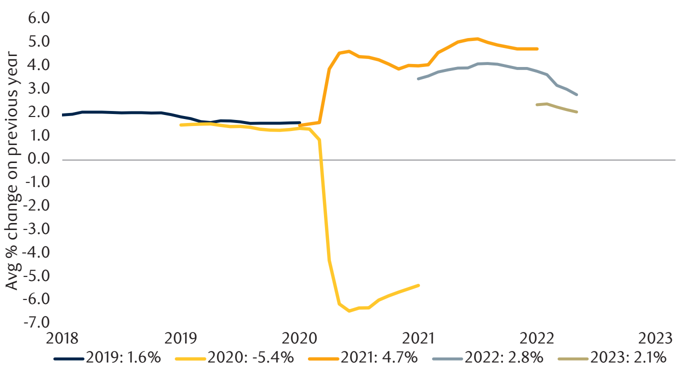
JUNE 24, 2022

Central banks pick up the pace to tame unacceptably high inflation

Eric Savoie, MBA, CFA
Investment Strategist, RBC Global Asset Management Inc.

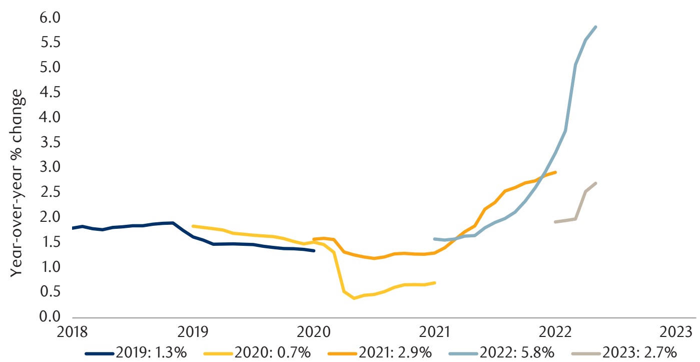
Consumers and investors are on edge as extremely high inflation leads to a rapid rise in the cost of living and more aggressive central-bank tightening. Price increases have been larger and lasted longer than most experts had predicted due in part to supply-chain challenges, rapidly changing consumer demands, the war in Ukraine and lingering tailwinds from the massive monetary and fiscal-stimulus packages deployed during the pandemic. Central banks are now in a precarious position where they need to tighten policy aggressively to rein in problematically high inflation at the same time that the economy has already begun slowing. The combination of aggressive rate hikes, a commodity-price shock and elevated inflation suggests that the risk of recession is higher than usual. Consensus estimates for growth continue to be ratcheted lower and those for inflation revised higher (exhibits 1 and 2). Our own forecasts are below consensus for growth and above consensus for inflation. We do think, however, that any recession that comes to pass would not be as severe or damaging as the ones following the global financial crisis and the COVID-19 pandemic.

Exhibit 1: Weighted average consensus real GDP
Growth estimates for major developed nations



Note: as of June 2022. Source: Consensus Economics

Exhibit 2: Weighted average consensus CPI
Inflation estimates for major OECD nations

