GLOBAL Insight WEEKLY

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

September 22, 2022

Committed to commitment?

Thomas Garretson, CFA – Minneapolis

The Fed remains full of surprises, and full of commitment, as policymakers continue to stare down inflation in the face of a deteriorating economic backdrop—both domestically and globally. But on the back of yet another supersized rate hike, U.S. fixed income yields have rarely looked better to us.

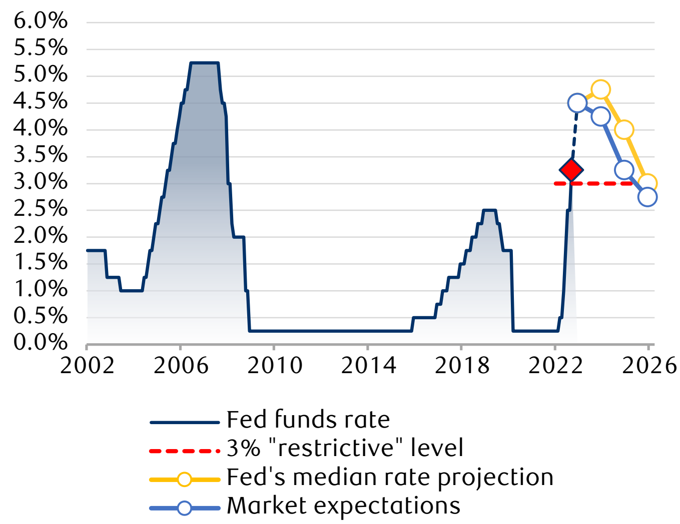
The Federal Reserve continues to march to the beat of its own drum, with another outsized rate hike, and a supercharged rate outlook, but it's the impact of those rate hikes on the economy that was our focus at this week's policy meeting. As Fed Chair Jerome Powell stated in his August speech at the Jackson Hole Economic Symposium, there would likely be some "pain" ahead for consumers, and the Fed's latest outlook suggests just that.

A recession by any other name would smell just as awful

The Fed remains hopeful of engineering a "growth recession" according to its updated projections and Powell's post-meeting press conference. Market reaction was less optimistic as equities sold off sharply and various Treasury yield curve measures dropped deeper into inversion, suggesting to us that another round of economic "hard landing" fears will likely rattle markets in the weeks and months ahead.

So how much pain might higher rates inflict? As the chart shows, following this week's 75 basis point (bps) hike to an upper bound of 3.25 percent and into "restrictive" territory as judged by Powell, the Fed now envisions raising rates to around 4.5 percent by the end of this year, and to 4.75 percent sometime next year—both levels handily exceeding our, and seemingly everyone's, expectations.

Market agrees with the Fed's near-term rate hike outlook, but sees earlier and deeper rate cuts



Source - RBC Wealth Management, Bloomberg; market expectations based on fed funds futures data; restrictive level based on the upper range of Fed's longer-run rate projection

That outlook is now at the heart of the Fed's hoped-for "growth recession": below-potential growth, which the Fed still judges to be 1.8 percent, for a stretch with real growth expected at just 1.2 percent next year and 1.7 percent in 2024, before economic growth returns to 1.8 percent in 2025, likely as a result of the rate *cuts* the Fed also

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

has penciled into its projections. On the back of that, unemployment is seen rising to 4.4 percent in both 2023 and 2024, before dropping back to 4.3 percent in 2025; all levels above the Fed's estimate of "full employment" of 4.0 percent, while inflation is seen falling to the 2.0 percent goal by 2025. So then—not great, but could be worse.

Wait, will it be worse?

If we take the Fed at its word, and there's little reason not to over the near term even if we have more concerns about the long term than policymakers do, and rates rise to 4.5 percent by December—that's 425 bps of policy tightening over a span of just nine months.

Needless to say, there's little precedent for that outside of the Volcker era of the 1980s. While some may argue rates remain historically low, it's the magnitude of the hikes that matters, in our view, particularly given the lagged impact of monetary policy on the economy. We believe policymakers will ultimately take that into consideration as this rate hike cycle nears its end.

And to that end, RBC Economics maintains a more cautious outlook with a mild recession expected in early 2023 that gives way to unemployment rates closer to 5.0 percent, before the Fed delivers rate cuts in the back half of next year. But even if the Fed might not come out and say it—that kind of scenario may actually be its goal, in our view. As Powell stressed in his press conference, returning price stability to the economy sooner rather than later should ultimately set the stage for a longer and more sustainable expansion, of the variety that we have seen for much of the past three decades.

