GLOBAL
Insight
WEEKLY

Wealth Management
RBC

Perspectives from the Global Portfolio Advisory Committee

March 24, 2022

Many moving parts

Joseph Wu, CFA – Toronto

The downward adjustment in equity valuations suggests there is now a larger cushion against near-term risks. However, geopolitical conflict and inflation expand the range of potential market outcomes. We look at portfolio positioning implications for both equities and fixed income.

The benefits of lower equity valuations

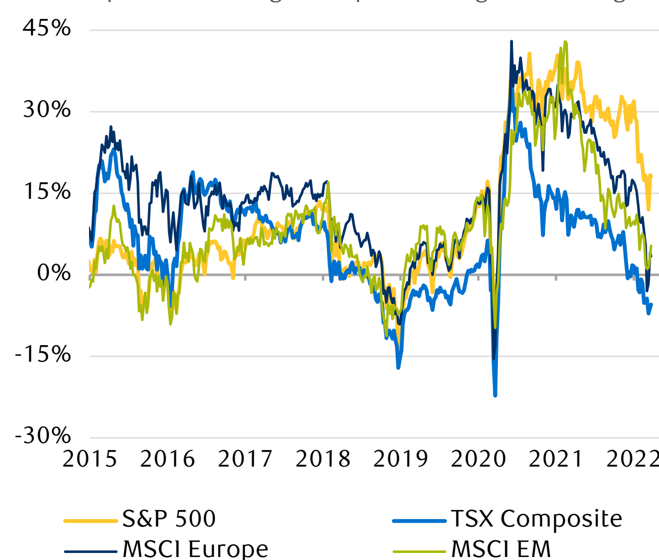
Despite a growing drumbeat of pessimism, the outlook for the world economy and corporate earnings has remained reasonably resilient. The Bloomberg consensus global real GDP growth rate for 2022 was recently revised lower to four percent (from 4.3 percent in February), but this expected pace of growth is still above the average growth rate of 3.7 percent between 2010 and 2019 and, in our view, should continue to provide a fundamentally supportive economic backdrop for earnings to stay in expansion mode.

The weakness in equities so far in 2022 has been driven in large part by a downward adjustment in valuations. The Bloomberg consensus forward 12-month earnings estimate for the MSCI All Country World Index is slightly higher today than it was at the start of the year, but the pricing multiple that market participants are willing to pay for those profits has declined as investors have demanded a higher risk premium to compensate for the mounting downside risks to growth. However, with earnings expected to maintain their upward trajectory, the upshot of the correction has been a considerable improvement in valuations, as shown in the chart at right.

The S&P 500, at 19.2x forward consensus 12-month earnings, still appears expensive relative to history, but not nearly as stretched as it was a few months ago.

Valuations have priced in some near-term headwinds

Forward price-to-earnings multiples vs. long-term averages



Source - RBC Wealth Management, Bloomberg; data through 3/23/22

Meanwhile, equity market valuations in Canada, Europe, and the emerging markets are now below or roughly in line with their long-term averages. Thus, even if earnings estimates are trimmed modestly in the coming months,

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

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Priced (in USD) as 3/23/22 market close (unless otherwise stated). Produced: March 24, 2022 2:04 pm ET; Disseminated: March 24, 2022 2:30 pm ET
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there now appears to be a relatively larger buffer against heightened near-term risks.

Conflict, commodities, and a history lesson

The range of possible outcomes in the conflict between Russia and Ukraine remains uncomfortably wide, stretching from a near-term ceasefire to a protracted multiyear war. But the recent optimism projected by negotiators about a diplomatic pathway to halt hostilities is encouraging, and has helped markets rebound from near-term lows.

Commodity prices, an important economic spillover channel, are a key area to monitor—and the Bloomberg Commodity Index has rallied nearly 30 percent since the start of the year. Until markets see definite signs that geopolitical tensions are easing, we think strength and volatility are likely to persist in commodity prices, particularly in energy products.

Geopolitical shocks are always disruptive in the short term, but a key lesson from history is that the impact of major military conflicts on markets has typically been brief. Even so, we think the road to a resolution that could allow attention to shift back to fundamental drivers will likely be potholed by unsettling developments that create more episodes of volatility.

