GLOBAL
Insight
WEEKLY

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

June 17, 2021

A first step on the long journey to rate hikes?

Atul Bhatia, CFA – Minneapolis

At its June meeting, the Federal Reserve opened the door to discussing asset purchase tapering and future interest rate increases. But with a long road still ahead, and inflation top-of-mind for many, we look at the economic factors that could shape future Fed policy.

The U.S. Federal Reserve struck a more hawkish note than markets expected at its June meeting, driving bond prices lower and yields higher across the Treasury curve. Although we share the view that the meeting is important in understanding future Fed policy moves, we would caution that the initial market reaction likely overstates the impact of the changing Fed projections and the language of the post-meeting statement.

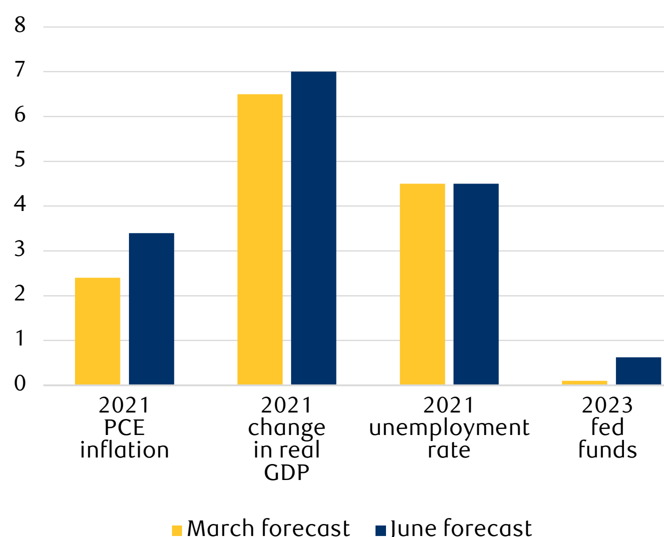
Interest rates: Big headline, less substance

In terms of policy, the central bank acted as expected, maintaining the current federal funds rate target range and the $120 billion monthly asset purchase program. At the same time, the members of the Federal Open Market Committee (FOMC)—the rate-setting group within the Fed—updated their individual economic projections for growth, inflation, and policy rates. The previous survey, in March, produced a median projection for rates at zero through the 2023 end of the forecast period; in this month's report, however, the median projection includes two rate hikes in 2023, leading to a federal funds rate of 0.625 percent.

We think this change in the median forecast rate should carry little weight in investor thinking. Member projections are snapshots in time and do not represent a plan for

Bump in 2021 growth and inflation projections leads to 2023 rate hike expectations

The Fed's changing forecasts for the U.S. economy (%)



Source - RBC Wealth Management, U.S. Federal Reserve

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

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future policy, a point Fed Chair Jerome Powell made during his post-meeting press conference. In addition, by 2023 the composition of the FOMC will have changed, with the rotating voting slots shifting to more dovish members. Prior Fed projections have not been particularly accurate predictors of policy rate changes, especially when dealing with minor rate differences years in the future.

The taper talk has begun

While the June meeting may not have provided a clear view of future rate hikes, we think the meeting did move the timeline on tapering, as the Fed acknowledged that discussions on reducing the pace of asset purchases will likely begin next month—a change from the central bank's prior stance that it was too early even to talk about talking about tapering. Combined with the Fed's earlier guidance that it would provide months of advance notice before implementation, we see tapering kicking off before year's end, potentially in early fall. We continue to see tapering as a year-long process, and believe a potential rate hike is unlikely for at least 18 months—and probably longer.

Market conditions—as well as inflation levels—likely contributed to the Fed's decision to start moving toward tapering. The absolute level of yields was near a multi-month low heading into the week, reducing the impact of any shift higher in yields on the prospects for tapering. In addition, the potential for unforeseen liquidity consequences from tapering is limited, as investors in recent months have returned more cash to the Fed than the Fed has pumped into the system. Since March, the Fed has purchased approximately $360 billion of Treasury and Agency securities, while investors deposited over $490 billion into the Fed's reverse-repurchase facility. Overall, it was an opportune moment to launch the taper process.

