GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

November 17, 2022

UK recession: First in, last out?

Frédérique Carrier – London

The UK seems to be the first major economy to enter recession, and could be the last to exit. We explore the reasons behind lackluster performance and conclude that despite an unpalatable economic scenario unfolding, investors can find opportunities.

Already in recession

The UK seems to be the first of the major advanced economies to enter recession. It is not doing so in a position of strength, as it is the only G7 economy still languishing below its pre-pandemic output levels, having had to contend with the economic shocks of Brexit and this year's energy crisis in addition to the impact of COVID-19.

In Q3, the UK's GDP contracted by 0.2 percent q/q, with retail sales falling both in August and September. Lead indicators for October also point to a slump. Consumption, the economy's main driver, is sputtering as a crippling cost-of-living crisis, with inflation exceeding 11 percent, takes its toll on consumers.

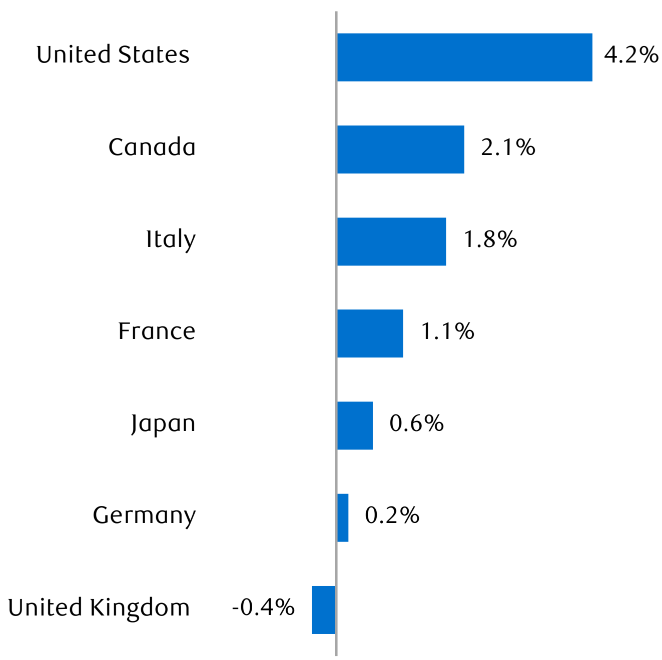
Prolonging the pain

More challenges are in store, as the government has announced sweeping spending cuts and tax increases, even as the Bank of England tightens monetary policy.

Newly appointed Prime Minister (PM) Rishi Sunak is imposing austerity in an effort to restore credibility after his predecessor Liz Truss' fiscal recklessness increased UK assets' risk premium. Sunak's austerity measures, which are projected to total around 1.9 percent of GDP

UK economy still below pre-pandemic levels

GDP growth from Q4 2019 to Q3 2022*



* Japan data only available up to Q2 2022

Source - Organization for Economic Corporation and Development

The next edition of the Global Insight Weekly will be published on December 1.

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

over the next five years, aim to get the nation's debt-to-GDP ratio—which stood at roughly 103 percent as of the end of 2021—falling at a comfortable pace.

Meanwhile, the Bank of England (BoE), the first major central bank to embark on a tightening cycle back in 2021, has raised interest rates to three percent so far. With a more prudent fiscal policy in place, we think the BoE will likely be less aggressive going forward. RBC Capital Markets believes the Bank Rate will reach 3.75 percent at the end of the current tightening cycle, less than the 4.9 percent consensus estimate.

Higher interest rates are already having an impact on the housing market. Mortgage financing tightened markedly as a result of the ill-fated fiscal expansion announced by Truss in September. Mortgage rates have since retreated, but remain elevated. In the UK, some 30 percent of mortgages are fixed for two years and will be coming up for refinancing at much higher rates. Surveys, including a recent one by UK real estate website Rightmove, suggest property prices are declining.

