GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee August 11, 2022

In the UK and Europe, a summer like no other

Frédérique Carrier – London

Amid scorching temperatures, three key events that will likely shape the regional economic outlook have marked the summer of 2022 so far: the contest to become the next UK prime minister; the EU plan to avoid winter energy shortages; and the collapse of the Italian government. We explore the potential outcomes, and suggest portfolio positioning.

UK leadership contest

Following the resignation of Prime Minister Boris Johnson, 180,000 Conservative Party members will choose their next leader. The winner, to be announced on Sept. 5, will automatically become the next prime minister of the UK. The leadership contest has now narrowed to two candidates—Foreign Secretary Liz Truss, the favourite to win according to polls, and former Chancellor of the Exchequer Rishi Sunak. Both candidates advocate fiscal easing to tackle the UK's slow growth.

The next occupant of Number 10 Downing Street will face a very challenging economic backdrop. The Bank of England expects UK inflation to rise to 13 percent and remain above 10 percent for most of next year; it recently hiked interest rates by 50 basis points (bps) to 1.75 percent—the largest increase since 1995. The central bank estimates that the UK economy will contract in both 2023 and 2024, to the tune of 1.25 percent and 0.25 percent, respectively. Markets expect the Bank Rate to reach 2.85 percent at the end of 2022.

These projections could prove overly pessimistic if energy prices decline swiftly, or if the new prime minister's fiscal response to the latest spike in gas prices and the cost of living crisis is significantly more substantial than the two candidates are suggesting at the moment.

Once in office, the new prime minister will likely be under pressure to act. The average household energy bill is set to increase to £3,358 a year in October, up from £1,400 a year ago, and rise again to £4,427 in April 2023, according to energy consultant Cornwall Insight. The situation is critical given the average household income was £25,971 in 2021, according to the Office of National Statistics.

Because income tax cuts do not tend to help low-income households, further direct payments or broad cuts in the sales tax or the value-added tax (VAT) are likely, in our view. A decrease in VAT proved an effective tool during the great financial crisis. Such cuts are easy to implement, stimulate consumption, and are temporary. This could entail further action by the Bank of England if this additional fiscal stimulus proves inflationary—in the neighbourhood of 25 to 50 bps beyond current market expectations, depending on the depth of the recession.

The pound has shown little sensitivity to the political uncertainty from the Conservative leadership contest. However, both candidates are expected to press on with plans to water down the Northern Ireland Protocol, the post-Brexit trading arrangement for Northern Ireland, a move which could trigger a trade war with the EU. This would weigh on the pound in the medium to long term, in our view, as would Truss's proposed review of the Bank of

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

Policy positions of the UK prime minister candidates

	Liz Truss Foreign Secretary	Rishi Sunak Former Chancellor of the Exchequer
Fiscal measures to boost economy	• Cancel planned six-percentage-point rise in corporate tax • Cancel recent increase in National Insurance rates • Cancel green levy on energy bills	• Extend recent targeted support of energy bills • Reduce business taxes after inflation recedes • Reduce basic rate of income tax • Temporarily cut VAT on energy bills
Other	• Alter Bank of England's price stability mandate	
Areas of agreement	• Press ahead with the Northern Ireland Protocol Bill (trade war risk?) • Deregulation (unspecified)	

Source - Financial Times, RBC Wealth Management

England's inflation-targeting mandate should she have the opportunity to pursue it as prime minister. Such a review would likely reduce the incentive for the central bank to follow through on its hawkish rhetoric, even as inflation remains elevated.

EU preparation to avoid energy shortages

Despite reducing its dependence on Russian gas imports to 15 percent of total consumption compared to 40 percent last winter, the EU remains in a precarious position. Natural gas prices surged to more than €200 per megawatt-hour at the end of July—twice the average price during the first half of 2022, and close to ten times the average from 2015 to 2022—as Russia again reduced natural gas deliveries via the Nord Stream 1 pipeline to 20 percent of capacity. We estimate these additional energy costs could represent as much as of three percent of the bloc's 2021 GDP.

