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Market and Investment Commentary February 2019



Wealth Management
Domestic Securities



Stocks Recover as Earnings Season Continues

Global equity and corporate bond markets rebounded sharply in January on dovish comments from the Federal Reserve and due to decent earnings reports in the U.S. While the earnings reports are mixed and there are still clear signs of slowing global growth, the markets are now pricing in no change in interest rates in both Canada and the U.S. (according to Bloomberg, as of February 5). One reason for the the Federal Reserve's moderation in tone could be that inflation measures are cooling as recent indicators have shown that input prices have pulled back sharply.

Canadian equities rose +8.74% in the month while U.S. equities in Canadian dollars increased by +3.86%. Canadian bonds rallied +1.34% during the month. While investors are breathing a sigh of relief after the December carnage, some questions remain.

The reason for the market sell-off in December is still not clear

While there are many offered explanations for the fourth quarter sell-off, it is not clear which one is correct or if it is a combination of factors. However, the equity and credit markets were definitely sending signals that conflicted with many commonly monitored economic indicators, especially those that factor in the U.S. Federal Reserve's calculations. The Federal Reserve is engaged in a balancing act between equity markets that were pricing in a recession, and economic data that is still signaling no imminent U.S. recession.

Is the Federal Reserve Making a Policy Mistake?

The easiest explanation for the sell-off is that the Fed's aggressive rate hiking policy is disconnected from reality. Jerome Powell stated in an October speech that we are not close to a neutral rate and further gradual rate hikes are warranted. He has since spoken publicly on a number of occasions and has delivered different messages and the

market has reacted sharply to each one. The market does not like uncertainty, and given the frequent comments from White House officials and other Fed governors, the mixed messages are spooking investors. It comes to a point where there is just too much communication. The Fed is focused on using unemployment and inflation to measure the health of the U.S. economy and to determine where rates should go. Both of which would support a case for further rate hikes. The problem might be that Jerome Powell is not making a policy mistake, but rather that he may not be communicating properly. In his December and January speeches, he has now moved to the position that the Fed will be patient and attentive to the messages given by the equity markets. The markets rallied on these comments.

Slowing Global Growth is Exacerbated by the U.S.-China Trade Spat

It is very easy to say that U.S. economic fundamentals are strong if we focus on low unemployment and stable inflation. However, many leading indicators have started to turn and there are clear signs that tariffs and weakening confidence have hit business investment. The ISM Purchasing Managers Index is one of the most reliable indicators since it is a survey of corporate supply chain managers and provides a great indication of what business are seeing. The ISM U.S. Manufacturing PMI turned sharply lower in December, coming in below expectations. The new orders component decreased significantly demonstrating that companies are seeing fewer customer orders than previous months. When the December durable goods number is finally released (delayed due to the government shutdown), it is expected to continue to reflect the downturn in manufacturing which started in August of last year. There is no doubt that companies are starting to point to tariffs as a cause for slowing orders and rising input costs.

The deceleration in manufacturing is not limited to the

U.S.; Europe, China and other emerging markets are all experiencing a similar slowdown. Even though the U.S. economy has proven resilient while other developed and emerging economies have struggled, there is a persistent fear that there is only so far the U.S. can go at it alone and that any global slowdown will eventually spill over.

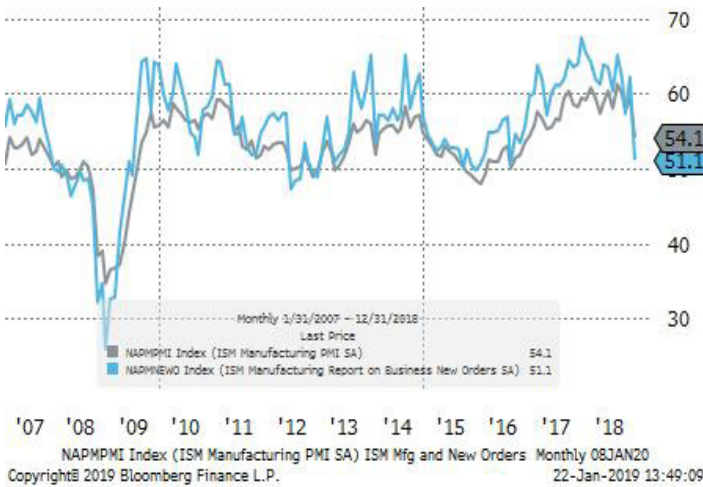


Figure 1 - The ISM Manufacturing PMI (grey) shows a sharp deceleration at both the aggregate level and in new orders (blue). Source: Bloomberg

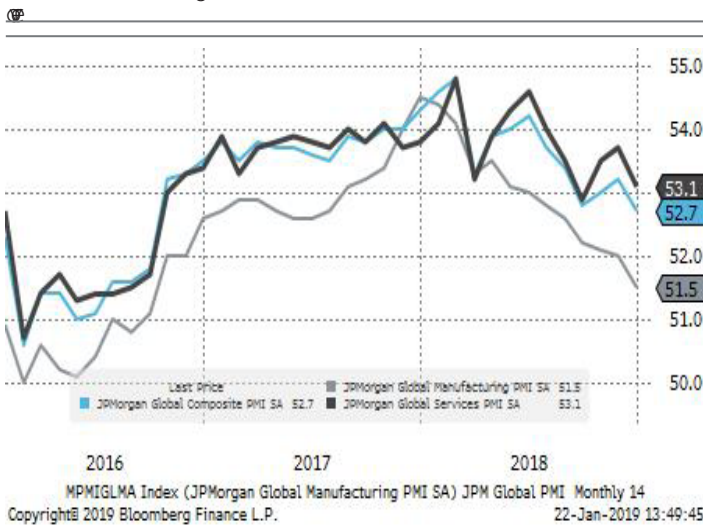


Figure 2 - The decline in the JP Morgan Global PMI composites confirms that global growth has decelerated but is not yet at recessionary levels. Source: Bloomberg

