GLOBAL
Insight
WEEKLY

Wealth
Management

Perspectives from the Global Portfolio Advisory Committee May 11, 2023

Not out of the woods

Kelly Bogdanova – San Francisco

Although the U.S. equity market has been holding its own in the face of multiple headwinds, the threat of volatility remains. We examine three lingering risks investors should keep top of mind as we near the time of year when market performance tends to moderate.

The U.S. equity market has held up reasonably well recently—all things considered.

It has digested serious regional banking system problems, further erosion in corporate earnings estimates, more Fed rate hikes, and mixed-to-deteriorating economic data.

The S&P 500 is toward the top end of its wide, year-long trading range. It's up 7.8 percent year to date as of Wednesday's close.

The market has responded positively to the decline in inflation from the highest level in 40 years and to better-than-feared corporate earnings data. Market participants' perception that the Fed has likely reached the end of its aggressive rate hike campaign has helped hold up share prices. Technology stocks have done a lot of the heavy lifting.

There are, however, three lingering risks we think investors should keep in mind, as they could generate volatility in the coming months during the time of year when market performance tends to soften. Historically, the S&P 500 and other major markets have typically underperformed from May through October.

Regional banking system stress persists

News that JPMorgan Chase acquired a substantial majority of First Republic Bank's assets did not bring relief for U.S. bank equities. As of midday trading on Thursday, the S&P 500 Regional Banks Index has declined almost six percent since the deal was announced on May 1.

We think First Republic's problems, combined with the Federal Deposit Insurance Corporation's lack of action to temporarily guarantee larger uninsured deposits, led some hedge funds to search for what they perceive to be the next regional bank victim(s). Short selling has added pressure on select bank stocks with deposit outflow vulnerabilities, in our view. As these stocks took another downward turn recently, this weighed further on bank equities overall.

Uncertainties and concerns about the potential for higher deposit insurance and regulatory costs have brought additional headwinds to bank stocks.

And the fact that all of this is unfolding amid the normal process of banks tightening lending standards due to weak economic trends hasn't helped matters. Bank stocks may not be factoring in the possibilities of a full-blown credit crunch, commercial real estate problems, or a recession just yet.

If additional banks succumb to deposit outflow and funding pressures, we think federal financial authorities have the tools to deal with the problems. But in the interim, any further negative news about specific regional

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

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banks would likely continue to weigh on bank stocks as a whole and could pressure the S&P 500 and other major indexes.

The debt ceiling debate could get messy

Equity market reaction to previous debt ceiling debates has varied.

A study by RBC Capital Markets shows that when there was not much drama in financial markets generally and when the debt ceiling political risks were relatively muted, S&P 500 declines associated with debt ceiling deadlines were modest, in the two percent to seven percent range.

However, the market had more difficulty coping with debt ceiling risks when angst in financial markets was already high for economic and various other reasons, and when political drama associated with raising the debt ceiling was also high. According to RBC Capital Markets, S&P 500 declines ranged from 10 percent to 19 percent during such periods.

2011 was the most acute episode when the S&P 500 dropped 19 percent. The political clash in Washington over the debt ceiling resulted in a near crisis. While a debt default was ultimately averted, the political resolution came late and the missteps resulted in the downgrade of the U.S. credit rating. During this period, fear regarding the European sovereign debt crisis was also high.

This go-around, we can't rule out an outsized negative equity market reaction if the debt ceiling clash comes down to the wire. There are high partisan tensions in Washington and major disagreements about how to raise the debt limit. This comes at a time when the market is also grappling with banking system stress and recession risks. (For additional thoughts, see the article, "The rocky road for debt ceiling negotiations.")

A recession looks more likely

Our U.S. leading economic indicators continue to point toward a domestic recession starting in the second half of the year, possibly in the summer. Three of our seven indicators have been pointing in this direction for months, and two started flashing yellow caution signals recently.

RBC Economics just revised its U.S. Real GDP growth estimates lower, and now forecasts three successive negative quarters instead of two. It anticipates GDP growth will fall 0.8 percent in Q2, 2.5 percent in Q3, and 0.5 percent in Q4.

