

UK: Stagflation nation?

Frédérique Carrier – London

The UK economy is stagnating. The struggling Conservative government may attempt to revive the economy through targeted tax cuts at its upcoming Autumn Statement, though this could underpin already sticky inflation. We explore what the opposition Labour Party would do should it gain power and observe that there are opportunities in equities and fixed income despite the lacklustre macro backdrop.

A struggling economy

Observers breathed a sigh of relief when it was revealed that UK GDP was flat quarter over quarter in Q3, against consensus expectations of a contraction. However, any celebrations were short-lived; as for 2023 overall, the economy has hardly grown.

In fact, we think economic data is likely to slip further as the full impact of much higher interest rates increasingly filters through to the economy. This could be partly offset by an improvement in real wages as inflation declines. Much will depend on the labour market. The risk is that it could weaken should the impact of higher rates put pressure on corporate margins. For now, the Office for National Statistics estimates that the unemployment rate stabilised at 4.2 percent over the three months to September, having been as low as 3.6 percent a year ago. Consensus expects GDP growth of a mere 0.4 percent in 2024, on par with what it projects for 2023.

Despite this economic weakness, we believe the Bank of England (BoE) will likely maintain the Bank Rate, currently at 5.25 percent, elevated for much of 2024. Inflation

excluding food and energy prices has waned but remains elevated, at 5.7 percent. Over the next couple of months, a more flattering year-over-year comparison could result in lower inflation. But RBC BlueBay Asset Management Chief Investment Officer Mark Dowding points out that the BoE will be alert to long-term inflation expectations remaining elevated or “de-anchoring.” The government has been very vocal in its promise to “halve inflation” by next month. Given the starting point was double-digit inflation, it seems to have directed the public to expect inflation of some five percent at year end. High inflation expectations increase the risk of inflation becoming entrenched.

Dowding also surmises that inflationary pressures could be increased if the UK government announces additional tax cuts at the upcoming Autumn Statement. The UK finances are in poor shape, but the Conservative government is in a precarious position, having trailed the opposition Labour Party in the polls for close to two years. It may be tempted to shore up its fortunes with feel-good measures ahead of what will likely be an election year. Though it is not our base case, the risk is that the BoE may well need to hike again in 2024 to bring inflation lower.

The next edition of the Global Insight Weekly will be published on November 30.

For perspectives on the week from our regional analysts, please see [pages 3–4](#).

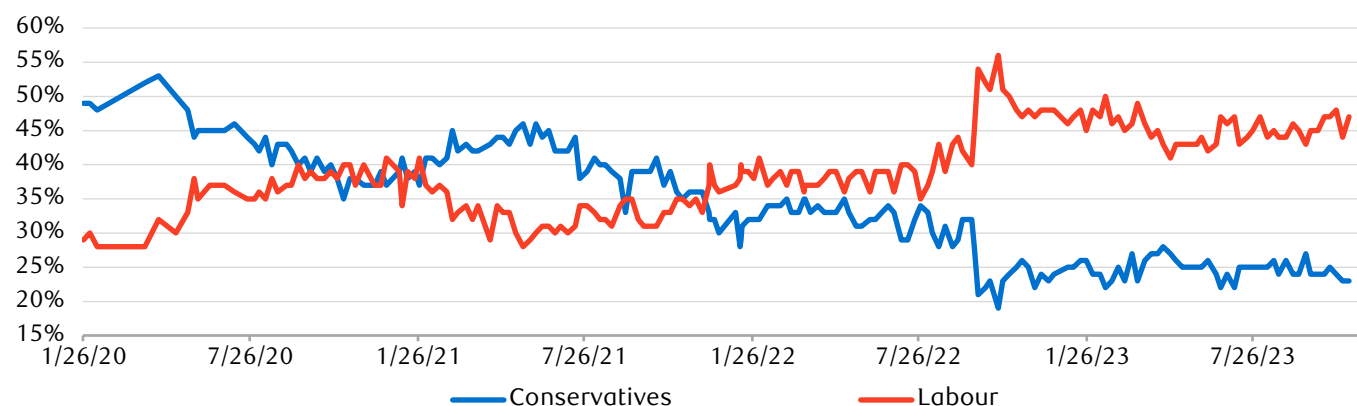
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Priced (in USD) as of 11/15/23 market close (unless otherwise stated). Produced: 11/16/23 1:45 pm ET; Disseminated: 11/16/23 1:48 pm ET

Labour has outperformed the Conservatives for two years

Westminster voting intention tracker



Source - YouGov; data as of 11/8/23

RBC BlueBay thinks the UK is facing a high risk of stagflation, a state characterized by low economic growth, high inflation, and rising unemployment.