With UK consumers particularly sensitive to the housing market, this suggests the BoE's efforts are having the intended effect of decelerating demand.

Deregulation is no panacea

Government hopes that getting rid of EU regulation would give industry a shot in the arm are proving unfounded so far. Reviewing 50 years of EU regulation is an enormous task; PM Sunak has backed away from his ambitious proposals to complete the exercise within 100 days of assuming the premiership. Moreover, business groups such as the Confederation of British Industry have warned that deregulation for its own sake could add extra costs to companies already facing difficult economic times, according to the Financial Times.

The result of all this will likely be a long-drawn-out recession. Consensus economic forecasts for the UK point to a contraction of 0.5 percent in 2023, but with downside risk as the impact of austerity gets incorporated into forecasts. The recession could last well into 2023.

A more cautious monetary policy will mean tolerating sticky inflation and a weaker pound, in our view.

Change of tack needed

Decisions taken by policymakers (fiscal recklessness followed by austerity in a recession) and by society at large (Brexit) have put the UK economy on a difficult path. In our view, the economy will eventually recover, but a change of direction would likely help it improve sooner.

Such a change may be emerging. Sunak differs from his three predecessors since 2016 in that he doesn't seem bent on taking an adversarial stance against the country's major trading partner, the EU. In early November, Sunak became the first PM since 2007 to attend a British-Irish Council Summit, and a bilateral summit with France has been announced for Q1 2023. A solution to the dispute over the Northern Ireland Protocol, the customs procedures designed to avoid a hard border on the island of Ireland since Brexit, would go some way towards reducing the uncertainty which has affected investment since the UK voted to leave the EU in 2016, in our view.

Low valuations, high dividends

With austerity making economic conditions more challenging, we maintain our Underweight recommendation for UK equities as part of a global portfolio.

However, we think there remain attractive opportunities in UK equities, which are trading at a historically large valuation discount to other markets, even accounting for differences in sector composition. For income-seeking investors, the FTSE All-Share Index has the highest dividend yield among the major regional equity markets, at over four percent.

We maintain our strong bias for internationally oriented companies. The valuation multiples of many leading UK-listed multinationals are now significantly lower than peers listed in other markets. Despite their strong outperformance in 2022, we believe that Energy companies in particular remain attractively valued, given the prospect of oil and gas prices remaining higher for longer. We would continue to be selective towards domestically focused UK stocks given our cautious stance on consumer spending.

With contributions from Thomas McGarrity, CFA

UNITED STATES

Ben Graham, CFA – Minneapolis

- **U.S. equities are on track for modest weekly declines** after last week's rally driven by lower-than-expected Consumer Price Index (CPI) data for October. Thus far this week, equities are somewhere in the 1%–3% lower range. Leadership is coming from the Dow Jones Industrial Average and S&P 500 while the tech-heavy Nasdaq and small-cap Russell 2000 lag. Sector leadership is evident in defensive areas such as Health Care and Consumer Staples while weakness can be seen in the more cyclical sectors such as Real Estate, Consumer Discretionary, and Energy.