In an effort to lessen the risk of shortages, the EU member states agreed to reduce gas consumption some 10 percent by March 2023. Participation in the plan, which allows for country-specific targets, is on a voluntary basis for now, but may become compulsory in the case of a region-wide emergency. Spain, for example, intends to reduce consumption by seven percent, and will require businesses to limit their heating and cooling (air conditioning set no lower than 27 C in summer and heating not to exceed 19 C this winter).

Many businesses are adapting, switching to other fuels, and substituting local production for imports where possible. For example, the CEO of German multinational chemical company BASF stated that the company could replace 15 percent of the natural gas used to generate electricity and steam with heating oil. And steel manufacturer ArcelorMittal is now buying metal inputs for one of its mills from a sister plant in Canada that has access to cheaper energy.

Reducing natural gas consumption today could reduce the risk of abrupt shutdowns during the winter, though the success of this effort will likely depend on both Russia's gas export strategy and the severity of the season. If Russia maintains very low levels of gas deliveries, the EU will likely speed up its energy substitution and transition processes, weakening Russia's leverage over the region.

The Italian job

Italy faces fresh elections on Sept. 25 following the resignation of centrist technocrat Prime Minister Mario Draghi. He had brought economic credibility to the country, pushing through reforms required for the country to receive €200 billion (five percent of GDP) from the EU's COVID-19 recovery fund.

Opinion polls suggest a coalition of three right-wing parties, which largely share similar Eurosceptic and populist views, is likely. Tax cuts and more spending are being discussed. Such a policy course would swell the national debt load—already at 150 percent of GDP. Against the backdrop of rising interest rates, this prospect has alarmed investors; yield spreads, or the gap between the yields on Italian and German 10-year government bonds, widened before stabilising.

Despite the current rhetoric, we think the new government is likely to avoid a confrontation with Brussels and deliver necessary reforms in order to access EU rescue funds. The European Central Bank has been clear that it would not intervene should Italy plunge into a crisis of its own making due to a Eurosceptic government reneging on its commitments to the EU. The situation bears monitoring.

Portfolio positioning

Despite Europe being very exposed to the fallout from the Russia-Ukraine war, the European stock market has performed broadly in line with the S&P 500 in local terms so far this year. With the region's economy slowing while the European Central Bank raises rates, the risk of policy error is not negligible. We would focus on opportunities linked to decarbonisation and the green economy, where the EU remains a leader. As for the UK, with clouds continuing to gather on the horizon, we are focused on companies which generate the majority of their revenue abroad.

UNITED STATES

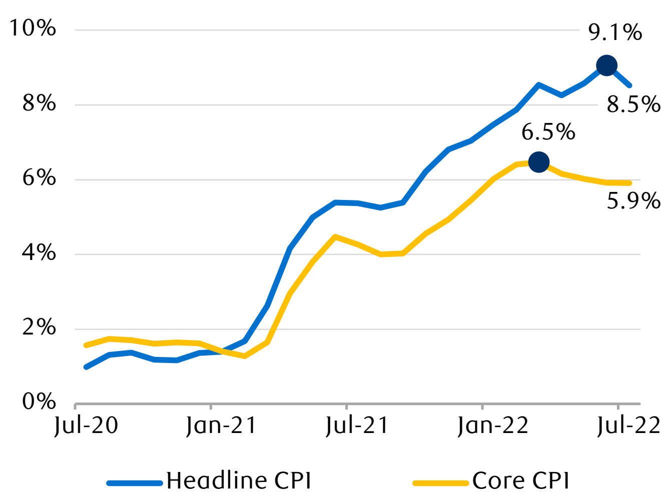
Ben Graham, CFA – Minneapolis

- **U.S. equities have rallied sharply in recent trading sessions** after softer-than-expected inflationary data for July led investors to believe the Fed will need to raise rates by less than previously expected in order to stamp out inflation. Stocks are broadly higher with the S&P 500, Nasdaq, and Dow each up between 2.2% and 2.6% this week as of mid-morning today. Small caps, as measured by the Russell 2000, have climbed more than 4% this week. Stocks broadly remain lower in 2022, but the S&P 500 and Nasdaq have clawed back roughly half of their peak-to-trough losses with the rally over the past nine weeks.

