

Global Insight

Weekly

Inflation fears may be inflated

Thomas Garretson, CFA – Minneapolis

Fears in the U.S. around inflation have been more persistent than actual inflation, and that remains the case as U.S. data continues to point to little inflation in the pipeline. But even if inflation materializes, the swelling global stock of negative-yielding debt is again likely to weigh on yields.

Away from the ongoing concerns about the stalemate over a second fiscal stimulus package in the U.S., and rising COVID-19 cases globally that are driving another round of targeted lockdowns, risks and concerns around inflation remain the one constant that is seemingly front and center in the minds of investors. Despite a decade-plus of below-par inflation around much of the world, rising deficits, enormous numbers around fiscal spending, and efforts by central banks may rightly justify such fears, but we maintain our view that inflation is not a near- or intermediate-term problem for fixed income investors.

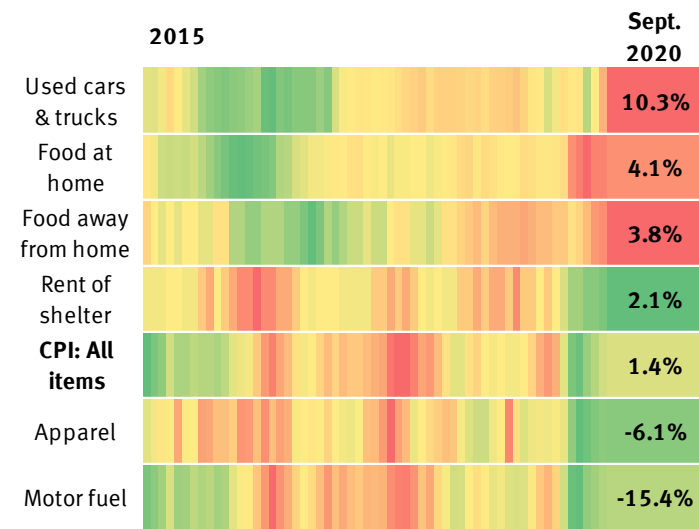
And perhaps these fears are only amplified by global yields that remain near historically low levels. The margin for error is simply lower than it ever has been as it doesn't take much in the way of inflation to begin eating away at those returns.

There are other forces at work in this world

In the U.S., this week saw the release of a wide swath of price data from consumers to producers, along with qualitative surveys on pricing pressures, with the key takeaway being that there simply doesn't appear to be inflationary forces in the pipeline.

The first chart attempts to capture recent price trends for key categories within the consumer price index (CPI). As many might suspect, food prices—both at and away from home—are running at the hottest levels of the past five years. Used car prices have skyrocketed over the past few months, accelerating to 10.3 percent year over year in the September report, not just the fastest pace in recent memory, but the fastest since the 1960s. A lack of supply has been the primary culprit as weak

Inflation trends: Where is it hot? Where is it cold?



Graphic shows consumer price index (CPI) year-over-year percentage change each month over past five years. Color scales reflect higher (red) or lower (green) inflation relative to the five-year average for each category. Source - RBC Wealth Management, Bloomberg; data through Sept. 2020

Market pulse

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- 3 Canada adds 378,000 jobs in September
- 4 European economies face new virus measures
- 4 Hong Kong and Singapore to launch a "travel bubble"

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new car sales due to production disruptions has meant that fewer used vehicles are being traded in. In fact, excluding used vehicles from the September CPI report would have shown that consumer prices actually fell slightly in September, as opposed to the 0.2 percent reported increase.

But those components are relatively minor in the CPI. Food spending comprises about 14 percent, with used vehicles, apparel, and motor fuel accounting for approximately 2.7 percent each. The largest component, rent and housing expense, which accounts for about 33 percent of the CPI index, has seen a marked deceleration in the aftermath of the pandemic, slowing to a 2.1 percent pace year over year, down from north of three percent last year. Yes, housing prices are on the ascent largely due to increased work-from-home demand, but high unemployment and the ongoing economic disruption will likely continue to drag that component lower.

