

The Fed is dead, long live the Fed

Thomas Garretson, CFA – Minneapolis

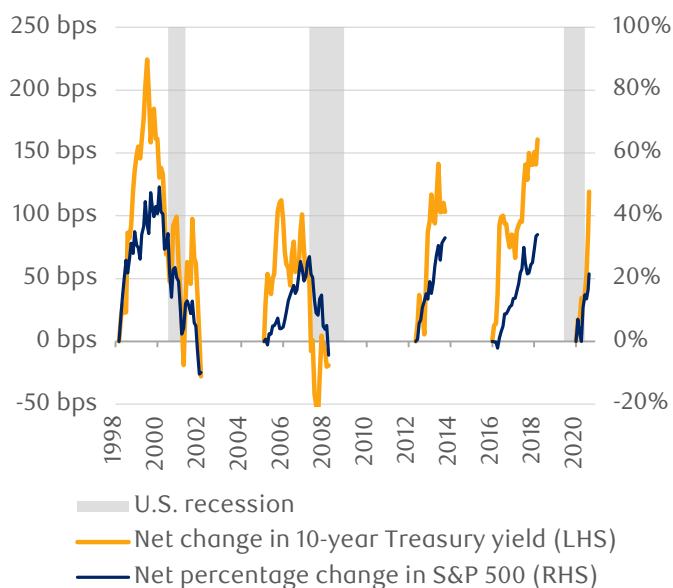
The days of the Fed preemptively tightening monetary policy based on forecasts are over. The Fed again confirmed this week that no matter how robust the outlook may be, the path of policy will depend on realized results. Let the reign of a new policy framework begin.

With this week's policy meeting, the Fed had the opportunity to update its economic forecasts for the first time since last December, a stretch when the market's expectations for growth and inflation have jumped sharply, largely on the back of sustained fiscal aid and the vaccine rollout. The Fed did that, and then some.

Polymakers now see above-consensus growth of 6.2 percent in real U.S. GDP for 2021, accompanied by the unemployment rate falling to 4.5 percent, from 6.2 percent currently, and all the way back to 3.5 percent by 2023, and inflation remaining above the two percent annual target throughout the forecast horizon, if only modestly so.

But as those types of upgrades were largely expected by the market, the bigger question—or concern—was whether the Fed would signal that rate hikes are now on the horizon. While a few more of the 18 members of the Federal Open Market Committee (FOMC) see rate hikes over the course of 2022 and 2023, the core majority of the FOMC still expects that rate hikes won't be necessary—even on the back of a strong economic recovery. This is largely due to the new average inflation targeting regime, which will require greater than two percent inflation for a period of time to make up for past shortfalls—and easy monetary policy will be needed to achieve that.

Episodes of sharply higher Treasury yields historically paired with strong stock market performance



Note: Chart shows periods when the 10-year Treasury yield has risen by over 100 basis points (bps) in less than eight months.

Source - RBC Wealth Management, Bloomberg; data through 3/18/21

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.

And with that, the Fed's old framework of preemptively tightening policy ahead of forecast achievement of economic goals once and for all comes to an end. May the Fed's new framework of being truly reactionary and basing policy responses on realized economic goals long live.

This is all ... quite normal, actually

But even with the confirmation that the Fed still plans to keep rates on hold for years, Treasury yields have continued their ascent in the aftermath of the Fed meeting, with the benchmark 10-year yield breaching 1.75 percent at one point, the highest level since January 2020.

In our view, this is simply a reflection that the Fed's messaging was a success. Short-term Treasury yields remain well-anchored on expectations the Fed won't tighten policy, while longer-term yields are recovering to more normal levels on a robust economic outlook. Just as flattening and inverting yield curves were a market signal of heightened recession risks throughout 2019, the ongoing steepening of yield curves should signal the opposite.

