GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee February 15, 2024

Positioning for inflation shocks

Sean Killin – Toronto

Geopolitical tensions and policy uncertainty are contributing to a murky economic outlook around supply chain disruptions—and their possible impact on inflation. We look at the monetary policy landscape and the potential role of fixed income in portfolio positioning.

Declining inflation trends have been established across much of the global economy, with tighter monetary policy proving effective in managing inflation—so far. Inflation measured by the U.S. Consumer Price Index (CPI) has fallen six percentage points since its June 2022 peak. RBC Economics expects this trend to continue, and forecasts the headline inflation rate falling to 2.3 percent y/y and Core CPI inflation (which excludes food and energy) declining to 2.5 percent y/y by Q4 2024.

However, the hotter-than-expected January U.S. inflation data reported this week underscore risks that inflation could drift higher, or remain sticky and above the Federal Reserve's two percent y/y target for a prolonged period. The CPI rose 3.1 percent y/y in January, ahead of the 2.9 percent y/y consensus forecast, while the Core CPI increased 3.9 percent y/y and has barely budged since October. Financial markets responded to the data with volatility; equities fell and bond yields rose to a lesser degree, highlighting that inflation risks and their consequences still merit close observation.

We think these inflation risks should be incorporated into a broader investment strategy. Specifically, we see opportunities in pockets of global debt markets.

Do supply chain challenges fuel inflation risks?

Although we view global supply chain disruptions as a fairly benign inflation risk in and of themselves, we think rising geopolitical tensions warrant attention given their potential to produce supply disruptions and a sustained decline in global manufacturing activity.

While the challenges facing global shipping today are different than the logistical backlogs associated with the COVID-19 crisis, the resurgence of geopolitical pressures in the Middle East has forced many vessels to avoid the Red Sea and Suez Canal passage. The result has been a meaningful rise in global commercial shipping costs.

These regional tensions also raise the potential for elevated energy prices as market participants grow concerned over the insecurity of future supply—or the prospect of outright supply scarcity.

On the production side, elevated input costs and sluggish goods demand have induced a contraction in manufacturing activity throughout the global economy. This contraction has been exacerbated by a broad and protracted slowdown in China's manufacturing sector, which supplies a sizeable portion of global goods. And due to the integrated nature of Sino-European industrials, similar trends have materialized in Europe's manufacturing sector.

Labour shortages in certain service-oriented portions of the U.S. economy have also aggravated service sector capacity issues.

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 2/14/24 market close (unless otherwise stated). Produced: 2/15/24 3:24 pm ET; Disseminated: 2/15/24 3:30 pm ET

If goods and services are short in supply and logistical challenges worsen, consumer prices may rise, particularly if demand conditions evolve.

Robust consumer demand conditions—especially in the U.S.—pose inflationary risks at this point of the business cycle and may push central banks to stay hawkish, in our view. The buildup of excess savings, sturdy wage growth, and a healthy labour market in developed countries have strengthened household balance sheets. This points to a continuation of strong consumption levels, and could give goods and services providers leeway to raise prices without materially suppressing demand.

Higher corporate pricing power can prove inflationary, but a high degree of concentrated demand can also create imbalances. This was shown following the COVID-19 crisis when household spending shifted from goods to services.

Policy risks: Cut and protect?

We see the premature loosening of monetary policy and a longer-term (secular) rise in trade protectionism as key risks to declining inflation trends. Central banks in developed economies have remained committed to achieving their objectives with policymakers generally acknowledging these risks, as evidenced by their recent pushback against markets' dovish rate cut expectations.

That being said, there is a risk that policymakers may prematurely stimulate the economy with interest rate cuts before inflation is anchored at target levels. Even in a well-intentioned bid to avoid recession, stimulative policy that is executed too swiftly, or incorrectly, could reignite excess demand and fuel inflation.

In addition to monetary policy risks, the shift away from globalization towards more fragmented and politicized trade relations has provided a tailwind to inflation. Geopolitical realignment and populism have increased G7 countries' propensity for trade protectionism. Wars in Ukraine and the Middle East, as well as heightened Sino-American tensions in a busy election year, have increased policy uncertainty and further accelerated the shift towards more fragmented trade relations. Tariffs on imports—which are essentially tax levies—and general trade protectionism risk dissolving the cost-saving effects of global trade and driving prices higher.

