GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee October 28, 2021

Fiscal policy progress

Atul Bhatia, CFA – Minneapolis

As proposed budget bills get closer to a vote, one thing appears clear—federal spending is likely to be a drag on near-term growth. The legislation moving through Congress may help cushion the blow—although potentially with unwanted inflationary side effects—but it is ultimately unlikely to be a near-term, economic game-changer.

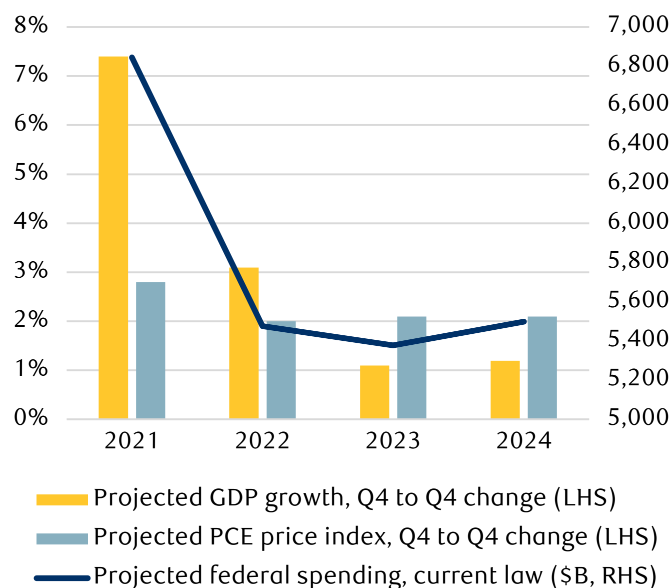
U.S. fiscal policy looks to be coming into broad focus. House Democrats appear to have the votes needed to pass the nearly $1 trillion traditional infrastructure bill—if a broader approximately $2 trillion fiscal package can make it through the House and Senate.

At the same time, details are sparse on the final version of the larger budget bill. Compared to the initial Biden plan, some programs will likely be scrapped, but the general approach seems to have been reducing benefit size—either through caps or means testing—or reducing the duration of a program, cutting funding from a decade to a few years. Any required tax increases are also expected to be lower than initially proposed.

Running to stand still

We think it is important for investors to keep in mind that even with the bills under consideration, federal spending is likely to shrink next year. Absent any new fiscal package, the Congressional Budget Office (CBO) expects government outlays to fall by nearly $1.3 trillion in 2022 with further declines in 2023. This drop in spending—a direct input into the GDP calculation—is one reason the CBO estimates the U.S. economy will grow by only 1.5 percent in 2023. The legislation currently under consideration would reduce the drag from declining

Projected decline in GDP mirrors upcoming federal spending drop



Source - Congressional Budget Office and RBC Wealth Management

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

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federal spending, but is unlikely to fully eliminate it, given the multiyear rollout for most programs.

Any federal fillip to demand may be unnecessary, however, depending on the behavior of U.S. households. During the pandemic, households have ramped up their pace of savings and accumulated nearly $1.8 trillion in deferred consumption. If this war chest is spent on consumer goods and services, a federal boost to demand is likely unnecessary; if most of it remains as savings, however, reducing the GDP drag from falling government spending is likely helpful. Complicating the analysis is the distribution of wealth gains, as savings- and investment-focused household groups have tended to do the best during the pandemic.

Growth versus inflation

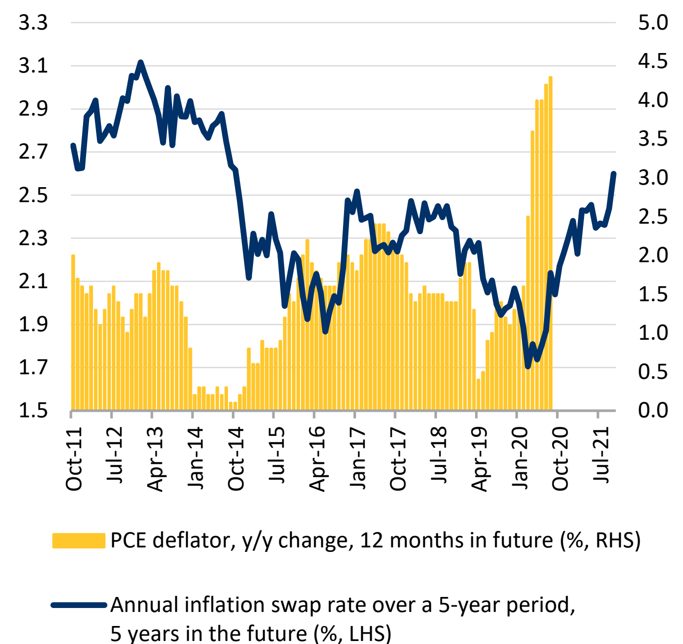
The legislation under consideration will likely benefit certain industries and sectors more than others, and the long-term advisability of these programs depends in large part on one's political viewpoint. Looking only at the short-term macroeconomic implications, though, the wisdom of passing fiscal measures at this point largely boils down to a view on the relative risk of excessive inflation versus disappointing growth.

