GLOBAL Insight WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

October 7, 2021

Crunch time

Thomas Garretson, CFA – Minneapolis

Political wrangling over the U.S. debt ceiling has captured recent headlines, but that's not the only concern we see for investors today. We look at developments in energy prices and monetary policy, which also have the potential to impact global markets.

Just as things were coming to a head for two front-and-center issues, the debt ceiling in the U.S. and the parabolic rise in global energy prices, each was granted a reprieve this week—but neither received a long-term solution.

The debt ceiling: A waste of everyone's time?

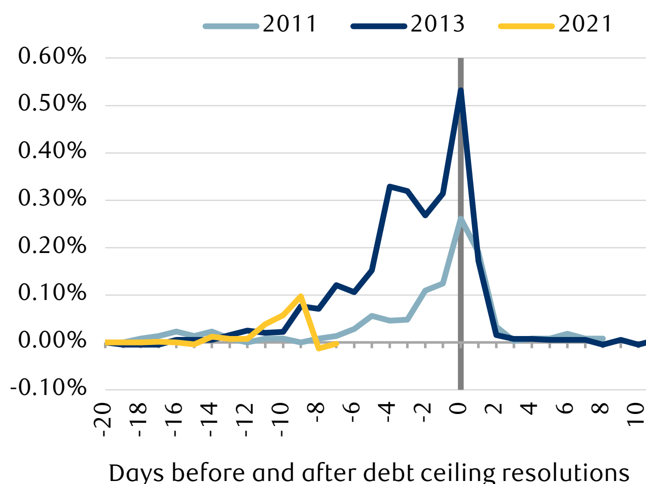
The U.S. government's debt ceiling appears to serve no practical purpose beyond functioning as, at best, a political football, and at worst, a pressure point of economic and market consternation, as was the case in 2011 and 2013, and has been recently. Among the voices that have recently called for it to be done away with are Treasury Secretary Janet Yellen and business leaders including JPMorgan Chase CEO Jamie Dimon.

One could argue a lot of ink has been spilled over something as basic as the U.S. paying its bills. That said, the debt ceiling still exists and technically matters, and there were some notable developments this week.

Just days before the Oct. 18 deadline when the U.S. Treasury projected it would exhaust its extraordinary measures and, therefore, its ability to meet debt and interest payment obligations, Senate leaders from both parties agreed to vote on a deal that would temporarily raise the debt ceiling to $28.9 trillion, a $480 billion increase. This would allow the government to fulfill its

Over before it started: Drop in yields suggests debt debate defused, for now

Net change in yield on near-term Treasury bills that would be most sensitive to a temporary default



Source - RBC Wealth Management, Bloomberg; data through 10/7/21

obligations through early December, pushing out the default risk.

As the first chart shows, short-term Treasury bill yields—a measure of how seriously markets are taking the threat of default—dropped sharply when Republicans initially

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

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floated the idea, suggesting markets anticipated (correctly) that Democrats would agree to this short-term extension. During past debt ceiling episodes in 2011 and 2013, the rise in Treasury bill yields was most pronounced in the week just prior to a potential default, falling sharply back to normal levels after eventual resolutions.

The big question is whether fixed income market participants will have to do this all over again in two months. Treasury bills that mature in December have already seen their yields rise modestly, suggesting markets see at least some chance of a repeat before the end of the year.

For now, we expect more legislative maneuvering and political jockeying. In regards to a longer-term agreement, Republicans still want Democrats to raise the debt ceiling on their own via budget reconciliation, which would force them to increase the limit by a set dollar amount. At this stage, it's unclear if Democrats will go down that route, continue to seek a bipartisan agreement, or simply attempt to remove the filibuster rule for this bill.

The three C's of credit

As a reminder, of the "three C's of credit"—Character, Capital, and Capacity—the debt ceiling issue is far more about the character of the U.S. government and its willingness to pay its bills than about its ability to do so.

