GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

September 21, 2023

Hope for the best, but prepare for the … best?

Thomas Garretson, CFA – Minneapolis

The Fed's recent projections suggest rates have neared cruising altitude and remain on a flightpath toward an economic soft landing. However, the flight may not be without a little turbulence. We explain what Fed's actions may mean for investors.

Stop me if you've heard this one before, but the Federal Reserve walks into its latest policy meeting, markets prepare for a dovish pivot, the Fed walks out, has a bit of a laugh, and quickly proceeds to remind everyone exactly who is in charge.

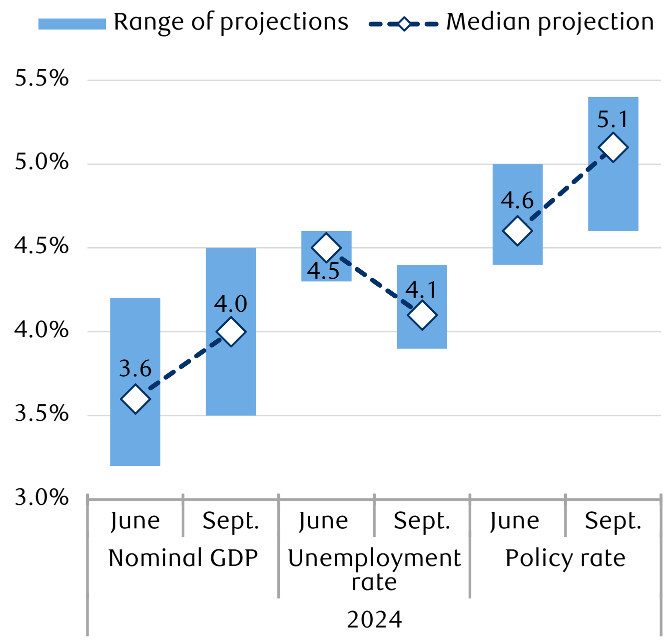
That has been the cadence of things through much of this rate hike cycle, and despite choosing to skip a rate hike at two of its last three meetings, including this week, as policymakers tip toe toward an eventual end, the Fed still found a way to tighten the hawkish screws on markets.

Really putting the soft in soft landing

While the aftermath of this week's meeting has seen equities come under pressure, with the S&P 500 down approximately two percent from pre-meeting levels while Treasury yields across the curve have reached fresh decade-plus highs, the nuts and bolts of the meeting were actually broadly in line with what the market was looking for—in that the path toward a soft economic landing has indeed widened based on recent economic data.

As the first chart shows, the Fed's economic projections gave the market what it wanted and were notably upgraded. Economic activity based on nominal GDP growth in 2024 was boosted by 40 basis points to 4.0 percent, compared to 3.6 percent based on the June meeting projections. Better growth was paired, unsurprisingly, with a better outlook for the labor market.

Key changes to the Fed's economic & rate projections



Source - RBC Wealth Management, Federal Reserve; range shows central tendency, which excludes outliers

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 9/20/23 market close (unless otherwise stated). Produced: 9/21/23 4:45 pm ET; Disseminated: 9/21/23 4:48 pm ET

The unemployment rate is now seen ending 2024 at just 4.1 percent, down from the previous 4.5 percent projection, and never deteriorates from that level throughout the Fed's forecast horizon into 2026; it stands at 3.8 percent as of the latest payrolls report for August.

Now we can all debate whether those numbers are realistic or a bit too lofty, we would probably fall in the camp of the latter, but if the Fed is all in on a soft landing, what's the deal with the increase in the policy rate to a full 5.1 percent at the end of next year which would suggest just one rate cut next year from its current level?

This is a story about what happens when rates stop being polite, and start getting real

You would be forgiven if you had assumed Fed policymakers also paired expectations for a stronger economy and a lower unemployment rate with a higher inflation forecast, but alas, they did not.

And that is likely at the heart of the market's modestly negative reaction to the latest Fed meeting.

