GLOBAL
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WEEKLY

Wealth Management
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Perspectives from the Global Portfolio Advisory Committee
January 13, 2022

Markets play catch-up to the Fed

Thomas Garretson, CFA – Minneapolis

Not only has it been a rather volatile start to the year for markets, but it has been a somewhat confounding one as well. Despite fears of a more aggressive Fed in the face of persistent inflation, it could actually mean better economic outcomes over the long run.

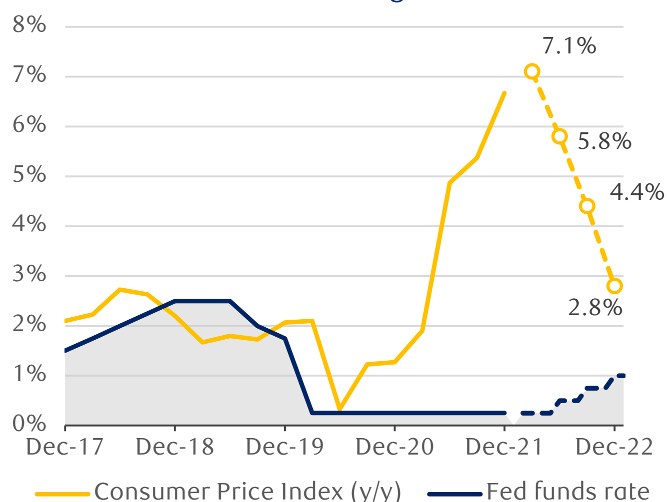
The big news of the week was, of course, inflation hitting seven percent on a year-over-year basis, according to the Consumer Price Index (CPI), the highest reading since 1982, and a level only seen as putting even more pressure on the Fed to act sooner rather than later.

And so naturally on a data point like that, stocks showed only a muted reaction, and Treasury yields dipped lower, while the dollar continues to weaken. In situations such as this, it's pretty standard fare to simply chalk it up to markets having already priced in certain data and expectations, and then move on.

But in some ways that's likely true in this case. Though current inflationary pressures continue unabated, the market's expectations for inflation in the coming years have actually moderated of late. After peaking at 3.2 percent last year, markets are now looking for inflation to average closer to 2.8 percent over the next five years.

And we can chalk that up to the Fed as policymakers continued to pledge allegiance to lower inflation this week.

Will modest rate hikes be enough to tame inflation?



Dashed lines indicate RBC Economics forecasts as of December 2021

Source - RBC Wealth Management, Bloomberg, RBC Economics

Fed up

As the chart shows, economists expect that the worst of the inflationary pressures are at least nearing an endpoint. Though inflation will likely continue to run north of seven percent on a year-over-year basis for the next couple of months, RBC Economics sees that pace slowing to 2.8 percent by the end of the year.

2022: A year of shifting gears

Click here to listen to a discussion of why the economy is positioned for above-trend growth and why equities should post positive returns, albeit with more volatility.

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Part of that comes from expectations around more aggressive Fed action this year to tame inflation. Markets are now fully priced for three rate hikes by December, beginning at the Fed's March policy meeting, with a 50 percent chance the Fed ends up delivering four, based on current market pricing. St. Louis Fed President James Bullard, who votes on policy this year and had forecast three rate hikes at the December meeting, already now sees a case for four, stating that: "If we get a couple of rate-hike moves under our belt during the first part of this year then we'll be in better shape."

Admittedly, three rate hikes this year to a policy rate range of 0.75 percent to 1.00 percent looks rather quaint against headline inflation running north of seven percent as evidenced by the chart on the previous page. But we believe that should be sufficient to at least start reining in the demand side of the demand-supply imbalance that continues to be the primary force behind inflation.

Fed Chair Jerome Powell stated this week that: "In a way, high inflation is a severe threat to the achievement of maximum employment. We think wages moving up is generally a good thing, but if you look back through history, there are times when wages have moved up in a way that has fostered persistent inflation, and that hurts everyone."

And perhaps that perfectly sums up and explains the market action to start the year: we envision a scenario where the Fed raises rates, but only to a certain point, before pausing as inflation cools, allowing for continued expansion and a full recovery of the labor market, particularly on the labor force participation front. If the Fed can achieve that, it's a net-positive for markets and the economy, and why markets may now be looking through current inflation numbers.

So goes January, so goes the year?