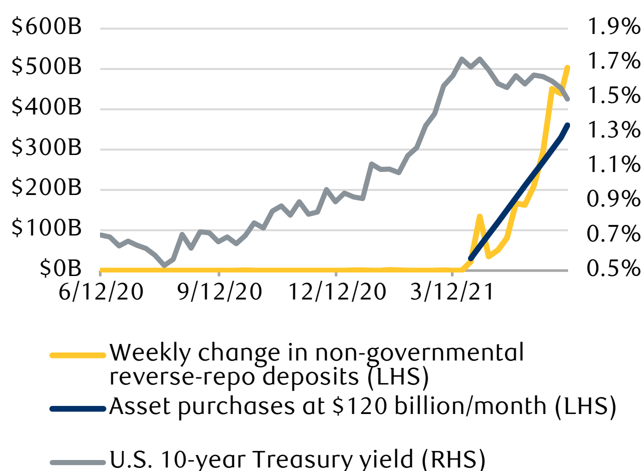
Inflation is transitory, except when it's not

Beyond taper talk, one of the most notable shifts in Fed language concerned inflation. The Fed still maintains—correctly, in our view—that current inflation is likely to prove transitory; however, the central bank now acknowledges the possibility that inflation may be higher and more persistent than it expects. In addition to the qualitative shift, the FOMC's median projection for 2021 PCE inflation jumped a full percentage point between March and June, rising to 3.4 percent from 2.4 percent.

One interpretation of the Fed's more hawkish tone, consistent with its comments and projections on inflation, is that the central bank now views the likely 2021 inflation overshoot as sufficient to meet the requirements of its recently adopted average inflation policy. The details of that policy have always been vague, and the Fed may be looking to take advantage of that purposeful ambiguity.

An opportune moment to talk taper

Cash coming back to Fed, and yield dip, make taper digestible



Source - RBC Wealth Management, Bloomberg; data through 6/9/21

Implications for investors

While it's easy to get caught up in the minutiae of Fed policy thinking, in practical terms not much has changed: the economy is still millions of jobs short of pre-pandemic employment levels; the ability of the Fed to sustainably generate sufficient inflation to overcome structural disinflation is questionable; and, even under optimistic assumptions, it will likely be years before policy rates move higher.

But we do see two key themes emerging from this month's meeting. First, stay invested. Not even the Fed can time the market; between March and June, its view of future rates shifted 60 basis points (bps) higher while the yield on the 10-year Treasury dropped 15 bps. We see little reason to think investors are likely to do better, and sitting on cash earning zero percent while waiting for the perfect bond entry point is unlikely to be a profitable strategy.

Second, long-term investors should trust in diversification and asset allocation. Whether inflation is transitory, and how the Fed will respond if it is not, are important questions, but the range of possible outcomes is wide. We believe investors should seek an investment strategy adaptable to a broad range of scenarios; a diversified portfolio, rebalanced appropriately, is among the soundest methods of dealing with uncertainty.

While the pandemic has created unique challenges for policymakers and investors alike, it has also reinforced basic investment principles—including the importance of sound asset allocation, consistent with risk tolerances. In our view, investors would be well-served to focus on core principles and avoid hasty responses to minor changes in the timing of potential Fed policy adjustments.

UNITED STATES

Ben Graham, CFA – Minneapolis

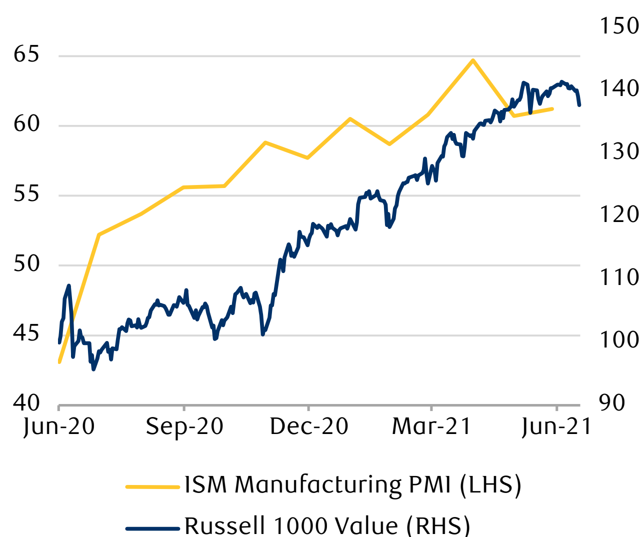
- **The Federal Reserve meeting and subsequent press conference appear to be on track to halt the recent weekly winning streak for U.S. equities at three weeks** as domestic stocks moved lower after the Fed changed its guidance for its bond-buying program and increased its inflation forecast, signaling a somewhat less accommodative monetary policy going forward. Thus far this week, U.S. stocks are slightly lower with small caps lagging large caps and value lagging growth. The S&P 500 has fallen 0.6% while the "growthier" Nasdaq has risen 0.7% and the value-oriented Dow Jones has moved 1.9% lower. The Russell 2000 is down 2.1% while growth outperformed value by more than 3.5 percentage points so far this week.

