March 28, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

The caution flag is waving

Kelly Bogdanova – San Francisco

The recent inversion of the yield curve is a reminder that all good things—and economic cycles—come to an end. The winds of change are blowing and investors should start thinking ahead. But we don't think it's time yet to batten down the hatches and would continue to Market Weight equities in portfolios.

Equity markets have been consolidating and hanging on to much of their year-to-date gains despite ongoing economic angst from the Big 3 economies of the U.S., Europe, and China, and the swift plunge in Treasury yields and related yield curve inversion.

Equity volatility has been relatively subdued even as the U.S. 10-year yield dropped 39 basis points in less than a month to 2.37%, its lowest level since December 2017, and the German 10-year yield turned negative for the first time since 2016.

Often lower sovereign bond yields that are accompanied by dovish central bank policies and tame inflation (like now) are catalysts for equities. In this case we think they are reflective of wobbly economic trends and raise questions about the sustainability of the long-in-the-tooth global and U.S. expansions.

The Treasury yield curve inversion—when short-term yields are higher than longer-term yields—illustrates the economic uncertainties. We certainly view it as a caution flag for equity markets, but it should not be the sole factor that drives portfolio allocations.

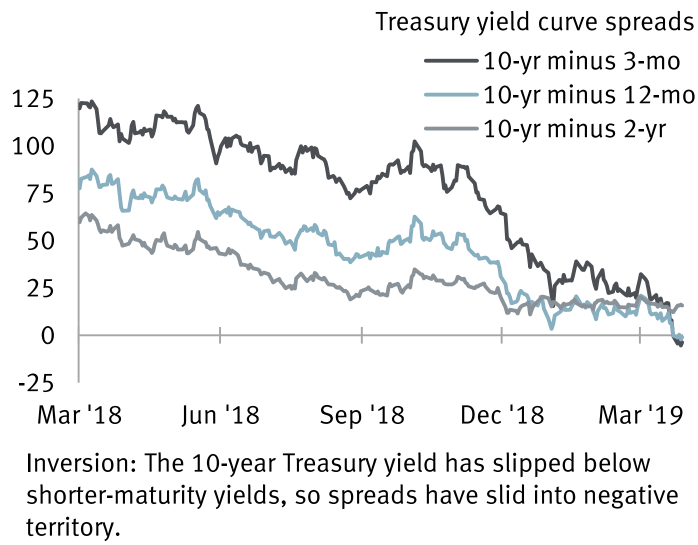
Distant early warning

A Treasury yield curve inversion is a notable event. It doesn't happen often because bond investors usually demand higher yields for investing their money over longer periods of time than they do for shorter periods. An inversion flips this relationship on its head.

Importantly, yield curve inversions typically precede recessions—but often by a number of months.

Yield curve inversion adds to economic jitters

Difference (spread) between various spots on the U.S. Treasury yield curve in basis points



Source - RBC Wealth Management, Bloomberg; daily data as of 8:03 pm GMT 3/28/19

Market pulse

Since the 1950s, it took 14 months, on average, for a U.S. recession to begin after an inversion (see upper table). During this time only one false signal was given, in the mid-1960s, when the curve inverted but no recession materialized.

Historically, the S&P 500 peaked about six months after inversion, on average. The timing varied considerably, from -2 to 21 months, so this is not a reliable market timing mechanism (see lower table). On a number of occasions the S&P 500 moved to new highs after inversion, and then shifted into a bear market before or during the forthcoming recession.

Unique aspects of this period could be contributing to the current inversion, including the massive quantitative easing program launched by central banks following the financial crisis and pressure from ultralow and negative yields in Europe. But we generally don't buy into the "this time it's different" thesis given each period is shaped by unique contours. We think the inversion caution flag should be heeded given the historical track record.

Consider other crucial cues

Not all or even a majority of economic indicators are flashing red or yellow just yet.

U.S. economic data has been mixed but no worse than other lull periods of this cycle. In addition to the yield curve, the other five leading indicators we view as important are still signaling the domestic economic expansion will persist.

Signs of stabilization in China have been elusive thus far, and upcoming manufacturing and services data should help set the near-term tone for markets worldwide. Trade remains a factor as well. If a trade deal is struck with the U.S.—even an imperfect one—it could help the Chinese economy regain its footing.

Recently Europe suffered another setback as momentum slumped further in March, especially in Germany and France, the region's largest economies. RBC Capital Markets expects Europe's economy to stabilize in coming months and then improve in the second half of the year.

Given these economic factors, and the typical time lag between Treasury yield curve inversions and equity market peaks and the onset of U.S. recessions, we don't think it's time to batten down the hatches. Once this consolidation period passes, there could more upside for the major equity indexes.

