GLOBAL Insight WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

September 8, 2022

# Navigating crosscurrents

Joseph Wu, CFA – Toronto

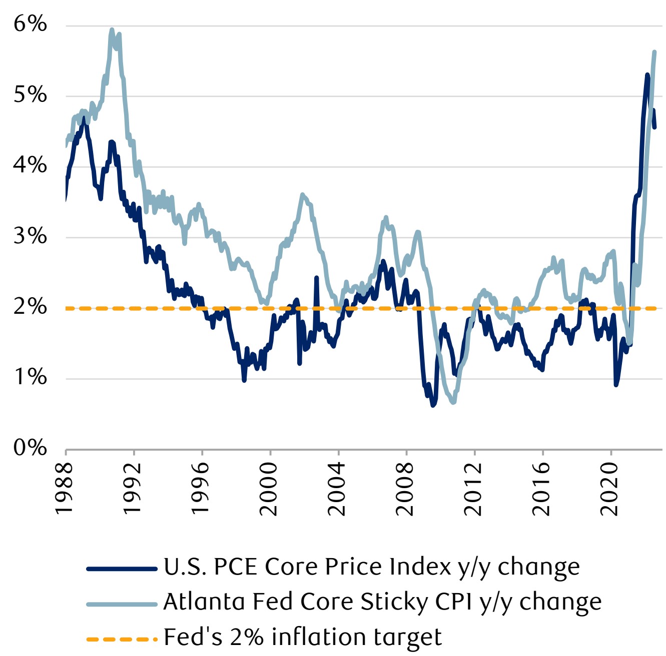
Volatility has returned to financial markets amid renewed uncertainty regarding the path of monetary policy, inflation, and the economy. We evaluate the macro headwinds and tailwinds, and discuss implications for portfolio positioning.

## What kind of inflation peak?

Inflation remains arguably the most important factor shaping the macro backdrop, because how it evolves will directly influence the pace of monetary policy tightening and, in turn, the economy and markets. While inflation in Europe is likely to remain more problematic due to an ongoing energy crisis with no resolution in sight, recent inflation data for the U.S. and other major economies that suggest price pressures may be cresting represent an auspicious development. Encouragingly, lower commodity prices, less supply chain congestion, and slowing growth should continue to provide some inflation relief over the coming quarters.

Although we believe price pressures should start to moderate, the speed at which inflation will ease remains highly uncertain; some dynamics suggest it could take considerable time for inflation to reach levels that are palatable for central banks. Focusing on the U.S., a combination of robust wage growth and elevated measures of “sticky” inflation—based on changes in the price of goods and services for which price changes are normally infrequent—signal that underlying core price pressures remain uncomfortably high, as shown in the chart at right. Accordingly, Federal Reserve policymakers recently reiterated their “unconditional” resolve to return

**Inflation remains too high for comfort**




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

For perspectives on the week from our regional analysts, please see pages 4-5.

inflation to a two percent target by continuing to raise rates and withdraw liquidity via quantitative tightening at a fairly brisk pace for the foreseeable future.

## Will corporate fundamentals stay resilient?

The world economy has lost substantial momentum this year, sagging under the weight of tighter financial conditions as higher borrowing costs and stubbornly elevated inflation have hampered both consumer demand and business activity. But we think the Fed's continued interest rate hikes despite GDP downgrades since the beginning of the year have shown it is willing to continue tightening amid growth headwinds, and futures markets expect further rate hikes in coming quarters. Accordingly, we believe risks to the economic outlook remain skewed to the downside (see upper chart at right).

While the number of downward revisions to analysts' earnings forecasts has ramped up in recent months, consensus EPS projections have held up much better (see lower chart at right) than the deceleration implied by the decline in global manufacturer sentiment and the sizable downgrades to 2022 GDP growth forecasts for major economies. The ongoing global growth slowdown nonetheless suggests corporate earnings are likely to remain vulnerable to negative revisions in the near term.

