GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

September 15, 2022

Volatility inflates

Kelly Bogdanova – San Francisco

The U.S. stock market was jolted this week amid evidence that inflation's grip remains uncomfortably stubborn. This unwelcome development, along with several other percolating challenges, could keep the market on edge. But we don't think investors should throw in the towel just because inflation and the related challenges may not lift overnight.

The U.S. equity market hit another rough patch and continues to struggle with the same forces that have been dogging it for much of the year: hot inflation and concerns about its potential knock-on effects.

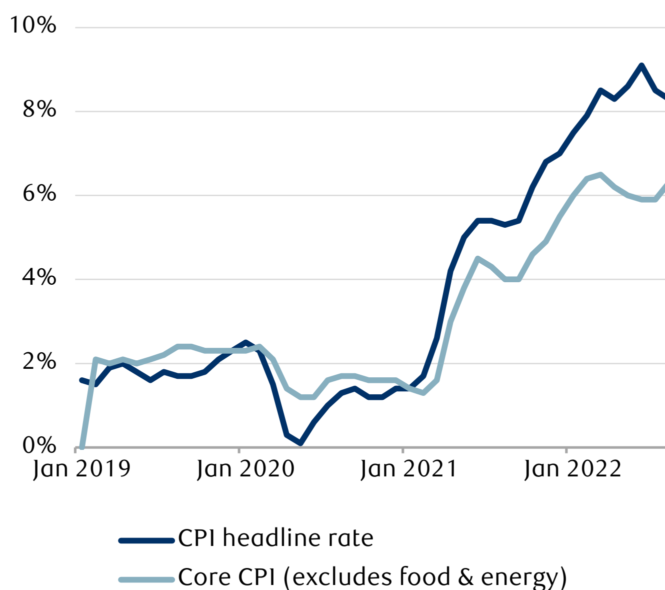
The S&P 500 and Nasdaq fell 4.3 percent and 5.2 percent, respectively, on Tuesday following a disappointing consumer inflation report. These are the biggest single-session losses since June 2020, which was soon after the most acute stage of the COVID-19 crisis. Roughly half of this summer's bounce has eroded.

While headline inflation is starting to recede, so far the pace has been slow. The Consumer Price Index (CPI) registered at 8.3 percent year over year in August. This is lower than the previous two months, but higher than Wall Street economists' 8.1 percent consensus forecast.

Also, the important core CPI rate, which excludes food and energy, jumped to 6.3 percent year over year and is near the peak level reached in March. Economists had expected it to rise in August, but not by this much.

Inflation remains at lofty levels

U.S. Consumer Price Indexes (year-over-year change)



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

This market calls for patience

We do not think this is the time for long-term investors to turn bearish on stocks or throw in the towel just because inflation has yet to be fully extinguished. The market has

For perspectives on the week from our regional analysts, please see pages 5-6.

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Priced (in USD) as of 9/14/22 market close (unless otherwise stated). Produced: 9/15/22 4:52 pm ET; Disseminated: 9/15/22 4:56 pm ET
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been grappling with this issue since January, and it was the cause of a deeper decline in the spring through early June.

We have not expected this problem to get resolved quickly, and there could be more bouts of market volatility until it becomes clear that inflation will eventually head down toward more normal levels.

When it comes to equity positioning, we think four factors will require some patience:

- **First, more Fed rate hikes are in the offing**. Before the disappointing August inflation data, the futures market expected the Fed would hike rates by 50 or 75 basis points (bps) at its September 20–21 meeting. Expectations now look for a 75 or 100 bps move, with about a 1-in-4 chance the central bank makes the larger move. Futures prices indicate likely additional hikes in November, December, and the first quarter of next year, which would ultimately lift the fed funds rate to about 4.50 percent. This is almost 100 bps above the expectations one month ago, and the level is relatively high considering fed funds began this year near the record low rate of just 0.25 percent. Meanwhile, the 10-year Treasury yield has risen to 3.45 percent and the 30-year mortgage rate has jumped to 6.19 percent.
- **Second, aggressive Fed tightening could aggravate recession risks**. Three of our seven recession indicators are already signaling that risks of an economic contraction in 2023 are on the rise. We think recession risks will continue to climb as the Fed hikes rates further and higher borrowing costs begin to weigh on economic activity. U.S. recessions have always been accompanied by equity bear markets of varying degrees. They typically get underway some months before the recession officially begins—on average, about five to seven months before. The market seems like it is already wrestling with this possibility.
- **Third, S&P 500 earnings could decline, and margins and P/Es could contract**. This is the main reason we think equities were so hard-hit by Tuesday's inflation news. While the market has already priced in a lot of bad news, we believe it could take more time for these risks to be fully priced in—in other words, a longer period of churning and volatility, and perhaps more downside.

