



# GLOBAL Insight 2024 Midyear Outlook

Special report



## U.S. debt dilemma

No quick fixes and no catastrophes

The federal government's debt has doubled since 2015—and shows no signs of turning around.

Atul Bhatia, CFA | Page 4

For important and required non-U.S. analyst disclosures, see [page 31](#).

All values in U.S. dollars and priced as of market close, June 21, 2024 unless otherwise stated.  
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Our U.S. Recession Scorecard saw an important negative shift in May when a third leading indicator was re-rated to recessionary red. A fourth may undergo a similar shift in the next couple of months. Equity investors should be aware that risks of the U.S. economy slipping into recession in the coming months are rising.

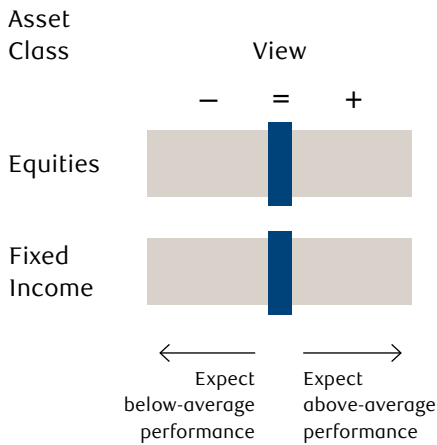
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## RBC'S INVESTMENT Stance

### Global asset class views



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

**+ Overweight** implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

**= Market Weight** implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

**- Underweight** implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

Source - RBC Wealth Management

### Equities

- The S&P 500's strong rally has persisted amid narrow leadership and unusually low volatility. Only eight stocks represent about 70% of the year-to-date return, seven of which are leveraged to artificial intelligence (AI). Performance of Canadian and European markets has been less unbalanced, but returns have substantially lagged the S&P 500 largely due to lower exposure to technology shares. Periods when a single investment theme dominates equity markets globally—like AI has since early 2023—can last a lot longer than one might think is rational, but they can also change shape or end when it's least expected. The old adage “don't put all your eggs in one basket” comes to mind.
- We think volatility has the potential to increase in the second half of the year. The Q2 earnings season, which will begin in mid-July, will be of particular focus. Furthermore, volatility typically perks up at some point during U.S. presidential election years.
- We would hold a Market Weight position in global equities and focus on high-quality companies in a diverse group of sectors.

### Fixed income

- Global bond yields remain volatile nearing the midpoint of 2024, but the average yield on the Bloomberg Global Aggregate Bond Index has steadied around 4.0% in recent months, though it remains below the 2023 peak of 4.4%. Global inflationary pressures continue to improve, after a brief uptick to start the year as both the Bank of Canada and the European Central Bank delivered rate cuts in June 2024, with RBC Capital Markets expecting the U.S. Federal Reserve to follow later in the year. Though yields, as of this writing, have dropped dramatically from the highs of late 2023, they remain well above the averages of the past 20 years and continue to present relatively attractive entry points, in our view. Still, we continue to exercise caution and patience over the near term as yields could retrace higher until the timing and magnitude of central bank policy easing come into greater focus.
- We remain Market Weight U.S. fixed income with yields remaining above multi-decade averages. Economic risks have subsided in the U.S. and globally. Though economic risks are not insignificant, we see value in high-yield corporate bonds at yields near 8%. We upgraded the sector to Neutral earlier in June 2024 via a reduced allocation to Treasuries.

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MIDYEAR  
Focus


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# U.S. debt dilemma: No quick fixes and no catastrophes

Commentators frequently conflate the federal government's debt with the nation's—a critical mistake, in our view. We dig into how investors should be thinking about fiscal policy and the debt and discuss why neither catastrophes nor quick fixes are likely.

## Key points

- **U.S. government debt has been rising rapidly since the global financial crisis, but broader measures of borrowing across the economy have remained relatively stable and on par with other developed economies.**
- **U.S. fiscal policy is likely already unsustainable, with politically sensitive programs costing more than current taxes generate.**
- **Higher inflation—not default or foreign coercion—is the likely trigger for the U.S. to put its budgetary house in order.**

The U.S. debt has always been a divisive matter. Not only is there disagreement on its causes and fixes, but no one can seem to agree if, or when, the federal debt becomes a concern.

Both sides of the argument have a problem, in our view. Folks saying that the amount of U.S. borrowing will lead to a calamity have to deal with a 40-year track record of being wrong, the counter-example of the Japanese economy functioning with debt levels nearly twice that of the U.S. today, and the fact that no sovereign has defaulted when borrowings are exclusively in its own fiat currency under its own law.

For those saying the debt is irrelevant, the path is no easier. The major stumbling block is the apparent absurdity of their argument: somehow, somewhere it must matter how much money we have borrowed to fund our current spending. After all, “there is no such thing as a free lunch” is not a bad starting premise for the study of economics.

Our view is between these two extremes. We believe the federal debt—in and of itself—is a manageable concern and that the U.S. is nowhere near a default risk. At the same time, we think that the conditions that created the debt—which are ongoing—are problematic and will impose future costs on the economy.

## Got debt? Sort of

Before turning to fiscal policy, which we see as the real issue, it's worth diving into the federal debt given how much press it gets. And it gets that level of attention for good reason—the federal government owes a gob smacking amount of money. Even without considering the debt to various government trust funds, the Treasury has borrowed nearly \$28 trillion dollars, or just under 100% of Gross Domestic Product (GDP). If Social

## U.S. DEBT DILEMMA

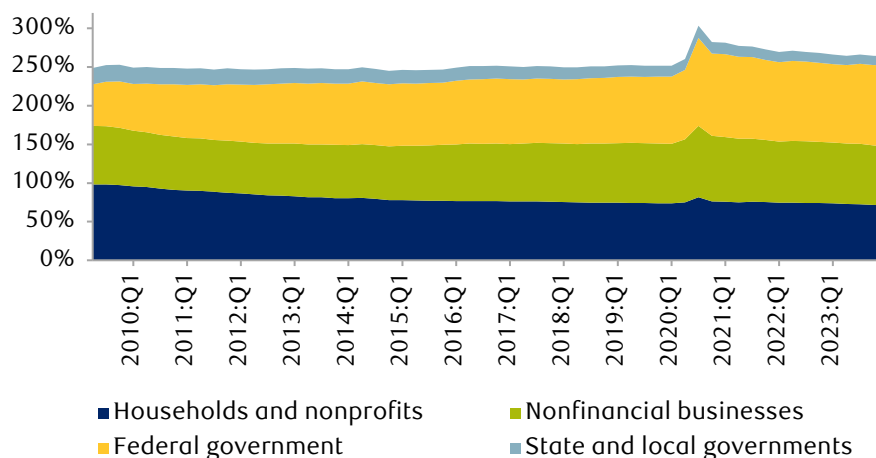
Security and similar obligations are included, the total is easily above \$33 trillion. Statistics like these seem to lend credence to the view that U.S. debt is out of control.

What's odd to us, though, is the laser-like focus on the federal government's borrowing. After all, most economic activity in the U.S. takes place outside the government and is instead the product of corporate and household activity. When we broaden out our perspective to include these sectors, the debt position of the U.S. as a country—not just a government—looks very different.

First, there has been no appreciable recent run-up in national borrowing. Aside from a COVID-19-related blip, the overall debt-to-GDP ratio has been remarkably stable over the past 15 years. There have certainly been changes in the composition of U.S. borrowing, but the amount of debt has grown at roughly the same pace as the economy overall for over a decade.

### Far from exploding, U.S. debt has been boringly consistent for 15 years

Total nonfinancial debt as percentage of U.S. GDP



Source - U.S. Federal Reserve; quarterly data through 2023

Nor does the U.S. debt burden look particularly troublesome compared to other large, developed countries. The combined debt load across U.S. corporations, households, and government entities was around 260% at the end of 2022, the last year for which International Monetary Fund stats are available. This puts the U.S. essentially at the median debt level for large, developed economies.

