GLOBAL Insight

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

February 2022

The bull market's rocky road

As the U.S. equity market faces headwinds including inflation and expected rate hikes, we look at the implications for portfolios.

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GLOBAL
Insight

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Central banks will be spending the next few months determining their next steps on the policy front. Despite the many questions they face, we think global monetary policy will remain accommodative through at least 2022.

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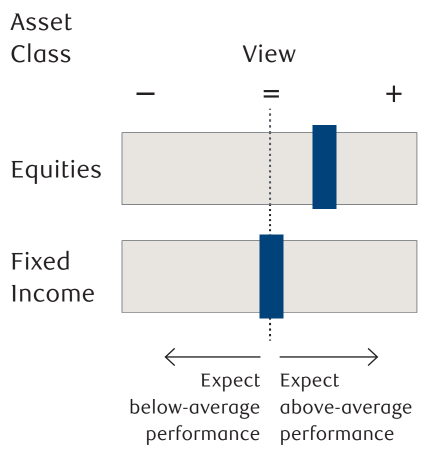
All values in U.S. dollars and priced as of market close, January 31, 2022, unless otherwise stated.

Wealth Management

RBC'S INVESTMENT Stance

Global asset class views



(+/=/–) represents the Global Portfolio Advisory Committee's (GPAC) view over a 12-month investment time horizon.

+ Overweight implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

= Market Weight implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

– Underweight implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

Source - RBC Wealth Management

EQUITIES

- The global equity market began the year with a swift selloff, with the U.S. leading to the downside, as concerns about central bank tightening plans, persistently high inflation readings, the impact of the omicron variant, and geopolitical threats, all converged. Despite these headwinds, we think the economic expansion is intact. Neither our leading economic indicators nor credit markets are signaling that U.S. recession risks have risen, and 2022 S&P 500 consensus earnings estimates have not been impaired.
- This is the stage of the economic cycle when challenges usually arise, as economic and earnings growth transition from the ultra-strong initial expansion phase to something more normal. When the U.S. economy is devoid of major recession risks, global equity bull markets typically endure, although they often include bumpy periods and normal corrections. We expect equity markets to ultimately regain their composure, opening the way to additional new highs. We remain moderately Overweight global equities.

FIXED INCOME

- Central bank rate hike fears have thrown fixed income markets for a loop, as markets now see many major global central banks needing to raise policy rates sooner and farther than previously expected, largely due to inflationary pressures that are proving more persistent than anticipated. The net result has been a sharp rise in yields across the curve, but most notably in short-dated maturities; this is driving yield curves sharply flatter, a sign that overly aggressive action by central banks could risk choking off growth and inflation expectations—and perhaps the economic recovery.
- We continue to favor shorter maturities in government debt, as we think markets still need to reprice around a more-aggressive Fed, but we maintain targets of 2% for the 10-year Treasury and 2.5% for the 30-year as levels where we would consider favoring longer maturities. In credit markets, valuations remain historically rich, but with few credit risks on the horizon, we still expect credit to outperform government debt in 2022 absent a policy misstep from central banks.
- We maintain our Market Weight in global fixed income with a Neutral allocation to corporate credit, but favor adding income via preferred shares and leveraged loans.

MONTHLY
Focus

The bull market's rocky road

What to make of the recent volatility in equity markets? As markets face headwinds including high inflation and the anticipation of interest rate hikes, we look at the sources of angst—and implications for portfolio positioning.

Kelly Bogdanova
San Francisco, United States
kelly.bogdanova@rbc.com

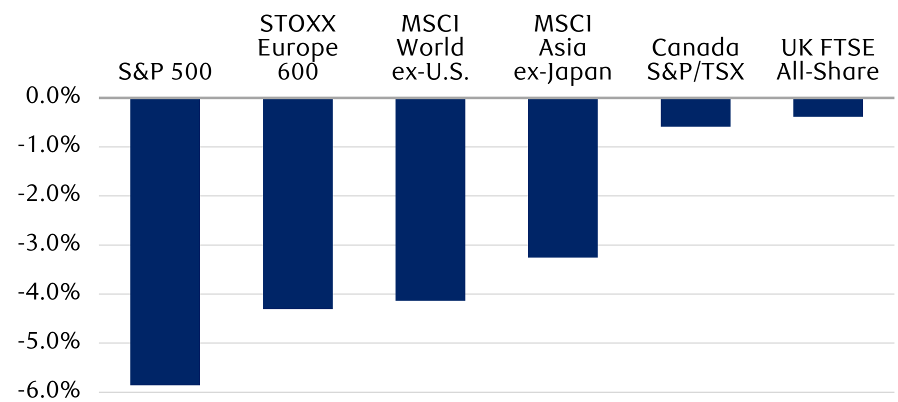
Jim Allworth
Vancouver, Canada
jim.allworth@rbc.com

The global equity market's mood shifted dramatically in the early weeks of 2022, as the S&P 500 and most other major indexes pulled back enough to break some well-established uptrends.

