil generally balanced. The price of crude oil slowly recovered from its US$70 low in early December to about US$78 today. Energy producers generate ample free cash flow with prices above US$75 per barrel, supporting shareholder returns through dividends and share buybacks. Natural-gas production climbed in North America while warm weather reduced demand, pushing prices down 20% to start the year. In response, some producers are cutting production and exploration, which should support prices from falling further until later in the year when large facilities for exporting liquified natural gas come online.

# Regional outlook – Europe

**Elma de Kuiper**
Portfolio Manager
RBC Global Asset Management (UK) Limited

Europe's equity-market index performed well during the three months ended February 29, 2024, staging a recovery from the previous quarter, after comments from central bankers suggested that interest rates have peaked and may be coming down sometime this year. The themes on investors' minds in 2023 were weight-loss drugs, stock buybacks, value stocks, banks and technology. In the UK, banks outperformed for a third consecutive year while mid-cap stocks continued to lag.

Stocks that are sensitive to the pace of economic growth outperformed in the year-end rally. Technology rebounded strongly but luxury lagged. Stocks that underperformed the most in Europe were those most exposed to China, one of the key reasons for the luxury-company weakness. Since the end of June, luxury stocks have underperformed the MSCI Europe Index by about 20%, and valuations, while elevated, are starting to look more reasonable. We note that stocks in Europe with dependable growth and strong balance sheets (stocks exhibiting growth and quality) are outperforming stocks that are considered undervalued by traditional market measures (value stocks).

Macroeconomic signals in Europe have been poor for a few quarters, but it appears that the outlook may be starting to brighten. While economic growth did slow in 2023, we did not experience a recession thanks in large part to resilient consumption. Shoppers did not pull back as much as might be expected in the face of rising goods prices and interest rates.

Meanwhile, eurozone purchasing managers' indexes have arrested their decline, and the EU's manufacturing PMI actually posted a small improvement in January led higher by rising new orders. The reading had been depressed for the past 18 months by post-pandemic supply-chain disruptions that now seem to be clearing. European economic data has come in below expectations since May 2023, but the trend is improving. The expectation for 2024 is for real GDP growth to be a relatively low 0.5%, followed by a more robust expansion in 2025.

One very positive development for financial markets is that inflation has decreased significantly. CPI in the eurozone, at 2.9%, is nearing central-bank targets, while inflation excluding food and energy, still a bit more elevated at 3.4%, is way down from last year. The reduction in inflation gives European central banks some room to cut policy rates, especially if unemployment were to increase or growth started to rapidly slow, neither of which is currently expected.

Europe's equity-market rally at the end of last year signalled that investors expect the European Central Bank to start cutting policy rates in early 2024. The path that rates take is, however, unpredictable, and it could be that investors have been too early in pricing in rate cuts. Regardless, given that inflation is much lower than this time last year, there is more scope now for monetary policy to be loosened if a deep recession or stagflation were to threaten.

## Europe – Recommended sector weights

| | MSCI Europe | Recommended weight |
|---|---|---|
| Energy | 5.2% | -0.2% |
| Materials | 6.8% | -0.6% |
| Industrials | 16.3% | 1.0% |
| Consumer discretionary | 11.2% | 0.3% |
| Consumer staples | 10.9% | -0.6% |
| Health care | 15.8% | 0.7% |
| Financials | 18.0% | 0.5% |
| Information technology | 8.2% | 0.8% |
| Communication services | 3.0% | -0.5% |
| Utilities | 3.8% | -1.1% |
| Real estate | 0.8% | -0.3% |

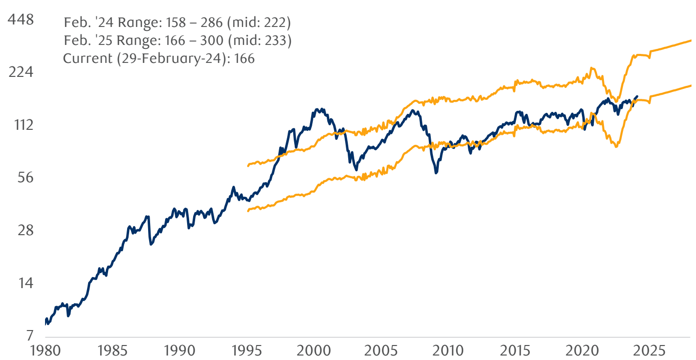
-1.5% -1.0% -0.5% 0.0% 0.5% 1.0% 1.5%

Underweight | Overweight

Note: As of February 29, 2024. Source: RBC GAM

> "A balanced portfolio is the most appropriate stance in the coming quarter, while we await more data to confirm the early signs of a positive trend."

