GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee December 7, 2023

Not living on borrowed time

Atul Bhatia, CFA – Minneapolis

Yes, the U.S. is facing a mountain of debt. No, the sky is not falling, despite media hand-wringing. With financial markets taking the U.S.'s deteriorating fiscal position in stride, we unpack the U.S. debt dilemma and argue that positioning portfolios for a U.S. debt crisis is likely to lead to subpar returns.

Late last year, we expressed a relatively sanguine view on U.S. debt levels. Since then, the U.S. fiscal position has undeniably deteriorated: debt-to-GDP has moved higher, debt servicing costs increased, and the Congressional Budget Office's projected fiscal balances shifted deeper into deficits. In short, the U.S. has more debt, more expensive debt, and is adding to the burden at a faster pace. Rating agencies have taken note, with fiscal policy and government dysfunction causing the U.S. to lose its AAA status.

At least for now, however, markets are shrugging off the news. As of Dec. 6, equity and bond markets were higher on the year, and the dollar had appreciated against trading partner currencies—a strange result if investors were worried about rising U.S. government credit risk.

We expect this behavior to continue and for asset prices to ignore U.S. debt levels. Longer-term, we continue to believe that investment plans built around any potential U.S. debt crisis are likely to underperform a balanced portfolio by significant amounts.

What gets (mis)measured gets (mis)managed?

The federal government has an astonishing $33 trillion in debt. Even after eliminating borrowing between various government agencies and adjusting for the growth of the economy, the only comparable debt in modern U.S. history was after World War II.

But that particular measurement—debt owed directly by the U.S. government to investors—is not the only measure of financial leverage in the overall economy. Households, banks, local governments, and non-financial corporations all rely on borrowed money to varying extents. And in these other areas, the U.S. doesn't look so bad.

This borrowing by lower-level entities has two impacts on a nation's financial balance.

One is the direct impact. Borrowing by households, for instance, tends to reduce future consumption as resources are diverted to debt servicing. At a macro level, there is little difference if GDP growth is under pressure from debt-laden governments or over-leveraged households—the economic risk and pain are substantially the same.

The other concern is that in a crisis this non-government debt will ultimately have to be backed by the entire nation and, as such, should be viewed as contingent obligations of the central government. The quintessential example, in our view, is the global financial crisis, when bank and household mortgage debt was effectively backstopped by an alphabet soup of government programs.

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

For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

Priced (in USD) as of 12/6/23 market close (unless otherwise stated). Produced: 12/7/23 3:06 pm ET; Disseminated: 12/7/23 3:15 pm ET

While we don't see a repeat of 2008 in the offing, we do think it's important to contextualize debt data between countries. Germany's federal debt is extremely low by international standards, but its banking system liabilities relative to GDP nearly triples that of the U.S. China is a net creditor at the national level, but the picture shifts when including substantial municipal and local government debt—a factor in Moody's recent decision to shift to a negative outlook on the world's second-largest economy. Closer to the U.S., Canada's federal debt is low, but households have built up a substantial debt burden—nearly 50 percent larger than the U.S. numbers adjusted for GDP.

Ignoring these liabilities and focusing only on central government debt ignores the similarities in the day-to-day impact of leverage on the broader economy, and also ignores the potential for a rapid and unforeseen increase in national debt in a crisis.

What you see is what you get

Say what you will about the U.S. appropriations process, it's an open book. This transparency is another underappreciated strength of the U.S. in terms of debt crisis risk.

Financial crises tend to arise when there is a rapid, unforeseen event. Problems with a long lead time tend to get resolved with adjustments instead of shocks. And this is what we see as likely: a gradual shift toward fiscal balance as the cost of debt funding erodes the value of tax cuts and higher spending.

Better before it gets worse

Even though we think a gradual adjustment is likely, we don't expect it to be anytime soon.

To begin with, not many people really care about fixing the problem. Surveys of even self-described fiscal hawks show that when it comes to ranking policy choices, debt reduction falls below tax cuts and identifiable spending priorities. In short, everyone wants debt reduction if someone else makes the sacrifice. That's a political non-starter.

