GLOBAL Insight WEEKLY

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

August 18, 2022

A summer without the doldrums

Kelly Bogdanova – San Francisco

Market activity often slows in the summer, but not this year. We assess the factors that have lifted U.S. equity indexes recently, and the market's prospects in light of lingering economic risks.

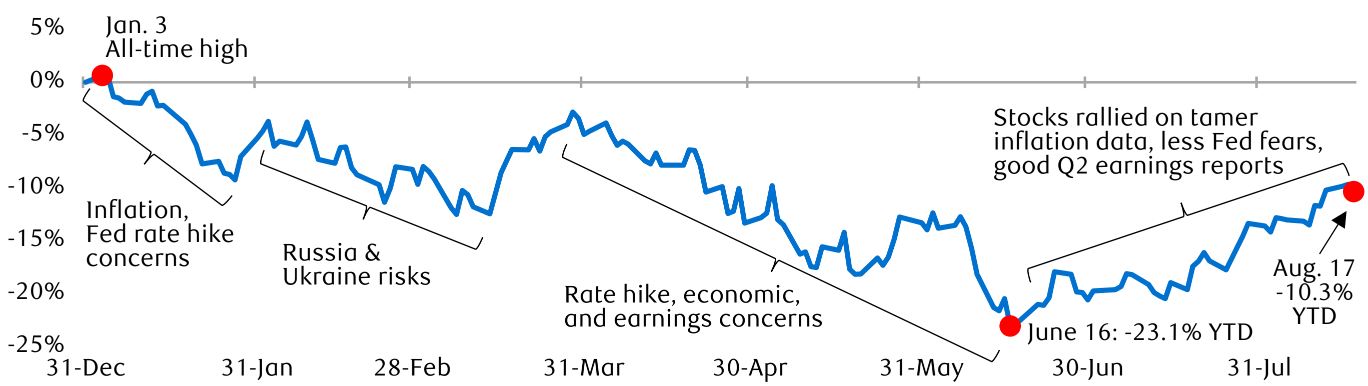
The long-running cliché about "summer doldrums"—when the stock market is typically sluggish as institutional and individual investors take time out to relax on vacations—has been stood on its head. The U.S. market has been anything but dull lately.

After the S&P 500 reached a low point on June 16, closing down 23.1 percent year to date, the market rallied notably, regaining much of that lost ground. The S&P 500 ended Wednesday's session down "only" 10.3 percent.

Developments that lifted the market …

- **Tamer inflation and prospects for a further retreat.** Yes, there is definitely much more to do on the inflation front and it could take a while, but with headline consumer inflation easing to 8.5 percent in July from 9.1 percent in June, the data are finally moving in the right direction. Declines in oil and gasoline prices and other commodities thus far in August should help the process along.
- **A vigilant <u>and</u> "data dependent" Fed.** Officials have stated they are determined to do whatever it takes to combat inflation. They also have emphasized they will be sensitive to incoming economic data and will adjust monetary policy accordingly. The combination of inflation vigilance and flexibility has diminished market

S&P 500 has rebounded off its mid-June low (YTD % change)



Source - RBC Wealth Management, Bloomberg; data through 8/17/22

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

participants' concerns that the Fed could overreach by raising rates much higher than is warranted.

- **Q2 earnings not just "better than feared," but better than expected.** S&P 500 revenue and profit results have been good overall. Many companies are coping with inflation and economic imbalances. With over 90 percent of S&P 500 companies having reported, earnings growth is pacing at 9.7 percent year over year. This is markedly higher than Wall Street analysts' 5.5 percent consensus forecast at the start of earnings season.
- **Not all economic indicators are rapidly decelerating.** Q2 GDP was decidedly negative for the second-straight quarter and some data since then have come in rather weak (New York region manufacturing, housing starts, and small business optimism), but the economy is not down for the count. The all-important and outsized services sector is still expanding at a healthy clip, national retail sales have been relatively resilient, and employment remains firm.

As these positive developments were absorbed, a reversal took place within the stock market.

The indexes and sectors that had been among the weakest through the first half of the year have rallied the most since the market reached a low point in mid-June. Small-cap stocks (Russell 2000), and the Consumer Discretionary and Technology sectors within the S&P 500 have been particularly strong.

Conversely, the Energy sector has been the worst performer since the June low, as crude oil prices have retreated significantly. This sector had been the strongest—by far—previously.