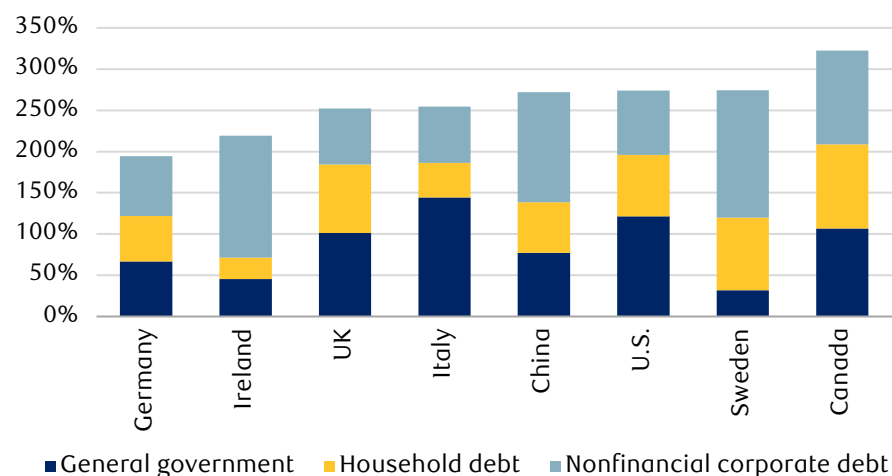
Put differently, if the U.S. were to dedicate its entire annual production to debt repayment, it would take about 2.6 years to wipe out all the money that households, businesses, and government entities have borrowed. That's essentially the same timeline faced by the UK or Sweden, and it's substantially less than Canada, where every dollar of productivity capacity has the burden of more than \$3 of debt outstanding.

In fact, when we look at U.S. borrowing, what stands out to us is not the amount but the composition of its debt. More than most other countries, it's the federal government that has borrowed against national assets, not private individuals or businesses.

## U.S. DEBT DILEMMA

### A broader measure of indebtedness shows the U.S. is fairly typical

Debt as a percentage of 2022 national GDP



Source - International Monetary Fund; includes bonds, loans, and debt securities

There's a lot to like, we think, about that debt profile.

To start, it's the cheapest way to borrow. As a nation, the U.S. dedicates fewer resources to financing costs than if households or businesses had taken on loans. In addition, the federal government is not—yet—forced to belt-tighten when interest rates move up. This is different from, say, Canadian households that are feeling the pinch from higher mortgage costs, with negative, economy-wide implications.

Viewed across the entire economy, the U.S. has constructed a borrowing profile that is reasonable for the size of its economy and has a relatively advantageous borrowing structure, in our view. Far from being an albatross, federal debt is a potential advantage relative to the alternative of household or corporate leverage.

### At least drunken sailors pay cash

While we believe that the federal government is the best positioned entity to carry a high debt burden, it is perhaps the worst entity at deciding whether additional borrowing is worthwhile. Households and corporations typically have a plan on how to repay any new borrowing, if only because lenders demand one. The federal government, by contrast, is never asked for a long-term repayment plan—not by bond buyers or voters.

It's important to be clear that the debt is not a partisan creation. Politicians of all stripes pay lip service to fiscal restraint, but when in office both parties keep taxes well below the level of spending.

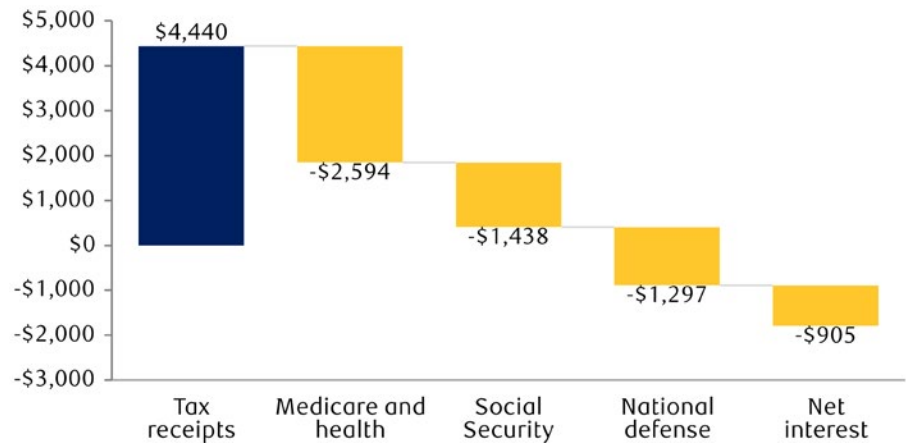
Part of the reason is voting math. Since at least the 1980s, there have been a few budget items that are electoral third rails—touching them is political death: The big three are Social Security; Medicare/Medicaid; and, to a lesser extent, defense. Combined, these “must fund” activities now exceed the federal government's tax receipts. Interest expense on existing debt is an increasingly important addition to this required annual outflow.



## U.S. DEBT DILEMMA

### When uncuttable spending meets unraisable taxes, the budget math can't add up

2023 U.S. revenue and expenditures by budget category (\$ billions)



Source - U.S. Treasury Department, RBC Wealth Management; data for fiscal year 2023

Against that backdrop, we think it's almost a given that the debt is going to continue to grow for the foreseeable future. In our view, it's unrealistic to expect politicians to meaningfully raise taxes or cut popular programs without some sort of external impetus.

In theory, that could come from the electorate. Survey data shows a high degree of voter concern on the federal debt. When asked, however, about their willingness to accept higher personal taxes or reduced benefits, voters quickly change their tune. Support for debt reduction only lasts as long as someone else pays. Politics is the art of the possible, and balancing the budget without shared sacrifice strikes us as effectively impossible.

### You want us in that mall, you need us in that mall

An alternate argument is that lenders will prompt fiscal retrenchment by pulling back from Treasury bonds. We see that as extremely unlikely.

In our view, simple self-interest decides the issue. The U.S. is the world's consumer, and both foreign and domestic producers need Americans to buy their products. Even those companies that don't directly sell in the country would almost certainly feel the impact of a U.S. economic contraction.

The current level of U.S. consumption is only possible because of credit, and it is in the producers' self-interest to recycle at least some of their earnings into continued lending.

The dynamic is easiest to see when looking at overseas actors. Foreign countries often buy U.S. dollars to gain a currency advantage for their exports, which results in a need to invest those dollars in low-risk assets such as Treasury bonds. Those bond purchases then give the U.S. government the needed resources to continue spending beyond its means.

Another way to think about the lending/selling dynamic is to look at the history of the car industry. The rise of the automobile finance corporation did not come about because car manufacturers were drawn to the

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## U.S. DEBT DILEMMA

consumer loan business; it was instead the realization that without credit, car demand evaporated and the producer, ultimately, suffered.

### **Not with a bang but a whimper**

Our view, then, is that we should expect the budget deficit to remain and probably grow, with federal debt increasing for the foreseeable future.

The process will inevitably end, and we see the inflationary impact of budget deficits as the most likely catalyst for change. Put simply, when the U.S. government spends more than it taxes, it adds to near-term demand, which is likely to be inflationary.

For the past several decades, the potential price consequences of government borrowing were, we believe, largely offset by other factors: growing low-cost supply from China, the deflationary consequences of the global financial crisis, and declines in household borrowing. These factors, we believe, are largely played out, potentially leading to more visible inflation from deficit financing.

That, we think, is good news for fiscal rationality. One of the key takeaways from the past two years, we would argue, is that inflation is intolerable across most sectors of U.S. society. While we think it's a utopian belief that voters will wake up one day and decide to belt-tighten to help their grandchildren, we see a relatively easy link between rising prices and consumer anger.

Regardless of what sparks the shift toward fiscal balance, our view is that the resolution is likely to be painful, but manageable. It will almost certainly come from a combination of cutting government spending and benefits, increasing taxes, and allowing higher inflation to reduce some of the real cost of repayment. The outcome of these adjustments is very likely to be negative for global growth, creating a headwind for all sectors of society, including workers, taxpayers, and investors.

In essence, we are saying that neither households nor corporations are quite as well-off today as they think they are. At a certain point, some of what is currently private wealth will need to be used to pay down national borrowings. That process will be a headwind for prosperity, and one that grows in strength every year, but it is also part of the normal cycles of change in a dynamic economy. After all, government borrowing taking place today is helping create private wealth through economic growth and investment gains.

### **Reasons for optimism**

"Predictions," according to a Danish proverb, "are difficult, especially about the future." The further in advance, the larger the likely error. "Catastrophizing" over long-term debt estimates ignores this reality and the history of prior failed projections.