Will there be a changing of the guard?

Given that the traditionally left wing Labour Party has held a consistently large lead in the polls for more than a year, we think it is worth considering how it could govern once in power.

Under Sir Keir Starmer's leadership, Labour has changed its spots. The policies of its radical left wing faction, from imposing higher taxes on high earners to nationalizing utilities, have been abandoned. The party seems to have moved successfully to the centre, and it has markedly improved ties with the corporate sector. Overall, we do not think a Labour win would incite strong negative reaction in financial markets.

At its recently held Labour Party conference, Starmer stated that the party aims for a closer relationship with the EU including regulatory alignment of "certain sectors" and accepting some oversight of the European Court of Justice. It is also looking to deregulate the planning process for new homes, to strengthen employment rights, and to forge ahead with the transition to a low-carbon economy.

Some of these goals may be difficult to achieve. The EU is unlikely to accept this cherry-picking approach, and planning deregulation may continue to meet fierce opposition as it threatens to change the landscape. Importantly, Labour would inherit a country with deep scars—not only from Brexit, but also from the BoE's fastest monetary policy tightening spree in three decades—and heavily indebted with gross debt to GDP approaching 100 percent. This may limit a new government's ability to reboot the economy.

Opportunities in an unloved market

We acknowledge the challenging domestic economic prospects but recommend a Market Weight exposure to UK equities. We believe the market's defensive qualities

should hold it in good stead given the more volatile backdrop we are expecting for the global economy and global equities in 2024. The UK's blue-chip equity index, the FTSE 100, has a relatively large exposure to defensive sectors (e.g., Health Care and Consumer Staples). Moreover, it has a bias to "old economy" industries, including Energy (approximately 14 percent of the FTSE 100), a sector where the risk-reward is favourable at present, in our view, given the tight supply-side dynamics, inexpensive valuations, and improving earnings momentum. Importantly, UK equity valuations are undemanding, with almost every sector trading on an abnormally high discount relative to history.

Given the challenging domestic economic prospects, we remain cautious on domestic stocks. We continue to recommend maintaining a bias for globally diverse, high-quality businesses. Across the market, the valuation multiples of many leading UK-listed global companies remain at a notable discount versus their international peers listed in other markets. We view this unwarranted "UK market discount" on these global companies as an opportunity for long-term investors in these stocks.

UK fixed income is an interesting asset class with yields elevated and the BoE close to the peak of its hiking cycle. We are somewhat concerned about the heavy Treasury issuance schedule however, so for non-UK-based investors, we suggest a Market Weight in Gilts with a bias to shift to Overweight in the near term.

For UK-based investors, the tax treatment of Gilts makes them an attractive investment. Gilts are exempt from capital gains tax, so no tax is paid on any profit realized when the Gilt matures—only income tax on the coupon is paid. This is particularly useful for higher-rate taxpayers, who would otherwise pay capital gains tax at 20 percent.

With contributions from Thomas McGarrity, CFA

UNITED STATES

Tyler Frawley, CFA – Minneapolis

■ **U.S. equities are sharply higher on the week as investors increasingly believe the Federal Reserve's rate hiking cycle is over.** All major indexes are higher, with the Nasdaq Composite's return of 2.18% making it the best relative performer. The S&P 500 has outperformed the Dow Jones Industrial Average, but both are higher, having risen 1.92% and 1.73%, respectively. Sector leadership is evident in Real Estate, which has returned 4.91%, and Materials, which has returned 3.25%. Energy is the only sector lower on the week, down 2.12%, as WTI crude oil prices have fallen to \$75/barrel, down from \$90/barrel just a month ago.

