GLOBAL
Insight
WEEKLY

Perspectives from the Global Portfolio Advisory Committee June 22, 2023

UK and Europe equities: Beyond the headlines

Frédérique Carrier – London

European and UK equity markets are trading at valuations we consider unusually attractive. Although we maintain Underweight stances on both regions and think index returns may remain muted through the end of the year, we see compelling opportunities.

Economic scars

With the UK's Conservative government struggling in the polls, attention is turning to how Labour would govern the country. The next election is due by January 2025, but is widely expected to be held next year.

The Labour Party appears to be focused on "making Brexit work" and on turning Britain into a "clean energy superpower" by 2030. The former goal suggests an effort to remove trade frictions, perhaps by achieving a relationship with the European Union akin to Norway's; this would require trust with the UK's largest trading partner to be rebuilt first. As for the latter, Labour is promising to deliver new jobs and energy security by eliminating barriers to green projects.

Should Labour win the next election, the new government will inherit a country with deep scars—not only from Brexit, but also from the Bank of England's (BoE) fastest monetary policy tightening spree in three decades. To quell inflation, which is showing worrying signs of becoming entrenched, the BoE has increased the Bank Rate from 0.1 percent at the end of 2021 to five percent today, and markets currently expect it to continue climbing to six percent by Q4 2023. *(For our views on the latest BoE announcements, see the regional perspective on page 4.)*

Higher interest rates will be particularly painful for mortgage holders. According to data provider Moneyfacts, the average cost of a two-year fixed-rate mortgage rose to over six percent this week, compared to roughly 2.25 percent 18 months ago.

Much of the increase in rates has not yet filtered through to the UK's 7.5 million mortgagor households. That is because 85 percent of UK mortgages are fixed-rate contracts, typically with terms of two or five years, unlike the usual 30-year term in the U.S. Therefore, interest rate hikes affect the economy only gradually.

The BoE estimates that 2.1 million households will reach the end of their fixed-rate terms in 2023. Most of those have rates below two percent, and could be renewed at rates up to three times higher, as the chart on the following page shows. In fact, with market expectations of mortgage rates remaining above four percent until the end of 2026, total mortgage costs could eventually increase by £12 billion a year according to the Resolution Foundation, a British think tank.

Higher monthly financing costs are likely to negatively impact both consumer spending and the housing market—and improve Labour's electoral prospects.

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

An internationally focused equities market

We maintain our Underweight recommendation for UK equities, but we believe there are opportunities despite the subdued outlook for the domestic economy. Nearly 80% of FTSE 100 companies' revenues are generated outside the UK. The valuation of the wider FTSE All-Share Index is just under 10x forward earnings, an "abnormal discount" according to our national research correspondent and, in our view, attractive. Dividends are generous, with an average yield of more than four percent, and well covered by operational cash flows. Thanks to a relatively high exposure to defensive sectors including Utilities, Health Care, and Consumer Staples, UK equities tend to perform relatively well when global activity levels wane, as we expect will be the case later this year.

Furthermore, the pound peaking should remove a headwind to UK equity performance. The currency has rallied recently to 1.28 against the U.S. dollar, but we believe it is likely to stabilise or even weaken going forward given UK interest rate expectations are already aggressive and economic fundamentals are weak.

We remain biased towards defensive, high-quality international revenue generators that trade at meaningful discounts to international peers. Our preferred defensive sector continues to be Health Care, although we think the valuation of Consumer Staples is becoming more appealing after a period of underperformance, and as the outlook for margins in the second half of the year has improved.

