

Eyes wide shut?

Atul Bhatia, CFA – Minneapolis

It looks like it's back to basics for the U.S. House of Representatives and the clock is ticking. The stopgap funding deal keeping the government open expires in mid-November, leaving the chamber little time to select a speaker and pass a budget. We unpack the difficulties to averting a shutdown and highlight the ripple effects to financial markets.

Following the removal of Kevin McCarthy as speaker of the U.S. House of Representatives, we see a high probability of a partial government shutdown in mid-November. Critically—and quite different than our thinking around the shutdown risk in late September—we think this closure could extend for significantly longer than a symbolic 24-to-48-hour period.

Getting the job is hard; keeping it may be harder

The House speaker is a highly partisan role, and candidates typically rely on votes from their own party to be elected. If that precedent holds—and we believe it probably will—the election process looks complicated, since a candidate can only afford to lose a handful of Republican votes and still command the needed majority. The current House Republican nominee—Steve Scalise—has so far failed to command enough support to take office.

In addition to complicating entering office, the thin majority also makes it difficult for a candidate to remain in office. Current rules allow any single member to call for a motion to vacate, the procedural maneuver

that was used to remove McCarthy. This leaves the incumbency of any speaker in the hands of any group of roughly 10 House Republicans, including the group that just deposed the last speaker.

Any speaker candidate knows this, and is therefore likely to be comfortable pushing an aggressively partisan policy platform. One result is that we think any pre-shutdown budget proposal from the new speaker is likely dead on arrival in the Senate and would never be signed by U.S. President Joe Biden. The odds of a pre-shutdown deal seem very low in our reading of the situation.

Will the lights stay off for a long time?

Under McCarthy, our view was that any shutdown was likely to be symbolic before a pragmatic deal was reached. We see greater risk of an extended shutdown under his successor for three reasons:

- **Likely profile of next speaker:** As mentioned, candidates for speaker are likely to self-select for more partisan views and are less likely to compromise. The speaker has broad control over the House's agenda, and can—at a minimum—

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put up significant roadblocks to any compromise budget deal getting a vote. There are procedural workarounds to the speaker's gatekeeping, but they are time-consuming and require bipartisan support.

- **Voter response may be positive:** Polling ahead of the McCarthy budget deal showed that Democrats were receiving significant blame from voters for a potential shutdown, and that closing the government—even if it led to no policy changes—could be advantageous for Republicans. If that polling remains consistent, then we think there's very little incentive for the next speaker to make concessions in order to support a quick reopening.
- **Major policy wins within reach:** In the lead-up to passing the September continuing resolution—the stopgap funding mechanism currently keeping the government open—Democrats agreed to pull funding for Ukraine aid, a key Republican demand. The stated reason for the concession was the political impact of prioritizing that single line item at the cost of closing the government. We believe it will be relatively easy for Republicans to secure other victories by using the same messaging: forcing Democrats to either concede on policy points or defend the choice to close the government rather than just give up a particular budget item.

In short, we think the next speaker is likely to want a shutdown, and may be able to gain both a policy and a political advantage from following through with one. Unless polling changes dramatically around which party is blamed for a closure, it is hard to see why a shutdown would end quickly.

The middle way is the hard way

While it's theoretically possible that a more pragmatic, deal-focused speaker could emerge, it's hard for us to see how that result is politically viable.

A pragmatist has little to no chance of being elected using only Republican votes, in our view. As recent events demonstrate, deal-making and compromise are inconsistent with the current incarnation of the motion to vacate, and any move to amend that procedure would likely cost a candidate more votes than the slim Republican margin.

In effect, a deal-making speaker would likely need some measure of Democratic support to be seated.

We see this as unlikely for two reasons.

First, the Democrats would likely receive nothing for their support. Any commitment from a speaker candidate would be unenforceable; once seated, the

A shutdown that led to a smaller budget deficit would likely prove disinflationary ... We think bond investors would likely respond positively to that move and would also welcome any improvement in U.S. debt dynamics.

candidate could renege and veer right and Democrats would be powerless.

Second, any commitment would likely be self-defeating. A speaker candidate that relies on Democrat support to be elected would, we believe, be tainted in the eyes of the average Republican voter. The result is that a Republican House member voting for such a candidate is risking their seat, most likely to a challenger from within their party.

One path for this type of solution would be a relatively senior Republican House member who would be willing to act as a caretaker, knowing that he or she could lose their seat in the next primary. In theory, this could work, with bipartisan pragmatic support. In practice, it's likely a pipe dream.