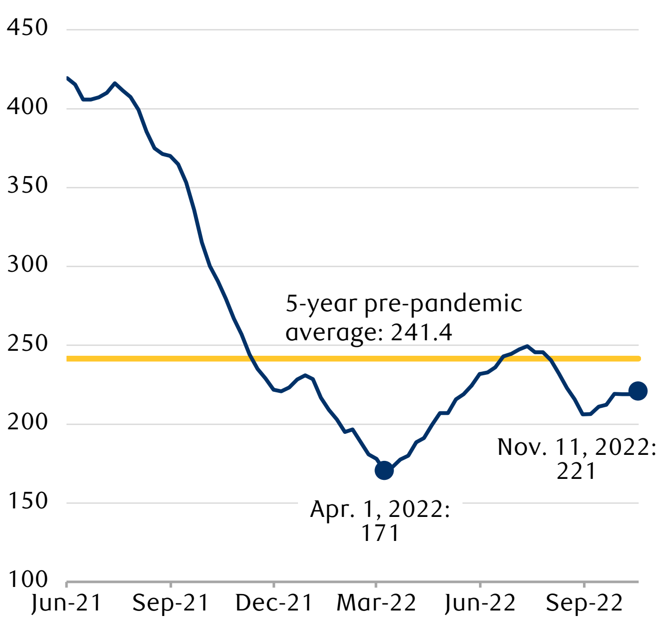
- **Economic releases this week showed the employment backdrop remains expansionary** and additional inflationary data surprised to the downside. Specifically, the Producer Price Index (PPI) climbed 6.7% y/y in October, notably slower than the consensus expectation of 7.1%. While initial unemployment claims of 222,000 for the week ending Nov. 11 shifted the four-week moving average higher to 221,000, claims are still well below the pre-pandemic average. As it currently stands, claims data remain indicative of an expansionary economy. We think the evolution of this data in the coming weeks and months should provide a good barometer of the direction of the overall U.S. economy.

- Finally, **retail sales in October were higher than the consensus expectation** as consumers increased their purchases 8.3% y/y, with an increase in underlying units purchased as well—meaning the overall rise in sales was not solely due to inflation. From an equity market perspective, the retail sales data was constructive. But this was offset by earnings commentaries from management teams in the Consumer Discretionary sector communicating that consumer spending trends have decelerated in the second half of the year and the deceleration has been present in November as well.

- **The 10-year U.S. Treasury rate continued to build on last week's CPI-related decline** after PPI data surprised to the downside. The key interest rate moved from 3.82% on Friday, Nov. 11 to 3.69% on Wednesday, Nov. 16. While the yield drifted up to 3.78% midday the following session, it was still well below the Oct. 24 high of 4.23%.

Unemployment claims remain below average despite recent developments

Weekly Initial Unemployment claims, 4-week average (in thousands)



RBC Wealth Management, FactSet; data through 11/11/22

CANADA

Luis Castillo & Simon Jones – Toronto

- **October headline CPI inflation in Canada came in at 6.9% y/y, roughly in line with expectations and unchanged from the prior month**. However, the Bank of Canada's (BoC's) preferred core inflation measures (CPI Core-Common, Median, and Trim) did tick higher from September. The usual suspects were once again at play in the headline figure: despite slower growth in food costs (0.2% m/m) compared to the prior month's 0.7%, prices for gasoline rose 9.2% m/m (18% y/y). **Although inflation appears to be peaking, levels remain uncomfortably high relative to BoC targets, doing little to derail market expectations for a 25 basis point hike in December**. That being said, as shown in its most recent Monetary Policy Report (MPR), the BoC did downwardly revise its inflation forecast for 2023 to 4.1% from 4.6%, and it still expects inflation to drop towards the 2% target by 2024 as tighter financial conditions work their way through the economy—a view that's been corroborated by bond market participants through fairly anchored short-term to midterm inflation breakevens (measures of market implied inflation expectations).

- **The Bank of Canada may be closer to the end of its tightening cycle than the market expects, according to a recent report by RBC Economics**. Although the economic implications of this year's aggressive monetary policy tightening are still unclear, with the Canadian economy likely headed for a recession in the months ahead, RBC Economics views the downside risks to growth as a key factor that could prevent the Bank of Canada from reaching the approximate 4.5% terminal rate currently priced into markets. There has been a notable shift in the communication from policymakers towards the long and variable lags between policy actions and their impact on both inflation and the economy. So, although the labour market and consumer spending have thus far proved resilient, **should the early signs of economic weakness continue to evolve in line with RBC Economics' below-consensus growth forecasts, government bond yields may be approaching their peak**.