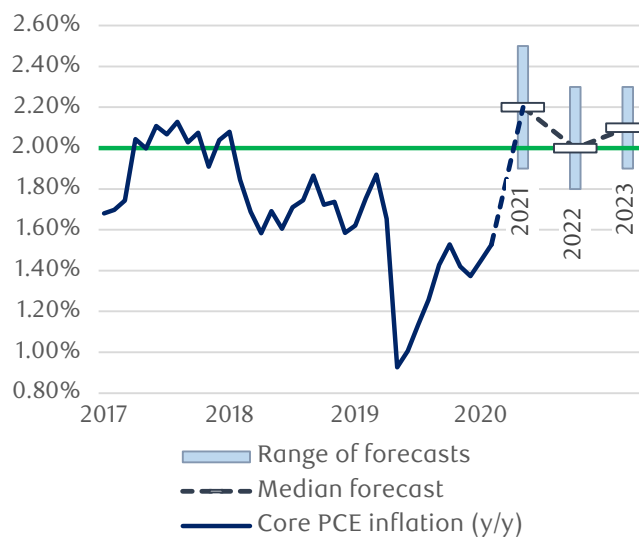
But the sharp rise in Treasury yields continues to be the focus of investors, amid some fears that it could be detrimental to stock market performance, and even for economic growth. From the lows for Treasury yields last summer, to 1.75 percent this week, the benchmark 10-year yield has jumped by over 120 basis points (bps). The chart on the previous page shows past periods when the 10-year yield has increased by similar magnitudes over brief periods. The key thing to note is that stocks performed strongly during each of these episodes; historically, it has been falling Treasury yields that have been a greater threat to risk assets, as in 2001 and 2007.

What's next for the Fed?

The last focus item for markets with respect to the Fed this week was whether the Fed might step in to quell rising Treasury yields, via a shift and/or an increase in its ongoing asset purchase program of \$80 billion per month in Treasuries, and \$40 billion of mortgage-backed securities.

But just as the Fed sees little need to raise short-term policy rates anytime soon, it currently sees little need to intervene in markets in order to keep a lid on yields. Again, we think the Fed is more than comfortable with rising Treasury yields, as long as it's reflective of growth and inflation. Absent significant market dislocation, we don't expect the Fed to step in to markets with an effort to keep yields low.

Inflation outlook



Note: Green line indicates the Fed's target 2% average inflation rate over a business cycle.

Source - RBC Wealth Management, Bloomberg, Federal Reserve

The next thing for investors to watch is likely the June FOMC meeting, when the Fed could begin to lay the groundwork for tapering, i.e., reducing, its asset purchase program, the base case for which would commence around the end of the year.

Confident in the outlook

Though the rise in Treasury yields has been historic this year, we still think there may be room to run. During past economic recoveries the yield curve as measured from 2-year Treasuries to 10-year Treasuries has steepened to about 225 bps on average in the aftermath of a recession. As discussed, it has steepened to only 160 bps so far. In our view, the 10-year Treasury will hold a range of 1.75 percent to 2.25 percent this year, which would be consistent with that type of trend. However, levels above that may attract the attention of the Fed. But as yield curves steepen, fixed income investors will likely be keen to begin putting money to work further out on yield curves.

We continue to believe that risk assets can continue to perform well amid rising yields. The bigger risk historically has been tighter monetary policy, but with the Fed's commitment this week that tighter policy is nowhere on the horizon, markets should be free to run.

UNITED STATES

Ben Graham, CFA – Minneapolis

■ **The 10-year Treasury rate move continues to impact U.S. equities; value stocks lead growth stocks** again this week, with the latter showing small losses thus far and the former showing small gains. Following the afternoon selloff on Thursday, March 18, the S&P 500 is down 0.7% so far this week. The Nasdaq is even lower after its 1.5% decline this week. The Dow Jones Industrial Average is the only major index to be higher with a 0.3% gain. Interestingly, small caps declined 3.6%. Sector leadership is evident in Industrials and Financials, while the laggards include Energy and Utilities. In our view, **Energy's weekly decline of 7.7% is most likely a function of the trade needing to take a breather after a 29% year-to-date gain**, and not indicative of something more broadly impacting the sector. Further supporting the sector is the price of oil, which has averaged \$61/bbl so far in 2021 after finishing last year with an average price below \$44/bbl.

