GLOBAL Insight WEEKLY

RBC Wealth Management

Perspectives from the Global Portfolio Advisory Committee

March 4, 2021

Will the Fed twist the yield curve?

Atul Bhatia, CFA – Minneapolis

The continuing U.S. economic recovery has stoked concern that inflation could drive interest rates higher, but a more complicated picture may be coming into focus. We examine the long-term market forces in play and the Fed's policy options.

The continuing global rise in interest rates has strong foundations in the market's growth expectations, as improving economic data and rising vaccination rates reduce demand for low-risk government debt. We believe the move is sustainable and reasonable given the improved economic trajectory.

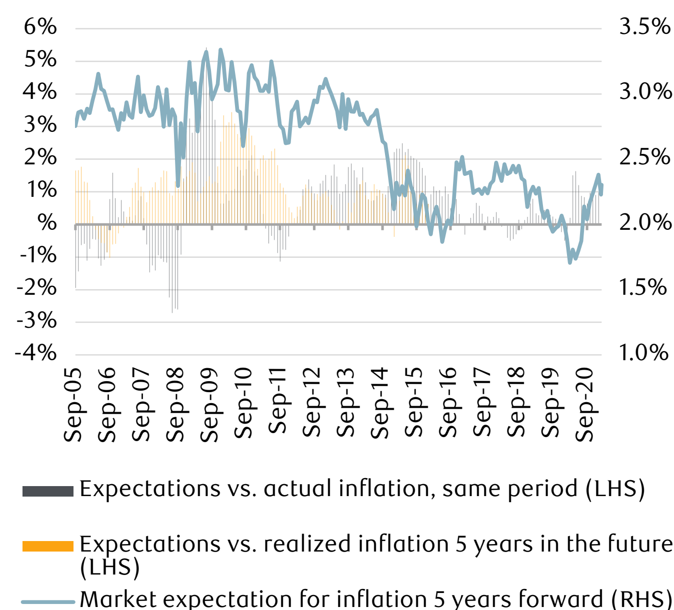
At the same time, concerns that the rise in longer-term rates could presage a near-term tightening of the Federal Reserve's monetary policy are misguided, in our view. Investors should also keep in mind the market forces that will likely help offset some of the upward pressure on longer-term rates even as the economy recovers.

Transitory inflation unlikely to move the Fed

Rising inflation expectations have partly fueled the recent drop in bond prices, as investors confront the potential simultaneous arrival of $1.9 trillion in fiscal stimulus and the large-scale return of consumers, flush with an extra $1.6 trillion in savings after pulling back from pre-pandemic spending levels. The potential combined demand increase is equivalent to 16 percent of U.S. GDP. As a result, relatively small shifts in estimates of vaccination rates and consumer confidence can have outsized effects on inflation projections. The impact on Consumer Price Inflation (CPI), which is reported on a

Markets consistently over-estimate inflation

5-year forward projection typically exceeds both current and future inflation readings



Source - RBC Wealth Management, Bloomberg

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

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year-over-year basis, is magnified by the comparison to a 2020 economy that was largely shut down.

The Fed is not likely to place any real weight on these outsized inflation reports when setting policy, in our view. The underlying economic events are non-recurring, and constitute necessary steps in the economic recovery the central bank is working hard to engineer. And while expectations for near-term inflation have increased sharply, we see little evidence that inflation expectations are hardening at a level the Fed would find troublesome. The Fed's preferred gauge of inflation expectations—the market's expectation for annual inflation over a five-year period starting five years in the future—is at only 2.3 percent, an unexceptional level by historical standards, and entirely consistent with the Fed's average two percent inflation targeting regime.

By statute, the Fed is mandated to maximize employment while keeping prices stable and long-term interest rates moderate. Today, prices are indeed stable and long-term rates moderate, but employment is far from maximized: the U.S. economy currently provides 10 million fewer jobs than it did before the start of the pandemic; the unemployment rate is almost three percent higher than it was a year ago; and the long-term unemployed now account for 40 percent of all jobless workers, the highest level since 2008. In light of this mandate, we see no cogent argument today for the Fed to shift to a tighter monetary policy stance, particularly as the market-led rise in rates has already tightened financing conditions across the economy.

