GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

June 30, 2022

Slowing growth's silver linings playbook

Atul Bhatia, CFA – Minneapolis

While we are cognizant of the risks and uncertainties of a recession, we believe the majority of the media's recession commentary is at best incomplete. It's important to consider secondary impacts of slowing growth, including the anti-inflationary impact and the policy flexibility it permits. Fixed income investors in particular may see positives in the current economic backdrop.

Financial press headlines have increasingly focused on the probability of a U.S. recession in the next year, while Fed Chair Jerome Powell, in recent congressional testimony, acknowledged the potential for tighter monetary policy to spark a significant decline in economic activity, the key characteristic of a recession.

Too frequently, in our view, the press stops its analysis at discussing the odds of a recession without engaging the more important questions of the economic and investment impact of slowing growth. For fixed income investors in particular, we see several potentially important positive implications if growth declines.

Growth-constraining policies have a purpose

One way to think about inflation is as an imbalance between supply and demand that drives prices higher. In that framework, the solution to excessively high inflation is to either increase supply or reduce demand to bring the market into balance without relying exclusively on the price mechanism. With policymakers limited in their ability to impact short-term supply, the majority of the policy work is being done on the demand side. By its nature, reducing demand will tend to constrain growth.

The large decline, for instance, in the federal budget—which the nonpartisan Congressional Budget Office shows dropping to $5.8 trillion this year from $6.5 trillion in 2020—has helped limit government demand, which accounts for roughly 15 percent of GDP. The lack of government transfer spending has an impact on private consumption as well, but the main impact on individual households and corporations is likely to come from monetary policy.

Policy is more than rates

One of the most notable aspects of this cycle is how effective the Fed has been in tightening policy through communication. With policy rates still in what both we and the Fed would consider accommodative territory, the central bank has managed to tighten financial conditions across tenors for nearly every sector of the economy. The Fed is in large part calibrating policy through a dialogue with markets; investors "speaking" through yield curves and the Fed validating or rejecting the implied policy path through a combination of speeches, testimony, and actual policy changes.

So in most of the ways that matter, the Fed's tightening cycle has already been implemented—corporations and households are dealing with the impact of higher borrowing rates and are now rethinking spending as potential returns on available investments have moved

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

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higher. The actual rate hikes and policy moves the Fed will likely put into place over the next several months, therefore, are simply playing catch-up to the market.

Recession or not, slowing growth has likely arrived

The numbers bear out the impact of tighter fiscal and monetary conditions. While official GDP numbers are only updated four times a year and are reported with considerable lag, the Atlanta Fed has created a real-time GDP calculation, which shows the U.S. economy currently at or near a standstill in terms of economic growth.

There are also signs that reported inflation may be heading lower as a result of policy and slower growth.

One is the recent drop in commodity prices, with the Bloomberg Commodity Index down over 10 percent since its early June highs. Another is the reported inventory increases at major retailers as consumer tastes have shifted since the early days of the pandemic. High inventories are typically cleared through price discounts, adding to potential disinflationary pressures over the medium term. Finally, wealth effects have stalled, as the near doubling in mortgage rates since last year has effectively halted the use of mortgage refinancing to fund spending; at current rates, the number of households able to profitably refinance is negligible.

Growth and policy feedback loop

Focusing exclusively on the probability of a recession has two main shortcomings, in our view.

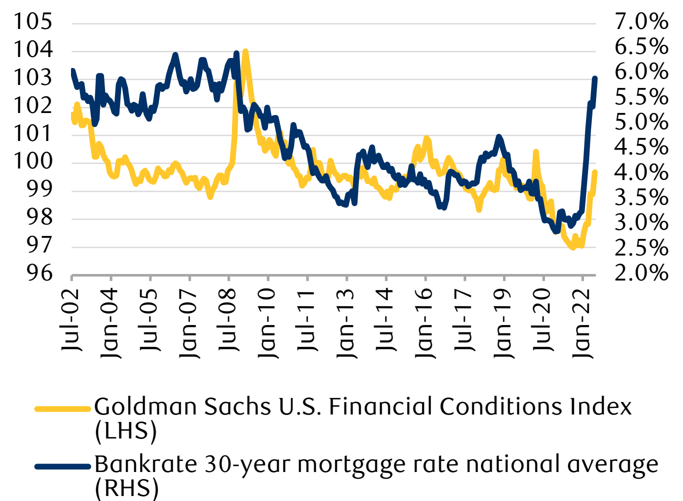
First, it ignores the questions of degree and duration. Some degree of slowing demand—and therefore slower GDP growth—is necessary to achieve price stability, barring a major and unanticipated uptick in supply. Whether that tips into the technical definition of a recession or a contraction is not particularly critical; the real world and financial market impact of 0.1 percent growth is not likely to be significantly different from a 0.1 percent contraction, for instance. Put differently, a 75 percent chance of a shallow recession is likely less problematic than a 25 percent chance of a deep and prolonged downturn—a single probability measure tells us very little.

