GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee

August 24, 2023

Persistent resilience

Joseph Wu, CFA – Toronto

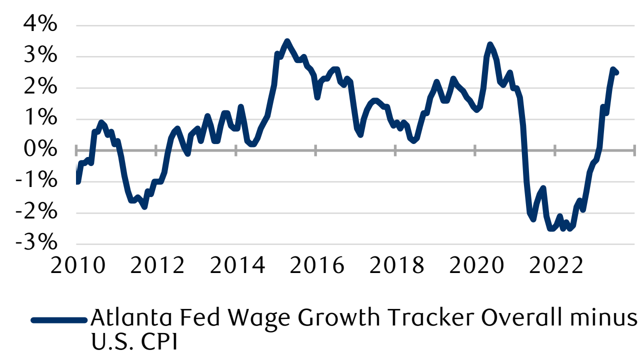
Broadly encouraging economic data have supported risk-bearing assets this year, though the recent backup in bond yields appears to have dented investor sentiment. We continue to believe an "up-in-quality" approach to portfolio allocations remains sensible.

Tailwinds

Despite a steep rise in interest rates across many countries over the past year, global growth has maintained an upward trajectory. As the largest economy in the world, the U.S. continues to display resilience. Projections from the Federal Reserve Bank of Atlanta's GDPNow model suggest U.S. real GDP could expand by over five percent in Q3. Should this forecast hold true, U.S. economic growth would more than double its Q2 rate, marking the fastest pace since Q4 2021. While we think this forecast will almost certainly be revised lower as the quarter progresses, the recent trend of economic data surprising on the upside paints a picture of an economy running stronger than expected. In our view, the following constructive factors that have been propelling the U.S. economy could help extend the growth runway in the near term:

Pay raises are outpacing inflation again after lagging for almost two years

U.S. real (inflation-adjusted) wage growth proxy



Source - RBC Wealth Management, Bloomberg; data through 7/31/23

- **Disinflation is well underway.** Since peaking at a 9.1 percent year-over-year (y/y) rate in June 2022, the U.S. Consumer Price Index (CPI) fell to 3.3 percent in July. Initially driven by lower energy and goods prices, the next source of disinflation is likely to come from housing-related categories. Real-time rent trackers have largely normalized to pre-pandemic levels, suggesting shelter inflation will ease substantially over the remainder of the year.
- **U.S. households remain in good shape.** Consumers still have deployable savings, and strong labour demand continues to augment income gains. Although the pace of hiring has slowed, the unemployment rate remains exceptionally low, job openings remain ample, and inflation-adjusted pay increases have turned positive (see exhibit).
- **There are few signs of strain in corporate fundamentals.** The Q2 reporting season has broadly featured above-average beat rates relative to consensus profit estimates, solid margins, and stable guidance. These trends indicate companies have been able to manage operating costs to defend margins without resorting to blanket layoffs.

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

For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

Priced (in USD) as of 8/23/23 market close (unless otherwise stated). Produced: 8/24/23 2:32 pm ET; Disseminated: 8/24/23 2:40 pm ET

Uncertainties

It is now easier to envision a “soft landing” for the U.S. economy, in which monetary policy tightening curbs inflation without inflicting major economic pain. But we think some uncertainties continue to stand out as potential sources of risk.

Lingering upside risks to inflation warrant monitoring, in our view. Price pressures have subsided meaningfully, but various measures of worker compensation growth still seem too high to be consistent with credible expectations of inflation returning to the Fed’s two percent target over the medium term. Core CPI (excluding food and energy) was 4.7 percent y/y in July, while the recent rebound in energy commodity prices serves as a reminder that central banks’ battle with inflation may not be over.

Given that Fed officials continue to reiterate their focus on inflation and a tight labour market, they will likely require more concrete evidence of softened labour demand before concluding that inflation is sustainably converging to their target and monetary policy does not need to tighten further.

We are also mindful of the delayed effects tied to monetary policy adjustments. Persistent economic strength has motivated some to take the view that the U.S. economy is immune to higher interest rates, but we believe the more likely explanation is the “long and variable” lag for monetary policy to be felt in the economy. According to RBC Global Asset Management, each rate hike can deliver a steady headwind to economic activity lasting about 2.5 years.