As Standard & Poor's stated in 2011, prior to its downgrade of the U.S.'s AAA credit rating, "The political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed." This point of view was echoed last week by Fitch Ratings, which noted that, "The debt limit impasse reflects a lack of political consensus that has hampered the U.S.'s ability to meet fiscal challenges for some time, and which is reflected in the Negative Outlook on the U.S.'s 'AAA' rating since July 2020."

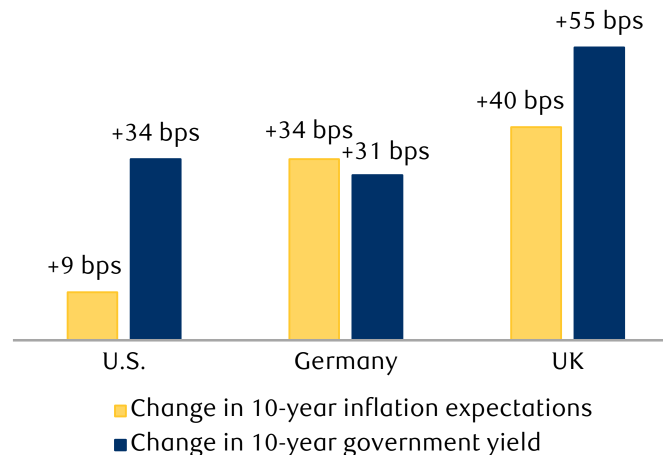
To be sure, we understand that some (perhaps many, maybe even most) investors harbor concerns about public debt levels in the U.S.—but the debt ceiling never has been, and never will be, the tool or means by which government spending is kept in check. It's nothing more than a self-imposed statutory number that has been raised about 80 times since the 1960s, and we are confident it will ultimately be raised again.

Global energy crunch

Nothing shows more clearly that policymakers, market participants, and investors have better things to worry about than what has transpired in global energy markets over recent weeks and months. At one point this week, natural gas prices were up nearly 700% for the year in the UK, and nearly 200% over the past month, while gas prices in Germany were up nearly 400% year to date, before reports that Russia was prepared to boost its exports, with conditions, took some of the steam out of prices.

Outside the U.S., rising energy prices fueling higher inflation expectations and government bond yields

Changes from 7/31/21 to 10/6/21, basis points (bps)



Source - RBC Wealth Management, Bloomberg

As the chart shows, global government bond yields have moved sharply higher, along with market-based inflation expectations, as soaring energy costs have introduced upside risks to the inflationary backdrop. Thus far, the U.S. has remained relatively insulated from rising natural gas prices, with inflation expectations largely unchanged. The rise in U.S. yields has been driven more by changes in Fed policy expectations.

Are higher natural gas prices coming to the U.S.?

Natural gas prices are up sharply this year in the U.S., by about 125%, but have thus far lagged the global energy crunch. Natural gas remains largely a regional commodity, and as is the case with most commodities, its price tends to be driven by regional factors and forces more than by global factors.

RBC Capital Markets' commodity strategy team raised its natural gas price forecast for the U.S. market this week. But in the final analysis, the price estimates remain at conservative levels as the team noted there is a limit to U.S. natural gas exports, which should keep U.S. prices in check by limiting any convergence with global price levels.

Inflation variations

Energy prices can be volatile, and are mostly driven by forces beyond the control of central banks. But energy prices are significant for monetary policy because they represent the latest threat to be added to a more persistent and higher inflationary backdrop, as well as another factor for global central banks to contend with. In our view, central banks will continue to look through some near-term inflationary pressures, and as always, it's not necessarily inflation itself that poses a threat to markets, but rather a central bank's response to it. We expect major global central banks to remain patient in removing policy accommodation.

UNITED STATES

Alan Robinson – Seattle

- In a news-filled week, **U.S. stocks finally broke higher on Oct. 7** after five successive days of large swings with little net change. The catalyst appeared to be a stopgap measure to extend the federal debt ceiling through early December. However, markets are still below the all-time highs set on Sept. 2, and the 24 trading days since that time marks the longest stretch this year without a new high in the S&P 500 Index (see chart). We view this as a healthy and typical pause; **September is often a month of consolidation and the "churning" action of the markets at month-end suggests a turning point** as investors await the onset of Q3 2021 earnings season.

