GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee
September 16, 2021

Germany: A change of tack?

Frédérique Carrier – London

Europe's largest economy may be poised for a shift in its political leadership, with broad implications beyond the country's borders for European Union policies including fiscal integration and economic regulations. We look at the potential impacts on financial markets of various coalition scenarios.

After an important shift in polls, German Finance Minister Olaf Scholz has emerged as the most likely successor to long-serving Chancellor Angela Merkel. The elections held on Sept. 26 will also determine whether a centre-right coalition will continue to lead the world's fourth-largest economy, as it has since 2005. The outcome will shape the future of Europe.

The times they are a-changin'

Until recently, Merkel's party—the centre-right alliance of the Christian Democratic Union and Christian Social Union (CDU/CSU)—had been widely expected to gain the most votes after the elections. But over the past month, the centre-left Social Democratic Party (SPD) has moved into the lead with as much as 25%–27% of the projected vote, while the CDU/CSU languishes at 20%–21%. This is a seismic shift, as the Union parties have never polled less than 30%.

The Social Democrats likely owe this change of fortune to Olaf Scholz, their candidate for chancellor. A highly experienced politician who has held the key post of finance minister since 2018, Scholz played a central role in establishing both the €750 billion EU rescue fund and the recently agreed global minimum tax. Thus, he could be viewed as a continuity candidate. As the leader of the SPD, Scholz would likely usher in an era of fiscal relaxation and greater integration with Europe, though his initiatives could be diluted by coalition partners and the German Constitution.

The complex coalition talks that will take place after the election could be lengthy. Under Germany's proportional election system, in which parties gain parliamentary seats in proportion to the number of votes cast for them, polling suggests a three-way coalition is likely to replace the current two-way coalition of the CDU/CSU and SPD.

If the recent polling is accurate, the SPD could have the opportunity to put a coalition together first. The Green Party, which has established itself as an important mainstream force, is likely to be included in any coalition and would uphold a green agenda. Who is chosen as the third member of the coalition, a centre-right or centre-left party, will be important.

Economic issues facing German voters

The outcome of the election will bear on several headline issues regarding Germany and the future of Europe. The table on the next page summarises the main parties' positions.

The German debt brake: In response to the COVID-19 pandemic, Germany suspended the constitutional mechanism which limits its deficit to 0.35% of GDP

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

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German political parties' platforms: economic policies

	Domestic policies		European policies	
Party	National debt	Taxation	Stability & Growth Pact	Fiscal integration
Christian Democratic & Social Union (CDU/CSU; centre-right)	Reintroduce debt brake; return to 60% debt-to-GDP ratio	Tax burden kept at current level or decreased; cap corporate tax rate at 25%	No softening of rules	**No.** Recovery fund to be one-off; adherence to EU rules; ambiguous on EU tools
Social Democratic (SPD; centre-left)	Not specifically discussed in manifesto	Reduce taxes on lower earners, raise taxes on others; wealth tax	Could be reformed to ensure mechanism is sustainable	**Yes.** EU should have tools including digital and carbon border taxes
Free Democratic (FDP; centre to centre-right)	Reintroduce debt brake; return to 60% debt-to-GDP ratio	Reduce taxes on low/ medium earners, raise taxes on higher earners	Quick return to rules	**No.** Recovery fund must be a one-off; EU should not have tools
Green (centre-left)	Allow expansionary fiscal policy to support a greener economy	Tax to penalise polluters; reduce taxes on lower earners, raise taxes on higher earners; wealth tax	In favour of reform	**Yes.** Permanent fiscal capacity possible; EU should have tools (digital & carbon border taxes)

Note: Beyond the four main parties, the left-wing Linke party commands roughly 6% of the vote; it is pro-spending and pro-Europe. The right-wing populist Alternative für Deutschland (AfD) polls around 12%–13%, but has been ruled out as a coalition partner by all other parties.
Source - RBC Wealth Management

over the budget cycle to ensure sustainable debt. With stimulus ongoing, the country is set to incur fiscal deficits of 7% in 2021 and around 3% in 2022, according to the government.

At issue is whether higher spending should continue. Changing the debt brake rule would require a two-thirds majority in both houses of parliament, which is out of reach. Unless an extraordinary emergency situation is invoked which allows the government to circumvent the 0.35% rule, fiscal policy is likely to remain supportive in the short term, but a change to the debt brake rule is unlikely.

European fiscal integration: German politicians are generally pro-European Union, but have shown little appetite for further integration. However, 2020 was a turning point, with the launch of the €750 billion EU recovery fund and debt sharing. Will the integration go further? The SPD and the Greens are open to the idea, while the CDU/CSU and Free Democratic Party (FDP) aren't.

