GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee May 19, 2022

# The perfect storm

Kelly Bogdanova – San Francisco

Worries about this unique period's peculiar challenges came together in a perfect storm this week, upending equity markets and flummoxing investors. It could take some time for the economic imbalances to sort themselves out, and sentiment has decidedly soured. Ironically, when the bears are out in force like they are today, that's typically not the time to give up on the market, in our view.

Strong bouts of equity market volatility usually don't disappear overnight, and the current multi-month swoon is proving this to be the case once again.

While equity indexes attempted to stabilize early in the week, on Wednesday the S&P 500 and Dow Jones Industrial Average traded down 4.0 percent and 3.6 percent, respectively, the biggest single-session declines since Q2 2020 during the acute COVID-19 period.

High inflation, ongoing supply chain problems, and concerns about economic growth—along with wariness about the Fed's ability to effectively right the ship—continue to weigh on the market.

But on Wednesday, for the first time during this lengthy selloff, these worries manifested in a big way on the corporate side, specifically within a major U.S. retailer's quarterly earnings report.

Target missed its consensus earnings forecast by a mile and lowered forward earnings and profit margin estimates, sending the stock tumbling 25 percent in a single session, its worst day since Black Monday in 1987. The S&P 500 Retailing Index, which includes Target and 20 other major retailers, fell 7.4 percent in sympathy, and the rest of the market slid with it.

## Earnings tripped up

Target's news exacerbated concerns about the turbulent economic waters, and underscored that this is indeed a unique period with peculiar challenges that are well outside the scope of a normal business cycle.

With the Q1 earnings season just about finished, the S&P 500 has delivered much stronger earnings per share growth compared to the consensus forecast before reporting began (11.8 percent versus 4.7 percent) and higher revenue growth (13.8 percent versus 10.8 percent) on a year-over-year basis. Beat rates and the magnitude of surprises have been high. Also, profit margins have deteriorated less than initially expected (-3.0 percent versus -7.3 percent). Even when the ultra-robust Energy sector is stripped out of the data, both S&P 500 earnings and revenue growth are up 6.4 percent and 10.5 percent, respectively—not bad considering very lofty comparisons

For perspectives on the week from our regional analysts, please see pages 4–5.

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Priced (in USD) as of 5/18/22 market close (unless otherwise stated). Produced: May 19, 2022 12:47 pm ET; Disseminated: May 19, 2022 12:52 pm ET
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in the year-ago period. If one judged the quarter on these figures alone, everything would look fine.

But there is more to the Q1 earnings story as indicated by Target's big miss and problems at retailers Walmart and Lowe's, along with stumbles earlier in the reporting season by Texas Instruments, Alphabet (Google), Boeing, Whirlpool, JPMorgan Chase, Netflix, PayPal, Harley-Davidson, and Baker Hughes, among other firms.

Target's situation is the most illustrative. The company blamed an unusual, rapid shift in customer spending from goods to services, which left it sitting on a mountain of household goods and apparel inventory that required extra warehouse space which came at a high price. The unwanted inventory prompted Target to discount a number of goods, much lower than usual—and despite this the company's inventories are still bloated. Target also cited high fuel and freight costs as being problematic in Q1.

We think Target's problems—and lesser but still meaningful struggles at Walmart—were exacerbated by supply chain and inflation challenges that began amid the global COVID-19 lockdowns and restrictions, and by households' unique buying habits during that period.

After stimulus checks rained down from federal and state governments during the pandemic, American households bought goods hand over fist, including big-ticket items. Now that the stimulus checks and outsized goods spending have largely run their course, and with inflation taking a greater toll, household spending is shifting away from goods and toward discretionary services (including pricey airfares and hotels) and higher-cost basic staples such as food, gasoline, and utilities.

It could take a number of months for the economic imbalances to sort themselves out, and for companies and the market to absorb the shifts. Much will depend on how consumer and business demand respond to Fed rate hikes, and how long supply chains remain constrained and inflation stays "sticky." The latter two challenges have become more complex lately due to the renewed COVID-19 lockdowns in China, problems with Ukraine's agriculture supplies, and sweeping Western sanctions on Russia that have added premiums to commodity prices worldwide.

The economic imbalances and Target's big miss are indications to us that the S&P 500 consensus earnings forecast of $227 per share for 2022 could be too high.