On a year-to-date basis, the Energy sector is still leading by a mile (+39.3 percent), while Communication Services is lagging the most (-25.0 percent).

Market reinforcements in waiting?

We think there are reasons the market could find support in the near term.

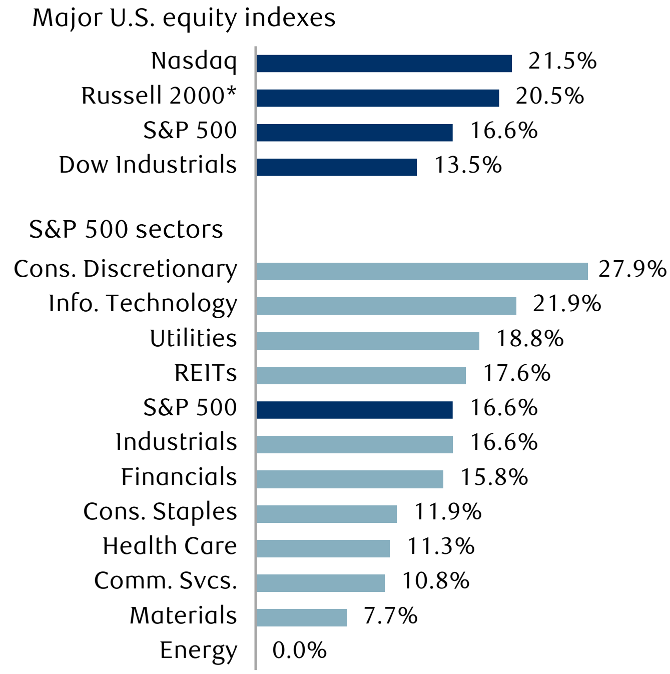
There have been numerous stock buyback announcements during the Q2 earnings season, which come on top of other companies' previously announced plans.

According to reports from our research providers, some institutional investors are experiencing FOMO—the "fear of missing out" on the rally—so they could increase exposure in coming weeks.

Some technical indicators are flashing positive signals. In the post-WWII era, when the S&P 500 recovered 50 percent of its bear market losses (like it has recently), the market did not subsequently trade down to a new lower low during the cycle, according to CFRA Research.

Based on data going back to the early 1900s, a study by research provider Fundstrat found that after the 50 percent retracement threshold was reached, the market went on to rally further 12 months later on 86 percent of occasions, with an average gain of 13 percent.

Performance since the low on June 16, 2022



* The Russell 2000 is a small-capitalization stock index

Source - RBC Wealth Management, Bloomberg; data through 8/17/22

Stay vigilant

These positive signals are encouraging, but now is not the time to become complacent, in our view.

The inflation battle has not yet been won. Assuming consumer prices retreat further this year and next—as RBC economists anticipate—it's not yet clear by how much they will decline. We doubt wage inflation has fully run its course, and inflationary pressures in certain segments of the economy could remain sticky. We think price trends in the non-commodity components of the Consumer Price Index will be key to the inflation story.

Economic data seem vulnerable to further slowing and a formal, broad-based recession is not out of the question. When the Fed hikes interest rates, there is usually a lag of some months before higher borrowing costs begin to weigh on economic activity. The most important leading indicator in our recession scorecard deteriorated recently.

S&P 500 estimates for 2023 declined moderately during the Q2 reporting season. They could decline further as the impact of previous and forthcoming Fed rate hikes kick in—the question is, by how much?

We think the bulk of the equity selloff and market risks are likely in the rearview mirror—as long as the Fed refrains from slamming on the brakes too hard, and inflation doesn't sit at rather elevated levels for a prolonged period.

We continue to recommend holding Market Weight (neutral) exposure to U.S. equities. This is designed to balance lingering recession risks with the possibility that ebbing inflationary pressures and slowing growth could provoke a change of heart by the Fed as early as the first half of next year.

