GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

January 27, 2022

Fed rate hike: Beware the Ides of March?

Atul Bhatia, CFA – Minneapolis

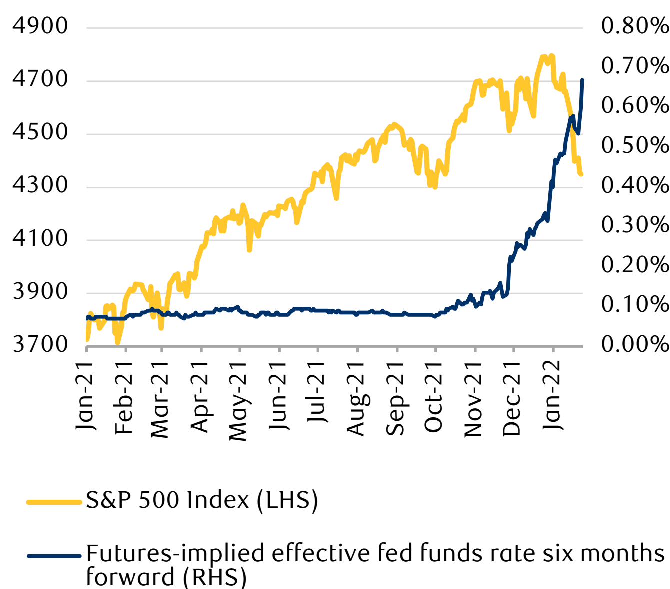
The Fed has put a March rate hike squarely on the table. While Fed tightening may create volatility, it strikes us as unlikely that the Fed will push the economy into recession through higher rates. We discuss why we have a relatively benign view on rate hikes and what cooling monetary policy means for the investment environment.

Global equity markets experienced significant volatility this past week, with several major indexes—including the S&P 500—dropping more than 10 percent from recent highs during intraday trading activity.

A combination of factors contributed to the selling pressure, including continued concerns about inflation, uncertainty around the potential impact of the Federal Reserve's shift to less accommodative monetary policy, profit-taking following a very strong nearly two-year appreciation in stocks, and geopolitical tensions.

While the geopolitical picture is still unclear, the Fed reduced some of the uncertainty around the policy framework at its recently concluded January meeting. The Fed's post-meeting statement—and comments made by Fed Chair Jerome Powell—confirmed our expectations as well as market pricing, by guiding investors to a March rate hike, which would be the first of the tightening cycle.

Rate hike expectations weigh on equities



Source - RBC Wealth Management, Bloomberg

The balance of risk in monetary policy

While policy mistakes are always possible—and some could reasonably argue that the Fed already made one by continuing with bond purchases for such a lengthy period—it strikes us as unlikely that the Fed will push the economy into recession through higher rates. The current inflationary pressures are coming largely from supply

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

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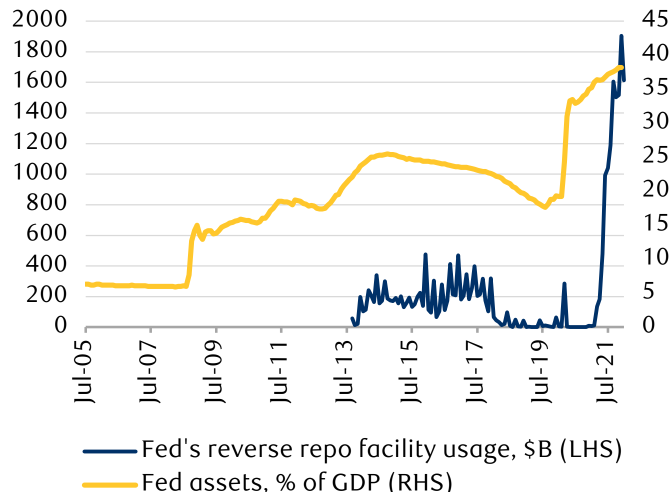
disruptions, and we believe the Fed's primary game plan is to cool monetary policy to the point that it is not further aggravating inflationary pressures, allowing supply-chain issues time to resolve. Since the Fed's goal is a somewhat limited one, we believe policymakers are unlikely to push on the brakes so hard as to tip the economy into recession.

