GLOBAL Insight WEEKLY

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee November 11, 2021

Why is the market largely unfazed by inflation?

Kelly Bogdanova – San Francisco

Inflation continues to rise, but the U.S. equity market has mostly looked the other way. We discuss why the market has surged amid difficult inflation trends, and lay out risk factors that could make inflation morph into a problem.

Whether or not U.S. inflation will turn out to be "transitory" as the Fed has asserted on many occasions, the reality is the official consumer and producer inflation data continue to march higher, and the anecdotal inflation evidence is now widespread.

The Consumer Price Index (CPI) surged 6.2 percent in October compared to a year ago, the highest level since 1990. The CPI jumped almost a full percentage point on a month-over-month basis, the biggest such increase since 2008. This consumer data came on top of a 12.5 percent surge in producer prices in October versus a year ago, the highest level since 1980 when inflation was raging in America.

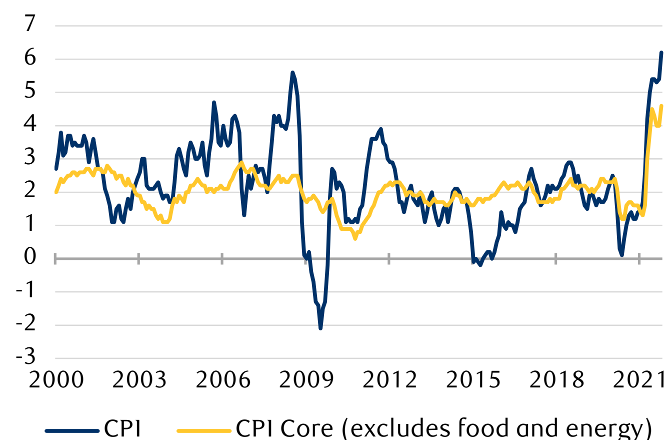
But the curious phenomenon is that the U.S. equity market has largely ignored high and rising inflation so far this year. At the same time the CPI surged from 1.4 percent to 6.2 percent from January to October, the S&P 500 rallied 22.6 percent, seemingly unfazed. What explains this positive equity market performance in the midst of difficult inflation trends? And will the market be able to continue to cope with inflation if it persists?

More than meets the eye

We think there are many reasons the market hasn't been bothered by high and rising inflation thus far in 2021:

Consumer inflation surpassed the previous peak

U.S. Consumer Price Indexes (CPI) in year-over-year percentage change



Source - RBC Wealth Management, Bloomberg; monthly data through 10/31/21

- The economy has been growing well-above the long-term trend rate and seems set to grow at an above-average pace in 2022, and the leading economic indicators have firmed;
- Household spending has been strong, and there is scope for more spending as household balance sheets are still flush with cash and wages are rising;

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

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Priced (in USD) as of 11/11/21 market close, ET (unless otherwise stated). Produced: Nov. 11, 2021 4:48 pm ET; Produced: Nov. 11, 2021 4:51 pm ET
For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

- S&P 500 corporate earnings growth has been robust and is on pace to rise 50 percent in 2021 and could tack on another 7 percent in 2022, according to the consensus forecasts;
- Some industries, such as commodity producers, benefit from inflation as do companies in other industries that are able to pass along any inflation in input costs by charging higher prices to their customers (in other words, companies with pricing power);
- Many companies, especially large firms, are effectively managing their expenses, offsetting or at least partially mitigating inflation's effects, and;
- More and more companies are using technology to improve productivity and contain or reduce labor costs and other expenses.

Importantly, there is a perception among equity market participants that COVID-19 is the main contributor to inflation, and that as the pandemic continues to dissipate and supply chains start to function more normally, inflation rates will begin to retreat.

We think there is some truth to this. Also, the unprecedented and significant amounts of U.S. fiscal and monetary stimulus have stoked inflation, in our view. And, yes, all of these inflationary impulses should wane as we get further away from the darkest days of the pandemic and policies begin to normalize.

But RBC Capital Markets, LLC's Chief U.S. Economist Tom Porcelli points out that not all of the inflation pressures are tied up with COVID-19 and the related supply chain disruptions. Inflation was starting to simmer before the pandemic, and now it has become broad-based, with 10 of the 15 major consumer inflation categories he monitors rising at the same time in the past few months. Furthermore, inflation in the service sector—by far the largest segment of the U.S. economy—is starting to perk up, according to Porcelli.

