GLOBAL Insight WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

August 26, 2021

Little shop of horrors – the Fed's repo facility

Thomas Garretson, CFA – Minneapolis

The record uptake of the Federal Reserve's Reverse Repurchase Facility has caused some fear among investors that systemic stresses might be brewing beneath the surface. But the drivers remain rather mundane, and we expect conditions to normalize later this year.

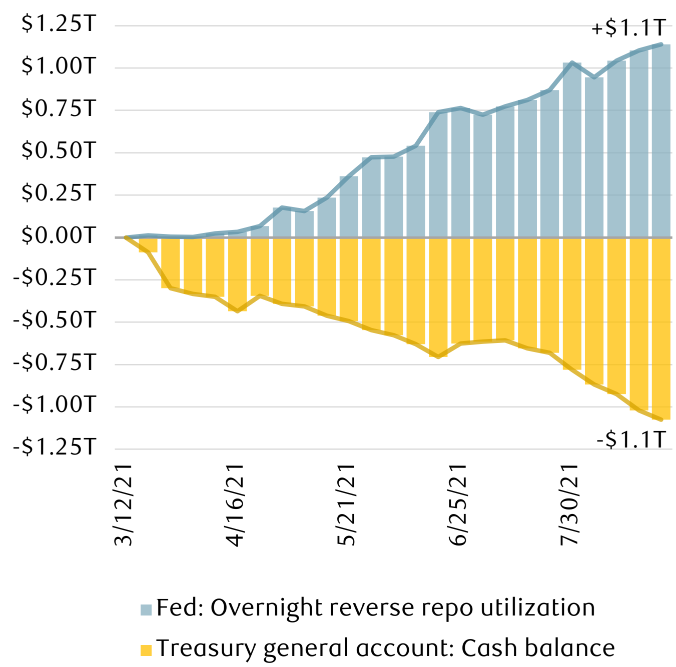
The uptake in the Federal Reserve's Overnight Reverse Repurchase Facility (RRP)—whereby the Fed takes excess cash out of the system by lending out securities it has on its balance sheet, which it then buys back the next day—has crossed the trillion-dollar threshold in recent weeks. And while the rise in usage of this facility was both anticipated and has been ongoing since March, when you get big numbers, the Fed, and the banking system involved, it does have a bit of a tendency to amplify investor fears.

And to be sure, those fears aren't completely unfounded. There has been a stigma in the past associated with banks and others turning to the Fed's various lending facilities as a potential sign of systemic stress, or of looming problems. But fortunately, that does not appear to be the case here.

Ahead of the curve

At the Fed's March policy meeting, officials were already preparing for the rise in RRP usage, as seen from the minutes of that meeting: "… market participants projected that reserves would grow at a historically rapid pace in coming months, reflecting continued expansion of the Federal Reserve's balance sheet along with a projected drawdown in the balances maintained in the Treasury General Account."

Trading places: As Treasury draws down cash and bill supply, investors find a new home at the Fed



Note: Cash balance and overnight repo utilization relative to levels on 3/12/21. Source - RBC Wealth Management, Bloomberg; shows net change from 3/12/21 through 8/24/21

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.

As the chart on the previous page shows, that's exactly what has happened, and is the simplest explanation of what is going on, in our view. The Treasury Department has been normalizing the level of cash in its general account from about $1.6 trillion at the beginning of the year, to around $300 billion, or what it roughly averaged prior to the pandemic. With the RRP facility usage jumping above $1 trillion, the Fed noted at its latest meeting in July that "The increase in [RRP] participation was driven in part by larger investments from money market funds, as ongoing reductions in net Treasury bill issuance contributed to downward pressure on yields of other investment options available to these funds."

Too much cash chasing too few safe assets has put downward pressure on money market rates, causing the Fed to step in, and driving cash to the Fed's RRP window.

Window shopping

At the same time that Treasury is cutting its cash level and the supply of outstanding Treasury bills, money flowing into money market funds has only increased. Money market fund assets stood at $4.5 trillion as of Aug. 18, up notably from pre-pandemic levels around $3.5 trillion.

So as money market funds, banks, and government-sponsored enterprises—all flush with cash—mosey down the street in search of safe assets to buy, they might first pop into the Treasury bill store, but the shelves are a bit bare for the aforementioned reasons, and anything that is left probably carries a yield of barely 0.03 percent due to all of the demand.

