GLOBAL
Insight
WEEKLY

Perspectives from the Global Portfolio Advisory Committee

September 29, 2022

The myth of the bond vigilante

Atul Bhatia, CFA – Minneapolis

The British pound's recent slide against the U.S. dollar amid turmoil in the UK bond market highlighted the relationship between government debt and currency markets. In an environment of heightened volatility, what are the near-term risks for investors?

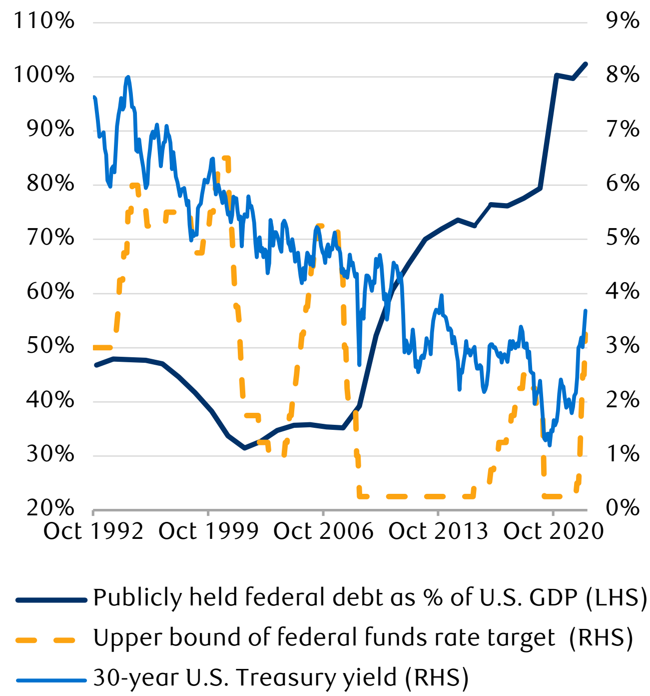
Bond-market investors often like to portray themselves as the trail bosses of financial markets, riding herd on profligate politicians. This narrative is often punctuated with references to "bond vigilantes," a term coined in the late 1980s to describe the role of the Treasury market in containing government spending, and a nod to James Carville's famous wish that he be reincarnated as the bond market because then "[I] can intimidate everybody."

The truth, of course, is much less heroic. Bond markets in 2017 easily funded an Argentine century bond—a 100-year obligation from a country that had defaulted eight times since independence and had not gone thirty years without defaulting since 1950. In 2020, Argentina experienced its ninth default and instead of a century, the bond survived only three years. This lack of effective oversight has not been confined to emerging markets; global investors have been willing to lend the U.S. government money at ever-lower interest rates even as total debt rose, culminating in investors holding claims of roughly $23 trillion at yields below two percent. Fed policy, not debt levels, is what pushed yields higher.

The myth of the bond vigilante has been dusted off following recent events in the United Kingdom. The British pound dropped five percent against the U.S. dollar in the days after the incoming UK government unveiled an updated budget heavy with tax cuts and additional spending. Yields on British government 10-year bonds

Vigilantism done wrong

Yields fall as debt rises; Fed policy, not investors, pulls rates higher



Source - RBC Wealth Management, Bloomberg; data through 9/28/22

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

increased by over one percentage point in three trading sessions, prompting the Bank of England to step in to stabilize the market. These dislocations—which impacted bond prices globally—have prompted press commentary on the potential for a similar move in the U.S. Treasury market.

We believe there is little near-term risk that bond investors will meaningfully constrain U.S. government spending. Instead, we expect bond markets will maintain the permissive attitude toward the U.S. that has characterized the past 30 years, guided by the ongoing—and potentially growing—demand for dollar reserves and the enhanced role of the Federal Reserve in the Treasury market.

Bonds are the tail, currency is the dog

Far from being the market that runs the world, bonds are in many ways a sideshow to currency markets. In 2019, an average of $600 billion worth of Treasuries changed hands every day—a respectable amount, certainly, but far short of the nearly 5.8 trillion U.S. dollars traded daily in global foreign exchange markets.

The U.S. dollar is ubiquitous in international finance. It dominates trade, with essentially all commodities and nearly 40 percent of overall international commercial transactions settled in dollars, according to the International Monetary Fund (IMF). Not coincidentally, the vast majority of central banks choose to hold at least part of their international reserves in dollars, given its proven acceptability to sellers of oil, food, and other critical inputs.

