GLOBAL
Insight
WEEKLY

Perspectives from the Global Portfolio Advisory Committee November 3, 2022

The Fed doesn't know where it's going, but it believes it has to get there

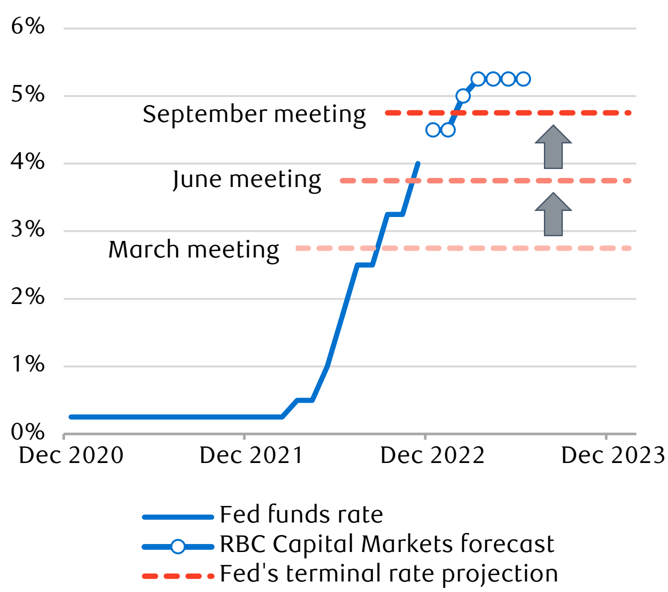
Thomas Garretson, CFA – Minneapolis

As global central banks approach the end-game phase of aggressive 2022 policy tightening campaigns, many have taken the first steps in signaling a more cautious approach to rate hikes ahead—except the Fed. The Fed now stands alone.

In the run-up to the final two major global central bank meetings this week featuring the Federal Reserve and the Bank of England (BoE), an air of dovishness floated over markets—first led by the Bank of Canada, which delivered a lower-than-expected 50 basis point (bps) rate hike on Oct. 26. That was followed by the European Central Bank the next day where policymakers delivered a second 75 bps hike but signaled a reluctance to state explicitly that more increases are in the pipeline, while raising doubts about the need to take policy rates much beyond the "neutral" level and into economically restrictive territory, despite still-elevated inflationary pressures.

And that set the stage for the latest Fed meeting this week where markets expected the Fed to follow suit with a long-awaited dovish pivot away from jumbo-sized rate hikes. It actually played out largely in line with consensus expectations—with the meeting confirming that after a fourth consecutive 75 bps rate hike, the pace would likely slow "as soon as the next meeting" in December, according to Fed Chair Jerome Powell during his press conference. But moments later he once again stamped down any sense that the Fed was at all ready to back down from its fight against inflation.

The Fed's expectations for where it's ultimately taking interest rates continue to shift higher



Source - RBC Wealth Management, Bloomberg, RBC Capital Markets, Federal Reserve Summary of Economic Projections

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

After an initial positive market response to the policy statement, something Powell apparently caught wind of as he went on to deliver some of his most hawkish statements, sending equity indexes down sharply, and Treasury yields higher.

Of particular note was that while the pace of hikes may well slow, the level of rates ultimately needed could be “higher than previously thought,” a level thought to be 4.75 percent as recently as the Fed’s mid-September meeting. Powell cited recent data on the labor market and inflation that have yet to show any real signs that the 375 bps of total policy tightening over the past nine months—the most over any similar window since 1980—has actually had much of any impact at all. As the chart on the previous page shows, the process of discovering how high rates need to go has been a process indeed—from a peak level of 2.75 percent at the March meeting, 3.75 percent in June, and 4.75 percent in September. It seems to us that the Fed still has no real sense of what that terminal level is, and that’s only adding uncertainty and volatility to U.S. markets.

So as a result of the Fed digging in its heels and offering few reasons to doubt its resolve, RBC Capital Markets raised its peak policy rate forecast to 5.25 percent, from 4.75 percent, which it sees being achieved by March of 2023 via a series of 50, 50, and 25 bps rate hikes in December, February, and March, respectively.

