GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee
July 14, 2022

Of fissures and fault lines

Kelly Bogdanova – San Francisco

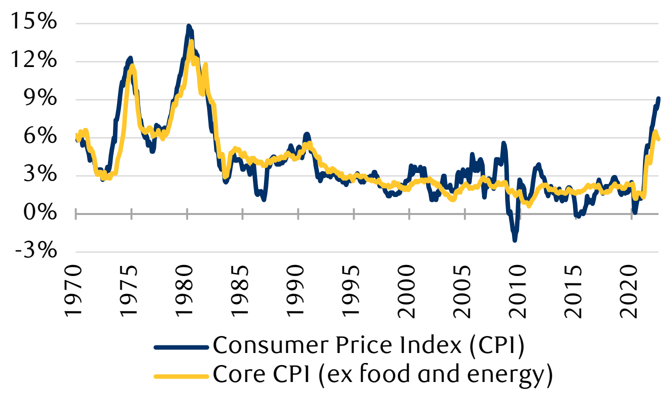
As inflation soars and recession fears rise, more uncertainty is hanging over the investment landscape. We take stock of these stubborn challenges, and look at whether a retrenchment in corporate earnings may be the next shoe to drop.

We have a feeling people who have been to the grocery store and have paid utility bills lately won't be surprised by this … U.S. inflation pushed higher yet again as the Consumer Price Index (CPI) surged 9.1 percent in June compared to the same month a year ago. Core CPI, which excludes food and energy, rose 5.9 percent year over year. Both readings exceeded economists' consensus forecasts. Some of the standout price increases compared to June 2021: Gasoline +59.9 percent, natural gas utilities +38.4 percent, airline fares +34 percent, electricity +13.7 percent, food at home +12.2 percent, new vehicles +11.4 percent, and eating out +7.7 percent.

Further breaking down the data, it was one of the biggest monthly increases on record. The CPI rose 1.3 percent in June compared to May, the hottest month-over-month rise of this inflation cycle and the 12th highest since 1947. Four of the previous jumps above 1.3 percent occurred during the high inflation surges from 1973–1980.

RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli does not expect much relief on the inflation front over the near term. He thinks year-over-year headline CPI will remain elevated even if month-over-month inflation decelerates because the data is running into difficult comparisons from last year.

U.S. consumer inflation (year-over-year % change)



Source - RBC Wealth Management, Bloomberg; monthly data through June 2022

RBC Global Asset Management Inc. Chief Economist Eric Lascelles notes that the energy price shock is now bleeding into other sectors, and this process takes time as price hikes filter across the economy. He wrote, "The point is that economic actors are still playing 'hot potato' with rising costs" with one industry passing along price hikes to another, and on down the line to consumers. Lascelles added, "Even as the labor market begins to soften, wage growth may not be done exerting upward pressure on inflation."

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

Recession risks continue to rise

With persistent inflation and big Fed rate hikes expected—the Treasury market is now pricing in a strong possibility for a 100 basis point (bps) rate hike at the Fed policy meeting in late July and another 100 bps of hikes for the remainder of the year—the bond market is signaling forthcoming deterioration in economic activity.

This is demonstrated by the all-important 10-year to 1-year Treasury yield curve, which we view as the most reliable of our seven recession indicators. It inverted for the first time this week, as the 1-year yield moved higher than the 10-year yield by 27 basis points on July 13, the day the CPI data was released. This is an abnormal relationship—typically, short-term yields are lower than longer-term yields, except during periods that precede recessions.

For our recession scorecard, the final call on this "inversion" (a potential shift in the indicator to red from yellow) will come at the end of the month because the historical data we have used for this indicator incorporates monthly average yields. But we don't expect this yield curve inversion to reverse over the remaining days in July. In our view, this means recession risks have risen notably and justify defensive equity positioning, as we explained in the latest update of our recession scorecard.

Porcelli is also concerned about recession risks—even more so than near-term inflation risks. During its fight against inflation, he thinks the Fed could overreach by hiking rates too much, thus slowing economic activity more than is necessary and "forcing" a recession. He believes the U.S. economy is already "quickly losing momentum," as evidenced by the Fed's own Beige Book Survey released yesterday. Porcelli points out the Fed is aggressively tightening into this deceleration, which could exacerbate the slowdown.

Is an earnings retreat the next shoe to drop?