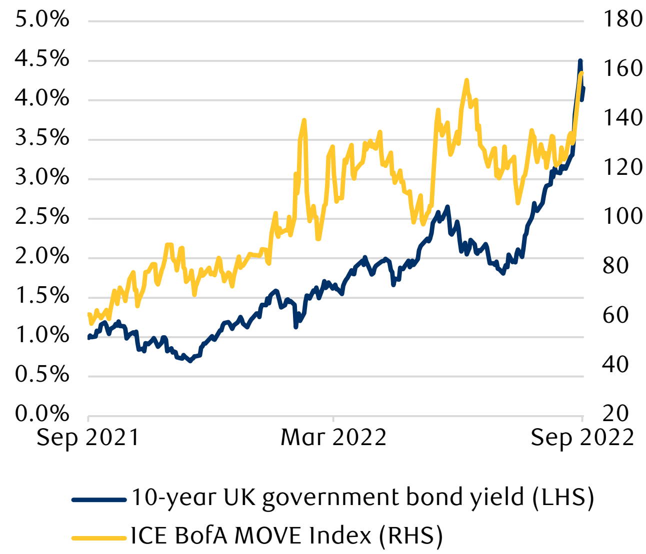
But central bankers—as well as large institutions and corporations that maintain dollar safety reserves—need a place to stash their greenbacks. Commercial banks are not an option, because reserves are designed to be a safety net in a crisis, and even large banks carry credit risk. Instead, these institutions look to U.S. Treasury bonds, which are ultimately backed by the ability to tax the world's largest economy. Just as importantly, even long-maturity Treasuries are easily converted to ready money, and U.S. government securities have historically appreciated during crisis periods as global investors shift their focus from the return *on* capital to the return *of* capital.

This means the appetite for U.S. dollar reserves creates a concurrent demand for U.S. Treasury bonds that can become self-fulfilling. Many investors think the U.S. government creates a budget of needed projects, subtracts tax revenues, and then taps bond markets to fund the difference; to some extent, that's true. But the funding mechanism is a two-way street. Reserve holders, anxious to hold U.S. government obligations, buy up available bonds, pushing yields lower and allowing the U.S. to fund an ever-expanding list of projects.

This effect is not small. According to the IMF, more than $7 trillion in official reserves were held in dollars at the end of 2021, compared to roughly $23 trillion in outstanding U.S. Treasury debt. This means that roughly one-third of tradeable U.S. government debt is held not by potential vigilantes, but by policymakers locked into their holdings as a result of other policy choices. With the Fed holding a similar amount, the idea of market control over spending looks increasingly difficult to sustain.

Treasury market volatility rises alongside UK gilt yields

Implied volatility of U.S. bond options



Source - RBC Wealth Management, Bloomberg; data through 9/29/22

The dollar is not going anywhere for now

We do not believe the dollar is at risk of losing its status as the world's preferred reserve currency in the near future, in large part because no viable alternative is readily apparent. In fact, we believe that the global COVID-19 pandemic and the supply chain weaknesses it has exposed will likely increase demand for dollar reserves in the short term, adding additional price-insensitive bond buyers. Over time, reserves may migrate toward a basket of other currencies, but for now we believe reserve migration will be more than offset by larger reserve holdings across the supply chain.

Nor is the Fed likely to retreat from the bond market. Although the central bank has embarked on a process of reducing its holdings, it has established an ongoing presence in the Treasury market. Even the current balance sheet reduction program is designed to gradually slow and maintain a critical reserve of Treasury holdings on the Fed's balance sheet.

Seeing the world as it is, not as it should be

It may be comforting to imagine living in the world of economics textbooks, where creditors carefully evaluate a country's fiscal and monetary trajectories, and yield moves provide real-time collective feedback. In the real world, however, the Fed's presence and the collective desire of institutions and individuals to hold dollars as a safety reserve means, for good or ill, that the U.S. faces little near-term risk of bond vigilantes taking control of the budget—or the yield curve.

