GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

February 17, 2022

In short, it's time to go long

Atul Bhatia, CFA – Minneapolis

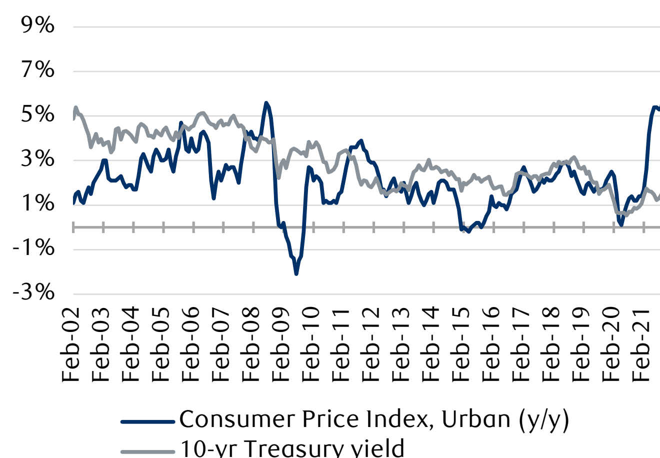
As bond investors await the next steps from the Federal Reserve, they may be examining a multitude of investment options. We explain why we believe looking to the long term is the right approach for seeking value in a rising rate cycle.

Bond markets have had a difficult start to 2022, with expectations for tighter monetary policy driving yields higher and bond prices lower. For Treasury markets, there has been some offset to the selling pressure, as investors have sought the safety of U.S. government debt amid rising global tensions in Ukraine, a geopolitical concern that RBC Wealth Management's Global Portfolio Advisory Committee recently examined and placed into historical context.

For monetary policy, we concur that the Fed will likely raise rates multiple times in 2022, but we believe current bond pricing reflects an overly aggressive tightening forecast, as indicated by futures markets showing a high probability of at least six rate hikes this year. In our view, it's critical for investors to remember that the impetus for tightening comes from the success of the fiscal and monetary response to COVID-19; with significant fiscal tightening on the way in 2022 and the likely normalization of supply chains later this year, we believe the Fed will be able to move at a more measured pace, a view we discuss more fully in a recently published article on "The price of success."

The recent losses and likely shift in monetary policy may create concern regarding the prospects for fixed income this year; while we acknowledge the macroeconomic headwinds, we believe there are still pockets of value in the U.S. fixed income market for investors with a longer-term mindset.

Rising inflation and potential policy response a potential headwind for bond prices



Source - RBC Wealth Management, Bloomberg; CPI data through 1/31/22, 10yr Treasury data through 2/17/22

Go long

One approach to dealing with policy uncertainty is to focus on longer-maturity Treasuries. Bonds that mature in 30 years, for example, tend to reflect longer-term

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

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For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

economic trends and growth rates more than shorter-maturity bonds, which are influenced more directly by Fed policy. High-grade, longer-maturity bonds offer two additional advantages.

First, because longer-maturity bonds are more sensitive to changes in the yield curve, a relatively small position in 30-year Treasuries can create a return profile similar to that of a much larger stake in shorter maturities. A $100,000 position in 30-year government debt, for instance, will likely generate similar market gains and losses as a $450,000 stake in five-year bonds, if yields change by a similar amount for each maturity. By focusing on longer maturities for high-grade debt, investors can free up assets to invest in other, potentially more attractive asset classes, while keeping exposure to the hedging characteristics of bonds.

Second, if the Fed does act more aggressively to combat inflation, we believe yields will likely rise faster on short-maturity bonds than on long-maturity bonds, as the slower growth implications of tight policy could create demand for 30-year government debt. Investors could still see losses on longer-maturity bonds, even if those securities outperformed other Treasury bonds. Of course, if the Fed were able to combat inflation with fewer policy moves, yields could decline by more on shorter-maturities, potentially leading longer-maturity bonds to underperform.

