GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

October 13, 2022

Fed up with all the pivot talk

Atul Bhatia, CFA – Minneapolis

Numerous Fed officials have thrown cold water on the idea of a policy pivot to rate cuts next year, stating the Fed will keep at it until inflation is undeniably under control. But we think the Fed's message is evolving to focus on the duration—and not the elevation—of short-term rates, which can create some potential opportunities.

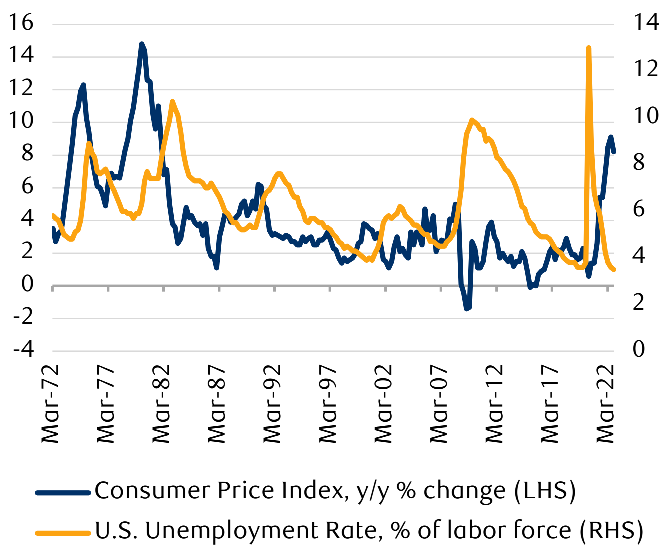
Last week saw a concerted effort by Federal Reserve policymakers to push back on the idea of a near-term policy pivot, a scenario where economic weakness leads the Fed to begin cutting rates as early as mid-2023. So far this month, a total of 10 Fed officials have publicly spoken against the idea, with some explicitly rejecting it and others implicitly attacking it by reiterating the central bank's firm commitment to continue the inflation fight until it is demonstrably won.

Despite the breadth and depth of the Fed speakers taking this position, markets largely shrugged off the talk; following the speeches, interest rate futures continued to price the Fed switching to rate cuts next year, with only a modest three basis point (bps) shift in the predicted overnight rate for November 2023. The real move in policy projections only came after employment and inflation data showed little impact from the Fed's policy moves so far: payrolls continued to grow, the unemployment rate declined, and inflation remained near four-decade highs.

We believe last week's events point to two likely truths for Fed communication and interpretation going forward: first, that markets will largely look to data, not speeches, to gauge the likelihood of the Fed staying hawkish; and, as importantly, that Fed policymakers will increasingly emphasize maintaining restrictive interest rates for longer periods as a key means of fighting inflation.

Fed officials should sound hawkish

Unemployment and inflation dictate Fed approach



Source - RBC Wealth Management, Bloomberg; quarterly data through 9/30/22

Talk is cheap, especially when it's free

We see little chance of a shift to more dovish rhetoric from the Fed in the near term. Part of this is institutional: the Fed's mandate is to maximize employment consistent with stable prices. Officials *should* be talking exclusively

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

about tighter rates and more restrictive policy with unemployment near historic lows and inflation near four-decade highs. Embracing early pivot talk also risks the central bank's credibility, in our opinion. The Fed took its shot at policymaking based on predictions with its transitory inflation argument. That failed. We believe to try a dovish argument again before the data is unambiguously supportive would call into question the seriousness of the Fed's commitment to price stability.

Personalities also play a role in the decision. Paul Volcker, who served as Fed chair from 1979 to 1987, is widely regarded among the preeminent central bankers for his role in reducing U.S. inflation from 14.8 percent to under three percent in a little over three years. His reputation has not suffered to any extent that we can see by a discussion of how central bank policies of that era may have been unnecessarily restrictive. Central bankers with an eye toward history and a desire to leave the institution at least as well off as they found it are unlikely to find themselves drawn to early dovish talk.

Data not discourse

Since the Fed has little reason to sound anything other than hawkish, investors have largely built such commentary into their calculations. One result is that market moves from individual speeches are relatively muted, as we saw last week.

Data, on the other hand, is becoming ever more consequential, and we believe markets will likely look to price a pivot scenario once they see even precursors of significantly slowing inflation, such as shifts in the Consumer Price Index, rising unemployment, or declining consumer sentiment and spending.

