Wealth Management
Dominion Securities

The Sandler Quarterly

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Friendly Fed Flashes Green Light For Markets – Proceed With Caution

KEY INSIGHTS

- North American equity markets reach new highs in June after a punishing May
- Interest rates fall as the Fed looks to begin lowering their target rate
- Trade tensions run hot and cold, causing market volatility and geopolitical uncertainty
- Economic indicators remain broadly positive but late cycle signs are not to be ignored

The second quarter, while volatile, maintained the positive momentum that kicked off in January. Equity markets pushed to new highs despite a sharp decline in May and a slew of worrisome headlines. We are closely monitoring a wide range of significant developments as they unfold in real time.

The global economy is encountering challenges from protectionism, a maturing business cycle and fading U.S. fiscal support (tax cuts), but is being helped by stimulative government initiatives and lower interest rates. Against this mixed economic backdrop, both equities and bonds have chosen to focus on falling interest rates. As a result, both asset classes have produced healthy gains year to date.

It is almost a forgone conclusion that the US Fed will lower interest rates later this month and Canada will likely lower later this year. This would be the first rate cut since 2008, after which the target rate remained effectively at zero (see *Figure 4)* until the current tightening cycle began in 2015. Equity markets are signaling that they welcome lower rates, but the rationale for easing may be nearly as important as the cuts themselves. If the market perceives rate cuts are in service of prolonging the current economic expansion, they should respond positively. If, however, the Fed signals that cuts are necessary because it perceives recession risks, then equity markets would be far less enthusiastic.

Headline economic data point to the US economy showing continued strength and resilience. Unemployment is at a 50 year low (see *Figure 1*) and leading indicators suggest an economy that is generally healthy. For that reason, we remain invested in high quality companies with exposure to the global economy. That said, our overall outlook at this time is defensive and vigilant. For some time now we have believed that, while the economy is in good shape, we are in the latter stages of the cycle.

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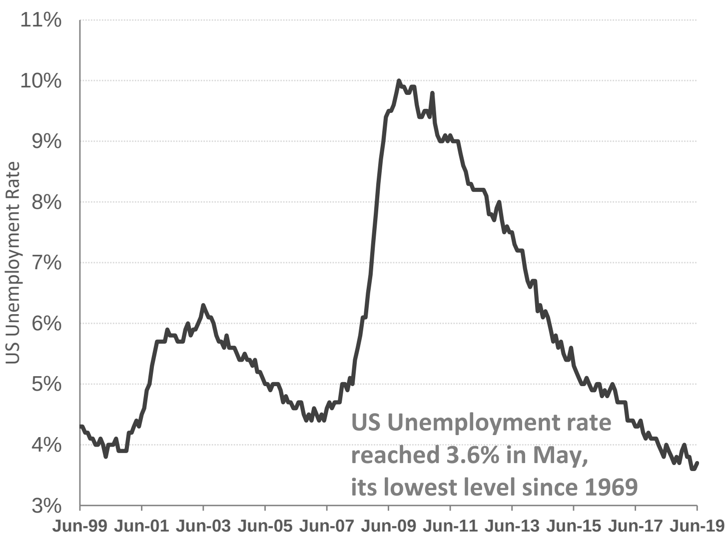

Figure 1*: US Unemployment Rate (Source: US Dept. of Labour)*

The Yield Curve

In our last newsletter, we discussed at length the inverted yield curve. Not to bore you all over again, but below is a brief refresher:

> *"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."*

This "upside down" interest rate scenario first occurred in late March and has remained in place since then (See *Figure 2*). As usual, there are no shortage of experts claiming that "it's different this time". We see no reason to think this time is any different and we are paying heed to this reliable indicator. Forewarned is forearmed.

In fact, our Chief Investment Strategist, Jim Allworth, recently wrote the following:

> *Predictably, many opinions—often well-reasoned and compelling—are being offered as to why a yield curve inversion no longer matters, or at least doesn't matter in this instance. In our experience, such opinions have always appeared at the time of previous inversions but, typically, recessions arrived nonetheless.*
>
> *For our part we are treating this occurrence as a "shot over the bow" for equity investors – one that should provoke an extra degree of vigilance. Were more indicator pins to topple in the coming months our defensive leanings would intensify. Virtually all bear markets have been associated with U.S. recessions and usually the stock market has set its final peak for the cycle some months before the recession begins. So, within the historical context, the inverting of the yield curve in May can be seen as opening the door to the arrival of a potential bull market peak for the first time in 10 years.*

We fully agree with Jim's assessment and have attached his recent opinion piece, "A New Phase" for your review.