As Tom Porcelli, RBC Capital Markets, LLC chief U.S. economist recently stated: “It bears repeating for those folks that think much higher inflation is upon us: It is hard to build the case for much firmer and persistent core inflation when goods prices are being suppressed by global forces.” RBC Economics forecasts both headline and core (excluding food and energy) inflation at just 1.7 percent next year, still far below the Fed’s two percent objective, and only flat from the inflation rate expected this year.

Additionally, for all of the stimulus—or perhaps maintenance—spending thus far, much of it may not be making its way into the economy. A recent New York Fed survey found that U.S. households spent just eight percent on non-essentials and only 18 percent on essentials, with roughly 35 percent each going to savings and to pay down debts, and the remaining four percent used for charitable donations. And consumers expect to spend an even smaller amount should there be a second round of stimulus, with 45 percent of any check expected to be targeted toward savings. It appears that the risks of higher inflation driven from the demand side will remain suppressed, while producer price data also released this week showed core prices rising just 1.2 percent year over year.

Investing around inflation

While higher inflation risks eat away at current income and savings, investors also tend to harbor fears about a spike in interest rates that push bond prices down. But this week served as yet another reminder that the gravitational pull of global yields remains firmly to the downside.

Amount of global negative-yielding debt nearing new record highs



Source - RBC Wealth Management, Bloomberg; data through 10/14/20

As the chart above shows, the global stock of negative-yielding debt has jumped, once again approaching fresh record highs in the process, as European Central Bank officials signaled over the weekend the need to do more to battle persistently low inflation, including the option of taking policy rates deeper into negative territory. At the same time, Bank of England officials surveyed banks about operational readiness should negative rates be implemented, though we continue to believe there is a relatively low likelihood of that tool being used in the near term. And it remains the case that we see almost no likelihood of negative rates in the U.S.

For U.S. investors, while we think another fiscal stimulus package would go a long way toward supporting the economic recovery, and potentially moving yields modestly higher, low inflation and global dynamics will almost certainly be offsetting factors. The net result may be that yields are stuck around current levels for the time being. Cash continues to yield nothing, and we remain in favor of putting money to work, while looking for potential volatility around the U.S. presidential election to get active in a low-yield environment.