But the yield curve inversion is yet another reason we would Market Weight rather than Overweight global (total) and U.S. equities—in other words, hold equity exposure at the benchmark level in portfolios. The caution flag is indeed waving. The movement of our other leading indicators should signal when it's time to trim exposure below that level.

U.S. Treasury yield curve track record

10-year to 12-month yield curve

U.S. economy: The yield curve has typically inverted before a recession begins

Month yield curve inverts	Month recession begins	Interval (in months)
Dec '56	Sep '57	9
Sep '59	May '60	8
Apr '68	Jan '70	21
Mar '73	Dec '73	9
Sep '78	Jan '80	16
Sep '80	Jul '81	10
Feb '89	Jul '90	17
Apr '00	Mar '01	11
Jan '06	Dec '07	23
	Average	14 months
	Median	11 months

Stock market: The S&P 500 has peaked about six months after inversion, on average, but the timing has varied considerably

Month yield curve inverts	Month S&P 500 peaks	Interval (in months)
Dec '56	Jul '57	7
Sep '59	Aug '59	-1
Apr '68	Dec '68	8
Mar '73	Jan '73	-2
Sep '78	Sep '78	0
Sep '80	Dec '80	3
Feb '89	Jul '90	17
Apr '00	Mar '00	-1
Jan '06	Oct '07	21
	Average	5.8 months
	Median	3 months

Source - RBC Wealth Management, Bloomberg, Federal Reserve, National Bureau of Economic Research

United States

Ben Graham, CFA – Minneapolis

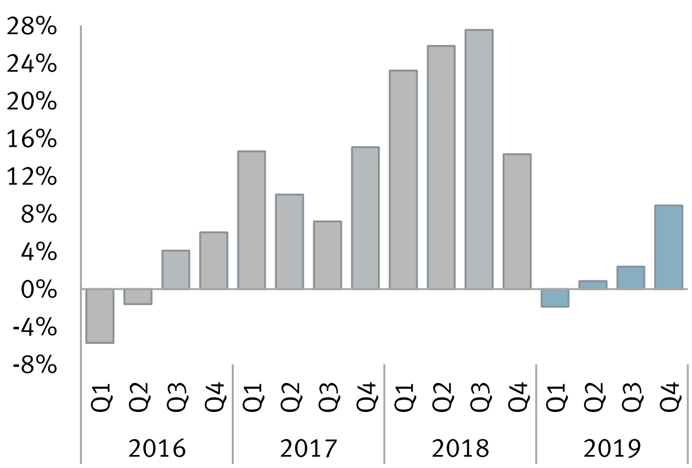
- **U.S. equities were relatively mixed in recent sessions** as the Fed is being pressured by the fixed income market to cut rates. Thus far during the week, **small caps are the clear leader**, as evidenced by the Russell 2000 climbing more than 1.0% while the S&P 500 trades essentially flat.

- **RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina recently raised her year-end 2019 S&P 500 price target to 2950 from 2900** and is forecasting further appreciation of 5% from current levels. Her rationale includes greater multiple expansion for U.S. equities in aggregate as the interest rate backdrop indicates a lower yield curve moving forward. Additionally, she is **maintaining her S&P 500 2019 EPS estimate of $171**, which supports our view of holding a Market Weight position in U.S. equities.

- As Q1 2019 earnings season approaches, it's interesting to note that quarterly **S&P 500 EPS estimates, per Refinitiv I/B/E/S, show a decline for the first time since Q2 2016**. Remember that H2 2015–H1 2016 was the last time there was an "earnings recession," defined as back-to-back quarters of EPS declines. At this time, **the market is not forecasting an earnings recession in 2019** as the anticipated Q1 2019 decline of 1.9% should be the worst result of the year according to Refinitiv I/B/E/S. The current consensus view is that the second, third, and fourth quarters of 2019 will see 0.9%, 2.4%, and 9.0% y/y earnings growth, respectively.

After an unsurprising decline, earnings should reaccelerate later in 2019

S&P 500 EPS growth y/y



Note: gray bars represent past growth, blue bars represent forecasted growth.
Source - RBC Wealth Management, Refinitiv I/B/E/S; data through 3/28/19

- **The final Q4 2018 GDP result was released recently with the U.S. economy officially expanding at 2.2%**, slightly below 2.3% consensus expectations and the prior quarter's 2.6%. Interestingly, this **may actually provide a bit of help in avoiding a recession in coming quarters**, as this lowers the hurdle rate for future growth and fits into the narrative from RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli. He anticipates a "lower for longer" expansion in which growth dips to 1.3% during the first quarter before averaging 2.6% for the full year.

