

Does the bond market care about inflation?

Atul Bhatia, CFA – Minneapolis

With U.S. inflation rising sharply and the Fed choosing to continue its accommodative monetary policy, the recent rally in Treasuries may seem surprising. We look beyond price increases to break down the factors driving the market response.

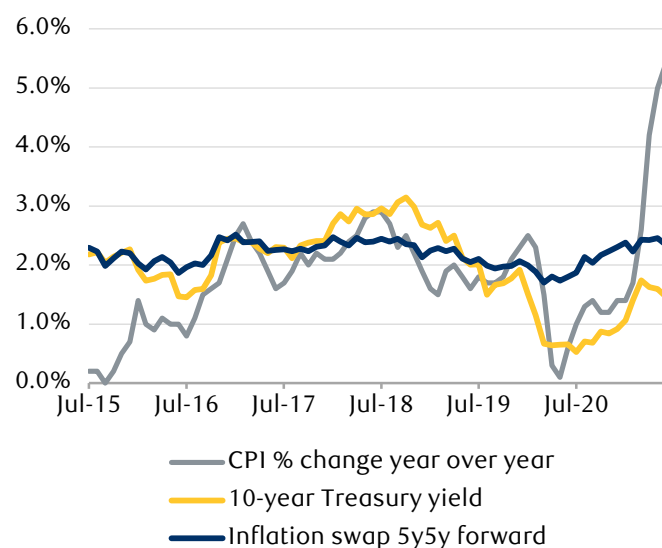
The 5.4 percent rise in consumer prices over the past year dominated market discourse this week. Inflation concerns were further strengthened by the accelerating pace of monthly price swings, with the June U.S. Consumer Price Index up 0.9 percent over May. Gains were concentrated in pandemic-linked sectors including used cars, restaurant meals, and hotel rooms. The distribution of price increases supports the U.S. Federal Reserve's view of transitory inflation, while the magnitude of the gains and a record one percent monthly increase in core producer prices increase upward pressure on wages and the potential for sustained inflation.

A Rorschach test for investors

The bottom line, in our view, is that interpretations of inflation data tell us as much about the analyst as they do the likely path of future events. The conditions are certainly present for sustained inflation: businesses have an ability to pass costs on to consumers, and real wages have declined. Workers thus have a strong incentive to seek higher wages, which employers can provide by passing on the cost to consumers, potentially setting off the classic wage-price inflation spiral.

But the appearance of some inflationary conditions does not inexorably lead to sustained future inflation.

Bond and inflation markets ignore CPI spike



Note: 5y5y inflation refers to expectations for inflation over a five-year period starting five years in the future.

Source - RBC Wealth Management, Bloomberg; CPI data through 6/30/21; inflation swap and 10-yr. Treasury data through 7/15/21

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

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Prior episodes of negative real wages have not caused sustained wage pressure; indeed, the share of national income paid to labor has declined from 64 percent to 60 percent since 2000 amid low real-wage growth. Demographics, income distributions, trade, and technology helped contain inflation in the recent past, and with nearly nine million former wage earners currently off payrolls, the downward forces on prices and wages remain strong. Even if workers can leverage post-pandemic conditions to increase earnings, the gain may be one-time, because the labor pool will likely grow after expanded unemployment benefits expire in September for most households.

Fed caution, market indifference

Federal Reserve Chair Jerome Powell downplayed the June inflation data in congressional testimony this week, and emphasized that the Fed was “a ways off” from starting to reduce its \$120 billion in monthly bond purchases.

To date, markets have taken a benign view of both the data and the discourse; long-tenor rates initially declined in response to the higher consumer and producer price inflation numbers, while short-end rates fell in response to Powell’s comments on the likelihood of ongoing monetary support. Both long-term rates and inflation expectations have remained steady at or below historical levels, despite the absence of a Fed response to rising inflation.

