

Heading toward uncharted territory

Kelly Bogdanova – San Francisco

As the dilemma of increasing federal debt continues, and with no concrete proposals for a slowdown on the horizon, more debt may lead the U.S. government and taxpayers to a financial destination to which they have not been before.

With more spending likely coming from Washington on traditional infrastructure, social programs, and climate initiatives—on top of trillions in COVID-19 relief and many years of bipartisan deficit spending—the ramifications of ever-increasing federal debt are on the minds of investors.

Our view about this uncomfortable topic hasn't changed since we [wrote](#) about it late last year: The more that debt mounts over the longer term, and the more that the debt-to-GDP ratio continues to rise, the more the U.S. government and taxpayers will enter uncharted territory. It's unclear to us where the tipping point is between manageable and unmanageable debt loads. So far, markets are behaving as though any tipping point is a long way off.

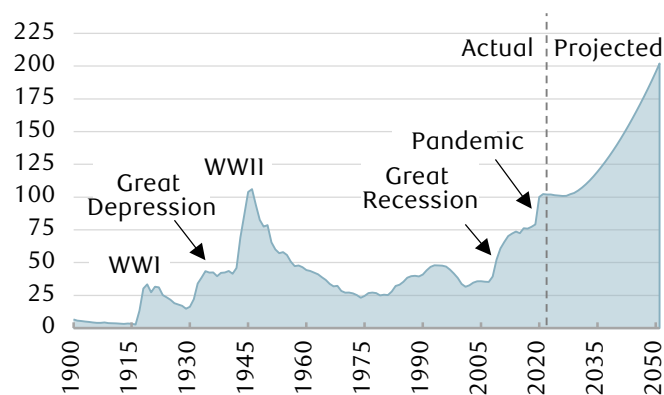
Debt service costs low for now

There are numerous risks associated with high debt loads, which we address below. But it's important to consider those risks are unlikely to manifest in the near term—or even this decade, primarily because the interest costs associated with servicing the federal debt are relatively low and manageable.

Debt servicing costs actually declined last year, despite total outstanding debt surging higher due to COVID-19 spending, because a portion of the debt was refinanced. There are still government bonds carrying much higher

The federal debt burden has risen since the Great Recession, and is projected to surge after 2030

U.S. federal debt held by the public as a % of GDP (actual and projected)



Source - RBC Wealth Management, Congressional Budget Office "The 2021 Long-Term Budget Outlook," March 2021

coupons that are maturing and being refinanced at today's ultralow rates. This is akin to refinancing a mortgage at a lower interest rate—the monthly payment decreases.

The Congressional Budget Office (CBO), tasked with monitoring and reporting on the deficit and long-term

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

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debt, among its other duties, forecasts that debt servicing costs are set to remain low for much of this decade.

While the CBO's latest debt projections, from March of this year, factor in trillions in COVID-19 spending, they don't include trillions in new spending Washington is contemplating for infrastructure, social programs, and climate initiatives. Because of this additional spending, we think deficits would increase beyond the CBO's latest projections—at least to some degree—despite the “pay-fors” (revenue offsets) that are included and economic stimulus that should result.

Greater risks after 2030

Regardless of the final price tag for these new spending initiatives—it's increasingly looking like it will be lower than the roughly \$4.5 trillion on the table now—the federal debt burden has the potential to deteriorate and become problematic after 2030 unless Washington changes its ways.

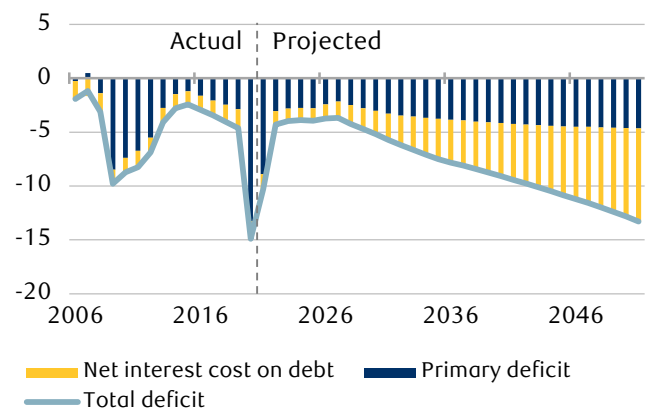
As the charts show, the CBO projects interest costs will become a much higher share of the annual deficit and will rise meaningfully as a proportion of GDP. (The CBO's projections are highly dependent on its interest rate and GDP assumptions: 10-year Treasury yield averages 3.0 percent from 2026 through 2031, rising steadily thereafter reaching 4.9 percent by 2051. GDP growth averages 1.6 percent from 2021 through 2051.)