■ **The CBOE Volatility Index (VIX) moved back below 20** this week, after rising off the mid-February lows that had marked its first dip below 20 since the beginning of the global COVID-19 pandemic. We believe a declining VIX, indicative of less fear in U.S. equity markets, remains one of the best potential catalysts to higher equity prices in 2021.

■ **Economic data for the week were mixed.** On the positive side of the equation, **both regional Fed activity indexes** (Empire State and Philadelphia) **were higher than expected.** However, **retail sales were surprisingly weak, housing starts decelerated** and came in lower than consensus expectations, and **initial jobless claims hit 770,000**—higher than last week's level and above consensus expectations of 701,000. Unfortunately, weekly jobless claims also exceeded the previous four-week average of 763,000.

CANADA

Arete Zafiriou & Sayada Nabi – Toronto

■ **Canada's labour market added 259,000 jobs in February**, reversing the 213,000 jobs lost in January. The **unemployment rate fell 1.2 percentage points to 8.2%**, its lowest level since March 2020. **Part-time employment growth outpaced full-time employment growth**, but work in both areas increased. The industries that were hit hardest in January rebounded last month as many provinces eased COVID-19 containment measures. Employment in the retail trade and accommodation & foods services industries increased by 122,000 and 65,000, respectively. **The level of employment, however, is still significantly below pre-pandemic levels.** Relative to a year ago, 599,000 fewer people are employed, with 80% of the job losses coming from the travel and hospitality

The ongoing decline in volatility is a potential catalyst for equities to climb higher

CBOE Volatility Index (VIX) since 1/1/20



Note: Dashed line represents a reading of 20.

Source - RBC Wealth Management, FactSet; data through 3/17/21

sectors. Additionally, 406,000 more employees are working less than half of their usual work hours. As public health restrictions continue to ease into March across various regions including large parts of Ontario, RBC Economics expects to see further job gains when the next jobs report is released on Apr. 9.

■ **Canada's consumer price index (CPI) moved up in February.** Headline CPI, which includes food and energy prices, has risen 1.1% y/y. February marks the first time in a year that energy prices (+2.4% y/y) have pushed into the positive. **RBC Economics expects energy price inflation to climb even higher** in March and April as oil prices have recovered since hitting lows last spring amid the pandemic outbreak. Outside of energy prices, current inflation trends are less worrisome, according to RBC Economics. Furthermore, RBC Economics believes the big concern about inflation does not lie in current trends, but more in the potential for a surge in household spending as the economy reopens, and especially in scenarios where demand outpaces supply. Overall, RBC Economics forecasts that core CPI, the measure that excludes food and energy prices, will increase into 2022; however, it'll be anchored around the Bank of Canada's 2% inflation target.

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

■ **German Chancellor Angela Merkel's centre-right Christian Democratic Union (CDU) suffered crippling defeats in two state elections.** However, the CDU is still the single largest party in Germany with support of some 33%, according to recent national polls. Therefore, **the conservative coalition of the CDU and the Christian**

Social Union (CSU) remains most likely to lead the country after the federal election in September 2021. Nevertheless, due to these setbacks, observers are likely to ponder what might happen should a new coalition emerge, such as one among the Greens, the centre-left Social Democratic Party of Germany (SPD), and the centre-right Free Democratic Party (FDP), although this has a lower probability of taking place.

■ **Should a left-led coalition occur, the main policy difference with the status quo may well be on the regulatory front, with potentially tighter labour regulations.** Those could be a headwind to German economic growth, in our view. More fiscal largesse from a left-leaning government could go some way to offset their impact, but as German politics is based on consensus, any such spending may be less than hoped for.

■ **Autos was the best-performing subsector in the STOXX Europe 600 Index during the week, boosted by updates from German automakers Volkswagen and BMW on their electric vehicle plans.** At its inaugural “Power Day” on Mar. 15, Volkswagen presented its technology roadmap for batteries and electric vehicles up to 2030. The company aims to gradually reduce battery costs by between 30% and 50%, depending on the model. **Volkswagen’s shares gained over 23%** since the updated plans were announced.