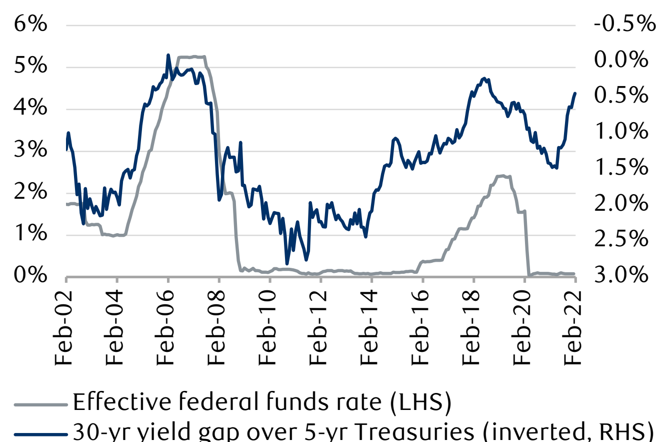
Credit where credit is due

For investors with greater risk tolerance, adding credit exposure can pair well with using longer-maturity Treasuries to free up assets.

The macroeconomic backdrop is not without risks—Fed tightening and fiscal contraction are headwinds. But recent data—including this week's retail sales—have underscored the strength of private demand and consumer spending. Retail sales in January were up 3.8%, despite the ongoing omicron variant and without considering gas and auto prices, both of which have seen large supply-constrained price increases. Inflation also helps reduce debt burdens in real terms, and corporate borrowers in the aggregate used 2020 and 2021's low rate environment to secure longer-term financing on attractive terms. In short, we view growth prospects and corporate balance sheets as supportive for credit markets, with default rates likely to remain low.

Shorter-term, higher-yielding debt also tends to be more heavily influenced by individual corporate factors than the general interest rate environment. Most importantly, because debt is governed by contractual obligations, market losses will eventually be recovered, unless there is a default or other credit event before maturity.

Longer-maturity bond yields historically rise more slowly as the federal funds rate increases



Source - RBC Wealth Management, Bloomberg; federal funds rate data through 1/31/22, yield data through 2/17/22

Rising coupons help hedge rising rates

Another fixed income instrument that can perform well with rising interest rates are floating-rate notes, known as "floaters." The coupon on these instruments is calculated using a short-tenor reference rate—frequently an overnight or quarterly rate—plus a fixed spread. As policy rates rise, these reference rates tend to rise as well, providing investors with additional income.

One potentially interesting subset of floaters is hybrid preferreds with a fixed-to-float structure. These securities typically offer a multi-year period of fixed coupons before converting to a floating-rate structure. Hybrids are subordinated securities and usually include options for the issuer to call the security, but for investors with the appropriate background and risk tolerance we think they can offer an interesting blend of interest rate and credit exposure.

Volatility for longer-term potential gains

We expect continued volatility in U.S. fixed income markets. Fed policy expectations will change with incoming data, and while we anticipate inflationary pressures will recede in H2, the precise timing and magnitude of price stabilization is uncertain. In a similar vein, although we believe macroeconomic conditions are favorable for credit performance, the backdrop of a shrinking central bank balance sheet and reduced fiscal spending could put corporate bond prices under near-term pressure even if defaults remain low.

We believe investors with a longer-term perspective, and the appropriate risk tolerance and liquidity profile, can use this uncertainty to judiciously utilize longer-maturity government bonds and additional credit risk in their fixed income allocation. For investors with a greater risk tolerance, equity markets continue to look attractive to us as well.

UNITED STATES

Alan Robinson – Seattle

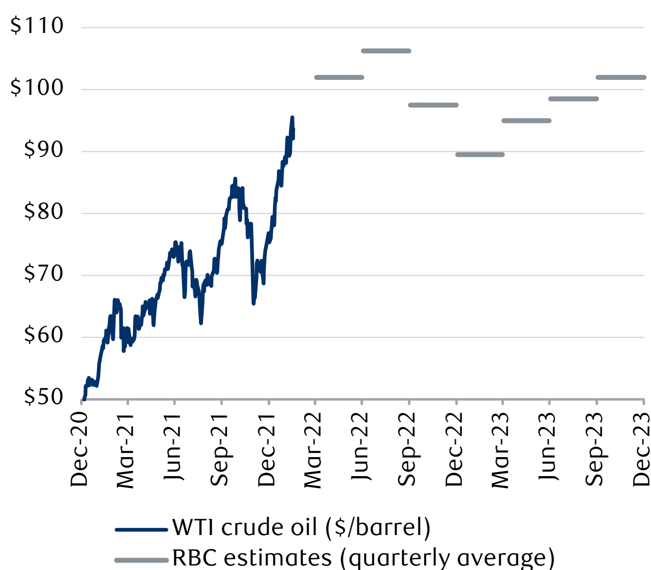
■ **U.S. stocks struggled to maintain gains during the week**. The number of COVID-19 cases continued to decline rapidly in the U.S. and other developed markets, but this positive driver was offset by the two Rs—rates and Russia. RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina believes the risk of higher interest rates is largely priced into stocks, but the worsening Russia/Ukraine situation is probably not priced in currently. However, on the positive side, Calvasina notes that net bullishness of retail investors fell to -30% at the end of January 2022, in line with the pandemic low of -29% jin Q2 2020. Historically, when this indicator is below -10% on a four-week average, the S&P 500 is up 86% of the time 12 months later with an average return of 15%. In other words, this indicator is now "so bad it might be good."