Because of heightened recession risks, we think Wall Street's consensus S&P 500 earnings estimates for future quarters are too optimistic and are bound to come down. Currently, they assume profits will rise through 2023. However, surrounding the previous 11 recession periods, corporate earnings retreated.

Yes, one can make a case that this cycle is different because some companies are clearly benefiting from pricing power that accompanies inflation. But if further slowing in the economy takes root in the coming quarters (remember, pressure on the economy from Fed rate hikes works with a lag), we think companies will start to experience declines in demand. While some S&P 500 firms may be able to offset this with robust price increases, others probably will not be able to keep pace with inflation and also could be hit by lower sales volumes, thus crimping overall S&P 500 profit margins, revenues, and earnings, in our view.

In this vein, equity investors should consider prior periods of earnings retrenchments during recessions. RBC Global Asset Management found that S&P 500 earnings retreated 23.6 percent, on average, as the table shows. But like a lot of historical equity market data, there are nuances.

Excluding the two periods associated with unique financial system turmoil (1990, 2007), which caused overall S&P 500 earnings to decline much more, the average retrenchment was 18.9 percent. And if we zero in on just the four recession periods associated with inflation shocks (1953, 1973, 1980, 1981), the average earnings decline during those periods was 17.7 percent.

Looking out to consensus S&P 500 earnings estimates for the next four quarters (Q3 2022 through Q2 2023), the forecast is for $241 per share, as measured by Refinitiv I/B/E/S. The estimate for full-year 2023 is for $250 per share. We think estimates for both of these periods are too high in light of recession risks.

While it's too soon to gauge which quarter will represent peak earnings, we think it's prudent to consider scenarios in which S&P 500 earnings could decline roughly 10 percent to 25 percent from the peak, similar to retrenchments during prior inflationary periods.

In the coming quarters, if broad segments of the economy do indeed show further signs of slowing that start to strain corporate operations, management teams could be compelled to revise down their projections, and then so too would Wall Street industry analysts whose estimates make up the consensus forecasts. We will be monitoring management guidance during the current Q2 earnings reporting season with interest.

Corporate profits retreated in each of the prior 11 U.S. recessions

S&P 500 earnings declines surrounding recession periods

Recession start	Earnings peak	Earnings trough	Earnings decline duration (months)	Earnings peak per share	Earnings trough per share	EPS change peak to trough
July 1953	Dec. 1950	Dec. 1953	36	$2.8	$2.5	-11.6%
Aug. 1957	Feb. 1956	March 1959	37	$3.6	$2.8	-23.4%
April 1960	June 1960	June 1961	12	$3.6	$3.0	-14.6%
Dec. 1969	April 1969	June 1970	14	$6.1	$5.1	-16.2%
Nov. 1973	Jan. 1975	Feb. 1976	12	$9.6	$7.6	-21.6%
Jan. 1980	July 1980	Aug. 1981	13	$15.6	$13.7	-11.9%
July 1981	Aug. 1982	July 1983	11	$16.3	$12.1	-25.8%
July 1990	Aug. 1989	May 1992	33	$25.7	$15.5	-39.7%
March 2001	Sept. 2000	March 2002	18	$55.8	$41.3	-25.9%
Dec. 2007	Aug. 2007	Oct. 2009	26	$89.8	$45.1	-49.8%
Feb. 2020	Jan. 2020	Feb. 2021	12	$152.5	$122.8	-19.5%
Average			**20**	**$34.7**	**$24.7**	**-23.6%**
Median			**14**	**$15.6**	**$12.1**	**-21.6%**

