GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

December 14, 2023

Thinking hard about a soft landing

Frédérique Carrier – London

Recession or soft landing? That's the big question. Proponents of both have evidence they think they can hang their hat on, but the debate won't be settled for months. Amid the uncertainty framing the investment picture, we explore how to position portfolios and what types of stocks investors should be on the lookout for.

The debate rages on

The question on everyone's mind is whether the U.S. economy will enjoy a soft landing in 2024 or succumb to a recession—with each piece of data dissected and interpreted according to market participants' biases. Such scrutiny stems from the U.S. Federal Reserve's reliance on "data dependency," which leaves markets at the mercy of each data release.

Take the recent data, for example. After U.S. nonfarm payrolls rose by 199,000 in November (consensus expectation: 185,000), most on the Street agreed that it suggests a very healthy labour market, and hence a strong economy with a soft landing in sight. Those concerned an economic contraction may be in the offing focused instead on average hourly earnings rising at an annual rate of four percent, a level inconsistent with the Fed's two percent inflation target. In this line of thinking, such high wage growth indicates interest rates will have to be maintained at current levels for longer, which may eventually propel the economy into recession.

In the feature article from our Global Insight 2024 Outlook, RBC Dominion Securities Inc. Investment Strategist Jim Allworth points out the debate will not be settled definitively for a while. In fact, it is the Business Cycle Dating Committee at the National Bureau of Economic Research which determines the official start date of any recession that arrives. And that announcement usually comes about a year after a recession has begun.

A useful framework

With economic data volatile—offering contradicting clues at best or being of poor quality at worst—using a framework to assess the macroeconomic backdrop can be a useful tool.

We are in the camp of those expecting a mild recession in the U.S. next year. The combination of high interest rates and restrictive bank lending standards that is in place today has historically resulted in recessions. Soft landings, on the other hand, have featured rising interest rates but no overt tightening of lending standards.

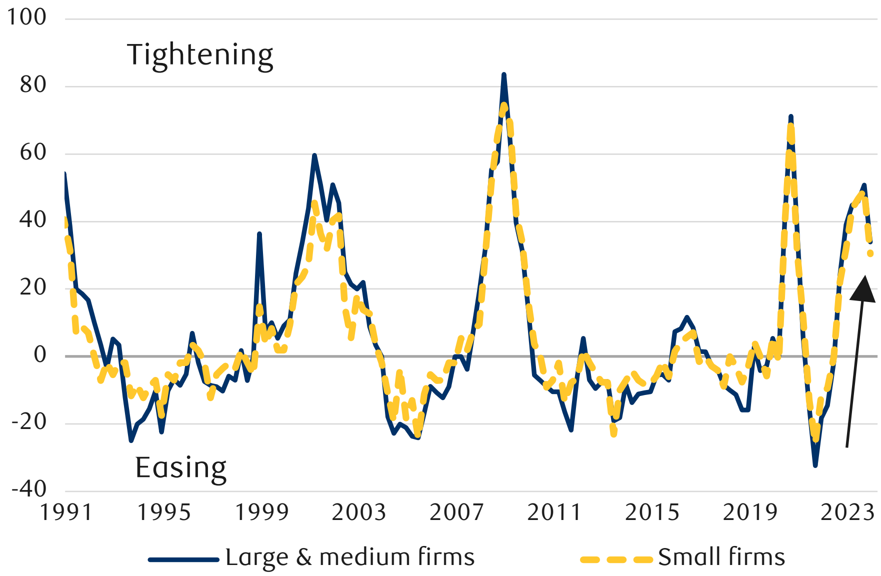
RBC Global Asset Management Inc. Chief Economist Eric Lascelles concurs, estimating the probability of a recession at 70 percent over the next 12 months.

Still, that leaves the probability of a soft landing at 30 percent, not an insignificant level. For our part, we

For perspectives on the week from our regional analysts, please see pages 3–4.

U.S. business lending standards have tightened

Net percent of banks tightening credit standards for commercial & industrial loans



Note: October 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices

Source - Federal Reserve Board, Macrobond, RBC Global Asset Management, RBC Wealth Management

acknowledge that shifts in monetary and fiscal policy over recent years could mean merely lower growth, as opposed to a recession.

So, it's worth looking at episodes of soft landings and observe how the S&P 500 reacted.

Soft influence

Since the mid-1950s, there have only been three soft landings, admittedly a small sample: in the 1960s, mid-1980s, and mid-1990s. In each of these episodes the S&P 500 performed very well, gaining on average more than 30 percent.

Paul Danis, head of asset allocation at RBC Brewin Dolphin, points out that specific or idiosyncratic circumstances contributed to each of these rallies. In the 1966 soft landing, the Fed loosened monetary policy very quickly, fuelling the rally. That resurgence proved short-lived, however, because the Fed was forced to resume its monetary policy tightening to rein in inflation which had flared up again, and the stock market duly corrected.