Monetary policy faces supply-side challenges

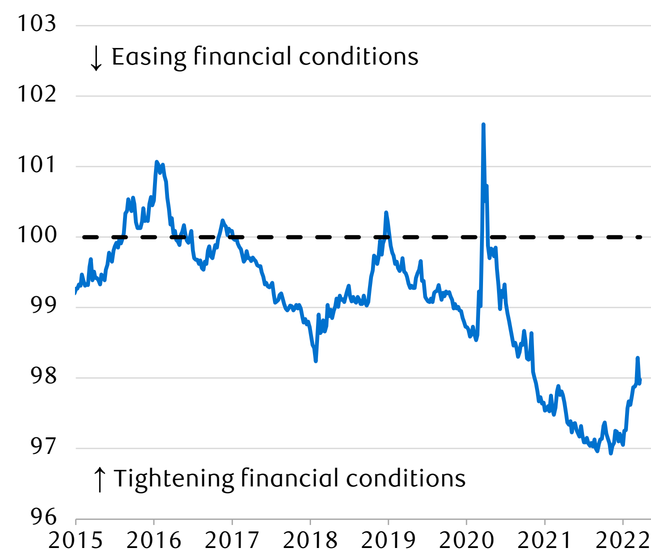
Coming into this year, the biggest question facing major central banks—particularly the U.S. Federal Reserve—was how to tighten monetary policy in order to tame inflation without materially undercutting growth. Since then, the possibility that spiking commodity prices and geopolitical turmoil could dampen economic activity has made this delicate balancing act even trickier. It is nevertheless worth reiterating that markets have already priced in a very steep tightening path by the Fed, with seven more interest rate increases expected before the end of 2022.

But whether the Fed will need all the rate hikes that are currently anticipated is still an open question. Many of the inflationary pressures we are witnessing today are coming from the supply side, and there appears to be little that monetary policy can do to influence factors such as oil supply, resource shortages, and logistical gridlocks. Recent signs of easing supply chain constraints also suggest the possibility that inflation could fade to some degree over the coming quarters, relieving pressure on the Fed. And with financial conditions having already tightened meaningfully in recent months, as the chart at right shows, central bankers can arguably breathe a little easier now.

Meanwhile, we believe the U.S. economy remains on a sturdy footing. The outlook for consumer spending appears resilient, underpinned by healthy household balance sheets thanks to pandemic savings, gains in net wealth, and a buoyant labor market. Business investment demand is also likely to remain supportive, in our view,

Financial conditions have done some tightening work for the Fed

Goldman Sachs U.S. Financial Conditions Index



Source - RBC Wealth Management, Bloomberg; data through 3/23/22

as firms seek to boost capital spending and replenish inventories to satisfy consumer demand.

There are certainly risks that warrant close monitoring, most notably the rapid flattening seen in key U.S. Treasury yield curves and the recent uptick in long-term inflation expectations, but we continue to see a relatively low probability of a U.S. recession on a 12-month horizon.

Stay the course with a defensive bias

We maintain a constructive stance towards equities and corporate credit, based on our view that the economic expansion remains intact and corporate earnings will likely rise further in coming quarters. Although valuations have priced in some near-term risks, we caution that further episodes of volatility are likely until investors gain greater confidence about the outlook for inflation, monetary policy, and the Russia-Ukraine war. For portfolios, this overall backdrop of solid fundamentals confronted by mounting risks suggests it may be sensible to moderately bolster defensive positioning.

In an environment where capital appreciation will likely be harder to come by, we believe dividend-paying and high-quality companies—characterized by the ability to raise payouts, above-average earnings stability, and lower debt levels—may help mitigate the effects of market volatility. Given limited visibility on the duration and severity of the war in Ukraine, both commodities and resource equities could prove to be useful portfolio diversifiers in the near term.

Within fixed income, upgrading quality by taking advantage of the substantial move higher in government bond yields, which now embed aggressive rate hike expectations, may also bolster portfolio resilience.

