GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee

February 9, 2023

UK and European equities—Too far too soon?

Frédérique Carrier – London

From depressed levels, UK and European equities have enjoyed powerful rallies this winter as both regions avoided crises. Still, it would be prudent not to be overly optimistic, as higher interest rates impact economies with a lag. We explore the portfolio implications.

A powerful rally

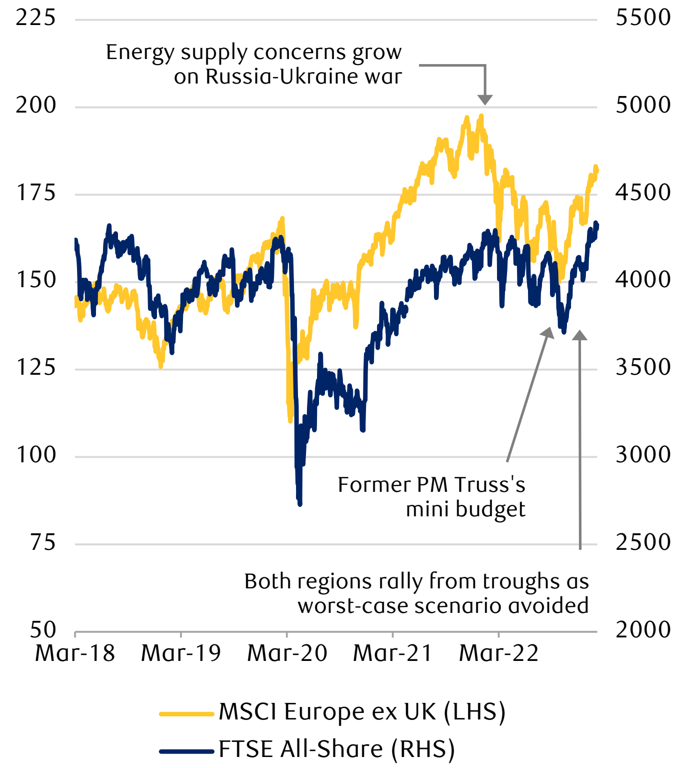
The UK and European equity markets have had strong rallies since their troughs six months ago. Back then, anxiety was at its highest—for good reasons.

In the UK, the country was in the throes of former Prime Minister Liz Truss' ill-fated economic plan, and market turmoil threatened to engulf the pensions industry. In Europe, governments feared energy shortages believing the war in Ukraine would switch off large swathes of the industrial complex during the winter.

Since then, a new government has restored some stability to the UK, while in Europe, mild weather and high levels of natural gas storage mean energy shortages are unlikely this winter.

Thus, in both instances, a crisis was avoided. And the good news kept coming. Wholesale natural gas prices retreated, benefitting both regions and lifting hopes that inflation would soon peak too. Bond yields declined from their autumn peak, underpinning equity valuations. For Europe, the reopening of the Chinese economy, to which it is heavily exposed through exports, is an additional boost. As a result, European business and economic sentiment have improved three months in a row.

UK and European indexes rally from their troughs



Source - RBC Wealth Management, Bloomberg; data through 2/8/23

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

Avoiding the worst-case economic scenario, the peaking of bond yields coupled with light positioning in both regions led to powerful equity rallies, as institutional investor inflows returned. The FTSE All-Share Index is up 17 percent and the MSCI Europe ex UK Index is up 22 percent in local currency terms since their autumn troughs.

Challenged outlook despite improvements

While crises were averted in the UK and Europe, their economic backdrops are likely to be subdued.

The International Monetary Fund calculates the UK will have the worst economic performance of advanced economies, including Russia, in 2023. It estimates a 0.6 percent contraction due to the challenges we have been highlighting for months—energy shortage and cost-of-living crisis, much higher interest rates, and the fallout from Brexit.

The UK government has announced it will go ahead with the increase in energy bills planned for April 2023, suggesting the cost-of-living crisis is unlikely to let up anytime soon. Interest rates have risen to four percent, and could go slightly higher still, up from 0.1 percent in December 2021, and while market expects the Bank of England could cut rates a little by year end, monetary policy is likely to be remain restrictive for a while. Higher taxes and reined-in fiscal stimulus complete the unpalatable picture.

