RBC Dominion Securities Inc.

Wealth Management
Dominion Securities

The Sandler Quarterly

Volume 14 | April 2019

Scott Sandler
VP & Portfolio Manager
scott.sandler@rbc.com
416-842-6684

Ronan Clohissey, CIM
VP & Portfolio Manager
ronan.clohissey@rbc.com
416-842-6683

Ross Deacon
Portfolio Manager
ross.deacon@rbc.com
416-842-6682

Michelle Noel Smith
Associate Advisor
michelle.noelsmith@rbc.com
416-842-8675

Brendan Hollis, CFA
Associate Advisor
brendan.hollis@rbc.com
416-842-8673

Steve James
Associate
steve.james@rbc.com
416-842-8674

Gary Tsang, CFA
Associate
gary.h.tsang@rbc.com
416-842-8672

Joshua Orr
Associate
joshua.orr@rbc.com
416-842-8676

Tiffany Kee
Assistant
tiffany.kee@rbc.com
416-842-6677

Fed Steps Down.....Markets Step Up!

KEY INSIGHTS

- Global stocks, bonds and commodities have rebounded strongly from December lows
- Central banks have done an about-face and further interest rate hikes appear to be off the table
- The yield curve briefly inverted, signaling the economic cycle is at a late stage and a potential recession ahead

What a difference a few months can make! 2019 has come roaring out of the gates and erased last year's losses, and then some. Six months ago, investors feared that central bankers would take away the punch bowl and push interest rates to a level that would derail the global economy. Since then there has been a significant change in tone at the Fed and the Bank of Canada. Policy makers have backed down and are taking a more dovish and accommodating stance. With interest rate increases all but off the table for 2019, and bankers leaning towards easier policies, the risk of recession in the near term is diminished.

Our last newsletter, entitled "*December rout may present opportunities*" discussed how equity valuations had become attractive following a brutal fourth quarter. This certainly turned out to be the case, with North American indices delivering double digit returns in the first quarter. At that time we discussed buying a new position in FedEx and adding to our existing Brookfield Properties holding. From their December lows, these two investments have increased by 20.2% and 34.7% respectively as of March 31st, 2019. Many of our other equity holdings are also enjoying gains with Starbucks and Disney trading recently at all time highs.

In January we commented that we were "*cautiously optimistic that equities can deliver positive returns in the coming months*". With such a strong start to the year now behind us, we remain cautiously optimistic in the near term but would certainly expect Q1's rate of return to moderate. Markets have delivered a year's worth of returns in three months; history has taught us that this cannot continue uninterrupted.

Many of the concerns of the day in December have faded for the time being. US China trade tensions appear to have thawed; Brexit has bought itself some more time; Washington DC is back to work following a lengthy shutdown; and, as mentioned above, further rate increases are no longer in the offing.

That said, the economy is a cyclical animal and we are clearly in the latter stages of this cycle. The recent inversion of the yield curve grabbed headlines and

Quarterly Review

Q1 2019

media attention. It is a reminder that all good things, and economic cycles, come to an end. A yield curve inversion means that short term interest rates are higher than long term rates. Essentially, you can get a higher return for loaning money for a short period than for a long period. This happens when investors are uncertain about the future. An inverted yield curve has been a reliable predictor of recession. The attached article, "*Yield curve inversion: A shot across the bow*", explains in greater detail why this is a notable event.

In simple terms, buying a bond is the same as loaning money. The bond buyer is the lender, the bond issuer is the borrower. Typically, one expects to achieve a higher return for loaning money over a longer period. Recently, that dynamic was flipped on its head, or inverted. When investors seek safety over opportunity they are willing to accept a lower return for holding a longer dated bond. Additionally, in an environment where central banks' next move may be to lower rates (as it is now), bond buyers are more eager to lock in rates for more extended periods. *Figure 1* shows the shape of a normal curve and an inverted curve.

What does all of this mean for us?

Since the 1950's, it took 14 months, on average, for a US recession to begin after an inversion. See *Table 1*. During this time, only one false signal was given. Our position has been, and continues to be one of vigilance. We remain invested in high quality companies and businesses that have been tested through many business cycles, but we have positioned your portfolio with a higher level of cash versus your stated target. This will provide stability in a volatile market and give us dry powder to take advantage of lower prices when the rest of the market decides it is time to become fearful of slower economic growth.

While the timing of the next recession is uncertain, we are quite sure that after 10 years of economic expansion we are closer to the end of this cycle than the beginning. The US business cycle scorecard (*Figure 2*) shows the majority of indicators are "late cycle", but with an increasing number skewing towards "end of cycle". In the attached article, "An aging economic expansion", RBC Chief Economist, Eric Lascelles, assigns a 35% likelihood of recession in 2019 with slightly higher odds in 2020.