■ **Inflation slowed more than expected in October.** On a year-over-year basis, both headline (3.2%) and core (4.0%) inflation came in below Bloomberg consensus expectations of 3.3% and 4.1%, respectively. Headline inflation benefited from lower energy prices, a continued decline in food inflation, and moderating core goods prices. There was also progress on the services side, albeit at a slower pace. The cost of shelter, one of the largest components of core inflation, remains stubbornly high—up 6.7% compared to its level a year ago.

■ This cooler-than-expected inflation report has led many investors to conclude that the Federal Reserve is done raising rates. The CME FedWatch tool, which uses futures pricing to calculate implied future moves in Fed policy, is now indicating no further hikes and a better

than 50% chance that the Fed will begin cutting rates by May 2024. While talk of rate cuts is premature, in our view, **we continue to believe the key question moving forward is whether the trend lower in inflation will align with a slowdown in economic growth**, or if the Fed will be successful in manufacturing its widely discussed “soft landing.”

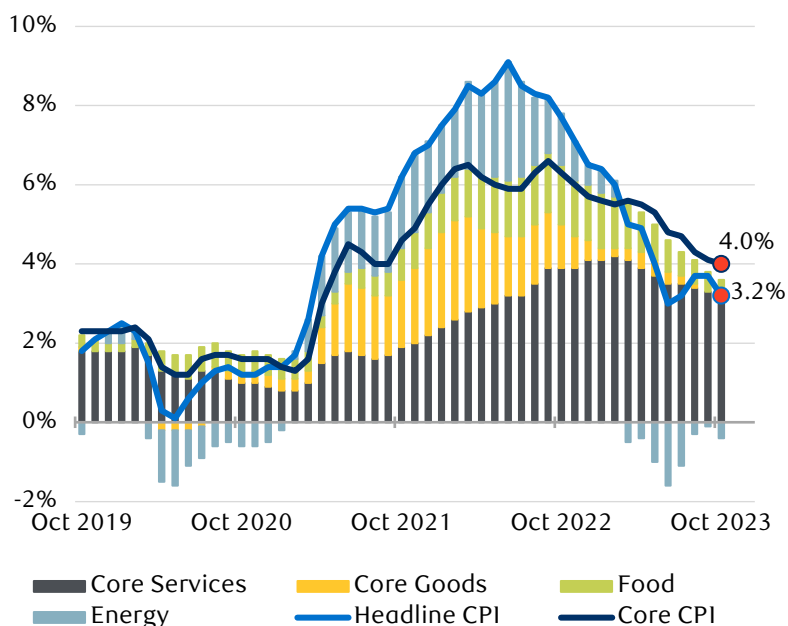
CANADA

Matt Altro & Sean Killin – Toronto

■ **The S&P/TSX Composite has performed well month to date, clawing back some of the losses it suffered in September and October.** Recent gains have been driven by 10 of 11 sectors within the index, with Information Technology leading to the upside by a wide margin, followed by advances in Utilities, Financials, and Real Estate. Interest rate sensitivity has been a common thread influencing these sectors. The decline in the Government of Canada 10-year bond yield to roughly 3.7% from 4.06% so far this month has helped boost valuations, particularly for the Information Technology sector, and has enhanced the relative income appeal of dividend-oriented sectors. Energy is the one sector with negative price returns, which can be attributed in part to low-single-digit percentage declines in oil prices and low-double-digit declines in natural gas prices. Nonetheless, 2023 has been a volatile year, and as we head into 2024 we think all eyes will continue to watch inflation data and what the Bank of Canada may do next.

What is driving inflation?

