GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

February 10, 2022

ECB turns hawkish

Frédérique Carrier – London

The European Central Bank, which had until now ruled out interest rate increases this year, adopted a hawkish tone that took financial markets by surprise. We look at the factors which led to this change, and explain how the eurozone's strengthened institutions should hold it in good stead for this monetary tightening cycle. We look at portfolio implications.

A surprisingly hawkish tone

Although it left both policy rates and the pace of asset purchases unchanged, the European Central Bank (ECB) adopted a hawkish tilt at its February meeting in a stark reversal of its long-standing position. Markets are now pricing in the first increase in interest rates as early as June, as opposed to December previously, and 0.40 percent in rate hikes by the end of 2022.

The resilience of the eurozone in the face of the omicron wave, tightening labour markets, and increasing inflation all led to this abrupt change of stance.

A resilient economy

Despite COVID-19 restrictions and supply-chain shortages, eurozone GDP grew 0.3 percent quarter over quarter (q/q) in Q4. While a marked slowdown from the 2.3 percent q/q growth generated in Q3, we think it points to some resilience under difficult circumstances.

The regional contribution to growth has changed markedly, however, with France and Italy driving growth, posting quarterly GDP increases of 0.7 percent and 0.6 percent, respectively. By contrast, the German economy, historically the engine of growth for the bloc, shrank by 0.7 percent in the period, due to supply-chain shortages in the automotive industry. While this performance is disappointing, there are signs manufacturing production started to improve in December. Overall, GDP in 2021 grew 4.6 percent in the eurozone, with seven percent in France, 6.5 percent in Italy, and a more muted 2.8 percent in Germany.

Q1 2022 is off to an encouraging start, with economic activity indicators pointing to continued expansion. Growth is likely to pick up later in the year, as supply-chain shortages ease. For now, the consensus expectation is for above-trend GDP growth of 4.1 percent in 2022, as financial support from the EU recovery fund contributes fully. As such, for the first time in five years the bloc's economic growth is likely to exceed that of the U.S. However, two factors need to be monitored closely—labour markets and the energy crisis.

Tight labour markets

Labour markets recovered further in December, with the overall unemployment rate falling below its pre-pandemic level, to seven percent, thanks to strong demand. Job vacancies are higher now than in 2019 due to a decline in active participation and reduced cross-border mobility, both caused by the pandemic. There also seems to be a shortage of skills necessary for the green transition.

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

The European Commission's euro area Employment Expectations Indicator (EEI), which measures companies' hiring expectations over the next three months, stands only slightly below its highest level on record, pointing to strong hiring going forward. Should labour demand continue its strong recovery, wage increases, which are currently running at low single-digit levels, could accelerate, at least in some sectors, fuelling inflation.

The energy crisis

Higher energy prices, natural gas prices in particular, are denting consumers' purchasing power. EU natural gas prices have increased close to 300 percent over the past year. Most governments have put in place measures to reduce the impact of high energy costs, ranging from capping consumer gas prices in 2022, as France did, to reducing taxes, such as was done by Italy and Spain, which reduced the consumer sales tax on energy. While this may take the sting from the vertiginous increase in prices, gas prices remain elevated and the risk is that consumers may well respond by cutting spending elsewhere.

The energy crisis is also having a major impact on inflation, which came in higher than expected in January. The headline harmonised index of consumer prices reached 5.1 percent. Energy prices were the main driver, as core inflation was a more subdued 2.3 percent for the euro area as a whole.

That energy is such an important element of the current surge in inflation is also visible in the large spread of national inflation, with France—which has capped energy prices—at one end of the spectrum with inflation of 3.3 percent and Lithuania (12.2 percent) at the other.

RBC Capital Markets expects inflation to continue to moderate throughout 2022 as the contribution of energy gradually normalises, though it now expects inflation to fall below the ECB's two percent target later than previously anticipated—by 2023.

Fear and trepidation?

The last time the ECB tightened monetary policy, in 2011, after the global financial crisis, it caused significant volatility in financial markets and choked off the recovery. The central bank soon had to abandon its policy. Since then, important progress has been made aiming to strengthen regional institutions.