Hawks fly longer not higher

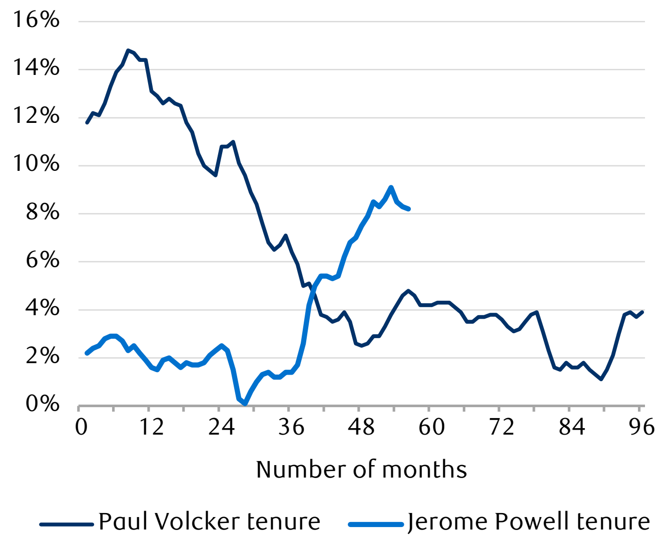
One notable and in our view sustainable change in Fed communication has been the emphasis on how long rates will remain at or near the cycle highs. Previous policy discussions had focused on the speed of hikes and the terminal rate, but the more recent speeches are targeting the length of time rates remain elevated.

We would not be surprised to see this rhetorical shift continue and even strengthen, as we see two strong policy arguments against pushing overnight interest rates much beyond the roughly 4.9 percent level priced into fixed income futures.

The first is that short-term rates have a disproportionate impact on small businesses and lower-rated corporate bond issuers. These entities tend to rely more on floating-rate bank loans and shorter-maturity bonds, making their financing costs more susceptible to Fed policy moves. Continuing to emphasize rate hikes risks potentially large increases in corporate bankruptcies, which bring significant real world costs. The Fed's inflation fight may require some economic pain, but bankruptcies leave scars.

Powell looks to channel the early days of Volcker

Inflation evolution by month of tenancy as Fed chair



Source - RBC Wealth Management, Bloomberg

Continuing to push short-end rates higher also creates problems for the Fed in the future, in our view. If inflation comes down significantly next year, the Fed will likely want to reduce interest rates, particularly if the economy has simultaneously slid into recession. Managing that transition toward a neutral policy rate is obviously easier if the Fed is starting with overnight interest rates at 4.5 percent instead of six percent. We believe a slower glide path on any eventual rate cuts will also help the central bank avoid an inflation and interest rate see-saw, where policy rate mistakes on one side are matched by errors on the other, leading to yo-yoing interest rates.

Investment implications

For investors, a Fed focused on the duration—and not the elevation—of short-term interest rates creates a few potential opportunities, in our opinion. One could be short-term Treasury obligations. If the Fed is going to stop hiking at or near currently expected levels, we believe government bonds with maturities in the next 1–2 years would likely outperform those with longer maturities, as much of the policy implications appear to be already priced into the shorter bonds.

Longer term, we believe growth assets are another potential beneficiary of an emphasis on communications over hikes. Undoing a rate hike requires formal central bank action and is a relatively clunky move, usually 25 bps at a time. A soft verbal commitment to "do what it takes" is much easier to unwind; it only takes a speech or two.

So while risk assets are unlikely to find much comfort in Fed rhetoric or actions in the immediate future, the relative ease of unwinding a communications-driven policy move could at least bring faster relief, if inflation does come down in the next 12 months.

UNITED STATES

Ben Graham, CFA – Minneapolis

- **U.S. equities are on track for their seventh weekly decline in the past nine weeks** as earnings season begins to ramp and September inflation data have come in higher than expected. As of Thursday morning, the S&P 500 is on track for weekly losses approaching 2%. The Russell 2000 appears to be headed for a similar decline, and the Nasdaq is faring worse with its decline approaching 3%. The Dow Jones Industrial Average is performing best, as the index flirts with a gain for the week.