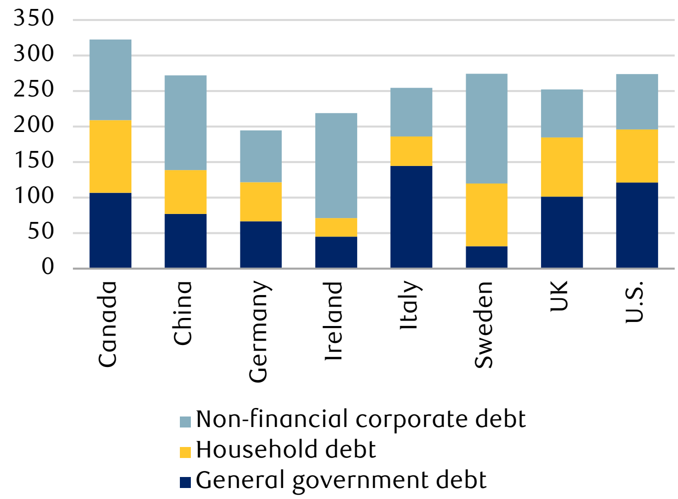
The overarching problem with pushing for lower debt levels is the near-total lack of evidence on what debt level creates problems for countries that issue bonds in their own currency. The best evidence we have is negative: Japan shows us that debt-to-GDP over 200 percent is not incompatible with low interest rates and low perceived default risk. Beyond that, we are in terra incognita.

The healthiest canary in the flock

This lack of empirical data cuts both ways. It makes it perfectly plausible to argue that the U.S. is on the cusp of losing investor confidence because of its large stock of outstanding debt.

In a broader sense, the U.S. is not so different after all

Debt including bonds, loans, and debt securities as percentage of 2022 GDP



Source - International Monetary Fund

For investors who remain convinced that a U.S. debt crisis is inevitable, we think bond financing markets are one clear indicator that there is no imminent concern.

Most bonds are financed using repurchase agreements, more commonly known as repos. A repo is essentially a short-term loan with bonds offered as collateral. Most repo loans are repaid within a day, meaning that lenders typically risk millions of dollars of cash to earn mere hundreds of dollars in interest. Odds like that tend to focus the mind on collateral quality, to say the least.

In repo markets, across all the different bond issuers, U.S. Treasuries are the preferred asset type for most lenders. Borrowers with Treasury collateral, broadly speaking, can borrow more and pay less than investors who offer other bonds as security. We see repo lenders as having the best claim to "canary in the coal mine" status for U.S. credit risk, and they are chirping happily as far as we can see.

No there, there

For at least 40 years, we have been hearing how U.S. fiscal imbalances are unsustainable. And for all that time those imbalances have been sustained, the U.S. economy has grown, and financial markets have generated positive returns.

Given this outcome, we find it somewhat surprising that the press continues to attach so much importance to U.S. debt levels. People generally focus on strategies that have worked, and this input has been an unmitigated failure for decades. We think that history is likely to continue and that positioning for a U.S. debt crisis is likely to lead to subpar returns.

UNITED STATES

Alan Robinson – Seattle

- **U.S. stock indexes have traded in narrow ranges**, just below their 2023 highs, during the first full week of December. As pressure from year-end tax-loss selling abated, sentiment turned more positive, with market bulls pointing to a higher likelihood of a soft landing for the economy in 2024. This was in contrast to the recessionary concerns that saw stocks hit a six-month low near the end of October.