Additional federal spending is almost certainly growth positive over the next two years, in our opinion. Arithmetically, ramping up federal spending has a direct, dollar-for-dollar impact on reported GDP. In addition, the types of programs currently before Congress tend to benefit households with a higher propensity to consume, another direct driver of GDP. Even if funded by higher taxes, the net effect of the proposed budget changes is likely to be growth-positive in the near future, although changing incentives and investment patterns could lead to a different long-term outcome.

At the same time, an increase in consumption is also likely to contribute to faster inflation, and recent data has already shown higher and more persistent price increases than the Fed expected. Markets are increasingly focused on the potential for a sustained increase in prices, with medium-term inflation expectations recently hitting the highest levels in nearly a decade.

But as was discussed in last week's Global Insight Weekly, the degree of concern around inflation may be misplaced. The rise in "sticky" prices has been significantly slower than in more flexible prices, an indicator that inflation may not persist. The rate of increase in core prices has also slowed, with the month-over-month increase in the Consumer Price Index ex-food and energy down to only 0.2 percent, well within historical context. And inflation expectation measures—even the market-based ones—tend to be very poor predictors of actual inflation, consistently overestimating future inflation readings. Finally, the same higher energy prices that have contributed to recent price increases have historically been a leading indicator of declining future inflation rates.

Inflation expectations are on the rise, but predictive power is weak



Source - RBC Wealth Management, Bloomberg

One of the key risks to this view of medium-term price stability is that rising wages become entrenched, leading to an upward spiral in both demand and consumer prices. The risk is there, but for now, both the CBO and the Fed's rate-setting Open Market Committee see the current bout of inflation as largely a one-time event; both groups estimate the Personal Consumption Expenditure price index will rise less than 2.2 percent in 2022. If wages continue to rise, we think the Fed could respond with an accelerated removal of policy accommodation, probably driving short-term interest rates higher and eventually bringing prices under control.

By providing a base of reliable demand, an increase in federal government spending could make it easier for the Fed to raise rates if needed, allowing policy normalization with a less pronounced contractionary effect.

Bottom line

As investors evaluate federal budget dynamics, we think it is important for them to separate their political preferences from their evaluation of the likely near-term macroeconomic impacts. In this case, the legislation moving through Congress is unlikely to be a near-term, economic game-changer. The total-dollar amount helps cushion the projected decline in federal spending, but with the impact spread out over many years, the growth contribution in any given year is likely to be relatively small. On balance, reducing the drag on GDP growth from declining federal spending is likely worth the potential uptick in inflation, although if price increases trigger early Fed action, any growth benefits may prove ephemeral.

UNITED STATES

Alan Robinson – Seattle

■ **The U.S. economy grew at a tepid 2.0% pace during Q3 2021**, according to preliminary data released during the week, missing consensus estimates of 2.6% growth. The result marked a sharp deceleration from the 6.7% growth posted in Q2 (see chart). RBC Economics blamed the slowdown on **depressed consumer spending growth of 1.6%, even as aggregate household wages grew 10%** in the quarter. This in turn reflected a shortage of things to buy, particularly motor vehicles, as supply-chain issues restricted availability. Consensus expectations see economic headwinds abating as Q4 continues, even if much of the "easy" growth from the reopening of the economy is in the rearview mirror. But many corporate management teams were more cautious in their outlooks during quarterly earnings conference calls.