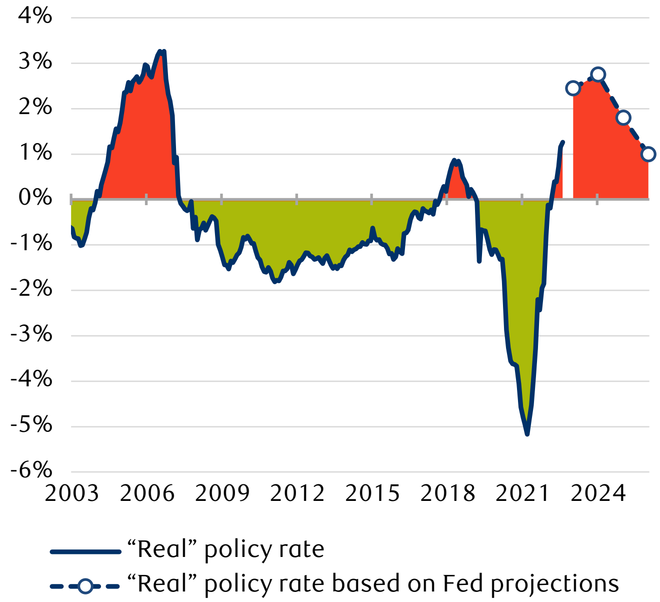
The Fed actually lowered inflation expectations for this year and left 2024 projections unchanged at 2.5 percent for headline personal consumption expenditures (PCE) inflation, and 2.6 percent for core (ex. food & energy) inflation. For a Fed that has been laser focused on inflation, and has seen notable improvement in recent months, such a significant increase in prevailing rate levels seen over the forecast horizon was perhaps a bit of a surprise even if markets have been repricing the "higher for longer" scenario for a number of months.

We think the real issue, for the economy and risk assets, is the level of real rates. As the last chart shows, based on the Fed's projections, real rates—which is the fed funds rate minus the headline PCE inflation rate—is now 50 basis points higher in upcoming years and near some of the highest levels since 2007. And if inflation slows more than the Fed expects—which the current Bloomberg consensus survey shows—real rates would only move higher. Equity valuations are highly sensitive to real rates, as is economic activity, therefore higher real rates also raise the risks of a policy mistake by the Fed.

There are two classes of forecasters: those who don't know, and those who don't know they don't know

As always, and as Fed Chair Jerome Powell was once again keen to point out, these numbers are nothing more than projections based on recent data, which certainly has improved, but is all highly uncertain. The Fed's latest forecasts do have an element of both hoping for the best economic outcomes and planning to implement policy based on the best case scenario.

Push it to the limit? Fed projections show extended run of high inflation-adjusted policy rates



Source - RBC Wealth Management, Bloomberg; "real" rate is fed funds rate minus headline PCE y/y inflation rate

While market turbulence has picked up as a result, the Fed is fully in data-dependent mode, which is to say it has no more idea of what happens next than anyone else. To wit, current market pricing based on Fed Funds futures data for one last rate hike this year, as the Fed still expects, sits squarely and neatly at 50/50. And where the Fed has rates holding north of 5.00 percent at the end of next year, the market is looking for something closer to 4.75 percent.

All told, our thinking as it relates to the Fed remains broadly unchanged: Rate hikes are likely over, and the risk bias is still toward multiple "insurance" rate cuts next year as economic activity and inflation slows.

The benchmark 10-year Treasury yield is now approaching our expected next stopping point of 4.50 percent this week, but could it have scope toward 5.00 percent? That's not yet our base case, but it seems there's little to stand in its way for the time being. Regardless, it remains a yield smorgasbord for fixed income investors—or at this stage, all investors—and we continue to recommend locking in yields.

