GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee

December 15, 2022

Return to sender

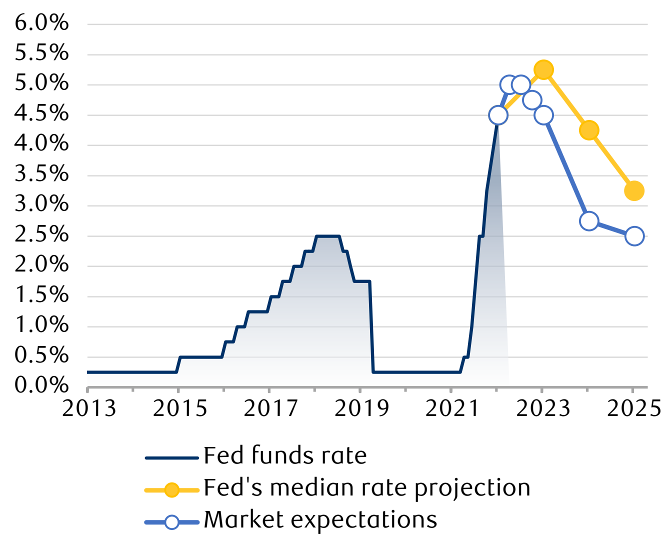
Thomas Garretson, CFA – Minneapolis

The Federal Reserve attempted to deliver another hawkish performance at this week's meeting, but after an extended run this year, market reaction suggests the act may be wearing thin. We maintain our view that Treasury yields have peaked and policymakers should turn to rate cuts late next year.

By nearly any metric, the Fed's latest committee meeting was more hawkish than most had expected, certainly with respect to an upgraded rate outlook that now has rates peaking at 5.25 percent in 2023 before starting to fade gradually through 2025. But as the first chart shows, the market still isn't buying it. Not only does current market pricing have the Fed struggling to achieve a policy rate of even 5.25 percent in 2023, pricing suggests the potential for roughly 50 basis points (bps) of rate cuts by the end of the year.

On the economic front, there was some anticipation that recent positive developments on inflation would be reflected in the outlook. But still no, and this despite the 425 basis points of policy tightening already delivered this year. The Fed's projections now have year-over-year core PCE inflation in Q4 2023 at +3.5 percent, up notably from +3.1 percent when policymakers last met in September and a far cry from their two percent goal. And that projection assumes not only economic growth of just +0.5 percent next year in real (inflation-adjusted) terms, but the unemployment rate rising to 4.7 percent, from 3.7 percent currently; historically, increases of that magnitude have almost always coincided with negative economic growth and officially recognized recessions.

Markets push back against ramped-up rate hike expectations, still see earlier and deeper rate cuts



Source - RBC Wealth Management, Bloomberg, Federal Reserve; shows upper-bound of Fed's target range; market expectations based on Overnight Index Swap data

The next edition of the Global Insight Weekly will be published on January 5, 2023.

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

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For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

Put simply, the Fed's own projections just don't make a lot of sense to us at this stage, so we won't spend any more time digging through the numbers. The early market reaction, with the S&P 500 down more than four percent since the meeting and Treasury yield curves moving even deeper into inversion, is a clear sign that the Fed increasingly risks doing more than is necessary, in our view.

Looking in the rearview mirror

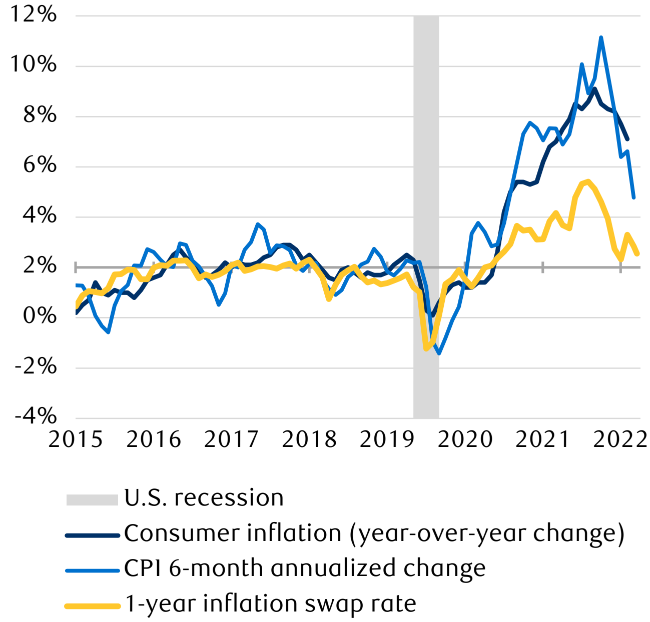
And therein lies the disconnect—it appears as though the Fed has abandoned much of the forward-looking guidance that markets can often provide, while hanging onto the "still more to do" messaging it has employed in recent months.

