GLOBAL
Insight
WEEKLY

Perspectives from the Global Portfolio Advisory Committee

January 20, 2022

China: The beat of a different drum

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A zero-tolerance policy response to COVID-19, declining property prices, and a flexible and accommodative central bank all set China apart from its Western counterparts. We discuss near-term prospects for China's economy and considerations for investing in the Chinese equity market.

Zero-tolerance COVID-19 response

Unlike most of the Western world that is trying to live with COVID-19 by imposing relatively light restrictions, and despite some 85 percent of its population being fully vaccinated, China is steadfast in pursuing its zero-tolerance policy of stopping community transmission through strict and swift containment measures. It recently locked down the city of Xi'an, home to 13 million people and a centre of semiconductor manufacturing. More cities, including Beijing, have also reported omicron cases in the past few days.

Many observers believe China's zero-tolerance policy is destined to fail due to the emergence of the highly transmissible omicron variant, and eventually China will have no choice but to follow the path taken in the West. Our RBC Wealth Management analysts do not agree. They point out that due to China's very large population, the unvaccinated 15 percent (totaling 210 million people) could easily overwhelm the health care system should a significant portion require emergency treatment. Moreover, research shows China's vaccines are less effective against omicron than against previous variants.

Lockdown risks therefore continue to rise in China, even as they decline elsewhere. Increased pandemic restrictions could lead to additional supply chain disruptions, hold back the normalization of the global economy, and fuel global inflation, while capping Chinese economic growth.

Challenges in the property sector

While housing prices are up in most western countries, they are down in China. Recently, many property developers have defaulted on their foreign debt—including high-profile giant Evergrande, which owns more than 1,300 development projects in more than 280 cities. Evergrande is now negotiating with Chinese creditors to delay payments on its domestic debt.

Since the material deterioration of the real estate sector in October 2021, the government hasn't intervened meaningfully to lessen the sector's woes. Property developers seeking to raise funding through onshore/offshore credit financing, shareholder support, or asset sales are struggling, as investors' and homebuyers' confidence has been dented. The refinancing market remains mostly shut.

Given that the property sector represents a remarkably high 25 percent of China's GDP, we think the authorities will make every effort to prevent a hard landing with additional incremental easing—though they are also likely to stick to their medium- and long-term deleveraging goals. As a result, the property market slowdown is likely to continue in the first half of the year and weigh on economic growth.

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

Will economic data stay positive?

Despite these issues, metrics of China's manufacturing and services activity (PMIs) recently turned higher. This contrasts with the U.S. and the eurozone, where recent economic data are slightly weaker though still consistent with economic expansion. China's Q4 2021 GDP growth was higher than consensus expected at 4.0 percent y/y, bringing full-year GDP growth to 8.1 percent y/y, much higher than the official target of six percent.

The government is now focused on economic stability and has introduced several measures aimed at supporting growth, including cutting banks' required reserve ratio, loosening restrictions on mortgage loans, and encouraging banks to lend more to smaller private enterprises. In an encouraging development, RBC Global Asset Management Inc. Chief Economist Eric Lascelles points out that China's credit impulse, or the monthly change in the flow of new credit as a share of GDP, has turned positive again after a long period in negative territory. This suggests Beijing is relaxing its efforts to curb lending at the moment.

Nevertheless, we believe it's likely that the zero-tolerance COVID-19 policy will eventually hinder Chinese manufacturing and exports, while the ongoing property market woes may hold back consumer spending and pose a threat to China's macroeconomic and financial stability.

According to a consensus forecast of economists reported by Bloomberg, Chinese GDP is expected to grow at a rate of 5.2 percent in 2022, slightly below previous expectations. RBC Global Asset Management remains comfortable with its below-consensus forecast of GDP growth under five percent for 2022, but believes the government will succeed in stabilizing growth once the omicron wave has retreated.