UNITED STATES

Atul Bhatia, CFA – Minneapolis

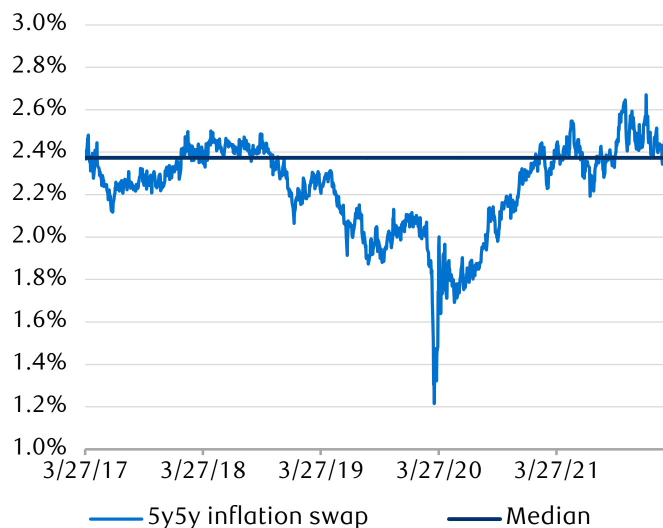
- **Government bonds remained under pressure this week** as hawkish testimony from Fed Chair Jerome Powell led traders to position for a faster pace of rate hikes. By midday Thursday, interest rate futures reflected a high probability the Fed will raise rates by a half-percentage point at one of its meetings this year and potentially as early as May 4. If it were to materialize, a half-point hike would be the first since early 2000. The impact of a potentially more aggressive Fed was felt across the curve, with two-year Treasury yields reaching as high as 2.16% and 10-year yields approaching 2.4% during the first half of the week.

- **One likely contributor to the hawkish Fed tone was the rise in medium-term inflation expectations**. The Fed's preferred gauge for measuring the consensus view on where inflation is settling is the 5y5y inflation swap, which uses market prices to establish an expected average annual inflation rate over a five-year period starting five years in the future. The measure has declined since the highs of earlier this month but remains well-above historical measures. The minutes of last week's Fed meeting are scheduled for release in early April, which should give us better insight into the Fed's comfort level with medium-term inflation.

- **Commodity prices remain elevated**, adding to the potential inflationary pressures the Fed faces in the near term. The rise comes despite the dollar trading near multiyear highs against a trade-weighted basket of major currencies. A stronger greenback typically acts as a restraint on rising commodity prices, which are quoted in U.S. dollars. The combination of a stronger dollar and higher input costs is likely to be felt most strongly overseas and in emerging markets, potentially driving central banks in those countries to hike rates more aggressively than the Fed.

Market signals on inflation expectations may trouble the Fed

Off the highs, but above historical norms and likely the Fed's comfort level



Source - RBC Wealth Management, Bloomberg; data through 3/24/22

CANADA

Matt Altro & Sean Killin – Toronto

- **The S&P/TSX Composite Index is on track to outperform most global peers by a substantial margin in Q1**, thanks to a strong rally in commodity prices, which has helped lift consensus 2022 earnings estimates. As of intraday on March 24, the S&P/TSX Composite Index is up approximately 4% year to date, beating the S&P 500 by a measure of nearly 10 percentage points and the MSCI All Country World Index by nearly 11 percentage points on a total-return basis. The Bloomberg Commodity Index, which tracks prices of 23 commodity futures in aggregate, is up over 30% year to date, with the majority of the upwards pressure driven by a confluence of events including an elevated demand environment, sustained logistical snags, and, more recently, the Russia-Ukraine conflict, which has injected geopolitical risk premiums into spot prices. The Energy and Materials sectors, which collectively account for approximately 30% of the index, have advanced roughly 28% and 23% year to date, respectively. Furthermore, rising commodity prices have also benefitted Canada's terms of trade, a ratio of import to export prices, with potential positive implications for the Canadian economy.

- **A political power-sharing deal has been struck between the Liberals and the New Democratic Party** with the intent to tackle several key areas, notably housing affordability and tax initiatives. The affordability plan is expected to focus on the rising cost of housing in Canada with proposals to ban "blind bidding" for homes and launch a Housing Accelerator Fund to increase the housing supply. These affordability initiatives could also kick-start a Liberal pledge to review the tax treatment of large corporate owners of residential real estate in an attempt to disincentivise excessive profits. If enacted, this could potentially have a negative effect on many publicly-traded REITs. Regarding the tax initiatives, last year, the Liberals proposed a surtax on the large banks and insurance companies, which could be addressed in the 2022 budget. RBC Capital Markets estimates that a combined earnings impact for the affected group could be about 4%, but does believe these measures have already been priced into the potentially impacted companies. That being said, we think attention should be paid to the possibility that this could lead to further scrutiny of their business operations.