Source - RBC Global Asset Management

UNITED STATES

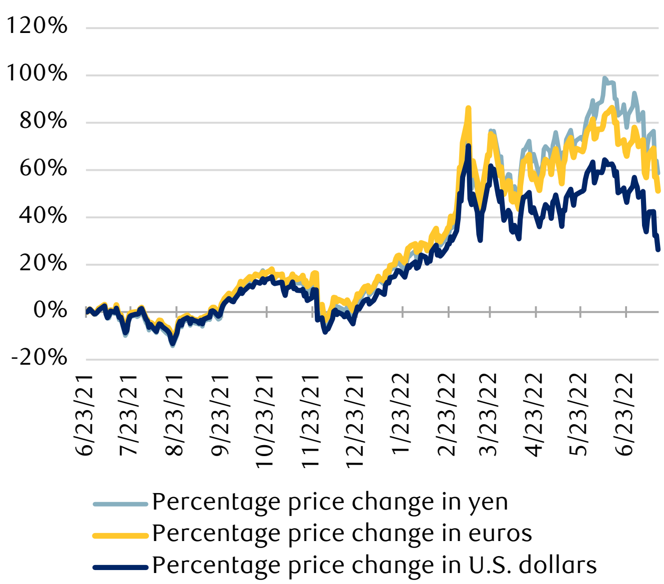
Atul Bhatia, CFA – Minneapolis

■ **Stronger-than-expected payroll growth in June and a four-decade high in Consumer Price Index (CPI) inflation have led markets to price in more aggressive tightening moves from the Fed.** (For more on this, see the feature article on page 1.) Following the CPI report, interest rate futures shifted to reflect a high probability of a 1% rate hike at the central bank's July 25 meeting, up from expectations for a 75 basis point increase earlier in the week. If the Fed were to move by the larger amount, it would take the overnight interest rate target band to what the Fed considers contractionary levels, a policy stance we would view as appropriate for the current environment of high inflation and low unemployment.

■ The Fed's recently released Beige Book—a qualitative survey of economic conditions across the country—showed moderate, broad-based growth, with supply chain issues and labor shortages making it more challenging for businesses to meet consumer demand. **Businesses in multiple districts flagged growing recession risks as a key concern, although there was wide variation among industries.** Hospitality and travel was particularly strong, while housing activity dropped as mortgage rates increased. One commonly cited risk was the drop in consumers' discretionary income, limited by rising fuel and food costs. The overall picture of inflation risks and slowing—but still positive—growth is unlikely to constrain the Fed's policy response, in our view.

Stronger dollar helps offset oil price rise

Brent oil price rises since June 2021 greater for U.S. trading partners



Note: All data normalized to June 23, 2021.

Source - RBC Wealth Management, Bloomberg

■ **One potential beneficiary of tighter Fed policy is the U.S. dollar, which is trading at multi-decade highs against major trading partners' currencies including the euro and the yen.** The stronger dollar should help the U.S. pull in a greater share of global supply and could also act as a headwind to increasing prices for commodities, which are typically traded in U.S. dollars. Commodity prices have been under pressure since mid-June, dragged down in part by global growth concerns.

CANADA

Simon Jones & Mila Krunic – Toronto

■ **Amid mounting concerns about the pervasiveness of inflation, the Bank of Canada (BoC) opted to raise interest rates by a full percentage point to 2.5%, the largest increase since 1998.** Despite exceeding consensus forecasts, an increase of this size had not been seen as outside the realm of possibility given CPI is running above 8%, labour market tightness is placing upward pressure on wages, and recent survey data indicates consumer and business inflation expectations continue to trend higher. The larger-than-expected move reflects a desire on behalf of the BoC to "front load" its interest rate hikes in an attempt to prevent inflation from becoming entrenched and avoid the need for even higher rates in the future. However, rates are expected to increase above current levels with BoC Governor Tiff Macklem suggesting rates will likely need to rise to the "top-end or slightly above the neutral range," estimated to be between two and three percent, in order to drain excess demand from the economy and return inflation to target.

■ **Employment data released by Statistics Canada shows labour market conditions continued to tighten in June despite the economy shedding approximately 43,000 jobs.** June's job losses mark the first time employment has declined for a reason unrelated to public health restrictions since the onset of the pandemic, with the decrease largely attributable to workers aged 55+ exiting the workforce. However, a notable decline in the number of individuals actively seeking employment resulted in the unemployment rate falling to a new record low of 4.9%. As the supply and demand imbalances in the labour market continue to intensify, employers are being forced to compete more fiercely to attract and retain talent. This has placed upward pressure on wages, which rose 5.2% y/y in June, and these increases likely supported the BoC's decision to raise the policy rate by 100 basis points.

