

On the up and up

Thomas Garretson, CFA – Minneapolis

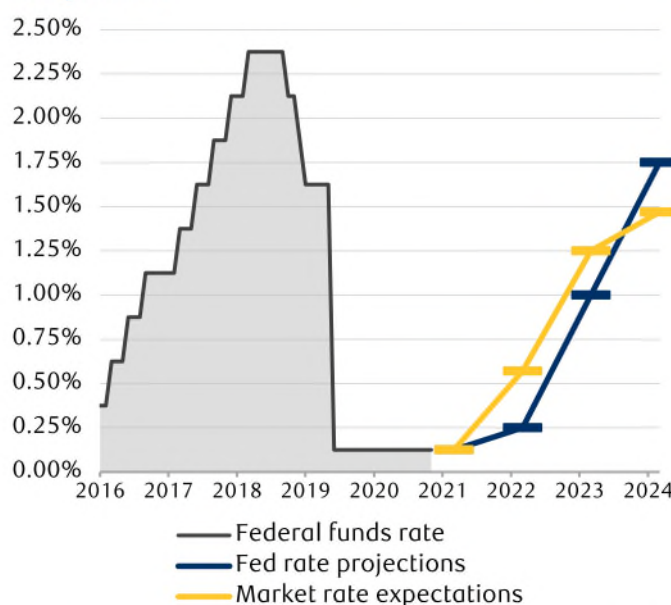
Inflationary pressures, once expected to prove transitory, have mutated into a persistent force. And expectations that central banks would largely ignore near-term inflation have given way to higher interest rate expectations in recent weeks. But have markets gone too far?

Though the Federal Reserve has yet to formally announce its plans for curtailing monthly asset purchases, an announcement we expect at its Nov. 3 meeting, the market is already looking beyond the tapering process to what the next rate hike cycle might look like—and, more importantly, when it might start.

As the first chart shows, the market is now priced for approximately two rate hikes of 0.25 percent each by the end of next year (whereas just one month ago it didn't expect any), followed by a further two hikes in 2023. The Fed, for its part, signaled at its September meeting that it is divided on the likelihood of even one hike next year; this implies the potential for three rate hikes in 2023, but the Fed's expected endpoint remains below market expectations.

The phenomenon of markets pulling forward the timing of expected rate hikes isn't exclusive to the United States; the same dynamic has emerged in many developed market economies. The most intense action has so far been in the UK, where RBC Capital Markets now expects the Bank of England to begin raising rates as early as this December, rather than in mid-2022 as previously expected. Our colleagues now anticipate a 0.25 percent rate hike in December, followed by 0.15 percent in February 2022, and yet another 0.25 percent in August of next year.

The market's rate expectations are now well ahead of Fed guidance



Source - RBC Wealth Management, Bloomberg, Federal Reserve September Summary of Economic Projections; data as of 10/21/21

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

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For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

It appears that markets now see higher-than-anticipated inflation as likely to force the hands of central bank policymakers, who have to this point largely pledged to be patient with respect to tightening policy. For investors, this raises the question of whether markets have gotten ahead of themselves.

Inflation may be driving inflated interest rate expectations

While there are ample supply-side shortages in the world today, there is no shortage of challenges for central banks. One is that higher interest rates probably aren't the answer for the shortages, the supply-side bottlenecks, and the more-persistent inflationary pressures that have resulted from them, even if markets expect central banks to respond with rate hikes.

A second—and real—challenge for central banks is that regardless of its root cause, high near-term inflation could morph into higher long-term inflation expectations. This is the more important concern, in our view.

However, there are few signs of higher long-term expectations becoming a problem. In the U.S., the Federal Reserve Bank of Cleveland splits Consumer Price Index data into two categories: “flexible” prices—those more sensitive to economic factors, such as motor fuel, car rental, natural gas, used cars, and hotels—go into one bucket. The rest—prices that are more stable and more sensitive to inflation expectations, such as apparel, rents, communication, and medical care services, go into the “sticky” bucket. It's the sticky bucket that tends to attract the attention of central banks, and thus far, sticky prices remain stuck in low gear. Currently, the Cleveland Fed's index of sticky prices is rising at a pace of 2.7 percent y/y, compared to a 14 percent y/y rate of increase for flexible prices.

The same dynamic can be seen in consumer data. The University of Michigan Survey of Consumers showed one-year inflation expectations rising to a decade-high 4.8 percent this month, while long-term inflation expectations remain anchored at just 2.8 percent, roughly equal to the average over the past 10 years.