The upside of up

But while still-high inflation has meant that questions remain about whether the Fed will succeed in bringing inflation down, markets have spoken. In March, when the Fed began its rate hike campaign, the Treasury Inflation-Protected Securities (TIPS) market traded with expectations that inflation would be nearly 5.0 percent over the next two years; today that expectation is just 2.4 percent. The same is true across the entirety of the TIPS yield curve. The top chart shows how real yields available to investors have shifted since March and are now not only above zero percent but also at the highest levels since 2009.

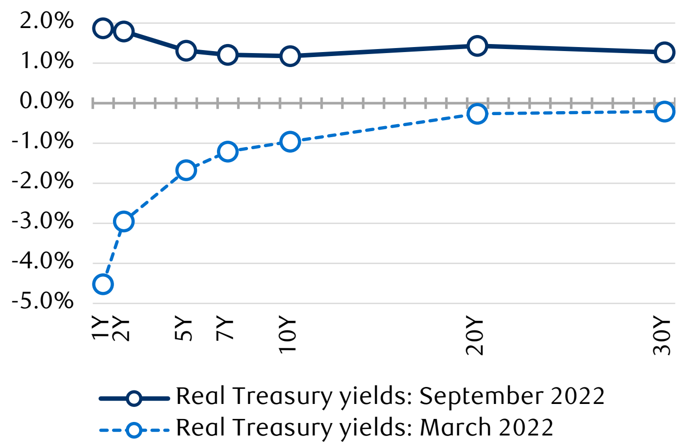
For example, the nominal two-year Treasury yielded about 2.0 percent at the end of March, but as noted above, expected inflation baked into markets was nearly 5.0 percent, for a "real" yield of minus 3.0 percent. That has since flipped—the two-year nominal Treasury now yields 4.1 percent with expected inflation of just 2.4 percent, for a real yield of nearly 2.0 percent, something rarely seen in recent decades and which we believe should begin to attract the attention of investors.

But wait, there's more

As the bottom chart shows, the Fed's efforts thus far have increased the potential return of U.S. fixed income across a wide swath of sectors, with yields at or near decade highs. Investment-grade corporate bonds now yield 5.2 percent compared to a 20-year average of just 4.3 percent.

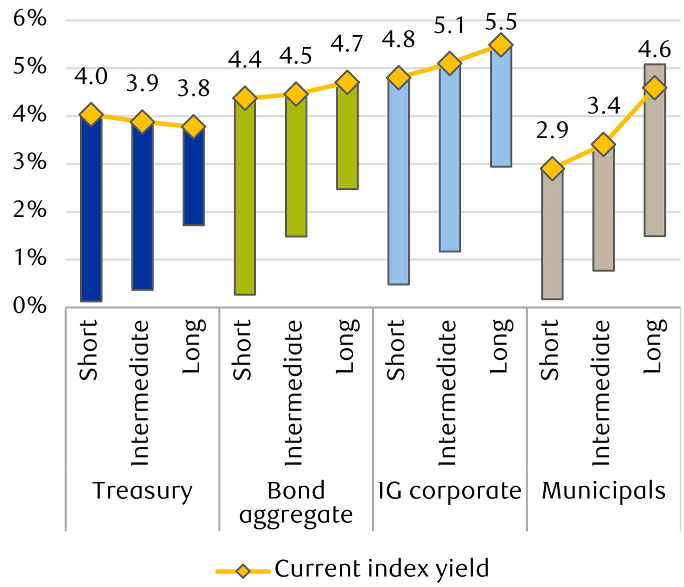
After being passed over by investors for much of the past decade, and perhaps rightly so given the anemic potential returns, we believe fixed income just might make sense again for a broader set of investors with yields at historically attractive levels. But as noted above with respect to rate hikes, and the potential for rate cuts: here today, gone tomorrow. Our base case remains that slowing global growth will ultimately force the Fed's hand, with the central bank bringing the rate hike cycle to an end this year, and at a level below 4.5 percent.