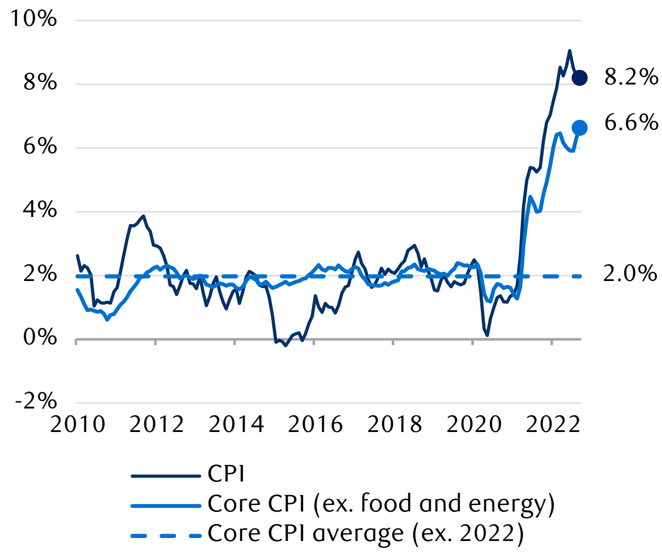
- **Sector leadership in the U.S. has been evident in Consumer Staples and Energy, the only sectors higher on a week-to-date basis**. The former is partially driven by the risk-off approach to equities this week, as well as by a PepsiCo earnings release that was much better than expected, while the latter sector is gaining due to OPEC+ production cuts. Other pockets of relative leadership include Industrials and Health Care, where losses are smaller than average. Weakness is most evident in Utilities and Information Technology, where losses this week total more than 3%.

- **Inflationary pressures re-accelerated in September, with the Consumer Price Index showing an increase of 0.4% m/m after August's much smaller 0.1% rise**. This led to headline inflation of 8.2% y/y, which was higher than consensus expectations. A similar trend was observable in the core inflation reading, which excludes energy and food prices. The primary difference between the two readings in the September data is that core inflation's increase to 6.6% took it to a new 2022 high, while the headline reading remained below its June peak of 9.1%. This was largely due to the fact that September's lower energy prices did not benefit the core rate, because energy is not included in that index. As a result, core prices increased more quickly in September. The largest contributors to this acceleration included rising rent and housing costs, medical care expenses, and auto insurance.

- **Weekly initial unemployment claims climbed 228,000, more than the consensus expectation and the second straight weekly rise**. The four-week moving average of 212,000 is starting to creep up, but importantly, it remains below the pre-pandemic average of 241,000.

Inflation remains very high

Headline and Core CPI, y/y



Note: Data since 2010, core CPI average excludes 2022 data

Source - RBC Wealth Management, FactSet; data through 9/30/22

CANADA

Sean Killin & Richard Tan, CFA – Toronto

- Although rising commodity prices have largely allowed the S&P/TSX Composite to outperform peers year to date, **Canada is not insulated from the effects of a slowing economic backdrop**. Unsurprisingly, the S&P/TSX Composite has given back its gains and is down about 12% on a total return basis for the year. As we approach the end of 2022, we think the market will still contend with the Bank of Canada's (BoC) aggressive tone for further rate hikes, the potential for downward revisions in corporate earnings, and pressure from tax-loss harvesting. With respect to the latter, Health Care, Information Technology, and Real Estate have been the worst-performing sectors year to date and we believe will see additional volatility in the coming months. While we acknowledge the risk of recession has increased, we also highlight that the S&P/TSX Composite is trading at about 11x forward earnings, a sizeable discount to its long-term average of approximately 15x. Put differently, we believe the discounted valuation is adequate compensation for people with a long-term investment horizon.

- **The risk of a Canadian recession has risen substantially, according to RBC Economics forecasts**. The housing market, which directly accounted for approximately 10% of Canadian Gross Domestic Product in Q1 2022, has cooled meaningfully year to date as the BoC tightens monetary policy. Highly leveraged households and tighter financial conditions could potentially place a larger dent in household consumption metrics and pose a substantial headwind to domestic economic activity. The historically tight labour market has also exhibited signs of weakness, despite wages continuing to rise. As exhibited in this week's U.S. CPI report, inflationary pressures are unlikely to abate without further monetary tightening. Overnight Index Swaps, which act as proxy for financial market expectations of interest rate hikes, are now pricing in a peak BoC policy rate of nearly 450 bps, which would imply another 125 bps of hikes from the BoC. Despite this, RBC Economics has suggested the labour market impact will be modest with the Canadian unemployment rate reaching 7% amidst the onset of an economic contraction, up from its current level of 5.2%, with the majority of jobless claims focused around the manufacturing sector.

