GLOBAL
Insight
WEEKLY

Perspectives from the Global Portfolio Advisory Committee

October 27, 2022

Not so concerning

Atul Bhatia, CFA – Minneapolis

The U.S. is the world's largest debtor, and the combination of rising interest rates and trillions in U.S. government debt has left some investors a bit nervous. We take a practical look at the implications of US rates and debt.

Interest rates in 2022 have jumped due to the Federal Reserve's monetary policy tightening, with the government's cost of borrowing money for five years increasing nearly three percent since the start of the year. Simple math would seem to indicate there is a potential problem brewing for the U.S.

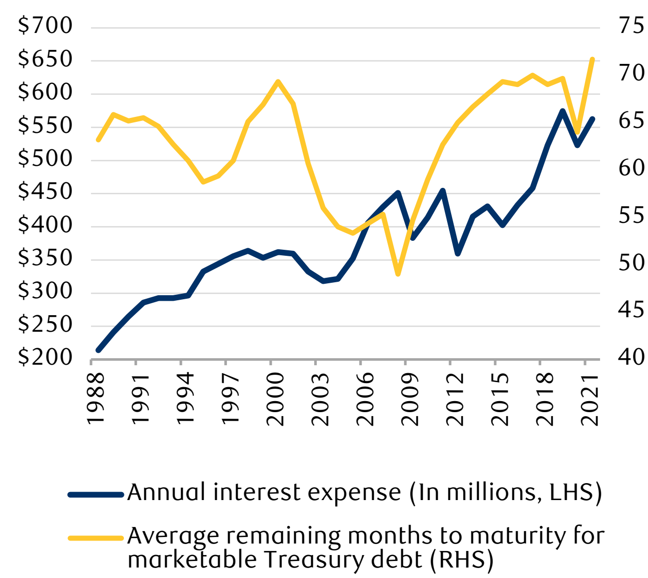
This feeling is seemingly confirmed by last year's comments from U.S. Treasury Secretary Janet Yellen—and others—that low policy rates made the U.S. government's debt burden manageable. Surely the converse—rising interest rates—must imply that the debt burden is at risk of becoming unmanageable.

Despite appearances, we see little reason for investor concern at this stage, and we do not see rising rates as likely to impose a meaningful constraint on investor appetite for U.S. government debt or on politicians' appetites for unfunded tax cuts and incremental spending.

Current impact is limited

Even though yields on newly issued debt are higher, the U.S. government sold large amounts of longer maturity debt in 2020–2021 to pay for pandemic relief and to lock in low interest rates. As a result, the weighted average coupon on Treasury obligations has only gone to two percent as of last month from 1.8 percent at its all-time low in February 2022. Borrowing costs will almost inevitably rise as maturing obligations are refinanced, but we think the government is in generally good shape as the process begins.

Prior long-term debt issuance slows impact of rising rates on debt service costs



Source - RBC Wealth Management, Bloomberg; data through 12/31/21

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

Of course, even though the debt burden change looks small in the aggregate, when dealing with dollar amounts in the trillions, even small changes matter. The 0.2 percent average coupon increase since February, for instance, translates into nearly $50 billion in additional required spending. And with approximately 15 percent of outstanding debt due to mature in the next 12 months, that cost increase is poised to grow. For investors thinking about the impact of rising debt service on their household budgets, these numbers may seem alarming.

But unlike households, government budgeting is not constrained to any given income amount. The U.S. Congress can spend as much as it likes, provided it has sufficient tax revenues or bond market funding. Borrowing money is more expensive than last year, but there has been no market pushback on government issuance that we can see. And to the extent that government spending is constrained by higher interest rates, it would be a welcome advance in the Fed's anti-inflation campaign.

Investors should also consider that higher interest rates and rising inflation have positive impacts on the government's finances. The inflation-adjusted debt burden, for instance, has shrunk by almost $80 billion since January 2021, as rising prices have eroded the value of U.S. Treasury obligations at a faster pace than the government sold additional debt. In a similar vein, the rate-hike-induced decline in government bond prices has reduced the value of outstanding government liabilities.

