June 20, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

The fast and the furious

Tom Garretson, CFA – Minneapolis

Major central banks have recently signaled their readiness to play a more active role in maintaining the economic expansion. With the possibility of quick policy maneuvers ahead, we look at the potential impact of interest rate cuts on equities and fixed income investments.

For investors wondering if major central banks had any gas left in the tank, with policy rates still historically low and balance sheets still historically large, the Federal Reserve and the European Central Bank (ECB) both delivered clear messages the week of June 17: we do, and we're prepared to use it.

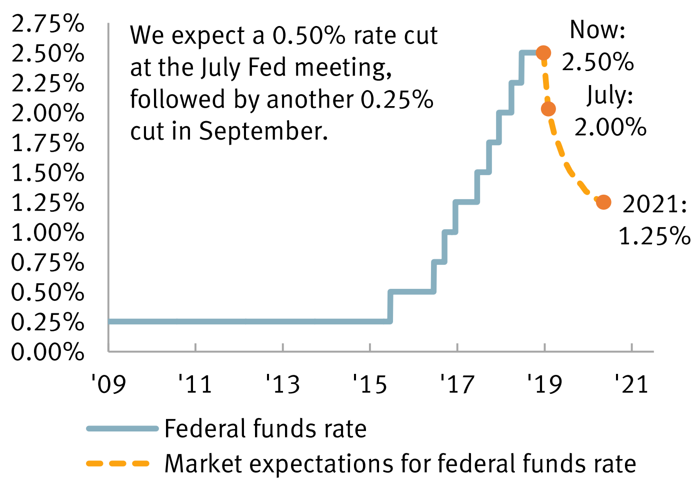
ECB President Mario Draghi seized the pole position June 17 in a speech that signaled further easing via rate cuts into negative territory could be on the table, and that there remains "considerable headroom" to scale up quantitative easing programs if necessary—a remarkable change in tone from a central bank that has recently pushed back against the idea that further easing was needed.

The Federal Reserve's pledge to stay "patient" this year with respect to adjusting policy rates was barely three months old when it was dropped at the June 19 meeting, with the Fed now stating that it "will act as appropriate to sustain the economic expansion." Additionally, eight officials—nearly half the committee—now foresee at least one rate cut this year, with seven of those envisioning two cuts.

We have long expected the Fed to dust off its playbook of the mid-1990s, when it cut policy rates modestly for "insurance" in the middle of the economic cycle in an effort to extend the expansion rather than to fight a recession, and this remains our base case for the current cycle.

Therefore, we view potential policy easing in a positive light, and the market's initial reaction appears to be agreement as the S&P 500 has reached a new all-time high, while U.S. investment-grade and high-yield corporate debt has rallied strongly.

The U.S. rate hike cycle likely to come to a swift end



Source - RBC Wealth Management, Bloomberg; market expectations based on forward rates

Market pulse

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Priced (in USD) as of 6/20/19 market close, EST (unless otherwise stated).
For important disclosures and required non-U.S. analyst disclosures, see **page 7**

But with the market now pricing a 100% chance of a Fed rate cut this year, the only questions left are how soon, and by how much?

Time for decisive action on interest rates

Though the Fed has made the most progress among major central banks in raising rates, reaching 2.50% on the federal funds rate, there clearly remains little room to maneuver—so this is no time for half measures. To this point the Fed has stuck with its "gradual" approach to raising rates out of concern that moving too quickly could risk a return to 0%. But at this stage, we think a decidedly different approach is called for. To avoid an early return to 0%, the Fed needs to act decisively and quickly to achieve the most "bang for the buck." Accordingly, we now expect the Fed will cut rates by 0.50% at its July meeting and follow up with a further 0.25% cut in September, after which it will likely take time to survey the monetary policy landscape.