EU Stability and Growth Pact (SGP): Intended to ensure EU member states pursue sound public finance policies, the pact limits governments' public debt to 60% of their GDP and budget deficits to 3% of GDP. Like the German debt brake, the rules were suspended until 2023 due to the COVID-19 crisis. European debt has grown beyond SGP limits, exceeding 100% of GDP. Given the wide gap between the SGP target and actual debt, the debate centres on whether the rules should be reformed. The SPD and the Greens see value in this, but the centre-right parties, and in particular the frugal FDP, favour enforcement of the existing rules.

One area of common agreement is **climate change**, with all parties calling for climate neutrality by 2050 at the latest—though differing on how to get there, and on the choice of supportive policies.

Most likely scenarios, and tail risk

With less than two weeks until the elections, fragmented voting intention and volatile polls make it difficult to predict the outcome. In our view, investors should be prepared to assess a new German government, possibly without the incumbent CDU/CSU.

If the SPD does indeed lead the formation of a new coalition, its choice of coalition partners will be key. An SPD + FDP + Greens coalition could curb the SPD's spending plans and its inclination towards the further integration of Europe, particularly if FDP leader Christian Lindner makes becoming finance minister the price for aligning his party with the SPD.

A left-wing coalition of the SPD, Greens, and the smaller Left (Linke) Party would be more inclined to spend, though it would be limited by the lack of a supermajority in both chambers. Its impact would more likely be felt in rolling back recent market reforms, a process that could limit German economic growth.

A CDU/CSU-led coalition should not be written off altogether, though it looks less likely at the moment. Such a government would probably be somewhat less inclined to spend, and more cautious towards further European integration.

Investment implications

As financial markets do not yet seem to have focused on the possibility of an SPD-led government, we believe such an outcome could lead Bund yields somewhat higher if additional spending comes into view. Meanwhile, such a government's favourable stance towards further EU integration could reduce spreads between periphery bonds (including those issued by Spain and Italy) and their German counterparts. But whatever the result, we think lengthy coalition-building talks could lead to volatility in European financial markets and put pressure on the euro.

UNITED STATES

Ben Graham, CFA – Minneapolis

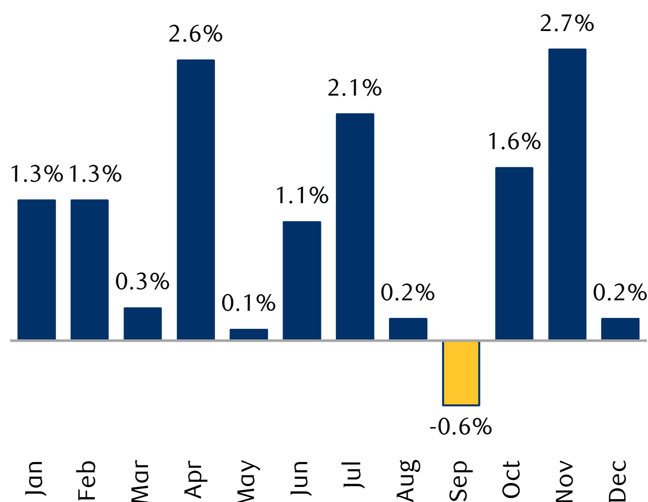
- **U.S. equities have continued their seasonal September slide despite modest gains so far this week.** The Nasdaq and Dow Jones have gained 0.4% this week, while the S&P 500 is up 0.3%; the small-cap Russell 2000 Index has moved just 0.2% higher. Sector leadership has been evident in Energy, which has climbed more than 4%. The next-best performers, however, are well behind with gains of less than 1%; they include Consumer Discretionary, Financials, and REITs. Utilities and Materials stocks are the worst performers so far this week, each declining more than 0.7%.

- For the month, the S&P 500 is down 1.6% so far. In our view, this should not come as a surprise to investors because **September is the only month in which the S&P 500 has delivered losses, on average, since 2010**. Specifically, the index has fallen by an average of 0.6% in September every year since 2010. No other month has been worse than a 0.1% gain, on average, over the same timeframe. However, the silver lining is that September weakness typically has come ahead of the most attractive window of returns: October through February. This five-month window has seen four of the five months deliver returns of 1% or more, on average, highlighted by November's average gain of 2.7%. Fundamentally, we believe this can be attributed to the beginning of a shift in focus to expectations for the year to come, starting with the back-to-school trend, and reflects initial uncertainty giving way to more strongly held convictions as the summer wanes and fall begins in earnest.

- Economically speaking, inflation data was the highlight of the week. **Core CPI climbed 0.1% in August and was 4.0% above 2020 levels. These are both 0.2% lower than consensus expectations**, raising the question of whether softer-than-expected data would be enough to delay the Fed's tapering plans. According to RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli, insofar as inflation relates to the Fed's tapering plans, the central bank is likely to be far less sensitive to small amounts of noise around inflationary data than many outside the bank appreciate. He believes plans for tapering, which appears likely to start in November, remain on track.