## Will the U.S. economic expansion endure?

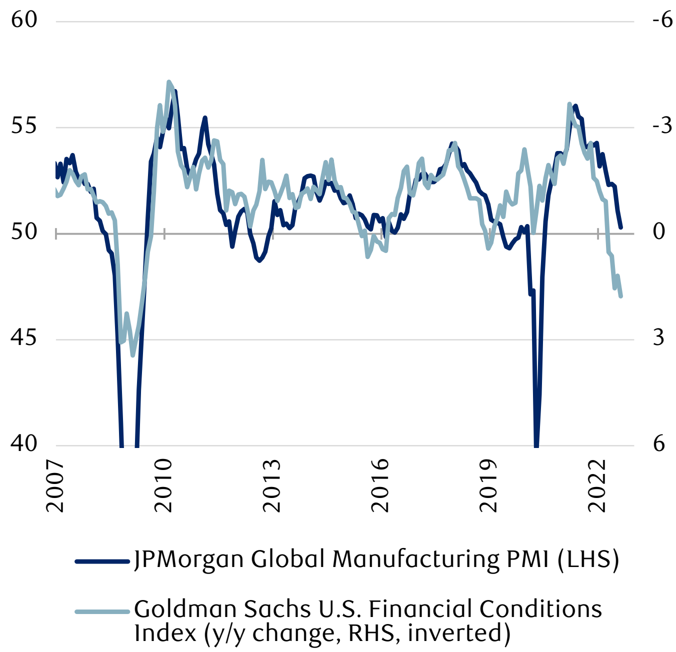
Setting the tone for the rest of the world, the U.S. economy has sharply decelerated this year, prompting worries of an imminent recession. But with households still buttressed by a sizable cushion of savings and the labour market showing strength with ample job openings, the immediate risks appear to be mostly contained and a "soft landing" scenario remains possible, in our view.

Nevertheless, we believe the probability of a U.S. recession will likely continue to build, in part because the Fed's intention to guide interest rates to a restrictive level would further squeeze financial conditions and curb economic activity. Meanwhile, RBC Global Asset Management's latest U.S. Business Cycle Scorecard update indicates the U.S. economy has rapidly matured, with a majority of indicators having recently shifted into late-cycle or end-of-cycle status. The recent deterioration in our U.S. Recession Scorecard, which has seen three out of seven indicators shift to recessionary status since June, corroborates the view that the likelihood of a U.S. economic downturn over the next 12 months is rising.

## Balancing opportunities and risks

Against this backdrop of unusually high macro uncertainty, many global leading indicators are still trending unfavourably, while the Chinese economy is strained by pandemic lockdowns and property market

### Global growth has downshifted as financial conditions tighten

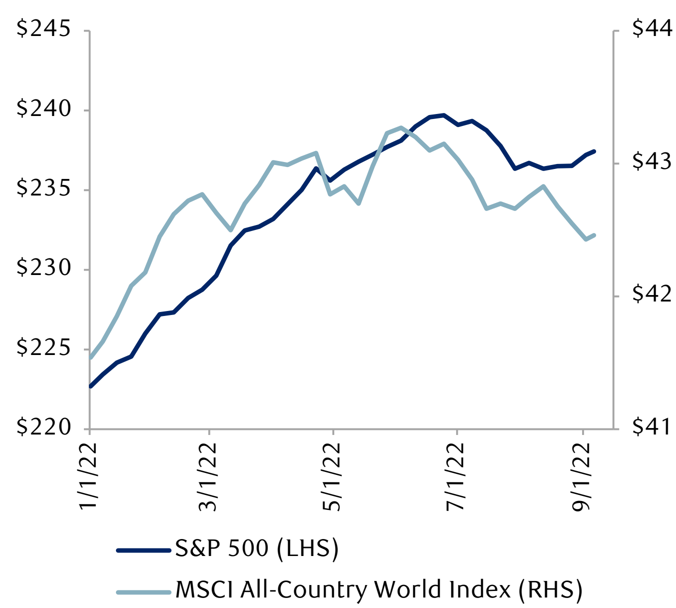



Note: A PMI (Purchasing Managers' Index) level of 50 demarcates expansion from contraction. For the financial conditions index, a falling line (higher values) implies tightening conditions.