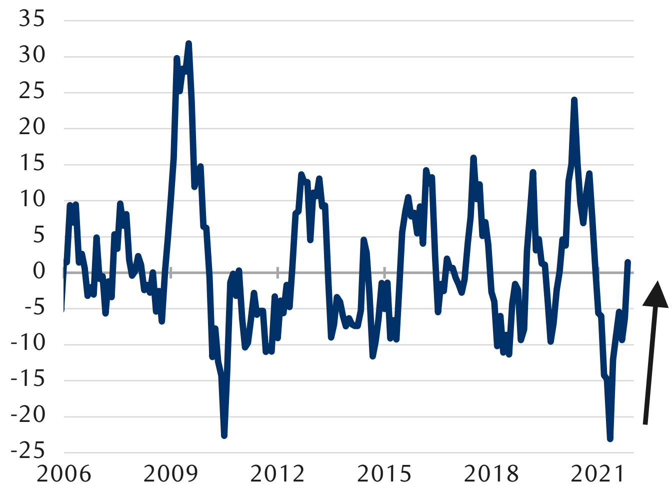
Monetary policy: Exceptionally flexible

With the risks to the economy tilted to the downside for now, we expect the People's Bank of China to remain flexible and accommodative. The central bank reduced interest rates for the first time since March 2020 on Jan. 17, lowering the seven-day reverse repo rate and the one-year medium-term lending facility (MLF) rate by 10 basis points (bps) each, to 2.10 percent and 2.85 percent, respectively. This follows other accommodative actions in late 2021, including cutting the required reserve ratio by 50 bps and the one-year loan prime rate by 5 bps, and launching re-lending facilities to support decarbonization and clean coal in November.

Though any further easing will likely be limited, in our view, China is a rare exception to the global trend of monetary tightening. Since at least last summer, Lascelles notes, most central banks have been tilting in an increasingly hawkish direction, either raising rates or signaling that such increases are on the way in 2022.

Chinese credit impulse turns positive

Chinese credit impulse (percentage points)



Note: Measured as year-over-year change of 3-month rolling average of sum of total social financing, excluding equities and local government bond issuance, as a percentage of GDP.
Source - RBC Wealth Management, Haver Analytics, RBC Global Asset Management; data through November 2021

Despite concerns over downside growth risk and moderate easing, the renminbi has gone from strength to strength recently, thanks to a robust trade surplus and ample dollar liquidity onshore driven by attractive sovereign bond yields. On a six- to 12-month horizon, we believe the imminent inclusion of Chinese bonds in the FTSE World Government Bond Index should continue to attract foreign capital and underpin the currency. RBC Capital Markets expects the renminbi to appreciate slightly in 2022 and reach 6.35 USD at the end of the year.

Is it too early for China equities?

Amid the resurgence of COVID-19, an economic slowdown, and property market turmoil, the MSCI China Index has continued to underperform the MSCI World Index, which represents developed markets.

While valuations have become attractive, in our view, we would hold off adding to China equity positions at the moment given the aforementioned challenges. An opportunity to increase China exposure is likely to emerge after the first quarter, when investors see signs the present wave of COVID-19 infections has started to recede and more clearly understand the earnings impact of recent macro developments and policy changes. When the time comes, we would look at opportunities benefiting from secular growth trends, including electric vehicles, renewables, and advanced manufacturing processes such as robotics, as outlined in our 2022 Outlook article about China's long-term prospects.

UNITED STATES

Alan Robinson – Seattle

■ **U.S. stocks continued their January slide** during the holiday-shortened week as higher interest rates upset equities. Not all sectors were impacted equally; growth stocks, led by the higher-valued Technology sector, bore the brunt of the selloff while value sectors trod water (see chart). **The downdraft tipped the tech-heavy Nasdaq Index into official correction territory**, after it logged a 10% decline from its Nov. 19, 2021 high during the week.

