Wealth Management
Dominion Securities

The Porretta Group

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Mark Porretta, CIM
Vice President, Portfolio Manager & Wealth Advisor
mark.porretta@rbc.com
905-764-5258

Theresa Bruno
Associate Wealth Advisor
theresa.bruno@rbc.com
905-764-1345

Eric Hoey
Associate Investment Advisor
eric.hoey@rbc.com
905-764-5847

The Porretta Group of RBC Dominion Securities

260 East Beaver Creek Rd.
Suite 500
Richmond Hill, ON
L4B 3M3

www.markporretta.com

Quarterly Update

Between COVID-19, inflation, lingering policy uncertainties and growth beginning to settle into a more normal pace, there has been no shortage of things to concern ourselves with over the last quarter. With that said, household fundamentals are strong, the cost and accessibility of credit remains highly supportive, and earnings growth should persist, albeit at a slower pace in 2022 and into 2023. Even if the Federal Reserve begins hiking interest rates in late 2022, the year leading up to the first Fed rate hike and the year following have typically been good periods for the stock market. While major indexes seem vulnerable to additional volatility, due to economic / political headwinds, in our view, the fact there has been no noticeable weakness in leading indicators (like yield curve and jobless claims) means that the positive equity market is likely to remain intact for some time.

Transitory or not

Whether or not U.S. inflation will turn out to be "transitory," as the Fed has asserted on many occasions, the reality is that the official consumer and producer inflation data continue to march higher, and the anecdotal inflation evidence is now widespread. The Consumer Price Index (CPI) surged 6.2% in October compared to a year ago, the highest level seen since 1990. The CPI also jumped almost a full percentage point on a month-over-month basis, the biggest such increase since 2008. This consumer data was on top of a 12.5% surge in producer prices in October as compared to a year ago, the highest level seen since 1980, when inflation was raging in America. But the curious phenomenon is that the U.S. equity market has largely ignored high and rising inflation so far this year. At the same time that the CPI surged from 1.4% to 6.2% from January to October, the S&P 500 rallied 22.6%, seemingly unfazed. We think there are many reasons the market hasn't been bothered by high and rising inflation thus far in 2021:

1. The economy has been growing well above the long-term trend rate and seems set to grow at an above-average pace in 2022, and the leading economic indicators have firmed;
2. Household spending has been strong, and there is scope for more spending as household balance sheets are still flush with cash and wages are rising;

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3. S&P 500 corporate earnings growth has been robust: it is on pace to rise 50% in 2021 and could tack on another 7% in 2022, according to the consensus forecasts;
4. Some industries (such as commodity producers) benefit from inflation, as do companies in industries that are able to pass along any inflation in input costs to their customers by charging higher prices (in other words, companies with pricing power);
5. Many companies, especially large firms, are effectively managing their expenses, offsetting or at least partially mitigating inflation's effects, and;
6. More and more companies are using technology to improve productivity and contain or reduce labour costs and other expenses.

A look back on tapering

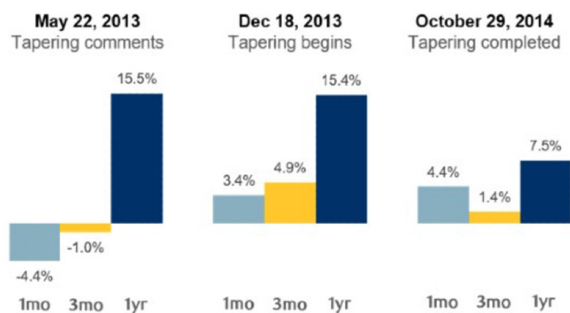
The broad strokes of the Fed's asset purchase tapering plans are as we expected: its current $120 billion per month in asset purchases will be cut by $15 billion per month, starting in November – a pace that would bring bond buying to an end by June of next year. The pace could be adjusted up or down based on economic developments, but we see little reason to think that will happen at this stage. The Fed has been clear that it wants to unwind its QE program before raising rates. Now, with June 2022 serving as the target end date of QE, investors have a clearer indication of when the Fed may move to raise rates.

For some investors, tapering stirs up negative connotations. This is largely because of the 2013 "Taper Tantrum," when the Fed began scaling back the stimulus measures it delivered in response to the 2008 Global Financial Crisis. In reviewing this period for key takeaways for investors today, there are a few dates to point out:

- **May 22, 2013:** Policymakers discuss tapering, surprising investors.
- **December 18, 2013:** The Fed officially announces they will begin reducing the pace of their asset purchases (this is the stage we're at in the current tapering cycle).
- **October 29, 2014:** The Fed completes the taper, ceasing monthly bond purchases.

The unanticipated tapering comments made in May 2013 unnerved equity markets initially, as seen in Figure 1. However, they were able to quickly overcome the short-term volatility, thanks to a strong economy and solid earnings growth. Meanwhile, equity returns after the Fed actually started to taper in 2013 – as well as when they eventually ended their quantitative easing program – were very strong.

Figure 1 | S&P 500 returns following key tapering dates



Source: RBC Global Asset Management

When it comes to financial markets, every situation is unique. Nevertheless, there is a common misconception that when central banks start to tighten monetary policy, it automatically hurts financial markets. As we can see from what happened in 2013 when the Fed started to taper its asset purchases, that's simply not the case. Financial markets should be happy when central banks are doing the right thing, not just when they are delivering stimulus. Sometimes, tighter policy is the best possible strategy for keeping the economic expansion going because it minimizes the risk of overheating. Thus far, the market has largely been supportive of this stance – undoubtedly aided by the Fed's clear communication in telegraphing policy decisions well in advance.

What are we doing?

On the whole, not a lot has changed from the last quarter. Our general thesis on the overall markets continues to be intact, and we are continuing to overweight equities and underweight fixed income. While there may be heightened volatility in the future, until there are recessionary indicators flashing at least yellow, we will give equities the benefit of the doubt. We took the opportunity over the past quarter to continue to add to high-quality names that we believe will continue to grow their earnings in the coming year. On the fixed income front, this year has been extremely challenging, due to the low rate environment as well as with rates moving higher (even as minimally as they have). This is shown in the major fixed income indices, which are down between -1% and -10%. Fixed income will likely continue to be a headwind, with rates projected to move up from here. This only reiterates the necessity of keeping our duration short and the credit quality high.

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