Heading into the 1984 episode, the real fed funds rate was over six percent. The steep decline, to one percent, was instrumental in driving robust equity returns.

The third soft landing occurred in the mid-1990s, a time of rapid globalization that both contained inflation and boosted profit margins. These factors fuelled the longest and strongest rally of all three.

Continuing to be constructive

To our mind, the recent rise in nonfarm payrolls suggests a lower chance of an imminent recession. This opens the road to new highs in equity markets, in our opinion. The S&P 500 has rallied 14 percent since the end of October as the Fed paused its rate hikes and the soft landing narrative gained traction. The rally suggests to us some discounting of the soft landing scenario, but we think stock markets may have more room to run.

It seems to us the U.S. economy is poised to start the new year on a strong enough footing to keep S&P 500 earnings growing, although probably not by as much as the current consensus estimate for 2024 ($245 per share, up 11.4 percent from 2023's expected $220) would suggest. In our opinion, any growth in earnings would leave room for share prices to advance between now and the end of 2024, even if the path for getting there remains in debate.

We continue to recommend a Market Weight position in global equities as well as U.S. equities. Our stance takes into account the wide range of possible outcomes for the U.S. economy: soft landing, average growth, mild recession, or otherwise.

We believe, however, that investors should consider limiting individual stock selections to high-quality businesses, or those they would be content holding through the economic cycle. This means companies with solid business models, quality management teams, robust cash flow generation, and strong balance sheets.

In our view, portfolios that have held their value to a better-than-average degree will be best-equipped to take advantage of the opportunities that are bound to present themselves when a stronger pace of economic growth reasserts itself.

UNITED STATES

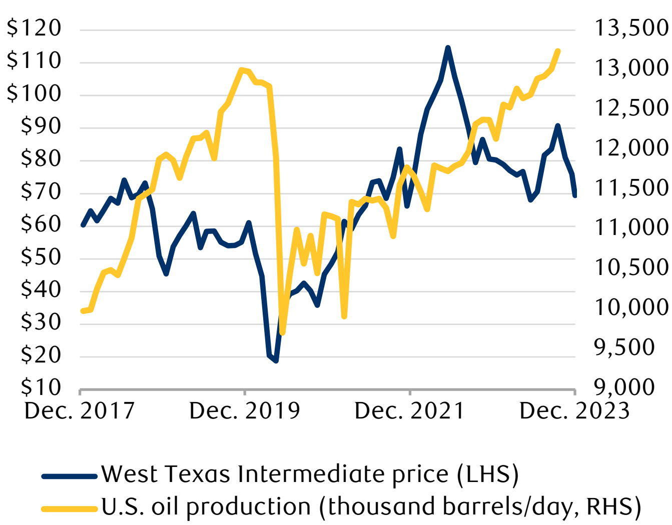
Tyler Frawley, CFA – Minneapolis

- **U.S. equities are sharply higher on the week after the Federal Reserve indicated interest rate cuts are likely next year**. All the major indexes are higher; the Dow Jones Industrial Average is the best relative performer with a return of 2.42%. The S&P 500 has outperformed the Nasdaq Composite, but both are higher, rising 2.21% and 1.97%, respectively. Leadership is in interest rate-sensitive sectors including Real Estate, which has returned 6.57%, and Utilities, which has returned 3.31%. Communication Services is the only sector lower on the week, falling 1.03%.

- **Oil prices are on track for a fourth consecutive week of declines as U.S. production hits record levels**. Since peaking in late September near $94/barrel, West Texas Intermediate (WTI) crude prices have fallen significantly, to just above $70/barrel today. This has been driven, in part, by record U.S. production that is now over 13.2 million barrels per day (bbl/day)—recently topping the pre-pandemic level of 13 million bbl/day for the first time. To counter elevated U.S. production and boost oil prices, OPEC+ members recently announced voluntary production cuts totaling 2.2 million bbl/day in Q1 2024. However, it remains to be seen if these production cuts will be enough to offset record production in the United States.

- **Tuesday's inflation report was broadly in line with expectations as both headline and core CPI matched consensus expectations, coming in at 3.1% and 4.0%, respectively**. A 2.3% decrease in energy prices helped push headline CPI slightly lower compared to October.

