GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee April 14, 2022

Is the U.S. dollar losing its global appeal?

Alan Robinson – Seattle

The volatile global geopolitical landscape has focused attention on challenges to the U.S. dollar's reserve currency status. We weigh these concerns and conclude that even in a multipolar world there are simply no practical alternatives to the global dominance of the dollar.

Since the U.S. government blocked Russian banks from the Society for Worldwide Interbank Financial Telecommunications (SWIFT) system, the world's main financial transaction gateway, as part of sanctions imposed due to Russia's invasion of Ukraine, some analysts have cautioned against this "weaponization" of the U.S. dollar. Those analysts believe the freezing of a large slice of Russia's foreign exchange reserves could prompt some countries to seek alternatives to the U.S. dollar in global trade and investment, and jeopardize the greenback's reserve currency status.

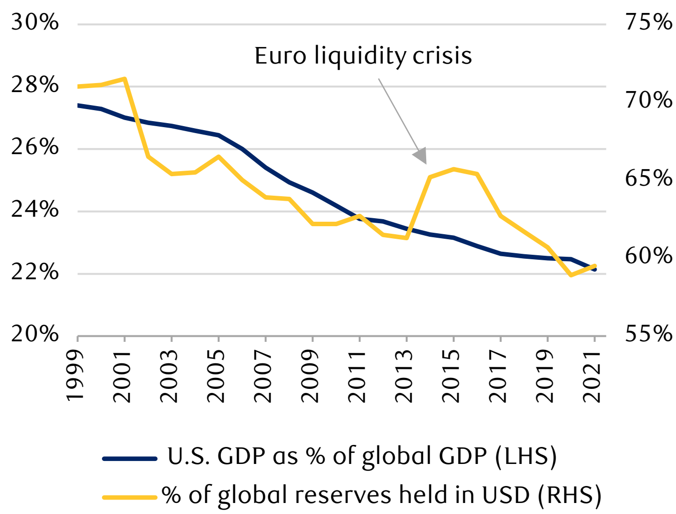
Reserve currencies by the numbers

Historically, the privilege of global reserve currency status has been reserved for those states with the world's largest economies. In modern history there have only been two such currencies—the British pound from the early 1800s to World War II, and the U.S. dollar since then. And it's a testament to the stickiness of reserve currency status that the pound remained the top dog for decades after the U.S. economy overtook Britain's in the 1870s.

Subsequent events only served to cement the dollar's hegemony, with the value of the currency tied to gold from 1944 to 1971 before floating freely in 1973. Even the creation of the euro as a global currency competitor in 1999 was unable to knock the greenback off its perch.

Change in U.S. dollar share of reserves is in line with long-term global economic trends

Share of reserves held in USD vs. U.S. share of global economy



Source - U.S. Bureau of Economic Analysis, FactSet, RBC Wealth Management

Foreign currency reserves are principally used by sovereign nations to smooth over volatility in their own currencies and to pay for imported necessities. The Asian financial crisis of 1997 served as a warning against

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

inadequate foreign reserves, and most central banks increased their reserves in the aftermath to preserve financial stability.

The dollar was the prime beneficiary of this newfound prudence. The currency's share of global reserves increased to 72 percent in 2001 from a low of 45 percent in the 1960s. Overall growth in the global economy over the past two decades had cut that share to 60 percent of the $12 trillion in total reserves by the end of 2021, according to the Federal Reserve, with approximately one-third of all U.S. government bonds now held by foreign sovereigns for this purpose. Other hard currencies make up the balance, but no single currency comes close to the U.S. dollar, with the euro accounting for 21 percent of reserves, the Japanese yen 6 percent, and the pound at 5 percent. And although China has sought to expand its global influence, only 2 percent of reserves are held in the yuan.

Why reports of the dollar's demise are exaggerated

The conditions for entry into the reserve currency club are few, but onerous. First, the currency needs to be fully convertible on international exchanges. This means the entity issuing the currency can't impose broad capital controls that might prevent the export of the currency.