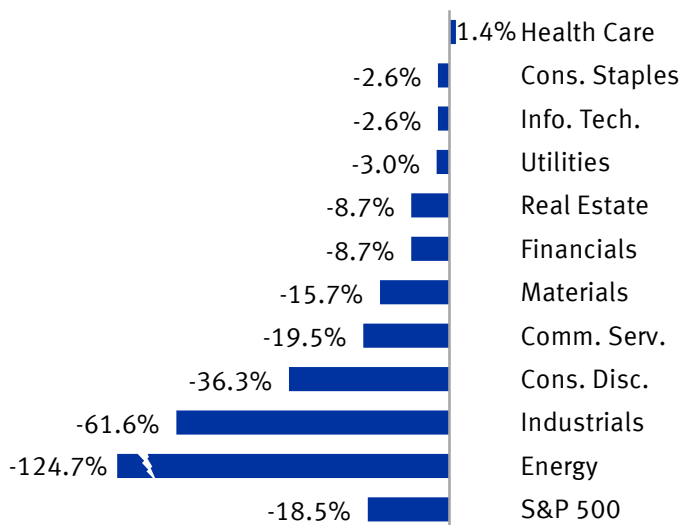
United States

Ben Graham, CFA – Minneapolis

- **U.S. equities are generally flat this week** with renewed leadership in the Tech- and Health Care-heavy Nasdaq, which is the only major U.S. index trading more than 1% higher this week. Other majors are marginally lower, with the S&P 500 slightly leading the Dow Jones Industrial Average despite neither being higher or lower by more than 0.3%, while the Russell 2000 is essentially flat on the week. **Sector leadership is evident in Communication Services, Information Technology, and both consumer sectors.** Laggards include Real Estate, Health Care, Financials, and Materials.
- **Earnings season unofficially kicked off on Tuesday** with the quarterly release from JPMorgan Chase and Co. The market's initial reaction has been muted despite strong beats from the financial and health care companies that have reported thus far. Clearly, buy-side expectations were much higher going into the end of the quarter than sell-side expectations, as shown by the market's advance ahead of the reports and the subsequent responses after the announcements. Further underscoring the reaction now that earnings season is upon us is the expectations backdrop. **As of June 30, consensus earnings expectations for Q3 were looking for a 24.3% year-over-year (y/y) contraction. That number has since shrunk considerably, to -18.5%**—an improvement of 580 basis points (bps). While

Despite sharp contraction expectations, improvement in this data has driven equities recently

S&P 500 earnings forecasts, Q3 2020



Note: Energy has been truncated due to the extreme reading
Source - RBC Wealth Management, FactSet; data through 10/15/20

the expectation is still negative, the 580 bps improvement is a very powerful number and one of the larger catalysts for the market's performance since June 30. The sectors forecast to have the best earnings growth in the quarter, according to FactSet consensus estimates, include Health Care, Consumer Staples, and Information Technology. The sectors with the worst expectations include Energy, Industrials, and Consumer Discretionary.

- **Economic data this week was mixed to negative**, with weekly unemployment claims rising by 898,000, well ahead of expectations for 825,000 and the worst single week since mid-August. Additionally, the Empire State Manufacturing Index was worse than hoped for; however, the Philadelphia Fed Manufacturing Index bucked these trends and was sharply higher than consensus forecasts.



Canada

Luis Castillo & Ryan Harder – Toronto

- **The Canadian economy added an impressive 378,000 jobs in September**, as reported by Statistics Canada, comfortably beating expectations of a 150,000 gain. Looking beneath the surface, the fundamentals of the report look solid as the majority of the gains (334,000) were in full-time employment, and the **unemployment rate fell from 10.2% to 9.0%** despite a participation rate coming in roughly 40 basis points higher, reaching 65%. This marks the continuation of several consecutive months of strong job gains following the reopening of the economy, which alongside a wave of fiscal stimulus has led to an increase in disposable income and a sharp rebound in consumer spending. With both full- and part-time employment now within 5% of pre-pandemic levels, **doubts have emerged about the continuation of this trend** as a resurgence of COVID-19 cases around the country has led to the re-emergence of pandemic-related restrictions.
- **The Canadian housing market has continued to be a hot spot in the broader economy**, even while other economic data has decelerated so far this autumn. With housing sales slowing to a standstill in the spring amid broad economic uncertainty and a selloff in risk assets, the gradual reopening of the Canadian economy has been accompanied by a significant amount of pent-up demand working its way through the data. Prices are now following suit, with the **vast majority of Canadian regions showing positive year-over-year price growth**. According to the MLS Home Price Index, nationwide prices were over 10% higher in September relative to the previous year. With mortgage deferrals ending and direct government stimulus being scaled back, we think the housing market's position as the lynchpin of the Canadian economy will face a challenging test to its resilience in the coming quarters.



Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Equities struggled in Europe during the week**, with both the STOXX Europe 600 ex UK and FTSE All-Share indexes retreating as **new COVID-19-linked restrictions were imposed**. France announced a 9:00 p.m. curfew for nine large cities, covering 20 million citizens, for at least six weeks; the Netherlands imposed a partial yet strict lockdown for at least four weeks including the closure of bars, restaurants, and cafes; Germany is considering new restrictions on socialising. As for the UK, heightened regional restrictions are being imposed, while the idea of a national “circuit breaker” in the form of a two-week lockdown over the autumn school holidays is being explored.
- **For continental Europe, new restrictions will hinder the recovery** which was already showing signs of stalling by the end of summer. RBC Capital Markets has downgraded its expectations for Q4 GDP growth to a contraction of 0.7% quarter over quarter, below the consensus estimate. **We believe growth should resume early in 2021**, spurred by the EU’s 750 billion euro rescue package and a further fiscal effort at national levels.
- As for the UK, the country awaits results from the endless **Brexit negotiations** whose outcome hangs in the balance. With the UK government having scaled back its ambitions drastically, a deal is theoretically possible, though it would involve trade frictions with the country’s largest export market. This may seem unappealing, but it would be a base to eventually build on and could help resolve inevitable differences. If negotiations fail, not only will the UK have to fall back on basic World Trade Organization terms, but the resulting acrimony after four years of negotiation coming to naught would make the UK’s relationship with its closest neighbour difficult for many months. **The unappealing short-term outlook for the economy is reflected in UK equities’ relative valuations**, which are at their lowest in over 10 years on many measures.