Second, we need to consider the anti-inflationary consequences of slowing growth and the policy flexibility it creates. If we were to see a significant drop in inflation alongside economic growth declines, there would be space for the Fed to respond. One simple remedy to slower growth would be to guide the market to a lower terminal rate, potentially even a relatively rapid flip to rate cuts.

Background could be bond-friendly

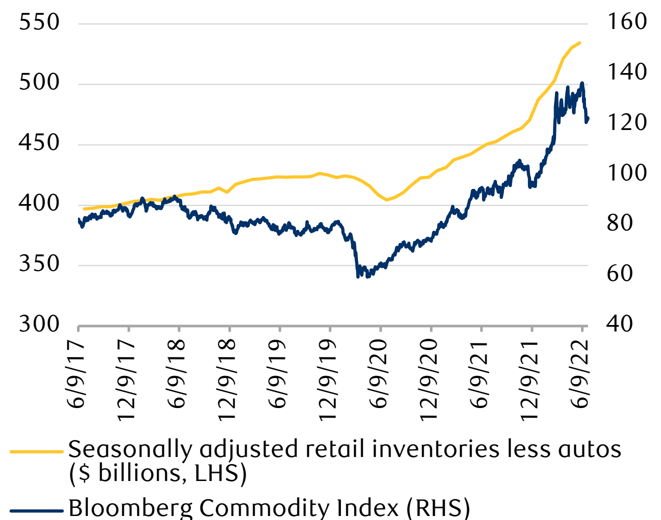
The potential for declining inflation alongside slower growth could make fixed coupon bonds—particularly those with long maturities—more attractive. In that environment, investors typically look at high-quality government and corporate bonds with more than 15

Policy rates accommodative, household and corporate monetary conditions are not



Source - RBC Wealth Management, Bloomberg; monthly data through 6/29/22

Declining commodity prices and rising inventories may help the Fed's inflation fight



Source - RBC Wealth Management, Bloomberg; data through 6/29/22

years to maturity. Securities backed by mortgages may be particularly appealing for some investors, as some of these securities combine very high credit quality with what we see as attractive prepayment characteristics.

There are of course risks to this view. If inflation remains elevated and the Fed is forced into more aggressive tightening, bonds across all maturities could suffer.

More than just a probability

We believe the majority of recession commentary is at best incomplete. We need to think about the secondary impacts of slowing growth, including the likely anti-inflationary impact and the policy flexibility it permits. While we are cognizant of the risks and the uncertainties, we believe that fixed income investors in particular may see positives in the current economic backdrop.

UNITED STATES

Michael Roedl – Minneapolis

- **U.S. consumer confidence slipped in June to the lowest level since February 2021**, according to the Conference Board's Consumer Confidence Index, as inflation at a four-decade high and growing concerns about a possible recession weighed on Americans' views of the economy. The index fell to 98.7, below the median consensus forecast. According to a report accompanying the update, consumers expect prices to rise at a faster pace over the next 12 months than they did in May. While wages have seen a moderate increase, purchasing power continues to weaken due to the rising cost of essential items, particularly food and energy. As illustrated by the chart, personal savings as a percentage of disposable income has fallen to the lowest level since the 2008 financial crisis.

- **Home-price growth is beginning to ease in the U.S. after soaring more than 20% so far this year**. While historically low interest rates fueled robust housing demand over the past two years, mortgage financing has become significantly more expensive as the Federal Reserve aggressively hikes rates against persistent inflation. Mortgage rates have nearly doubled since the beginning of the year; according to a Mortgage Bankers Association report released this week, the average 30-year fixed mortgage rate is now 5.84%. In our view, the Fed's path towards tighter monetary policy will likely blunt the rise of home prices throughout the year as higher rates further erode affordability, especially for younger prospective homebuyers.