  Even if earnings growth holds up in the remaining quarters of this year and the end result comes close to the 2022 S&P 500 consensus forecast of $225 per share, we highly doubt the $244 per share 2023 consensus forecast will be reached if economic growth slows meaningfully and especially if a full-blown recession materializes. During the four previous inflation-driven recessions, S&P 500 earnings fell an average of 17.7 percent from peak to trough, as discussed in our article titled, "As earnings go, so goes the market."

  If history is a guide, we also think a recession would prompt the lofty S&P 500 profit margin to retreat markedly. Furthermore, if inflation lingers above the Fed's two percent target rate for some time, the S&P 500's price-to-earnings (P/E) ratio could compress to around 15x the forward consensus earnings estimate, below the 17x average of the past 10 years.
- **Fourth, the Ukraine crisis now poses additional, wider risks**. Given Ukraine's recent military offensive, we think the stakes of the conflict have risen and the associated economic and geopolitical risks have deepened and broadened. The leadership of Russia, along with key segments of the population, no longer perceive that they are merely fighting the Kiev leadership and Ukrainian military equipped with NATO weapons. Top Russian Security Council officials are now much more frequently communicating via formal statements and social media that they believe NATO itself is confronting Russia by using the "hands and feet of Ukrainians" as its soldiers. Importantly, Russian security officials also assert the West's ultimate goal is for the Russian state to break up into multiple segments. From our perspective, NATO and Russia relations have recently reached a new bottom and are at the lowest point in history. To us, this makes it more likely the conflict in Ukraine will drag on for some time. At a minimum, we think this would have negative consequences for the greater European economy and would be a headwind for global growth due to the sanctions confrontation.

Portfolio playbook

The market seems like it's coming to the realization that inflation and the related challenges will not lift overnight, and economic conditions could deteriorate further in the next six months.

For long-term investors, we continue to recommend holding Market Weight (neutral) exposure to U.S. equities, and we would include a mix of defensive and growth stocks, with a tilt toward quality stocks. This is designed to balance lingering recession risks with the possibility that the eventual ebbing of inflationary pressures and slowing growth next year could provoke a change of heart by the Fed at some point in 2023.

Keep in mind, during periods of economic duress—often when headlines are at their worst and investor sentiment is rather negative—early hints of economic green shoots typically spark new bull market cycles even before recessions end. And the period surrounding U.S. midterm elections has historically brought some welcome surprises for the U.S. market.

UK equities downgrade: A difficult winter ahead

Frédérique Carrier – London

With the energy crisis continuing to bite and central banks becoming more aggressive, we have recently downgraded the UK and Europe to Underweight from Market Weight. We focus here on the reasons behind our downgrade of UK equities, acknowledge their cheap valuation, and conclude that while caution is warranted some attractive opportunities remain.

The energy crisis bites

While the UK is not dependent on Russian gas, which represented just four percent of total UK gas supply in 2021, the country is heavily dependent on the fuel in general and is suffering from the high prices set in international markets. Natural gas represents more than 40 percent of UK energy usage. Moreover, the 2017 closure of the UK's largest storage facility left the country in a precarious position. Remaining storage capacity of a mere 1.5 billion cubic meters, according to Ofgem, the UK's energy regulator, is insufficient for a country that consumes 77 billion cubic meters of natural gas annually.

Households are feeling the crunch of higher energy costs. On average, a household with income of £31,400 saw its energy bill increase to £2,500 currently from £1,339 last year. It was set to increase to £6,000 by next summer according to Cornwall Insight, a consultancy, a crippling level for many households and businesses.