Many factors have been credited with causing the selloff: high and persistent inflation; the potential for more aggressive tightening by the U.S. Federal Reserve; and the possibility that both of these factors could have knock-on effects on economic and corporate earnings growth—not to mention the COVID-19 pandemic that has yet to be tamed, and escalating geopolitical tensions. After ignoring these issues through the end of 2021, investors finally took notice, ushering in a multi-week selloff.

Markets have pulled back, with the U.S. leading to the downside

Performance of select equity indexes since the peak in the U.S. market (Jan. 3 – Jan. 31, 2022)



Source - RBC Wealth Management, Bloomberg

Despite the headwinds—which we evaluate below—we think the economic expansion is intact. In our view, the market can work through this period and eventually resume its uptrend, albeit following a more modestly sloped, bumpier path than investors had become accustomed to in 2021. Neither our leading economic indicators nor credit markets are signaling that U.S. recession risks have risen; in many important areas, the landscape is largely unchanged.

This pullback, however, is a reminder that corrections and volatility are normal occurrences in bull markets.

MONTHLY FOCUS

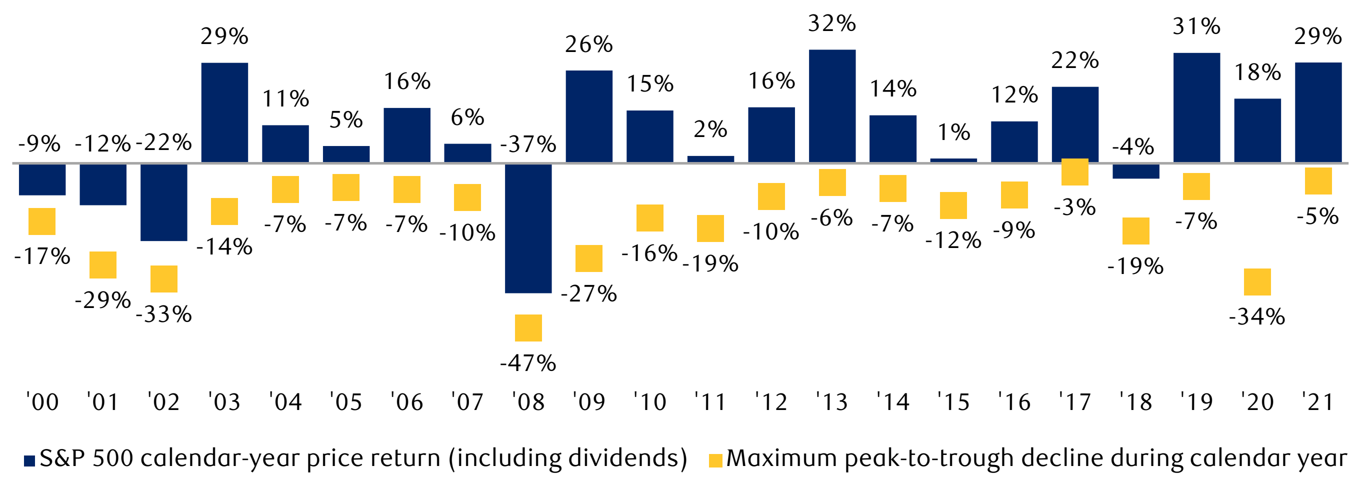
The bull market's rocky road

As the chart illustrates, the S&P 500 has pulled back 10 percent or more at some point during the year in over half of the years since 2000. It's important to recognize that pullbacks and corrections are not uncommon even in good years: among the 13 years with above-average annual returns, 10 included periods where the market pulled back seven percent or more.

Every market disruption has different catalysts and unique contours. In our view, the outlook for inflation and Fed policy, together with the knock-on effects these could have on economic expansion and corporate earnings growth, are the primary considerations that should factor into equity portfolio positioning.