Trade Tensions

The high-profile trade dispute between the US and China has faded from the front pages temporarily. Don't think for a minute though that this situation won't rear its ugly head again. Markets swooned in May as the situation came to a boil; the S&P500 fell by more than 6% for the month only to recover in June. In addition to tensions with China, US tariff threats are hanging over the European and Japanese auto industries, as well as ongoing spats with Turkey, India and Vietnam. Even when a trade deal appears to be negotiated, tariff threats can come right back. Mexico knows this all too well. Persistent tariff and sanctions risks will continue to generate volatility and weigh on industries caught in the crosshairs.

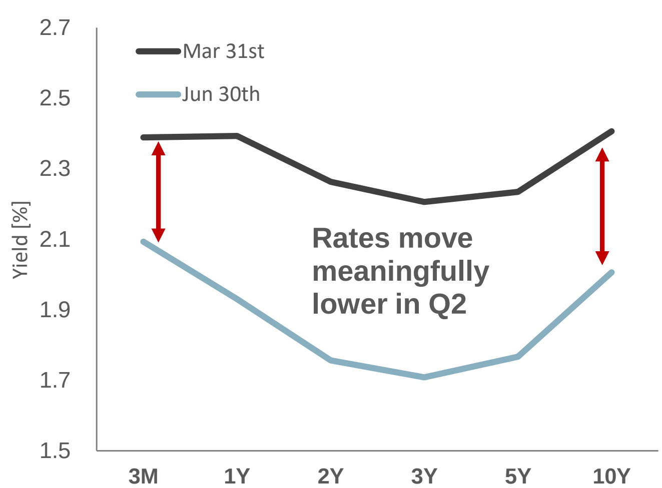

Figure 2*: US Yield Curves (Source: Bloomberg)*

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Party Like It's 1999

North American equity indices are at or near all-time highs. Before this bull market changes course there may well be a period of euphoria as greed takes over and investors cannot stand the thought of missing out. Be very wary of this should it occur. The average stock market decline (from peak to trough) during recessions and bear markets since WWII has been 30% (see *Figure 3* below).

	Recession	Peak Date	Trough Date	% Decline
1	Recession of 1949	06/15/1948	06/13/1949	-21%
2	Recession of 1953	01/05/1953	09/14/1953	-15%
3	Recession of 1958	08/02/1956	10/22/1957	-22%
4	Recession of 1960-61	08/03/1959	10/25/1960	-14%
5	Recession of 1969-70	11/29/1968	05/26/1970	-36%
6	Recession of 1973-75	01/11/1973	10/03/1974	-48%
7	Recession of 1980	02/13/1980	03/27/1980	-17%
8	Recession of 1981-82	11/28/1980	08/12/1982	-27%
9	Early 1990's Recession	07/16/1990	10/11/1990	-20%
10	Early 2000s Recession	03/24/2000	10/09/2002	-49%
11	Great Recession	10/09/2007	03/09/2009	-57%
Non-Recession Bear Markets				
1	1962 Flash Crash	12/12/1961	06/26/1962	-28%
2	1987 Flash Crash	08/25/1987	12/04/1987	-34%
	AVERAGE			**-30%**

***Figure 3**: Characteristics of recessions and related stock market declines (Source: JPM)*

Market cycles typically end on a high note. Recently, we have seen a rash of companies going public with sky high valuations; cannabis stocks are still a hot topic on the cocktail circuit; bitcoin increased by over 300% in less than 6 months; and Beyond Meat is worth more than Molson Coors, as is Chewy, a website that allows you to buy pet food online!!

As defensive investors, we cannot ignore the late cycle signs and geopolitical tensions that could ultimately tip us into a recession. We know with certainty that the economy is cyclical. We also know that after more than 10 years of economic expansion, we are surely closer to the end of this cycle than the beginning. Admittedly, we do not know when the downturn will arrive but we have been preparing for this and feel that our portfolios are well positioned to weather the storm and benefit from the opportunities that lower valuations (and investor panic) will present.