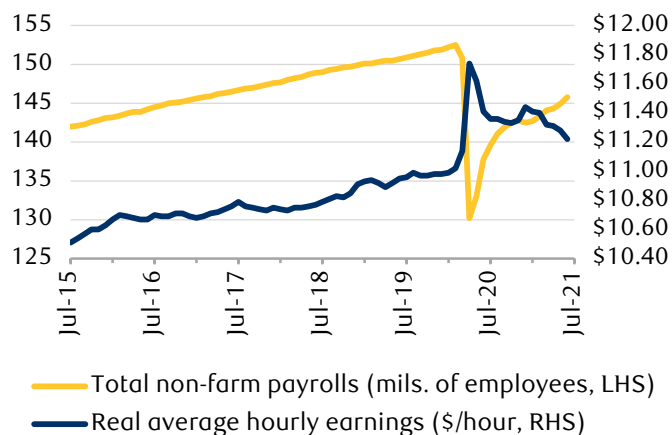
We think the market’s response to the most recent inputs is broadly appropriate, given the strength of existing disinflationary forces. Bond investors are also recognizing potential risks to growth, such as smaller-than-expected fiscal programs or higher consumer savings rates. Just as importantly, we believe markets are aware that the Fed has a proven toolkit to bring inflation down, and that the central bank would be under pressure to respond if inflation expanded to broad swathes of the economy.

The market’s response underscores the fundamental truth that while it is easy for economists and strategists to point out potential Fed policy mistakes, it is difficult—and usually counterproductive—for investors to position for extreme outcomes like rampant domestic inflation or stagflation. These outlier events rarely occur and even when they do, timing the market response is incredibly difficult, as this week proved: not even a multi-decade high in the pace of Consumer and Producer Price Index increases, paired with a Fed chair committed to continuing monetary accommodation, could create gains for bond bears.

Updating our views

This week’s events have left our views mostly unchanged. We continue to believe that inflation will largely prove transitory, although the level of increase may be higher than the Fed or the market thought likely only a few months ago. As a result, we see the 10-year Treasury ending the year with a yield near 1.75 percent.

Real wage gains may prove difficult as labor pool grows



Source - RBC Wealth Management, Bloomberg; data through 6/30/21

Despite this relatively benign outlook and Powell’s comments on tapering, we think it is increasingly likely that the Fed will begin to reduce bond buys in Q4 of this year, as several of the more hawkish members of the Federal Open Market Committee will lose their votes in 2022; these members are likely to dissent if policy remains unchanged by year’s end. Maintaining unanimity is always important to preserve the central bank’s credibility, but particularly so with inflation above the two percent target and interest rates at zero.

An earlier start to tapering should have little fundamental impact, in our view. Even with tapering, the Fed will likely be adding bonds to its balance sheet throughout 2022. Initial market response to the taper announcement may be negative, but this should fade over time. In the end, Powell and other doves may choose to accept these costs in exchange for more votes in favor of what would still be accommodative policy.

Investor interest in asset purchase tapering often comes at the expense of fiscal policy focus. This is likely a mistake. The breadth of potential fiscal policy outcomes is striking; a bipartisan Congressional group has agreed on nearly \$600 billion in infrastructure spending, while on the left flank, Democratic Senator Bernie Sanders is advocating a \$6 trillion increase in federal spending over 10 years. Should Congress fail to pass any infrastructure legislation, interest rates would likely drop even further on growth concerns, while a large, debt-fueled spending package could push yields higher.

Fortunately for investors, the high degree of uncertainty around inflation and interest rates can be countered in part by solid asset allocation and periodic rebalancing. We continue to believe that investors should take a “barbell” approach to fixed income allocations: emphasizing longer-maturity Treasuries for their outperformance potential during economic downturns, along with more growth-oriented investments that have higher return potential.

UNITED STATES

Ben Graham, CFA – Minneapolis

■ **U.S. stocks have moved generally lower this week**, consolidating some of their recent gains. **Small caps have been hardest hit** as the Russell 2000 has declined nearly 4%. However, the most common volatility index—the CBOE Volatility Index (VIX)—moved fractionally higher. Large-cap indexes in the U.S. are down less than 1% for the week while the Russell 1000 Growth index is outperforming the Russell 1000 Value by approximately 50 basis points. Sector leadership is evident in secular growth and defensive exposures with Information Technology, Utilities, and Consumer Staples stocks the best performers thus far this week. Laggards include Energy, declining by more than 5%, and Consumer Discretionary.

■ **Earnings season kicked off with banks and select Consumer and Health Care companies reporting.** PepsiCo was the poster child for a good surprise this season as the recovery play was evident in its financials while the banks are broadly beating expectations on weaker-than-average quality as the results are fueled by large loan loss reserve releases.