The possibility that monetary policy may have to remain restrictive for some time (higher rates for longer) or turn even more restrictive (more rate hikes), if Fed officials deem it necessary to counteract upside inflation risks, could inject additional uncertainty into the economic outlook. This uncertainty, coinciding with more onerous bank lending standards that are making it harder for households and businesses to get loans, could increase the vulnerability of the economy to higher borrowing costs, with spillover effects for corporate earnings.

Putting it all together

Global equities have generated solid returns this year, buoyed by continued robust data out of the U.S. which have allayed prevalent worries around a significant growth slowdown coming into 2023. Lower inflation and ongoing resilience in the labour market have emboldened markets to lean into a benign “soft landing” as the most probable outcome for the economy over the coming quarters.

This optimistic economic view has been reflected in the stock market through a rebound in valuation multiples and stabilization in consensus earnings estimates. In fixed income markets, compensation for taking credit risk has diminished—reflected in narrower credit spreads—though higher base interest rates have helped keep all-in yields at attractive levels (see exhibit).

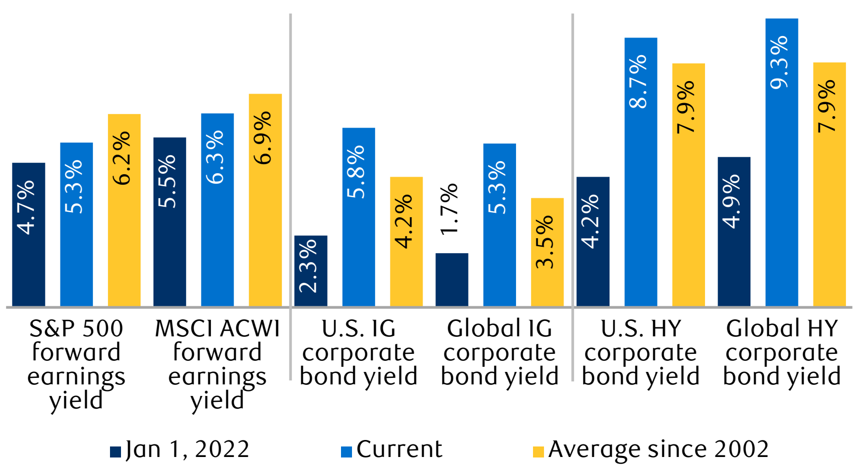
On balance, we think a modestly defensive stance in portfolios with a focus on relative value remains sensible on the belief that the U.S. economy is likely in the later stages of the business cycle.

While history shows that the late-cycle period usually still delivers positive returns for stocks, we believe investors should prepare for potential bouts of volatility as perceptions about the outlook can shift rapidly. In this part of the cycle, we think equity portfolios can benefit from emphasizing companies with robust quality characteristics—lower debt levels, consistent pricing power, reliable cash flow generation, and sustainable dividends—as they tend to be better equipped to weather tougher economic conditions.

Given the rally in equity markets this year, relative value—proxied by the spread of bond yields over equity earnings yields—has moved in favour of bonds. Along these lines, we continue to see timely opportunities in fixed income markets for deploying capital, with government bonds a useful source of portfolio defensiveness and the potential for mid-to-high single-digit returns in corporate credit. Yields in many bond markets have risen to their highest levels in more than a decade. Historically, starting yields have translated closely into annualized returns over the medium term.

Return potential in bonds now looks more competitive relative to equities

Valuations across major asset classes*



*Earnings yield is the inverse of the forward price-to-earnings ratio. Bond yield refers to yield to worst for the Bloomberg U.S. Corporate Index, the Bloomberg Global Agg Credit Index, the Bloomberg U.S. Corporate High Yield Index, and the Bloomberg Global Corporate High Yield Index.