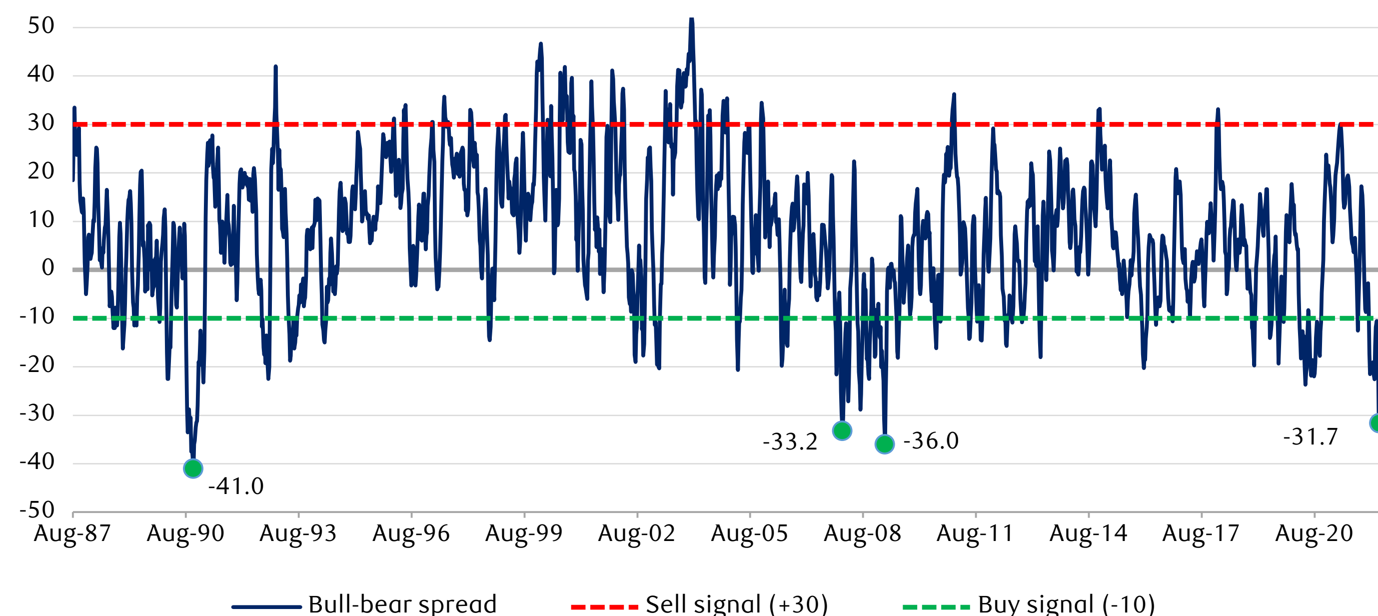
## Bears on parade

Given these headwinds and with the S&P 500 down 18.2 percent from its peak in January, it should be no surprise that stock market sentiment has deteriorated significantly. Among individual investors, it recently declined to one of the most bearish levels in almost 35 years, according to a weekly survey by the American Association of Individual Investors (AAII).

The bull-bear spread, which measures the percentage of investors who are bullish about the market's prospects

**Investor sentiment has become very bearish, which is usually a contrarian indicator**

AAII bull-bear spread* (4-week moving average)




* The bull-bear spread is based on the weekly Investor Sentiment Survey by the American Association of Individual Investors (AAII) and represents the percentage of respondents reporting bullish sentiment minus the percentage reporting bearish sentiment.

Source - RBC Capital Markets U.S. Equity Strategy, RBC Wealth Management, AAII, Bloomberg; weekly data 8/13/87–5/19/22. The -31.7 data point is from 5/5/22; the most recent reading on 5/19/22 is -29.5.

for the next six months minus the percentage who are bearish, dropped to -31.7 in early May, on a four-week moving average basis. This means there were 31.7 percent more bears than bulls, which is the fourth-most-bearish low point since AAII began conducting its survey in mid-1987, as the chart on the previous page illustrates.

It's not just individual investors who currently have gloomy attitudes about the market. In recent weeks, sentiment of institutional investors (managers of mutual funds, pension funds, and hedge funds) has likewise fallen to very bearish levels based on a variety of indicators.