For now, our view remains that the first Fed rate hike is still a long way down the road, perhaps arriving late next year, and that there are more important issues to consider than the timing of rate hikes.

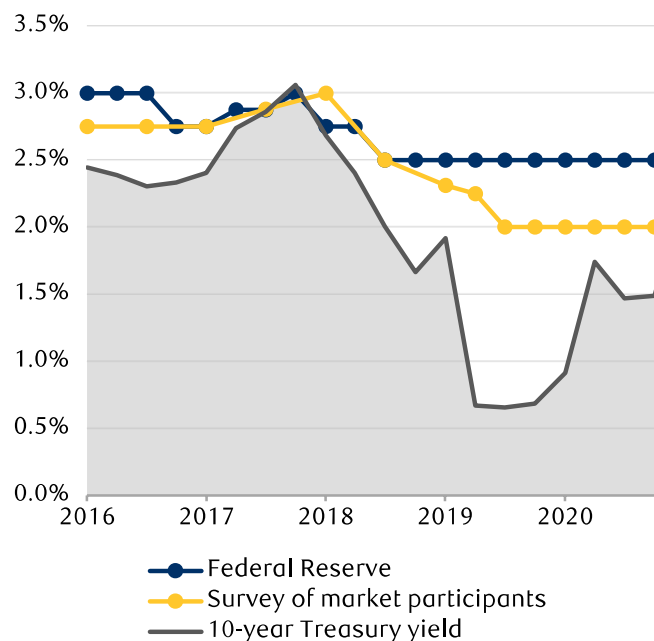
It's not how you start, but how you finish

While global markets are currently wringing their hands over the timing of rate hikes, we expect their concern will soon shift to the bigger idea of how high policy rates could rise this time around.

Keeping the focus on the Fed and the U.S., the second chart shows that a significant gap remains between how high the Fed thinks its policy rate will go—2.5 percent—and the more modest 2.0 percent expectation

The peak level for the Fed's policy rate is likely to dictate peak levels for longer-term Treasury yields

Evolution of “neutral” long-run policy rate estimates vs. 10-year Treasury yield



Source - RBC Wealth Management, Bloomberg, Federal Reserve Bank of New York Survey of Market Participants; data as of 10/21/21

of a panel of market participants surveyed by the New York Fed. The ultimate policy rate will have implications for the benchmark 10-year Treasury yield, a number that reverberates through equity and fixed income markets in the U.S. and around the world.

In 2018, three important numbers converged on a single value: the Fed's view of the long-run policy rate, the market's view of it, and the 10-year Treasury yield all came together at 3.0 percent. We expect a similar process to play out this time around; the question is whether the final number will settle at 2.5 percent, 2.0 percent, or even somewhere higher or lower. In our view, something closer to 2.0 percent would be a reasonable expectation at this stage.

Slow and low

The first rate hikes from major global central banks may indeed arrive earlier than previously anticipated. But in our view, an earlier start will likely translate to a more gradual pace, and ultimately to lower peak levels.

Where we previously expected the 10-year Treasury yield could rise toward 2.50 percent over the next year or two, we now think that number could end up as low as 2.00 percent. Peak levels could be even lower than in the past, and they could be here sooner rather than later. The potential implication is that although fixed income yields have risen of late, they might not actually have that much further to go—and consequently, investors will have to be more proactive in adding yield to portfolios.

UNITED STATES

Ben Graham, CFA – Minneapolis

■ **U.S. equities are on track for their third consecutive week of gains, bringing October 2021 return-to-date gains to more than 5%.** The S&P 500 and Nasdaq are on track for 1.7% and 2.1% gains this week, respectively, while the Russell 2000 is up 1.4% and Dow Jones 0.9% so far. Equity gains are broad-based with sector leadership coming from Utilities, Health Care, and Real Estate. Despite all sectors being higher, relative weakness is evident in Consumer Staples, Materials, and Consumer Discretionary.

■ **Earnings season has begun in earnest** as companies reporting results have broadened from Financials last week to include Health Care, Information Technology, Consumer, and Communications companies this week. **S&P 500 earnings are on track for nearly 30% q/q growth**, fueled by 14% revenue growth and margin expansion and beat rates for the S&P 500 surpassing 75% on the top and bottom lines. So far this earnings season, when companies report a top and bottom line beat, they are outperforming the market by 0.9% on average. When they fail to beat both measures, they are actually underperforming the market by 2.8% on average.

