The 2022 Midyear Outlook

Tylar Lunke:

Hello everybody and welcome to a midyear update from RBC Wealth Management. We're recording this on Thursday, June 30, 2022. My name is Tylar Lunke and I lead the Managed Portfolio Strategies team. And I'm joined by two guests today. Janet Engels, head of the Portfolio Advisory Group, and Tom Garretson, senior portfolio strategist on the Fixed Income Strategies team. I want to say thanks to you both for the time and perspective today and a special thanks to everybody for joining us. We know it's been difficult as far as the start to this year for investors, both in equity and fixed income, but we're going to turn and look a bit forward from here.

And our goal over the next 15 minutes or so is really to provide some perspective on the markets given we are indeed halfway through 2022, including a bit on where we are today, potential return prospects from here, and then close with thoughts about portfolio positioning. So with that as the setup, Janet, welcome. We'll start with you. So we are halfway through the year here and at the beginning of the year on an audio clip like this one, you mentioned that it was a year of shifting gears. Is that still the case?

Janet Engels:

Thanks, Tylar. You're absolutely right. There have been a number of notable shifts that have taken place this year. We've had a shift from a year of low volatility, such as we experienced in 2021, to much higher volatility for the markets this year. And as you mentioned, we've also had some downward pressure on asset prices. We've also seen a shift in the forecast for economic growth, not only here in the United States, but globally. And within the U.S., We've seen a shift from the demand for goods to the demand for services still pretty lumpy.

And of course, we're still seeing some of those supply chain issues. But the more important shifts, the shifts that the market are focused on are several fold. First, the Fed moved from being tolerant to intolerant of inflation. The Fed in terms of their rate strategy moved from moving rates higher to aggressively moving rates higher. Central banks are no longer suppressing bond yields, meaning we've moved from quantitative easing to quantitative tightening. Recession risks have also shifted higher and markets and investors are beginning to shift their view from one of a growth scare to a possible recession scenario.

Tylar Lunke:

So Tom, will bring you into the conversation and Janet touched on some of the Fed and the shifts in their thinking. What are the current expectations for the Fed, for rates and as they attempt to combat this inflation?

Tom Garretson:

Thank you, Tylar. So yeah, if the first half of the year was highlighted by inflation fears, I do think the back half of the year is going to be highlighted by growth concerns and that will play into Fed policy. So the first half of the year was an aggressive approach that trying to get back on page with inflation. I think the growth narrative will kind of dominate the Fed's thinking in the back half of the year. So we do expect when they meet at the end of the month in late July, we'll probably see another 75 basis point rate hike, do think the debate will be between 50 basis points and 75 basis points.

But I think at this stage if they do deliver another 75 basis point rate hike, that would bring the policy rate to 2.5%, which is the exact middle of their kind of 2% to 3% range, which they have pegged as kind of the neutral level for the U.S. Economy in terms of not boosting growth, but not also restricting it. I think at that point, they'll probably pivot to more of a cautious approach. And so starting with a September meeting, I think they'll drop all the way back to a 25 basis point per meeting rate hike pace. So in September, November and December, we'll probably see 25 basis point rate hikes.

That would bring the policy rate to 3.25%. And I think at that point in December, that's effectively the end of the rate hike cycle. So I think the Fed calls quits there, again at 3.25%. And right now the market's essentially pricing that the Fed could start to cut rates as soon as the middle point of next year. Might be a bit early, but our base case now is we do expect some easing into 2023. As growth concerns grow, as inflation starts to ease, I think the Fed could see scope to deliver some insurance rate cuts. And again, that's kind of the soft landing scenario that everybody's hoping for from the Fed in terms of the economy.

So, that's kind of our base case expectations for the Fed is, again, we'll see a shift of pivot in Fed's approach from aggressive to a bit more cautious one in the back half of the year. Again, a peak policy rate of 3.25% this cycle and it'll kind of take things from there into 2023 based on how growth and inflation kind of develops in the first half of next year.

Tylar Lunke:

So Janet, back over to you, Tom just laid out kind of our thoughts on rates in the Fed and how that will shift from kind of tightening now to more growth in the future. But, so in your view, what does this mean more specifically for equities from here?

Janet Engels:

Well, I think as Tylar mentioned, that's one of the two scenarios that we think are plausible in the market. So when I think about the path forward for equities for the rest of the year, it's really that trajectory of inflation that will be critical and has implications for equity markets in the coming months. What exactly happens, and I think that's what Tom was trying to say, what exactly happens remains

uncertain. So we are really looking for catalysts for the equity market that could spark a move to new highs or signal a recession.

And I thought we could just go through some of the scenarios that we're looking at. Scenario number one is that inflation remains stubbornly elevated, forcing the Fed to tighten harder for longer. In short, that would mean an overshoot by the Fed and possible recession, restrictive credit that could lead to a hit to corporate earnings and certainly would be a difficult environment for share prices. We look a bit further at this in a scenario that occurred in the 1970s within the midyear outlook. The second scenario is as Tom described it, it's more of the soft landing scenario.