UNITED STATES

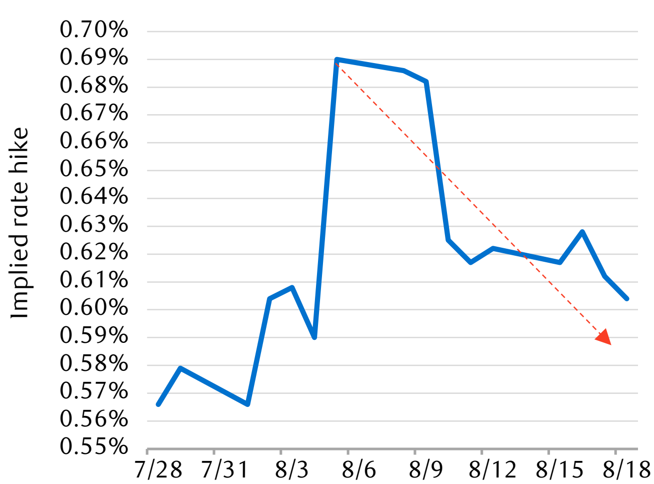
Michael Roedl – Minneapolis

- **The minutes of yesterday's Federal Open Market Committee meeting showed that policymakers aren't quite as hawkish as they were over the past few months**. The language suggests the Fed may begin dialing back the pace of interest rate hikes going forward. While a third consecutive 75 basis point (bps) rate increase remains on the table for September, we believe a smaller 50 bps hike is more likely based on signs that inflation may be easing and policymakers are considering the potential risks of overtightening.

- **The New York Fed's Empire State Manufacturing Survey for August delivered disappointing data**, with the general business conditions index falling more than 42 points on a sharp decline in orders and shipments for the month. The contraction in manufacturing activity was the second-largest on record, behind only the pandemic-induced plunge of April 2020. **About 44% of factories in the state reported weaker business conditions, nearly double the month prior**. While figures in the New York region are typically volatile, the magnitude of the downturn may presage weaker-than-expected manufacturing activity in upcoming regional surveys.

- **The Fed's interest rate policy continued to weigh on sentiment this week, pushing Treasury yields higher with municipal bond yields following suit**. This week's muni selloff has produced heightened volatility across the yield curve, particularly on short-dated maturities, as yields have surged by more than 20 bps since the beginning of the week. We anticipate munis will face more challenges in the near term due to increasing supply. State and local governments are projected to sell around $15 billion of new-issue muni bonds over the next 30 days, the most since mid-July.

September rate hike projections shift lower on easing inflation



Source - RBC Wealth Management, Bloomberg; data through 8/18/22

CANADA

Richard Tan, CFA & Mila Krunic – Toronto

- While over 90% of companies in the S&P/TSX Composite have reported earnings, **investors will likely assess the strength of the Canadian economy when the banks begin reporting Q3 2022 earnings next week**. Heading into the quarter, RBC Capital Markets lowered its earnings expectations for the group and believes the banks will halt the release of their credit reserves. In our view, a buildup of reserves would be seen as prudent given the rising risks of a recession and may receive positive support by the market. From a loan growth standpoint, RBC Capital Markets is also calling for modest sequential growth driven by solid commercial lending, offset by softer mortgage originations. Unsurprisingly, net interest margins are also anticipated by RBC Capital Markets to expand on the back of aggressive rate hike policies on both sides of the border. Finally, the capital markets and wealth management divisions will likely be headwinds for the banks this quarter due to unfavourable financial market conditions. Overall, the Canadian banks are trading around 1.5x price-to-book value, which effectively prices in a garden variety recession, in our view.

- **Canadian CPI growth has likely peaked in Q2**, according to RBC Economics. Inflation was at 7.6% y/y in July, abating from an 8.1% reading in the previous month. The weaker print was led by lower gasoline prices, which offset higher natural gas and food prices. Gasoline dropped to $1.85/litre in July after reaching just above $2/litre in June. Housing costs, which have trended lower since May as sales slowed and borrowing costs continued to climb, were another noteworthy item that contributed to July's lower inflation reading. Strong summer travel demand caused prices to increase above levels a year ago; hotel prices rose 47.7% while travel tours and airfares climbed 9.4% and 57.7%, respectively. However, inflation remains well above long-term averages, and consumer demand will likely have to taper further before inflation reaches the Bank of Canada's 1%–3% target range.