Risk factors

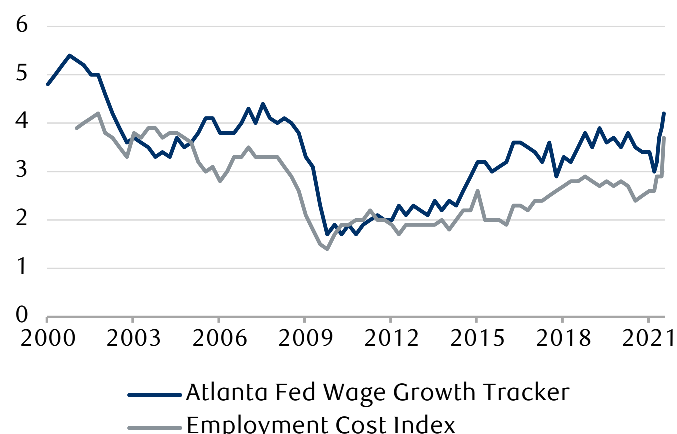
Even though the U.S. equity market has coped well with high and rising inflation thus far, it did react negatively to October's CPI surge. The S&P 500 retreated 0.8 percent on the day the data were released, and was particularly impacted by the related rise in bond yields and flattening of the Treasury yield curve.

What could make inflation morph into a problem for the equity market?

- An inflation spike to even higher levels, which could put greater pressure on S&P 500 profit margins to the degree that earnings growth could become constrained or outright retreat in 2022;
- Heightened fear of a Fed policy mistake or an actual policy mistake—with the central bank either responding too aggressively or not responding aggressively enough to inflation—such that it would threaten the economic recovery and notably increase recession risks, and/or;

U.S. wages continue to rise

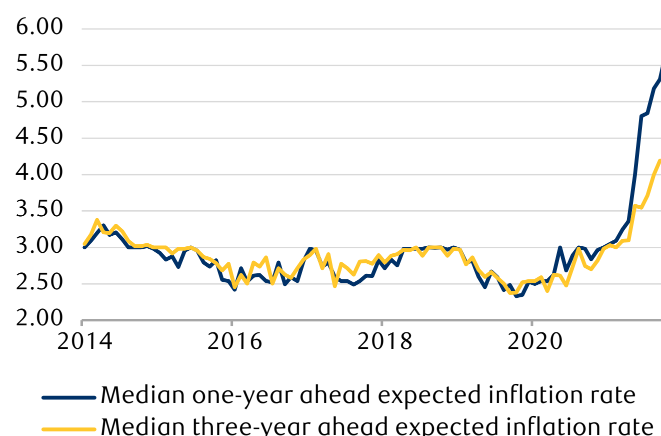
Broad measures of U.S. wage inflation (year-over-year percentage change)



Source - RBC Wealth Management, Bloomberg; quarterly data through September 2021; ECI data begins in 2001

Consumers foresee high inflation in the next year and elevated inflation further out

Consumer inflation expectations: Near-term versus medium-term (%)



Source - RBC Wealth Management, New York Fed Survey of Consumer Expectations; monthly data through 10/31/21

- A change in perception that inflation has become entrenched and could last much longer than equity market participants currently expect.

Easing, but not pleasing

Our base-case forecast is that inflation pressures should ease next year, and even Porcelli, an inflation hawk, anticipates this will occur. But as we've stated on many occasions, we think U.S. inflation levels will remain uncomfortably elevated for the next couple years. It's unclear whether the equity market has fully factored in this scenario.

Depending on the path of inflation and, importantly, the Fed's response to it—whether it manages the situation effectively or ineffectively—inflation could generate volatility for the U.S. equity market in 2022.

UNITED STATES

Atul Bhatia, CFA – Minneapolis

- October's 6.2% y/y increase in the Consumer Price Index (CPI)—the largest since 1990—contributed to last week's decline in bonds. **Yields**, which move inversely to prices, **reached 0.51% on Treasuries maturing in two years**, the highest level at that tenor since March 2020. **Yields on 5-year U.S. government bonds rose by 0.14%** following the CPI data, as markets anticipate a **potential need for the Fed to move more aggressively on policy rates to contain inflation**. Concerns on the possible growth impact of an accelerated tightening cycle helped longer-maturity bonds outperform; the yield difference between 30-year and 5-year government obligations has compressed to the lowest levels since the pandemic struck.

- **Private payrolls grew by 604,000 employees in October**, nearly 45% above the median estimate in Bloomberg's pre-release market survey. The accelerating pace of hires **helped drop the unemployment rate to 4.6%**, potentially indicating that rising wages are beginning to clear the hiring backlog in the economy. **One remaining concern is the stagnant labor participation rate**—only 61.6% of Americans over the age of 16 are working or looking for work, compared to 63.4% pre-pandemic. Lower labor participation is one reason the unemployment rate is low even though the economy is operating with four million fewer employees than in February 2020.

- **Nearly $600 billion in new infrastructure spending was approved by Congress last week in a bipartisan bill**. The measure is heavily weighted toward physical infrastructure, with roads, power, and rail accounting for almost half of the incremental funds. Passage of the traditional infrastructure bill may reduce the negotiating leverage of progressives as the legislature takes up the broader Build Back Better fiscal legislation, potentially reducing its $1.75 trillion estimated price tag. **The timeline to pass additional budget measures may be brief**, with Congress needing to act on the debt ceiling limit before year-end to avoid a U.S. government default.