Seasonally weak September should come as no surprise

S&P 500 average monthly return since 2010



Source - RBC Wealth Management, FactSet; data through 9/15/21

CANADA

Arete Zafiriou, CFA & Sean Killin – Toronto

- **Canada's labor market continued to recover in August.** Employment rose by 90,000, bringing the labor market just 156,000 jobs shy of its pre-pandemic level in February 2020. **The majority of gains came from the services sector as provinces lifted pandemic restrictions**, allowing businesses to reopen and increase capacity. The accommodation and food services industry led with 75,000 new jobs, most of which came from Ontario, where indoor dining restrictions only eased in late July. On the other hand, the goods-producing sector lost jobs in August as supply chain bottlenecks continued to weigh on manufacturing employment. **The unemployment rate ticked lower to 7.1%**, down significantly from the pandemic peak of 13.7% in May 2020, but still more than 1.0% above the levels of late 2019 and early 2020. The decline corresponded with a decrease in the labor force participation rate, which is the proportion of the working age population that is employed or looking for work.

- **Canada's Consumer Price Index jumped 4.1% in August** from one year earlier. This marks the fifth straight month of inflationary conditions above the Bank of Canada's (BoC) target range of 1%–3% and the highest level since 2003. Inflation and affordability have been topics at the forefront of Canadian politics, with this latest data release coming just ahead of a federal election on Sept. 20. Given well-anchored inflation expectations and considerable slack in the economy, **BoC Governor Tiff Macklem maintains the view that the recent trend of above-target inflation is likely transitory**. Components of the index that saw the largest increases were airplane ticket prices, housing costs, and gasoline prices. The price of gas has risen 32.5% in the last year and investors expect the upward pressure to ease as the industry recovers from Hurricane Ida's impact in the Gulf of Mexico. Global supply chain disruptions as a result of rising COVID-19 cases and a surge in consumer demand have also driven prices up, with many firms passing on the costs to consumers.

EUROPE

Thomas McGarrity, CFA – London

- **The recovery in UK labour market data continues.** In the three months to July, the unemployment rate fell to 4.6%, down from 4.7%, while the number of payrolled employees is back to pre-pandemic levels, according to HMRC payroll data for August, despite GDP still running considerably below the levels prior to the COVID-19 outbreak. The number of vacancies rose to over one million for the first time in the history of the data series. However, **other measures point to there still being a degree of slack** in the labour market, including hours worked and self-employment remaining 4% and 14%, respectively, below pre-pandemic levels.

- **The UK Consumer Price Index (CPI) increased by 3.2% y/y in August**, above consensus expectations for a 2.9% gain and up from a 2.0% rise in July. **Base effects were a key driver of the pickup in inflation**, with half of the 1.2 percentage point upswing coming from restaurants and hotels **lapping the "Eat Out to Help Out" government subsidy scheme** and the value-added tax reduction that led to temporary price reductions in the hospitality sector in August 2020. Other key drivers behind the rise in inflation between July and August, as well as the upside surprise to expectations, came from food, core goods (e.g., household goods, cars), and recreational services.

- **Higher inflation is already factored into the thinking of the Bank of England's Monetary Policy Committee** (MPC), which sees much of the current rise as transitory. The MPC expects inflation to stay higher over the remainder of 2021 and early next year, peaking at 4%, before falling back.

- Due to the above-consensus inflation print and stronger-than-anticipated labour market data, **the market now has higher expectations for an increase in the UK base rate in Q1 2022**. The key to the outlook remains the labour market, specifically if the current tightness translates into an acceleration of wage growth, in addition to how the picture is impacted by the UK's furlough scheme ending at the end of this month. The health of the UK labour market post the furlough wind-down will be clearer for the MPC to assess in Q1 2022 because of data lags. Accordingly, our base case is for the MPC to raise the UK base rate in Q2 next year. RBC Capital Markets currently forecasts two rate hikes by the MPC next year, 15 basis points (bps) in May and 25 bps in November.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- The Asia Pacific equity market traded lower during the week, dragged down by Hong Kong and China. **Share prices of Chinese casino operators and internet names fell sharply this week.**

Share prices of Macau casino operators fell sharply

Bloomberg Intelligence Macau gaming market index

Source - RBC Wealth Management, Bloomberg; daily data through 9/16/21

- **Beijing is moving to tighten its grip on the world's biggest gambling hub, Macau.** According to a document up for public consultation, the government is looking at **appointing representatives to "supervise" the casino operators** as well as boosting local shareholdings and tightening controls on the distribution of dividends. While few details were provided in Tuesday's announcement, **the overall approach indicates a level of scrutiny not previously seen in Macau**. The Bloomberg Intelligence index of the six big casino operators in Macau fell 23% on Wednesday, the biggest slide since its inception in 2005. Following the recent crackdown on the technology and education sectors, we believe the new focus on casinos represents another source of uncertainty for investors.