Source - RBC Wealth Management, Bloomberg; data through 8/18/23

UNITED STATES

Atul Bhatia, CFA – Minneapolis

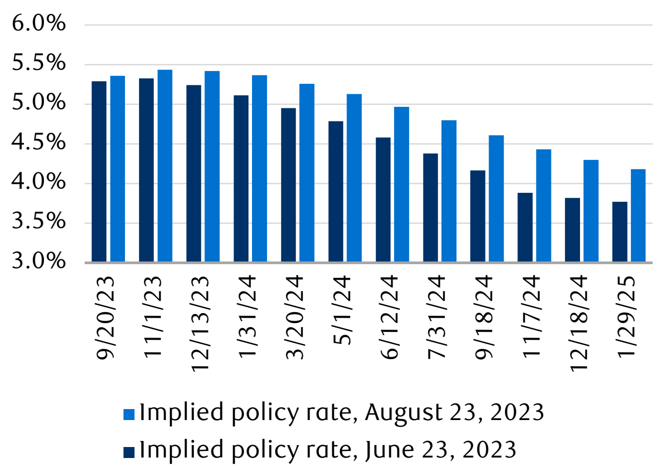
- **Falling prices on 10-year U.S. government bonds this week briefly pushed yields**—which move inversely to price—**to their highest level since 2007**. The market move followed a series of stronger-than-expected economic reports, comments from several Federal Reserve speakers on the potential need for higher interest rates to combat inflation, and increases in the size of recent government bond auctions. The resulting move higher in yields was, we believe, exacerbated by the thin trading conditions typical of August. The selling pressure ebbed this week Wednesday on economic data indicating slowing manufacturing activity in the U.S. and weaker-than-expected growth in services activities. Bond sentiment also improved as total payrolls in March 2023 were revised downward by 306,000. Through Wednesday's close, 10-year bond yields were 6 basis points lower on the week.

- **The recent market volatility is likely to raise investor interest in this Friday's speech by Fed Chair Jerome Powell at the Jackson Hole monetary policy conference**. This year's central bank symposium is focusing on "Structural Shifts in the Global Economy," although we believe market participants are more likely to concentrate on any guidance for short-term policymaking. We think Powell will steer clear of offering any specifics and will instead emphasize the Fed's data dependency amid an overarching commitment to price stability.

- **Interest rate futures pricing continues to reflect a relatively low chance of significant future Fed rate hikes**, with roughly a 50% chance of an additional hike this cycle based on Wednesday's closing levels. Recent price changes have instead emphasized shifts in when—and how quickly—the central bank will look to reduce restrictive policy. Two months ago, futures showed a high probability that overnight rates would dip below 5% in Q1 2024 and would end the year near 3.8%; as of Wednesday, investors now see rates above 5% through at least June 2024, and expect a year-end 2024 level closer to 4.2%.

Futures pricing suggests delayed cuts, not more hikes

Hawkish tilt still sees low odds of mutiple hikes; 5%+ rates may linger



Source - RBC Wealth Management, Bloomberg; data as of 8/23/23

CANADA

Sean Killin & Richard Tan, CFA – Toronto

- **Global crude oil prices rallied over the summer, with West Texas Intermediate (WTI) prices now sitting approximately 18% above the year-to-date lows.** This comes at a time when global refinery runs are up an incremental 2.2 million barrels per day on a year-over-year basis. The kicker is that this has not translated into inventory builds across major regions such as the U.S., Europe, and China. Put differently, refined product supply has not kept up with demand. **Over the near term, RBC Capital Markets believes demand for refined products will remain healthy and expects the physical market to stay tight.** As a result, RBC Capital Markets expects WTI to trade around US$80 per barrel until a new catalyst emerges. Overall, we believe this provides a solid backdrop for energy producers to generate attractive levels of cash flow, pay down debts, and return capital to shareholders.

- **The Canadian economy remains on solid footing, with household consumption trends proving resilient.** Housing activity, which accounts for a sizeable portion of Canadian GDP, has improved meaningfully in recent months—despite the impact of higher borrowing rates. There have also been some modest improvements in Canadian manufacturing activity, as Statistics Canada's advance estimate of sales in the manufacturing sector points to an increase of 0.7% m/m in July. **On a more cautious note, the leveraged position of Canadian households remains in focus.** In aggregate, for every dollar of disposable income earned, Canadian households currently hold CA$1.81 of debt. There is a risk that if labour market weakness begins to materialize, household debt will continue to become harder to service, which could ultimately place downward pressure on economic activity.