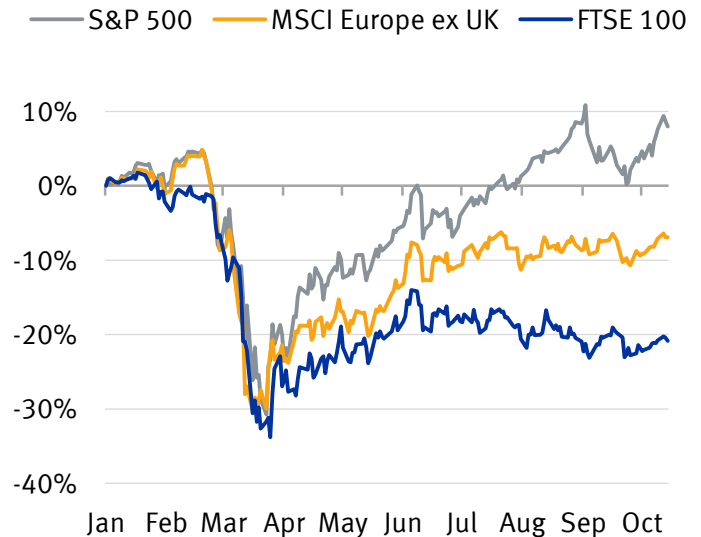
Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- **China and Hong Kong markets had a strong start this week** with the China market resuming trading after the National Day Golden Week holiday.
- **At 637 million, domestic tourist traffic during the holiday recovered to 79% of last year’s level**. However, tourism industry income of RMB 467 million was down 30% y/y. Due

Brexit and COVID-19 restrictions weigh on European equities

Year-to-date performance



Source - RBC Wealth Management, FactSet; data through 10/15/20

to the COVID-19 pandemic, local travel, city-periphery travel, and inner-province travel are most preferred. **Improvement in long-haul demand was weaker than expected**, partly due to restrictions on students for travel outside the province, which also led to strength in hotel occupancy in top-tier cities.

- **China’s consumer price index rose 1.7% y/y in September**, down from a 2.4% gain in August and below the consensus forecast of a 1.9% rise. We think the data shows an economic recovery is on the way but will not be smooth. Consumer demand still has a way to go to recover to pre-COVID-19 levels.
- **Alibaba (9988 HK)**, the e-commerce giant in China, had **the largest one-day price drop in a month** on Thursday. A Reuters article reported that the U.S. State Department has submitted a proposal to add Alibaba’s Ant Group to a trade blacklist. The State Department did not comment about the matter in the report. According to Bloomberg, the Ant Group IPO, which is taking place simultaneously in Shanghai and Hong Kong, is expected to raise as much as \$35 billion. Ant Group did not comment in the report.
- **Hong Kong and Singapore have agreed to launch a “travel bubble” between the two locations in weeks**. The arrangement eliminates quarantine requirements for residents of both areas and requires travelers to prove they have tested negative for COVID-19. Hong Kong-listed Cathay Pacific Airways (293 HK) jumped as much as 7.8% on Thursday, the most in more than seven weeks.



