GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee April 8, 2021

Infrastructure, inflation, and a possible Fed policy rethink

Atul Bhatia, CFA – Minneapolis

With the Biden administration poised to ramp up government spending further, markets are casting a wary eye on inflation. But the infrastructure plan—if it gets through Congress—has the potential to improve existing, highly supportive policy, and we look at how a Fed framework that's already favorable to growth could get more so.

Chronicle of a spike foretold

Both the Fed and the market are estimating a sharp spike in economic activity and inflation in the coming months, driven by the $1.9 trillion fiscal stimulus, economic reopening releasing some or all of the accumulated $1.6 trillion in excess consumer savings, and year-over-year comparisons to a largely shut-down global economy. These forces are powerful but potentially ephemeral. Stimulus payments are generally one-time or short-lived in nature and the majority of economic gains during the pandemic have accrued to investing households who tend to save at a higher rate than the median. After an initial bout of spending, these households may well return to saving. For these and other reasons, the Fed has already telegraphed that it will discount near-term price spikes and instead wait for confirmation that inflation expectations are well-entrenched at or above target level. This is likely a multiyear process as the Fed evaluates business and consumer trends.

Fiscal efficiency

President Joe Biden's $2.25 trillion infrastructure plan—if enacted—could speed the Fed's decision-making. The plan has two critical attributes: first, it is a multiyear spending plan, so it has a higher chance of impacting underlying inflation expectations; second, fiscal policy gains will likely be less heavily skewed toward investors than monetary policy gains. Rising wages to lower-income households are typically spent immediately, potentially creating the type of self-sustaining inflation the Fed wants.

The infrastructure bill will likely be subject to considerable revision during the legislative process and may never pass into law. Whatever its final form, the key considerations for the Fed are likely to be the magnitude and duration of the spending plan and the distribution toward higher consumption, lower-income households. The more pronounced and durable the fiscal impact, the greater the Fed's flexibility to adjust monetary accommodation. We believe long-term investors will be well-served to focus on the infrastructure plan and its ramifications and de-emphasize the large, but expected, increases in near-term inflation.

Infrastructure funding and debt

In addition to the spending aspects of the plan, there is considerable uncertainty around its funding. The plan calls for higher corporate taxes to cover the bulk of the

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

Priced (in USD) as of 4/8/21 market close, ET (unless otherwise stated). Produced: Apr. 8, 2021 4:05 pm ET; Disseminated: Apr. 8, 2021 4:45 pm ET
For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

costs. Even if Congress were to raise the statutory corporate tax rate, the effective rate for large corporations will likely remain well below that mark. According to the Treasury Department, U.S. multinationals currently pay less than eight percent of earnings to the U.S., despite the 21 percent corporate tax rate; under the prior 35 percent tax regime, actual collections amounted to only 16 percent. As a result, legislation notwithstanding, a large portion of any spending plan is likely to be funded by government borrowing.

But with nearly $22 trillion—or just over 100 percent of U.S. GDP—in existing federal debt, some in Congress have questioned the sustainability of additional borrowing. In testimony to the Senate, Treasury Secretary Janet Yellen addressed those concerns in part by highlighting that low interest rates keep debt servicing costs down and allow the U.S. to comfortably manage higher debt-to-GDP levels. This position has also found support from former Treasury Secretary Lawrence Summers, an outspoken critic of current policy. In a paper written late last year, he suggested that debt-to-GDP was an inappropriate measure and that keeping inflation-adjusted debt service costs—currently near 0.5 percent in the U.S.—below two percent of GDP was a better target.

To some degree, this choice between debt-to-GDP and debt service is a false dichotomy. The larger the debt-to-GDP ratio, the greater the impact of a rise in borrowing costs and the more likely and quickly debt service costs rise above the two percent level. For the U.S., with debt-to-GDP near 100 percent, the Summers' analysis would imply the need for Fed policy to keep inflation-adjusted government borrowing costs below two percent and potentially lower as debt-to-GDP increases.