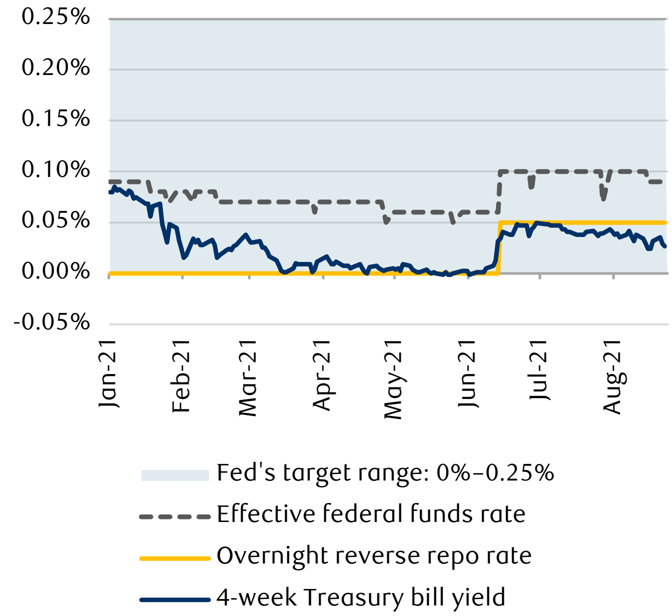
But you know who does have a lot of the stuff? The Fed. It's been buying Treasuries at a pace of $80 billion each month for a while now, with total inventory on hand of more than $5 trillion, which would be the theoretical limit of the RRP facility uptake. So everyone runs across the street to the Fed's storefront where the Fed shows off its wares of Treasury securities available to be lent out in repurchase agreements, and is more than eager to mop up the excess cash lying around each night.

Raise the floor

This confluence of events broadly has put downward pressure on short-term rates, toward the bottom of the Fed's current federal funds target range of zero percent to 0.25 percent. The effective fed funds rate was trading as low as 0.05 percent prior to June when Fed policymakers, a bit uncomfortable with rates around that level, made a technical adjustment in the RRP rate, which forms the floor for short-term rates, to 0.05 percent.

As the chart shows, that has boosted the effective fed funds rate back toward the midpoint of the Fed's target range around 0.10 percent. It is also higher than zero percent, which has also caused other government-sponsored enterprises to shift their funds to the Fed's RRP facility.

Fed's efforts aimed at keeping rates within the target range



Source - RBC Wealth Management, Bloomberg, U.S. Federal Reserve

But not just anyone can shop at the Fed's RRP window, and so, while the one-month Treasury bill yield initially rose on that adjustment, it has since slipped back to 0.03 percent. So for the time being, the Fed can offer more attractive rates than comparable options, which should keep RRP utilization elevated.

Road back to normal

The plumbing of the financial system can be a bit boring, as it should be, so if you've made it this far, what comes next?

We do expect an eventual return to normal ... or at least to as normal as anything can be these days. Treasury is managing its cash balance and Treasury bill issuance around the debt ceiling, which is expected to be hit around Oct. 31 based on Congressional Budget Office projections, though our expectation is that the ceiling will be raised by then. From there, bill issuance will resume, while passage of the infrastructure bill and the budget would likely require a further increase in Treasury issuance, higher Treasury bill yields, and less need for the Fed's RRP facility. The Fed's eventual taper of asset purchases will likely also help to alleviate the issue.

While the use of the Fed's lending facilities has reached levels previously unseen, we don't view that as a sign of any type of systemic distress, and see little reason for investors to adjust portfolios or investment strategies as a result.