■ **RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina** recently published her quarterly earnings outlook for the second quarter. She **anticipates strong results will materialize**, but it is unclear how much higher stocks will climb on Q2 results alone without increased full-year guidance from management teams. Calvasina is also watching a weakening of the rate at which cyclical stocks earnings are revised higher, as this could be a headwind for the reflation trade going forward.

■ **Economically speaking, inflation was the headline event this week**, but regional activity indexes showed mixed results as the Empire State activity index surprised positively while the Philadelphia Fed activity index was lower than consensus expectations. Weekly initial jobless claims filings were in line with the consensus estimate at 360,000, bringing the four-week average to 383,000, the lowest level since the COVID-19 pandemic started.

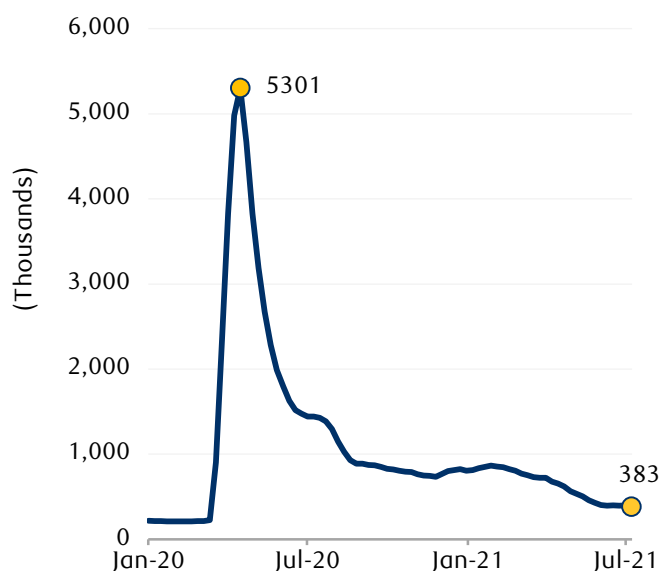
CANADA

Luis Castillo & Simon Jones – Toronto

■ **The Bank of Canada (BoC) maintained its 0.25% policy rate, while tapering the pace of Government of Canada (GoC) bond purchases to CA\$2 billion per week from CA\$3 billion per week.** This marks the third time the central bank has decreased the pace of asset purchases, from a high of CA\$5 billion per week last year. Since the onset of the pandemic, the bank's holdings of GoC bonds have increased significantly to more than 40% of all outstanding GoC bonds. **The BoC now expects**

Jobless claims continue to decline, but remain above pre-COVID levels

Weekly initial jobless claims, 4-week average



Source - RBC Wealth Management, FactSet; data through 7/9/21

GDP growth of 6% in 2021, slightly lower than previous expectations, while the 2022 forecast was revised to 4.6% from 3.7%, driven largely by the assumption that consumer spending will pick up in 2022 as households tap the excess savings that have been accumulated during the pandemic. **The BoC has also revised its 2021 inflation forecast to 3.5%** from 2.2%, while maintaining that above-target inflation will prove transitory in nature as supply constraints eventually ease. Guidance regarding the timing of future rate hikes was left unchanged with the bank still expecting rate hike conditions to be met by H2 2022.

■ **The labour market grew significantly more than expected in June**, recouping 231,000 of the 275,000 jobs that had been lost in April and May. This resulted in the unemployment rate declining 0.4% to 7.8%, even with 170,000 people rejoining the labour force. All of the employment growth during the period occurred in part-time work, as the aggregate number of full-time jobs declined modestly. Consistent with the easing of public health restrictions, job gains were concentrated in high-contact industries that rely on face-to-face interaction. Accommodation and food services and retail trade were the largest beneficiaries of June's reopening; however, they continue to account for a disproportionate amount of the jobs lost during the pandemic. **The long-term unemployment rate was little changed**, with the number of people unemployed for longer than six months remaining near record highs.

EUROPE

Thomas McGarrity, CFA – London

■ **The European Union (EU) set out its far-reaching plans to combat climate change**, dubbed “Fit for 55.” The package of proposals aims to align the EU’s climate, energy, transport, and taxation policies to its goal of reducing net greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels, setting Europe on a path to becoming the world’s first carbon-neutral continent by 2050. The proposals are just a starting point, and require approval from the European Parliament and EU member states, a process that will likely take some time—18 months to two years, we expect.

