GLOBAL
Insight
WEEKLY

Wealth Management
RBC

Perspectives from the Global Portfolio Advisory Committee

July 28, 2022

Data dependency to depend on dour data

Thomas Garretson, CFA – Minneapolis

This week marked a shift at the Fed as policymakers have left forward guidance for markets behind in favor of a meeting-by-meeting approach, where policy adjustments will depend on the incoming data. But as this week also showed, the incoming data might not be all that great, and this rate hike may be one of the last.

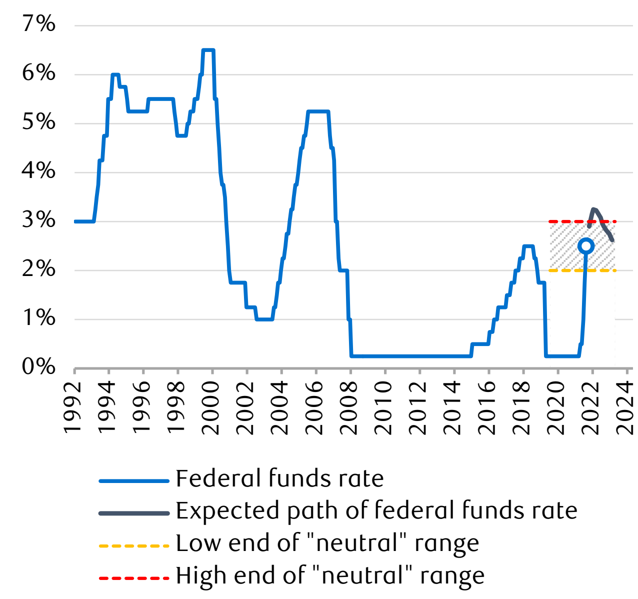
Job one is done. Since late last year, the Fed has used its most powerful tool, forward guidance, to prepare markets for rate hikes. Ever-higher inflation this year has led the Fed to ramp up the pace of those hikes in an effort to get policy rates back to "neutral," and expeditiously so. Now, following a second consecutive 75 basis point (bps) rate hike taking the target range to 2.25 percent to 2.50 percent, the stance of monetary policy sits in the middle of the Fed's estimated neutral range for the economy of 2.00 percent to 3.00 percent, where, in theory, policy is neither restricting nor boosting economic growth.

And job one was relatively easy—there were few risks and low chances of making a policy error to this point and from low rates amid a strong economy and robust labor markets. Job two begins now, and it will be decidedly more difficult, in our view.

Here for a good time, not a long time

Fed Chair Jerome Powell maintained yesterday that the best way to sustain the economic expansion is to get inflation under control, and to do that by getting policy rates to neutral, and perhaps to moderately restrictive levels. What does that mean? No one knows, up to and including the Fed. The neutral rate is just a "guess" based on models, and it can't be observed in real time. It's only after the fact, and usually in the midst of a recession,

The market sees more rate hikes in the pipeline, but also rate cuts



Note: Neutral range shows the low (2%) and high (3%) projections from the Fed's Summary of Economic Projections for June.

Source - RBC Wealth Management, Bloomberg; rate hike expectations based on federal funds rate futures data

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

where we can look back and say, oh, right, so that was the neutral rate.

As the chart on the previous page shows, that breaking point was 6.50 percent in 2000, which gave way in short order to a recession; it was 5.25 percent in 2006 and a full 14 months where the Fed was able to leave policy alone before the financial crisis. In 2019? Cracks started to form in the economy with rates at just 2.50 percent, and it was barely six months before the Fed began to cut, followed by the pandemic in 2020. The point is that the Fed is either raising rates, or cutting rates. A rare exception was the 1994–1998 period, and much has been made about that episode, where aggressive Fed rate hikes didn't spark an official recession, but the operative word in this sentence is "rare."

Even before this week's policy meeting, we expected the Fed would only tip-toe past the neutral level as the stakes only get higher, with the Fed likely to slow the pace of rate hikes all the way back to 25 bps increments, and only as needed based on the data, starting with the Sept. 20–21 meeting, in our view. With markets now pricing rate cuts as early as next year, we think the Fed is already nearing the end of this rate hike cycle. And the case for that view only grew stronger with this week's GDP report.

3 D's of recessions: Depth, diffusion, and duration

Are we in a recession? Are we in a technical recession? Wait, what even is a technical recession? Who gets to say we're in a recession, technical or otherwise?