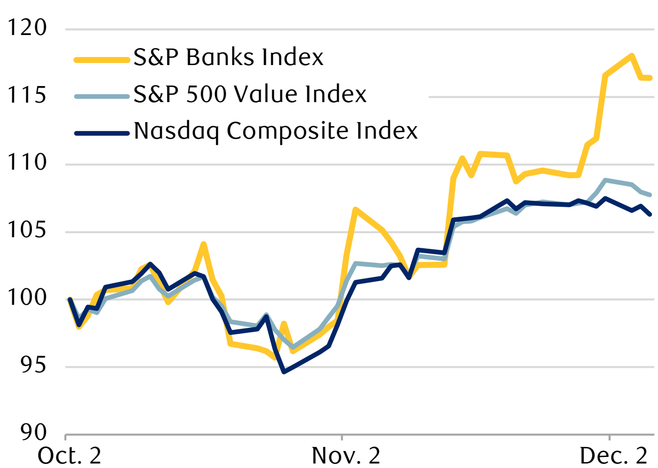
- **Generally tepid economic data reported during the week** buoyed the market, as traders saw this as evidence of a gradually slowing economy that might trigger interest rate cuts from the Fed sooner rather than later. October factory orders were down 3.6% m/m, but the services sector looked a little healthier as the ISM Services Purchasing Managers' Index beat consensus forecasts with a 52.7 result. A reading below 50 indicates a contraction.

- **Economists pored over employment-related data** in advance of the monthly payrolls report due Dec. 8. The JOLTS report showed far fewer job openings than expected, and unit labor costs for Q3 2023 were down 1.2% q/q. The ADP private payroll report also missed forecasts, with only 103,000 new jobs, as the once-buoyant leisure and hospitality segment posted job losses. This data added to the cooling-economy narrative pushing interest rates lower.

- **The Banks sector was in focus** during the week as commentary from industry conferences and testimony to lawmakers by bank CEOs persuaded traders that the recent selloff in bank stocks might be overdone. According to bank bosses, the consumer is still healthy even if spending is slowing, the credit landscape is manageable, and an economic soft landing is still in the cards. These executives also warned lawmakers that further regulatory pressure would harm the broad economy. This shift in narrative has seen bank stocks handily outperform value stocks and the Tech sector in recent weeks (see chart).

Banks vault above the market as investors reassess risks

Relative performance around the Q4 2023 low



Source - RBC Wealth Management, FactSet; daily closing data normalized with 10/2/23 = 100

CANADA

Matt Altro & Richard Tan, CFA – Toronto

- **The Bank of Canada (BoC) maintained its 5% overnight policy rate** at its Dec. 6 meeting. This continued pause was driven by recent data showing a weak economic backdrop, including a 1.1% annualized contraction in GDP in Q3 and unemployment ticking higher despite core inflation measures that are still above the 1%–3% BoC target range. Furthermore, the central bank has concluded that as of Q4 demand pressures are easing within the economy, implying that monetary policy has been doing its job. Despite this, wage growth remains resilient in the 4%–5% y/y range, but further softening of the labour market should work against it. All in, inflation has been softening within Canada given incrementally weaker data points, but it is important to be aware that the central bank has not softened its tone and remains vigilant of any potential shifts in trends.

- **The diversified Canadian banks have rallied 4%, on average, since Q4 2023 results were announced.** At first glance, earnings were mixed with half the group exceeding consensus expectations while the remainder were modestly below. However, we note that Q4 typically comes with a higher degree of noise due to one-time events such as restructuring costs (e.g., company layoffs). The group also continued to build reserves ahead of a slowing economic outlook and an environment where many households will be renewing mortgages at significantly higher interest rates. On the flip side, we are comforted that a few banks posted declines in negatively amortizing mortgages, and most were able to increase their dividends. Overall, we believe bank stocks come with attractive and sustainable dividend yields, and valuations have priced in a degree of economic softness in the year ahead. We expect volatility to persist in the coming quarters, but we would be comfortable if income-oriented investors added incremental positions.

EUROPE

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Expectations regarding European Central Bank (ECB) action have swung sharply during the week**, with markets now anticipating the current deposit rate of 4% being cut several times in 2024. Markets are pricing in a greater than 60% probability of a cut next March, and an interest rate of 2.6% at the end of 2024. Two weeks ago, they expected the rate to close out 2024 at a much higher 3.2%.

- Markets interpreted comments from normally hawkish ECB board member Isabel Schnabel, to the effect that further interest rate increases might not be necessary, as a major turning point. She pointed out that **macro data in Europe continues to signal weakness, and November inflation dropped to 2.4%** year over year.