■ Ahead of its 2021 Analyst and Investor Day, BMW stated it expects profitability in its autos segment to improve to 6%–8% in 2021, ahead of consensus expectations for less than 6%. Moreover, it announced that it expects fully electric models to account for at least 50% of global deliveries to customers by 2030. **BMW’s shares climbed over 13% during the week, and the gains helped push Germany’s blue-chip DAX Index to a record high.**

ASIA PACIFIC

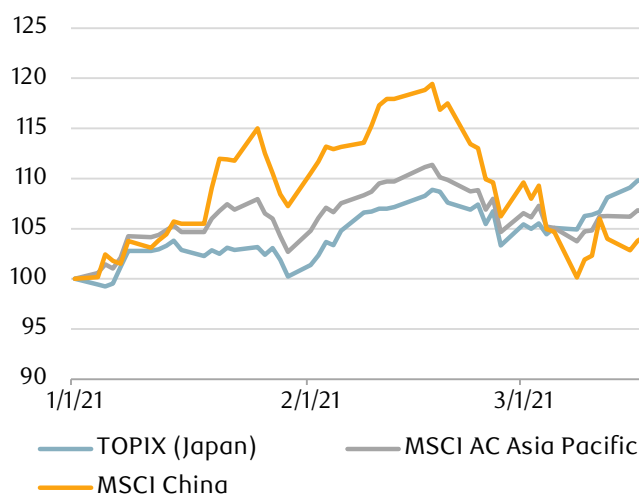
Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

■ **Most Asian stocks climbed this week** on the Federal Reserve’s projection for interest rates to remain near zero through 2023. **China equities stabilized** from the recent pullback.

■ **China’s economic activity surged in the first two months of the year.** Industrial production, up 35.1% y/y during the period, beat the Bloomberg consensus estimate of 32.2%, while retail sales growth accelerated to 33.8% y/y, ahead of the 32% forecast. The strong growth was partially due to a very low base in 2020. These low base effects could last until April, as economic activity started to pick up in May 2020.

Japan takes the lead in Asia

2021 performance to date, indexed to 100



Source - RBC Wealth Management, FactSet; data through 3/17/21

■ **China warned that it will accelerate regulation on “platform” companies that have amassed data and market power.** The term “platform” is a broad definition for technology companies operating anything from social media businesses to e-commerce and could include companies such as **Tencent** (700 HK) and **Alibaba** (9988 HK). President Xi Jinping ordered regulators to step up oversight of internet companies, crack down on monopolies, promote fair competition, and prevent the disorderly expansion of capital.

■ **Samsung Electronics** (005930 KS), one of the world’s largest makers of chips and consumer electronics, **warned of a “serious imbalance” in the semiconductor industry**, as global shortages cause disruption. The company expects the chip shortage to pose a problem to its business next quarter. Samsung also said **it might skip the launch of the next Galaxy Note smartphone** to streamline its lineup.

■ **Pinduoduo** (PDD), the fast-growing Chinese e-commerce giant, announced Wednesday that **founder and Chairman Colin Huang has stepped down from the board.** Chen Lei, who replaced Huang as CEO last July, will also serve as chairman. Pinduoduo said Huang will “pursue research in the food and life sciences, disciplines where breakthroughs could drive the future of China’s largest agriculture platform.”