Second, it needs a deep and liquid pool of assets denominated in that currency. In the case of the U.S. dollar, the $23 trillion government bond market provides this liquidity. The euro's creation briefly promised a similarly competitive bond market, but Germany's reluctance to borrow combined with Italy's taste for spending created a liquidity crisis during the last decade that limited the amount of investment-grade bonds available. And the subsequent negative interest rate dynamics in the eurozone reduced the pool of interest-bearing bonds further.

Finally, the currency needs to be insulated from interference by domestic politicians and based in a jurisdiction with a strict adherence to law. Confidence in a currency leads to its stability, which is important if it is to act as a store of value. While the euro meets two of these three criteria, the Chinese yuan is still working toward these goals.

Rating the alternatives

There is no shortage of potential competition for the reserve currency mantle, but we find most come up short. The euro is still the most credible challenger, in our view, but even with a likely increase in bond issuance to fund defense and infrastructure buildout, we believe the absence of explicit fiscal integration in the eurozone makes it a long shot.

Potential reserve assets: grading the competition

Subjective grades based on relative strength in each criterion

Reserve vehicle	Liquidity	Convertibility	Stability	Overall
U.S. dollar	A	A	A	**A**
Euro	B	A	A	**B**
Gold	B	C	C	**C**
Chinese yuan	C	D	B	**C**
Real assets	C	C	C	**C**
Cryptos	C	C	D	**D**
Emerging market debt	D	D	D	**D**

Source - RBC Wealth Management

China clearly aims for more influence on the global stage, but its currency is not fully convertible, or free of influence from its politicians, and its domestic bond market lacks sufficient depth.

Cryptocurrencies are the new kid on the block, but are arguably too untested as a long-term store of value and in many cases operate in a legal gray area.

Precious metals have long existed as a store of value, but the practicalities of storage and transport in the volumes required limit their use. Other real assets including real estate, farmland, mines, and oil fields may offer strategic benefits but are hardly portable and sometimes difficult to trade. And while emerging market debt has attracted yield-sensitive investors, its lack of stability and liquidity in a crisis counts against it.

The paucity of alternatives to the dollar comes into sharp focus in Russia's reserve composition. While its central bank attempted to shield its reserves pre-invasion, it still kept 20 percent in U.S. dollars and 40 percent in euros, with the remaining 40 percent likely held in hard-to-convert assets, which underlines the difficulty of storing reserves in anything other than hard currencies.

Will the U.S. dollar deliver?

We expect the U.S. dollar to keep its preeminent reserve currency status for the foreseeable future. The demand for an alternative to the U.S. dollar has most recently come from institutions seemingly motivated by avoiding accountability to global standards, a constituency without global influence, in our view. In addition, the criteria needed to actually function as a liquid store of value rule out most contenders. While some decline in the share of dollar reserve assets makes sense in a multipolar world, the dollar isn't going away anytime soon, in our view.

