GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

October 14, 2021

Supply chain shortcomings

Kelly Bogdanova – San Francisco

Problems with supply chains have become a greater source of concern and are underpinning inflation pressures. There is no quick way to relieve the bottlenecks. We examine the root causes, and discuss the impact on the equity market.

As major equity indexes came off the boil in September, key reasons for the market's retreat were supply chain constraints and their knock-on effect on inflation. The problems have been present and well known for many months, but they have become exacerbated recently. We think they are unlikely to abate anytime soon.

COVID-19 prompted much of the supply chain bottlenecks, and there are other factors:

- **A sharp increase in demand for goods:** As the global economy re-opened after being nearly shut down in 2020, demand surged. Supply chains aren't built for this. Also, the pandemic has sparked lifestyle changes as household spending has shifted more toward goods and away from services. Consequently, shipping volumes from Asia to North America are up 27 percent compared to pre-pandemic levels, according to RBC Global Asset Management (RBC GAM).
- **Labor shortages in a variety of industries:** This has occurred for multiple reasons, including ongoing concerns about COVID-19 risks, a mismatch between job openings and qualified applicants, and perhaps changes in career goals and priorities helped along by the pandemic. In August, the proportion of the American workforce that voluntarily quit their jobs surged to the highest level on record going back to 2001.
- **Low supply of container ships:** The shipping industry was running low on ships even before the pandemic. Over many years, the number of shipyards worldwide has dropped 63 percent since the previous peak level in 2008, according to RBC GAM. More ship capacity will likely go offline as new regulations come into force in 2023 that will require ships to be retrofitted for environmental purposes.
- **High shipping costs:** The most widely followed measure of container shipping costs, published by research firm Drewry, indicates that while container prices have retreated a bit so far in October, they are still up 283 percent from a year ago.
- **Abnormally long processing times at ports:** Shortages of longshore workers and increased demand for goods have backed up container and ship positioning. When ships sit idle off the coast it reduces the number of trips they can take, and the backlog mounts.
- **Truck driver shortages:** Land-based transportation systems are having difficulty processing the large volume of containers stacked up at ports because of the COVID-19-related shortages of truck drivers, particularly in North America.
- **Lean inventories:** Global supply chain problems quickly become consequential and multiply when inventories are tight. Moreover, because the problems are well

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.

known, orders for raw materials, component parts, and finished goods are now being placed earlier than normal, which is lengthening the queue, creating a vicious cycle, RBC GAM points out.

- **Energy price spikes:** This problem has surfaced more recently, and could persist through the winter, at least. Two examples: Chinese manufacturing has been constricted by power shortages and rationing due to high coal prices and the government's power consumption limits; and, the surge in natural gas spot prices in Europe has hampered the fertilizer industry, which impacts agriculture production and prices. Power bills for businesses and households are on the rise in Europe and Asia.
- **The UK's own unique problems:** Brexit labor rules that place restrictions on EU workers have hobbled distribution channels. Separately, trade frictions between the UK and EU are at risk of heating up in the coming months over the Northern Ireland protocol, which could cause another set of supply chain challenges.

The global versus equity market impact

The bottlenecks are unlikely to disappear overnight. A month ago, RBC Elements conducted a digital intelligence study that indicated 77 percent of the major ports it monitors were experiencing abnormally long turnaround times, and that the overall global problem was trending "unequivocally worse."

But there is an important distinction to be made between the impact on the global shipping industry and the impact on U.S. stock market sectors. Some sectors are experiencing major-to-moderate supply chain problems (Consumer Discretionary, Materials, and Industrials), while other sectors are not experiencing problems (Health Care and Information Technology), according to a survey of RBC Capital Markets equity analysts. The remaining six sectors seem to be coping, and fall somewhere in between, as the chart illustrates.

Lori Calvasina, RBC Capital Markets, LLC's head of U.S. equity strategy, believes the survey results indicate that supply chain problems facing the broader domestic equity market "may not be as dire as September headlines suggested." Management teams' comments during the Q3 earnings reporting season should provide further insights on implications for profit margins, and on the magnitude and potential duration of the problem.

RBC GAM's Chief Economist Eric Lascelles anticipates that the holiday shopping season will keep shipping costs "extremely high" over the next couple months, and thinks supply chain problems could persist another six months to a year. It will take time to resolve the labor supply-demand mismatch. Some firms have already warned that bottlenecks could last into 2023.