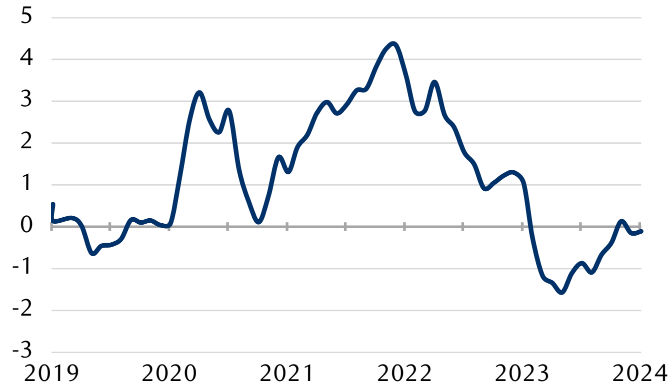
Fixed income shock absorption

Fixed income valuations have undergone a larger adjustment than equity valuations and provide a return profile that is compelling, in our view, irrespective of the inflation outcome. More specifically, we see opportunities in developed-market government bonds given their low risk profile and competitive returns relative to corporate credit.

If inflation rises or remains above target, we think current elevated yield-to-maturity levels provide shock-absorption potential for portfolios in the event that yields rise in response to new inflation premiums.

Supply chains: under pressure but still smooth

New York Fed's Global Supply Chain Pressure Index



Source - RBC Wealth Management, Bloomberg; data through 1/31/24

Elevated bond yields offer solid shock-absorption potential

Bloomberg U.S. Aggregate Investment Grade Bond Index

Source - RBC Wealth Management, Bloomberg; data through 1/31/24

One way to illustrate this capacity to absorb higher inflation is through a ratio known as yield to duration. This ratio represents the upward change in yields (or, conversely, the downward movement in bond prices) required over the next 12 months for a bond index to generate a forward 12-month return of 0.0 percent. This allows investors to appropriately assess the potential downside that could be realized if bond yields rise.

In March 2022, we estimated that U.S. investment-grade debt markets only had 20 to 30 basis points (bps) of shock absorption. Today, as a result of higher interest rates, inflation, and shifting term premiums, investment-grade debt markets have developed a buffer of 85 to 100 bps, in our assessment.

Higher starting yields in fixed income create an opportunity to prepare portfolios for a wide range of potential economic outcomes. Robust shock absorption, elevated yields, and an improving quality of aggregate global debt markets continue to provide some sanctuary from inflationary risks in portfolios, in our view.

UNITED STATES

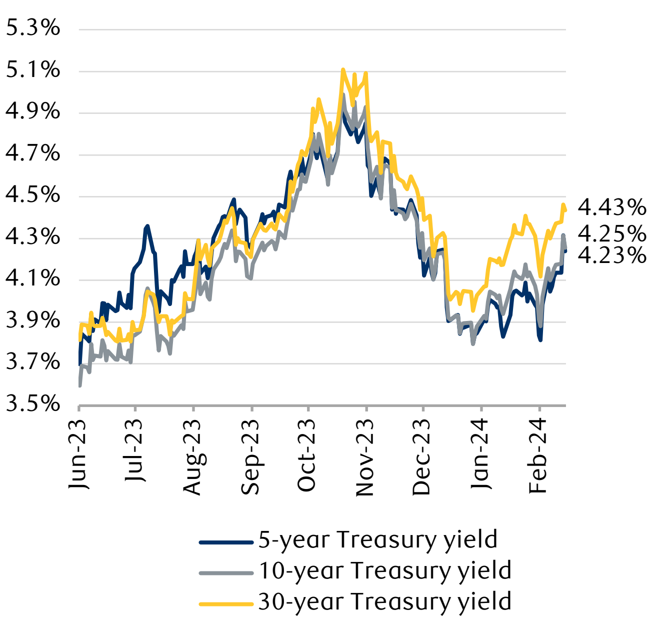
Michael Roedl – Minneapolis

- **Fixed income markets faced a reality check on Tuesday after the Consumer Price Index (CPI) report for January showed inflation was more stubborn than markets expected**, causing Treasury yields to jump across the curve. Core inflation, which excludes food and energy prices, saw the largest increase as services prices accelerated by the fastest pace in two years. Shelter costs, the largest category in services, advanced 0.6% m/m, matching the sharpest gain since early 2023.