■ **A key element of the EU’s plans is the expansion of its Emissions Trading Scheme (ETS)**, notably to extend the scope of the existing program to include shipping and to introduce a new program covering both buildings and road transport, in a bid to accelerate the pace of decarbonisation. Companies involved in these activities will now likely have to buy allowances to offset their excess emissions. **This would leave a much broader set of companies significantly exposed to any further increases in the price of carbon**, which would increase their operating costs and put yet more pressure on environmental laggards.

■ On the flip side, more ambitious government policy, coupled with targeted “green” fiscal spending, is **supportive to many attractive long-term investment opportunities**, in our view (for more, see our May article on [GreenTech and clean energy](#)). Over a third of the €750 billion EU recovery fund is budgeted for the region’s transition to a cleaner energy system, including renewables, building renovation, and clean mobility. **We believe this supports the medium-term outlook for the European Capital Goods subsector**, home to many global leaders in sustainability-focused industrial applications and where a great deal of innovation is taking place.

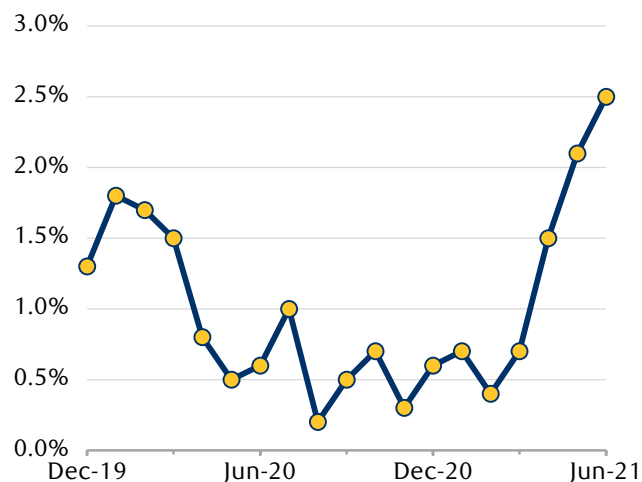
■ **UK CPI inflation rose to 2.5% y/y in June, ahead of consensus expectations of 2.2% y/y** and the 2.1% y/y increase in May. RBC Capital Markets believes the Bank of England’s Monetary Policy Committee will look beyond the current rise in UK inflation, and wait for evidence on how the unwinding of the national furlough scheme will affect the labour market in the months ahead.

ASIA PACIFIC

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

■ **China’s GDP expanded 7.9% y/y in Q2**, largely in line with the 8% Bloomberg consensus forecast. The recovery has shown signs of steadying after a sharp V-shaped rebound, largely the result of industrial output and exports. The consumption recovery has been lagging

UK CPI inflation rises to 2.5% year over year



Source - RBC Wealth Management, Bloomberg, Office for National Statistics; monthly data through June 2021

due to the virus resurgence and consumers spending cautiously.

■ However, **June retail sales, which expanded 12.1% y/y, beat the Bloomberg 10.8% median forecast**. The strong result was supported by restaurants and catering services, which rose almost 30% y/y. The retail sales increase could fuel optimism that the recovery is becoming more balanced.

■ **The People’s Bank of China released RMB 1 trillion into the interbank system on July 15 by lowering most banks’ required reserve ratio (RRR) by 50 basis points**. The central bank also injected RMB 100 billion through a one-year medium-term lending facility (MLF), less than the RMB 400 billion coming due. It also kept the borrowing rate unchanged at 2.95%. A MLF allows the central bank to inject liquidity into the banking system and influence interest rates for longer-term loans. We think the liquidity operation indicates policymakers may want to keep monetary policy largely unchanged. The RRR cut may not be the start of a new easing cycle, in our opinion.

■ **Taiwan Semiconductor Manufacturing Co. (2330 TT/NYSE: TSM) expects sales to rise more than 20% y/y in 2021** as the semiconductor supply is likely to remain tight into 2022. **Its sales are likely to be boosted by Apple’s (AAPL) 90 million production plan of its upgraded iPhones for H2 2021**. TSM plans to ramp up production of microcontrollers by close to 60% this year, which could help to reduce the chip shortage for its automobile clients starting this quarter.

