GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee November 4, 2021

Picking apart Fed policy plans

Thomas Garretson, CFA – Minneapolis

It's official, the Fed pulled off the "taper" without the "tantrum." Not only have Treasury yields failed to increase sharply as they did following 2013 asset purchase tapering, they have actually moved lower following the Fed's announcement this week. We look at key reasons why and answer some burning questions.

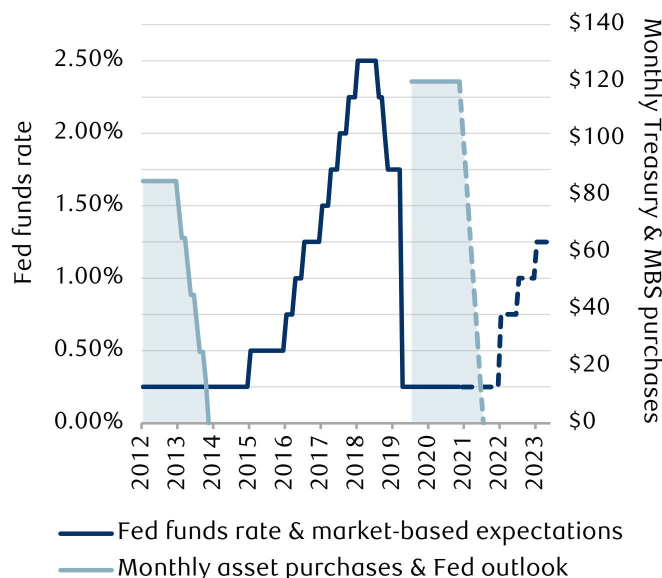
The broad strokes of the Fed's asset purchase tapering plans are as we expected: its $120 billion per month in asset purchases will be cut by $15 billion per month, starting this month, a pace that would bring bond buying to an end by June of next year. The pace could be adjusted up or down based on economic developments, but we see little reason to think that will happen at this stage—boring is better for markets.

The bigger factor, and the one driving sharply higher front-end yields of late, has been the market's repricing of rate hike expectations. Just prior to the Fed meeting this week, markets were penciling in as many as three 0.25 basis point rate hikes next year, and though expectations have cooled following some pushback from the Fed, as the chart shows, the current policy tightening timeline from tapering to the first rate hike remains highly truncated compared to the last cycle. And probably still too truncated, in our view.

So while the long-anticipated taper announcement was the highlight of the meeting, there are a lot of moving parts with respect to the Fed's outlook and market dynamics at the moment, so perhaps it's best to address some burning questions.

Too much too soon?

The Fed's truncated withdrawal timeline



Note: Dashed lines indicate projections

Source - RBC Wealth Management, Bloomberg, Federal Reserve, tapering forecast based on Fed's November announcement; data through 11/4/21

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

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Priced (in USD) as of 11/4/21 market close, ET (unless otherwise stated). Produced: Nov. 4, 2021 4:38 pm ET; Produced: Nov. 4, 2021 5:19 pm ET
For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

1) Inflation is high ... why isn't the Fed worried about high inflation?

This was the key development from the Fed's official statement: Policymakers still expect inflation to be "transitory" despite it proving more persistent than they expected. Had they dropped that characterization of inflation, it likely would have emboldened the market and its expectations for multiple rate hikes next year.

The simple fact remains that much of the pricing pressure is concentrated in certain sectors exposed to supply and demand imbalances—which are largely beyond the reach of the Fed's policy tools—a point the Fed made by inserting language alluding to such in its statement.

And as Fed Chair Jerome Powell stated during his press conference, the U.S. has a dynamic economy that is more than capable of rebalancing itself in coming months, likely easing inflationary pressures.

2) What is "maximum employment" going to look like this cycle?

We believe this is the key issue for the Fed and will determine the outlook for rates; it also relates to issues around inflation. Put simply, the Fed is looking for inflation, but the *right* kind of inflation—and that is stable inflation around two percent that is being fueled by an economy and labor market operating at full capacity—broadly speaking that's not what we have today, but when we will is the million dollar question.

Labor force participation holds the key here: There has been a boom in early retirements, estimated by the Fed to have topped three million, partly explaining (but not completely) why the total labor force is still five million people shy of pre-pandemic levels, while obfuscating an official 4.8 percent unemployment rate, which may or may not overstate the true tightness of the labor market.