Source - RBC Wealth Management, Bloomberg; monthly data through 8/31/22

### Profit estimates show resilience despite softening economy

Consensus forward 12-month EPS estimates

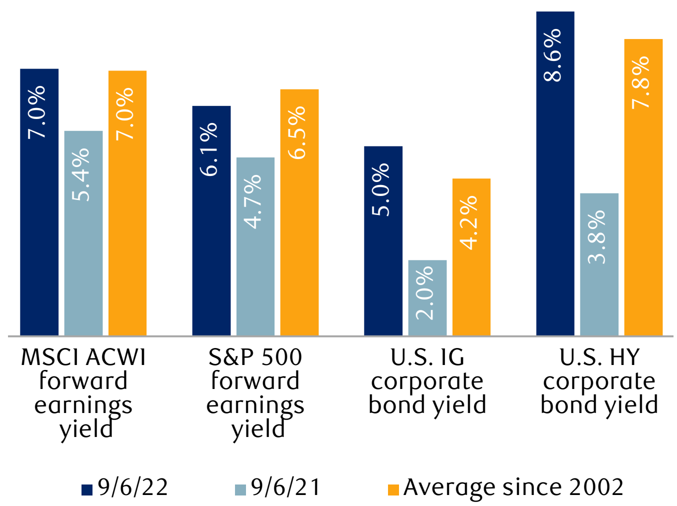



Source - RBC Wealth Management, Bloomberg; weekly data through 9/6/22 woes and U.S. political risk is likely to flare up as the midterm elections draw closer. We therefore believe investors should maintain a moderately defensive and flexible stance in portfolio positioning, with a focus on relative value opportunities.

For equity markets, we believe earnings delivery will be crucial. In an environment of slower but still positive economic growth, we think earnings could remain resilient over the next 12 months and help provide fundamental support for share prices. In a recessionary environment, however, profits are likely to decline meaningfully. As we laid out in the August Global Insight, the previous 11 U.S. recessions since the 1950s saw S&P 500 earnings fall by an average of 23.6 percent.

Meanwhile, we believe the opportunity set in fixed income markets—where expected returns appear increasingly reasonable thanks to substantially higher bond yields and modestly better compensation for credit risk compared to a year ago—has vastly improved. On a relative basis, the yield advantage that equities commanded over corporate bonds has also sharply diminished over the past year, as the chart at right shows. Moreover, we think the significantly higher starting yields available today can provide more of a cushion to absorb further rises in rates, as well as helping to strengthen the diversification capacity of bonds in relation to equities.

### Relative value has moved in favour of fixed income




Note: Earnings yield is the inverse of the forward price-to-earnings ratio. IG = investment-grade; HY = high-yield. Bond yield refers to yield to worst for the Bloomberg U.S. Corporate Index (for investment-grade bonds) and the Bloomberg U.S. Corporate High Yield Index Value (for high-yield bonds).

Source - RBC Wealth Management, Bloomberg; weekly data through 9/6/22

## UNITED STATES

Atul Bhatia, CFA – Minneapolis

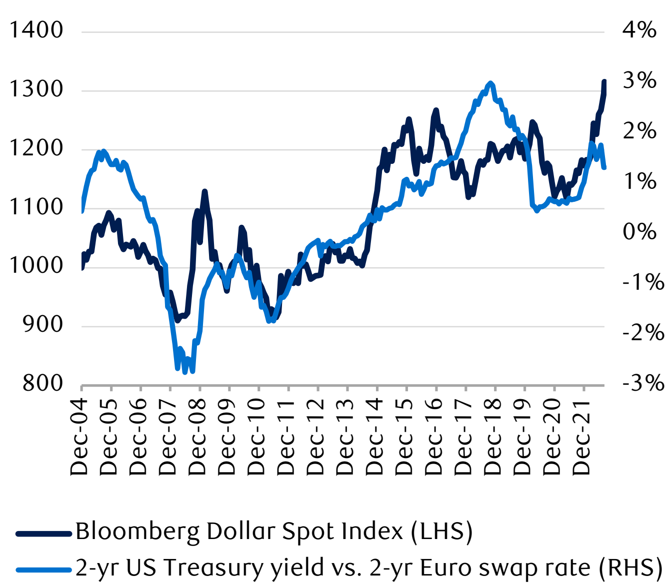
- **August employment data showed a mixed picture for U.S. labor markets.** Demand for workers was strong, with 315,000 jobs created during the month, but supply grew by an even greater amount, as sidelined workers returned to the labor force. The resulting 0.2% increase in the unemployment rate was the largest since April 2020 and the start of pandemic-related shutdowns in the United States. **Federal Reserve policymakers likely welcomed the data**, as rising unemployment should help contain wage-driven inflation while job creation helps limit the negative growth implications of tighter monetary policy.

