GLOBAL
Insight
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RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

September 1, 2022

Beyond the hype

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Many long-term investors look to Federal Reserve speechmaking for insight. In reality, those sound bites have been an unreliable guide to future policy moves. We explore that fact and explain why investors should look to planning—not parsing—when building portfolios.

Fed Chair Jerome Powell's widely anticipated keynote address at the monetary policy symposium in Jackson Hole, Wyoming, took a hawkish tone, emphasizing the central bank's commitment to fighting inflation, even if it results in slower growth and higher unemployment. Price stability, he argued, is a prerequisite to stable, long-term growth and robust job creation.

While we don't dispute that monetary policy is critical to the overall economy and market pricing, we think speeches such as Powell's likely offer less insight into future Fed actions than may first appear, and that the split in market reaction—where equity prices have declined more significantly than bonds—reflects that underlying reality.

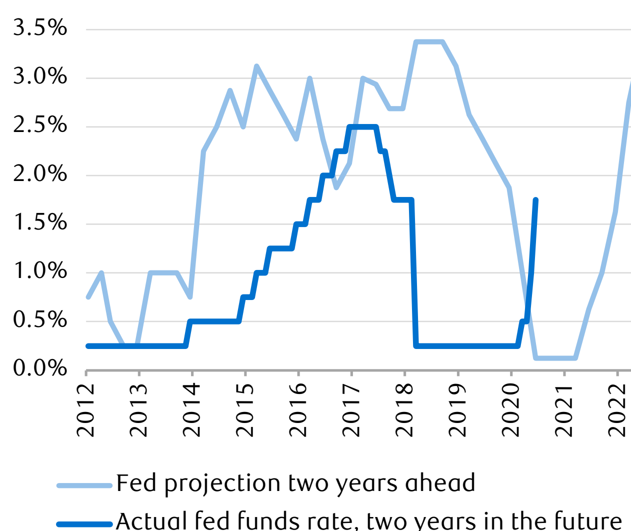
Long-term projections have a poor track record

The Fed is a remarkably poor predictor of its own behavior. Even the members who vote on policy have been unable to forecast their own future votes with any degree of accuracy. As the chart shows, the Fed's "dot plot," or the quarterly projections from Fed policymakers, have been remarkably inaccurate in projecting future interest rates.

The key failing of long-term Fed projections—in speeches and the dot plots—is that they tell us what Fed members are likely to do if the economy unfurls exactly as expected. But the economy rarely cooperates, and the results are evident in the large forecast errors. Longer-term Fed projections are analogous to a household budget based around winning the lottery; they may tell us something about the individuals involved, but not much will be directly useful in the future.

Fed forecasts rarely realized

Two-year-ahead projection significantly different from actual future rates



Source - RBC Wealth Management, Bloomberg; data through 6/30/22

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.

The Fed is aware of the problem and has added additional context and commentary to its formal projections, and we believe the same qualified approach should be taken to Powell's comments.

Multiple audiences, multiple purposes

Central bank speakers are also constrained in what views they can express.

Fed policymakers and researchers have advanced cogent arguments against increasing rates much beyond their current level in the near term: policy acts with a lag, so the full impact of recent hikes has yet to be felt; the majority of current inflation is coming from supply chain disruptions that are unlikely to be resolved by tighter policy; and there are signs core inflation has already peaked.

But even if this reasonable, well-supported position reflected Powell's actual view, we think he was effectively precluded from saying so at Jackson Hole because it would risk entrenching inflation expectations, possibly pushing wages—and future inflation—higher. As importantly, after the failure of the "transitory" inflation label, the central bank risks its institutional credibility if it gets ahead of market sentiment on proclaiming victory on prices.

The result is a kabuki theater element to Fed speechmaking, as policymakers tell markets and consumers what they need to hear instead of offering a balanced assessment of current conditions.

Show, don't tell

Powell's speech offered helpful clarity on near-term policy moves, as we believe he largely solidified the idea that this month's policy choice is between an increase of 50 and 75 basis points (bps). Interest rate futures and 2-year Treasury yields now reflect this position, with the latter hitting the highest levels in nearly 15 years.