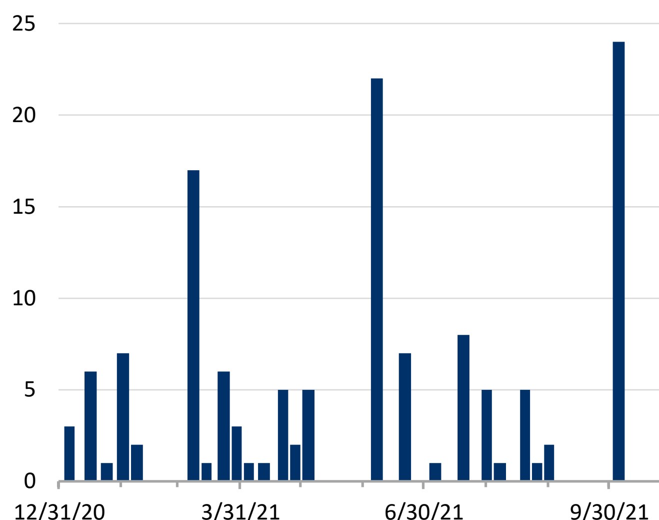
- **Consensus expectations for earnings season have dimmed recently as supply chain issues, inflation, and COVID-19 continue to act as headwinds.** Retailer Bed Bath & Beyond (BBBY) cut its 2021 outlook citing a store traffic slowdown, and paint maker Sherwin-Williams (SHW) lowered guidance due to raw material shortages. And retail giant Costco Wholesale (COST) warned of higher costs, even as it benefited from a ramp-up in sales of bulk items.

- However, RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina believes **many of these concerns are already well-understood by institutional investors**. Her proprietary survey found that while high valuations and deteriorating profit forecasts remain an issue, investors are most concerned about China, geopolitical risk, and monetary policy. Respondents still favored the "reflation" trade, with most expecting leadership from Energy, Financials, and value stocks as interest rates rise.

- **Regulatory concerns in the technology sector also resurfaced during the week following allegations by Facebook, Inc. (FB) whistleblower** Frances Haugen that the company prioritized inflammatory content via its engagement-based ranking system, and that its image-sharing sites were harmful to young people. In Senate testimony Haugen suggested there were "conflicts of interest between what was good for the public and what was good for Facebook." This may increase regulatory scrutiny on "Big Tech," which accounts for nearly a quarter of the S&P 500 by market capitalization.

Investors used to seeing new highs have had to be patient this fall

Number of trading days since new high in S&P 500



Source - RBC Wealth Management, FactSet; data through 10/7/21

CANADA

Luis Castillo & Simon Jones – Toronto

- **The benchmark 10-year Government of Canada (GoC) rate has climbed more than 30 basis points (bps) since mid-September**, sitting at its highest level since May and less than 10 bps shy of its 2021 peak. **Rate markets appear to be looking past pandemic fears** as we think the focus shifts squarely on monetary policy amid a pick-up in hawkish central bank commentary. The components of this recent jump in yields seem to suggest markets are more concerned about rate hikes than inflation, as a big portion of the move has been driven less so by a further accelerating expectation of rising inflation and more so by the real yield. The inflation expectation, as measured by the 10-year inflation breakeven, has risen modestly, while the 10-year real yield is up more than 20 bps, potentially suggesting markets could be growing more confident in the central bank's ability to rein in inflation.

- **Canadians took advantage of the rising temperatures and easing public health restrictions to make up for the services spending they had been deprived of throughout most of the pandemic.** This resulted in the accommodation and food services sector growing at a double-digit rate (12.5% m/m) for the second consecutive month. The warmer weather wasn't entirely good news for the economy, however. Wildfires and drought conditions in Western Canada severely hampered agricultural and forestry production, causing the sector to decline 5.5% m/m. This weakness, alongside 1.1% m/m and 0.9% m/m declines in the manufacturing and construction sectors, respectively, more than offset the rise in consumption, leading GDP to contract a modest 0.1% m/m in July, according to Statistics Canada. Fortunately, the slowdown in growth is expected to be short-lived with preliminary estimates from Statistics Canada indicating GDP grew 0.7% m/m in August, due in large part to the continued rebound in service-related spending.