Following are the potential long-term consequences of the ever-increasing federal debt load that we think are most likely to unfold:

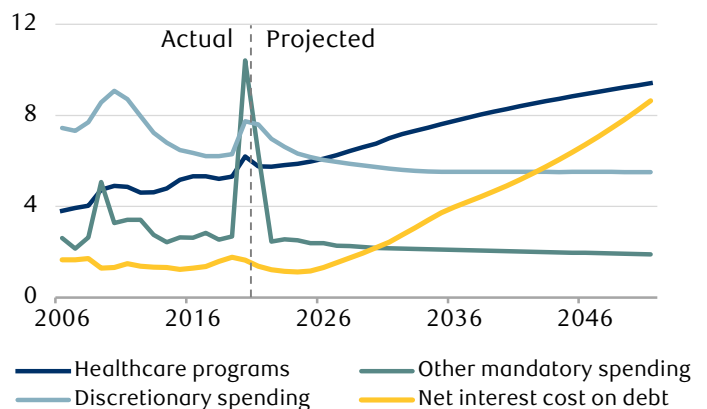
- **Suppressed interest rates** – The Fed has the incentive to keep interest rates low, which would further burden savers and fixed income investors. According to RBC Global Asset Management, while interest rates will likely rise over time, they will need to be suppressed, given that public debt loads will likely remain high and given there is no painless way to pay down those debts.
- **Higher tax burdens** – The government's ability to cut taxes would be more limited, and there would be a greater potential for sweeping tax hikes on individuals and corporations. Taxes could certainly rise between now and the long term.
- **Less flexibility with spending** – The government's ability to spend on desirable programs, emergencies, and economic stimulus would be more limited.
- **Weakened social safety net** – Medicare and Medicaid benefits could be scaled back, as could Social Security payments. These programs represent a growing and significant portion of the projected non-interest spending over time, according to the CBO.
- **Reduced economic growth** – Japan is a case in point. Its debt-to-GDP ratio has hovered above 200 percent for 10 years. Japan's real GDP averaged only 1.3 percent growth per year from 2010 through 2019, whereas the U.S. averaged 2.3 percent growth. We think Japan's high

Interest costs are projected to become a greater share of the deficit and rise meaningfully

U.S. annual federal deficit by category as a % of GDP (actual and projected)



U.S. federal outlays by component category as a % of GDP (actual and projected)



Source - RBC Wealth Management, Congressional Budget Office “The 2021 Long-Term Budget Outlook,” March 2021

debt load is one of the main reasons for its sluggish economic performance, along with demographic challenges.

There are additional, long-term debt-related risks the CBO lists in its analysis such as the loss of confidence in the dollar as the world's reserve currency; the potential for difficulty in financing debt in international markets, which could lead to higher interest rates and expense; inflationary pressures; and a fiscal crisis. However, the CBO acknowledges that financial markets are not currently sending signals these risks are of concern.

Low rates for longer

From a pure “balance sheet” perspective, we believe higher federal debt loads are manageable in the near and intermediate term, but pose longer-term threats. At a minimum, the debt dilemma is a powerful incentive for policymakers to further suppress interest rates. This is a key reason we recommend investors consider strategies for a low interest rate environment that may linger for much longer than one might think is reasonable.

UNITED STATES

Alan Robinson – Seattle

■ **U.S. stocks ended the month of August on a solid footing**, with the S&P 500 Index posting its seventh consecutive monthly gain (see chart) and having hit 12 all-time highs during the month. The key driver was likely the **dovish commentary on interest rates by Fed Chair Jerome Powell** at the annual Jackson Hole Economic Symposium. Year-to-date returns of 20.4% make it harder for investors to find timely new stock ideas, but we note that over the last 70 years when the markets were up over 20% by August, six times out of seven they also posted positive returns for the rest of the year, with the typically weak month of September eclipsed by seasonal strength in the final quarter.