■ **The Energy sector has benefited from the recent geopolitical upheaval,** having gained 23% year to date through Feb. 16, 2022, compared to a 6% decline for the S&P 500. RBC Capital Markets, LLC Global Commodity Strategist Michael Tran thinks there's more to come. He believes oil is in a "supercycle" based on a rare combination of favorable supply AND demand dynamics. He has raised his forecasts for oil prices and sees a risk oil may hit $115 per barrel this summer before leveling off between $100 and $110 per barrel (see chart).

■ As we approach the two-year anniversary of the COVID-19 pandemic, **RBC Global Asset Management Inc. Chief Economist Eric Lascelles has updated his proprietary business cycle scorecard**. His model uses 17 inputs to gauge where the U.S. economy stands within its long-term business cycle. He concludes the economy is firmly "mid-cycle" compared to early/mid-cycle readings at the start of the year. While he thinks this suggests the cycle will likely be shorter than its predecessor, it also points to several more years of growth, albeit with likely more moderate equity gains in the future compared to recent years.

Supply & demand factors continue to support oil prices

Oil price and forecasts



Source - FactSet, RBC Capital Markets, RBC Wealth Management; data as of 2/17/22

CANADA

Luis Castillo & Simon Jones – Toronto

■ **Canada's Consumer Price Index for January showed a 5.1% y/y rise, the fastest annual increase in prices anyone under the age of 30 has seen in their lifetime**. Transportation, food, and shelter costs remained key drivers; notably, the shelter category has experienced the sharpest annual increase since 1990 at 6.2% y/y. However, the concentration of inflation in these three categories has been gradually diluted in recent months, as price pressures have branched out to other areas. According to RBC Economics, the share of the consumer basket experiencing price increases above 2% versus pre-pandemic levels grew to 62% over the three-month period that ended in January. Despite the highest inflation print since 1991, results are still broadly in line with the Bank of Canada's recently updated economic projections, which call for 5% average CPI growth in H1 2022 and 5.1% in Q1.

■ After a sharp rebound in employment following the pandemic-induced layoffs, **Canada's labour market has tightened substantially** and businesses are now having difficulty filling job openings. To adapt to this new normal, **businesses have begun increasing their spending on technology and automation** in an effort to enhance the productivity of each worker. However, many businesses are still having to raise wages to attract and retain talent, and these costs are being passed on to consumers through higher prices. Canada has historically relied on immigration to increase its workforce, and after a brief lull due to the pandemic, this trend is expected to continue. On Monday, **the Government of Canada announced its intention to welcome approximately 1.3 million people to the country over the next three years**, the majority of whom are expected to be economic immigrants selected on the basis of their ability to contribute to the Canadian economy. This increase in immigration, and the government's greater emphasis on immigrants' potential economic contributions, should help alleviate some of the inflationary pressures that have resulted from ongoing labour shortages.

EUROPE

Rufaro Chiriseri, CFA & Thomas McGarrity, CFA – London

- **UK inflation slightly overshot the Bank of England's (BoE) and economists' consensus expectations**, with the Consumer Prices Index rising by 5.5% y/y in January compared to a 5.4% y/y expectation. Inflation hit a 30-year high which was attributable to higher prices for clothing and footwear and for household goods. The BoE's February Monetary Policy Report forecasts inflation to peak around 7% in April when the energy price cap takes effect, before gradually decelerating towards the central bank's 2% target in early 2024. Following the data release, markets have taken a pause as **current expectations for the year-end Bank Rate have cooled from a peak of 2.09% to 1.87% this week**; in our view, this likely indicates expectations were somewhat elevated.