The European economy continues to sail into stiff headwinds, and while the ECB was thought to be tacking toward rate hikes next year, RBC Capital Markets now expects two 10-basis point (bp) cuts in the deposit rate by the end of the year (which would take rates to -0.60%) though it too sees a risk that the ECB could move sooner and deeper. With respect to quantitative easing, we believe the ECB is likely to signal that another round is possible, but unlikely to introduce a new program over the near term.

Is this trip really necessary?

In the U.S., labor markets remain solid, though the pace of hiring has slowed in recent months, and the Fed's latest projections actually upgrade the growth outlook and downgrade inflation expectations despite concerns about the potential economic impact of tariffs. So the story is largely about inflation at the present time: with little inflation in the pipeline, the Fed has room to ease policy modestly with little risk of overheating the economy.

But as the chart shows, concerns about global growth are lingering. Manufacturing purchasing managers' indexes (PMIs), which are highly correlated with economic growth, continue to move lower in the U.S. and across the globe; the global index is now below 50, the level that signals a contraction in manufacturing activity. As PMIs have fallen, the market's expectation of rate cuts has risen. On a fundamental level, there is also a case to be made for central banks to ease policy at this stage.

Drive defensively

Our outlook remains constructive—but cautiously so. While the old adage of "don't fight the Fed" (or central banks generally) still holds for those invested in equities and other risk assets, downside risks for the global economy and the level of uncertainty about the outlook are both rising. Therefore, we remain Market Weight with respect to our allocations to U.S. equities and U.S. fixed income, but maintain defensive postures in both.

For fixed income investors, we have long recommended extending maturities to lock in yields, and with rate cuts looming, we continue to recommend this route even as yields across nearly all sectors move lower.

Central banks have tried to take a passive approach in recent years as global economies continued to recover, but we believe now is the time for them to take an active approach to sustain the expansion.

Global manufacturing activity trending lower ...

	Mar 2018	Jun 2018	Sept 2018	Dec 2018	Mar 2019	May 2019
U.S. PMI	55.6	55.4	55.6	53.8	52.4	50.5
Eurozone PMI	56.6	54.9	53.2	51.4	47.5	47.7
Global PMI	53.2	52.9	52.1	51.4	50.5	49.8

... Likelihood of rate cuts trending higher

	Mar 2018	Jun 2018	Sept 2018	Dec 2018	Mar 2019	May 2019
Fed	0%	0%	0%	13%	70%	100%
ECB	0%	0%	10%	9%	10%	88%

Source - RBC Wealth Management, Bloomberg, IHS Markit; manufacturing activity based on Markit Purchasing Managers' Indexes; likelihood of rate cuts in 2019 is market consensus based on federal funds futures data.

Europe in focus

European equity downgrade

Frédérique Carrier – London

With the economies of its largest trading partners slowing, we believe Europe's much-anticipated economic recovery is likely to remain just out of reach for the time being. Valuations are not low enough, in our view, to reflect this, as well as a likely uptick in political tension from difficult U.S./EU auto tariff negotiations, a reinvigorated populist government in Italy, and a potential no-deal Brexit. Accordingly, we have downgraded European equities to Underweight.

The elusive economic recovery

Europe's economy depends heavily on trade. Exports represent a high 44.4% of regional GDP, compared to 30.1% for the U.K, 18.6% for Canada, and 12.1% for the U.S., according to the World Bank. Of those exports, 39% go to Europe's three largest trading partners: the U.K. (16%), the U.S. (15%), and China (8%), according to European Commission data. Hence, slowdowns in the economic growth of major trading partners due to trade tensions and the spectre of a hard Brexit create substantial headwinds for the region.

European economic data, which showed green shoots in the spring, have had a more difficult run recently with most releases falling short of consensus expectations. As a result, the European Central Bank (ECB) has pared back its growth projections for FY 2020 and FY 2021.

We believe consensus corporate earnings growth forecasts will need to be adjusted to reflect this new reality, as they are too high at 8% for this year and 10% for 2020, especially in light of slightly negative Q1 earnings-per-share (EPS) growth for the region.