Reality check: Pullbacks happen even in good years

S&P 500 total returns and pullbacks each year since 2000



Source - RBC Wealth Management, Bloomberg; data through 12/31/21

The challenge of taming inflation

Our economists' near-term inflation outlook is for more of the same: uncomfortably high inflation rates for several months. They anticipate the situation will improve in the second half of the year. The rate of goods inflation seems set to recede as supply chains gradually get back in gear and COVID-19-related anomalies fade further.

Some improvement is baked into Wall Street's expectations, if only because the surging inflation in the second half of 2021 will make for easy comparisons with the same period this year.

Sticker shock

But even if U.S. inflation were to fall back from its current rate of 7.0 percent to an average of 4.0 percent in Q3 and 2.7 percent in Q4—a plausible scenario, according to RBC Capital Markets—it would still be advancing at an above-normal clip.

Consumer prices are already 8.3 percent in aggregate above where they were before the pandemic began in January 2020—this is what households and businesses experience; their reference point is not the year-over-year rate.

MONTHLY FOCUS

The bull market's rocky road

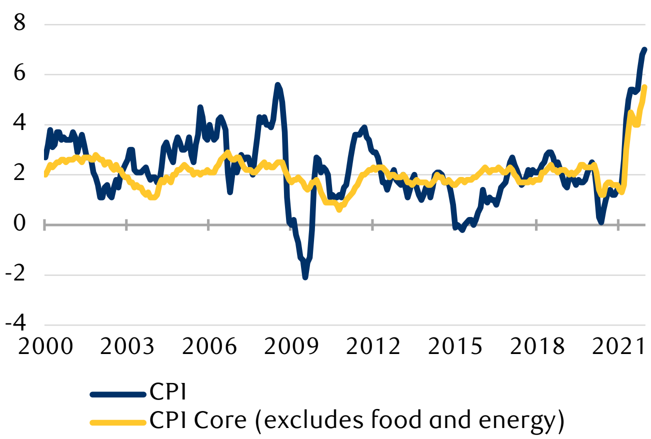
We think it will take some time for households and businesses to absorb the current inflation shock, not just in the U.S. but elsewhere, even if the year-over-year growth rate of inflation diminishes in the second half of 2022 and subsides further in 2023 as we expect. Some of the global inflation angst may be expressed at the ballot box, as 2022 will see U.S. midterm congressional elections in November, UK local elections (which are regarded as indications of approval or disapproval of parliamentary stewardship) in May, and the French presidential election in April.

No quick fix

Looking further out, our economists acknowledge inflation could remain above the Fed's two percent target level for some time, possibly for a couple of years. Even after inflation rates start to recede, it could take a number of quarters for financial markets to become confident that elevated inflation is not going to be a long-term challenge. As this gets sorted out, more stock market volatility can't be ruled out.

Highest inflation reading since 1982

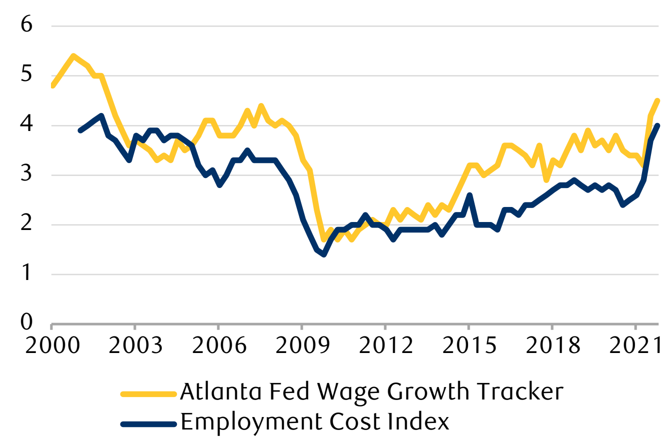
U.S. Consumer Price Indexes (CPI) (year-over-year percentage change)



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

U.S. wage inflation has perked up

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



Source - RBC Wealth Management, Bloomberg; data through 12/31/21

Will corporate earnings prove resilient?

S&P 500 companies are not yet seeing inflation eat into their overall index profit margins, nor has it dented 2022 earnings estimates—key considerations for the market.

However, the early innings of the Q4 2021 earnings season have revealed inflation is weighing more heavily on some individual companies' profit margins. More management teams (particularly those of large banks and investment firms) have stated that higher compensation and other costs could constrain margins in coming quarters. Wage pressures are not just impacting large firms; higher compensation costs are the single most important challenge cited in a recent survey by the National Federation of Independent Businesses, the largest small-business advocacy group in the U.S.