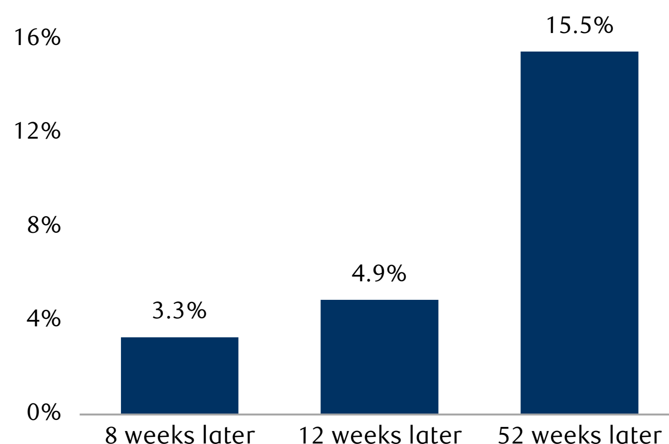
Ironically, with sentiment this negative, this is not the time to give up on the market, in our opinion. Extreme sentiment readings are often contrarian indicators for market performance. When investors' attitudes are rather bearish, the market often rallies within a 12-month time span, and when attitudes are unusually bullish, the market typically stumbles soon thereafter.

An RBC Capital Markets study found that when the AAII bull-bear spread falls below -10, it is typically a short-term buy signal, whereas when the reading rises above +30, it is usually a short-term sell signal (these levels are shown by the green and red lines in the chart on page 2). Specifically, the study reveals that since 1987 when the bull-bear spread fell below the -10 threshold, the market bounced soon thereafter and rose 15.5 percent 52 weeks later, on average.

To us, the very gloomy attitudes about the market signal that even if volatility persists and there is additional downside in the near term, if history is a guide, the market has the potential to upend the majority's expectations and deliver worthwhile gains within 12 months from now. This is one of the reasons we think long-term investors should stay the course. For additional factors, see our recent article, "Can this volatile stock market regain momentum?"

**The market tends to rise after sentiment becomes very bearish**

Average S&P 500 return after the bull-bear spread is below -10*




* Data represents forward returns when the 4-week moving average of percentage of bulls minus percentage of bears in survey results from the American Association of Individual Investors (AAII) is below -10; survey measures weekly sentiment data from 8/13/87 to 5/19/22.

Source - RBC Capital Markets U.S. Equity Strategy, RBC Wealth Management, AAII, Bloomberg

## UNITED STATES

Atul Bhatia, CFA – Minneapolis

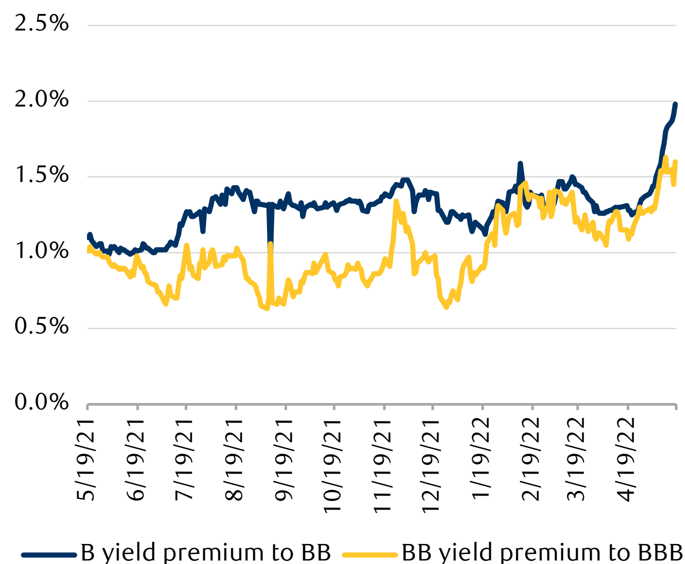
- **Treasury bond volatility remained high during the week**, as the market continued to weigh the impact of tighter monetary conditions on asset prices and domestic growth. Major government bond maturities saw high-to-low yield differences of 16 basis points (bps) or more from Monday's close through Thursday morning's pre-market trading. **Changing Fed expectations do not appear to be the primary driver of the most recent price volatility**; instead, investors appear to be struggling to determine how the combination of tighter policy and high inflation will affect the U.S. consumer and growth more generally. We expect government bond volatility to remain elevated in the near term.

- **Growth concerns are increasingly evident in the corporate bond market as well**. The yield premium investors demand for lower-rated securities—which tend to see larger increases in default rates during recessions—has increased lately. **One potentially concerning change is the rapid increase in the yield spread between B-rated and BB-rated debt**; this measure often moves when investors are concerned about credit fundamentals and potential near-term defaults. Credit spread widening in late 2021 and earlier this year had been concentrated on the spread between the BB and BBB rating categories, which represents the crossover between investment-grade and high-yield corporate debt and often moves in response to changing financing and trading conditions.