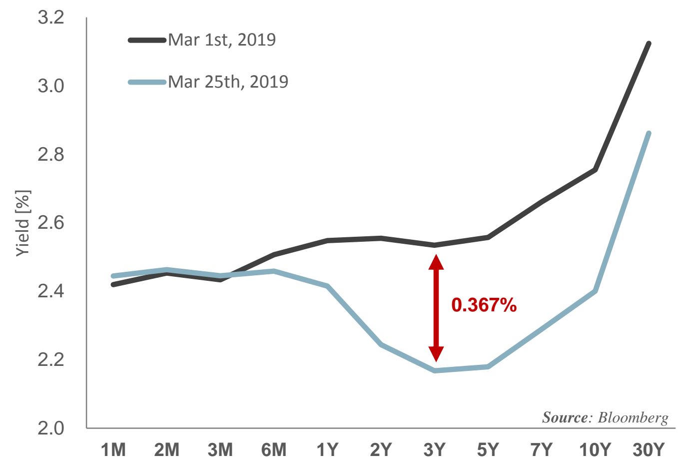


Figure 1*: US Yield Curve, March 1st, 2019 vs. March 25th, 2019*

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

Table 1*: Historical recession timing after a yield curve inversion*

Come what may, our strategy will remain the same:

- *Establish an asset allocation target that suits your investment goals*
- *Buy high quality companies that have proven themselves through the business cycle*
- *Seek investments that pay an income and buy them at fair or undervalued prices; hold plenty of cash, bonds and preferred shares*
- *Rebalance back to the target asset allocation when necessary*

Quarterly Review

Q1 2019

	Start of cycle	Early cycle	Mid cycle	Late cycle	End of cycle	Recession
Inventories		●	○			
Consumer durables		○	●	●		
Leverage			●	○		
Housing			●	●		
Equity profitability			●	●		
Prices			○	●	○	
Monetary policy			○	●	○	
Credit			○	●	○	
Business investment			○	●	○	
Bonds				●	○	
Economic trend				●	●	
Employment				●	●	
Equity direction				●	●	
Economic slack				●	●	
Volatility				●	●	
Sentiment				○	●	
Cycle age					●	
Votes for each stage of business cycle	0	1.5	6.5	14	9.5	0
Votes in previous period	0	2	9	13.5	6.5	0

Legend: ● = most likely stage of business cycle (full weight); ○ = alternative interpretation (0.5 weight)
Source - RBC Global Asset Management

***Figure 2**: US Business cycle scorecard*

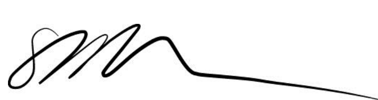
	Q1 2019	1 Year**
Indices		
S&P/TSX	12.42%	4.78%
Dow Jones	11.15%	7.57%
S&P 500	13.06%	7.32%
Nasdaq	16.48%	9.42%
Euro Stoxx	11.67%	-0.29%
Japan Nikkei	5.95%	0.22%
India Sensex	7.19%	17.30%
VIX (Volatility)	-51.62%	-40.05%
Commodities		
Gold	0.77%	-2.50%
Silver	-2.43%	-7.63%
Copper	9.04%	-4.08%
Oil	32.44%	-5.31%
Natural Gas	-14.35%	1.87%
Currency		
CAD	2.17%	-4.07%
EUR	-2.17%	-8.57%
JPY	-1.12%	-3.83%
AUD	0.67%	-7.66%
GBP	2.20%	-7.27%

*** ending March 29h, 2019*

Adhering to a disciplined rebalancing strategy has been shown to enhance returns over time. It worked very well for us in December and January; our systematic approach had us buying as others panicked and sold great companies to us at lower prices.

Looking forward to the summer, markets tend to be a little quieter. That said, it does not mean there isn't lots to do. Summer can be a great time to review your portfolio and tend to financial planning matters. We are available and always happy to schedule a call or meeting.

Sincerely,



Scott Sandler
VP & Portfolio Manager

Ronan Clohissey, CIM
VP & Portfolio Manager

Wealth Management
Dominion Securities

The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc.* nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. RBC Dominion Securities Inc. and Royal Bank of Canada are separate corporate entities which are affiliated. *Member CIPF. ®Registered trademark of Royal Bank of Canada. Used under licence. ©Copyright 2004. All rights reserved.