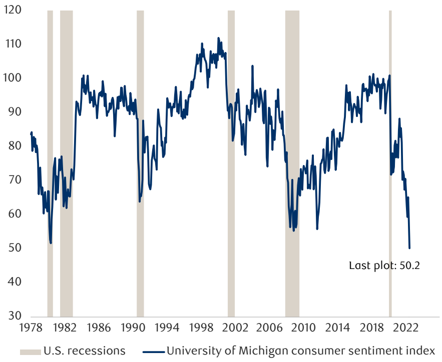


Note: as of June 2022. Source: Consensus Economics

Consumers and businesses lack confidence, but spending is holding up so far

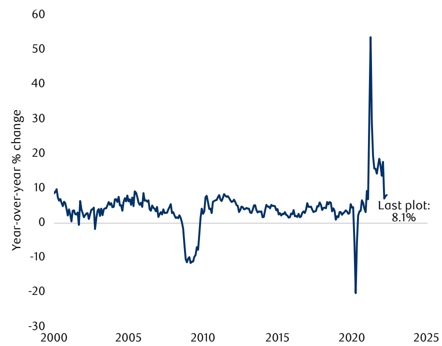
With the economy facing a variety of headwinds and the outlook highly uncertain, consumers and businesses are feeling quite pessimistic about their future. The University of Michigan Consumer Sentiment Index fell to its lowest reading in nearly a half century and is at levels that have in the past been associated with recessions (Exhibit 3). But, interestingly, consumer spending remains relatively robust and is still rising at a rapid pace (Exhibit 4). As for the business community, small-business confidence has also waned but, here too, we have not seen a decline in actual sales (Exhibit 5). It would be unusual for these survey-based confidence measures to be at such negative readings without the actual sales data following suit, so we believe the surveys are foreshadowing economic weakness ahead.

Exhibit 3: University of Michigan Consumer Sentiment Index



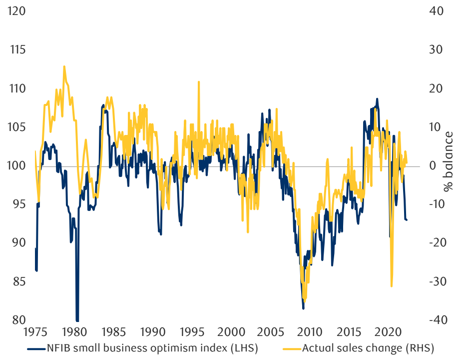
Note: as of June 22, 2022. Source: NFIB, BCA Research, Bloomberg, RBC GAM

Exhibit 4: U.S. retail sales Adjusted retail & food services sales y/y % change



Note: as of May 2022. Source: U.S. Census Bureau, RBC GAM

Exhibit 5: U.S. small business survey – Optimism index



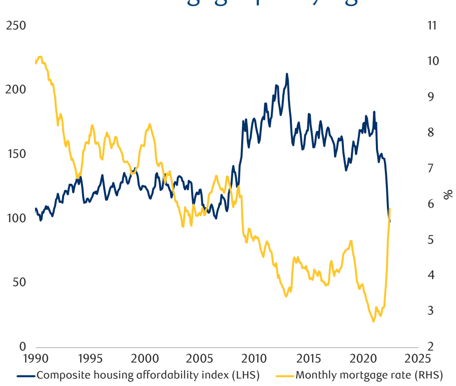
Note: as of June 22, 2022. Source: NFIB, BCA Research, Bloomberg, RBC GAM

Housing market is starting to feel the pinch from higher rates

One segment of the economy that is highly sensitive to interest rates is the real estate market, and it started showing signs of softening as borrowing costs began rising rapidly. Home prices soared during the pandemic as people sought bigger spaces to work at home and made other changes to their working and living arrangements.

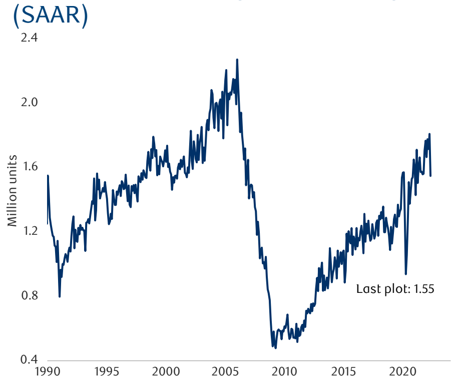
High housing prices were supported by historically low interest rates, but the rate landscape shifted rapidly this year. U.S. 30-year fixed mortgage rates surged to 6% in June from 3% at the start of the year and housing affordability is now the worst it's been in 30 years (Exhibit 6). While house prices do not appear to have fallen much yet, construction and home sales began shrinking in recent months (exhibits 7 and 8).

Exhibit 6: Housing affordability index – Median family income relative to mortgage qualifying income



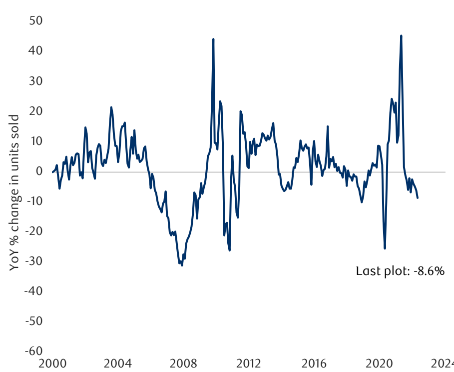
Note: as of June 23, 2022. Source: National Association of Realtors, RBC GAM