The ECB has announced it is prepared to take bold steps to support the regional economy should it weaken further. Although interest rates are already in negative territory, RBC Capital Markets now expects two 10 bps rate cuts this year, in September and December. It is also possible that the central bank will relaunch its quantitative easing programme next year.

The ECB's actions are unlikely to remove the key obstacle to the region's growth, in our view: declining trade activity. As discussed in a recent *Global Insight Weekly* article, central banks' ability to boost economic expansion through ever-lower interest rates appears limited, at the margin.

ECB staff lowers 2020 and 2021 growth expectations again

ECB growth projections

	Dec 2018	Mar 2019	Jun 2019
2019	1.7%	1.6%	1.2%*
2020	1.7%	1.1%	1.4%
2021	1.5%	1.5%	1.4%

*Given robust Q1 2019 GDP data, the ECB tweaked upwards its 2019 estimates in June, though that estimate remains below the 1.7% it had calculated for 2019 back in December 2018.
Source - RBC Wealth Management

Political tensions return

On the political front, tensions are likely to increase over the course of the next few months in response to U.S./EU trade negotiations (particularly around the auto sector) and a bolstered populist government in Italy. Following a strong showing for his party in the recent European Parliament elections, Italian coalition government leader Matteo Salvini has resumed talk of breaching EU fiscal rules and issuing a parallel currency. Business sentiment in Italy is likely to deteriorate as this situation develops. Finally, the possibility of a chaotic no-deal Brexit will also test nerves of investors and the business sector.

Equity valuations could be lower

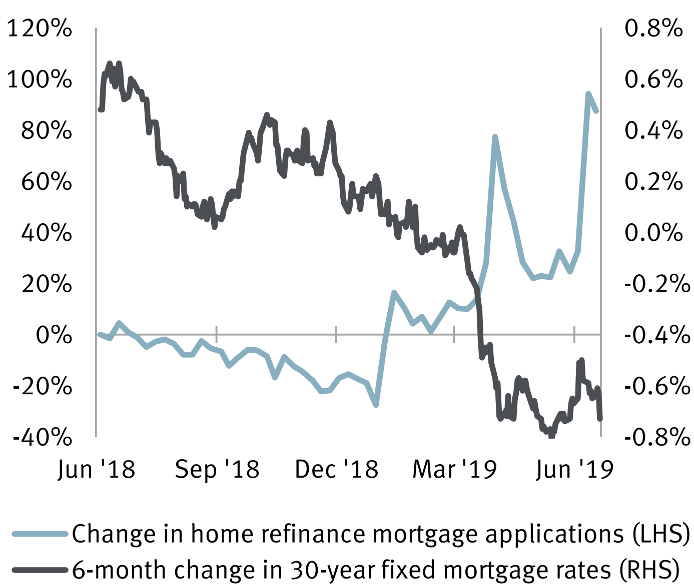
After a strong rally in Q1 which brought its performance in line with the MSCI World Index, the MSCI Europe ex UK Index now trades at 13.1x 2020 earnings, in line with its long term average. Valuations are thus not low enough, in our view, to reflect more mitigated growth prospects and the expected upcoming political noise, supporting our Underweight positioning in European equities.

