RBC Global Asset Management

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ECONOMIC OUTLOOK – FALL 2013

Normalization

Three striking new themes have solidified over the past quarter. The first is the stark role reversal between developed and developing nations. After a long post-crisis malaise, the developed world is finally enjoying renewed economic growth. The U.S. is rebounding, Europe has exited recession and Japanese policy-makers are prodding their economy forward. Alas, emerging market economies are now headed in the opposite direction, sputtering in response to a variety of new headwinds and vanished tailwinds.

The second theme is a dramatic increase in global borrowing costs spurred by U.S. Federal Reserve (Fed) plans to scale back its bond-buying program. This complicates the economic outlook by threatening to smother newfound growth. From an investment perspective, it has dulled fixed income returns over the past quarter, but newly enlarged coupons look to reward bond investors in the future.

The third theme is economic normalization, which represents an extension of the first two. Improving growth in the developed world and rising bond yields are important examples of normalization after years of subpar growth and abnormally low borrowing costs. The normalization has extended to the stock market, where valuations have steadily increased over several years and are now near normal levels in a number of markets. Even risk appetite has finally broken into risk-seeking mode (Exhibit 1).

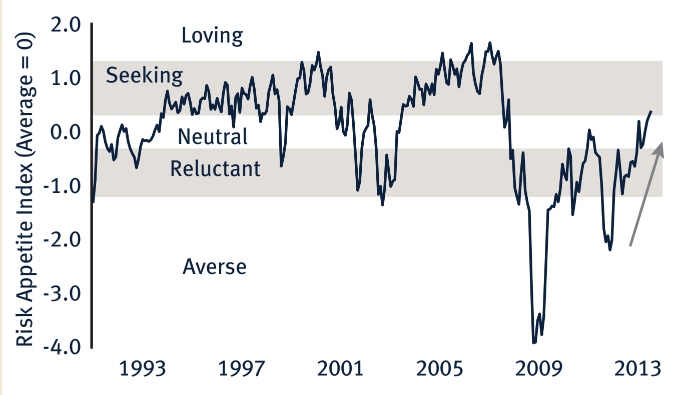
Shifting Forecasts

The major economies of the developed world – the U.S., the U.K., the eurozone and Japan – are all enjoying better growth as they finally begin to escape the shackles of the global financial crisis. In sharp relief, many major emerging market economies – China, India, Brazil, Mexico and South Korea among them – have slowed as prior tailwinds die down and new headwinds appear. Market expectations are for a continuation of this trend. Indeed, forecasters are scrambling to upgrade their developed world growth forecasts and downgrade developing nations. To be clear, few are calling for emerging economies to actually grow more slowly than developed economies. But the extent of emerging market outperformance is expected to narrow.

Taper Talk

Monetary policy pivoted importantly over the summer when the Fed began openly musing about tapering its program of bond purchases in the second half of 2013. In response, the yield on the U.S. 10-year Treasury has zoomed over 100 basis points above its May low (Exhibit 2). The ferocity of this action has no equal since the infamous bond market backup of 1994. Of course, there is an important distinction between buying fewer bonds – which is what the Fed proposes – and liquidating its entire holdings, let alone raising the Fed funds rate. By all accounts, the latter two options are still several years away. The Fed merely contemplates reducing the rate

Exhibit 1: Reviving Risk Appetite



Note: Measures risk appetite based on 46 normalized inputs.
Source: Bloomberg, BofA ML, Consensus Economics, Credit Suisse, Federal Reserve Bank of Philadelphia, Haver Analytics, NedDavis, RBC Global Asset Management

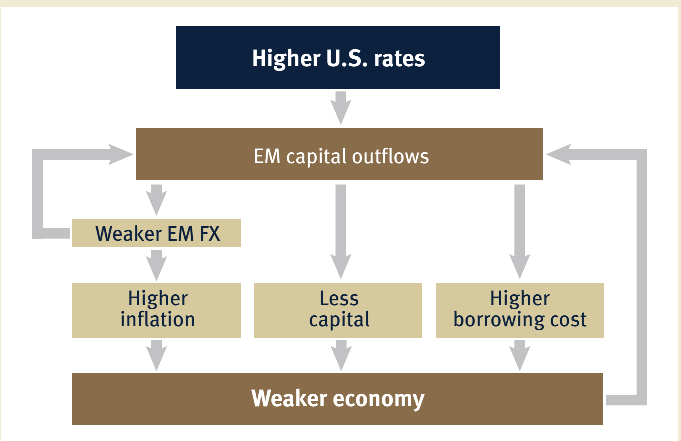
Exhibit 2: QE Taper Expectations Push Up Bond Yields