UNITED STATES

Tyler Frawley, CFA – Minneapolis

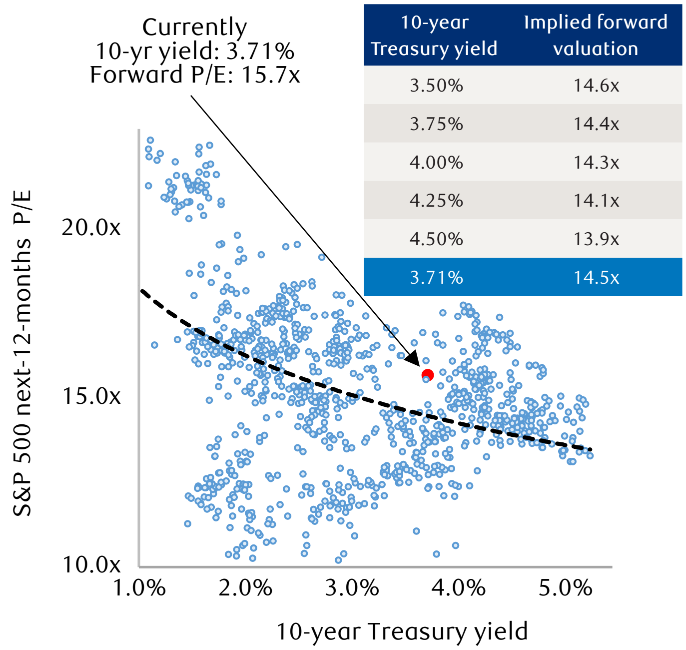
- **U.S. equities are moderately lower on the week**, following last week's 4.65% decline on the S&P 500, as **investors continue to digest tightening financial conditions as central banks worldwide continue their aggressive rate hiking cycles**. All the major indexes are lower, but the Dow Jones Industrial Average has performed the best, falling only 1.56%. Sector leadership is evident in Energy, which is 2.60% higher on the week. The Utilities sector has lagged, falling 6.28%, as rising Treasury yields have likely pushed some income-seeking investors to reallocate funds into bonds.

- **Despite falling considerably since the beginning of the year, U.S. equity markets may have additional downside**, in our view, even if earnings hold up. When looking at the relationship between corporate earnings and the S&P 500 over the past 20 years, we see that **as 10-year Treasury yields rise, valuation multiples, such as the price-to-earnings (P/E) ratio, tend to fall**. With the 10-year Treasury yield sitting near 3.71%, we could expect forward valuation to be approximately 14.5x next year's consensus earnings estimate. If that were to occur, it would represent approximately 7.6% downside from current levels. If we take RBC Capital Markets, LLC's Head of U.S. Equity Strategy Lori Calvasina's 2023 S&P 500 earnings per share estimate of $212—which is more conservative than the consensus estimate of $242—and apply the same 14.5x multiple, we get to roughly 3,050 on the S&P 500, representing approximately 17% downside from current levels. This leads us to believe that, given the recent spike in 10-year Treasury yields, valuation multiples may continue to pressure equity indexes, and it will be important to continue monitoring the situation for the remainder of the year and into 2023.

- It has been a relatively light week in terms of economic data. On Tuesday, the FHFA House Price Index, which measures changes in single-family home values, was released and showed that home prices rose 13.9% y/y in July, but fell 0.6% from their June levels. This was the first monthly decline in home prices since May 2020 as **rising mortgage rates and a challenging macroeconomic environment continue to weigh on housing affordability**.

As Treasury yields rise, the forward P/E multiple tends to fall

10-year Treasury yield versus forward valuation



10-year Treasury yield	Implied forward valuation
3.50%	14.6x
3.75%	14.4x
4.00%	14.3x
4.25%	14.1x
4.50%	13.9x
3.71%	14.5x

Source - RBC Wealth Management, FactSet; data range: 9/27/02–9/28/22

CANADA

Matt Altro & Mila Krunic – Toronto

- **The Canadian dollar has declined by roughly 8% against its U.S. counterpart so far this year, and is now trading at approximately US$0.73, its lowest level in more than two years**. The weakness in the loonie has occurred in an environment of broad-based U.S. dollar strength, as aggressive rate hikes by the Federal Reserve and demand by investors seeking refuge from heightened financial market volatility have bolstered the greenback. **Nevertheless, it is worth noting that the loonie has held up much better than many other major currencies**, thanks in part to Canada's relatively stronger economy and the Bank of Canada largely matching the Fed in the pace and scale of rate hikes. The yen, British pound, and euro have depreciated between 14% and 25% relative to the U.S. dollar year to date. While the weakening loonie should help make Canadian exports to the U.S. more competitive, it could also feed through to higher prices for imports, adding to inflationary pressures.