Take the 2010s, for instance. If there was a prevailing theme to budget discussions at that time, it was rising healthcare costs and how Medicare spending would pressure the U.S. Treasury beyond control. Fast forward 10 years and Medicare costs per beneficiary were stable for a decade.



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## U.S. DEBT DILEMMA

The root causes of the improvement are still debated, but the beneficial financial consequences amount to nearly \$4 trillion since 2011, according to an analysis published in Health Affairs.

Artificial intelligence (AI) and technology in general are obvious potential positive factors for the federal budget, in our opinion. The impact is two-fold, with rising prosperity increasing tax contributions and more efficient, technology-enabled operations reducing costs. Just as the internet helped transform the provision of government services, we think it would be foolish to rule out the possibility of an AI-induced budget fillip.

The simple reality is that not all uncertain outcomes turn out to be unfavorable.

### **Extreme outcomes extremely unlikely**

Our view of high debt creating future growth headwinds is common in economic textbooks, but less frequently found in the popular press, who instead put forward theories of a bankrupt Treasury failing to make payments or the risk of China using its bond holdings to exert influence or control over U.S. policy.

We think these risks are vastly overstated and overlook three key realities.

First, the federal government is not a typical borrower. Its debt is issued in its own currency under its own law, giving it debt management tools such as taxing interest payments or forcing the Fed to buy bonds through money printing. These are not costless—they would come with inflation or difficulty selling bonds in the future—but they're not even on the table for other debtors.

Second, a U.S. default would be a global economic catastrophe. There were \$600 billion in subprime mortgages outstanding in 2006, and they managed to throw the global economy into a recession that took years for recovery; Treasuries have nearly 50x that amount outstanding. A U.S. default would almost inevitably throw the U.S. and the world into a severe recession and eviscerate bank capital globally. There would be, in our view, no winners, only varying degrees of losing.

Third, default is not currently a viable option for creditors. U.S. solvency is not an immutable law of nature; we accept that default is a possibility. But for a default to be a realistic alternative, there would have to be sufficient non-U.S. demand to allow for a deep and severe U.S. recession without it tipping into a global recession. In addition, there would have to be an asset that replaces Treasuries as the dominant source of inter-bank collateral. Until that happens, we think creditor self-interest argues against a default.

For these reasons, we also reject the idea that China—or any other nation—can realistically use its bond holdings for geopolitical advantage. It would be economically disastrous for whatever nation pulled its cash, and it would be unlikely to work in practice, as the U.S. can legally use its sovereign authority to cushion any blow.

More fundamentally, we think this argument reverses where power lies in the lending relationship. The U.S. has already received goods and services

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## U.S. DEBT DILEMMA

from China and paid for them with over a trillion dollars in IOUs. China, we would argue, is the one exposed to geopolitical risk in this scenario, not vice versa.

### **Debate, discussion, and debt**

The so-called debate on the federal debt often seems to be a choice between hyperbolic claims of imminent collapse and a Panglossian view that no matter the amount, the debt is not a concern.

We believe that is a false dichotomy. In our view, the current level of debt will not lead to a default but will likely impose eventual economic costs in the form of lower growth, reduced government benefits, higher taxes, and higher inflation. If, as we project, deficits continue and the debt burden grows, then the eventual resolution will take longer and weigh more on the economy than if it were addressed sooner.

## GLOBAL Equity



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# Trees don't grow to the sky

## Key points

- AI has propelled a “magnificent few” to trade at extremely rich valuation multiples, leaving all the rest at much more reasonable valuations.
- But they may not be as inexpensive as they appear as heavy investment in AI looks to become a costly price of staying competitive for almost all businesses without any certainty of a profitability payoff.
- A soaring S&P 500 price-to-earnings multiple by itself won't define the limits of the market advance, in our view. But when combined with optimistic/complacent investor sentiment readings and interest rates that are almost double what they averaged in the pre-pandemic decade, a cautious, watchful approach is called for.

Coming out of the global financial crisis in mid-2009, the U.S. economy was embarking on what turned out to be the longest uninterrupted economic expansion in the country's history, accompanied by the longest-ever equity bull market. But you might have never known that if you read or watched the financial news outlets. Pundits, investors, and bloggers mostly viewed the roughly 11-year-long advance of the economy, earnings, and stock market with scepticism and trepidation.

## Worried and concerned at 15x–18x in the post-financial crisis decade

They worried that the systemic weaknesses revealed first in the global financial crisis followed by the European sovereign debt crisis had not been adequately dealt with. Many fully expected these to re-emerge with potentially disastrous consequences for financial markets. Stock market valuations did not reflect these elevated risks, in their opinion.

The price-to-earnings (P/E) ratio for the bellwether S&P 500 Index ranged mostly between 15x and 18x over that long stretch. Those observers consistently referred to the market as “expensive,” “richly valued,” “priced

## Equity views

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

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

for perfection,” or “dangerously ahead of itself.”

Fast forward through the pandemic convulsions to today and we find the S&P 500 trading at 24x consensus earnings expectations for this year. A P/E ratio of 20x has always been regarded by investors as the line beyond which the market was “overvalued” or “living on borrowed time.” And with good reason: the market has rarely traded beyond that level. But now it is.

## Calm and confident at 24x today

However, in our opinion, despite today's much higher P/E multiple, the degree of valuation concern expressed by investors and

## GLOBAL EQUITY

commentators alike has become unusually subdued. It is certainly running at a much lower pitch and volume than during much of the previous decade when the S&P 500 was mostly six to eight multiples cheaper.

The contrast between P/Es in 2012–2019 and where we find them today in 2024 is even starker when interest rates are factored in. The 10-year Treasury yield averaged roughly 2.3% through most of the pre-pandemic decade. Today it's closer to 4.3%. Higher bond yields would normally lead to a lower P/E multiple for the market; instead, we have a markedly higher P/E.

What seems to be lulling investors into a complacent acceptance of today's elevated valuations is the much-discussed idea that P/Es are only high because of the outsized impact of a small, very select group of extravagantly priced mega-cap tech and tech-related stocks, which are seen to be the clearly dominant beneficiaries of fast-emerging developments in artificial intelligence (AI). When the so-called Magnificent 7 (Apple, Amazon, Alphabet/Google, META, Microsoft, NVIDIA, and Tesla) are taken out of the calculation, what remains—the S&P 493 they have been dubbed—are trading at a seemingly more benign 18.4x earnings. (Foreign markets—Canada's S&P/TSX, MSCI UK, and MSCI Europe—are even cheaper nearer 16x.) But 18x earnings was regarded as fully valued back in the pre-pandemic, much-lower-interest-rate world.

### AI A-OK?

What's more, if AI turns out to have as dramatic an effect on business and the economy as many expect, then the magnificent few and some others like them might well go on reaping outsized benefits for some time yet. But, in fact, every business will have to spend heavily on AI just to stay competitive within their sector, which might mean little to no improvement in profitability despite the heavy investment. And there will be some

businesses that will be unable to keep up in this expensive race and suffer an outright decline in fortunes.

So, 18x earnings may not be such a benign valuation after all for a group of businesses in a world where competitive risks have risen dramatically with the advent of AI and where interest rates have almost doubled.

### Not so fast

The way to reconcile this constructively would be to have earnings grow fast enough to offset the heavier drag of higher interest rates. However, faster profit growth would normally require faster GDP growth. Some think that is what AI will make possible. However, not everyone agrees. The Congressional Budget Office (CBO), a non-partisan agency, regularly prepares long-term forecasts of the U.S. economy for the U.S. Congress. Its latest, published in March, sees real GDP growth settling on either side of 2.0% for the coming 10 years and slowing to 1.6% after that.

Presumably, the CBO economists are just as aware of the emergence of AI as everybody else and perhaps more informed as to its potential to produce faster GDP growth. Their expectations appear underwhelming to us.

So, faced with the possibility AI won't ride to the rescue, we are left with P/Es ranging between uncomfortably high at 24x for the S&P 500 and fully valued at 18x for the underpowered S&P 493. What does that tell us about equity market prospects from here?

### Higher but ...

In the near term, the next six to 12 months say, the answer is "not very much." We see no useful correlation between the P/E ratio on a given day and the S&P 500's return over the following year. Very high P/Es can get even higher. In fact, we think that is the most likely path immediately ahead. But in an environment where

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## GLOBAL EQUITY

most investors appear confident, even complacent, about the prospect of future market gains, we believe the most revealing market statistic to watch is “breadth”—are the majority of stocks moving in the same direction as the broad index?

