

Global Insight

Weekly

To QE, or not to QE

Thomas Garretson, CFA – Minneapolis

That is the question investors are pondering as a record run for U.S. stock markets in recent months has coincided with the first expansion of the Fed's balance sheet in years, raising concerns that risk asset rallies are being fueled by the Fed, and not by fundamentals.

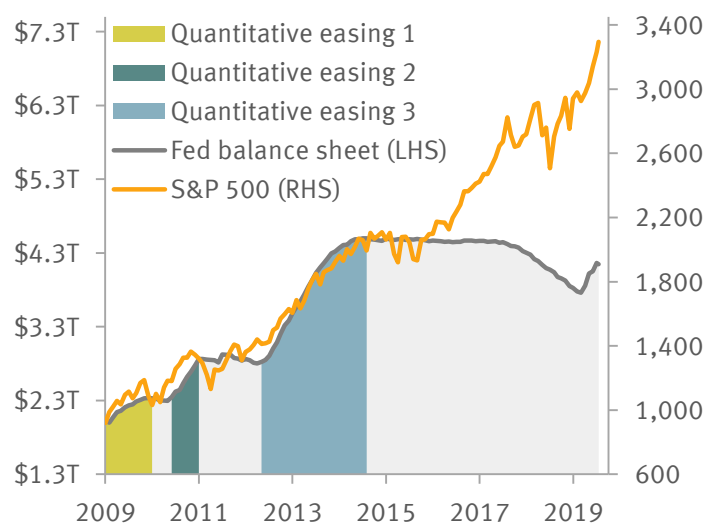
For the first time since 2014, when the Fed ceased its third round of quantitative easing (QE) via asset purchases of Treasuries and mortgage-backed securities, the Fed's balance sheet is once again on the rise. Since last September, the Fed's balance sheet has grown by almost \$400 billion, while the S&P 500 has rallied by nearly 13 percent, setting 34 new record highs in the process.

Naturally, skepticism abounds with respect to the legitimacy of this latest rally, as it has correlated nearly perfectly with the expansion of the Fed's balance sheet—while debates centered on whether the Fed's latest round of asset purchases is a form of “quantitative easing” that is boosting markets rage on.

This was a common narrative during the early part of the post-financial crisis period, as stock markets were highly correlated with the Fed's balance sheet and each round of quantitative easing—as seen in the chart—and that stocks were only rising because of the actions of the Fed. The second narrative was that as soon as the Fed stepped away it would be time to get out of markets without the Fed's support. Of course, as the chart also shows, that proved not to be the case as the S&P 500 eventually carried on its merry way as economic and earnings fundamentals continued to improve.

Now, as was the case then, we would recommend that investors not take their investing cues from the Fed's balance sheet. The Fed has certainly moved to provide support for markets and the economy in recent months, but this latest balance sheet expansion is more technical in nature than it is stimulative, in our view, and there may be other factors at play.

The Fed's balance sheet is expanding again; is this fueling the recent stock market run?



Source - RBC Wealth Management, Bloomberg, Federal Reserve; data through 1/15/20

Market pulse

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- 4 Relief for Japan's fragile economic recovery?

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Faulty plumbing

The Fed began buying short-dated Treasury bills last fall amid signs of stress in the repurchase, or “repo,” markets, an indication of liquidity issues in the financial system. This differs notably from the QE programs of the past where the Fed was buying longer-dated securities and other assets in an effort to push yields down.

The latest balance sheet expansion is simply a reflection of—and necessitation for—the implementation of monetary policy under the Fed’s new regime of excess bank reserves in order to keep short-term interest rates within the Fed’s target range of 1.50 percent to 1.75 percent.

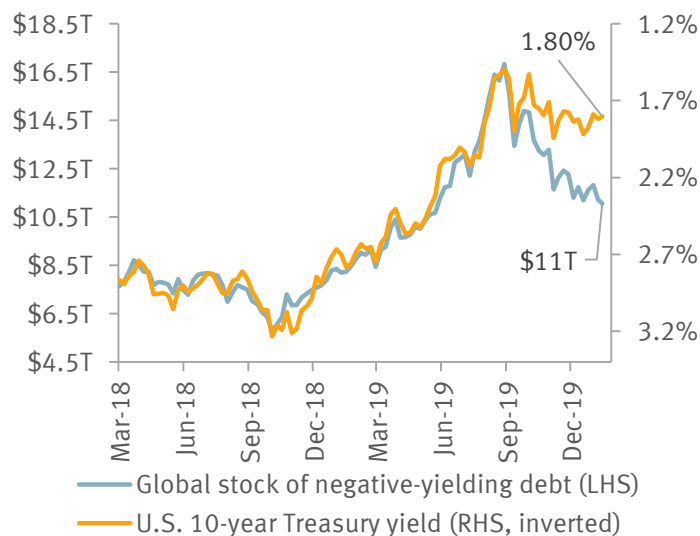
The key point is that the Fed’s balance sheet will likely never return to pre-crisis levels that were below \$1 trillion and that this is now the norm. We believe the Fed will continue to build a buffer of excess reserves in the financial system via Treasuries to be purchased through June of this year, and that the balance sheet will then continue to grow “organically,” as it always has in line with demand for currency and other factors—taking it beyond even levels seen in the aftermath of the financial crisis.