- **The Organisation for Economic Co-operation and Development (OECD)**, in an Economic Outlook Interim Report released on Monday, stated it **expects the Bank of Canada to raise its policy rate to 4.5% in 2023**; Canada's Financial Post reported this would be 50 basis points (bps) above consensus expectations. The OECD also reduced its Canadian GDP growth forecast for 2023 to 1.5%, down from 2.6% in June, and cut its projection for global economic growth amid ongoing monetary policy tightening by major central banks and intensifying conflict in Ukraine. The latter has provoked a severe energy and inflation crunch in Europe that is a major source of downward pressure for the world economy. **Although the fading of pandemic-related disruptions should boost economic activity, a challenging macro backdrop suggests global growth is likely to remain subdued through the remainder of the year**. Moreover, the OECD trimmed its 2023 global growth forecast to 2.2%, down from 2.8% in June, underscoring the fact that generalized tightening of monetary policy in response to persistently elevated inflation across most major economies remains a headwind.

EUROPE

Rufaro Chiriseri, CFA & Blaine Karbonik, CFA – London

- **The UK government's latest Growth Plan**, which involves unfunded tax cuts and threatens long-term debt sustainability, attracted wide criticism, including from the International Monetary Fund.

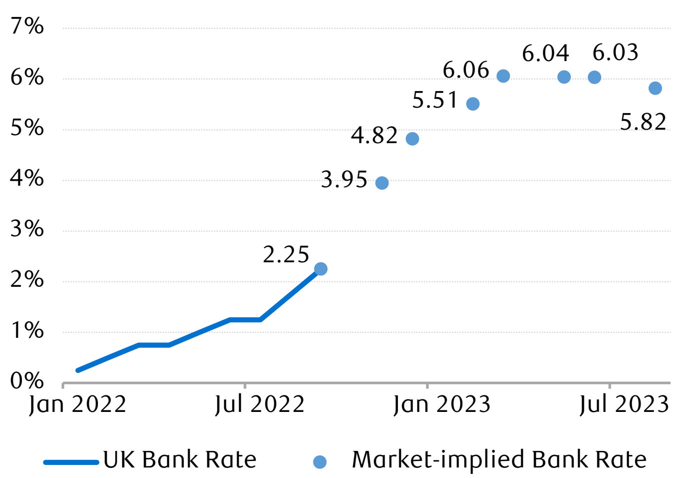
- **30-year Gilt yields surged by 115 basis points (bps) to 5.14% after the announcement of the Growth Plan, a level not seen since June 2002**. The move was initially due to concerns about the policy but was likely exacerbated by pension fund cash needs. These funds are the largest holders of government bonds, and **the rapid fall in asset prices may have caused some fund managers to sell Gilts to raise cash for collateral requirements, pushing yields even higher**. In order to restore orderly market conditions, the Bank of England (BoE) started purchasing longer-maturity bonds. It announced it will do so until mid-October, giving Gilts some temporary reprieve as the 30-year Gilt yield fell back to 3.92% in the hours following the announcement.

- Unfortunately, we believe the root cause of the problem—which is the loss of confidence in UK fiscal policy—will not be addressed by this intervention, and **we expect increased pressure on Gilt yields in the near term**. We see an increased likelihood for a jumbo rate hike of at least 100 bps at the BoE's Nov. 3 meeting; current market pricing reflects a possible 150 bps hike.

- **The government's fiscal policy also severely affected the pound, which fell to a record low of $1.04 GBPUSD** before recovering to around $1.08 GBPUSD. Sterling's weakness comes despite the move higher in interest rates, causing some market participants to draw comparisons to an emerging market currency with a growing risk premium. **The pound remains vulnerable, in our view**, and it's unclear to us if monetary policy intervention by itself can stem the rout.

UK interest rates expected to rise significantly

UK base rate



Source - RBC Wealth Management, Bloomberg; data as of 9:45 am ET 9/29/22

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Asia equities have been in risk-off mode this week** as the strong U.S. dollar, the Federal Reserve's hawkish stance, and a rising concern of global recessions have dented risk appetite. The MSCI Asia Pacific Index dropped 3.8% in the first three days of the week. South Korea and Taiwan equities have been the worst performers in the region as the countries' heavy reliance on exports could be hurt by a slowdown of global demand.

- **China's total industrial profits contracted 2.1% y/y from January to August** (vs. -1.1% y/y in the January–July period). Downstream industries saw better profit recovery compared with upstream industries. The National Bureau of Statistics highlighted that among downstream industries, the automobile sector saw better profit growth in August on the back of policy support. In addition, the electric power sector recorded significant improvement in profits due to strong electricity demand. It is encouraging to see some recovery of certain industries. However, we think the recovery trend will remain bumpy as rising external uncertainties and elevated operating costs may continue to weigh on the Industrials sector.