Through all this upward move since the AI stocks took control, the breadth readings for the S&P 500 have been positive. While the Magnificent 7 have accounted by far for most of the value added to the index, the majority of stocks were also moving higher. If that remains the case, we believe this advance has further to run.

### **... trees don't grow to the sky**

Longer term, unusually high market P/E ratios typically point to below-average equity returns measured over the following decade. The fact that the excessive market multiples are attributable to one overwrought sector or a handful of heavyweight favorites has not tended to mitigate that outcome.

Investors have had to contend with substantially overweighted high-fliers in the past, such as the “Nifty Fifty” in the early 1970s, the energy and commodity stocks in the late 1970s, the tech sector leading up to the “tech wreck,” and the financials heading into the global financial crisis. Not just the overvalued leaders but the majority of other stocks also suffered when the tide eventually turned.

We don't believe markets are finished moving higher. But thinking about risk appetite and having a plan for becoming more defensive when conditions dictate are things to contemplate in the coming months. We believe stocks are no longer compellingly valued and investor sentiment is increasingly complacent. The combination argues for a cautious, watchful approach on the part of investors.

## Regional equity perspectives

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### United States

■ Following an outsized rally amid unusually low volatility, we think U.S. equity market volatility could increase during the second half of the year.

■ The S&P 500 has surged 15.8% including dividends year to date through June 18. While the price gain is almost 1.5 times that of the average annual return of the past 40 years, the rally has been rather narrow. Just eight stocks represent 71% of the index’s return, seven of which are leveraged to artificial intelligence (AI), led by chipmaker NVIDIA. This leaves the other 499 stocks in the index during this period combining for only 29% of the total return. Now is not the time to chase the biggest winners, in our view.

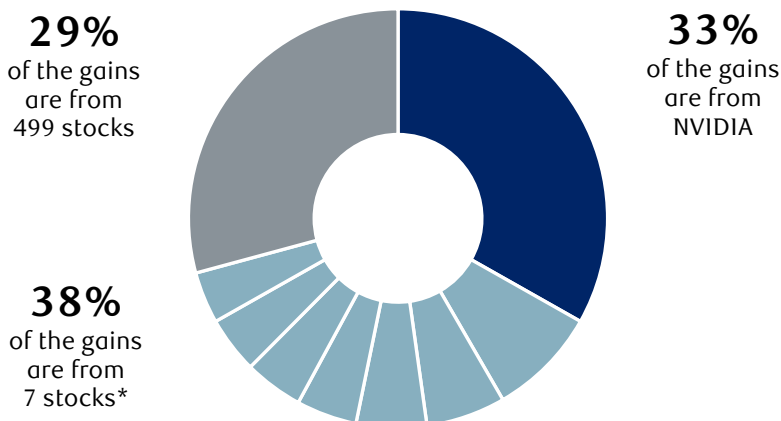
■ We don’t view the S&P 500’s relatively high 21.3x forward price-to-earnings ratio as much of a hinderance so long as consensus earnings forecasts hold up. When the AI-leveraged Magnificent 7 stocks are stripped out, the valuation is lower at 18.4x—a level somewhat more elevated than average, but not unreasonable from our vantage

point. However, the valuation gap between the S&P 500 and the S&P 500 excluding the Magnificent 7 stocks is [unusually wide](#).

■ Volatility has all but vanished. The S&P 500 has gone more than 335 trading days without a 2% or more single-day decline, according to a study by RBC Global Asset Management. This is the longest stretch since 2018 and much longer than the 23-day average since 1999. We think volatility could increase in coming weeks and months. First of all, these data indicate a volatility episode is overdue. Second, the U.S. presidential campaign season—largely ignored by investors heretofore—could generate market swings as institutional investors start to focus on the debates and political party conventions this summer. Typically during election years volatility perks up at some point.

■ We think the S&P 500 seems due for a normal pause or pullback. We recommend Market Weight exposure to U.S. equities—a constructive allocation—as we don’t see tangible signals that the bull market could come to an end just yet.

**A small group of stocks have powered the S&P 500 higher**  
Percentage contribution to the S&P 500’s year-to-date gain of 15.8%



\* The seven stocks, from largest to smallest contribution to the S&P 500 total return, are Microsoft, Alphabet (both share classes), Meta Platforms, Amazon.com, Broadcom, Apple, and Eli Lilly.

Source - RBC Wealth Management, FactSet; year-to-date total return data (includes dividends) through 6/18/24. During the period, 507 stocks were in the S&P 500 (Alphabet counted once)



## REGIONAL EQUITY PERSPECTIVES

### Canada

■ Slower-than-expected economic growth, a cooling labour market, and ongoing disinflation make a compelling case for the Bank of Canada's continuation of its interest rate cuts. RBC Economics anticipates a total reduction equivalent to four 25-basis point cuts throughout the remainder of 2024. These cuts should afford domestic consumers some relief. Still, we remain cognizant that the rate environment continues to impact borrowers on a lagged basis as debts mature and are refinanced at higher rates (most notably mortgages).

■ Ongoing vigilance on domestic consumer exposure within equity portfolios remains warranted. Fiscal second-quarter earnings from the Canadian banks suggested a relatively benign consumer backdrop, but there were pockets of stress in certain areas, with credit card and auto loan delinquencies rising. We expect that headwind to continue for the foreseeable future. However, we note that this dynamic has been well-anticipated by the market and is reflected to some degree in the banking industry's below-average valuation multiples.

■ The Materials sector has been a bright spot for the domestic equity market, although we struggle to reconcile certain commodity prices with near-term fundamentals. We continue to recommend resource exposure in the Energy space where the cash returns to shareholders remain attractive as producers hit targeted leverage thresholds. Recession calls have been receding as the probability of a "soft landing" grows. Should a recession materialize over the next year, we believe Canadian Energy producers are in a strong position to navigate a period of depressed commodity prices, thanks in large part to their lower debt loads and capital discipline.

■ Amongst the weakest areas of the market has been Telecommunications Services. The competitive intensity

that commenced in early 2023 has continued thus far in 2024 as the incumbents fight for market share. Elevated competitive intensity, a slowing growth outlook, high interest rates, and elevated balance sheet leverage leave us unenthusiastic about the sector.

### United Kingdom

■ With the Labour Party continuing to command a considerable lead in the polls, it seems very likely to lead the new government, in our opinion. A Labour government would try to stimulate growth through making it easier to acquire permits to build new homes and commercial buildings, and resetting relations with the EU, still its largest trading partner. Labour has also promised to expand the scope of responsibility of the British Business Bank, which invests in small and medium enterprises, and to look to nationalize the rail industry.

■ Labour's proposed budget looks to increase investment in green industries, as well as health care, schools, and childcare. While the Conservative government had been actively outsourcing services, Labour would take back control of several activities to lower the bill paid to consultants.

■ To fund its policies, Labour promises to close tax loopholes and increase a number of specific taxes, such as the energy profits levy. It has committed to keep the corporate tax rate at 25% for the duration of Parliament and to maintain the income tax top rate and capital gains tax.

■ The new government will likely find that its policies will be restricted by the weak national finances, with the fiscal deficit exceeding 4% of GDP and government debt just above 100%.

■ We believe the unique composition of the UK equity market, including its high weighting to commodities and defensive sectors, means UK equities at the index level will remain

## REGIONAL EQUITY PERSPECTIVES

inextricably linked to either the “value” factor outperforming “growth” or defensives outperforming cyclicals, or both.

- Within the UK equity market, we believe high-quality large-cap stocks that are well-placed to benefit from structural (long-term) growth tailwinds while trading on reasonable valuations, often at a discount to their global peers listed overseas, remain an attractive area of opportunity. We also see selective opportunities in domestically focused UK stocks, where, encouragingly, the economic backdrop appears to be improving. In our view, the low valuation of UK equities means that takeover interest in UK companies from international competitors and private equity is likely to remain elevated.

### Continental Europe

- In the short term, attention will likely focus on EU politics and the fallout from the June European parliamentary elections and the July French legislative elections.

- We do not anticipate a reversal of European policies despite the advance of far-right parties, as the centre retained more than 55% of the votes. However, the green parties’ poor showing will likely delay the implementation of the bloc’s climate agenda.

