



Stuck on uneasy street

Kelly Bogdanova – San Francisco

Stock markets haven't been able to shake off the volatility, and it looks like this testing period may drag on. We look at the four issues conspiring to keep downward pressure in place and how they will shape the investment landscape from here.

The same issues that have dogged equity markets all year have pressured stocks further lately—inflation, interest rate hikes, and concerns about economic growth. But some notable developments on these fronts signal to us that this challenging, volatile period could persist.

What has changed ...

In a little over two weeks, the S&P 500 has retreated another 9.6 percent on top of prior accumulated losses, pushing the index down a total of 21.6 percent from its all-time high in early January.

Four main factors have pressured the market lately:

(1) Higher, stickier inflation: The May U.S. inflation report put an exclamation point on the likelihood that inflation isn't set to move back to normal anytime soon.

In fact, given that gasoline prices have pushed up again, RBC Capital Markets, LLC's Chief U.S. Economist Tom Porcelli estimates the headline Consumer Price Index (CPI) could drift up to nine percent in the upcoming June report, exceeding the 8.6 percent level in May which broke another 40-year high.

He and other RBC economists still cite circumstances that could reduce headline inflation somewhat later this year. The core CPI rate (excludes food and energy) could pull

back notably by then, especially if demand for both goods and services declines amid an economic slowdown.

Even if this plays out, headline inflation—which impacts households the most—will probably be uncomfortably high for the remainder of 2022 and could also sit well above the Fed's two percent target next year. The stock market has been adjusting to this “sticky” inflation scenario.

The root causes of inflation are being hotly debated. Some economists mostly blame the COVID-19 supply chain breakdowns. Others acknowledge the key role of these logistics disruptions, but mainly point to the excessive and unprecedented monetary and fiscal stimulus during the pandemic period, arguing that the Fed and federal government ignited the inflation fire themselves. Also, some cite government disincentives and restrictions on producing and processing fossil fuels.

Additional COVID-19 restrictions/shutdowns in China and sanctions on Russia are two developments exacerbating and prolonging the already difficult global inflation and supply chain environments. There isn't much central bankers can do about these impulses. The sweeping Western sanctions on Russia, the world's largest commodity producer, are having a negative “boomerang effect” on Western economies, especially European

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

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Priced (in USD) as of 6/22/22 market close (unless otherwise stated). Produced: 6/23/22 2:53 pm ET; Disseminated: 6/23/22 2:57 pm ET
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countries. Officials who enthusiastically put the sanctions in place—perhaps without fully gauging the consequences for households and businesses—seem loathe to reverse course.

(2) More aggressive, front-end loaded rate hikes: It should be no surprise the Fed has signaled it plans to hike rates aggressively again at its July meeting largely due to persistently high inflation and the upward drift in consumers' medium-term inflation expectations. Following 150 basis points (bps) of rate hikes so far this year, the bond market is currently pricing in roughly another 175 bps of tightening through year-end, which would take the fed funds rate up to 3.5 percent. And it's not just the Fed that is slamming on the brakes—central banks in most developed countries are hiking rates aggressively too. The pace is at roughly four times the typical speed. All of this raises another concern ...

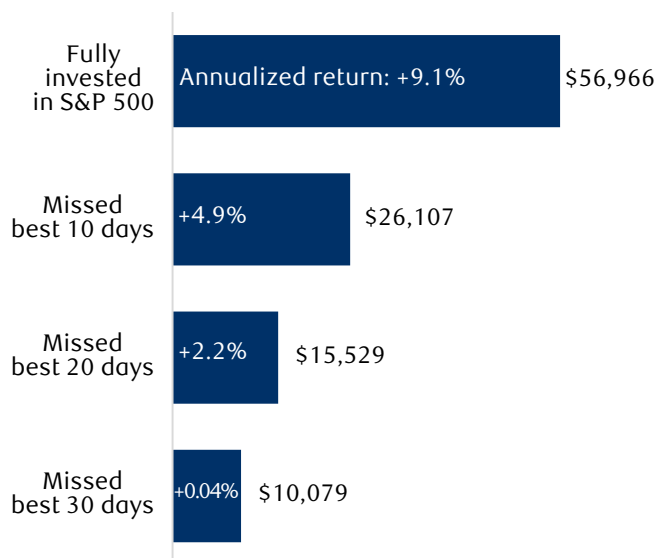
(3) Greater risk of recession: While a U.S. recession looked like a relatively moderate risk in the eyes of RBC's economists just a few weeks ago, this is no longer the case. RBC Global Asset Management Inc. Chief Economist Eric Lascelles recently wrote, "There are a significant number of rules of thumb that suggest a recession is more likely than not over the coming two years. Rate hiking cycles have a strong association with subsequent recessions. A spike in oil prices, as recently occurred, is also associated with subsequent recessions. Lastly, past bouts of inflation this high have all resolved via recession ... Historically, when central banks around the world are hiking rates in synchronized fashion, economic activity has weakened significantly with a lag of 10 months. The intensity of the tightening is now consistent with recession."