Beyond those short-term interest rate moves, however, Treasury markets largely shrugged off the speech, with longer-term bond yields quickly returning to last week's levels. In the three days following the speech, 5-year bond yields consistently closed below 3.27%, hardly consistent with the idea of the Fed aggressively hiking and maintaining rates well beyond its current target.

Bond investors seem unwilling to give Powell the benefit of the doubt on anything beyond the immediate policy moves, apparently preferring to wait and see how economic data and the Fed's resolve shape up.

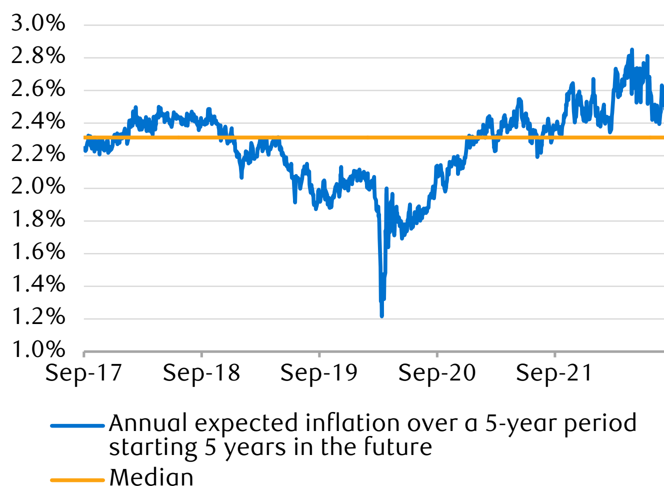
Larger cross-market impacts

Despite the bond market's relative stability, equity markets have moved notably lower since the speech.

In part, this is because equities—particularly growth equities—are very sensitive to higher yields. If rates were to rise 1% more than markets expect, the loss on a 5-year Treasury would likely be less than 5%, as the impact of the higher rate environment disappears at maturity. It's not great performance, but manageable for most investors, in our opinion. For equities, the likely loss could be greater, as the impact of higher rates persists until they come down. So even if there is only a 10% chance the Fed follows through, equity markets have to take greater notice than most bond investors.

Could markets handle a non-hawkish view?

Inflation expectations remain elevated despite Fed Chair's tough talk



Source - RBC Wealth Management, Bloomberg; data through 8/31/22

In addition to the ongoing challenges with inflation and the potential policy response, equities face other potential headwinds: the elevated risk of a full-blown domestic recession, the likelihood 2023 consensus earnings estimates are too high, and the energy crisis in Europe. We believe these factors help explain why we have seen stocks and corporate bond prices—which tend to be growth sensitive—decline since the symposium.

For these reasons—among others—we continue to recommend Market Weight exposure to U.S. and global equities.

Follow a plan, not the headlines

We know a little—but not much—more as a result of Powell's speech. Policy will ultimately depend on the broader economic backdrop, even if we now have more reason to believe that a 75 bps hike is on the table this month.

For the individual investor with a long-term view, we would argue that the hype around the speech emphasizes the importance of looking first and foremost at asset allocation and long-term planning. No one has a crystal ball, and attempting to time the market—even in the guise of predicting monetary policy moves—is unlikely to be beneficial to investment returns.