UNITED STATES

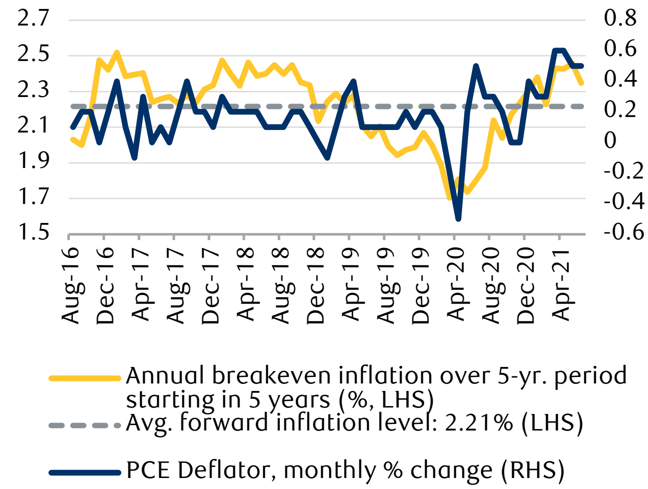
Atul Bhatia, CFA – Minneapolis

- **Bond markets are looking to Fed Chair Jerome Powell's Aug. 27 speech for additional insights on the central bank's plans for reducing its monthly bond purchase program**, a process known as tapering. The address comes as part of the Fed's annual monetary policy conference, a venue that has frequently been used for major policy announcements. Despite the event's history, we expect Powell to provide relatively few details on the timing of the purchase drawdown; instead, **we anticipate a speech that emphasizes the differences between reducing asset purchases and raising interest rates**, with an eye to diminishing expectations that the conclusion of the tapering process will inexorably lead to immediate rate hikes.

- **Fiscal policy took a step forward this week as the House of Representatives passed the Senate's $3.5 trillion budget resolution**. The move does not commit the government to any new spending; rather, it allows the Senate to pass future fiscal measures with a simple majority, obviating the need for Republican support. **Democrats remain divided on key elements of the budget**, however, including the total size of the spending increase, how to fund the program, and several climate change-linked provisions. This week's vote allows the Democrats to begin discussions on how to bridge these gaps. Our base case is that Congress eventually passes a package worth more than a trillion dollars over the next decade, although likely shy of the $3.5 trillion framework that advanced this week.

- **Inflation data due out on Aug. 27 will show a slowing, but still elevated, pace of price gains**, according to Bloomberg survey data. The PCE Deflator—the Fed's preferred inflation measure—is expected to show a 0.4% monthly consumer price increase for July, slightly below the 0.5% increase in June. The declining pace of gains is **consistent with the Fed's argument in favor of transitory inflation**, although supply chain issues continue to complicate production and pricing. For now, markets remain largely aligned with the Fed's view, with medium-term inflation pricing slightly above recent average levels but well within historical highs.

Inflation is high, but slowing pace and faith in Fed keeps medium-term outlook contained



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

CANADA

Luis Castillo & Simon Jones – Toronto

- Despite the risk-off mood that has dominated markets in recent months as the rising number of delta variant cases and the removal of accommodative monetary policy have proven to be major sources of worry, sentiment appears to have improved somewhat this week as investors rotate back into cyclicals—including commodities, with oil being one of the most notable movers. **The Canadian dollar has benefitted from this week's bounce in commodity prices, appreciating modestly against the U.S. dollar.** Past periods of strong investor appetite for riskier assets have been associated with strength in the Canadian currency, while risk-off periods have been associated with weakness. Amidst this positive risk backdrop, **Government of Canada 10-year bond yields rose more than 10 basis points (bps) from last week's lows**—but remain almost 40 bps below their March peaks. Canadian bond markets continue to be largely influenced by events south of the border, and Friday's virtual Jackson Hole speech by Federal Reserve Chair Jerome Powell will be the main event this week.

- **Sales at brick-and-mortar retailers surged in June with the continued easing of restrictions on non-essential retail.** According to Statistics Canada, retail sales rose 4.2% m/m during the month, narrowly missing preliminary estimates of 4.4% m/m. The strong gains were driven primarily by improving sales at clothing stores (+49.1% m/m), sporting goods retailers (+27.9% m/m), and home furnishing stores (+23.7% m/m). However, not all categories benefitted from the eased restrictions. Sales at food and beverage retailers declined 2.6% m/m, led by weaker sales at supermarkets and other grocery stores (-3.5% m/m). The decline is consistent with the reopening of food service businesses, which are not captured in the goods-oriented retail sales figures. This **shift in consumer preferences towards service-related spending**, along with the weaker-than-usual report rate from survey companies, are likely contributing factors behind the decline in Statistics Canada's preliminary estimate for July, which indicates retail sales could fall 1.7% m/m.