- **The rapid shift in interest rate expectations puts an additional spotlight on the ECB's Dec. 14 meeting.** So far, the central bank's position has been that interest rates would be kept at current levels for some time. Wage growth of 4% is inconsistent with the ECB's 2% inflation target and the risk of potential oil price increases due to war in the Middle East. With market expectations having moved so quickly, ECB President Christine Lagarde's comments regarding the bank's future course of action will be under increased scrutiny. The quandary remains: cutting interest rates too soon risks inflation flaring up, but maintaining elevated rates for too long risks a deeper economic slowdown.

- **The growing narrative in favor of interest rate cuts in 2024 has kept European equities hovering around four-month highs**, and up over 10% in euro terms since their October lows. The rally has been led by rate-sensitive parts of the market, including Real Estate and Retail, as well as long-duration technology-related stocks.

- The forward 12-month price-to-earnings ratio of the STOXX Europe ex UK Index rerated from 12.2x at the end of October to around 13.5x currently. It remains below the index's 10-year median average of 14.7x.

- **Should the ECB adopt a more lenient stance, we think European equities could continue to rerate.** In our view, absent a sustained bond rally, the valuation discount relative to history may persist given the earnings risks that currently exist, particularly for cyclicals.

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Moody's Investors Service**, one of the big three global credit rating agencies, **downgraded the outlook for China's government credit rating to negative** from stable on Tuesday. The agency said the move was mainly due to concerns the central government may increase financial support to local governments and state-owned enterprises. This reflects challenges posed by slower medium-term economic growth and a cooling property market.

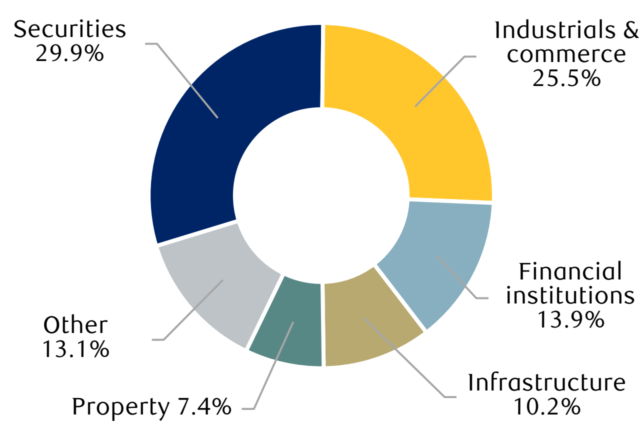
- **The rating agency also reduced the credit rating outlooks for Hong Kong and Macau to negative from stable**, reflecting their political, financial, and economic ties to China. Sentiment towards China and Hong Kong equities has remained sluggish during the week, partially affected by the downgrade.

- **Moody's concerns are well-known in the market, in our view.** Many investors' anxieties center on local governments' debt burden and recent turmoil in China's trust industry. We acknowledge that these issues are worrisome and reflect the slowing property market and economic growth exerting pressure on local government revenue and parts of the financial industry. However, we don't anticipate systemic financial risks.

- **Many local governments, despite being heavily indebted, hold substantial real assets.** We estimate that local government assets totaled roughly RMB 240 trillion by the end of 2021, far exceeding their liabilities of around RMB 100 trillion. Local governments could monetize some infrastructure such as roads and bridges to generate revenue, providing an additional financial buffer.

- **Regarding companies in the trust industry, financial conglomerate Zhongzhi Enterprise Group's recent missed payments to investors might not be the last such instance.** However, financial regulators have been curbing trust and shadow-banking lending since 2017. Trust industry assets account for just 5% of China's total financial system assets. Investment exposure of trust companies to the property market is only around 7% of total trust investment as of Q1 2023. Therefore, the likelihood of a trust industry problem leading to a systemic financial crisis remains low, in our view.