And without a doubt, getting it right this economic cycle will be an enormous challenge for the Fed.

If the central bank gets it wrong and raises rates too soon, it risks cutting short the economic expansion in addition to labor market gains, opportunities, and higher wages for millions of people.

If the Fed gets it wrong and raises rates too late, it risks a wage-driven inflationary spiral of higher prices due to higher labor costs, which then loops back to higher wages, and higher costs.

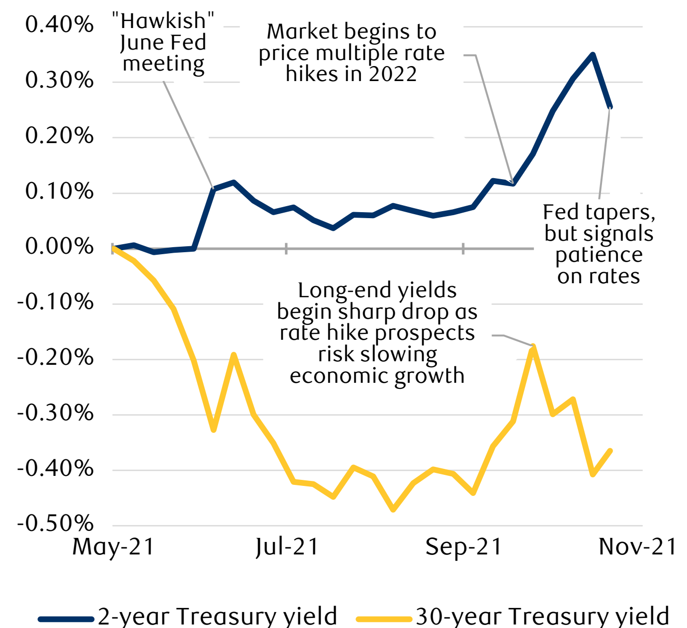
If the Fed gets it right, well, it will look like 2019 when the unemployment rate was just 3.5 percent without any real signs of intolerable inflationary pressures.

3) Why are yield curves flattening, what is the market telling us?

Finally, if there's one thing to pay attention to, we think it's the shape of yield curves. Over the course of a business cycle, the slope of the Treasury yield curve steepens,

Looking for market signals in yield curve dynamics

Net change in yields since May



Source - RBC Wealth Management, Bloomberg; data through 11/4/21

flattens for some period of time, and then inverts—which historically has preceded recessions.

As the chart shows, short-term yields have risen sharply both in the U.S. and globally on rising central bank rate hike expectations. Long-term yields, more reflective of long-term growth and inflation expectations, have actually been falling for most of the year. That has brought our preferred segment of the curve, the difference between 5-year and 30-year Treasury yields, to the lowest level since before the pandemic started at just 0.85 percent—suggesting that either the market has priced in too many rate hikes or that the growth and inflation outlook is deteriorating. We believe it's likely some combination of the two, as they are related.

The path forward

In our view, the market got a bit carried away recently in terms of pricing multiple Fed rate hikes next year. We expect the Fed will continue to have cause to remain patient, and that policymakers will continue to gently push back against market expectations, which should drive a modest resteepening of yield curves. But for investors, yield curves will remain the best barometer of whether the Fed is at risk of making a policy mistake, especially as the end of asset purchases gives way to a potential rate hike cycle in the middle of next year.