MONTHLY FOCUS

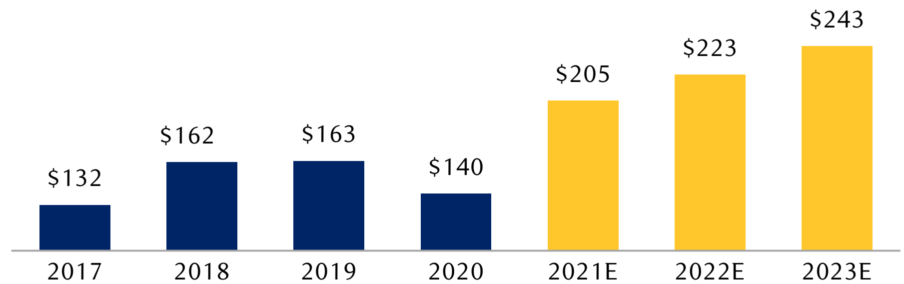
The bull market's rocky road

Even consumer staples companies, which usually are able to pass higher input costs on to consumers through price increases, have noted that it is becoming more difficult to manage expenses.

Thus far, all of this hasn't signaled trouble for 2022 earnings; the S&P 500 consensus forecast of $224 per share is slightly higher than it was a month ago and RBC Capital Markets maintains its $223 per share forecast.

Earnings projected to grow moderately in 2022 and 2023

S&P 500 annual earnings per share and RBC Capital Markets forecasts*



*Actual results in dark blue; RBC Capital Markets 2021–2023 forecasts in yellow
Source - RBC Wealth Management, RBC Capital Markets estimates, Bloomberg,

The Fed shakes things up

Since the Fed acknowledged the need to fight inflation more aggressively, rate hike expectations have shifted significantly, and this has shaken equity markets.

In the middle of last year, Fed indications led the market to expect the first interest rate increase wouldn't arrive before late 2022 or early 2023. Fast-forward through a series of shifts in Fed communications, and today we find the market pricing in five hikes this year and one next year, with the first now expected in March. As a result, from the beginning of last December through the end of January, the 10-year Treasury yield jumped from 1.40 percent to 1.78 percent.

In search of a soft landing

As we've pointed out previously, the Fed doesn't tighten monetary policy with the intent of pushing the economy into recession. It always attempts to engineer a "soft landing" wherein the economy slows enough to reduce inflationary pressures or other excesses but avoids an outright downturn. Historically, the results have been mixed: of the 17 Fed tightening cycles since 1953, eight ended in recession, while nine produced no recession.

We can't remember a rate hike cycle where equity market participants didn't worry and debate whether the Fed would be able to engineer a soft landing—this is par for the course. And these concerns typically flare around the beginning of every Fed tightening cycle, despite the fact that the U.S. equity market has historically performed very well in the 12 months preceding the first rate hike and has typically gone on to deliver positive gains in the 12 months following that initial increase.

Could the Fed spoil the party this time around? Yes, eventually. But before that could happen, monetary conditions would have to become much tighter; we think that would be a considerable distance down the road, and involve many more rate hikes than the Fed currently has planned for this year and next.

Tightening tensions

Financial markets will also have to contend with the Fed reducing the size of its balance sheet as a proportion of GDP—a process known as quantitative tightening or QT. Our Fixed Income Strategies team points out that the Fed's balance sheet has ballooned to almost $9 trillion, a record 38 percent of GDP, since the Fed started pumping liquidity into the financial system during the height of the COVID-19 pandemic. The previous peak of 26 percent was reached in 2013, in the aftermath of the global financial crisis.

When the Fed moved to reduce its bloated balance sheet in the post-financial-crisis decade, both bonds and equities corrected. While our fixed income colleagues see the potential for similar, temporary volatility spikes as the Fed winds down the balance sheet this time around, they do not see a high risk of permanent impairment to asset prices. They point out that the Fed possesses several tools to keep the challenges associated with QT at bay, but market volatility is likely to emerge nonetheless.

A bull market in transition

Equity markets are grappling with these uncomfortable headwinds. This is the stage of the economic cycle when challenges typically arise, as economic and earnings growth transition from the ultra-strong initial expansion phase to something more normal.

When the U.S. economy is devoid of major recession risks, global equity bull markets typically endure, although they often include bumpy periods and normal corrections. It is when recession risks increase meaningfully that bull markets tend to run into real trouble. Currently, none of our seven leading economic indicators of U.S. recession are flashing red, or even yellow; their behavior suggests this economic expansion has farther to run. That should mean corporate earnings and business values will be able to move higher from here.