Energy prices fall, services inflation remains high



Source - RBC Wealth Management, Bloomberg; data through 10/31/23, year-over-year percentage change

■ **The Bank of Canada's (BoC) rate hike campaign has cooled housing market activity meaningfully since the midpoint of 2023.** This slowdown in home resales, which have dropped nearly 12% over the past four months, has reversed much of the increase in activity seen in the first half of 2023. According to RBC Economics, this has almost entirely unwound the tightness in supply-demand conditions that prevailed earlier this year. Despite the pullback in housing market activity driving the broader residential real estate market into more balanced territory, where sales are roughly equal to new listings, housing affordability remains a significant concern. The effects of higher interest rates have far outweighed any meaningful decrease in housing prices, with mortgage rates now at levels not seen in over a decade. While financial markets are pricing in cuts to the BoC's overnight rate, RBC Economics does not foresee a significant improvement in affordability measures in the near term.

EUROPE

Thomas McGarrity, CFA – London

■ **European equities gained amid the broad rally in global equities** following the softer-than-expected U.S. inflation data. Rate-sensitive stocks within industries such as Real Estate and retail bounced on hopes the interest rate hiking cycle has peaked. Many of the best-performing stocks during the week have high levels of short interest, suggesting short covering has played a part in the recent equity rally.

■ **Mining stocks were boosted by a weaker U.S. dollar and higher iron ore prices.** The latter is trading near an eight-month high, seemingly buoyed by Bloomberg news reports that the Chinese government is considering a new wave of stimulus measures to support its ailing property sector. The basic resources industry group has been the worst performer within the STOXX Europe 600 year to date. Accordingly, incremental signs of a stabilization of China's property sector would be supportive to European- and UK-listed miners, especially given their low valuations. On the flip side, however, continued uncertainty around global economic growth prospects may constrain the group. In relation to commodity-linked equities, we believe the risk-reward remains more attractive for Energy than for mining.

■ **UK CPI inflation, at 4.6% y/y in October, came in softer than both consensus and Bank of England (BoE) expectations, at 4.7% y/y and 4.8% y/y, respectively.** Of the 2.1 percentage point (pp) m/m fall, the majority (1.6 pp) is explained by energy prices, following the commencement of the new three-month Ofgem price cap period. However, there was more to the story including food price inflation continuing to ease (falling to 10.1% y/y in October from 12.1% y/y in September). Moreover, restaurants and hotels were also a downward influence on overall inflation (0.1 pp). This helped Services CPI inflation fall to 6.6% y/y vs. 6.9% y/y in September, the level the BoE had projected it settling at through Q4 2023.

■ **We believe the softer-than-expected UK inflation data strengthens the case for no change at the BoE's next Monetary Policy Committee meeting in December.** We think the bar remains high for further UK rate hikes and that the current 5.25% Bank Rate will be the peak for UK interest rates.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

■ **Asia Pacific equity markets traded broadly higher during the week, led by the Hang Seng Index.** The Hang Seng jumped almost 4% on Wednesday, its best day in almost four months, as investors positioned for a **high-stakes meeting between Chinese President Xi Jinping**

Hang Seng posts best daily return since July

Hang Seng Index one-year price chart



Source - RBC Wealth Management, Bloomberg; daily data through 11/16/23

and U.S. President Joe Biden on the sidelines of the Asia-Pacific Economic Cooperation (APEC) summit in San Francisco.

■ After a two-hour meeting between the two leaders and accompanying top officials, **both sides issued positive statements highlighting “progress” being made.** The key agreements include: establishing an understanding that Xi and Biden can call each other directly to resolve any miscommunication; restoring high-level military communications; combating fentanyl; and opening a dialogue over artificial intelligence. At a subsequent dinner with business leaders alongside the APEC summit, Xi remarked that China wants to be friends with the U.S. and that China would not fight a war with anyone. While the APEC summit continues and more meetings of senior officials are scheduled, **we believe the initial meeting between the two global economic heavyweights delivered several small wins for the bilateral relationship with prospects of warmer ties ahead.**

■ **Tencent Holdings (700 HK) reported Q3 2023 earnings results that exceeded consensus expectations** as video advertising on WeChat posted strong growth. Revenue grew by 10% y/y while core earnings surged by 39% y/y. **Management noted it will continue to look for ways to return cash to shareholders** despite already returning approximately \$24 billion to investors year to date, and now favours share buybacks over dividends or asset sales. Lastly, management highlighted that the “current level of gross margin [Q3: 49.5%] is sustainable and we believe there is room for it to grow further.”