EUROPE

Rufaro Chiriseri, CFA – London

- **The cracks in the eurozone economy are starting to show as economic activity slumped to the lowest levels since November 2020**. The preliminary HCOB Eurozone Purchasing Managers' Index (PMI) fell to 47 in August from 48.6 in July, significantly below economists' consensus expectation of 48.5. This is firmly in contraction territory as a reading below 50 indicates a decline in economic activity. The services data, which had been in the expansion zone (above 50), showed a meaningful slump into the contraction zone.

■ **The weaker-than-expected data increases the likelihood of a European Central Bank (ECB) pause at the upcoming September meeting, in our opinion**. Yet, the activity data also revealed a more concerning issue—rising sector input cost inflation arising from wage pressures. While this is not our base case, the recent increase in inflation expectations could prompt further tightening beyond 3.75% by the ECB. In the bond market, we can see the reaction by deconstructing real yields, which are the difference between nominal yields and inflation expectations. Since July 18, we have observed rising 10-year nominal Bund yields which have been predominantly driven by the rise in inflation expectations. We think this will raise eyebrows at the ECB as it is not an encouraging prospect while the central bank attempts to stamp out inflation.

■ **The UK preliminary composite S&P Global/CIPS PMI fell into contractionary territory in August**, slipping to 47.9 from 50.8 in July, the lowest reading since the beginning of 2021 and below economists' consensus expectations. The same disappointing trend is reflected in the manufacturing sector, which fell to 42.5—a level last seen at the beginning of the pandemic. Similar to Europe, the services sector survey cited higher wages as a contributor to rising input costs. Despite the recent upside surprise in Q2 GDP, this activity data shows signs of waning. Market expectations of the terminal Bank Rate fell to 5.8% from a peak of 6% just a week ago. We continue to expect one more hike—to 5.5%—in September.

■ After weeks of rising yields, **disappointing economic activity indicators in the U.S., UK, and eurozone led to a strong rally in bond markets** as growth concerns emerged. After hitting a high of 2.72% last week, the German 10-year Bund rallied by 20 bps to 2.52% while 10-year Gilt yields rallied by 28 bps to 4.42%.

ASIA PACIFIC

Jasmine Duan – Hong Kong

■ **U.S. Secretary of Commerce Gina Raimondo will travel to Beijing and Shanghai August 27–30** for meetings with senior Chinese government officials and American business leaders. According to the press release from the U.S. Commerce Department, Raimondo "looks forward to constructive discussions on issues relating to the U.S.-China commercial relationship, challenges faced by U.S. businesses, and areas for potential cooperation." In the run-up to Raimondo's visit, **the Commerce Department on Monday removed 27 Chinese entities from the "Unverified List,"** which restricts entities' access to exports from the U.S.

■ **The market has interpreted the developments positively** as they indicate the two countries are trying to address certain issues and concerns through dialogue. Investors believe these talks between senior officials of the U.S. and China can pave the way for U.S. President Joe Biden and Chinese President Xi Jinping to meet at the Asia-Pacific Economic Cooperation meeting in November.

■ **China announced that it will suspend the imports of seafood originating from Japan** starting from August 24 to mitigate risks from Japan's discharge of nuclear-contaminated wastewater. The import ban will likely deal a blow to Japan's fishing industry as China is the largest export destination for Japanese seafood. According to Nikkei Asia, Japan's seafood exports to China amounted to ¥87.1 billion (US$620 million) in 2022.

■ **Chinese search engine giant Baidu (BIDU / 9988 HK) announced better-than-expected Q2 earnings**. Total revenue was up 15% y/y to RMB34.1 billion, 2% above the Bloomberg consensus estimate. The solid results were mainly driven by strong online marketing business. **The company is committed to invest in artificial intelligence** (AI) and launched a generative AI large language model, Ernie 3.5, in May 2023. Baidu expects immediate AI monetization once the commercialization plan is approved by the regulators.