As for Europe, economic activity is picking up nicely. The Composite Purchasing Managers' Index (PMI) for the eurozone reached 50.2 in January, up from December's 49.3 and the highest level since June 2022. Bloomberg consensus 2023 GDP expectations improved marginally to 0.15 percent growth compared to the 0.1 percent contraction estimate at the beginning of the year.

But with the European Central Bank (ECB) leaning on an aggressive monetary policy and pre-announcing another 50 basis point interest rate hike, the path for higher rates seems clear. Unlike the Fed, whose dual objectives of maximum sustainable employment and low inflation leave it some wiggle room, the ECB is solely focused on inflation. So long as core inflation is much above its two percent target, interest rates will likely be maintained.

The Bloomberg consensus expectation is for rates to peak at 3.5 percent, a high level for an economy that had functioned on negative interest rates for eight years. Energy price caps are in place in most countries until April 2024—perhaps too short a period for businesses to have the confidence to invest.

Earnings risk

Corporate earnings in the UK and Europe have been resilient so far thanks to COVID-19-induced pent-up demand at a time consumers were flush with cash from stimulus efforts. Thanks to this backdrop, corporates were able to pass through higher input costs, lifting margins which are at an all-time high.

But the situation has evolved. Pent-up demand has largely been exhausted, supply chain disruptions have largely resolved themselves, and inventories have been built up. Corporate pricing power may erode, particularly as there is increasingly widespread evidence of downtrading to cheaper goods. Importantly, we believe the impact of central bank monetary policy tightening will be felt with a lag, reducing demand. Lower revenues could translate into lower margins for companies with a high fixed cost base. In short, corporate earnings upgrades are likely to be difficult to come by.

The pause that refreshes?

The easy stock market gains may be behind us, as the economic backdrop is likely to remain challenging, more so in the UK, but also in Europe. Complacency may have set in—the VDAX, an index of volatility on the German stock market index, is at its lowest level since January 2022. Finally, geopolitics, in the form of tensions between the U.S. and China, may act as a headwind in the short term.

Following months of institutional investors' outflows as prospects darkened last year, some money is likely to return. Overall valuations for the FTSE All-Share and the MSCI Europe ex UK remain attractive, at 10x and 14x 2023 estimated earnings, respectively, much below those in the United States. This should keep these regions on investors' radar.

However, some pockets of the market appear expensive. Our national research provider estimates that European non-financial cyclical stocks seem to be discounting GDP growth rates of over four percent. Moreover, it argues that the equity valuation of China-exposed European capital goods companies relative to the market is at an all-time high.

We believe low valuation levels compared to the U.S. warrant some positioning in the UK and Europe for a globally diversified portfolio. However, we would be selective and wouldn't chase the rally. More than ever, the old adage 'investor patience will be rewarded' is likely to be true.

