GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

December 9, 2021

# Conundrum, continued

Atul Bhatia, CFA – Minneapolis

Ten-year Treasury yields remain stubbornly below both current and expected future inflation. How can investors make sense of this apparently illogical behavior in the bond market?

In 2005, then-Fed Chair Alan Greenspan identified what he termed a "conundrum": despite the Fed having hiked overnight rates by 1.5 percent, the yield on 10-year government bonds remained essentially unchanged.

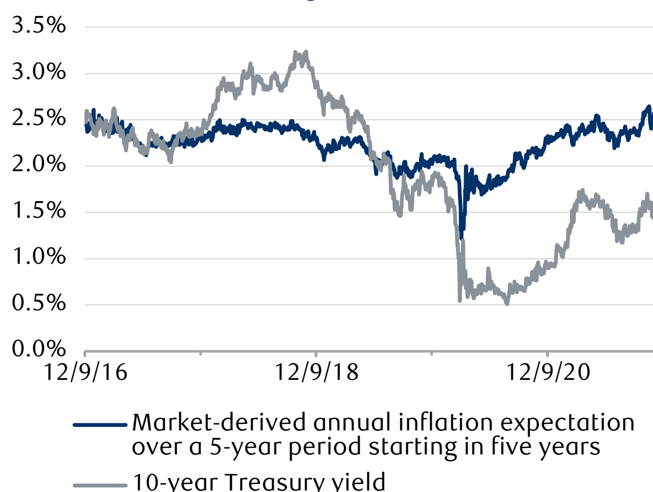
Since then, the conundrum has, if anything, amplified. Yields on 10-year government bonds are almost five percent below the last observed inflation reading, nearly one percent below market expectations for medium-term inflation, and they are essentially flat since Fed Chair Jerome Powell indicated a likely shift to tighter monetary policy, even as markets price nearly 0.75 percent in Fed rate hikes in 2022. Clearly, the conundrum continues.

## Traditional theory and valuation seem incomplete

Longer-term bond rates are frequently broken down into three components: real growth in the economy; compensation for inflation; and a catch-all "term premium" to describe uncertainty about the other two variables.

Traditional theory would look to growth or inflation expectations to explain current low rates: specifically, that the potential for the fed funds rate to reach 0.75 percent next year, and possibly 1.5 percent in the next three years, will engineer an economic contraction that will drop the sum of real growth and inflation over a decade below 1.5 percent. While it's possible to make the math work out using those levers, we believe the argument is largely unsatisfying in logical terms and inconsistent with other markets.

**Yield on 10-year Treasury not keeping pace with market's inflation trading**




Source - RBC Wealth Management, Bloomberg; daily data through 12/8/21

The government's contribution to growth is poised to flip negative next year, but the large stock of household savings—and consumers' demonstrated willingness to spend—should more than offset that headwind. We believe inflation likewise appears poised to drop, both on

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

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fundamentals and on base rate effects, but it would likely require a decline into deflationary territory to justify 10-year yields below 1.5 percent, given reasonable economic growth forecasts.

Arguments that growth and inflation will justify 10-year yields are also inconsistent with other market signals. Medium-term inflation is now trading at roughly a 2.5 percent level, while investment-grade borrowers—on average—can borrow funds for nearly a decade at or below that level. Is it possible for growth and inflation to stay low when companies are essentially paid to borrow money? Of course. Is it likely? Probably not, and at best, it is a highly debatable contention.

It's also difficult to square the extremely low growth environment bond markets are ostensibly predicting with corporate earnings and equity valuations. Major U.S. equity indexes are at or near record highs, large-cap valuations are stretched, and the consensus forecast implies S&P 500 earnings growth of 8.5 percent in 2022.

## Faster hike, lower end

Another explanation for ongoing low 10-year rates is that initiating the rate hike cycle earlier will likely lead the Fed to stop hiking at lower levels. If the Fed were to stop hiking at 1.25 percent and hold it there for the next decade, then an investor could likely profitably hold 10-year Treasuries at current levels.