Operation Twist returns?

One policy option the Fed may choose is to relaunch Operation Twist, which involves selling short-term assets like T-bills and reinvesting the proceeds into longer-maturity Treasury bonds. The policy would have two major benefits from the Fed's perspective. First, it would send a strong signal to the market on long-term rates. Yields on the 10-year Treasury bond are a benchmark for many corporate investments, so slowing the rate rise there could help the Fed achieve its larger employment and growth goals. Second, Operation Twist could help avoid potential problems in short-term money markets. The Treasury Department's recent decision to spend down existing cash balances instead of issuing new T-bills has raised concerns about the availability of short-maturity, risk-free assets for money market investors. The Fed could replace some of the missing supply by selling off its holdings.

Given the potential dual benefits of Operation Twist, we would not be surprised to see at least a discussion of the strategy at the Fed's next meeting, scheduled for March 16–17.

Fed may twist curve back into shape

10-year yield vs. 3-month bill yield at multiyear high

Note: The chart shows the difference in yield between a U.S. Treasury bond maturing in 10 years and a 3-month Treasury bill.
Source - RBC Wealth Management, Bloomberg

Headwinds to rising long-term interest rates

Even without direct Fed intervention, there are downward forces on long-term interest rates. One is the potential for persistent low inflation. Zero interest rates and balance sheet expansion have been empirically tested across developed markets since 2008 without creating consistent, on-target inflation. The benefits of these monetary policies have flowed primarily to higher-income savers, while inflation is based on the consumption basket of the average American, who relies on wages for spending. Without an increase in wage income, it is difficult to see sustained upward price pressure.

Rising long-term Treasury rates also impact the federal budget. U.S. government debt is at 127 percent of GDP, the highest level since World War II. If the Treasury Department were forced to pay 2018-level interest on today's record debt load, almost $160 billion annually would be redirected towards debt service. Shifting resources from spenders to savers in this way would tend to decrease long-term interest rates.

Finally, higher U.S. Treasury yields also draw in foreign investors. Although the most recent Treasury Department data on foreign bond holdings is from December 2020, we know that as of mid-February the Federal Reserve was holding more than $3 trillion in Treasury securities on behalf of foreign official and institutional investors—the largest total since early 2018. As yields increase further, we would expect additional foreign purchases to help temper any rise in interest rates.

UNITED STATES

Alan Robinson – Seattle

- **U.S. equities started the week on the front foot on confirmation a third COVID-19 vaccine was approved** for emergency pandemic use. Johnson & Johnson (JNJ) expects to deliver more than 20 million doses in March. President Joe Biden announced the U.S. will now have enough vaccines for all U.S. adults by the end of May, two months earlier than originally planned. However, the positive sentiment faded as increasing case counts cast doubts on plans to ease restrictions in most of the country.
- **Economic data was mixed**. The ISM Services Purchasing Managers' Index reading of 55.3 for February was down from January's 58.7. However, the ISM Services Prices Index rose by 7.6 points to 71.8, the strongest level since September 2008, with the report noting capacity constraints and human resource issues driving prices higher, even as the February ADP National Employment Report showed another month of anemic job gains.
- **The U.S. Senate edged closer to approving a COVID-19 relief package** ahead of the expiry of unemployment benefits later this month. Next on the fiscal agenda will likely be an infrastructure bill. In combination, these measures should lead the economy to significant near-term growth at the cost of spiraling long-term fiscal deficits.
- **Global oil prices rose nearly 5% on Mar. 4 to $67 per barrel of Brent crude ahead of the "OPEC+" meeting of oil exporters that day**. The 2020 global recession prompted the group to slash production by a record of 9.7 million barrels per day (mb/d) last year, before easing cuts to 7.2 mb/d from January 2021. Ahead of the OPEC+ press conference, RBC Capital Markets, LLC's Global Head of Commodity Strategy Helima Croft expected a modest production increase of up to 1 mb/d to meet increasing demand from improving global economies. But she also cautioned that Saudi Arabia has a bias to higher oil prices and may be reluctant to increase supply until oil approaches $75–$80 per barrel. **Firmer oil prices should sustain the rebound seen in energy stocks this year**.