UNITED STATES

Ben Graham, CFA – Minneapolis

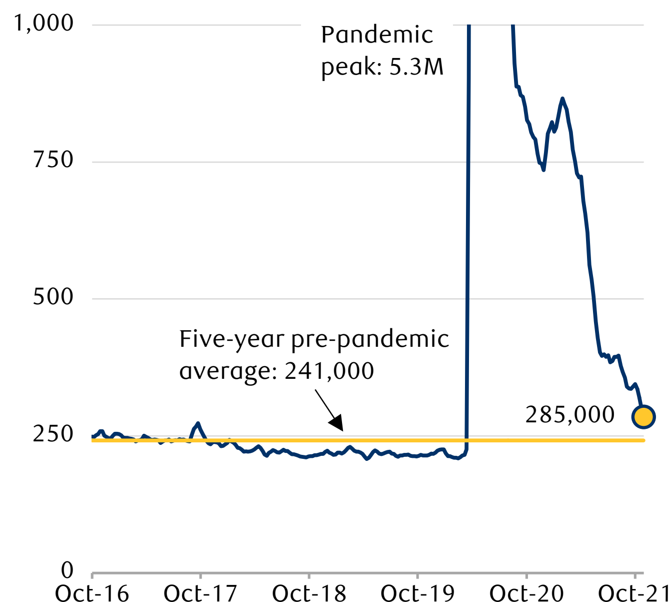
- **U.S. equities are on track for another week of gains after the Fed's tapering messaging threaded the needle**. Small caps are delivering the largest rally, climbing 4.6% thus far this week. The S&P 500 is up 1.6% and the Nasdaq leads the Dow Jones Industrial Average by a tally of 2.9% to 0.9%. Sector leadership is evident in Consumer Discretionary and Tech stocks, with gains greater than 2.9% for each, while on the other side of the coin, Financials and Utilities have each declined at least 0.5% this week.

- Earnings season, at least for large caps, is nearing its conclusion as companies constituting 82% of the S&P 500's market capitalization have reported Q3 results. So far, the trend has been better than hoped for versus the start of the quarter, as **earnings per share growth for the S&P 500 is on track for a 37.5% y/y improvement, up from a consensus expectation of 26.4% immediately before results began to be released**. The acceleration above expectations has been fueled by strong beat rates in Information Technology, Communication Services, Financials, and Materials. Both consumer sectors are showing the worst earnings surprise trends, with Consumer Discretionary actually growing less than hoped for due to inflationary pressures impacting operations and earnings.

- On the economic front, **initial unemployment claims continue to trend constructively** with this week's initial filings of 269,000 setting **another post-COVID-19 low**. Importantly, this continues to bring the four-week moving average lower as well, with the metric falling below 300,000 recently to 285,000 today. This compares to a five-year average prior to the pandemic of 241,000. Other economic activity was generally favorable as well, with the Institute for Supply Management Manufacturing and Non-Manufacturing Purchasing Managers' Indexes (PMIs) registering 60.8 and 66.7, respectively. Both were higher than consensus expectations, with a much larger surprise on the services-driven Non-Manufacturing PMI.

Unemployment claims tick lower, move toward pre-pandemic levels

Weekly initial unemployment claims, four-week average (Thousands)



Note: Chart is truncated in order to show pre-pandemic levels
Source - RBC Wealth Management, FactSet; data through 10/21/21

CANADA

Luis Castillo & Simon Jones – Toronto

- **Canadian economic activity accelerated in August** after experiencing a modest contraction in July. GDP grew at 0.4% m/m in August, according to Statistics Canada, missing consensus expectations for a 0.7% rebound. Despite this undershoot, **the hard-hit services sector continues to recover** as restaurants and bars (+5.4%), hotels (+11.3%), and entertainment and other recreational activities (+6.4%) all experienced strong month-over-month gains. Goods-producing industries were primarily responsible for dampening output. The agriculture and forestry (-5.7%) industry was especially weak as the sector grapples with record-setting heat adversely impacting production. However, these declines were partially offset by a modest recovery in manufacturing (+0.5%), which experienced a sharp decline in July. Preliminary estimates from Statistics Canada indicate GDP was effectively unchanged in September.

- **The Bank of Canada (BoC) has opened up a new chapter in post-pandemic monetary policy, announcing the end of quantitative easing and the beginning of the reinvestment phase**. This does not mean that monetary accommodation is coming to an end. The reinvestment phase will simply maintain the level of stimulus in the financial system, but not increase it further. The bond market responded by selling off short-term maturity bonds quite abruptly. The BoC's new guidance essentially **pulls the timing for rate hikes forward from H2 2022 to potentially as early as April**. This change in guidance also led to an aggressive flattening of the yield curve as short-term rates rose significantly, driven by the market's concerns that elevated inflation could force the BoC to ease accommodation sooner and more aggressively than previously expected.