Given the sharp repricing of Fed rate hike expectations of late, the bond market is now off to one of its worst starts to a year since 2009, with the benchmark Bloomberg U.S. Aggregate Bond Index down 1.5 percent through Jan. 12. And this follows 2021, which was already a rare down year for U.S. bond markets. As the chart shows, there have only been four such instances of negative calendar-year returns, and never has the market delivered investors back-to-back declines since the inception of this index.

Will that streak come to an end in 2022? It's certainly possible given that yields remain historically low, but after the jump in yields so far this year, we think further gains will be more moderate, and that bond market returns in 2022 will likely be flat.

For context, bond prices decline as yields rise, so for investors the question becomes whether the price decline is greater than the coupon earned in any given year. So, with all of the concern around rising rates and higher Treasury yields, what might returns actually look like?

The benchmark 10-year Treasury currently yields approximately 1.73 percent. If purchased today, the yield would have to rise to 1.94 percent for the price decline to wipe out the coupon earned for the year; should the yield rise to 2.20 percent by the end of 2022, as RBC Capital Markets currently forecasts, the total return would be negative 2.2 percent. But what if yields were to decline? A slip back to just 1.50 percent would actually generate a solid 3.60 percent return for the year.

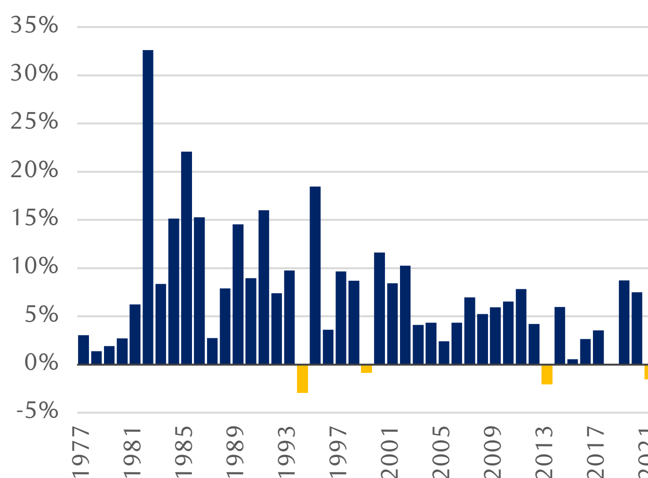
The outlook for shorter-dated Treasuries looks slightly better, in our view. Should the 2-year yield rise to 1.35 percent from 0.90 percent currently, as RBC Capital Markets expects, returns would still be positive at 0.44 percent.

But for buy-and-hold investors, all of this may be a moot point, given that returns in any given year are largely inconsequential. But for those reasons, we maintain a slightly negative outlook for Treasuries, and a positive outlook for corporate bonds and preferred shares. However, and importantly, we do expect that over the course of 2022 that bias could shift back in favor of Treasuries should the benchmark 10-year Treasury yield move north of 2.0 percent.

As always, though the return outlook for bonds may be bleak based on current forecasts, they will continue to add ballast and stability for portfolios should volatility persist in 2022.

What's in store for bond markets after a rare down year in 2021?

Bloomberg U.S. Aggregate Bond Index annual total returns since inception



Source - RBC Wealth Management, Bloomberg

UNITED STATES

Atul Bhatia, CFA – Minneapolis

■ **The dollar declined this week, with the trade-weighted U.S. Dollar Index down nearly 1% YTD.** The move comes despite the dollar's increasing yield advantage relative to major currencies; as of Jan. 12, the 2-year Treasury was returning 1.18% more than comparable euro currency swap rates, a 0.15% increase since the start of the year. One possible reason for the drop in the greenback—which tends to outperform in periods of equity weakness and market stress—is growing investor confidence in the state of the global economy and the Fed's ability to contain inflation (see this week's focus article). **Oil and other commodities have benefited from the dual tailwinds of a weaker dollar and potentially stronger growth**, with the Bloomberg Commodity Index up nearly 5% YTD.

■ **Prospects for additional fiscal stimulus in 2022 are uncertain**, with key Senate Democrat Joe Manchin saying last week that negotiations on the Build Back Better Act had ended. Although the measure could be resurrected, the compressed legislative calendar before midterm congressional elections leaves little time for negotiation and passage of the bill. If the legislation is not passed, the Congressional Budget Office projects 2022's federal spending dropping $1.3 trillion compared to last year, which Moody's Analytics estimates would cut 0.75% off 2022 GDP growth. But **even with the fiscal headwind, Moody's sees 4% growth this year**, helped in part by stronger wages and increased consumer spending.