UNITED STATES

Alan Robinson – Seattle

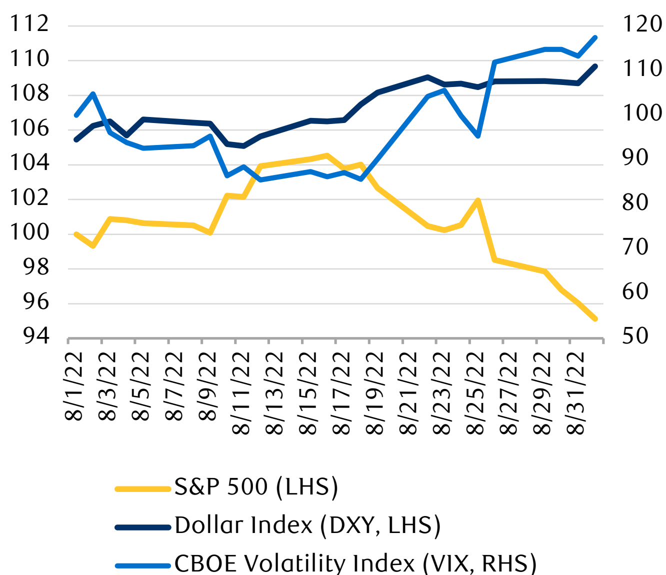
- **U.S. stocks ended August on a weak note, with the S&P 500 Index down nearly 4% for the month, reversing solid gains at the start of the month**. The risk-off pivot halfway through August was driven by a perfect storm of higher interest rates and a stronger dollar (see chart) which impacts the foreign earnings of U.S. companies. Geopolitical concerns also resurfaced over increased tensions between China and Taiwan, and renewed COVID-19 fears in the former. Even some positive U.S. economic news, including better-than-expected labor market data ahead of the important August jobs report due Sept. 2, was not enough to reverse the trend. **Traders were in "Good news equals bad news" mode, figuring a strong economy would prompt more Fed hawkishness**.

- **The Information Technology sector bore the brunt of the losses, with the semiconductor industry particularly impacted**. The bellwether Philadelphia SOX index of leading chipmakers fell 10% during the final week of August as a number of early-cycle chip companies including Micron (MU), NVIDIA (NVDA), and Analog Devices (ADI) highlighted worsening global demand. The index fell a further 4% on the first day of September after the U.S. government announced restrictions on the export to China of high-end chips used in artificial intelligence (AI) applications.

- **There were, however, a few positive factors for the stock market. The "peak inflation" narrative** resurfaced, as supply chain normalization and lower energy prices contributed to a deceleration in cyclical price pressures.

August—In like a lion, out like a lamb

Dollar and Volatility finish up, stocks finish down



Note: S&P 500 and VIX Index normalized with 8/1/22 values = 100. DXY represents actual values.

Source - RBC Wealth Management, FactSet; daily data as of 11:45 am ET 9/1/22

And **earnings resilience** provided another bullish talking point as consensus earnings estimate revisions for the broad market inflected slightly higher over the past few weeks due to better top-line trends and pricing power. RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina noted in her August analyst survey that respondents leaned modestly positive on the outlook for their industries over the next six to 12 months, and had favorable views on valuations and the demand backdrop. They also downplayed the potential impact of corporate minimum tax and stock buyback provisions in the Inflation Reduction Act.

CANADA

Mila Krunic & Richard Tan, CFA – Toronto

- **The Canadian banks wrapped up Q3 2022 earnings with mixed results**. To begin, the group built reserves for potential credit losses on a sequential basis in the event the economy continues to cool and loan losses rise. While this likely places a lower priority on share repurchases and dividend increases, we view this build as prudent in the face of rising recessionary risks. From a business line perspective, personal and commercial banking was a source of relative strength driven by the sharp rise in interest rates in Canada and the U.S. Meanwhile, wealth management also delivered solid results despite volatile market conditions. On the flip side, capital markets was a drag on earnings due to lower debt and equity originations, partially offset by increased trading activity. Capital ratios experienced a modest sequential decline but remain healthy, in our view, and well above statutory requirements. All things considered, we believe the banks are appropriately valued at approximately 1.55x price-to-book compared to the long-term average of roughly 1.85x, baking in a garden variety recession.

- **The Canadian economy modestly accelerated in Q2** as GDP rose at a 3.3% annualized pace after a revised 3.1% increase in Q1. However, this **growth was below consensus expectations** of a 4.4% increase. Meanwhile, the latest monthly reading shows the economy contracted by 0.1% in July, reversing June's gain of 0.1%, as the pace of growth slowed into the summer on the back of elevated inflation and the Bank of Canada's interest rate hikes. The rise in growth in Q2 was driven by increased business investment in inventories, non-residential structures, and machinery and equipment, as well as household spending on services and semi-durable goods. Declines in housing investment and household spending on durable goods detracted from growth, as did a rise in imports that exceeded exports. The increase in import volumes (+6.9%) was led by passenger cars and trucks, particularly electric and hybrid models, whose appeal has been enhanced by high gas prices. Export volumes rose 2.6% in Q2 (after falling 2.3% in Q1) thanks to strong U.S. demand for aluminum.

