GLOBAL Insight WEEKLY

Wealth Management RBC

Perspectives from the Global Portfolio Advisory Committee May 5, 2022

A change of pace, in more ways than one

Thomas Garretson, CFA – Minneapolis

This week's Federal Reserve meeting was followed by a somewhat surprising press conference from Chair Jerome Powell, at which he appeared to push back against the market's aggressive rate hike expectations. Inflation, it turns out, may not be the only thing on central bankers' minds.

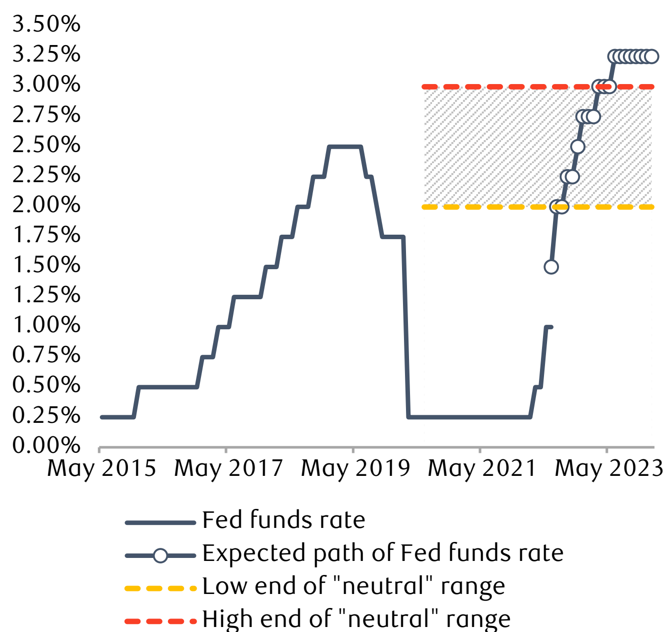
As had been widely expected, the Federal Reserve upped its rate hike pace at the May 3–4 meeting, raising the policy rate by 50 basis points (bps). After the 25 bps move in March, this brings the target policy rate to a range of 0.75%–1.00%. It was an aggressive move, to be sure, and one not seen at a Fed meeting since 2000.

But what followed was perhaps the first "dovish" press conference in roughly a year from Fed Chair Jerome Powell, during which he pushed back against the idea that the Fed could increase the pace once again at the June meeting; markets had been pricing in a strong likelihood that the Fed could opt for a 75 bps increment, even as Powell indicated that 50 bps moves are likely to continue for at least a "couple" of meetings. Overall, there was a sense that the Fed Chair didn't share the sense of urgency to raise rates that the market has shown of late, given all of the uncertainty around the economic outlook both domestically and globally.

While the pace of rate hikes was one focus of the meeting, the other was once again the idea of the "neutral" rate for the economy—or the point at which monetary policy is neither boosting growth nor restricting it. Powell noted that the true neutral rate can't be known in advance, and that it's an imprecise number; instead, he offered up a range of two to three percent, which is currently the range of all estimates from the Fed's longer-run rate forecasts.

How far will the Fed take rates?

Fed funds rate and expected path



Source - RBC Wealth Management, Bloomberg; rate hike expectations based on OIS data, neutral range shows the low and high projections from the Fed's Summary of Economic Projections; data as of 5/5/22

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

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Priced (in USD) as of 5/4/22 market close (unless otherwise stated). Produced: May 5, 2022 3:08 pm ET; Disseminated: May 5, 2022 3:34 pm ET
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In fact, that range hasn't changed since June 2020, despite everything that has occurred in markets and the economy since then, suggesting policymakers have some level of confidence the neutral level does indeed fall somewhere within that range.

Highway to the danger zone?

The chart on the previous page shows how we think the Fed will approach rate hikes from here. We expect two more 50 bps hikes in June and July, which would take the upper bound to two percent, at the low end of the neutral range. After that point, we believe the Fed will pivot to a more cautious approach, moving in 25 bps increments that will take the policy rate to a level of 2.50% to 2.75% by the end of the year, around the midpoint of the estimated neutral range. From there, we envision the Fed once again adopting a "data dependent" approach as it begins work on engineering a so-called soft landing for the economy, which Powell said he believes the Fed has a "good chance" of achieving.

If inflationary pressures remain elevated and the labor market remains too tight, we think the Fed could proceed to move rates above the neutral range and into restrictive territory, as the market still expects will be necessary. But if inflationary pressures do ease into the back half of 2022, as RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli strongly expects, then a cautious approach will have proved prudent as the central bank reduces the chance of overtightening and potentially risking a recession in late 2023.