■ **In terms of economic data, housing and weekly unemployment claims took center stage.** September housing starts declined 1.6% m/m, on 1.56 million housing starts, much lower than the consensus expectation of a 0.5% expansion. The weekly initial unemployment claims total of 290,000 was more favorable than the consensus expectation of 299,000, and brought the four-week average to 320,000, the lowest level since the pandemic began. In terms of gauging the economic recovery to a more normal level of output and growth, weekly initial claims is a commonly utilized input, and the gap between today's levels and pre-pandemic averages continues to shrink.

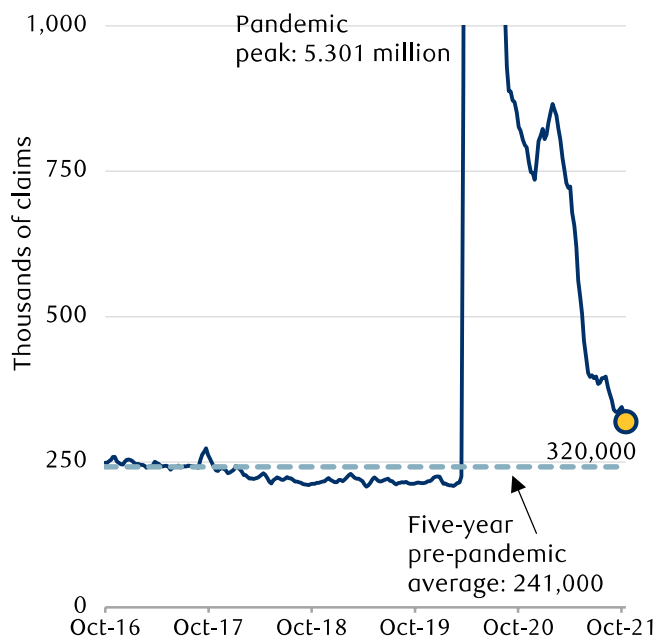
CANADA

Luis Castillo & Simon Jones – Toronto

■ **Canada's Consumer Price Index (CPI) accelerated to 4.4% y/y in September, its fastest pace since February 2003, according to Statistics Canada.** Base effects contributed significantly to the hefty year-over-year figure, as evidenced by the more moderate 0.2% m/m increase from August to September. Despite a modest 0.1% m/m pullback in gasoline prices, many of the other recent drivers of inflation maintained their momentum and continued to press higher, most notably food and shelter (both up 0.3% m/m). Although Bank of Canada (BoC) Governor Tiff Macklem recently acknowledged

Unemployment claims tick lower, move toward pre-pandemic levels

Weekly initial unemployment claims, four-week average



Note: Chart is truncated in order to show pre-pandemic levels

Source - RBC Wealth Management, FactSet; data through 10/21/21

that inflation could prove more persistent than initially thought, the BoC has remained steadfast in its view that these price increases will prove transitory. However, with CPI having exceeded the upper limit of the BoC's target range of 1%–3% for six consecutive months, the market is growing increasingly suspicious of the central bank's ability to remain on hold until H2 2022 and has instead priced in the potential for multiple rate hikes over the next 12 months.

■ **The gap between Canadian and U.S. short-term interest rates has widened significantly over the past month**, driven largely by the market's expectation that the BoC will be more aggressive than the Federal Reserve in raising rates. Since the start of October, the 2-year Government of Canada rate has risen by more than 30 basis points (bps), while the 2-year U.S. Treasury is up by roughly 15 bps. Short-term interest rate differentials tend to influence currency fluctuations, and the widening gap between Canada and the U.S. has contributed to the relative strength of the Canadian dollar against its U.S. counterpart. We think the BoC's tilt towards more hawkish monetary policy has played a role in market expectations, given that it has tapered its asset purchases three times while the Fed has yet to start. However, both central banks have remained consistent in their messaging that

the timing of rate hikes would be independent of the tapering timeline.