Canada

Arete Zafiriou & Richard Tan, CFA – Toronto

- From RBC Economics' perspective, the **federal budget** released on March 19 was more of a grab bag of **voter-friendly measures** as opposed to an emphasis on any particular single-line items. Over the next five years, the government plans to increase spending on housing for first-time home buyers, training and education, national pharma care, and income security for low-income seniors via a guaranteed income supplement. That said, RBC Global Asset Management (GAM) believes the budget remains in good standing, representing 1% of GDP and a public debt-to-GDP ratio that is low and gradually declining. Current polls are giving the Conservatives a slight edge over the Liberal Party to win the next election. We note that it's still early and would refrain from extrapolating until we get a better sense as to each party's platform.

- RBC Capital Markets does not believe that the new budget's housing measures would have a significant effect on the Canadian housing and mortgage market or the companies in its Canadian Financials coverage universe. The **new housing initiatives** would allow first-time home buyers to apply for a shared equity mortgage (SEM) with the Canadian Mortgage Housing Corporation (CMHC). CMHC will effectively have "skin in the game" by financing 10% on newly constructed homes and 5% on existing homes. In order to qualify, buyers must have the minimum down payment for an insured mortgage (5%), and must have a maximum household income of $120,000 annually. The SEM combined with the insured mortgage is capped at four times household income. Given these requirements, we believe it is **unlikely to benefit buyers in Canada's most expensive cities** (i.e., Toronto and Vancouver). RBC GAM believes this **could have the adverse effect of increasing home prices** rather than making houses more affordable for millennials.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- In an attempt to sway hardline Conservative Brexiters, **Prime Minister Theresa May said she would resign if her Withdrawal Agreement passes in the House of Commons**. Unfortunately, her **strategy might have backfired** as Labour backbenchers, whose support is needed for the deal to pass, may be more reluctant to vote in favour of her deal knowing she will very likely be replaced by a more hardline Brexiter. Moreover, the Democratic Unionist Party, the Northern Ireland party on which her working majority depends, stated that it will not support the deal. Unless it changes its mind, we believe there is a relatively low possibility that her Withdrawal Agreement will attract enough votes to scrape through.

- Independent of this, in an attempt to break the impasse at Westminster over the Withdrawal Agreement, **indicative votes took place to try to find a Brexit strategy that could command a majority**. Eight versions of Brexit were put to Members of Parliament and given the divisions in the House, no majority for any option was likely in this initial round.

- **That proved to be the case**. The Commons voted overwhelmingly against a no-deal Brexit and a hard Brexit. Softer versions of Brexit garnered more votes than the prime minister's Withdrawal Agreement had to date. In addition, a Confirmatory Referendum, where any potential deal is put to a public vote, gathered the most votes, though not a majority of MPs' votes.

- **Should a third meaningful vote on the Withdrawal Agreement fail or not be put to the House, the process of indicative votes will continue**. With fewer alternatives to vote on as the least popular options fall away, the new deadline of April 12 looming, and the default of no deal remaining, the hope of those organizing the vote is that a majority will coalesce around a single option.

- Even if Parliament finds a majority for a softer version of Brexit, **the uncertainty is far from over**. The government will likely be unwilling to implement it, as a soft version of Brexit would go against its manifesto.

- **We think the likelihood of a general election would rise** in this case, as it would if no majority around a Brexit strategy is found. This uncertainty is **likely to weigh on the pound**.

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **Asian equities continue to tread water** after a strong rally at the start of the year. Attention is focused on the U.S.-China trade talks.

- **China's industrial sector began the year on a weak footing** with respect to earnings. Industrial profits in January and February were down 14% y/y, the **worst performance in around a decade**. Much of this weakness may be seasonal: China's National Bureau of Statistics estimated that without the seasonal impact around the timing of the major Chinese New Year holiday—during which factories may shut for a week or longer—profit growth would have only been slightly negative.

- Even so, the decline is a **nod to both a sluggish domestic economy and a slow global economy**. Several sectors in particular contributed to the decline, including autos, chemicals, and steel.

- In 2018, industrial profits rose by 10.3% but **began to turn negative in November and December**. Revenue has also slowed, from 8.5% growth in 2018 to a 3.3% y/y increase in January and February.

- **Manufacturing and industrial production has also tailed off in Japan**. The Nikkei Japan Purchasing Managers' Index, a leading economic indicator, was an underwhelming 48.9 in March and unchanged from February. Japanese exports have also been soft over the past few months. However, **equity valuations in Japan remain attractive**, in our view, with over 50% of the stocks listed in the benchmark TOPIX Index trading below book value.