- **The U.S. Dollar Index (DXY) slipped during the week, hitting 103.29 in pre-market trading Thursday, down nearly 1.3% from last week's multi-decade high**. The greenback had rallied in part on the idea that U.S. growth would outperform major trading counterparts despite higher Treasury yields, potentially providing a double boost to the dollar relative to major currencies. This week's growth concerns were accompanied by a drop in the dollar's income advantage, as 2-year Treasury yields fell nearly 12 bps relative to comparable-maturity euro rates. The dollar's traditional status as a relatively lower-risk asset may help cushion potential future declines.

**Investors' yield demands increase; lower-rated risk premiums rising amid economic concerns**

Yield differences between rating-specific bond indexes




Note: B-rated debt represented by the Bloomberg B US High Yield Index, BB by the Bloomberg Ba US High Yield Index, and BBB by the Bloomberg Baa Corporate Index.

Source - RBC Wealth Management, Bloomberg; data through 5/18/22

## CANADA

Sean Killin & Richard Tan, CFA – Toronto

- **The Canadian headline inflation rate reached 6.8% y/y in April**, modestly ahead of the 6.7% consensus projection. It appears the primary culprits were strong contributions from the shelter and food categories which advanced 7.4% and 8.8% y/y, respectively. We believe this will ultimately strengthen the Bank of Canada's position to increase its overnight rate at the June 1 meeting. As a slight positive, while inflation and rising interest rates have weighed on financial markets, **the S&P/TSX Composite Index continues to hold its own relative to global developed peers** due to robust commodity prices and the Energy and Materials sectors accounting for nearly one-third of the index. Furthermore, the S&P/TSX Composite trades at meaningful discount to the S&P 500 on forward earnings and, therefore, may provide some relative downside protection should interest rates continue to move higher.

- **Geopolitics, scarcity, and demand have been placing pressure on Canadian oil producers to increase output**. Given the disruptions throughout the global energy market brought on by the war in Ukraine and the flurry of economic sanctions that followed, energy scarcity has become a growing driver of inflationary pressure throughout much of the global economy. U.S. and Canadian diplomatic channels have begun to search for alternative sources of fossil fuels to increase domestic and European energy supply. One of the proposed methods is to increase Canadian energy output. The Canadian Minister of Natural Resources, Jonathan Wilkinson, has estimated Canada can increase output by approximately 300,000 barrels per day (bbl/d). The federal estimate is much more conservative than the 900,000 bbl/d estimate provided by the former premier of Alberta in his testimony before a U.S. Senate committee earlier this week. A 900,000 bbl/d output would nearly match that of the U.S. release of 1,000,000 bbl/d from its strategic petroleum reserves and present the possibility of alleviating rising energy costs.

## EUROPE

Frédérique Carrier & Rufaro Chiriseri, CFA – London

- **In the UK**, economic news flow indicated weakening economic activity after a post-omicron bounce, and worsening upward price pressures. **March GDP contracted 0.1% m/m, with private sector services output particularly weak**. Given the loss of momentum into Q2, RBC Capital Markets believes that the Bank of England's (BoE) latest GDP projections for the next couple of quarters may prove overly optimistic. We note that UK **business investment, though off its pandemic lows, remains below pre-Brexit-referendum levels**.

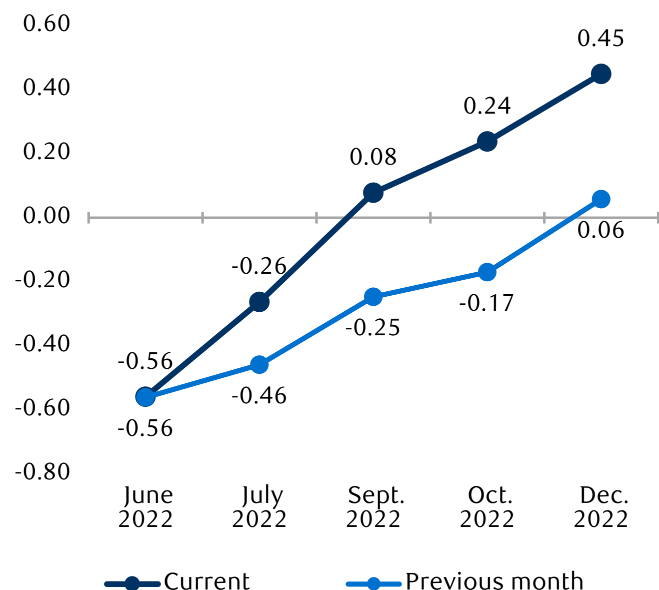
- Despite weakening economic momentum, the **labour market is tight** with the unemployment rate reaching 3.7% in the three months to the end of March. Hiring demand remains strong while labour supply is suffering from early retirement, long-term illness, and lower immigration—particularly from the EU—so **wage pressures remain high**. A BoE survey suggests companies believe they can pass on these higher costs to consumers.