(4) A potential hit to earnings growth: If the U.S. economy stumbles or contracts, we would expect corporate earnings to take a hit. In previous recessions, the median S&P 500 earnings decline was 13 percent, although it varied widely and the earnings declines surrounding the three recessions since 2001 were greater.

S&P 500 consensus earnings estimates of Wall Street industry analysts are currently not factoring this in. The consensus forecast is for \$230 per share in 2022 (10 percent growth compared to 2021), and \$252 per share in 2023, according to Refinitiv I/B/E/S. Earnings estimates have drifted higher since January, and growth this year is forecast to be back-end loaded. If a broad slowdown or a recession unfolds later this year or next, we think these estimates would get a haircut. The process could start soon, during the Q2 earnings season which begins in mid-July. The market may have already begun preparing for downward earnings revisions—as evidenced by the swift selloff in the past couple weeks.

Even though profit estimates are vulnerable to retreating, it's important to consider the impact of inflation on revenues. When the economy slows, sales naturally slow too. But in an inflationary environment, selling prices are

Dollar value of \$10,000 invested May 2002 to April 2022



Source - RBC Wealth Management, FactSet; returns based on S&P 500 Total Return Index. Past performance is not indicative of future returns; individuals cannot invest directly in an index.

usually elevated for many products and services. So if inflation stays sticky, and a number of large companies continue to benefit from pricing power, aggregate S&P 500 earnings may not retreat as much this cycle as they would during a non-inflationary slowdown or recession.

Take the long view on volatility

Regardless of whether a recession occurs, we think the U.S. equity market is in the process of factoring one in, rather than just pricing in a mere "growth scare." Whereas the previous four growth scares resulted in S&P 500 declines that averaged 17.4 percent, recessions typically produced deeper and longer-lasting downturns. Surrounding 13 U.S. recessions since 1937, the S&P 500 fell 32 percent and the market took a little over a year to bottom, on average. There was a lot of variation in terms of performance and duration, and a number of the recession periods included unique drivers that shaped the market's path.

We think it's a fruitless exercise for long-term investors to try to time the market and pick the bottom. During all except one of the aforementioned recessions, the S&P 500 bottomed before the recession officially ended, and often when the economic headlines were the scariest. Furthermore, being out of the market on big rally days—which can occur just as abruptly and unexpectedly as big selloffs—can negatively impact long-term returns, as the chart illustrates.

If recession probabilities continue to rise, we think there could be a longer bout of market volatility and more downside before this episode ends. But with the S&P 500 already down more than 20 percent from its peak, it seems much of the weakness has been priced in.