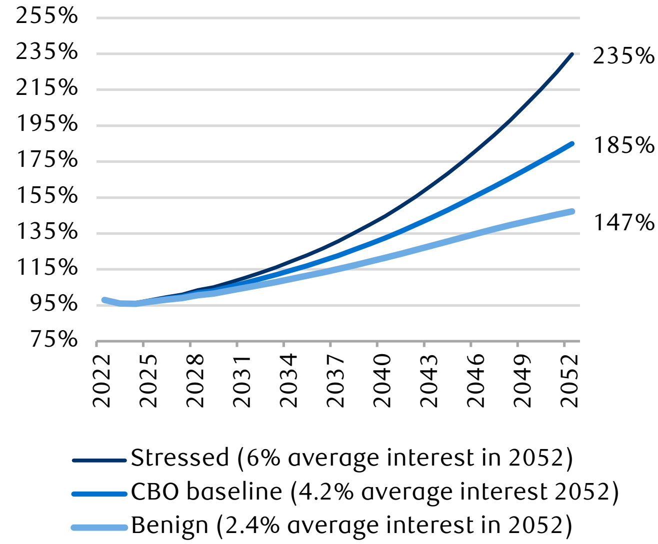
A long wait for "I told you so"

The simple truth is that U.S. national debt will almost certainly increase for the foreseeable future. Even at current interest rates, debt-fueled tax cuts and spending increases are popular with voters and politicians across the political spectrum, despite occasional rhetoric to the contrary. And why not? With foreign investors scooping up nearly a third of U.S. debt, as a nation the U.S. essentially exchanges slips of paper promising future payment for valuable goods and services today. Long-term rates of four percent are apparently insufficiently ominous compared to the temptations of current consumption.

This leads to longer-term outlooks that are frankly troubling. The baseline projection, for instance, from the Congressional Budget Office (CBO), a non-partisan economic forecasting agency, has nearly a third of government revenue dedicated to debt service by 2052 as accumulated government borrowing hits 185 percent of the economy. If future rates were to be only 1.8 percent higher than the baseline forecast, the CBO sees debt payments consuming nearly 80 percent of the government's revenue with a total government debt burden over 2.3x the size of the economy. It is difficult to see those numbers as sustainable, in our opinion.

But as economist Herbert Stein pointed out in the 1980s, "if something cannot go on forever, it will stop." In other words, if the U.S. cannot attract sufficient capital to fund aspirational spending it will be forced to deal with the matter. There are multiple ways to resolve a government debt burden, including paying it back, inflating it away, defaulting, or some combination thereof. Each of these scenarios has a dramatically different investment implication.

Evolution of U.S. federal debt-to-GDP ratio under various interest rate scenarios



Source - RBC Wealth Management, Congressional Budget Office (CBO); data as of 10/26/22

To us, that really highlights the key weakness of the debt servicing commentary: it has little to no practical investment implication. We don't engage in macroeconomic analysis for the fun of it; the goal is to identify exploitable investment opportunities. The investment strategy "knowing that if nothing changes in three decades, we could be in for some real trouble" has two fatal flaws: one, things do change; and two, the price swings of the next 30 years will likely dwarf any expected profits from the view. It's both wrong and irrelevant at any reasonable time scale.

Let it go

Since at least the Reagan administration of the 1980s, readers of the financial press have enjoyed periodic bouts of commentary on the perils of the U.S. budget. The latest concerns on the cost of debt servicing follow prior worries on government borrowing crowding out private investment and bond holders refusing to buy Treasuries. Investing based on those earlier fears would have proven quite costly, and we see little chance that this time is different.

Even investors convinced in the folly of growing government debt loads would be well-served to remember John Maynard Keynes' admonition that "markets can remain irrational longer than you can remain solvent."

