GLOBAL
# Insight
WEEKLY

Wealth Management
RBC

Perspectives from the Global Portfolio Advisory Committee

June 9, 2022

# The summer of our discontent?

Frédérique Carrier – London

Markets remain unsettled amid runaway inflation and slowing economic growth. With many major central banks taking forceful actions to arrest the challenges, we look at the prospects for the major economies and what investors can expect from this evolving period.

The combination of the Russia-Ukraine conflict and China's zero-tolerance COVID-19 policy has extended the post-pandemic supply chain shock and contributed to push inflation to the highest level since the 1980s. Central banks have responded aggressively in many countries, but not all. We explore the economic scenarios for key regions and investment implications of central bank policy divergence.

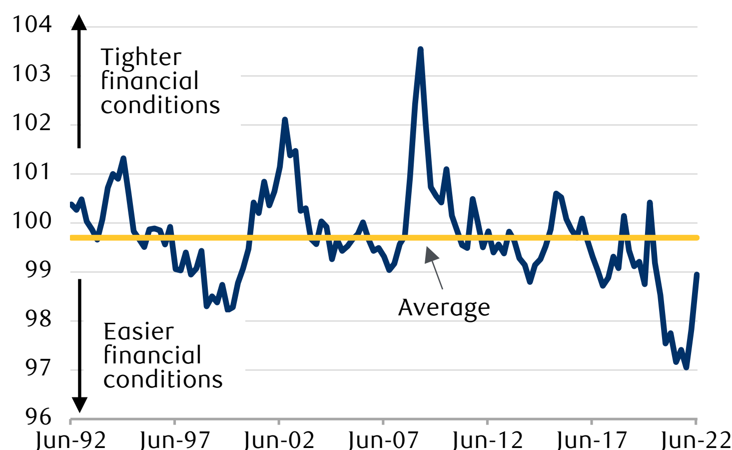
## U.S.: Taking the heat out

The U.S. appears most insulated from the energy and food security crises that have been exacerbated by the Russia-Ukraine war. Inflation and a cost-of-living squeeze are constraining consumer spending, though much less so than in other regions thanks to robust income and employment growth, combined with strong household and business balance sheets.

U.S. financial conditions have tightened over the past four months at a rate seen only twice in the past 30 years. Yet they remain close to their long-term average and seem not restrictive yet, according to Mark Dowding, CEO of BlueBay Asset Management, an RBC group company. The Fed welcomes the moderation of economic activity, and hopes that some of the heat can be taken out of the labour market, alleviating recent upward pressure on wages and the risk of a second-round inflationary impact.

**U.S. financial conditions close to long-term average**

Goldman Sachs Financial Conditions Index




Source - RBC Wealth Management, Bloomberg; quarterly data through 6/3/22

As long as inflation is elevated, the Fed will likely seek to engineer a slowdown in the labour market by continuing to tighten financial conditions—via interest rate hikes and culling assets from its close to $9 trillion balance sheet, a process known as quantitative tightening—until rates are near 2.5 percent. We expect inflation to fall steadily going forward, though the path from eight percent to five percent could be shorter than that from five percent to two percent. Economic activity is slowing down, but from a high level.

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

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Priced (in USD) as of 6/8/22 market close (unless otherwise stated). Produced: 6/9/22 2:35 pm ET; Disseminated: 6/9/22 2:39 pm ET
For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6

The Fed's monetary policy tightening has underpinned U.S. dollar strength, which can be problematic for many countries from emerging markets to the UK. A strong greenback means the price of imported goods quoted in U.S. dollars, such as energy, increases for such markets.

## China: COVID-19 cases recede

While most of the Western world is grappling with uncomfortably high inflation, China's inflation pressures are modest due to weak demand. The country's zero-COVID strategy has been a substantial drag on the Chinese economy. The People's Bank of China has eased monetary policy, but whether these supporting measures are effective remains to be seen. Residents may continue to behave cautiously out of concern for potential COVID-19 containment measures.