The bottom line, in our view, is that the Fed Chair has injected some optionality back into the outlook for rate hikes—turning aside from what was recently seen as a one-way path higher that might be followed unswervingly until something simply broke.

Communication breakdown?

But whether that was really Powell's intent remains a topic for debate, as market volatility has only increased in the aftermath of the meeting. The S&P 500 has since given up all of its post-meeting gains, dropping more than three percent through the midpoint of the trading session on May 5, as rate hike expectations have actually risen in the wake of his press conference.

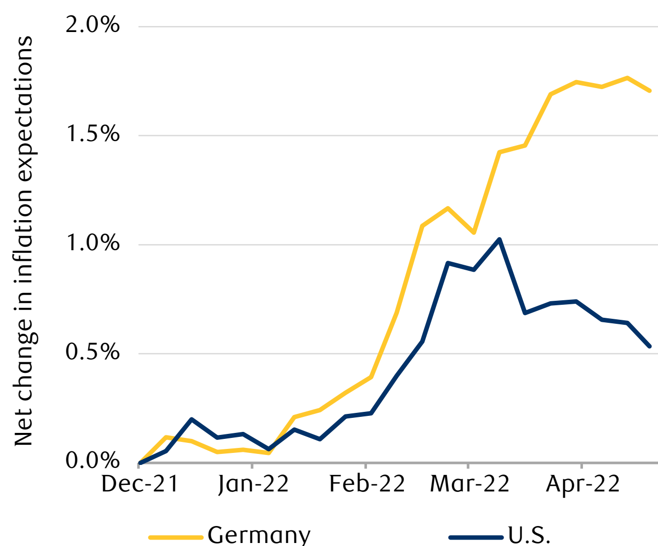
Or perhaps the market was looking for the Fed to front-load rates in an effort to get policy back to neutral sooner, rather than later—implying that the Fed would have to do less in terms of rate hikes later on. With the Fed appearing not to share the market's sense of urgency, the risk remains that policymakers will stay behind the inflation curve and need to raise rates more aggressively later.

No time for complacency

On the one hand, the Fed Chair signaled that there are reasons to be optimistic. Policymakers are seeing signs

U.S. inflation expectations may have peaked in March, but pressures are still rising in Europe

Change in five-year inflation expectations



Source - RBC Wealth Management, Bloomberg, based on inflation-protected government securities; data as of 5/5/22

that inflation levels have peaked, borne out by market pricing as inflation expectations in the U.S. have indeed faded from their March highs, as shown in the chart above. Record numbers of job openings alongside rising wages should continue to bring people back into the labor force, which in turn should take the steam out of wage inflation and ease pressure on the Fed to tighten policy.

On the other hand, however, global inflationary pressures are still on the rise. Although we think the U.S. remains relatively well insulated from the energy-related shock waves reverberating through Europe, the pace of price increases will keep the pressure on all major global central banks. And the timeline for supply chain improvements keeps getting pushed back without a resolution to the Russian invasion of Ukraine and the lockdowns in China, which are driving port congestion around the world. At its June meeting, the Fed will update its economic and rate hike projections (which proved to be a point of consternation for markets earlier this year); a significant shift in the economic data points between now and then—in particular, the nonfarm payrolls report, due out this week in the U.S.—could bring about another hawkish outlook from the Fed.

There's no doubt the Fed and other global central banks are walking a tightrope. But while we expect policymakers to remain aggressive in their tightening plans, this week's meeting may have been the first sign that the Fed won't be singularly focused on high inflation, but will maintain a measure of caution at a time when it seems that uncertainty is only increasing.