- According to a Bloomberg report, **China's National Press and Publication Administration is reassessing gaming titles submitted for approval** by developers to ensure they comply with fresh curbs on playing time and other anti-addiction safeguards unveiled in August. The watchdog turned back applications around late August and asked developers to resubmit titles with the new mandatory measures built in. The adjustments have revived painful memories among investors of a 10-month freeze on game monetization licenses in 2018. The South China Morning Post reported that **NetEase (9999 HK) has started to scale down some of its studios and projects** since early September amid the crackdown on gaming. We believe a protracted delay in game approvals is likely to weigh on the gaming sector, which depends on the launch of new titles to sustain growth and draw in new users.

MARKET Scorecard

Data as of September 16, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,473.75	-1.1%	19.1%	32.1%	49.2%
Dow Industrials (DJIA)	34,751.32	-1.7%	13.5%	24.0%	28.3%
Nasdaq	15,181.92	-0.5%	17.8%	37.4%	86.2%
Russell 2000	2,232.91	-1.8%	13.1%	43.8%	40.9%
S&P/TSX Comp	20,602.10	0.1%	18.2%	26.4%	23.0%
FTSE All-Share	4,051.44	-1.4%	10.3%	19.3%	0.6%
STOXX Europe 600	465.95	-1.0%	16.8%	24.9%	19.6%
EURO STOXX 50	4,169.87	-0.6%	17.4%	24.9%	18.5%
Hang Seng	24,667.85	-4.7%	-9.4%	-0.2%	-9.1%
Shanghai Comp	3,607.09	1.8%	3.9%	9.8%	19.0%
Nikkei 225	30,323.34	8.0%	10.5%	29.2%	37.9%
India Sensex	59,141.16	2.8%	23.9%	50.5%	59.3%
Singapore Straits Times	3,064.54	0.3%	7.8%	22.3%	-4.4%
Brazil Ibovespa	113,794.30	-4.2%	-4.4%	14.2%	9.8%
Mexican Bolsa IPC	52,192.33	-2.1%	18.4%	42.1%	21.8%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.334%	2.6	42.1	63.8	-51.2
Canada 10-Yr	1.235%	1.9	55.8	66.1	-24.7
UK 10-Yr	0.817%	10.3	62.0	60.6	12.3
Germany 10-Yr	-0.302%	8.1	26.7	18.2	17.8
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.42%	0.3%	-0.4%	0.1%	19.4%
U.S. Investment-Grade Corp	1.97%	0.5%	0.3%	2.6%	27.3%
U.S. High-Yield Corp	3.75%	0.5%	5.0%	10.8%	23.3%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,752.04	-3.4%	-7.7%	-10.6%	16.9%
Silver (spot $/oz)	22.89	-4.2%	-13.3%	-15.7%	28.2%
Copper ($/metric ton)	9,608.00	0.8%	24.0%	41.4%	64.4%
Oil (WTI spot/bbl)	72.61	6.0%	49.6%	80.8%	15.4%
Oil (Brent spot/bbl)	75.66	3.7%	46.1%	79.2%	9.6%
Natural Gas ($/mmBtu)	5.29	20.9%	108.5%	133.5%	97.4%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	92.8500	0.2%	3.2%	-0.4%	-5.8%
CAD/USD	0.7884	-0.5%	0.4%	3.9%	4.4%
USD/CAD	1.2684	0.5%	-0.3%	-3.7%	-4.2%
EUR/USD	1.1769	-0.3%	-3.7%	-0.4%	7.0%
GBP/USD	1.3795	0.3%	0.9%	6.4%	11.0%
AUD/USD	0.7294	-0.3%	-5.2%	-0.2%	6.2%
USD/JPY	109.7400	-0.3%	6.3%	4.6%	1.5%
EUR/JPY	129.1600	-0.6%	2.4%	4.2%	8.6%
EUR/GBP	0.8532	-0.6%	-4.5%	-6.4%	-3.6%
EUR/CHF	1.0915	1.0%	1.0%	1.6%	-0.1%
USD/SGD	1.3454	0.0%	1.8%	-1.0%	-2.2%
USD/CNY	6.4576	0.0%	-1.1%	-7.0%	-8.6%
USD/MXN	19.9438	-0.6%	0.1%	-4.8%	2.6%
USD/BRL	5.2669	2.2%	1.3%	39.4%	29.1%

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 4:35 pm ET 9/16/21

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Rating	Count	Percent	Count	Percent
Buy [Outperform]	787	55.70	318	40.41
Hold [Sector Perform]	575	40.69	173	30.09
Sell [Underperform]	51	3.61	4	7.84

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