UNITED STATES

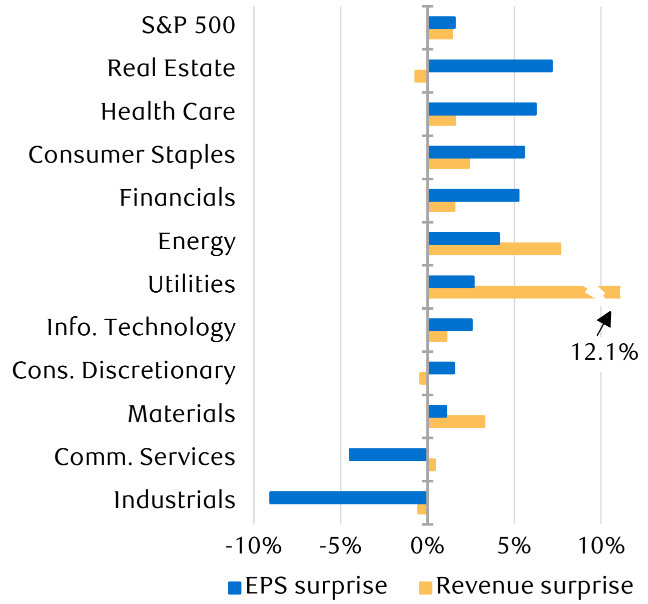
Tyler Frawley, CFA – Minneapolis

■ **U.S. equities are on track for weekly gains as quarterly earnings continue to come in**. All major indexes are higher, with the Dow Jones Industrial Average leading the way with a return of 3.80%. The S&P 500 has outperformed the Nasdaq Composite, but both are higher, having risen 2.16% and 0.19%, respectively. Sector leadership is evident in Industrials, which has returned 5.18%, and Consumer Staples, which has returned 4.42%. Communication Services is the only sector that is down on the week, having fallen 4.49% following disappointing quarterly results from Alphabet Inc. and Meta Platforms.

■ Despite relatively disappointing results from the likes of Alphabet, Microsoft, and Meta, **Q3 earnings season is off to a relatively solid start overall** with 45% of the S&P 500 having already reported. Of the companies that have announced, over 55% have reported sales that exceeded analyst expectations, beating by an average of 1.4%. From an earnings perspective, 72% have beaten expectations, though the average earnings beat of 1.6% is lower than the long-term average. Real Estate and Health Care companies have seen the strongest results, beating earnings expectations by 7.2% and 6.2%, respectively. Industrials have seen the softest results, with earnings coming in 9.1% below consensus. As earnings reports continue to roll in over the next few weeks, Utilities and Energy will bear watching, as only a small proportion of companies in these sectors have reported so far.

■ **Economic data has been mixed this week**. The FHFA House Price index, which measures changes in single-family home values, reported that prices in August fell 0.7% compared to July. This marked the second consecutive month of declines—and the first consecutive monthly declines since March 2011—as soaring mortgage rates continued to weigh on affordability. However, this morning's **better-than-expected GDP data** showed the U.S. economy grew at an annualized rate of 2.6% in Q3, ahead of economists' 2.0% consensus forecast, driven by resilient consumer spending and a narrowing of the trade deficit.

S&P 500 earnings report card: EPS & revenue surprises



Note: Surprise data is market capitalization weighted

Source - RBC Wealth Management, Bloomberg; data through a.m. earnings on 10/27/22

CANADA

Luis Castillo & Simon Jones – Toronto

■ **The Bank of Canada (BoC) has eased off the accelerator, raising its policy rate by 50 basis points (bps), rather than the 75 bps the market had been expecting**. Despite making a smaller-than-expected move, and acknowledging that a lot has already been done, the BoC reiterated that additional hikes would be needed to address lingering excess demand and tightness in labour markets. That being said, after 350 bps worth of rate hikes in relatively short order, the pace of additional hikes is becoming less certain as central banks opt for less forward guidance while they study the lagging economic impact of the aggressive tightening that has already been delivered. On that note, the BoC has revised its economic projections, and now expects GDP growth to slow to just under 1% in 2023 from 3.25% in 2022 (vs. previous forecasts calling for a 1.8% expansion next year). **The central bank also revised its inflation forecast for 2023 downward, to 4.1% from 4.6%**, in line with the expectation that price increases should ease further towards the 2% target by 2024 as tighter financial conditions work their way through the economy.

■ **Canadian retail sales increased 0.7% in August compared to the previous month, according to Statistics Canada, well ahead of the 0.2% consensus expectation**. While the unexpectedly strong result was largely driven by higher sales at food and beverage stores, the gains were relatively broad-based across the economy, with sales increasing in roughly half of the subsectors tracked by the agency. While this surge in spending to end the summer is welcome news, August's increase only partially reverses the declines experienced in July, and the road ahead could be a somber one. Elevated inflation and the knock-on effects associated with higher interest rates appear to be weighing on consumer spending. **The spending data compiled by RBC Economics indicates Canadians began paring back their spending on discretionary goods and services in September**, particularly in areas related to housing, travel, and accommodation. Statistics Canada's preliminary estimate for September retail sales suggests a decline of 0.5%.

EUROPE

Frédérique Carrier – London

■ **In Europe, unseasonably warm autumn temperatures and storage levels nearing full capacity have enabled natural gas prices to retreat**. Natural gas prices for delivery in Europe within a month are down 70% from their summer peak and back to their levels before the start of the Russia-Ukraine conflict.