EUROPE

Thomas McGarrity, CFA & Blaine Karbonik, CFA – London

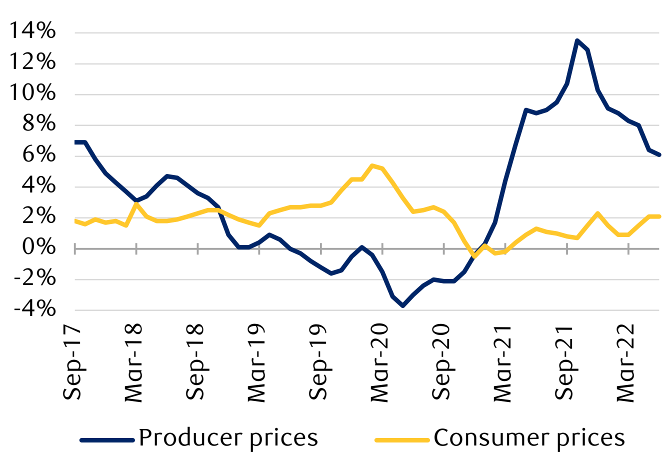
- **The euro's recent slump took another turn lower**, momentarily crossing a major threshold—parity with the U.S. dollar (1.00 EUR/USD). The pair last traded at parity in 2002, early in the common currency's existence. Although it was the strong U.S. CPI data that tipped the pair across the line this time, multiple factors have been contributing to the euro's recent fall. Top of mind now for investors is the intensifying energy crisis, with the growing risk that Russia could cut off gas exports to Germany via the Nord Stream 1 pipeline. We think this has heightened the angst that the region is headed towards a recession, weighing on the currency.

- **Adding to the euro's perfect storm has been rate pressure.** Although the European Central Bank is poised to raise rates for the first time in over a decade this month, it's lagging global central bank peers that are well underway on their tightening paths. Finally, the surging U.S. dollar, bolstered by risk-off sentiment and an aggressive U.S. Fed, has exacerbated the move lower in the EUR/USD pair. Although the depreciation has come faster than many anticipated, bearish factors remain in place, and we remain cautious on the euro in the short term. RBC Capital Markets recently revised its forecasts for the pair and is now expecting a trough of 0.97 in Q1 2023 versus parity previously.

- **In addition, RBC Capital Markets now expects a shallow recession in the euro area around the start of 2023.** However, it is of the view that the worst-case outcome of an actual gas shortage, leading to business shutdowns and a severe recession, is not the most likely outcome due to various mitigating factors. The key mitigating factors that Germany has in its control to help avoid a gas shortage are: substituting supply via alternative sources of energy; reducing domestic demand in various ways, including influencing changes in consumption patterns; and reducing exports. Weather patterns are, of course, an unknown.

- **Political uncertainty in Italy is rearing its head again.** Prime Minister Mario Draghi offered to resign after the Five Star Movement, a key member of the coalition government in Italy, abstained from voting on a confidence vote on support measures for households and businesses hit by high energy prices. However, his offer was rejected. The political turmoil saw the spread between the yield on Italian 10-year government bonds over German Bunds jump to a one-month high.

China's consumer inflation



Source - RBC Wealth Management, China National Bureau of Statistics, Bloomberg; monthly data since September 2017

ASIA PACIFIC

Emily Li – Hong Kong

- **China's consumer price index grew 2.5% in June**, according to the National Bureau of Statistics, the strongest pace since 2020 and faster than consensus expectations. The growth was partially driven by a rebound in pork prices. The government planned to contain pork price increases with techniques such as selling pork from the state reserves and asking hog farmers not to hoard supplies. We don't think inflation will become a crisis for China.

- **Foreign fund inflows to Japan's equity market accelerated last week as the nation's benchmark index rose and the Japanese yen weakened.** Last week's total inflows increased to US$3.87 billion, above the four-week average of US$2.48 billion in outflows. We expect the momentum to remain in the short term.

- **The Taiwan Stock Exchange Weighted Index closed 2.7% higher yesterday**, the biggest jump in the past four months, mainly driven by the authorities' promise to prop up domestic shares for the first time since 2020. The National Financial Stabilization Fund received authorization to support local equities. The intervention reinforces the challenges faced by Taiwan's Tech-reliant market, which is confronting a weaker outlook and rising concerns of a U.S. recession.

- **China Vanke Co. (2202 HK/000002 CH) wants to kick off the Hong Kong initial public offering (IPO) of its property management arm as early as September.** The firm hopes to raise at least US$2 billion, according to people who asked not be identified in a Bloomberg report. The company did not comment on the report. Meanwhile, **LianLian DigiTech (a competitor of Ant Group Co.) is in talks to raise approximately RMB 1.5 billion (US$223 million) ahead of an IPO in Hong Kong as soon as next year**, according to an unsubstantiated report by Bloomberg. The Hangzhou-based startup specializes in cross-border payments for e-commerce giants including Amazon.com (AMZN US) and Sea's (SE US) Shopee. We think a successful fintech IPO could be a positive catalyst for the sector that saw Ant's failed debut in 2020.