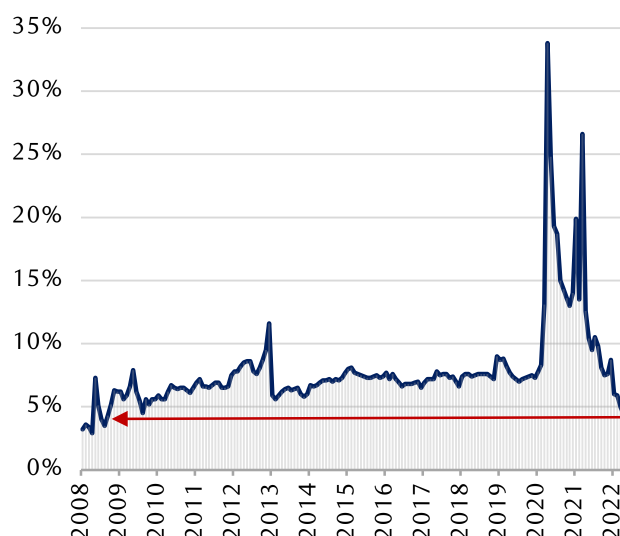
- **The yield on U.S. high-yield bonds reached a fresh 26-month high this week amid renewed concerns about the impact of inflation and higher rates on global growth**. High-yield spreads versus Treasuries are back above 500 basis points, with the Bloomberg U.S. High Yield Corporate Index yielding 8.80% as of Wednesday's close. Issuance in the high-yield sector has been scarce this year with supply currently running at $67.3 billion, down about 76% year over year, according to data compiled by Bloomberg.

CANADA

Matt Altro & Sean Killin – Toronto

- **The Canadian equity market continues to confront a number of headwinds, including accelerating inflation and rising interest rates, which have deepened the risk-off tone**. Relatively defensive sectors—such as Utilities, Communication Services, and Real Estate, which generally provide average dividend yields above 4% with prospects of capital appreciation over the long term—should, in our view, continue to interest quality-oriented investors amid elevated risk aversion. We think the same macroeconomic forces that have contributed to the general pullback in

Personal savings as percentage of disposable income; the lowest since 2008 financial crisis



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

equities could also create potential opportunities in other equity sectors, such as Software Consolidators, to deploy capital and acquire companies at valuations that appear relatively attractive. Meanwhile, sustained strength in oil prices should continue to support robust shareholder distributions in the Energy sector, where valuations remain below the five-year average. Another sector where valuations have compressed below the five-year average is Consumer Discretionary, which could benefit from a recovery in economic momentum and an easing of the inflation pressures that have negatively impacted household disposable income and discretionary spending trends.

- **The housing market is generating a potential headwind for the Canadian economy**. With residential real estate investment accounting for approximately 10% of nominal GDP at its most recent peak in Q4 2021, according to Statistics Canada, investors are monitoring the risks that tighter financial conditions and rising mortgage costs will depress housing activity. Of the three components that make up total residential real estate investment—new construction, renovations, and ownership transfer costs—the last may represent the area of greatest risk in the near term due to slowing sales activity. **RBC Economics' aggregate housing affordability measure, which monitors ownership costs as a percentage of median household income, has hit its worst level in over thirty years**, despite recent robust wage growth. With affordability near all-time lows, there is a possibility that prospective purchasers will be reluctant to buy due to the higher cost of capital paired with still-elevated housing prices. The drag stemming from the ongoing slowdown in residential investment could continue to weigh on the economic outlook in coming quarters, in our view.

EUROPE

Thomas McGarrity, CFA – London

- **European equities have suffered their worst H1 performance since 2008**, with the STOXX Europe 600 ex UK Index down around 20% in euro terms so far this year. The worst-performing areas of the market have been: (i) consumer cyclicals, including retail, amid growing fears that inflationary pressures will squeeze discretionary spending; (ii) Technology, as the sharp rise in interest rates has deflated valuation multiples; and (iii) Real Estate, due to the rise in yields and worries around the prospect of a recession. The significant outperformer has been the Energy sector, buoyed by higher oil and gas prices.