- At the time of writing, it is unclear whether French President Emmanuel Macron’s strategy to call a legislative election will pay off. In doing so, he hopes his party may be able to redress its marked loss to the far-right National Rally (Rassemblement National or RN) party.

- Markets worry that the RN’s expansive fiscal policy at a time when the country’s fiscal deficit exceeds 5% could destabilise the region, much like Greece did in 2012. This would be problematic as France is the second-largest economy in the eurozone. Ultimately, we believe that if the RN becomes part of the government, it would likely align itself with Brussels’

fiscal policies. It would not be in the RN’s best interest to upset the apple cart ahead of the French presidential elections in 2027, in our view.

- Meanwhile, the recovery in the euro area is taking place. Inflation is waning, and the European Central Bank (ECB) is cutting rates, which should underpin domestic demand.

- The MSCI Europe ex UK Index reached a 12-month high in June 2024. The uncertainty of the French legislative elections ushers in a period of volatility. We maintain our Market Weight position and balanced approach, seeking exposure to high-quality European stocks, especially in the Technology, Industrials, and Health Care sectors alongside selective opportunities which can benefit from the improving macro backdrop and relatively inexpensive valuations available today. Should a deteriorating political situation lead to near-term moves appearing overdone, we would seek to add to positions.

### Asia Pacific

- China’s economic data remained unbalanced in May. Exports and manufacturing investment remained strong growth drivers, while domestic consumption stayed relatively soft. It is encouraging that the government is determined to support the property market, in our view, as a prolonged downturn could put the banking system at risk. However, the current policy measures may be insufficient, and we expect policies to step up support to follow. It will likely take time for the property market to stabilize and recover.

- We anticipate a “K-shaped” recovery, with housing prices in high-tier cities being the first to stabilize and rebound, and pricing in other cities drifting lower for a while longer. In the longer term, we believe supply and demand will be the key determinants of housing prices. We argue that there could be an undersupply issue in Tier-1 and Tier-2 cities in the coming years due to the

sharp decline of new housing starts, inventory clearance, and the release of pent-up demand.

■ For Chinese equities, we believe that the property market outlook and policy effectiveness will drive the market in the near term. As the U.S. election approaches in November, we expect trade policies against Chinese goods to be more relevant. We maintain a Market Weight position as we believe many investors would prefer to sell on strength. We will focus on picking individual stocks and capturing trading opportunities.

■ Thus far during the quarter, the Japanese equity market has declined in dollar terms as the yen depreciated from 150 to above 159 against the U.S. dollar. We expect the pressure on the yen to peak in H2 2024, driven by a likely Federal Reserve interest rate cut and a potential Bank of Japan rate hike. RBC Capital Markets expects one rate cut by the Fed in December.

■ We continue to favor Japanese equities and suggest an Overweight position due to: (1) a sustainable 2% inflation target that appears in sight, which should enable companies to raise prices; (2) renewed investment from friend-shoring and onshoring will likely underpin economic activity; (3) return on equity and shareholder returns are improving due to corporate governance reforms; (4) domestic demand should recover thanks to high savings and further wage hikes; (5) inbound tourism is strong due to the weak yen; and (6) domestic inflows into the stock market from retail investors should improve following the revamp of the Nippon Individual Savings Account scheme.

■ The valuation of the MSCI Japan Index remains undemanding when compared to other developed markets. However, risks to our constructive views include slowing exports and a volatile yen.

GLOBAL  
Fixed income

# The only certainty is uncertainty



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### Key Points

- The global central bank easing cycle has begun with the first rate cuts from major developed market central banks delivered in June. But it remains the base case that this easing cycle is unlikely to resemble those typically seen in past decades.
- Steady and aggressive rate hike campaigns are likely to give way to more sporadic and intermittent rate cut offensives as policymakers navigate the push-pull of bringing inflation down and extending current economic expansions.
- Modest central bank policy easing should support riskier assets such as corporate bonds. For investors weighing the safety of government bonds against the extra yield offered by credit-sensitive sectors, we now see more justification for credit exposure at what are still historically elevated yields.

After a multi-year rate hike campaign by most global central banks to rein in inflation, the Bank of Canada was the first of the G7 central banks to cut rates in June 2024, followed closely by the European Central Bank. Those moves look set to pave the way for others later this year.

The Bank of England is likely the next to get in on the fun, where we expect first cut at the August meeting, and likely one more by year-end.

But at the 2024 halfway point, the Federal Reserve remains the unknown. At the start of the year, markets had priced in a wildly ambitious seven rate cuts this year. At one point since that time, markets toyed with the possibility of no cuts. Now expectations lie somewhere around one or two cuts.

### No easy paths

A lack of normalcy is seemingly the norm in a post-pandemic world. Historically speaking, central banks are either in the midst of raising rates or cutting them—there hasn't been much in between.

But this easing cycle could look different.

### Fixed income views

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

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

The Bank of Canada appears most likely to follow a traditional easing path of steady and consistent rate cuts. Current market pricing suggests approximately 150 basis points of easing over the next year, the most of the major central banks. While Canada has made the most progress on returning inflation back toward target, this has come at the expense of notably lackluster economic growth, likely setting the stage of a sustained easing cycle. RBC Capital Markets is currently projecting the policy rate ending 2025 at just 3.0%, a full 200 basis points below the 5.0% peak policy rate achieved.

## GLOBAL FIXED INCOME

For the rest however, each rate decision is likely to be both a highly debated affair and made on a case-by-case basis all dependent on the incoming data.

The European Central Bank is a prime example of what investors might want to expect over the near term. Though policymakers decided to proceed with a rate cut in June 2024, it was about as hawkish as a rate cut could be as policymakers also declined to commit to any preset path for further rate adjustments, dependent upon potential “bumps in the road” along the way. The rate cut also came with an increase to inflation forecasts, somewhat dimming hopes of further cuts this year. While we still expect two more in 2024, as does current market pricing, it is no sure thing.

While the rate hike cycle was essentially a one way move higher, the way back down is likely to feature more fits and starts than has been the case in most previous easing cycles.

### Higher highs, higher lows

Central banks, broadly speaking, had to raise rates to levels not seen in decades to get inflation under control. And while the timing and cadence of cuts to bring rates back down remain uncertain, the expectation that once they do come

down it will only be to still-elevated levels appears more certain.

As the chart shows, rates in the U.S. and the UK are still expected to be north of 4.0% by this time next year. With respect to the Fed, its estimate of the so-called “neutral” rate of the economy which neither boosts nor restricts economic activity and inflation has been shifting higher.

Since 2019, the median projection from Fed policymakers has pegged that rate at around 2.5%. It shifted modestly to 2.6% at the March meeting, and following the June confab now sits at 2.8%.

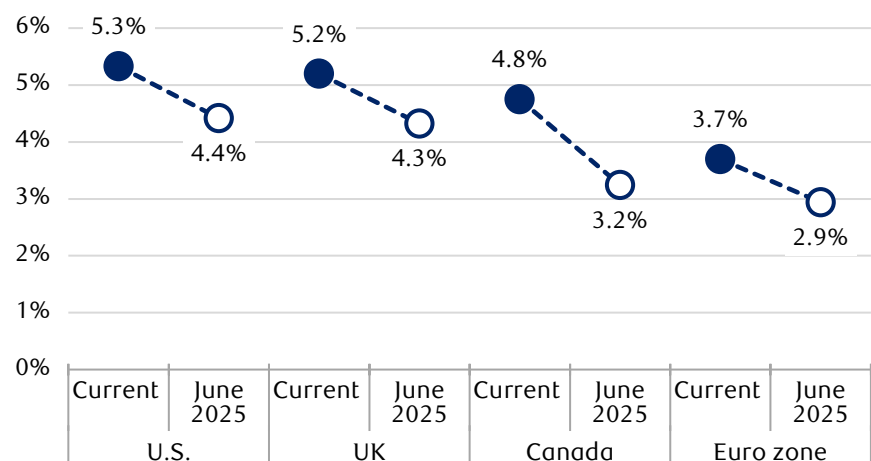
We expect it to continue moving higher, settling at around 3.0%.

So, the base case remains that most central banks will stay on track for gradual, and uneven, rate cut cycles, but the balance of risks leans toward the possibility that rate cuts will accelerate should economic activity slow—as is typically the case.