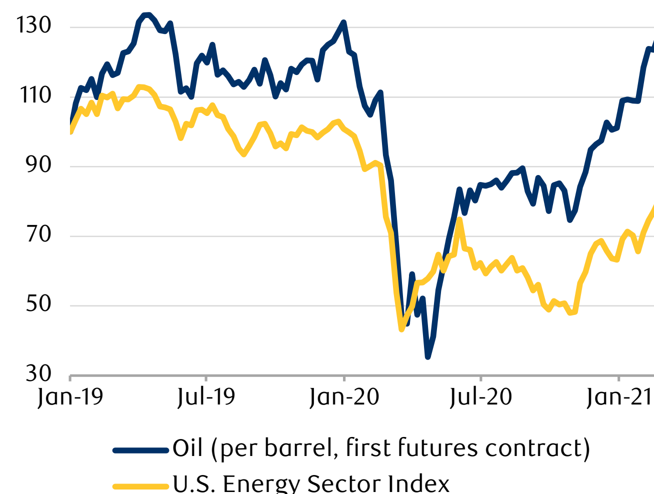
CANADA

Carolyn Schroeder & Richard Tan, CFA – Toronto

- **The S&P/TSX Composite is trading at approximately 16x forward earnings, a premium to its long-term average of roughly 14.8x dating back to 2001**. While Canadian equities may seem expensive at first glance, we would argue that valuations are actually attractive in the context of equity risk premiums—a measure of potential excess return over the risk-free rate. Currently, the S&P/TSX Composite is generating an equity risk premium of nearly 4.9%, about 100 basis points above its long-term average. In other words, investors of Canadian equities are being compensated more than average to be invested into equities compared to Government of Canada bonds all else equal. Furthermore, we believe the setup for Canadian equities is compelling because (1) the S&P/TSX Composite is trading at a discount to U.S. equities and (2) Canada is a resource-based economy and the outlook for commodities such as oil and copper has improved, in our view.
- **The Canadian economy continued to grow during the second wave of COVID-19** as GDP surged 9.6% (annualized) in Q4 2020 despite restrictions. The level of GDP in the quarter was still down 3.2% y/y, but that's much improved from the 13% y/y drop in Q2 2020. Unsurprisingly, consumer spending on hospitality/travel services remained exceptionally weak, but other parts of the economy have continued to improve. Although consumer spending on goods edged lower in Q4, as virus containment measures limited in-store shopping, it was still up 4.6% from a year ago. The manufacturing sector also pulled back in December, though likely rebounded in January alongside improving business sentiment. With containment measures already easing gradually again in most parts of the country in February, RBC Economics believes it is highly likely growth will remain positive through the second wave.

Oil has regained its pre-COVID range, Energy sector yet to catch up

Relative performance of oil price and Energy sector stocks since 2019



Source - Thomson One Refinitiv, RBC Wealth Management; weekly closing prices with 1/4/19 = 100