- **Higher-than-expected inflation data further reduced already slim prospects that policymakers will begin cutting rates this quarter**, and we think it's possible any further acceleration could reignite discussions of another rate hike in the pipeline. That said, officials still have multiple inflation reports to review before the Fed's next policy meeting on Mar. 19–20, including another CPI release. However, with recent news of mass job cuts and Treasury yields potentially gaining upward momentum, we think consumers will likely dial back spending in the months ahead, while higher Treasury yields should add pressure to housing. As illustrated by the chart, 5-, 10-, and 30-year Treasury yields following the CPI report are at their highest levels since early December.

- **U.S. retail sales declined during January as consumers took a breather after the holiday shopping season**. The value of retail purchases dropped 0.8% from December, marking the largest downward move in nearly a year. Nine of the 13 retail sales categories covered in the data experienced declines, led by building materials and auto dealers. Nonetheless, **seasonal factors for January make it difficult to draw a definitive conclusion on the state of the consumer**, in our view. But overall, consumers have been a pillar supporting strong GDP growth over the past year, which has helped keep the U.S. economy out of a recession so far.

Treasury yields reach new highs on the year



Source - RBC Wealth Management, Bloomberg; data as of 2/14/24

CANADA

Josh Nye & Sean Killin – Toronto

- **Canada's strong jobs report appears less impressive beneath the surface**. Hiring picked up in January, and the country's unemployment rate unexpectedly ticked lower for the first time in a year. However, job gains were confined to part-time positions, and the decline in the jobless rate was driven by a drop in the number of people looking for work. Population growth continues to outpace labour market expansion, causing the employment rate to fall to a two-year low in January. Overall, a softening trend in Canada's labour market remains in place—but that softness has yet to show up in wage growth, which was up 5.3% y/y. That remains well above the pace that would be consistent with the 2% inflation target of the Bank of Canada (BoC), particularly in light of sluggish productivity growth. The BoC has cited this as one of the factors keeping it from pivoting to rate cuts, with the minutes of January's policy meeting noting that "unless productivity growth was exceptionally strong, wage growth in this range could hold inflation up."

- **The Canadian housing market is beginning to heat up**. The BoC's interest rate hikes created a robust headwind to housing market activity over the past two years, causing resale volumes and prices to decelerate. Now, with the BoC signalling that the bulk of monetary tightening is likely behind us for this business cycle and mortgage rates subsequently falling across the country, housing activity has begun to reaccelerate. What seems to be a durable bottom in Canada's housing market correction has been underscored by a pickup in home resale activity. According to RBC Economics, January saw resale activity pick up to 473,000 units, up from 422,000 in November but still meaningfully off the peak of 764,000 in March 2021. Price growth has stabilized but not fully recovered, with the MLS Home Price Index rising 0.4% y/y in January. The ratio of sales to new listings, which identifies market imbalances, shows that current dynamics are balanced but could begin to favour sellers if sales outpace listings. We expect interest rate sensitivity to dominate the Canadian housing market this year.