UNITED STATES

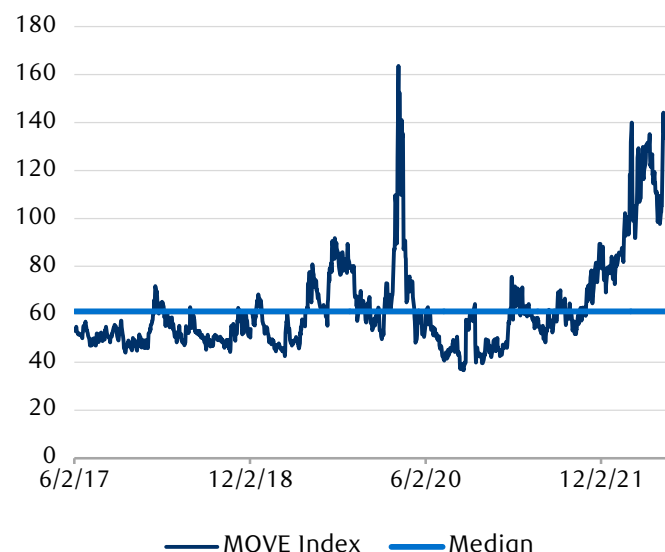
Atul Bhatia, CFA – Minneapolis

■ **Fed Chair Jerome Powell struck a cautious tone on the U.S. economy during congressional testimony.** Powell emphasized the central bank's focus on curtailing inflation through higher rates, even as he acknowledged the risk of Fed policy tipping the economy into recession. Powell's remarks made clear, however, that the central bank is committed to achieving price stability and that it views entrenched inflation as a more significant long-term concern than failing to achieve a so-called soft landing. He did not directly address the potential for the Fed to repeat a 75 basis points (bps) hike at its next meeting, although he did say that market pricing for the path of rate hikes was "appropriate."

■ **Treasury markets responded positively to Powell's comments,** as bond investors priced in a potential economic contraction helping the Fed's anti-inflation fight; yields fell between 3 and 7 bps, depending on maturity, following his testimony. We expect bond prices to remain volatile as we anticipate market focus to slowly shift from inflation to slowing economic growth, an environment that tends to favor government bonds. The MOVE Index—an options-based measure of future volatility—has increased significantly year to date and is now approaching pandemic-era highs, one indication of the high level of economic and market uncertainty.

■ **The U.S. dollar remains strong relative to the currencies of major trading partners.** The U.S. Dollar Index—a roughly trade-weighted basket—is near the highest levels of at least the past five years with both high relative rates and flight-to-quality buyers helping the greenback's year-to-date rally. The stronger dollar is

Economic uncertainty helps push bond volatility higher



Source - RBC Wealth Management, Bloomberg; data through 6/21/22

helpful in the Fed's inflation fight as it allows the U.S. to attract more global supply to meet domestic demand. The U.S. currency rally has created difficulties for energy importers overseas, as they are forced to use more domestic currency to buy dollar-denominated oil and energy assets.

CANADA

Luis Castillo & Simon Jones – Toronto

■ **Canadian CPI inflation is exceeding expectations.** With monetary policy at center stage of the investment world, and policymakers focused on the challenge of bringing multi-decade-high inflation back under control, perhaps no single data point is as impactful as the Consumer Price Index (CPI). Canadian headline CPI inflation hit 7.7% y/y in May, 40 basis points above consensus expectations. Food and energy costs (particularly gasoline prices) continued to be major drivers pushing the headline figure higher. That being said, price increases were broad-based, with none of the major categories decreasing in the month. CPI inflation set another new record, rising to its highest level since 1983. But despite inflation running consistently hotter than expected in 2022, the Bank of Canada appears to have regained a great deal of market credibility regarding its inflation-fighting abilities, as inflation breakevens (a market-implied measure of future inflation expectations) have declined meaningfully over the past three months.

■ **Retail sales rose 0.9% in April according to Statistics Canada, topping the agency's preliminary estimate and the 0.8% consensus forecast.** Sales increased in six of 11 subsectors, led by miscellaneous retailers (+11.3%), general merchandise stores (+4.2%), and gasoline stations (+3.0%). Although Statistics Canada does not provide granular detail on the miscellaneous category, it includes a wide variety of retailers such as office supply & stationary stores, pet stores, and pool retailers. Building material & gardening supply dealers (-4.3%) and furniture & home furnishing stores (-1.1%) were the two categories which saw the largest month-over-month declines, as Canadians appear to be taking a breather from their home improvement projects. Despite persistently high inflation, retail sales were equally strong in volume terms, rising 0.9% during the period.

EUROPE

Thomas McGarrity, CFA & Rufaro Chiriseri, CFA – London

■ **Russia has reduced gas supply in recent days, via the Nord Stream 1 pipeline into Germany, by around 60% amidst the ongoing sanctions dispute and EU restrictions on equipment to support pipeline maintenance.** Overall gas flows into Europe from Russia are down 55% versus the start of 2022, according to RBC Capital Markets.

