GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee

March 17, 2022

The Fed goes above and beyond

Thomas Garretson, CFA – Minneapolis

Investors' eyes were focused on the Fed's much-anticipated rate hike announcement. Although some economic projections were expected, there were some surprises. We explain what impact a new rate trajectory could have on the economy.

Central banks largely stood their ground this week with the Bank of England delivering its third consecutive rate hike since last December to bring its policy rate to 0.75 percent, while the Federal Reserve began its own rate hike campaign with a 25 basis point move to a 0.25–0.50 percent fed funds rate target range at its March 15–16 meeting. Despite rising geopolitical concerns and economic uncertainty, central banks seemingly, at least thus far, continue to prioritize getting inflation under control over managing potential downside economic and market risks.

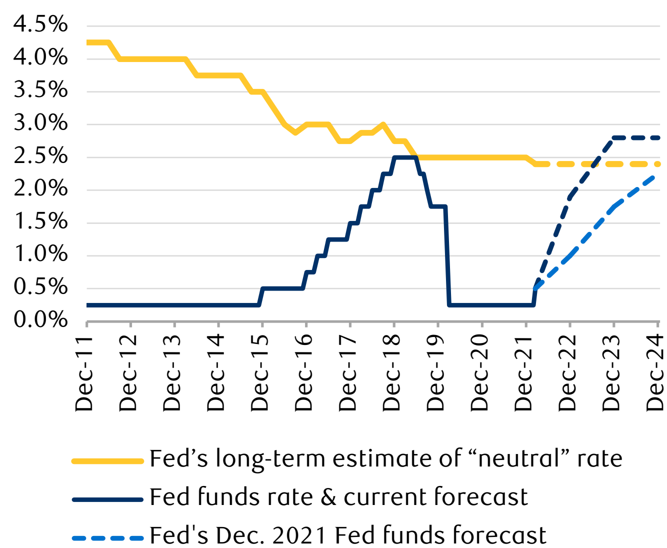
But it was the Fed's meeting that garnered the bulk of the headlines, and sparked the most market volatility this week—if only briefly.

Slow out of the gate, but more to come

With all eyes on the Fed's rate hike plans, it was the median estimates of the Fed's updated Summary of Economic Projections that showed policymakers now expect seven rate hikes this year, in line with current market-based pricing, but well above what we expected the Fed to project. Following this week's move, and with six meetings remaining, that would suggest a 25 basis point rate hike at every meeting, to a policy rate range of 1.75–2.00 percent.

But even beyond that development, it was the extent to which the Fed now envisions rates needing to move in

The Fed's updated rate hike timeline shows monetary policy could restrict economic activity by end of 2023



Source - RBC Wealth Management, Bloomberg, Federal Reserve; Dashed lines show Fed's projections

For perspectives on the week from our regional analysts, please see pages 4–5.

order to return to price stability, to 2.75 percent by the end of 2023, and above the Fed's current estimate of the longer-run "neutral" rate for the U.S. economy of 2.40 percent, or the level below which monetary policy is seen supporting economic growth, and above which it is potentially restrictive. Where the Fed's previous forecasts failed to reach that threshold over the entire forecast window, it could now be breached as early as next year. If the Fed maintains a 25 basis point-per-meeting pace into 2023, the policy rate would first exceed the Fed's estimated 2.40 percent "neutral" rate for the economy as early as its March 2023 meeting.

As the chart on page 1 shows, the last time these two metrics converged was in 2019 when the fed funds rate of 2.50 percent matched the Fed's "neutral" rate, which created sufficient market and economic stress to cause the Fed to begin a series of rate cuts, even before the onset of the global pandemic. So therein lies the next challenge for markets and investors to navigate as the Fed moves to tighten monetary policy, and perhaps aggressively so.

Price stability, but at what cost?

It wasn't just the Fed's upgraded rate hike projections that caught markets off guard, or the extent to which rates may rise this cycle, it was also the evolution of the economic outlook amid rising inflationary pressures, and waning economic growth prospects.

