GLOBAL
Insight
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Management

Perspectives from the Global Portfolio Advisory Committee

January 16, 2025

Pay attention to triggers for Europe

Frédérique Carrier – London

Due to structural headwinds, we downgraded European equities to Underweight from Market Weight in December 2024. Yet a number of headline-grabbing events are likely to occur in Q1 2025 that could be well received by equity markets if their outcomes are either not as bad as feared or better than anticipated. We peruse the opportunities that may emerge within European equities.

U.S. tariffs: Is the bark worse than the bite?

The tariffs that U.S. President-elect Donald Trump has threatened to impose on the EU could be a significant headwind to a region saddled with meagre economic growth. RBC Global Asset Management Inc. Chief Economist Eric Lascelles calculates that two years after the implementation of a 10 percent blanket tariff, eurozone GDP would be one percent smaller than it otherwise would have been.

Reflecting the tariff concerns, 2025 consensus GDP growth forecasts for the eurozone have been downgraded marginally to one percent from 1.2 percent since the U.S. elections in November.

Trump's transactional approach suggests to us there may be room for negotiations. By giving the U.S. some concessions, such as increased defence spending or purchasing more U.S. oil and liquified natural gas, the EU may be able to avoid the worst-case scenario of an escalating trade war or see only certain sectors affected by tariffs.

Given investors' anxiety regarding the impact of tariffs on the region, such relatively favourable outcomes—which may only happen after acrimonious negotiations—would likely be a relief for markets, in our view.

German federal elections: A new dawn?

The elections to be held on Feb. 23 are important given the German economy, the EU's largest, has sputtered since the end of the pandemic. Due to little ideological overlap, the three-party coalition that governed the country since 2021 proved ineffective at redressing the situation.

The coalition eventually collapsed, unable to strike an agreement to provide the fiscal stimulus the economy sorely needed. Additional spending has not been possible due to the "debt brake," the measure enshrined in the German constitution that limits the deficit to a stringent 0.35 percent of GDP per year. Modifying this rule requires a high two-thirds majority in parliament—a threshold unachievable to date.

Polls are indicating change is coming. The centre-right conservative alliance of the Christian Democratic Union of Germany (CDU) and the Christian Social Union in Bavaria (CSU) is likely to garner the most votes but fall short of a majority. A coalition with the centre-left Social Democratic Party (SDP) as a junior partner is the consensus outcome—such a coalition has governed effectively in the past.

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

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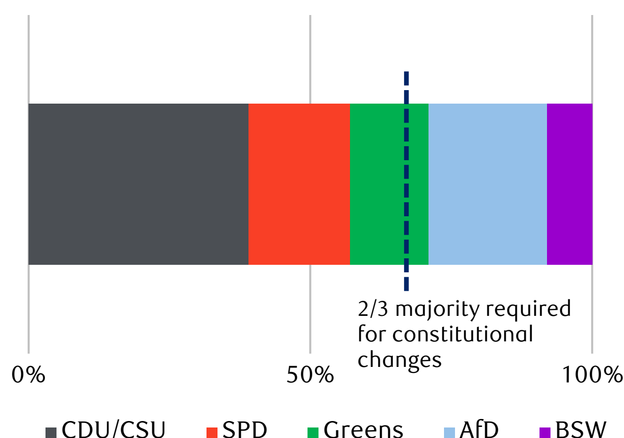
Likely distribution of German parliamentary seats could make amendment of the "debt brake" possible



Source - RBC Capital Markets, wahlrecht.de

RBC Capital Markets expects a CDU/CSU-led government would have little alternative but to modestly loosen its fiscal stance. It also foresees some additional defence and infrastructure spending under this outcome.

Reforming the debt brake may no longer be inconceivable, particularly if the three traditional parties (CDU/CSU, SDP, and the Greens) achieve a two-thirds majority, as predicted by current polls. All three parties seem open to the possibility of reform and politicians increasingly see the constitutional rule as outdated given the ailing economy and the low level of Germany's indebtedness—which is very low in an international context with a debt-to-GDP ratio below 60 percent.