If (or when) economic data deteriorate further, the market's path could be bumpy again. For market participants to contemplate a recession—like they have for many months—is one thing, but to actually see economic weakness revealed in the data is quite another.

There are two silver linings

Due to these lingering headwinds, we think the risk-reward outlook for the market is more challenging over the near term, and the S&P 500 is vulnerable to additional volatility and downside.

But it's important to keep two things in mind: (1) The S&P 500 typically bottoms well before economic conditions improve, and often when headlines and investor sentiment are still rather negative, and (2) A shift in Fed policy could support the market over time.

Historical data show there has often been downside risk to the S&P 500 right before the Fed paused its rate hike cycle, but gains typically occurred in the months afterward, as shown in the top table. We think last week's Fed rate hike, which lifted the fed funds rate to 5.25 percent, will be the last increase of its aggressive hiking campaign.

In the periods before and after the Fed's first rate cut, stocks typically rose, including at an above-average rate three and six months later, as the lower table illustrates. We think it's possible the Fed will start to cut rates later this year, especially if a recession occurs.

These factors support our view that investors with long investment time horizons should maintain long-term strategic asset allocations.

Historical U.S. market performance when Fed policy shifts

Before and after the final rate hike in a Fed tightening cycle:
Downside risk right before the Fed pauses, but typically gains afterward

S&P 500 performance Final Fed rate hike	Before final rate hike			After final rate hike		
	6 months	3 months	1 month	1 month	3 months	6 months
Median 1970 – 1979	-1.0%	-2.5%	-4.5%	2.6%	-4.4%	2.8%
Median 1980 – 1989	9.0%	7.3%	-0.5%	1.2%	1.4%	8.0%
Median 1990 – 2018	2.4%	2.3%	1.0%	0.6%	7.2%	13.3%
Median since 1970	**2.9%**	**0.5%**	**-0.7%**	**1.0%**	**1.7%**	**5.9%**

Before and after first rate cut in a Fed loosening cycle:
Stocks typically rise, including at an above-average rate 6 months later

S&P 500 performance First Fed rate cut	Before first rate cut			After first rate cut		
	6 months	3 months	1 month	1 month	3 months	6 months
Median 1970 – 1979	0.1%	-0.1%	-0.2%	1.2%	9.6%	8.5%
Median 1980 – 1989	7.1%	4.5%	1.9%	-0.2%	7.5%	10.0%
Median 1990 – 2020	5.9%	0.5%	1.7%	0.1%	1.7%	8.8%
Median since 1970	**5.7%**	**1.3%**	**1.2%**	**0.1%**	**4.2%**	**9.0%**

Source - RBC Capital Markets U.S. Equity Strategy, Bloomberg; periods of positive performance shaded in green, periods with negative performance shaded in red

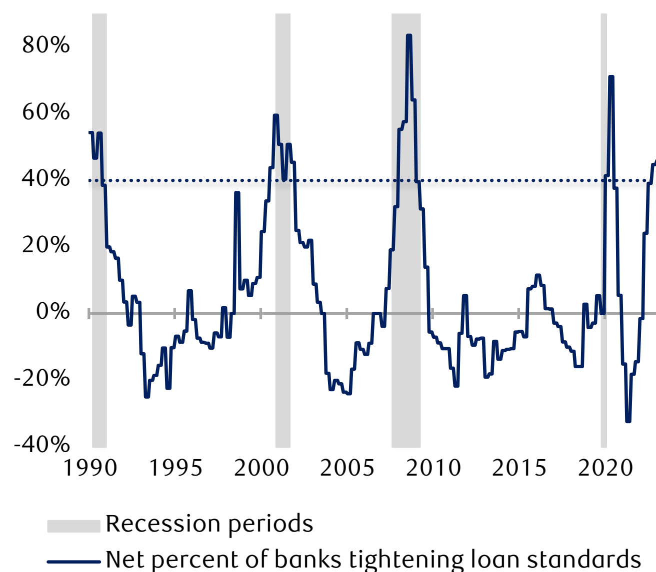
UNITED STATES

Tyler Frawley, CFA – Minneapolis

- **U.S. equities are on track for mixed results this week as earnings season begins to wind down**. Leadership is most notable in growth stocks, with the S&P 500 Growth Index advancing 0.21% while the S&P 500 Value Index is down 0.67%. Sector leadership is evident in Communication Services, up 4.46%, while Energy has lagged, falling 2.43% on the week.