Fixed income

For some time we have focused on keeping our bond maturities short term in duration. Our reasoning was that tying up money for 10 years at historically low rates seemed to be an unwise and risky decision. Economic strength, we believed, would cause central banks to continue to raise interest rates. As our short term bonds matured we would buy new ones with higher rates in the future. We were wrong. Since January 1st, the Government of Canada 5 year yield has fallen from 1.89% to 1.39% as central banks around the world now consider reversing course and lowering rates (see *Figure 4*). In hindsight, the thing to have done was buy the longest dated bonds possible......but then again, hindsight always reveals the best course of action. As mentioned earlier, short dated bonds now yield more than longer maturities. For this reason we will stay the course and maintain a bond portfolio with a relatively short duration.

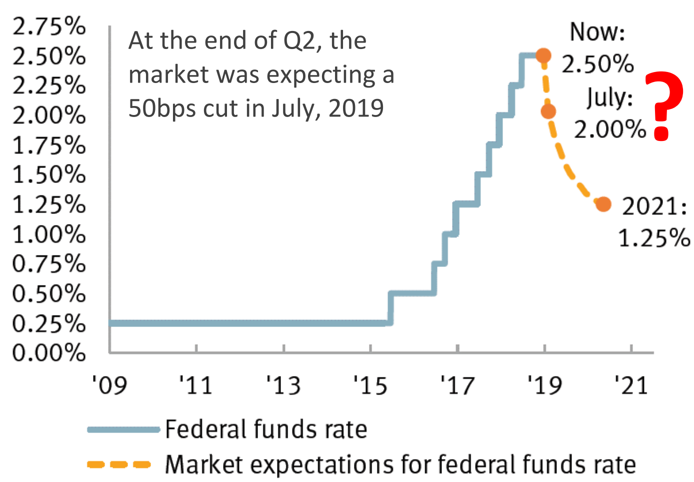

***Figure 4**: US Federal Funds Rate (Source: Bloomberg, RBC)*

Gold

With the recent decline in interest rates, the real yield (after accounting for inflation) has now reached 0% in the US and gone negative in Europe. In this environment investors are compelled to look at alternative stores of value. Typically gold stands out as an attractive option. Additionally, after 6 years of trading sideways (see

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***Figure 5**: Gold Price (Source: Thomson Reuters)*

Figure 5), there has been a lack of investment in bringing new supply to market. All of this helps to explain why the price of gold has recently moved higher. Much of the price increase will fall to the bottom line of the established producers. With this in mind, we have made a small initial investment in an exchange traded fund (ETF) which owns a basket of the world's largest gold companies. In the past, we have been vocal about avoiding the risks of investing in commodity related businesses. For this reason we feel compelled to notify you and explain our rationale. We specifically chose to buy a basket of senior producers rather than take on the risk of one specific company. Should you have specific questions about this investment please be in touch, we would be happy to discuss.

With the exception of some vacation time, we will have a full team in the office through the summer. This can be a great time to book a review of your portfolio and investment policy statement (IPS) before things get busy again in the fall. Please call us at any time to schedule a meeting. Enjoy the summer!

Sincerely,

Scott Sandler
VP & Portfolio Manager

Ronan Clohissey, CIM
VP & Portfolio Manager

	2019 YTD*	1 Year*
Indices		
S&P/TSX	14.38%	0.64%
Dow Jones	14.03%	9.59%
S&P 500	17.35%	8.22%
Nasdaq	20.66%	6.60%
Euro Stoxx	15.73%	2.30%
Japan Nikkei	8.76%	-4.61%
India Sensex	10.36%	11.21%
VIX (Volatility)	-40.68%	-6.28%
Commodities		
Gold	9.91%	12.53%
Silver	-1.16%	-4.98%
Copper	0.55%	-9.71%
Oil	28.76%	-21.15%
Natural Gas	-24.08%	-18.52%
Currency		
CAD	4.16%	0.30%
EUR	-0.82%	-2.66%
JPY	1.60%	2.60%
AUD	-0.41%	-5.20%
GBP	-0.45%	-3.87%

** ending June 30th, 2019*

Wealth Management
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RBC Dominion Securities Inc.