If there was one thing that stood out to us in particular, it was the backward-looking nature of not just the Fed's economic and rate projections, but also Fed Chair Jerome Powell's press conference. Perhaps it was a function of just how confounding the Fed's own economic and rate projections were at this meeting that most of the questions centered on how the Fed even came up with its forecasts, which appeared to reflect a lack of awareness of, or an unwillingness to make concessions to, market developments and recent data—even if it's admittedly still too early to provide a concrete "all clear" signal.

While inflation certainly remains high, there is a wide swath of economic and market data that strongly suggests pressures are easing, and markedly so. As the second chart shows, while headline CPI inflation is still running at an elevated 7.1 percent year-over-year pace, the six-month annualized rate—which captures more of the recent inflation dynamics—has dropped to just 4.8 percent. At the same time, inflation swaps (which are benchmarked to expected headline consumer price inflation over the next year) are trading to just 2.5 percent, having almost completely returned to pre-pandemic levels.

Among the other things we are watching is the NFIB Small Business Survey. The index on employee compensation, which tends to lead actual year-over-year wage growth, has posted one of its largest declines on record since the summer to reach its lowest level since August 2021, reducing the risk of wage pressures in the pipeline. And the index on hiring plans from the same survey, which should be of particular interest for a Fed that still fears too many job openings relative to the supply of labor, is nearing a two-year low, suggesting that labor demand is already fading. Rents, another concern for the Fed, have seen monthly gains slow sharply to near zero and on the cusp of turning negative, according to data from Zillow.

After rising faster than expected, early signs point to inflation now falling faster than expected



Source - RBC Wealth Management, Bloomberg; y-axis crosses at Fed's 2% target

Done and dusted

So as 2022 comes to a close, there remains a wide gap between what we think Fed policymakers should do and what they are likely to do. How that gap closes should be clear by the Fed's March 22 meeting next year, but we continue to think the central bank will move back toward market and consensus expectations.

We look for the Fed to further slow the pace of rate hikes to the traditional 25 bps increments at its Feb. 1 meeting, while signaling a forthcoming pause, which would then be confirmed at the March meeting when it next updates its economic and rate projections, in conjunction with one final 25 bps rate hike to bring things to an end with the policy rate in a range of 4.75 percent to 5.00 percent.

But we think that will only set the stage for a quick pivot to rate cuts later in the year, which we see reflected in a benchmark 10-year Treasury yield that has collapsed from a high of 4.24 percent in October to just 3.34 percent in the aftermath of the Fed meeting. And the yield gap between the 10-year Treasury and the 1-year Treasury at 4.40 percent is now at -121 bps, easily the deepest yield curve inversion since the early 1980s.

We had thought this meeting would show the Fed had gotten the memo, but the market's message remains clear: further rate hikes risk more economic damage than is necessary.

UNITED STATES

Alan Robinson – Seattle

- **After a positive start to the week, U.S. stocks came under heavy selling pressure following the Federal Reserve interest rate hike on Wednesday**. The size of the hike was not the issue, rather it was the continued hawkish rhetoric over inflation that upset equity investors.