UNITED STATES

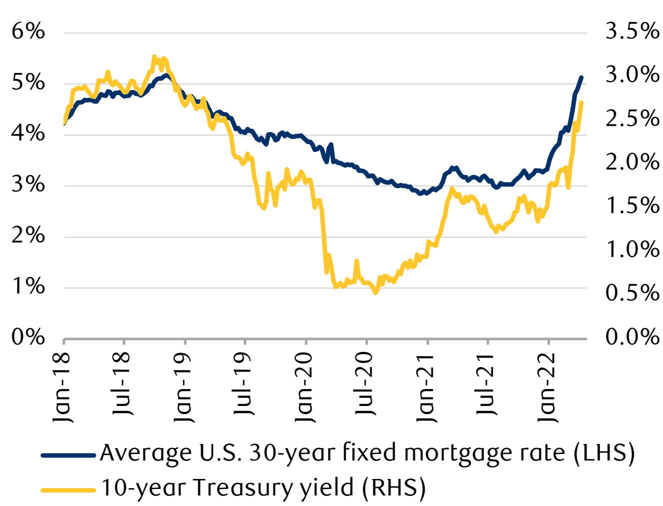
Michael Roedl – Minneapolis

- **Consumer prices accelerated by the fastest pace since 1981, reinforcing the Fed's intention to raise rates more aggressively to curb inflation.** The Consumer Price Index rose 8.5% in March from a year earlier following a 7.9% gain in February. Soaring gasoline prices were the primary driver of higher inflation followed by rising food costs. Core inflation, which excludes food and energy prices, was weaker than projected in the Bloomberg survey of economists due to the 6.5% plunge in used vehicle prices. **Many economists believe March will mark the peak inflation rate this year** given it captures the initial impact from the Russian invasion of Ukraine. Despite the market now pricing in three 50 basis point (bps) rate hikes in 2022, we don't believe the Fed will approach its neutral target (the rate that neither restricts nor boosts economic growth) any time soon. This is especially the case given persistent consumer demand that should help support economic growth, and the ongoing inflationary pressures from the war in Ukraine and related sanctions, both of which seem to have no end in sight.

- While housing was one of the few bright spots during the pandemic, **higher interest rates and limited supply are shifting prospective homebuyers toward the sidelines**. Mortgage rates remain on the rise as Treasury yields push higher. According to the Mortgage Bankers Association, average 30-year mortgage rates have risen to 5.1%, as of data compiled April 13, about 180 bps higher versus the start of the year, as illustrated by the chart. In addition, the refinance share of mortgage activity, which amounted to over half of the mortgage applications from mid-2019 through 2021, fell significantly to under 40%.

U.S. mortgage rates are rising as Treasury yields push higher

Average 30-year fixed mortgage rate vs. 10-year Treasury yield



Source - RBC Wealth Management, Bloomberg; daily data through 4/13/22

- **Investors who are more interest rate sensitive should consider a barbell approach, which utilizes short- and long-dated maturities.** A barbell's main attraction is that investors can benefit in both rising and declining interest rate scenarios. Should rates decline, maturities on the long end of the yield curve will typically perform well since the bonds were originally purchased at higher rates. If rates increase, investors can take advantage of reinvesting short-term maturities that come due at higher yields. We suggest capitalizing on relative steepness in the municipal yield curve by purchasing intermediate-to-long-end maturities. To complete the barbell, we favor investment-grade corporates in 2-to-5-year maturities. Short-term corporates currently show relative value over short-term munis, even for investors in the highest tax bracket.

CANADA

Luis Castillo & Simon Jones – Toronto

- **The Bank of Canada (BoC) delivered its second policy rate hike of 2022, lifting rates by 50 bps**. This is the first time since May 2000 that the BoC has announced a rate increase of that magnitude. Recent economic data would argue in favour of such a pace of monetary tightening. The labour market in particular was cited in the announcement. With employment now hovering above pre-pandemic levels and the unemployment rate dropping to its lowest level on record, businesses have continued to report difficulty meeting demand due to worsening labour frictions. **The BoC revised its inflation forecast higher to an average of just under 6% in the first half of 2022**, as the usual culprits (energy, food, and supply chain disruptions) continue to put upward pressure on prices. In addition to rate hikes, the BoC also announced intentions to begin reducing the size of its balance sheet through quantitative tightening later this month, by allowing maturing bonds to roll off the balance sheet without reinvesting the proceeds.

- **The Canadian labour market is continuing to fire on all cylinders**. The most recent employment report released by Statistics Canada showed 72,500 new jobs were added to the economy in March, building on February's outsized gain of 337,000. Despite coming in just shy of consensus expectations, the increase in employment was still able to push the unemployment rate down to 5.3%, its lowest level since comparable data became available in the mid-1970s. Aided by the reopening of Quebec and Ontario, employment gains were seen across both goods- and services-producing industries, with accommodation and food services (+15,000) and construction (+14,000) driving the increases. However, **as the labour market continues to tighten there are signs that wage growth is beginning to accelerate**, with average hourly earnings ticking up by 3.4% y/y in March, after rising 3.1% y/y in February.