Failing this, the new government could declare an "emergency" in 2025 to create a special fund for government spending—a measure which would only require a simple majority in parliament.

Beyond a modestly higher level of spending, a CDU/CSU-led government is likely to be more pro-business, in RBC Capital Markets' view, prioritising economic policies over environmental ones. The CDU/CSU manifesto calls for a decrease in the business tax to 25 percent from 30 percent, to be at least partly financed by pruning unemployment benefits. RBC Capital Markets also believes some deregulation is possible, along with a potential return to nuclear energy production through reactivation or the establishment of new reactors to alleviate energy cost pressures.

Overall, we believe that an end to the paralysis that characterised the previous coalition government, a more pro-business government, and modestly accommodative fiscal policy would be beneficial to the economy. These policies, if implemented, would likely please equity markets, in our opinion.

Yet investors should be mindful that large-scale fiscal stimulus remains unlikely, as the CDU/CSU is, after all, a conservative party in the European context. Moreover, Germany suffers from structural challenges including its flailing industrial model, which cannot be addressed solely by fiscal policy.

China: A fading headwind?

A healthier Chinese economy would improve Europe's prospects given China is a key export destination for European goods, and as many European companies have operations there.

While official announcements in China over the past few months have largely underwhelmed, in our view, recent ones have suggested a "more proactive fiscal policy," the first such indication of that since 2020, and a change in the monetary policy stance to "moderately loose" from "prudent" for the first time in 14 years. In December, following the two-day Central Economic Work Conference, Beijing pledged to stabilise the property market in 2025.

All this suggests to us that investors should remain confident that an expansionary policy is coming. RBC Global Asset Management believes China still has policy space to provide significant economic support. We expect policy announcements at the March 2025 "Two Sessions," the annual key political confab for major policy decisions.

A large stimulus announcement would boost Europe's fortunes, in our view.

Where does all this leave investors?

We believe there are notable near-term headwinds to European equity index outperformance. They range from a lack of competitiveness and meagre economic growth to geopolitical risks. These headwinds warrant holding a modest Underweight in European equities.

Yet given investor sentiment is downbeat and low valuations already seem to reflect many of these headwinds, a positive outcome from any of these events could provide opportunities for investors. A ceasefire agreement between Russia and Ukraine and a deeper European Central Bank rate-cutting cycle would also be perceived positively, in our view.

We continue to focus on world-leading companies that benefit from and drive global structural trends, particularly in niches such as semiconductor manufacturing equipment, electrical and mechanical engineering, industrial gases, and health care.

UNITED STATES

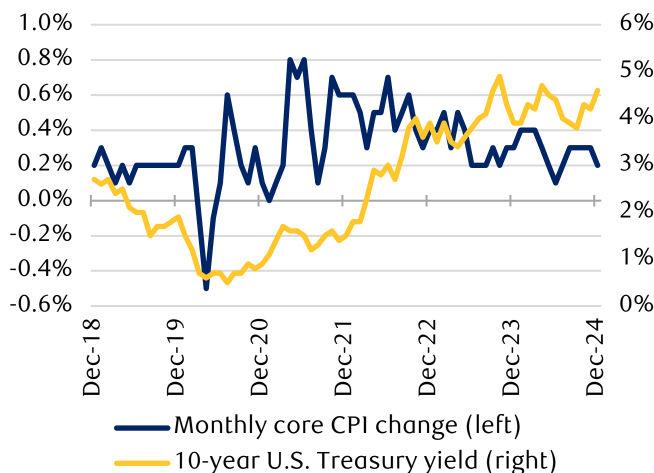
Atul Bhatia, CFA – Minneapolis

- **Recent economic data presented a relatively benign view of the U.S. economy.** The December nonfarm payroll report showed the U.S. created 256,000 jobs last month, while unemployment dropped to 4.1%. Both measures were better than the November numbers and were stronger than projected by economists surveyed by Bloomberg.