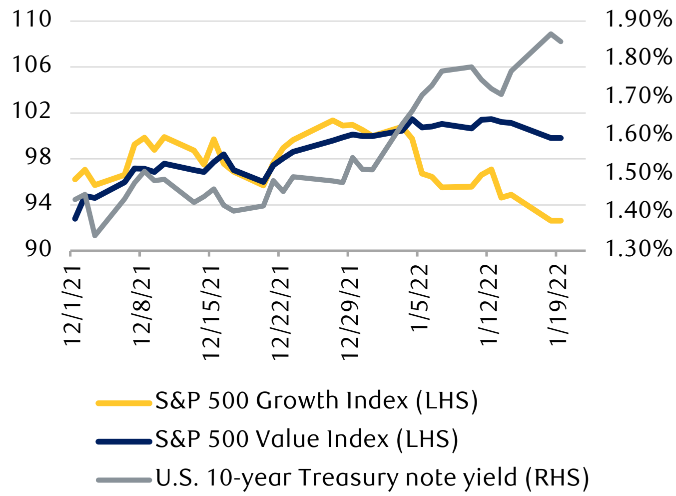
■ **The yield on the U.S. 10-year Treasury bond jumped to 1.87% at the start of the week, its highest level since January 2020**, as inflation concerns triggered hawkish rhetoric from Federal Reserve officials. Market indicators now suggest traders expect four 25 basis point interest rate hikes this year, although we note that actual year-on-year inflation figures should peak during the first half of the year due to low base prices in the first half of 2021 and an improving supply of goods and labor.

■ While higher interest rates are typically a headwind to the performance of Technology stocks, the extent of their decline since November prompted RBC Wealth Management's U.S. Investment Committee to adopt a **more positive short-term tactical view toward the Tech sector** during the week, reflecting a view that the cyclical nature of the sector should provide support as COVID-19 cases recede. Corporate activity in this sector also hit the headlines as Microsoft (MSFT) announced a bid to buy games company Activision Blizzard (ATVI) for $69 billion, a 45% premium to ATVI's pre-bid stock value.

■ The volatility in bond and equity markets overshadowed **the start of Q4 2021 earnings season**. Analysts expected revenue and earnings per share growth of 13% y/y and 21% y/y for the quarter, according to consensus expectations at the start of the week. **Early reporters during the week included banks, which generally missed consensus expectations**. While revenues for these companies were solid, compensation expenses were generally higher than expected, leading to earnings misses. We expect higher costs to be a recurring theme across most sectors during earnings season.

Value stocks handle higher rates better than growth stocks

S&P 500 Growth and Value Indexes' relative performance



Note: Indexes normalized with 12/31/21 = 100
Source - RBC Wealth Management, FactSet; data through 1/19/22

CANADA

Simon Jones & Luis Castillo – Toronto

■ **The quarterly Business Outlook Survey from the Bank of Canada (BoC) painted a picture of an economy contending with mounting inflationary pressures and labour market tightness**. Demand remains robust across most of the economy, but the number of firms indicating that their sales are being limited by supply constraints increased. In fact, more than 75% of respondents indicated they would have difficulty meeting an unexpected rise in demand. While some of this difficulty is due to ongoing supply chain disruptions, labour shortages are also intensifying, and the majority of firms said they plan to raise wages over the next 12 months in order to attract and retain workers. To compensate for this rise in wages and input costs, many firms intend to pass their higher costs on to consumers by raising prices. Although the data may be somewhat stale because the survey was conducted prior to the omicron surge, which has likely dampened business sentiment, we think these findings will be key considerations in the BoC's upcoming interest rate decision.

■ **Inflationary pressures came into focus this week, with the December Consumer Price Index (CPI) report revealing Canadians are experiencing the largest yearly price increases in more than 30 years**. CPI growth came in at 4.8% y/y, and among the biggest drivers were some of the most essential and hardest-to-avoid categories including transportation, food, and shelter. According to RBC Economics, the breadth of price growth has also continued to increase, as 58% of the CPI basket grew at a pace above 2% in Q4. Despite CPI inflation printing its highest reading since 1991, the bond market's reaction was muted, with rates moving slightly lower on the announcement; we believe this indicates bond rates are already positioned for an aggressive BoC response. The market is currently pricing in six rate hikes for 2022, and the likelihood of a January hike has continued to climb in recent days.

EUROPE

Rufaro Chiriseri, CFA & Thomas McGarrity, CFA – London

- **UK inflation rose to 5.4% in December** from 5.1% in November—above the 5.2% consensus estimate and the **highest in 30 years**. Economists expect inflation to rise further in the coming months, particularly after the energy price cap is revised in April.