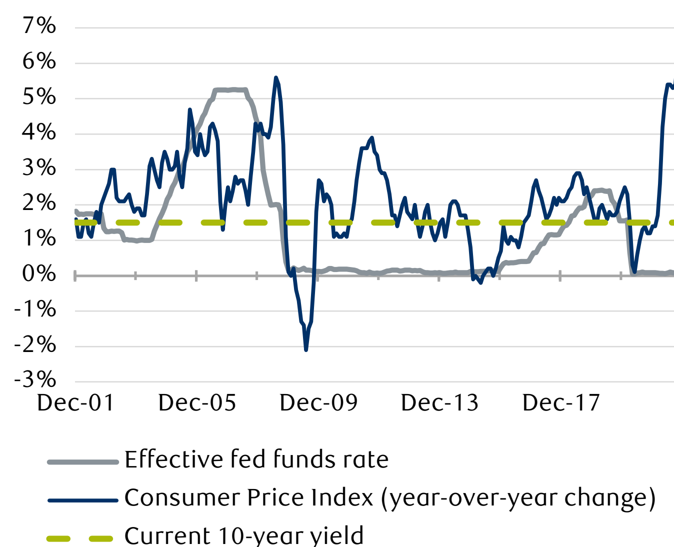
One problem with this argument is that it's unclear how the Fed will keep overnight rates below inflation for years without triggering a rising price cycle that prompts a more aggressive response. It's possible that longstanding disinflationary factors will help the Fed out, but it would likely require a shift in consumer behavior. And as the reaction to Powell's recent comments indicates, the Fed is capable of surprising pivots; current levels of 10-year yields seem to offer little cushion for any unexpected Fed reaction.

## Why buy at these levels?

We can think of several reasons why investors continue to buy Treasuries at these levels and why they may continue to do so:

- **Price-insensitive asset allocators.** Both institutional and private investors have asset allocation plans that drive investment decisions. Following strong equity outperformance in 2021, there is greater demand for fixed income across the board. Put differently, with equities at or near record highs, investors look to fixed income—and particularly longer-maturity fixed income—to help protect against possible growth disappointments.
- **Uncertainty reigns.** The omicron variant serves as a reminder that COVID-19 risks remain, and geopolitics are an additional source of potential uncertainty. For many investors, Treasuries' high probability for return of capital outweighs any return on capital considerations.
- **Rate hikes may be more consequential.** Fiscal policy is due to be contractionary next year and we expect most of the growth impulse to come from private consumption. With retirement account and home equity valuations high for many individuals, the feeling of prosperity can tend to boost spending, even if those funds are not immediately available. If the Fed tightening had a significant impact on home or equity markets, then even moderate tightening could prompt a rally in longer-maturity bonds.
- **Don't fight the Fed.** Even if the Fed is hiking near-term rates, policymakers have not indicated any significant discomfort with the shape of the yield curve and they continue to reinvest maturing Treasury holdings in newly issued bonds. Low 10-year yields can provide many benefits, not least of which is helping the government fund itself. With the Fed apparently content with low 10-year maturities, investors have few incentives to aggressively position for higher yields.

**Will Fed policy justify low rates? Inflation may pose a challenge**




Source - RBC Wealth Management, Bloomberg; monthly data through 11/30/21 for 10-year yield and fed funds, CPI data through 10/31/21

## Lower for longer (maturities)

We believe there may be upward pressure on longer-term bond yields during 2022, but we think it will be difficult for 10-year yields to sustainably exceed two percent next year, even though this is well below even the Fed's own projected nominal GDP growth. In our view, the difference is best explained by the likelihood of persistently low policy rates, with assistance from economic uncertainty and price-insensitive buyers. Although this blend of factors may be unsatisfying from a theoretical perspective, we believe it helps explain the apparently illogical price-setting behavior of U.S. Treasury markets.

## UNITED STATES

Michael Roedl – Minneapolis

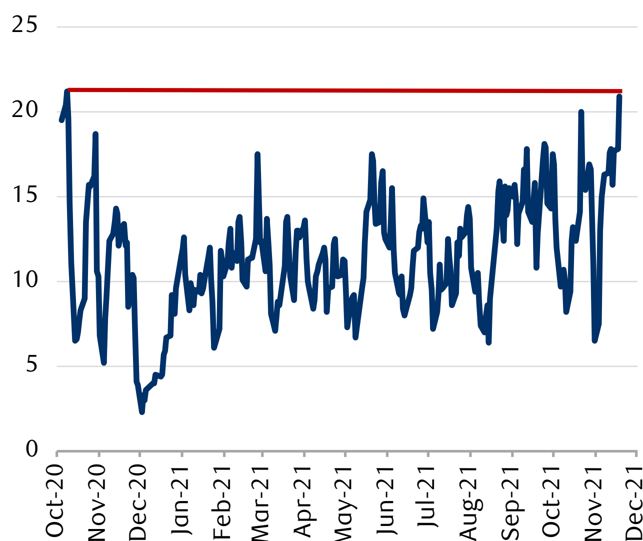
- The municipal market is one of the top-performing U.S. fixed income sectors year to date as investors fear potential tax hikes in 2022. However, **U.S. municipalities are making a last minute push for funding as state and local governments are scheduled to pack in about $21 billion of new issue municipal debt sales prior to year-end**. As illustrated by the chart, December scheduled issuance would generate the largest quantity of visible supply since October 2020. Therefore, while persistent muni demand should continue into year-end, we think the supply surge could potentially build a case for higher yields going into next year.