Real Treasury yields, adjusted for expected inflation, exceed 1% across the curve, highest levels since 2009



Source - RBC Wealth Management, Bloomberg

The Fed's aggressive rate hike campaign has translated to decade-high yields for much of U.S. fixed income



Note: Bars show 10-year range of yields ex 2020

Source - RBC Wealth Management, Bloomberg Bond Indexes

UNITED STATES

Ben Graham, CFA – Minneapolis

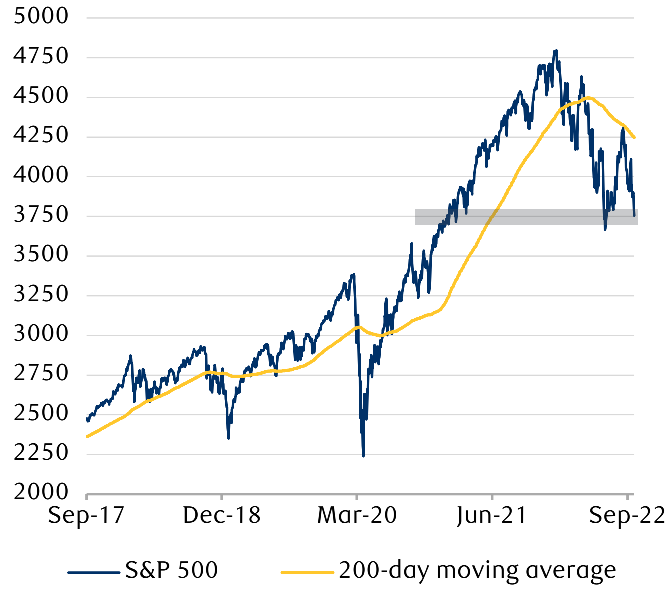
- **U.S. equities are broadly lower in reaction to the Federal Reserve's announcement of another rate hike**, as well as the messaging after its meeting concluded on Wednesday; the S&P 500 re-entered bear market territory with a 21% YTD decline as of 10:30 am ET Thursday morning. Leadership has been purely relative, as the Dow Jones has declined 2.3% so far this week and the S&P 500 is down 2.7%. The Nasdaq and Russell 2000 are even worse, with each trading about 4% lower. Sector leadership has been evident in Consumer Staples, Utilities, and Energy (where weekly declines have been the smallest), while the worst-performing pockets of the U.S. market have been Real Estate, Consumer Discretionary, and Financials.

- Technically speaking, the week's moves have renewed concerns around where the equity market will bottom this cycle. **It's still too early to know whether the June 2022 lows will hold, according to RBC Capital Markets, LLC Technical Strategist Rob Sluymer**. However, the broader point is that we believe the 3700–3800 range to be critical because the next level of support, should that range be broken, is near 3500 for the S&P 500. A value of 3500 would represent a further 6% to 7% contraction from today's levels. Similar trends are in place for the Nasdaq and the Russell 2000, with the bottom line being that the direction of U.S. equities in the next few weeks will be telling for where stocks ultimately wind up at year's end, in our view.

- Economically speaking, the Fed's 75 basis point rate hike, which brought the federal funds rate into a range of 3.0% to 3.25%, was the highlight of the week. **However, other data showed incremental strength in the economy, particularly in the housing market**. Noisy August new home sales sharply reversed July's contraction, as the 12.2% increase surprised relative to consensus expectations by nearly 10 percentage points. In the context of July's 10.9% m/m decline, we think it's fair to say that volatility in the housing market is on the rise. Additionally, **initial unemployment claims held steady at 213,000**, coming in below the consensus expectation of 220,000.

U.S. equities are at a key level

S&P 500 and its 200 day moving average, 5 years



Note: Gray bar represents the key range of 3700 to 3800

Source - RBC Wealth Management, FactSet; data through 11:15 am ET, 9/22/22

CANADA

Sean Killin & Richard Tan, CFA – Toronto

- **Canadian inflationary pressures decelerated more sharply than anticipated in August, with headline CPI registering a 7.0% y/y increase, 0.3 percentage points below consensus estimates**. This marks the second consecutive month of slowing headline inflation, down from 7.6% in July. Falling energy prices as a result of a slowing global economy were the main driver of cooling headline inflation, and have subsequently been reflected in transportation costs across the board. The downward trend in headline CPI increases could be a sign that inflation peaked in June; however, the trend in Core CPI (which excludes the more volatile energy and food prices) has moderated only slightly. Core inflation dropped to 5.7% y/y in August from 6.0% in July, but remains well above the target range at which the Bank of Canada (BoC) would ease up on tightening monetary policy, in our view.

