GLOBAL
Insight
WEEKLY

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

May 13, 2021

Is the inflation genie out of the bottle?

Kelly Bogdanova – San Francisco

The Fed has remained sanguine about the surge in consumer prices, which it regards as temporary. But rapidly accelerating inflation has investor fears heating up. We don't think this is the start of runaway inflation, and we look at what this spike means for equity performance and portfolio positioning.

Surging consumer inflation has spooked the equity market, and has fueled a debate among economists and market participants: Is this higher inflation transitory? And if it is, how long will "transitory" inflation last?

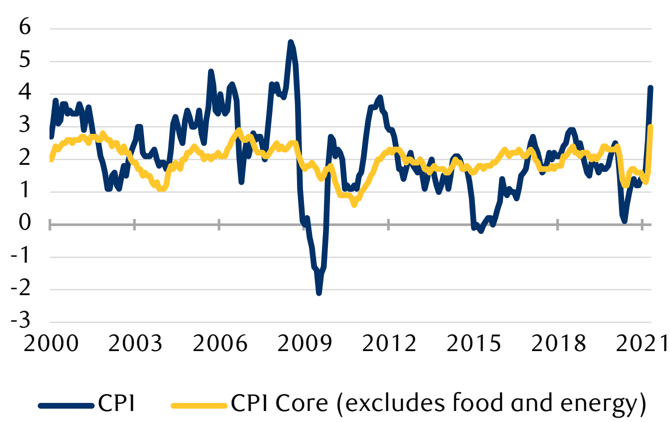
The Consumer Price Index (CPI) jumped 4.2 percent in April compared to the level one year ago. This is the highest consumer inflation rate since 2008, and is well beyond the 3.6 percent consensus forecast of economists. When viewed against consumer prices just one month prior, the CPI jumped 0.8 percent, the biggest monthly gain since 2009.

The core rate, which strips out volatile food and energy prices, also rose dramatically compared to March of this year. At 0.9 percent, the increase was three times higher than economists had expected and the sharpest monthly increase since 1982.

We think much of the inflation spike is a short-term phenomenon. The annual inflation rate plunged to almost zero percent at this time last year when the economy was shut down, and has rebounded sharply this year as businesses have reopened. Once we are past the April, May, and June period when prices last year were falling, the year-over-year comparisons should be less extreme.

Highest inflation reading since 2008

U.S. Consumer Price Indexes (CPI) in year-over-year percentage change



Source - RBC Wealth Management, Bloomberg; data through April 2021

The question of how long "transitory" inflation will last is more difficult to gauge. The longer it lingers, the greater the risk that the Federal Reserve will shift away from its uber-accommodative monetary policies. We think this will take some quarters to convincingly sort out. This could

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

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keep equity market volatility and pullback risks elevated for the time being.

RBC Global Asset Management Inc. Chief Economist Eric Lascelles does not see runaway 1970s-style inflation as a threat. Lascelles wrote, “Yes, inflation will be quite high over the next few months and then slightly elevated over the next few years. But, from a structural standpoint, it is far from obvious that inflation has to be high over the next several decades. If anything, the long-term forces still argue for deflationary pressures to dominate.” The long-term forces he’s referring to are demographic headwinds, deflation in key segments of the economy (including technology), declining unionization, and maturing emerging market economies.

The Fed has already signaled that the hot April inflation data will not in and of itself change the course of its highly accommodative policies, and we think the Fed has reasons to stand firm even if inflation remains elevated in the near term, as our U.S. fixed income portfolio strategist discusses in this report.

Inflation’s sway

For equity investors, there are two main issues to consider: The impact of inflation on the U.S. market as a whole, and the impact on sectors within the market, both of which influence portfolio positioning.

For the S&P 500 overall, profit margins usually rise when inflation and expectations of future inflation push up from a low level—as long as wages aren’t the major factor for the inflation boost. Most companies have pricing power, as they are typically able to pass some or all of the inflation in input costs along to their customers, maintaining or increasing profit margins. We saw this pattern in Q1 earnings reports, and expect to see it again during the Q2 reporting season. Furthermore, when commodity prices rise, this often provides a broad range of industries with added pricing power—even some non-commodity producers.

Throughout this expansion period and in others in recent decades, the public’s expectations about the direction of future inflation and the broader stock market have been positively correlated. As households’ inflation expectations have risen, the market has worked its way higher.