### MSCI Europe Index Equilibrium
Normalized earnings and valuations




Source: RBC GAM

Earnings estimates peaked in September 2022, and the 2024 consensus has fallen by 9% in euro terms since then. The consensus expectation is now for 5.4% earnings growth for Europe in 2024, which is consistent with an economic soft landing. The key question is whether the 14% decline in earnings reported by European companies in the third quarter of 2023 – the worst drop in three years – marked the bottom. Barring big surprises, our view that it is reasonable to assume that we should see some improvement from this point.

We pointed out in previous quarters that profit margins are historically wide, with European margins a full 2 percentage points higher than pre-pandemic (10.5% versus 8.5%). European equities carry an earnings yield of 8%, well above the long-term average and four times the 2% nominal yield on the German 10-year bond. In addition, European investors benefit from a combined dividend and buyback yield of almost 6%, which is close to the highs of late 2022. European stock valuations are 33% below those in the U.S. based on forward P/E ratios, a historic discount, and compare with a figure of 20% before the pandemic.

Attractive relative valuations have been a thing in Europe for some time and so are not sufficient in themselves for us to advocate being overweight the region. However, today's investment environment is arguably quite different. Earnings expectations are reasonable and macroeconomic signals seem to be, if not improving, at least not worsening. There appears to be limited potential that corporate profitability and economic growth will worsen too much, and balance sheets are still well capitalized. Against this backdrop, even relatively small improvements in the macroeconomic data could suggest healthy gains in European equities.

We highlight, however, that there are risks around lingering inflation and the cost-of-living crisis, as well as ever-present geopolitical risks. For this reason, it is inappropriate to be too cyclically or defensively positioned. A balanced portfolio is the most appropriate stance in the coming quarter, while we await more data to confirm the early signs of a positive trend.

# Regional outlook – Asia

**Chris Lai**
Portfolio Manager
RBC Global Asset Management (Asia) Limited

Asian equities rose in the three months ended February 29, 2024, given a solid global economic backdrop, as the U.S. appeared to have avoided a recession and inflation extended its retreat from uncomfortably high levels. The region's outperformers over the past three months included Japan, which benefited from wage increases and corporate-governance reforms, and India, after the results of state elections indicated widespread support for the pro-business approach of Prime Minister Modi. Taiwan's stock market was driven primarily by the performance of Taiwan Semiconductor, whose sales have been supercharged by advances in artificial intelligence, and the Philippines, whose economy was led by a recovery in investment and exports.

Notable underperformers included the stock markets of Hong Kong and China, where the economy remains sluggish amid weak household and business confidence. Thailand, which relies on tourism for about 20% of GDP, was hurt by weaker-than-expected tourist arrivals. The best-performing sectors in Asia were Information Technology, Energy and Industrials, while Communication Services and Materials underperformed the benchmark.

### Japan

Japan's GDP growth is forecast to slow in 2024 to 0.9% from 2.0% in 2023 but remains healthy given the economy's anemic performance in recent decades. Domestic demand is expected to hold up while export strength will depend on the state of the global economy and the value of the Japanese yen, whose weakness is beneficial for exports. The key to Japan's expansion this year will be the impact of higher wages on personal consumption and inflation. Wage increases are in our view likely to exceed inflation in the second half of 2024, spurring a recovery in personal consumption that will be helped by income-tax cuts included in the government's economic package.

With inflation near 2% after more than two decades of deflationary pressures, economic conditions are in place for the Bank of Japan (BOJ) to lift interest rates above zero sometime in early 2024, ending its strict policy of suppressing interest rates. Such a step would signal to investors that deflation is a thing of the past.