Focus article

Yield curve inversion: A shot across the bow

Jim Allworth
Vancouver, Canada
jim.allworth@rbc.com

Has inversion of the yield curve started the “recession clock”? The closing chapter of all economic cycles is a recession. The recent inversion makes it appropriate to start thinking about that eventuality but we believe it will take some doing to get the U.S. into recession from here. We are content for now with our Market Weight exposure to stocks in a global portfolio.

The Treasury yield curve has inverted—short-term interest rates have moved above long-term rates. Or, more precisely in this case, long-term rates have fallen below short-term rates.

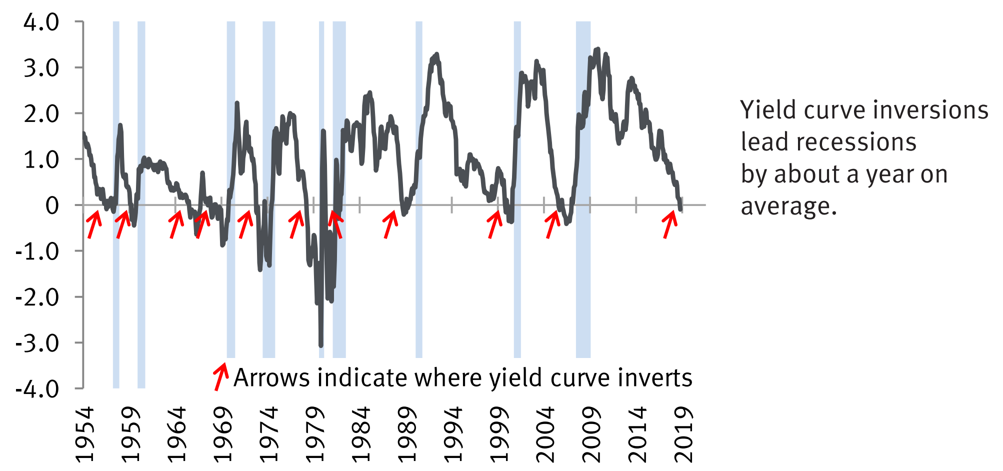
This has garnered a lot of attention because in past economic cycles “inversion” has proven to be a reliable signal that a U.S. recession was on the way—on average about 11 to 14 months from the date of inversion.

Long, bruising equity bear markets, not just in the U.S. but also in Canada, the U.K., Europe, and Japan, have been associated with U.S. recessions. These bear markets have typically started months before the recession gets underway. That makes inversion of the yield curve a valuable early warning signal that a more defensive investment state of mind is called for.

Is the recession clock starting?

The debate is already raging as to what, if any, credence should be given to the yield curve’s signal this time. There are a number of arguments—some very compelling—asserting that this inversion has occurred for very different reasons

Yield differential between the 10-year and 1-year U.S. Treasury notes



Note: Shaded areas indicate recessions
Source - RBC Wealth Management, U.S. Federal Reserve, National Bureau of Economic Research

than in past cycles and therefore can be safely ignored. Perhaps. But in our experience, arguments like this have always surfaced around the time of previous inversions and, even though the mechanical reasoning was often correct, a recession (and equity bear market) eventually arrived.

There was one exception. The yield curve deeply inverted in 1965 and no recession ensued. However, U.S. GDP growth went from 10.1% (yes, that's no typo, 10.1%!) in Q1 1966 to an effective standstill at 0.2% five quarters later. Around that time the stock market corrected by a brisk, but not disastrous, 20%.

Despite the wonderful track record of yield curve inversion as a recession/bear market early warning, we believe the routes taken by the economy and markets this time will undoubtedly wind up being different in some important aspects. That should make investors reluctant to bank everything on a signal given by just one indicator, no matter how historically reliable.

Eric Lascelles, chief economist for RBC Global Asset Management (see "An aging economic expansion" on page 12), rates 17 different economic variables and concludes that this longest of U.S. economic expansions is in its late-to-end-of-cycle phase. Of course, this last part of the expansion cycle before the next recession arrives could prove to be very drawn out. Certainly the early-cycle and mid-cycle phases were unusually extended.

Our U.S. recession scorecard follows six indicators, all of which have usefully warned of recessions ahead of time. Three (the yield curve, unemployment claims, and the Conference Board Leading Economic Index) have given their signals about a year ahead of the recession getting underway. The other three (see table) typically flash red much closer to the event. To date, only the yield curve has given a warning signal.

Only the yield curve is giving a warning signal

RBC Wealth Management U.S. economic indicator scorecard

Indicator	Status (Expansion)	Status (Neutral)	Status (Recessionary)
Yield curve (12-month to 10-year)	–	✓	–
Unemployment Claims	✓	–	–
Unemployment Rate	✓	–	–
Conference Board Leading Index	✓	–	–
ISM New Orders Minus Inventories	✓	–	–
Fed Funds vs. Nominal GDP Growth	✓	–	–

Source - RBC Wealth Management, Bloomberg, FRED Economic Data St. Louis Fed

This last part of the expansion cycle could prove to be very drawn out.