While the risks currently facing equity markets have the potential to generate further volatility or downside, we don't think the economic backdrop has deteriorated in such a way that investors should reposition broad asset class exposure in portfolios. We remain moderately Overweight global equities, with the view that major developed equity markets have the potential to deliver worthwhile gains for the year ahead and probably beyond.

GLOBAL

Equity

Jim Allworth
Vancouver, Canada
jim.allworth@rbc.com

Farther to run

Global equity markets have been trending lower for several weeks as worries over central bank tightening plans, the impact of the omicron variant, persistently uncomfortable inflation readings, and geopolitical threats have all converged at the start of the new year.

So far, none of these look capable of delivering a fatal blow to the global economic recovery. The leading indicators of a U.S. recession tracked by RBC Wealth Management (updated in January) are unanimously pointing toward a U.S. economic expansion that has farther to run—perhaps much farther. None are signaling that a downturn in the world's largest economy is approaching.

A growing economy is typically accompanied by rising corporate earnings and advancing business values. That said, the upward trajectories of growth, earnings, and valuations are likely to be shallower in slope and bumpier than during last year's turbocharged run to higher ground. Volatility, already on the scene, could be a feature for some time yet. But we expect equity markets to regain their composure in the second half of the year, opening the way to additional new highs by year's end.

For a fuller discussion of the factors influencing equity markets, see "The bull market's rocky road" on page 4.

Equity views

Region	Current
Global	+
United States	+
Canada	=
Continental Europe	+
United Kingdom	=
Asia (ex Japan)	=
Japan	=

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

GLOBAL
Fixed income

Thomas Garretson, CFA
Minneapolis, United States
tom.garretson@rbc.com

The stage is set

The Federal Reserve has signaled that it may "soon be appropriate" to begin raising its overnight policy rate, which for all intents and purposes is likely when the Fed next meets March 15–16. While we believe a rate increase is all but certain, there is still some lingering uncertainty on the rate hike front: might the Fed choose to start strong? Fed Chair Jerome Powell appeared to leave open the possibility the Fed may need to act more aggressively in the face of persistent inflation, causing markets to not only price a 100% probability of one 25 basis point rate hike in March, but also a 33% chance policymakers could actually raise rates by 50 basis points, something not seen since the Fed's May 2000 meeting.

The Bank of Canada flirted with the idea of raising its policy rate at its January meeting, but ultimately took a pass with the next meeting coming in early March, where the first rate hike is now widely expected. RBC Capital Markets expects a March rate hike followed by two more this year, with the policy rate ending 2022 at 1.00%.

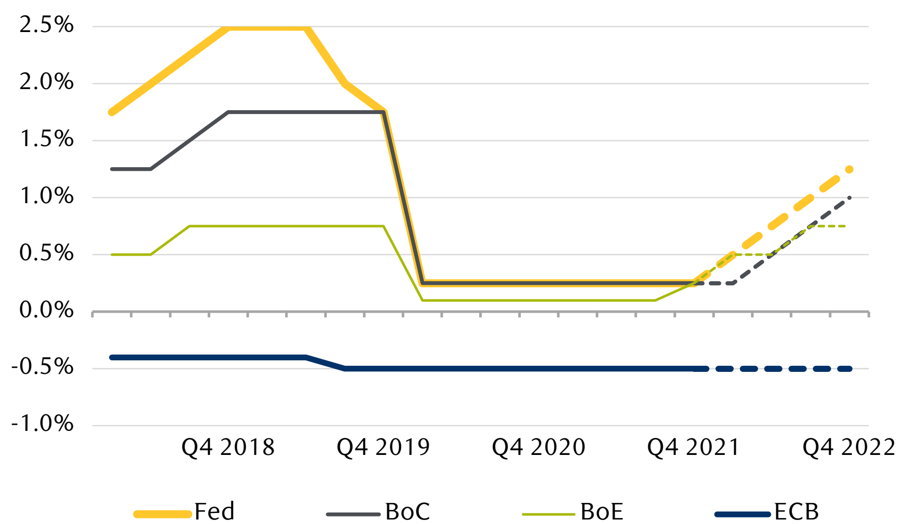
Fixed income views

Region	Gov't bonds	Corp. credit	Duration
Global	=	=	5–7 yr
United States	–	=	5–7 yr
Canada	=	=	5–7 yr
Continental Europe	=	=	5–7 yr
United Kingdom	=	=	5–7 yr