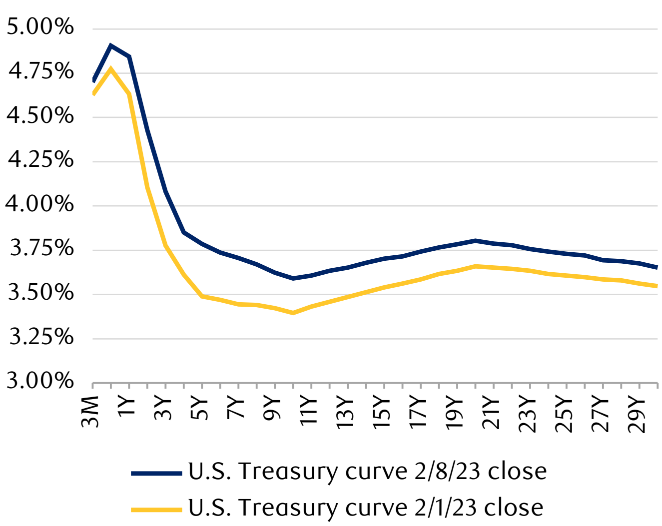
UNITED STATES

Michael Roedl – Minneapolis

■ **The U.S. labor market started the year on an exceptionally strong note** as hiring unexpectedly soared in January while at the same time unemployment fell to 3.4%, marking the lowest level since 1969. According to the jobs report, hiring was broad-based across the country as nonfarm payrolls advanced by 517,000, nearly double the gain from the previous month. In our view, the robust jobs data was likely somewhat influenced by seasonal adjustments, but we still see the data as an outlier after payrolls exceeded even the highest forecast. Nevertheless, **the strong jobs report provides the Fed with more reassurance to keep interest rates high for the time being**, and the futures market now reflects overnight policy rates moving above 5% this year, which implies up to two more 25 basis point (bps) rate hikes by May. However, **we think the Fed will stop raising rates after one more 25 bps hike in March**.

■ **U.S. fixed income markets have seen increased volatility this week** as investors continue to digest last Friday's jobs report. As of Wednesday's close, Treasury bond yields—which move inversely to price—are up anywhere between 5 bps and 15 bps from Friday depending on which area of the yield curve. Even though all Treasury bond maturities have seen price declines this week, we believe the primary drivers of the selloff differentiate between the short end versus the long end of the Treasury curve. In our view, short-term Treasury yields have risen the most this week from investors readjusting their expectations for tighter Fed policy in the near term. Meanwhile, we believe long-term yields are less influenced by Fed policy, and are instead reacting to easing recessionary risks implied by the strong jobs report.

Treasury yields are up across the curve from last week following the robust January jobs report



Source - RBC Wealth Management, Bloomberg

■ **The U.S. trade balance widened to $67.4 billion during the month of December**, a 10.5% increase from November as imports greatly outweighed exports for the month. That said, even though imports outpaced exports by the widest margin since September, **the overall trade balance has substantially improved from the lows set in March of last year**, when the deficit reached $106.4 billion.

CANADA

Luis Castillo & Simon Jones – Toronto

■ **Bank of Canada (BoC) Governor Tiff Macklem delivered a monetary policy speech in which he reminded Canadians of the BoC's mandate and its tools to target price stability, as well as the mechanics that drive policy and its transmission to the economy.** He reiterated the lagging impacts of monetary policy, stating "Typically, we don't see the full effects of changes in our overnight rate for 18 to 24 months", while noting Canadians are feeling some of that bite already as rising borrowing costs dent spending on big-ticket items such as furniture and appliances. Along with some gentle pushback on the market's expectation for rate cuts in H2 2023—"Bank of Canada won't be cutting interest rates anytime soon"—he also recognized that any meaningful drop in inflation would have to come from a moderation in wage growth. These comments will likely keep markets tightly glued to upcoming labour data. For tomorrow's labour report, RBC Economics is expecting a 5,000-plus job gain and an unemployment rate uptick to 5.1%.

■ **The Bank of Canada this week released its first Summary of Deliberations**, a new initiative to increase the transparency of the interest rate setting process. The report, which will be published roughly two weeks after each policy decision, outlined the rationale and key considerations underlying the decision to raise the policy rate 25 basis points on Jan. 25. The rate decision was ultimately rooted in the ongoing labour market tightness, which has placed upward pressure on wages, and the resilience of the domestic economy. However, the BoC's Governing Council noted that progress had been made on returning inflation to target and, while recognizing that the full effects of the tightening had not yet filtered through to the economy, it felt comfortable signaling a pause on further rate increases. While the pause is conditional on inflation and economic activity unfolding in line with its projections, the Governing Council wanted to send a clear message that the bar for further rate increases is now higher and would require an "accumulation of evidence" to suggest inflation is not trending towards target.

