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Review

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A mixed picture

By Jim Allworth, Investment Strategist - RBC Dominion Securities

Major global equity markets rebounded from their deep, mid-summer swoon. Canada's TSX Composite is ahead of the pack, running to a succession of new highs since early in the year. Now the S&P 500 has also climbed into new high ground in response to the Fed's half-point rate cut.

That leaves the S&P 500 trading at a chunky 23.5x this year's consensus earnings per share estimate of $243, and 20.4x next year's $280 forecast. Usually, investors think of multiples at 20x or higher as "expensive" and "unsustainable" or "limiting additional upside." But history offers no clear valuation line in the sand beyond which stocks cannot move.

In our view, it's not excessive valuation that tips markets into a downturn. Rather, it is a marked negative re-appraisal of earnings prospects. Sometimes those take the form of a "growth scare." These usually resolve themselves into earnings outcomes that are not as damaging as first feared. Markets correct or consolidate for a while before embarking on a renewed upleg.

Recessions, on the other hand, tend to last longer and typically result in a series of negative earnings revisions that often turn out to be deeper than the modest "trimming" of estimates that's often the first response to an economic slowdown. As investors give up on their hopes for earnings for the year at hand, they also tend to lose confidence in the ability of the economy and earnings to resume growing once the recession is over at the rates that had justified premium price-to-earnings (P/E) multiples.

An ongoing debate

This stark difference in equity market outcomes is one reason why the U.S. recession/no recession debate rages on, as it always has in response to an extended Fed tightening cycle. As has been true for a while, neither side is yet bold enough to claim victory nor willing to admit defeat.

The "soft landing" crowd has taken heart from an economy that continues to grow and positive equity market performance that appears to support their view. S&P 500 consensus earnings estimates—$243 per share, up 10% for this year and $280 per share, up 15%, for next—are not far from where they began the year. At better than 23x this year's earnings and more than 20x next, it looks as though a soft landing has been bought and paid for.

This group is also cheering the Fed's new commitment to further lowering rates as "sealing the deal."

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On the other side of the argument, the "hard landing" proponents would argue that the next year's earnings growth estimate is usually not much more than an extrapolation of the current year's growth rate, plus or minus a bit. In their view, the 2025 earnings outlook could change considerably if the underlying assumptions about the path of the economy were to change.

Hard landing proponents are at pains to point out that it has almost always been the case that the stock market is at a valuation peak and investors are too optimistic about the outlook for the economy and earnings just before a bear market begins. They also note that Fed rate reductions won't necessarily save the day. Central bank rate cuts act on the economy with a lag – usually taking 6 to 12 months to show up in improved activity. In 8 of the last 10 recessions the Fed had already started cutting before the downturn began.

Eye on consumer spending

The composition of GDP bears examining. Consumer spending consistently accounts for about 70% of U.S. GDP. In Canada, it is closer to a still-dominant 55%. It is very hard for the U.S. and most other advanced economies to slip into recession without the consumer pulling back on spending.

Over the past couple of years, U.S. consumer spending growth has been running between +1% and +3% per year. Through much of that time, the fuel for that spending—disposable income (i.e., personal income after tax)—was growing faster than the spending itself, allowing savings to build. But, for the past three quarters, consumer spending has been growing markedly faster than disposable income, as households reduce savings and take on debt to maintain spending levels.

In some ways, it goes beyond what those numbers reveal: over the past couple of years the price of necessities—food, utilities, property and auto insurance, etc.—rose by 20% or more. Those prices have stopped rising at that accelerated pace but have shown little to no signs of coming down, while the cost of debt service has also moved noticeably higher. That leaves less disposable income available to buy cars, appliances, meals away from home, travel or home improvements—all examples of discretionary purchases, most of which have a higher multiplier effect on the overall economy.

For now, lingering optimism about job security and future wage gains have given consumers the confidence to reduce savings and borrow to maintain spending. However, without a resurgence in disposable income growth, a more challenging economic growth environment could be drawing closer.

U.S. Recession Scorecard

Indicator	Status		
	Expansion	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)			✓
Unemployment claims		✓	
Unemployment rate			✓
Conference Board Leading Index			✓
Non-financial corporate cash flows	✓		
ISM new orders versus inventories		✓	
Fed funds rate vs. nominal GDP growth			✓

Source: RBC Dominion Securities Inc.

Proceed with caution

That leaves us with a mixed picture. We note that our Recession Scorecard, which was giving the U.S. economy a unanimous expansionary "green" signal a little more than two years ago, has seen the seven indicators that it tracks slide gradually toward recessionary "red." There can always be a first time. Even "all red" wouldn't guarantee a recession. But it seems imprudent not to acknowledge that the historical risks that indicate the U.S. is headed for recession have risen, and with them, the risks that estimates of future S&P earnings will have to be revised lower, reducing the support for today's elevated P/E multiples. That view calls for a cautious approach to equity selection in a portfolio and perhaps, eventually, to a reduced equity exposure.