EUROPE

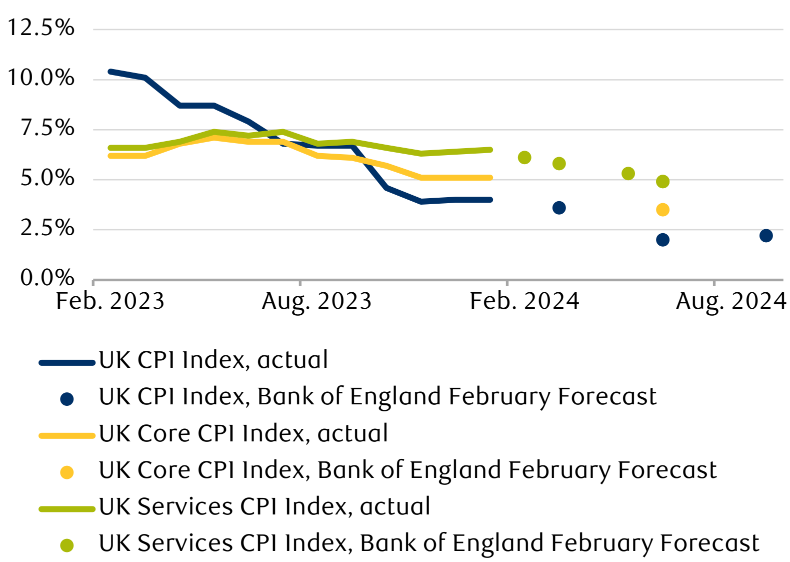
Rufaro Chiriseri, CFA – London

- **There was some relief for the Bank of England (BoE) as UK inflation held steady at 4% y/y in January**, unchanged from December. More positively, both headline and services inflation were lower than the BoE's forecasts in its February Monetary Policy Report (MPR). That being said, the data was a little mixed against the BoE's three areas of focus, which include labour market tightness, private sector wage growth, and services inflation.

- The quality of the UK Labour Force Survey data is being distorted by low response levels, and we therefore approach the data with some caution. **The unemployment rate in December fell to 3.8% from 3.9% previously, which still points to a tight labour market**. Private sector pay growth decelerated to 6.2% in the three months to December from 6.7% previously but was still above the MPR's forecast of 6%. The preliminary Q4 GDP data showed a drop of 0.3% q/q, marking the second consecutive quarterly contraction and resulting in a technical recession in H2 2023. Based on the BoE's own view that the economy was in a recession in Q4, **we think the weak GDP data will do little to shift the central bank's stance**.

- The market's forecasts for rate cuts by December have also eased, and the Bank Rate is now expected to reach 4.42% compared to 4.05% at the beginning of February. **We continue to think that a rate cut in the first half of the year is too soon**. However, we acknowledge the risk of an earlier move is dependent on how the upcoming data releases measure up against the February MPR projections.

Inflation undershoots the Bank of England's February Monetary Policy Report estimates



*Core CPI excludes food and energy

Source - RBC Wealth Management, Bloomberg, Bank of England; data as of 5:30 am ET, 2/15/24

- **European Central Bank (ECB) President Christine Lagarde dispelled hopes for imminent rate cuts** as concerns for stubborn wage growth remain in focus. On Thursday, Lagarde stated that the ECB wishes to avoid making a "hasty decision" and policymakers "do not have enough evidence yet" to give them confidence that inflation will remain in a downward trend. ECB officials seem torn between a cut in April or June, in our view, but more officials appear to be leaning towards a later date. Markets have subsequently dialed back year-end expectations for cumulative rate cuts to 118 basis points (bps) from 160 bps previously.

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Sentiment toward Asian equities is largely mixed so far this week**. China's onshore market remained closed due to the Chinese New Year holiday, whereas both the Hong Kong and Taiwan markets have a short trading week. **Taiwan stocks reached a new record high on Thursday**, boosted by a strong advance from Taiwan Semiconductor Manufacturing Co. (2330 TT). The surge in demand for artificial intelligence is fueling investor enthusiasm, contributing to the company's robust performance.

- **Japan's economy has unexpectedly fallen into recession**, with GDP contracting for a second consecutive quarter. **Provisional GDP declined 0.4% in Q4 2023**, following a downwardly revised 3.3% slump in Q3. The Bloomberg consensus estimate called for 1.1% y/y growth in Q4. Japan slipped to the world's fourth-largest economy in dollar terms, behind Germany.

- **Japan's GDP contraction was mainly due to weak domestic demand**. Inflation may have had a detrimental impact on spending habits. However, **exports and inbound tourism were robust**, benefiting from the depreciation of the Japanese yen. The weak GDP figure may delay the Bank of Japan's rate hike decision, which markets had been expecting in April.

- **Macau reported a 34% rise in mainland Chinese tourists during the first three days of the Lunar New Year** compared to 2019, signaling a robust recovery for the city's tourism and gambling industries. This boost in visitors is **in line with Macau's gaming revenue report for January that showed a 67% increase** from the previous year. The city's initiatives to host an increasing number of non-gaming entertainment events appear to be successful in attracting leisure tourists and a younger demographic. Macau casino stocks rallied, with MGM China (2282 HK) jumping more than 10% in two days.