But this week Federal Reserve Bank of Dallas President Robert Kaplan was the latest to weigh in on the idea that the Fed may be behind the rally in risk assets. He voiced a concern that the combination of recent rate cuts, the Fed’s commitment to keep policy rates on hold, and the expansion of the balance sheet “are contributing to elevated risk-asset valuations. And I think we [the Fed] ought to be sensitive to that.” To be sure, Fed Chair Jerome Powell, for his part, has been adamant that balance sheet expansion has not been adding stimulus to the economy. While minimal inflationary pressures give the Fed room to be patient, we expect that financial stability concerns will be a more frequent topic for Fed officials in the weeks and months ahead.

Breaking up is hard to do

Beyond the Fed’s balance sheet, though perhaps somewhat related to the current stance of Fed policy, is the lack of a threat posed from U.S. Treasury yields that may be helping to support risky assets, including U.S. equity and credit markets. The

Negative-yielding debt dragged U.S. yields lower; why isn't its decline pulling U.S. yields higher?



Source - RBC Wealth Management, Bloomberg Barclays Global Agg. Negative Yielding Debt Index; data through 1/16/20

benchmark Treasury yield has held below two percent since last August, even as the global stock of negative-yielding debt has declined sharply amid a modestly improved global growth backdrop, breaking a relationship with global yields that had been in place for over a year.

We would focus more of our attention on this dynamic than on the progression of the Fed’s balance sheet. While low Treasury yields may be a positive for stock markets and valuations, the Treasury market appears to be pricing in a somewhat more subdued economic outlook than stocks currently are, even as the global outlook is improving.

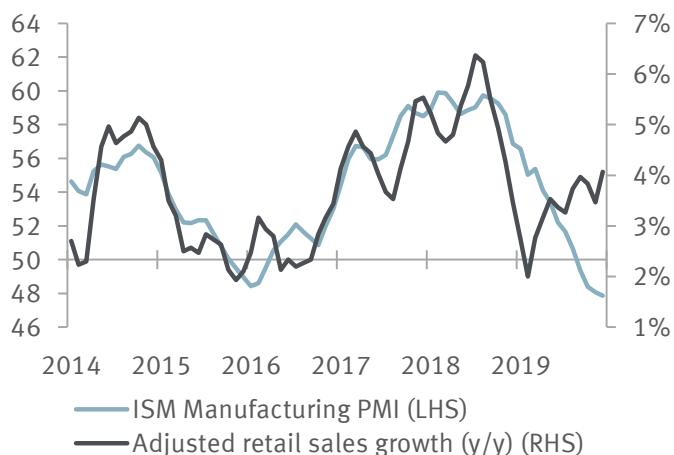


United States

Bill Kuehn, CFA – Minneapolis

- **December's retail sales data reaccelerated from November's slowdown**, with sales expanding 5.8% y/y. With record-high equity prices, the announcement of a Phase 1 trade deal with China, and overall elevated consumer confidence, it comes as little surprise that retail sales were strong in December during the all-important holiday shopping season. With the consumer remaining the backbone of U.S. economic growth, **the December acceleration in spending was a welcome sign**; however, when the headline retail sales number is peeled back, the outlook isn't quite as rosy.
- Weak sales in December 2018 that were hindered by slumping equity prices, and the government shutdown exaggerated the strength of December 2019's results, as the year-over-year comparison was quite easy. Additionally, Thanksgiving, almost a week later than in 2018, also helped push sales into December. Following the data release, **the Atlanta Fed revised its GDP Now model for fourth-quarter GDP growth lower**, to 1.8% q/q from 2.3% q/q, citing an estimate that fourth-quarter real personal consumption expenditures growth declined to 1.6% q/q from 2.3% q/q.
- As we kick off fourth-quarter earnings season, **many U.S. banks have reported earnings this week, with mixed results**. Generally, banks' trading divisions have surprised analysts by generating more revenue in the fourth quarter than anticipated. However, the three interest rate cuts by the Federal Reserve in 2019 are beginning to erode net interest margins on banks' loan portfolios, with the reduced loan revenue offsetting the strength in trading revenue. Banks