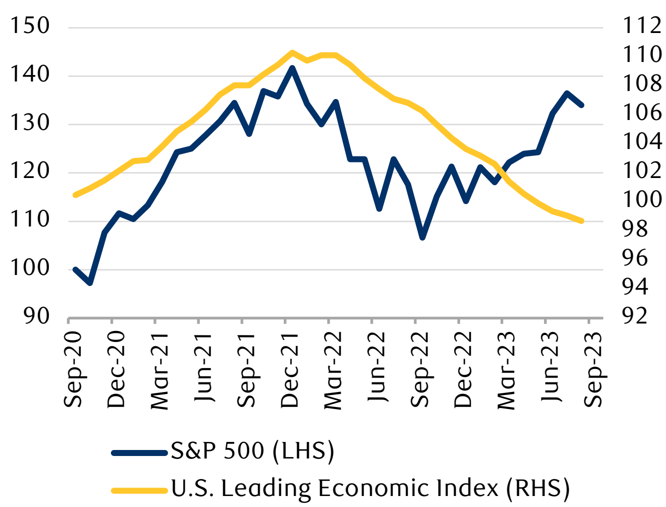
UNITED STATES

Alan Robinson – Seattle

- **U.S. stocks had another tough week** as investors digested the Federal Reserve's "higher for longer" view of the trajectory for interest rates. It wasn't all bad news; employment indicators remained strong, with initial claims for unemployment hitting eight-month lows. And Tech investors applauded the proposal by networking company Cisco Systems Inc. (CSCO) to acquire Splunk Inc. (SPLK) for $26 billion, a 31% premium to the target's prior closing price.
- **However, these bright spots were overshadowed by multiple factors**: mounting concerns over the impact of the auto workers strike and its potential to snowball through the broader economy; continued high energy prices; the resumption of student loan repayments in October and their impact on the consumer; and the likelihood of a government shutdown as factions within the House of Representatives squabble over a budget.
- **RBC Capital Markets, LLC U.S. Economist Michael Reid believes the likelihood of a shutdown is greater than 90%**, as avoiding one would require Congress to pass 12 appropriation bills by October. As of today, only one of those bills has been passed by the House, and it has progressed no further.
- But it's worth noting that **a shutdown would likely have less of an impact on the markets than the debt ceiling standoff the U.S. endured during Q2 2023**. A shutdown would not impact U.S. Treasury issuance or interest payments, and a debt downgrade or default is not on the table. Reid notes that the most recent (and longest) government shutdown only reduced 2019 GDP by about 0.02%, according to the Congressional Budget Office.
- **The Conference Board's Leading Economic Index posted its 17th successive monthly decline**, even though the broad stock market has rallied over the last 11 months. In our view, the apparent disconnect between these two typically correlated data series suggests equity investors appear to be ignoring the dislocations caused by a tightening Fed.

A leading indicator doesn't appear to be doing its job

Conference Board U.S. Leading Economic Index vs. the S&P 500



Note: Stock returns are one of many inputs to the U.S. Leading Economic Index.

Source - FactSet, RBC Wealth Management; monthly data normalized with 8/31/20 = 100; data through 8/31/23

CANADA

Josh Nye & Luis Castillo – Toronto

- **Canada's slowing economy is showing up in credit spreads**. Canadian investment-grade (IG) corporate bond spreads have widened slightly since late July as risk assets have generally underperformed. But that widening stands in contrast to the U.S. situation, where IG spreads have remained fairly steady near 18-month lows. U.S. spreads are some 10 basis points (bps) below longer-run levels, while Canadian spreads are around 30 bps wider. We think economic momentum has much to do with this divergence. Canada's economy is slowing more than the Bloomberg consensus estimate, while U.S. GDP growth appears to be accelerating in Q3. While there is a risk that spreads may widen further as the economy slows, we think this is a good entry point into higher-quality corporate debt. The current yield to maturity on the Bloomberg Canada Aggregate Corporate Index (about 5.7%) is now roughly in line with its weighted average duration (5.6 years); in our view, this provides a nice buffer against potential price declines associated with higher rates or wider spreads.
- **Canada's headline inflation accelerated in August**, coming in at 4.0% y/y—20 bps above expectations in a Bloomberg survey of economists and 70 bps above the prior month's reading, with a month-over-month figure that doubled expectations. Like last week's U.S. Consumer Price Index reading, a surge in energy prices was a primary culprit, adding 0.7 percentage points to the headline figure. That being said, growing price pressures extended beyond just energy. Among core measures of inflation (excluding volatile food and energy prices), the Bank of Canada's preferred CPI-trim and CPI-median both rose 0.44% m/m, pushing the year-over-year figures to 3.9% and 4.1%, respectively. We don't expect this report to sit well with a central bank that has expressed little patience for upside inflation data surprises, especially at a time when the pace of wage growth is coming in twice as fast as pre-pandemic averages, at levels consistent with above-target inflation.

EUROPE

Rufaro Chiriseri, CFA – London

- **In a narrowly balanced decision, the Bank of England (BoE) kept the Bank Rate at 5.25% on Thursday**, with five of the nine voting members of the Monetary Policy Committee (MPC) opting for a pause in rate hikes. Before the MPC meeting, economists' consensus (as well as our own expectations) had been for a 25 basis point increase. However, market pricing had shown the chances of a hike fading to 50% from 80% following a significant downside surprise in inflation data. Bond markets reacted with an initial 2-year Gilt rally that faded before settling around 4.87%—significantly below the September peak of 5.27%. The pound sterling slumped to 1.2239 (near six-month lows) against the U.S. dollar, before recovering to around 1.2287.

- The BoE's post-meeting statement was little changed from August, as the MPC sees current interest rates as "restrictive" and will continue monitoring signs of persistent price pressure. We think this is evidence that policy will likely remain restrictive for longer, and that a hiking option remains on the table. **While there are risks of upside surprises in wage and price growth data, we believe this pause likely concludes the current hiking cycle**.