MARKET Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	5,000.62	3.2%	4.8%	20.9%	13.6%
Dow Industrials (DJIA)	38,424.27	0.7%	1.9%	12.7%	11.2%
Nasdaq	15,859.15	4.6%	5.6%	32.6%	15.0%
Russell 2000	2,012.10	3.3%	-0.7%	3.7%	-0.4%
S&P/TSX Comp	20,889.40	-0.6%	-0.3%	0.9%	-2.2%
FTSE All-Share	4,132.87	-1.0%	-2.3%	-4.9%	-1.9%
STOXX Europe 600	485.24	-0.1%	1.3%	4.9%	5.3%
EURO STOXX 50	4,709.22	1.3%	4.2%	11.1%	15.9%
Hang Seng	15,879.38	2.5%	-6.9%	-24.8%	-35.3%
Shanghai Comp	2,865.90	2.8%	-3.7%	-13.0%	-16.4%
Nikkei 225	37,703.32	3.9%	12.7%	36.6%	39.2%
India Sensex	71,822.83	0.1%	-0.6%	17.7%	27.3%
Singapore Straits Times	3,139.07	-0.4%	-3.1%	-5.4%	-8.2%
Brazil Ibovespa	127,018.29	-0.6%	-5.3%	17.8%	11.5%
Mexican Bolsa IPC	57,232.40	-0.2%	-0.3%	8.7%	9.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.261%	34.9	38.2	51.8	227.4
Canada 10-Yr	3.559%	23.7	44.9	37.6	165.2
UK 10-Yr	4.044%	25.0	50.7	52.3	245.5
Germany 10-Yr	2.337%	17.1	31.3	-10.1	205.4
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.97%	-2.1%	-2.3%	1.6%	-6.6%
U.S. Investment-Grade Corp	5.45%	-2.1%	-2.3%	3.8%	-5.4%
U.S. High-Yield Corp	7.91%	-0.3%	-0.3%	9.8%	5.1%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,991.36	-2.4%	-3.5%	7.4%	6.4%
Silver (spot $/oz)	22.36	-2.6%	-6.0%	2.3%	-6.2%
Copper ($/metric ton)	8,155.50	-4.1%	-3.6%	-8.6%	-18.3%
Oil (WTI spot/bbl)	77.87	2.7%	8.7%	-1.5%	-18.4%
Oil (Brent spot/bbl)	81.54	-0.2%	5.8%	-4.7%	-15.5%
Natural Gas ($/mmBtu)	1.61	-23.5%	-36.1%	-37.4%	-61.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	104.7310	1.4%	3.4%	1.5%	8.7%
CAD/USD	0.7383	-0.8%	-2.2%	-1.5%	-6.0%
USD/CAD	1.3545	0.8%	2.3%	1.6%	6.4%
EUR/USD	1.0727	-0.8%	-2.8%	-0.1%	-5.1%
GBP/USD	1.2564	-1.0%	-1.3%	3.2%	-7.1%
AUD/USD	0.6492	-1.2%	-4.7%	-7.1%	-8.9%
USD/JPY	150.6200	2.5%	6.8%	13.1%	30.4%
EUR/JPY	161.5800	1.7%	3.8%	13.1%	23.7%
EUR/GBP	0.8538	0.1%	-1.5%	-3.2%	2.2%
EUR/CHF	0.9501	2.0%	2.3%	-4.0%	-9.1%
USD/SGD	1.3481	0.5%	2.1%	1.5%	0.1%
USD/CNY	7.1936	0.3%	1.3%	5.4%	13.2%
USD/MXN	17.0941	-0.7%	0.7%	-7.7%	-16.3%
USD/BRL	4.9740	0.4%	2.4%	-4.1%	-4.7%

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 Tuesday'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 -2.2% return means the Canadian dollar fell 2.2% vs. the U.S. dollar year to date. USD/JPY 150.62 means 1 U.S. dollar will buy 150.62 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 2/14/24

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As of December 31, 2023

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Hold [Sector Perform]	575	39.66	154	26.78
Sell [Underperform]	46	3.17	6	13.04

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