Higher energy prices, coupled with soaring food prices and supply chain disruptions, conspired to lift UK inflation to 9.9 percent year over year in August, the highest level of G7 countries. The Bank of England (BoE), worried it would peak much higher, was one of the first central banks to take action in Q4 2021. The base rate increased to 1.75 percent from 0.1 percent in just eight months. The country is heading towards recession if it isn't already in one. Q2 GDP contracted by 0.1 percent, and sterling has fallen by 14 percent against the dollar and by 3.5 percent against the euro since the beginning of the year, despite the BoE's interest rate increases.

New government, bold announcement

Amid this economic crisis, former Prime Minister Boris Johnson resigned. During the conservative leadership campaign, Liz Truss (now the prime minister) campaigned on reforms and tax cuts and appeared little concerned about fiscal rectitude. Anyone who doubted her didn't have to wait long to see proof of her conviction as she announced a bold, if blunt, support package within days of her ascension.

Truss announced a package to cap the average annual household energy bill at £2,500 for two years. Similar, though as yet unquantified, guarantees were given to businesses and public bodies such as schools—for only six months, although extensions may be possible. A £40 billion liquidity facility for energy suppliers struggling with collateral repayments will also be made available.

The package is expensive because it is universal, covering both high- and low-income households. Targeting only the most vulnerable would have been less expensive. Though the final cost will depend on future wholesale energy price moves, initial indications of a two-year cost of £125 billion–£150 billion, or some six percent of GDP, suggest a higher price tag than that associated with the UK banks bailout during the global financial crisis (£133 billion), and more than twice that of the pandemic's furlough scheme (£70 billion) which ran for 18 months. The package, combined with promised tax decreases including a cut in National Insurance Contribution and rolling back the planned corporate tax increase to 25 percent from 19 percent, measures worth just over one percent of GDP, represent a very sizeable fiscal expansion.

Details of the financing are still scarce, which is unusual for a package of this size, and should emerge along with a mini emergency budget later this month. Swelling national debt levels should not be a surprise following Truss ruling out windfall taxes on energy companies.

We think the package removes some important downside risks to growth in the short term. Any upcoming recession may be shallower than would have otherwise been the case. With the energy bills capped, we think inflation will likely peak sooner and lower than the Bank of England's expectation of a 13 percent peak by the end of the year.

However, offering such a large stimulus package at a time inflation is so high, may incentivize the BoE to continue to hike rates aggressively. Markets currently expect peak interest rates beyond 4 percent, a level which would likely crimp future growth.

Moreover, the package, by freezing prices, also removes the incentive to reduce consumption. To the extent that high natural gas prices are due to a shortage of the commodity, the possibility of blackouts in the winter remains. The government's measures to increase supply by lifting a ban on fracking and increasing drilling in the

North Sea are not likely to have any immediate impact on scarce energy supplies, in our opinion.

New government's long-term plans

Beyond the immediate emergency measures to help the country navigate what promises to be a treacherous winter, Truss' programme aims to raise the UK's growth to 2.5 percent, from the Office for Budget Responsibility's expectation of 1.7 percent, by lowering taxes and deregulating.

Rolling back the proposed increase in corporate tax to 25 percent from 19 percent may help, although the UK already has the lowest tax rate of the G7 by far. As for deregulation, efforts may be constrained by free trade agreement requirements.

Getting this right is important to unleash growth as business investment has not returned to trend growth since the 2016 Brexit vote, nor has it bounced back to the pre COVID-19 level. A stable and clear regulatory environment would also help, as would a less volatile relationship with the country's largest trading partner, the EU.