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

- **The Bank of England (BoE) surprised markets by keeping the UK base rate on hold at a historic low of 0.1%.** Over the past few weeks, BoE Governor Andrew Bailey had given strong signals about potential rate hikes, particularly in light of rising natural gas prices and higher inflation expectations. Markets had priced in interest rates as high as 1.25% a year from now, and appeared unsettled by the potential for a policy mistake at a time when unemployment is set to increase following the end of the government's jobs support programme and taxes are rising.

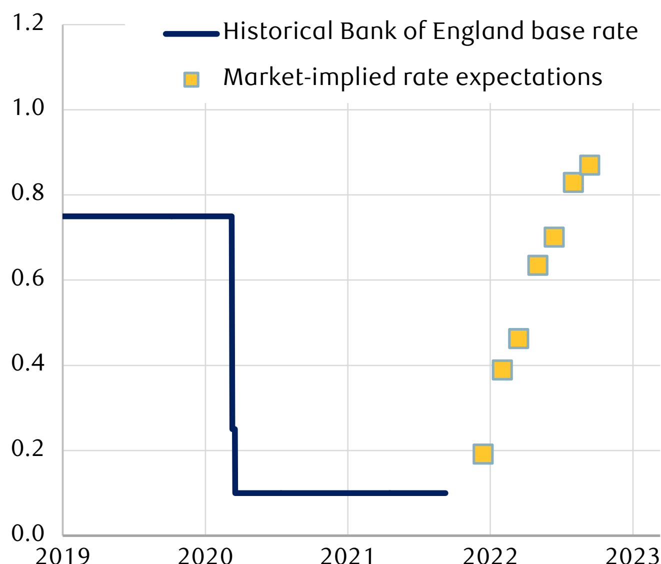
- By keeping rates on hold, the BoE encouraged markets to reconsider their aggressive expectations. Moreover, it stated that rate increases to 1% by the end of 2022 would leave inflation below its 2% target. **Market expectations for the bank rate fell below 0.9%.**

- Nevertheless, Bailey stressed that some modest tightening of monetary policy over the forecast period would likely be necessary to meet the 2% inflation target sustainably in the medium term. **We think a rate hike announcement at the next meeting of the BoE's Monetary Policy Committee, on Dec. 16, should not be ruled out**, though the decision will likely be influenced by how much of an impact the termination of the jobs support programme has on unemployment.

- Stocks of **domestically focused UK banks**, whose net interest margins would benefit from higher UK interest rates, fell in the 3%–5% region following the BoE's rate decision.

- In Europe, **Swiss pharmaceutical giants Roche and Novartis announced that Roche would repurchase the 53.3 million Roche voting shares held by Novartis** for around CHF19 billion ($20.7 billion). The transaction will remove an entanglement between the two competitors that has existed since a failed takeover attempt by Novartis in 2001.

Markets expect the base rate to increase to around 1% by the end of 2022



Source - RBC Wealth Management, Bloomberg; data as of 10:30 am ET 11/4/21

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Chinese Premier Li Keqiang said China's economy faces new downward pressures and that taxes and fees need to be cut** to address the problems affecting small and medium-sized companies. **Li's remarks came after further signs of weakness in October activities** due to power shortages and strict COVID-19 containment measures. China's official manufacturing Purchasing Managers' Index (PMI) fell to 49.2 in October, the lowest reading since March 2020. The non-manufacturing PMI dropped to 52.4, from 53.2 in September, below the 53.0 consensus forecast.

- **We expect China's macroeconomic policy to turn moderately growth-supportive**, given the downward pressure on the economy. We think China could provide fiscal policy support by using the remaining quota of government bond issuance and slightly increasing fiscal spending. In addition, the People's Bank of China could manage liquidity through open market operations. We may also see continuous fine-tuning of industry policies. Some changes have already been seen, such as accelerating the mortgage loan approval process in the real estate market, and making changes on the decarbonization side, to increase coal production and electricity tariffs. However, we believe a major reversal in both monetary and industry policies is unlikely as they are critical to China's economic reform and transformation.

- **Japanese Prime Minister Fumio Kishida vowed to act fast on his economic program** after his election win. He stated he would seek to pass an extra budget as soon as possible and push strongly for emissions reductions. Kishida said tax breaks for companies that raise salaries would be stepped up and the latest plans for dealing with the pandemic will be unveiled by the middle of the month. He also pledged to make clean energy investment a priority. In April, Japan announced two targets: a 46% emissions reduction by 2030 from fiscal 2013 levels and achieving zero carbon emissions by 2050.