EUROPE

Rufaro Chiriseri, CFA & Thomas McGarrity, CFA – London

- **Euro area inflation surprised to the upside and exceeded consensus expectations in August, rising to 9.1% y/y from 8.9% y/y in July**. With inflation now above the European Central Bank's (ECB) June forecast, markets have firmly priced in an interest rate hike of 50 basis points (bps) at the ECB's upcoming meeting on Sept. 8, and a further 100 bps of tightening by year's end. However, a 75 bps hike appears possible at the upcoming meeting following a recent hawkish speech by ECB Governing Council member Isabel Schnabel at the Fed's Jackson Hole symposium, as well as comments from six other council members calling for a larger rate hike.

- The ECB faces a tough balancing act amid rising energy costs, persistent supply bottlenecks, and constraints on labour supply that continue to exert pressure on manufacturing activity, which slowed in August. Consequently, **we expect the ECB to downgrade its growth forecasts at its upcoming meeting**. RBC Capital Markets is forecasting a European recession in the winter months this year.

- Since the end of July, the STOXX Europe 600 ex UK Index has fallen 6.5%, meaning **European stocks have now given up almost all the ground they gained in the summer market rally**. During the week, the weakest areas of the market included: Basic Resources, as metal commodity prices fell on recession concerns and a new COVID-19 lockdown in the Chinese city of Chengdu; high-multiple Tech stocks, as bond yields surged higher; and Utilities, on increasing windfall tax concerns.

- **European Commission President Ursula von der Leyen said the commission is working to curb soaring energy prices through emergency intervention measures**, which will be outlined in a speech on Sept. 14. Measures being considered include price caps, windfall taxes on energy companies, and power demand reduction. In addition to limiting energy prices in the short term, **the measures will also seek structural reform of the EU power market** by decoupling the price of electricity from natural gas prices. This could, for example, allow cheaper renewable energy help to set electricity prices.

Rising German Bund yield is nearing the 5-year peak

German 10-year yield

Source - RBC Wealth Management, Bloomberg; data as of 7:00 am ET 9/1/22

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **The Asia Pacific equity market traded broadly lower during the week, weighed down by Japan and Australia**. The MSCI AC Asia Pacific Index ended August down 1.13% m/m, giving back some of the gains posted in July, and is down 17.91% year to date. The latest weakness has been driven by more aggressive rate-hike expectations after central banks across the globe vowed to step up their fights against inflation. Also weighing on investor sentiment is the risk of a possible uptick in tension between China and Taiwan.

- **China state media announced that top leaders of the Communist Party of China are expected to propose that the party hold its 20th National Congress on Oct. 16 in Beijing**. The national congress is held every five years and is primarily a political event to determine the next group of leaders for the ruling party. This year's gathering takes on additional significance, as it will be widely watched as an indicator of when China may begin to ease its so-called "dynamic zero-COVID" policy. Separately, according to a CNBC report, some analysts expect President Xi Jinping to increase his share of political associates at the top two levels of the Chinese leadership during the congress.

- **BYD Co (1211 HK), a leading Chinese electric-vehicle manufacturer, fell more than 12% this week after Warren Buffett's Berkshire Hathaway trimmed its stake in the company**. Berkshire slightly reduced its holdings from 20.04% to 19.92%, according to a filing on the Hong Kong exchange. The stock fell even though BYD's Q2 results came in at the top end of its previous guidance, beating expectations on the back of record new energy vehicle (NEV) sales, a better sales mix, and cost-control initiatives. Revenue grew 68% y/y or 25% q/q with strong NEV sales growth of 33% q/q.