EUROPE

Rufaro Chiriseri, CFA & Thomas McGarrity, CFA – London

- The UK's Chancellor of Exchequer provided his much anticipated Autumn Statement, setting out the government's **medium-term fiscal plans to put the UK back on the path to fiscal credibility and sustainability**. The total package of measures represents a fiscal consolidation of £55 billion by the end of fiscal year 2027–2028, with £30 billion in spending cuts and £25 billion in tax increases.

- Notably, **public spending cuts will be back-loaded and deferred to 2025–2026, after the expected 2024 general election**. Tax increases feature more prominently in the early years of the plan, with increased tax revenues coming from: (1) the freezing of employer National Insurance Contributions thresholds; (2) a new 45% levy on the "extraordinary returns" of electricity generators; and (3) an increase in the windfall tax on oil and gas companies' UK-derived earnings to 35% from 25%.

- The medium-term plan for public finances was accompanied by **grim economic forecasts from the UK's independent Office for Budget Responsibility (OBR)**. The OBR projects UK real GDP to decline by 1.4% in 2023, in contrast to the current consensus forecast of a 0.5% decline among economists surveyed by Bloomberg, and forecasts unemployment to rise to 4.9% midway through 2024 versus 3.6% in September 2022. Moreover, the OBR estimates real household disposable income in the UK will fall by 7% over the next two years—the biggest drop ever, wiping out the previous eight years' growth.

- **UK inflation broke records again in October, surging to 11.1% y/y from 10.1% y/y in September**—the highest reading in 41 years. Gas and electricity prices, followed by food prices, were the largest contributors to inflation accelerating. In line with other economists' estimates, the OBR forecasts a peak in inflation in Q4 2022, followed by a sharp drop next year.

- The UK's tight labor market and eye-watering inflation warrant further rate increases, in our view, albeit at a slower pace as the looming recession comes into focus for the Bank of England. **We anticipate a 50 bps hike at the Dec. 15 meeting**, in line with market expectations.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets have traded higher during the week, led by Hong Kong**, with the Hang Seng Index up more than 20% from the late October low. Sentiment for H-shares (stocks of companies based in Mainland China that trade on the Hong Kong Exchange or foreign exchanges) has been buoyant on the back of what is viewed as a warming U.S.-China relationship, and supportive domestic policies by the Chinese government.

- **President Xi Jinping spoke for more than three hours with President Joe Biden in a bilateral meeting ahead of the G20 summit**. The two leaders set a more positive tone for relations, in our view, which had fallen to a low point after U.S. House Speaker Nancy Pelosi made a controversial visit to Taiwan. Both presidents agreed to resume bilateral talks on climate change, economic stability, and health and food security. While some important issues remain unresolved, we believe the consensus of the two leaders to avoid further conflicts could ultimately improve bilateral relations if it is followed up by constructive deeds in the future.

- Separately, supporting investors' sentiment, **the Chinese government announced 20 measures to modestly relax COVID-19 restrictions and another 16 to support the property sector**. While we think the new COVID-19 measures probably will not encourage many people to travel yet, we view this as an important step. We believe the property sector measures should support cash-strapped developers by providing much-needed breathing space.

- **Tencent Holdings (700 HK) reported better-than-expected Q3 2022 earnings** driven by cost savings where further improvement in cost structure aided margins. Tencent also announced that it will be distributing the bulk (91%) of its holdings in Meituan (3690 HK) to its shareholders at a ratio of 1 Meituan share for every 10 Tencent shares held. This will reduce Tencent's stake in Meituan to 1.5% from 15.5%. We think Tencent's action led to a broad selloff of Chinese internet stocks on Thursday as investors feared more divestments by Tencent are in the pipeline.