The path of the pandemic could play an important role, after all, it is the source of much of the stress. Calvasina notes that the trend in global COVID-19 infection rates has been a loose leading indicator for freight costs. So if infections peaked in September 2021, there could be relief over time.

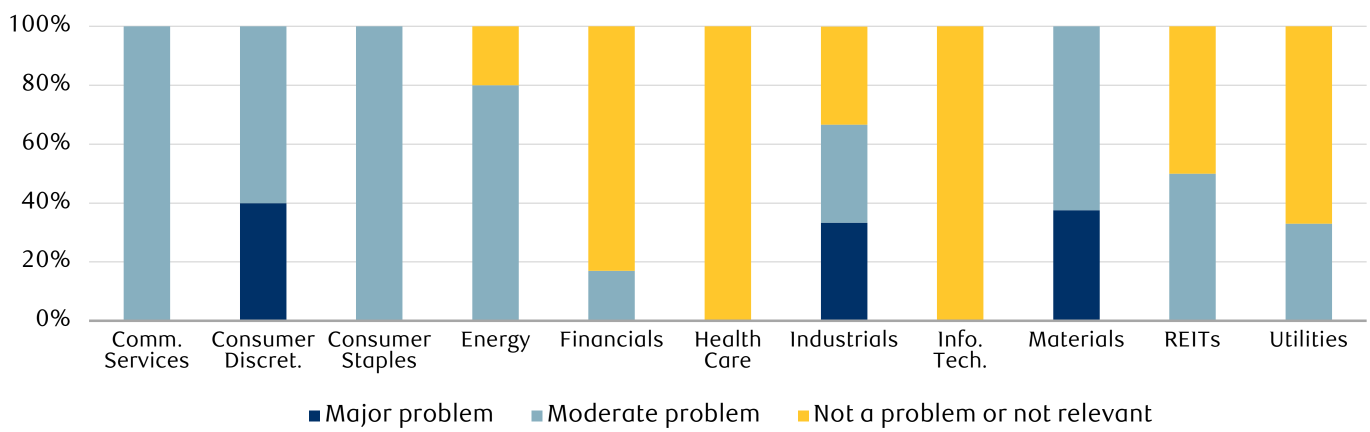
Ongoing supply chain pressures will likely be a headwind for economic growth and have knock-on effects on inflation over the near term and possibly midterm. However, Lascelles anticipates that once supply chain pressures ease—with the increase in shipping costs and product input shortages eventually abating—this should end up being a deflationary and pro-growth force for the U.S. and global economies.

No easy fix

As long as supply chain problems don't worsen meaningfully or drag on for an extended period, we think the overall impact on corporate profits and the equity market will be contained. But this issue is one of the reasons we believe inflation will remain elevated in North America and will rise in Europe and Asia, and that equity market volatility could persist and returns could be more muted in the next 12 months.

Supply chain headwinds most prominent for Consumer Discretionary, Materials, and Industrials

Survey of RBC Capital Markets equity analysts: How would you characterize supply chains for your industry?



Source - RBC Capital Markets U.S. Equity Strategy, RBC Capital Markets estimates; sector scores are derived from industry scores in the relevant sectors. Survey conducted in late September/early October 2021.