- **The picture appears less rosy going forward**. The 12-month forward price for natural gas remains much above its pre-war level despite the recent decline. The longer-term prospect for energy prices tends to matter more for economic activity. Moreover, RBC Capital Markets points out that those prices are still nine times higher than they are in the U.S., which doesn't bode well for European competitiveness.

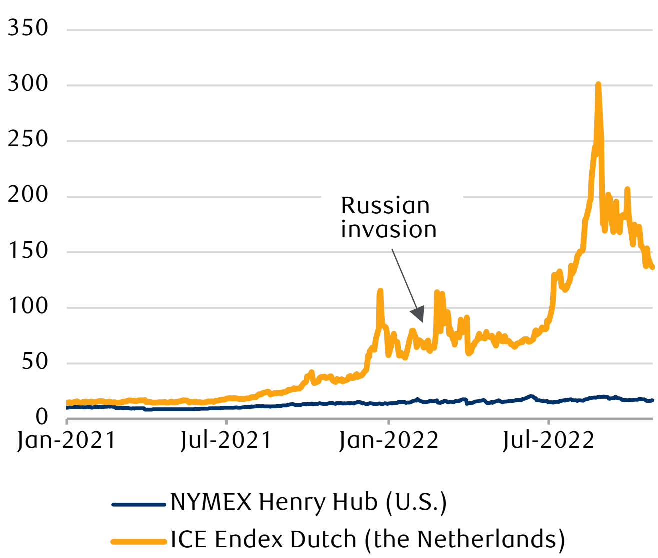
- However, **decreasing natural gas prices should provide some inflation relief**, though steady increases in other categories such as food mean inflation may continue to be problematic for some time. This is a challenge for the European Central Bank (ECB) given that the economy is weakening markedly. Recent economic activity indicators suggest the region is already in recession, and RBC Capital Markets expects it to stretch into Q1 2023.

- It is against this challenging background that the ECB announced a 0.75% increase in interest rates and that further increases would be necessary, both of which were widely expected.

- **In the UK, the appointment of Rishi Sunak as prime minister was greeted with relief in financial markets**. Even the announcement that Chancellor Jeremy Hunt's debt reduction plan would be delayed by two weeks (to November 17) was shrugged off. Gilt yields on 10- and 30-year sovereign bonds fell back close to the levels they held just before the ill-fated mini-budget was announced by the previous government. This suggests to us that the recent market turmoil was more about former Prime Minister Liz Truss' flawed economic strategy than strictly elevated national debt levels.

European natural gas prices have slumped, but remain elevated

12-month generic natural gas futures (USD/MWh)



Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 10/26/22

- **Chancellor Hunt's budget will likely include tax increases and spending cuts of some £40 billion**. This austerity, combined with the Bank of England raising rates at a time when economic activity is already slowing quickly, make for a challenging backdrop. The provisional S&P Global UK Composite Purchasing Managers' Index for October fell sharply to 47.2 vs. 49.2 in September, a level which points to the UK economy already being in recession.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **The Asia Pacific equity market has traded higher this week** with Hong Kong the only market bucking the trend. On Monday, the Hang Seng Index fell below the 16,000 level for the first time in more than 13 years, marking the biggest one-day selloff since November 2008. Investor confidence was shaken following the conclusion of the 20th National Congress of the Communist Party of China and the announcement of the new Politburo Standing Committee. **We believe investors have three concerns**: the consolidation of President Xi Jinping's power, pro-growth and pro-reform officials being left out of the Politburo Standing Committee, and some scepticism about the "focus on development" statement. We expect the "common prosperity" theme to strengthen—increasing the earnings of low-income groups, promoting fairness, better balancing development across different regions of China, and the possibility of major tax reform.

- **Japan's government may have intervened in the FX market again this week**, according to a Reuters report. Officials have declined to comment on the intervention. Prime Minister Fumio Kishida had said previously that the country would not shy away from "appropriate" steps when needed. The yen, however, failed to cling to early gains as markets continued to focus on the widening divergence between the Bank of Japan's ultra-easy monetary policy and steady rate hike plans by the U.S. Federal Reserve. On the back of rising inflation and a resilient labour market, some economists expect the Bank of Japan to start adjusting its yield curve control policy in early 2023.