Those are the questions many are asking following the first estimate of Q2 U.S. GDP this week, which came in at -0.90 percent. That marked the second consecutive decline, following the 1.60 percent drop in Q1. Well that's easy. The rule of thumb is two quarters of economic contraction is a recession. We're in a recession.

But not quite. Yes, Q1 was bad, but as we have discussed previously, and as the table shows, that "phantom" decline almost entirely came from a drop in imports on supply chain issues and lockdowns in China. We can't buy what we can't get, and it was only one weak category, so diffusion was low. Suspect that doesn't play into the recession narrative.

Weakness in Q2 was a bit more broad-based as personal consumption slowed, inventory drawdowns subtracted from growth, and fixed investment fell sharply as higher rates took their toll on the housing market. But consumers continue to shift spending from goods to services, which the Fed has wanted to see, and that should take some pressure off of goods price inflation. Inventories should be ignored, in our view. Companies built them up last year, which boosts GDP; they're drawing them down this year, which is a drag on growth in any given quarter, but over time it eventually offsets itself.

The National Bureau of Economic Research (NBER) officially dates recessions, but it basically only announces them after the fact. If we are in a recession now, we likely won't "officially" know about it until sometime next year.

Breaking down the key drivers and trends of GDP

Quarter-over-quarter seasonally adjusted annual rate and contribution of each component to headline GDP

	June 2022	March 2022	Dec. 2021	Sept. 2021
Gross Domestic Product	**-0.90**	**-1.60**	**6.90**	**2.30**
Personal Consumption Expenditures	0.70	1.24	1.76	1.35
Goods	-1.08	-0.07	0.28	-2.21
Services	1.78	1.31	1.48	3.57
Gross private domestic investment	-2.73	0.93	5.82	2.05
Fixed investment	-0.72	1.28	0.50	-0.16
Change in private inventories	-2.01	-0.35	5.32	2.20
Net exports	1.43	-3.23	-0.23	-1.26
Exports	1.92	-0.55	2.24	-0.59
Imports	-0.49	-2.69	-2.46	-0.68
Government consumption	-0.33	-0.51	-0.46	0.17
Federal	-0.20	-0.46	-0.29	-0.35
State and local	-0.13	-0.05	-0.17	0.52

Source - RBC Wealth Management, Bloomberg

While we don't make the rules, would we say that we're currently in a recession? Probably not. We're coming off of 2021 where we had three quarters of more than six percent growth, so in terms of "depth" the contraction doesn't look that deep. The "diffusion" of weakness still isn't broad-based, and the "duration" of the true economic weakness may only be a couple of months at this point.

But there's no doubt that the economy is losing momentum, and quickly, and that recession risks later this year are only growing. Now it's a question of how far the Fed wants to push this.

All mixed up

At the end of the day, monetary policy acts with a long lag on the economy. So, given all of the economic and market stress we have already seen this year, it suggests to us that the Fed doesn't have to do much more, and that rate hikes already delivered to this point will do their job in restraining growth and inflation into next year. We expect roughly two more 25 bps hikes this fall before the Fed stops around three percent.

And this is borne out by recent market action. Since the Fed started with a 75 bps hike in June, followed by another this week, along with two quarters of economic contraction, the S&P 500 is up by more than 11 percent over that stretch, yield curves—though still inverted—have started to re-steepen as the market dials back rate hike expectations, and credit markets only show mild signs of stress.

For another week of Fed aggressiveness, mixed economic data, and general volatility in a year certainly not lacking for it, markets seem to have weathered it rather well thus far.