MARKET Scorecard

Data as of August 31, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,955.00	-4.2%	-17.0%	-12.6%	13.0%
Dow Industrials (DJIA)	31,510.43	-4.1%	-13.3%	-10.9%	10.8%
Nasdaq	11,816.20	-4.6%	-24.5%	-22.6%	0.3%
Russell 2000	1,844.12	-2.2%	-17.9%	-18.9%	18.1%
S&P/TSX Comp	19,330.81	-1.8%	-8.9%	-6.1%	17.1%
FTSE All-Share	4,007.46	-2.4%	-4.8%	-2.5%	19.9%
STOXX Europe 600	415.12	-5.3%	-14.9%	-11.8%	13.3%
EURO STOXX 50	3,517.25	-5.1%	-18.2%	-16.2%	7.5%
Hang Seng	19,954.39	-1.0%	-14.7%	-22.9%	-20.7%
Shanghai Comp	3,202.14	-1.6%	-12.0%	-9.6%	-5.7%
Nikkei 225	28,091.53	1.0%	-2.4%	0.0%	21.4%
India Sensex	59,537.07	3.4%	2.2%	3.4%	54.1%
Singapore Straits Times	3,221.67	0.3%	3.1%	5.5%	27.2%
Brazil Ibovespa	109,522.88	6.2%	4.5%	-7.8%	10.2%
Mexican Bolsa IPC	44,919.22	-6.7%	-15.7%	-15.7%	21.9%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.193%	54.4	168.3	188.4	248.8
Canada 10-Yr	3.115%	50.5	168.9	189.9	249.3
UK 10-Yr	2.801%	93.7	183.0	208.7	249.0
Germany 10-Yr	1.541%	72.4	171.8	192.4	193.8
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.91%	-2.5%	-10.4%	-11.2%	-11.3%
U.S. Investment-Grade Corp	4.76%	-2.4%	-13.7%	-14.4%	-12.3%
U.S. High-Yield Corp	8.32%	-1.9%	-10.8%	-10.2%	-1.1%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,710.67	-3.1%	-6.5%	-5.7%	-13.1%
Silver (spot $/oz)	17.98	-11.7%	-22.9%	-24.7%	-36.1%
Copper ($/metric ton)	7,893.00	-0.5%	-19.0%	-17.2%	17.8%
Oil (WTI spot/bbl)	89.55	-9.2%	16.3%	30.7%	110.2%
Oil (Brent spot/bbl)	96.49	-12.3%	24.1%	32.2%	113.1%
Natural Gas ($/mmBtu)	9.17	11.5%	145.9%	109.5%	248.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	108.6920	2.6%	13.6%	17.3%	18.0%
CAD/USD	0.7612	-2.6%	-3.8%	-4.0%	-0.7%
USD/CAD	1.3136	2.7%	3.9%	4.1%	0.7%
EUR/USD	1.0052	-1.6%	-11.6%	-14.9%	-15.8%
GBP/USD	1.1621	-4.5%	-14.1%	-15.5%	-13.1%
AUD/USD	0.6842	-2.0%	-5.8%	-6.5%	-7.2%
USD/JPY	138.9500	4.3%	20.7%	26.3%	31.2%
EUR/JPY	139.6800	2.6%	6.7%	7.5%	10.5%
EUR/GBP	0.8650	3.1%	2.8%	0.8%	-3.1%
EUR/CHF	0.9833	1.0%	-5.2%	-9.0%	-8.9%
USD/SGD	1.3975	1.2%	3.6%	3.9%	2.7%
USD/CNY	6.8904	2.2%	8.4%	6.7%	0.6%
USD/MXN	20.1375	-1.1%	-1.9%	0.3%	-8.0%
USD/BRL	5.1873	0.3%	-7.0%	0.7%	-5.6%

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 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -3.8% return means the Canadian dollar fell 3.8% vs. the U.S. dollar year to date. USD/JPY 138.95 means 1 U.S. dollar will buy 138.95 yen. USD/JPY 20.7% return means the U.S. dollar rose 20.7% vs. the yen year to date.

Source - Bloomberg; data as of 8/31/22 market close

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Buy [Outperform]	851	58.41	290	34.08
Hold [Sector Perform]	560	38.44	169	30.18
Sell [Underperform]	46	3.16	6	13.04

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