GLOBAL
Insight
WEEKLY

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

May 26, 2022

Less may be more for corporate bond investors

Atul Bhatia – Minneapolis

Amid heightened market uncertainty over economic growth, the Fed continues to stare down historic levels of inflation. But what the Fed has in its favor is that the required anti-inflationary tightening is coming at a time of relative strength for the U.S. consumer. We look at what this backdrop means for Fed policy and opportunities in fixed income.

Inconspicuous consumption

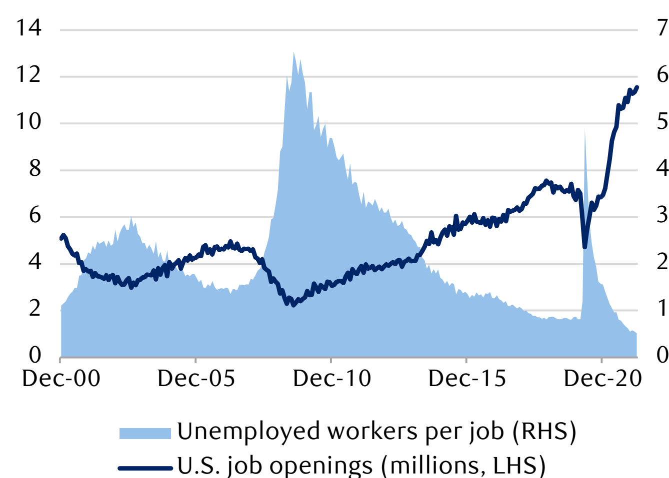
The U.S. economy is consumption driven, with just under 70 percent of U.S. gross domestic product directly attributable to personal consumption. The next largest component—private domestic investment—is indirectly influenced by consumption trends, as business investment tends to ramp up and down to meet expected future demand.

By most measures, the U.S. consumer remains in good financial shape. Unemployment is near record low levels, average hourly earnings are at their highest levels in nominal terms, and with two job openings for every unemployed worker, prospects for continued wage strength appear robust. It's true that wages have not been keeping pace with inflation, but if food or energy prices decline, workers may see meaningful increases in discretionary income.

It would not be surprising to see some softening of demand as consumers react to inflation and higher interest rates. Recent retailer earnings reports, for instance, have shown some weakness as consumers reprioritize following higher food and fuel prices amid a broader shift from goods to services. Any future weakness, however, would be coming from a relatively strong level of consumer demand, a point that was underscored in both the April retail sales report and the Q1 GDP report.

Acute U.S. labor shortage may support wages

Fewer unemployed workers than jobs atypical for U.S.



Source - RBC Wealth Management, Bloomberg; monthly data through 3/31/22

Against this backdrop, it is somewhat surprising to see the litany of financial headlines portraying a near-term recession as inevitable. As we have highlighted in the past, while risks of recession are present and may increase in the following months none of the indicators in our recession scorecard indicate a likely near-term GDP contraction.

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

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Priced (in USD) as of 5/25/22 market close (unless otherwise stated). Produced: May 26, 2022 3:45 pm ET; Disseminated: May 26, 2022 4:02 pm ET
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Confidence in the Fed appears intact

The recently released minutes of the Federal Reserve's May policy meeting and recent Fed speeches laid out the Fed's plan to move expeditiously to a neutral policy, where interest rates are neither adding to nor subtracting from underlying demand. The Fed's stated belief, which we share, is that a faster removal of accommodation will allow the central bank to combat inflation with a lower final level of rates.

Investors appear receptive to this view, with market pricing as of May 25 reflecting a relatively rapid decline in inflation, even with less aggressive action from the Fed. Fixed income pricing shows a likely 2.9 percent inflation rate over the next five years, with a drop to approximately 2.55 percent annual inflation over the following five years. Both measures, respectively referred to as the 5-year breakeven and the 5y5y forward inflation rate, were down nearly 30 basis points in the month ending May 25. This decline in expected inflation comes despite markets seeing less aggressive Fed action compared to earlier this month, with futures markets now showing a likely 2.9 percent maximum policy rate this cycle compared to 3.3 percent in early May.