### Safety in sovereigns, or extra yield in credit?

Regardless of the timing, or scope, of rate cuts, it’s clear to us that we have reached the point where yields are now likely to trend lower. And fixed income investors are taking notice.

### Markets are pricing in shallow rate cut cycles



Source - RBC Wealth Management, Bloomberg, Long-run market-implied policy rate based on 1-year forward contract data

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## GLOBAL FIXED INCOME

Though it remains the case that short-term yields of inverted yield curves remain higher than yields on longer-dated securities, there is a growing focus on extending maturities to lock in yields for as long as possible, and before they begin to fade away.

At the beginning of the year, and as markets had priced in far too many rate cuts from central banks, in our view, we conceded that parking in cash at elevated yields was a fair investment strategy. At the start of the second quarter and on the back of rising yields globally, we shifted to recommending a gradual process of moving out of cash and into longer-dated securities.

This remains our approach, but perhaps with a bit more haste. As we don't see a resumption of rate hike cycles, we think the key risk for investors is whether yields drop slowly as is currently priced into markets, or if they drop faster due to some unforeseen event or economic slowdowns.

The next choice for investors in a fading yield environment is whether to seek safety in sovereign bonds or in bonds with some type of credit risk, such as corporate bonds.

While economic risks have seemingly faded globally in recent months, credit markets are trading like there are no economic risks whatsoever. Credit spreads—or the excess yields over government bonds to compensate investors for implied credit risks—remain at historically low levels. Maybe investors are even beginning to think that corporate balance sheets are looking better than government balance sheets, which we say only slightly tongue in cheek.

That said, with easing cycles having commenced and economic risks fading—though not entirely gone—investors may want to add credit exposure at historically high yields, even if the compensation for credit risks remains somewhat low.



# Regional fixed income perspectives

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## United States

■ The disappointing lack of further progress on inflation in the first quarter partially reversed over the course of the second quarter. With renewed optimism on the inflation front, markets are again pricing in multiple Fed rate cuts this year, though conviction remains low. At the June meeting, the median projection of the 19 members of the Federal Open Market Committee showed a likelihood of just one rate cut this year, but only just. Nine members expected two cuts, eight just one, and the rest foresaw no cuts. In our view, should inflation continue to come in soft over the course of the summer, a first rate cut by September remains on the table.

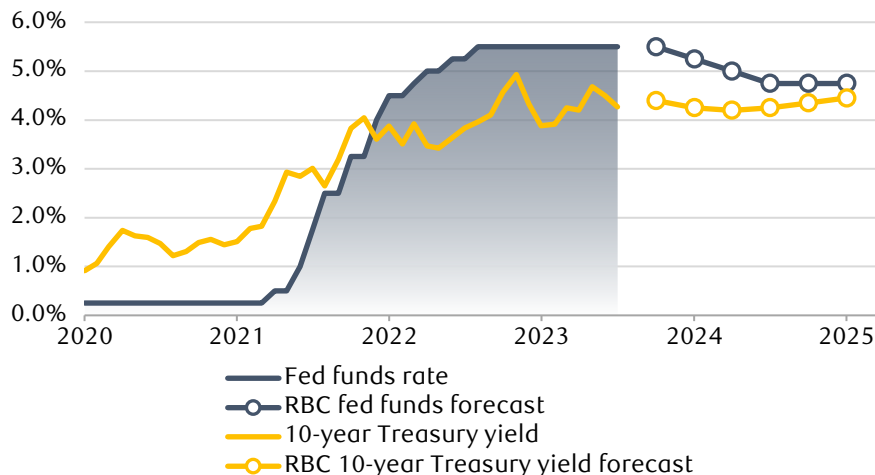
■ Credit market valuations remain rich in the U.S., but we think it is undeniable that total yields remain historically attractive. For investors with the appropriate risk appetite, we see value in a barbell approach of allocating to short-term Treasuries where yields are still north of 5%, and to high-yield corporate bonds where index yields remain around 8%. As a sector, the high-yield corporate market has broadly refinanced its debt with most maturities not coming due until 2029, which should reduce near-term credit risks.

■ While corporate bond valuations have been historically rich for much of 2024, the municipal bond market has been even more expensive. However, that began to change over the course of May and June as municipalities have flooded markets with new bond issuance ahead of elections later this year. As a result, the average yield ratio on a 10-year AAA-rated General Obligation muni relative to Treasuries has improved from a low of 57% in March to 66% as of June 21, nearly the highest ratio since November 2023, though still below historical averages.

## Canada

■ Over the last number of months, the Canadian economy has shown signs of weakness, growing at a slower pace than it did over the last three years, while the unemployment rate rose steadily. As macroeconomic weakness materialized and inflation moved lower, the Bank of Canada (BoC) was ultimately compelled to deliver its first interest rate cut of 2024, while guiding to additional cuts ahead. We view the potential for a BoC-induced drop in interest rates as supportive of longer-duration bonds in portfolios, i.e., those bonds with a higher price sensitivity to interest rate movements and most positively exposed to a drop in interest rates.

## Updated rate outlook



Source - RBC Wealth Management, Bloomberg, U.S. Federal Reserve, RBC Capital Markets forecasts as of June 2024

## REGIONAL FIXED INCOME PERSPECTIVES

■ Though a tactical shift to longer-duration bonds in anticipation of additional BoC interest rate cuts is reasonable, in our view, another strategy seems more appropriate given the lingering uncertainty regarding the timing and magnitude of rate cuts. Bond investors should focus on yields which are still hovering at the upper end of their 20-year historical range, moving away from an investment thesis that is heavily dependent on interest rate forecasts. This “yield” approach was much more difficult to implement when bond yields were sub-2% not long ago.

■ Despite a Canadian corporate bond market that is still providing compelling yields, we view the additional yield compensation offered for the risk of default (or credit spread) as historically low. This credit spread compression has also lowered the hurdle for Government of Canada bonds to deliver higher returns on a forward-going basis. When the yield compensation for risk is this low, understanding that bond markets are vulnerable to an outlook that is anything but perfect is key. Our bond preference has shifted away from what we see as the riskier categories of the fixed income market (such as higher-yielding bonds issued by corporations with weaker balance sheets) towards categories with less risk, such as bonds issued by the Government of Canada or the U.S. Treasury.

### United Kingdom

■ Interest rate cuts in the UK are now likely on the horizon. Our base case still calls for an initial 25 basis point (bps) rate cut from the Bank of England (BoE) in August and a further 25 bps of easing to reach 4.75% by the end of 2024—in line with market expectations of 4.72%. That hinges on the BoE’s three areas of focus, services inflation, private sector wage growth, and labour market tightness, being aligned with its forecasts. If the data surprises to the upside, the BoE might be hesitant to deliver

the two cuts we expect this year. While economic growth has been more resilient than our expectations, households’ sensitivity to rising mortgage costs poses a risk to future growth and could prompt more easing from the central bank. The BoE’s report on mortgage lending activities in Q1 revealed that the value of mortgages in arrears rose by 4.2% q/q to £21.3 billion—a 44.5% y/y increase and the highest since Q3 2014.

■ UK Gilts are currently trading around their six-month averages. Therefore, we are loath to add to long-duration bonds, but we maintain our modest Overweight allocation to Gilts. Despite record borrowing for the 2024–25 tax year and BoE bond sales, demand from investors has been robust. The Labour Party is currently leading in the polls for the general election on July 4 and the party’s manifesto emphasizes economic and fiscal stability. If there is a Labour victory, the risk of irresponsible government spending is likely low, in our view.

■ Corporate spreads tightened considerably in H1 2024, but recent widening in June makes valuations appear less rich. Spreads could remain well contained in H2 with muted supply and strong inflows from institutional investors, and from corporate fundamentals having improved in Q1 thanks to stronger growth and earnings profiles. Yet we remain highly selective as growth, political, and inflationary risks remain. We prefer short-duration exposure in senior-ranking bank bonds and issues from the consumer staples and technology sectors.

### Continental Europe

■ The European Central Bank (ECB) delivered an initial interest rate cut in June, but we think the path forward will be determined by magnitude and frequency of the “bumps in the road,” such as the recent upside surprises in wage growth and upward revisions to ECB staff inflation forecasts. The governing council places significant

## REGIONAL FIXED INCOME PERSPECTIVES

weight on the quarterly staff forecasts; therefore, the September and December staff forecasts will be key to watch for the Governing Council's reaction, in our view.