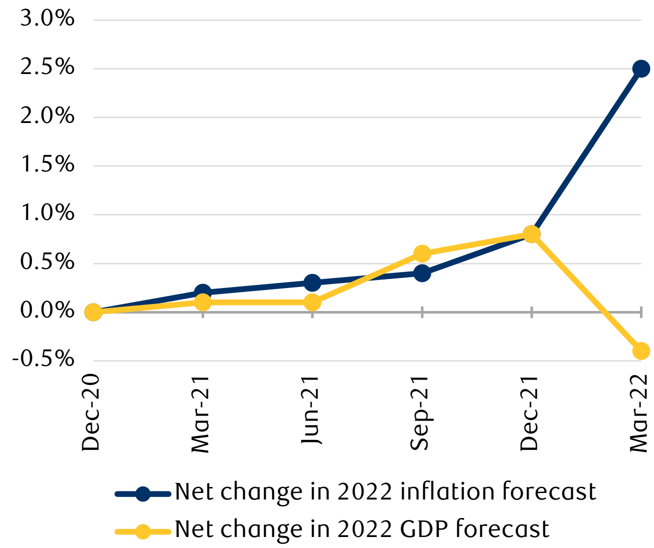
As the chart above shows, the Fed's expectations for both economic growth and inflation have been moving steadily higher, and in tandem, since December 2020. But as inflation has proved more persistent in recent quarters, that has changed. The Fed's updated numbers show headline inflation running at 4.3 percent this year, compared to a 2.6 percent estimate last December. Economic growth, on the other hand, received a sharp downgrade to 2.8 percent this year from 4.0 percent previously. Likely, and largely, it is a reflection of the Fed's plans to raise rates more aggressively than thought before.

While this dynamic may further stoke the flames of "stagflation" fears, it's important to note that GDP growth of 2.8 percent this year, and 2.2 percent next year, is still well above the 1.8 percent the Fed judges to be the long-term sustainable growth rate for the U.S. economy. But an aggressive rate hike timeline to above-neutral levels is one that could put monetary policy in a more precarious spot earlier than previously expected should the central bank battle against inflation come at the cost of the economic expansion.

Put in the work now to have options later

While no one wants to even utter the word "recession," especially at a time when it still feels like the economy has barely left the last one behind, it's the Fed's outlook—paired with current market signals such as ever-flatter

After rising in tandem, the Fed's inflation and growth forecasts diverged sharply at the March meeting



Source - RBC Wealth Management, Federal Reserve; the Fed currently projects 2.8% GDP growth this year, with a headline personal consumption expenditures inflation rate of 4.3%

Treasury yield curves—that suggests to us that it may not be too early to begin exploring the likelihood, as well as the potential ramifications, of such an outcome of global central bank policy tightening.

Put simply, we continue to think the near-term recession risks are low, certainly in 2022, but not low enough to ignore into 2023. Analysts often look to the 1990s as an idyllic stretch where early Fed rate hikes in the decade succeeded in getting inflation under control, allowing the Fed to pause and to tweak policy as needed later on, which ultimately led to a sustained economic recovery. Given a strong labor market backdrop today, a scenario like this would be our base case.

As Fed Chair Jerome Powell noted during his press conference, "The goal, of course, is to restore price stability while also sustaining a strong labor market. In fact, it's a precondition, really, for achieving the kind of labor market that we want, which is a strong and sustained labor market…"

It's certainly too early to say whether the Fed can, in fact, engineer a soft landing for the economy. And while near-term market and economic risks may remain high as central banks seek to move early and aggressively, we think the longer-run backdrop remains on solid footing, and that central banks will ultimately retain flexibility in removing accommodation as appropriate down the road.

Shadow of war: Downgrade European equities to Market Weight

Frédérique Carrier – London

The Russia-Ukraine conflict will cast a pall over global economic growth, and Europe is more vulnerable than most. Despite the EU's decisive response, the region's short-term outlook has become murkier. Given Europe has a relatively high proportion of cyclical stocks, we prefer to reduce risk and would peel back exposure to European equities.

Uncertain and complicated short-term outlook

Elevated energy costs, supply chain disruptions, and reduced demand as the uncertainty of the war dampens consumer spending will all conspire to dent the European economic recovery in 2022, in our opinion. This unwelcome turn comes after the region started the year on a relatively strong footing, benefiting from the reopening of economies after lifting the COVID-19-induced restrictions.