MARKET
Scorecard

Data as of July 13, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,801.78	0.4%	-20.2%	-13.0%	20.5%
Dow Industrials (DJIA)	30,772.79	0.0%	-15.3%	-11.8%	18.0%
Nasdaq	11,247.58	2.0%	-28.1%	-23.4%	8.2%
Russell 2000	1,726.04	1.1%	-23.1%	-22.9%	23.0%
S&P/TSX Comp	18,615.19	-1.3%	-12.3%	-8.2%	19.0%
FTSE All-Share	3,935.82	-0.1%	-6.5%	-3.3%	15.0%
STOXX Europe 600	412.81	1.4%	-15.4%	-10.4%	11.4%
EURO STOXX 50	3,453.97	0.0%	-19.6%	-15.6%	3.1%
Hang Seng	20,797.95	-4.9%	-11.1%	-25.6%	-19.3%
Shanghai Comp	3,284.29	-3.4%	-9.8%	-7.9%	-4.6%
Nikkei 225	26,478.77	0.3%	-8.0%	-7.8%	16.2%
India Sensex	53,514.15	0.9%	-8.1%	1.4%	45.8%
Singapore Straits Times	3,128.69	0.9%	0.2%	-1.2%	18.9%
Brazil Ibovespa	97,881.16	-0.7%	-6.6%	-23.6%	-0.8%
Mexican Bolsa IPC	47,461.35	-0.1%	-10.9%	-3.7%	30.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	2.937%	-7.6	142.7	152.1	231.9
Canada 10-Yr	3.153%	-7.0	172.7	180.0	261.4
UK 10-Yr	2.060%	-16.9	108.9	142.8	187.4
Germany 10-Yr	1.145%	-19.1	132.2	143.9	156.2
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.71%	0.4%	-10.0%	-10.1%	-10.8%
U.S. Investment-Grade Corp	4.65%	0.7%	-13.7%	-13.7%	-12.0%
U.S. High-Yield Corp	8.56%	1.7%	-12.7%	-11.7%	0.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,735.49	-4.0%	-5.1%	-4.0%	-3.7%
Silver (spot $/oz)	19.21	-5.3%	-17.6%	-26.1%	0.7%
Copper ($/metric ton)	7,335.00	-11.1%	-24.7%	-21.8%	11.5%
Oil (WTI spot/bbl)	96.30	-8.9%	25.1%	28.0%	140.1%
Oil (Brent spot/bbl)	99.61	-13.2%	28.1%	30.2%	133.2%
Natural Gas ($/mmBtu)	6.61	21.8%	77.2%	78.8%	280.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	108.0040	3.2%	12.9%	16.4%	12.0%
CAD/USD	0.7705	-0.8%	-2.6%	-3.6%	4.9%
USD/CAD	1.2978	0.8%	2.7%	3.7%	-4.6%
EUR/USD	1.0058	-4.1%	-11.5%	-14.6%	-11.3%
GBP/USD	1.1890	-2.4%	-12.1%	-13.9%	-5.3%
AUD/USD	0.6757	-2.1%	-7.0%	-9.3%	-2.6%
USD/JPY	137.4200	1.3%	19.4%	24.2%	28.1%
EUR/JPY	138.2100	-2.8%	5.6%	6.1%	13.6%
EUR/GBP	0.8459	-1.8%	0.5%	-0.8%	-6.4%
EUR/CHF	0.9846	-1.7%	-5.1%	-9.0%	-7.8%
USD/SGD	1.4056	1.1%	4.2%	3.7%	1.1%
USD/CNY	6.7187	0.3%	5.7%	3.9%	-4.0%
USD/MXN	20.7356	3.1%	1.0%	3.4%	-8.9%
USD/BRL	5.3979	2.7%	-3.2%	4.5%	-0.2%

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 -2.6% return means the Canadian dollar fell 2.6% vs. the U.S. dollar year to date. USD/JPY 137.42 means 1 U.S. dollar will buy 137.42 yen. USD/JPY 19.4% return means the U.S. dollar rose 19.4% vs. the yen year to date.

Source - Bloomberg; data as of 7/13/22 market close

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As of June 30, 2022

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Buy [Outperform]	851	58.41	290	34.08
Hold [Sector Perform]	560	38.44	169	30.18
Sell [Underperform]	46	3.16	6	13.04

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