Confidence matters

Indicators aside, we believe it will take some doing to get the U.S. into recession from here. One need only check in on the American consumer who thoroughly dominates the U.S. economy at almost 70% of GDP. Consumers are confident and for many good reasons. The unemployment rate was last below 4% in the mid-1960s; unemployment claims recently hit all-time lows; there are 7.6 million

unfilled jobs on offer, according to the Labor Department; wage rates are rising nicely; home values and other components of household wealth are elevated and don't look frothy or otherwise overly vulnerable; and consumer spending has remained mostly in line with income growth, suggesting household debt has not become unmanageable.

It has usually taken the arrival of tight monetary conditions to tip the economy into recession. "Tight money" has two necessary components: prohibitively high interest rates and banks that have become noticeably more restrictive in their lending practices. Neither is present today and with the Fed apparently on hold for the rest of this year restrictive credit conditions still lie some ways off. Looking at the latest monthly survey of thousands of small and medium-sized U.S. businesses by the National Federation of Independent Business, just 3% of respondents (historically very low) report being unable to get the credit they need, while 51% say they need no credit.

And what does this say for investment strategy?

The "inversion signal" has always been hard for investors to get behind precisely because it has given such a long early warning. It is usually followed by several quarters of positive economic growth—one such interval lasted almost two years. And the stock market typically has some months or even quarters to go before it sets its final high. It is difficult for investors to adopt a defensive approach when the economy continues to perform and earnings look set to go on growing.

For our part, we note that most stock markets are still below last year's highs and about at the same level as 12 months ago. Price-to-earnings multiples are reasonable and no longer as extended as they were in early 2018. We have been impressed by the power and breadth of the liftoff from the ultra-depressed December low point. We expect new highs lie ahead for the U.S. broad averages and for most developed economy stock markets.

We are content for now to maintain our benchmark target weight (Market Weight) exposure to stocks in a global portfolio. However, we are treating the inversion of the yield curve as a "shot across the bow" for equity investors. We expect to counsel the adoption of a progressively more defensive posture over the course of the next six to 12 months.

Focus article

An aging economic expansion

Eric Lascelles
Toronto, Canada
eric.lascelles@rbc.com

Given the august age of the U.S. expansion, it's fair to think about the expansion's life expectancy and the appropriate investment strategy. Recently we checked in with Eric Lascelles, chief economist at RBC Global Asset Management, about the economic growth outlook, the cycle positioning of the U.S. economy, and recession probabilities.

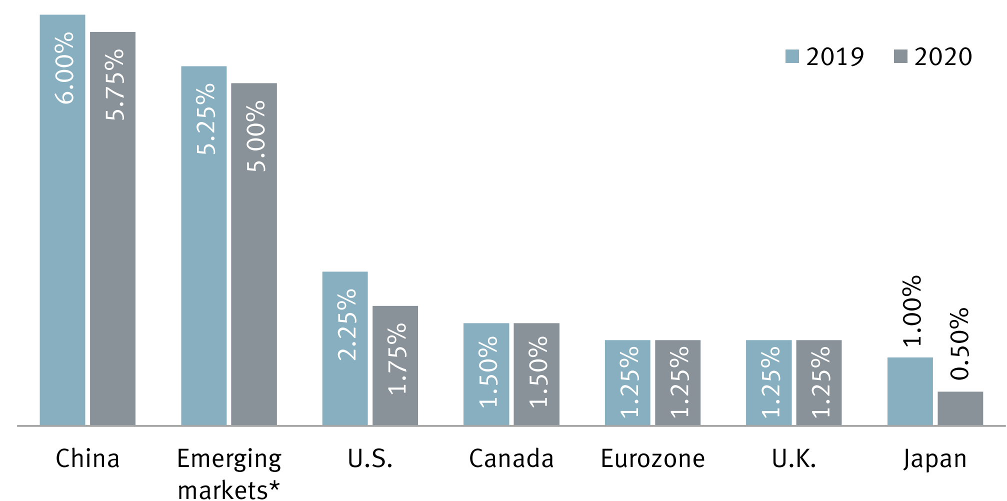
Q. U.S. economic growth has exceeded that of other developed countries. Will that persist?

A. U.S. fiscal stimulus is fading, ceasing to provide a material boost to economic growth in 2019, and eventually translating into an outright drag in 2020. This marks quite a contrast to last year, when stimulus provided a heroic boost to U.S. growth.