But when it comes to sectors within the market, inflation doesn’t necessarily treat them equally. According to an RBC Capital Markets study going back to 2004, some of the most economically-sensitive value sectors (those that are highly cyclical) outperformed when inflation expectations rose, such as Energy, Materials, and Financials. In contrast, the Technology, Health Care, and Communication Services sectors were underperformers. This track record supports our ongoing recommendation to tilt U.S. equity holdings toward “value” stocks instead of “growth” for 2021, at least.

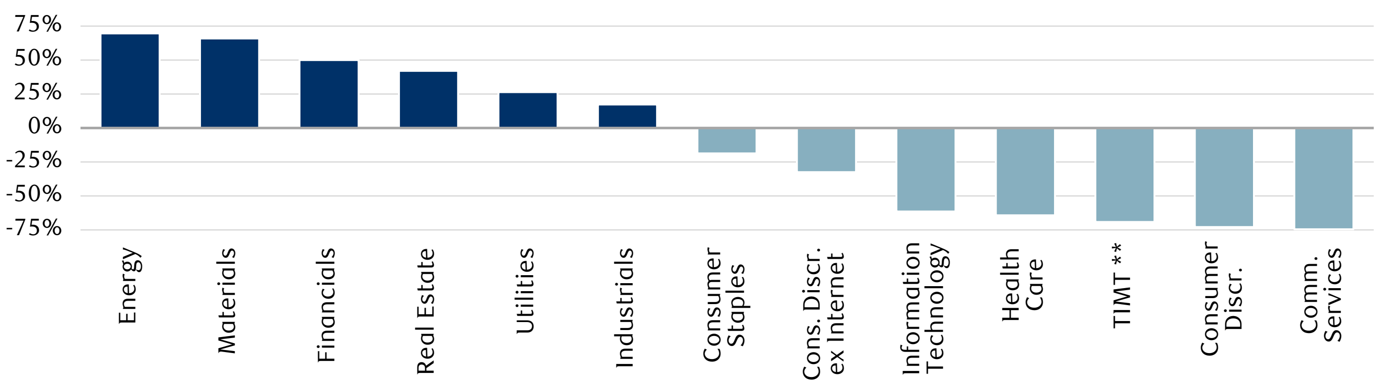
But the challenge for the overall U.S. equity market is that the inflation-vulnerable and valuation-stretched Tech sector represents a much bigger share of the market than it used to: 26 percent of the S&P 500 today versus 17 percent in 2010. As long as inflation jitters are front and center, institutional investors may be inclined to ratchet down their Tech exposure, at least temporarily. To us, this means more adjustment time for the market as a whole, which could include additional volatility and rotation between sectors.

A hurdle, not a roadblock

It’s still early in the business cycle, and the tight credit conditions necessary to produce the next recession, an accompanying decline in corporate profits, and an equity bear market appear to be a long way off. We think long-term investors should look through the latest inflation disruption and continue to moderately Overweight equities in portfolios. But we think heightened inflation risks underscore the need to tilt U.S. exposure more toward “value” stocks than “growth” stocks.

Energy, Materials, and Financials tend to outperform the S&P 500 the most when inflation expectations rise

Correlations of relative S&P 500 sector performance with inflation expectations since 2004*



* The S&P 500 sector performances are measured relative to the S&P 500 Index as a whole. Inflation expectations are measured by the University of Michigan Inflation Expectations Surveys of Consumers, which presents the median expected growth of prices of goods and services over the next five years
** TIMT stands for Technology, Internet, Media, and Telecommunications
Source - RBC Capital Markets U.S. Equity Strategy, Haver, S&P Capital IQ/ClariFi; data from 2004 through March 2021

UNITED STATES

Alan Robinson – Seattle

- **Stocks gave up their gains from the prior week's record close**, as concerns about inflation and higher interest rates resurfaced. Volatility, a measure of "fear" in the stock market, surged higher midweek before levelling off. A spike in bond yields accompanied this move, but we note that the recent pick-up in yields was much less than we saw in Q1 2021, and volatility was less pronounced too (see chart). Other concerns included worries over higher capital gains tax rates, which tend to impact sectors that have recently outperformed, on concerns investors may book their gains sooner rather than later.