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

Taking center stage has been the Bank of England (BoE), first out of the gate with a rate hike in December. Policymakers are again expected to raise rates at the BoE's early February meeting, bringing the policy rate to 0.50%, according to RBC Capital Markets' expectations, which is also a key level as BoE officials have stated that it's the level at which it "intends to begin to reduce the stock of purchased assets, by ceasing to reinvest maturing assets." As it stands, we expect the BoE to then

RBC Capital Markets' central bank policy rate forecasts



Source - RBC Wealth Management, Bloomberg, RBC Capital Markets forecasts; data as of 1/27/22

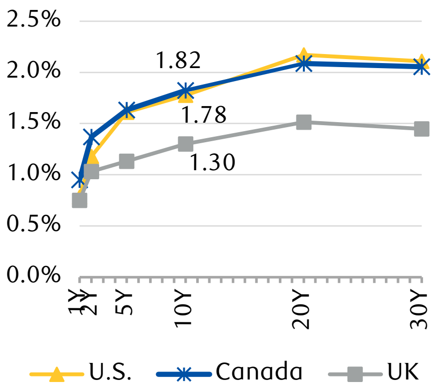
GLOBAL FIXED INCOME

pause, with the next rate hike not expected until Q3 2022.

However, we believe the European Central Bank is likely to remain offstage for the duration of 2022, with any potential for rate hikes still a 2023 event.

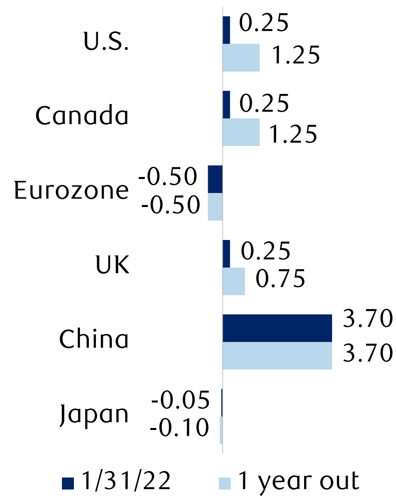
There has clearly been a policy "sea change" among many major central banks of late as the significant fiscal support during the pandemic now needs to be met to some extent with a proper, and offsetting, monetary policy response. But, in our view, it remains the case that the stance of global monetary policy will remain accommodative through at least 2022, even if there is heightened volatility along the way.

Sovereign yield curves



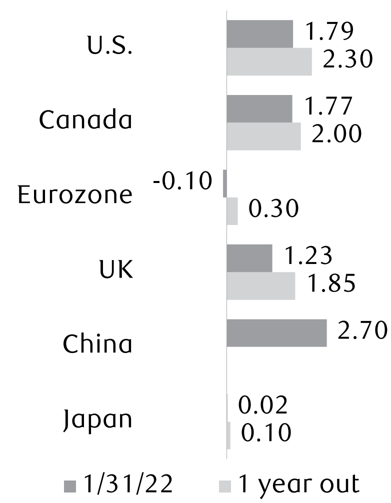
Source - Bloomberg; data through 1/31/22

Central bank rate (%)



Source - RBC Investment Strategy Committee, RBC Capital Markets forecasts, Global Portfolio Advisory Committee, RBC Global Asset Management

10-year rate (%)



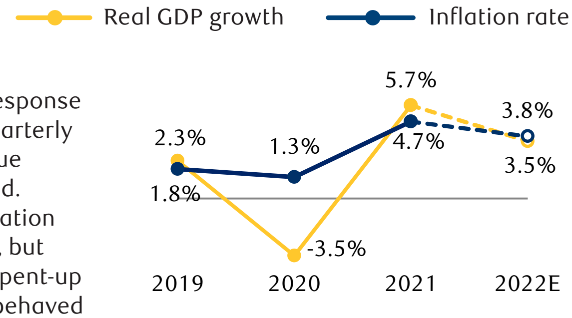
Note: Eurozone utilizes German Bunds.
Source - RBC Investment Strategy Committee, Global Portfolio Advisory Committee, RBC Global Asset Management

KEY

Forecasts

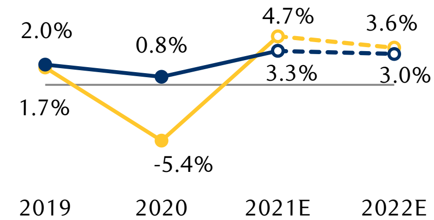
United States: Inflation headlines

Q4 spending sagged in the final weeks in response to the omicron case surge. The outsized quarterly GDP gain, at a 6.2% annualized rate, was due to a big inventory build as final sales slowed. Reversing that may weaken Q1. Surging inflation numbers have a few more months to come, but goods inflation should begin to subside as pent-up demand looks mostly filled. Expect better-behaved inflation data in H2 and in 2023. First Fed hike expected in March, two or three more this year.