- Treasury yields—which move in the opposite direction of prices—have been volatile to start the month, with a 16 basis point (bps) trading range for 2-year Treasuries and a 19 bps range for 10-year government bonds through Sept. 7. The price swings come as investors react to mixed economic data and the implications for future rate hikes. Another factor likely weighing on Treasuries is the Fed's quantitative tightening program. **Beginning this month, the Fed will allow its bond portfolio to shrink by up to $95 billion/month** as some maturing securities are not replaced. This change in central bank policy is a potentially significant drop in demand for government bonds. Overall, we believe volatility is likely to remain elevated, but we do not think 10-year yields will push significantly above 3.5% during the remainder of 2022.

- **The U.S. dollar continues to rise against global currency counterparts.** The Bloomberg Dollar Index—an annually rebalanced, trade-weighted measure of exchange rates—hit the highest level since calculation began in 2004. Prior bouts of dollar strength were associated with an increasing U.S. relative interest rate advantage, but the most recent run-up comes as Treasury yields lag some of their overseas counterparts. **The likely explanation for this month's push higher by the greenback is the potential for stronger relative U.S. economic growth,** with European prospects constrained by the energy crisis and Asia facing ongoing production shutdowns related to anti-COVID measures.

**Recent dollar strength more than just yields**

USD gains come despite declining relative rate advantage




Source - RBC Wealth Management, Bloomberg; data through 9/7/22

## CANADA

Sean Killin & Matt Altro – Toronto

- As September begins and the leaves are soon to fall, **the S&P/TSX Composite Index closed out the summer months from a point of weakness**, down 6.8% from June 1 to Aug. 31. This is a relative underperformance when compared to the S&P 500 Index and the Dow Jones Industrial Average, down 4.3% and down 4.5%, respectively, over the same period. The largest detractor from returns within Canada came from Financials (-8.6%), as weak capital markets activity and banks' buildup of reserves weigh on earnings. Materials had a drag on the index as well, down 15.9%, but made less of a dent on S&P/TSX performance as the sector represents 11% of the index compared to the 31% weighting of the Financials sector. The S&P/TSX was helped by Industrials (+7.5%), Consumer Discretionary (+2.7%), and Utilities (+1.2%). Looking forward, **we believe the market's focus will continue to be on the Financials and Energy sectors as the health of the economy and geopolitical tensions continue to weigh on investor sentiment**.

- With the headline Consumer Price Index at 7.6% in Canada in July, **the inflation fight continues for the Bank of Canada (BoC) as policymakers decided to implement another outsized interest rate hike at the Sept. 7 meeting**. The widely anticipated 75 basis point (bps) hike brings the benchmark overnight interest rate to 3.25%, which is slightly above the 2%–3% range that the BoC believes is the neutral rate of interest. Following this framework, monetary policy has technically moved into restrictive territory in Canada. Subsequently, RBC Wealth Management's Multi-Asset Strategy team now sees corporate profits being discounted at a higher rate of interest alongside the potential for consensus Canadian economic growth expectations to be revised lower, particularly given the sizeable amount of domestic GDP that is attributed to the interest rate-sensitive Real Estate sector. **Despite the BoC's persistence in hiking rates so far this cycle, we believe there is still work to be done in tightening monetary policy**, as inflation continues to run above target. As of Sept. 7, overnight index swaps, which represent financial market expectations of the benchmark overnight interest rate, are pricing in at least another 50 bps of hikes this cycle.

## EUROPE

Frédérique Carrier – London

- **The European Central Bank (ECB) increased the deposit rate from 0% to 0.75%, the largest rate hike since the launch of the euro in 1999.** Hawks on the ECB's Governing Council have been encouraged by the eurozone economy holding up better than widely expected in the face of adversity. With the squeeze from higher energy prices and the central bank intent on lowering growth so as to tame inflation, the region will very likely endure a recession. **RBC Global Asset Management now expects a GDP contraction of 0.5% in 2023**, after its expectation for an above-trend expansion of 2.5% in 2022.