Baidu's share price reacted positively after second-quarter results were reported

Source - RBC Wealth Management, Bloomberg; daily data through 8/23/23

MARKET
Scorecard

Data as of August 23, 2023

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,436.01	-3.3%	15.5%	7.4%	-1.0%
Dow Industrials (DJIA)	34,472.98	-3.1%	4.0%	4.8%	-2.4%
Nasdaq	13,721.03	-4.4%	31.1%	10.8%	-8.2%
Russell 2000	1,870.03	-6.6%	6.2%	-2.6%	-15.3%
S&P/TSX Comp	19,879.79	-3.6%	2.6%	-0.5%	-2.9%
FTSE All-Share	3,992.96	-4.9%	-2.0%	-2.8%	-2.4%
STOXX Europe 600	453.45	-3.8%	6.7%	5.1%	-3.9%
EURO STOXX 50	4,266.67	-4.6%	12.5%	16.8%	2.2%
Hang Seng	17,845.92	-11.1%	-9.8%	-8.5%	-28.9%
Shanghai Comp	3,078.40	-6.5%	-0.4%	-6.0%	-11.5%
Nikkei 225	32,010.26	-3.5%	22.7%	12.5%	16.4%
India Sensex	65,433.30	-1.6%	7.5%	10.8%	17.8%
Singapore Straits Times	3,174.18	-5.9%	-2.4%	-2.2%	2.8%
Brazil Ibovespa	118,134.59	-3.1%	7.7%	4.7%	0.6%
Mexican Bolsa IPC	53,635.34	-2.2%	10.7%	11.8%	3.0%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.194%	23.5	31.9	114.8	294.2
Canada 10-Yr	3.648%	14.8	34.8	60.6	248.2
UK 10-Yr	4.468%	15.9	79.6	189.2	393.3
Germany 10-Yr	2.517%	2.5	-5.4	119.8	299.8
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	5.20%	-2.2%	-0.2%	-3.4%	-14.0%
U.S. Investment-Grade Corp	5.86%	-2.6%	0.8%	-1.8%	-15.8%
U.S. High-Yield Corp	8.73%	-1.0%	5.7%	4.0%	-4.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,915.20	-2.5%	5.0%	9.6%	6.1%
Silver (spot $/oz)	24.30	-1.8%	1.4%	27.1%	2.8%
Copper ($/metric ton)	8,330.70	-5.3%	-0.4%	2.0%	-10.4%
Oil (WTI spot/bbl)	79.49	-2.8%	-1.0%	-15.8%	20.8%
Oil (Brent spot/bbl)	82.87	-3.1%	-3.5%	-17.3%	20.5%
Natural Gas ($/mmBtu)	2.48	-5.8%	-44.6%	-73.0%	-37.1%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	103.3970	1.5%	-0.1%	-4.8%	11.2%
CAD/USD	0.7393	-2.5%	0.2%	-4.2%	-6.5%
USD/CAD	1.3526	2.5%	-0.2%	4.4%	6.9%
EUR/USD	1.0863	-1.2%	1.5%	9.0%	-7.5%
GBP/USD	1.2719	-0.9%	5.3%	7.5%	-7.3%
AUD/USD	0.6479	-3.5%	-4.9%	-6.5%	-10.1%
USD/JPY	144.8900	1.8%	10.5%	5.9%	32.1%
EUR/JPY	157.3900	0.6%	12.1%	15.4%	22.1%
EUR/GBP	0.8541	-0.3%	-3.5%	1.4%	-0.2%
EUR/CHF	0.9539	-0.5%	-3.6%	-0.8%	-11.0%
USD/SGD	1.3527	1.7%	1.0%	-2.8%	-0.3%
USD/CNY	7.2785	1.9%	5.5%	6.5%	12.3%
USD/MXN	16.7958	0.3%	-13.9%	-15.9%	-17.3%
USD/BRL	4.8536	2.7%	-8.1%	-4.9%	-9.8%

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 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD 0.2% return means the Canadian dollar rose 0.2% vs. the U.S. dollar year to date. USD/JPY 144.89 means 1 U.S. dollar will buy 144.89 yen. USD/JPY 10.5% return means the U.S. dollar rose 10.5% vs. the yen year to date.

Source - Bloomberg; data as of 8/23/23

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As of June 30, 2023

			Investment Banking Services Provided During Past 12 Months	
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