EUROPE

Rufaro Chiriseri, CFA – London

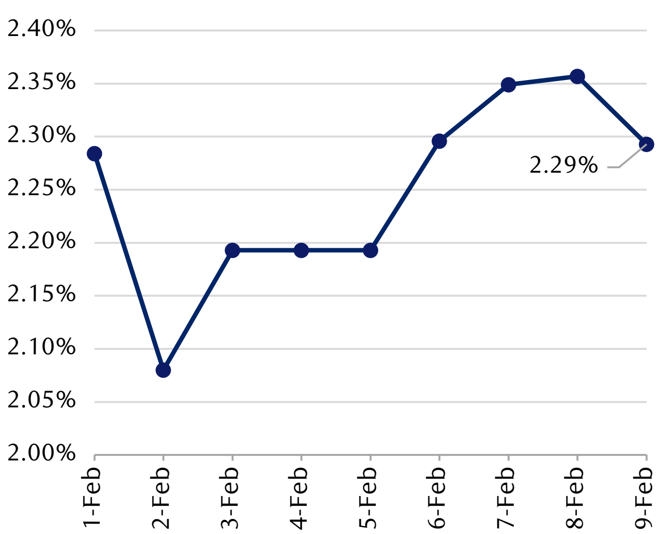
- **Central banks have to maintain a "zen-like balance" on interest rates**, according to Bank of England (BoE) Chief Economist Huw Pill in reference to adjusting interest rates just enough to bring down inflation without breaking too many things along the way. It's clear to us that the central bank is near the conclusion of the most aggressive tightening cycle in decades. In a separate discussion, Governor Andrew Bailey did not entirely rule out another hike, but he also equally removed language around "further increases" being necessary. Silvana Tenreyro, one of the most dovish members, has gone further and stated that interest rates are currently "too high" at 4%. When asked by the Parliament's Treasury Committee about rate cuts, she stated that she would be considering a rate cut without a specific time frame.

- **At this stage, only one out of nine voting members has hinted at rate cuts**; therefore, we think it's too early to conclude that this is a consensus view. Though current market pricing shows a rate cut in Q4 2023, we think this is too early considering inflation remains high and wage growth data is not yet meaningfully declining. We still expect the Bank Rate to peak at 4.25%.

- **The European Central Bank (ECB) is also hiking at the fastest pace on record**, but unlike the BoE that is likely to downshift to 25 basis point (bps) hikes, ECB President Christine Lagarde has all but committed to another 50 bps hike in March. We think the downtrend in inflation will tame the ECB's hawkish tone after March, and the central bank will likely deliver another 25 bps hike and conclude this hiking cycle at 3.25%. In the euro area's largest economy, Germany's official flash inflation estimates show a further decline in January to 9.2% y/y from 9.6% y/y in December, beating economists' consensus 10% y/y expectations. On this optimistic note, bond markets ended their losing streak since last Friday as German 10-year Bunds rallied and yields fell by 8 bps to 2.28%.

German 10-year sovereign debt rallies

Yield of 10-year German Bunds



Source - Bloomberg; as of 2/9/23 17:20 GMT

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets have traded broadly lower so far this week** as sentiment weakened on risks the U.S. rate hike cycle could persist longer than market participants had previously anticipated. Also, investors are moving beyond the initial China reopening enthusiasm and turning their attention toward sustainability of the improvements in the Chinese economy and corporate earnings. We expect Chinese equities to remain volatile in the near term, driven by profit-taking and positioning for an economic recovery and/or policy stimulus. We are increasingly constructive on Chinese equities for a long-term time horizon compared to our view six or 12 months ago.

- **The new Chinese cabinet will take office next month and observers expect more business-friendly and growth-supportive policies** led by China's premier-in-waiting and No. 2 on the Politburo Standing Committee, Li Qiang. Chinese President Xi Jinping mentioned in a speech this week that China "must strive to achieve an overall improvement in economic activity this year" and "more effort should be made" to strengthen business confidence. The speech reinforced our belief that more accommodative policies are on the way.

- **Three potential Bank of Japan (BoJ) governor candidates have emerged**—former BoJ Deputy Governors Hirohide Yamaguchi and Hiroshi Nakaso, and current Deputy Governor Masayoshi Amamiya—and there is a political divide over who will be appointed. According to a Bloomberg report, Japan's ruling Liberal Democratic Party members see the possibility of division within the party if Prime Minister Fumio Kishida's choice for the new BoJ chief is someone who is unlikely to follow the current path of monetary easing.

- **Toyota Motor Corporation, the world's largest carmaker, posted Q3 results for FY 2023** that exceeded market expectations, but has kept its conservative profit guidance in light of supply chain constraints.