- **Bank lending standards continued to tighten during Q1**. According to the Federal Reserve's Senior Loan Officer Opinion Survey (SLOOS), the net percentage of U.S. banks tightening commercial and industrial loan standards for large and mid-sized businesses increased to 46.0% in the first three months of the year, up slightly from 44.8% in Q4 2022. Banks cited deterioration in credit quality, reduced collateral values, increased funding costs, and deposit outflows during the quarter as reasons for the tightening. If this trend continues, we think the effects of more stringent lending standards are likely to be felt across the economy, as decreased credit availability will likely limit businesses' ability to finance things like new equipment and hiring. While the Federal Reserve may view this positively, as decreased demand and a cooler labor market could help drive inflation lower, we see a potential risk that decreased availability of credit could help drive the economy into a recession. Going back to 1990, the net percentage of banks that indicated they were tightening lending standards has only peaked above 40% on four previous occasions—all of which coincided with the economy entering a recession. Despite the Fed continuing to insist that a soft landing is possible, **further tightening in credit standards risks a hard landing, in our view**.

Lending standards continue to tighten



Note: Dashed line represents 40%

Source - RBC Wealth Management, Bloomberg; monthly data through April 2023

- **Inflation moved lower for a tenth straight month in April.** This week's Consumer Price Index (CPI) report showed that headline inflation climbed 4.9% in April compared to a year ago, slightly below the 5.0% consensus expectation and down from 5.0% in March. Core inflation, which excludes food and energy prices, rose by 5.5% y/y, down from 5.6% last month. While the slight step down in year-over-year inflation is promising, the slow pace of declines illustrates how difficult it could be to reach the Fed's 2% target.

CANADA

Mila Krunic & Matt Altro – Toronto

- As the impressive run in Canadian housing prices over the past couple of years started to fade, households began to question if an end is near. **RBC Economics notes that activity has ramped up significantly in many local housing markets from the depressed levels observed in March, and prices have begun to tick higher again**. Unfortunately, affordability remains a problem, especially amongst first-time homebuyers, and this has the potential to significantly limit the housing market recovery. Within Toronto, April resales jumped 27% m/m and demand-supply conditions tightened for a fifth straight month. In Montreal, resales were up an estimated 12% m/m, reversing part of the 34% decline since early 2022. In Vancouver, new listings increased an estimated 9% m/m, and Calgary saw home resales rise by an estimated 29% m/m.

- **The Canadian labour market surprised to the upside once again in April**. Canada added 41,400 jobs, with full-time employment down 6,200 and part-time employment up 47,600. Over the last seven months, employment has increased by 412,000, which is three times the trend rate from 2010 to 2019. April's unemployment rate held steady for a fifth straight month at 5.0%, while total hours worked were up 0.2% m/m and wages were up 5.2% y/y. The labour market continues to look very firm at the moment, though we are conscious this is a lagging economic indicator. According to RBC Economics, the Bank of Canada is likely done raising interest rates due to mounting growth concerns. A healthy labour market and high inflation, on the other hand, do not yet support a shift to rate cuts, and RBC Economics thinks the Bank of Canada will remain on hold for the rest of the year.

EUROPE

Rufaro Chiriseri, CFA – London

- **The Bank of England (BoE) delivered a 25 basis point (bps) interest rate increase to reach a Bank Rate of 4.5% at the meeting on Thursday**. The widely expected move marks the twelfth consecutive rate hike and the highest Bank Rate since 2008. The Monetary Policy Committee (MPC) voted seven to two in favour of the hike, with the dissenters preferring to leave the rate unchanged. The committee's forward guidance is unchanged from March, stating that "if there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required," giving the committee optionality to respond to new data.