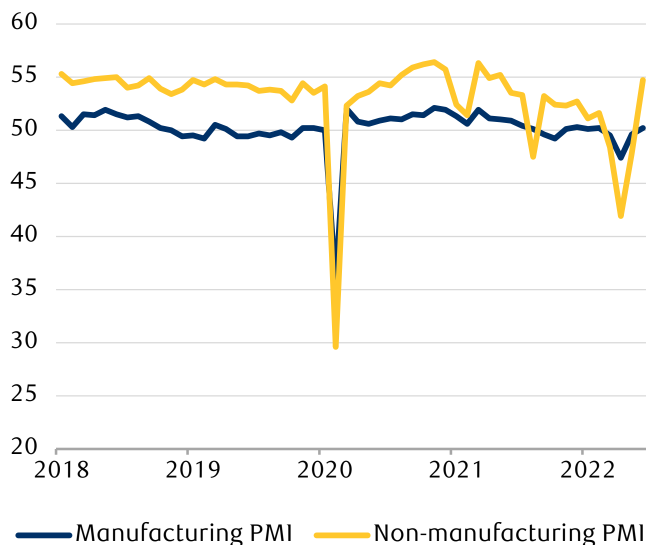
- The well-documented macro uncertainties and the potential for stagflation have already been discounted in the European equity market, in our view. However, **consensus earnings expectations for the region have actually moved higher, despite weakening forward economic indicators**. The consensus estimate of 2022 aggregate earnings growth in the European market currently stands at around 12%, but we see potential for this to enter a downgrade cycle in the coming months as economic growth and margin headwinds build. The market's weakness has arguably begun to reflect this prospect, but it nonetheless means **the European equity market's forward 12-month price-to-earnings ratio of around 12x consensus earnings may be artificially low**.

- **UK equities have fared better than European equities so far this year**. The UK's large-cap FTSE 100 Index's blend of high weightings in commodities-linked and traditionally defensive sectors, alongside its tiny weighting in Technology stocks, have resulted in the index producing a negative return of -1% YTD in GBP terms (-11% in USD).

- The UK stock market is not reflective of the UK economy, however. The midcap FTSE 250 Index, which is significantly more domestically focused, is down more than 20% YTD. During the week, **the monthly Business Barometer survey by Lloyds Banking Group showed confidence amongst UK firms falling to its lowest level in 15 months**. This is just the latest data pointing to weakening growth momentum as inflation pressures intensify for both businesses and consumers.

- **Within UK equities, we continue to be selective with regard to domestically focused stocks** given our cautious stance on the UK consumer outlook due to the unfolding cost-of-living crisis, **and maintain our bias towards more internationally oriented companies**.

China's official manufacturing and non-manufacturing PMIs climbed back above 50 in June



Source - RBC Wealth Management, Bloomberg; monthly data through 6/30/22

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **China and Hong Kong equity indexes have outperformed other major indexes in Asia during the week**. China announced earlier in the week that it would shorten the mandatory quarantine time for inbound travelers to seven days from 14 days, the first time the quarantine requirement has been reduced since the start of the pandemic. Investors responded positively to the announcement, as many have viewed the zero-COVID policy as a major concern for Chinese equities. One day later, however, President Xi Jinping made it clear that China intends to stick to its zero-COVID strategy. Although the policy is still strict, we think there is room for further fine-tuning.

- **China's economic recovery appears to be underway, with both the official manufacturing and non-manufacturing purchasing managers' indexes (PMIs) above 50** amid easing lockdowns and improving supply chain dynamics. The manufacturing PMI rose to 50.2 from 49.6 in May, and the non-manufacturing index jumped 6.9 points to 54.7. We expect the growth recovery to continue as more cities emerge from lockdowns and business activities gradually resume.

- **Chinese tech giant Tencent (700 HK) announced that its major shareholder, Prosus, will sell its holdings in the company**. Prosus, a holding company owned by South African multimedia group Naspers, said it is selling the shares to fund its own share buyback program rather than due to concern over Tencent's fundamentals, and expects the number of shares sold each day to be a small percentage of the average daily turnover of Tencent's shares. The news brought some volatility to Tencent's share price during the week.