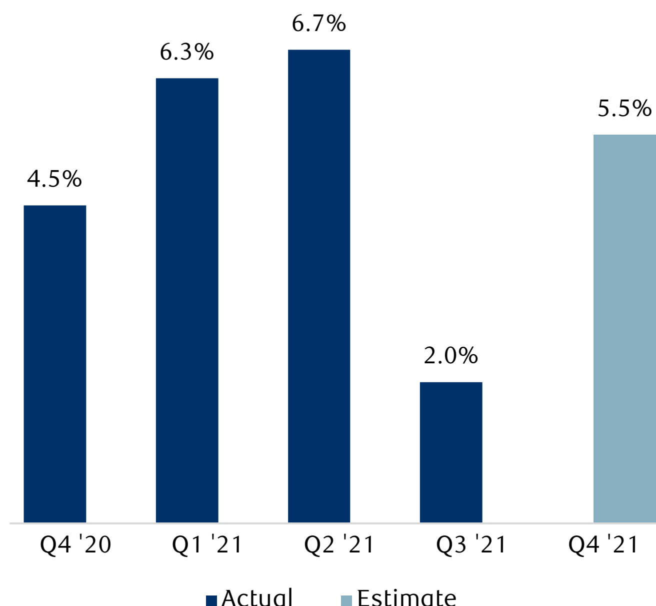
■ This week marks the peak of earnings season. Broadly speaking, **quarterly results beat consensus forecasts, but forward-looking guidance was more downbeat**. Management teams typically err on the side of caution near the end of the year, but ongoing uncertainty over COVID-19 trends, inflation, and supply chains added to the gloom.

■ As a case in point, defense contractor Lockheed Martin Corp. (LMT) spooked investors by cutting earnings forecasts through 2022, which contributed to a 12% decline in its share price. The company cited a decision to make $1.5 billion in advance payments to its supply-chain partners to ensure they could continue to operate. In our view, this underlines **the interconnected nature of corporate America and the likelihood these issues may persist for several quarters**.

■ While software and internet companies tend to be insulated from supply-chain issues, many of them flagged a different disruption to their businesses. **Apple Inc.'s (AAPL) decision to enhance user privacy protections** by limiting advertisers' ability to use its IDFA user-tracking feature has reverberated through the internet advertising ecosystem. Shares in Facebook Inc. (FB) and Snap Inc. (SNAP) weakened after analysts drilled down on this issue. Meanwhile, shares of Alphabet Inc. (GOOGL) rallied on hopes the company, which is less reliant on Apple, would gain market share.

Economists expect impact of Q3 2021 COVID-19 resurgence to fade

U.S. GDP growth, q/q annualized



Source - RBC Wealth Management, Bureau of Economic Analysis, FactSet; Q3 '21 data is preliminary, Q4 '21 estimate is average of economists' forecasts

CANADA

Sean Killin & Richard Tan, CFA – Toronto

■ **With roughly two months left in CY2021, the S&P/TSX Composite is on pace for a solid year of gains**. The key Canadian equities benchmark has returned approximately 23% YTD, underperforming the S&P 500 by approximately 156 basis points in local-currency terms. Furthermore, the S&P/TSX Composite trades at a discount to the S&P 500 based on consensus forward earnings estimates although we acknowledge that the Canadian economy tends to be more resource-driven and, therefore, should be more sensitive to changes in commodity prices (i.e., greater volatility in earnings). Fortunately, most commodity markets have sharply rebounded in 2021 with a few pointing towards sustained momentum heading into 2022. Specifically, RBC Capital Markets believes we're still in the early days of a multiyear energy bull market and is calling for a constructive outlook on the back of strengthening demand and tight supply conditions. Energy has been the best-performing sector on the S&P/TSX Composite thus far in 2021 and represents about 13% of the index.

■ **In August, Canadian retailers saw sales growth across all provinces**, with Ontario and Quebec posting the largest increases. Statistics Canada (StatCan) reported that retail sales were up 2.1% q/q to CA$57.2 billion, with sales increasing in nine of the 11 retail trade subsectors, representing 94.6% of retail trade. Sales were led higher by food and beverage stores, gasoline stations, and clothing and accessories stores that saw increases of 4.8%, 3.8%, and 3.9%, respectively. Notably, **core sales, which excludes automotive and gas sales, increased for the first time in three months**, growing 2.7%. Provincial governments have continued to ease their public health restrictions across the country, which StatCan sees as an influential driver of in-person retail sales growth. Retail e-commerce sales rose 3.2% m/m on a seasonally adjusted basis, despite contracting 2.9% from the same period in 2020, as the popularity of in-person services has grown. Sales in furniture and home furnishing stores were drawn down 2.4% due to ongoing subsector supply-chain constraints.