With the implications of the conflict becoming clearer, economic forecasts are being revised down. Eric Lascelles, chief economist at RBC Global Asset Management Inc., recently further fine-tuned his 2022 projection for the eurozone's GDP growth to 2.5 percent, down from 3.8 percent early this year. Still, the decline in energy prices of late could give the region some respite.

Lascelles looks for inflation to peak higher, at around eight percent year over year. Worried about such a high level, and the impact of the war on economic growth, the European Central Bank (ECB) is angling for some flexibility. While it announced it will accelerate the reduction of its asset purchase programme, aiming to end it in Q3, the ECB also suggested it could increase bond buying again if circumstances warranted. Furthermore, the ECB's statement after the March 10 policy meeting omitted the comment that rates could rise shortly after the end of asset purchases. RBC Capital Markets expects the ECB will only increase interest rates in 2023.

Dealing with the crisis

The EU's response to the war has been swift and decisive, and showed strong cohesion across the region, in our view. It applied punishing sanctions, and mobilised EU funding to deliver weapons to Ukraine. With the new geopolitical order making reducing the reliance on Russian energy imports an imperative, the EU proposed an ambitious plan, REPowerEU, to decrease Russian natural gas imports by two-thirds by the end of 2022 and completely by 2030. This will require procuring natural gas from alternative sources, relying more on coal and nuclear power, accelerating the rollout of renewable energy, and pursuing various energy efficiency policies while replenishing reserves. It remains to be seen whether all this can be achieved within the set time frames, and at what cost, but the direction is clear. More details on this plan should be forthcoming over the next two months.

Furthermore, a fiscal response is in the offing that should eventually underpin growth. At an informal summit on March 10–11, EU leaders agreed on the priorities of defense, energy, and economic resilience. A spending programme of €2 trillion was discussed. There was a general recognition that the €750 billion recovery fund to help member countries weather the pandemic has been productive by providing member states with fiscal flexibility, enabling the EU to coordinate loans and transfers, and allowing for the issuance of debt at the EU level. In effect, the recovery fund is seen as a prototype with the discussion evolving towards whether there is scope to use it to underpin new initiatives as not all funds have been released. More joint debt issuance is likely, in our view. The summit also launched a dynamic framework for the meetings of the EU Council coming up later in March and June where more details should be ironed out.

Portfolio implications

We opine that in the medium term fiscal spending should underpin growth, while over the long term the EU should eventually emerge from the conflict with stronger institutions. But the short-term outlook is nevertheless more complex than it was earlier this year.

The MSCI Europe ex UK Index is down more than 10 percent in local currency terms since its January high, leaving the index to trade at 14.5x the forward consensus earnings estimate, a steeper-than-average discount to the U.S. on a sector-neutral basis. This low level suggests that the reductions in growth forecasts largely appear to be factored into the current valuation.

Yet we think it is prudent to downgrade European equities to Market Weight from Overweight given it is a market with a relatively high proportion of cyclicals.

We still believe there is an attractive opportunity in stocks related to the green energy transition. This remains very much a priority for the EU, and if anything it is now seen as a security issue and not just an environmental matter. Europe continues to be a leader in this area and we think compelling opportunities can be found after the recent correction.

UNITED STATES

Alan Robinson – Seattle

■ **U.S. stocks gained ground during the week on thin volume**, as trepidation over the Fed meeting gave way to relief that the outcome was not too far from consensus expectations. Geopolitical concerns still buffeted the market, but lower oil prices and solid U.S. economic data attracted buyers.

■ With the door finally closing on the post-pandemic era of near-zero interest rates, **what does history tell us about the direction of U.S. equities during Fed tightening cycles?** Somewhat surprisingly, stocks have performed well in most cases, after an initial period of flat returns (see chart).

■ RBC Global Asset Management Inc. Investment Strategist Eric Savoie studied the monthly performance of the S&P 500 Index before and after the first rate hike of the 17 cycles since 1954. In the year leading up to the first hike, stocks gradually rallied across all instances. This makes sense, as the Fed would only start to hike if the economy was doing well enough to weather higher rates.