In particular, we think the establishment in 2020 of the €750 billion EU recovery fund points to a willingness to share fiscal burdens. Financed by borrowing on behalf of the EU as a whole, the fund is largely allocated to southern member countries as they have suffered the most from the pandemic. The Banking Union, established a decade ago, ensures that if a financial institution needs to be recapitalised after bond and equity investors have been tapped, the European Stability Mechanism, an intergovernmental organisation which provides financial assistance, can be accessed, so that the host country is no longer the sole recourse. Moreover, the banking system is now much stronger, as the banks, prompted by regulators, have taken steps to rebuild their balance sheets. Finally, the ECB has given itself more tools to manage volatility in financial markets.

These structural changes suggest to us that the region should better withstand the upcoming monetary tightening cycle. Nevertheless, the ECB plans to keep a close eye on how its highly indebted member countries are impacted by its actions. Italian sovereign 10-year bond yield spreads relative to their German counterpart have already widened since the ECB meeting, though they remain much below their 12-year average.

Maintain Overweight

The 2022 global investment backdrop has already set out to be more volatile than last year's. That also applies to European equities, particularly given the tensions between the West and Russia. Yet we continue to suggest holding an Overweight, or above-benchmark, position in this asset class. Given the prospect of above-average economic growth this year, we believe earnings growth expectations of around seven percent are undemanding, leaving room for upgrades. Valuations have improved and the MSCI Europe ex UK Index trades at a forward price-to-earnings ratio of 14.3x, below its five-year average. As for sectors, we think Financials appears well positioned to benefit from higher interest rates and the robust growth outlook, while the Industrials sector could also provide attractive opportunities given Europe is a leader in green technologies.

The spread of Italian sovereign bond yields to German bond yields has started to widen

Yield gap of Italian 10-year government bonds over German counterparts

Source - RBC Wealth Management, Bloomberg; data through 2/9/22

UNITED STATES

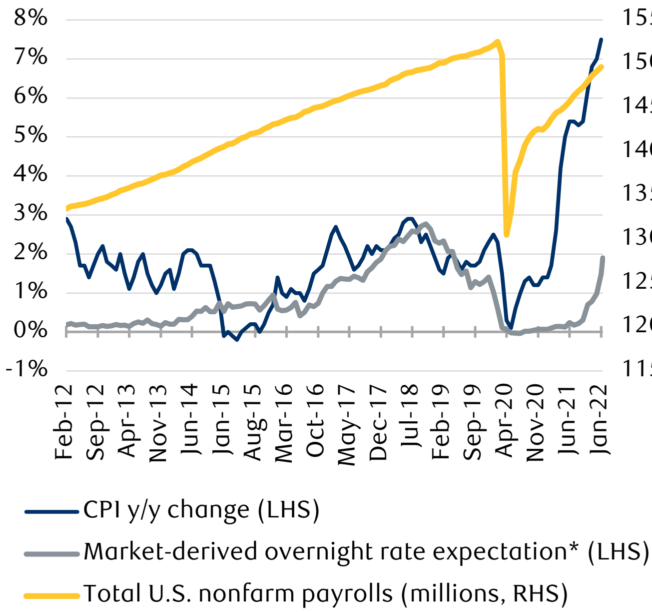
Atul Bhatia, CFA – Minneapolis

- **U.S. prices rose at the fastest pace since 1982 last month**, with the January Consumer Price Index (CPI) 7.5% higher y/y and so-called core inflation (which removes volatile food and energy prices) up 6% in the same time period. The increases were led by food, electricity, and shelter costs, but gains were broad-based and included components such as medical costs that had shown relative price stability in prior reports. One potential positive for policymakers is that **inflation remains heavily tilted to goods rather than services**, with prices for the former rising at nearly three times the pace of the latter. As supply-chain issues are resolved, **we expect some downward pressure on future CPI levels**—although it will likely be some time before we approach the Fed's 2% target, in our view.