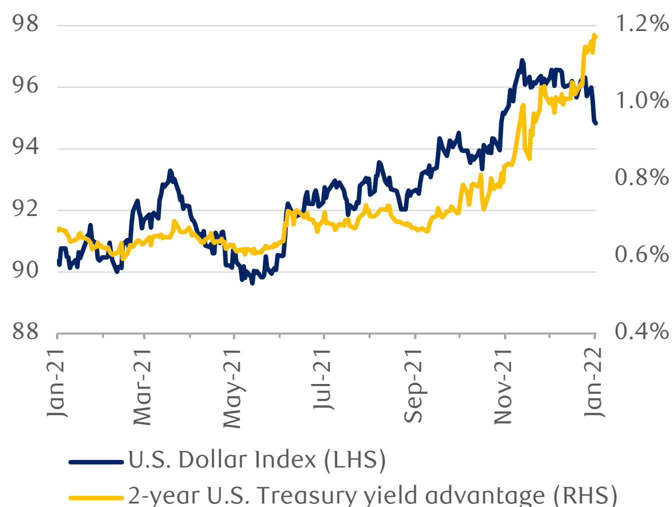
■ **Corporate bond investors appear to be growing more comfortable with tighter monetary and fiscal policy.** The premium required for investors to buy debt rated below investment grade instead of Treasury bonds had risen to 3.08% earlier this month, nearly 0.15% higher than at the end of 2021; that spread declined to just under 3% this week, as investors saw increased appetite for bonds across the rating spectrum. Even issuers rated CCC—the lowest rating level before default—were active, with **more than $1 billion of new CCC-rated bonds sold so far this week**.

CANADA

Sean Killin & Richard Tan, CFA – Toronto

■ **RBC Capital Markets hosted its annual Canadian Bank CEO Conference**, and senior banking leaders generally shared an optimistic tone with respect to the banking environment for the year ahead. Starting with inflation, costs are expected to rise but **risks overall should be manageable**. The banks also emphasized that they could slow down investments or defer expenses in the event that inflation comes in higher than expected.

Dollar Index drops despite growing yield advantage



Note: Yield advantage calculated as U.S. Treasury yield over euro swap rates for 2-year maturities

Source - RBC Wealth Management, Bloomberg

The group was also constructive on revenue growth on the back of a rising interest rate environment. Currently, the Canadian bond market is pricing in five to six rate hikes by the end of 2022. The outlook for loan growth was positive for most categories, although mortgage originations may slow, driven by a rich housing market and rising interest rates. In terms of credit, risks remain benign and the banks kept their outlooks unchanged despite the emergence of the omicron variant. **Overall, we believe it will be another good year for the Canadian banks and valuations remain fair**.

■ **The Canadian labour market had a strong recovery throughout 2021, with full-year job growth at 886,000**. The labour market remained firm ahead of the omicron wave, with the economy adding 55,000 jobs in December and the unemployment rate declining to 5.9%, which is just slightly above the pre-pandemic figure and around levels that are viewed as consistent with a healthy labour market. The rapidly spreading omicron variant has led some provinces, such as Ontario and Quebec, to implement public-health restrictions, including the closure of high-contact in-person services. These restrictions will likely have an impact on the unemployment rate in January. The Bank of Canada (BoC) has been closely monitoring the labour market, which will be factored into its monetary policy decisions. With omicron's impact on the labour market expected by policymakers to be temporary and inflation continuing to run above target, **we believe the BoC will stay the course with its monetary tightening path**, despite the possibility of a near-term rise in the unemployment rate.

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

- UK Prime Minister Boris Johnson is again embroiled in controversy as he and his aides broke strict lockdown rules last May by holding a large party in the garden of his official residence. After a number of recent controversies, his position looks increasingly vulnerable. According to RBC Capital Markets, **the likelihood that Johnson will still lead the Conservative Party at the 2024 elections has declined further to a mere 30%**.

- **So far this month, the pound has strengthened** as the risks to the economy from the omicron variant seem relatively contained. RBC Capital Markets points out that the currency's indifference to increasing political uncertainty is due to ambiguity about the implications of a Johnson departure.