- **UK inflation dropped to 6.7% y/y in August from 6.8% y/y in July**. The decline was in contrast to economists' consensus estimates and the BoE's forecasts, both of which expected an increase in price growth due to a modest rise in fuel prices during the summer. In addition, core inflation (excluding food and energy) fell to 6.2% y/y from 6.9% y/y, below the MPC's August forecasts. The central bank appears to have taken comfort in data moving in the right direction for its three key areas of focus: services inflation, labour market tightness, and wage growth.

- **A hawkish surprise was the BoE's decision to step up the pace of its balance sheet reduction, in a process known as quantitative tightening**. The faster pace will shrink the central bank's balance sheet by £100 billion instead of £80 billion in the second year of quantitative tightening, above RBC Capital Markets' forecast of £95 billion. The £100 billion total represents a combination of increased Gilt sales and Gilts maturing in the next 12 months.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

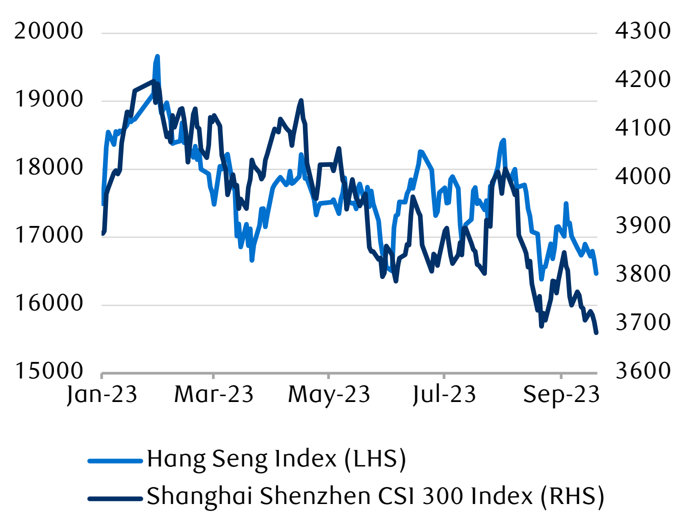
- **Asia Pacific equity markets traded lower during the week with almost every region posting losses**. Taiwan has had the worst performance, dragged down by its largest index constituent—Taiwan Semiconductor Manufacturing Co. Ltd. (2330 TT). Most large-cap Asia Tech stocks fell on Thursday, following their U.S. peers lower after the Federal Reserve left its benchmark interest rate unchanged while signalling borrowing costs will likely stay higher for longer following one more hike this year.

- **The Hang Seng and CSI 300 are testing their 2023 year-to-date trading volume lows**. We think the declines suggest people who purchase stocks when a market is down—often called "dip buyers"—are staying away from the market for the time being. We perceive investors remain cautious on the Chinese economy following a string of weak macro data. The recent report of a rebound in Macau visitors to levels last seen in 2019 has failed to boost sentiment. Bloomberg reported that net foreign outflows from Chinese stocks showed no sign of abating, with sales of 24 billion yuan so far this month after a record 90 billion yuan selloff in August. That said, as was discussed in last week's Global Insight Weekly, we think Beijing is implementing a little more stimulus than is generally recognized, and the Chinese economy can stabilize from here. We are maintaining our Neutral stance on China and Hong Kong equities, a balanced approach in our view, given their attractive valuations, negative investor sentiment (often a contrarian indicator), and potential for policies (announced or upcoming) to start having positive impact.

- **The liquefied natural gas facilities (LNG) strike in Australia may end soon as a deal appears near, according to Australia's workplace tribunal, as reported by Bloomberg**. Commodity traders are closely monitoring production in Western Australia, which supplied about 7% of the world's LNG last year. While the facilities are exporting as planned, we think a prolonged disruption would threaten supplies for the winter season and likely push up prices. The strike, which started on Sept. 8, could end as soon as tomorrow as Australia's regulator works to broker an agreement between Chevron Corp. (CVX US) and unions, according to the same Bloomberg report.