We see multiple reasons to justify the market's confidence in the Fed's ability to constrain inflation with a relatively low terminal rate. One is the possibility for additional supply, with increased overseas production, eventual reduction of supply chain bottlenecks, and a transition from goods to services demand. Another potentially supportive factor is the pre-pandemic labor market dynamic, which saw the U.S. economy operating comfortably with low unemployment and low inflation. Even a modest uptick in unemployment could allow a reassertion of employer bargaining strength, with concurrent downward pressure on wages and inflation.

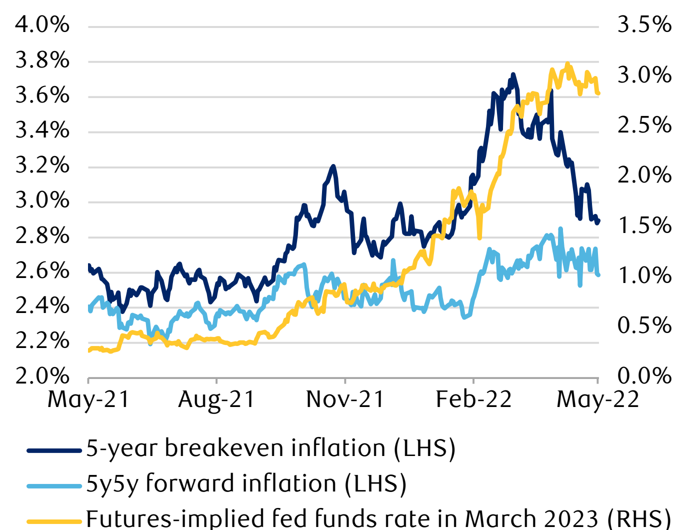
One benefit the Fed has in its favor is that the required anti-inflationary tightening is coming at a time of strong household demand. Personal consumption was up 3.1 percent in Q1, according to recently released economic data, while overall domestic growth fell due to rising imports and shrinking government expenditures. This favorable baseline lessens the risks of a Fed overshoot, in our view.

A bond for all seasons

In a scenario of moderating wages, moderating inflation, and moderating growth, we believe there are multiple potentially attractive investment opportunities. Equities, as we discussed in last week's edition, may be well positioned for price gains over the medium term after recent pullbacks.

Corporate bonds are another asset class that could perform well if the economy muddles through, particularly if the Fed ends up hiking less than previously expected. Investment-grade bond indexes have fallen approximately 13 percent this year. The majority of the loss was a result of higher Treasury yields, although credit premiums also played a part. If the Fed is able to bring inflation down with a lower terminal fed funds rate, longer-maturity corporate bonds could perform well, potentially getting a boost from tighter credit spreads if growth is maintained. And of course, barring a credit event, bonds will return par at maturity.

Fixed income markets see less-aggressive rate hikes, inflation impact still significant



Source - RBC Wealth Management, Bloomberg; daily data through 5/25/22

Sub-investment-grade bonds, often referred to as high yield, are another asset class that could do well in a more benign economic environment. These issuers tend to be more sensitive to growth, with historical default rates well above investment-grade-rated issuers. This greater risk draws out higher average yields: the broad sub-investment-grade index is yielding roughly 7.5 percent while the highest-rated tranche, the BB sector, is yielding around six percent.

For many investors, corporate bonds fill an important portfolio niche. They provide exposure to economic conditions, but because the cash flows are stated in advance, the securities are typically less sensitive to overall earnings and cost pressures. As long as a company is making enough to comfortably pay interest and principal, the bond holder is typically satisfied.

Risk but potential

Given the centrality of private consumption to the U.S. economy and the strength of recent economic data reports, we continue to believe that a near-term recession remains an unlikely event. In an environment of subdued, but still positive, economic growth, we believe corporate bonds are broadly well positioned to deliver expected cash flows and the recent pullback in prices provides what we consider to be attractive risk-adjusted yields.