- **Chancellor of the Exchequer Rishi Sunak is currently the favourite to replace Johnson if there is a leadership contest**. If he were to become prime minister, **fiscal policy would likely become more austere**, a move which on balance would be a negative development for the currency, in our view. Foreign Secretary Liz Truss, the other strong contender according to polls, doesn't have a clear fiscal agenda. Should the risk of Johnson's early departure continue to rise, there will be greater focus on what policies the various candidates may bring.

- **UK equities have gotten off to a good start in 2022, buoyed by the rotation towards cyclical value sectors**. The large-cap-focused FTSE 100 Index, of which over 30% is made up of miners, energy, and banks, is up almost 2.5% in local currency (GBP) and over 4% in U.S. dollar terms year to date. In terms of relative performance, UK equities are more highly correlated to value stocks outperforming growth stocks than are equities in any other major region, according to our national research source. Thus, **the UK tends to be one of the best-performing regions when the value style outperforms**.

- We continue to recommend investors hold a **Market Weight position in UK equities**. Within this, we would have a bias towards more internationally oriented companies, while taking a selective approach towards domestically focused stocks.

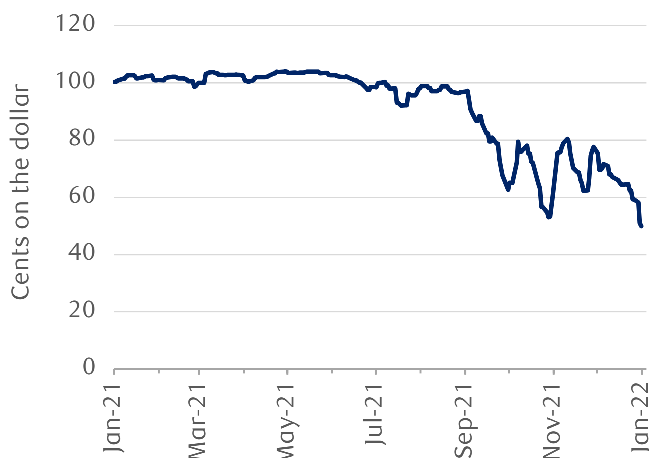
ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Sunac China (1918 HK), China's third-largest property developer by sales, sold 452 million shares** at HK$10 per share in a top-up placement, a 15% discount to Wednesday's closing price. Part of the proceeds will be used to repay short-term loans. **The placement roiled the sector** amid ongoing liquidity concerns with China's highly leveraged developers. Sunac's dollar bond due in 2024 fell to a record low on Thursday.

Sunac dollar bonds hit fresh lows after share sale

Price of Sunac China's 6.65% dollar bond due 2024



Source - RBC Wealth Management, Bloomberg; daily data, 1/13/21–1/12/22

- Since the material deterioration of the property sector in October 2021, three months have passed without much meaningful action from the government. **While we expect some additional easing measures, we think they might be more of a policy recalibration** rather than a major loosening.

- **We are cautious on the China property bond market**, particularly the high-yield market. Unless we see significant and accelerated easing, **volatility will likely remain very high** and we see little prospect for the sector to turn around in the near term. It is likely we will see more credit defaults or distressed bond exchanges materializing, especially in the first half of 2022.

- **China's total social financing growth in December picked up slightly** to 10.3% y/y from 10.1% y/y in November. The People's Bank of China's underlying data shows a moderate easing in medium- to long-term loans to the household sector amid a recent relaxation in mortgage policy. However, medium- to long-term loans to the corporate sector remained weak, which likely indicates that banks remain cautious in lending to property-related companies. We believe China's **overall macro policy stance will be neutral with an easing bias this year**, but we do not expect a shift towards policy stimulus.

- The world's largest foundry, **Taiwan Semiconductor Manufacturing Co. (2330 TT / TSM), reported better-than-expected earnings for Q4 2021**. The company announced net income was up 16% y/y to a record NT$166.2 billion (US$6 billion), beating the average Bloomberg analyst estimate of NT$161.4 billion. The strong results were driven by robust demand for chips for smartphones, high-performance computing, Internet of Things devices, electric vehicles, and consumer electronics.