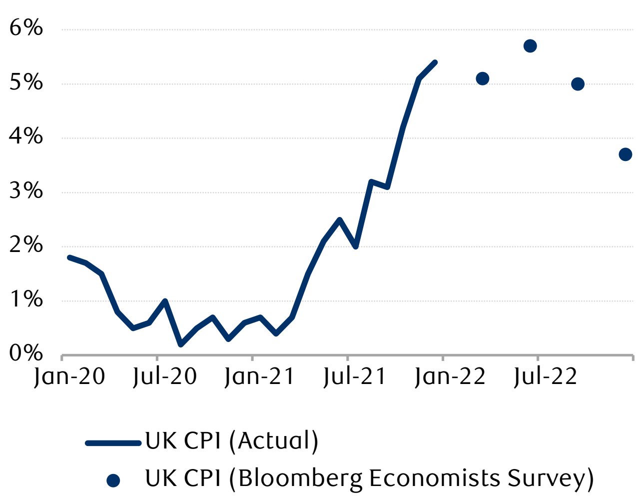
- **The UK unemployment rate fell to 4.1%** in November (consensus: 4.2%). Against the backdrop of a tight labour market, Bank of England (BoE) Governor Andrew Bailey warned that there is a risk the UK could drift into a wage-price spiral as workers demand higher wages as prices rise. However, current wage growth data is not showing an acceleration, falling from 4.9% y/y to 4.2% y/y in the three-month period ending in November 2021. **The inflation and unemployment data released this week have cleared the path for the BoE to raise interest rates by 0.25%** at the February policy meeting, in our view.

- **GlaxoSmithKline (GSK) announced it rejected three unsolicited offers from Unilever to acquire its consumer healthcare division**, which GSK plans to demerge in the middle of 2022. The latest proposal was for a total acquisition value of £50 billion, which GSK stated "fundamentally undervalued" the business. Unilever's share price fell more than 8% on Monday following the announcement, with the approach being greeted with skepticism from both shareholders and industry analysts, according to a Bloomberg report. Unilever announced on Wednesday that it would not increase its offer above £50 billion. Key areas of concern cited around the proposed acquisition from a Unilever perspective included that it would result in the company's balance sheet becoming heavily indebted, as well as questions around its strategic fit.

- **Europe's biggest tech firm, ASML, reported Q4 earnings ahead of consensus** due to particularly strong "Installed Base" sales relative to Street expectations. Very strong demand across semiconductor end markets is putting pressure on ASML's customers for more wafer output; however, ASML is experiencing higher demand for its systems than its production capacity can accommodate. Resultantly, ASML is seeing strong demand from its customers to upgrade their existing capabilities in order to increase wafer output from their installed base systems. **ASML expects "strong demand" to continue in 2022**, forecasting revenue growth of around 20% y/y.

UK inflation expected to peak in Q2 this year

Historical UK CPI inflation and 2022 forecasts



Source - RBC Wealth Management, Bloomberg; data as of 1/20/22

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets traded broadly lower during the week**, with the MSCI Asia Pacific Index down more than 2% as of Wednesday's close. Leading the pack lower were South Korea and Vietnam. South Korea's KOSPI Index has traded lower for five consecutive days. The spike in U.S. bond yields led to a retreat in not only U.S. Tech shares but Tech shares in South Korea and other Asian markets as well. Meanwhile, **South Korea's central bank raised its benchmark rate to 1.25%**, bringing it back to pre-pandemic levels, to stem inflation risks and signaled it may tighten further. All of these factors served to dampen risk appetite.

- **The People's Bank of China** (PBoC) further relaxed its monetary policies. The central bank **cut the one-year loan prime rate (LPR) by 10 basis points to 3.7%**, from 3.8%. Most new and outstanding loans in China are based on the one-year LPR. The five-year LPR—which influences the pricing of mortgages—was reduced by five basis points to 4.6% from 4.65%, the first reduction since April 2020. The moves were stronger than some analysts expected given this is the second consecutive month that the one-year LPR was adjusted lower.

- **The Ministry of Housing and Urban-Rural Development** of China is in the process of **drafting a nationwide rule to provide developers with easier access to presale funds held in escrow accounts** to help them meet debt obligations, according to a Reuters report. We believe this would be a concrete move to address the property sector's liquidity risk, although the granting of access and monitoring of usage of such funds will likely be stringent. If this development materializes, we believe it will likely serve as a turning point for market sentiment on the sector.