CANADA

Ricardo Andrade, CFA & Sean Killin – Toronto

- As the Fed has formally announced its plans for tapering the pace of its quantitative easing program, we believe investor attention could increasingly shift towards the timing and pace of the next rate hike cycle. **To address the question of whether the start of the next Fed rate hike cycle could negatively impact the Canadian equity market**, we identified 18 Fed rate hikes dating back to 1958 and analyzed how the S&P/TSX Composite Index has historically performed in the year leading up to and after the first rate hike. Overall, **we found that the initial hike hasn't tended to matter** for the Canadian equity market. To wit, our study showed that the S&P/TSX Composite generated positive outcomes 78% of the time in the 12 months leading up to the first hike with average returns of 13.9%, while returns in the 12 months thereafter were also healthy, averaging 10.1% with a positive outcome 72% of the time.

TSX Composite performance around start of Fed rate hike cycle since 1958

Total returns

	Trailing returns			Forward returns		
	12 mos.	6 mos.	3 mos.	3 mos.	6 mos.	12 mos.
Median	10.90%	7.00%	4.30%	2.40%	4.40%	11.30%
Average	13.90%	5.90%	4.90%	2.20%	3.10%	10.10%
Positive outcome	78%	72%	72%	67%	67%	72%

Source - RBC Wealth Management, Bloomberg; data through 10/31/21

- **The Canadian labour market recovery continued in October, with Canada's unemployment rate declining for the fifth consecutive month**, coming in at 6.7% compared to 6.9% in September. This still leaves the unemployment rate about one percentage point above the pre-pandemic level recorded in February 2020. Strong jobs gains registered in industries such as retail trade (+72,000) were offset by declines in accommodation and food services (-27,000). The most notable change in October was a drop in the number of self-employed workers, which fell to its lowest level since 2007. In some industries, workers migrated onto payrolls, as the losses in self-employed workers were offset by gains in paid employees. **Wage growth has also modestly accelerated**, up 2.0% y/y in October versus 1.7% in September. In addition, **Canada's labour force participation rate is either at or above pre-pandemic levels** for most age groups, which is in stark contrast to comparable metrics for the U.S.

EUROPE

Thomas McGarrity, CFA – London

- **The Q3 reporting season is almost complete in Europe**. In aggregate, results have delivered a solid beat to consensus expectations, with STOXX Europe 600 EPS surprising positively by around 9%. **The Financials sector had the highest proportion of companies beating consensus earnings estimates**, with lower-than-forecast bank loan loss provisions the primary driver.

■ On the flip side, **Industrials delivered the lowest number of beats among the major sectors in the region**, and saw a negative 1% aggregate earnings surprise. Pretty much every European capital goods company within the sector highlighted supply chain disruption during the quarter. That dynamic, in addition to cost inflation, is crimping the earnings in the short term for some companies, pressures likely to persist in Q4. Looking beyond these short-term supply and margin challenges, we believe the long-term growth outlook for the European Capital Goods sub-sector remains attractive, supported by numerous structural tailwinds, including decarbonisation trends. Europe is home to many leading global companies in sustainability-focused industrial applications and green technologies that should be well-placed to benefit from increased capital spending, by corporates and governments, aimed at reducing carbon emissions as part of the drive to net-zero.

■ **The Office for National Statistics estimates UK GDP grew 1.3% q/q in Q3**, slightly below the Bank of England's (BoE) 1.5% forecast, owing to downward growth revisions in July and August. Notably, growth momentum improved as the quarter progressed—GDP contracted by 0.2% m/m in July followed by a modest 0.2% m/m expansion in August, and a solid 0.6% m/m gain in September.

■ While the GDP data might reassure members of the BoE Monetary Policy Committee (MPC) regarding the growth momentum of the UK economy, **we think the forthcoming labour market reports will arguably be more important data points for the MPC on the timing for increasing interest rates** because the reports will provide evidence on the impact of the UK's furlough scheme ending. The market-implied probability for a 15 basis point base rate increase by the BoE at its December meeting stands at 56%, according to Bloomberg.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

■ **Asia-Pacific equity markets were mixed this week with Japan and South Korea lagging the region**. The Nikkei 225 Index is down more than 1% this week as the latest earnings results from a string of companies underscored the fallout from rising costs of raw materials, although analysts broadly believe the overall earnings picture was not disappointing.