Exhibit 7: U.S. housing – new private housing units started Total starts including farm housing (SAAR)



Note: As of May 2022. Source: Bloomberg

Exhibit 8: U.S. housing - sales of existing homes – Total existing home sales



Note: as of May, 2022. Source: National Association of Realtors

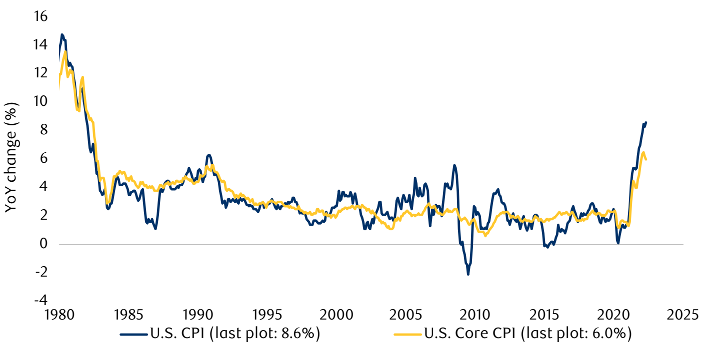
Inflation remains problematic, but could be peaking

There are signs that today's extremely high inflation is peaking. While the U.S. Consumer Price Index (CPI) is rising at its fastest pace in four decades, lifted by food and energy prices, the core CPI, which excludes them, has been declining gradually from its March top (Exhibit 9). The headline CPI measure could be near its peak as well, given that a variety of commodity prices are down significantly from their highs (Exhibit 10). Oil is down 15% from its peak, copper has fallen 24% and lumber has lost 60%. Moreover, inflation expectations have also come off their highs, indicating that investors believe the worst of the inflation spike may have already occurred (Exhibit 11). While inflation could remain elevated in the next few months, all signs suggest we could start to see some significant relief later this year and into 2023.

Fed delivers substantial rate hike, vows commitment to fight inflation

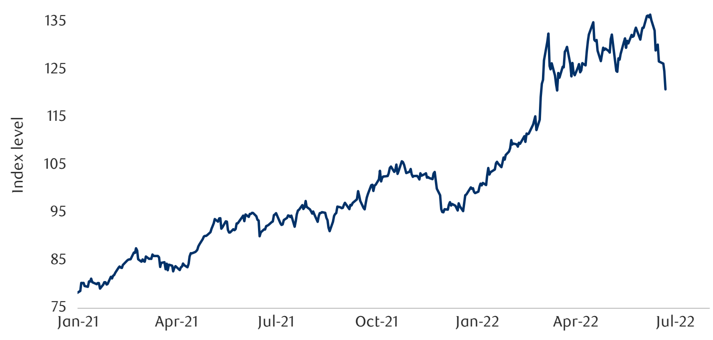
Even if inflation tops out at current levels, the gap between where inflation is and where the Fed wants it to be is unacceptably large. This discrepancy is leading to unusually large short-term interest-rate hikes such as the U.S. Federal Reserve (Fed)'s 75-basis-point increase to 1.75% on June 15, when Fed Chair Jerome Powell reiterated his commitment to getting inflation back to the 2% level. Powell mentioned that the Fed's estimate of a neutral policy rate is 2.5% which means that, technically the Fed is still engaging in a stimulative monetary policy since the fed funds rate remains below that level. The question for investors is how far above neutral does the Fed need to push for inflation to come down? Exhibit 12 plots the expected path for interest rates based on futures pricing. The various lines on the chart

Exhibit 9: U.S. CPI and Core CPI (ex. food & energy)



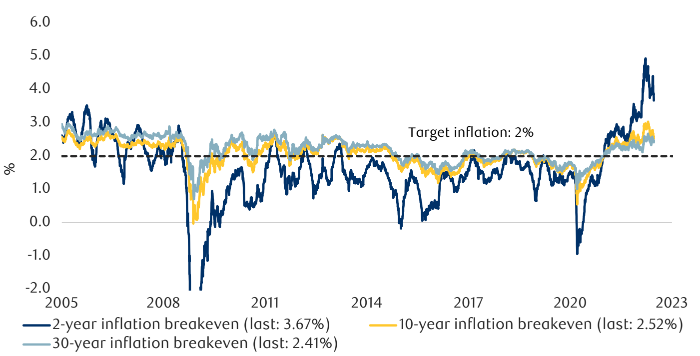
Note: as of June 10, 2022. Source: Bloomberg, RBC GAM