- The MPC's May Monetary Policy Report (MPR) projections take into account market expectations that the Bank Rate will likely peak around 4.8% and fall back to 3.5% by Q2 2026. The central bank policymakers likely view this terminal rate as appropriate, as their forecast sees inflation falling quickly to 5% by year's end and reaching the 2% target by Q4 2024, albeit later than previously forecast in February. **A big surprise lay in the MPR growth forecast, where the central bank made the largest upward revision on record**. The BoE not only expects higher growth, it now expects the UK economy to dodge a recession altogether and grow this year. The MPC cited an uptick in labour participation and fiscal measures as contributors to the upward revision.

- Mortgages and the transmission of higher interest rates to homeowners were a hot topic during the press conference following the policy decision. Around 85% of UK mortgages are linked to fixed rates, and these are predominantly fixed for two years. **A key assessment by the central bank acknowledges that only about 70 bps of the rate hikes have fed through to homeowners**, and thus there is still quite a lot of pass-through to be realised by around 1.3 million households when their mortgage deals expire this year. This is a significant limiting factor for the BoE to continue hiking beyond 4.75%, in our view.

ASIA PACIFIC

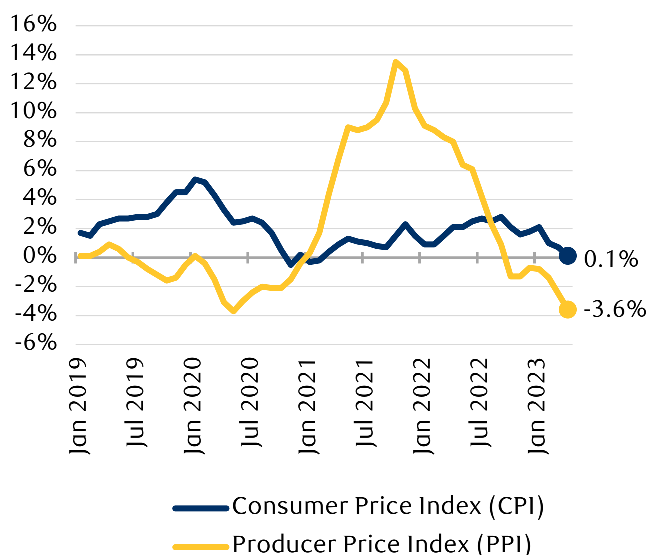
Jasmine Duan – Hong Kong

- **China's recent economic data show an uneven economic recovery**. Consumption during the country's Labor Day holiday was encouraging. The number of tourists was 20% above the 2019 level, and total travel revenue surpassed the pre-pandemic level for the first time. Jewelry, apparel, and cosmetics are among the segments leading the consumption recovery.

- **But data in other areas, including inflation and trade, signal the recovery is still facing some challenges.** Headline Consumer Price Index (CPI) inflation fell to 0.1% y/y in April from 0.7% y/y in March, and Producer Price

China's CPI and PPI inflation further declined in April

Year-over-year percent change



Source - RBC Wealth Management, Bloomberg; monthly data through April 2023

Index (PPI) deflation reached -3.6% y/y in April compared to -2.5% y/y in March. According to the National Bureau of Statistics, the base effect of high food and energy prices last year was the main reason for the weak CPI data. Besides the base effect, subdued domestic and external demand drove the PPI down.

- We are not surprised to see some economic data weaken sequentially, and expect the catch-up effect following China's reopening should start to fade in April. Domestic demand is not yet strong enough to offset the external demand slowdown. **In our view, doubts about the post-pandemic recovery and geopolitical uncertainty are the two major concerns for investors in Chinese equities today**. However, we note that investors tend to pay more attention to negative data, which could lead to market volatility in the near term as new economic data are released.

- **The U.S. Public Company Accounting Oversight Board (PCAOB) released its first inspection reports for audit firms based in China**. The report identifies "unacceptable rates" of audit deficiencies and states that "any deficiencies are unacceptable." However, the report also mentions that "it is not unexpected to find such high rates of deficiencies in jurisdictions that are being inspected for the first time" and notes that the findings are consistent with other first-time inspections around the world. American depositary receipt (ADR) equities of Chinese companies initially declined on Wednesday following the release of the report, and later recovered some ground.