United States

Bill Kuehn, CFA – Minneapolis

- **The S&P 500 closed at an all-time high** following the Federal Reserve's signal it could cut interest rates. Nevertheless, **sentiment indicators are beginning to crack** amid the ongoing trade dispute with China. The National Association of Homebuilders (NAHB) Sentiment Index fell in June as the **impact of higher costs from tariffs begins to outweigh lower mortgage rates**. A recent study by the NAHB estimated that hundreds of inputs vital to housing are impacted by tariffs, representing $21.4B worth of goods imported from China. The Empire Manufacturing Index and the Philly Fed Business Outlook Survey both **declined sharply in June**, with the Empire Manufacturing Index falling to the lowest levels since 2016. The University of Michigan Sentiment Index, a measure of consumer confidence, declined as consumers' expectations for the future retreated sharply. The decline in sentiment suggests President Donald Trump's **decision to increase levies on imports from China could begin to weigh on spending**, as negative mentions of tariffs were spontaneously made by 40% of respondents, up from 21% in May.
- **Housing data dominated the economic calendar recently**, and despite the continued decline in mortgage rates, **homebuilding activity has yet to increase materially** and is unlikely to contribute meaningfully to economic growth this year. May's **housing starts fell 0.9% m/m** with the decline concentrated in single family homes which fell 6.4%, while multi-family housing starts provided a partial offset, rising 10.9% m/m. While weather is partly to blame for the monthly slowdown, the broader economic environment continues to deteriorate. Trade tariffs have increased building material costs, and a lack of qualified labor continues to impede homebuilding activity.
- The sharp decline in mortgage rates has mainly led to **a spike in refinancing activity** as existing homeowners take advantage of cheaper borrowing costs. Refinancings have led to lower monthly payments for homeowners, which has slightly boosted consumer spending, the largest portion of the economy. **May's retail sales data came in above estimates**, growing 0.5% m/m, and helping to push consensus Q2 GDP estimates higher, with the Atlanta Fed's GDP Now model tracking at 2.0% q/q.

The 73-basis point decline in 30-year mortgage rates has mainly boosted refinancing activity



Source - RBC Wealth Management, Bloomberg; data through 6/20/19

Canada

Richard Tan, CFA & Sayada Nabi – Toronto

- During the week, **the Canadian government reapproved the Trans Mountain Expansion (TMX) project**, an asset purchased on behalf of Canadians for CA$4.5B in 2018. Construction is expected to begin later this summer and, while an official in-service date has not been announced, RBC Capital Markets believes TMX can be completed in 2022 or 2023 if there are no additional delays. Upon completion, the expanded pipeline **will be capable of delivering 890,000 barrels per day**, nearly tripling its current capacity. The Canadian energy market has been plagued by insufficient pipeline capacity, as demonstrated by the discount of Western Canadian Select (WCS) relative to West Texas Intermediate (WTI). The expansion **will provide access to new markets for domestic oil producers and may catalyze further contraction in WTI-WCS spreads**. We believe the TMX can be a positive for the broader Energy sector, though tangible construction progress is key as the project continues to be subject to uncertainties from potential court challenges.
- **RBC Capital Markets conducted its first annual survey to assess Canadian consumer patterns in the realm of e-commerce**. This led to the discovery that although e-commerce has increased convenience and price competition, it **represents a low percentage of overall Canadian retail spending**. The survey revealed that 55% of respondents make 20% or less of their purchases online, and that younger respondents are more likely to shop online. RBC Capital Markets found that sales of books, electronics, movies, music, and toys have shifted to online platforms and believes these products to be more "e-commerce friendly." On the other hand, items that respondents prefer to purchase in stores include mattresses and groceries. Although RBC Capital Markets

recognizes challenges, it **regards e-commerce as a fast-growing part of the retail landscape** and notes that Canadian retailers are focusing long-term investments on the "last mile," as it is quickly becoming a key differentiator.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