China/Hong Kong trading at or near year-to-date lows

Hang Seng Index and Shanghai Shenzhen CSI 300 Index



Source - RBC Wealth Management, Bloomberg; daily data through 9/21/23

MARKET Scorecard

Data as of September 20, 2023

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,402.20	-2.3%	14.7%	14.2%	1.0%
Dow Industrials (DJIA)	34,440.88	-0.8%	3.9%	12.2%	1.4%
Nasdaq	13,469.13	-4.0%	28.7%	17.9%	-8.5%
Russell 2000	1,810.10	-4.7%	2.8%	1.3%	-17.1%
S&P/TSX Comp	20,214.69	-0.4%	4.3%	4.4%	0.3%
FTSE All-Share	4,197.78	3.4%	3.0%	6.3%	5.3%
STOXX Europe 600	460.66	0.5%	8.4%	14.2%	1.4%
EURO STOXX 50	4,275.98	-0.5%	12.7%	23.3%	5.7%
Hang Seng	17,885.60	-2.7%	-9.6%	-4.8%	-25.8%
Shanghai Comp	3,108.57	-0.4%	0.6%	-0.4%	-14.0%
Nikkei 225	33,023.78	1.2%	26.6%	19.3%	8.3%
India Sensex	66,800.84	3.0%	9.8%	11.9%	14.2%
Singapore Straits Times	3,242.00	0.3%	-0.3%	-0.8%	6.6%
Brazil Ibovespa	118,695.32	2.6%	8.2%	5.5%	9.1%
Mexican Bolsa IPC	52,501.55	-1.0%	8.3%	11.5%	3.8%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.393%	28.5	51.8	83.0	308.2
Canada 10-Yr	3.907%	34.3	60.7	80.5	268.0
UK 10-Yr	4.215%	-14.5	54.3	92.5	342.1
Germany 10-Yr	2.702%	23.6	13.1	77.6	302.2
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	5.21%	-1.2%	0.1%	-0.1%	-13.6%
U.S. Investment-Grade Corp	5.85%	-1.2%	1.5%	2.1%	-15.1%
U.S. High-Yield Corp	8.60%	-0.3%	6.8%	7.9%	-4.7%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,930.11	-0.5%	5.8%	15.9%	9.4%
Silver (spot $/oz)	23.21	-5.0%	-3.1%	20.4%	4.2%
Copper ($/metric ton)	8,233.50	-2.0%	-1.6%	5.2%	-9.0%
Oil (WTI spot/bbl)	90.28	8.0%	12.5%	6.9%	30.3%
Oil (Brent spot/bbl)	93.19	7.3%	8.5%	2.8%	26.1%
Natural Gas ($/mmBtu)	2.74	-1.2%	-38.9%	-64.5%	-41.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	105.3500	1.7%	1.8%	-4.4%	12.9%
CAD/USD	0.7427	0.3%	0.7%	-0.7%	-4.8%
USD/CAD	1.3465	-0.3%	-0.7%	0.7%	5.0%
EUR/USD	1.0660	-1.7%	-0.4%	6.9%	-9.1%
GBP/USD	1.2344	-2.6%	2.2%	8.5%	-9.6%
AUD/USD	0.6448	-0.6%	-5.4%	-3.6%	-11.1%
USD/JPY	148.2700	1.9%	13.1%	3.1%	35.5%
EUR/JPY	158.0600	0.2%	12.6%	10.3%	23.2%
EUR/GBP	0.8636	0.9%	-2.5%	-1.4%	0.6%
EUR/CHF	0.9580	0.0%	-3.2%	-0.3%	-11.9%
USD/SGD	1.3653	1.0%	1.9%	-3.2%	1.0%
USD/CNY	7.2863	0.4%	5.6%	3.8%	12.7%
USD/MXN	17.0891	0.3%	-12.4%	-14.6%	-15.2%
USD/BRL	4.8734	-1.6%	-7.7%	-5.2%	-8.5%

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 0.7% return means the Canadian dollar rose 0.7% vs. the U.S. dollar year to date. USD/JPY 148.27 means 1 U.S. dollar will buy 148.27 yen. USD/JPY 13.1% return means the U.S. dollar rose 13.1% vs. the yen year to date.

Source - Bloomberg; data as of 9/20/23

Authors

Luis Castillo – Toronto, Canada
luis.castillo@rbccm.com; RBC Dominion Securities Inc.

Rufaro Chiriseri, CFA – London, United Kingdom
rufaro.chiriseri@rbc.com; RBC Europe Limited

Thomas Garretson, CFA – Minneapolis, United States
tom.garretson@rbc.com; RBC Capital Markets, LLC

Nicholas Gwee, CFA – Singapore
nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

Josh Nye – Toronto, Canada
josh.nye@rbc.com; RBC Dominion Securities Inc.

Alan Robinson – Seattle, United States
alan.robinson@rbc.com; RBC Capital Markets, LLC

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