EUROPE

Thomas McGarrity, CFA – London

- **Improving growth forecasts from the UK's Office for Budget Responsibility** (OBR) enabled the Chancellor of the Exchequer to raise net public spending (equivalent to 0.7% of forecast 2022 GDP) and reduce borrowing projections for coming years in the OBR's Autumn Budget and Spending Review. **The OBR revised its 2021 UK GDP growth forecast upwards to 6.5% from 4.0%** (current Bloomberg consensus: 6.9%) and expects the economy to return to pre-pandemic output levels by early next year.

- **Gilts outperformed following the large reduction in projected UK borrowing requirements for the remainder of the fiscal year**. The yield on the 10-year Gilt fell 12 basis points, its biggest one-day drop since March 2020, to dip below 1% on Oct. 27, before bouncing back somewhat the following day. RBC Capital Markets believes the move will likely reverse over the medium term, as net Gilt supply eventually settles at a much higher level than seen over the past decade.

- As expected, no major policy changes were announced at the October meeting of the European Central Bank (ECB). The December meeting is likely to see guidance on the path forward after the scheduled expiration of the Pandemic Emergency Purchase Programme (PEPP) in March 2022. **President Christine Lagarde kept the ECB in the "transitory" camp when it comes to inflation**, stating, "While the current phase of higher inflation will last longer than originally expected, we expect it to decline in the course of next year."

- UK-listed energy major **Royal Dutch Shell was in the spotlight after U.S. activist investor Third Point announced it had taken a stake, worth roughly $750 million according to Bloomberg, in the company** and called for it to split itself into two new companies—one for Shell's legacy oil and gas assets (upstream, refining, and chemicals), and a separate standalone entity focused on what Third Point terms Shell's "energy transition businesses" of liquefied natural gas, renewables, and marketing. Third Point argues Shell has too many competing stakeholders. Shell's management defended the current structure, saying the integration of its traditional oil and gas assets alongside renewables is key to the company's energy transition strategy because cash flows from the former help finance investments in the latter.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

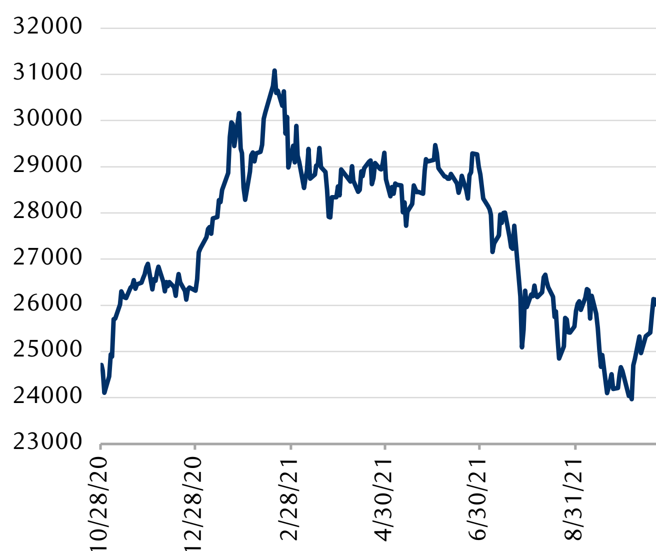
- **Trading on Asian equity markets was mixed during the week. Hong Kong lagged the rest of the region**, with the Hang Seng Index down close to 2% for the week as tech firms have taken a heavy hit after U.S. authorities banned China Telecom from the country over national security concerns, ramping up tensions between the world's two largest economies. Also weighing on sentiment was **the Hong Kong government's decision to tighten COVID-19 travel restrictions** in order to bring the international hub more in line with mainland China. The announcement came despite concerns from Hong Kong's business community that business travel remains challenging under a strict quarantine regime.

- **China's state media agency, Xinhua, commented that the spillover effect of Chinese real estate companies' debt default risks on the financial industry is generally controllable**, stating "there will be clues if a property is likely to default on its debts, so the risk of spillover to the financial industry can be predicted." China Evergrande Group averted default last week with a last-minute bond coupon payment. On Sunday, the company said it had resumed work on more than 10 projects in six cities, including Shenzhen. Separately, state media also reported that China would "strengthen adjustments" in tax collection to boost revenue and reform the country's income distribution, but in a targeted and accurate way, as part of efforts to achieve long-term "common prosperity," referring to a policy drive by President Xi Jinping to narrow the gap between rich and poor. China aims to "divide the pie" by "reasonably" adjusting the income of its top earners and elevating the earnings of lower-income groups. Analysts expect change to come in the form of new property taxes, reflecting China's determination to reshape its property market.