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

- **The UK's Office for Budget Responsibility (OBR) scaled back its GDP growth forecasts to 3.8% for 2022 and 1.8% for 2023**, from the 6% and 2.1%, respectively, it expected last November. These estimates do not include the impact of the war in Ukraine, so there is downside risk. Moreover, the OBR raised inflation expectations to 7% on average this year, a 30-year high.

- **UK Chancellor of the Exchequer Rishi Sunak announced a new budget** that includes modest stimulus measures to help households impacted by the steep rise in the cost of living, **opting to keep some powder dry for a one percentage point reduction in the basic income tax rate in 2024**, just ahead of the next general elections.

- For this year, the controversial increase in national insurance contribution—a new health and special care levy—will go ahead, though the income threshold to be subject to it was raised. The Chancellor's budget lowers the fuel duty by 5 pence a litre for 12 months, but in a nod to the government's "net zero" ambitions, it also abolishes the sales tax on home insulation and energy efficiency measures. Another key measure is the allocation of £500 million to support the poorest households. **Overall, since the October budget, the government has announced extra spending and tax cuts worth some 0.8% of GDP, only mitigating the fiscal drag from the expiry of pandemic emergency measures**. Further measures may be announced in the October budget, at which point the economic consequences on consumers and businesses from inflationary pressures will be clearer.

- **One month on from Russia initiating its attack on Ukraine, European equities are back to the level they were before the war started**. Having initially fallen more than 9% in the two weeks following the invasion, the STOXX Europe ex UK Index has recouped those losses. However, in light of the heightened risks and economic consequences of the conflict, we recently downgraded European equities to Market Weight from Overweight, and recommend increasing the defensive tilt of investments in the region. Moreover, in a regional context, we believe the recent bounce in European equities presents investors who remain Overweight Europe a good opportunity to reduce exposure to Market Weight, or in line with portfolio benchmarks.

ASIA PACIFIC

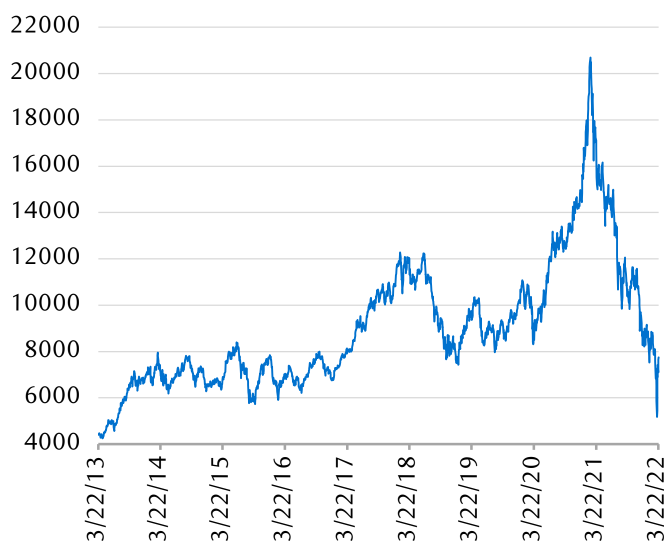
Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets, led by Japan, traded broadly higher during the week**. The Nikkei 225 posted its seventh consecutive daily gain, as of Wednesday's close, and is up about 12% since its March 9 low, to trade at the highest level in more than two months. We think a weaker yen and the government's decision to remove all quasi-state of emergency measures supported positive sentiment toward equities.

- **U.S.-listed Chinese stocks have almost regained all their losses since the escalation of the Russia-Ukraine conflict a month ago**. The shares sold off in the first half of March as the U.S. SEC moved towards delisting Chinese companies. The Nasdaq Golden Dragon China Index is up more than 50% since its March 15 low (its lowest level since 2013). The sharp correction in the earlier part of the month prompted Beijing to announce its intention to keep the stock market stable, ease the regulatory crackdown, and support property and technology companies. According to Reuters, Chinese authorities recently asked major U.S.-listed companies, including Alibaba and JD.com, to prepare for more audit disclosures in order to remain listed in the United States. Notwithstanding the recent strong rebound, we continue to urge caution as there are still plenty of risks for the segment. We view Tencent's recent weak quarterly results as an example.

- **Alibaba Group (9988 HK) is ramping up its share buyback program**, which will run through March 2024, to US$25 billion. The up-sized amount represents one of the largest shareholder buyback programs in the internet industry. The announcement came after Beijing pledged to support the economy and markets and finish the clampdown on the Tech sector. Separately, Xiaomi Corp. (1810 HK) also announced a US$1.3 billion share buyback program.