Wealth Management REVIEW

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www.rbcwealthmanagement.com | July 2019

In brief

Supporting emerging artists

At RBC, our commitment to the arts includes supporting artists in the earliest stages of their careers and helping artists bridge the gap from "emerging" to "established." As part of the RBC Emerging Artists Project, the RBC Foundation recently announced its largest-ever annual grant, $300,000 per year for three years, in support of The Music Video Production (MVP) Project. The MVP Project provides grants to artists, directors and producers nationwide to create video treatments in various musical genres, including pop, indie rock, hip-hop, electronic and dance. To learn more about The MVP Project, a joint RBCxMusic/Prism Prize initiative, visit: **www.mvpproject.ca**

A new phase

By Jim Allworth

Our portfolio investment approach is straightforward:

- To get financial markets right you need to get the economy right;
- The economy one needs to get right above all others is the U.S. economy, far and away the largest in the world and the one that sets the cyclical rhythm for the global economy;
- As long as there is no U.S. recession/global economic downturn looming, an investor should remain committed to holding equities at some pre-determined, long-term target exposure in a portfolio;
- Once the path shifts decisively toward an eventual U.S. recession, equities should be approached more cautiously and defensively.

We use a number of indicators and approaches to assess the likelihood of a recession arriving. Six such indicators are rated in the Recession Scorecard (next page). Until just a few months ago all six were unequivocally signaling no recession in sight. Recently one – the gap between short-term Treasury rates and the 10-year Treasury Note rate – has crossed a threshold that would suggest a U.S. recession will be under way in about a year.

Two others – ISM new orders versus inventories and the Conference Board leading economic index – have moved closer to, but not yet crossed, their respective negative signal boundaries. The other three have not and look unlikely to produce a negative signal any time soon.

None of these indicators has a "perfect" historical track record – although some come close. And even if one did there can always be a first time for everything. But followed as a group over time these have given a reliable reading of how the recession probabilities are shifting.

The indicator that has "flipped" to negative is the so-called "shape of the yield curve," much discussed in the financial press. Simply put, the gap between short-term interest rates and long-term yields, normally comfortably wide in favour of the latter, has flip-flopped with short-term T-Bill rates now higher than the 10-year Treasury Note yield. This "inversion" has almost always been a harbinger of a recession arriving a year or so down the road.

Predictably, many opinions – often well-reasoned and compelling – are being offered on why yield curve inversion no longer matters or at

Continued on page 2

A new phase ... Continued from page 1

U.S. recession scorecard

Indicator	Status		
	Expansion	Neutral	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

least doesn't matter in this instance. In our experience such opinions have always appeared at the time of previous inversions but, typically, recessions arrived nonetheless.

For our part we are treating this occurrence as a "shot over the bow" for equity investors – one that should provoke an extra degree of vigilance. Were more indicator pins to topple in the coming months our defensive leanings would intensify. Virtually all bear markets have been associated with U.S. recessions and usually the stock market has set its final peak for the cycle some months before the recession begins. So, within the historical context, the inverting of the yield curve in May can be seen as opening the door to the arrival of a potential bull market peak for the first time in 10 years.

All that said, the other indicators in the scorecard have yet to topple into negative territory. The U.S. economy continues to grow, especially the all-important and dominant consumer sector. Credit conditions remain largely accommodative – i.e., interest rates are low and banks willing to lend. The corporate earnings outlook is constructive, if not overtly buoyant, while price/earnings multiples – 17.8x this year's forecast earnings for the S&P 500, 15.2 for the TSX – though not cheap are not unusually demanding either.

Nor are the market's internals particularly worrying. The majority of stocks have been moving up in gear with the broad averages. This is not a case where the indexes are being propelled higher by a handful of fast-rising, large cap favorites. While there are some narrow pockets of speculative activity – cannabis stocks come to mind – the broad-based "get-in-at-any-cost," unsustainable market froth characteristic of many market tops seems to us to be completely absent. If anything investor attitudes are mostly cautious and somewhat downbeat.

In what we expect will be a repeated theme in this space, we counsel investors to revisit the question of "risk appetite" were an economic and earnings downturn to play out sometime in the coming quarters. Focusing on the quality of holdings also seems more than usually appropriate.

We believe it's too early to become overtly defensive in equity portfolios. But thoughtful readiness and preparation for a change in the investment landscape, which might arrive unannounced or from an unexpected quarter, is always the right policy.

For more thoughts on how to structure portfolios in the current environment please request a copy of our latest issue of *Global Insight Monthly.*

Jim Allworth is co-chair of the RBC Global Portfolio Advisory Committee.

Beware U.S. recessions