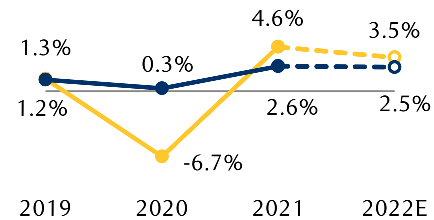
Canada: Omicron shutdowns

Q3 GDP improved after an early-quarter delta-related slump. The improvement continued into Q4, but December and January likely hit by omicron shutdowns. Employment was very strong in November and December. Total employment now comfortably above its pre-pandemic level, and the unemployment rate is only fractionally above a multi-decade low. Bank of Canada looks to be heading toward a first rate hike in March.



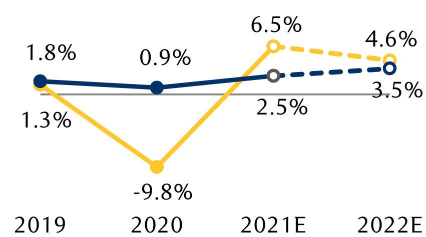
Eurozone: Services weak

After the Q3 GDP surge, renewed restrictions and "lockdown for the unvaccinated" starting in December produced weak German results, somewhat offset by stronger-than-expected growth in France and Spain. France delivered its best annual growth in more than 50 years with full-year GDP up 7%. Supply chain/shipping disruptions look to have eased modestly. The ECB will end its bond purchase program in March but no rate increases are forecast for the coming year.



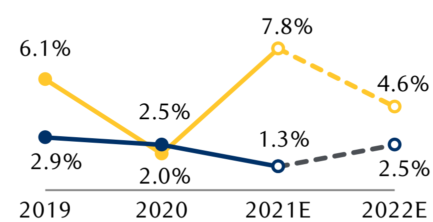
UK: BoE tightening cycle underway

The services sector weakened noticeably in December mostly in response to omicron. Tourism not yet in recovery. Retail sales and consumer confidence weak as is business confidence. Construction soft. Delivery times improved as supply chain/shipping disruptions eased somewhat. Exports improving. Inflation, at 5.4%, has the Bank of England poised for a second rate hike this month with another forecast in August.



China: A slow H1 unfolding

GDP growth slowed in response to COVID-19 variant outbreaks, power shortages, and regulatory tightening. Industrial production remains subdued. The manufacturing PMI remains vulnerable. New orders sluggish, retail sales soft. Credit woes in the large property development sector have been brought about by government tightening policies, which have eased somewhat but not yet decisively. Slow growth likely to persist through H1.



Japan: Exports strong, consumer weak

Industrial production has revived as exports have improved steadily from summer lows. Supply chain/shipping disruptions easing somewhat. Capex remains weak. Household sector weak as omicron case numbers have surged to pandemic high. An improved vaccine programme holds some hope for a consumer spending revival in 2022. Inflation moribund. The BoJ is expected to stay on hold.

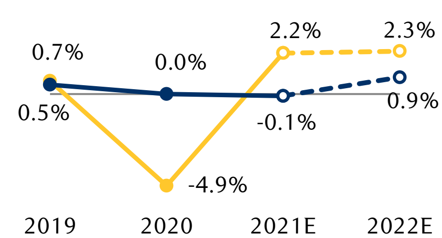


Chart source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management, Bloomberg consensus estimates

MARKET Scorecard

Data as of January 31, 2022

Equities

Global markets sold off in January, driven in part by inflation fears, rising interest rates, and continued COVID-19 concerns.

Bond yields

Not only did global equity markets sell off, sovereign bond markets felt the sting of inflation and rising yields.

Commodities

Oil and natural gas posted strong gains, while gold, silver, and copper sold off amid economic uncertainty.

Currencies

The U.S. dollar firmed against the world's major currencies including the euro, Canadian dollar, and Japanese yen.