UNITED STATES

Ben Graham, CFA – Minneapolis

- **U.S. equities may be on track for a week of gains after seven consecutive weeks of declines in the S&P 500** despite persistently elevated volatility levels. As of this morning's trading, the S&P 500 has gained 3.8% thus far this week while the Nasdaq and Dow Jones Industrial Average are up 2.9% and 4.4%, respectively, highlighting the relative outperformance of value over growth this week. The Russell 2000 small-cap index had been lagging its large-cap peers, until midday trading today, as the Russell 2000 has now climbed 3.6% this week. Leadership in the U.S. equity market is evident in the Energy, Financials, and Utilities sectors. Communication Services leads the laggards with Consumer Discretionary and Health Care not far behind.

- **From a valuation perspective, the S&P 500 has declined materially thus far this year with the 2022 P/E ratio falling to 17.3x currently from 21.3x**. This 19% valuation decline has occurred largely as earnings expectations have surprisingly held steady throughout the year. The real culprits behind this re-rating lower likely include rising geopolitical uncertainties around the world, inflation that has accelerated to multi-decade highs, and a Fed that is attempting to tame said inflation despite an unprecedented starting point in the sense that interest rates are so far behind the inflationary curve.

- Economically speaking, **weekly initial jobless claims were in line with expectations** at 210,000, which is a reasonably low level and indicative of a labor market that remains healthy. Additional data points of note this week included pending home sales declining 3.9% m/m, worse than the consensus expectation of -1.7%, and new home sales for April totaling 591,000, a near 17% decline from March, on a seasonally adjusted basis. Taken together, the housing market appears to be digesting higher mortgage rates as the market sees slowing activity.

Valuations decline despite earnings estimates holding up

S&P 500 2022 price-to-earnings ratio

Source - RBC Wealth Management, FactSet; data through 5/26/22 at 11:30 am ET

CANADA

Luis Castillo & Simon Jones – Toronto

- **Surging inflation, aggressive central banks, slowing economic growth, and geopolitical conflict have climbed to the top of the list of investor worries**. Following one of the worst months on record for bond returns in April, an abrupt selloff in risk assets has dominated markets over the past few weeks, as a flight to safety has seen government bond rates move lower across maturities. The rate on the benchmark 10-year Government of Canada bond has dropped by nearly 40 basis points (bps) since peaking in early May. The move lower has been largely dominated by a sharp drop in inflation expectations on the back of strong rate hike commitments by central bankers who continue to see scope for multiple hikes this year. The Canada 5-year inflation breakeven (a bond market implied measure of inflation expectations over the next 5 years) has dropped by more than 50 bps since late April.

- **Retail sales fell short of expectations in March with total sales coming in virtually unchanged relative to February's levels, according to Statistics Canada**. The consensus estimate among economists was for a 1.4% increase in sales, in line with Statistics Canada's preliminary estimate; however, a steep 6.4% decline in sales at motor vehicle and parts dealers wiped out the gains from the remaining 10 subsectors. Excluding motor vehicle dealers and gas stations, core retail sales posted a solid 1.5% increase, but a fair amount of that gain was attributable to higher prices. The toll inflation is having on consumers' purchasing power is evident in the sales volume figures which declined by 1% during the period. Statistics Canada's preliminary estimate indicates retail sales rebounded 0.8% in April; however, while inflation remains elevated, we think the volume figures are likely to be underwhelming.

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

- **UK Chancellor of the Exchequer Rishi Sunak announced a £15 billion fiscal package** earlier today to support low-income households and pensioners amid the unfolding cost-of-living crisis. The fiscal measures will be partly funded by a windfall tax, named the Energy Profits Levy, on the "extraordinary profits" made in the UK by oil and gas companies. The 25% surcharge on Energy sector profits related to UK projects is expected

to raise around £5 billion in its first 12 months, according to the HM Treasury. The share prices of UK-listed energy majors Shell and BP were relatively unchanged by the announcement, reflecting that UK projects represent a small proportion of their respective asset bases.