EUROPE

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The UK government presented its budget** to Parliament on Mar. 3. **Fiscal policies will continue to be expansive** for some time. Measures to reduce the ballooning deficit were also announced for 2023, with the UK being one of the first countries to worry about fiscal rectitude.
- **Emergency measures to support the economy**, such as the furlough scheme for employees, **are being extended through the summer**, beyond the point when the economy is expected to be fully reopened in mid-June. The Chancellor of the Exchequer also announced near-term incentives to encourage businesses to invest over the next two years.
- **These supportive measures were much more generous than what was widely expected**. According to RBC Capital Markets, **the measures represent a boost of some 2.5% to the UK's GDP**, and bring all the country's COVID-related fiscal relief to a high 14% of GDP (vs. Canada's 13%). As such, this support should help underpin the economic recovery in the near term and justifies the market's expectation the UK interest rate tightening cycle will start in H1 2023.
- **However, a large increase in corporate taxes will occur in 2023**, taking effect after the government expects the economy to have strengthened. **The rate will jump from 19% to 25% in 2023**, just one year before the next general elections are slated to take place. This is more than had been expected by the business sector and will bring the corporate tax rate closer to the G7 average corporate tax rate. Moreover, personal tax allowances, such as the capital gains tax allowance and the pensions lifetime allowance, will be frozen from April this year. Additional announcements regarding taxes will be made at the next budget release, probably in November. All told, in four years' time, **the UK tax burden will rise to its highest level in 50 years**, according to the Financial Times.
- **UK domestic-focused stocks were generally boosted by the larger-than-expected fiscal support measures**, with the performance of the homebuilders standing out. This helped the UK's midcap equity index, the FTSE 250, which is significantly more domestically focused than the large-cap FTSE 100 Index, close at its highest point in over a year. The FTSE 250 is now less than 4% below its all-time high set in January 2020 prior to the outbreak of the pandemic.

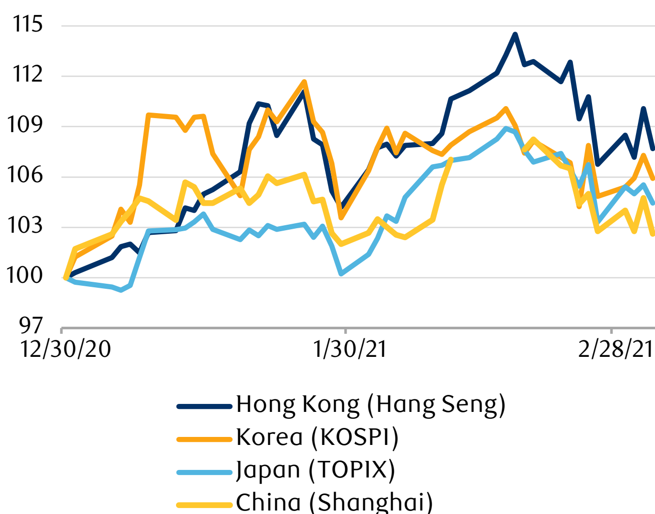
ASIA PACIFIC

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

- **Asian equities were choppy this week** following a surge in U.S. sovereign bond yields that reignited valuation concerns. The Technology sector struggled while Real Estate, Financials, and Energy shares

Key Asian equity markets converge to the downside after volatile start to 2021

Relative equity index performance



Source - Thomson One Refinitiv, RBC Wealth Management; daily closing prices with 12/30/20 = 100

outperformed as part of a global shift to the value segment. China led losses amid the worst drop in the Asia Pacific region on Thursday, with the CSI 300 Index down 3.2% as investors sold what we view as overvalued sectors such as baijiu (a type of Asian liquor) and solar energy.

- The China market correction also comes after **a warning from China's top banking regulator**, Guo Shuqing, that he's "very worried" about risks emerging from bubbles in global financial markets and the nation's property sector, sparking concerns about further tightening in China.
- China's "Two Sessions", the annual gatherings of the Chinese People's Political Consultative Conference (CPPCC) and the National People's Congress (NPC), commence on Thursday and Friday, respectively. **The "Two Sessions" are a window to the central government's priorities and plans for the coming year**. One of the NPC's tasks this year will be to pass the final version of China's 14th five-year plan. The outlines of the five-year plan published in November indicate China intends to boost domestic consumer demand and encourage self-reliance in the hi-tech sector, as part of its "dual circulation" strategy.
- **Japan may extend the virus emergency in the Tokyo region**, which was set to expire on Mar. 7, for another two weeks. A final decision would be made after consulting with experts and local leaders. The announcement comes as Tokyo's governor and the leaders of the three most-populous prefectures adjacent to the capital were pressing for a two-week extension to stem infections that have fallen, but not as fast as some officials had hoped.