Exhibit 10: Bloomberg Commodity Index



Note: as of June 23, 2022. Source: Bloomberg, RBC GAM

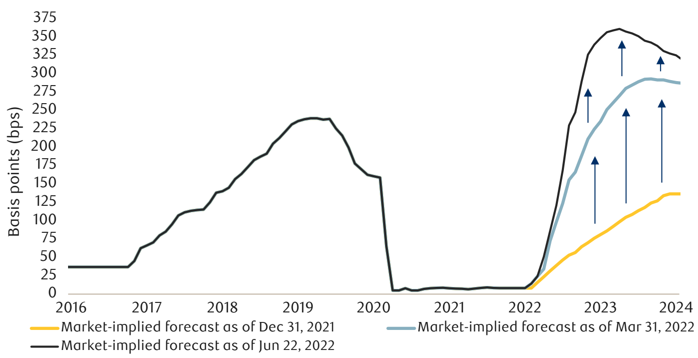
Exhibit 11: U.S. Treasuries inflation breakevens



Note: as of June 23, 2022. Source: Bloomberg, RBC GAM

Exhibit 12: Implied fed funds rate

12-months futures contracts



Note: as of June 23, 2022. Source: Bloomberg, U.S. Federal Reserve, RBC GAM show that this path has been adjusted meaningfully higher so far this year. Currently, the market is pricing in a fed funds rate of around 3.6% by mid-2023 and is already expecting rate cuts shortly after the peak in fed funds is reached. In our view, the aggressive rate-hiking path signaled by markets, should it materialize, could lead to challenges with liquidity and jeopardize the financial well-being of highly indebted businesses and individuals. There is a fair chance that tightening ultimately undershoots current lofty expectations.

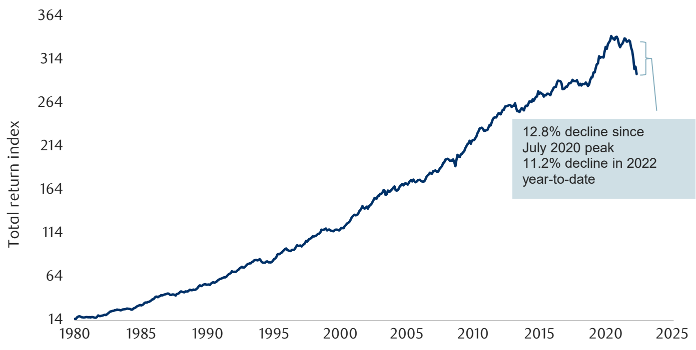
Historic sell-off in bonds takes a pause

Bonds have extended their sell-off as inflation persists and the Fed accelerates the pace of rate increases. The ICE BofA U.S. Broad Market Index has declined as much as 13% this year as the U.S. 10-year yield rose to a high of 3.47% on June 14 (Exhibit 13). More recently, as investors began pricing in a greater probability of recession, safe-haven government bonds have rallied and the U.S. 10-year yield has retraced closer to 3.0%. This bond rally is consistent with our view that yields have reached a level where bonds offer more of a cushion against a downturn in the economy. Our models suggest that valuation risk in the sovereign-bond market has been alleviated as a result of the surge in yields so far this year (Exhibit 14). Yields could again move higher if the Fed fails to control inflation and is forced to keep hiking aggressively, but our base case is that inflation will ultimately calm and that further sustained increases in yields from here will likely be limited.