Source: Federal Reserve Board, RBC Global Asset Management at which it delivers stimulus from the current $85 billion-per-month pace. The timing of this taper is not yet clear, with the Fed seeming more reluctant than the market had imagined to pull the trigger. There is still a fair chance that the taper begins before 2013 is through.

Global Impact

As the world's bond bellwether, it is unsurprising that rising U.S. rates have elevated borrowing costs globally. But whereas rising interest rates are perhaps appropriate for the U.S., they are less tolerable elsewhere. The problem is simply that higher rates equate to slower growth. This is serious enough. However, the problem has an added dimension for vulnerable developing economies (usually ones running current-account deficits) such as India and Indonesia. Higher U.S. yields have attracted money away from emerging market investments. This can trigger a Rube Goldberg-like sequence of events for the most vulnerable countries (Exhibit 3), including a sharply weaker exchange rate, higher borrowing costs, elevated inflation and ultimately slower economic growth. These developments push still more investors away from emerging markets, and round and round it goes. Fortunately, there is evidence that this process is beginning to stabilize.

Exhibit 3: Emerging Markets Vicious Circle



Source: RBC Global Asset Management

China's Challenges

China is the world's second-largest economy and easily the most important in its contribution to global growth. It is thus somewhat disconcerting that its economy is among those that have decelerated. We have dedicated two recent research reports to this subject: "What Looms After China's Credit Boom" and "China: Growing Pains for a Growing Power." China's growth prospects are subject to a wide range of forces, rendering the outcome far from certain. On the negative side, China has already lost forward momentum from two of its major growth engines: exports and credit. It has saturated the world with manufactured goods and is no longer as competitive as it once was. This means it cannot continue to rely on outsized export growth.

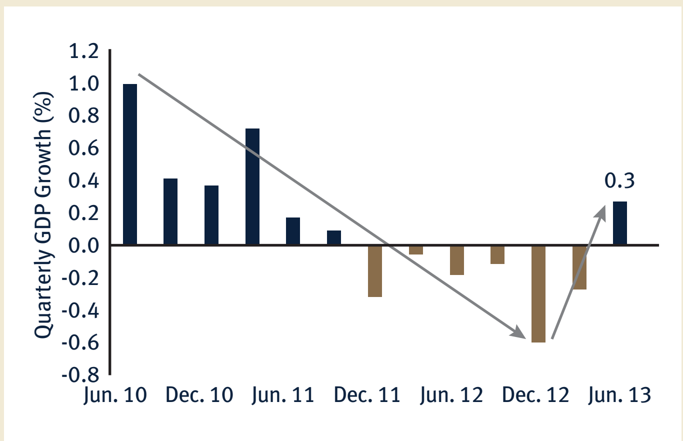
Improving U.S. Prospects

The U.S. outlook remains fairly good, despite subpar economic growth over the first half of 2013. We chalk that up to the consequences of the January 1, 2013 fiscal cliff, combined with a bit of bad luck (our models suggest GDP probably should have grown a bit more quickly than it did given the healthy state of other macroeconomic indicators). The second half of the year is shaping up to be somewhat better. Fiscal drags remain, but leading indicators such as the ISM Manufacturing Index have begun marching higher, jobless claims are falling nicely and consumer confidence is finally improving.

Eurozone Growth

The eurozone has achieved an important and long-awaited milestone by scratching out a bit of economic growth in the second quarter of 2013 (Exhibit 4). Of course, the technical restoration of growth doesn't assure that the economic suffering is over. The growth rate is hardly robust, several peripheral nations are likely to remain stuck in recession for several more quarters and unemployment will remain worryingly high for many years.