Stagnation across the Channel

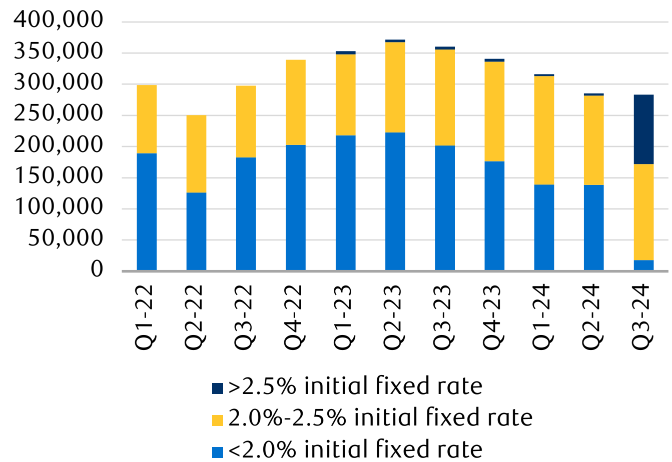
The euro zone has entered a technical recession after regional GDP contracted by 0.1 percent in two consecutive quarters. Economic activity in service sectors is holding up well, but this is not enough to offset the slump in manufacturing due to global destocking.

While the outlook is muted, we think investors should not be too pessimistic. Consensus expectations are for 0.6 percent growth this year, and unemployment is at its lowest level in more than 20 years, at 6.6 percent. Moreover, fiscal stimulus, while much less generous than in recent years, should continue to underpin the economy.

Notably, as economic activity levels deteriorated, European equities gave back some of their outperformance accumulated between August 2022 and March 2023. Despite valuations which are again inexpensive relative to the U.S., with the MSCI Europe ex UK Index trading on 13.4x forward earnings, we continue to suggest an Underweight position in the region due to its historical tendency to underperform when global activity levels weaken.

Many UK mortgages could be renewed at much higher rates

Number of fixed-rate mortgages coming up for renewal by initial effective interest rate*



* Data do not include remortgages with the same lender or second mortgages, so these numbers likely underestimate the situation.

Source - Bank of England

Opportunities beyond the headlines

Despite the challenges, we think there are opportunities for the inquisitive investor. One interesting area, in our view, is Tech. A popular narrative is that Europe has low exposure to technology and is thus at a disadvantage, particularly in light of the buzz around generative AI. While European indexes have substantially lower weighting in Information Technology, there are opportunities connected to the infrastructure build required for generative AI. We believe leading semiconductor equipment manufacturers are particularly well positioned, as are select electrical equipment providers given datacentres will require more power, smarter power management systems, and better cooling.

We also continue to like luxury stocks that combine strong growth, brand and operational momentum, and reasonable valuations. However, we see potential for greater variation in share price performance within the sector given the bumpy China recovery.

Finally, we remain positive on the long-term prospects for European industrial stocks that are well placed to benefit from capex spending connected to decarbonization, automation, and onshoring trends.

The macroeconomic backdrop of both the UK and Europe is challenging, but many of the challenges appear to be already discounted in valuations. We think that while returns on the broad indexes are likely to be modest for the rest of the year, there are compelling opportunities for investors willing to look deeper.