- **The UK unemployment rate remained unchanged at 4.1%, with the number of vacancies rising to a new record high just below 1.3 million**. According to RBC Capital Markets, forward indicators suggest further tightening of the labour market. In our view, the inflation and unemployment data favour a 0.25% interest rate hike at the BoE's March meeting, and this is our base case; however, a 0.50% move cannot be ruled out given the BoE nearly approved a hike of that magnitude at its February meeting.

- **The "unprecedented inflationary environment,"** in the words of Reckitt Benckiser CEO Laxman Narasimhan, **is being felt particularly acutely in the Consumer Staples sector**, where results and guidance have been somewhat mixed this earnings season. Henkel and Unilever have issued operating margin guidance significantly below consensus expectations; Unilever, for example, forecasts its underlying operating margin will shrink between 140 basis points (bps) and 240 bps in 2022, to 16%–17% (it was 18.4% in FY2021). Nestlé, whose portfolio is tilted to "premium" Staples categories such as coffee and pet food, guided to an operating margin of 17.0%–17.5% in the year versus current consensus of 17.5%. Nestlé's CEO commented that the company has seen the most margin pressure in mid-range products, whereas more premium products have been able to offset inflation through pricing.

- While we recognize the sector's attractive defensive characteristics, **we recommend being Underweight Consumer Staples** at present as we think cost inflation headwinds tilt earnings risks to the downside.

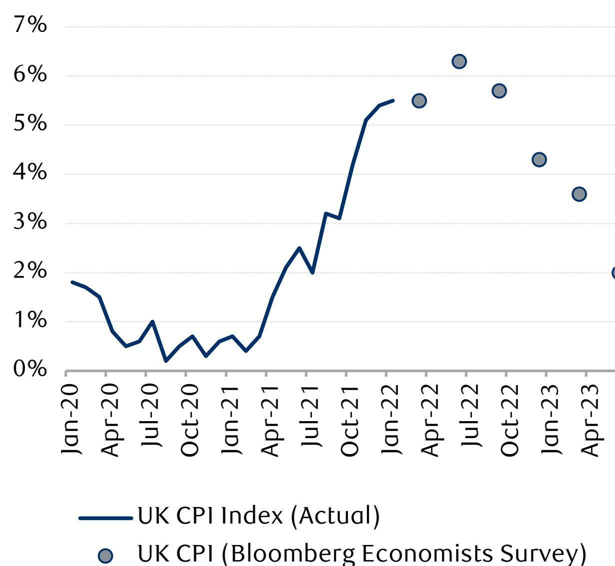
ASIA PACIFIC

Emily Li – Hong Kong

- **President Xi Jinping called for Hong Kong officials to take "all necessary measures" to get the city's COVID-19 outbreak under control**, an unusually direct intervention that could pave the way for stricter measures and possibly a broader lockdown in the Asian financial hub. Hong Kong is planning to test its entire population in an effort to stamp out the worsening outbreak. Stocks tied to Hong Kong's economic reopening, including those of vaccine makers, casinos, cosmetics makers, and jewelers, gained after a report on the mass testing plan spurred optimism that the city is laying the groundwork to loosen pandemic restrictions.

UK inflation expected to peak in Q2 this year

UK CPI Inflation including 2023 forecasts



Source - RBC Wealth Management, Bloomberg; data as of 2/17/22

- **China announced it has decided to clear Pfizer Inc.'s COVID-19 pill Paxlovid for use**. Paxlovid is an antiviral medication given to COVID-19 patients shortly after they test positive. Clinical trial data released in November showed that adults at high risk of the disease who received the pill were 89% less likely to be hospitalized or die from COVID-19. The conditional approval over the weekend makes Paxlovid the first foreign pharmaceutical product China has endorsed for COVID-19, as the country has been steadfast in sticking to domestically developed vaccines and therapeutics. The decision was a surprise for the market. We think this could lead to a more flexible COVID-19 containment approach in China in the future.

- **The People's Bank of China (PBoC) injected a net RMB 100 billion into the banking system with its medium-term lending facility on Tuesday**, while leaving the borrowing rate unchanged. We think the move signals the central bank wants to keep policy accommodative to ensure economic stability. In addition, PBoC Governor Yi Gang said China will keep the accommodative monetary policy flexible and appropriate, and increase support for key areas and weak links in the economy. The central bank projects China's potential growth rate, or the maximum the economy can expand without fueling inflation, is about 5%–5.7% in the five years through 2025.