- Alongside elevated inflation, **rising interest rates have been another key headwind for the financial markets**. Following the BoC's September rate hike of 75 basis points (bps), the overnight policy rate now sits at 3.25%, having risen 300 bps since the beginning of the year. As we approach the end of 2022, the futures market is pricing in a terminal rate of approximately 4%, implying another 75 bps of rate hikes are still on the table. Accordingly, **we believe upside for risk-on assets such as stocks will likely be capped in the near term**. However, we also acknowledge the S&P/TSX Composite is trading around 12x forward earnings, a sizeable discount to its long-term average of approximately 15x. Furthermore, Canadian equities are trading at a wider-than-normal discount versus U.S. equities, and thus we continue to see good value in staying invested. **Overall, we believe a slowing economic backdrop is well reflected in the S&P/TSX Composite, and we maintain our Market Weight (neutral) stance on Canadian equities**.

EUROPE

Frédérique Carrier & Rufaro Chiriseri, CFA – London

- On Friday, Sept. 21, **new UK Chancellor Kwasi Kwarteng will announce an emergency budget that is widely expected to shed light on the total cost of the recently announced energy support package**—and how the government proposes to finance it. Tax cuts promised by Prime Minister Liz Truss are also likely to figure in the budget, and could include a cut to the national insurance contribution, the reversal of a planned corporation tax increase, a reduction of the tax on new home purchases, and broader national tax breaks intended to stimulate corporate investment.

- The new UK government believes lowering taxes will spur economic growth. Financial markets worry that a large fiscal stimulus at a time when inflation is already high could worsen the country's economic situation. **The pound reached a low against the dollar of 1.1270, firmly below its low in the wake of the 2016 Brexit referendum**. The domestic challenges the UK faces mean we continue to favor internationally oriented companies.

- **The Bank of England (BoE) increased its benchmark rate by 50 basis points (bps) to 2.25%** on Thursday, disappointing the market, which had priced in a larger hike. Following the decision, market expectations for the year-end Bank Rate dropped from 3.75% to 3.60%, implying 135 bps of additional tightening during the rest of 2022. **Our base case is approximately 100 bps of tightening this year as the BoE forecasts inflation peaking at 11% in October, down slightly from the prior forecast of 13%**. There are risks to our base case scenario and further tightening may be required, as the Monetary Policy Committee (MPC) statement highlighted the possibility that the energy price freeze could "limit the reduction" in household spending and the deep recession predicted in August may be less severe than expected. The MPC further stated these fiscal measures are material for the economic outlook, and it would fully assess implications at its November meeting.

- **Despite the large increases in government borrowing, the BoE voted to begin reducing government bond holdings by £80 billion over the next 12 months**, starting Oct. 3. This amount is consistent with the announcement at the central bank's August meeting.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- The Asia Pacific equity market traded broadly lower during the week. **The MSCI Asia Pacific Index currently trades at its lowest level since mid-2020**. The Asia market saw a broad selloff on Thursday after the Federal Reserve raised U.S. interest rates by 75 basis points (bps) and indicated it plans another hike of the same magnitude in November. The Fed's year-end rate forecasts for 2022 and 2023 were also higher than consensus expectations, dashing hopes of some easing in late 2023. Meanwhile, **the Hang Seng Index fell to its lowest level since late 2011** this week on the back of rising U.S.-China tensions and the latest Fed move.

- **The Bank of Japan (BoJ) stayed on hold, keeping its yield curve control policy and asset purchase program unchanged**. The yen weakened further against the U.S. dollar following the BoJ's announcement, falling to its lowest level since 1998. The decision may indicate the BoJ is unlikely to shift its monetary policy before Governor Kuroda's term ends in April 2023. That said, we expect political pressure from the weakening yen to continue to mount. Meanwhile, Japan's August consumer prices rose 3%, while the CPI excluding fresh food increased 2.8%, both coming in hotter than expected.

- **HSBC Holdings plc (5 HK), one of the largest lenders in Hong Kong, raised its main lending rate in Hong Kong for the first time in four years**, increasing borrowing costs for property owners and businesses at a time when the economy is struggling with COVID-19 restrictions and an outflow of talent. HSBC increased its prime rate by 12.5 bps to 5.125% and warned of more increases to come. The move came hours after **the Hong Kong Monetary Authority raised its base rate by 75 bps**, keeping in step with the Fed.