With contributions from Thomas McGarrity, CFA

UNITED STATES

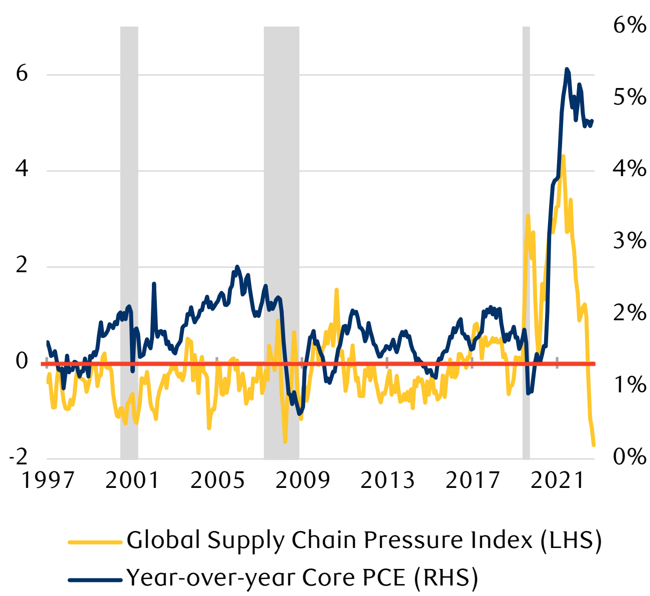
Tyler Frawley, CFA – Minneapolis

■ **U.S. equities are on track for moderate losses this week** as Fed Chair Jerome Powell hinted at further monetary tightening during his testimony to Congress yesterday. All major indexes are down on the week, with the S&P 500 being the best relative performer, but still falling 0.89%. The Dow Jones Industrial Average has been the worst relative performer, falling 1.20%.

■ **Global supply chain pressures continue to ease**. Supply chain disruptions following the COVID-19 outbreak contributed to the rapid rise in inflation as global shipping and transportation costs surged and backlogs and wait times rose to historically high levels. According to a report published this week from the Federal Reserve Bank of San Francisco, nearly 60% of the inflation increase following the pandemic was attributable to these types of logistical bottlenecks and the resulting cost pressures. However, according to the Global Supply Chain Pressure Index, supply chain pressures have been steadily improving since peaking in October 2021 and are now nearing their lowest levels on record—with the index going back to 1997. While year-over-year Core Personal Consumption Expenditures, the Fed's preferred measure of inflation, remain stubbornly elevated at 4.7% as of April 2023, it appears that the improving supply chain situation could act as a tailwind for falling inflation in the months ahead.

■ **The U.S. housing market continues to show signs of recovery** as May housing starts came in well ahead of expectations. On Tuesday, the U.S. Department of Housing and Urban Development released its monthly housing report which showed that there were 1.63 million U.S. housing starts in May—well above economist expectations of 1.40 million. This represents a 21.7% m/m increase, the largest month-over-month percentage rise since October 2016. Additionally, the 291,000-unit m/m increase was the largest since January 1990. While the degree to which housing starts accelerated was unexpected, we view the general trend as unsurprising especially when considering the fundamentally undersupplied U.S. housing market following nearly 15 years of underbuilding since the global recession.

Global supply chain pressures continue to ease



Note: Shaded areas represent recession periods

Source - RBC Wealth Management, Bloomberg; Global Supply Chain Pressure Index is through May 2023, y/y Core PCE data is through April 2023

CANADA

Matt Altro & Richard Tan, CFA – Toronto

■ Earlier this month, **the Bank of Canada (BoC) raised the overnight lending rate by 25 basis points**, and the focus remains on the health of the consumer. The economy has proven more resilient than originally thought, as GDP continued to edge higher in Q1, by an annualized rate of 3.1%, after growth stalled in Q4 2022. This increase was driven by a large uptick in consumer spending and higher net exports, partially offset by a smaller inventory build and a drop in residential investment. However, cracks are starting to form. Unemployment remains low, but job openings have declined, according to RBC Economics. Furthermore, consumer delinquency rates have begun to rise (albeit from abnormally low levels), and household disposable income may subsequently soften as well. Per RBC Economics, the BoC remains committed to its 2% inflation target and more rate hikes are on the table if the economy does not show significant signs of slowing.

■ **The Office of the Superintendent of Financial Institutions (the Canadian financial regulator) announced it will increase the domestic stability buffer (DSB) by 50 basis points (bps) to 3.50%**, effective Nov. 1, 2023. In short, this is an effort to ensure the Big Six Canadian banks will have sufficient capital to respond to potential vulnerabilities in the economy and to absorb losses in times of financial stress. As a function of the DSB hike, the capital ratio requirements will also increase by 50 bps to 11.5%. We note that the banks are already sitting above the new regulatory minimum, and RBC Capital Markets expects bank capital levels to trend higher in the coming quarters. Therefore, we view the risk of raising discrete equity as low outside of dividend reinvestment plans. Canadian bank equity valuations continue to look inexpensive relative to long-term averages. However, we struggle to identify catalysts to materially improve valuations at this point in the credit cycle and, as such, we believe that long-term income-focused investors attracted to elevated dividend yields may find greater opportunity than capital growth investors.