EUROPE

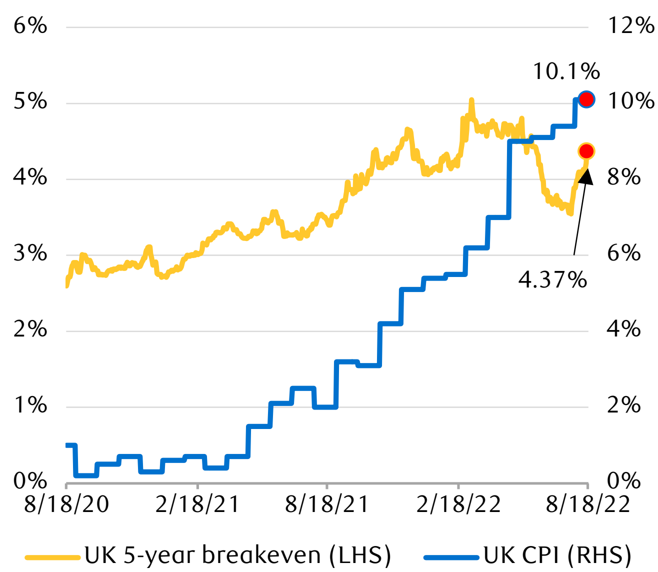
Frédérique Carrier & Rufaro Chiriseri, CFA – London

- **UK GDP contracted slightly less than the consensus expectation in Q2, falling 0.1% q/q, despite two bank holidays in a part of the year when economic activity typically slows**. Going forward, the challenges the economy faces are well known, including the cost of living crisis and ongoing negotiations with the EU—two issues which the new prime minister, to be announced on Sept. 5, will need to tackle with some urgency. For now, RBC Capital Markets expects GDP growth of 3.5% this year and 0.4% in 2023, though the level of uncertainty surrounding these estimates is particularly high.

- **UK inflation rose to 10.1% y/y in July, from 9.4% y/y in June**, outpacing the expectations of the Bank of England (BoE) and economists in a Bloomberg survey, and marking **the first double-digit reading in 40 years**. Food prices have risen 13% over the past year and were the largest contributor to July's figure, evidence that rising prices are no longer confined to energy.

- The yield differential between 5-year nominal and inflation-linked government bonds, otherwise known as the breakeven rate, has shifted higher to 4.37% from 4% in July; this highlights the market's increased expectations for inflation to remain above the BoE's 2% target over the next five years. Markets have now fully priced in two consecutive 50 bps interest rate hikes, with the year-end Bank Rate now expected to reach 3.25% compared to 2.85% a week ago. **The short end of the yield curve reacted negatively, with 2-year bond yields rising to 2.36% and exceeding 10-year yields (currently 2.30%), resulting in the deepest yield curve inversion since 2008**. With the BoE still in accommodative policy territory, we think this is unlikely to be the finale of the selloff in front-end yields, and expect increased volatility in the short term.

Future inflation expectations remain elevated



Source - RBC Wealth Management, Bloomberg; data through 8/16/22

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets have traded mixed during the week** with the Nikkei 225 attempting to break the year-to-date high while the Hang Seng continues to move in a very tight range it has occupied since the beginning of August.

- **China's latest economic data were weaker than expected**. Retail sales, industrial production, and fixed asset investment data for July missed analysts' expectations and marked a slowdown from June. Shortly after the data release, Premier Li Keqiang called on six provinces—Guangdong, Jiangsu, Zhejiang, Henan, Sichuan, and Shandong—to take the lead in supporting the country's growth. The six provinces account for 45% of China's GDP and nearly 60% of national trade and foreign investment. Separately, the People's Bank of China unexpectedly cut two interest rates moderately on Monday. We think this week's events suggest there is a high level of urgency to maintain economic growth, although no emphasis was put put on the national GDP target. We anticipate more stimulus support ahead.

- **Singapore signaled the wealthy may face more taxes** as the government seeks more inclusive growth and looks for ways to shield the most vulnerable groups from the impact of high prices. Finance Minister Lawrence Wong's comments follow an assurance from Prime Minister Lee Hsien Loong that the government is prepared to do more to help lower-income households deal with price increases hovering at a 14-year high. Inflation is expected to peak by the end of the year before easing, according to Wong.

- **Tencent holdings (700 HK) reported its first-ever quarterly y/y revenue decline** as strict regulations on gaming and a resurgence of COVID-19 in China weighed on its top line. That said, Q2 2022 EPS came in better than feared, helped by efficiency improvement initiatives and cost savings from Tencent's portfolio companies. During the post-earnings conference call, Tencent's chief strategy officer pushed back against a report the company intends to sell all or much of its US$24 billion stake in Meituan (3690 HK).