MARKET Scorecard

Data as of March 18, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,915.46	2.7%	4.2%	63.3%	38.2%
Dow Industrials (DJIA)	32,862.30	6.2%	7.4%	65.1%	26.8%
Nasdaq	13,116.17	-0.6%	1.8%	87.6%	70.0%
Russell 2000	2,267.59	3.0%	14.8%	128.8%	45.0%
S&P/TSX Comp	18,836.47	4.3%	8.0%	60.7%	15.9%
FTSE All-Share	3,862.12	4.3%	5.1%	39.7%	-3.4%
STOXX Europe 600	426.59	5.3%	6.9%	52.5%	11.6%
EURO STOXX 50	3,867.54	6.4%	8.9%	62.1%	14.2%
Hang Seng	29,405.72	1.5%	8.0%	31.9%	0.0%
Shanghai Comp	3,463.07	-1.3%	-0.3%	26.9%	11.8%
Nikkei 225	30,216.75	4.3%	10.1%	80.7%	40.0%
India Sensex	49,216.52	0.2%	3.1%	70.5%	29.2%
Singapore Straits Times	3,137.66	6.4%	10.3%	29.4%	-2.3%
Brazil Ibovespa	114,835.40	4.4%	-3.5%	71.7%	14.8%
Mexican Bolsa IPC	47,572.39	6.7%	8.0%	33.9%	12.7%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	1.712%	30.7	79.9	52.0	-89.2
Canada 10-Yr	1.613%	25.8	93.6	56.5	-10.3
UK 10-Yr	0.875%	5.5	67.8	7.9	-32.1
Germany 10-Yr	-0.264%	-0.4	30.5	-2.9	-34.7
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.57%	-1.2%	-3.4%	4.3%	15.9%
U.S. Investment-Grade Corp	2.28%	-2.2%	-5.1%	13.5%	20.5%
U.S. High-Yield Corp	4.44%	-0.4%	0.3%	27.0%	17.8%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,735.62	0.1%	-8.6%	16.8%	33.1%
Silver (spot \$/oz)	26.03	-2.4%	-1.4%	117.3%	69.6%
Copper (\$/metric ton)	9,070.75	-0.7%	17.1%	91.8%	40.5%
Oil (WTI spot/bbl)	60.00	-2.4%	23.7%	194.6%	1.5%
Oil (Brent spot/bbl)	62.47	-5.5%	20.6%	151.1%	-7.5%
Natural Gas (\$/mmBtu)	2.48	-10.4%	-2.2%	54.9%	-12.8%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	91.8400	1.1%	2.1%	-9.2%	-4.9%
CAD/USD	0.8007	2.0%	2.0%	16.1%	6.8%
USD/CAD	1.2488	-2.0%	-1.9%	-13.9%	-6.3%
EUR/USD	1.1914	-1.3%	-2.5%	9.2%	5.1%
GBP/USD	1.3930	0.0%	1.9%	20.0%	5.1%
AUD/USD	0.7761	0.7%	0.9%	34.4%	9.2%
USD/JPY	108.9000	2.2%	5.5%	0.8%	-2.3%
EUR/JPY	129.7500	0.8%	2.8%	10.0%	2.7%
EUR/GBP	0.8553	-1.4%	-4.3%	-9.0%	0.0%
EUR/CHF	1.1054	0.7%	2.2%	4.6%	-2.6%
USD/SGD	1.3441	0.9%	1.7%	-7.0%	-0.5%
USD/CNY	6.5069	0.4%	-0.3%	-6.3%	-3.1%
USD/MXN	20.4832	-1.8%	2.9%	-13.6%	7.5%
USD/BRL	5.5685	-0.6%	7.1%	47.4%	46.9%

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 0.80 means 1 Canadian dollar will buy 0.80 U.S. dollar. CAD/USD 2.0% return means the Canadian dollar rose 2.0% vs. the U.S. dollar year to date. USD/JPY 108.90 means 1 U.S. dollar will buy 108.90 yen. USD/JPY 5.5% return means the U.S. dollar rose 5.5% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 3/18/21.

Authors

Thomas Garretson, CFA – Minneapolis, United States

tom.garretson@rbc.com; RBC Capital Markets, LLC

Ben Graham, CFA – Minneapolis, United States

benjamin.graham@rbc.com; RBC Capital Markets, LLC

Sayada Nabi – Toronto, Canada

sayada.nabi@rbc.com; RBC Dominion Securities Inc.

Arete Zafiriou – Toronto, Canada

arete.zafiriou@rbc.com; RBC Dominion Securities Inc.

Thomas McGarrity, CFA – London, United Kingdom

thomas.mcgarrity@rbc.com; RBC Europe Limited

Frédérique Carrier – London, United Kingdom

frederique.carrier@rbc.com; RBC Europe Limited

Jasmine Duan – Hong Kong, China

jasmine.duan@rbc.com; RBC Investment Services (Asia) Limited

Nicholas Gwee, CFA – Singapore

nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

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			Count	Percent
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Hold [Sector Perform]	615	40.73	166	26.99
Sell [Underperform]	67	4.44	12	17.91

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