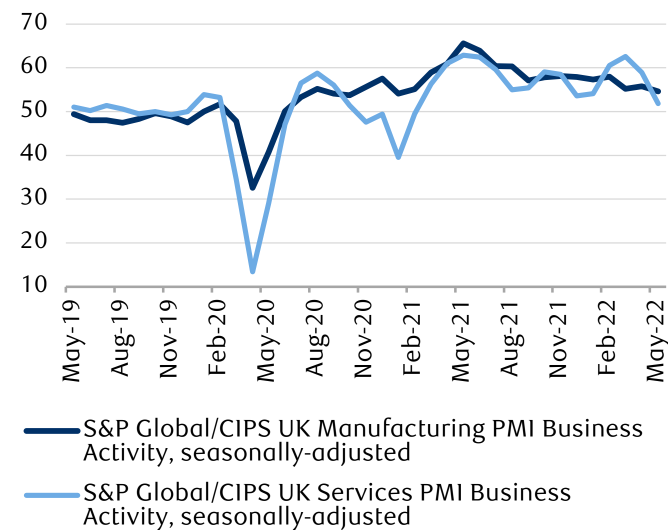
- **A separate windfall tax on the electricity generation industry's "excess profits" resulting from higher power prices is also being explored**. According to a Financial Times report, the tax is not forthcoming at this stage owing to it being too complicated to design in time for an announcement. It does seem likely to be included in the autumn as a way to help finance a further set of support measures when the next increase is due to hit consumer energy bills. RBC Capital Markets believes such an intervention by the UK government would be short-sighted, risking billions of investment into low-carbon energy projects in the years ahead.

- **Within UK equities, we continue to recommend being highly selective towards domestically focused UK stocks** given the weakening consumer outlook, and we maintain our bias for more internationally-oriented companies.

- **UK economic activity indicators showed a larger loss of momentum in May than consensus expectations**. Most notable was a sharp deterioration in the S&P Global/CIPS Services Flash Purchasing Managers' Indexes (PMIs) despite the backdrop of a strong labour market. We think the acute loss of consumer confidence is to blame. RBC Capital Markets expects Q2 GDP growth to be flat quarter over quarter, following Q1's 0.8% growth, though risks are on the downside.

- **In the euro area, May PMIs pointed to the services sector remaining strong** thanks to continued reopening effects, while the manufacturing sector suffers from supply chain disruptions and weakening demand. Both indicators remain firmly in expansion territory for now.

UK manufacturing and services economic activity wane



Source - RBC Wealth Management, Bloomberg; data through 5/25/22

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **China Premier Li Keqiang held an emergency meeting** with thousands of representatives from local government, state-owned companies, and financial firms. **Premier Li warned** that "Economic indicators in China have fallen significantly, and **difficulties in some aspects, and to a certain extent, are greater than when the epidemic hit us severely in 2020**." We think the comments add to market expectations that Beijing will miss its 5.5% GDP growth target for 2022. In recent weeks, more private economists have lowered their GDP growth forecasts. Economists surveyed by Bloomberg now expect China GDP to grow to just 4.5% in 2022. To boost growth, **Premier Li outlined 33 support measures to help businesses**, including more than US$21 billion of additional tax reductions.

- **Japan is set to welcome small groups of tourists from overseas starting June 6, according to TV Asahi, another sign of further easing of COVID-19 restrictions**. We expect domestic consumption to continue to recover as the economy reopens over the coming months.

- **Singapore is maintaining its 3%–5% GDP growth forecast for 2022 but cautioned that growth will likely come in at the lower half of the range**, weighed down by the war in Ukraine and strict COVID-19 lockdowns in China, according to Singapore's Ministry of Trade and Industry. Singapore GDP grew 3.7% y/y in Q1 2022, higher than the government's 3.4% advance estimate but matching analysts' forecasts in a Reuters poll. Separately, Singapore's core inflation jumped 3.3% y/y in April, the highest level since February 2012, fueled by higher inflation for electricity and gas, as well as food and other goods. Against the backdrop of rising inflation and risk of slower growth, **we continue to expect the Monetary Authority of Singapore to tighten monetary policy again in October**.