There are wild card outcomes. The House can elect anyone to be speaker; there is no requirement it be a sitting member. We would not entirely rule that out, but we think it is a fairly remote possibility at this point.

Shutdown impacts and preparation

Shutdowns have historically not caused significant immediate market impacts, as the table on the following page indicates, but it is difficult to draw robust conclusions given the paucity of data on shutdowns lasting more than 48 hours.

This time around, we believe even a brief shutdown is likely to lead to Moody's cutting the U.S. credit rating below AAA. We see limited direct impact from another ratings downgrade, although a shutdown and ratings move could add to governability concerns, potentially putting pressure on longer-term U.S. Treasury bonds.

Economically, a shutdown that led to a smaller budget deficit would likely prove disinflationary, which could

Impact of past government shutdowns on markets has been mixed*

Start	End	Length (days)	Unemployment rate change (percentage points)	S&P 500 change (%)	10-year Treasury yield change (basis points)
12/21/18	01/25/19	34	0.1	8.1%	-4.1
01/19/18	01/22/18	2	0	1.1%	2.8
09/30/13	10/17/13	16	0	2.7%	-0.4
12/15/95	01/06/96	21	0	0.2%	-7.8
11/13/95	11/19/95	5	0	0.7%	-2.6
10/05/90	10/09/90	3	0	-2.4%	16.5
12/18/87	12/20/87	1	0	2.7%	4.8
10/16/86	10/18/86	1	0	-1.2%	12.7
10/03/84	10/05/84	1	0	-0.6%	-22.2
09/30/84	10/03/84	2	0.1	-2.2%	5
11/10/83	11/14/83	3	0	1.6%	7.5
12/17/82	12/21/82	3	0	2.4%	-10
09/30/82	10/02/82	1	0.3	-0.1%	-1
11/20/81	11/23/81	2	0	-0.1%	30
09/30/79	10/12/79	11	0.1	-3.7%	64
09/30/78	10/18/78	17	-0.2	-2.4%	4
11/30/77	12/09/77	8	-0.4	-1.2%	8
10/31/77	11/09/77	8	0	0.7%	-2
09/30/77	10/13/77	12	0	-3.2%	13
09/30/76	10/11/76	10	0.1	-3.4%	-20

* The change in unemployment represents the month-over-month change between the start month and end month. For those shutdowns that lasted a few days, the change is "0" because the shutdown did not extend beyond the start month.

Source - RBC Capital Markets, Bloomberg, Haver Analytics, U.S. House of Representatives

prompt a faster shift to less restrictive policy from the U.S. Federal Reserve. We think bond investors would likely respond positively to that move and would also welcome any improvement in U.S. debt dynamics. A smaller federal budget would likely be a headwind to near-term growth and increase the odds of a U.S. recession, in our view.

An extended shutdown does cause damage, particularly to families dependent on government wages and payments, as well as to the myriad ancillary businesses and contractors that depend directly or indirectly on the U.S. for revenue. Missed payments are

typically made good following a shutdown, so some—but not all—of the missed consumption would likely be recovered. The longer the shutdown lasts, however, the smaller the likely recovery percentage.

In this case, we think volatility is likely to increase in the run-up to a potential November shutdown, and we see elevated risk of a potential equity selloff. In a closure, we would favor high-quality fixed income, particularly in the middle part of the yield curve. Longer-term bonds may benefit from a potential improvement in U.S. fiscal dynamics, but that improvement may be offset by governance concerns.

UNITED STATES

Kelly Bogdanova – San Francisco

■ **The U.S. equity market continued to bounce during the week**, pushing the S&P 500 and Nasdaq up 3.4% and 4.0%, respectively, since the Oct. 3 lows as of midday Thursday. The market had previously become oversold on a technical basis, and the recent pullback in Treasury yields and calming comments from some Fed officials have supported equities recently. The growth segment of the S&P 500 has only slightly led the value segment during this period. Market participants took Thursday's somewhat hotter-than-expected September consumer inflation report in stride because the all-important core rate (excludes food and energy) was in line with economists' consensus forecast of 4.1% y/y and declined from 4.3% y/y in August. We think there is scope for the U.S. equity market to move higher over the near term, but much will depend on the forthcoming Q3 earnings season—which begins in earnest on Friday (Oct. 13)—and Middle East developments.