One reason for our relatively benign view on rate hikes is experience. Both the Fed and market participants, we believe, have a fairly well-calibrated sense, developed over decades, for the likely impact of a quarter- or half-point rate hike.

Rate hikes also operate largely through the banking system. Since the Fed is both a central bank and a banking regulator, it has a multitude of formal and informal channels to receive feedback on how policy moves are impacting the real economy. This offers the Fed much greater transparency on rate moves relative to balance sheet size, where impacts extend more directly to non-banking entities.

Fed balance sheet growth led by reverse repo

Quantitative tightening may drive volatility despite "excess" liquidity



Source - RBC Wealth Management, Bloomberg; Fed's reverse repo facility data starts in March 2013

Excess liquidity may not be excessive everywhere

Although we do not see rate hikes as a likely source of significant long-term economic concern, we do see the potential for higher volatility across markets as the Fed tightening progresses, particularly when the central bank begins reducing its balance sheet, a process known as quantitative tightening or "QT."

Concerns about QT may seem like an issue for a distant date, given the amount of liquidity the Fed has created with asset purchases. Its balance sheet is approaching $9 trillion, or a record 38 percent of GDP; prior to the global financial crisis the balance sheet hovered around six percent of GDP and even at its post-financial crisis highs, Fed assets had never previously risen above 26 percent of GDP.

Most tellingly, market participants have placed nearly $1.5 trillion in the Fed's reverse repo facility—essentially choosing to return liquidity to the central bank rather than use it directly. With that amount of excess liquidity already parked at the Fed—which we believe will take the Fed at least a year to draw down—it may seem that concerns about balance sheet liquidity are a matter for 2023 or later.

History, however, points in a different direction. In 2019, the Fed reduced its balance sheet from approximately 20 percent of GDP to just over 17 percent of GDP as part of its last round of policy normalization. Although the balance sheet after the reduction was nearly three times its size prior to the financial crisis, the relatively small contraction caused a meaningful—but temporary—dislocation in bond financing markets. The Fed quickly stepped in to provide the needed liquidity, and it has since created a $500 billion standing facility to avoid any repeats of the issue during this round of QT.

We see the potential for similar, temporary disruptions as liquidity becomes more restricted in the interdealer market as the Fed's balance sheet shrinks. But like the September 2019 hiccup in Treasury repo markets, we believe the Fed has ample tools to deal with liquidity disruptions, including partnering with the Treasury Department to provide temporary support to a wide range of markets. So while the uncertainties associated with QT may bring volatility, we do not see a high risk of permanent impairment to asset prices.

Preparation is key

With policy shifting from accommodative to more restrictive, and with the recovery entering a slower growth phase, investors likely need to adjust their expectations to periodic bumps in the road. But as RBC Wealth Management's Global Portfolio Advisory Committee highlighted in a recent market update, the key issue for investors is if the headwinds and turbulence are sufficient to push the real economy into recession. At the moment, we do not see the market signals that typically precede an economic contraction, and as such we remain constructive about the path for equities and risk assets.

We believe this week's price volatility across markets is a salutary reminder of the need to be prepared for temporary dislocations in markets, both to prepare portfolios and to avoid hasty decisions.

UNITED STATES

Michael Roedl – Minneapolis

- **Equities have fallen in 2022** with the Nasdaq down 13.4% and the S&P 500 lower by 9.2%. Almost every S&P 500 sector has traded lower this month due to uncertainties associated with the Fed rate hike cycle and ongoing inflation. **Growth stocks have faced the majority of downside pressure**, driving the S&P 500 Growth Index down 13.0%, while value stocks have outperformed the broader market, with the S&P 500 Value Index only losing 4.0% for the month. One bright spot has been the Energy sector, up 19.2% due to rallying oil prices amid geopolitical risks and potential implications on global energy markets. Financials and Consumer Staples also performed relatively well compared to other sectors, supported by higher Treasury yields and expectations of rate hikes.

- **High-yield credit markets typically have a close correlation to equities**, but sub-investment-grade bonds have performed relatively well so far this year, down only 1.9%. Credit spread moves reflect a similar story, widening only 20 basis points in January. At 3.25%, the spread between Treasuries has yet to show significant pressure after hovering near record lows for the majority of 2021. In our view, this modest movement signals healthy credit conditions despite recent market disruptions.