UNITED STATES

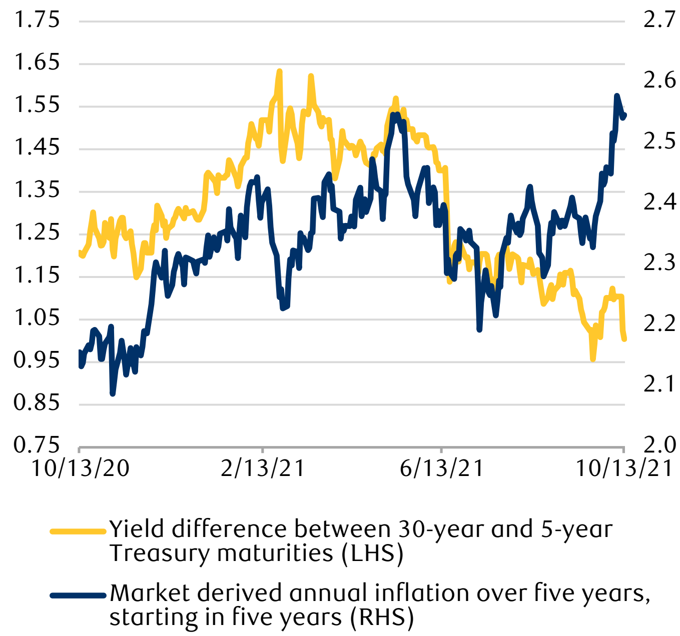
Atul Bhatia, CFA – Minneapolis

- **Congress passed legislation increasing the government's borrowing capacity**, postponing any potential U.S. default until early December, according to Treasury estimates. There is still no clear path forward on a longer-term solution to the debt ceiling challenge, as partisan divisions remain key obstacles. Progress on fiscal policy was similarly slight. While Bloomberg is reporting an emerging consensus among Congressional Democrats for a plan to increase spending by $2 trillion over the next 5–10 years, key divisions remain on which programs to include and how to fund them.

- **U.S. employment grew by 194,000 in September, the slowest pace of 2021 and below the 500,000 median estimate in a Bloomberg survey of economists**. The jobs news was not all bad, however, as the pace of hiring in August was revised upward by 120,000 and rising average hourly wages in September helped offset some of the consumption impacts of lower job creation. Despite the weak job creation last month, we continue to believe the Fed will use its November meeting to announce the kickoff to tapering, with the actual reduction in bond purchases likely beginning in December or January.

- **Rising energy and metal prices contributed to a sharp increase in medium-term inflation expectations in October**. The Fed's preferred expectations measure—a market-derived estimate of annual inflation over a five-year period beginning five years in the future—rose to nearly 2.6% this week, the highest level in four years. Despite the concerns on rising consumer prices, longer-maturity government bonds outperformed shorter-term Treasuries as markets are apparently pricing in a scenario of moderately tighter monetary policy and modestly slower growth over the long term.

Diverging signals: medium term inflation shifts higher while 30 year bonds outperform



Source - RBC Wealth Managemen, Bloomberg; data through 10/13/21

CANADA

Arete Zafiriou, CFA & Sean Killin – Toronto

- **Canada's labour market recovery stretched into September, accumulating an additional 157,000 jobs from August**, according to RBC Economics. The unemployment rate dropped to 6.9% in September from 7.1% in August, but remained more than a percentage point above pre-pandemic levels. **A total of 142,000 new jobs were added in service-producing industries**, despite the spread of the COVID-19 delta variant that has limited global growth and heavily impacted high-contact services sectors. Hiring in accommodation & food services declined in September for the first time in four months, with employment in the sector remaining roughly 180,000 below pre-pandemic levels. Professional services and public administration added 37,000 and 30,000 jobs, respectively, to their ranks last month, propped up by public administration jobs created as a result of Canada's federal election. **Goods-producing industries posted a net gain of 15,000**, as losses in construction and agriculture were offset by 22,000 new manufacturing hires. RBC Economics believes the current outlook suggests further job gains are likely to be smaller, but notes there is still slack in in-person service sector employment, which leaves room for employment growth. **Labour market improvement looked well above GDP data**, as hours worked increased by an annualized 6.8% in Q3 2021, ahead of RBC Economics' 4.5% GDP rise in the quarter. This makes it more likely that the Bank of Canada will react to the sustained strengthening of the economy and taper its asset purchases, in our view.

- **Canadian housing affordability deteriorated across the board in September**. According to RBC Economics, ownership costs as a percentage of median household income rose to the highest level in over 30 years, with RBC's aggregate measure (including both single-detached and condominiums) rising 2.7% to reach 45.3% in Q2 2021 versus the long-term average of 40.6%. Condos remain less of a financial burden than single-family homes, with the national condo measure ticking up modestly to 32.6%. Meanwhile, the measure for single-detached homes jumped 3.0% in the quarter to 49.7%, as higher pandemic-driven demand for space boosted family home prices. **RBC Economics predicts that tight demand-supply conditions will continue to put upward pressure on housing prices in the coming months**, adding further strain to affordability.

EUROPE

Frédérique Carrie – London

- The UK-EU relationship is souring again. **The UK is unhappy with the deal it signed with Brussels less than two years ago and wants to renegotiate the Northern Ireland Protocol**, or the mechanism that prevents the implementation of a "hard" border between the Republic of Ireland (an EU member) and Northern Ireland, part of the UK. Preventing the return to a hard border is important: the lifting of border restrictions between Ireland and Northern Ireland in the 1990s helped bring an end to three decades of sectarian conflict.