Higher for shorter

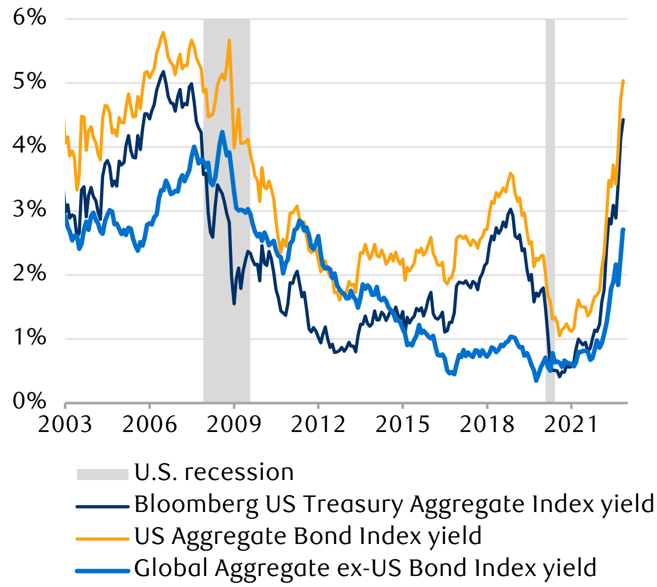
To this point, the broad sense has been that the Fed would take rates to a high level—but perhaps not excessively high—and then leave them there for an extended period of time as a hoped-for “soft landing” played out. But in our view, the risk is only growing that the Fed is going to simply keep at it until something breaks, and that higher rates will mean a faster policy reversal as prospects of a “hard landing” for the economy grow. As the saying goes, the bigger they are, the harder they fall.

And the Fed seems … okay with this? Also from Powell’s press conference, he clearly remains in the camp that sees the risks of doing too little as outweighing the risks of doing too much, stating “… if we were to overtighten, we could then use our tools strongly to support the economy. Whereas, if we don’t get inflation under control because we don’t tighten enough, now we’re in a situation where inflation is now entrenched …” This essentially means that if the Fed gets it wrong, it could simply start cutting rates.

A tale of two countries

Whereas the Fed continues to be unwilling to give markets even an inch by warning that rates could go higher than expected, the BoE took a different tack by stating that if policy rates did indeed rise as high as markets had been expecting—north of five percent in 2023—a two-year long recession could be the result.

Global central bank tightening has brought bond yields back to near 20-year highs



Source - RBC Wealth Management, Bloomberg bond indexes

So though the BoE delivered a 75 bps rate hike, the biggest in over 30 years, by pushing back firmly against the market it has set a firmly dovish tone, with the pound falling nearly two percent against the dollar in the aftermath of its meeting. That puts dollar strength—which has already caused global stress—back on the radar as the Fed now stands alone.

Narrow seas, wide opportunities

While Powell noted that the path to a soft economic landing was “narrowing,” we believe the opportunities for fixed income investors as a result of aggressive central bank rate hikes have only widened. As the chart shows, yields on aggregate investment-grade bond indexes around the globe are nearing multi-decade highs. But as Powell also noted, the Fed could be forced to reverse course just as quickly as it set out, which means the window for investors to put money to work at historically attractive levels may also close sooner than some may expect.

UNITED STATES

Alan Robinson – Seattle

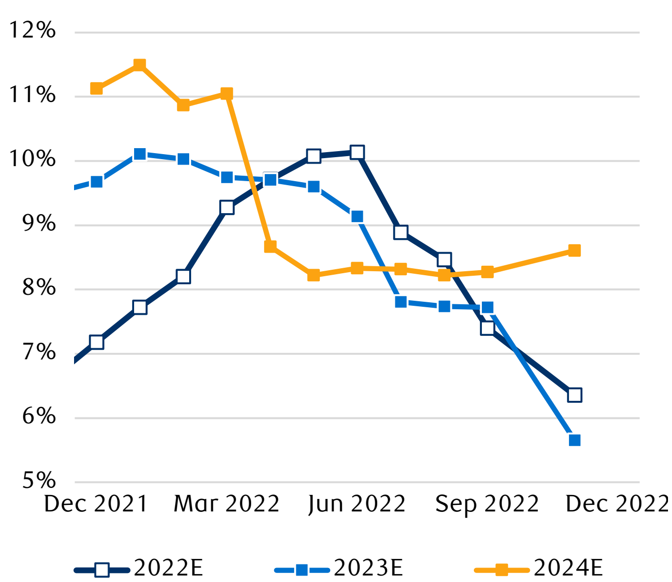
- **U.S. stocks had a tough week, surrendering the gains made the prior week**. Investors digested cautious corporate commentaries from the peak week of earnings season, and the impact was exacerbated by the continued hawkish narrative from the Fed.