■ However, economic data started to turn more mixed during the week. **August's Consumer Confidence Index reading of 113.8 was the lowest since February** and missed consensus forecasts of 124. Survey respondents cited concern over the rapid rise in COVID-19 cases among unvaccinated Americans, although the pace of vaccinations has risen strongly since July, particularly since the FDA granted full approval to the Pfizer vaccine. **Consumers shifted their spending habits** during August, with airlines noting disappointing traveler numbers while fast food outlets recorded strong demand as consumers avoided dining in restaurants.

■ The slowdown in economic momentum prompted **cuts in Q3 2021 GDP growth forecasts**, with analysts citing consumer resistance to paying the higher prices caused by ongoing supply chain issues. The Atlanta Fed's widely followed GDPNow forecast for Q3 growth fell to 3.7% on Sept. 2 from 5.3% a day earlier, and other analysts published sub-3% forecasts.

■ **Hurricane Ida hit the Gulf Coast** as a powerful Category 4 storm, with flooding and wind damage causing a high human toll. In contrast to 2005's Hurricane Katrina, disruptions to the energy industry were more limited thanks to lessons learned in the wake of that historic storm and to the impact of shale oil taking market share from offshore production. Oil prices leveled off near \$68 per barrel in the aftermath, only \$2 higher than the pre-storm level.

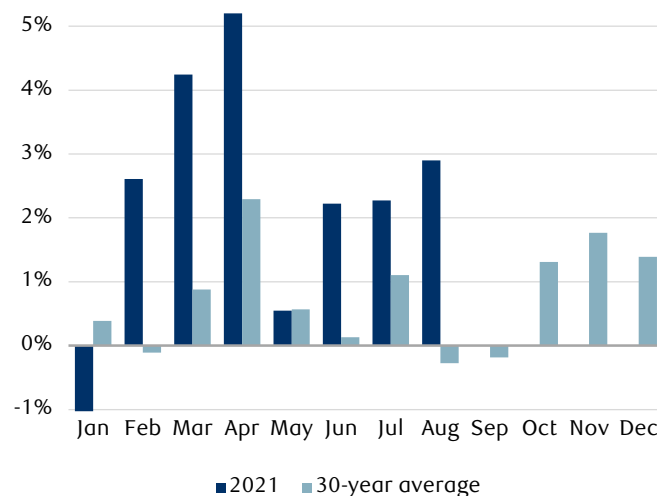
CANADA

Richard Tan, CFA & Sean Killin – Toronto

■ **The Canadian banks reported a clean sweep, with earnings beating consensus estimates.** Broadly speaking, the stronger earnings were **driven primarily by a pickup in top-line revenue growth and improving credit conditions.** With respect to the former, while loan growth remains modest, we believe the backdrop is healthy on the back of excess consumer savings and

August capped a seven-month winning streak for U.S. stocks

S&P 500 monthly returns, excluding dividends



Source - RBC Wealth Management, FactSet; data through 8/31/21

healthy consumer appetite to spend. Furthermore, **the banks continue to benefit from a benign credit risk environment** which, in turn, has allowed them to release reserves back into earnings, a trend we expect to continue for the next few quarters. Lastly, **capital levels are sitting at a 13% average across the Big Six banks** vs. 11.8% a year ago. After capital restrictions are lifted, we believe the banks will be in good standing to ramp up return-of-capital plans via dividend increases and share buybacks. Overall, we are maintaining a constructive view on the banks and note that valuations are still reasonable relative to historical levels.

■ **Canadian GDP unexpectedly fell by an annualized 1.1%, in contrast to the Bank of Canada's forecast of 2.0% growth.** Exports fell at an annualized 15%, driven largely by a pullback of automobile parts production as car companies continued to struggle with a semiconductor chip shortage. In addition to supply chain disruptions and lower goods production, a cooling housing market also weighed on economic activity as residential investment shifted to a drag from a major driver of growth. Despite the economic contraction, there were a number of metrics that allow for a positive outlook. Demand improved as the economy reopened, with some of the service sectors hit hardest by the pandemic roaring back throughout June and July. Business investment and household purchasing power strengthened. **The savings rate has continued to increase and household spending on services, still below pre-shock levels, has room for further recovery.** Economic growth in H2 2021 depends heavily on the impact of delta variant developments, but high vaccination rates in Canada should help shore up economic resilience.