Infection cases are now receding and lockdowns are being eased. More stimulus may be in the offing—comments from Chinese President Xi Jinping at the April Politburo meeting and those of Premier Li Keqiang at the June State Council meeting suggest the government is eyeing strong policy support to offset headwinds.

Four policy areas that were tightened in 2021 could further turn towards easing: (1) Fiscal policy, with infrastructure and pandemic fiscal stimulus picking up; (2) monetary policy, with another 75 basis point (bps) cut in the reserve requirement ratio for banks and 20 bps of policy rate cuts widely expected for the rest of this year; (3) housing market regulations; and (4) big tech, as China has shown signs of softening its crackdown. Should fiscal and monetary policy gain better traction, growth should eventually accelerate, in our view.

A material and sustained easing of lockdowns should also improve supply chains and could reduce inflationary pressures.

## Europe: Too close for comfort

Europe faces a difficult environment on several fronts. Given its reliance on Russian energy, it is most vulnerable to geopolitical risk. Headline inflation reached a high of 8.1 percent year-over-year in May, though this was mostly driven by food and energy, unlike in the U.S. where inflation is broad-based. After excluding those two components, inflation on the Continent is a more manageable 3.8 percent.

Even so, we expect inflation to remain elevated and, as a result, for the European Central Bank (ECB) to end its bond purchase programme in June, and from there to lift rates out of negative territory to zero percent. Though this may not sound like much, it is the first tightening in more than 10 years. Once rates are at zero, the ECB is likely to pause and take stock of the situation, in our view.

Following the initial steps of rate normalization, we see growth softening over the course of this year. However, fiscal support from the EU's recovery fund should aid in offsetting the slowdown.

## UK: Heat or eat

The UK faces an acute cost-of-living crisis and arguably the most challenging growth and inflation dynamics of any developed market. We expect private consumption to be restrained. Moreover, we see a persistent drag on growth from ongoing weakness in exports, exacerbated by continued adjustments to post-Brexit trading rules.

The Bank of England (BoE), the first major central bank to embark on a tightening cycle, will likely continue to raise rates. A recently announced support package for households worth 0.6 percent of GDP has led market participants to expect the Bank Rate to reach 2.3 percent at year-end, implying a 25 bps hike at every policy meeting this year. The BoE walking a tightrope between growth and inflation is one of the reasons why sterling has struggled against the dollar year to date.

## Japan: Prime Minister Kishida's "new capitalism"

Japan faces similar currency weakness, and this may partly offset the drag from the slowdown of its main export markets. A weaker yen is driving some inflation, though to a subdued level compared to Western economies, at 2.5 percent currently. As such, the Bank of Japan remains on hold as the central bank still sees its top priority as supporting the economy.

On May 31, Prime Minister Fumio Kishida unveiled a plan—"the new capitalism"—to modernize the economy and boost growth, including tax incentives and greater support for decarbonization, digitization, and innovation. Given that Kishida enjoys an approval rating of 66 percent, many of these measures are likely to be implemented, potentially stimulating the economy. An improved growth outlook and subdued inflation are the main reasons we are constructive on this market.

## Investment implications

Though central bank policies differ, investors are facing an environment of generally structurally higher inflation and interest rates, lower liquidity, and a less stable geopolitical environment.

Equities have largely priced in this more challenging backdrop in a short space of time. Valuations are now below the long-term average in the U.S. and are at very low levels in Europe, China, the UK, and Japan.

In the short term, though investors may still be unsettled about grappling with concerns over inflation and Western central bank hawkishness, if global and U.S. recessions are avoided, as our economic indicators are currently suggesting, we think the magnitude of equity market downside will be limited. We expect this period of market volatility to eventually resolve to the upside, as inflation wanes and the global economy stabilizes.