Credit spreads widen, but they remain well below levels consistent with recession

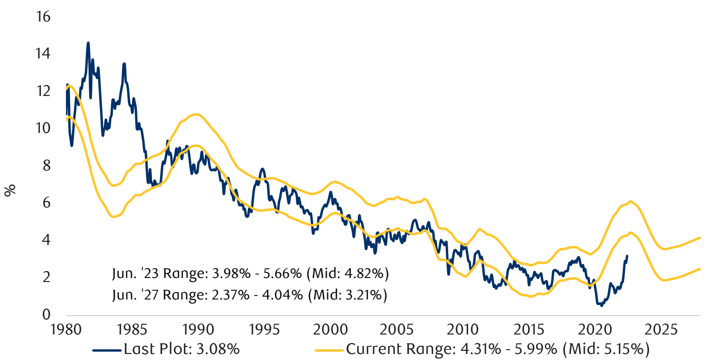
The sell-off in corporate bonds is also due to concerns of an economic downturn that would hinder companies' ability to repay their debts. Credit spreads for U.S. investment-grade and high-yield bonds have widened to their largest in two years (Exhibit 15). Note, however, that even with the recent increase, spreads remain well below levels that are consistent with recessions. During a recession, we could expect investment-grade spreads to rise to 250 basis points and high-yield spreads to rise to 900 basis points, but those spreads are currently at just 149 basis points and 543 basis points, respectively. Either the bond market is telling us that the risk of recession is fairly low or that, in the event one materializes, corporate-bond prices could have much further to decline. That said, the pandemic flushed out many of the troubled debts that existed pre-COVID-19, and there hasn't been sufficient time for excesses to build up again in credit markets. Another positive is the fact that balance sheets are in relatively good shape, and it is therefore possible that corporate bonds could be more resilient to a downturn.

Exhibit 13: ICE BofA U.S. Broad Market Index
Total return index



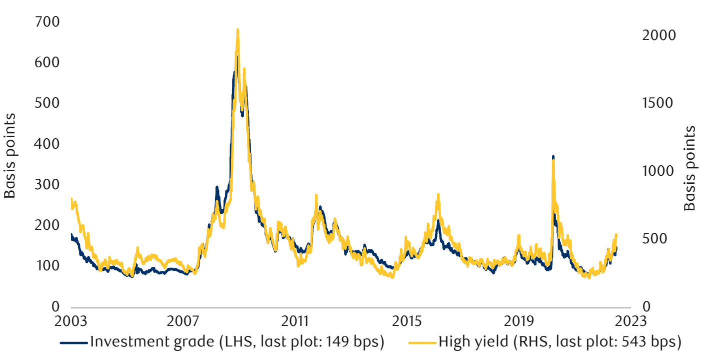
Note: as of June 22, 2022. Source: Bloomberg, RBC GAM

Exhibit 14: U.S. 10-year T-Bond yield
Equilibrium range



Note: as of June 23, 2022. Source: RBC GAM

Exhibit 15: U.S. corporate bond spreads
Difference with U.S. 10-year Treasury yield



Note: as of June 23, 2022. Source: Barclays Capital, Bloomberg, RBC GAM

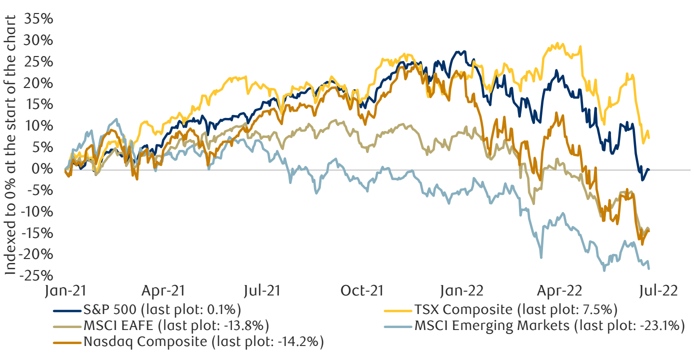
Equities extend decline, valuation risk greatly reduced

Stocks encountered another leg down as central banks turned more hawkish and the economic outlook became increasingly uncertain. Most major markets fell to new lows for the year and the S&P 500 Index officially fell into a bear market of more than 20% below its peak (Exhibit 16). Since the start of 2021, the S&P/TSX Composite Index is the only major market we track that is still sitting on a gain. The S&P 500 is flat over that period, while the MSCI EAFE Index, the MSCI Emerging Markets Index and the NASDAQ Composite Index are all down by double digits. Valuation risk has been significantly alleviated as a result of the intense sell-off. Our composite of global equity-market valuations now sits at fair value after being as much as 37% above fair value in December 2021 (Exhibit 17). Stocks are not necessarily cheap in aggregate, but there are large differences between regions. The S&P 500 remains at the more expensive end of the spectrum (Exhibit 18) while other equity markets are at or below their fair values.