EUROPE

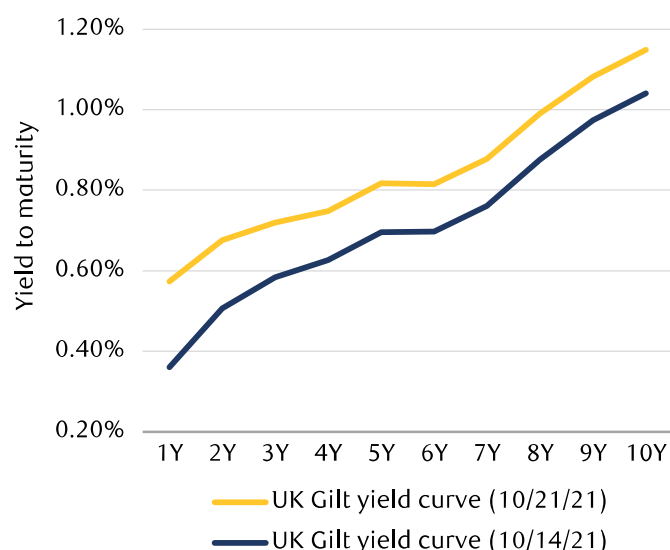
Thomas McGarrity, CFA & Faisal Manji – London

■ **Yields on short-term UK government bonds jumped this week, after Bank of England Governor Andrew Bailey commented that the central bank “will have to act” to curb inflation.** The market-implied probability of an increase in the bank rate was brought forward significantly, with the first rate hike now fully priced in for November and further tightening anticipated in December, which would bring the main policy rate to 0.50%. Markets are calling for another three hikes in 2022, which would raise the policy rate to 1.25% by the end of next year.

■ However, we think this implied move might be too aggressive. Our underlying concern is that policy tightening may do little to combat the causes of inflation, and could hamper growth. RBC Capital Markets also thinks the upward repricing for the UK bank rate is somewhat overdone; its revised forecasts call for a first hike in December, and for the bank rate to reach 0.75% by the end of 2022.

■ **Nestlé reported results ahead of market expectations**, with organic sales growth of 6.5% y/y vs. the 3.6% y/y consensus estimate, as the company's volumes grew 4.4% y/y despite accelerating price increases (2.1% y/y). Based on these results, the company raised its full-year guidance to 6%–7%, which would mark the fastest sales growth in a decade for the world's biggest food company. Consumer Staples peer **Unilever also reported organic sales growth for Q3, ahead of consensus**, as a pricing increase that was much higher than anticipated (4.1% y/y) compensated for a year-over-year decline in volumes during the quarter. Nestlé

Front-end UK Gilt yields quickly shift higher



Source - RBC Wealth Management, Bloomberg

and Unilever maintained their full-year margin guidance despite cost inflation pressures.

■ **Europe's biggest technology company, ASML, slipped slightly** after its Q4 guidance came in below consensus expectations, with the company stating that materials shortages in its supply chain will hold back installed-base revenues this quarter. The stock remains up 68% YTD. Elsewhere in Tech, software group **SAP reported acceleration in its cloud revenues and orders**, leading the company to slightly increase its full-year guidance.

■ COVID-19-related revenues for its pharma and diagnostics divisions helped Swiss Health Care giant **Roche's Q3 revenues beat consensus expectations**, and the company increased its full-year sales guidance.

ASIA PACIFIC

Jasmine Duan – Hong Kong

■ **China's Q3 2021 GDP grew 4.9% y/y**, below Bloomberg consensus of 5% and down from Q2's 7.9%. **Industrial production rose 3.1% in September**, below the 4.5% Reuters estimate. We believe the weak economic indicators mainly reflect the impacts of a property market slowdown and power shortages. On the positive side, September saw continued solid growth in the export sector and a moderate recovery in retail sales, which rose 4.4% y/y.

■ At the People's Bank of China's (PBoC) quarterly press conference on Oct. 15, **officials said China can manage financial risks and the central bank doesn't see a need for significant stimulus**, despite the slowdown in the economy. Because officials didn't make any mention of the required reserve ratio (RRR), some economists had to dial down their expectations for an RRR cut this year. We expect the PBoC to rely on open-market operations, medium-term lending facility, and more targeted tools to keep liquidity relatively stable.

■ **Chinese Vice Premier Liu He said on Wednesday that risks in China's housing market remain controllable overall**, despite individual problems that have arisen. He also stressed that developers' reasonable funding needs are being met, and that the property market's healthy development trend remains unchanged. Separately, PBoC Deputy Governor Pan Gongsheng said financial activities by China's property sector and financial market prices are both gradually normalizing; financial and housing authorities will work with local governments to safeguard healthy property market development and the interests of home buyers. **China has recently begun loosening restrictions on mortgage loans** at some of its largest banks, and accelerating the approval of mortgages. This fine-tuning of policy may provide some relief to property developers, and in turn, help alleviate investors' concerns about debt in the industry.