- **The People's Bank of China (PBoC) issued a statement yesterday emphasizing the importance of maintaining a stable exchange rate**. The central bank warned against betting on a one-sided movement of the yuan. While the PBoC attempts to restrain the rise of USD/CNY by setting the daily reference rate for the yuan at a level stronger than the average consensus estimate, there is no sign of setting a strict cap. Although the U.S. dollar's strength appears to be the key reason for the yuan's decline above 7 against the dollar, we believe the yuan will stay weak as China's economic outlook remains uncertain.

MARKET Scorecard

Data as of September 28, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,719.04	-6.0%	-22.0%	-14.6%	11.0%
Dow Industrials (DJIA)	29,683.74	-5.8%	-18.3%	-13.5%	7.6%
Nasdaq	11,051.64	-6.5%	-29.4%	-24.0%	-0.6%
Russell 2000	1,715.24	-7.0%	-23.6%	-23.1%	13.6%
S&P/TSX Comp	18,648.92	-3.5%	-12.1%	-7.6%	14.8%
FTSE All-Share	3,820.23	-4.7%	-9.2%	-5.3%	15.3%
STOXX Europe 600	389.41	-6.2%	-20.2%	-13.9%	7.2%
EURO STOXX 50	3,335.30	-5.2%	-22.4%	-17.8%	3.5%
Hang Seng	17,250.88	-13.5%	-26.3%	-29.6%	-26.5%
Shanghai Comp	3,045.07	-4.9%	-16.3%	-15.5%	-5.4%
Nikkei 225	26,173.98	-6.8%	-9.1%	-13.3%	11.3%
India Sensex	56,598.28	-4.9%	-2.8%	-5.1%	49.0%
Singapore Straits Times	3,116.31	-3.3%	-0.2%	1.3%	25.5%
Brazil Ibovespa	108,451.20	-1.0%	3.5%	-1.5%	14.6%
Mexican Bolsa IPC	45,442.21	1.2%	-14.7%	-10.8%	22.1%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.733%	54.1	222.3	219.6	308.0
Canada 10-Yr	3.077%	-4.1	165.1	157.4	252.5
UK 10-Yr	4.012%	121.1	304.1	301.8	381.0
Germany 10-Yr	2.120%	57.9	229.7	231.9	264.8
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.86%	-5.0%	-15.2%	-15.1%	-16.0%
U.S. Investment-Grade Corp	5.77%	-5.8%	-19.2%	-19.0%	-17.6%
U.S. High-Yield Corp	9.63%	-3.9%	-14.7%	-14.1%	-4.0%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,659.16	-3.0%	-9.3%	-4.3%	-11.8%
Silver (spot $/oz)	18.89	5.0%	-18.9%	-15.9%	-20.2%
Copper ($/metric ton)	7,422.00	-5.4%	-23.8%	-20.0%	13.1%
Oil (WTI spot/bbl)	82.15	-8.3%	6.7%	9.1%	102.3%
Oil (Brent spot/bbl)	89.15	-7.6%	14.6%	12.7%	110.1%
Natural Gas ($/mmBtu)	6.87	-24.8%	84.1%	17.6%	226.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	112.7730	3.7%	17.9%	20.3%	19.6%
CAD/USD	0.7345	-3.6%	-7.2%	-6.8%	-1.8%
USD/CAD	1.3615	3.7%	7.7%	7.3%	1.8%
EUR/USD	0.9736	-3.2%	-14.4%	-16.7%	-16.5%
GBP/USD	1.0879	-6.4%	-19.6%	-19.6%	-15.2%
AUD/USD	0.6520	-4.7%	-10.2%	-9.9%	-7.8%
USD/JPY	144.1400	3.7%	25.3%	29.3%	36.6%
EUR/JPY	140.3500	0.5%	7.2%	7.7%	14.0%
EUR/GBP	0.8950	3.5%	6.4%	3.7%	-1.5%
EUR/CHF	0.9504	-3.3%	-8.4%	-12.5%	-11.9%
USD/SGD	1.4338	2.6%	6.3%	5.6%	4.4%
USD/CNY	7.2005	4.5%	13.3%	11.5%	5.7%
USD/MXN	20.1475	0.0%	-1.9%	-1.0%	-10.1%
USD/BRL	5.3634	3.5%	-3.8%	-1.2%	-5.3%

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 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -7.2% return means the Canadian dollar fell 7.2% vs. the U.S. dollar year to date. USD/JPY 144.14 means 1 U.S. dollar will buy 144.14 yen. USD/JPY 25.3% return means the U.S. dollar rose 25.3% vs. the yen year to date.

Source - Bloomberg; data as of 9/28/22

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