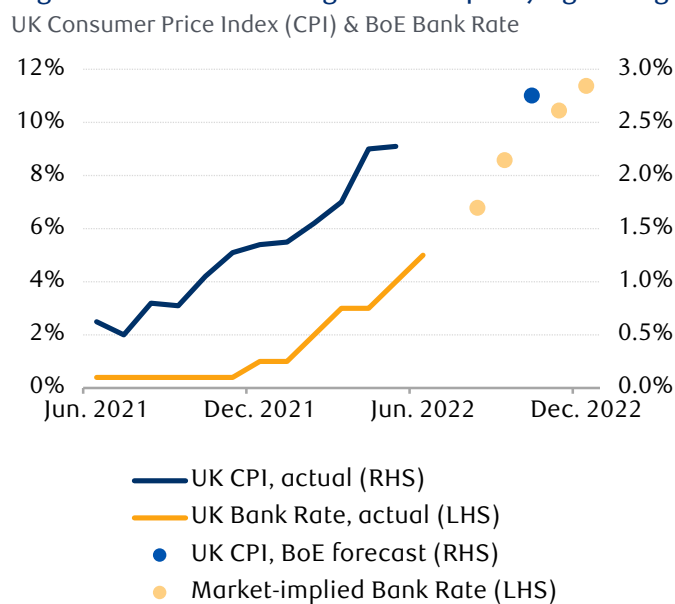
■ **The further material cut of Russian gas flows has caused Germany to trigger stage two (the Alert level) of its three-level gas emergency plan**, which indicates a “significant deterioration” of the gas supply situation, but the market being able to cope without “non-market-based measures.” Intervention measures, such as rationing gas to industrial customers, would only happen should phase three (the Emergency level) be triggered.

■ **Germany’s and the EU’s gas storage facilities are currently 58% and 55% full, respectively.** However, the rate of filling through the summer seems likely to slow materially if Russian gas flows continue to be squeezed. Germany’s economy minister warned that if gas supplies remain at their current low levels, then the country won’t reach its target of getting gas storage up to 90% capacity by December unless additional measures are taken.

■ **One implication of the growing gas crisis is that Germany and other European nations appear to be rethinking coal shutdowns and reopening mothballed coal plants.** While a key element of the REPowerEU plan is to simplify permitting for renewables projects, little appears to have happened in practice on this front.

■ **The continued gas supply issues, coupled with continued supply chain disruptions, are likely key factors** driving the weakening of euro area economic activity indicators and weighing on business sentiment. Despite slowing economic activity, the European Central Bank is set to start hiking the deposit rate next month to combat inflation.

Higher UK inflation leading to further policy tightening



Source - RBC Wealth Management, Bloomberg; as of 9:02 am ET 6/23/22

■ **UK inflation rose to 9.1% y/y in May, in line with consensus.** The Bank of England (BoE) now expects inflation to reach 11% in October when the energy price cap is reset. BoE Chief Economist Huw Pill recently stated that the central bank will need to raise rates “more aggressively” due to the risk of prices developing a “self-sustaining momentum.” He admitted that growth will be sacrificed to combat higher inflation, indicating the delicate balancing act needed in the months ahead.

ASIA PACIFIC

Emily Li – Hong Kong

■ **The Chinese government stressed the importance of boosting China’s economy.** Pro-growth policies under review include front-loading stimulus to accelerate the implementation of existing policies and enhancing the adjustment of macro policies as part of the effort to keep economic growth within a reasonable range. In addition, on June 21, Finance Minister Liu Kun stated that fiscal spending and the sale of special local government bonds are going to be increased. Banks are also being urged to step up lending for infrastructure projects.

■ **The Hong Kong Monetary Authority bought the local dollar at the fastest pace on record this month to defend its currency from weakness.** Although the total has reached HK\$78.1 billion (equivalent to US\$10 billion), the currency remains at the weak end of the 7.75–7.85 per greenback trading range. The downward pressure on the Hong Kong dollar reflects outflows due to a widening interest-rate gap with the United States.

■ **China’s semiconductor chip industry recorded the fastest growth rate in the world despite U.S. sanctions** on local chipmakers/artificial intelligence (AI) players such as Huawei Technologies Co. and Hikvision (002415 CH). Nineteen of the world’s 20 fastest-growing chip companies over the past four quarters were from China. We think the growth indicates the importance of the US\$550 billion semiconductor industry, a sector that plays an outsized role in everything from military defense to the advent of future technologies such AI and autonomous cars.