- **The gap between job openings and job hiring is widening** as some employers are unable to offer competitive compensation or employment conditions, and as larger firms hike wages to attract workers. McDonald's (MCD) announced it will raise hourly wages by 10% at its non-franchised restaurants to help retain workers, and Chipotle (CMG) plans to raise its average hourly wage by about $2.

- **The dust finally settled on a very strong Q1 2021 earnings season**. At the start of the week, 88% of S&P 500 companies had reported Q1 results, according to FactSet. Of these, 86% beat the consensus earnings forecast, the highest percentage since records have been kept starting in 2008. Prior to the beginning of earnings season, analysts expected earnings to grow 24% y/y. With most reporting completed, that blended growth rate now stands at 49%, eclipsed only by the 55% rate seen in Q1 2010 following the 2009 recession.

- **The Financials sector has been the biggest contributor to earnings growth**, thanks to banks' ability to release funds reserved for recessionary loan losses that didn't materialize. The Information Technology sector was also a major contributor thanks to demand for work-from-home solutions and internet shopping.

- **Management teams' outlooks were upbeat too**. Generally, they were optimistic about the economic recovery and pent-up consumer demand, and backed up their rosy views by increasing share buybacks. **Inflation was the biggest worry**, but managers expect to pass higher input costs along to consumers to protect profit margins.

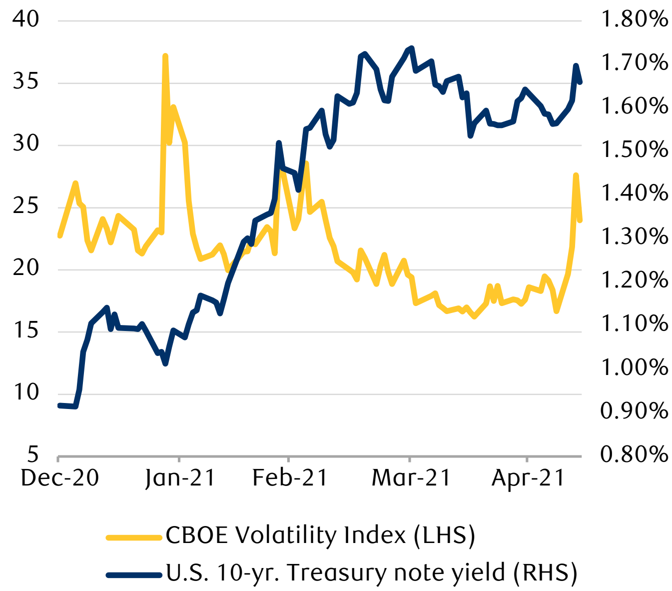
CANADA

Luis Castillo – Toronto

- Canadian inflation breakevens (a measure of market-implied inflation expectations) resumed their upward trajectory this week following a brief pause in April. As economies slowly start to re-emerge from a pandemic-driven hibernation, inflation concerns have become consensus, with both Canadian and U.S. inflation

Volatility and bond yields both tracking higher, still below year highs

Implied stock volatility vs. bond yields



Source - RBC Wealth Management, FactSet

breakevens comfortably surpassing pre-pandemic levels and now sitting at multiyear highs. However, **the Bank of Canada's more hawkish tone towards monetary policy relative to the Federal Reserve's more patient and dovish posture has contributed to diverging inflation expectations**. This divergence in messaging has resulted in one of the largest inflation breakeven gaps between the two countries in over a decade, as investors anticipate that the Bank of Canada will be more sensitive to rising inflation than its U.S. counterpart.

- Central banks have repeatedly expressed that the required economic conditions have not yet been met to warrant a deviation from current accommodative monetary policy. One of the main points of contention has been the labour market, which despite improving trends is still below pre-pandemic levels. Given the renewed health restrictions in Canada, consensus expectations for the April employment report were not optimistic. Nevertheless, **Canada lost 207,000 jobs, worse than the expected -150,000, and the unemployment rate rose to 8.1% from 7.5%** a month prior. As reported by Statistics Canada, the majority of job losses came from Ontario and British Columbia in the sectors most impacted by the tightening of restrictions, including retail trade; accommodation and food services; and information, culture, and recreation. With strong restrictions still in place, **a reversal in the upcoming May report looks unlikely** to us. However, with the pace of vaccinations ramping up, we believe **the employment outlook further out on the horizon looks a little more promising**.