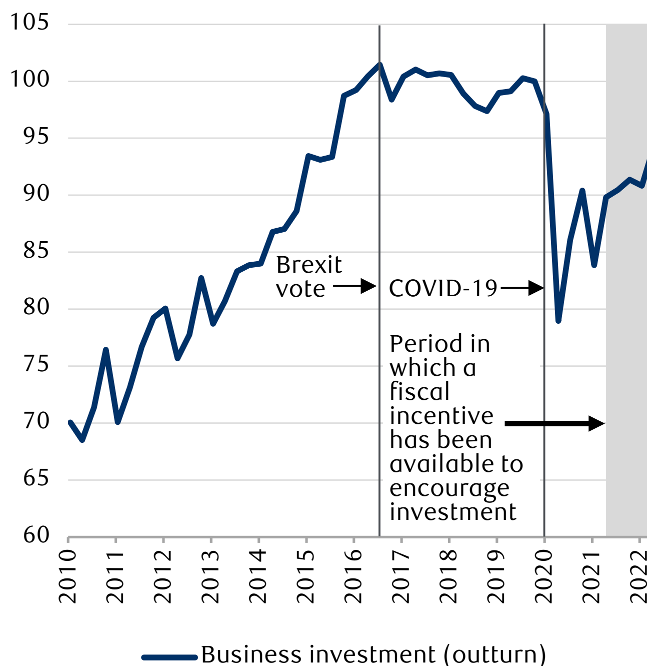
Equity strategy

Given the challenges ahead, we think it is prudent to take some profit in UK equities, which have outperformed year to date in local currency terms. We recognize the overall FTSE All-Share Index remains very cheap on an absolute and relative basis, at less than 10x next year's earnings estimate. UK equities also offer the highest dividend yield among the major regional equity markets (FTSE All-Share: four percent), a feature that may be very relevant for UK-based income-focused investors.

We maintain our strong preference for internationally oriented companies and remain cautious on UK domestics. We continue to have a strong bias to quality, resilient companies, with market-leading competitive positions and strong balance sheets. Within cyclicals, we believe there are select opportunities in companies whose valuations already largely reflect short-term recession risks but remain well positioned for medium- to long-term structural trends, such as the decarbonisation of the economy.

Thomas McGarrity, CFA contributed to this report

UK business investment struggles



Note: UK business investment (Q4 2019 = 100)

Source - Office for National Statistics, RBC Wealth Management

UNITED STATES

Alan Robinson – Seattle

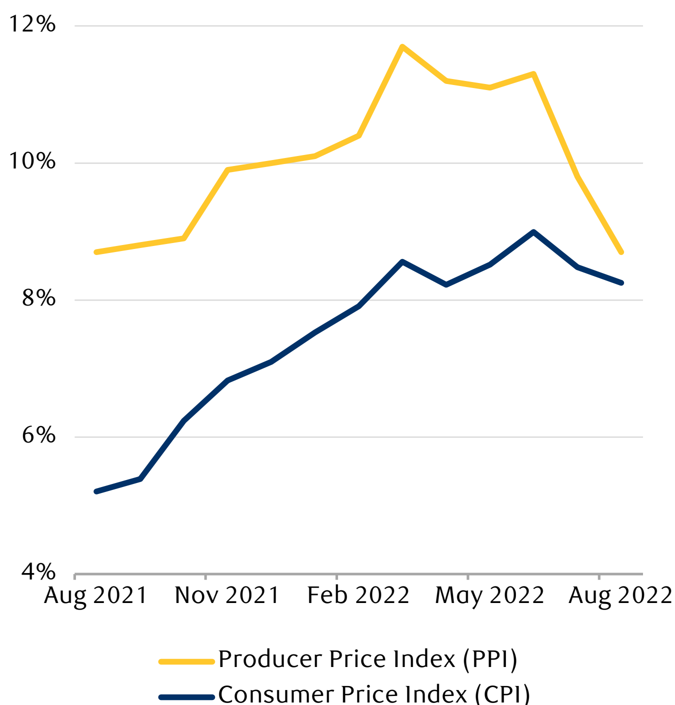
- After an initial sharp decline on Sept. 13, following the release of U.S. Consumer Price Index (CPI) data showing a rise in core prices, **the U.S. market stabilized somewhat as the week progressed**. We think this can be traced to traders taking a broader view of the data. The quarterly trend in core inflation peaked in June 2022, and several of the factors driving CPI increases are lagging measures that are at odds with more benign real-time data. **But the most positive takeaway from the week's inflation data, in our view, was found in a measure of inflation experienced at the factory door**. The Producer Price Index had been running much hotter than the CPI over the summer, but now appears to be deflating (see chart). This is important for the stock market as high input costs tend to eat into corporate profit margins.