- **Nonfarm payrolls added 210,000 workers** in the latest November report, well below Bloomberg's pre-release survey consensus of 550,000. **Although meager, we do not believe the report will stop the Fed from announcing a faster pace of tapering** at next week's policy meeting. Despite November being the slowest month of job growth year to date, there were some positives in the report, as labor force participation edged higher and the unemployment rate fell to 4.2%. The omicron variant remains a concern, but we believe the Fed will look through that risk for now as it actively attempts to curb heightened inflationary pressures in the U.S. economy.

- **Senate leaders Chuck Schumer and Mitch McConnell have agreed on a novel plan to raise the country's debt ceiling** after the U.S. Treasury warned Congress of running into a cash shortfall by mid-December, which could potentially lead to payment defaults for upcoming Treasury maturities coming due. The plan includes a separate procedural bill that would enable the Senate to increase the debt ceiling with a simple majority vote, rather than the 60 votes typically needed due to filibuster rules. With this procedural bill having just been adopted in the House of Representatives and Senate, the formal votes to raise the debt ceiling would take place, presumably by Dec. 15.

**December muni supply highest since Oct. 2020**

Visible muni supply (billions)




Source - RBC Wealth Management, Bloomberg; daily data through 12/7/21

## CANADA

Luis Castillo & Simon Jones – Toronto

- **The Bank of Canada (BoC) held monetary policy steady this week, keeping the policy rate unchanged and maintaining the overall level of Government of Canada bond holdings**. In a statement following its Dec. 8 meeting, the bank conveyed a positive tone on the macroeconomic front, emphasizing that GDP has progressed as expected and that the labour market has returned to pre-pandemic levels, while also recognizing that the omicron variant adds new uncertainty. With a quantitative easing program now in the rear view mirror and an economy running on the track of recovery, bond markets have been pricing in multiple rate hikes for 2022. However, the BoC's statement delivered a splash of cold water on those aggressive expectations as the central bank maintained its forward guidance, providing no hints about potential deviations from its rate hike timeline ("middle quarters of 2022") and reiterating that ongoing slack in the economy continues to warrant a considerable level of monetary policy support.

- **November was a strong month for the Canadian labour market, with job gains of 154,000 far exceeding consensus forecasts of 37,500**. Potential drivers behind the larger-than-expected gains included continued easing of public health restrictions in Ontario and Quebec as well as the conclusion of fiscal programs such as the Canadian Recovery Benefit. Service-producing sectors, which remain well below pre-pandemic levels of employment, accounted for the bulk of November's hiring, adding 127,000 new employees during the period. Nonetheless, employment growth was broad-based with six provinces reporting increases, and goods-producing sectors adding a more modest, but still impressive, 27,000 jobs. With the number of participants in the labour force effectively unchanged from October, November's strong rise in employment caused the unemployment rate to drop 0.7 percentage points to 6.0%. Looking ahead, the severe flooding in British Columbia, which was not captured in November's report, could act as a headwind for employment in December.

## EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

- **The STOXX Europe 600 ex UK Index has recovered most of its losses since reports of the new COVID-19 omicron variant emerged**. The Travel & Leisure and Banks subsectors have been among the biggest underperformers during this time, in tandem with, respectively, increased travel restrictions and long-term interest rates moving lower.

- Recent news flow undoubtedly portends some near-term uncertainty, likely resulting in heightened volatility persisting in the weeks ahead. We believe, however, **the resurgence of the virus is unlikely to meaningfully alter the economic or earnings outlook for Europe in 2022**. Accordingly, we maintain the view that investors should hold European equities at an Overweight, or above-benchmark, position in portfolios.