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

■ **Having closed at an all-time high on Monday, May 10, the STOXX Europe 600 Index pulled back almost 2% through the rest of the week** amid growing concerns around U.S. inflation (as outlined in the feature article). Notably, defensive sectors such as Consumer Staples and Health Care, which have lagged the index year to date, held up better than the broader market. To us, this indicates a degree of profit-taking in areas of the market aligned to "reopening trades" that have strongly outperformed over the past six months.

■ **The European Commission (EC) sharply upgraded its economic forecast for the euro area.** It now expects GDP growth to be 4.3% y/y in 2021, followed by 4.4% in 2022, versus its previous forecast for 3.8% in both years. For the first time, the EC factored in the impact of the €750 billion EU recovery fund, which is likely to start distributing funds in the third quarter of this year. Half the resources are earmarked for Italy and Spain, whose economies have been the hardest hit by the pandemic given their normally large tourism sectors. Notably, the EC significantly raised its projections for GDP growth in Italy and Spain, and now sees all euro area economies returning to pre-pandemic levels before the end of 2022.

■ The improving outlook for the euro area has pushed the **German 10-year Bund yield up sharply to its highest level in almost two years**, at around -0.11%. RBC Capital Markets' global macro strategists believe higher yields alongside steeper curves are coming, on the view that forthcoming growth and activity data releases will be strong. Moreover, the Bund yield has broken out of important technical levels.

■ **In the UK, March GDP grew 2.1% m/m, beating consensus expectations for 1.5%.** While the economy was barely reopening then, children returned to school, boosting economic activity. This plus the preparations for the spring reopening combined to generate the rebound. As of the end of March, the UK economy was 6% smaller than a year ago.

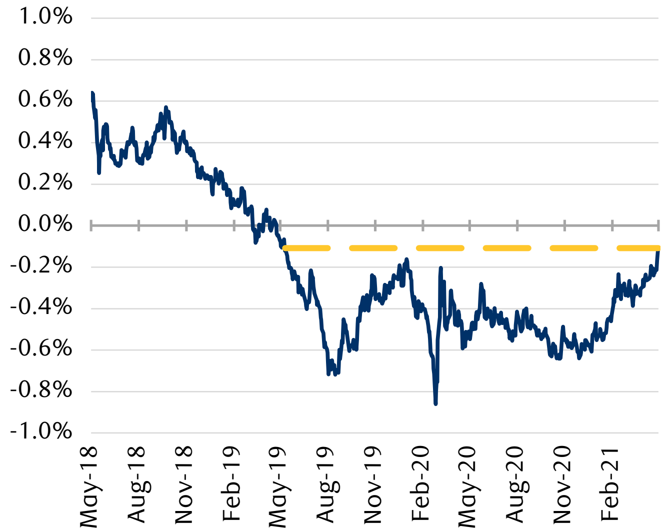
ASIA PACIFIC

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

■ Asian stocks have largely been under pressure during the week as worries regarding inflation and a resurgence of COVID-19 cases have suppressed investor sentiment. **The MSCI Asia Pacific Index has corrected by around 9% from its February peak** and has given up almost all the gains from 2021.

■ **Taiwan equities have been the worst performer this week**, with the Taiwan Stock Exchange Weighted

The German 10-yr. Bund yield is at its highest level in almost two years



Source - RBC Wealth Management, Bloomberg

Index slumping 9.7% in four trading days. On Wednesday alone, the index was down almost 9%, the worst one-day performance in 54 years. **There are a few reasons for the sharp correction**: a worsening COVID-19 outbreak, the spillover effect of a deepening slump in global tech shares, and the liquidation of leveraged positions. According to Bloomberg, margin debt expanded 46% in 2021 to about NT$274 billion (US$9.8 billion) two weeks ago, the highest level since 2011.

■ **China's credit expansion slowed in April** as the central bank maintained a neutralized policy stance. **Bank loan growth slowed to 12.3% y/y** compared to 12.6% during same period last year. In March of this year, the People's Bank of China asked banks to curtail loan growth in the coming months and keep it at roughly the same level as 2020.

■ **China Huarong Asset Management Co.** (2799 HK), the state-owned distressed-debt manager, said it's prepared to make future bond payments and has seen no change in the level of support it receives from China's government, aiming to allay investor concerns after local media reported regulators had balked at the company's restructuring plan.