### Rest of Asia

An economic recovery in China and Hong Kong will require pick-ups in technology, advanced manufacturing and infrastructure construction to make up for the drag being exerted by real estate, whose contribution to China's GDP, according to research by Bloomberg, fell to 19.4% in 2023 from 24.2% in 2018. Any improvement in economic growth will hinge on sustained domestic and export demand and may require a further boost from monetary easing and/or fiscal stimulus in the form of higher government spending.

## Asia – Recommended sector weights

| Sector | MSCI Pacific | Recommended weight |
|---|---|---|
| Energy | 3.0% | 0.0% |
| Materials | 6.5% | -1.0% |
| Industrials | 12.5% | 0.5% |
| Consumer discretionary | 14.7% | 0.3% |
| Consumer staples | 4.7% | -0.4% |
| Health care | 6.0% | 0.0% |
| Financials | 19.7% | 0.1% |
| Information technology | 20.2% | 1.0% |
| Communication services | 7.6% | -0.1% |
| Utilities | 2.1% | -0.4% |
| Real estate | 3.1% | -0.1% |

-1.2% -0.8% -0.4% 0.0% 0.4% 0.8% 1.2%

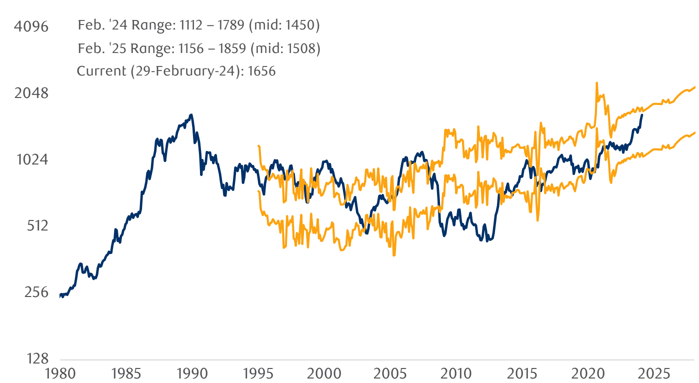
Underweight | Overweight

Note: As of February 29, 2024. Source: RBC GAM

> "The key to Japan's expansion this year will be the impact of higher wages on personal consumption and inflation."

### MSCI Japan Index Equilibrium

Normalized earnings and valuations




Source: RBC GAM

The Chinese government has set what we consider to be an ambitious 2024 growth target of about 5.0%. Achieving this goal will likely require the People's Bank of China (PBOC) to keep monetary policy accommodative through reductions in policy rates and banks' reserve requirements, and the government to cushion the fall in property investment, which will involve bolstering affordable housing and urban redevelopment. Recent measures have included lowering mortgage rates and lifting home-purchase curbs in cities that are not among the country's very biggest. The Chinese government has also tried to stimulate consumption through tax subsidies that encourage spending on electric vehicles, home renovations and domestic travel.

We expect GDP growth in India to remain strong at 6.2% in 2024, down from 7% in 2023. India remains one of the faster-growing economies in Asia, led by infrastructure spending and other fiscal stimulus, as well as increased manufacturing and construction. A macroeconomic environment of resilient growth and steady inflation may be setting the stage for the Reserve Bank of India to gradually trim rates. General elections are likely to be held in a few months, and opinion polls suggest that Modi's coalition will win a majority.

Higher interest rates have slowed Australia's economy more than expected, and we have therefore lowered our 2024 GDP growth forecast to 1.1% from 1.4%. Real economic growth should bottom out in mid-2024, and we anticipate that household consumption will pick up in the second half of 2024 as slowing inflation enables the Reserve Bank of Australia (RBA) to halt interest-rate increases and as tax cuts boost disposable income. That said, services inflation in Australia exceeds 4% and is among the highest in Western nations given elevated labour costs and manufacturing limitations. We forecast that inflation will remain above the RBA's 2%-3% target band in 2024, meaning the central bank will probably lag its peers in rolling back policy rates.

South Korea's GDP is forecast to quicken this year to 2.0% from 1.4% in 2023, led by strong semiconductor demand. However, strong manufacturing and exports are being offset by weak domestic demand. We expect inflation to fall to 2% in 2024 from 4% last year, providing cover for the Bank of Korea to begin lowering interest rates sometime this year.