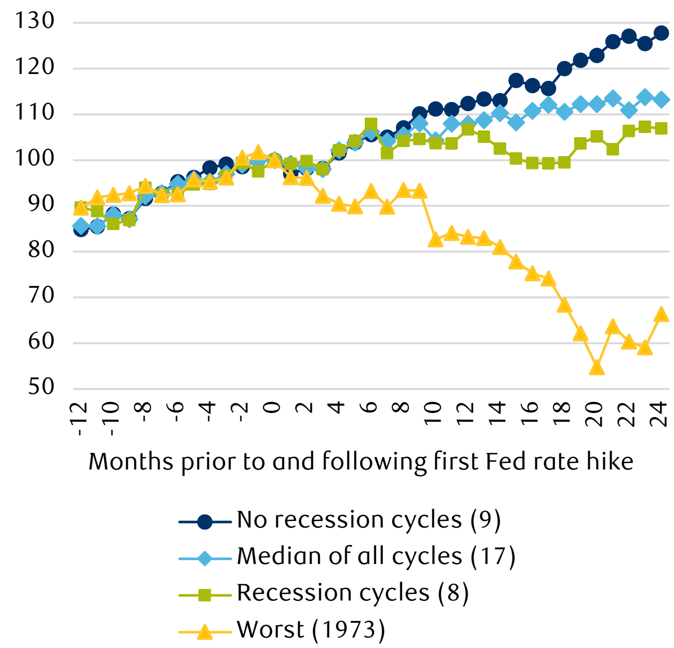
■ **After the first hike, equity market performance typically depended on whether the hiking cycle triggers an eventual recession**. In the nine cases when a recession was avoided, the index posted median returns of 6%, 13%, and 28% after six, 12, and 24 months, respectively. During the eight recession cycles, returns were flat after an initial bump higher, posting median returns of 8%, 7%, and 7% over the same periods. The worst post-hike returns were precipitated by external events, with the OPEC shock of 1973 triggering a severe recession and bear market.

■ Given the Fed board members' consistent acknowledgment of the **dangers of over-tightening**, we expect the current cycle to follow the non-recessionary path, although we also caution that inflation hasn't been this high in several decades.

■ **Some industry sectors have tended to perform better than others during hiking cycles**. Over the past 30 years, median returns 12 months after the first hike were better than the overall market for Technology (+29%), Energy (+26%), Financials and REITs (both +15%), and Industrials (+14%).

Don't fear the rate hike: Stocks can still rally as long as hikes don't trigger recessions

Median S&P 500 level before and after first rate hike



Source - RBC Global Asset Management, RBC Wealth Management, Bloomberg; data range: 1954-2018, normalized, with level at first hike =100

CANADA

Luis Castillo & Simon Jones – Toronto

■ **Canada's Consumer Price Index (CPI) for February rose 5.7% y/y, the fastest annual price increase since 1991** and the second straight month of inflation above 5%. The usual culprits (shelter, food, and energy) drove the February surge, with the food and energy categories alone responsible for nearly half the headline gain. However, inflation is gradually becoming less concentrated in these categories as price pressures spread to other areas. According to RBC Economics, the share of the consumer basket experiencing price increases above 2% versus pre-pandemic levels was up to 65% in February. Inflation data over the last couple of months have started to creep above the Bank of Canada's (BoC) most recent quarterly projections, which in January called for 5% average CPI growth in the first half of 2022 and 5.1% in Q1. These results continue to reinforce the BoC's case for policy rate normalization, making another 25 bps hike at the April meeting a real possibility, in our view.

■ The February jobs report, released by Statistics Canada on Friday, March 11, indicates the Canadian economy is nearing full employment. **Total employment increased by 337,000 in February, exceeding economists' expectations and more than making up January's omicron-induced decline of 200,000**. Even with a rise in labour force participation, February's surge in employment caused the unemployment rate to decline sharply to 5.5%, from 6.5% in January. With this percentage-point decline, **the unemployment rate now sits below the pre-pandemic level (5.7%) and is only a tick higher than its record low of 5.4%**. As governments ease public health restrictions, it comes as no surprise that most of February's employment gains occurred in high-contact sectors such as food and accommodation services (+114,000), culture and recreation (+73,000), and retail trade (+21,000). Coupled with the higher-than-expected CPI reading, we think the strength of February's labour market data should provide the BoC with ample justification for raising rates again in April.