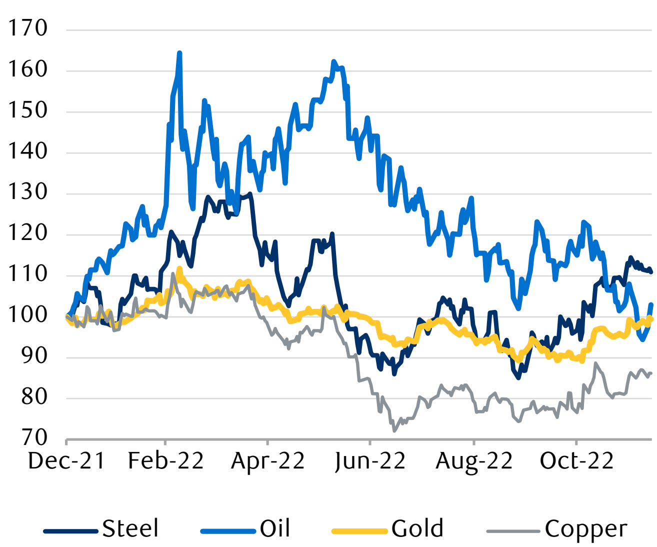
- We think their frustration was warranted, given the weaker-than-expected economic data released during the week. **November Consumer Price Index (CPI) inflation was lower for the fifth month in a row**, up only 0.1% m/m, and core CPI inflation of 0.2% m/m (or 6% y/y) was the lowest in 15 months. RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli notes this trend is likely to continue, and annualized CPI figures should move even lower over the next eight months since the year-ago price levels were so high. He writes, "We think the pieces are in place for core [annualized inflation] to hold a 3-handle by midyear [2023] and a 2-handle by year-end."

- **Global commodity prices have also signaled a slowdown in inflation recently**. Key industrial commodities have all come off the boil recently (see chart) which should help producers lower their costs, benefiting their profit margins and the prices of consumer goods.

- **As U.S. investors look to the new year, one of these commodities may offer improving returns**. While supply is likely to exceed demand for most commodities in a slowing economy, the opposite may be true of oil according to RBC Capital Markets, LLC Global Energy Strategist Michael Tran. He expects a reduction in oil exploration budgets to reduce supply and push West Texas Intermediate oil prices back toward $100 per barrel by the end of next year, or about 33% higher than current prices. In this scenario, oil company stocks should perform well.

- Most other market strategists have already laid out their 2023 outlooks for U.S. stocks. **According to a Bloomberg survey, over 70% of fund managers see equities rising next year**. This makes sense to us given the negative returns this year, even in the face of a (hopefully mild) potential recession. But we caution that earnings estimates for 2023 may need to fall further before a new bull market starts.

Commodity prices end the year well off their highs, signaling lower inflation



Note: Values normalized with 12/31/21 = 100

Source - RBC Wealth Management, FactSet; data through 12/14/22

CANADA

Richard Tan, CFA & Luis Castillo – Toronto

- **November brought a much-needed reprieve to a bond market that is still on track to log one of its worst calendar years on record from a total-return perspective**. The yield on the benchmark 10-year Government of Canada bond dropped by more than 30 basis points (bps), as markets interpreted the shift towards smaller rate hikes from the Bank of Canada (BoC) as a new dovish pivot in monetary policy. The BoC began decelerating its pace of hikes, lifting the policy rate by 50 bps at its October and December meetings compared to the previous 75 bps hike in September and 100 bps hike in July. In addition, this week's fifth consecutive decline in year-over-year U.S. CPI inflation continues to fuel downward momentum in Canadian rates, as markets look for a shift in central bank messaging. We don't think a decelerated pace of tightening represents a pivot just yet, and we view any potential policy shift as likely to be dictated by how quickly inflation returns to target.

- **Following the BoC's decision to lift the policy rate by 50 bps in early December, BoC Deputy Governor Sharon Kozicki delivered the Economic Progress Report, which confirmed the bank is no longer hiking on autopilot**. Although the BoC stands ready and willing to act forcefully if inflation continues to surprise to the upside, with interest rates now firmly in restrictive territory the BoC is now taking a "more data-dependent" approach and "will be considering whether the policy interest rate needs to rise further" rather than debating the size of the next move. Underpinning that decision were the early signs that tighter monetary policy has begun working its way through the economy: consumption of goods has decreased substantially and demand is easing in interest rate sensitive sectors. Despite these factors leading to early indications inflation is losing momentum, it's still too early to declare victory, in the BoC's opinion, with excess demand in the services sector continuing to push prices higher.