# Regional outlook – Emerging markets

**Veronique Erb**
Portfolio Manager
RBC Global Asset Management (UK) Limited

Last year was a historic period for emerging-market fixed income: interest rates set by central banks were for the first time on a par with those in developed markets. The convergence resulted largely from decisions by emerging-market central bankers to eschew less aggressive fiscal and monetary expansion during the pandemic, which held inflation low relative to developed markets.

This convergence in interest rates – which meant that emerging-market rates were falling – might suggest that emerging-market equities would have outperformed given an improving economic-growth outlook. That was not the case, as emerging-market stocks at the benchmark level were held back in 2023 by the disproportionately large impact of China. Outside China, emerging-market equities performed well, with Brazil, Taiwan, South Korea, Mexico and India all returning more than 20%. For the first time in two decades, emerging-market benchmark stock and bond indexes did not move in lockstep.

The question is whether equities in emerging markets will catch up to bonds this year. Our view is that emerging-market central banks have room to continue easing this year, and that most emerging-market central bankers outside China will lean toward lowering rates, which will tend to support equities.

The intensifying threat of deflation in China, weak GDP growth and subdued lending have hurt the country's property sales, even with modest economy-bolstering measures. A key question we ask ourselves is: what might trigger a more aggressive response to the incremental easing that we have seen to date? We believe that it will become increasingly clear to China's leadership within the next two months that a more aggressive response is required.

Other risks in China are both demographic and debt-related. The aggregate emerging-market population declined last year for the first time in 60 years, and the working-age population has been coming down since peaking in 2012. On the debt side, non-performing loans have soared into the trillions of renminbi as state-controlled companies and consumer borrowers fall behind on their debt.

Meanwhile, many western investors are opting to leave China, as foreign direct investment is falling for the first time since 1998 amid overcapacity in most sectors and a Sino-U.S. trade war. At the same time, an increasing number of Chinese companies are setting up overseas, with Chinese outward direct investment increasing 35% year over year to a seven-year high of US$53.4 billion in the third quarter of 2023. Investments have been mainly flowing from Chinese businesses into the 10 countries that make up the Association of Southeast Asian Nations, as well to India and Bangladesh.

Against this backdrop, China's trade surplus has surged, driven primarily by China's growing exports to other emerging markets. The country's annualized trade surplus rose as high as US$910 billion in April 2023 from US$361 billion in March 2020. Simultaneously, the renminbi has emerged as the fourth most-active currency for global payments after the U.S. dollar, the euro and the British pound, accounting for 4.6% of all foreign transactions in November of last year.

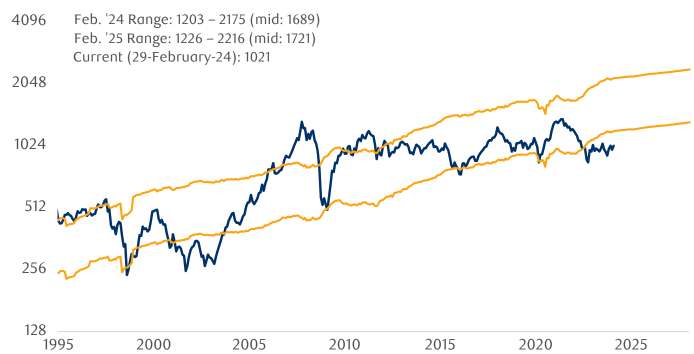
China is making inroads in its effort to bring more countries within its sphere of economic influence. Saudi Arabia, the world's largest oil exporter, and the United Arab Emirates, where Dubai is located, have joined the emerging-market bloc that includes China, India, Russia, Brazil and South Africa (BRICS), and the bloc has expressed its desire to create a system to settle payments between member countries.

Even so, the deterioration in China's economy has affected its importance in the benchmark emerging-market equity index and raises questions about China's ability to maintain its dominant position. China's weight in the MSCI Emerging Markets Index has dropped to 26% today from 44% in October 2020. At the same time, India's weight is now 18%, up from 9%; Latin America accounts for 9%; and Saudi Arabia, Qatar, the United Arab Emirates and Kuwait collectively contribute 7%.