EUROPE

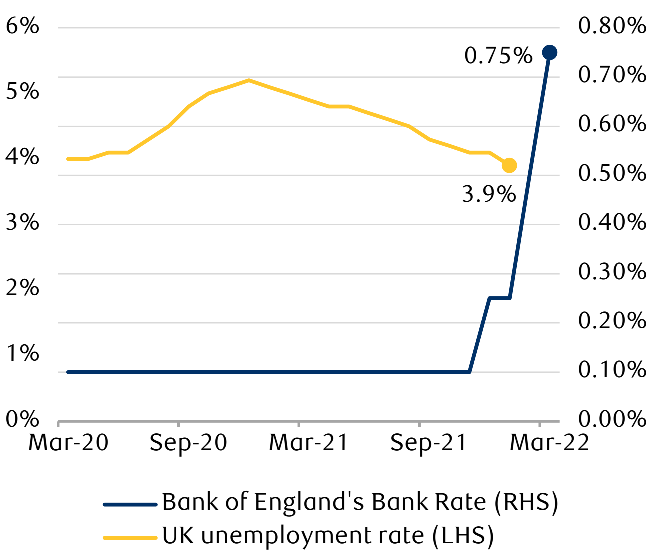
Rufaro Chiriseri, CFA – London

- The Bank of England's (BoE) decision to raise interest rates back to the pre-pandemic level of 0.75% from 0.5% came as no surprise to the market. However, **the BoE's dovish statement on future rate hikes came as a surprise**—changing from "likely" to "may be appropriate," indicating a softening on its stance for further rate hikes. The hike was backed by eight of the nine Monetary Policy Committee members, with Deputy Governor Sir Jon Cunliffe voting for no change. Cunliffe's decision was driven by the "very material negative impacts" that higher commodity prices will exert on households, which are already facing an income squeeze.

- **The BoE now expects inflation to rise to "around 8%" in Q2** and says peak inflation—expected later this year, when Ofgem, the UK's energy regulator, resets the energy price cap—could be "several percentage points higher" than the February 7.25% forecast. The BoE warned that the war in Ukraine will exacerbate global supply chain disruptions and further emphasized that this squeeze on real income could push inflation below target in the medium term due to lower household demand.

- **The UK unemployment data released this week supported the BoE's rate hike decision**. The unemployment rate fell to 3.9% from 4.1% and the number of vacancies rose above 1.3 million. The latest total pay growth data exceeded consensus for the second successive month, rising from 4.6% y/y to 4.8% y/y in the three-month period ending January.

UK unemployment & Bank of England Bank Rate



Source - RBC Wealth Management, Bloomberg; data as of 8:00 a.m. ET, 3/17/22

- Following the rate decision, markets have taken a pause as current expectations for the year-end Bank Rate have cooled from a peak of 2.25% to 2%, and largely priced out the possibility of a 0.50% hike at the May or June meetings. Against the backdrop of an income squeeze and a shift in the BoE's statement, **current Bank Rate expectations are somewhat elevated, in our view**.

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Chinese equities surged on Wednesday and Thursday**, after Chinese policymakers vowed to stabilize financial markets and addressed major concerns investors have about the market. The MSCI Golden Dragon Index rose 8% on Wednesday and the Hang Seng TECH Index has gained almost 32% in the past two days.

- **The State Council meeting, which prompted the rally, was held on Wednesday and chaired by Vice Premier Liu He, China's top economic official**. Key messages from the meeting include: 1) concrete actions must be taken to bolster the economy in the first quarter; 2) regarding regulation over U.S.-listed Chinese firms, regulators of the two countries have maintained good communication and made positive progress, and a concrete cooperation plan is being worked on; 3) continuous support will be provided for all types of companies seeking an overseas listing; and 4) the regulatory environment needs to be transparent and predictable to proceed, and regulatory reform for large platform companies should be completed as soon as possible.

- **Support was also shown for the Real Estate sector**, with a suggestion it is important to come up with timely solutions to prevent risk and launch supporting measures for the transformation to a new development approach. In addition, a news report by the state-run Xinhua news agency indicated China's finance ministry said it will not expand the trial for real estate tax reform in 2022. China property stocks reacted positively to the news.

- **We think these developments will boost investors' confidence and offer positive indications to the Chinese equity market**. However, we believe investors would like to get more insight about the concrete measures associated with the statements and the other challenges facing China's economy before turning more bullish, such as how the current round of COVID-19 outbreaks is being contained and what the future COVID-19 containment strategy will be, easing of global geopolitical tension, more clarity on Tech sector regulation, and easing measures for the property sector, etc. Before this happens, the Chinese equity market could remain volatile in the short term.