UNITED STATES

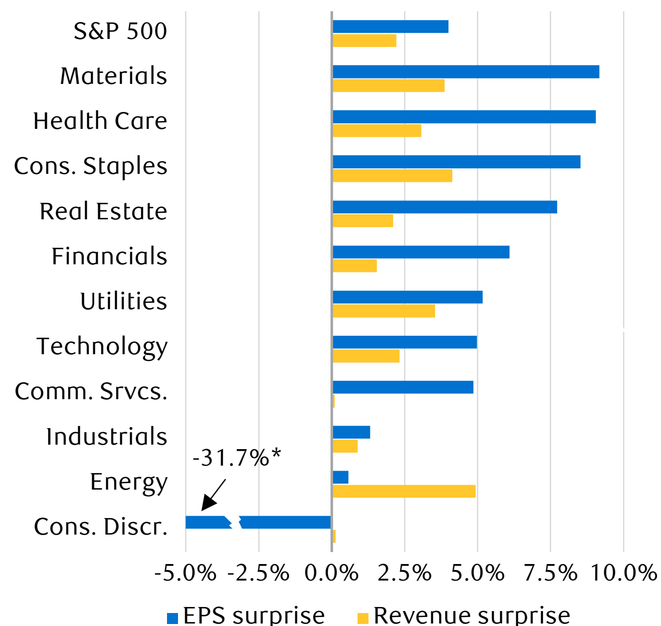
Tyler Frawley, CFA – Minneapolis

- **U.S. equities appear to be on track for mixed results** in what has been volatile trading on the heels of the Fed announcement yesterday afternoon. Although investors had initially cheered Chair Jerome Powell's statement that the Fed was not actively considering rate hikes larger than 50 basis points, markets have turned sharply lower today as investors continue to ponder how the Fed will be able to tame inflation without pushing the economy into a recession. Performance of the major indexes is mixed for the week as of intraday trading Thursday, with the S&P 500 and Dow Jones Industrial Average hanging on to weekly gains, returning 0.35% and 0.03%, respectively. The Nasdaq turned negative for the week earlier this afternoon, falling 0.21%. Sector leadership is evident in Energy (up 7.26%) and Communication Services (up 2.46%), while Real Estate has been the worst-performing sector, down 2.75%. For more thoughts on the market, see our recent commentary in the May issue of Global Insight.

- **Earnings season has continued to surprise** to the upside, with over 83% of the S&P 500 having already reported. **Over 66% of the companies that have announced results reported sales that exceeded consensus expectations**, beating by an average of 2.2%, according to Bloomberg. In addition, **nearly 79% have beaten earnings expectations by an average of 4.0%**. Materials and Health Care companies have seen the strongest results, beating earnings expectations by 9.2% and 9.1%, respectively. Consumer Discretionary companies have struggled so far, with earnings coming in 31.7% below expectations; however, this is largely tied to the significant EPS miss Amazon reported late last week. As earnings reports continue to roll in over the next couple of weeks, we think the sectors to keep an eye on will be Consumer Staples and Consumer Discretionary as 37% and 32%, respectively, of companies have yet to report.

EPS & revenue surprises

S&P 500 Earnings Report Card



*Magnitude of the decline for Consumer Discretionary is truncated so as to not distort the other data in the chart.

Source - RBC Wealth Management, Bloomberg, data through AM earnings on 5/5/22

- **Economic activity has been underwhelming so far this week**. The ADP Employment Change data came in well below Bloomberg expectations, with private payrolls only increasing by 247,000 for April, as the labor market showed signs of slowing as the economy moves toward full employment, vs. a Bloomberg estimate of a 383,000 gain. Additionally, the Institute for Supply Management Manufacturing and Services Purchasing Managers' Indexes registered 55.4 and 57.1, respectively, both missing consensus expectations. 57.1 was the lowest reading for the Manufacturing Index in 20 months as manufacturers become more nervous about how China's ongoing zero-COVID policy will impact their already tight supply chain situations.

CANADA

Matt Altro & Richard Tan, CFA – Toronto

- Within a matter of months, **the outlook for Canadian banks has shifted somewhat from an environment filled with optimism towards a sentiment that is slightly more cautious**, weighed upon by increased macroeconomic risks. Heading into 2022, investors welcomed the prospects of rising rates and higher lending margins. However, persistently high inflation, aggressive monetary policy from central banks, and, of course, the Russia-Ukraine crisis will likely lead to a slowdown in loan growth and a pickup in credit risk. As a result, **RBC Capital Markets modestly lowered its Q2 2022 earnings estimates for the banks** driven in part by expectations for softer capital markets activity and increased volatility in financial markets. RBC Capital Markets also believes that the group is less likely to release credit reserves this quarter given the evolving macroeconomic conditions. Overall, **we believe some of these risks have been reflected in current valuations**. The diversified banks are trading at approximately 10.0x forward consensus earnings estimates versus their five-year average of roughly 10.6x.

- **The first quarter of this year saw an impressive return for the S&P/TSX Composite, outperforming the S&P 500 by a substantial margin on a total-return basis**. With supply of a broad range of commodities struggling to meet resurgent demand due to a variety of factors including geopolitical tensions, the Russia-Ukraine conflict, and logistical issues, exposure to resource-oriented equities proved beneficial. With the S&P/TSX Composite carrying a sizeable weighting of about 30% to such sectors, namely Materials and Energy, versus the S&P 500's weighting of about 7%, the domestic benchmark clearly benefitted more from the commodity price rally.

EUROPE

Rufaro Chiriseri, CFA & Frédérique Carrier – London

- **The European Commission proposed a sixth sanctions package which includes a complete ban on all Russian oil**. The phaseout would take place over the course of the year so as to minimize the impact on global energy markets. It also suggests banning EU vessels from carrying Russian oil, a measure which could complicate the ability of key Russian oil-consuming countries such as India to continue to ramp up their imports of the commodity.