India is set to become the world's third-largest economy by 2026 and the third-largest stock market by 2030. The government of Indian Prime Minister Narendra Modi has laid out a road map for expanding the economy to US$5 trillion by 2026, which would enable India to overtake Japan and Germany and leave it behind only the U.S. and China. India's capital markets are expanding as well, driven by a spate of IPOs and a steady stream of private companies that will at some point be ready for the public equity markets.

One significant development in India over past decade has been an explosion in the number of people with sufficient

**MSCI Emerging Markets Index Equilibrium**
Normalized earnings and valuations




Source: RBC GAM

financial resources to open bank accounts and invest. Assets under management in mutual funds have risen fivefold since 2018 – more than double the growth in bank deposits - and the number of individuals holding mutual funds has risen to 140 million. Systematic investment plans have driven much of the growth in household savings, especially for affluent savers.

The importance of countries beyond China to both the world economy and the emerging-market equity benchmark is becoming clearer. Recent gains from oil producers in the Middle East and exporters in Southeast Asia will be bolstered by Vietnam and other Latin countries. Saudi Arabia, for example, is poised to double its weight in the emerging-market benchmark to 9% by 2027, as foreign ownership limits are removed and the number of IPOs increases.

We feel, therefore, that there are enough supportive factors for emerging-market stocks to maintain performance as China's influence on the index recedes.

# RBC GAM Investment Strategy Committee

## Members

**Daniel E. Chornous, CFA**
Chief Investment Officer
RBC Global Asset Management Inc.
Chair, RBC GAM Investment Strategy Committee

Dan Chornous is Chief Investment Officer of RBC Global Asset Management Inc. (RBC GAM), the Royal Bank of Canada's wholly-owned investment management subsidiary. The firm manages assets nearing (CAD) $599.3 billion for institutional, high net worth and individual investors in fixed income, equity and alternative mandates in Canada and around the world. Since joining RBC GAM in November 2002, Dan has been responsible for the overall direction of investment policy and asset management across the firm's global investment platform. Prior to that, Dan was Managing Director, Capital Markets Research and Chief Strategist at RBC Capital Markets.

Dan joined the RBC Global Asset Management board immediately upon his arrival at the firm. In December 2010, Dan joined the board of BlueBay Asset Management following its merger with RBC GAM. He also sits on the board of RBC Global Asset Management (UK) Ltd., is a member of the RBC Pension Investment Strategy Committee and chairs the RBC GAM Investment Strategy Committee (RISC) among others. For many years, Dan has been active in the Canadian investment community. He served on the board of the Canadian Coalition for Good Governance from 2008 to 2020 and as its chair from 2012 to 2016. In addition, he is a member of CFA Society Toronto Advisory Council, a past member of the Toronto United Way major giving cabinet, a former Director of the Toronto Society of Financial Analysts and of the Winnipeg Society of Financial Analysts.

Dan is a graduate of the University of Manitoba (B. Comm, Honours, 1980) and is a member of The Associates, Asper School of Business. In 1985, Dan was awarded the Chartered Financial Analyst designation.

*AUM in CAD as of February 29, 2024

**Soo Boo Cheah, MBA, CFA**
Managing Director &
Senior Portfolio Manager
RBC Global Asset Management (UK) Limited

Based in the U.K., Soo Boo is responsible for managing global fixed-income allocations. He specializes in assessing the impact of central bank policies and global macroeconomic trends on developed-market bonds. In his role as a senior portfolio manager, he integrates a wide range of investment strategies involving interest rates, currencies, and derivatives. Soo Boo started his career in the investment industry in 2000 and holds an MBA from University of New Brunswick. Soo Boo has been a CFA charterholder since 2002.

**Dagmara Fijalkowski, MBA, CFA**
Managing Director &
Head of Global Fixed Income & Currencies
RBC Global Asset Management Inc.

As Head of Global Fixed Income and Currencies, Dagmara leads a team of 40+ investment professionals in Toronto, London and Minneapolis with almost $100 billion in assets under management. In her duties as a portfolio manager, Dagmara leads management of several bond funds, including the RBC Bond Fund, and manages foreign-exchange hedging and active overlay programs. She leads the Fixed Income Strategy Committee, which determines appropriate levels of risk taking given market opportunities. Dagmara is a member of the RBC Investment Policy Committee, which determines the asset mix for balanced products; and the RBC Investment Strategy Committee. In 2016, she was appointed to the RBC GAM Executive Committee. Dagmara, who began her investment career in 1994, holds an MBA from the Richard Ivey School of Business at the Western University in Canada and a Master's degree in economics from the University of Lodz in Poland. Dagmara has been a CFA charterholder since 1997.