- Traders were relieved that a looming threat to domestic supply chains was averted at the eleventh hour. **U.S. rail operators reached an agreement with their unions earlier today, ending the threat of a national rail strike** that had been due to start tomorrow. The Association of American Railroads had estimated that stopping the country's long-distance freight trains could have reduced daily economic output by more than $2 billion, or about 3%, and would have tied up about 17% of the nation's trucking capacity as freight moved to the highways. **Supply chains may not be out of the woods yet**, though, as port workers on the West Coast are still in negotiations for a new contract to replace the one that expired in June.

- Global oil prices have been subdued since their early-summer peak as G7 nations have walked a tightrope between imposing sanctions on Russian oil exports and avoiding a supply crunch. Negotiations in Washington, D.C. during the week aimed to fortify these measures by implementing **a price cap on Russian crude shipped to Asian emerging markets**, with the objective of limiting Russia's ability to fund the conflict in Ukraine while maintaining a level of stability in the global oil market. We believe continued success on this front should help keep a lid on energy-driven inflation spikes.

The Fed watches Core CPI, but CEOs watch the PPI/CPI spread*

Headline Producer & Consumer Inflation (year-over-year change)



* PPI/CPI = Producer/Consumer Price Index

Source - U.S. Bureau of Labor Statistics, RBC Wealth Management; monthly data through August 2022

CANADA

Luis Castillo & Simon Jones – Toronto

- Despite the expectation of an economic slowdown in the near term, **RBC Economics has recently updated its forecasts for upcoming central bank hikes**. In line with the market's own repricing, RBC Economics forecasts now point towards a more aggressive final stretch of hiking. The general messaging from global central banks continues to suggest full steam ahead with rate hikes, including the acceptance of economic pain in the process as the deployment of a front-loaded attack on inflation gets underway. Following a jumbo hike of 75 basis points (bps) from the Bank of Canada (BoC) earlier this month, RBC Economics is now looking for a 4% terminal BoC rate by year-end 2022 vs. 3.5% previously. With just two meetings remaining in 2022, this would imply a 50 bps hike in October followed by a 25 bps hike in December, largely in line with current bond-market positioning.

- **Canadian employment declined for a third consecutive month in August** as the labour market shed another 39,700 jobs, according to Statistics Canada, bringing the cumulative declines during that period to roughly 114,000. The employment declines, as has been the case so far this summer, were concentrated in the education sector, a sector that is understandably volatile at this time of year. We expect these losses to reverse, at least partially, in the coming months as the new school year gets underway. Unlike June and July, there was notable weakness elsewhere in the Labour Force Survey. For instance, interest-rate-sensitive sectors have begun to show signs of softening as evidenced by the sharp decline in construction sector employment, which fell by 28,000. Although the August employment declines were partially offset by gains in various service-oriented sectors, with job losses accelerating and becoming more concentrated in full-time work, it is increasingly apparent to us that the labour market has started to lose some of its forward momentum.

EUROPE

Thomas McGarrity, CFA – London

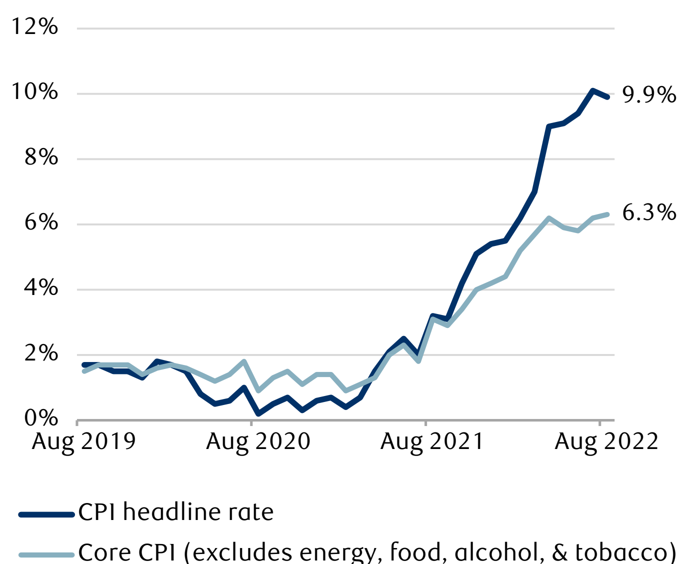
- **The European Commission (EC) published its proposed measures to address the region's energy crisis**. One key proposal on the supply side is a temporary revenue cap of €180/MWh for "inframarginal" electricity producers—those based on generating technologies with lower costs, such as renewables, nuclear, and lignite—which are providing electricity to the grid at a cost below the price level set by the more expensive "marginal" producers (i.e., natural gas power plants). The EC estimates its proposed cap would generate annual revenues of up to €117 billion for EU member states. **RBC Capital Markets European Utilities analysts regard the €180/MWh level as better than what investors may have anticipated when the EC began formulating market intervention measures**, while it provides visibility on earnings for the next few years, which should start to attract investors back to the sector. From a medium-term perspective, the critical necessity of accelerating renewable energy deployment in response to the European energy crisis supports our preference for Utilities companies with strong renewables portfolios.