Optimistic earnings expectations are vulnerable to downgrades

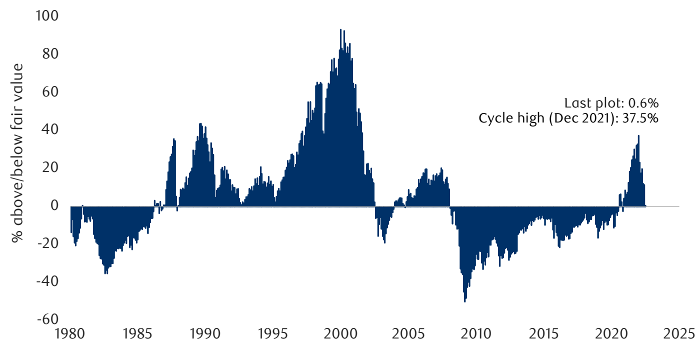
While expectations for the economy have downshifted, analysts have been reluctant to cut their earnings estimates. The outlook for corporate profits remains robust, with the consensus of analysts anticipating that S&P 500 earnings will rise 10.3% in 2022 and another 9.7% in 2023 (Exhibit 19). If these forecasts materialize, S&P 500 earnings per share would rise to US$252 by the end of next year, providing

Exhibit 16: Major equity market indices
Cumulative price returns indices in USD



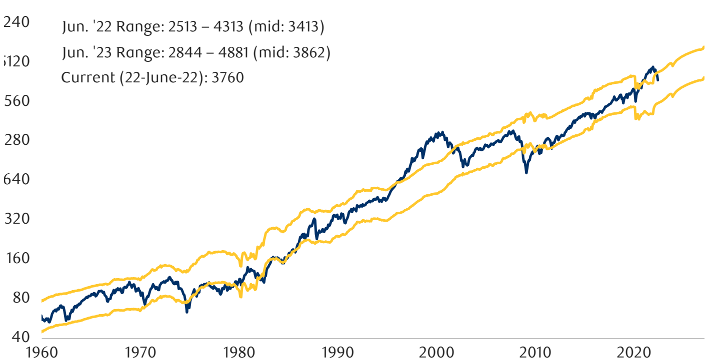
Note: as of June 22, 2022. Price returns computed in USD. Source: Bloomberg, RBC GAM

Exhibit 17: Global stock market composite
Equity market indexes relative to equilibrium



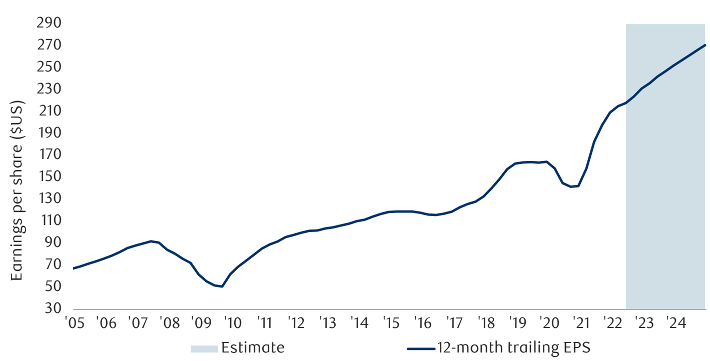
Note: as of June 17, 2022. GDP-weighted average of RBC GAM fair value models for a variety of countries. Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM

Exhibit 18: S&P 500 equilibrium
Normalized earnings & valuations



Source: RBC GAM

Exhibit 19: S&P 500 Index
12-month trailing earnings per share



Note: as of June 17, 2022. Estimate is based on a consensus of industry analysts' bottom-up expectations. Source: Thomson Reuters, RBC GAM solid support for the equity market. That said, companies are reporting increasing cost pressures and the economy is slowing. It would be unusual for earnings to be immune to downgrades in this environment and we know that, historically, earnings have declined an average of 25% during past recessions. With profit margins at record highs, earnings above their long-term trend and the economy slowing, it is likely in our view that reported earnings will come in below current consensus estimates.