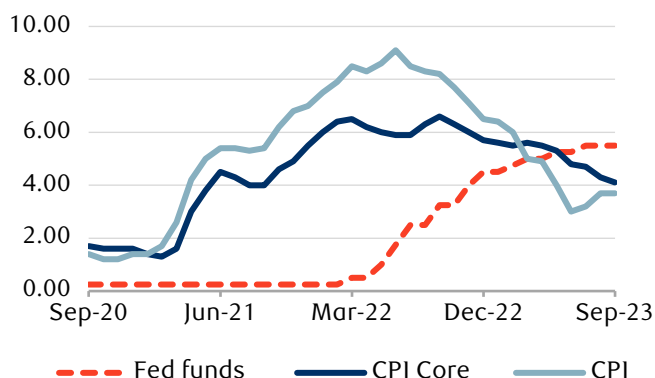
■ **Israel's war with Hamas**, following the latter's surprise military assaults last weekend, **likely contributed to the recent rise in Treasury prices and decline in yields**, although the magnitude of the flight-to-safety move is difficult to quantify. **While the sharp worsening of the situation in the Middle East has not seemed to impact the equity market thus far, we are following developments closely** given that previous military interventions and geopolitical clashes have caused short-term equity market pullbacks. In the 19 previous such events since World War II, the S&P 500 declined 6.3%, on average, and it typically took a month or so for the market to recover from its low point. However, performance and recovery times varied widely, and some of the events were impacted by the reaction of crude oil prices and supplies. In this instance, oil initially bounced 4.3% after the Israel-Hamas hostilities began but it has since pulled back.

■ According to Middle East expert Helima Croft, who is RBC Capital Markets, LLC's global head of commodity strategy, **the main regional risks associated with the Israel-Hamas conflict center around the degree of direct involvement of other Middle Eastern countries, such as Iran, and the degree to which the fighting spreads to include other proxy groups, primarily Hezbollah.**

■ **There are vigorous diplomatic efforts taking place, with multiple parties attempting to contain the fighting.** The major powers—the U.S., Russia, and China—are engaged, including at the highest levels. Regional powers are communicating with the major powers and one another. The leaders of Saudi Arabia and Iran spoke on Wednesday, their first discussion since the two countries restored diplomatic ties with the help of China in March of this year, following a seven-year dispute over hostilities related to Yemen and Syria.

As the Fed has hiked rates, inflation has cooled off

Consumer Price Indexes versus fed funds rate (%)



Source - RBC Wealth Management, Bloomberg; monthly data through 9/30/23

CANADA

Luis Castillo & Josh Nye – Toronto

■ Despite the recent geopolitically induced flight-to-quality, which has seen the yield on the Government of Canada 10-year bond drop by nearly 30 basis points (bps) since early October, **the spread between the 10-year and 2-year Government of Canada yields has risen by nearly 50 bps since bottoming in July**. These “bear-steepeners,” characterized by a climb in rates concentrated in longer-maturity bonds and rare on a historical basis, have experienced the lowest frequency of occurrence compared to other yield-curve regimes such as “bull-steepeners” (falling rates led by shorter-term maturities) and “bear-flatteners” (rising rates led by shorter-term maturities). The latter two are largely influenced by monetary policy through easing or tightening cycles, respectively. A hawkish Bank of Canada (BoC) still fighting inflation is preventing shorter-term maturity yields from falling, and a stronger-than-expected economy is pushing longer-term maturities higher. In other words, markets believe the economy can handle higher rates for longer.

■ **Canada's jobs report beat the expectations from a Bloomberg survey of economists** with a 64,000 gain in September, though much of the increase was in education, which tends to be volatile around the start and end of the school year. The gain was also concentrated in part-time work, and overall hours worked fell. Job vacancies continue to decline, but the unemployment rate held steady at 5.5% for the second straight month after rising by a half percent over the prior three months. Wage growth ticked higher and remains well above levels consistent with 2% inflation. The BoC will have to balance sticky inflation and wage pressures with signs of a cooling economy at its policy meeting later this month.