UNITED STATES

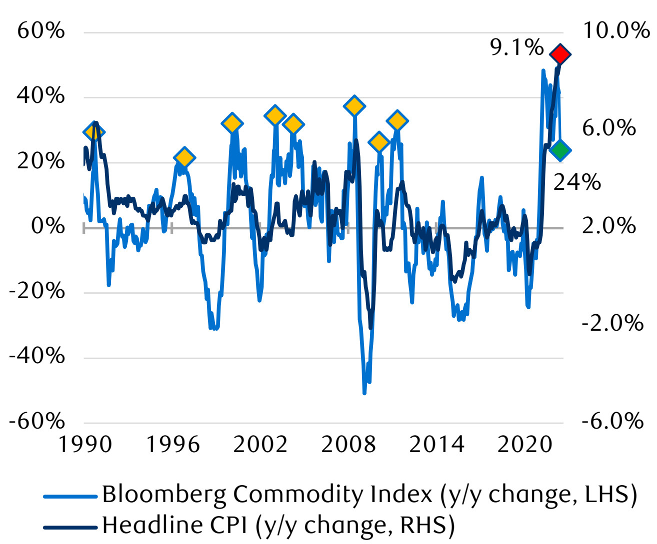
Tyler Frawley, CFA – Minneapolis

- **U.S. equities are on track for weekly gains** following relatively dovish comments from Federal Reserve Chair Jerome Powell. The major indexes are higher as of intraday trading today, with the S&P 500 leading the way with a 2.82% return for the week. The Nasdaq Composite has outperformed the Dow Jones Industrial Average, but both are higher, having risen 2.73% and 2.09% this week, respectively. Energy, up 5.36% on the week, is once again leading the way for sectors. Consumer Discretionary has lagged, up only 1.23% on the week.

- **Ongoing inflation concerns are well-established, and we think consumer prices are likely to remain elevated**, relative to pre-pandemic levels, for the foreseeable future. There are signs, however, that the widely cited year-over-year headline Consumer Price Index (CPI) may be nearing a peak within the next few months, given the recent fall in commodity prices. When we analyze the historical trend, we can see that from 1990 to 2020 there were eight instances where the year-over-year Bloomberg Commodity Index made notable peaks above 20% growth before falling sharply. Following those instances, year-over-year headline CPI peaked approximately two months later, on average. Given that commodity prices flow through to just about everything consumers buy, it is likely even a slightly more moderate Headline CPI reading in the coming months would be viewed favorably by the market. This would be an important first step in the Fed's tightening cycle.

- **It has been a busy week of economic data**. GDP fell 0.9% in Q2, the second consecutive quarter of contraction, well below economists' consensus 0.4% growth forecast. However, it was not surprising given the Atlanta Fed GDPNow data had been signaling a contraction. Regardless of whether two quarters of negative GDP growth fits the official definition of recession, RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli notes that it is starting to feel like a recession in many areas. While the GDP numbers garnered the majority of the attention, earlier this week New Home Sales data came in at 590,000, the lowest level in over two years, as higher mortgage rates, reduced affordability, and lower consumer confidence contributed to lower demand. Initial Jobless Claims fell slightly from last week to 256,000. While this number is above pre-pandemic levels, it remained well below levels that would be expected in an economy on the brink of recession. However, Porcelli believes the employment situation will soon begin to soften.

Commodity prices have fallen; will inflation be next?



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

CANADA

Sean Killin – Toronto

- **Canadian firms have been coping with the tightest labour market in recorded history** as an aging population, declining immigration flows, and structural shifts in the Canadian labour market have brought job vacancies to their highest level on record. Statistics Canada's recent Survey on Business Conditions provided a platform for further analysis on the strategies implemented by private sector businesses coping with ongoing labour shortages. These strategies have key implications for corporate profitability and are helping to dictate some thematic shifts in the Canadian economic backdrop. The most popular strategy by respondents was to increase wages, contributing to a wage-price loop which fed inflation. Increasing the human capital of the workforce was the second most popular strategy implemented by Canadian firms, with the majority of firms stating they intend to sponsor further education and on-the-job training for their employees. With a rising cost of capital and rising inflation, these strategies to alleviate output constraints risk placing further pressure on corporate profit margins and the free cash flow of Canadian firms.

- **Canadian energy diplomacy could potentially alleviate scarcity in European energy markets and assist with the transition away from dependence on Russian oil and gas**. In an address this week, Canadian Prime Minister Justin Trudeau announced a plan to invest in infrastructure projects that would help accelerate Canada's transatlantic energy exports. Five liquefied natural gas terminals across Nova Scotia, Quebec, and Ontario are slated to receive the bulk of the investment; with a combined capacity of 41.6 million metric tonnes per annum, they could enable Canadian exports to significantly boost European supply. Although the construction of new terminals would require time, capital, and regulatory approvals, it could be a step towards better European energy security. It could further provide a lift to the Canadian economy as both infrastructure investment and the opportunity to bring resources to the international market provide solid growth prospects, in our opinion. Geopolitically, bilateral relations between Canada and Germany are strengthening as German Chancellor Olaf Scholz is scheduled for an official state visit to Canada in August.