- Samsung Electronics Co. (005930 KS) said **the tight supply of computer chips that is hurting industries worldwide is set to persist through next year**. The company reported quarterly profits exceeding analysts' forecasts, boosted by rising prices in its semiconductor business.

Hong Kong equity market lagging the region

Hang Seng Index



Source - RBC Wealth Management, Bloomberg; daily data through 10/28/21

MARKET Scorecard

Data as of October 28, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,596.42	6.7%	22.4%	40.5%	51.2%
Dow Industrials (DJIA)	35,730.48	5.6%	16.7%	34.7%	31.9%
Nasdaq	15,448.12	6.9%	19.9%	40.4%	85.5%
Russell 2000	2,297.98	4.2%	16.4%	48.9%	46.2%
S&P/TSX Comp	21,197.53	5.6%	21.6%	36.0%	29.4%
FTSE All-Share	4,137.54	1.9%	12.6%	31.1%	2.5%
STOXX Europe 600	475.16	4.5%	19.1%	38.9%	19.1%
EURO STOXX 50	4,233.87	4.6%	19.2%	42.9%	16.8%
Hang Seng	25,555.73	4.0%	-6.2%	3.4%	-5.0%
Shanghai Comp	3,518.42	-1.4%	1.3%	7.6%	18.1%
Nikkei 225	28,820.09	-2.1%	5.0%	23.1%	26.0%
India Sensex	59,984.70	1.5%	25.6%	50.3%	52.8%
Singapore Straits Times	3,203.82	3.8%	12.7%	29.0%	0.6%
Brazil Ibovespa	105,705.00	-4.8%	-11.2%	10.8%	-2.3%
Mexican Bolsa IPC	51,248.84	-0.3%	16.3%	37.1%	17.1%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.578%	9.1	66.5	80.7	-26.4
Canada 10-Yr	1.671%	16.2	99.4	107.6	4.6
UK 10-Yr	1.009%	-1.3	81.2	79.6	28.7
Germany 10-Yr	-0.136%	6.3	43.3	48.9	19.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.64%	0.1%	-1.4%	-0.6%	6.7%
U.S. Investment-Grade Corp	2.19%	0.5%	-0.8%	1.8%	10.7%
U.S. High-Yield Corp	4.22%	-0.2%	4.3%	10.4%	14.0%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,798.91	2.4%	-5.2%	-4.2%	20.5%
Silver (spot $/oz)	24.07	8.5%	-8.8%	2.9%	34.8%
Copper ($/metric ton)	9,667.00	8.1%	24.8%	43.6%	64.2%
Oil (WTI spot/bbl)	82.81	10.4%	70.7%	121.5%	48.4%
Oil (Brent spot/bbl)	84.51	7.6%	63.1%	116.0%	37.3%
Natural Gas ($/mmBtu)	5.72	-2.5%	125.4%	91.0%	134.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	93.3660	-0.9%	3.8%	0.0%	-4.5%
CAD/USD	0.8102	2.8%	3.2%	7.9%	5.8%
USD/CAD	1.2342	-2.7%	-3.0%	-7.4%	-5.5%
EUR/USD	1.1682	0.9%	-4.4%	-0.5%	5.2%
GBP/USD	1.3793	2.4%	0.9%	6.2%	7.2%
AUD/USD	0.7544	4.4%	-1.9%	7.1%	10.3%
USD/JPY	113.5700	2.0%	10.0%	8.9%	4.2%
EUR/JPY	132.6800	2.9%	5.2%	8.3%	9.7%
EUR/GBP	0.8470	-1.4%	-5.2%	-6.4%	-1.9%
EUR/CHF	1.0655	-1.2%	-1.4%	-0.4%	-3.5%
USD/SGD	1.3439	-1.0%	1.6%	-1.6%	-1.3%
USD/CNY	6.3918	-0.8%	-2.1%	-5.0%	-9.6%
USD/MXN	20.3760	-1.3%	2.3%	-4.3%	6.6%
USD/BRL	5.6500	3.8%	8.7%	-1.7%	41.5%

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 0.81 means 1 Canadian dollar will buy 0.81 U.S. dollar. CAD/USD 3.2% return means the Canadian dollar rose 3.2% vs. the U.S. dollar year to date. USD/JPY 113.57 means 1 U.S. dollar will buy 113.57 yen. USD/JPY 10.0% return means the U.S. dollar rose 10.0% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 10/28/21

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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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