- A total of 85% of the S&P 500 companies are expected to have reported earnings by the end of the week, and **if trends continue, overall earnings for the quarter will have grown by only 2% y/y. This growth rate likely overstates the actual health of earnings**. If we exclude the outsized impact of the Energy sector, which accounts for only 5% of the S&P 500 by market capitalization, earnings growth would have turned negative at single-digit percentage rates.

- **It wasn't all bad news, with some upbeat commentaries on continued pricing power and consumer spending on travel and leisure. Industrial demand remained surprisingly firm**, with the Aerospace & Defense sub-industry continuing to shine. The most notable negative outlooks cited heightened macro uncertainty, inflation, weaker online advertising revenues, reduced spending on big-ticket items, and a shift away from pandemic beneficiaries.

- Aside from the well-telegraphed macro concerns, **most companies' reports also cited earnings headwinds from the strong U.S. dollar.** The average value of the trade-weighted dollar was 16% higher in Q3 2022 compared to the same quarter last year. With almost half of S&P 500 revenues generated overseas, this implies single-digit declines in revenues from currency headwinds alone. Technology companies were particularly impacted.

Evolution of S&P 500 annual EPS growth estimates



Source - RBC Wealth Management, FactSet

Apple (AAPL), Alphabet (GOOGL), Microsoft (MSFT), and even Johnson & Johnson (JNJ) claimed foreign currency weakness impacted their revenue by 5%–6% during the quarter, with further impacts expected in Q4.

- While earnings forecasts for the next few quarters have slowly crept lower (see chart), we think they might not have gone far enough given widespread fears of a recession in 2023. **Realistic forecast reductions that account for negative earnings growth are probably needed before longer-term inflows into equities resume, in our view**. This "stickiness" in earnings estimates is partly due to reluctance by management teams to provide guidance for 2023.

CANADA

Sean Killin & Mila Krunic – Toronto

- **The Canadian economy edged slightly higher in August, posting 0.1% m/m growth in GDP**, topping its initial estimate that suggested no growth for the month. The preliminary estimate for September puts the annualized growth rate for the third quarter to 1.6%, down from an annualized growth rate of 3.3% in the second quarter. According to Statistics Canada, output rose in 14 out of 20 sectors in August. Service-producing sectors led the way, rising 0.3% m/m, which helped offset a pullback in the goods industry, which declined 0.3%. The sectors that grew for the month included agriculture (3.9% m/m), utilities (1.5%), retail trade (1.2%), and wholesale trade (0.9%), while construction (-0.7% m/m), manufacturing (-0.8%) and oil and gas extraction (-1.0%) declined. Statistics Canada noted that while residential construction was down for the fourth time in five months, activity in August was 8% above the February 2020 pre-pandemic level.

- **The Canadian Government is preparing the release of fresh spending forecasts** in order to update its approach to fiscal policy in the post-pandemic inflationary era. For context, tighter monetary policy and its impact on financial conditions throughout the Canadian economy have meaningfully slowed economic growth expectations, as household consumption begins to feel the pressure of higher interest rates and elevated inflation. As a result, RBC Economics is expecting Canada to slip into a recession in early 2023, as household consumption metrics further degrade, which has pushed the current government to implement supportive policy measures in the past. That being said, with the immense financial market volatility that followed the September release of former British Prime Minister Liz Truss' budget fresh in the minds of policymakers, it's clear to us that Canadian legislators are attempting to signal that their fiscal plan is short-term targeted support, rather than long-term structural shifts in fiscal policy.

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

- **The European economy eked out 0.2% q/q growth in Q3, thanks to the final effects of the economic reopening**. Investment in France, consumption in Germany, and tourism in Spain offset weakness in other sectors. Looking ahead, **prospects for economic growth remain challenging**, in our view. Real wage growth is at multi-decade lows and the European Central Bank (ECB) has increased interest rates more sharply and aggressively than ever before.

