GLOBAL
Insight
WEEKLY

Perspectives from the Global Portfolio Advisory Committee

February 23, 2023

The push and pull on U.S. equities

Kelly Bogdanova – San Francisco

When equity markets are in transition there are usually a number of fits and starts as they work their way through bear market declines and get closer to beginning a sustainable bull phase. We look at the negative influences weighing on the market today, but also see some reasons why the S&P 500 could deliver positive full-year returns, once all is said and done.

Following a strong run since last autumn, the U.S. equity market has been wobbly. Uncertainties that had previously receded have come back to the fore, generating volatility and downside in major U.S. indexes. While the S&P 500 shot up almost 17 percent from the October 2022 low through early February, it has pulled back 4.5 percent since then. As of Wednesday's close, the index is 16.8 percent below the all-time high reached in early 2022.

The negative influences

Market participants are once again mulling over the possibility that:

- **The Fed's rate hike cycle could persist into the summer**, with a higher probability of the fed funds rate rising another 75 basis points (bps) to 5.50 percent between now and the central bank's June or July policy meetings, according to futures market positioning. Resilient consumer spending, the strong labor market, and higher-than-comfortable near-term inflation projections have contributed to this sentiment. The Fed's institutional biases are also playing a role. Just a couple months ago markets were contemplating only 25 bps more in hikes.
- **Rates could stay higher for longer**, impacting corporate borrowing costs and limiting business capital investment.

The U.S. market continues to work through headwinds

S&P 500 Index

Source - RBC Wealth Management, Bloomberg; daily data through 2/22/23

- **If inflation lingers above normal for longer, the market's valuation could become more difficult to justify**. The S&P 500 is trading at a price-to-earnings (P/E) ratio of 17.9x the forward 12-month consensus earnings forecast, above the 20-year average of

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

15.7x. Typically, inflation needs to be low or at least demonstrating that it is moving toward sustainably low levels for the market's P/E to be able to hover at the high end of the historical range for any meaningful period of time. Additionally, U.S. equities now look pricey compared to bonds based on equity risk premium analysis. This is the reverse of what occurred in recent years.

- **If the Fed ends up overtightening, the economy could ultimately tip into recession**. There is a fine line between the optimal number of rate hikes and overdoing it. As the Fed continues to fight inflation and the tight labor market at a time when some economic indicators have already weakened, RBC Capital Markets, LLC's Chief U.S. Economist Tom Porcelli is becoming more concerned that Chair Jerome Powell's Fed will overdo it. Porcelli thinks the central bank should have already stopped hiking rates.
- **Corporate margins and earnings could face additional pressure**. The consensus earnings forecast for 2023 has fallen to $223 per share from $252 per share last May. By some metrics, the current Q4 2022 earnings season is the weakest quarter in the past 24 years except for those during recessions, according to our national research correspondent. At this stage, the consensus forecast is for only 2.2 percent year-over-year earnings growth for 2023, and we think there is downside risk to this estimate—especially if a recession materializes.

It's not unusual for a number of uncertainties to linger after big selloffs like the one that occurred in 2022, and for issues that had previously caused volatility to create angst once again. This typically happens when equity markets are in transition. As the major indexes work their way through bear market declines and get closer to beginning a sustainable bull phase, there are usually a number of fits and starts. Given the lingering headwinds, investors should expect more volatility this year—this would be normal market behavior.