But perhaps not yet. So far in this equity market advance, measures of "breadth" have been leading the market: both the advance-decline line and the equal-weighted version of the S&P 500 posted new highs in early September. Now the index itself has followed suit. The TSX was already in new high ground. As long as market breadth remains "in gear" with the broad averages, we are inclined to give stocks the benefit of the doubt.

However, were a new market upleg to emerge, wherein breadth measures failed to participate and moved into a downtrend, a deeper, broader retrenchment for equity markets might be in the works. All the more reason a cautious, watchful approach is called for.

For a more detailed discussion of our outlook for financial markets, ask for a copy of our current issue of Global Insight.

Jim Allworth is co-chair of the RBC Global Portfolio Advisory Committee.

Why longevity risk matters

By Tony Maiorino, Vice President & Director, Head - Family Office Services, RBC Wealth Management

Over the last century, average life expectancy among Canadians has generally been on the rise.[1] Many factors, like advancements in healthcare and lifestyle changes, have contributed to that trend. While greater lifespans are considered a blessing among many, there may be implications of a population that's living longer and a larger senior population overall in Canada. From a financial planning and risk mitigation perspective, this has introduced a new consideration in recent years: longevity risk.

What is longevity risk?

Longevity risk can generally be defined as the uncertainty associated with how long an individual will live and the potential that their lifespan will be longer than expected. It poses a unique challenge within financial planning—the possibility of outliving one's financial resources. While longer lifespans are a testament to progress, they should also trigger important questions about how to prepare financially for potentially extended lifetimes.

How longevity risk may impact planning

When you look at longevity risk in relation to retirement years, it may have a significant impact on retirement planning. In times when people are routinely living into their 80s, 90s and beyond, traditional retirement models—which were built on assumptions of lower life expectancies—may come up short. With those models, there's a greater risk of exhausting retirement savings too soon, or plans may not account for the potential costs of care or healthcare support that someone may need later in life.

To address these challenges, some are considering newer retirement planning strategies. These may include a more flexible approach to retirement age; phased retirement; and the integration of various income sources such as pensions, government programs (like CPP, OAS and GIS) and personal savings.

A shift in mindset

As part of your planning, it's important to look at different possible scenarios, also factoring in longevity risk. What if you need to retire early? What if you have greater healthcare support costs than anticipated? If you have a longer retirement, how might your annual expenses shift over time? Is it best to deplete tax-deferred savings first or taxable savings first? What will your income stream look like if you have more

retirement years? Considering these questions, doing analysis and having projections created will show how changing your financial assumptions may impact your retirement plans and future financial situation.

How might longevity factor into investment approaches?

Within overall planning, some investors may want to think about how to adapt their strategies to account for longevity risk. In some cases, traditional investment models may need to be revisited to ensure portfolios are protected in the face of extended retirement periods. While diversification should remain a key principle, investors may want to consider allocating a portion of their portfolios to assets with long-term growth potential.

Something that's also emerged more recently is the concept of "longevity investing," which focuses on companies and industries poised to benefit from an aging population. For example, this might include healthcare and pharmaceutical companies, as well as technology firms developing solutions for the elderly, such as home healthcare devices and assisted living technologies.

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Technology and longevity – an important connection

Further to contributing to longer lifespans, advancements in healthcare and technology are also shaping how individuals age. Think of items like wearable health monitors and telemedicine services. Beyond enhancing quality of life for some older Canadians and having the potential to improve health outcomes, these types of innovations also influence the financial implications of longevity.

Consider, for example, home healthcare equipment and assistive devices. Technologies that enable aging in place may reduce the demand for costly institutional care, impacting long-term care insurance considerations. A recent survey by the National Institute on Ageing indicates that over 90 percent of Canadian seniors want to stay in their homes as long as possible; in this sense, technologies also serve an important purpose in empowering seniors to maintain independence at home and have their healthcare needs met. From a planning perspective, for those who do want to age in place, it's important to understand what the associated costs of care may be (e.g. equipment and assistive devices, in-home healthcare services) and factor that into your plans.

Incorporating longevity risk as part of your planning

Longevity risk is a multifaceted consideration that has the potential to touch on various aspects of Canadians' lives.

In this era of unprecedented longevity, where over the next two decades, the population of Canadians aged 85 and over could triple to almost 2.5 million people,[2] the opportunity exists to redefine aging and retirement. By understanding and addressing the challenges posed by longevity risk, longer lifespans can be appropriately supported and planned for.

To find out more about how longevity may factor into your financial plans or other areas of your wealth planning, reach out to your RBC advisor.

This article was originally published on LinkedIn and has been excerpted.

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[1]Government of Canada. "How healthy are people in Canada? An indicators dashboard". Accessed November 2023. How long do people live in Canada? – How healthy are people in Canada – Canada.ca
[2]Census in Brief. A portrait of Canada's growing population aged 85 and older from the 2021 Census (statcan.gc.ca)

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