EUROPE

Frédérique Carrier, Stephen Metcalf, & Thomas McGarrity, CFA – London

- **Natural gas prices in Europe and the UK**, which had gone up by more than 150% in the past two months, **retreated after Russia suggested it would be open to stabilising prices by increasing its supply** to Europe. Russia had been widely criticised by industry observers for allegedly holding back additional supplies that would be above and beyond the level of its contractual obligations as it awaits approval for the Nord Stream 2 pipeline, a natural gas pipeline which would double Russian exports to Germany.

- Natural gas prices have surged this year due to **much higher demand than supply**. Demand for natural gas has rebounded rapidly from the pandemic low. Other regions, such as Asia, are moving away from coal in an effort to reduce carbon emissions, so **a bidding war for liquefied natural gas cargoes has ensued**.

- **Demand has also increased due to higher carbon emissions prices**. In Europe and the UK, high-emitter companies, such as energy producers, are charged for emitting carbon above a threshold established by the authorities. Higher carbon prices are making coal even less attractive for energy production given it has a higher emissions profile than natural gas.

- As for supply, due to the energy transition, the EU has decreased the production of natural gas so as to focus more on renewables. The UK, in turn, remains highly dependent on natural gas and has seen its wind energy generation suffer from calm weather. This mismatch of supply and demand is fuelling concerns about a **potential energy crisis as Europe moves into winter, and is adding to worries about inflation** and its effect on consumers.

- In the UK, the energy crisis has taken an additional turn as a result of the UK leaving the EU. **With the end of freedom of movement**, which enabled European truck drivers to seamlessly work in the UK before Brexit, **gasoline is lacking**.

UK natural gas prices remain extremely elevated

UK NBP natural gas forward day ahead

Note: A therm is a unit of heat used for measuring gas supply; mid price on a monthly basis
Source - RBC Wealth Management, Bloomberg; data through 10/7/21

- **Utilities was the best-performing sector in both Europe and the UK during the week**, boosted by the aforementioned rising power prices. One potential worry for investors, in our view, is the **threat of political intervention given higher power prices**. While acknowledging that governments may take small steps to protect consumer bills, RBC Capital Markets believes they will not undertake any major interventions (e.g., windfall taxes) that could threaten future investment in the energy transition given the significant political commitment to the region's net-zero targets.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets, led by Japan, traded lower during the week**. The Nikkei 225 briefly entered correction territory, declining more than 10% off its mid-September high, earlier in the week. Meanwhile, mainland China stock markets are closed for Golden Week. Investor sentiment in Asia has been dampened by concerns regarding the U.S. debt ceiling, global energy crunch, and Fed policy, as the central bank has signaled it will begin tapering its bond-buying program before year end.

- **Fantasia Holdings Group, a Chinese company that develops high-end apartments and urban renewal projects, failed to repay a US$205.7 million bond that came due Monday**. This prompted a flurry of rating downgrades to levels signifying default. The stumble stirred broader angst about the property market amid lingering uncertainty about Evergrande, one of the nation's largest developers and the biggest issuer of high-risk bonds in Asia. While we believe Fantasia itself poses fewer threats to broader markets than Evergrande due to its smaller size, **the builder's saga has flagged several risks that are increasingly weighing on investors' minds**. Observers have been concerned about the possible fallout and contagion from the Evergrande crisis, including how it might constrain China's economic growth. Property development is a critical sector, accounting for nearly 25% of Chinese economic activity. We believe any potential contagion across the property sector and financial system would be manageable as we think Beijing would provide state assistance and also fiscal stimulus to offset any meaningful decline in economic activity.

- **The Reserve Bank of New Zealand (RBNZ), on Wednesday, raised its official cash rate to 0.5%**, joining South Korea and Norway as the earliest countries to raise rates in the pandemic era. "The Committee noted that further removal of monetary policy stimulus is expected over time, with future moves contingent on the medium-term outlook for inflation and employment," the RBNZ said in a release.