MARKET
Scorecard

Data as of January 13, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,659.03	-2.2%	-2.2%	22.3%	41.7%
Dow Industrials (DJIA)	36,113.62	-0.6%	-0.6%	16.3%	24.9%
Nasdaq	14,806.81	-5.4%	-5.4%	12.8%	59.7%
Russell 2000	2,159.44	-3.8%	-3.8%	2.2%	29.3%
S&P/TSX Comp	21,292.96	0.3%	0.3%	18.7%	23.1%
FTSE All-Share	4,273.23	1.5%	1.5%	12.2%	1.1%
STOXX Europe 600	486.05	-0.4%	-0.4%	18.8%	16.2%
EURO STOXX 50	4,315.90	0.4%	0.4%	19.3%	14.2%
Hang Seng	24,429.77	4.4%	4.4%	-13.5%	-15.6%
Shanghai Comp	3,555.26	-2.3%	-2.3%	-1.2%	14.1%
Nikkei 225	28,489.13	-1.1%	-1.1%	0.1%	19.4%
India Sensex	61,235.30	5.1%	5.1%	23.7%	46.3%
Singapore Straits Times	3,257.30	4.3%	4.3%	9.4%	0.2%
Brazil Ibovespa	105,529.50	0.7%	0.7%	-13.5%	-10.1%
Mexican Bolsa IPC	53,930.45	1.2%	1.2%	17.9%	20.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.699%	18.9	18.9	61.6	-14.7
Canada 10-Yr	1.704%	27.8	27.8	89.4	9.4
UK 10-Yr	1.105%	13.4	13.4	79.8	35.5
Germany 10-Yr	-0.090%	8.7	8.7	43.2	6.9
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.98%	-1.5%	-1.5%	-2.3%	3.9%
U.S. Investment-Grade Corp	2.56%	-1.9%	-1.9%	-1.8%	6.2%
U.S. High-Yield Corp	4.45%	-0.6%	-0.6%	4.5%	11.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,822.81	-0.3%	-0.3%	-1.2%	17.8%
Silver (spot $/oz)	23.09	-0.9%	-0.9%	-8.4%	28.6%
Copper ($/metric ton)	10,081.00	3.5%	3.5%	26.1%	60.9%
Oil (WTI spot/bbl)	82.12	6.7%	6.7%	55.2%	41.4%
Oil (Brent spot/bbl)	83.89	7.9%	7.9%	49.6%	30.7%
Natural Gas ($/mmBtu)	4.26	14.2%	14.2%	56.2%	95.2%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	94.8740	-0.8%	-0.8%	5.0%	-2.5%
CAD/USD	0.7989	1.0%	1.0%	1.4%	4.3%
USD/CAD	1.2517	-0.9%	-0.9%	-1.4%	-4.1%
EUR/USD	1.1455	0.7%	0.7%	-5.8%	2.9%
GBP/USD	1.3709	1.3%	1.3%	0.5%	5.5%
AUD/USD	0.7280	0.2%	0.2%	-5.9%	5.4%
USD/JPY	114.1500	-0.8%	-0.8%	9.9%	3.8%
EUR/JPY	130.7600	-0.1%	-0.1%	3.5%	6.8%
EUR/GBP	0.8356	-0.7%	-0.7%	-6.3%	-2.5%
EUR/CHF	1.0439	0.6%	0.6%	-3.3%	-3.4%
USD/SGD	1.3466	-0.2%	-0.2%	1.5%	0.0%
USD/CNY	6.3598	0.1%	0.1%	-1.7%	-7.7%
USD/MXN	20.3463	-0.9%	-0.9%	2.5%	8.2%
USD/BRL	5.5289	-0.8%	-0.8%	4.2%	33.5%

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 0.79 means 1 Canadian dollar will buy 0.79 U.S. dollar. CAD/USD 1.0% return means the Canadian dollar rose 1.0% vs. the U.S. dollar year to date. USD/JPY 114.15 means 1 U.S. dollar will buy 114.15 yen. USD/JPY -0.8% return means the U.S. dollar fell 0.8% vs. the yen year to date.

Source - Bloomberg; data as of 16:35ET 1/13/22

Authors

Thomas Garretson, CFA – Minneapolis, United States
tom.garretson@rbc.com; RBC Capital Markets, LLC

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

Sean Killin – Toronto, Canada
sean.killin@rbc.com; RBC Dominion Securities Inc.

Richard Tan, CFA – Toronto, Canada
richard.tan@rbc.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

Jasmine Duan – Hong Kong, China
jasmine.duan@rbc.com; RBC Investment Services (Asia) Limited

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As of December 31, 2021

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Rating	Count	Percent	Count	Percent
Buy [Outperform]	831	57.59	365	43.92
Hold [Sector Perform]	557	38.60	180	32.32
Sell [Underperform]	55	3.81	3	5.45

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