China trust companies investment mix



Source - China Trustee Association, RBC Wealth Management; data as of March 2023

MARKET Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,549.34	-0.4%	18.5%	15.4%	-0.9%
Dow Industrials (DJIA)	36,054.43	0.3%	8.8%	7.3%	2.3%
Nasdaq	14,146.71	-0.6%	35.2%	28.4%	-7.1%
Russell 2000	1,852.05	2.4%	5.2%	2.2%	-15.9%
S&P/TSX Comp	20,274.21	0.2%	4.6%	1.4%	-2.8%
FTSE All-Share	4,096.16	1.0%	0.5%	-0.4%	-0.5%
STOXX Europe 600	470.06	1.8%	10.6%	7.1%	0.3%
EURO STOXX 50	4,483.26	2.3%	18.2%	13.8%	8.4%
Hang Seng	16,463.26	-3.4%	-16.8%	-15.3%	-29.5%
Shanghai Comp	2,968.93	-2.0%	-3.9%	-7.6%	-17.3%
Nikkei 225	33,445.90	-0.1%	28.2%	19.9%	19.8%
India Sensex	69,653.73	4.0%	14.5%	11.2%	22.7%
Singapore Straits Times	3,087.24	0.5%	-5.0%	-5.1%	-0.9%
Brazil Ibovespa	125,622.65	-1.3%	14.5%	14.0%	17.6%
Mexican Bolsa IPC	54,100.37	0.1%	11.6%	6.0%	6.9%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.104%	-22.2	22.9	57.3	267.0
Canada 10-Yr	3.282%	-27.2	-1.8	50.7	175.7
UK 10-Yr	3.943%	-23.3	27.1	86.7	320.5
Germany 10-Yr	2.200%	-24.7	-37.1	40.0	258.8
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.86%	1.2%	2.8%	1.4%	-10.8%
U.S. Investment-Grade Corp	5.42%	1.3%	5.3%	3.4%	-11.5%
U.S. High-Yield Corp	8.26%	0.6%	10.0%	8.9%	-1.1%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	2,026.03	-0.5%	11.1%	14.4%	13.9%
Silver (spot $/oz)	23.92	-5.3%	-0.1%	7.8%	6.9%
Copper ($/metric ton)	8,252.75	-1.6%	-1.3%	-1.6%	-13.7%
Oil (WTI spot/bbl)	69.38	-8.7%	-13.6%	-6.6%	-0.2%
Oil (Brent spot/bbl)	74.30	-10.3%	-13.5%	-6.4%	1.7%
Natural Gas ($/mmBtu)	2.57	-8.2%	-42.5%	-53.0%	-29.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	104.1530	0.6%	0.6%	-1.3%	8.1%
CAD/USD	0.7357	-0.2%	-0.3%	0.5%	-6.1%
USD/CAD	1.3592	0.2%	0.3%	-0.4%	6.6%
EUR/USD	1.0767	-1.1%	0.6%	2.9%	-4.6%
GBP/USD	1.2560	-0.5%	3.9%	3.5%	-5.3%
AUD/USD	0.6551	-0.8%	-3.8%	-2.0%	-7.1%
USD/JPY	147.2800	-0.6%	12.3%	7.5%	29.8%
EUR/JPY	158.5800	-1.7%	12.9%	10.6%	23.8%
EUR/GBP	0.8573	-0.6%	-3.2%	-0.6%	0.8%
EUR/CHF	0.9416	-1.2%	-4.9%	-4.5%	-9.9%
USD/SGD	1.3418	0.3%	0.2%	-1.3%	-2.0%
USD/CNY	7.1606	0.4%	3.8%	2.4%	12.3%
USD/MXN	17.2849	-0.6%	-11.4%	-12.6%	-18.6%
USD/BRL	4.9026	-0.3%	-7.2%	-6.4%	-13.8%

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 -0.3% return means the Canadian dollar fell 0.3% vs. the U.S. dollar year to date. USD/JPY 147.28 means 1 U.S. dollar will buy 147.28 yen. USD/JPY 12.3% return means the U.S. dollar rose 12.3% vs. the yen year to date.

Source - Bloomberg; data as of 12/6/23

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