The slowdown in China is a cause for concern since it is unclear how effective government intervention will be. China is currently facing its most difficult period in years

and 2019 growth forecasts were revised down to +6.2%, down from the likely +6.6% growth rate of 2018 (source: Bloomberg). China accounts for one third of total annual global growth. The reason why 6% is a troubling figure is because of how indebted both the private and public sectors are. (China's debt to GDP ratio was over 265% at the end of 2017 and is expected to increase to 300% by 2022. Source: Bloomberg). Slower Chinese growth will challenge the government's economic plans and place a heavy burden on repayments. This colossal amount of debt will surely have a global impact should it collapse. We cannot attribute the slowdown completely to U.S. tariffs; it began well before trade frictions escalated. China's extremely high growth rate cannot last forever and the increasing debt load will make it that much more difficult to maintain. President Xi Jinping is trying to balance out the need for continued accelerated growth while managing the debt load.

Any hard landing in China will spread to its neighbors and then eventually to Western developed economies. The government is currently enacting measures to stimulate the economy, including reducing the reserve requirements for banks and encouraging increased private sector lending. The equity markets tend to rally when such measures are announced so any resolution to the trade war and improving Chinese economic data will be a strong catalyst for equity market stabilization.

Cracks Finally Appeared in the Credit Markets

Most recessions and economic downturns are preceded by deteriorating credit conditions. When volatility initially hit the markets in early 2018, it was contained to equities while credit spreads didn't significantly move. In times of volatility, investors tend to reduce their holdings in riskier high yield and investment grade bonds and move to the safety of government issues. It was a consensus view that interest rates were going to continue to increase in 2019 and 3 to 4 hikes by the Fed were expected. It was unthinkable that the market would start pricing in a pause

in hikes or even the potential for a cut in rates in 2020. Spreads in investment grade credit and high yield bonds spiked during the quarter which is what we would expect to see during a large risk-off move. It is difficult to say if the widening spreads caused the equity market sell-off or vice-versa. In any event, global government bonds rallied during the quarter as the yield on the U.S. 10 year declined to 2.68% from a peak of 3.24% hit in November. In Canada, government bonds returned +2.12% compared to +0.86% for Canadian corporate issues (based on the FTSE Canada All Government Bond and the FTSE Canada All Corporate Bond indices. Source: Morningstar Direct).

The pace at which spreads widened created the opportunity for the short-term rally we have seen thus far in January. It is clear that at this point of the cycle, credit and equities are now positively correlated and should be expected to move in a similar direction when volatility spikes.



Figure 4 - Spreads of investment grade bonds have widened to levels not seen since 2015 during a period characterised by an earnings recession. Source: Bloomberg.

2018 Asset Class Review

2018 was a very difficult year for most asset classes. Of the major asset classes we track in their base currencies, only Canadian bonds were positive for the year. Any

gains from the majority of non-Canadian asset classes would have come from weakness in the Canadian dollar. In years where the majority of asset classes are negative and correlations converge, the benefits of diversification are muted. Consecutive years where most asset classes are negative are infrequent and tend to happen during recessions (Source: RBC Dominions Securities, Bloomberg).

During the quarter, gold was the top asset class returning +7.11% in USD or +13.18% in CAD. Had you held gold in U.S. dollars for all of 2018, the return would still be negative despite the strong quarter.

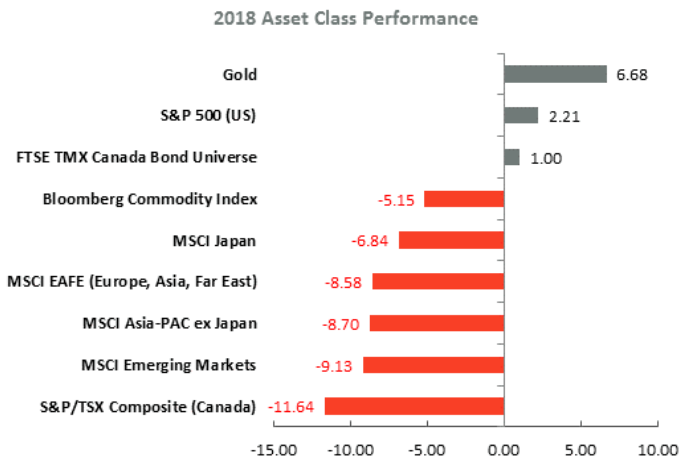


Figure 5 - Gold and U.S. equities were positive in 2018 due to the weakness of the Canadian dollar. Canadian bonds finished with a decent year despite large swings in yields. Source: Morningstar Direct.

Summary

There were few places to hide from the increased volatility of the fourth quarter. Bets on gold and longer term government bonds would have been a necessary place to be to provide some cushion against the equity market declines. Given the backdrop of higher interest rates, taking on interest rate risk was a non-consensus position. Given the market's sensitivity to comments from Jerome Powell and U.S.-China trade developments, it is easy to say that they are responsible. However, the answer is not

yet clear. The risk-reward trade off of any investment is still one of the most important things to consider when determining portfolio positioning. There are bright spots within both the U.S. and Canadian economies and reduced interest rate expectations are fuelling renewed optimism. However, continued trade tensions and slowing global growth could still present headwinds. We continue to believe that current risk exposures should be balanced and that diversification is the best way to achieve that.

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