MARKET
Scorecard

Data as of November 4, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,680.06	1.6%	24.6%	35.9%	52.0%
Dow Industrials (DJIA)	36,124.23	0.9%	18.0%	29.7%	31.5%
Nasdaq	15,940.31	2.9%	23.7%	37.5%	89.0%
Russell 2000	2,402.43	4.6%	21.7%	48.7%	50.4%
S&P/TSX Comp	21,342.13	1.5%	22.4%	33.4%	28.0%
FTSE All-Share	4,160.90	0.8%	13.3%	25.7%	2.6%
STOXX Europe 600	483.21	1.6%	21.1%	33.0%	19.8%
EURO STOXX 50	4,333.34	1.9%	22.0%	37.1%	18.2%
Hang Seng	25,225.19	-0.6%	-7.4%	1.4%	-8.4%
Shanghai Comp	3,526.87	-0.6%	1.5%	7.6%	18.5%
Nikkei 225	29,794.37	3.1%	8.6%	25.7%	30.4%
India Sensex	60,067.62	1.3%	25.8%	47.9%	49.0%
Singapore Straits Times	3,219.69	0.7%	13.2%	28.0%	-0.5%
Brazil Ibovespa	103,412.10	-0.1%	-13.1%	5.7%	-4.9%
Mexican Bolsa IPC	51,873.46	1.1%	17.7%	38.4%	18.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.530%	-2.2	61.7	76.7	-24.7
Canada 10-Yr	1.656%	-6.7	97.9	104.1	12.8
UK 10-Yr	0.944%	-9.0	74.7	73.7	21.9
Germany 10-Yr	-0.224%	-11.8	34.5	41.4	12.7
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.67%	-0.1%	-1.7%	-1.2%	6.0%
U.S. Investment-Grade Corp	2.24%	-0.2%	-1.2%	0.8%	9.7%
U.S. High-Yield Corp	4.25%	0.0%	4.4%	8.9%	14.0%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,791.76	0.5%	-5.6%	-5.8%	18.7%
Silver (spot $/oz)	23.78	-0.5%	-9.9%	-0.5%	31.7%
Copper ($/metric ton)	9,648.50	-1.6%	24.5%	41.3%	64.8%
Oil (WTI spot/bbl)	78.81	-5.7%	62.4%	101.3%	39.4%
Oil (Brent spot/bbl)	80.75	-4.3%	55.9%	95.9%	30.0%
Natural Gas ($/mmBtu)	5.64	4.0%	122.3%	85.3%	100.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	94.3230	0.2%	4.9%	1.0%	-3.3%
CAD/USD	0.8027	-0.6%	2.2%	5.4%	5.6%
USD/CAD	1.2458	0.6%	-2.1%	-5.2%	-5.3%
EUR/USD	1.1555	0.0%	-5.4%	-1.5%	3.8%
GBP/USD	1.3496	-1.4%	-1.3%	3.9%	4.8%
AUD/USD	0.7400	-1.6%	-3.8%	3.0%	7.5%
USD/JPY	113.7700	-0.2%	10.2%	8.8%	4.8%
EUR/JPY	131.4600	-0.2%	4.2%	7.3%	8.8%
EUR/GBP	0.8562	1.4%	-4.2%	-5.2%	-0.9%
EUR/CHF	1.0544	-0.4%	-2.5%	-1.4%	-4.1%
USD/SGD	1.3508	0.1%	2.2%	-0.6%	-0.6%
USD/CNY	6.3972	-0.1%	-2.0%	-3.8%	-9.0%
USD/MXN	20.5401	-0.1%	3.1%	-1.9%	7.1%
USD/BRL	5.5963	-0.7%	7.7%	-1.2%	39.3%

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 2.2% return means the Canadian dollar rose 2.2% vs. the U.S. dollar year to date. USD/JPY 113.77 means 1 U.S. dollar will buy 113.77 yen. USD/JPY 10.2% return means the U.S. dollar rose 10.2% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 11/4/21

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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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