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

■ **August's eurozone inflation estimate** (the flash harmonised index of consumer prices) **leapt to a 10-year high of 3% y/y, a level not reached since 2011.** Pricing pressures are increasing in the EU, but the August headline seems to overstate the situation: the **1.6% increase in core inflation** (which excludes energy, food, alcohol, and tobacco) was more modest, though above the prior month's increase of 0.7% y/y. The biggest culprit seems to have been a year-over-year increase in the prices of clothing and footwear due to a delayed sales season last year that depressed prices. The spike in inflation is unlikely to shift the European Central Bank to a more hawkish stance, in our view, as the bank will likely view the increase in inflation as a temporary phenomenon.

■ **The STOXX Europe 600 Index delivered its seventh consecutive month of gains in August,** its longest period of successive monthly gains for eight years. From the end of January to the end of August, the index was up 19% in euro terms.

■ **The best-performing sector in the region so far this year is Technology,** with a total return of 35%. Even taking into account its outperformance, we continue to hold a positive view on the long-term prospects for the European technology sector—particularly the semiconductor capital equipment manufacturers, whose earnings momentum should continue to be supported by new semiconductor manufacturing capacity being built out over the coming years to meet strong chip demand and ease supply shortages.

■ **Consumer internet group and technology investor Prosus was one of the biggest gainers during the week,** rising more than 10% in the two days following the announcement that it had acquired Indian digital payments provider BillDesk for \$4.7 billion. Prosus' shares have been negatively impacted in recent months by its 29% stake in Chinese gaming and social media platform Tencent. The latter's share price has weakened markedly following government intervention in China's Tech sector.

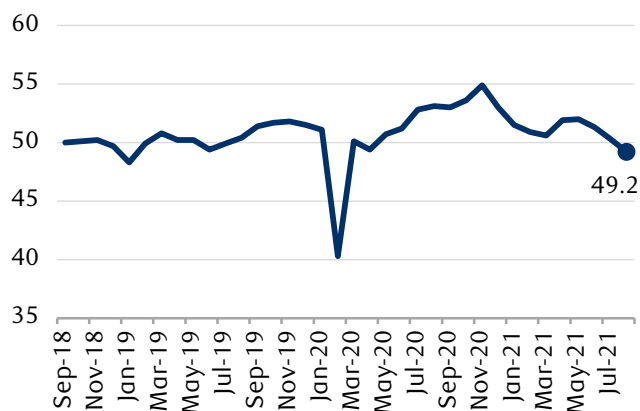
ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

■ **The Hang Seng Index is on track to post four consecutive daily gains for the first time since March of this year.** Chinese Tech shares climbed this week as bargain hunters loaded up on the beaten-down sector. The rally came despite new rules to further tighten Beijing's tech industry oversight.

China's momentum slows amid strict virus controls

Caixin China General Manufacturing PMI



Note: PMI under 50 is considered contractionary.

Source - RBC Wealth Management, Bloomberg; monthly data through 8/31/21

■ **The Caixin China Manufacturing Purchasing Managers' Index (PMI) for August dropped to 49.2 from 50.3 in July,** missing the median estimate of 50.1 and falling into the contractionary zone for the first time since April 2020. We think smaller firms, which are more represented in this survey compared to other manufacturing indexes, were likely feeling the pressure more than their larger peers. The data adds to signs of slowing growth momentum in the domestic economy after China imposed strict measures last month to bring new COVID-19 cases under control. Given the surprise drop in the Caixin Manufacturing PMI, we believe policymakers have more reasons to step up growth support and potentially introduce another cut in the reserve requirement ratio in the coming months.

■ **Beijing's new data security law took effect Sept. 1.** It stipulates fines of up to 10 million yuan for a range of offences including data leaks and failing to verify the identity of buyers or sellers of information. Its scope is broad, and includes data stored and handled within China's borders as well as data abroad that could harm China's national security or citizens' rights. We note that organizations and individuals are forbidden to hand over information to overseas law enforcement authorities without Beijing's permission. Separately, The Wall Street Journal reported that **China's stock market regulator is planning to block tech firms that handle large amounts of sensitive user data from going public overseas.** We think these steps are aimed at tightening the oversight of the Tech sector that will shape China's digital economy for decades.