- **Inflation data were the highlight of the week**, and while it finally leveled off on a month-over-month basis, price pressures remain firmly in place. The headline Consumer Price Index (CPI) was flat on a m/m basis, but still increased 8.5% y/y—albeit less than the 9.1% rise in June. The core reading, which excludes food and energy costs, was 0.3% higher m/m and increased 5.9% y/y. The decline from peak inflation was primarily due to the retreat in gasoline prices, which fell 7.7% m/m (+44.0% y/y, but well below previous trends). The shelter component, which is a significantly larger component of CPI data, increased 0.5% m/m in July (+5.7% y/y). In terms of the overall headline CPI month-over-month trend, these two factors mostly offset each other and led to the flat monthly reading. Going forward, particularly after the August data are released, base effects (the comparison with previous data) will start to play a larger role in potentially slowing inflation further on a year-over-year basis as the strong inflationary increases from H2 2021 will be more difficult to clear and should bring the headline and core rates down at least somewhat. There's still a long way to go in the inflation battle, but for the time being, the data are moving slowly and incrementally in the proper direction, as RBC Capital Markets, LLC's Chief U.S. Economist Tom Porcelli assessed.

Potential peak inflation

Consumer Price Index (CPI, y/y)



Source - RBC Wealth Management, FactSet; data through July 2022

- **Treasury bill markets rallied on the inflation news** as the 3-month Treasury rate fell to 2.50% as of this morning from 2.58% before the CPI data were released. The yield curve remains inverted as the 1-year Treasury yield exceeds that of the 10-year Treasury by 36 basis points, continuing to indicate economic vulnerabilities. Almost every time this curve has inverted in the past 75 years, a recession has occurred months later. There was only one exception, in the mid-1960s, and even that time GDP growth retreated sharply to 1.4% from 10.1%. For more about historical signals of yield curve inversions and the current status of other leading indicators, see this update.

CANADA

Matt Altro & Sean Killin – Toronto

- **The latest Canadian jobs report, released last Friday, showed further signs of cooling in the economy, although unemployment remained steady at a multi-decade low of 4.9%.** Employment declined for the second month in a row as Canada lost 31,000 jobs in July, with health care and social assistance, wholesale and retail trade, and education services shedding a combined 53,000 jobs. This was partially offset by the addition of 25,000 jobs within the goods-producing sector. Bank of Canada (BoC) Governor Tiff Macklem cautioned that inflation in Canada appears set to remain "painfully high" for the rest of the year, leading many economists to forecast another larger-than-average rate hike at the next BoC meeting in September, Bloomberg reported. With higher borrowing costs expected to feed through to slower economic activity and weaker demand, this could help alleviate inflationary pressures in the coming quarters—which, in turn, could afford the BoC some flexibility to fine-tune its monetary policy stance, including a potential pause in interest rate hikes.

- **Cyclical sector leadership has returned to the S&P/TSX Composite in the most recent resuscitation of global risk appetite**. The TSX has rebounded by nearly 10% since the mid-July lows, with the most recent rally primarily underpinned by strength in the Information Technology sector (+19.5%). The Industrials (+12.7%), Consumer Discretionary (+12.0%), and Materials (+11.1%) sectors followed. In terms of valuations, price-to-earnings multiples have compressed meaningfully this year and despite the most recent rally, multiples in cyclical sectors remain significantly below their long-term averages. Although Canadian equities have recovered smartly in recent weeks, the TSX is still down around 5% year to date, due in part to significant underperformance by the Info Tech sector (-46% year to date). Given the scarcity in physical commodity markets and the injection of geopolitical risk premiums, the Energy sector continues to be a notable outperformer, up roughly 25% year to date. With Energy making up approximately 17% of the TSX, it comes as no surprise that **Canadian equities have continued to outperform their global peers so far this year**.

EUROPE

Thomas McGarrity, CFA – London

- **Falling water levels in the German section of the Rhine River, due to extreme temperatures, are set to make it virtually impassable at a key waypoint**. Such difficulty for one of Europe's most important waterways could choke off shipments of energy products and other industrial commodities and chemicals, creating further potential supply disruptions for Industrials and Materials companies, and present another headwind for the German economy. In 2018, the last time low Rhine water levels caused transit issues, it resulted in a 1.5% m/m hit to industrial production that November. Since then, many companies have adjusted their operations, including more flexible logistics networks, in an attempt to mitigate the potential negative earnings impacts during future occurrences.