MARKET
Scorecard

Data as of October 7, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,399.76	2.1%	17.1%	28.7%	49.7%
Dow Industrials (DJIA)	34,754.94	2.7%	13.6%	22.8%	31.3%
Nasdaq	14,654.02	1.4%	13.7%	28.9%	84.2%
Russell 2000	2,250.09	2.1%	13.9%	39.7%	50.2%
S&P/TSX Comp	20,416.21	1.7%	17.1%	24.3%	24.3%
FTSE All-Share	4,038.83	-0.5%	9.9%	21.0%	2.2%
STOXX Europe 600	458.57	0.8%	14.9%	25.5%	19.8%
EURO STOXX 50	4,098.34	1.2%	15.4%	26.7%	18.1%
Hang Seng	24,701.73	0.5%	-9.3%	1.9%	-4.3%
Shanghai Comp	3,568.17	0.0%	2.7%	10.9%	22.8%
Nikkei 225	27,678.21	-6.0%	0.9%	18.2%	29.5%
India Sensex	59,677.83	0.9%	25.0%	49.6%	59.0%
Singapore Straits Times	3,101.15	0.5%	9.0%	22.2%	0.1%
Brazil Ibovespa	110,585.40	-0.4%	-7.1%	15.8%	10.0%
Mexican Bolsa IPC	50,876.98	-1.0%	15.5%	36.0%	18.4%
Gov’t bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.575%	8.7	66.2	78.8	1.7
Canada 10-Yr	1.565%	5.6	88.8	94.1	26.4
UK 10-Yr	1.077%	5.5	88.0	77.4	62.6
Germany 10-Yr	-0.185%	1.4	38.4	30.8	39.0
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.57%	0.0%	-1.6%	-0.6%	5.4%
U.S. Investment-Grade Corp	2.14%	-0.1%	-1.3%	1.8%	9.1%
U.S. High-Yield Corp	4.16%	-0.3%	4.2%	9.8%	15.0%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,755.17	-0.1%	-7.5%	-7.0%	17.5%
Silver (spot $/oz)	22.59	1.9%	-14.4%	-5.1%	29.5%
Copper ($/metric ton)	9,052.60	1.2%	16.8%	35.8%	59.2%
Oil (WTI spot/bbl)	78.30	4.4%	61.4%	96.0%	48.4%
Oil (Brent spot/bbl)	82.42	5.0%	59.1%	96.3%	41.3%
Natural Gas ($/mmBtu)	5.75	-2.0%	126.4%	120.6%	149.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	94.1980	0.0%	4.7%	0.6%	-4.8%
CAD/USD	0.7971	1.1%	1.5%	5.7%	6.1%
USD/CAD	1.2546	-1.1%	-1.4%	-5.4%	-5.7%
EUR/USD	1.1554	-0.2%	-5.4%	-1.8%	5.3%
GBP/USD	1.3617	1.1%	-0.4%	5.4%	10.8%
AUD/USD	0.7312	1.2%	-5.0%	2.4%	8.6%
USD/JPY	111.6400	0.3%	8.1%	5.3%	4.1%
EUR/JPY	128.9900	0.1%	2.2%	3.5%	9.6%
EUR/GBP	0.8486	-1.2%	-5.1%	-6.8%	-4.9%
EUR/CHF	1.0736	-0.5%	-0.7%	-0.5%	-1.6%
USD/SGD	1.3585	0.1%	2.8%	-0.1%	-1.6%
USD/CNY	6.4448	0.0%	-1.3%	-5.1%	-9.8%
USD/MXN	20.6427	0.0%	3.7%	-4.2%	5.5%
USD/BRL	5.5078	1.2%	5.9%	-1.8%	34.1%

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 1.5% return means the Canadian dollar rose 1.5% vs. the U.S. dollar year to date. USD/JPY 111.24 means 1 U.S. dollar will buy 111.64 yen. USD/JPY 8.2% return means the U.S. dollar rose 8.2% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 10/7/21

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As of September 30, 2021

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Hold [Sector Perform]	562	39.75	172	30.60
Sell [Underperform]	52	3.68	3	5.77

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