- **January's nonfarm payrolls report showed significant progress in the labor market**. Not only did the U.S. add nearly half a million jobs to start the year—despite the omicron variant's impact—but revisions to last year's numbers showed 700,000 more jobs were created in 2021 than were initially reported. The U.S. has now recovered all but three million of the jobs destroyed during the pandemic, a notable improvement from the 22 million jobs lost in April 2020. **Adding to the positive jobs sentiment was a third week of declines in initial jobless claims**, as continuing labor shortages have led companies to discharge workers at the slowest pace in at least 20 years.

- **With employment largely recovered and inflation significantly above target, the consensus expectation—which we share—is for the Fed to begin rolling back pandemic accommodation at its March meeting**. Market pricing following the January CPI report now reflects a meaningful probability of a 0.5% hike in the federal funds target rate at the next meeting, as opposed to the earlier consensus expectation of 0.25%. A larger initial hike may not be entirely negative for investors in longer-maturity bonds, however, if the faster start presages a lower terminal rate for this hiking cycle. With five weeks remaining until the next scheduled Fed meeting, **incoming data may lead to further shifts in market expectations on policy**.

Rising inflation and employment drive expectations for faster Fed action



* Expected one-month average starting in one year

Source - RBC Wealth Management, Bloomberg; monthly data through 1/31/22

CANADA

Sean Killin & Richard Tan, CFA – Toronto

- Unlike the equity markets, **the Canadian real estate market carried forward its momentum** with key metropolitan cities posting year-over-year price gains in January. In our view, three factors have been driving the price gains in the Canadian housing market. To begin, supply remains low by historical standards and demand continues to be robust as households reprioritize the need for larger spaces in a hybrid/remote working environment. Second, real assets are generally viewed as a potential hedge against inflation, and thus the above-average inflation prints have likely contributed to the upward swing in the real estate market. Third, a rising rate environment likely means consumers with mortgage preapprovals from the last few months are likely being quoted at materially lower rates compared to today's market. As a result, we believe some consumers are being motivated to close on a property and to secure more attractive financing ahead of rate hikes. Overall, **RBC Economics believes prices will continue to climb in 2022**, albeit at a slower pace year-over-year.

- **The omicron variant's economic impact is set to be noteworthy but ultimately short-lived across Canadian labour markets, in our view**. The unemployment rate rose to 6.5% in January from 6.0% in December, as the economy shed approximately 200,000 jobs as a result of broad public-health measures implemented by Ontario and Quebec, Canada's most populated provinces. Unsurprisingly, these losses were mainly concentrated in high-contact service-sector jobs, as the hospitality and food service industries continue to be disproportionately affected by pandemic public-health restrictions. The variant's high level of transmissibility led to a 2.2% decrease in hours worked, which is the largest drop since April of last year, as 10% of employees were absent from their jobs at some point in the month due to illness or an inability to work. **The Bank of Canada held its benchmark rate unchanged at its January policy meeting**, citing the preliminary impact of the variant's spread, **but it continued to signal that rate hikes are coming soon**. Despite January's labour force survey coming in worse than the months prior, RBC Economics expects a recovery to start in February with public-health measures easing across the country.

EUROPE

Rufaro Chiriseri, CFA & Thomas McGarrity, CFA – London

- **Following the hawkish tone from the Bank of England and European Central Bank (ECB) last Thursday, the tantrum in bond markets continued during the week.** The yield on UK 10-year Gilts soared to 1.51%, a level last seen in November 2018, while the German 10-year Bund rose to 0.279%, its highest level since January 2019, having been in negative-yielding territory from May 7, 2019 until Jan. 31 of this year.

- The European bond market selloff has been more pronounced in the heavily indebted nations of Italy and Greece, which have debt levels around 160% and 200% of GDP, respectively, as of the end of 2021. Both nations have benefited from the ECB's bond buying through the Pandemic Emergency Purchase Programme, which has kept borrowing costs low for the euro area. **We now expect a faster tapering of bond purchases, and therefore see potential for yields to rise further from current levels.** The cost of borrowing over 10 years has doubled for Italy and Greece since last December's ECB meeting, and the ECB will be closely watching these rising yields when deliberating its forward guidance.