EUROPE

Thomas McGarrity, CFA – London

- **Earnings season has been somewhat mixed**, in our view. At the approximate halfway stage, aggregate STOXX Europe 600 Index earnings have come in around 2% below consensus expectations.

- **Consumer Staples companies have had a good reporting season**, with some, including Nestlé, Unilever, and Reckitt Benckiser, upgrading their full-year sales guidance. Results across the sector suggest there has been relatively limited demand elasticity for branded consumer goods despite higher prices.

- **Results from the region's luxury goods companies show demand for luxury items remains healthy in North America and Europe**, helping to offset the negative impact from China's lockdowns. For example, sector bellwether LVMH reported organic revenue growth of 19% year over year in Q2, beating the 13% consensus expectation. Beyond luxury in the Consumer Discretionary sphere, weakness in China coupled with excess inventories saw sporting goods company adidas reduce its full-year earnings guidance.

- **High oil and gas prices helped Energy major Shell to deliver record quarterly earnings for the second consecutive quarter**. The company is materially stepping up its share buybacks in the current quarter, with $6 billion worth to be undertaken over the next three months.

- **Fears of a gas shortage in Europe this winter escalated following Russia further reducing gas supplies to the region**. Gas flows via the Nord Stream 1 pipeline were cut to just 20% of normal capacity, less than a week after supplies resumed at around 40% following a 10-day period of annual maintenance. We think it is reasonable to assume Russia will continue to constrain gas exports to Europe in order to maintain some sort of negotiating hand. RBC Capital Markets' commodity strategists believe gas will remain an economic weapon for the Kremlin in an attempt to force Europe to reconsider its support for Ukraine. We recommend having defensive growth and quality tilts to European equity allocations in portfolios at present, reflecting the region's weakening macro backdrop.

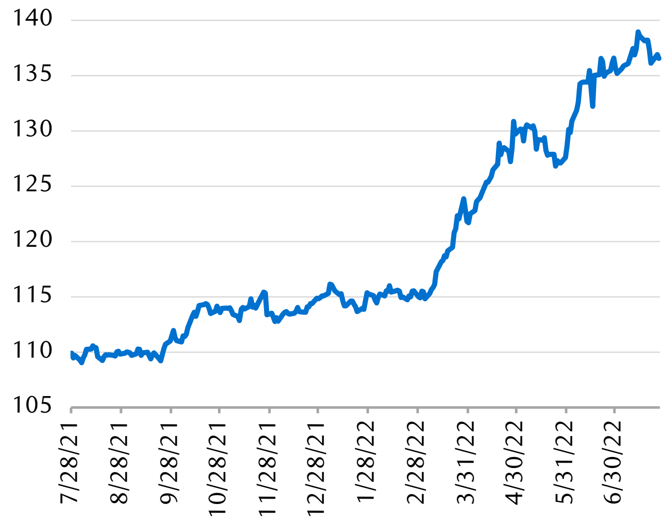
ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets have traded mixed this week** with Japan, Hong Kong, and Taiwan slightly lower while the rest of Asia is slightly higher. The yen

Hedge funds may be backing off their weak yen trades

USD/JPY daily prices



Source - RBC Wealth Management, Bloomberg; data through 7/27/22

strengthened by close to 1% against the U.S. dollar today. According to a Bloomberg report, hedge funds are covering their short yen positions as they reassess the impact of lowered expectations for rate hikes, although larger flows from institutions have not been seen. Shorting the yen against the dollar has been a popular macro trade as the Federal Reserve and Bank of Japan (BoJ) embark on diverging monetary policies. However, the trade may be hitting its limits as investors consider how recession risks could lead to less aggressive rate hikes by major central banks. We believe such a development would alleviate pressure on the BoJ, which recently kept its easing policy unchanged.

- **The number of new COVID-19 cases in China rebounded** this week in the southern region, a key manufacturing hub. According to a Bloomberg report, the Shenzhen city government has asked its 100 biggest companies to restrict operations to employees living within a closed loop with little to no contact with people beyond their plants or offices over a period of seven days. We think risks to the easing global supply chain pressures are skewed to the downside given the near-term overhang on China manufacturing. On a more positive note, Beijing will be welcoming direct inbound passenger flights from overseas for the first time in more than two years as China eases parts of its pandemic border regime.