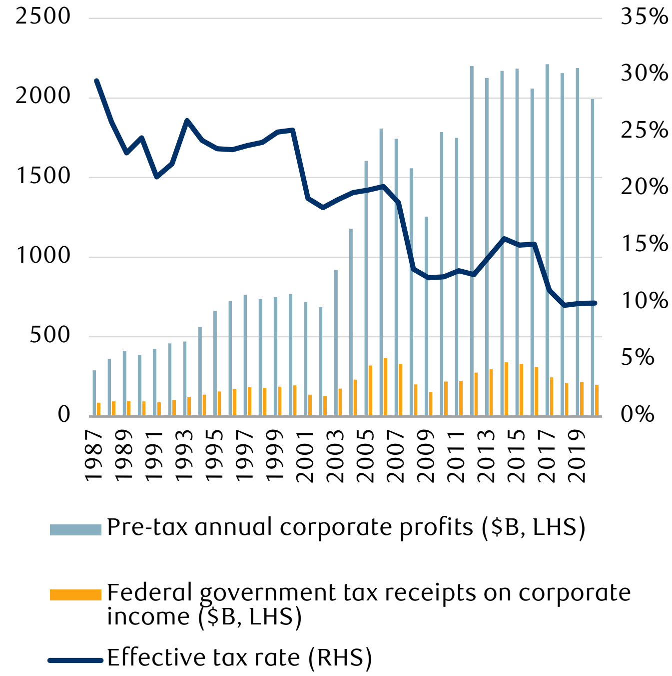
Fed policy constrained in a different direction

A focus on federal debt service costs would imply the need for a different type of monetary accommodation. Rather than attempt to stimulate demand by pushing bond yields and credit spreads down across the board, the Fed would be able to more narrowly focus on Treasury funding rates and inflation. It could likely accomplish a two percent real rate with a more normalized interest rate policy, although potentially with added emphasis on asset purchases and with a consistent tolerance for higher inflation.

A rejuvenated fiscal policy has the potential to achieve the Fed's employment and price goals more quickly than monetary policy can accomplish, theoretically freeing the Fed to reduce accommodation. At the same time, based on how fiscal policy is funded, the Fed may face a new set of limited constraints against rates rising, this time in the form of federal budgetary pressures. As a result, the Biden infrastructure plan has the potential to improve the existing, highly supportive policy framework, by allowing for monetary policy normalization with potentially limited impact to asset prices.

Effective corporate tax rate well below statute

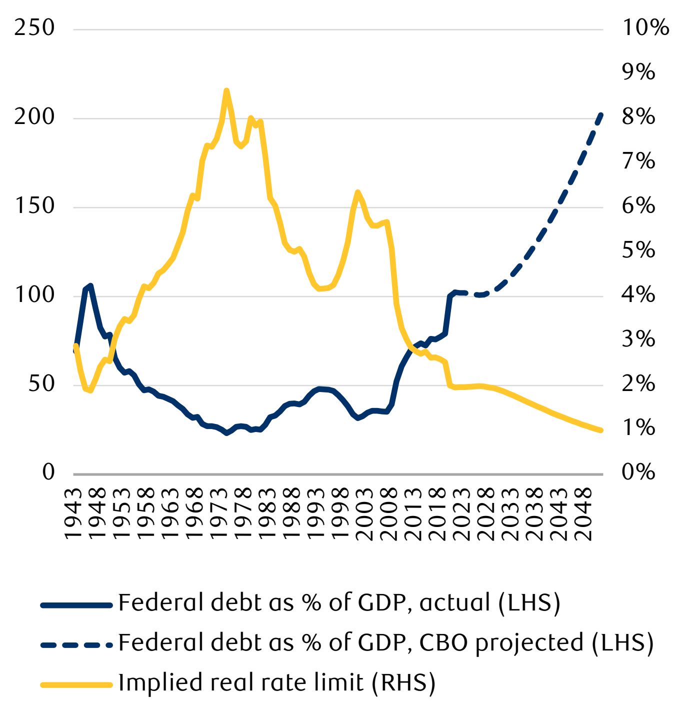
1987 – 2020



Source - RBC Wealth Management, St. Louis Federal Reserve

Higher debt tolerable with lower real rates

1943 – 2050E



Source - RBC Wealth Management, Congressional Budget Office (CBO)

UNITED STATES

Ben Graham, CFA – Minneapolis

- As the 10-year Treasury rate pauses around 1.6%, **U.S. equities have clawed their way higher on the back of growth-oriented stocks and the Nasdaq** so far in April. The former has climbed 2.2% higher thus far this week while the latter has gained 2.6%. The S&P 500 has gained more than 1.9% and the Dow Jones Industrial Average has lagged among large-cap indexes with its 1.1% gain. Small caps have continued their recent spate of underperformance with their week-to-date decline of 0.5%.