- **The robust labor performance came alongside relatively benign inflation data,** with the Consumer Price Index (CPI) rising 2.9% y/y in December. Prices outside of food and energy—often called core prices—rose 3.2% y/y. Despite the elevated level, the trend in core prices was reassuring, with the monthly pace slowing to 0.2%, below prior months and the expectations of economists surveyed by Bloomberg. **The key for investors, we believe, is the resumption of disinflation following a six-month period of stalled progress.** Concerns on inflation have weighed on bonds since the start of the year, with the 10-year U.S. Treasury yield moving 22 basis points (bps) higher to 4.79% by the Jan. 14 close. Immediately following the CPI report's release, rising bond prices pushed 10-year yields down 12 bps and helped spark a 1.5% rally in the S&P 500.

- **We think the combination of strong labor markets and above-target inflation is likely to keep the Fed on hold at its January policy meeting.** The central bank's mandate is to create full employment consistent with price stability, and we believe it is difficult to argue that labor markets need monetary support with unemployment at 4.1%. Instead, we think the Fed is likely to wait and see how the data develops going forward. Interest rate futures following the CPI data release showed a high probability that the Fed would resume rate cuts by its June meeting.

U.S. core price disinflation resumes; will bond yields also head lower?



Source - RBC Wealth Management, Bloomberg

CANADA

Matt Altro, CFA & Zachariah Muhn – Toronto

- **The diverging economic trajectories of Canada and the U.S. are increasingly reflected in the monetary policy approaches of their central banks.** While the U.S. Federal Reserve has lowered interest rates by 100 bps over three cuts since the start of this easing cycle in September 2024, the Bank of Canada (BoC) has gone further, reducing rates by 175 bps across five adjustments. Widening growth and interest rate differentials as well as political uncertainty in Canada have weighed on the Canadian dollar, which has depreciated roughly 6.2% against the U.S. dollar over the past 12 months to sub-US$0.70 levels. **Although a weaker loonie increases the cost of imported goods, the impact on Canadian consumers is likely less pronounced than commonly assumed.** According to RBC Economics, about 20% of Canadian final consumption is produced abroad, with only half of that coming from the U.S. and the remainder from countries against whose currencies the Canadian dollar has performed better. Looking ahead, RBC Economics expects this monetary policy divergence to persist, as the BoC will likely continue cutting rates in an effort to stimulate economic growth and combat at least one of the many forces driving the loonie lower.

- **Canada's labour market ended 2024 on a strong note.** December's employment data showed a gain of 91,000 jobs, well above consensus expectations of 25,000 and matching the fastest pace of hiring in the past two years. According to Statistics Canada, nearly two-thirds of the gains were attributable to full-time employment opportunities. The unemployment rate fell to 6.7% from 6.8% in November, defying consensus expectations of an increase to 6.9%. For the BoC, a single positive jobs report is likely not enough to trigger a pause in rate cuts, although markets will be watching labour and inflation data closely for potential insights into the central bank's policy rate decisions as policymakers pursue a data-dependent approach to monetary easing.

EUROPE

Rufaro Chiriseri, CFA – London

- **Against the backdrop of rising global bond yields in 2025, the underperformance of UK Gilts relative to euro-area and U.S. sovereign bonds has captured investors' attention** and reminded many of the Gilt-market turmoil following the 2022 Liz Truss budget. But the speed and magnitude of recent yield increases pale in comparison to 2022, when 30-year yields rose around 140 bps in just six days; this time, yields have risen by around 62 bps since the Oct. 30 budget.

- **A number of factors explain Gilt investors' nervousness.** One is that gross Gilt issuance through to 2029–2030 is forecasted by the Debt Management Office to remain above historical 10-year averages (excluding 2020). This supply overhang combined with the recent rise in yields will result in higher government borrowing costs, which could reduce fiscal headroom.