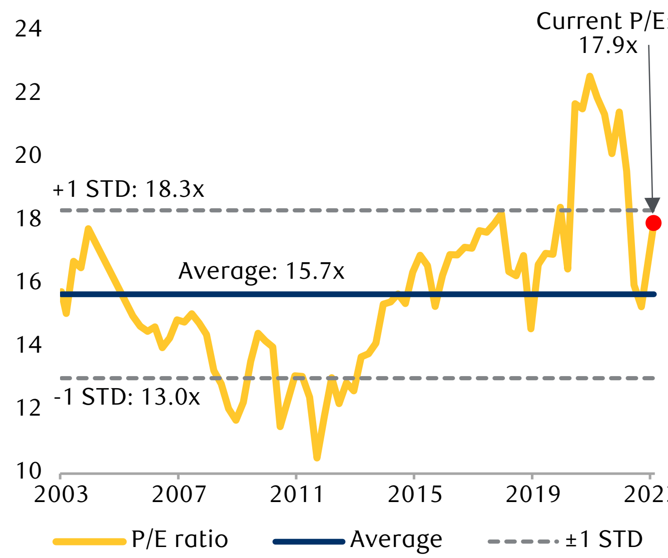
The positive influences

Even if volatility persists in the coming weeks and months, we continue to see reasons why the S&P 500 can deliver positive full-year returns, once all is said and done.

- **Inflation should push lower this year**. The path downward will likely be bumpy and it could take longer than is comfortable for inflation to get back to the Fed's two percent target. But price trends for commodities and goods, and projections for rents are pointing toward notably lower inflation by year end, according to RBC economists' forecasts.
- **The earnings outlook looks "less bad"—warts and all**. We think 2023 S&P 500 earnings could end up at $210–$220 per share, lower than the current $223 per share consensus estimate. This would be roughly equal

The market's valuation is now above average

S&P 500 price-to-earnings ratio based on forward 12-month consensus estimates



Source - RBC Wealth Management, Bloomberg; quarterly data except for the final data point that is from 2/22/23. "STD" stands for "standard deviation."

to or slightly down from the 2022 estimate of $218 per share. Such an outcome would be "less bad" than previous recession periods. We think this is possible because household spending should be relatively more resilient this cycle than in recent economic contractions. Household balance sheets appear to be in better shape due to sturdier employment trends and high savings levels when this period began. Both will likely erode, but not as much as in previous recessions.

- **Investors should heed the long-standing axiom, "As goes January, so goes the year"**—aka the "January effect." In January 2023, the S&P 500 climbed 6.2 percent, the Dow Jones Industrial Average rose 2.8 percent, and the small-cap Russell 2000 rallied 9.7 percent. According to Stock Trader's Almanac data since 1950, when the S&P 500 rose in January *and* was up during the first five trading sessions of the year *and* there was a "Santa Claus rally"—all of which occurred this time around—the market posted gains for the full year 90 percent of the time; the average gain was 17.5 percent. Following bear market years (like last year), it rose on 100 percent of occasions. Furthermore, it would be rare for the S&P 500 to deliver back-to-back negative return years; that has occurred only twice in the post-WWII era.

We think these positive factors, balanced by the lingering headwinds, argue for Market Weight exposure to U.S. equities, with an eye toward becoming more aggressive with sector and industry positioning or more constructive overall should the market pull back further.

UNITED STATES

Atul Bhatia, CFA – Minneapolis

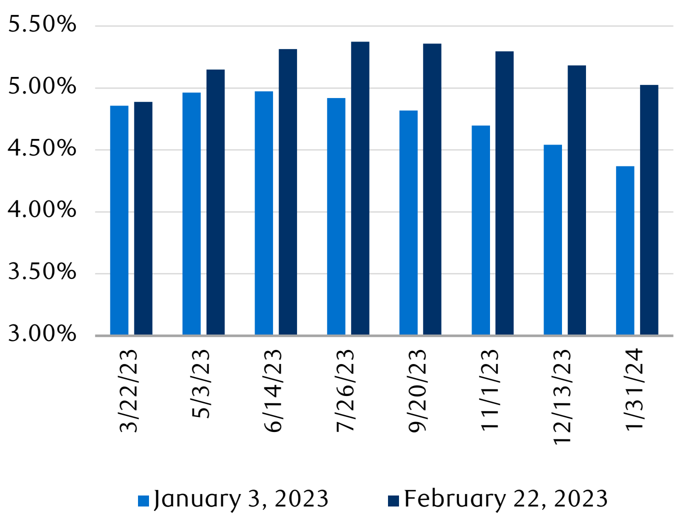
- **Recent data continue to present a mixed picture of the U.S. economy**. The nationwide S&P Global Composite PMI (Purchasing Managers' Index) reflected essentially flat activity overall with modest growth in services. Meanwhile, two regional Federal Reserve bank metrics were less constructive: the New York Fed's monthly Services Business Activity Index showed a broad slowdown in activity, while the Philadelphia Fed released data showing a modest expansion in non-manufacturing activity but a sharp deterioration in business sentiment. We believe the overall picture reflects the headwinds of tighter monetary policy and general uncertainty while highlighting the resilience of the U.S. economy.