- **Recent sector trends are also notable**. So far this week, leadership is evident in Tech, Communication Services, and Health Care as these are the only sectors in the green. The economically-sensitive (cyclical) Materials sector has declined more than 4.0% while others in this category such as Industrials and Financials have declined more than 2.5% as value stocks trailed the broader market. **RBC Capital Markets, LLC's Head of U.S. Equity Strategy Lori Calvasina believes some of this performance divergence is related to the recent peak in ISM data**. She points out that when the ISM Manufacturing Purchasing Managers' Index falls—albeit this time from nearly a 30-year high—cyclical sectors usually lag. In contrast, classic defensive sectors such as Health Care, Utilities, and Consumer Staples tend to outperform when the ISM Manufacturing PMI is falling. **As far as portfolio positioning goes for long-term investors, she maintains her overweight to cyclicals as they historically outperform in an above-average GDP growth environment**. She wrote, "We are reluctant to abandon our Cyclical sector overweights without further evidence that what appears to be a quite strong underlying economic growth backdrop is truly at risk." But Calvasina acknowledges classic defensive sectors have scope to perform well in the near term due to some institutional investors' concerns about peaking economic indicators and relatively attractive valuations.

- **Recent economic reports were mixed but generally support the economic recovery narrative**. Inflation data, as measured by Purchasing Prices Index (PPI) inputs, was higher than consensus expectations. May retail sales missed the lofty consensus forecasts, but April's sales were revised upward, highlighting the stickiness of March's stimulus-fueled acceleration. Housing starts increased 3.6% m/m in May, slightly behind the consensus forecast. Labor and building materials shortages likely played a role. Initial jobless claims of 412,000 surprised to the upside and were higher than the prior week for the first time in nearly two months.

Value stocks rise and then pause with U.S. manufacturing activity

Russell 1000 Value and ISM Manufacturing PMI, since 6/1/20



Source - RBC Wealth Management, FactSet; data as of 11:15 am ET 6/17/21

CANADA

Richard Tan, CFA & Arete Zafiriou – Toronto

- **Resale activity in the Canadian housing market recorded its second straight monthly decline in May**, supporting RBC Economics' view that **March resale levels were likely the cyclical peak**. However, RBC Economics also notes that **home prices have yet to peak**, driven by strong competition among a smaller pool of buyers. Major markets such as Ottawa, Montreal, and Toronto experienced strong gains on a year-over-year basis, but this trailed smaller markets outside the Greater Toronto Area, which gained more than 40% y/y as households transitioned away from the city in favour of larger spaces. Overall, RBC Economics believes inventory levels will remain tight and expects further escalation in prices on the back of low interest rates, evolving household needs, and high household savings. As of the end of May, the average Canadian home appreciated by approximately 24% y/y, which compares to the S&P/TSX Composite at roughly 34%.

- **Canada's headline Consumer Price Index (CPI) expanded 3.6% y/y in May, the highest annual inflation rate since May 2011. Prices rose in every major category**. Energy prices contributed almost half of the increase, up 26.4% from low base levels a year ago. Food prices grew 1.5% from higher base levels last May, and RBC Economics expects growth to continue amid high agricultural commodity prices. Excluding volatile energy and food prices, the CPI increased 2.4% y/y last month, up from 1.8% in April. Homeowners' replacement costs increased 11.3% y/y, continuing the 16-month trend of positive growth as home prices jumped due to higher consumer demand and construction costs. Passenger vehicle prices also ticked higher, up 5.0% y/y in May due in part to the global

semiconductor chips shortage. As the economy reopens in the coming quarters, **RBC Economics expects consumer demand to rise and become a key driver of price growth in H2 2021**.