- The standout beneficiaries this year from the hawkish pivots by central banks have been Banks stocks in a sector context, and the UK's FTSE 100 Index from a regional equity market perspective.

- **European and UK banks are among the most rate-sensitive globally**; accordingly, the upward repricing in front-end interest rates should benefit their net interest margins and thus improve their earnings outlooks. Within the STOXX Europe 600 Index, Banks are up almost 15% year to date.

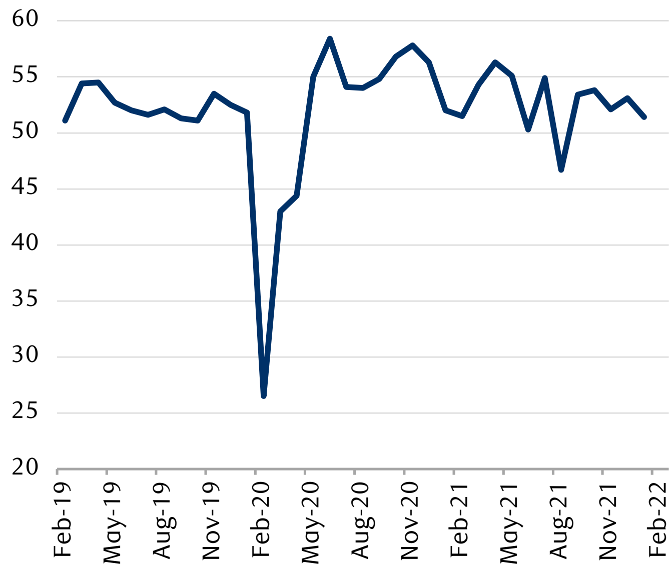
- The UK's FTSE 100 Index, of which almost 40% comprises Financials, Energy, and Miners, is up around 3.5% in 2022, buoyed by the **market rotation towards "value" investing amid the sharp rise in yields**. The relative performance of UK equities has the highest correlation to value outperforming growth of any major region, according to our national research sources, and thus the UK tends to be one of the best-performing regions when the value style outperforms.

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **China announced travel and consumption data for the Lunar New Year holiday.** During the seven-day national holiday, about 130 million passenger trips were taken via road, rail, and other domestic transport routes, a 31.7% increase over 2021, but still nearly 70% below pre-pandemic levels. Domestic tourism revenue reached RMB 289.2 billion over the seven days, down 3.9% y/y, and 56.3%

Caixin China Services Purchasing Managers' Index fell to the lowest level since August 2021



Source - RBC Wealth Management, Bloomberg; monthly data through 1/31/22

of the 2019 level. In addition, the Caixin China Services Purchasing Managers' Index fell to 51.4 for January from 53.1 in December, its lowest level since August 2021. **The domestic consumption recovery remains lackluster**, being largely affected by local COVID-19 containment measures and people still cautious toward travelling and spending.

- **The U.S. Commerce Department added 33 Chinese entities to its Unverified List (UVL) on Monday.** These entities are primarily high-tech manufacturers (including those that produce laser components and pharmaceuticals), government research labs, and two universities. The Commerce Department adds parties to the list if it is unable to verify the end use of U.S. exports by those entities. U.S. exporters must apply for a licence to export certain items to companies on the UVL. We note that the UVL is different from the Entity List and the Military End User List. The UVL could increase procedural and licensing costs in the purchase of raw materials, but does not bar companies from doing business with U.S. entities. However, we think this development could be a short-term overhang for the share prices of newly added companies.

- **The People's Bank of China said in a statement on Tuesday that bank loans to fund low-cost rental projects will no longer be subject to regulatory curbs.** The rules required banks to trim their loan exposure to the property sector to a certain level. The measure may help counter the slowdown in property development and ease some funding pressure on developers.