- Our base case is two more rate cuts to reach 3.25% by year-end, in line with current market pricing. That being said, if the September staff inflation forecasts continue to show an acceleration in inflation in 2025 and the ECB wage tracker indicates pay growth no longer decelerating, it could limit rate cuts, in our view. On the other hand, if price pressures and economic growth decelerate faster than the staff's estimates, it could prompt more cuts to stimulate the economy.

- We do not expect any disruptions from the central bank continuing to trim its balance sheet in a process known as quantitative tightening (QT). Thus, we maintain our modest overweight position in sovereign and multinational debt. While French spreads, the gap between the yields of French sovereign bonds and German Bunds, are at record high levels and seem attractive, we are reluctant to add positions given the heightened political and fiscal uncertainty France faces. We prefer Greece over Italy for lower-rated nations, and we balance the allocations across Germany, Belgium, Netherlands, European Union, and regional agency bonds.

- Recovering economic growth and ECB rate cuts are supportive for corporate fundamentals, and we expect minimal disruption from central bank QT even as the ECB holds 30% of the corporate universe (non-financial corporate bonds held by the ECB that met its criteria to purchase). In addition, investors have digested the record year-to-date supply in stride, leading to significant spread compression. Recent credit spread widening in June makes valuations less expensive and a better entry point, albeit not in cheap territory, in our view. We are selective on issuers and prefer short duration exposure in the Consumer

Staples, Communication Services, and Information Technology sectors and allocations in senior-ranking bank bonds.

### Asia Pacific

- Year to date, Asia credit has shown robust performance, with Asia ex-Japan corporate investment-grade and high-yield segments achieving total returns of +2.05% and +8.3%, respectively. This was largely driven by the sharp tightening in spreads across credit segments.

- Investors are paying close attention to the recent measures announced on May 17 aimed at addressing China's prolonged property crisis, which include reduced down payment ratios for homebuyers and adjustments to mortgage rates. Notably, the government will also direct funds toward local governments to purchase units completed but remaining unsold, with the expectation they will redeploy the apartments as affordable housing. These measures are meant to be a step in the right direction. However, questions remain as to whether they are enough given their small scale, despite their scope, particularly considering the execution risks involved. Nonetheless, we believe the measures could be a precursor to further policy stimulus ahead of the Third Plenum in July.

- Hong Kong non-financial companies have begun to see some silver lining amidst weak revenue growth and margin pressures. Funding costs have decreased with one-month HIBOR rates declining more than 100 basis points since the decade high on November 11, 2023. Prominent Hong Kong corporates, particularly those with a mainland China presence, have also moved their debt mix toward the renminbi, reducing their funding costs. One sector which has enjoyed a rebound in demand is Hong Kong property. Companies with residential exposure have benefitted from the government lifting all restrictive measures on property purchases in February this year. Primary home

sales have increased, and we believe companies within this sector should see credit spreads well supported.

- Singapore corporates, particularly government-linked companies, continue to see strong demand from Singapore-based private banks and institutions for local currency issuances. Given their modest sizes, most new issuances are easily absorbed and subsequently tightly held by investors, contributing to strong technicals across the space.

- For the second half of 2024, within Asia credit we continue to have a bias toward high-quality issuers and investment-grade bonds. While there is room for a possible widening of credit spreads toward the end of 2024, we believe Asia credit is currently well-supported by technicals. Hence, for Asia credit we also prefer a shorter duration (i.e., lower sensitivity to interest rates), while investors continue to enjoy attractive coupon income.

# Commodities

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## Commodity forecasts

Commodity	2024E	2025E
Oil (WTI \$/bbl)	\$79.45	\$77.79
Natural gas (\$/MMBtu)	\$2.31	\$3.13
Gold (\$/oz)	\$2,061	\$2,140
Copper (\$/lb)	\$4.39	\$4.50
Soybeans (\$/bu)	\$12.40	\$12.38
Wheat (\$/bu)	\$6.05	\$6.25

Source - RBC Capital Markets forecasts (oil, natural gas, gold, and copper), Bloomberg consensus forecasts (soybeans and wheat); data as of 6/25/24

### Crude oil

OPEC+ has decided to extend production cuts to the end of 2025. This comes at a time when the market is filled with different opinions surrounding the health of the global economy. However, the cuts can be reversed depending on market conditions. RBC Capital Markets is projecting a WTI price of US\$84/barrel by year end.



### Natural gas

Natural gas prices have strengthened over the past few months as power demand has increased, largely driven by warmer weather. While the market is still well-supplied and storage inventories remain high, RBC Capital Markets' increased utilization assumptions provide a rationale that could support current price strength.



### Gold

Gold has rallied to record highs this past year, driven by a softening economy and a spree of central bank purchases. In our view, as some central banks reported no purchases in May, a pause in gold price appreciation may take place in the near term, with the potential for reacceleration as interest rates come down over the year ahead.



### Copper

Despite recent weakness in copper prices, the commodity is still up double digits on a year-to-date basis. Improving demand in China and the increasing potential of Federal Reserve rate cuts have kept copper prices elevated. RBC Capital Markets expects prices to remain elevated for the remainder of the year but to potentially soften by improving supply in the back half of the year.



### Soybeans

The USDA is projecting global oilseeds production for 2024/2025 to increase, driven by higher soybean production, which the USDA is expecting to reach a record high. Furthermore, the USDA sees the economics of soybean planting as favoring further planting, aided by growing global trade largely driven by increased consumption in Asia. That said, this increased supply will likely lead to lower prices, in our view.



### Wheat

The U.S. Department of Agriculture (USDA) is forecasting global wheat production at record numbers in 2024–2025. In addition, the USDA is projecting higher food, seed, and industrial (FSI) consumption, attributed to population growth, government programs, and relative affordability. In our view, this, in turn, should be supportive of higher year-end wheat prices.



Chart source - RBC Wealth Management, Bloomberg; data range 1/1/23–6/12/24

# Currencies

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## Currency forecasts

Currency pair	Current rate	Forecast July 2025	Change
<b>Major currencies</b>			
USD Index	105.20	105.62	0%
CAD/USD	0.73	0.71	-2%
USD/CAD	1.38	1.41	2%
EUR/USD	1.08	1.09	1%
GBP/USD	1.27	1.21	-5%
USD/CHF	0.90	0.99	10%
USD/JPY	157.00	158.0	1%
AUD/USD	0.66	0.68	3%
EUR/JPY	169.00	172.0	2%
EUR/GBP	0.85	0.90	6%
EUR/CHF	0.97	1.08	12%
<b>Emerging currencies</b>			
USD/CNY	7.25	7.28	0%
USD/SGD	1.35	1.34	-1%

Change is defined as the implied appreciation or depreciation of the first currency in the pair quote.

Source - RBC Capital Markets forecasts, Bloomberg; data as of 6/13/24

## U.S. dollar: Supported by higher U.S. yields

The U.S. Dollar Index (DXY) hit a new high for the year in late April, driven by strong U.S. economic data and investors pushing back expectations for the timing of the first rate cut from the Federal Reserve to later in 2024. We expect the DXY to remain supported in Q3 on higher relative U.S. Treasury yields, with RBC Economics expecting a Fed rate cut only later this year. However, economic data could drive broader dollar moves.

## Euro: ECB cut rates in June as expected

The EUR/USD pair barely moved after the European Central Bank (ECB) cut interest rates in June in what was deemed by the market as a “hawkish cut.” Recent economic data in the eurozone have come in stronger than market consensus and while RBC Economics retained its forecast of two further cuts in 2024, it sees the risks skewed towards fewer cuts. We look at EUR/USD to remain in a relatively tight 1.05–1.09 range for the rest of 2024.

## Canadian dollar: USD/CAD target at 1.40 in Q4

The Bank of Canada (BoC) cut rates in June, driven by what it stated was “continued evidence that underlying inflation is easing.” With economic data slowing down in Canada, we look for weakness in the Canadian dollar

throughout 2024. RBC Economics expects three more BoC rate cuts this year, versus the market’s expectation for only two.