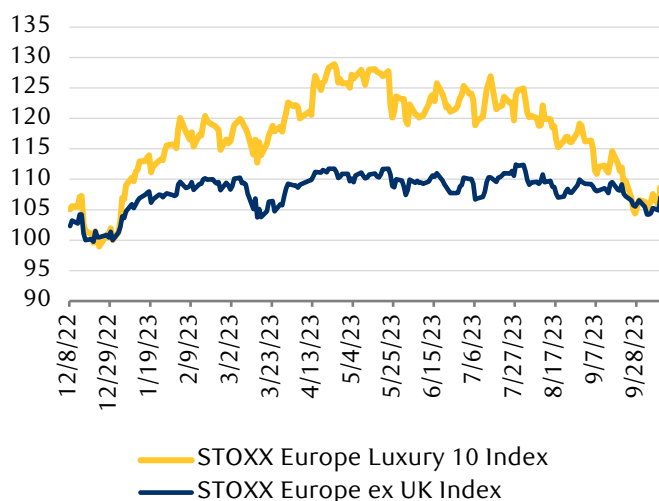
EUROPE

Thomas McGarrity, CFA – London

■ **Global luxury goods leader LVMH reported Q3 sales below consensus expectations, the company's first top-line quarterly miss in more than three years.** The group overall, as well as its Fashion and Leather Goods (F&LG) division (represented approximately 50% of group sales year to date in 2023), delivered organic growth of 9% y/y, versus consensus expectations for both of around 11%. Within F&LG, the biggest drag was from Europe, with sales in the region declining by a mid-single digit percentage year over year, which offset a positive surprise in China. The group's Wines & Spirits division was particularly weak relative to consensus expectations, reporting -14% y/y organic growth (consensus: -2%). Both champagne and cognac sales undershot the consensus owing to weak demand and inventory destocking in the U.S., while demand is recovering slowly in China.

■ LVMH's results weighed on the stock as well as the broader luxury goods space. **The luxury group, having strongly outperformed in the early part of 2023, has been one of the weakest-performing parts of the European equity market over the past six months, unwinding all its year-to-date outperformance.** At the start of the year, the market appeared bullish on the outlook for luxury spending in China amid the reopening of its economy, reflecting that luxury spending remained below 2019 levels. The hope was that this dynamic would help to offset a degree of normalization of luxury spending from the very high levels seen over the past couple of years in the U.S. and Europe. However, the reality has been that while luxury spending in China has recovered robustly in some areas, it has not been enough to offset the moderation of growth in the U.S. and Europe,

European luxury goods' strong outperformance has unwound over the past six months



Note: Performance normalised to a factor of 100

Source - RBC Wealth Management, Bloomberg; data through 10/11/23

where the magnitude of the growth slowdown appears to be slightly greater than anticipated by consensus expectations. This has translated into negative earnings revisions for luxury goods stocks, as well as a valuation de-rating owing to an uncertain near-term outlook.

■ We believe the luxury goods space lacks a positive catalyst in the short term, which could hold it back as weak sentiment is likely to persist in the near term reflecting the aforementioned dynamics. **However, the luxury goods industry remains an attractive opportunity for long-term investors** in European equities, in our view, as it possesses strong pricing power and should continue to benefit from secular tailwinds, including the growth of the middle class in China.

ASIA PACIFIC

Emily Li – Hong Kong

■ **China is contemplating raising its budget deficit for 2023 as the government prepares to implement a new round of stimulus** to help the economy achieve the official growth target, per a Bloomberg report. Policymakers are evaluating the **possibility of issuing a minimum of one trillion yuan (US\$137 billion) in additional government debt**, according to the report. The purpose of this debt issuance would be to fund infrastructure projects such as water conservation initiatives. While an official announcement could be made as early as this month, ongoing deliberations imply to us that the government's plans may be subject to change.

■ **HSBC (5 HK) has agreed to purchase Citigroup's (C US) retail wealth management portfolio in mainland China**, as part of its expansion efforts in the country. According to a statement by HSBC, the portfolio consists of approximately US\$3.6 billion in assets and deposits from wealth customers across 11 major cities. The terms of the transaction were not disclosed, but Citigroup expects the deal to be finalized in H1 2024. The acquisition is in line with HSBC's strategy to establish itself as a leader in one of the world's rapidly growing wealth markets, as it focuses on its pivot to Asia.

■ **Despite a significant US\$56 billion selloff in Hong Kong developers' shares, it may not necessarily indicate a good entry point, in our view. The correction in the city's housing market appears far from over to us** given high borrowing costs and the looming possibility of additional drops in home prices. The market value of the equities in the real estate sector has shrunk by over one-fourth since late January, making it the worst-performing sector in the MSCI Hong Kong Index. The valuations of two of the city's largest developers, Sun Hung Kai (16 HK) and Henderson Land Development (12 HK), are cheaper than they were during the 1997–98 Asian financial crisis. However, we believe it is still premature to consider the sector for investment.