MARKET Scorecard

Data as of September 2, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,536.95	0.3%	20.8%	26.7%	55.0%
Dow Industrials (DJIA)	35,443.82	0.2%	15.8%	21.8%	34.2%
Nasdaq	15,331.18	0.5%	19.0%	27.2%	92.5%
Russell 2000	2,304.02	1.3%	16.7%	44.7%	54.1%
S&P/TSX Comp	20,795.12	1.0%	19.3%	24.5%	26.5%
FTSE All-Share	4,133.54	0.6%	12.5%	24.1%	3.6%
STOXX Europe 600	474.60	0.8%	18.9%	27.8%	24.7%
EURO STOXX 50	4,232.10	0.9%	19.1%	26.8%	23.3%
Hang Seng	26,090.43	0.8%	-4.2%	3.9%	1.8%
Shanghai Comp	3,597.04	1.5%	3.6%	5.6%	23.0%
Nikkei 225	28,543.51	1.6%	4.0%	22.8%	38.4%
India Sensex	57,852.54	0.5%	21.2%	48.0%	55.0%
Singapore Straits Times	3,088.84	1.1%	8.6%	21.6%	0.2%
Brazil Ibovespa	116,677.10	-1.8%	-2.0%	14.5%	16.0%
Mexican Bolsa IPC	52,087.47	-2.3%	18.2%	40.6%	23.7%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	1.287%	-2.2	37.4	63.9	-20.9
Canada 10-Yr	1.159%	-5.7	48.2	61.1	-0.5
UK 10-Yr	0.681%	-3.3	48.4	45.1	26.6
Germany 10-Yr	-0.385%	-0.2	18.4	8.8	31.7
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.43%	0.0%	-0.7%	-0.5%	19.1%
U.S. Investment-Grade Corp	2.00%	0.0%	-0.2%	1.7%	26.7%
U.S. High-Yield Corp	3.85%	0.1%	4.6%	9.9%	22.8%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,809.63	-0.2%	-4.7%	-6.9%	18.3%
Silver (spot \$/oz)	23.89	0.0%	-9.5%	-12.9%	29.4%
Copper (\$/metric ton)	9,332.25	-2.1%	20.4%	39.1%	66.8%
Oil (WTI spot/bbl)	69.99	2.2%	44.2%	68.6%	27.0%
Oil (Brent spot/bbl)	72.77	-0.3%	40.5%	63.8%	24.1%
Natural Gas (\$/mmBtu)	4.63	5.9%	82.5%	86.4%	102.8%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	92.2240	-0.4%	2.5%	-0.7%	-6.8%
CAD/USD	0.7969	0.5%	1.5%	4.0%	6.2%
USD/CAD	1.2550	-0.5%	-1.4%	-3.8%	-5.8%
EUR/USD	1.1875	0.6%	-2.8%	0.2%	8.2%
GBP/USD	1.3836	0.6%	1.2%	3.6%	14.7%
AUD/USD	0.7401	1.2%	-3.8%	0.9%	10.2%
USD/JPY	109.9400	-0.1%	6.5%	3.5%	3.5%
EUR/JPY	130.5500	0.5%	3.5%	3.7%	12.0%
EUR/GBP	0.8583	0.0%	-4.0%	-3.3%	-5.6%
EUR/CHF	1.0858	0.5%	0.4%	0.6%	-0.1%
USD/SGD	1.3426	-0.2%	1.6%	-1.5%	-3.5%
USD/CNY	6.4565	-0.1%	-1.1%	-7.0%	-10.0%
USD/MXN	19.9636	-0.5%	0.2%	-8.3%	-0.9%
USD/BRL	5.1865	0.7%	-0.2%	37.3%	23.8%

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 0.79 means 1 Canadian dollar will buy 0.79 U.S. dollar. CAD/USD 1.5% return means the Canadian dollar rose 1.5% vs. the U.S. dollar year to date. USD/JPY 109.04 means 1 U.S. dollar will buy 109.94 yen. USD/JPY 6.5% return means the U.S. dollar rose 6.5% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 9/2/21

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Sell [Underperform]	51	3.61	4	7.84

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