MARKET SCORECARD

Data as of October 15, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,483.34	3.6%	7.8%	16.3%	26.6%
Dow Industrials (DJIA)	28,494.20	2.6%	-0.2%	5.4%	12.8%
Nasdaq	11,713.87	4.9%	30.6%	43.8%	57.6%
Russell 2000	1,638.88	8.7%	-1.8%	7.6%	5.5%
S&P/TSX Comp	16,501.03	2.4%	-3.3%	0.5%	7.1%
FTSE All-Share	3,286.96	0.1%	-21.7%	-17.5%	-14.8%
STOXX Europe 600	362.91	0.5%	-12.7%	-7.9%	1.0%
EURO STOXX 50	3,192.69	0.0%	-14.8%	-11.3%	-0.6%
Hang Seng	24,158.54	3.0%	-14.3%	-8.8%	-5.1%
Shanghai Comp	3,332.18	3.5%	9.2%	11.4%	29.8%
Nikkei 225	23,507.23	1.4%	-0.6%	5.9%	5.5%
India Sensex	39,728.41	4.4%	-3.7%	3.2%	13.9%
Singapore Straits Times	2,523.62	2.3%	-21.7%	-19.0%	-17.1%
Brazil Ibovespa	99,054.10	4.7%	-14.3%	-5.2%	18.8%
Mexican Bolsa IPC	38,059.23	1.6%	-12.6%	-12.0%	-20.3%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,907.64	1.2%	25.7%	28.8%	55.5%
Silver (spot \$/oz)	24.25	4.4%	35.9%	39.3%	65.1%
Copper (\$/metric ton)	6,702.50	0.5%	9.0%	16.8%	6.3%
Oil (WTI spot/bbl)	40.96	1.8%	-32.9%	-22.4%	-42.9%
Oil (Brent spot/bbl)	43.17	5.4%	-34.6%	-26.5%	-46.6%
Natural Gas (\$/mmBtu)	2.78	10.0%	27.0%	18.9%	-14.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.736%	5.2	-118.2	-103.5	-242.0
Canada 10-Yr	0.568%	0.7	-113.4	-99.6	-193.4
U.K. 10-Yr	0.180%	-4.9	-64.2	-51.4	-143.0
Germany 10-Yr	-0.610%	-8.8	-42.5	-19.3	-111.3

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.18%	0.1%	6.9%	7.4%	19.2%
U.S. Invest Grade Corp	1.95%	0.7%	7.4%	9.1%	24.1%
U.S. High Yield Corp	5.24%	1.6%	2.2%	4.8%	12.0%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	93.8010	-0.1%	-2.7%	-4.6%	-1.3%
CAD/USD	0.7564	0.8%	-1.7%	-0.2%	-1.8%
USD/CAD	1.3220	-0.7%	1.8%	0.2%	1.8%
EUR/USD	1.1709	-0.1%	4.4%	6.1%	1.1%
GBP/USD	1.2901	-0.1%	-2.7%	0.9%	-1.9%
AUD/USD	0.7094	-0.9%	1.0%	5.0%	-0.5%
USD/JPY	105.4300	0.0%	-2.9%	-3.2%	-5.7%
EUR/JPY	123.4500	-0.2%	1.4%	2.8%	-4.6%
EUR/GBP	0.9076	0.1%	7.3%	5.2%	3.1%
EUR/CHF	1.0707	-0.8%	-1.4%	-2.8%	-6.3%
USD/SGD	1.3600	-0.4%	1.0%	-0.8%	-1.2%
USD/CNY	6.7254	-1.0%	-3.4%	-5.0%	-2.8%
USD/MXN	21.2864	-3.7%	12.5%	10.6%	13.0%
USD/BRL	5.6167	0.1%	39.4%	48.6%	50.3%

Source - Bloomberg. Note: 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. Data as of 8:35 pm GMT 10/15/20.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -1.7% return means the Canadian dollar fell 1.7% vs. the U.S. dollar year to date. USD/JPY 105.43 means 1 U.S. dollar will buy 105.43 yen. USD/JPY -2.9% return means the U.S. dollar fell 2.9% vs. the yen year to date.

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			Count	Percent
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Hold [Sector Perform]	619	41.60	135	21.81
Sell [Underperform]	81	5.44	11	13.58

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