EUROPE

Rufaro Chiriseri, CFA – London

- **A shock interest rate hike of 50 basis points (bps) from the Bank of England signals deep concern amongst the voting members of the Monetary Policy Committee (MPC), in our view**. The vote was 7-2 in favour of the move at the June meeting, where the voting members judged that the "scale of recent upside surprises" in inflation and wage data warranted a bigger-than-expected increase. The inflation data released this week were above consensus expectations for the fourth consecutive month. CPI inflation was unchanged at 8.7% y/y from April and, more importantly, May services inflation is ahead of the May Monetary Policy Report forecast of 6.8% y/y.

- In the run-up to the meeting, Gilt yields had priced in market expectations of a higher 6% terminal Bank Rate. Consequently, 2-year Gilt yields took the BoE decision in stride and continued hovering around the 2008 highs of 5%. **The rollercoaster moves in 2-year Gilts have been remarkable, with yields having risen by 160 basis points this quarter—half of that in June alone**.

- All three areas of focus for the MPC—services inflation, private sector pay, and labour market tightness—are ahead of their May forecasts. **We believe this leaves the central bank open to delivering more hikes, although multiple 50 bps moves are not our base case**. We think a peak policy rate of 5.50%–5.75% seems plausible, but that's predicated on how quickly services inflation abates and whether the committee is convinced by forward indicators that show signs of price growth slowing. That being said, a Bank Rate of around 6% could tip the UK economy into a recession later this year. This might be the unfortunate price for achieving a slowdown in price growth, in our view. According to the central bank's own estimates, around 57% of mortgages due for renewal in 2023 were fixed at an interest rate below 2%, which puts a further squeeze on around 1.3 million households that will renew their mortgages this year.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **After three weeks of solid gains, the Asia Pacific equity market traded broadly lower this week, weighed down by China and Hong Kong**. After a rally from 18,000 in late May that took it above the 20,000 mark last Friday, the Hang Seng Index gave up some gains this week on the back of profit-taking and market disappointment with interest rate cuts in China.

Hang Seng Index giving up gains after strong rebound

Source - RBC Wealth Management, Bloomberg; daily data through 6/21/23

- **U.S. Secretary of State Antony Blinken met with Chinese Foreign Minister Qin Gang for more than seven and a half hours on Sunday**. The U.S. State Department called the talks "candid, substantive and constructive." Qin accepted an invitation to Washington and called for "stable, predictable" relations. But just a day after Blinken left Beijing, U.S. President Joe Biden called Chinese President Xi Jinping a "dictator" and China responded by calling it a "provocation." While the comments may not set off a new diplomatic crisis, they risk eroding the symbolic progress made just a day before. We acknowledge that U.S.-China relations are at the lowest point since they were established in the 1970s, as the Chinese side described, but view Blinken's Beijing visit as an important development. However, there remains a lot of work to be done to mend the relationship, in our view.

- **Alibaba Group (9988 HK) surprised the market by announcing a leadership shakeup**. Current Executive Vice Chairman Joe Tsai will succeed Daniel Zhang as chairman. At the same time, Eddie Yongming Wu, chairman of Taobao and Tmall Group, will succeed Zhang as CEO of Alibaba Group, and also replace him on the company's board of directors. Zhang will continue to lead Alibaba Cloud Intelligence Group as its chairman and CEO. Shares of Alibaba Group fell following the announcement, but Reuters reported several analysts viewed the change as positive, both from a corporate governance perspective and because it would allow Zhang to focus more on the cloud business, an important growth engine for Alibaba Group.