*With contributions from Jasmine Duan.*

## UNITED STATES

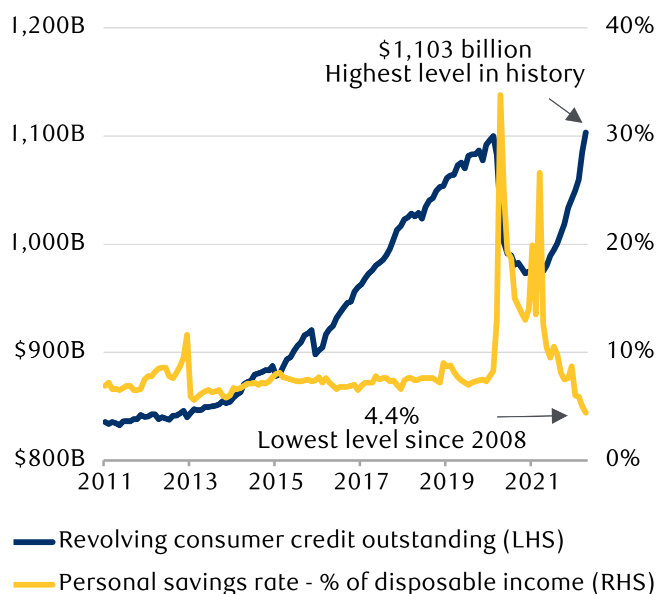
Tyler Frawley, CFA – Minneapolis

- **U.S. equities are on track for mixed results in what has been relatively quiet trading so far this week, as investors look forward to tomorrow's Consumer Price Index data from the Bureau of Labor Statistics.** As of intraday trading today, the Nasdaq Composite has led the way, returning 0.11%. The S&P 500 has outperformed the Dow Jones Industrial Average, but both are modestly lower, falling 0.18% and 0.20%, respectively. Sector leadership is evident in Energy, advancing 2.29%. Real Estate has been the biggest laggard, falling 1.84%.

- **As inflation remains stubbornly elevated, consumers have begun to reduce savings and are increasingly tapping into credit** to weather the rise in food, energy, and housing costs. Personal savings as a percentage of disposable income has fallen steadily since peaking at 33.8% in April 2020 (when it was boosted by government stimulus and a drop in discretionary spending due to pandemic restrictions) and stood at 4.4% as of the end of April, according to the most recent available data, the lowest level since 2008. The outstanding balance of consumer credit, on the other hand, has risen sharply since bottoming in early 2021, and is now back to its pre-pandemic level. **This dynamic could be interpreted as a red flag for consumer spending—which accounts for approximately 70% of U.S. GDP**—because eventually individuals could deplete their savings and exhaust their available credit, leading to a period of weak consumer demand. Although these numbers are worth keeping an eye on, we continue to believe that a significant slowdown in consumer spending is unlikely in the near term, as household balance sheets remain significantly healthier than they were in 2019 due to savings accumulated during the pandemic.

- It's been a relatively light week for economic data thus far. **The Mortgage Bankers Association's weekly survey revealed that the number of mortgage applications decreased 6.5% last week**, pushing the Market Composite Index to its lowest level in 22 years as higher mortgage rates continue to suppress mortgage activity. Looking forward, all eyes will be on tomorrow morning's U.S. inflation report. Investors will be looking for signs that inflation has peaked, which could help assuage market fears over how long the Fed's current rate hiking cycle will need to continue.

**U.S. personal savings rate continues to fall and consumer credit utilization spikes as inflation remains elevated**




Source - RBC Wealth Management, Bloomberg, Federal Reserve; data through April 2022

## CANADA

Luis Castillo & Simon Jones – Toronto

- **Canadian benchmark rates have been climbing at a faster pace than their U.S. equivalents, largely on the back of last week's hawkish Bank of Canada (BoC) comments that accompanied its 50 basis points (bps) rate hike decision.** Although bond markets had priced in the hike's magnitude in advance, the language of the announcement was slightly more hawkish than anticipated, placing a greater focus on the risks of inflation and re-opening the door for a greater than 50 bps hike in the future, if deemed necessary. For most of the week, the Canadian bond market has been repricing its BoC hike expectations higher and it is now looking for a policy overnight rate above 3% by the end of the year. The 2-year to 30-year maturity portion of the Canada sovereign bond curve is now sitting at rates above the 3% mark, after having climbed by roughly 30 bps over the past week alone, nearly doubling the move seen in the United States. RBC Economics has also recently updated its policy expectations, lifting its forecast for the BoC's end-of-year policy rate to 2.75% from 2.50%.