- **On the demand side, the EC has proposed requiring EU member states to reduce electricity consumption by at least 5% during selected peak price hours**, while aiming to reduce overall electricity demand by at least 10% during the coming winter.

- **Headline UK CPI inflation eased back slightly to 9.9% y/y in August from 10.1% y/y in July**, mainly owing to lower fuel prices. However, core inflation continued its upward climb, increasing to 6.3% y/y from 6.2% previously.

Core inflation continues to trend upwards

UK Consumer Price Indexes (year-over-year change)



Source - Office for National Statistics, RBC Wealth Management; data through August 2022

Elsewhere on the UK data front, **the unemployment rate unexpectedly fell to 3.6%**, its lowest level since 1974. However, the drop was not primarily driven by "good reasons" (e.g., strong employment growth) but rather by **a sharp reversal in labour supply** owing to a decline in the number of available workers, with increases in long-term illness and educational enrollment both detracting from labour force participation. **Wages surprised to the upside** again, with average weekly earnings for May to July increasing by 5.5% y/y.

- Expectations for next week's Bank of England (BoE) decision on interest rates remain split between a hike of 50 basis points (bps) and a possible 75 bps increase. In light of recent inflation and labour market data, **RBC Capital Markets continues to expect the BoE to raise the UK Bank Rate by 50 bps at both its September and November meetings**.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **The Asia Pacific equity market has traded broadly lower this week**, with the MSCI Asia Pacific Index posting its worst drop in two weeks on Wednesday following hotter-than-expected U.S. inflation data. Hong Kong and China are leading the market lower during this holiday-shortened week.

- **The yen rebounded from a 24-year low of 145 against the U.S. dollar this week after Reuters reported that the Bank of Japan had conducted a rate check with banks on Wednesday**, apparently in preparation to step in to tame sharp yen declines. This latest development reflects a growing concern within the Kishida administration that the yen's rapid drop is hurting consumption as imports (especially food and fuel) become more expensive, and is affecting firms' capital expenditure decisions. However, the Reuters report noted many analysts and traders doubt an intervention, if it occurs, would provide meaningful support to the yen, especially with a more hawkish Fed.

- **China's largest banks are lowering their benchmark deposit rates across the board** for the first time since 2015. The move will reduce funding costs for borrowers, and may boost lending to support growth.

- **China's National Press and Public Administration granted publishing licences for 73 online games this week**. NetEase (9999 HK) received its first video game licence in 14 months. The Chinese regulators did not approve any commercial games from Tencent (700 HK), but one of the company's subsidiaries received a licence for an educational game. China suspended game approvals in August 2021 before resuming them in April of this year. Tencent has yet to receive an approval for the major titles in its pipeline since the suspension ended.