MARKET Scorecard

Data as of October 21, 2021

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 0.80 means 1 Canadian dollar will buy 0.80 U.S. dollar. CAD/USD 2.9% return means the Canadian dollar rose 2.9% vs. the U.S. dollar year to date. USD/JPY 114.05 means 1 U.S. dollar will buy 114.05 yen. USD/JPY 10.5% return means the U.S. dollar rose 10.5% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 10/21/21

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,549.78	5.6%	21.1%	32.4%	51.3%
Dow Industrials (DJIA)	35,603.08	5.2%	16.3%	26.2%	32.7%
Nasdaq	15,215.70	5.3%	18.1%	32.5%	86.4%
Russell 2000	2,296.19	4.2%	16.3%	43.2%	48.1%
S&P/TSX Comp	21,212.39	5.7%	21.7%	30.7%	29.2%
FTSE All-Share	4,102.33	1.1%	11.7%	25.8%	3.5%
STOXX Europe 600	469.71	3.3%	17.7%	30.2%	19.1%
EURO STOXX 50	4,155.73	2.7%	17.0%	30.7%	15.4%
Hang Seng	26,017.53	5.9%	-4.5%	5.1%	-2.6%
Shanghai Comp	3,594.78	0.7%	3.5%	8.1%	22.3%
Nikkei 225	28,708.58	-2.5%	4.6%	21.4%	27.3%
India Sensex	60,923.50	3.0%	27.6%	49.7%	55.0%
Singapore Straits Times	3,188.50	3.3%	12.1%	26.2%	1.6%
Brazil Ibovespa	107,735.00	-2.9%	-9.5%	7.1%	1.6%
Mexican Bolsa IPC	52,020.05	1.2%	18.0%	34.5%	19.8%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	1.692%	20.5	77.9	87.0	-10.7
Canada 10-Yr	1.695%	18.6	101.8	107.3	12.9
UK 10-Yr	1.202%	18.0	100.5	96.0	45.2
Germany 10-Yr	-0.102%	9.7	46.7	48.6	24.2
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.67%	-0.5%	-2.1%	-1.1%	5.8%
U.S. Investment-Grade Corp	2.25%	-0.6%	-1.9%	1.0%	9.4%
U.S. High-Yield Corp	4.16%	-0.1%	4.4%	9.5%	14.4%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,782.55	1.5%	-6.1%	-7.4%	20.1%
Silver (spot \$/oz)	24.15	8.9%	-8.5%	-3.6%	37.5%
Copper (\$/metric ton)	10,481.25	17.2%	35.3%	50.2%	80.6%
Oil (WTI spot/bbl)	83.25	11.0%	71.6%	109.0%	56.2%
Oil (Brent spot/bbl)	84.76	7.9%	63.6%	103.1%	43.8%
Natural Gas (\$/mmBtu)	5.20	-11.3%	104.9%	72.1%	132.4%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	93.7730	-0.5%	4.3%	1.3%	-3.7%
CAD/USD	0.8083	2.5%	2.9%	6.3%	5.8%
USD/CAD	1.2373	-2.4%	-2.8%	-5.9%	-5.5%
EUR/USD	1.1620	0.3%	-4.9%	-2.0%	4.2%
GBP/USD	1.3790	2.3%	0.9%	4.9%	6.4%
AUD/USD	0.7464	3.3%	-3.0%	4.9%	8.7%
USD/JPY	114.0500	2.5%	10.5%	9.0%	5.0%
EUR/JPY	132.5200	2.8%	5.0%	6.8%	9.4%
EUR/GBP	0.8427	-1.9%	-5.7%	-6.6%	-2.1%
EUR/CHF	1.0674	-1.0%	-1.3%	-0.6%	-2.9%
USD/SGD	1.3473	-0.8%	1.9%	-0.5%	-1.0%
USD/CNY	6.3932	-0.8%	-2.1%	-3.9%	-9.6%
USD/MXN	20.3053	-1.6%	2.0%	-3.8%	6.2%
USD/BRL	5.6579	4.0%	8.8%	0.9%	37.0%

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			Count	Percent
Buy [Outperform]	800	56.58	341	42.62
Hold [Sector Perform]	562	39.75	172	30.60
Sell [Underperform]	52	3.68	3	5.77

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