MARKET
Scorecard

Data as of August 17, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,274.04	3.5%	-10.3%	-3.9%	26.4%
Dow Industrials (DJIA)	33,980.32	3.5%	-6.5%	-3.9%	22.0%
Nasdaq	12,938.12	4.4%	-17.3%	-11.7%	16.2%
Russell 2000	1,987.31	5.4%	-11.5%	-8.7%	25.3%
S&P/TSX Comp	20,181.44	2.5%	-4.9%	-0.9%	21.2%
FTSE All-Share	4,146.49	1.0%	-1.5%	0.6%	21.4%
STOXX Europe 600	439.03	0.2%	-10.0%	-7.3%	18.9%
EURO STOXX 50	3,756.06	1.3%	-12.6%	-10.5%	13.6%
Hang Seng	19,922.45	-1.2%	-14.9%	-22.6%	-21.4%
Shanghai Comp	3,292.53	1.2%	-9.5%	-4.5%	-4.3%
Nikkei 225	29,222.77	5.1%	1.5%	6.6%	26.5%
India Sensex	60,260.13	4.7%	3.4%	8.0%	58.4%
Singapore Straits Times	3,262.76	1.6%	4.5%	4.6%	26.9%
Brazil Ibovespa	113,707.76	10.2%	8.5%	-3.6%	14.2%
Mexican Bolsa IPC	48,707.54	1.2%	-8.6%	-5.6%	24.0%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	2.900%	25.2	139.0	163.9	221.2
Canada 10-Yr	2.859%	24.9	143.3	170.5	227.3
UK 10-Yr	2.288%	42.4	131.7	172.6	207.2
Germany 10-Yr	1.083%	26.6	126.0	155.4	153.4
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.60%	-0.7%	-8.8%	-9.5%	-9.7%
U.S. Investment-Grade Corp	4.42%	-0.1%	-11.7%	-12.3%	-10.5%
U.S. High-Yield Corp	7.46%	1.6%	-7.7%	-6.2%	3.3%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,763.72	-0.1%	-3.6%	-1.3%	-11.2%
Silver (spot $/oz)	19.82	-2.7%	-15.0%	-16.2%	-27.9%
Copper ($/metric ton)	7,975.00	0.6%	-18.1%	-13.6%	23.6%
Oil (WTI spot/bbl)	88.11	-10.7%	14.4%	32.3%	105.4%
Oil (Brent spot/bbl)	93.27	-15.2%	19.9%	35.1%	105.6%
Natural Gas ($/mmBtu)	9.23	12.2%	147.5%	140.6%	294.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	106.6420	0.7%	11.5%	14.5%	14.9%
CAD/USD	0.7746	-0.9%	-2.1%	-2.2%	2.4%
USD/CAD	1.2910	0.9%	2.2%	2.2%	-2.3%
EUR/USD	1.0176	-0.4%	-10.5%	-13.1%	-14.3%
GBP/USD	1.2050	-1.0%	-11.0%	-12.3%	-8.0%
AUD/USD	0.6936	-0.7%	-4.5%	-4.4%	-3.9%
USD/JPY	135.1000	1.4%	17.4%	23.3%	27.5%
EUR/JPY	137.4800	1.0%	5.0%	7.1%	9.3%
EUR/GBP	0.8445	0.6%	0.4%	-0.9%	-6.8%
EUR/CHF	0.9686	-0.5%	-6.6%	-9.6%	-10.0%
USD/SGD	1.3821	0.1%	2.5%	1.4%	1.0%
USD/CNY	6.7811	0.5%	6.7%	4.5%	-2.2%
USD/MXN	19.9844	-1.9%	-2.7%	-0.1%	-10.0%
USD/BRL	5.1635	-0.2%	-7.4%	-2.5%	-6.3%

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 0.77 means 1 Canadian dollar will buy 0.77 U.S. dollar. CAD/USD -2.1% return means the Canadian dollar fell 2.1% vs. the U.S. dollar year to date. USD/JPY 135.10 means 1 U.S. dollar will buy 135.10 yen. USD/JPY 17.4% return means the U.S. dollar rose 17.4% vs. the yen year to date.

Source - Bloomberg; data as of 8/17/22 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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