- We continue to recommend avoiding extreme positioning, and becoming entrenched on a single macro view. Rather, **we particularly emphasise owning stocks of companies with strong pricing power** given the cost inflation pressures in the system, and recommend owning a blend of exposure across secular growth stocks, quality cyclicals, and defensive companies.

- **The pound has continued to plummet so far this month**. Worries that the omicron variant might mean the Bank of England will delay its decision to increase interest rates at its upcoming Dec. 16 policy meeting is one reason. Another is that UK Prime Minister Boris Johnson is embroiled in a scandal which threatens his political survival. According to RBC Capital Markets, the odds that he will still lead the Conservative Party at the 2024 elections have declined significantly below 50%, raising the spectre of political uncertainty. A by-election in the constituency of North Shropshire in mid-December is Johnson's next political test.

### The pound is now at its lowest level year to date

GBP/USD

Source - RBC Wealth Management, Bloomberg; daily data through 12/8/21

- Finally, **the government announced restrictions to contain the spread of the omicron variant**, including a directive to work from home where possible, vaccine passports for entry into large venues, and a requirement to wear facemasks in many public settings. Though these measures will likely be unhelpful to the economic recovery, **we do not expect them to be a meaningful headwind**.

## ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets traded broadly higher during the week**, led by Japan and China. In Tokyo, the Nikkei 225 Index rose as easing worries over the impact of the omicron variant led investors to buy names whose valuations had fallen during the recent selloff, such as SoftBank Group (9984 JP) and travel-related stocks.

- Following Chinese Premier Li Keqiang's remark on Dec. 3 that China would improve the pertinence and effectiveness of its macroeconomic policy to ensure stable and healthy growth, **the People's Bank of China announced it would cut the reserve requirement ratio (RRR) by 15 basis points (bps) effective Dec. 15**. This cut will release liquidity of RMB 1.2 trillion. We expect the RRR reduction to have a marginal positive impact on economic growth; it should ease liquidity concerns and will release long-term and stable funds, which should have a higher multiplier effect on macro growth.

- **The U.S. House of Representatives passed a bill on Wednesday that would take a harder line against China** over the alleged oppression of ethnic minorities. If the bill is signed into law, **new restrictions would be placed on imports from Xinjiang** in an attempt to ensure goods produced through forced labor by Uyghurs, Kazakhs, Kyrgyz, and members of other minority groups will not be purchased or sold in the U.S. The Chinese Foreign Ministry called the bill "pure political manipulation" and denied that forced labor is prevalent in the region. Xinjiang produces about half of the world's polysilicon, a key material for solar panels; unsurprisingly, shares of most Chinese solar equipment manufacturers reacted negatively to the announcement during Asian trading hours.

- **A group of Kaisa Group Holdings Ltd. bondholders is close to signing nondisclosure agreements with the developer** in a move that would pave the way for negotiation of a potential financing deal for the beleaguered firm, according to a Bloomberg report. The group has been discussing various potential financing arrangements. Kaisa's creditors have yet to receive payment on a US$400 million bond that matured Tuesday, putting the company on the brink of becoming the second major Chinese property developer to renege on debt obligations this week.