Inflation ebbs, the economy slows and tightening becomes less urgent with the Fed again, even perhaps putting rate hikes on hold and moving into the next easing cycle. Again, this is the soft landing approach that could be certainly positive for earnings and for share prices overall. Each scenario in our mind is plausible, but to build a scenario where share prices move meaningfully higher in the near term requires a catalyst. So what might those catalysts be? An actual Fed rate cut, a marked downturn in energy prices, a couple of inflation readings that are significantly softer than the market expects, or in fact a stronger-than-anticipated second-quarter earnings season, especially if the guidance going forward is more positive.

At the present time, however, none of these appear to be that likely. So until some catalysts emerge, we believe a more convincing reversal in the equity market trend is unlikely in the near term. Investors are beginning to price in more than a growth scare. In some cases, investors are looking at a recessionary scenario and we address that in the midyear outlook as well. On the other hand, current readings of unusually deep investor pessimism suggest that there's limited downside from here in the markets.

So what we think the most likely path for share prices through the remainder of the year will generally be sideways until we see circumstances that would either reinvigorate the case for strong and sustained economic and corporate earnings or conversely reveal that a recession is rapidly approaching. And as we said before, both of these are indeed plausible. The lingering concerns about inflation and central banks' pivots towards more aggressive rate hikes prolong the risks, in our view, for equities. So right now, we'd prefer to wait out the next six months of aggressive monetary tightening that we think lies ahead of us and have a more neutral stance on equities.

And that's a slight change from our modest Overweight position.

Tylar Lunke:

So neutral stance on equities and walking through a couple different potential scenarios there. Tom, how about back over to you on the fixed income side and in your view, what are the return expectations for the rest of the year, let's say?

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Tom Garretson:

Well, the bad news is not much. The good news is going to at least be better than we've seen through the first half of the year. And so if we start with Treasuries and kind of the benchmark ten year to date, it yields about 3.1%. And as I mentioned, if we're right, that Fed does stop raising rates at 3.25% or a range of 3% to 3.25%, today that 10 years right in the middle of that range and historically speaking the 10 years tends to peak out wherever the Fed funds rate peaks out as well. And so in that case, we kind of think that the ten year ends the year where it's trading right now.

So right around three, maybe three and a quarter percent is kind of our target for year end. And so basically you're looking at basically at a half year's coupon. That's all you're going to learn from fixed income on the treasury market side. The big question would be if by the end of the year for pricing in more recession risks, or even rate cuts into 2023, we could see the ten year dip back below 3%. So that's what we're thinking in terms of Treasuries. With respect to credit markets right now, investment-grade corporate bonds yield about 1.5% over Treasuries.

And that's a low end of kind of the growth scare scenario that we saw back in 2018. In terms of recessions, 250 over Treasuries is kind of the high end. And so that's the range where you see attractive valuations in investment grade corporate bond markets. Again, between that 150 basis points and 250 basis points over Treasuries. In our view, given that we're at the low end of that range and maybe some risk that spreads could move wider still into the back half of the year, as Janet mentioned, if there's further pressure on equities as there is further volatility, we could see spreads continue to move modestly wider.

That would mean under performance relative to Treasuries just as we've seen the first half of the year. So again, I think if there's anything from fixed income markets for the back half of the year, it's going to be muted returns, probably positive, but certainly not enough to offset the losses we've already seen this year. But again, since the early stages of the process of climbing back some of that under performance that we've seen. So not a whole lot to expect, but should be a better second half of the year than we've seen the first half of 2022.

Tylar Lunke:

All right. So muted but slightly positive for the rest of the year. Thank you, Tom. And so Janet, just to wrap things up a bit here and thinking a little bit more high level, what does all this mean for portfolios? Should clients be thinking about taking any action here? Any comments you'd want to share?

Janet Engels:

Well, if I think about portfolio positioning overall, when I think about equities in a sideways market overall, we think a barbell approach to growth and value makes sense. In an uncertain environment, some of the value stocks look attractive. They're a bit more expensive or valuations are a bit higher. But

on the other side, as we move and get some more clarity on the outcome for the economy and whether it's a recession, growth stock valuations have moved down quite a bit. So, there's some opportunities. So, a barbell approach makes sense to us,

But I think the more important thing for investors is to remind ourselves that we've been here before. Bear markets happen, pullbacks in bear markets happen, recessions happen, the business cycle has not been repealed. So when I think about an investor and I think about our more neutral stance, it's not a negative stance on equities and is suggesting that we ride through this period of uncertainty and we look for opportunities.

Tylar Lunke:

Very good. Well, thank you, Janet, and thanks to Tom as well for the perspectives today. And we want everybody to know we'll continue to provide updates and special reports as the narrative evolves, and especially want to make note that the midyear outlook from RBC is linked from the audio player for this recording. So take a look at that and then also keep an eye out for additional articles published within the global insight suite, as well as from across RBC. And of course, as a reminder, if you have any questions about your investments, we would encourage you to stay in touch with your RBC financial advisor.

Thanks again for your time today, take care and have a great day.

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