- **The Canadian economy grew at an annualized rate of 3.1% during Q1 2022, according to Statistics Canada, falling short of the 5.2% consensus expectation.** Although GDP growth wasn't as strong as economists expected, the miss was largely attributed to a downward revision of January's GDP growth, indicating that omicron-related restrictions weighed on the economy more heavily than initially thought. However, consumer spending has surged since these pandemic-related restrictions were eased, as evidenced by the monthly data that shows GDP grew at a robust 0.7% m/m pace in March. With near-term economic growth supported by robust consumer spending, and the BoC intensely focused on bringing inflation back towards its 2% target, we think it will take more than a modest GDP growth miss to change the trajectory of monetary policy.

## EUROPE

Rufaro Chiriseri, CFA & Frédérique Carrier – London

- **As widely expected, the European Central Bank (ECB) Governing Council held rates unchanged at -0.50% and announced an end to asset purchases on July 1**. The council cemented a rate increase of 25 basis points (bps) in July—the first rate hike in more than a decade—and further stated that a 50 bps hike may be appropriate in September, depending on the inflation outlook. The market now expects around 140 bps of policy tightening in 2022.

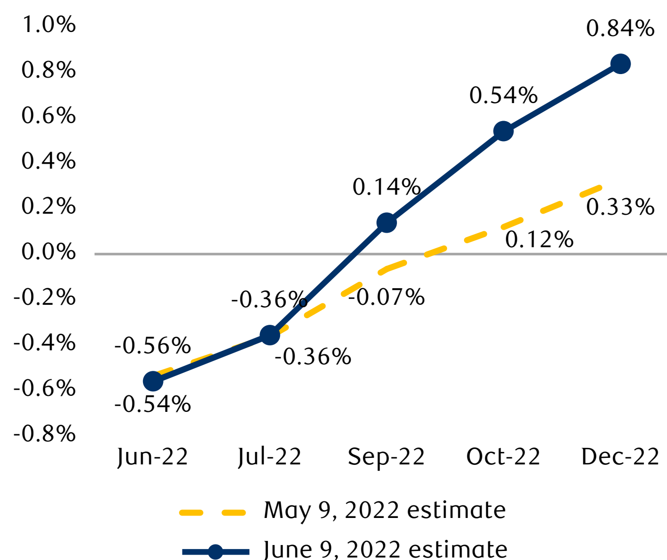
- **The war between Russia and Ukraine continues to weigh on consumer confidence and dampen the economic growth outlook, and this is reflected in the newly updated ECB staff forecasts**. Regional growth estimates for 2022 and 2023 have been revised downwards to 2.8% and 2.1%, respectively, while the 2024 estimate has been raised to 2.1%. The ECB acknowledged that "inflation pressures have broadened and intensified," and this is reflected in staff inflation projections rising to 6.8% for 2022 and 3.5% for 2023. Crucially, in 2024 inflation is seen at 2.1%, which is above the 2% ECB target; therefore, further tightening may be warranted.

- The yield on 2-year German Bonds jumped 13 bps to 0.81%, while the Italy-Germany sovereign bond yield spread widened to 218 bps, levels last seen in May 2020. **ECB President Christine Lagarde stated that the central bank "will deploy either existing or new instruments" to tackle "unwarranted" fragmentation if it hampers the effectiveness of monetary policy across member states**. Fragmentation risks increase when the premium that investors demand to hold lower-rated euro-area sovereign debt, such as Italian and Greek bonds, rises significantly above historic ranges.