**Stuart Kedwell, CFA**
Managing Director &
Senior Portfolio Manager
RBC Global Asset Management Inc.

Stu co-leads the North American Equity team and is a member of the RBC GAM Investment Strategy Committee, which is responsible for establishing the firm-wide global asset mix for mutual funds and for institutional and high net worth private clients. Stu began his career in 1996 with RBC Dominion Securities in the firm's Generalist program, a two-year internship in which participants rotate through different areas of the firm. In 1998, he joined the RBC Investments Portfolio Advisory Group, which provides investment ideas and recommendations to RBC DS Investment Advisors. He was also a member of the RBC DS strategy & focus list committees. Stu has been with the firm since 2002 and is a CFA charterholder.

**Eric Lascelles**
Managing Director &
Chief Economist
RBC Global Asset Management Inc.

Eric is the Chief Economist for RBC Global Asset Management Inc. (RBC GAM) and is responsible for maintaining the firm's global economic forecast and generating macroeconomic research. He is also a member of the RBC GAM Investment Strategy Committee, the group responsible for the firm's global asset-mix recommendations. Eric is a frequent media commentator and makes regular presentations both within and outside RBC GAM. Prior to joining RBC GAM in 2011, Eric led a team of economists and fixed income strategists at another large Canadian financial institution. He began his career as a research economist for a federal government agency.

**Scott Lysakowski, CFA**
Managing Director & Senior Portfolio Manager
Head of Canadian Equities (Vancouver)
RBC Global Asset Management Inc.

Scott is Head of the Vancouver-based Canadian Equity Team. He is primarily responsible for overseeing equity research and portfolio management of the firm's core Canadian equity strategies. Scott also serves as lead manager for the Canadian income strategies. Scott began his investment management career with the firm in 2002 as a senior research analyst and portfolio manager within the Toronto-based Canadian Equity Team. He transitioned to the Vancouver team seven years later and assumed his current leadership role in 2012. During his tenure with the organization, he has conducted research for and managed a broad spectrum of Canadian equity portfolios, specializing in dividend and income mandates.

**Hanif Mamdani**
Managing Director &
Head of Alternative Investments
RBC Global Asset Management Inc.

Hanif Mamdani is Head of both Corporate Bond Investments and Alternative Investments. He is responsible for the portfolio strategy and trading execution of all investment-grade and high-yield corporate bonds. Hanif is Lead Manager of the PH&N High Yield Bond and Alternative strategies, including a multi-strategy hedge fund. He is also a member of the Asset Mix Committee. Prior to joining the firm in 1998, he spent 10 years in New York with two global investment banks working in a variety of roles in Corporate Finance, Capital Markets and Proprietary Trading. Hanif holds a master's degree from Harvard University and a bachelor's degree from the California Institute of Technology.

**Bryan Mascoe, CFA**
Managing Director & Senior Portfolio Manager
Co-head, Fixed Income (Vancouver)
RBC Global Asset Management Inc.

Bryan is co-Head and a senior portfolio manager on the PH&N Fixed Income Team. He co-manages the investment-grade credit research effort. As part of this role, he manages our dedicated corporate bond portfolios and is responsible for performing credit analysis on investment-grade issuers. He also assists with the strategy and trade execution of corporate bonds held in broader short, universe, and long fixed-income mandates. Bryan has a Bachelor of Commerce degree from the University of British Columbia and is a Leslie Wong Fellow as a graduate of the UBC Portfolio Management Foundation. He has been a CFA charterholder since 2005.

**Sarah Riopelle, CFA**
Managing Director & Senior Portfolio Manager
Investment Solutions
RBC Global Asset Management Inc.