- **Samsung Electronics Co. (005930 KS) will not be cutting back on capital expenditures this year**, instead, it is increasing its capex, a sharp contrast to its rivals that have announced cuts. In a statement, Samsung's newly appointed Executive Chairman Jay Y. Lee said, "Without a doubt, we are at a pivotal moment ... now is the time to act, to be bold and unwavering in our focus." Samsung plans to boost chip-related capital spending by 9% this year to 47.7 trillion won (US$33.6 billion).

MARKET Scorecard

Data as of October 26, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,830.60	6.8%	-19.6%	-16.3%	12.6%
Dow Industrials (DJIA)	31,839.11	10.8%	-12.4%	-11.0%	15.0%
Nasdaq	10,970.99	3.7%	-29.9%	-28.0%	-3.4%
Russell 2000	1,804.33	8.4%	-19.6%	-21.4%	12.4%
S&P/TSX Comp	19,279.76	4.5%	-9.2%	-8.9%	19.9%
FTSE All-Share	3,866.01	2.7%	-8.1%	-6.8%	18.2%
STOXX Europe 600	410.31	5.8%	-15.9%	-13.8%	15.3%
EURO STOXX 50	3,605.31	8.7%	-16.1%	-14.6%	16.1%
Hang Seng	15,317.67	-11.1%	-34.5%	-41.2%	-38.5%
Shanghai Comp	2,999.50	-0.8%	-17.6%	-16.6%	-7.7%
Nikkei 225	27,431.84	5.8%	-4.7%	-5.8%	16.8%
India Sensex	59,543.96	3.7%	2.2%	-2.9%	48.3%
Singapore Straits Times	3,008.38	-3.9%	-3.7%	-6.1%	19.2%
Brazil Ibovespa	112,763.79	2.5%	7.6%	6.0%	11.6%
Mexican Bolsa IPC	49,327.11	10.5%	-7.4%	-5.5%	29.0%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.003%	17.4	249.3	239.5	320.2
Canada 10-Yr	3.276%	10.3	185.0	164.6	264.9
UK 10-Yr	3.576%	-51.7	260.5	246.6	330.1
Germany 10-Yr	2.111%	0.3	228.8	222.8	269.1
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	5.04%	-1.7%	-16.0%	-15.8%	-16.6%
U.S. Investment-Grade Corp	5.97%	-1.5%	-20.0%	-19.7%	-18.6%
U.S. High-Yield Corp	9.46%	1.4%	-13.5%	-12.7%	-4.4%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,664.60	0.2%	-9.0%	-7.2%	-12.5%
Silver (spot $/oz)	19.57	2.8%	-16.1%	-19.0%	-19.4%
Copper ($/metric ton)	7,634.00	-0.6%	-21.6%	-23.3%	12.9%
Oil (WTI spot/bbl)	87.91	10.6%	14.2%	3.9%	128.0%
Oil (Brent spot/bbl)	95.89	9.0%	23.3%	11.0%	137.0%
Natural Gas ($/mmBtu)	5.70	-15.7%	52.9%	-3.0%	88.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	109.7050	-2.2%	14.7%	16.8%	17.9%
CAD/USD	0.7377	2.0%	-6.8%	-8.6%	-2.5%
USD/CAD	1.3555	-2.0%	7.3%	9.4%	2.6%
EUR/USD	1.0083	2.9%	-11.3%	-13.0%	-14.6%
GBP/USD	1.1629	4.1%	-14.1%	-15.5%	-10.7%
AUD/USD	0.6496	1.5%	-10.6%	-13.4%	-8.8%
USD/JPY	146.3600	1.1%	27.2%	28.2%	39.6%
EUR/JPY	147.5800	4.0%	12.7%	11.5%	19.2%
EUR/GBP	0.8671	-1.2%	3.1%	2.9%	-4.4%
EUR/CHF	0.9945	2.8%	-4.2%	-6.8%	-7.2%
USD/SGD	1.4057	-2.1%	4.2%	4.3%	3.3%
USD/CNY	7.1730	0.8%	12.9%	12.4%	6.9%
USD/MXN	19.9391	-1.0%	-2.9%	-1.4%	-4.8%
USD/BRL	5.3864	-0.5%	-3.4%	-3.2%	-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 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -6.8% return means the Canadian dollar fell 6.8% vs. the U.S. dollar year to date. USD/JPY 146.36 means 1 U.S. dollar will buy 146.36 yen. USD/JPY 27.2% return means the U.S. dollar rose 27.2% vs. the yen year to date.

Source - Bloomberg; data as of 10/26/22

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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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