MARKET Scorecard

Data as of February 8, 2023

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,117.86	1.0%	7.2%	-8.9%	5.2%
Dow Industrials (DJIA)	33,949.01	-0.4%	2.4%	-4.3%	8.2%
Nasdaq	11,910.52	2.8%	13.8%	-16.1%	-14.8%
Russell 2000	1,942.60	0.6%	10.3%	-5.0%	-15.2%
S&P/TSX Comp	20,679.54	-0.4%	6.7%	-3.3%	12.8%
FTSE All-Share	4,322.83	1.6%	6.1%	2.1%	16.0%
STOXX Europe 600	459.46	1.4%	8.1%	-1.3%	11.9%
EURO STOXX 50	4,209.15	1.1%	11.0%	1.9%	14.8%
Hang Seng	21,283.52	-2.6%	7.6%	-12.5%	-27.4%
Shanghai Comp	3,232.11	-0.7%	4.6%	-6.4%	-8.5%
Nikkei 225	27,606.46	1.0%	5.8%	1.2%	-6.1%
India Sensex	60,663.79	1.9%	-0.3%	4.9%	18.1%
Singapore Straits Times	3,388.52	0.7%	4.2%	-0.4%	15.6%
Brazil Ibovespa	109,951.49	-3.1%	0.2%	-2.0%	-8.1%
Mexican Bolsa IPC	53,125.01	-2.6%	9.6%	1.6%	20.2%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.615%	10.9	-25.9	165.2	244.5
Canada 10-Yr	3.017%	10.1	-28.3	116.0	200.5
UK 10-Yr	3.313%	-1.9	-35.9	182.4	283.8
Germany 10-Yr	2.363%	7.7	-20.8	209.8	280.8
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.47%	-0.9%	2.2%	-8.1%	-11.6%
U.S. Investment-Grade Corp	5.11%	-0.8%	3.2%	-8.8%	-12.7%
U.S. High-Yield Corp	8.06%	0.4%	4.3%	-4.4%	-3.7%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,875.76	-2.7%	2.8%	2.7%	2.5%
Silver (spot $/oz)	22.31	-6.0%	-6.9%	-3.8%	-18.2%
Copper ($/metric ton)	8,893.00	-3.3%	6.3%	-9.3%	10.5%
Oil (WTI spot/bbl)	78.47	-0.5%	-2.2%	-12.2%	35.4%
Oil (Brent spot/bbl)	85.07	0.7%	-1.0%	-6.3%	40.5%
Natural Gas ($/mmBtu)	2.42	-9.8%	-45.9%	-43.0%	-16.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	103.4880	1.4%	0.0%	8.2%	13.8%
CAD/USD	0.7437	-1.0%	0.8%	-5.5%	-5.3%
USD/CAD	1.3446	1.1%	-0.8%	5.8%	5.5%
EUR/USD	1.0712	-1.4%	0.1%	-6.2%	-11.1%
GBP/USD	1.2070	-2.0%	-0.1%	-10.9%	-12.2%
AUD/USD	0.6924	-1.9%	1.6%	-3.1%	-10.1%
USD/JPY	131.4200	1.0%	0.2%	13.7%	24.9%
EUR/JPY	140.7800	-0.4%	0.3%	6.7%	11.0%
EUR/GBP	0.8875	0.7%	0.2%	5.3%	1.2%
EUR/CHF	0.9866	-0.9%	-0.3%	-6.6%	-8.9%
USD/SGD	1.3263	0.9%	-1.0%	-1.4%	-0.5%
USD/CNY	6.7921	0.5%	-1.5%	6.7%	5.3%
USD/MXN	18.9409	0.5%	-2.9%	-8.1%	-5.8%
USD/BRL	5.2013	2.5%	-1.5%	-1.1%	-2.9%

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 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 0.8% return means the Canadian dollar rose 0.8% vs. the U.S. dollar year to date. USD/JPY 131.42 means 1 U.S. dollar will buy 131.42 yen. USD/JPY 0.2% return means the U.S. dollar rose 0.2% vs. the yen year to date.

Source - Bloomberg; data as of 2/8/23

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As of December 31, 2022

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Sell [Underperform]	55	3.67	3	5.45

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