- **The minutes of the Fed's most recent meeting emphasized a view that additional rate hikes are likely to be needed** as the central bank continues to fight inflation above its target level. Inflation and employment numbers released since that meeting have strengthened the case for tighter policy, according to public comments by several regional Fed leaders. **Investors have apparently taken the warnings to heart**, with interest rate futures now reflecting a high probability of 5.5% overnight target rates by midyear and policy rates above 5% through at least early 2024. This is in sharp contrast to the start of the year, when prices reflected a peak rate of 5% and multiple rate cuts over the course of 2023.

- **The prospect of higher interest rates has sparked moves across financial asset classes**. Treasury bonds have had poor price performance so far in February. Yields—which move in the opposite direction to price—were up by more than 50 basis points (bps) on 5-year U.S. government bonds from the start of the month through yesterday's close; other maturities saw yields increase between 30 and 50 bps in the same period. **One beneficiary of the shift toward higher yields is the U.S. dollar**. The DXY Dollar Index, which tracks the greenback on a roughly trade-weighted basis against a basket of global currencies, is up 2.4% so far in February.

Investors heed the Fed's warnings

Futures-implied policy rate expectations for upcoming Fed meetings have shifted higher



Source - RBC Wealth Management, Bloomberg; data as of 6:00 am ET 2/23/23

CANADA

Matt Altro & Sean Killin – Toronto

- **The January consumer price index (CPI) rose 5.9% y/y, a comforting sign that a deceleration in inflation is occurring**. This is a smaller climb than the 6.1% expected from surveyed economists, and represents a 0.5% m/m change compared to the 0.7% expectation. On the back of this reading, short-term bonds rallied, bringing down yields and propping up the Canadian dollar compared to the U.S. dollar. Although inflation data continue to come in well above the Bank of Canada's 2% target, we think the continued easing of inflation promotes a positive tone for the central bank to hold rates at 4.5% at its March 8 policy meeting.

- **Canadian headline retail sales have continued to advance as nominal consumption metrics in the economy show some sustained signs of resilience**. Retail sales increased 0.5% m/m in December, with activity increasing in seven of the 11 retail subsectors. Motor vehicle and parts dealers led the majority of the strength in Canadian retail; however, core retail sales (which exclude gasoline and motor vehicle parts) increased by 0.4% m/m. This was primarily driven by a mix of higher prices and moderate consumption levels at general merchandise and grocery stores. Geographically, sales rose in four provinces, with concentrated strength in high-density urban areas. That being said, despite the nominal headline strength, when adjusting retail sales for seasonality and inflation, sales growth is not nearly as impressive as Canadians continue to experience the effects of above-trend inflation.

EUROPE

Frédérique Carrier – London

- **The UK and European economies seem to be more resilient than anticipated**. Both surprised to the upside of consensus with the February S&P Global Eurozone Composite Purchasing Managers' Indexes jumping to 53 and 52.3 in the UK and Eurozone, respectively, from below 50 at year-end 2022. In both cases, strong performance of services drove the improvement, with manufacturing activity remaining below the expansionary level of 50.