Index (local currency)	Level	1 month	YTD	12 months
S&P 500	4,515.55	-5.3%	-5.3%	21.6%
Dow Industrials (DJIA)	35,131.86	-3.3%	-3.3%	17.2%
Nasdaq	14,239.88	-9.0%	-9.0%	8.9%
Russell 2000	2,028.45	-9.7%	-9.7%	-2.2%
S&P/TSX Comp	21,098.29	-0.6%	-0.6%	21.7%
FTSE All-Share	4,191.81	-0.4%	-0.4%	15.1%
STOXX Europe 600	468.88	-3.9%	-3.9%	18.4%
EURO STOXX 50	4,174.60	-2.9%	-2.9%	19.9%
Hang Seng	23,802.26	1.7%	1.7%	-15.8%
Shanghai Comp	3,361.44	-7.6%	-7.6%	-3.5%
Nikkei 225	27,001.98	-6.2%	-6.2%	-2.4%
India Sensex	58,014.17	-0.4%	-0.4%	25.3%
Singapore Straits Times	3,249.59	4.0%	4.0%	12.0%
Brazil Ibovespa	112,143.50	7.0%	7.0%	-2.5%
Mexican Bolsa IPC	51,330.86	-3.6%	-3.6%	19.4%
Bond yields	**1/31/22**	**12/31/21**	**1/29/21**	**12 mo. chg**
U.S. 2-Yr Tsy	1.179%	0.732%	0.109%	1.07%
U.S. 10-Yr Tsy	1.777%	1.510%	1.066%	0.71%
Canada 2-Yr	1.275%	0.951%	0.155%	1.12%
Canada 10-Yr	1.771%	1.426%	0.889%	0.88%
UK 2-Yr	1.045%	0.687%	-0.106%	1.15%
UK 10-Yr	1.302%	0.971%	0.327%	0.98%
Germany 2-Yr	-0.528%	-0.601%	-0.733%	0.21%
Germany 10-Yr	0.011%	-0.185%	-0.518%	0.53%
Commodities (USD)	**Price**	**1 month**	**YTD**	**12 months**
Gold (spot $/oz)	1,797.17	-1.8%	-1.8%	-2.7%
Silver (spot $/oz)	22.47	-3.6%	-3.6%	-16.8%
Copper ($/metric ton)	9,578.00	-1.7%	-1.7%	21.8%
Oil (WTI spot/bbl)	88.15	14.5%	14.5%	68.9%
Oil (Brent spot/bbl)	91.21	17.3%	17.3%	63.2%
Natural Gas ($/mmBtu)	4.87	30.7%	30.7%	90.1%
Agriculture Index	464.78	4.4%	4.4%	19.0%
Currencies	**Rate**	**1 month**	**YTD**	**12 months**
U.S. Dollar Index	96.5400	0.9%	0.9%	6.6%
CAD/USD	0.7869	-0.5%	-0.5%	0.5%
USD/CAD	1.2708	0.6%	0.6%	-0.5%
EUR/USD	1.1235	-1.2%	-1.2%	-7.4%
GBP/USD	1.3447	-0.6%	-0.6%	-1.9%
AUD/USD	0.7067	-2.7%	-2.7%	-7.5%
USD/JPY	115.1100	0.0%	0.0%	10.0%
EUR/JPY	129.3300	-1.2%	-1.2%	1.7%
EUR/GBP	0.8353	-0.7%	-0.7%	-5.7%
EUR/CHF	1.0413	0.4%	0.4%	-3.7%
USD/SGD	1.3513	0.2%	0.2%	1.7%
USD/CNY	6.3612	0.1%	0.1%	-1.1%
USD/MXN	20.6355	0.5%	0.5%	0.3%
USD/BRL	5.3102	-4.8%	-4.8%	-3.0%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Equity performance and bond yields in local currencies. U.S. 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 0.5% return means the Canadian dollar has risen 0.5% vs. the U.S. dollar during the past 12 months. USD/JPY 115.11 means 1 U.S. dollar will buy 115.11 yen. USD/JPY 10.0% return means the U.S. dollar has risen 10.0% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg

Research resources

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Ryan Harder, CFA – Fixed Income Portfolio Advisor, Portfolio Advisory Group, RBC Dominion Securities Inc.

Patrick McAllister, CFA – Manager, Equity Advisory & Portfolio Management, Portfolio Advisory Group, RBC Dominion Securities Inc.

Alan Robinson – Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group – U.S. Equities, RBC Capital Markets, LLC

Michael Schuette, CFA – Multi-Asset Portfolio Strategist, RBC Wealth Management Portfolio Advisory Group – U.S., RBC Capital Markets, LLC

David Storm, CFA, CAIA – Chief Investment Officer, BI & Asia, RBC Europe Limited

Tat Wai Toh – Head of Portfolio Management, BI & Asia, Royal Bank of Canada, Singapore Branch

Joseph Wu, CFA – Portfolio Manager, Multi-Asset Strategy, RBC Dominion Securities Inc.

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