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

- **The STOXX Europe 600 Index notched its longest record-setting streak in more than 20 years** with a ninth successive record high on Wednesday, June 16. In Q2 thus far, **there has been a pause in the rotation towards value stocks and sectors**, with "quality" stocks—particularly luxury goods in the Consumer Discretionary sector—leading the way, while the defensive Consumer Staples and Health Care sectors have also outperformed.
- Banks have been a notable exception to the underperformance of value stocks during the quarter, and continue to outperform. **In light of the Fed's announcement, we think equity market leadership in the short term could shift back to what we saw in Q1**, with value cyclicals such as banks and other shorter-duration stocks outperforming longer-duration growth and quality stocks.
- **UK CPI inflation came in ahead of expectations** at 2.1% y/y in May, versus consensus of 1.8%, driven by base effects from lapping a depressed comparative (i.e., May 2020 when the UK was in full lockdown), particularly fuel prices, in combination with the reopening of the economy as pandemic restrictions are eased. Given that a significant proportion of inflation can be attributed to the two aforementioned factors, we think the **Bank of England's Monetary Policy Committee will likely continue to look past inflation above its 2% target level** for the time being.
- Although the **European Central Bank** raised its forecasts for growth and inflation for this year and the next at its meeting last week, we think it is also **unlikely to join the tapering movement soon** because it has renewed its commitment to conduct net purchases under its Pandemic Emergency Purchase Programme at a significantly higher pace. This monetary policy differential could weigh on the euro, which weakened by nearly 1.5% compared to the U.S. dollar after the Fed meeting.

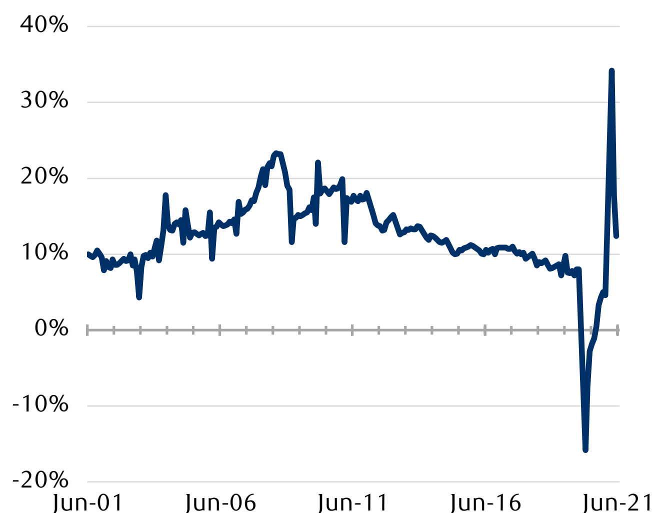
ASIA PACIFIC

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

- **The Asia-Pacific equity market traded flat during the week**, continuing the trend since the beginning of the month.
- **The latest economic data from China suggests the recovery is stabilizing** even though the numbers were slightly below estimates: industrial output +8.8% y/y in May (Bloomberg survey +9.2%), retail sales +12.4% (Bloomberg survey +14.0%), and fixed-asset investment +15.4% year to date. **The strong economic rebound since the outbreak of COVID-19 has been driven by heavy industry, the property market, and an export boom, with consumer spending remaining the weak link.** We believe the latter is the key to a more sustainable growth outlook. While spending is picking up gradually as vaccine rollouts accelerate in mainland China and the labor market improves, the recent holiday spending figures suggest consumers are still holding back on purchases. Meanwhile, near-term economic risk is skewed to the downside with the virus outbreak in the southern province of Guangdong. According to the Bloomberg survey, **economists expect China's economy to gradually moderate this year from 8% y/y growth in Q2 to 6.2% in Q3 and 5% in Q4**.

China economic activity normalizing

China's monthly retail sales growth (y/y)



Source - RBC Wealth Management, Bloomberg; monthly data through May 2021

- We believe investors have anticipated the normalizing growth prospects, and **we maintain our overweight stance on China equities with a preference for domestic companies and stocks with a value tilt**. We expect leading domestic Consumer Staples players to emerge as the largest beneficiaries of the government's policy to boost domestic consumption, and value to continue to outperform growth on the back of a tightening credit environment.
- **Economists have raised their forecasts for Singapore's 2021 GDP growth from 5.8% y/y to 6.5%**, according to a survey by Singapore's central bank. Economists expect an expansion of 15% y/y in Q2, coming off the low base a year ago, when Singapore was in the midst of "circuit breaker" measures. A further deterioration of the COVID-19 pandemic remains the most-cited downside risk. While we are neutral on ASEAN (Southeast Asia) equities, **we have a preference for Singapore as a reopening play**.