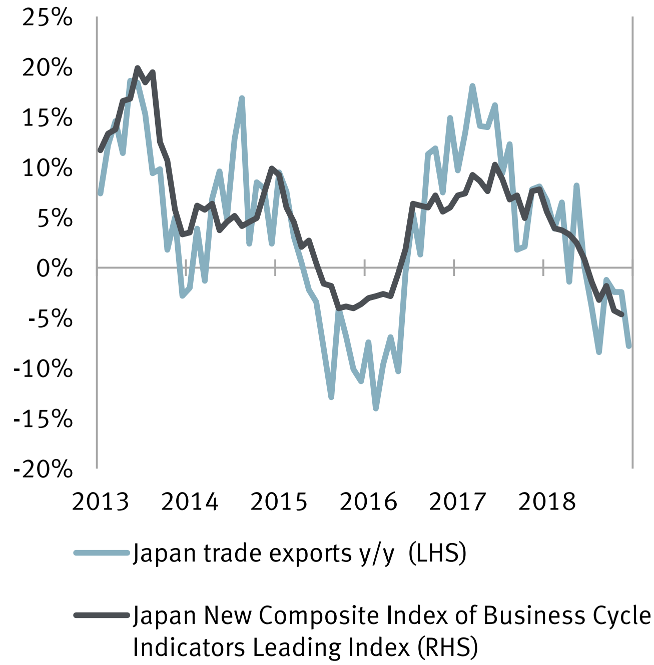
- At the time of this writing, decisions are being made about future U.K. leadership, **as MPs will be narrowing the prime minister candidate list from three to two**. We think former Foreign Secretary **Boris Johnson is almost certain to be one of the two finalists** put to the Conservative grassroot members for selection late next month, given his wide support (157 of 311 votes on the fourth ballot). He is also the favorite to emerge as the winner of the grassroot vote and become the next prime minister, in our opinion.
- **Johnson has toned down his hard-Brexit rhetoric somewhat** since his main hard-Brexit rival, Dominic Raab, was eliminated from the contest. It is **unclear what Johnson actually stands for**, though he is likely to maintain his pledge to reopen the Brexit Withdrawal Agreement and modify the Irish backstop to appeal to members prior to their vote. We believe his main appeal to Conservative members is his capacity to unify his party.
- Whoever emerges **will face the same difficulties as those faced by former Prime Minister Theresa May**, and, should it be Boris Johnson, as discounted in markets, he will have less political capital in Brussels than his predecessor, given his long history of skepticism towards the EU. This will make the prospect of desired renegotiations rather remote, particularly by the tight October 31 deadline.
- **The pound, which reflects Brexit uncertainty, has fallen by as much as 5% against the U.S. dollar since early May**. A comparatively hawkish Bank of England in a globally dovish environment enabled the currency to claw back some of the losses recently.

Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- **U.S. President Donald Trump** confirmed that he **and China's President Xi Jinping will have an "extended" meeting on trade at the G20 summit** in Japan. Trump also mentioned that both countries' respective teams will begin talks prior to the meeting. This is the first positive development since trade talks collapsed in early May. **China's official response was constructive** but more measured, stating that there should be a continuation of open communications.

Japan's exports continue to fall amid global uncertainty, dimming the economic outlook



Source - RBC Wealth Management; Bloomberg; data through 6/20/19

- **Asian equities, especially markets in China and Hong Kong, rebounded after months of escalation in trade tensions**. But we think the **rebound will be constrained**, as the likelihood of the two countries reaching a deal is still questionable. We also don't expect the dispute about trade and technology issues to be resolved completely. We think investors will remain cautious about Asian equities due to those uncertainties.
- The Hong Kong market bounced following the government's suspension of the proposed extradition bill. Chief Executive Carrie Lam won't withdraw the bill, but she also won't proceed unless all concerns can be addressed, and said it is unlikely that would happen during the current legislative session ending next year. The **Hang Seng Properties Index**, which had reacted negatively to the proposed bill due to the economic and political uncertainties surrounding the property sector outlook, **has rallied by 3.9% so far during the week** following the bill's suspension.
- **Japan's exports fell for the sixth straight month** as the trade tensions added to concerns about global demand. The value of shipments abroad fell 7.8% y/y in May. Exports to China continued to decrease, falling 9.7% y/y. Shipments to the U.S. rose 3.3%, while exports to Europe declined 7.1%.