■ **Bank of Korea Governor Rhee Chang-yong said he is open to the possibility of a larger-than-usual interest-rate hike** as he emphasized the importance of prioritizing the war against inflation. South Korea’s central bank stated that inflation would accelerate beyond the 4.5% annual forecast it gave last month. Shipment data for June showed the country’s trade deficit ballooning to a record, fueling concern about the inflationary pressure coming from a weaker won.

MARKET Scorecard

Data as of June 22, 2022

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,759.89	-9.0%	-21.1%	-11.5%	20.6%
Dow Industrials (DJIA)	30,483.13	-7.6%	-16.1%	-10.2%	17.1%
Nasdaq	11,053.08	-8.5%	-29.4%	-22.5%	9.9%
Russell 2000	1,690.28	-9.3%	-24.7%	-26.4%	17.9%
S&P/TSX Comp	19,004.04	-8.3%	-10.5%	-5.9%	22.5%
FTSE All-Share	3,913.28	-6.9%	-7.0%	-3.3%	13.1%
STOXX Europe 600	405.74	-8.5%	-16.8%	-11.1%	11.9%
EURO STOXX 50	3,464.64	-8.6%	-19.4%	-16.0%	6.9%
Hang Seng	21,008.34	-1.9%	-10.2%	-25.8%	-14.3%
Shanghai Comp	3,267.20	2.5%	-10.2%	-8.2%	10.2%
Nikkei 225	26,149.55	-4.1%	-9.2%	-9.5%	16.5%
India Sensex	51,822.53	-6.7%	-11.0%	-1.5%	48.4%
Singapore Straits Times	3,093.31	-4.3%	-1.0%	-0.5%	17.6%
Brazil Ibovespa	99,522.32	-10.6%	-5.1%	-22.7%	4.4%
Mexican Bolsa IPC	47,144.36	-8.9%	-11.5%	-6.0%	23.7%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	3.156%	31.2	164.6	169.3	244.8
Canada 10-Yr	3.417%	52.6	199.1	201.2	287.3
UK 10-Yr	2.499%	39.8	152.8	171.9	230.6
Germany 10-Yr	1.638%	51.6	181.5	180.2	207.7
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.98%	-3.2%	-11.8%	-11.6%	-11.9%
U.S. Investment-Grade Corp	4.85%	-3.9%	-15.3%	-14.9%	-12.3%
U.S. High-Yield Corp	8.50%	-5.3%	-12.9%	-11.0%	0.5%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,837.48	0.0%	0.5%	3.3%	4.7%
Silver (spot \$/oz)	21.42	-0.6%	-8.1%	-16.9%	20.9%
Copper (\$/metric ton)	8,995.49	-4.8%	-7.6%	-3.0%	53.5%
Oil (WTI spot/bbl)	107.69	-6.1%	39.9%	47.4%	166.2%
Oil (Brent spot/bbl)	110.74	-9.9%	42.4%	48.0%	157.1%
Natural Gas (\$/mmBtu)	6.82	-16.3%	82.7%	109.2%	309.6%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	104.2070	2.4%	8.9%	13.6%	7.4%
CAD/USD	0.7725	-2.3%	-2.4%	-4.9%	4.5%
USD/CAD	1.2944	2.3%	2.4%	5.2%	-4.3%
EUR/USD	1.0566	-1.6%	-7.1%	-11.5%	-6.2%
GBP/USD	1.2267	-2.7%	-9.3%	-12.1%	-1.6%
AUD/USD	0.6931	-3.4%	-4.6%	-8.2%	0.3%
USD/JPY	136.2500	5.9%	18.4%	23.1%	27.4%
EUR/JPY	143.9600	4.2%	10.0%	9.0%	19.6%
EUR/GBP	0.8613	1.1%	2.4%	0.6%	-4.6%
EUR/CHF	1.0162	-1.3%	-2.1%	-7.3%	-4.8%
USD/SGD	1.3871	1.3%	2.8%	3.2%	-0.4%
USD/CNY	6.7023	0.5%	5.4%	3.4%	-5.2%
USD/MXN	20.0444	2.0%	-2.4%	-1.5%	-11.0%
USD/BRL	5.1817	9.5%	-7.1%	4.5%	-1.4%

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.

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Source - Bloomberg; data as of 6/22/22 market close

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As of March 31, 2022

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			Count	Percent
Buy [Outperform]	841	57.68	330	39.24
Hold [Sector Perform]	569	39.03	172	30.23
Sell [Underperform]	48	3.29	3	6.25

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