MARKET Scorecard

Data as of March 4, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,768.47	-1.1%	0.3%	20.4%	34.9%
Dow Industrials (DJIA)	30,924.14	0.0%	1.0%	14.1%	19.8%
Nasdaq	12,723.47	-3.6%	-1.3%	41.1%	67.9%
Russell 2000	2,146.92	-2.5%	8.7%	40.2%	36.3%
S&P/TSX Comp	18,125.72	0.4%	4.0%	8.0%	13.0%
FTSE All-Share	3,792.09	2.4%	3.2%	-0.1%	-3.4%
STOXX Europe 600	411.91	1.7%	3.2%	6.6%	9.8%
EURO STOXX 50	3,704.85	1.9%	4.3%	8.3%	11.7%
Hang Seng	29,236.79	0.9%	7.4%	11.5%	1.0%
Shanghai Comp	3,503.49	-0.2%	0.9%	16.3%	15.7%
Nikkei 225	28,930.11	-0.1%	5.4%	37.1%	32.6%
India Sensex	50,846.08	3.6%	6.5%	32.4%	41.0%
Singapore Straits Times	3,014.78	2.2%	6.0%	-0.3%	-7.3%
Brazil Ibovespa	112,690.20	2.4%	-5.3%	5.1%	19.1%
Mexican Bolsa IPC	46,004.19	3.2%	4.4%	6.0%	8.5%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.554%	14.9	64.0	50.1	-116.9
Canada 10-Yr	1.494%	13.9	81.7	48.2	-40.2
UK 10-Yr	0.731%	-8.9	53.4	36.2	-54.2
Germany 10-Yr	-0.311%	-5.1	25.8	32.7	-46.9
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.45%	-0.4%	-2.5%	0.4%	16.9%
U.S. Investment-Grade Corp	2.12%	-0.7%	-3.7%	1.2%	22.3%
U.S. High-Yield Corp	4.19%	0.2%	0.9%	8.1%	18.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,699.25	-2.0%	-10.5%	3.8%	32.1%
Silver (spot $/oz)	25.40	-4.8%	-3.8%	47.5%	68.3%
Copper ($/metric ton)	9,128.25	-0.1%	17.8%	61.2%	41.3%
Oil (WTI spot/bbl)	63.83	3.8%	31.6%	36.4%	12.8%
Oil (Brent spot/bbl)	67.10	1.5%	29.5%	31.2%	2.2%
Natural Gas ($/mmBtu)	2.75	-0.9%	8.2%	50.3%	-3.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	91.6120	0.8%	1.9%	-5.9%	-5.2%
CAD/USD	0.7896	0.6%	0.5%	5.7%	5.0%
USD/CAD	1.2666	-0.6%	-0.5%	-5.4%	-4.8%
EUR/USD	1.1972	-0.9%	-2.0%	7.5%	5.6%
GBP/USD	1.3895	-0.3%	1.6%	7.9%	5.4%
AUD/USD	0.7722	0.2%	0.4%	16.5%	8.9%
USD/JPY	107.9700	1.3%	4.6%	0.4%	-3.4%
EUR/JPY	129.2600	0.5%	2.4%	7.9%	2.0%
EUR/GBP	0.8617	-0.6%	-3.6%	-0.4%	0.1%
EUR/CHF	1.1124	1.4%	2.9%	4.4%	-1.8%
USD/SGD	1.3374	0.4%	1.2%	-3.4%	-1.3%
USD/CNY	6.4699	-0.1%	-0.9%	-6.8%	-3.5%
USD/MXN	21.1301	1.3%	6.1%	8.2%	9.5%
USD/BRL	5.6686	1.2%	9.0%	50.0%	50.0%

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 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 0.5% return means the Canadian dollar rose 0.5% vs. the U.S. dollar year to date. USD/JPY 107.97 means 1 U.S. dollar will buy 107.97 yen. USD/JPY 4.6% return means the U.S. dollar rose 4.6% vs. the yen year to date.

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

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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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