Hang Seng Index has rallied more than 20% from Oct. 31 low

Source - RBC Wealth Management, Bloomberg; data through 11/17/22

MARKET Scorecard

Data as of November 16, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,958.79	2.2%	-16.9%	-15.8%	9.2%
Dow Industrials (DJIA)	33,553.83	2.5%	-7.7%	-7.2%	12.0%
Nasdaq	11,183.66	1.8%	-28.5%	-30.0%	-6.2%
Russell 2000	1,853.17	0.3%	-17.5%	-22.9%	3.8%
S&P/TSX Comp	19,957.96	2.7%	-6.0%	-8.1%	18.2%
FTSE All-Share	4,035.87	4.1%	-4.1%	-3.6%	11.5%
STOXX Europe 600	430.17	4.4%	-11.8%	-12.1%	10.4%
EURO STOXX 50	3,882.78	7.3%	-9.7%	-11.8%	12.0%
Hang Seng	18,256.48	24.3%	-22.0%	-29.0%	-30.8%
Shanghai Comp	3,119.98	7.8%	-14.3%	-11.4%	-6.8%
Nikkei 225	28,028.30	1.6%	-2.7%	-6.0%	8.2%
India Sensex	61,980.72	2.0%	6.4%	2.7%	42.0%
Singapore Straits Times	3,266.17	5.6%	4.6%	0.8%	18.9%
Brazil Ibovespa	110,243.33	-5.0%	5.2%	5.6%	3.6%
Mexican Bolsa IPC	51,544.94	3.3%	-3.2%	0.7%	26.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.692%	-35.6	218.2	205.8	278.6
Canada 10-Yr	3.060%	-19.1	163.4	127.5	232.3
UK 10-Yr	3.149%	-36.7	217.8	215.8	280.0
Germany 10-Yr	1.996%	-14.6	217.3	223.8	254.1
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.69%	2.4%	-13.7%	-13.2%	-14.4%
U.S. Investment-Grade Corp	5.48%	3.4%	-16.9%	-16.2%	-16.2%
U.S. High-Yield Corp	8.71%	1.4%	-11.3%	-10.7%	-3.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,773.71	8.6%	-3.0%	-4.2%	-6.1%
Silver (spot $/oz)	21.48	12.1%	-7.9%	-13.5%	-13.3%
Copper ($/metric ton)	8,348.25	11.0%	-14.3%	-12.8%	17.7%
Oil (WTI spot/bbl)	85.59	-1.1%	11.2%	6.0%	107.0%
Oil (Brent spot/bbl)	92.65	-2.3%	19.1%	12.4%	111.4%
Natural Gas ($/mmBtu)	6.23	-1.9%	67.1%	20.4%	131.1%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	106.2960	-4.7%	11.1%	10.8%	14.7%
CAD/USD	0.7503	2.2%	-5.2%	-5.8%	-1.9%
USD/CAD	1.3328	-2.2%	5.5%	6.1%	1.9%
EUR/USD	1.0391	5.2%	-8.6%	-8.2%	-12.3%
GBP/USD	1.1914	3.9%	-12.0%	-11.3%	-9.7%
AUD/USD	0.6739	5.3%	-7.2%	-7.7%	-7.9%
USD/JPY	139.5400	-6.2%	21.3%	21.5%	33.4%
EUR/JPY	145.0000	-1.3%	10.8%	11.6%	17.0%
EUR/GBP	0.8722	1.2%	3.7%	3.5%	-2.9%
EUR/CHF	0.9819	-0.8%	-5.4%	-6.8%	-9.2%
USD/SGD	1.3703	-3.3%	1.6%	1.0%	1.9%
USD/CNY	7.0982	-2.8%	11.7%	11.0%	7.8%
USD/MXN	19.3385	-2.4%	-5.8%	-6.8%	-4.7%
USD/BRL	5.3925	4.1%	-3.3%	-1.9%	-0.7%

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 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -5.2% return means the Canadian dollar fell 5.2% vs. the U.S. dollar year to date. USD/JPY 139.54 means 1 U.S. dollar will buy 139.54 yen. USD/JPY 21.3% return means the U.S. dollar rose 21.3% vs. the yen year to date.

Source - Bloomberg; data as of 11/16/22

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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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