MARKET
Scorecard

Data as of May 25, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,978.73	-3.7%	-16.5%	-5.0%	34.6%
Dow Industrials (DJIA)	32,120.28	-2.6%	-11.6%	-6.4%	31.3%
Nasdaq	11,434.74	-7.3%	-26.9%	-16.3%	22.6%
Russell 2000	1,799.16	-3.5%	-19.9%	-18.4%	32.7%
S&P/TSX Comp	20,383.75	-1.8%	-4.0%	4.2%	35.2%
FTSE All-Share	4,147.08	-0.9%	-1.4%	3.4%	25.6%
STOXX Europe 600	434.31	-3.6%	-11.0%	-2.4%	25.8%
EURO STOXX 50	3,677.10	-3.3%	-14.5%	-8.9%	23.8%
Hang Seng	20,171.27	-4.4%	-13.8%	-30.2%	-12.1%
Shanghai Comp	3,107.46	2.0%	-14.6%	-13.2%	10.3%
Nikkei 225	26,677.80	-0.6%	-7.3%	-6.6%	28.6%
India Sensex	53,749.26	-5.8%	-7.7%	6.1%	75.2%
Singapore Straits Times	3,179.58	-5.3%	1.8%	1.1%	27.2%
Brazil Ibovespa	110,579.81	2.5%	5.5%	-10.1%	29.1%
Mexican Bolsa IPC	51,717.07	0.6%	-2.9%	5.9%	44.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	2.749%	-18.5	123.9	119.0	209.0
Canada 10-Yr	2.775%	-9.1	134.9	131.5	228.7
UK 10-Yr	1.910%	0.5	93.9	112.4	173.6
Germany 10-Yr	0.952%	1.4	112.9	111.9	144.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.36%	0.7%	-8.9%	-8.2%	-8.3%
U.S. Investment-Grade Corp	4.29%	0.2%	-12.5%	-10.9%	-7.0%
U.S. High-Yield Corp	7.75%	-2.7%	-10.7%	-7.9%	7.6%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,853.84	-2.3%	1.3%	-2.4%	7.0%
Silver (spot $/oz)	22.00	-3.4%	-5.6%	-21.4%	27.3%
Copper ($/metric ton)	9,459.00	-3.2%	-2.9%	-4.5%	79.8%
Oil (WTI spot/bbl)	112.58	7.5%	46.2%	69.9%	235.6%
Oil (Brent spot/bbl)	114.38	4.6%	47.1%	66.6%	221.9%
Natural Gas ($/mmBtu)	8.98	23.9%	140.6%	208.1%	418.5%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	102.1560	-0.8%	6.8%	14.0%	2.3%
CAD/USD	0.7803	0.4%	-1.4%	-5.8%	9.1%
USD/CAD	1.2815	-0.3%	1.4%	6.2%	-8.4%
EUR/USD	1.0679	1.3%	-6.1%	-12.8%	-2.0%
GBP/USD	1.2581	0.1%	-7.0%	-11.1%	3.2%
AUD/USD	0.7089	0.4%	-2.4%	-8.5%	8.3%
USD/JPY	127.2800	-1.9%	10.6%	17.0%	18.2%
EUR/JPY	135.9200	-0.8%	3.8%	2.0%	15.8%
EUR/GBP	0.8488	1.2%	0.9%	-2.0%	-5.1%
EUR/CHF	1.0276	0.1%	-1.0%	-6.3%	-3.0%
USD/SGD	1.3752	-0.6%	1.9%	3.7%	-3.5%
USD/CNY	6.6932	1.3%	5.3%	4.4%	-6.2%
USD/MXN	19.8321	-2.9%	-3.4%	-0.3%	-12.0%
USD/BRL	4.8235	-3.0%	-13.5%	-9.5%	-11.4%

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.

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Source - Bloomberg; data as of 5/25/22 market close

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As of March 31, 2022

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Buy [Outperform]	841	57.68	330	39.24
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Sell [Underperform]	48	3.29	3	6.25

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