- **UK Prime Minister Boris Johnson narrowly survived a confidence vote, leaving him significantly weakened**. To shore up his government's popularity, he is talking up tax cuts, though it is unclear whether fiscally conservative Chancellor of the Exchequer Rishi Sunak would welcome such a move. **The pound has been oblivious to the political drama**, as even though Johnson's days in charge may be numbered, it is not clear there would be a change of policy direction should the Conservative party eventually replace him.

**Further policy tightening expected**

Euro-area market implied deposit rate




Source - RBC Wealth Management, Bloomberg; data as of 15:26 GMT 6/9/22

## ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Risk sentiment regarding Chinese equities has largely improved during the week**, following the reopening of Shanghai and Beijing. Chinese Premier Li Keqiang, at the latest State Council executive meeting on June 8, further expressed the need to implement stimulus measures to ensure stable growth and secure employment. We think investors believe the worst may be behind them and stimulus could support economic recovery.

- **There are signs the Tech sector crackdown could be easing**. According to The Wall Street Journal, Chinese regulators are preparing to wrap up their investigation into the ride-hailing giant Didi Global Inc. (DIDI), and allow its main apps to return to mobile stores as soon as this week. What's more, China recently approved the second batch of licenses, for 60 domestic games, following the first batch on April 11. Chinese Tech stocks were boosted by the news, with the Hang Seng TECH Index up by almost 8% in the past four trading days.

- **China's latest trade data are also encouraging** as supply chain pressure eases. Exports, in dollar terms, surged 16.9% y/y in May, beating the 8% Bloomberg consensus estimate. Imports were up 4.1% y/y vs. the 2.8% economists' expectation. External demand seems resilient; however, we think there are still uncertainties due to geopolitical tensions and inflation pressures in developed countries.

- **We think most of the near-term catalysts in the China market are positive regarding risk sentiment**. But, after the recent rally, investors will have to re-evaluate the fundamentals in the next few weeks, in our opinion. The following are among the several key questions we think investors should be asking: How is the latest COVID-19 situation progressing? Are there any new major cities under lockdown or partial lockdown? What is the effect of the recent stimulus? While we believe much of the negative news has been priced into the market, one of our key concerns is that downward earnings revisions could occur as analysts assess the impact of the recent lockdowns.