Record U.S. production puts pressure on oil prices



Source - RBC Wealth Management, Bloomberg; most recent data as of 12/13/23; monthly data except for the final WTI data point which is as of 12/13/23

However, inflation in shelter costs—which account for a nearly 35% weighting in the CPI calculation—remained stubbornly elevated at 6.5% y/y, which contributed to year-over-year core CPI remaining flat when compared to October. Despite the inflation picture being mixed in November, it was enough to keep the Fed on hold in terms of future rate hikes, as policymakers held the fed funds rate flat on Wednesday for a third consecutive meeting. In addition to holding rates steady, policymakers also lowered their "dot plot" projections for 2024, with officials now seeing the fed funds rate ending 2024 at 4.6%, down from the September projection of 5.1%, suggesting the Fed anticipates cutting rates by 0.75% next year.

CANADA

Estefani Ayazo, CFA & Jonathan Laser – Toronto

- **Canada's bank regulators left the mortgage stress test unchanged for the third year in a row**. According to the Office of the Superintendent of Financial Institutions (OSFI), the minimum qualifying rate (MQR) for uninsured mortgages will remain at the higher of 5.25% or 2.0% above a borrower's mortgage rate. These requirements, which we view as prudent, have helped to sustain a resilient mortgage system, build loan quality, and mitigate delinquencies. As the Bank of Canada (BoC) has raised rates aggressively, a large number of mortgages have seen their MQR rise above 5.25%. Since stress tests only apply to chartered banks, many borrowers have shifted their preference toward alternative lenders. This trend contributed to the slowdown in mortgage activity chartered banks experienced during the H1 2023, but their market share of outstanding mortgages has remained the same compared to a year ago. Despite some calls for OSFI to loosen the standards, change seems unlikely in the near future, which should continue to support loan quality.

- **Canada's sluggish labour productivity growth remains a source of concern to policymakers**. Labour productivity fell 0.8% in Q3 according to data released by Statistics Canada last week, marking the sixth consecutive quarterly decline. The drop in productivity was mainly driven by a contraction in business output, while hours worked increased slightly. As a result, the federal government has faced mounting pressure to refocus on boosting investment, especially as Canada's gross domestic product per capita has remained on a downward trend in recent years. Given softer economic data, policymakers are facing calls to redirect fiscal policy towards skill development and research and development, which could help boost labour productivity in upcoming years.

EUROPE

Frédérique Carrier – London

- **UK GDP contracted 0.3% m/m in October vs. the consensus expectation of a 0.1% contraction**. Moreover, there was a broad-based decline, with services, industrial production, and construction all impacted. Whereas in the past, weakness could be explained away by one-off factors such as bank holidays or a royal occasion, no such idiosyncratic event offers solace this time.

- **The Office of National Statistics is struggling to get quality data on labour markets**. A dearth of survey responses has been making it difficult to assess the state of the labour market. Regarding private sector regular pay growth, it appears to have been slowing but remained at an uncomfortably high 7.3% y/y for the three months to October.

- In a "finely balanced" decision, **the Bank of England (BoE) maintained the Bank Rate at 5.25%** to tame inflation that remains stuck at elevated levels—core inflation was a high 5.7% y/y in October. The BoE also maintained its "sufficiently restrictive for sufficiently long" message. It is concerned that wage growth, which exceeds 7% y/y, could rise further following the recent minimum wage increase. Wage and inflation developments may keep the Monetary Policy Committee on hold for longer than the market currently envisages (first cut expected in May).

UK wage growth remains elevated

Monthly change in regular pay, year over year (based on 3-month rolling average)

Source - RBC Wealth Management, Bloomberg; data through 10/31/23

- **As for the European Central Bank (ECB), its message was decidedly hawkish**. It maintained the 4% deposit rate even though inflation has fallen quickly to an enviable 2.4% level. The ECB remains concerned about wage growth, which at 4% remains at a level inconsistent with the central bank's 2% inflation target. Markets expected the first rate cut as soon as March given the weak state of the economy but revised their expectations to April. RBC Capital Markets thinks rate cuts will not arrive until H2 2024 and foresees only two, leaving a 3.5% deposit rate at the end of 2024.

ASIA PACIFIC

Emily Li – Hong Kong

- **China experienced its most significant consumer prices decline in three years**, indicating the difficulties encountered during the economic recovery. According to a statement released by the National Bureau of Statistics on Saturday, November's consumer price index dropped by 0.5% m/m and y/y. It was the largest decline since November 2020 and surpassed economists' 0.2% decrease projection. Furthermore, producer prices experienced a more substantial 3% decline vs. the 2.8% consensus expectation from economists. Throughout 2023, China has grappled with deflationary pressures, which stands in contrast to many other regions worldwide where central banks are primarily focused on curbing inflation.

- **On Dec. 12, China held its annual Central Economic Work Conference**, during which it deemed the economic situation more challenging and emphasized the need for better coordination and preparedness in macroeconomic policies. The conference introduced a new approach called "building the new before abolishing the old," which entails prioritizing development over problem solving. This implies the old economy, represented by projects such as affordable housing, dual-use infrastructure, and urban village renovation, may receive additional support. At the conference, a more proactive fiscal expansion was anticipated and an emphasis was placed on the importance of maintaining consistency in macroeconomic policies to mitigate any potential negative effects arising from non-economic policies.