- **The share prices of large pharmaceutical companies Sanofi and GSK fell 13% and 16%, respectively**, during the week as fears ratcheted up around potential liabilities related to Zantac litigation in the U.S. on allegations the product causes cancer. The price declines have come ahead of a trial expected to start in Illinois later this month that could propel a surge in lawsuits if the companies lose, according to Bloomberg Intelligence Litigation analysts.

- **UK-listed insurer Aviva was one of the best-performing stocks in the region during the week**. Its share price has gained over 12% following the company reporting H1 results that beat consensus expectations, as well as announcing its intention to launch a share buyback with its full-year 2022 results announcement. Swiss-listed Zurich Insurance's H1 results also beat consensus expectations. Zurich's business operating profit (BOP) increased 25% y/y to US$3.39 billion, the company's highest first-half BOP since 2008 and its second-highest ever. A key driver for the increase was higher premium prices within its Property and Casualty division, with the company expecting commercial pricing to remain ahead of loss cost inflation for the remainder of 2022.

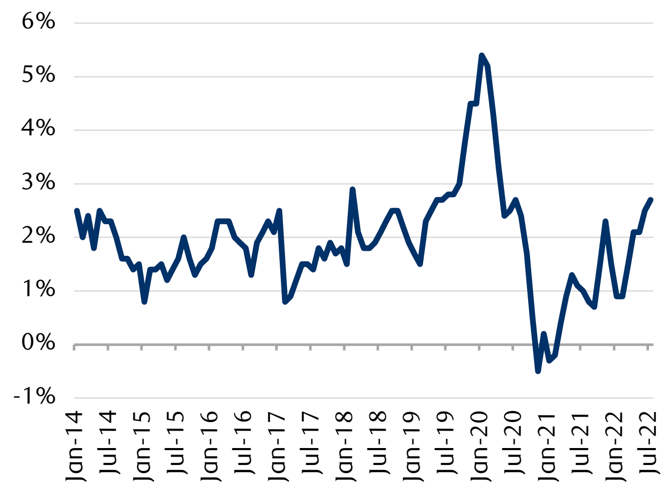
ASIA PACIFIC

Jasmine Duan – Hong Kong

- **China's Consumer Price Index (CPI) rose 2.7% y/y in July to the highest level in two years**, but slightly under the Bloomberg consensus estimate of 2.9%. In our view, the higher inflation was **mainly driven by rising pork and vegetables prices**, reflecting reduced hog supply and the impact of hot weather. Meanwhile, **the energy price component of the CPI eased**. The Core CPI (which excludes volatile food and energy prices) softened by 20 basis points (bps) to 0.8% y/y, led by weaker price growth in tourism & entertainment services, due to a COVID-19 resurgence and corresponding containment measures.

Inflation in China surges to highest level in two years

China's Consumer Price Index (y/y)



Source - RBC Wealth Management, Bloomberg; data through 7/31/22

- The People's Bank of China (PBoC) recently noted that it anticipates upward inflationary pressure in the second half of the year, which could exceed 3% in some months. However, **the PBoC said China should be able to achieve the target of keeping full-year inflation around 3% in 2022**, thanks to its "prudent" monetary policy and measures taken to ensure stable food and energy supply.

- **COVID-19 cases in China surged to a three-month high**. Hainan Province, a popular Chinese resort island, reported the most cases in this round of the outbreak. Although this surge is concerning, **we think it will cause less disruption to supply chains and the economy**. China intends to stick to its zero-COVID policy, but officials have been fine-tuning the implementation. For example, the classification for medium- and high-risk areas has been standardized, which largely reduces the potential for stricter containment measures at the local level.

- Earlier this week, **Hong Kong announced the hotel quarantine period for inbound travelers will be cut to three days** from seven days, starting Aug. 12. After the three-day quarantine, travelers can return home and will then undergo four days of health monitoring. We view this as a positive move for Hong Kong to maintain competitiveness and pave the way for further loosening of travel restrictions.