MARKET SCORECARD

Data as of June 20, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,954.18	7.3%	17.8%	6.8%	21.2%
Dow Industrials (DJIA)	26,753.17	7.8%	14.7%	8.5%	24.6%
NASDAQ	8,051.34	8.0%	21.3%	3.5%	30.1%
Russell 2000	1,563.50	6.7%	15.9%	-8.4%	11.4%
S&P/TSX Comp	16,574.83	3.4%	15.7%	0.9%	9.4%
FTSE All-Share	4,054.83	3.3%	10.3%	-3.5%	-0.8%
STOXX Europe 600	386.16	4.6%	14.4%	0.5%	-0.8%
EURO STOXX 50	3,468.08	5.7%	15.5%	0.8%	-2.6%
Hang Seng	28,550.43	6.1%	10.5%	-3.9%	10.5%
Shanghai Comp	2,987.12	3.1%	19.8%	2.4%	-4.9%
Nikkei 225	21,462.86	4.2%	7.2%	-4.8%	6.1%
India Sensex	39,601.63	-0.3%	9.8%	11.4%	26.5%
Singapore Straits Times	3,314.51	6.3%	8.0%	0.0%	2.6%
Brazil Ibovespa	100,303.40	3.4%	14.1%	39.1%	65.1%
Mexican Bolsa IPC	43,645.11	2.1%	4.8%	-6.7%	-11.0%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,386.79	6.2%	8.1%	9.4%	11.6%
Silver (spot $/oz)	15.41	5.8%	-0.5%	-5.4%	-6.4%
Copper ($/metric ton)	5,897.00	1.6%	-0.9%	-12.8%	4.7%
Oil (WTI spot/bbl)	56.65	5.9%	24.8%	-14.5%	31.0%
Oil (Brent spot/bbl)	64.64	0.2%	20.1%	-13.5%	40.5%
Natural Gas ($/mmBtu)	2.21	-9.8%	-24.7%	-25.3%	-23.9%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.027%	-9.8	-65.8	-91.2	-13.0
Canada 10-Yr	1.470%	-1.8	-49.7	-71.3	-3.0
U.K. 10-Yr	0.806%	-8.0	-47.1	-49.1	-18.9
Germany 10-Yr	-0.318%	-11.6	-56.0	-69.5	-58.0
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.53%	0.9%	5.7%	7.9%	6.5%
U.S. Invest Grade Corp	3.26%	1.4%	8.8%	9.9%	8.2%
U.S. High Yield Corp	5.96%	1.7%	9.3%	6.3%	9.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	96.6430	-1.1%	0.5%	1.6%	-1.1%
CAD/USD	0.7575	2.4%	3.3%	0.8%	0.5%
USD/CAD	1.3201	-2.3%	-3.2%	-0.8%	-0.5%
EUR/USD	1.1286	1.0%	-1.6%	-2.5%	1.4%
GBP/USD	1.2701	0.6%	-0.4%	-3.6%	0.6%
AUD/USD	0.6918	-0.3%	-1.9%	-6.1%	-8.7%
USD/JPY	107.3900	-0.8%	-2.1%	-2.7%	-3.6%
EUR/JPY	121.2000	0.2%	-3.7%	-5.1%	-2.3%
EUR/GBP	0.8886	0.5%	-1.1%	1.2%	0.8%
EUR/CHF	1.1082	-0.9%	-1.5%	-3.9%	2.1%
USD/SGD	1.3566	-1.3%	-0.5%	-0.2%	-2.4%
USD/CNY	6.8519	-0.8%	-0.4%	5.8%	0.3%
USD/MXN	19.0327	-3.0%	-3.1%	-6.5%	4.6%
USD/BRL	3.8395	-2.1%	-0.9%	1.8%	15.4%

Source - Bloomberg. Note: 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. Data as of 8:35 pm GMT 6/20/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 3.3% return means the Canadian dollar rose 3.3% vs. the U.S. dollar year to date. USD/JPY 107.39 means 1 U.S. dollar will buy 107.39 yen. USD/JPY -2.1% return means the U.S. dollar fell 2.1% vs. the yen year to date.

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As of March 31, 2019

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Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	794	54.01	202	25.44
Hold [Sector Perform]	589	40.07	107	18.17
Sell [Underperform]	87	5.92	5	5.75

Ratings:

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