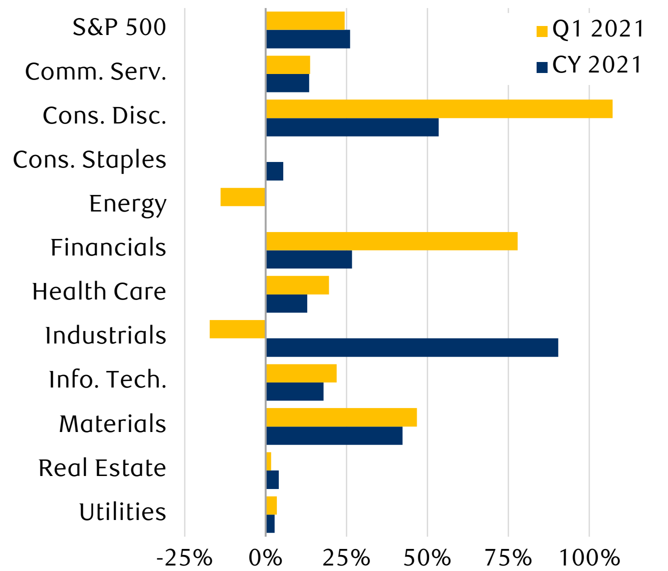
- **Sector leadership is evident across growth-oriented equities as well with Tech leading on strength in the largest companies in the sector**. Hardware (Apple) has been the best-performing industry recently. Communication Services also leads, as does Consumer Discretionary, on similar trends for Google-parent Alphabet and Amazon.com. **Weakness has been most evident in Energy**, down 3.6% so far this week while other cyclical sectors such as Industrials, Materials, and Financials also lag, but by a much smaller margin.

- **Earnings season kicks off in earnest next week** with a focus on Financials and select Health Care companies. Heading into Q1 results, consensus earnings expectations are highest for Financials and Consumer Discretionary stocks, while Industrials and Energy stock earnings are anticipated to decline on a year-over-year basis. **This is an interesting dynamic because this quarter's prior-year comparison is Q1 2020**, and as a reminder, the pandemic was in its infancy at that point. Certainly, lockdowns and economic fears started to materialize in Q1 2020, but the first two months of that quarter were strong. Look for Q2 2021 results to show elevated growth rates across all sectors.

- **Economic data for the week was largely mixed**, as Institute for Supply Management (ISM) Purchasing Managers' Indexes (PMI) showed an ongoing economic acceleration in the composite number with its reading of 59.7 and the non-manufacturing PMI reading of 63.7. Unfortunately, elevated readings on these indicators are associated with weaker-than-average returns over the next three- and six-month time periods. Weekly initial jobless claims rose to 744,000, ahead of consensus expectations at 660,000 and last week's reading of 728,000.

S&P 500 and sector earnings expectations

Consensus estimates for Q1 and full-year 2021 earnings growth



Note: Energy full-year 2021 earnings are not meaningful due to the sector's net loss in 2020

Source - RBC Wealth Management, FactSet; data through 4/8/21

CANADA

Carolyn Schroeder & Richard Tan, CFA – Toronto

- **The housing fervor that reignited in Canada last summer took a widespread, albeit uneven, toll on affordability across the country**. The RBC Housing Affordability Measure rose in all markets we track where an increase represents a loss of affordability. The measure, which looks at ownership costs as a percentage of median household income, recorded the most significant deterioration in Montreal, Ottawa, Toronto, and Vancouver, as a **tight demand-supply situation was a key driver for property values to increase at the fastest rates in years**. Meanwhile, Atlantic Canada and the Prairies are still relatively affordable despite some deterioration over H2 2020. The enthusiasm for properties with larger living spaces has seemingly increased during the pandemic and RBC's measure for single-detached homes increased by 1.4 percentage points to 54.7% in Q4, pointing to the less affordable conditions. Condo affordability, on the other hand, remained little changed for the most part with some markets (e.g., Edmonton, Toronto, and Vancouver) seeing a small improvement as prices slipped in the face of abundant inventories.

- Like the Canadian real estate market, the equity markets have also benefited from price appreciation with the S&P/TSX Composite closing approximately 8% higher at the end of Q1 2021. Gains have been led by strength in the Health Care, Energy, Financials, and Consumer Discretionary sectors, driven by the risk-on environment as investors look ahead to a normalizing economy and a rebound in corporate profits. In many ways, the year-to-date performance of the equity markets is like a mirror image of the performance seen in 2020. Investors are gravitating back to sectors that underperformed last year on improving business outlooks, whereas the Technology sector has quickly become one of the worst relative performers year-to-date on the back of higher interest rates and decelerating growth profiles. Overall, we believe that Canadian equities are well-positioned to benefit from the reflationary trade, but we also remind investors that there will likely be bumps along the way (e.g., delays in vaccinations).