EUROPE

Faisal Manji & Frédérique Carrier – London

- **Speed, sequencing, and flexibility were in focus at Thursday's European Central Bank (ECB) policy meeting**. The ECB's statement reiterated the accelerated plan to end net asset purchases at some point in Q3 with the usual "data dependent" caveat. We learned that any **adjustments to interest rates will occur "some time after" the end of net asset purchases and "will be gradual."** ECB President Christine Lagarde clarified that this could be anything from several months to just one week. Lagarde also admitted that "the upside risks to the inflation outlook have intensified."

- **Market pricing still implies that rate hikes will start in July** and that the key ECB deposit rate will reach 0% by yearend, from -0.50% today. However, the euro weakened by about 1% versus the U.S. dollar to the lowest level in two years in reaction. The ECB is in a difficult position on how much it can tighten to combat inflation given Europe's economic sensitivity to the Russia-Ukraine war. Lagarde recognised this in her press conference and explained that **actions currently being considered by the U.S. Federal Reserve, such as balance sheet reduction, would not be appropriate for the ECB**.

- **UK headline inflation rose more than the consensus expected, to 7.0% y/y in March**, up from 6.2% y/y in February. The Office for National Statistics notes that the acceleration in inflation was mostly due to the sharp spike in petrol and diesel prices since the Russian invasion. **RBC Capital Markets expects April inflation to be higher still**, as it will capture for the first time the full effects of the lifting of the energy price cap. In the minutes of the Monetary Policy Committee's March meeting, policymakers expect that inflation could increase beyond 8% later in the year.

- High inflation, along with the unemployment rate reaching the pre-pandemic level of 3.8% and wage growth running a little faster than it was pre-COVID, means **we expect the Bank of England to continue its hiking cycle before pausing and taking stock later this summer**.

The euro sank to a two-year low versus the U.S. dollar following the most recent ECB meeting

EUR/USD

Source - RBC Wealth Management, Bloomberg; daily data through 4/13/22

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific shares saw mixed trading during the week**, with the China and Hong Kong markets broadly lower. Investors in Asia continue to keep a close eye on the COVID-19 situation in China, in particular Shanghai. Chinese officials announced that **Shanghai will ease a lockdown for the 43% of its housing complexes with no infections for two weeks**, but will stick with its strict rules. As of the time of this writing, the total number of cases in Shanghai had risen to 27,719, rewriting the daily record for the 12th time in 13 days. The Chinese equity market got a respite from the pullback on Thursday as investors look for another round of monetary easing—a cut in banks' reserve requirement ratio—soon.

- **New Zealand, South Korea, and Singapore tightened their monetary policies this week.** New Zealand delivered a larger-than-expected 50 basis point rate hike. The Bank of Korea's Monetary Policy Board voted to raise the benchmark interest rate by a quarter of a percentage point to 1.50%, the highest since August 2019. The Monetary Authority of Singapore (MAS) will "recentre the mid-point" of the Singapore dollar nominal effective exchange rate policy band at the prevailing rate, as well as "slightly raise" the rate of appreciation of the policy band. The MAS raised its core inflation forecast to 2.5%–3.5% this year, from its January projection of 2%–3%.

- **China approved new video game licenses for the first time since July 2021**, a balm for investors concerned about Beijing's intentions toward the industry. The regulator licensed 45 titles from publishers including Baidu (9888 HK), XD (2400 HK), and iDreamSky (1119 HK). Tencent (700 HK) and NetEase (9999 HK) were noticeably absent from the list, however. Separately, Alibaba shares (9988 HK) fell this week following a Bloomberg News report that China's top anti-graft watchdog was among the agencies involved in a recent inquiry into links between Jack Ma's Ant Group Co. and state-owned Chinese companies.