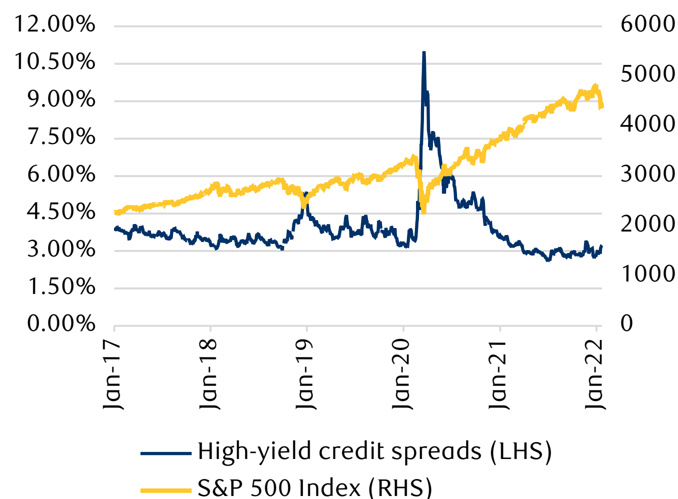
- **Inflows into leveraged loan funds have reached a record pace this month** as investors prepare for Fed rate hikes beginning as soon as March. Loan funds received a cash influx of $2.25 billion for the week ending Jan. 19, exceeding the previous record of $1.87 billion in 2013, during the so-called “taper tantrum.” Leveraged loan buyers are primarily drawn to the sector’s floating rate coupon feature, which can provide a hedge against rising interest rates. We expect leveraged loans to perform relatively well in the months ahead as strong inflows will likely continue amid fear of rising interest rates.

CANADA

Sean Killin & Richard Tan, CFA – Toronto

- **There are no rate hikes in Canada yet, as the Bank of Canada (BoC) decided to hold its benchmark overnight interest rate unchanged at 25 basis points at this week’s meeting**. This was in line with consensus expectations, and likely a result of the short-lived economic drag caused by the omicron variant and its associated public health restrictions. BoC overnight index swaps, which constitute the part of the market that signals changes in monetary policy, have been pricing in a January rate hike and continue to aggressively price in six or more hikes on a 12-month horizon. The case for raising interest rates is becoming stronger, as policymakers

High-yield credit spreads hold tight levels despite equity selloff



Source - RBC Wealth Management, Bloomberg; daily data through 1/25/22

acknowledge that economic slack has been almost entirely absorbed, pointing to resilience in the Canadian economy. According to data from the BoC’s Q4 Business Outlook Survey, firms are facing capacity pressures and elevated input costs across the board. When these factors are added to the central bank’s upwardly revised inflation outlook (now at 4.2% for the year) and an unemployment rate below pre-pandemic levels, we think it’s not unreasonable to expect rate hikes at upcoming meetings. Eyes are on the next BoC policy meeting, scheduled for March 2.

- **A risk-off tone has yet again overtaken equity markets, and the S&P/TSX Composite Index is on pace to end the month in negative territory**. While spikes in volatility are rarely welcomed, we see several reasons to think the S&P/TSX Composite is well positioned for the year ahead. First, while the BoC left overnight rates unchanged, the central bankers’ tone remains hawkish, in our view. As a result, we believe it is only a matter of time until the start of **rate hikes that should be supportive of margin expansion in the Financials sector. The setup for Energy is also constructive**, in our view, on the back of strengthening oil demand and supply growth that will likely take some time to respond. In aggregate, these two sectors account for approximately 50% of the S&P/TSX Composite. On the other side of the ledger, **this week’s volatility was most pronounced in Technology** as market participants aggressively re-valued secular growth companies that have little or no earnings. For those looking to pick up high-growth tech stocks, we would recommend layering in positions over time.

EUROPE

Frédérique Carrier & Thomas McGarrity, CFA – London

- Tensions between the West and Russia continue to mount, and the risk of military activity inside Ukraine continues to escalate. Investors are worried since **geopolitical conflicts that result in an energy shock tend to have a larger and longer-lasting impact on financial markets**. Russia is an important supplier of energy to Europe, providing 32% of Germany's gas supplies, 34% of its crude oil, and 53% of its coal, according to RBC Capital Markets.