EUROPE

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Economic activity edged up in the eurozone and the UK in March**. The IHS Markit Eurozone Services Purchasing Managers' Index (PMI) reached 49.6, just below the 50 demarcation mark between expansion and contraction. The Composite PMI reached 53.2 thanks to the strong manufacturing sector. The IHS Markit/CIPS UK Services PMI came in at a strong 56.3, with the Composite PMI touching 56.4 as the UK prepares to open up.

- **The Pan-European STOXX Europe 600 Index was up 7.7% in euro terms in Q1**. Beneath the surface, a notable rotation was evident: **cyclical stocks significantly outperformed defensives**, reflecting increased optimism for the post-COVID economic recovery as well as rising inflation expectations and bond yields, with the latter being driven by higher growth expectations.

- The **top five performers** in the quarter were Autos (+23.7%), Banks (+19.1%), Travel & Leisure (+18.7%), Basic Resources (+13.8%), and Insurance (+12.3%). The **laggards** were Real Estate (-2.3%), Utilities (-0.6%), Health Care (+0.8%), Personal & Household Goods (+1.2%), and Food & Beverages (+2.2%).

- We see **scope for cyclicals to continue to outperform** in the months ahead. **However, the bulk of the outperformance is probably behind us** given the valuations of many non-financial cyclicals appear fairly full and will likely require earnings upgrades to come through in the coming months in order to be sustained. Among cyclicals, we believe companies in the Financials sector remain attractively valued and note that they are seeing positive earnings momentum.

- **Valuations are also starting to look attractive for many quality defensive stocks in areas such as Health Care, Consumer Staples, and Utilities** that have solid medium-term growth outlooks and deliver steady, growing dividends.

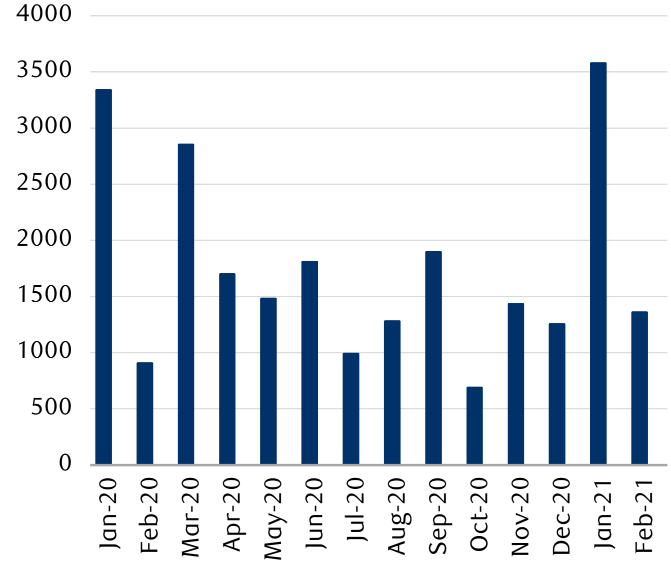
ASIA PACIFIC

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

- **Asia-Pacific equity markets traded mostly higher during the week**, led by Australia, Taiwan, and South Korea. Robust iron ore prices and the continued strength in U.S. equities have pushed the Australian ASX 200 Index up for a fifth straight day.

China seeks to curtail loan growth

China Monthly New Loan Index (in CNY trillions)



Source - RBC Wealth Management, Bloomberg; monthly data through 2/28/21

- **The People's Bank of China has asked banks to curtail loan growth for the rest of 2021**. Banks were told to keep total advances at roughly the same level as last year, according to a Bloomberg report. The request came after Chinese banks advanced a record ¥4.9 trillion of new loans (+16% y/y) in the first two months of the year. Analysts believe the prospect of higher interest rates and fewer soured loans may help boost Chinese banks' bottom line, where many saw their earnings slump after they were enlisted to help borrowers obtain cheap credit during COVID-19. We believe China's government is taking advantage of the economic recovery to deleverage—a long-term goal. However, the move is also expected to fuel concerns about policymakers tightening monetary policy—a move that could weigh on the outlook for the Chinese equity market.

- **Japan's household spending fell 6.6% y/y for a third straight month in February**, likely a result of the COVID-19 state of emergency, which has since been lifted entirely. Assuming the virus curve remains flattened, we believe spending will pick up in Q2 on the back of pent-up demand and a high household savings rate.