Global economic headwinds include protectionism, fading fiscal stimulus, and somewhat less favourable financial conditions (recent inversion of yield curves). These headwinds blow more strongly in the U.S., suggesting that the country's growth advantage could begin to shrink relative to the rest of the developed world. The economy of the other global behemoth—China—also continues to slow, though stimulus programs may start to gain traction by the second half of the year.

Given the time of year, it is perhaps also worth mentioning that U.S. growth often suffers from a curious seasonal distortion that makes the first quarter of each year appear unnaturally weak. Any U.S. softness in the near term needs to be filtered through this lens.

RBC's GDP growth forecasts



* Emerging markets forecast is a weighted average of China, India, South Korea, Brazil, Mexico, and Russia
Source - RBC Global Asset Management's *Global Investment Outlook*, Spring 2019

One of the more compelling endorsements of a late-cycle view is that the U.S. economy is now extremely tight.

Q. What factors are signaling the economy is "late" in the cycle?

A. As usual, many of the 17 inputs that go into our scorecard of the U.S. cycle disagree with one another. Counterintuitively, this is the strength of the approach. Whereas nearly any assertion can be supported by a rogue data series somewhere, it is much harder to be misled (or mislead) when considering many angles at once.

First, "late cycle" is clearly the single best guess, receiving considerably more support than the rest (see table below).

Second, although this has been the conclusion for many quarters running, there is considerable forward motion beneath the surface. Whereas a year ago "mid cycle" was giving "late cycle" an honest run for its money, the "mid cycle" argument has withered markedly over the past year. Simultaneously, the "end of cycle" argument has strengthened substantially, now representing the second-most plausible conclusion.

U.S. business cycle scorecard

	Start of cycle	Early cycle	Mid cycle	Late cycle	End of cycle	Recession
Inventories		●	○			
Consumer durables		○	●	●		
Leverage			●	○		
Housing			●	●		
Equity profitability			●	●		
Prices			○	●	○	
Monetary policy			○	●	○	
Credit			○	●	○	
Business investment			○	●	○	
Bonds				●	○	
Economic trend				●	●	
Employment				●	●	
Equity direction				●	●	
Economic slack				●	●	
Volatility				●	●	
Sentiment				○	●	
Cycle age					●	
Votes for each stage of business cycle	0	1.5	6.5	14	9.5	0
Votes in previous period	0	2	9	13.5	6.5	0

Legend: ● = most likely stage of business cycle (full weight); ○ = alternative interpretation (0.5 weight)
Source - RBC Global Asset Management

One of the more compelling endorsements of a late-cycle view is that the U.S. economy is now extremely tight. When asked to list their main problems, businesses rarely mention poor sales, and regularly complain about the quality of workers they are able to attract. This is relevant to the cycle in part because it is hard to continue growing once economies start to bump up against their natural constraints, and in part because tight economies are prone to boiling over, triggering the end of the cycle.

In the credit space, auto-loan delinquencies have been rising for some time and are now fairly high, especially in subprime lending. Meanwhile, credit-card delinquencies are also rising—albeit gradually and from historically very low levels. In fairness, mortgage delinquencies are still low and the broader household-debt environment is not overly worrisome, but little dents in the armour are forming—a classic signal of an aging business cycle.

Q. What are the odds the U.S. could slip into recession this year or next?

A. The business cycle and the risk of a recession are intertwined concepts, with recessions representing the natural conclusion of the business cycle. Of the recession models we monitor, most acknowledge a rising recession risk, though with substantially different assessments of the precise likelihood. We assign a 35% chance of a 2019 recession, and slightly higher odds for 2020.

Q. What does a "late-cycle" economy mean for investment strategy?

A. The world remains awash in uncertainty. Some of this could manifest in the form of better-than-expected outcomes—the possibility, for example, that secular stagnation might ebb more quickly than presently assumed. However, much of the uncertainty tilts toward downside risks. Among a fairly long list of these risks, the three primary items are protectionism, Chinese growth, and the U.S. business cycle.

The fact that we may be late in the cycle doesn't make the case that investment risk-taking should be abandoned altogether, but rather that it must be undertaken cautiously, as the risk-reward equation isn't as favourable as it was earlier in the cycle.

The fact that we may be late in the cycle doesn't make the case that investment risk-taking should be abandoned altogether, but rather that it must be undertaken cautiously.

We anticipate continued financial-market volatility in 2019, due to the lateness of the cycle, the flatness of the yield curve, and the degree to which the big macro questions of the day such as Brexit and tariffs will be resolved by mercurial politicians.

Thank you for sharing your thoughts, Eric.