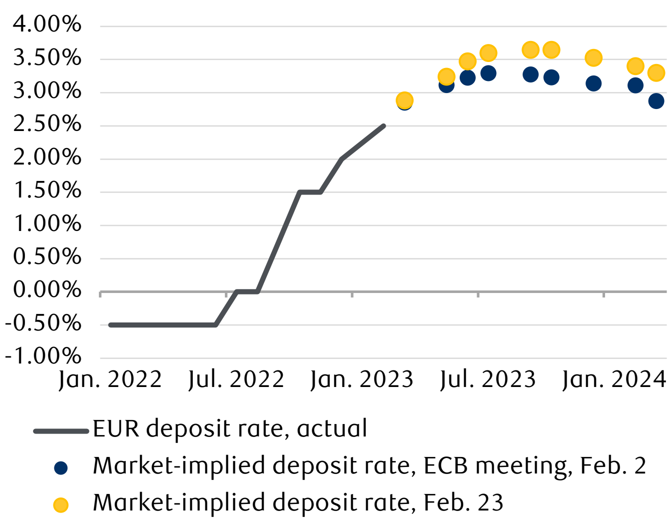
- **For the UK, we think the uptick in activity can be attributed to improving supply chains, lower natural gas prices, and rising business confidence**. The latter could trickle through to the household sector battered by the cost-of-living crisis, if business hiring intentions improve. For the Bank of England, which was counting on a recession and higher unemployment to rein in double-digit inflation, this may pose a challenge. Markets are now implying rates will peak slightly beyond 4.6%, remaining near that level until early next year.

- **The European Central Bank will focus on better activity and rising wages, and will maintain its hawkish tone, in our view**. Investors are now expecting the central bank to raise rates close to the 3.75% all-time high from 2.5% currently.

- **Earnings in Europe and the UK combined have also been resilient**. With just over half of companies having reported, positive trends are becoming apparent. Top-line growth has been very robust—over 10%—thanks to strong demand and pricing. Flow-through to earnings has been limited, however, due to higher costs including wage inflation. As a result, earnings growth was lower at 5%. It was worthy growth, in our opinion, given economic prospects were bleak only a few months ago.

- **Statements accompanying the results suggest the corporate sector is cautiously optimistic about the economic outlook** given U.S. resilience and China reopening its economy, though it remains cautious on margins.

Markets now expect a higher European terminal rate



Source - RBC Wealth Management, Bloomberg; data as of 6:16 am ET 2/23/23

ASIA PACIFIC

Emily Li – Hong Kong

- **Japan's trade deficit jumped to a record ¥3.5 trillion ($26.1 billion) in January**, up from ¥1.45 trillion in December. Besides one-off factors such as the Lunar New Year holiday, the slowing global economy could be the main reason. Export growth slowed sharply to 3.5%, dragged down by reduced demand for chip-making equipment and cars and auto parts machinery to China. Exports to the U.S. and Europe also decelerated. Meanwhile, imports increased 17.8% y/y, as costly energy shipments continued. The record trade deficit is an overhang on Japan's economy as it struggles for recovery momentum with new Bank of Japan Governor Kazuo Ueda taking the reins in April.

- **Initial public offerings (IPOs) in Asia's equity markets have posted the slowest start to a year since 2019**. IPOs in Asia have raised just $6.2 billion since the beginning of the year compared to $4.2 billion over the same period in 2019, despite an almost 20% rally in equities from an October low. The IPOs are dominated by mainland Chinese offerings, given China's monetary policy easing and the long lead time for share sales.

- **Hong Kong Exchanges and Clearing Ltd. (388 HK) will study a series of proposals to optimize its trading mechanism**, including making arrangements to maintain market operations during periods of inclement weather, which means the market may no longer have "typhoon holidays". Given the global financial industry has adjusted to remote working amid the pandemic and most orders are now received and executed electronically, halting trading is likely to be increasingly inconvenient. The rival hub in Singapore has never halted trading at its stock exchange due to weather-related events.

- **Baidu Inc. (9888 HK) announced a $5 billion share buyback**. The news came after the company reported upbeat results, mainly due to the better-than-expected cloud computing service offsetting the advertising business slowdown. Baidu also unveiled plans to incorporate a ChatGPT-like service in its search engine next month.