Nasdaq Golden Dragon China Index up more than 50% since March 15 low



Source - RBC Wealth Management, Bloomberg; data through 3/23/22

MARKET Scorecard

Data as of March 23, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,456.24	1.9%	-6.5%	14.0%	99.2%
Dow Industrials (DJIA)	34,358.50	1.4%	-5.4%	6.0%	84.8%
Nasdaq	13,922.60	1.2%	-11.0%	5.3%	102.9%
Russell 2000	2,052.21	0.2%	-8.6%	-6.1%	104.7%
S&P/TSX Comp	21,932.18	3.8%	3.3%	17.5%	95.3%
FTSE All-Share	4,156.60	0.0%	-1.2%	8.9%	52.4%
STOXX Europe 600	454.03	0.2%	-6.9%	7.3%	61.9%
EURO STOXX 50	3,869.22	-1.4%	-10.0%	1.1%	55.7%
Hang Seng	22,154.08	-2.5%	-5.3%	-22.3%	2.1%
Shanghai Comp	3,271.03	-5.5%	-10.1%	-4.1%	23.0%
Nikkei 225	28,040.16	5.7%	-2.6%	-3.3%	66.0%
India Sensex	57,684.82	2.6%	-1.0%	15.3%	122.0%
Singapore Straits Times	3,364.26	3.8%	7.7%	7.4%	50.6%
Brazil Ibovespa	117,457.34	3.8%	12.1%	3.7%	84.8%
Mexican Bolsa IPC	55,154.68	3.3%	3.5%	18.2%	67.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	2.286%	46.1	77.6	66.6	150.0
Canada 10-Yr	2.317%	50.4	89.1	82.3	152.4
UK 10-Yr	1.627%	21.7	65.6	86.4	120.2
Germany 10-Yr	0.466%	33.1	64.3	80.7	84.1
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.92%	-3.2%	-6.3%	-4.8%	-1.9%
U.S. Investment-Grade Corp	3.67%	-3.5%	-8.6%	-5.1%	10.4%
U.S. High-Yield Corp	6.19%	-1.9%	-5.6%	-0.9%	32.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,945.49	1.9%	6.4%	12.6%	25.3%
Silver (spot $/oz)	25.14	2.8%	7.9%	0.3%	89.5%
Copper ($/metric ton)	10,259.50	3.4%	5.3%	14.3%	121.8%
Oil (WTI spot/bbl)	116.63	21.8%	51.5%	102.1%	472.8%
Oil (Brent spot/bbl)	121.65	20.5%	56.4%	100.1%	350.1%
Natural Gas ($/mmBtu)	5.13	16.4%	37.4%	104.3%	219.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	98.6190	2.0%	3.1%	6.8%	-3.8%
CAD/USD	0.7960	0.9%	0.6%	0.2%	15.5%
USD/CAD	1.2563	-0.9%	-0.6%	-0.2%	-13.3%
EUR/USD	1.1008	-1.9%	-3.2%	-7.1%	2.6%
GBP/USD	1.3206	-1.6%	-2.4%	-4.0%	14.4%
AUD/USD	0.7502	3.3%	3.3%	-1.6%	28.5%
USD/JPY	121.1000	5.3%	5.2%	11.5%	8.9%
EUR/JPY	133.3000	3.3%	1.8%	3.6%	11.7%
EUR/GBP	0.8335	-0.3%	-0.9%	-3.3%	-10.3%
EUR/CHF	1.0245	-0.4%	-1.3%	-7.4%	-3.0%
USD/SGD	1.3577	0.2%	0.6%	1.0%	-7.1%
USD/CNY	6.3724	1.0%	0.3%	-2.2%	-10.1%
USD/MXN	20.2134	-1.2%	-1.5%	-3.0%	-20.3%
USD/BRL	4.8392	-6.1%	-13.2%	-12.4%	-6.0%

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 0.6% return means the Canadian dollar rose 0.6% vs. the U.S. dollar year to date. USD/JPY 121.10 means 1 U.S. dollar will buy 121.10 yen. USD/JPY 5.2% return means the U.S. dollar rose 5.2% vs. the yen year to date.

Source - Bloomberg; data as of 3/23/22 market close

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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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