MARKET Scorecard

Data as of October 11, 2023

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 -0.3% return means the Canadian dollar fell 0.3% vs. the U.S. dollar year to date. USD/JPY 149.10 means 1 U.S. dollar will buy 149.10 yen. USD/JPY 13.7% return means the U.S. dollar rose 13.7% vs. the yen year to date.

Source - Bloomberg; data as of 10/11/23

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,376.95	2.1%	14.0%	22.0%	0.4%
Dow Industrials (DJIA)	33,804.87	0.9%	2.0%	15.6%	-2.0%
Nasdaq	13,659.68	3.3%	30.5%	31.0%	-5.7%
Russell 2000	1,773.30	-0.7%	0.7%	4.7%	-20.1%
S&P/TSX Comp	19,663.84	0.6%	1.4%	7.9%	-3.7%
FTSE All-Share	4,118.20	-0.2%	1.1%	9.8%	1.2%
STOXX Europe 600	453.16	0.7%	6.7%	16.8%	-1.0%
EURO STOXX 50	4,200.80	0.6%	10.7%	25.8%	3.1%
Hang Seng	17,893.10	0.5%	-9.5%	6.3%	-29.3%
Shanghai Comp	3,078.96	-1.0%	-0.3%	3.3%	-14.3%
Nikkei 225	31,936.51	0.2%	22.4%	21.0%	12.1%
India Sensex	66,473.05	1.0%	9.3%	16.3%	10.5%
Singapore Straits Times	3,192.87	-0.8%	-1.8%	2.8%	2.5%
Brazil Ibovespa	117,050.74	0.4%	6.7%	1.9%	4.3%
Mexican Bolsa IPC	50,344.74	-1.0%	3.9%	9.9%	-2.5%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	4.558%	-1.3	68.3	61.1	294.6
Canada 10-Yr	3.921%	-10.5	62.1	44.6	229.5
UK 10-Yr	4.328%	-10.9	65.6	-11.5	314.0
Germany 10-Yr	2.718%	-12.1	14.7	42.0	283.9
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	5.41%	-0.3%	-1.5%	1.0%	-15.0%
U.S. Investment-Grade Corp	6.09%	-0.4%	-0.4%	3.9%	-16.7%
U.S. High-Yield Corp	8.98%	-0.4%	5.4%	9.2%	-5.9%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,874.36	1.4%	2.8%	12.5%	6.9%
Silver (spot \$/oz)	22.04	-0.6%	-8.0%	15.1%	-2.4%
Copper (\$/metric ton)	7,945.00	-3.3%	-5.0%	3.7%	-17.3%
Oil (WTI spot/bbl)	83.49	-8.0%	4.0%	-6.6%	20.5%
Oil (Brent spot/bbl)	85.51	-10.3%	-0.5%	-9.3%	2.2%
Natural Gas (\$/mmBtu)	3.38	15.3%	-24.5%	-48.8%	-28.3%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	105.7190	-0.4%	2.1%	-6.6%	12.1%
CAD/USD	0.7356	-0.1%	-0.3%	1.5%	-8.2%
USD/CAD	1.3594	0.1%	0.3%	-1.5%	8.9%
EUR/USD	1.0619	0.4%	-0.8%	9.4%	-8.1%
GBP/USD	1.2312	0.9%	1.9%	12.3%	-9.4%
AUD/USD	0.6412	-0.4%	-5.9%	2.2%	-12.8%
USD/JPY	149.1000	-0.2%	13.7%	2.2%	31.6%
EUR/JPY	158.3400	0.2%	12.8%	11.8%	21.0%
EUR/GBP	0.8625	-0.5%	-2.6%	-2.5%	1.5%
EUR/CHF	0.9578	-1.0%	-3.2%	-1.0%	-10.6%
USD/SGD	1.3632	-0.2%	1.8%	-5.2%	0.6%
USD/CNY	7.3007	0.0%	5.8%	1.8%	13.2%
USD/MXN	17.8316	2.3%	-8.6%	-11.2%	-14.6%
USD/BRL	5.0504	0.3%	-4.4%	-4.7%	-8.8%

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As of September 30, 2023

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			Count	Percent
Buy [Outperform]	820	55.97	250	30.49
Hold [Sector Perform]	590	40.27	148	25.08
Sell [Underperform]	55	3.75	5	9.09

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