- Details are still being worked out, including **possible member-state exemptions**, such as for Hungary and Slovakia, how the bloc's oil supplies might be shared, and plans for joint oil purchases.

- **The impact on the EU economy from these sanctions will mostly be dictated by oil prices**. As the EU has been discussing these sanctions for a few weeks with limited impact on oil prices, we surmise **they may not have much direct impact on the region's business cycle as things stand**. RBC Capital Markets, LLC Global Head of Commodity Strategy Helima Croft points out that the scope of additional sanctions to curtail oil exports to other key markets and Russian President Vladimir Putin's response to the European action will determine any future impact on oil prices.

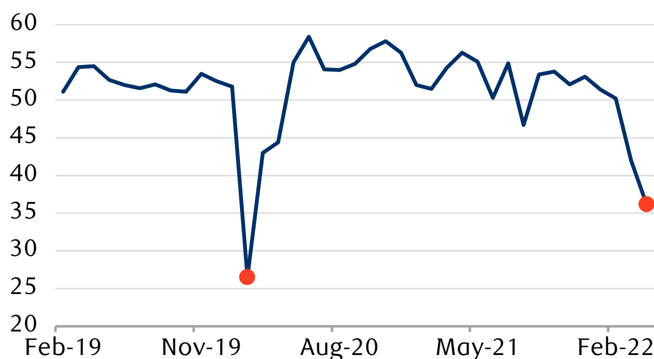
- Meanwhile, the initial economic indicator for April suggests that despite a weakening in manufacturing activity due to supply constraints and weakening demand, **euro area activity remained firm** during the month as the **services sector continues to benefit from a reopening bounce**.

- As widely expected by market participants, **the Bank of England (BoE) raised interest rates to 1% from 0.75%** on Thursday. Six out of nine members voted for a 25 basis point (bps) increase, with three dissenting votes for a 50 bps increase. Markets eased off hiking expectations, which immediately sent 2-year Gilt yields tumbling by nearly 25 bps.

- **BoE May Monetary Policy Report forecasts inflation peaking at 10% in Q4 2022** as the BoE expects a further 40% increase on the energy price cap set by energy regulator Ofgem in October. The central bank also expects UK GDP to contract by 0.25% in 2023 as real household incomes get squeezed, but it sees inflation falling significantly over time, to 1.3% by 2025.

- **Gilt sales were set to commence once the Bank Rate reached 1%; however, an update is expected to be provided in August** following a BoE staff review. BoE Governor Andrew Bailey cautiously stated that "this will be the first Gilt sale by the Bank" and "it's an important thing to get right."

Caixin China Services Purchasing Managers' Index fell to the lowest level since February 2020



Source - RBC Wealth Management, Bloomberg; monthly data through 4/30/22

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **China just completed a five-day national Labor Day holiday, and travel and spending data for the period was not very strong due to the country's stringent COVID-19 containment measures**. Tourist spending over the time frame was RMB 64.7 billion ($9.8 billion), down 43% y/y. In addition, only 16 million rail trips were taken, an 80% y/y decrease. The latest Purchasing Managers' Index (PMI) data also reflected the lockdown's impact. The April Caixin China Services PMI slumped to 36.2, below the Bloomberg consensus estimate of 40 and marking the lowest level since February 2020.

- **COVID-19 cases in Shanghai continue to drop, but community spread remains**. It could take a few more weeks to fully lift the city's strict lockdown because Shanghai authorities said a requirement is to reach zero community transmission. Beijing has locked down certain housing units and shut more than 60 subway stations, over 10% of the network, to contain the pandemic. **Zhengzhou, a central Chinese city, imposed a seven-day lockdown** starting May 4. Foxconn Technology, operator of the largest iPhone assembly factory in Zhengzhou, said it can still function under a closed loop arrangement, but the company had to freeze the hiring of assembly line personnel until further notice.

- **China's Politburo, at its April 28 meeting, called for stronger counter-cyclical easing after recognizing economic and job market challenges**. Following the meeting, major financial regulators pledged policy support, with the central bank vowing to ensure sufficient market liquidity while enhancing risk management. China's banking regulator called for an orderly reduction of banks' provision coverage ratio to release credit resources to support infrastructure projects. In addition, the Shenzhen Stock Exchange said it will support the financing needs of property developers to foster healthy and stable developments in the real estate market.

- **We believe the announced policies highlight the government's efforts to stabilize economic growth and capital markets**. But, we think the near-term impact is only at the sentiment level, and investors need to see more concrete measures before turning more positive on China's equity market.

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