- Today, following the UK's exit from the EU, **there are checks made on goods moving from Great Britain (England, Scotland, and Wales) to Northern Ireland** in order to ensure there is no need for international controls at the Irish border. The oversight of those checks is the responsibility of the European Court of Justice (ECJ).

- The UK, which negotiated this arrangement, says **checks on goods going from Great Britain to Northern Ireland are unacceptable** as both are part of the UK, and wants any dispute to be resolved through international arbitration instead of through the ECJ. The EU has proposed reducing checks on some goods but keeping ECJ regulatory oversight, a move it thinks should help businesses in Northern Ireland that are crippled by paperwork in the current system.

- How the situation evolves from here largely depends on the UK. Should London find the EU's proposed compromise unacceptable, as the government's current rhetoric suggests, it could suspend parts of the Protocol. This would effectively signal a trade war with the EU, which would be forced to respond, in the view of RBC Capital Markets analysts. In the worst-case scenario, **tariffs could be imposed that would further crimp trade between the EU and the UK at a time when the country already faces challenges including shortages, an energy crisis, and fiscal headwinds**. Should the UK wish to start such a diplomatic row, it may wait until after the COP26 United Nations Climate Change Conference of which it is the host.

- Alternatively, should tensions subside for now, the best-case scenario would be for this unstable situation to be managed. Even so, **the issue seems likely to flare up later** given the fundamentally conflicting goals of the parties involved.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

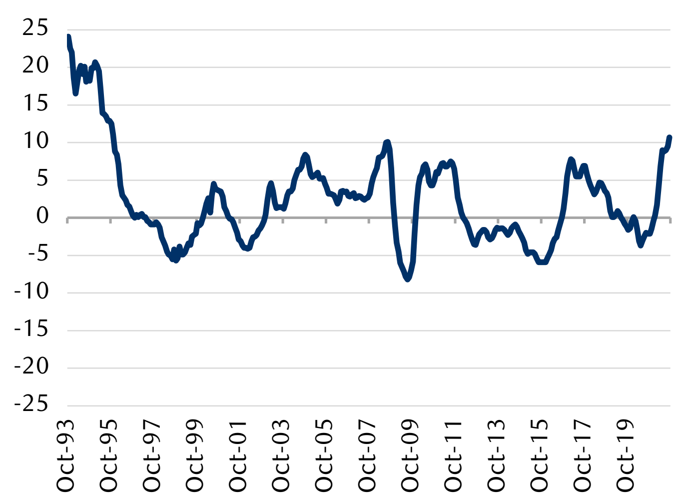
- **Asia Pacific equity markets traded mostly flat during the week**. Several ASEAN countries—Philippines, Indonesia, and Malaysia—showed the strongest results. Meanwhile, Hong Kong suspended stock market trading on Wednesday as strong winds and rain from Typhoon Kompasu slammed the financial hub, causing the city to raise the storm warning alert to No. 8, the third-highest on its scale, from No. 3 a day earlier.

- **China's Producer Price Index surged 10.7% y/y in September**, the biggest jump since November 1995. Factory-gate inflation climbed thanks to a nationwide energy crisis and escalating coal prices. The higher coal prices and the policy goal of reducing energy consumption have led to electricity shortages, resulting in power rationing and factory production stoppages. **Economists expect inflation pressure to persist due to deadly floods in Shanxi province, a major coal-producing region**. China announced it will allow electricity prices to rise further which will, in turn, increase consumer inflation. Higher inflation and a weakening domestic economy have heightened concerns of stagflation in China. Economists expect the People's Bank of China to again cut the reserve requirement ratio for banks in an attempt to spur liquidity in the economy.

- **The Monetary Authority of Singapore (MAS) unexpectedly tightened its monetary policy**—increasing the slope of its currency band "slightly" from 0%—as the central bank has become increasingly concerned about the risk of persistent inflation. **Singapore is joining a growing list of countries tightening their monetary policies**. At the same meeting, it was also reported that Singapore GDP expanded 6.5% in Q3, in line with expectations. The MAS noted that growth is "likely to remain above trend in the quarters ahead." Thanks to vaccination rates picking up, we remain positive on the ASEAN outlook; in particular, we prefer Singapore, given its leading vaccination rate (above 80%) and export-oriented economy.