EUROPE

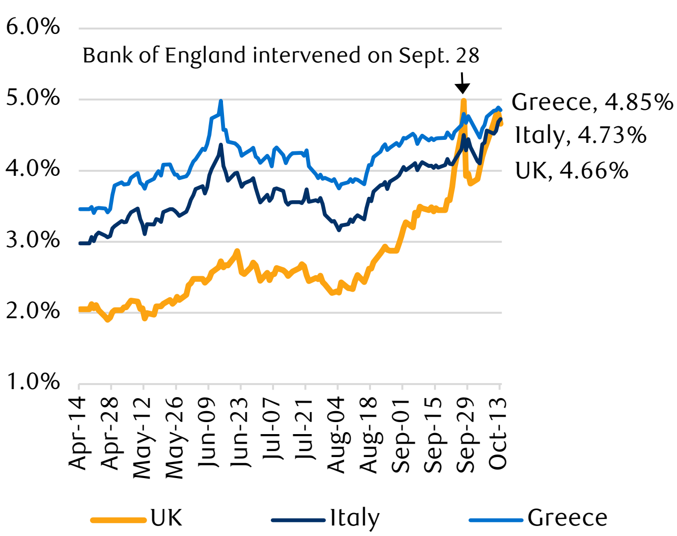
Frédérique Carrier, Rufaro Chiriseri, CFA, & Thomas McGarrity, CFA – London

- **The roil in bond markets continues as pension funds continue facing margin calls on their hedges, resulting in further sales of Gilts to raise cash**. This week, the forced selling extended to index-linked Gilts, and in a bid **to counter these "fire sales" the Bank of England (BoE) increased its daily purchasing cap** to £10 billion from £5 billion. The central bank stepped in to support the market on Sept. 28, and despite calls for an extension from pension funds, BoE Governor Andrew Bailey stated that these measures will cease on Oct. 14. Unsurprisingly, it has been a week of extreme capitulation in Gilt yields; the UK 30-year yield rose to 5.1% before rallying to settle at 4.66% after the BoE significantly stepped up bond purchases to a daily record of £4.56 billion. With the BoE attempting to stabilise markets, **the focus is now on the government to restore fiscal sustainability by cutting back on expenditures**.

- **UK unemployment dropped to the lowest level since 1974**, at 3.5%, in the three-month period to the end of August. **Wage growth accelerated in the same period**, with total pay up 6% compared to the year-ago figure. Are these signs of a healthy job market? On the surface, we would say yes. **But the fall in unemployment was mostly due to a rise in the number of inactive workers**. RBC Capital Markets points out that the number of inactive workers due to ill health is now at a record high, an issue most likely related to the National Health Service's increasingly long waiting lists.

Investors demand Gilt yields close to Italian and Greek yields

UK, Italy, and Greece 30-year bond yields



Source - RBC Wealth Management, Bloomberg; data as of 10:05 am ET, 10/13/22

- UK GDP fell by 0.3% m/m in August, much below the consensus expectation of flat growth. **RBC Capital Markets expects Q3 GDP to significantly contract by 0.7% to 0.9% q/q** given the main lead indicators suggest that economic activity has further to slow. We believe the underlying weakness of the UK economy will ultimately constrain the BoE's ability to raise the Bank Rate as aggressively as current market pricing implies.

- **Equity markets were not unscathed** as the turmoil around the UK put another dent in domestically exposed stocks, including banks, insurers, homebuilders, and retailers. The unwelcome fiscal newsflow reinforces our **continued caution towards UK domestic stocks and strong preference for more internationally oriented companies**.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **The Asia Pacific equity market has traded sharply lower during the week** with the MSCI AC Asia Pacific Index trading at its lowest level since April 2020. The Hang Seng Index is down more than 7% for the week, at the time of this writing, its worst weekly decline since March 2020. Sentiment on greater China equities has been weak this week on the back of rising new COVID-19 cases in various Chinese cities and unconfirmed reports of a stealth shutdown. China officials have called on local governments to try to avoid extensive lockdowns to contain the virus and/or to end them as soon as possible.

- **The yen is trading at a 24-year low against the U.S. dollar**, inching closer to the 147 level. The move lower came after BoJ Governor Haruhiko Kuroda reaffirmed his commitment to maintain the loose monetary policy to bring inflation up to the 2% goal "in a sustainable and stable manner," including a much larger gain in wages. While we do not rule out further intervention by the Ministry of Finance in the currency market, we maintain our view that any intervention will not have a lasting impact on the yen, which is driven by the diverging monetary policies and a very strong dollar.

- **Taiwan Semiconductor Manufacturing Co. (2330 TT)**, the largest dedicated contract semiconductor manufacturer in the world, has cut its 2022 capital spending goal by about 10%, an indicator of its own expectations for growth in the sector. Despite posting better-than-expected Q3 2022 earnings and managers reaffirming their long-term revenue targets and declaring 2023 a year of growth, on the Taiwan exchange the stock ended the day lower. TSMC and its semiconductor peers are facing fresh restrictions from the U.S. government on doing business with China, which adds to a long list of headwinds facing the sector.