MARKET
Scorecard

Data as of February 10, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,504.08	-0.3%	-5.5%	15.2%	34.4%
Dow Industrials (DJIA)	35,241.59	0.3%	-3.0%	12.1%	20.4%
Nasdaq	14,185.64	-0.4%	-9.3%	1.5%	47.3%
Russell 2000	2,051.16	1.1%	-8.6%	-10.1%	23.0%
S&P/TSX Comp	21,531.72	2.1%	1.5%	16.7%	21.4%
FTSE All-Share	4,296.96	2.5%	2.1%	15.4%	3.8%
STOXX Europe 600	472.35	0.7%	-3.2%	15.4%	11.2%
EURO STOXX 50	4,197.07	0.5%	-2.4%	15.0%	10.6%
Hang Seng	24,924.35	4.7%	6.5%	-17.0%	-8.5%
Shanghai Comp	3,485.91	3.7%	-4.2%	-4.6%	20.6%
Nikkei 225	27,696.08	2.6%	-3.8%	-6.3%	16.9%
India Sensex	58,926.03	1.6%	1.2%	14.8%	43.8%
Singapore Straits Times	3,428.00	5.5%	9.7%	17.2%	8.4%
Brazil Ibovespa	113,367.80	1.1%	8.2%	-4.3%	0.7%
Mexican Bolsa IPC	52,599.58	2.5%	-1.3%	17.6%	18.8%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	2.042%	26.5	53.2	91.9	47.2
Canada 10-Yr	1.944%	17.3	51.8	95.5	63.3
UK 10-Yr	1.524%	22.2	55.3	103.5	96.7
Germany 10-Yr	0.284%	27.3	46.1	72.1	69.5
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.30%	-1.1%	-3.2%	-3.9%	0.4%
U.S. Investment-Grade Corp	2.95%	-1.2%	-4.5%	-4.3%	1.2%
U.S. High-Yield Corp	5.37%	-0.1%	-2.9%	0.9%	8.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,826.34	1.6%	-0.2%	-0.9%	16.2%
Silver (spot $/oz)	23.19	3.2%	-0.5%	-14.2%	30.5%
Copper ($/metric ton)	10,103.00	5.5%	3.7%	21.7%	78.8%
Oil (WTI spot/bbl)	89.88	2.0%	16.7%	53.2%	81.3%
Oil (Brent spot/bbl)	91.31	0.1%	17.4%	48.5%	71.4%
Natural Gas ($/mmBtu)	3.95	-19.0%	5.8%	35.6%	123.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	95.7810	-0.8%	0.1%	6.0%	-3.1%
CAD/USD	0.7858	-0.1%	-0.7%	-0.2%	4.6%
USD/CAD	1.2726	0.1%	0.7%	0.2%	-4.4%
EUR/USD	1.1418	1.6%	0.4%	-5.8%	4.6%
GBP/USD	1.3553	0.8%	0.2%	-2.0%	4.9%
AUD/USD	0.7161	1.3%	-1.4%	-7.3%	7.1%
USD/JPY	116.0600	0.8%	0.9%	11.0%	5.7%
EUR/JPY	132.5200	2.5%	1.2%	4.5%	10.6%
EUR/GBP	0.8425	0.9%	0.1%	-3.8%	-0.3%
EUR/CHF	1.0582	1.6%	2.0%	-1.9%	-0.8%
USD/SGD	1.3454	-0.4%	-0.3%	1.4%	-3.2%
USD/CNY	6.3541	-0.1%	0.0%	-1.6%	-9.0%
USD/MXN	20.5745	-0.3%	0.2%	2.7%	10.0%
USD/BRL	5.2497	-1.1%	-5.8%	-2.5%	21.4%

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 -0.07% return means the Canadian dollar fell 0.7% vs. the U.S. dollar year to date. USD/JPY 116.06means 1 U.S. dollar will buy 116.06 yen. USD/JPY 0.9% return means the U.S. dollar rose 0.9% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 2/10/22

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Hold [Sector Perform]	557	38.60	180	32.32
Sell [Underperform]	55	3.81	3	5.45

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