## British pound: Weaker on a constrained UK fiscal backdrop

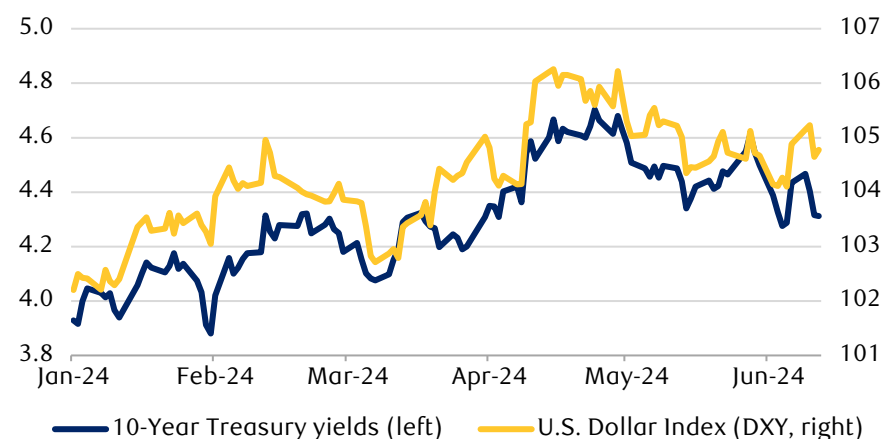
The pound has outperformed most G10 currencies in 2024 so far, on the back of stubborn inflation in the UK that pushed back the timing of interest rate cuts from the Bank of England (BoE). The announcement of a July UK general election did not move the pound much. However, we think it remains vulnerable due to a constrained fiscal backdrop that the next government will face, and the BoE’s inability to quickly cut interest rates to help an economy at a nascent stage of recovery.

## Japanese yen: USD/JPY to retest 160 by year’s end

USD/JPY surged to a 34-year high above 160 at the end of April, prompting the Japanese authorities to intervene twice in the foreign exchange market to prop up the yen. The USD/JPY pair continues to be driven by the wide interest rate differentials between the U.S. and Japan, which we expect to remain in play until the Fed cuts interest rates or if the Bank of Japan starts to hike rates aggressively, which is less likely in our view.

## DXY has closely tracked 10-year Treasury yields in 2024

We expect the USD to remain supported until the end of 2024, as we expect the Fed to cut rates only in December



Source - Bloomberg, RBC Wealth Management, data through 6/13/24



## U.S. RECESSION Scorecard

# Clouding over

Just two years ago, the Recession Scorecard was flashing nothing but expansionary green lights for the U.S. economy. Starting in summer 2022 that unequivocally unanimous rating began to deteriorate. First, the Treasury yield curve inverted in July 2022—i.e., the 1-year Treasury yield rose above the 10-year yield—signaling that credit conditions were tightening in a serious way. Every recession in more than 100 years has been preceded by such a yield shift.

A couple of months later a second of our seven indicators—the Conference Board’s Leading Economic Index—changed to recessionary red by falling below where it had been a year earlier. This has occurred before the onset of every U.S. recession since the late 1950s or for as long as this indicator has been around. In the months that followed, three more Scorecard series shifted out of the expansionary green zone to the cautionary yellow rating.

Now a third indicator in the Scorecard has been rerated to the recessionary red column. As of Q1, the growth rate of U.S. nominal GDP has fallen below the fed funds rate. Such a crossing point has occurred either before or

just after the start of every recession back to the 1950s.

The “expectations landscape” is now within an important timing window: On average, recessions have arrived 25 months following the first fed funds rate hike—which was April 2024. However, although the average elapsed time from the “first hike” to recession is slightly more than two years, in more than half the instances measured, the wait time was longer than 25 months.

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

The 1-year Treasury yield rose above the 10-year yield decisively in July 2022, with the negative gap growing further over most of the following year. While the average time interval between “inversion” of the yield curve and the onset of recession is 13 months, the gap was longer than average in four instances, with the longest being 23 months. As of July, this will be the longest inversion in more than 100 years.

Yield curve inversion is an unequivocal indication that credit conditions are tightening, a fact

### U.S. Recession Scorecard

Indicator	Status		
	Expansionary	Neutral/ Cautionary	Recessionary
Yield curve (10-year to 1-year Treasuries)			✓
Unemployment claims		✓	
Unemployment rate	✓*		
Conference Board Leading Economic Index			✓
Non-financial corporate cash flows	✓		
ISM New Orders minus Inventories		✓	
Fed funds rate vs. nominal GDP growth			✓

\* Potential change to Recessionary status pending.

Source - RBC Wealth Management

## U.S. RECESSION SCORECARD

confirmed for eight consecutive quarters by the Fed's Senior Loan Officer Survey (most recent issue released on May 4). A majority of U.S. banks continue to raise lending standards on almost every category of business and consumer loan, including commercial and industrial loans for businesses of all sizes, credit card loans, consumer installment loans, mortgage loans, and commercial real estate loans.

The negative spread between the 1-year yield and the 10-year yield reached its widest point this cycle so far last June at 158 basis points (bps). It has since narrowed dramatically to just 55 bps in April before widening back out to 90 bps in recent weeks. The crossover from "inverted" to "normal" has tended to occur just as the recession is starting or a few months before.

### Conference Board Leading Economic Index

Historically, this indicator has given reliable early warnings of recession. When the index has fallen below where it was a year earlier, a recession has always followed—usually two to three quarters later.

This indicator turned decisively negative in Q3 2022, shifting it to the recessionary red column. As of the May 2024 report, the index had fallen for 28 of the preceding 29 months moving deeply into negative territory, although the rate of the year-over-year decline has slowed over the past six months. The indicator has never fallen this deeply without a recession arriving.

### ISM New Orders minus Inventories

The difference between the New Orders and Inventories sub-indexes of the ISM Purchasing Managers' Index has turned negative near the start of most U.S. recessions. But it has also registered occasional false positives—signaling a recession was imminent when none subsequently

arrived. Moreover, this indicator only relates to activity in the manufacturing sector (some 15% of the U.S. economy) and is derived from a survey rather than hard data. For those reasons, we look at it as a corroborative indicator rather than a decisive one taken on its own.

After setting its most recent low in September 2022, this indicator rose steadily (we use a three-month moving average) and moved back above zero last summer. After three consecutive months in positive territory, we shifted the rating from recessionary red to neutral/cautionary yellow despite the fact the new orders component by itself remained decisively negative. That new orders reading finally managed to reach expansionary territory in January 2024; however, a particularly weak reading in May, if not quickly reversed, could push the overall indicator back into an outright negative reading this summer.

### Unemployment claims

The monthly low for this cycle occurred in September 2022. The cycle low for claims has typically been registered about 12 months before the start of the next recession. So far, no lower reading has been posted in the intervening months, leaving the indicator's status at yellow.

The fact that temporary employment, job openings, and average hours worked have all been falling on a year-over-year basis adds to the likelihood the tide may be turning for unemployment claims.

### Unemployment rate

The unemployment rate jumped to 4.0% in May after setting a cycle low of 3.4% in April 2023. While it edged gradually higher over the intervening 12 months, it has not yet moved into a decisive uptrend. However, any sustained move above 4.0% in the next few months, in our view, would signal a recession is on the way.

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## U.S. RECESSION SCORECARD

### **Non-financial corporate cash flows**

This gives an indication of the ability of such businesses, in aggregate, to internally fund any capital spending they want or need to do. Historically, whenever it has posted a year-over-year negative reading, a decline in corporate capital spending has typically followed, either indicating a recession is coming or deepening one that is already underway. These cash flows, while well down from their pandemic peak, are still above a negative crossing point as of Q1. There is a long lag time before this data is reported with the Q2 release not coming until September.

### **Fed funds rate vs. nominal GDP growth**

The fed funds rate has risen above the six-month annualized run rate of nominal GDP either before or at the start of every recession in the past 70 years. (Nominal GDP is GDP not adjusted for inflation.) That GDP run rate has been declining

since its pandemic reopening high of 23% recorded in Q4 2020. By the end of last year, it had slowed to 6.7%, still above the 5.50% fed funds rate. Now, however, the Q1 GDP data release puts that six-month run rate of nominal GDP growth at just 4.9%, below the fed funds rate, satisfying this historical precondition of a recession. We recently shifted this indicator into the recessionary red column.

### **Clock still ticking**

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

## Research resources

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			Count	Percent
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