China's Producer Price Index: Biggest jump since 1995

Year-over-year change (%)



Source - RBC Wealth Management, Bloomberg; monthly data through Sept. 2021

MARKET
Scorecard

Data as of October 14, 2021

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 0.80 means 1 Canadian dollar will buy 0.80 U.S. dollar. CAD/USD 2.9% return means the Canadian dollar rose 2.9% vs. the U.S. dollar year to date. USD/JPY 113.68 means 1 U.S. dollar will buy 113.68 yen. USD/JPY 10.1% return means the U.S. dollar rose 10.1% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 10/14/21

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,438.26	3.0%	18.2%	27.2%	49.6%
Dow Industrials (DJIA)	34,912.56	3.2%	14.1%	22.4%	30.3%
Nasdaq	14,823.43	2.6%	15.0%	26.0%	84.2%
Russell 2000	2,274.18	3.2%	15.2%	40.2%	51.1%
S&P/TSX Comp	20,819.94	3.7%	19.4%	26.5%	26.8%
FTSE All-Share	4,107.88	1.2%	11.8%	23.1%	3.4%
STOXX Europe 600	465.92	2.4%	16.8%	25.7%	19.6%
EURO STOXX 50	4,149.06	2.5%	16.8%	26.8%	16.7%
Hang Seng	24,962.59	1.6%	-8.3%	1.2%	-5.9%
Shanghai Comp	3,558.28	-0.3%	2.5%	6.5%	18.3%
Nikkei 225	28,550.93	-3.1%	4.0%	20.8%	31.0%
India Sensex	61,305.95	3.7%	28.4%	50.3%	60.4%
Singapore Straits Times	3,164.86	2.5%	11.3%	23.8%	1.3%
Brazil Ibovespa	113,185.50	2.0%	-4.9%	13.9%	8.5%
Mexican Bolsa IPC	52,140.24	1.5%	18.3%	37.1%	20.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.513%	2.5	59.9	78.7	-21.7
Canada 10-Yr	1.534%	2.5	85.7	95.2	1.6
UK 10-Yr	1.042%	2.0	84.5	82.2	40.5
Germany 10-Yr	-0.191%	0.8	37.8	39.0	26.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.61%	-0.1%	-1.7%	-1.1%	6.2%
U.S. Investment-Grade Corp	2.18%	-0.1%	-1.4%	0.9%	10.2%
U.S. High-Yield Corp	4.29%	-0.5%	4.0%	9.0%	14.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,795.87	2.2%	-5.4%	-5.6%	20.3%
Silver (spot $/oz)	23.54	6.2%	-10.8%	-3.0%	33.3%
Copper ($/metric ton)	9,759.50	9.1%	25.9%	45.6%	68.7%
Oil (WTI spot/bbl)	81.31	8.4%	67.6%	98.1%	51.7%
Oil (Brent spot/bbl)	84.27	7.3%	62.7%	94.5%	42.0%
Natural Gas ($/mmBtu)	5.65	-3.6%	122.7%	114.5%	148.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	93.9750	-0.3%	4.5%	0.6%	-4.5%
CAD/USD	0.8083	2.5%	2.9%	6.3%	7.0%
USD/CAD	1.2371	-2.4%	-2.8%	-5.9%	-6.5%
EUR/USD	1.1597	0.1%	-5.1%	-1.3%	5.2%
GBP/USD	1.3673	1.5%	0.0%	5.1%	8.4%
AUD/USD	0.7417	2.6%	-3.6%	3.6%	9.5%
USD/JPY	113.6800	2.1%	10.1%	8.1%	4.9%
EUR/JPY	131.8400	2.3%	4.5%	6.7%	10.3%
EUR/GBP	0.8482	-1.3%	-5.1%	-6.0%	-3.0%
EUR/CHF	1.0712	-0.7%	-0.9%	-0.2%	-2.6%
USD/SGD	1.3485	-0.7%	2.0%	-0.6%	-1.5%
USD/CNY	6.4397	-0.1%	-1.3%	-4.1%	-8.9%
USD/MXN	20.5563	-0.4%	3.2%	-3.5%	6.7%
USD/BRL	5.5156	1.3%	6.1%	-1.4%	33.7%

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As of September 30, 2021

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Rating	Count	Percent	Count	Percent
Buy [Outperform]	800	56.58	341	42.62
Hold [Sector Perform]	562	39.75	172	30.60
Sell [Underperform]	52	3.68	3	5.77

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