- Eric Lascelles, chief economist at RBC Global Asset Management Inc., thinks Russia would only stop supplying energy as a strategy of last resort. **Cutting supplies would not only be problematic for the continent but would also have negative consequences for Russia**. Government revenues would shrink, and such a move would likely trigger sanctions, e.g., losing access to the SWIFT financial network, which would be detrimental to the Russian economy, at least in the short term. It could also motivate reluctant countries such as Germany to participate more fully in the conflict, and would likely encourage Europe to diversify its suppliers and accelerate efforts to further develop renewable energy.

- We believe the tensions have contributed to the recent volatility in equity markets. **Russian equities have been the most negatively impacted**, with the MSCI Russia Index down 30% since its November peak, while the MSCI Europe ex UK Index is down around 8% in the same period.

- The situation remains an ongoing risk to European equities, and we could see a further modest pullback should the situation escalate. However, acts of war rarely have a lasting influence on global financial markets, so long as an energy shock is avoided. **While we remain vigilant to the risks, we continue to be comfortable being Overweight European equities**.

- The tensions have driven gains in one sector: **Energy has rallied year to date** with UK-listed majors BP and Shell up 20% and 18%, respectively, in the period.

ASIA PACIFIC

Jasmine Duan & Emily Li – Hong Kong

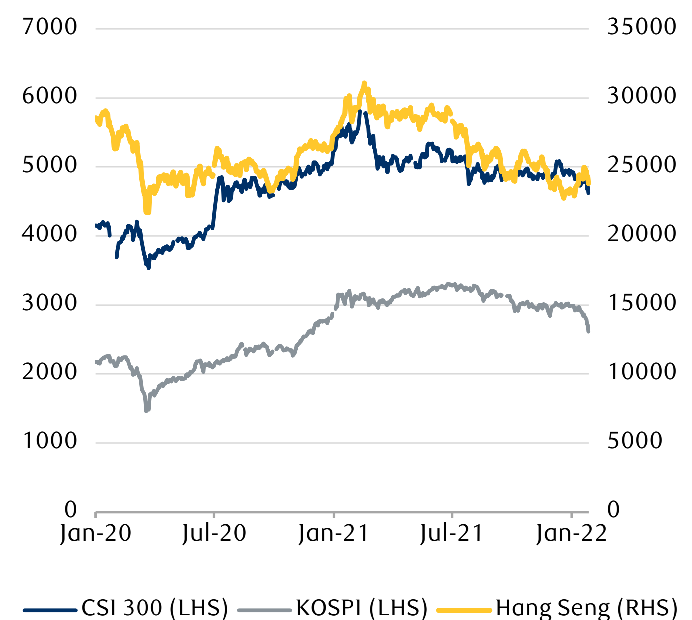
- **Asian equities tumbled on Thursday following hawkish remarks from the U.S. Federal Reserve**. China's CSI 300 Index closed 2% lower and slid into a bear market; the index is now down more than 20% from its February 2021 peak. Hong Kong stocks resumed their decline, led by further weakness in Alibaba (9988 HK/BABA) as more analysts trimmed their price targets before the release of the company's earnings report. South Korea's KOSPI Index dropped 3.5% and entered a bear market. Local retail investors, who had been a key source of support for the Korean market amid the pandemic, joined foreigners in selling shares.

- **According to Bloomberg, Chinese authorities are considering a proposal to break up China Evergrande Group (3333 HK) by selling the bulk of its assets**. The restructuring proposal calls for the developer to sell most assets except for its separately listed property management and electric-vehicle units. The company has told creditors it aims to issue a preliminary restructuring plan in the next six months and intends to treat all categories of bondholders equally.

- **A Bloomberg Intelligence index of Chinese education firms has plunged 27% in the past three days**. The drop was triggered by an unverified document that mentioned a potential ban on the variable interest entity structure used by Chinese education companies to list abroad, as well as restrictions on their school assets, M&A expansion, and tuition-fee increases. There has been no official announcement on the matter, but investors chose to sell the shares amid regulatory uncertainties.

- **Taiwan's gross domestic product grew 6.3% y/y in 2021**, the fastest rate of expansion since 2010. Investors' 2022 outlook remains bullish after Taiwan Semiconductor Manufacturing Co. (2330 TT/ TSM) revealed plans earlier this month to spend between US$40 billion and US$44 billion over the coming 12 months, equivalent to around 5% of Taiwan's economy, on new plants to help ease the shortage of semiconductors.