Exhibit 4: Eurozone Eked Out Some Growth



Source: Statistical Office of the European Communities, Haver Analytics, RBC Global Asset Management

Japan Fires Three Arrows

Japan remains easily the most fascinating country in the developed world as it endeavours to outpace slow growth and deflation. The main story remains Prime Minister Abe's "three arrows" of monetary stimulus, fiscal stimulus and structural reform. The first two arrows have been shot, and more monetary stimulus from the Bank of Japan is possible. The third arrow – structural reform – is much discussed but still in the quiver. The Liberal Democratic Party's victory in the upper-house election this summer is a promising step toward the delivery of structural changes. No discussion of Japan is complete without acknowledging its stupendously high public debt load. This has proven surprisingly sustainable given a high private savings rate and low borrowing costs, but as global interest rates rise and Japan experiments with bold initiatives, the risk of trouble on this front grows.

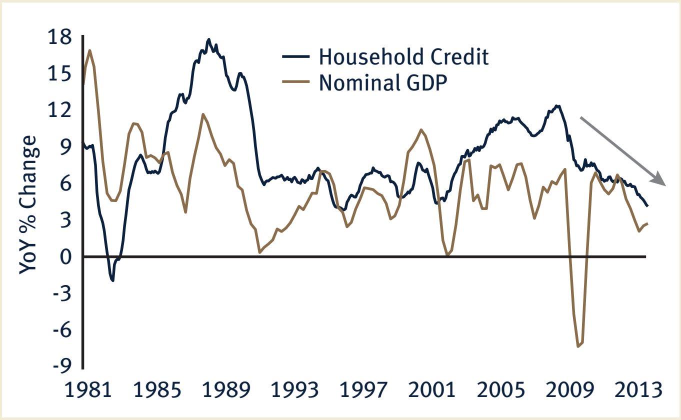
Britain's Princely Performance

The U.K. is the developed nation on which our thinking has evolved the most over the past quarter. Britain's economy had been stuck in the mud for several years until growth suddenly picked up in the latest quarter. Expectations should still be kept in check due to several persistent drags, including feeble wage growth, rapidly declining North Sea energy production and a beleaguered financial services industry. But recent budgetary efforts to revive the housing market seem to be working and a new governor at the Bank of England has delivered additional stimulus and policy coherence.

Sluggish Canada

The Canadian economy continues to grow, but is not participating fully in the developed world's recent liftoff. Mainly, this is because the country benefited from robust consumer spending and a hot housing market while many other countries suffered in the aftermath of the financial crisis. Now, Canada finds itself falling back to Earth as borrowing costs rise and credit growth slows (Exhibit 5). Canada's housing market remains the key issue. Affordability is not bad given low mortgage rates, but as rates rise, fewer potential buyers will be able to afford home purchases.

Exhibit 5: Canadian Household Credit Growth and GDP Growth



Source: Bank of Canada, Statistics Canada, Haver Analytics, RBC Global Asset Management

Evaluating Higher Bonds Yields

The speed and extent of the global bond market sell-off since May was aggressive, but it was not entirely shocking. Interest rates were extremely and unsustainably low, and we have patiently maintained an underweight position in bonds for some time to avoid the painful adjustment when it came and to capitalize on the opportunities afforded by higher yields. We acknowledge that it is difficult to justify the degree of fixed income price declines given the Fed's vagueness on when quantitative easing will be phased out. We calculate that prospects for tapering were worth around 10 to 20 basis points to the bond market – far less than the actual move. However, the fact that the Fed is shifting in its thinking away from the delivery of stimulus and toward its eventual removal may be reason enough for the outsized move. Moreover, several of our bond models now suggest the bond market is more fairly valued today than it was before yields began to rise.

Headwinds Beginning to Fade

Many of the headwinds that have dominated since the financial crisis are beginning to fade. Marked improvement in the global economy, stock markets reaching new highs and bond yields beginning to normalize are all signs that a sustained economic recovery has taken hold. That's not to say that risks to the global economy don't still exist. However, over the summer months, sentiment seems to have shifted. Investors are no longer focusing solely on the risks to the recovery, and instead may now be acknowledging the positive momentum that could continue to propel growth. This normalization – and perhaps regime change – in the economic outlook and investor sentiment would mean that interest rates continue to drift higher, reflecting the reduced need for safe-haven assets and the eventual tightening of global monetary policy.

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