- **The EU continues to fill its natural gas storage capacity**, which has now reached 82.5% as of Sept. 6 and above the 80% target, in an attempt to mitigate an acute energy crunch this winter. While this is an encouraging sign, it does not eradicate the risk of shortages, in our view. Whether those happen—and if so, their magnitude—will likely depend on how cold the winter is and the extent of declining household energy demand. EU natural gas demand is already down 10% compared to a year ago, but RBC Capital Markets calculates a decline of 25% is necessary in order to avoid energy shortages over the next two winters.

- **EU energy ministers are preparing to gather at an emergency meeting on Friday, Sept. 9.** They will discuss decoupling electricity prices from gas prices, measures to relieve pressure on energy companies stemming from collateral requirements, and French President Emmanuel Macron's proposal of a new levy on energy companies at the European level. Further cuts to consumption will also be on the table.

- There have also been **calls for a common fiscal capacity**, a tool similar to that used in response to the COVID-19 pandemic, which included common debt, **to help sectors struggling with the energy crisis**.

### Japan's GDP stronger than expected in Q2

Real GDP annualized q/q growth rate


Source - RBC Wealth Management, Bloomberg; quarterly data since 6/30/17

- **In the UK, new Prime Minister Liz Truss announced a package to protect households and businesses from high energy prices, with the cost estimated by the Financial Times at £150 billion**, or some 6% of GDP, though the final cost will depend on energy price moves. Financed by higher government borrowing, as opposed to a windfall tax on energy companies, the package should be supportive of the economy, but may lead the Bank of England to raise interest rates further. More details are to be revealed in an emergency mini-budget set for late September. The pound reached a low of 1.14 against the U.S. dollar, a level perilously close to its 1985 low.

## ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Japan's economy expanded more than initially estimated in Q2.** GDP grew at an annualized rate of 3.5%, beating the Bloomberg consensus estimate of 2.9%. The recovery was helped by steady consumer and business spending as Japan gradually emerged from the winter COVID-19 outbreak. However, this trend could be challenged in the coming months, in our view, as a resurgence of COVID-19 in July saw the reintroduction of curbs.

- The southwestern Chinese city of Chengdu has maintained strict anti-COVID restrictions and extended a lockdown in most of its downtown areas. Authorities have allowed restrictions in some suburban districts to ease. **Stringent COVID-19 containment measures continue to add pressure to China's economic outlook. Exports in August significantly missed analysts' expectations.** Outbound shipments rose 7.1% y/y, slowing from an 18% gain in July and marking the first slowdown since April when the Shanghai lockdown disrupted supply chains and manufacturing.

- **The 20th National Congress of the Chinese Communist Party will convene on Oct. 16.** The congress will be closely observed as it will set the country's policy direction for the next five years. **While we don't expect the zero-COVID policy to be lifted immediately after the meeting, we are watching for signs that China is preparing for a reopening**, including: (1) A change in the government's narrative towards COVID-19. Recently, a Chinese health expert expressed that China should aim to loosen COVID-19 containment measures in the future and gradually reduce disruptions to daily life. (2) A reacceleration of the vaccination program. After a strong uptick from March to May, the vaccination rate slowed in recent months. We would need to see the rate pick up again if China is indeed targeting a reopening. (3) The development of more effective domestic COVID-19 drugs. China approved its first homegrown COVID-19 antiviral in July. Before that, it had approved only one oral antiviral, developed by Pfizer, and while that treatment has been highly effective, supplies in China are limited.