MARKET
Scorecard

Data as of June 29, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,818.83	-7.6%	-19.9%	-11.0%	25.1%
Dow Industrials (DJIA)	31,029.31	-5.9%	-14.6%	-9.5%	21.2%
Nasdaq	11,177.89	-7.5%	-28.6%	-23.1%	13.2%
Russell 2000	1,719.37	-7.8%	-23.4%	-25.5%	21.0%
S&P/TSX Comp	19,078.64	-8.0%	-10.1%	-5.4%	24.0%
FTSE All-Share	4,019.53	-4.3%	-4.5%	-0.6%	16.9%
STOXX Europe 600	413.42	-6.8%	-15.2%	-9.4%	14.9%
EURO STOXX 50	3,514.32	-7.3%	-18.2%	-14.4%	8.7%
Hang Seng	21,996.89	2.7%	-6.0%	-24.1%	-9.5%
Shanghai Comp	3,361.52	5.5%	-7.6%	-5.9%	13.5%
Nikkei 225	26,804.60	-1.7%	-6.9%	-7.0%	21.9%
India Sensex	53,026.97	-4.6%	-9.0%	0.9%	51.7%
Singapore Straits Times	3,134.87	-3.0%	0.4%	1.5%	21.8%
Brazil Ibovespa	99,621.58	-10.5%	-5.0%	-21.8%	4.1%
Mexican Bolsa IPC	48,061.61	-7.1%	-9.8%	-4.5%	27.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.087%	24.3	157.7	161.8	246.4
Canada 10-Yr	3.306%	41.5	188.0	188.9	279.6
UK 10-Yr	2.385%	28.4	141.4	164.7	222.2
Germany 10-Yr	1.519%	39.7	169.6	168.9	198.9
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.88%	-2.5%	-11.2%	-11.1%	-11.5%
U.S. Investment-Grade Corp	4.81%	-3.5%	-15.0%	-14.7%	-11.9%
U.S. High-Yield Corp	8.62%	-5.7%	-13.2%	-11.7%	1.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,818.11	-1.0%	-0.6%	3.2%	2.6%
Silver (spot $/oz)	20.76	-3.7%	-10.9%	-19.5%	16.2%
Copper ($/metric ton)	8,360.00	-11.5%	-14.2%	-10.2%	40.5%
Oil (WTI spot/bbl)	109.78	-4.3%	42.6%	50.4%	176.5%
Oil (Brent spot/bbl)	115.20	-6.2%	48.1%	54.1%	176.2%
Natural Gas ($/mmBtu)	6.43	-21.1%	72.3%	77.0%	276.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	105.1030	3.3%	9.9%	14.2%	7.8%
CAD/USD	0.7755	-1.9%	-2.0%	-3.8%	5.9%
USD/CAD	1.2895	2.0%	2.0%	4.0%	-5.6%
EUR/USD	1.0441	-2.7%	-8.2%	-12.2%	-7.1%
GBP/USD	1.2124	-3.8%	-10.4%	-12.4%	-1.4%
AUD/USD	0.6880	-4.1%	-5.3%	-8.4%	0.2%
USD/JPY	136.6100	6.2%	18.7%	23.6%	27.0%
EUR/JPY	142.6300	3.3%	9.0%	8.5%	17.9%
EUR/GBP	0.8612	1.1%	2.4%	0.2%	-5.8%
EUR/CHF	0.9969	-3.2%	-3.9%	-9.0%	-6.8%
USD/SGD	1.3936	1.7%	3.3%	3.6%	0.0%
USD/CNY	6.7009	0.4%	5.4%	3.7%	-5.4%
USD/MXN	20.1258	2.4%	-2.0%	1.5%	-12.8%
USD/BRL	5.1799	9.4%	-7.1%	4.5%	-4.2%

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 0.77 means 1 Canadian dollar will buy 0.77 U.S. dollar. CAD/USD -2.0% return means the Canadian dollar fell 2.0% vs. the U.S. dollar year to date. USD/JPY 136.61 means 1 U.S. dollar will buy 136.61 yen. USD/JPY 18.7% return means the U.S. dollar rose 18.7% vs. the yen year to date.

Source - Bloomberg; data as of 6/29/22 market close

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As of March 31, 2022

			Investment Banking Services Provided During Past 12 Months	
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Sell [Underperform]	48	3.29	3	6.25

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