MARKET Scorecard

Data as of March 16, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,357.86	-0.4%	-8.6%	10.0%	82.6%
Dow Industrials (DJIA)	34,063.10	0.5%	-6.3%	3.8%	68.7%
Nasdaq	13,436.55	-2.3%	-14.1%	-0.3%	94.6%
Russell 2000	2,030.72	-0.8%	-9.6%	-12.5%	95.7%
S&P/TSX Comp	21,468.83	1.6%	1.2%	13.7%	73.7%
FTSE All-Share	4,074.09	-2.0%	-3.2%	5.0%	43.0%
STOXX Europe 600	448.45	-1.0%	-8.1%	5.1%	57.6%
EURO STOXX 50	3,889.69	-0.9%	-9.5%	1.0%	58.7%
Hang Seng	20,087.50	-11.6%	-14.1%	-30.8%	-12.9%
Shanghai Comp	3,170.71	-8.4%	-12.9%	-8.0%	13.7%
Nikkei 225	25,762.01	-2.9%	-10.5%	-13.9%	51.5%
India Sensex	56,816.65	1.0%	-2.5%	12.8%	81.0%
Singapore Straits Times	3,290.90	1.5%	5.4%	6.0%	31.9%
Brazil Ibovespa	111,112.40	-1.8%	6.0%	-2.5%	56.1%
Mexican Bolsa IPC	53,411.88	0.0%	0.3%	10.8%	40.2%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	2.187%	36.2	67.7	56.9	146.8
Canada 10-Yr	2.180%	36.7	75.4	61.0	140.5
UK 10-Yr	1.630%	22.0	65.9	84.5	119.2
Germany 10-Yr	0.392%	25.7	56.9	72.8	85.3
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.74%	-2.5%	-5.6%	-4.0%	-3.3%
U.S. Investment-Grade Corp	3.65%	-3.9%	-9.0%	-5.2%	0.9%
U.S. High-Yield Corp	6.47%	-2.8%	-6.5%	-2.0%	19.3%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,921.55	0.7%	5.0%	11.0%	26.9%
Silver (spot $/oz)	25.04	2.4%	7.4%	-3.5%	93.9%
Copper ($/metric ton)	9,857.25	-0.6%	1.2%	10.0%	86.8%
Oil (WTI spot/bbl)	95.04	-0.7%	23.4%	46.7%	231.1%
Oil (Brent spot/bbl)	97.44	-3.5%	25.3%	42.5%	224.3%
Natural Gas ($/mmBtu)	4.76	8.1%	27.6%	85.7%	162.1%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	98.3760	1.7%	2.8%	7.1%	0.3%
CAD/USD	0.7881	-0.1%	-0.4%	-1.9%	10.5%
USD/CAD	1.2688	0.1%	0.4%	1.9%	-9.5%
EUR/USD	1.1033	-1.7%	-3.0%	-7.3%	-1.3%
GBP/USD	1.3143	-2.1%	-2.9%	-5.4%	7.1%
AUD/USD	0.7289	0.4%	0.4%	-5.9%	19.2%
USD/JPY	118.7300	3.2%	3.2%	8.9%	12.2%
EUR/JPY	130.9900	1.5%	0.1%	1.0%	10.6%
EUR/GBP	0.8394	0.4%	-0.2%	-2.0%	-7.9%
EUR/CHF	1.0377	0.9%	0.0%	-5.7%	-2.0%
USD/SGD	1.3585	0.3%	0.7%	1.0%	-4.4%
USD/CNY	6.3526	0.7%	-0.1%	-2.4%	-9.2%
USD/MXN	20.6317	0.8%	0.5%	0.1%	-9.8%
USD/BRL	5.0816	-1.4%	-8.9%	-9.7%	1.6%

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 -0.4% return means the Canadian dollar fell 0.4% vs. the U.S. dollar year to date. USD/JPY 118.73 means 1 U.S. dollar will buy 118.73 yen. USD/JPY 3.2% return means the U.S. dollar rose 3.2% vs. the yen year to date.

Source - Bloomberg; data as of 3/16/22 market close

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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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