- **Yet inflation in the euro area is showing no sign of abating**, soaring to 10.7% y/y in October, up from 9.9% in September and 0.4 percentage points above consensus expectations. Energy prices were the main culprit but rising input costs are increasingly being passed through to end users. Inflation is spreading to manufactured goods.

- **Increasingly broad-based inflation that remains much above the ECB's target will likely keep pressure on the central bank to continue to increase interest rates**, even despite a recession becoming more likely. We think the ECB was too slow in realizing that even if inflation is due to supply shocks, if it remains too high for too long it risks engendering spillover effects. The risk, in our opinion, is that the ECB tries to remedy its mistake by pursuing a policy of increasing interest rates too much, too quickly into a weakening economic environment, resulting in a deeper recession in 2023 than is already widely forecast.

- Given the weakening economic outlook and downside risks, **we continue to recommend being Underweight European equities**. However, we acknowledge that valuations are inexpensive relative to history and U.S. equities, while investor caution is already fairly pronounced.

- When allocating to European equities within a broader global equity allocation, **we would focus on stock selection and key structural long-term trends such as decarbonisation**. At the sector level, we continue to like Health Care, especially Pharmaceuticals where we see several opportunities in what we view as reasonably valued, quality defensive companies.

ASIA PACIFIC

Jasmine Duan – Hong Kong

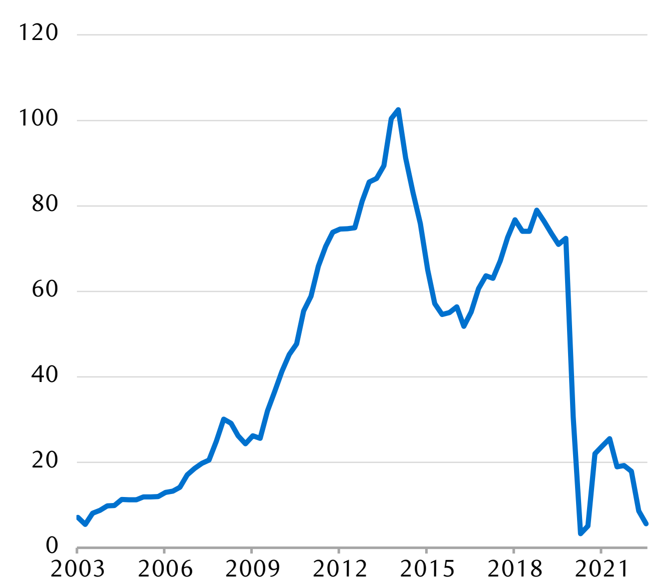
- **Asian equities largely traded higher for the first three days of the week**. But the rally paused today in response to the Federal Reserve's hints of more policy tightening than had previously been anticipated. Chinese equities remained choppy as news on lockdowns and reopenings continued to bring volatility to the market. A seven-day lockdown in Zhengzhou City in Henan Province has affected Foxconn Technology's main factory, which is one of the key plants for iPhone production. The lockdown is expected to last until Nov. 9. The Foxconn plant is utilizing a "closed-loop" operation to minimize contact with areas outside of the large factory complex; however, its production could still be affected.

- **China resumed accepting online visa applications and group tours to Macau effective Nov. 1**. In-person applications had been required for the past 2.5 years due to COVID-19 restrictions. The resumption should encourage more mainland tourists to visit Macau, in our opinion, and has boosted investor sentiment on the Macau gaming sector. The Bloomberg Intelligence Index of Macau's six casino operators surged almost 20% this week, which we believe is positive news for the Macau tourist industry. However, we think tourist numbers will only increase gradually due to a concern that a tightening of border control could happen if there is a COVID-19 outbreak.

- **Chinese companies continue to report third-quarter earnings**. According to Bloomberg data, companies that have reported earnings account for 41% of MSCI China Index market capitalization. Sixty-six percent of these companies delivered lower-than-expected numbers, and the aggregate EPS surprise has come in 6% below consensus estimates. Energy and Consumer Discretionary are the only sectors that have delivered positive earnings surprises, while Real Estate and Communication Services have posted among the worst earnings results. Many large technology companies such as Alibaba (9988 HK / BABA) and Tencent (700 HK) are scheduled to announce results in mid-November.