Bank of Japan stayed on hold leading the yen to weaken further against the U.S. dollar to lowest level since 1998

USD/JPY daily prices

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

MARKET Scorecard

Data as of September 21, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,789.93	-4.2%	-20.5%	-13.0%	15.5%
Dow Industrials (DJIA)	30,183.78	-4.2%	-16.9%	-11.0%	11.2%
Nasdaq	11,220.19	-5.0%	-28.3%	-23.9%	4.1%
Russell 2000	1,762.16	-4.4%	-21.5%	-19.4%	18.6%
S&P/TSX Comp	19,184.54	-0.8%	-9.6%	-5.2%	20.0%
FTSE All-Share	3,973.75	-0.8%	-5.6%	-1.4%	22.6%
STOXX Europe 600	407.05	-1.9%	-16.6%	-11.3%	14.1%
EURO STOXX 50	3,491.87	-0.7%	-18.8%	-14.8%	10.5%
Hang Seng	18,444.62	-7.6%	-21.2%	-23.9%	-23.0%
Shanghai Comp	3,117.18	-2.7%	-14.4%	-13.7%	-6.0%
Nikkei 225	27,313.13	-2.8%	-5.1%	-8.5%	16.9%
India Sensex	59,456.78	-0.1%	2.1%	0.8%	56.3%
Singapore Straits Times	3,261.79	1.2%	4.4%	6.5%	31.2%
Brazil Ibovespa	111,935.86	2.2%	6.8%	1.5%	15.4%
Mexican Bolsa IPC	46,992.51	4.6%	-11.8%	-7.5%	32.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.528%	33.5	201.8	220.5	286.2
Canada 10-Yr	3.035%	-8.3	160.9	180.7	248.4
UK 10-Yr	3.311%	51.0	234.0	250.4	315.4
Germany 10-Yr	1.893%	35.2	207.0	221.0	242.3
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.44%	-2.4%	-12.9%	-13.8%	-13.8%
U.S. Investment-Grade Corp	5.24%	-2.4%	-16.3%	-17.3%	-15.1%
U.S. High-Yield Corp	8.79%	-1.0%	-12.1%	-11.7%	-1.7%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,673.83	-2.2%	-8.5%	-5.7%	-12.5%
Silver (spot $/oz)	19.54	8.6%	-16.2%	-13.1%	-20.9%
Copper ($/metric ton)	7,826.00	-0.2%	-19.7%	-12.9%	16.5%
Oil (WTI spot/bbl)	83.44	-6.8%	8.4%	18.3%	112.3%
Oil (Brent spot/bbl)	89.96	-6.8%	15.7%	21.0%	117.1%
Natural Gas ($/mmBtu)	7.78	-14.8%	108.6%	61.9%	324.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	111.3040	2.4%	16.3%	19.4%	18.8%
CAD/USD	0.7429	-2.5%	-6.1%	-4.8%	-1.1%
USD/CAD	1.3460	2.5%	6.5%	5.0%	1.1%
EUR/USD	0.9844	-2.1%	-13.4%	-16.0%	-16.4%
GBP/USD	1.1275	-3.0%	-16.7%	-17.5%	-12.0%
AUD/USD	0.6629	-3.1%	-8.7%	-8.3%	-8.2%
USD/JPY	144.0500	3.7%	25.2%	31.9%	37.6%
EUR/JPY	141.8400	1.5%	8.4%	10.7%	15.1%
EUR/GBP	0.8731	0.9%	3.8%	1.7%	-4.9%
EUR/CHF	0.9519	-3.2%	-8.3%	-12.1%	-11.6%
USD/SGD	1.4174	1.5%	5.1%	4.8%	4.1%
USD/CNY	7.0502	2.3%	10.9%	9.0%	3.6%
USD/MXN	20.0206	-0.6%	-2.5%	-0.6%	-6.2%
USD/BRL	5.1742	-0.2%	-7.2%	-1.9%	-4.4%

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 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -6.1% return means the Canadian dollar fell 6.1% vs. the U.S. dollar year to date. USD/JPY 144.05 means 1 U.S. dollar will buy 144.05 yen. USD/JPY 25.2% return means the U.S. dollar rose 25.2% vs. the yen year to date.

Source - Bloomberg; data as of 9/21/22

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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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