EUROPE

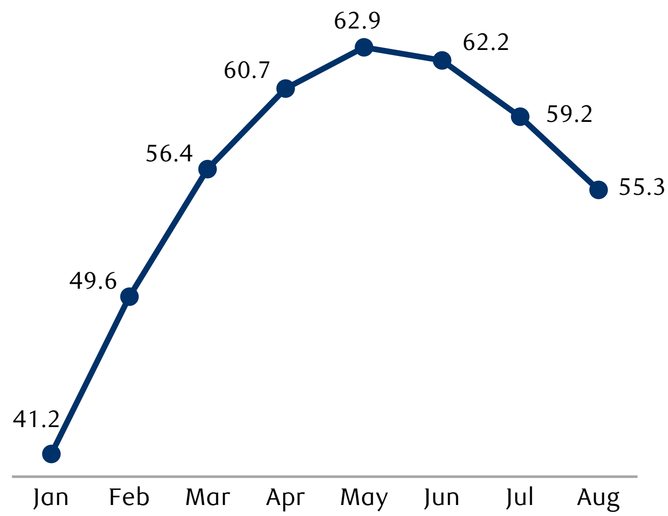
Thomas McGarrity, CFA & Frédérique Carrier – London

- **The August euro area flash Purchasing Managers' Indexes** (PMIs) showed **service sector activity remained strong**, supported by lockdown restrictions remaining comparatively limited plus signs of a recovery in tourism activity. Although still at elevated levels by historical standards, **manufacturing activity weakened slightly** as the effects of supply chain disruptions on output began to show up in the PMI survey data.

- **In the UK, the IHS Markit flash Composite PMI fell to 55.3, its lowest reading since March of this year**, the month prior to the reopening of the economy. RBC Capital Markets stated that this month's PMI survey is further evidence that the "normalisation" of activity points to the initial phase of the recovery from the pandemic having passed. **RBC Capital Markets forecasts UK GDP growth will slow to 2.7% q/q in Q3** from 4.8% q/q in Q2, while maintaining its annual GDP growth estimates of 7% in 2021 and 5.3% in 2022.

UK PMI data is evidence that the pace of recovery has likely peaked

IHS Markit flash Composite UK Purchasing Managers' Index



Source - RBC Wealth Management, Bloomberg / IHS Markit

- **Big shifts in voter polls are making the result of the upcoming Sept. 21 German federal elections unpredictable**. The main centre-right bloc, the CDU/CSU, had a very comfortable lead only three weeks ago, but it has been superseded by its coalition partner, the centre-left SPD, to the extent that its leader, Minister of Finance Olaf Scholz, could lead the next government. **Voters are seemingly so fragmented in their opinions that we think a three-way coalition is very likely**.

- **A three-party coalition would be more difficult to put together than a two-party coalition**. With Angela Merkel stepping down as chancellor after more than 15 years in that role, and maintaining popularity ratings that are the envy of her international peers, **Germany is entering a new phase**. Uncertainty regarding lengthy coalition talks could be a new source of volatility for financial markets.

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Chinese Technology stocks had a short rebound earlier this week**, driven by Tencent (700 HK)'s share buyback program and bargain hunters' buying. In addition, e-commerce retailer JD.com (9618 HK) announced strong Q2 earnings. Cathie Wood's Ark Invest buying JD.com stock further boosted sector sentiment. However, the Tech rally lost momentum on Aug. 26 as a few Tech companies, including short-video platform Kuaishou (1024 HK), announced weaker-than-expected results.

- **We think valuation of some Tech stocks is quite undemanding at current levels**. However, we think the regulatory reset will remain an overhang for the foreseeable future. In addition, the earnings impact of the latest regulations is largely unknown so far. As Tech companies gradually report Q2 earnings, we expect continuous near-term sector volatility.

- **Chinese smartphone maker** Xiaomi (1810 HK) reported Q2 2021 adjusted net profit of RMB 6.3 billion, up 87% y/y, beating consensus estimates. In addition, it **became the No. 2 smartphone maker globally** for the first time. Xiaomi announced it will buy autonomous driving technology startup Deepmotion, for about US$77.4 million, to fast track development of its electric vehicle business.

- **On Wednesday, Japan expanded its COVID-19 state of emergency** to cover more than 70% of the population and 79% of the economy. However, the government kept its assessment of the economy unchanged. **The Cabinet Office said the overall economy continues to improve from an extremely low base**. But it also highlighted a divide between the exporters, which have benefited from the global recovery, and restaurants, bars, and other service businesses that have struggled due to virus containment measures.