- **This week, China's financial policymakers are in Hong Kong to engage in discussions with bankers**, in hopes of enhancing the city's position as a prominent hub for investments, deals, and talent. On Wednesday, the Ministry of Finance organized a meeting with several banks, including HSBC, Standard Chartered, and Bank of China. The discussions centered on how to enhance Hong Kong's position as an international finance center, its risks and challenges, and how strengthening ties with mainland China can help consolidate its hub status.

MARKET
Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,707.09	3.0%	22.6%	17.1%	0.8%
Dow Industrials (DJIA)	37,090.24	3.2%	11.9%	8.7%	4.0%
Nasdaq	14,733.96	3.6%	40.8%	30.9%	-4.4%
Russell 2000	1,947.51	7.7%	10.6%	6.3%	-10.7%
S&P/TSX Comp	20,629.45	1.9%	6.4%	3.0%	-0.6%
FTSE All-Share	4,112.17	1.4%	0.9%	0.2%	0.1%
STOXX Europe 600	472.46	2.4%	11.2%	6.7%	-0.2%
EURO STOXX 50	4,530.19	3.4%	19.4%	13.6%	8.3%
Hang Seng	16,228.75	-4.8%	-18.0%	-17.2%	-32.3%
Shanghai Comp	2,968.76	-2.0%	-3.9%	-6.5%	-19.4%
Nikkei 225	32,926.35	-1.7%	26.2%	17.8%	15.0%
India Sensex	69,584.60	3.9%	14.4%	11.3%	19.4%
Singapore Straits Times	3,104.26	1.0%	-4.5%	-5.1%	-0.5%
Brazil Ibovespa	129,465.08	1.7%	18.0%	25.0%	20.6%
Mexican Bolsa IPC	55,197.91	2.1%	13.9%	9.7%	9.5%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.024%	-30.2	14.9	52.3	260.8
Canada 10-Yr	3.246%	-30.8	-5.4	40.0	185.1
UK 10-Yr	3.830%	-34.6	15.8	52.9	313.3
Germany 10-Yr	2.173%	-27.4	-39.8	24.8	255.5
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.93%	1.2%	2.9%	0.8%	-10.7%
U.S. Investment-Grade Corp	5.47%	1.4%	5.5%	2.9%	-11.3%
U.S. High-Yield Corp	8.29%	0.8%	10.2%	7.8%	-1.4%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	2,026.90	-0.5%	11.1%	11.9%	13.4%
Silver (spot $/oz)	23.79	-5.9%	-0.7%	0.2%	6.5%
Copper ($/metric ton)	8,259.75	-1.5%	-1.3%	-2.2%	-12.5%
Oil (WTI spot/bbl)	69.47	-8.5%	-13.4%	-7.9%	-2.6%
Oil (Brent spot/bbl)	74.60	-9.9%	-13.2%	-7.5%	0.3%
Natural Gas ($/mmBtu)	2.34	-16.4%	-47.7%	-66.2%	-38.3%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	102.9380	-0.5%	-0.6%	-1.0%	6.9%
CAD/USD	0.7404	0.4%	0.4%	0.3%	-5.2%
USD/CAD	1.3506	-0.4%	-0.4%	-0.3%	5.5%
EUR/USD	1.0880	-0.1%	1.6%	2.3%	-3.6%
GBP/USD	1.2622	0.0%	4.5%	2.1%	-4.5%
AUD/USD	0.6672	1.0%	-2.1%	-2.7%	-6.4%
USD/JPY	143.0300	-3.5%	9.1%	5.5%	26.0%
EUR/JPY	155.6100	-3.6%	10.8%	8.0%	21.4%
EUR/GBP	0.8619	-0.1%	-2.6%	0.2%	0.9%
EUR/CHF	0.9485	-0.5%	-4.2%	-3.9%	-8.9%
USD/SGD	1.3333	-0.3%	-0.5%	-1.0%	-2.5%
USD/CNY	7.1708	0.5%	3.9%	3.2%	12.6%
USD/MXN	17.2613	-0.7%	-11.5%	-11.6%	-17.9%
USD/BRL	4.9183	0.0%	-6.9%	-7.3%	-13.3%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Tuesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 0.4% return means the Canadian dollar rose 0.4% vs. the U.S. dollar year to date. USD/JPY 143.03 means 1 U.S. dollar will buy 143.03 yen. USD/JPY 9.1% return means the U.S. dollar rose 9.1% vs. the yen year to date.

Source - Bloomberg; data as of 12/13/23

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