MARKET Scorecard

Data as of May 10, 2023

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,137.64	-0.8%	7.8%	3.4%	-1.2%
Dow Industrials (DJIA)	33,531.33	-1.7%	1.2%	4.3%	-3.5%
Nasdaq	12,306.44	0.7%	17.6%	4.8%	-8.2%
Russell 2000	1,759.51	-0.5%	-0.1%	-0.1%	-20.5%
S&P/TSX Comp	20,499.31	-0.7%	5.7%	3.1%	5.9%
FTSE All-Share	4,220.42	-1.5%	3.6%	5.5%	3.9%
STOXX Europe 600	463.64	-0.6%	9.1%	10.3%	4.1%
EURO STOXX 50	4,306.76	-1.2%	13.5%	21.2%	7.0%
Hang Seng	19,762.20	-0.7%	-0.1%	0.7%	-30.9%
Shanghai Comp	3,319.15	-0.1%	7.4%	9.3%	-3.2%
Nikkei 225	29,122.18	0.9%	11.6%	11.3%	-1.3%
India Sensex	61,940.20	1.4%	1.8%	13.9%	25.1%
Singapore Straits Times	3,242.29	-0.9%	-0.3%	0.3%	1.9%
Brazil Ibovespa	107,448.21	2.9%	-2.1%	4.2%	-11.9%
Mexican Bolsa IPC	55,534.68	0.8%	14.6%	13.1%	11.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.435%	1.3	-44.0	44.4	183.3
Canada 10-Yr	2.901%	6.0	-39.9	-10.3	138.5
UK 10-Yr	3.800%	8.1	12.8	195.2	301.2
Germany 10-Yr	2.288%	-2.5	-28.3	128.8	250.0
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.42%	-0.7%	2.9%	-0.7%	-9.6%
U.S. Investment-Grade Corp	5.26%	-1.3%	3.0%	0.1%	-11.1%
U.S. High-Yield Corp	8.61%	-0.6%	4.0%	2.7%	-4.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	2,031.47	2.1%	11.4%	10.5%	10.6%
Silver (spot $/oz)	25.40	1.4%	6.0%	19.4%	-7.0%
Copper ($/metric ton)	8,562.25	-0.2%	2.4%	-7.3%	-17.5%
Oil (WTI spot/bbl)	72.56	-5.5%	-9.6%	-27.3%	11.8%
Oil (Brent spot/bbl)	76.65	-3.6%	-10.8%	-25.2%	12.2%
Natural Gas ($/mmBtu)	2.18	-9.5%	-51.3%	-70.5%	-25.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	101.4370	-0.2%	-2.0%	-2.4%	12.4%
CAD/USD	0.7477	1.3%	1.3%	-2.6%	-9.5%
USD/CAD	1.3374	-1.3%	-1.3%	2.7%	10.5%
EUR/USD	1.0983	-0.3%	2.6%	4.3%	-9.4%
GBP/USD	1.2626	0.5%	4.5%	2.5%	-10.6%
AUD/USD	0.6778	2.5%	-0.5%	-2.3%	-13.4%
USD/JPY	134.3400	-1.4%	2.5%	3.0%	23.5%
EUR/JPY	147.5500	-1.7%	5.1%	7.4%	11.8%
EUR/GBP	0.8699	-0.8%	-1.7%	1.7%	1.3%
EUR/CHF	0.9769	-0.9%	-1.3%	-6.8%	-10.6%
USD/SGD	1.3249	-0.7%	-1.1%	-4.7%	-0.1%
USD/CNY	6.9304	0.3%	0.5%	2.9%	8.0%
USD/MXN	17.5544	-2.5%	-10.0%	-13.9%	-12.0%
USD/BRL	4.9485	-0.8%	-6.3%	-3.6%	-5.3%

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 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 1.3% return means the Canadian dollar rose 1.3% vs. the U.S. dollar year to date. USD/JPY 134.34 means 1 U.S. dollar will buy 134.34 yen. USD/JPY 2.5% return means the U.S. dollar rose 2.5% vs. the yen year to date.

Source - Bloomberg; data as of 5/10/23

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As of March 31, 2023

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Outperform]	824	56.05	236	28.64
Hold [Sector Perform]	591	40.20	132	22.34
Sell [Underperform]	55	3.74	4	7.27

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