MARKET
Scorecard

Data as of April 13, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,446.59	-1.9%	-6.7%	7.4%	61.0%
Dow Industrials (DJIA)	34,564.59	-0.3%	-4.9%	2.6%	47.8%
Nasdaq	13,643.59	-4.1%	-12.8%	-2.5%	66.5%
Russell 2000	2,025.10	-2.2%	-9.8%	-9.1%	67.1%
S&P/TSX Comp	21,838.02	-0.2%	2.9%	13.7%	55.1%
FTSE All-Share	4,211.90	0.6%	0.1%	6.9%	30.3%
STOXX Europe 600	456.78	0.2%	-6.4%	4.8%	37.7%
EURO STOXX 50	3,827.96	-1.9%	-10.9%	-3.5%	32.3%
Hang Seng	21,374.37	-2.8%	-8.6%	-25.0%	-12.0%
Shanghai Comp	3,186.82	-2.0%	-12.4%	-6.2%	14.5%
Nikkei 225	26,843.49	-3.5%	-6.8%	-9.8%	41.0%
India Sensex	58,338.93	-0.4%	0.1%	20.2%	90.1%
Singapore Straits Times	3,342.22	-1.9%	7.0%	4.8%	30.2%
Brazil Ibovespa	116,781.96	-2.7%	11.4%	-2.1%	48.1%
Mexican Bolsa IPC	54,172.62	-4.2%	1.7%	14.0%	56.5%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	2.701%	36.3	119.1	108.6	192.9
Canada 10-Yr	2.636%	23.1	121.0	113.2	188.2
UK 10-Yr	1.799%	18.9	82.8	102.0	149.3
Germany 10-Yr	0.766%	21.8	94.3	105.8	111.3
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.20%	-2.2%	-8.0%	-7.0%	-6.6%
U.S. Investment-Grade Corp	3.94%	-3.1%	-10.5%	-8.1%	-2.8%
U.S. High-Yield Corp	6.51%	-1.9%	-6.7%	-3.2%	15.1%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,976.89	2.0%	8.1%	13.3%	15.2%
Silver (spot $/oz)	25.72	3.7%	10.3%	1.5%	66.8%
Copper ($/metric ton)	10,326.25	-0.4%	6.0%	16.0%	106.8%
Oil (WTI spot/bbl)	104.25	4.0%	35.4%	73.2%	365.2%
Oil (Brent spot/bbl)	108.91	0.9%	40.0%	71.1%	243.1%
Natural Gas ($/mmBtu)	7.07	25.3%	89.5%	169.8%	309.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	99.8580	1.6%	4.4%	8.7%	0.5%
CAD/USD	0.7960	-0.4%	0.6%	-0.2%	10.7%
USD/CAD	1.2563	0.5%	-0.6%	0.2%	-9.6%
EUR/USD	1.0890	-1.6%	-4.2%	-8.9%	-0.2%
GBP/USD	1.3117	-0.2%	-3.1%	-4.6%	4.8%
AUD/USD	0.7453	-0.4%	2.6%	-2.5%	16.8%
USD/JPY	125.6600	3.3%	9.2%	15.2%	16.6%
EUR/JPY	136.8400	1.6%	4.5%	5.0%	16.3%
EUR/GBP	0.8303	-1.4%	-1.3%	-4.4%	-4.8%
EUR/CHF	1.0179	-0.3%	-1.9%	-7.5%	-3.6%
USD/SGD	1.3625	0.6%	1.0%	1.6%	-3.7%
USD/CNY	6.3682	0.4%	0.2%	-2.7%	-9.7%
USD/MXN	19.7706	-0.5%	-3.7%	-1.6%	-16.4%
USD/BRL	4.6814	-1.3%	-16.0%	-18.1%	-10.0%

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 125.66 means 1 U.S. dollar will buy 125.66 yen. USD/JPY 9.2% return means the U.S. dollar rose 9.2% vs. the yen year to date.

Source - Bloomberg; data as of 4/13/22 market close

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As of March 31, 2022

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Hold [Sector Perform]	569	39.03	172	30.23
Sell [Underperform]	48	3.29	3	6.25

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