■ **South Korea announced bigger tax breaks plus KRW1 trillion (US$883 million) in loans for the local chip industry**. The government plans to spend around US$450 billion to build the world's biggest chipmaking base over the next decade. **Samsung Electronics Co.** (005930 KS) and **SK Hynix Inc.** (000660 KS) will lead with **a combined KRW510 trillion of investment in semiconductor research and production until 2030**.

MARKET Scorecard

Data as of May 13, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,112.50	-1.6%	9.5%	44.4%	40.2%
Dow Industrials (DJIA)	34,021.45	0.4%	11.2%	43.8%	28.7%
Nasdaq	13,124.99	-6.0%	1.8%	48.2%	61.6%
Russell 2000	2,170.95	-4.2%	9.9%	71.9%	34.4%
S&P/TSX Comp	19,135.81	0.1%	9.8%	29.0%	16.0%
FTSE All-Share	3,966.08	-0.4%	8.0%	23.0%	-2.0%
STOXX Europe 600	437.32	0.0%	9.6%	30.8%	13.0%
EURO STOXX 50	3,952.45	-0.6%	11.3%	39.0%	14.1%
Hang Seng	27,718.67	-3.5%	1.8%	14.8%	-5.1%
Shanghai Comp	3,429.54	-0.5%	-1.3%	19.2%	18.0%
Nikkei 225	27,448.01	-4.7%	0.0%	39.9%	23.3%
India Sensex	48,690.80	-0.2%	2.0%	53.7%	26.1%
Singapore Straits Times	3,123.26	-3.0%	9.8%	20.5%	-5.1%
Brazil Ibovespa	120,705.90	1.5%	1.4%	52.7%	27.0%
Mexican Bolsa IPC	48,829.31	1.7%	10.8%	32.0%	10.7%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.656%	3.0	74.2	95.3	-81.4
Canada 10-Yr	1.566%	2.0	88.9	95.3	-16.8
UK 10-Yr	0.898%	5.6	70.1	66.7	-32.1
Germany 10-Yr	-0.120%	8.2	44.9	38.7	-12.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.58%	-0.4%	-3.0%	-0.2%	16.3%
U.S. Investment-Grade Corp	2.23%	-0.6%	-4.1%	5.1%	21.7%
U.S. High-Yield Corp	4.15%	0.0%	1.9%	19.3%	19.7%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,826.98	3.3%	-3.8%	8.4%	42.6%
Silver (spot $/oz)	27.09	4.5%	2.6%	82.4%	81.8%
Copper ($/metric ton)	10,433.25	6.1%	34.6%	101.9%	67.5%
Oil (WTI spot/bbl)	63.82	0.4%	31.5%	166.0%	2.5%
Oil (Brent spot/bbl)	66.96	-0.4%	29.3%	125.3%	-6.0%
Natural Gas ($/mmBtu)	2.97	1.4%	17.0%	52.8%	17.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	90.7210	-0.6%	0.9%	-9.4%	-7.0%
CAD/USD	0.8223	1.1%	4.7%	16.3%	10.6%
USD/CAD	1.2161	-1.0%	-4.4%	-14.0%	-9.6%
EUR/USD	1.2081	0.5%	-1.1%	11.9%	7.9%
GBP/USD	1.4054	1.7%	2.8%	13.8%	7.3%
AUD/USD	0.7730	0.2%	0.5%	20.8%	10.6%
USD/JPY	109.4500	0.1%	6.0%	3.1%	-1.2%
EUR/JPY	132.2200	0.6%	4.8%	15.4%	6.6%
EUR/GBP	0.8596	-1.2%	-3.8%	-1.7%	0.5%
EUR/CHF	1.0942	-0.3%	1.2%	4.0%	-4.0%
USD/SGD	1.3335	0.2%	0.9%	-6.1%	-2.2%
USD/CNY	6.4520	-0.4%	-1.2%	-7.1%	-4.6%
USD/MXN	19.9384	-1.5%	0.1%	-18.2%	5.0%
USD/BRL	5.3102	-2.3%	2.1%	40.5%	33.8%

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 0.82 means 1 Canadian dollar will buy 0.82 U.S. dollar. CAD/USD 4.7% return means the Canadian dollar rose 4.7% vs. the U.S. dollar year to date. USD/JPY 109.45 means 1 U.S. dollar will buy 109.45 yen. USD/JPY 6.0% return means the U.S. dollar rose 6.0% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 5/13/21

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Hold [Sector Perform]	559	40.68	179	32.02
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