- UK consumer prices accelerated 9% y/y in April, the **highest level of inflation in 40 years**, mostly due to an increase in the household energy cap (which sets price hikes for domestic gas and electricity) and escalating food prices. RBC Capital Markets expects UK inflation to peak in Q2.

- The BoE, which is coming under increasing political criticism for its handling of inflation, will likely continue to focus on high inflation and tight labour markets in setting the course of interest rates. The market sees further tightening with **year-end Bank Rate expectations jumping to 2.2% from 2% in one week alone**.

### ECB July hike fully priced in

European Central Bank market-implied rate expectations




Source - RBC Wealth Management, Bloomberg; data through 5/19/22

- Meanwhile, **in the euro area, April inflation was unchanged** from March's reading of 7.4%. Core inflation, which excludes food and energy, increased during the period to 3.5% from 3%, pointing to a broadening of price pressures.

- **The European Central Bank's (ECB) hawkish cohort is gaining momentum** as there is now broad agreement that negative interest rates should end "relatively quickly." Furthermore, one of the most hawkish members of the ECB's rate-setting body also stated that "an interest rate hike would be possible already during the month of July." Markets have now fully priced in a 25 bps hike at the July meeting.

## ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Asian equities were somewhat volatile today following the overnight selloff of U.S. stocks**. However, the Chinese onshore market was relatively resilient for the day and whole week, as the number of new COVID-19 cases continues to fall and policymakers vow to support the economy. Shanghai plans to lift its strict COVID-19 lockdown measures and allow "normal life" to resume starting June 1. Beijing is still striving to contain the COVID-19 spread by starting three rounds of mass testing across four districts. However, two other cities reported surging cases—Tianjin, a port city next to Beijing, and Guang'an in Sichuan province, within a two-hour drive of Chongqing. Future COVID-19 developments in those two cities will need to be watched closely.

- **The Shanghai lockdown has put significant pressure on China's April macroeconomic data**, with credit growth, industrial production, and retail sales coming in far below consensus estimates. In response to the weak data, Premier Li Keqiang has asked local governments to act decisively and launch measures to support growth as soon as possible. Although we don't expect a change to China's zero-COVID policy in the near term, we note the booster shot vaccination rate has increased to above 60% for people above 60 years of age, from only 50% in April.

- **Shares of Chinese tech giant Tencent (700 HK) were down as much as 9% today, after reporting flat Q1 2022 revenue growth**. Its profit reached RMB 23.4 billion, but missed the Bloomberg consensus estimate of RMB 29.3 billion. The weak earnings were due to the lockdown's impact, the government's video game playing rules previously instituted to protect minors, and a business strategy adjustment. Company management said it sees a clear supporting signal from senior government officials for regulatory reforms, but noted it takes time for actual measures to be implemented. The statement added pressure on the whole tech sector as investors worry that a regulatory reset may not end as soon as the market had hoped.