MARKET
Scorecard

Data as of October 12, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,577.03	-0.2%	-24.9%	-17.8%	1.2%
Dow Industrials (DJIA)	29,210.85	1.7%	-19.6%	-15.0%	1.3%
Nasdaq	10,417.10	-1.5%	-33.4%	-28.0%	-12.3%
Russell 2000	1,687.76	1.4%	-24.8%	-24.5%	2.3%
S&P/TSX Comp	18,206.28	-1.3%	-14.2%	-10.9%	9.9%
FTSE All-Share	3,712.50	-1.4%	-11.8%	-8.5%	10.0%
STOXX Europe 600	385.88	-0.5%	-20.9%	-15.6%	3.5%
EURO STOXX 50	3,331.53	0.4%	-22.5%	-17.8%	1.0%
Hang Seng	16,701.03	-3.0%	-28.6%	-33.1%	-32.2%
Shanghai Comp	3,025.51	0.0%	-16.9%	-14.7%	-9.9%
Nikkei 225	26,396.83	1.8%	-8.3%	-6.5%	12.0%
India Sensex	57,625.91	0.3%	-1.1%	-4.4%	42.0%
Singapore Straits Times	3,083.19	-1.5%	-1.3%	-0.9%	20.8%
Brazil Ibovespa	114,827.12	4.4%	9.5%	2.4%	17.8%
Mexican Bolsa IPC	45,679.84	2.4%	-14.3%	-11.9%	19.1%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.902%	7.4	239.2	232.5	312.9
Canada 10-Yr	3.426%	25.3	200.0	180.5	279.8
UK 10-Yr	4.436%	34.3	346.5	328.8	416.5
Germany 10-Yr	2.314%	20.6	249.1	240.0	285.9
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.88%	-0.7%	-15.2%	-14.9%	-15.7%
U.S. Investment-Grade Corp	5.81%	-0.6%	-19.2%	-18.7%	-17.7%
U.S. High-Yield Corp	9.57%	0.5%	-14.3%	-13.3%	-5.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,672.76	0.7%	-8.6%	-5.0%	-13.0%
Silver (spot $/oz)	19.03	0.0%	-18.4%	-15.7%	-24.2%
Copper ($/metric ton)	7,661.25	-0.3%	-21.3%	-19.5%	13.9%
Oil (WTI spot/bbl)	87.27	9.8%	13.4%	8.2%	121.3%
Oil (Brent spot/bbl)	92.22	4.8%	18.6%	10.5%	121.0%
Natural Gas ($/mmBtu)	6.43	-4.9%	72.5%	16.9%	123.3%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	113.3030	1.1%	18.4%	19.9%	21.7%
CAD/USD	0.7234	0.0%	-8.6%	-9.8%	-5.1%
USD/CAD	1.3824	0.0%	9.4%	10.9%	5.4%
EUR/USD	0.9698	-1.1%	-14.7%	-15.9%	-17.9%
GBP/USD	1.1093	-0.7%	-18.0%	-18.4%	-15.1%
AUD/USD	0.6273	-2.0%	-13.6%	-14.7%	-13.0%
USD/JPY	146.9200	1.5%	27.7%	29.3%	39.5%
EUR/JPY	142.4800	0.4%	8.8%	8.8%	14.5%
EUR/GBP	0.8742	-0.4%	3.9%	3.0%	-3.3%
EUR/CHF	0.9678	0.0%	-6.7%	-9.8%	-9.9%
USD/SGD	1.4351	0.0%	6.4%	5.7%	5.7%
USD/CNY	7.1748	0.8%	12.9%	11.3%	6.4%
USD/MXN	19.9878	-0.7%	-2.6%	-3.8%	-5.7%
USD/BRL	5.3022	-2.1%	-4.9%	-4.3%	-4.2%

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 0.72 means 1 Canadian dollar will buy 0.72 U.S. dollar. CAD/USD -8.6% return means the Canadian dollar fell 8.6% vs. the U.S. dollar year to date. USD/JPY 146.92 means 1 U.S. dollar will buy 146.92 yen. USD/JPY 27.7% return means the U.S. dollar rose 27.7% vs. the yen year to date.

Source - Bloomberg; data as of 10/12/22

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As of September 30, 2022

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Sell [Underperform]	52	3.52	5	9.62

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