MARKET Scorecard

Data as of June 21, 2023

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,365.69	4.4%	13.7%	16.0%	3.3%
Dow Industrials (DJIA)	33,951.52	3.2%	2.4%	11.2%	0.2%
Nasdaq	13,502.20	4.4%	29.0%	22.0%	-4.5%
Russell 2000	1,863.02	6.5%	5.8%	10.0%	-18.5%
S&P/TSX Comp	19,705.95	0.7%	1.7%	2.3%	-2.2%
FTSE All-Share	4,115.41	1.2%	1.0%	4.3%	2.2%
STOXX Europe 600	457.01	1.2%	7.6%	11.9%	0.4%
EURO STOXX 50	4,322.75	2.5%	13.9%	23.7%	5.1%
Hang Seng	19,218.35	5.4%	-2.8%	-10.9%	-32.5%
Shanghai Comp	3,197.90	-0.2%	3.5%	-3.3%	-9.4%
Nikkei 225	33,575.14	8.7%	28.7%	27.9%	19.9%
India Sensex	63,523.15	1.4%	4.4%	20.9%	20.8%
Singapore Straits Times	3,223.66	2.1%	-0.9%	3.4%	3.4%
Brazil Ibovespa	120,420.75	11.2%	9.7%	20.8%	-6.8%
Mexican Bolsa IPC	54,053.72	2.5%	11.5%	12.4%	7.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.723%	8.0	-15.2	44.8	223.4
Canada 10-Yr	3.387%	20.0	8.7	-11.4	197.3
UK 10-Yr	4.405%	22.2	73.3	175.1	363.6
Germany 10-Yr	2.435%	15.3	-13.6	66.4	260.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.71%	0.0%	2.4%	1.0%	-10.6%
U.S. Investment-Grade Corp	5.43%	0.4%	3.2%	2.7%	-12.5%
U.S. High-Yield Corp	8.63%	1.5%	5.2%	7.3%	-4.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,932.48	-1.5%	5.9%	5.4%	8.4%
Silver (spot $/oz)	22.66	-3.5%	-5.4%	4.5%	-12.7%
Copper ($/metric ton)	8,552.25	6.0%	2.2%	-4.9%	-6.6%
Oil (WTI spot/bbl)	72.28	6.2%	-9.9%	-34.7%	-1.9%
Oil (Brent spot/bbl)	77.14	6.2%	-10.2%	-32.7%	3.0%
Natural Gas ($/mmBtu)	2.59	14.3%	-42.1%	-62.0%	-18.8%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	102.0670	-2.2%	-1.4%	-2.3%	11.1%
CAD/USD	0.7596	3.1%	3.0%	-1.9%	-6.1%
USD/CAD	1.3165	-3.0%	-2.9%	1.9%	6.5%
EUR/USD	1.0988	2.8%	2.6%	4.3%	-7.8%
GBP/USD	1.2764	2.6%	5.6%	4.0%	-8.4%
AUD/USD	0.6796	4.5%	-0.2%	-2.5%	-9.8%
USD/JPY	141.8600	1.8%	8.2%	3.9%	28.6%
EUR/JPY	155.8800	4.7%	11.0%	8.3%	18.6%
EUR/GBP	0.8608	0.2%	-2.8%	0.3%	0.6%
EUR/CHF	0.9812	0.8%	-0.8%	-3.6%	-10.3%
USD/SGD	1.3402	-0.8%	0.1%	-3.3%	-0.2%
USD/CNY	7.1794	1.0%	4.1%	7.3%	11.0%
USD/MXN	17.1255	-3.2%	-12.2%	-14.9%	-16.4%
USD/BRL	4.7671	-5.7%	-9.7%	-7.0%	-4.9%

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 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 3.0% return means the Canadian dollar rose 3.0% vs. the U.S. dollar year to date. USD/JPY 141.86 means 1 U.S. dollar will buy 141.86 yen. USD/JPY 8.2% return means the U.S. dollar rose 8.2% vs. the yen year to date.

Source - Bloomberg; data through 6/21/23

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As of March 31, 2023

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