- **Alibaba Group (9988 HK), in a press release, said it will be applying for a primary listing on the Hong Kong Stock Exchange**, upgrading from a secondary listing, with the change expected by year-end 2022. The move could allow the stock to be included in the Stock Connect link with the Shanghai and Shenzhen exchanges. The move may boost liquidity for the Tech sector and encourage Tech peers to re-evaluate their trading status in Hong Kong.

MARKET Scorecard

Data as of July 27, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,023.61	6.3%	-15.6%	-8.6%	24.2%
Dow Industrials (DJIA)	32,197.59	4.6%	-11.4%	-8.2%	21.1%
Nasdaq	12,032.42	9.1%	-23.1%	-17.9%	14.2%
Russell 2000	1,848.34	8.2%	-17.7%	-15.7%	24.5%
S&P/TSX Comp	19,254.56	2.1%	-9.3%	-4.6%	19.1%
FTSE All-Share	4,055.16	2.9%	-3.6%	1.1%	19.9%
STOXX Europe 600	428.12	5.1%	-12.2%	-6.7%	16.9%
EURO STOXX 50	3,607.78	4.4%	-16.1%	-11.2%	9.2%
Hang Seng	20,670.04	-5.4%	-11.7%	-17.6%	-16.0%
Shanghai Comp	3,275.76	-3.6%	-10.0%	-3.1%	2.2%
Nikkei 225	27,715.75	5.0%	-3.7%	-0.9%	22.0%
India Sensex	55,816.32	5.3%	-4.2%	6.2%	47.1%
Singapore Straits Times	3,205.14	3.3%	2.6%	2.1%	24.4%
Brazil Ibovespa	101,437.96	2.9%	-3.2%	-18.6%	-2.9%
Mexican Bolsa IPC	46,842.92	-1.4%	-12.1%	-8.0%	24.1%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	2.779%	-23.4	126.9	153.8	216.4
Canada 10-Yr	2.763%	-46.0	133.7	159.6	224.1
UK 10-Yr	1.961%	-26.8	99.0	140.3	185.2
Germany 10-Yr	0.946%	-39.0	112.3	138.7	143.7
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.59%	1.5%	-9.0%	-9.9%	-10.3%
U.S. Investment-Grade Corp	4.52%	2.1%	-12.6%	-13.5%	-12.1%
U.S. High-Yield Corp	8.14%	4.1%	-10.7%	-9.5%	0.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,734.69	-4.0%	-5.2%	-3.6%	-10.7%
Silver (spot $/oz)	19.09	-5.8%	-18.1%	-22.7%	-22.3%
Copper ($/metric ton)	7,520.25	-8.9%	-22.8%	-22.8%	17.0%
Oil (WTI spot/bbl)	97.26	-8.0%	26.3%	35.7%	133.8%
Oil (Brent spot/bbl)	107.42	-6.4%	38.1%	44.2%	147.5%
Natural Gas ($/mmBtu)	8.69	60.2%	132.9%	118.8%	401.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	106.4450	1.7%	11.3%	15.2%	13.6%
CAD/USD	0.7798	0.4%	-1.4%	-1.7%	4.1%
USD/CAD	1.2823	-0.4%	1.5%	1.8%	-4.0%
EUR/USD	1.0198	-2.7%	-10.3%	-13.7%	-13.2%
GBP/USD	1.2155	-0.2%	-10.2%	-12.4%	-5.6%
AUD/USD	0.6995	1.3%	-3.7%	-5.0%	-2.2%
USD/JPY	136.5900	0.6%	18.7%	24.4%	29.6%
EUR/JPY	139.3000	-2.1%	6.4%	7.4%	12.5%
EUR/GBP	0.8390	-2.5%	-0.3%	-1.5%	-8.0%
EUR/CHF	0.9784	-2.3%	-5.7%	-9.5%	-9.5%
USD/SGD	1.3826	-0.6%	2.5%	1.6%	0.3%
USD/CNY	6.7590	0.9%	6.3%	3.8%	-3.4%
USD/MXN	20.3969	1.4%	-0.6%	2.1%	-7.0%
USD/BRL	5.2449	-0.2%	-5.9%	1.4%	1.8%

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 -1.4% return means the Canadian dollar fell 1.4% vs. the U.S. dollar year to date. USD/JPY 136.59 means 1 U.S. dollar will buy 136.59 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 7/27/22 market close

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As of June 30, 2022

			Investment Banking Services Provided During Past 12 Months	
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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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