MARKET
Scorecard

Data as of September 14, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,946.01	-0.2%	-17.2%	-11.2%	16.6%
Dow Industrials (DJIA)	31,135.09	-1.2%	-14.3%	-10.0%	11.2%
Nasdaq	11,719.68	-0.8%	-25.1%	-22.1%	6.0%
Russell 2000	1,838.46	-0.3%	-18.1%	-16.8%	19.6%
S&P/TSX Comp	19,726.14	2.0%	-7.1%	-4.0%	20.6%
FTSE All-Share	3,996.83	-0.3%	-5.0%	-1.5%	18.7%
STOXX Europe 600	417.51	0.6%	-14.4%	-10.7%	13.3%
EURO STOXX 50	3,567.56	1.4%	-17.0%	-14.9%	7.6%
Hang Seng	18,847.10	-5.5%	-19.4%	-26.1%	-23.5%
Shanghai Comp	3,237.54	1.1%	-11.1%	-11.6%	-1.3%
Nikkei 225	27,818.62	-1.0%	-3.4%	-9.3%	18.1%
India Sensex	60,346.97	1.4%	3.6%	3.6%	55.7%
Singapore Straits Times	3,258.02	1.1%	4.3%	5.8%	31.2%
Brazil Ibovespa	110,546.67	0.9%	5.5%	-4.8%	10.2%
Mexican Bolsa IPC	46,745.15	4.1%	-12.3%	-9.8%	26.7%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.404%	21.2	189.4	212.1	273.2
Canada 10-Yr	3.160%	4.2	173.4	198.7	260.7
UK 10-Yr	3.132%	33.1	216.1	239.4	293.8
Germany 10-Yr	1.716%	17.5	189.3	205.6	219.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.25%	-1.5%	-12.1%	-13.2%	-13.1%
U.S. Investment-Grade Corp	5.07%	-1.4%	-15.4%	-16.7%	-14.4%
U.S. High-Yield Corp	8.42%	0.4%	-10.9%	-10.7%	-0.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,697.06	-0.8%	-7.2%	-6.0%	-13.3%
Silver (spot $/oz)	19.63	9.1%	-15.8%	-17.7%	-27.6%
Copper ($/metric ton)	7,994.25	1.9%	-17.9%	-15.2%	17.3%
Oil (WTI spot/bbl)	88.48	-1.2%	14.9%	25.6%	137.5%
Oil (Brent spot/bbl)	94.57	-2.0%	21.6%	28.5%	138.8%
Natural Gas ($/mmBtu)	9.11	-0.1%	144.3%	73.3%	294.5%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	109.6540	0.9%	14.6%	18.4%	17.8%
CAD/USD	0.7597	-0.2%	-4.0%	-3.6%	0.1%
USD/CAD	1.3164	0.3%	4.2%	3.7%	-0.1%
EUR/USD	0.9977	-0.8%	-12.3%	-15.5%	-15.9%
GBP/USD	1.1542	-0.7%	-14.7%	-16.4%	-10.2%
AUD/USD	0.6748	-1.4%	-7.1%	-7.8%	-7.4%
USD/JPY	143.1400	3.0%	24.4%	30.5%	35.4%
EUR/JPY	142.8400	2.2%	9.1%	10.3%	13.9%
EUR/GBP	0.8644	-0.1%	2.7%	1.1%	-6.4%
EUR/CHF	0.9602	-2.3%	-7.4%	-11.6%	-10.9%
USD/SGD	1.4061	0.6%	4.2%	4.6%	3.1%
USD/CNY	6.9618	1.0%	9.5%	8.1%	2.2%
USD/MXN	19.9603	-0.9%	-2.8%	0.2%	-5.4%
USD/BRL	5.1640	-0.4%	-7.4%	-1.5%	-2.0%

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 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -4.0% return means the Canadian dollar fell 4.0% vs. the U.S. dollar year to date. USD/JPY 143.14 means 1 U.S. dollar will buy 143.14 yen. USD/JPY 24.4% return means the U.S. dollar rose 24.4% vs. the yen year to date.

Source - Bloomberg; data as of 9/14/22 5:25 p.m. ET

Authors

Kelly Bogdanova – San Francisco, United States
kelly.bogdanova@rbc.com; RBC Capital Markets, LLC

Frédérique Carrier – London, United Kingdom
frederique.carrier@rbc.com; RBC Europe Limited

Thomas McGarrity, CFA – London, United Kingdom
thomas.mcgarrity@rbc.com; RBC Europe Limited

Alan Robinson – Seattle, United States
alan.robinson@rbc.com; RBC Capital Markets, LLC

Luis Castillo – Toronto, Canada
luis.castillo@rbccm.com; RBC Dominion Securities Inc.

Simon Jones – Toronto, Canada
simon.jones@rbccm.com; RBC Dominion Securities Inc.

Nicholas Gwee, CFA – Singapore
nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

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Distribution of ratings – RBC Capital Markets Equity Research
As of June 30, 2022

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