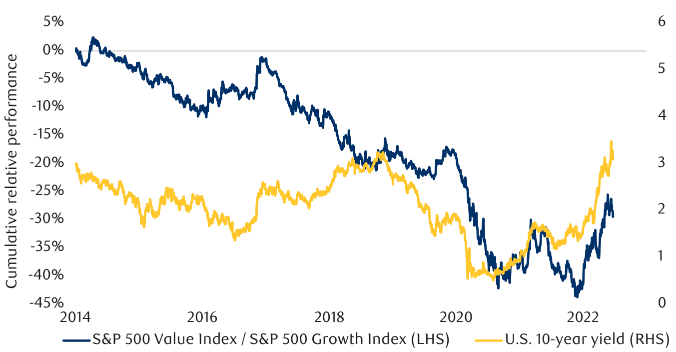
The style rotation out of growth and into value may be stalling

Growth stocks underperformed for the better part of 2022 but have started to hold their ground more recently. Rising interest rates and inflation have put downward pressure on valuations, which hurt expensive growth stocks, in particular, during the downturn. As a result, value stocks outperformed growth stocks by more than 25% from the start of 2022 to late May (Exhibit 20). Since then, however, growth stocks have started to hold up relative to value stocks and even outperformed slightly. This slight outperformance in growth stocks more recently has been coincident with a slight decline in inflation expectations, increased expectations of recession and a 20% decline in energy shares in just two weeks. Growth stocks tend to outperform during periods where the economy is slowing because they have a proven ability to generate profit growth regardless of the economic backdrop. It is not yet clear whether this shift to growth stocks will be sustained, as the market appears to be weighing the possibility of higher inflation and interest rates, which would favour value stocks, versus the chance of recession, which would favour growth stocks.

Asset mix – positioning closer to neutral

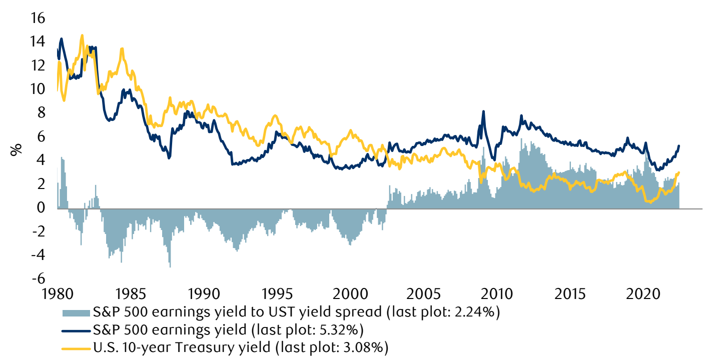
The macroeconomic backdrop is highly uncertain, growth is slowing, inflation is elevated and central banks are hiking interest rates aggressively to restore consumer-price stability at the risk of sending economies into recession. Given our view that the range of potential outcomes is larger than usual, that recession risk is high and that bond yields are at levels that would offer protection against a downturn in a balanced portfolio, we have made two asset-mix changes so far this month. The first was to move 50 basis points out of cash into bonds as the U.S. 10-year Treasury yield climbed above 3.0%. Later, as yields rose even further, we moved another 100 basis points into bonds, sourced from stocks. We are still maintaining a slight overweight in stocks, recognizing that the risk premium in favour of stocks over bonds remains, although that the premium has narrowed as bond yields rose (Exhibit 21). As a result, our asset mix is much closer to neutral than it has been at prior points in the cycle. Our current recommended asset mix for a global balanced investor is 61.5% equities (strategic: "neutral": 60%), 37.5% bonds (strategic "neutral": 38%) and 1.0% in cash.

Exhibit 20: Value to growth relative performance
S&P 500 Value Index / S&P 500 Growth Index



Note: as of June 23, 2022. Source: Bloomberg, RBC GAM

Exhibit 21: S&P 500 earnings yield
12-month trailing earnings/index level



Note: as of June 23, 2022. Source: RBC GAM, RBC CM

Disclosure

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to people in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

Additional information about RBC GAM may be found at www.rbcgam.com.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the above-listed entities in their respective jurisdictions.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions.

RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

Publication date: June 24, 2022