Wealth Management
Dominion Securities

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Quarterly update

Following a strong first quarter that saw the markets steadily rise, the last three months brought another bout of volatility as markets reacted to various headlines. We've gone from watching the markets pull back in response to trade discussions between the U.S. and China, to seeing the markets near all-time highs again by June 30. As we move into the later stages of this economic cycle, we note that the markets are reacting with increasing volatility to any sort of news, both positive and negative. While few believe that a recession is imminent, the economic data is telling us that we are closer to a recession than we were even nine months ago. As we close out the second quarter near all-time highs for various global markets, there are a number of global issues that have yet to be resolved: U.S. and China trade discussions, monetary policy in the U.S. and the alarming quantity of negative-yielding bonds in the market. Until there is further clarity around these issues, volatility will continue and we will remain defensive.

Continued trade discussions

With the 2020 federal election ahead, the U.S. President and his team are keen to see the markets stay near all-time highs. One of the accomplishments that the U.S. administration will hang their hat on is the performance in the markets and economy. If they can roll into 2020 with the markets near their all-time highs, they will be much more confident about winning a second term. This is why a trade deal with China is so important. While neither side seems to be willing to budge, it's evident that they both have a vested interest in seeing a deal consummated, as a deal will have an enormous impact on their respective economies and markets. The U.S. administration is particularly motivated to see a deal done, as it recognizes the impact the ongoing uncertainty will

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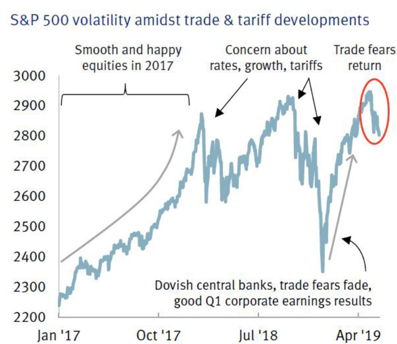

Source - RBC Global Asset Management, RBC Wealth Management, *Wall Street Journal*, Haver Analytics; data through 5/28/19

have on the markets (see the graph above). While the U.S. administration has been positioning the introduction of tariffs as a must-have for the economy, it may be overlooking the potential collateral damage that tariffs bring on. Protectionism and tariffs have historically had a negative impact on economic performance, as the cost of raw materials and goods increase for U.S. manufacturers and consumers, leaving them with less money to stimulate the economy and markets.

180-degree change from the Federal Reserve

This time last year, the economy was running at near-full capacity. The markets were approaching their all-time highs, and the Federal Reserve was looking to raise rates two to three times in the coming year. Fast-forward nine months, and we are now looking at possible rate cuts. It's rare that you see the Federal Reserve change their stance so dramatically in the span of nine months. With key indicators in the U.S. such as the labour markets, consumer spending and GDP exhibiting strength, we wonder what the rationale is for the Federal Reserve to cut rates. It feels like the it is sending us mixed messages. We have mentioned previously that we do not believe that the next recession is imminent in the short term, which leads us to believe that the Federal Reserve remains cautious around trade disputes and global growth. We believe that the rate cuts that are priced in are not a signal of the end of the cycle but rather "insurance" to prevent a further slowdown of economic momentum and, by extension, prolong the expansion. Historically, much of the world central banks tend to follow the Federal Reserve, so if in the Fed does cut rates, look for global rates to follow in kind.

The landscape is changing in the bond market

Another area of concern is the rise in negative yielding bonds. Over the last nine months, we have seen the global inventory of bonds yielding below zero go from $6 trillion USD to $13 trillion USD. This is concerning on two fronts. It indicates that investors may be losing confidence in the global markets by accepting to be paid less than their original purchase if the bonds are held to maturity and interest rates are indicated to move lower. With negative yielding bonds currently making up approximately 25% of the global debt and climbing, this is an concern as most central banks are also looking to decrease rates going forward. As more central banks continue to cut interest rates, this will continue to lower yields. As a result of this, you have a pool of investors that are risk off and another pool that is risk on. While you have the investors willing to take that marginal loss, the investor who doesn't see value in losing money on their safe assets are likely to invest into risker assets like the stock market or real estate; potentially propping both markets up higher and creating a bubble.

What are we doing?

In the context of the aforementioned issues, our view remains consistent and we continue to position our portfolio in a more defensive stance. At the moment, we do not see adequate reward in maintaining an overweight equity exposure with markets priced at all-time highs and uncertainty by: the ongoing trade war with China, the lack of clear direction from the Federal Reserve and the threat of negative global interest rates. Due to the heightened volatility and risk, we have trimmed back on our allocation to equity and have shifted the proceeds to cash and high-quality, short-duration fixed income. We believe this allocation repositioning will give us flexibility to deploy cash when opportunities become available, while protecting the portfolios in the near term.

Thanks you for your continued confidence and business.

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