Since 2009, Sarah has managed the entire suite of RBC Portfolio Solutions which totals $180 billion in assets. She is a member of the RBC GAM Investment Strategy Committee, which sets global strategy for the firm, and the RBC GAM Investment Policy Committee, which is responsible for the investment strategy and tactical asset allocation for RBC Funds' balanced products and portfolio solutions. In addition to her fund management role, she works closely with the firm's Chief Investment Officer, ensuring that all aspects of the investment management function at RBC GAM are running smoothly. She is co-chair of the RBC Wealth Management Diversity Leadership Committee – Canada, as well as a member of the Dean's Advisory Board for both the Telfer School of Management at the University of Ottawa and the Faculty of Management at Laurentian University.

Sarah joined RBC Global Asset Management in 2003 and held roles in Investment Strategy and Canadian Equities before assuming her current responsibilities in 2009. Prior to joining RBC GAM, Sarah worked at RBC Capital Markets in both the Quantitative Research and Investment Strategy groups. She began her career in the investment industry in 1996 after graduating from the University of Ottawa with a Bachelor of Commerce degree, majoring in Finance and International Management. She was awarded the Chartered Financial Analyst designation in 2001.

**Martin Paleczny, CFA**
Managing Director &
Senior Portfolio Manager
RBC Global Asset Management Inc.

Martin Paleczny, who has been in the investment industry since 1994, began his career at Royal Bank Investment Management, where he developed an expertise in derivatives management and created a policy and process for the products. He also specializes in technical analysis and uses this background to implement derivatives and hedging strategies for equity, fixed-income, currency and commodity-related funds. Since becoming a portfolio manager, Martin has focused on global allocation strategies for the full range of assets, with an emphasis on using futures, forwards and options. He serves as advisor for technical analysis to the RBC GAM Investment Strategy Committee.

**Kristian Sawkins, CFA**
Managing Director & Senior Portfolio Manager
Co-head, Fixed Income (Vancouver)
RBC Global Asset Management Inc.

Kristian is co-Head and a senior portfolio manager on the PH&N Fixed Income team, specializing in universe and short-term bond mandates. He is also a member of the PH&N IM Asset Mix Committee. Kristian joined Phillips, Hager & North Investment Management in 2002 as an associate analyst with the Canadian Equities Team and moved to the Fixed Income Team in 2005. Prior to joining the organization, Kristian spent three years at a major investment bank in New York across a few different roles. Kristian has a Bachelor of Commerce degree from the University of British Columbia and is a Leslie Wong Fellow as a graduate of the UBC Portfolio Management Foundation. He has been a CFA charterholder since 2002.

**Jaco Van der Walt, DCom**
Managing Director & Global Head of
Quantitative Research & Investments
RBC Global Asset Management Inc.

As Head of Quantitative Investments, Jaco leads an experienced team that is driven to continually innovate across all its capabilities, including research, portfolio management, data and systems to leverage the combination of human and machine in investment decision-making. He previously held an executive role at one of South Africa's largest financial services companies, leading the Investment Management Office, with experience spanning pensions, insurance, banking and wealth management. As asset owner, he also chaired the boards and investment committees of several of the company's pension plans, promoting investment excellence and driving transformational change to ensure members reach their retirement goals. Jaco began his investment career in 1996 and holds a Master's degree in Economics from the University of Toronto and a Doctorate from the University of Pretoria.

**Milos Vukovic, CFA**
Managing Director &
Head of Investment Policy
RBC Global Asset Management Inc.

Milos, who joined RBC in 2003, oversees investment-management activities including new-fund launches, performance analytics and trade-cost analysis. He is also responsible for developing and monitoring investment mandates and implementing tactical asset allocation for the RBC GAM investment solutions. Milos earlier worked for a Big 4 accounting firm and two top-tier securities firms. He earned an MBA at the Schulich School of Business and has held the CFA designation since 2004.

**Brad Willock, CFA**
Managing Director &
Senior Portfolio Manager
RBC Global Asset Management Inc.

Brad Willock joined RBC Global Asset Management in July 2002 and is a Senior Portfolio Manager and CFA charterholder. In his current role, Brad has responsibility for RBC Global Asset Management's core and income-oriented U.S. equity strategies. He joined RBC in May 1996 after receiving a bachelor's of commerce degree with distinction from the University of Calgary. Prior to that, Brad obtained a bachelor's of science degree at the University of British Columbia and represented Canada at the 1992 Barcelona Summer Olympics in volleyball.

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