## MARKET
# Scorecard

Data as of December 9, 2021

| Equities (local currency) | Level | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| S&P 500 | 4,667.45 | 2.2% | 24.3% | 27.1% | 48.8% |
| Dow Industrials (DJIA) | 35,754.69 | 3.7% | 16.8% | 18.9% | 28.1% |
| Nasdaq | 15,517.37 | -0.1% | 20.4% | 25.8% | 80.0% |
| Russell 2000 | 2,220.21 | 1.0% | 12.4% | 16.7% | 36.2% |
| S&P/TSX Comp | 20,925.49 | 1.3% | 20.0% | 19.2% | 23.4% |
| FTSE All-Share | 4,167.39 | 3.5% | 13.4% | 12.7% | 3.7% |
| STOXX Europe 600 | 476.99 | 3.0% | 19.5% | 20.8% | 17.4% |
| EURO STOXX 50 | 4,208.30 | 3.6% | 18.5% | 19.2% | 14.6% |
| Hang Seng | 24,254.86 | 3.3% | -10.9% | -8.5% | -8.5% |
| Shanghai Comp | 3,673.04 | 3.1% | 5.8% | 8.9% | 26.0% |
| Nikkei 225 | 28,725.47 | 3.2% | 4.7% | 7.1% | 22.6% |
| India Sensex | 58,807.13 | 3.1% | 23.2% | 27.6% | 45.2% |
| Singapore Straits Times | 3,142.45 | 3.3% | 10.5% | 10.5% | -1.2% |
| Brazil Ibovespa | 106,291.20 | 4.3% | -10.7% | -5.9% | -4.2% |
| Mexican Bolsa IPC | 51,238.02 | 3.1% | 16.3% | 19.9% | 22.1% |
| **Gov't bonds (bps change)** | **Yield** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. 10-Yr Treasury | 1.497% | 5.3 | 58.4 | 56.1 | -32.2 |
| Canada 10-Yr | 1.512% | -5.6 | 83.5 | 76.0 | -7.5 |
| UK 10-Yr | 0.755% | -5.4 | 55.8 | 49.4 | -0.8 |
| Germany 10-Yr | -0.353% | -0.4 | 21.6 | 25.2 | -4.6 |
| **Fixed income (returns)** | **Yield** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Aggregate | 1.77% | -0.5% | -1.8% | -1.2% | 5.7% |
| U.S. Investment-Grade Corp | 2.36% | -0.4% | -1.4% | -0.3% | 8.7% |
| U.S. High-Yield Corp | 4.40% | 1.2% | 4.6% | 5.5% | 13.7% |
| **Commodities (USD)** | **Price** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| Gold (spot $/oz) | 1,775.37 | 0.0% | -6.5% | -3.5% | 21.5% |
| Silver (spot $/oz) | 21.96 | -3.8% | -16.8% | -8.3% | 32.2% |
| Copper ($/metric ton) | 9,654.75 | 1.5% | 24.6% | 25.3% | 59.7% |
| Oil (WTI spot/bbl) | 70.94 | 7.2% | 46.2% | 55.8% | 20.2% |
| Oil (Brent spot/bbl) | 73.90 | 4.7% | 42.7% | 51.2% | 15.0% |
| Natural Gas ($/mmBtu) | 3.78 | -17.2% | 48.9% | 54.8% | 69.4% |
| **Currencies** | **Rate** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Dollar Index | 96.2440 | 0.3% | 7.0% | 5.7% | -1.4% |
| CAD/USD | 0.7869 | 0.6% | 0.2% | 0.9% | 4.2% |
| USD/CAD | 1.2707 | -0.6% | -0.1% | -0.9% | -4.0% |
| EUR/USD | 1.1291 | -0.4% | -7.6% | -6.5% | 2.1% |
| GBP/USD | 1.3220 | -0.6% | -3.3% | -1.3% | 0.6% |
| AUD/USD | 0.7148 | 0.3% | -7.1% | -4.0% | 4.8% |
| USD/JPY | 113.4800 | 0.3% | 9.9% | 8.9% | 4.5% |
| EUR/JPY | 128.1300 | -0.1% | 1.5% | 1.7% | 6.7% |
| EUR/GBP | 0.8541 | 0.2% | -4.4% | -5.3% | 1.5% |
| EUR/CHF | 1.0437 | 0.2% | -3.5% | -2.9% | -4.5% |
| USD/SGD | 1.3651 | 0.0% | 3.3% | 2.0% | 0.4% |
| USD/CNY | 6.3776 | 0.2% | -2.3% | -2.5% | -9.4% |
| USD/MXN | 20.9513 | -2.3% | 5.2% | 5.4% | 8.9% |
| USD/BRL | 5.5802 | -0.8% | 7.3% | 8.0% | 34.8% |

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 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 0.2% return means the Canadian dollar rose 0.2% vs. the U.S. dollar year to date. USD/JPY 113.48 means 1 U.S. dollar will buy 113.48 yen. USD/JPY 9.9% return means the U.S. dollar rose 9.9% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 12/9/21

## Authors

**Atul Bhatia, CFA – Minneapolis, United States**
atul.bhatia@rbc.com; RBC Capital Markets, LLC

**Michael Roedl – Minneapolis, United States**
michael.roedl@rbc.com; RBC Capital Markets, LLC

**Luis Castillo – Toronto, Canada**
luis.castillo@rbccm.com; RBC Dominion Securities Inc.

**Simon Jones – Toronto, Canada**
simon.jones@rbccm.com; RBC Dominion Securities Inc.

**Frédérique Carrier – London, United Kingdom**
frederique.carrier@rbc.com; RBC Europe Limited

**Thomas McGarrity, CFA – London, United Kingdom**
thomas.mcgarrity@rbc.com; RBC Europe Limited

**Nicholas Gwee, CFA – Singapore**
nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

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| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| 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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