EUROPE

Frédérique Carrier – London

- **November inflation in the UK ticked down and was below expectations**. Unlike in the U.S., where inflation is now much below its June peak, UK inflation remains stubbornly elevated, reaching 10.7% y/y compared to the 41-year high of 11.1% y/y a month earlier.

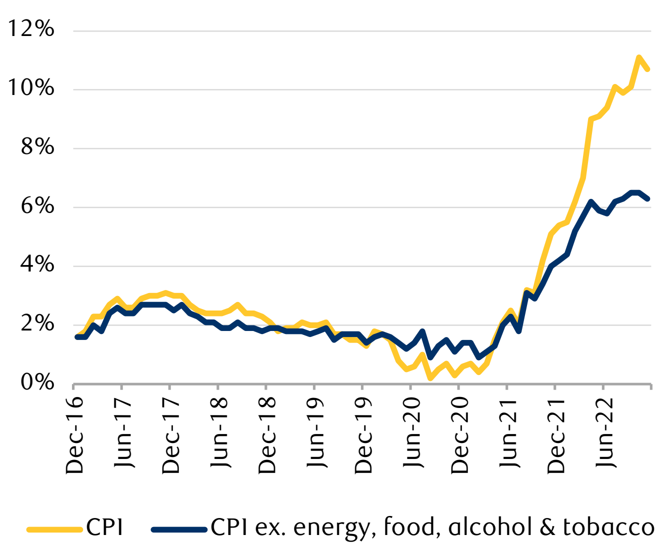
- Encouragingly, RBC Capital Markets points out that with half of the main consumer price inflation categories making downward contributions, including alcohol and tobacco, clothing and footwear, and recreation, **consumer price inflation may have peaked**. Households and businesses struggling with the cost-of-living crisis will hope that is the case.

- **Facing double-digit inflation in Europe, the Bank of England opted to increase the Bank Rate 50 basis points (bps) to 3.5%, the highest level since 2007**, at its last meeting of 2022. A tight labour market, partly due to a labour shortage after the pandemic and Brexit, likely influenced its decision, in our view. For now, RBC Capital Markets expects rates to peak at 3.75% in Q1 2023 and to be maintained at that level throughout the year.

- **In Europe, the European Central Bank (ECB) increased the deposit rate by 50 bps to 2% and signalled the need for further rate hikes to tame inflation**. With staff projections for inflation in 2023 exceeding 6%, ECB President Christine Lagarde delivered a very hawkish message, suggesting interest rates would have to continue to "rise significantly at a steady pace" to ensure they prove sufficiently restrictive for inflation to return to the 2% target. We think that statement suggests two further 50 bps hikes are possible.

Is UK inflation finally peaking?

UK Consumer Prices Index (CPI) y/y inflation



Source - RBC Wealth Management, Bloomberg; monthly data through 11/30/22

- **Messaging around its balance sheet reduction was more subdued**. The ECB announced that as of next March, it will no longer reinvest maturing bonds that were issued as part of its asset purchase programme.

- **The ECB is making interest rates its main inflation-fighting weapon**. The risk remains that in an effort to shore up its credibility, the bank will raise rates too aggressively, which would deepen the expected recession.

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Asian equities are largely down this week due to investor concerns about the surge of COVID-19 cases in China and the hawkish tone from the U.S. Federal Reserve**. China further accelerated its reopening process by announcing 10 new measures for COVID-19 control last week. Under the new measures, home quarantine is allowed, mass compulsory COVID-19 testing is largely reduced, and citizens no longer need to show their health-tracking QR code and test results when traveling between regions.

- **Top Chinese health experts expect this round of the pandemic will likely peak during China's New Year festivities in January, and the situation could stabilize in three months**. The prevailing strain in China mainly targets the upper respiratory tract, rather than the lungs, and therefore should cause milder symptoms and have a lower mortality rate compared to previous variants. According to the health experts, the recent mortality rate is close to 0.1%.

- The current COVID-19 strain has a high basic reproduction number (R0) of 10–18.6, compared to an R0 of 5–6 for the delta variant. Therefore, **we expect a sharp surge in cases to add pressure on the economy in Q1 2023 and lead to market volatility**. However, the situation could improve quickly when infections stabilize, and mobility and consumption data should pick up.