■ **A gauge of Chinese property stocks is up more than 10% this week, the biggest weekly jump since November 2018**. The rebound follows a series of articles published in state media in the past few days signaling support measures are on the way to help Chinese developers tap debt markets, potentially easing a liquidity crunch. Key aspects of the reports included the prospect of allowing real estate firms to sell debt in the domestic interbank market, and potentially to allow state-owned enterprises to increase borrowing for the purpose of buying struggling developers. State media also reported that banks boosted lending to the sector last month, which supported sentiment. Finally, Evergrande Group's bond interest payment appears that it will help the firm avert a default again, and provided investors with some reprieve. We continue to expect some policy fine-tuning in the property space and we believe it will take time to rebuild investors' confidence.

China property stocks having best week since Nov. 2018

Bloomberg Intelligence China Real Estate Owners and Developers Valuation Peers Index

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

■ **Sony Group (6758 JP) has reduced its PlayStation 5 (PS5) production outlook for this fiscal year due to component and logistics constraints**, according to a Bloomberg report. Sony is now targeting only 15 million units, down from the previous 16 million units. Sony's CFO told investors in October that logistics issues and parts shortages have grown more severe. The PS5 became the fastest Sony console to reach 10 million units of sales in July. However, uneven vaccine rollouts across developing nations where Sony suppliers have their production bases have made supplies of chips and parts unpredictable, the report noted.

MARKET
Scorecard

Data as of November 11, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,649.27	1.0%	23.8%	30.1%	50.6%
Dow Industrials (DJIA)	35,921.23	0.3%	17.4%	22.2%	29.7%
Nasdaq	15,704.28	1.3%	21.8%	33.2%	85.5%
Russell 2000	2,409.14	4.9%	22.0%	38.7%	51.1%
S&P/TSX Comp	21,581.98	2.6%	23.8%	28.7%	27.8%
FTSE All-Share	4,212.39	2.0%	14.7%	17.3%	4.2%
STOXX Europe 600	485.29	2.1%	21.6%	24.9%	19.7%
EURO STOXX 50	4,358.00	2.5%	22.7%	25.7%	17.9%
Hang Seng	25,247.99	-0.5%	-7.3%	-3.7%	-6.2%
Shanghai Comp	3,532.79	-0.4%	1.7%	5.7%	21.4%
Nikkei 225	29,277.86	1.3%	6.7%	15.5%	25.5%
India Sensex	59,919.69	1.0%	25.5%	37.5%	48.5%
Singapore Straits Times	3,238.07	1.2%	13.9%	19.3%	-0.1%
Brazil Ibovespa	107,594.70	4.0%	-9.6%	2.7%	-0.7%
Mexican Bolsa IPC	51,707.01	0.8%	17.3%	26.6%	18.6%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.549%	-0.3	63.6	57.4	-39.2
Canada 10-Yr	1.684%	-3.9	100.7	90.8	10.3
UK 10-Yr	0.920%	-11.4	72.3	50.7	10.9
Germany 10-Yr	-0.231%	-12.5	33.8	27.6	1.4
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.69%	0.0%	-1.5%	-0.4%	6.8%
U.S. Investment-Grade Corp	2.24%	0.2%	-0.9%	1.6%	10.9%
U.S. High-Yield Corp	4.16%	0.5%	4.9%	7.8%	14.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,862.07	4.4%	-1.9%	-0.2%	27.9%
Silver (spot $/oz)	25.25	5.6%	-4.4%	4.0%	49.8%
Copper ($/metric ton)	9,705.50	-1.1%	25.2%	41.4%	65.6%
Oil (WTI spot/bbl)	81.59	-2.4%	68.2%	96.8%	43.5%
Oil (Brent spot/bbl)	82.59	-2.1%	59.4%	88.6%	32.8%
Natural Gas ($/mmBtu)	5.13	-5.4%	102.1%	69.3%	94.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	95.1610	1.1%	5.8%	2.3%	-3.1%
CAD/USD	0.7948	-1.5%	1.2%	3.8%	5.2%
USD/CAD	1.2582	1.6%	-1.1%	-3.7%	-4.9%
EUR/USD	1.1449	-0.9%	-6.3%	-2.8%	3.8%
GBP/USD	1.3365	-2.3%	-2.2%	1.1%	4.0%
AUD/USD	0.7290	-3.0%	-5.3%	0.1%	6.4%
USD/JPY	114.0800	0.1%	10.5%	8.2%	4.6%
EUR/JPY	130.6100	-0.9%	3.5%	5.2%	8.6%
EUR/GBP	0.8566	1.4%	-4.2%	-3.8%	-0.2%
EUR/CHF	1.0546	-0.4%	-2.5%	-2.4%	-3.8%
USD/SGD	1.3544	0.4%	2.4%	0.4%	-0.5%
USD/CNY	6.3914	-0.2%	-2.1%	-3.6%	-8.8%
USD/MXN	20.6693	0.5%	3.8%	0.8%	8.1%
USD/BRL	5.4046	-4.1%	4.0%	0.1%	30.3%

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.

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

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As of September 30, 2021

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