## MARKET
# Scorecard

Data as of May 18, 2022

| Equities (local currency) | Level | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| S&P 500 | 3,923.68 | -5.0% | -17.7% | -4.9% | 32.8% |
| Dow Industrials (DJIA) | 31,490.07 | -4.5% | -13.3% | -7.5% | 28.0% |
| Nasdaq | 11,418.15 | -7.4% | -27.0% | -14.2% | 23.6% |
| Russell 2000 | 1,774.85 | -4.8% | -21.0% | -19.7% | 33.1% |
| S&P/TSX Comp | 20,101.38 | -3.2% | -5.3% | 3.0% | 37.3% |
| FTSE All-Share | 4,110.49 | -1.8% | -2.3% | 2.6% | 23.8% |
| STOXX Europe 600 | 433.95 | -3.7% | -11.0% | -2.1% | 27.0% |
| EURO STOXX 50 | 3,690.74 | -2.9% | -14.1% | -7.9% | 26.7% |
| Hang Seng | 20,644.28 | -2.1% | -11.8% | -27.8% | -13.7% |
| Shanghai Comp | 3,085.98 | 1.3% | -15.2% | -12.6% | 7.3% |
| Nikkei 225 | 26,911.20 | 0.2% | -6.5% | -5.3% | 33.7% |
| India Sensex | 54,208.53 | -5.0% | -6.9% | 8.0% | 80.5% |
| Singapore Straits Times | 3,225.35 | -3.9% | 3.3% | 2.6% | 27.0% |
| Brazil Ibovespa | 106,247.15 | -1.5% | 1.4% | -13.6% | 30.9% |
| Mexican Bolsa IPC | 50,394.03 | -2.0% | -5.4% | 1.2% | 35.8% |
| **Gov't bonds (bps change)** | **Yield** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. 10-Yr Treasury | 2.884% | -5.0 | 137.4 | 124.7 | 215.8 |
| Canada 10-Yr | 2.946% | 8.0 | 152.0 | 138.1 | 240.3 |
| UK 10-Yr | 1.865% | -4.0 | 89.4 | 99.7 | 160.8 |
| Germany 10-Yr | 1.030% | 9.2 | 120.7 | 113.3 | 149.7 |
| **Fixed income (returns)** | **Yield** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Aggregate | 3.55% | -0.6% | -10.0% | -8.9% | -8.9% |
| U.S. Investment-Grade Corp | 4.46% | -1.3% | -13.8% | -11.5% | -7.0% |
| U.S. High-Yield Corp | 7.64% | -2.4% | -10.4% | -7.5% | 9.6% |
| **Commodities (USD)** | **Price** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| Gold (spot $/oz) | 1,816.61 | -4.2% | -0.7% | -2.8% | 4.9% |
| Silver (spot $/oz) | 21.41 | -6.0% | -8.1% | -24.0% | 26.2% |
| Copper ($/metric ton) | 9,386.25 | -3.9% | -3.6% | -9.5% | 77.4% |
| Oil (WTI spot/bbl) | 109.59 | 4.7% | 42.3% | 67.3% | 244.4% |
| Oil (Brent spot/bbl) | 109.24 | -0.1% | 40.4% | 59.0% | 213.8% |
| Natural Gas ($/mmBtu) | 8.24 | 13.7% | 120.8% | 173.4% | 361.9% |
| **Currencies** | **Rate** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Dollar Index | 103.9020 | 0.9% | 8.6% | 15.8% | 4.3% |
| CAD/USD | 0.7758 | -0.2% | -1.9% | -6.4% | 8.1% |
| USD/CAD | 1.2891 | 0.3% | 2.0% | 6.8% | -7.5% |
| EUR/USD | 1.0463 | -0.8% | -8.0% | -14.4% | -4.1% |
| GBP/USD | 1.2343 | -1.8% | -8.8% | -13.0% | 1.2% |
| AUD/USD | 0.6955 | -1.5% | -4.2% | -10.7% | 6.6% |
| USD/JPY | 128.1900 | -1.2% | 11.4% | 17.7% | 19.4% |
| EUR/JPY | 134.1200 | -2.1% | 2.5% | 0.8% | 14.5% |
| EUR/GBP | 0.8481 | 1.1% | 0.8% | -1.6% | -5.2% |
| EUR/CHF | 1.0348 | 0.8% | -0.3% | -5.7% | -2.4% |
| USD/SGD | 1.3893 | 0.4% | 3.0% | 4.5% | -2.0% |
| USD/CNY | 6.7542 | 2.2% | 6.3% | 5.1% | -5.0% |
| USD/MXN | 20.0544 | -1.8% | -2.3% | 1.1% | -15.6% |
| USD/BRL | 4.9688 | -0.1% | -10.9% | -5.6% | -13.1% |

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 0.77 means 1 Canadian dollar will buy 0.77 U.S. dollar. CAD/USD -1.9% return means the Canadian dollar fell 1.9% vs. the U.S. dollar year to date. USD/JPY 128.19 means 1 U.S. dollar will buy 128.19 yen. USD/JPY 11.4% return means the U.S. dollar rose 11.4% vs. the yen year to date.

Source - Bloomberg; data as of 5/18/22 market close

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As of March 31, 2022

| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| Buy [Outperform] | 841 | 57.68 | 330 | 39.24 |
| Hold [Sector Perform] | 569 | 39.03 | 172 | 30.23 |
| Sell [Underperform] | 48 | 3.29 | 3 | 6.25 |

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