MARKET
Scorecard

Data as of February 17, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,380.26	-3.0%	-8.1%	11.4%	29.6%
Dow Industrials (DJIA)	34,312.03	-2.3%	-5.6%	8.5%	16.7%
Nasdaq	13,716.72	-3.7%	-12.3%	-1.8%	41.0%
Russell 2000	2,028.09	0.0%	-9.7%	-10.1%	20.2%
S&P/TSX Comp	21,176.33	0.4%	-0.2%	15.2%	18.6%
FTSE All-Share	4,212.87	0.5%	0.1%	10.5%	1.6%
STOXX Europe 600	464.55	-0.9%	-4.8%	11.6%	7.5%
EURO STOXX 50	4,113.19	-1.5%	-4.3%	11.2%	6.7%
Hang Seng	24,792.77	4.2%	6.0%	-20.2%	-11.3%
Shanghai Comp	3,468.04	3.2%	-4.7%	-5.1%	16.2%
Nikkei 225	27,232.87	0.9%	-5.4%	-10.1%	15.8%
India Sensex	57,892.01	-0.2%	-0.6%	12.0%	41.0%
Singapore Straits Times	3,441.57	5.9%	10.2%	17.8%	7.1%
Brazil Ibovespa	113,528.50	1.2%	8.3%	-5.7%	-1.5%
Mexican Bolsa IPC	52,712.06	2.7%	-1.1%	17.0%	17.1%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.965%	18.8	45.5	69.5	38.0
Canada 10-Yr	1.918%	14.7	49.2	80.7	55.3
UK 10-Yr	1.463%	16.1	49.2	89.1	82.2
Germany 10-Yr	0.231%	22.0	40.8	59.9	63.2
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.44%	-1.9%	-4.1%	-4.1%	-0.3%
U.S. Investment-Grade Corp	3.13%	-2.7%	-5.9%	-5.0%	-0.2%
U.S. High-Yield Corp	5.70%	-1.5%	-4.2%	-0.5%	6.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,897.85	5.6%	3.8%	6.9%	20.0%
Silver (spot $/oz)	23.83	6.1%	2.2%	-13.0%	34.7%
Copper ($/metric ton)	10,034.75	4.8%	3.0%	19.4%	73.1%
Oil (WTI spot/bbl)	91.76	4.1%	19.2%	50.1%	76.3%
Oil (Brent spot/bbl)	92.82	1.8%	19.3%	44.3%	61.0%
Natural Gas ($/mmBtu)	4.51	-7.5%	20.8%	40.0%	145.3%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	95.8290	-0.7%	0.2%	5.4%	-3.2%
CAD/USD	0.7870	0.0%	-0.5%	-0.1%	4.2%
USD/CAD	1.2707	0.0%	0.6%	0.0%	-4.0%
EUR/USD	1.1360	1.1%	-0.1%	-5.6%	4.8%
GBP/USD	1.3616	1.3%	0.6%	-1.7%	4.7%
AUD/USD	0.7189	1.7%	-1.0%	-7.3%	7.1%
USD/JPY	114.9300	-0.2%	-0.1%	8.6%	4.6%
EUR/JPY	130.5700	1.0%	-0.3%	2.5%	9.7%
EUR/GBP	0.8344	-0.1%	-0.8%	-3.9%	0.1%
EUR/CHF	1.0454	0.4%	0.8%	-3.4%	-1.6%
USD/SGD	1.3435	-0.6%	-0.4%	1.1%	-3.3%
USD/CNY	6.3384	-0.4%	-0.3%	-1.9%	-9.2%
USD/MXN	20.3025	-1.6%	-1.1%	0.4%	9.4%
USD/BRL	5.1697	-2.6%	-7.3%	-4.5%	19.5%

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 -0.05% return means the Canadian dollar fell 0.5% vs. the U.S. dollar year to date. USD/JPY 114.93 means 1 U.S. dollar will buy 114.93 yen. USD/JPY -0.1% return means the U.S. dollar fell 0.1% vs. the yen year to date.

Source - Bloomberg; data as of 4:45 pm ET 2/17/22

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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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