- **The Bank of Korea raised interest rates by 25 basis points to 0.75%** on Thursday, which made the country the first major Asian economy to raise interest rates since the start of the pandemic. The central bank said it will keep the door open for further policy action, but will take COVID-19 developments, financial imbalances, and moves by other central banks, including the Federal Reserve, into account.

MARKET
Scorecard

Data as of August 26, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,470.00	1.7%	19.0%	28.5%	55.3%
Dow Industrials (DJIA)	35,213.12	0.8%	15.1%	24.3%	36.0%
Nasdaq	14,945.81	1.9%	16.0%	28.1%	90.3%
Russell 2000	2,213.98	-0.6%	12.1%	41.9%	50.0%
S&P/TSX Comp	20,504.15	1.1%	17.6%	22.1%	27.4%
FTSE All-Share	4,106.66	1.9%	11.8%	21.6%	5.3%
STOXX Europe 600	470.34	1.9%	17.9%	26.1%	26.7%
EURO STOXX 50	4,169.87	2.0%	17.4%	24.2%	24.5%
Hang Seng	25,415.69	-2.1%	-6.7%	-0.3%	-1.0%
Shanghai Comp	3,501.66	3.1%	0.8%	5.2%	22.3%
Nikkei 225	27,742.29	1.7%	1.1%	19.1%	36.9%
India Sensex	55,949.10	6.4%	17.2%	43.2%	49.2%
Singapore Straits Times	3,109.42	-1.8%	9.3%	22.3%	1.4%
Brazil Ibovespa	118,724.00	-2.5%	-0.2%	18.0%	23.1%
Mexican Bolsa IPC	52,290.69	2.8%	18.7%	38.5%	30.5%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.349%	12.7	43.6	66.1	-18.6
Canada 10-Yr	1.238%	3.5	56.1	62.5	2.4
UK 10-Yr	0.600%	3.5	40.3	29.8	11.9
Germany 10-Yr	-0.407%	5.4	16.2	0.8	25.9
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.46%	-0.5%	-1.0%	-0.4%	18.8%
U.S. Investment-Grade Corp	2.04%	-0.7%	-0.6%	2.1%	26.2%
U.S. High-Yield Corp	4.01%	0.1%	4.1%	9.9%	22.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,791.72	-1.2%	-5.6%	-8.3%	17.3%
Silver (spot $/oz)	23.54	-7.7%	-10.9%	-14.4%	33.2%
Copper ($/metric ton)	9,362.50	-3.5%	20.8%	41.5%	66.8%
Oil (WTI spot/bbl)	67.42	-8.8%	39.0%	55.4%	25.7%
Oil (Brent spot/bbl)	71.44	-6.4%	37.9%	56.5%	21.7%
Natural Gas ($/mmBtu)	4.20	7.3%	65.4%	70.7%	88.3%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	93.0590	1.0%	3.5%	0.1%	-5.1%
CAD/USD	0.7885	-1.7%	0.4%	3.6%	4.5%
USD/CAD	1.2681	1.7%	-0.3%	-3.5%	-4.3%
EUR/USD	1.1753	-1.0%	-3.8%	-0.7%	5.9%
GBP/USD	1.3701	-1.5%	0.2%	3.7%	12.1%
AUD/USD	0.7239	-1.4%	-5.9%	0.1%	6.8%
USD/JPY	110.0700	0.3%	6.6%	3.8%	3.7%
EUR/JPY	129.3700	-0.7%	2.5%	3.2%	9.8%
EUR/GBP	0.8579	0.5%	-4.0%	-4.2%	-5.6%
EUR/CHF	1.0789	0.4%	-0.2%	0.4%	-0.7%
USD/SGD	1.3541	0.0%	2.4%	-0.8%	-2.4%
USD/CNY	6.4818	0.3%	-0.7%	-6.6%	-9.4%
USD/MXN	20.3563	2.5%	2.2%	-7.2%	2.1%
USD/BRL	5.2650	1.0%	1.3%	39.3%	26.7%

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 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 0.4% return means the Canadian dollar rose 0.4% vs. the U.S. dollar year to date. USD/JPY 110.07 means 1 U.S. dollar will buy 110.07 yen. USD/JPY 6.6% return means the U.S. dollar rose 6.6% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 8/26/21

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Buy [Outperform]	787	55.70	318	40.41
Hold [Sector Perform]	575	40.69	173	30.09
Sell [Underperform]	51	3.61	4	7.84

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