Macau gross gaming revenue has dropped to a historic low due to fewer tourists

Macau Gross Gaming Revenue Index



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

MARKET Scorecard

Data as of November 2, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,759.69	-2.9%	-21.1%	-18.8%	13.6%
Dow Industrials (DJIA)	32,147.76	-1.8%	-11.5%	-10.8%	19.4%
Nasdaq	10,524.80	-4.2%	-32.7%	-32.7%	-3.9%
Russell 2000	1,789.14	-3.1%	-20.3%	-24.2%	14.1%
S&P/TSX Comp	19,277.01	-0.8%	-9.2%	-8.9%	22.8%
FTSE All-Share	3,910.01	0.9%	-7.1%	-5.7%	22.8%
STOXX Europe 600	413.39	0.3%	-15.3%	-13.8%	18.8%
EURO STOXX 50	3,622.01	0.1%	-15.7%	-15.7%	20.0%
Hang Seng	15,827.17	7.8%	-32.4%	-36.9%	-35.3%
Shanghai Comp	3,003.37	3.8%	-17.5%	-14.3%	-6.9%
Nikkei 225	27,663.39	0.3%	-3.9%	-6.3%	18.8%
India Sensex	60,906.09	0.3%	4.6%	1.5%	53.2%
Singapore Straits Times	3,141.13	1.6%	0.6%	-2.8%	28.6%
Brazil Ibovespa	116,928.66	0.8%	11.5%	10.8%	24.5%
Mexican Bolsa IPC	50,864.85	1.9%	-4.5%	-1.5%	37.5%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.098%	5.1	258.8	255.0	325.5
Canada 10-Yr	3.332%	8.1	190.6	160.8	269.6
UK 10-Yr	3.399%	-11.7	242.8	236.0	318.0
Germany 10-Yr	2.141%	-0.1	231.8	230.6	278.1
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	5.01%	0.2%	-15.5%	-15.6%	-16.0%
U.S. Investment-Grade Corp	5.91%	0.4%	-19.2%	-19.3%	-17.6%
U.S. High-Yield Corp	8.97%	0.1%	-12.4%	-11.7%	-2.6%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,635.29	0.1%	-10.6%	-8.5%	-13.7%
Silver (spot $/oz)	19.22	0.3%	-17.6%	-18.4%	-20.2%
Copper ($/metric ton)	7,717.00	2.6%	-20.8%	-21.0%	14.3%
Oil (WTI spot/bbl)	90.00	4.0%	16.9%	7.3%	144.5%
Oil (Brent spot/bbl)	95.68	0.9%	23.0%	12.9%	145.5%
Natural Gas ($/mmBtu)	6.17	-2.9%	65.5%	11.4%	90.3%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	112.0820	0.5%	17.2%	19.1%	19.1%
CAD/USD	0.7295	-0.6%	-7.8%	-9.5%	-3.6%
USD/CAD	1.3708	0.6%	8.5%	10.5%	3.7%
EUR/USD	0.9817	-0.7%	-13.7%	-15.2%	-15.7%
GBP/USD	1.1390	-0.7%	-15.8%	-16.3%	-11.8%
AUD/USD	0.6352	-0.7%	-12.5%	-14.5%	-10.0%
USD/JPY	147.9300	-0.5%	28.5%	29.8%	41.3%
EUR/JPY	145.2600	-1.2%	11.0%	10.1%	19.1%
EUR/GBP	0.8620	0.0%	2.5%	1.3%	-4.4%
EUR/CHF	0.9850	-0.5%	-5.1%	-7.0%	-7.9%
USD/SGD	1.4178	0.1%	5.1%	5.1%	3.8%
USD/CNY	7.2900	-0.2%	14.7%	13.9%	9.0%
USD/MXN	19.6734	-0.7%	-4.2%	-5.3%	-8.0%
USD/BRL	5.1468	-0.6%	-7.7%	-9.5%	-10.4%

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 0.72 means 1 Canadian dollar will buy 0.72 U.S. dollar. CAD/USD -7.8% return means the Canadian dollar fell 7.8% vs. the U.S. dollar year to date. USD/JPY 147.93 means 1 U.S. dollar will buy 147.93 yen. USD/JPY 28.5% return means the U.S. dollar rose 28.5% vs. the yen year to date.

Source - Bloomberg; data as of 11/2/22

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As of September 30, 2022

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