MARKET Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,502.88	7.4%	17.3%	12.8%	-3.8%
Dow Industrials (DJIA)	34,991.21	5.9%	5.6%	4.2%	-3.0%
Nasdaq	14,103.84	9.7%	34.8%	24.2%	-11.0%
Russell 2000	1,801.22	8.4%	2.3%	-4.7%	-25.0%
S&P/TSX Comp	20,057.89	6.3%	3.5%	0.3%	-7.5%
FTSE All-Share	4,083.22	3.3%	0.2%	0.7%	-2.8%
STOXX Europe 600	454.52	4.8%	7.0%	4.6%	-6.9%
EURO STOXX 50	4,315.53	6.3%	13.8%	10.2%	-1.6%
Hang Seng	18,079.00	5.6%	-8.6%	-1.4%	-28.8%
Shanghai Comp	3,072.84	1.8%	-0.5%	-2.0%	-13.0%
Nikkei 225	33,519.70	8.6%	28.5%	19.8%	12.6%
India Sensex	65,675.93	2.8%	7.9%	6.1%	8.2%
Singapore Straits Times	3,132.12	2.1%	-3.7%	-4.4%	-3.3%
Brazil Ibovespa	123,165.76	8.9%	12.2%	8.8%	15.8%
Mexican Bolsa IPC	52,796.47	7.6%	8.9%	2.2%	2.7%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	4.535%	-39.5	66.1	76.6	292.1
Canada 10-Yr	3.755%	-30.9	45.5	63.2	203.1
UK 10-Yr	4.227%	-28.5	55.5	93.2	326.3
Germany 10-Yr	2.644%	-16.2	7.3	53.6	287.3
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	5.21%	3.3%	0.4%	1.2%	-12.2%
U.S. Investment-Grade Corp	5.85%	3.9%	2.0%	3.3%	-13.6%
U.S. High-Yield Corp	8.70%	3.1%	7.8%	8.0%	-3.6%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,959.43	-1.2%	7.4%	10.1%	5.2%
Silver (spot \$/oz)	23.44	2.6%	-2.2%	8.7%	-6.5%
Copper (\$/metric ton)	8,144.00	1.4%	-2.6%	-2.4%	-16.1%
Oil (WTI spot/bbl)	76.66	-5.4%	-4.5%	-11.8%	-5.2%
Oil (Brent spot/bbl)	80.96	-7.4%	-5.8%	-13.7%	-1.3%
Natural Gas (\$/mmBtu)	3.17	-11.5%	-29.3%	-47.5%	-36.9%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	104.4030	-2.1%	0.9%	-1.9%	9.4%
CAD/USD	0.7309	1.4%	-0.9%	-2.9%	-8.5%
USD/CAD	1.3682	-1.4%	0.9%	3.0%	9.3%
EUR/USD	1.0847	2.6%	1.3%	4.8%	-4.6%
GBP/USD	1.2414	2.1%	2.7%	4.6%	-7.5%
AUD/USD	0.6509	2.7%	-4.5%	-3.7%	-11.4%
USD/JPY	151.3800	-0.2%	15.5%	8.7%	32.6%
EUR/JPY	164.2100	2.4%	17.0%	13.9%	26.6%
EUR/GBP	0.8738	0.4%	-1.3%	0.2%	3.1%
EUR/CHF	0.9632	0.0%	-2.7%	-1.4%	-8.4%
USD/SGD	1.3505	-1.4%	0.8%	-1.5%	-0.2%
USD/CNY	7.2468	-1.0%	5.0%	2.9%	13.5%
USD/MXN	17.2936	-4.2%	-11.3%	-10.7%	-16.2%
USD/BRL	4.8649	-3.4%	-7.9%	-8.6%	-10.8%

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 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 -0.9% return means the Canadian dollar fell 0.9% vs. the U.S. dollar year to date. USD/JPY 151.38 means 1 U.S. dollar will buy 151.38 yen. USD/JPY 15.5% return means the U.S. dollar rose 15.5% vs. the yen year to date.

Source - Bloomberg; data as of 11/15/23

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			Count	Percent
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