Major Asian equity indexes have retreated from 2021 peak



Source - RBC Wealth Management, Bloomberg; daily data since 1/1/20

MARKET
Scorecard

Data as of January 27, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,326.51	-9.2%	-9.2%	15.3%	33.4%
Dow Industrials (DJIA)	34,160.78	-6.0%	-6.0%	12.7%	19.7%
Nasdaq	13,352.78	-14.7%	-14.7%	0.6%	46.1%
Russell 2000	1,931.29	-14.0%	-14.0%	-8.4%	17.5%
S&P/TSX Comp	20,544.11	-3.2%	-3.2%	17.9%	17.8%
FTSE All-Share	4,230.83	0.5%	0.5%	13.8%	2.7%
STOXX Europe 600	470.33	-3.6%	-3.6%	16.7%	13.6%
EURO STOXX 50	4,184.97	-2.6%	-2.6%	18.3%	13.8%
Hang Seng	23,807.00	1.7%	1.7%	-18.7%	-14.8%
Shanghai Comp	3,394.25	-6.7%	-6.7%	-5.0%	14.0%
Nikkei 225	26,170.30	-9.1%	-9.1%	-8.6%	12.1%
India Sensex	57,276.94	-1.7%	-1.7%	20.8%	39.2%
Singapore Straits Times	3,260.03	4.4%	4.4%	10.2%	0.6%
Brazil Ibovespa	112,611.60	7.4%	7.4%	-2.8%	-1.6%
Mexican Bolsa IPC	50,466.02	-5.3%	-5.3%	14.0%	14.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.801%	29.1	29.1	78.5	19.3
Canada 10-Yr	1.777%	35.1	35.1	98.3	47.3
UK 10-Yr	1.228%	25.7	25.7	95.9	72.0
Germany 10-Yr	-0.059%	11.8	11.8	48.7	32.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.14%	-2.4%	-2.4%	-3.4%	1.7%
U.S. Investment-Grade Corp	2.78%	-3.5%	-3.5%	-3.5%	2.9%
U.S. High-Yield Corp	4.98%	-1.9%	-1.9%	3.0%	10.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,796.50	-1.8%	-1.8%	-2.6%	13.6%
Silver (spot $/oz)	22.77	-2.3%	-2.3%	-9.9%	25.8%
Copper ($/metric ton)	9,952.50	2.2%	2.2%	27.2%	74.1%
Oil (WTI spot/bbl)	86.61	12.5%	12.5%	63.9%	63.0%
Oil (Brent spot/bbl)	89.87	15.5%	15.5%	61.0%	51.5%
Natural Gas ($/mmBtu)	6.27	68.0%	68.0%	127.0%	229.4%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.2390	1.6%	1.6%	7.3%	-0.7%
CAD/USD	0.7848	-0.8%	-0.8%	0.5%	3.5%
USD/CAD	1.2743	0.8%	0.8%	-0.4%	-3.4%
EUR/USD	1.1145	-2.0%	-2.0%	-8.0%	1.1%
GBP/USD	1.3380	-1.1%	-1.1%	-2.2%	2.5%
AUD/USD	0.7032	-3.2%	-3.2%	-8.2%	4.0%
USD/JPY	115.3700	0.3%	0.3%	10.8%	5.9%
EUR/JPY	128.5800	-1.8%	-1.8%	2.0%	7.2%
EUR/GBP	0.8330	-1.0%	-1.0%	-5.9%	-1.3%
EUR/CHF	1.0377	0.0%	0.0%	-3.6%	-2.9%
USD/SGD	1.3528	0.3%	0.3%	1.8%	-0.4%
USD/CNY	6.3682	0.2%	0.2%	-1.8%	-8.3%
USD/MXN	20.7643	1.1%	1.1%	2.3%	9.8%
USD/BRL	5.4105	-3.0%	-3.0%	0.0%	28.5%

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 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD -0.08% return means the Canadian dollar fell 0.8% vs. the U.S. dollar year to date. USD/JPY 115.37 means 1 U.S. dollar will buy 115.37 yen. USD/JPY 0.3% return means the U.S. dollar rose 0.3% vs. the yen year to date.

Source - Bloomberg; data as of 16:35ET 1/27/22

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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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