MARKET Scorecard

Data as of August 10, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,210.24	1.9%	-11.7%	-5.1%	25.3%
Dow Industrials (DJIA)	33,309.51	1.4%	-8.3%	-5.5%	19.9%
Nasdaq	12,854.80	3.7%	-17.8%	-13.1%	17.2%
Russell 2000	1,969.25	4.5%	-12.3%	-12.1%	24.3%
S&P/TSX Comp	19,885.94	1.0%	-6.3%	-3.0%	19.8%
FTSE All-Share	4,150.68	1.1%	-1.4%	1.0%	22.9%
STOXX Europe 600	439.88	0.4%	-9.8%	-6.9%	20.6%
EURO STOXX 50	3,749.35	1.1%	-12.8%	-10.5%	15.0%
Hang Seng	19,610.84	-2.7%	-16.2%	-26.3%	-19.6%
Shanghai Comp	3,230.02	-0.7%	-11.3%	-8.5%	-4.4%
Nikkei 225	27,819.33	0.1%	-3.4%	-0.2%	24.6%
India Sensex	58,817.29	2.2%	1.0%	7.8%	54.0%
Singapore Straits Times	3,286.33	2.3%	5.2%	2.5%	29.1%
Brazil Ibovespa	110,235.76	6.9%	5.2%	-9.8%	6.6%
Mexican Bolsa IPC	47,808.21	-0.7%	-10.3%	-6.5%	24.9%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	2.783%	13.4	127.3	143.4	220.7
Canada 10-Yr	2.672%	6.2	124.6	140.0	217.8
UK 10-Yr	1.951%	8.7	98.0	136.2	182.0
Germany 10-Yr	0.888%	7.1	106.5	134.5	141.4
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.64%	-0.8%	-8.9%	-9.2%	-10.5%
U.S. Investment-Grade Corp	4.50%	-0.7%	-12.2%	-12.2%	-12.2%
U.S. High-Yield Corp	7.65%	0.6%	-8.6%	-7.1%	1.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,792.03	1.5%	-2.0%	3.6%	-11.6%
Silver (spot $/oz)	20.60	1.2%	-11.6%	-11.8%	-29.3%
Copper ($/metric ton)	7,980.50	0.6%	-18.1%	-15.9%	24.8%
Oil (WTI spot/bbl)	91.93	-6.8%	19.4%	34.6%	119.2%
Oil (Brent spot/bbl)	97.07	-11.8%	24.8%	37.4%	115.8%
Natural Gas ($/mmBtu)	8.23	0.0%	120.7%	101.3%	282.4%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	105.2130	-0.7%	10.0%	13.1%	12.4%
CAD/USD	0.7828	0.2%	-1.1%	-2.0%	4.5%
USD/CAD	1.2775	-0.2%	1.1%	2.0%	-4.3%
EUR/USD	1.0300	0.8%	-9.4%	-12.1%	-12.3%
GBP/USD	1.2217	0.4%	-9.7%	-11.7%	-6.5%
AUD/USD	0.7080	1.4%	-2.5%	-3.7%	-1.0%
USD/JPY	132.9000	-0.3%	15.5%	20.2%	25.4%
EUR/JPY	136.9100	0.6%	4.6%	5.7%	10.1%
EUR/GBP	0.8431	0.4%	0.2%	-0.4%	-6.1%
EUR/CHF	0.9712	-0.2%	-6.4%	-10.2%	-9.6%
USD/SGD	1.3694	-0.8%	1.5%	0.7%	-0.3%
USD/CNY	6.7238	-0.3%	5.8%	3.7%	-3.4%
USD/MXN	20.0372	-1.6%	-2.4%	-0.2%	-10.7%
USD/BRL	5.0837	-1.7%	-8.8%	-2.1%	-7.3%

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 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD -1.1% return means the Canadian dollar fell 1.1% vs. the U.S. dollar year to date. USD/JPY 132.90 means 1 U.S. dollar will buy 132.90 yen. USD/JPY 15.5% return means the U.S. dollar rose 15.5% vs. the yen year to date.

Source - Bloomberg; data as of 8/10/22 market close

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As of June 30, 2022

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Hold [Sector Perform]	560	38.44	169	30.18
Sell [Underperform]	46	3.16	6	13.04

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