MARKET
# Scorecard

Data as of June 8, 2022

| Equities (local currency) | Level | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| S&P 500 | 4,115.77 | -0.4% | -13.6% | -2.6% | 27.3% |
| Dow Industrials (DJIA) | 32,910.90 | -0.2% | -9.4% | -4.9% | 19.4% |
| Nasdaq | 12,086.27 | 0.0% | -22.7% | -13.2% | 21.8% |
| Russell 2000 | 1,891.01 | 1.4% | -15.8% | -19.3% | 23.0% |
| S&P/TSX Comp | 20,792.43 | 0.3% | -2.0% | 3.6% | 30.2% |
| FTSE All-Share | 4,193.26 | -0.2% | -0.4% | 3.4% | 17.1% |
| STOXX Europe 600 | 440.37 | -0.7% | -9.7% | -3.0% | 17.7% |
| EURO STOXX 50 | 3,788.93 | 0.0% | -11.9% | -7.5% | 12.6% |
| Hang Seng | 22,014.59 | 2.8% | -5.9% | -23.5% | -11.1% |
| Shanghai Comp | 3,263.79 | 2.4% | -10.3% | -8.8% | 11.1% |
| Nikkei 225 | 28,234.29 | 3.5% | -1.9% | -2.5% | 21.8% |
| India Sensex | 54,892.49 | -1.2% | -5.8% | 5.0% | 59.7% |
| Singapore Straits Times | 3,225.80 | -0.2% | 3.3% | 1.9% | 15.3% |
| Brazil Ibovespa | 108,367.67 | -2.7% | 3.4% | -16.5% | 11.0% |
| Mexican Bolsa IPC | 49,819.30 | -3.7% | -6.5% | -2.1% | 24.7% |
| **Gov't bonds (bps change)** | **Yield** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. 10-Yr Treasury | 3.023% | 17.9 | 151.3 | 149.0 | 214.8 |
| Canada 10-Yr | 3.268% | 37.7 | 184.2 | 181.7 | 259.2 |
| UK 10-Yr | 2.246% | 14.5 | 127.5 | 147.6 | 191.2 |
| Germany 10-Yr | 1.354% | 23.2 | 153.1 | 157.8 | 167.3 |
| **Fixed income (returns)** | **Yield** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Aggregate | 3.53% | -0.7% | -9.6% | -9.1% | -9.0% |
| U.S. Investment-Grade Corp | 4.35% | -0.7% | -12.5% | -11.3% | -8.4% |
| U.S. High-Yield Corp | 7.35% | -0.9% | -8.8% | -6.6% | 4.3% |
| **Commodities (USD)** | **Price** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| Gold (spot $/oz) | 1,850.81 | 0.7% | 1.2% | -2.2% | 9.0% |
| Silver (spot $/oz) | 22.03 | 2.2% | -5.5% | -20.2% | 24.0% |
| Copper ($/metric ton) | 9,699.25 | 2.7% | -0.4% | -2.4% | 70.7% |
| Oil (WTI spot/bbl) | 122.11 | 6.5% | 58.6% | 74.3% | 219.7% |
| Oil (Brent spot/bbl) | 124.05 | 1.0% | 59.5% | 71.8% | 204.0% |
| Natural Gas ($/mmBtu) | 8.69 | 6.7% | 133.0% | 177.8% | 385.8% |
| **Currencies** | **Rate** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Dollar Index | 102.5600 | 0.8% | 7.2% | 13.9% | 6.1% |
| CAD/USD | 0.7964 | 0.7% | 0.7% | -3.5% | 6.6% |
| USD/CAD | 1.2556 | -0.7% | -0.6% | 3.7% | -6.2% |
| EUR/USD | 1.0714 | -0.2% | -5.8% | -12.0% | -5.1% |
| GBP/USD | 1.2537 | -0.5% | -7.4% | -11.4% | -1.5% |
| AUD/USD | 0.7191 | 0.2% | -1.0% | -7.1% | 2.4% |
| USD/JPY | 134.2900 | 4.4% | 16.7% | 22.6% | 23.8% |
| EUR/JPY | 143.8800 | 4.2% | 9.9% | 7.9% | 17.5% |
| EUR/GBP | 0.8546 | 0.3% | 1.6% | -0.6% | -3.7% |
| EUR/CHF | 1.0486 | 1.8% | 1.1% | -3.9% | -3.0% |
| USD/SGD | 1.3762 | 0.5% | 2.0% | 3.9% | -0.8% |
| USD/CNY | 6.6838 | 0.2% | 5.2% | 4.4% | -5.5% |
| USD/MXN | 19.5747 | -0.4% | -4.7% | -0.7% | -9.0% |
| USD/BRL | 4.8886 | 3.3% | -12.3% | -2.9% | 1.4% |

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.

Examples of how to interpret currency data: CAD/USD 0.79 means 1 Canadian dollar will buy 0.79 U.S. dollar. CAD/USD 0.7% return means the Canadian dollar rose 0.7% vs. the U.S. dollar year to date. USD/JPY 134.29 means 1 U.S. dollar will buy 134.29 yen. USD/JPY 16.7% return means the U.S. dollar rose 16.7% vs. the yen year to date.

Source - Bloomberg; data as of 6/8/22 market close

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As of March 31, 2022

| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| Buy [Outperform] | 841 | 57.68 | 330 | 39.24 |
| Hold [Sector Perform] | 569 | 39.03 | 172 | 30.23 |
| Sell [Underperform] | 48 | 3.29 | 3 | 6.25 |

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