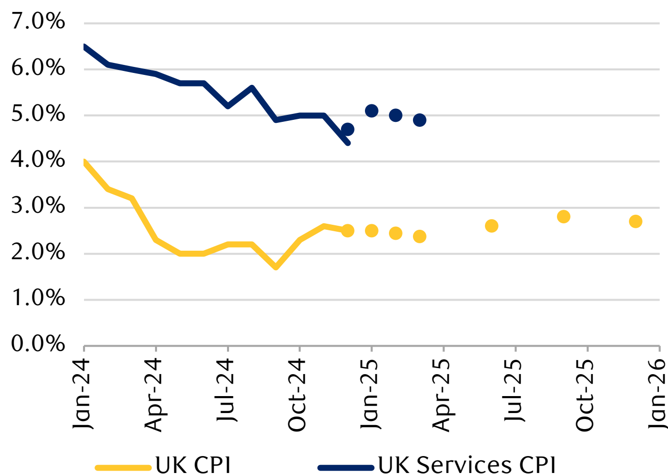
- While fiscal concerns have led the narrative, **Gilts are also highly sensitive to capital flows** due to the UK's reliance on overseas investors to fund the government and current account deficits. Excluding the U.S., the UK fiscal and current-account deficits are the largest amongst G7 nations and the eurozone, leaving the UK vulnerable to capital outflows when other markets look more attractive to investors.

- Moreover, to ensure stability in funding, **the UK Treasury traditionally issues a higher proportion of longer-dated debt compared to other developed nations.** The UK issues only around 5% in short-term debt compared to around 20% in the U.S. Therefore, when concerns around longer-term inflation and debt sustainability led to higher global yields, the effect was more acute in the UK.

- While not an indication of a crisis, **the movement in yields spells tougher times ahead for Gilts**, in our view—especially longer-dated bonds.

- **Some respite was given recently by headline UK inflation, which surprised to the downside,** slowing to 2.5% y/y in December from 2.6% y/y in November. Services inflation, which reflects domestic price pressures, decelerated to 4.4% y/y, and more importantly came in below the Bank of England's November projection of 4.7% y/y. Unsurprisingly, on Wednesday the market-implied probability of a February interest rate cut increased to 90% from 64%. Gilts rallied and the 10-year yield dropped 15 bps to settle at 4.73%.

UK services inflation undershoots the Bank of England's forecast



Dots represent Bank of England November 2024 forecasts.

Source - RBC Wealth Management, Bank of England, Bloomberg

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Markets are pricing in an 86% probability of a January interest rate hike by the Bank of Japan (BoJ) at its next meeting,** up from 58% last Friday. BoJ Governor Kazuo Ueda and Deputy Governor Ryozo Himino said earlier this week that they will decide if a hike is warranted at the bank's January meeting. However, according to a Bloomberg report, other BoJ officials see a good chance of a rate hike at the upcoming meeting if the new U.S. administration does not create too many surprises. The prospects of stronger-than-expected domestic inflation and wage increases will likely also be part of the rate decision. The yen has strengthened to 155.21 against the U.S. dollar as of this writing as expectation of a rate hike builds. Our view on the economic impact from an interest rate hike is skewed to the upside. **While rate hikes lead to higher interest expenses for corporate Japan, we expect higher rates to benefit households and the financial sector,** also taking into consideration factors such as improving sales and business efficiency, better cost pass-through, and business restructuring.

- **The Bank of Korea (BoK) unexpectedly held its interest rates unchanged as it weighs the impact of a weakening won against a backdrop of political instability and a slowing economy.** The won is currently trading close to a 10-year low against the U.S. dollar. Investor sentiment has been dampened by President Yoon Suk Yeol's shock martial law decree and a Jeju Air crash last month that was the worst aviation disaster in the country's history. The BoK lowered interest rates at its two previous policy meetings, with the most recent cut being a preemptive effort to support the economy. While the central bank has decided to pause for the time being, further easing remains on the table.

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