## MARKET
# Scorecard

Data as of September 7, 2022

| Equities (local currency) | Level | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| S&P 500 | 3,979.87 | 0.6% | -16.5% | -12.0% | 16.1% |
| Dow Industrials (DJIA) | 31,581.28 | 0.2% | -13.1% | -10.0% | 12.3% |
| Nasdaq | 11,791.90 | -0.2% | -24.6% | -23.3% | 4.2% |
| Russell 2000 | 1,832.00 | -0.7% | -18.4% | -19.5% | 19.3% |
| S&P/TSX Comp | 19,241.44 | -0.5% | -9.3% | -7.5% | 18.6% |
| FTSE All-Share | 3,976.83 | -0.8% | -5.5% | -3.5% | 19.6% |
| STOXX Europe 600 | 412.01 | -0.7% | -15.5% | -12.9% | 12.0% |
| EURO STOXX 50 | 3,502.09 | -0.4% | -18.5% | -17.1% | 5.7% |
| Hang Seng | 19,044.30 | -4.6% | -18.6% | -27.7% | -22.6% |
| Shanghai Comp | 3,246.29 | 1.4% | -10.8% | -11.7% | -1.4% |
| Nikkei 225 | 27,430.30 | -2.4% | -4.7% | -8.3% | 18.8% |
| India Sensex | 59,028.91 | -0.9% | 1.3% | 1.3% | 53.7% |
| Singapore Straits Times | 3,210.83 | -0.3% | 2.8% | 3.3% | 27.9% |
| Brazil Ibovespa | 109,763.77 | 0.2% | 4.7% | -6.9% | 8.4% |
| Mexican Bolsa IPC | 46,056.97 | 2.5% | -13.5% | -11.3% | 25.7% |
| **Gov't bonds (bps change)** | **Yield** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. 10-Yr Treasury | 3.269% | 7.7 | 175.9 | 189.6 | 255.1 |
| Canada 10-Yr | 3.146% | 2.8 | 172.0 | 191.4 | 255.0 |
| UK 10-Yr | 3.034% | 23.3 | 206.3 | 229.7 | 278.6 |
| Germany 10-Yr | 1.577% | 3.6 | 175.4 | 189.9 | 204.0 |
| **Fixed income (returns)** | **Yield** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Aggregate | 4.11% | -1.1% | -11.7% | -12.2% | -12.5% |
| U.S. Investment-Grade Corp | 5.01% | -1.5% | -15.5% | -15.8% | -14.1% |
| U.S. High-Yield Corp | 8.56% | -0.4% | -11.6% | -11.1% | -1.8% |
| **Commodities (USD)** | **Price** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| Gold (spot $/oz) | 1,718.02 | 0.4% | -6.1% | -4.3% | -11.2% |
| Silver (spot $/oz) | 18.46 | 2.6% | -20.8% | -24.1% | -31.2% |
| Copper ($/metric ton) | 7,751.00 | -1.2% | -20.4% | -16.9% | 13.8% |
| Oil (WTI spot/bbl) | 81.94 | -8.5% | 6.4% | 19.9% | 106.0% |
| Oil (Brent spot/bbl) | 87.73 | -9.1% | 12.8% | 22.4% | 108.8% |
| Natural Gas ($/mmBtu) | 7.80 | -14.6% | 109.1% | 70.7% | 201.3% |
| **Currencies** | **Rate** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Dollar Index | 109.5500 | 0.8% | 14.5% | 18.4% | 18.2% |
| CAD/USD | 0.7623 | 0.1% | -3.7% | -3.6% | -0.2% |
| USD/CAD | 1.3119 | -0.1% | 3.8% | 3.7% | 0.2% |
| EUR/USD | 1.0006 | -0.5% | -12.0% | -15.5% | -15.3% |
| GBP/USD | 1.1536 | -0.7% | -14.8% | -16.3% | -12.4% |
| AUD/USD | 0.6767 | -1.1% | -6.8% | -8.4% | -7.0% |
| USD/JPY | 143.7800 | 3.5% | 24.9% | 30.4% | 35.3% |
| EUR/JPY | 143.8700 | 3.0% | 9.9% | 10.2% | 14.6% |
| EUR/GBP | 0.8674 | 0.3% | 3.1% | 1.0% | -3.4% |
| EUR/CHF | 0.9775 | -0.5% | -5.8% | -10.2% | -9.7% |
| USD/SGD | 1.4041 | 0.5% | 4.1% | 4.3% | 2.8% |
| USD/CNY | 6.9656 | 1.1% | 9.6% | 7.7% | 2.0% |
| USD/MXN | 19.9904 | -0.7% | -2.6% | 0.2% | -7.5% |
| USD/BRL | 5.2512 | 1.3% | -5.8% | 1.6% | -1.0% |

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 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -3.7% return means the Canadian dollar fell 3.7% vs. the U.S. dollar year to date. USD/JPY 143.78 means 1 U.S. dollar will buy 143.78 yen. USD/JPY 24.9% return means the U.S. dollar rose 24.9% vs. the yen year to date.

Source - Bloomberg; data as of 9/7/22 market close

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As of June 30, 2022

| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
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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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