- **China Construction Bank** (939 HK), China's second-largest bank and the second-largest bank in the world by assets, kicked off earnings season for the big China banks and posted a **5.1% y/y increase in earnings** to RMB254.7B ($37.9B), **lower than forecast**. The bank reported a strong capital position with its CET ratio at 13.8%. Asset quality (a reflection of bad loans) remained quite good, although there were rising provisions set against off-balance sheet items.

- **Samsung Electronics** (005930 KS), a diversified global technology company and the largest producer of smartphones, issued **a surprise profit warning** for its Q1 results due in April. The company stated that this was due to a decline in prices for its memory chips and displays. Again, we think this may be reflective of a slow global economy as well as slowing sales of smartphones.

MARKET SCORECARD

Data as of March 28, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,815.44	1.1%	12.3%	8.1%	19.4%
Dow Industrials (DJIA)	25,717.46	-0.8%	10.2%	7.8%	24.2%
NASDAQ	7,669.17	1.8%	15.6%	10.4%	30.5%
Russell 2000	1,535.10	-2.6%	13.8%	1.5%	12.3%
S&P/TSX Comp	16,155.49	1.0%	12.8%	6.5%	3.6%
FTSE All-Share	3,951.36	1.6%	7.5%	1.7%	-1.1%
STOXX Europe 600	376.84	1.1%	11.6%	2.1%	-0.1%
EURO STOXX 50	3,320.29	0.7%	10.6%	-0.3%	-4.2%
Hang Seng	28,775.21	0.5%	11.3%	-4.2%	18.2%
Shanghai Comp	2,994.94	1.8%	20.1%	-4.1%	-7.9%
Nikkei 225	21,033.76	-1.6%	5.1%	0.0%	9.5%
India Sensex	38,545.72	7.5%	6.9%	16.9%	31.1%
Singapore Straits Times	3,203.58	-0.3%	4.4%	-5.3%	1.4%
Brazil Ibovespa	94,388.94	-1.3%	7.4%	12.5%	46.0%
Mexican Bolsa IPC	42,942.23	0.3%	3.1%	-6.9%	-13.0%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,290.77	-1.7%	0.6%	-2.6%	3.1%
Silver (spot $/oz)	15.02	-3.8%	-3.1%	-7.9%	-17.5%
Copper ($/metric ton)	6,336.00	-3.3%	6.5%	-4.5%	8.3%
Oil (WTI spot/bbl)	59.30	3.6%	30.6%	-7.9%	22.6%
Oil (Brent spot/bbl)	67.88	2.8%	26.2%	-2.4%	32.2%
Natural Gas ($/mmBtu)	2.72	-3.2%	-7.4%	0.9%	-12.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.389%	-32.6	-29.5	-39.1	-2.9
Canada 10-Yr	1.558%	-38.4	-40.9	-56.4	-7.1
U.K. 10-Yr	1.000%	-30.2	-27.7	-36.6	-19.2
Germany 10-Yr	-0.069%	-25.2	-31.1	-57.2	-45.7
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.88%	2.1%	3.1%	4.9%	6.1%
U.S. Invest Grade Corp	3.59%	2.6%	5.3%	5.4%	8.0%
U.S. High Yield Corp	6.50%	0.7%	7.0%	5.7%	10.5%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.2280	1.1%	1.1%	8.0%	-2.5%
CAD/USD	0.7439	-2.0%	1.5%	-3.9%	-0.4%
USD/CAD	1.3442	2.0%	-1.4%	4.0%	0.4%
EUR/USD	1.1225	-1.3%	-2.1%	-8.8%	3.8%
GBP/USD	1.3049	-1.6%	2.3%	-7.3%	4.8%
AUD/USD	0.7077	-0.2%	0.4%	-7.6%	-7.3%
USD/JPY	110.6500	-0.7%	0.9%	3.6%	-0.4%
EUR/JPY	124.2100	-1.9%	-1.3%	-5.5%	3.4%
EUR/GBP	0.8602	0.3%	-4.3%	-1.6%	-1.0%
EUR/CHF	1.1179	-1.5%	-0.7%	-5.1%	4.2%
USD/SGD	1.3565	0.3%	-0.5%	3.4%	-3.0%
USD/CNY	6.7390	0.7%	-2.0%	7.0%	-2.0%
USD/MXN	19.3478	0.3%	-1.5%	5.7%	1.7%
USD/BRL	3.9028	3.9%	0.7%	17.5%	24.3%

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 3/28/19.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 1.5% return means the Canadian dollar rose 1.5% vs. the U.S. dollar year to date. USD/JPY 110.65 means 1 U.S. dollar will buy 110.65 yen. USD/JPY 0.9% return means the U.S. dollar rose 0.9% vs. the yen year to date.

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As of December 31, 2018

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