MARKET
Scorecard

Data as of February 22, 2023

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,991.05	-2.1%	3.9%	-7.3%	3.0%
Dow Industrials (DJIA)	33,045.09	-3.1%	-0.3%	-1.6%	4.8%
Nasdaq	11,507.07	-0.7%	9.9%	-14.0%	-15.0%
Russell 2000	1,894.68	-1.9%	7.6%	-4.3%	-15.8%
S&P/TSX Comp	20,193.33	-2.8%	4.2%	-3.4%	9.6%
FTSE All-Share	4,322.65	1.6%	6.1%	3.6%	14.9%
STOXX Europe 600	462.22	2.0%	8.8%	1.6%	11.9%
EURO STOXX 50	4,242.88	1.9%	11.8%	6.5%	14.7%
Hang Seng	20,423.84	-6.5%	3.2%	-13.2%	-32.6%
Shanghai Comp	3,291.15	1.1%	6.5%	-4.8%	-9.6%
Nikkei 225	27,104.32	-0.8%	3.9%	2.5%	-10.1%
India Sensex	59,744.98	0.3%	-1.8%	4.3%	20.1%
Singapore Straits Times	3,300.04	-1.9%	1.5%	-3.0%	14.5%
Brazil Ibovespa	107,152.05	-5.5%	-2.4%	-5.1%	-4.9%
Mexican Bolsa IPC	53,180.99	-2.5%	9.7%	1.1%	18.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.921%	41.5	4.7	198.2	255.6
Canada 10-Yr	3.372%	45.6	7.2	145.0	213.8
UK 10-Yr	3.600%	26.8	-7.2	212.9	292.1
Germany 10-Yr	2.520%	23.4	-5.1	227.7	285.9
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.80%	-2.8%	0.2%	-9.5%	-12.4%
U.S. Investment-Grade Corp	5.50%	-3.4%	0.5%	-10.1%	-13.7%
U.S. High-Yield Corp	8.86%	-2.4%	1.3%	-6.0%	-6.4%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,825.60	-5.3%	0.1%	-3.8%	0.9%
Silver (spot $/oz)	21.51	-9.4%	-10.2%	-10.8%	-23.6%
Copper ($/metric ton)	9,183.50	-0.2%	9.8%	-7.8%	0.6%
Oil (WTI spot/bbl)	73.75	-6.5%	-8.1%	-20.1%	19.9%
Oil (Brent spot/bbl)	80.48	-4.7%	-6.3%	-16.9%	23.4%
Natural Gas ($/mmBtu)	2.16	-19.5%	-51.7%	-52.0%	-26.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	104.5600	2.4%	1.0%	8.9%	16.2%
CAD/USD	0.7377	-1.8%	0.0%	-5.8%	-6.9%
USD/CAD	1.3556	1.9%	0.0%	6.2%	7.5%
EUR/USD	1.0603	-2.4%	-1.0%	-6.4%	-12.8%
GBP/USD	1.2043	-2.2%	-0.3%	-11.4%	-14.4%
AUD/USD	0.6805	-3.5%	-0.1%	-5.7%	-14.0%
USD/JPY	134.9000	3.7%	2.9%	17.2%	28.4%
EUR/JPY	143.0700	1.2%	1.9%	9.8%	12.0%
EUR/GBP	0.8804	-0.1%	-0.6%	5.6%	1.9%
EUR/CHF	0.9878	-0.7%	-0.2%	-5.4%	-9.3%
USD/SGD	1.3407	2.0%	0.1%	-0.4%	1.4%
USD/CNY	6.8929	2.0%	-0.1%	9.0%	6.6%
USD/MXN	18.3665	-2.5%	-5.8%	-9.5%	-11.4%
USD/BRL	5.1593	1.6%	-2.3%	2.0%	-5.5%

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 Wednesday'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 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD 0.0% return means the Canadian dollar is flat in comparison to the U.S. dollar year to date. USD/JPY 134.90 means 1 U.S. dollar will buy 134.90 yen. USD/JPY 2.9% return means the U.S. dollar rose 2.9% vs. the yen year to date.

Source - Bloomberg; data as of 2/22/23

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As of December 31, 2022

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Rating	Count	Percent	Count	Percent
Buy [Outperform]	839	56.05	225	26.82
Hold [Sector Perform]	603	40.28	151	25.04
Sell [Underperform]	55	3.67	3	5.45

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