MARKET
Scorecard

Data as of June 17, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,221.86	0.4%	12.4%	35.6%	46.1%
Dow Industrials (DJIA)	33,823.45	-2.0%	10.5%	29.5%	29.5%
Nasdaq	14,161.35	3.0%	9.9%	42.9%	80.5%
Russell 2000	2,287.46	0.8%	15.8%	60.4%	49.2%
S&P/TSX Comp	20,144.04	2.1%	15.5%	30.6%	23.2%
FTSE All-Share	4,071.33	1.4%	10.8%	17.5%	1.4%
STOXX Europe 600	459.33	2.8%	15.1%	25.5%	21.4%
EURO STOXX 50	4,158.14	2.9%	17.0%	27.3%	22.9%
Hang Seng	28,558.59	-2.0%	4.9%	16.7%	4.9%
Shanghai Comp	3,525.60	-2.5%	1.5%	20.1%	22.1%
Nikkei 225	29,018.33	0.5%	5.7%	29.2%	37.4%
India Sensex	52,323.33	0.7%	9.6%	56.2%	34.3%
Singapore Straits Times	3,138.31	-0.8%	10.4%	17.6%	-2.2%
Brazil Ibovespa	128,057.20	1.5%	7.6%	34.0%	31.2%
Mexican Bolsa IPC	50,202.80	-1.3%	13.9%	32.5%	16.8%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.507%	-8.7	59.4	76.9	-58.7
Canada 10-Yr	1.394%	-9.2	71.7	85.8	-5.9
UK 10-Yr	0.776%	-1.9	57.9	58.6	-7.4
Germany 10-Yr	-0.195%	-0.8	37.4	19.7	4.9
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.55%	0.1%	-2.2%	-0.6%	17.3%
U.S. Investment-Grade Corp	2.11%	0.6%	-2.3%	2.5%	24.1%
U.S. High-Yield Corp	3.89%	0.8%	3.1%	12.6%	21.0%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,772.35	-7.1%	-6.6%	2.6%	32.3%
Silver (spot $/oz)	25.88	-7.7%	-2.0%	47.9%	74.4%
Copper ($/metric ton)	9,638.25	-6.0%	24.4%	67.9%	65.7%
Oil (WTI spot/bbl)	71.04	7.1%	46.4%	87.1%	36.8%
Oil (Brent spot/bbl)	73.06	5.4%	41.0%	79.5%	19.9%
Natural Gas ($/mmBtu)	3.25	8.7%	27.8%	98.2%	36.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	91.9410	2.4%	2.2%	-5.4%	-5.8%
CAD/USD	0.8094	-2.4%	3.1%	9.8%	8.6%
USD/CAD	1.2355	2.4%	-2.9%	-8.9%	-7.9%
EUR/USD	1.1909	-2.6%	-2.5%	5.9%	6.2%
GBP/USD	1.3928	-2.0%	1.9%	10.9%	11.1%
AUD/USD	0.7552	-2.4%	-1.8%	9.7%	10.2%
USD/JPY	110.2500	0.6%	6.8%	3.0%	1.6%
EUR/JPY	131.3000	-2.0%	4.1%	9.1%	7.8%
EUR/GBP	0.8551	-0.6%	-4.3%	-4.5%	-4.5%
EUR/CHF	1.0927	-0.6%	1.1%	2.4%	-2.5%
USD/SGD	1.3427	1.6%	1.6%	-3.6%	-2.1%
USD/CNY	6.4483	1.2%	-1.2%	-7.1%	-6.9%
USD/MXN	20.4259	2.4%	2.6%	-8.6%	6.5%
USD/BRL	5.0153	-3.9%	-3.5%	32.7%	29.0%

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 0.80 means 1 Canadian dollar will buy 0.80 U.S. dollar. CAD/USD 3.1% return means the Canadian dollar rose 3.1% vs. the U.S. dollar year to date. USD/JPY 110.25 means 1 U.S. dollar will buy 110.25 yen. USD/JPY 6.8% return means the U.S. dollar rose 6.8% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 6/17/21

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As of March 31, 2021

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Rating	Count	Percent	Count	Percent
Buy [Outperform]	762	55.46	299	39.24
Hold [Sector Perform]	559	40.68	179	32.02
Sell [Underperform]	53	3.86	4	7.55

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