- **On Wednesday, China published a strategic plan to further boost domestic demand**. According to the plan, China will raise the scale of consumption and investment to a new level by 2035, and a complete system to increase domestic demand will be established. Goals include significantly increasing wages and the size of the Chinese middle-income group, and further minimizing the development gap between urban and rural areas. As both global demand and real estate development are slowing, we think China will rely more on domestic demand to drive future growth. More measures aimed at promoting the recovery of domestic consumption are likely to be announced next year.

MARKET Scorecard

Data as of December 14, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,995.32	-2.1%	-16.2%	-13.8%	9.5%
Dow Industrials (DJIA)	33,966.35	-1.8%	-6.5%	-4.4%	13.7%
Nasdaq	11,170.89	-2.6%	-28.6%	-26.7%	-10.2%
Russell 2000	1,820.45	-3.5%	-18.9%	-15.7%	-4.9%
S&P/TSX Comp	19,891.65	-2.7%	-6.3%	-3.7%	14.4%
FTSE All-Share	4,100.26	-1.0%	-2.6%	0.0%	11.5%
STOXX Europe 600	442.51	0.6%	-9.3%	-5.8%	12.9%
EURO STOXX 50	3,975.26	0.3%	-7.5%	-4.1%	13.5%
Hang Seng	19,673.45	5.8%	-15.9%	-16.8%	-25.4%
Shanghai Comp	3,176.53	0.8%	-12.7%	-13.2%	-5.7%
Nikkei 225	28,156.21	0.7%	-2.2%	-1.0%	5.3%
India Sensex	62,677.91	-0.7%	7.6%	7.8%	35.5%
Singapore Straits Times	3,278.57	-0.4%	5.0%	5.0%	14.7%
Brazil Ibovespa	103,745.77	-7.8%	-1.0%	-2.8%	-9.5%
Mexican Bolsa IPC	50,014.33	-3.2%	-6.1%	-2.4%	14.8%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.476%	-13.0	196.6	203.5	258.3
Canada 10-Yr	2.824%	-11.4	139.8	139.2	210.7
UK 10-Yr	3.315%	15.4	234.4	259.1	309.3
Germany 10-Yr	1.940%	1.0	211.7	230.9	256.0
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.38%	1.6%	-11.2%	-11.3%	-12.4%
U.S. Investment-Grade Corp	5.10%	2.1%	-13.6%	-13.6%	-13.9%
U.S. High-Yield Corp	8.33%	1.6%	-9.2%	-8.4%	-3.7%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,807.30	2.2%	-1.2%	2.1%	-1.1%
Silver (spot $/oz)	23.93	7.8%	2.7%	9.0%	0.4%
Copper ($/metric ton)	8,449.25	2.7%	-13.3%	-10.2%	9.3%
Oil (WTI spot/bbl)	77.28	-4.1%	0.4%	9.3%	64.5%
Oil (Brent spot/bbl)	82.85	-3.0%	6.5%	12.4%	64.7%
Natural Gas ($/mmBtu)	6.37	-8.1%	70.8%	70.0%	137.5%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	103.6090	-2.2%	8.3%	7.3%	14.2%
CAD/USD	0.7383	-1.0%	-6.7%	-5.0%	-5.8%
USD/CAD	1.3544	1.0%	7.2%	5.3%	6.1%
EUR/USD	1.0680	2.6%	-6.1%	-5.1%	-12.1%
GBP/USD	1.2424	3.0%	-8.2%	-6.1%	-6.8%
AUD/USD	0.6861	1.1%	-5.5%	-3.4%	-8.9%
USD/JPY	135.4500	-1.9%	17.7%	19.1%	30.2%
EUR/JPY	144.6600	0.7%	10.5%	13.0%	14.5%
EUR/GBP	0.8596	-0.4%	2.2%	1.0%	-5.6%
EUR/CHF	0.9875	0.3%	-4.8%	-5.1%	-8.3%
USD/SGD	1.3472	-1.0%	-0.1%	-1.7%	0.9%
USD/CNY	6.9501	-2.0%	9.3%	9.2%	6.1%
USD/MXN	19.6178	1.8%	-4.4%	-7.6%	-3.1%
USD/BRL	5.2899	1.9%	-5.1%	-7.0%	3.4%

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.

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Source - Bloomberg; data as of 12/14/22

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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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