MARKET Scorecard

Data as of July 15, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,360.03	1.5%	16.1%	35.1%	44.6%
Dow Industrials (DJIA)	34,987.02	1.4%	14.3%	30.2%	27.9%
Nasdaq	14,543.13	0.3%	12.8%	37.8%	76.1%
Russell 2000	2,190.29	-5.2%	10.9%	48.2%	40.2%
S&P/TSX Comp	20,183.72	0.1%	15.8%	25.7%	22.2%
FTSE All-Share	4,005.80	-0.2%	9.0%	15.2%	-2.5%
STOXX Europe 600	456.20	0.7%	14.3%	22.0%	17.7%
EURO STOXX 50	4,056.39	-0.2%	14.2%	20.1%	15.8%
Hang Seng	27,996.27	-2.9%	2.8%	9.9%	-2.0%
Shanghai Comp	3,564.59	-0.7%	2.6%	6.0%	21.2%
Nikkei 225	28,279.09	-1.8%	3.0%	23.2%	30.4%
India Sensex	53,158.85	1.3%	11.3%	47.5%	36.7%
Singapore Straits Times	3,139.98	0.3%	10.4%	18.5%	-6.2%
Brazil Ibovespa	127,467.90	0.5%	7.1%	25.2%	22.8%
Mexican Bolsa IPC	50,274.85	0.0%	14.1%	37.4%	16.7%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	1.299%	-16.9	38.6	66.9	-79.0
Canada 10-Yr	1.263%	-12.6	58.6	72.8	-32.9
UK 10-Yr	0.664%	-5.2	46.7	49.8	-13.7
Germany 10-Yr	-0.334%	-12.7	23.5	11.0	-8.3
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.44%	0.5%	-1.1%	-0.5%	18.6%
U.S. Investment-Grade Corp	2.00%	0.6%	-0.7%	2.1%	26.1%
U.S. High-Yield Corp	3.74%	0.4%	4.0%	13.7%	22.1%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,829.53	3.4%	-3.6%	1.1%	29.4%
Silver (spot \$/oz)	26.32	0.8%	-0.3%	35.6%	71.1%
Copper (\$/metric ton)	9,302.55	-0.5%	20.0%	45.8%	55.7%
Oil (WTI spot/bbl)	71.65	-2.5%	47.7%	73.9%	20.3%
Oil (Brent spot/bbl)	73.30	-2.4%	41.5%	67.4%	10.3%
Natural Gas (\$/mmBtu)	3.62	-0.8%	42.7%	103.7%	50.4%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	92.5800	0.2%	2.9%	-3.6%	-4.5%
CAD/USD	0.7937	-1.6%	1.1%	7.2%	3.6%
USD/CAD	1.2599	1.6%	-1.0%	-6.7%	-3.4%
EUR/USD	1.1811	-0.4%	-3.3%	3.5%	4.9%
GBP/USD	1.3823	-0.1%	1.1%	9.8%	10.4%
AUD/USD	0.7420	-1.0%	-3.6%	5.9%	5.4%
USD/JPY	109.8300	-1.2%	6.4%	2.7%	1.8%
EUR/JPY	129.7200	-1.5%	2.8%	6.3%	6.8%
EUR/GBP	0.8545	-0.3%	-4.4%	-5.7%	-5.0%
EUR/CHF	1.0841	-1.2%	0.3%	0.6%	-2.2%
USD/SGD	1.3544	0.7%	2.4%	-2.5%	-0.1%
USD/CNY	6.4609	0.1%	-1.0%	-6.9%	-6.1%
USD/MXN	19.9569	0.1%	0.2%	-10.6%	5.2%
USD/BRL	5.1140	2.9%	-1.6%	35.3%	36.1%

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 0.79 means 1 Canadian dollar will buy 0.79 U.S. dollar. CAD/USD 1.1% return means the Canadian dollar rose 1.1% vs. the U.S. dollar year to date. USD/JPY 109.83 means 1 U.S. dollar will buy 109.83 yen. USD/JPY 6.4% return means the U.S. dollar rose 6.4% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 7/15/21

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			Count	Percent
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Sell [Underperform]	51	3.61	4	7.84

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