- South Korea's biggest company, **Samsung Electronics (005930 KS), pre-announced FY Q12021 results** with profits up 44% y/y, above expectations, as the early release of a new flagship smartphone and strong gadget sales softened the blow from a Texas power failure that shut down one of its plants. Samsung had previously warned of softer Q1 profitability, anticipating weaker demand. Instead, the economic rebound from the pandemic happened faster than expected, and semiconductor prices are on the rise.

MARKET
Scorecard

Data as of April 8, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,097.17	3.1%	9.1%	49.0%	41.5%
Dow Industrials (DJIA)	33,503.57	1.6%	9.5%	43.0%	27.2%
Nasdaq	13,829.31	4.4%	7.3%	70.9%	73.9%
Russell 2000	2,242.60	1.0%	13.6%	88.2%	42.0%
S&P/TSX Comp	19,228.87	2.8%	10.3%	38.1%	17.2%
FTSE All-Share	3,960.97	3.4%	7.8%	26.1%	-2.7%
STOXX Europe 600	436.86	1.7%	9.5%	33.7%	12.7%
EURO STOXX 50	3,977.83	1.5%	12.0%	39.5%	15.7%
Hang Seng	29,008.07	2.2%	6.5%	21.0%	-3.6%
Shanghai Comp	3,482.56	1.2%	0.3%	23.7%	7.3%
Nikkei 225	29,708.98	1.8%	8.3%	53.5%	36.5%
India Sensex	49,746.21	0.5%	4.2%	66.4%	28.5%
Singapore Straits Times	3,186.40	0.7%	12.0%	25.5%	-3.9%
Brazil Ibovespa	118,313.20	1.4%	-0.6%	50.5%	21.5%
Mexican Bolsa IPC	48,188.15	2.0%	9.4%	39.4%	6.1%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.625%	-11.6	71.1	85.2	-89.8
Canada 10-Yr	1.463%	-9.5	78.6	65.0	-27.2
UK 10-Yr	0.749%	-9.6	55.2	36.5	-36.7
Germany 10-Yr	-0.336%	-4.4	23.3	-3.0	-34.3
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.57%	0.4%	-3.0%	0.8%	16.3%
U.S. Investment-Grade Corp	2.23%	0.6%	-4.1%	8.4%	21.8%
U.S. High-Yield Corp	4.00%	0.6%	1.5%	24.4%	19.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,756.72	2.9%	-7.5%	6.7%	35.4%
Silver (spot $/oz)	25.49	4.4%	-3.5%	70.4%	67.1%
Copper ($/metric ton)	8,919.00	1.5%	15.1%	79.2%	38.1%
Oil (WTI spot/bbl)	59.60	0.7%	22.8%	137.5%	-7.5%
Oil (Brent spot/bbl)	63.33	-0.3%	22.3%	92.8%	-10.9%
Natural Gas ($/mmBtu)	2.52	-3.4%	-0.8%	41.3%	-7.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	92.0720	-1.2%	2.4%	-8.0%	-5.1%
CAD/USD	0.7961	0.0%	1.4%	11.5%	6.0%
USD/CAD	1.2562	0.0%	-1.3%	-10.4%	-5.6%
EUR/USD	1.1914	1.6%	-2.5%	9.7%	5.8%
GBP/USD	1.3734	-0.4%	0.5%	10.9%	5.2%
AUD/USD	0.7655	0.8%	-0.5%	22.9%	7.4%
USD/JPY	109.2800	-1.3%	5.8%	0.4%	-2.0%
EUR/JPY	130.2000	0.3%	3.2%	10.2%	3.7%
EUR/GBP	0.8676	1.9%	-2.9%	-1.0%	0.6%
EUR/CHF	1.1010	-0.5%	1.8%	4.3%	-2.1%
USD/SGD	1.3402	-0.3%	1.4%	-6.0%	-1.1%
USD/CNY	6.5511	0.0%	0.4%	-5.6%	-2.5%
USD/MXN	20.0975	-1.6%	0.9%	-16.4%	6.0%
USD/BRL	5.5822	-0.9%	7.4%	47.7%	45.0%

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 0.79 means 1 Canadian dollar will buy 0.79 U.S. dollar. CAD/USD 1.4% return means the Canadian dollar rose 1.4% vs. the U.S. dollar year to date. USD/JPY 109.28 means 1 U.S. dollar will buy 109.28 yen. USD/JPY 5.8% return means the U.S. dollar rose 5.8% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 4/8/21

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As of March 31, 2021

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Sell [Underperform]	53	3.86	4	7.55

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