MARKET Scorecard

Data as of January 20, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,482.73	-5.9%	-5.9%	16.4%	34.6%
Dow Industrials (DJIA)	34,715.39	-4.5%	-4.5%	11.3%	18.3%
Nasdaq	14,154.02	-9.5%	-9.5%	5.2%	50.8%
Russell 2000	2,024.04	-9.9%	-9.9%	-6.3%	19.1%
S&P/TSX Comp	21,058.18	-0.8%	-0.8%	16.9%	19.7%
FTSE All-Share	4,274.52	1.6%	1.6%	12.0%	0.7%
STOXX Europe 600	483.35	-0.9%	-0.9%	17.6%	14.0%
EURO STOXX 50	4,299.61	0.0%	0.0%	18.6%	13.2%
Hang Seng	24,952.35	6.6%	6.6%	-16.7%	-13.3%
Shanghai Comp	3,555.06	-2.3%	-2.3%	-0.8%	14.8%
Nikkei 225	27,772.93	-3.5%	-3.5%	-2.6%	15.3%
India Sensex	59,464.62	2.1%	2.1%	19.4%	43.2%
Singapore Straits Times	3,294.82	5.5%	5.5%	9.9%	0.4%
Brazil Ibovespa	109,102.00	4.1%	4.1%	-8.8%	-8.2%
Mexican Bolsa IPC	52,508.35	-1.4%	-1.4%	16.4%	14.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.813%	30.3	30.3	73.3	-0.9
Canada 10-Yr	1.837%	41.1	41.1	101.1	26.9
UK 10-Yr	1.225%	25.4	25.4	92.4	57.5
Germany 10-Yr	-0.024%	15.3	15.3	50.5	19.4
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.10%	-2.2%	-2.2%	-3.1%	3.0%
U.S. Investment-Grade Corp	2.69%	-2.9%	-2.9%	-3.0%	4.8%
U.S. High-Yield Corp	4.68%	-1.2%	-1.2%	3.4%	10.7%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,838.28	0.5%	0.5%	-1.8%	17.8%
Silver (spot $/oz)	24.44	4.9%	4.9%	-5.4%	35.2%
Copper ($/metric ton)	9,864.00	1.3%	1.3%	22.7%	58.2%
Oil (WTI spot/bbl)	86.90	12.9%	12.9%	63.2%	48.4%
Oil (Brent spot/bbl)	87.14	12.0%	12.0%	55.4%	33.7%
Natural Gas ($/mmBtu)	3.82	2.5%	2.5%	50.6%	90.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	95.7920	0.1%	0.1%	5.9%	-1.9%
CAD/USD	0.7997	1.1%	1.1%	1.0%	4.3%
USD/CAD	1.2506	-1.0%	-1.0%	-1.0%	-4.2%
EUR/USD	1.1306	-0.6%	-0.6%	-6.6%	1.9%
GBP/USD	1.3594	0.5%	0.5%	-0.4%	4.5%
AUD/USD	0.7225	-0.5%	-0.5%	-6.7%	5.1%
USD/JPY	114.1500	-0.8%	-0.8%	10.2%	3.6%
EUR/JPY	129.0600	-1.4%	-1.4%	3.0%	5.6%
EUR/GBP	0.8317	-1.1%	-1.1%	-6.2%	-2.5%
EUR/CHF	1.0374	0.0%	0.0%	-3.7%	-3.4%
USD/SGD	1.3473	-0.1%	-0.1%	1.7%	0.0%
USD/CNY	6.3411	-0.2%	-0.2%	-1.9%	-7.7%
USD/MXN	20.5333	0.0%	0.0%	4.7%	10.0%
USD/BRL	5.4372	-2.5%	-2.5%	2.4%	29.8%

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 0.79 means 1 Canadian dollar will buy 0.79 U.S. dollar. CAD/USD 1.1% return means the Canadian dollar rose 1.1% 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 1/20/22

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Sell [Underperform]	55	3.81	3	5.45

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