Consumer spending keeps driving economic growth as manufacturing slump continues



Source - RBC Wealth Management, Bloomberg; 3-month rolling averages through 1/16/20



Canada

Ryan Harder & Meika McKelvey – Toronto

- **Canadian employment bounced back in December** with the economy adding 35,200 jobs. Monthly job growth averaged an impressive approximately 27,000 in 2019, for a yearly gain of 320,000—the second-highest level since 2007. Overall, the details underpinning the headline employment beat were mainly positive with **full-time jobs completely reversing the November weakness**, while the usually stable unemployment rate unwound 0.3 percentage points of the 0.4 percentage point increase seen last month, returning to near **multi-decade lows** at 5.6%. Unfortunately, the **wage picture was not as rosy** with average hourly earnings growth slowing to 3.8% y/y for permanent workers. December's print essentially leaves the labour market looking more like it did after the October report and was an encouraging data point following the series of weaker activity prints in Q4 2019.
- **The Q4 Business Outlook Survey (BOS) added some additional optimism** to the Canadian outlook, showing a **marginal improvement in business sentiment** as the headline indicator rose to +0.7 from +0.4. According to the Bank of Canada (BoC), the BOS results suggest business sentiment is “broadly positive” and in aggregate, firms' outlooks are supported by expectations of “healthy domestic and foreign sales.” **Capacity pressures also remained elevated**, signaling to the BoC that the economy appears to be operating close to full employment—likely helping to discount some of the weakness seen in recent data. Interestingly, in a special survey question, the **BoC asked firms about climate change** for the first time, with more than 50% of the affected respondents noting negative impacts.
- Next Wednesday, **the BoC will hold its first rate meeting of 2020**, accompanied by the release of an updated Monetary Policy Report. With a bounceback in employment for December, balanced comments from BoC Governor Stephen Poloz on January 9, and a modestly upbeat BOS, we think it would be difficult to make a case for an immediate rate cut in January. RBC Capital Markets is looking for the BoC to remain on hold until April, and market pricing for a policy move next week is close to 0%.

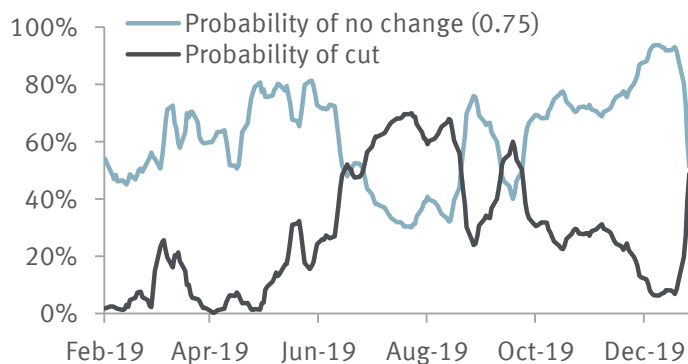


Europe

Alastair Whitfield – London

- News in Europe has taken a bit of a back seat, with no major data or events, and the focus has been more localized to the UK. **The Bank of England (BoE) for one has been causing a stir for foreign exchange and fixed income markets** since last weekend, with a number of Monetary Policy Committee (MPC) members **signaling the potential need for a cut in interest rates**. This impacted the pound in the early part of this week, falling to 1.2959 against the dollar before recovering to 1.3055 on January 16. Similarly, UK government 10-year bond yields have fallen to 0.64% from 0.77% on January 10. Meanwhile, the FTSE 100 remained broadly flat up to Thursday this week despite some intraday volatility. While the signals from the MPC included one current dissenting voter on the committee (Michael Saunders), which doesn't come as a surprise, **the market has moved substantially in pricing the probability of a rate cut at over 60%**.
- **The latest Consumer Price Index data added fuel to the fire** in disappointing consensus expectations, with a December headline print of 1.3% vs. 1.5% in the prior month and the consensus estimate of 1.5%. Despite the decline, this actually leaves inflation in line with the MPC's average forecast of 1.4% over the last three months. So it **may not be quite as bad as the headline reading may suggest**.
- While a **contraction in GDP data for November** of -0.3% has been another factor for the market increasing expectations for a potential rate cut, **we believe this does not provide evidence of how the economy has responded to the election outcome**. It does, however, point to the fact that at a time of notable uncertainty ahead of the election, GDP grew slightly better than consensus expectations by 0.1% in the three months to the end of November.

Market-implied odds of a rate cut drastically increase as MPC members signal need for cut



Source - RBC Wealth Management, Bloomberg; weekly averages through 1/16/20

- This emphasizes that while there is reason for caution, **MPC members will be looking for evidence between now and the next BoE meeting on January 30 for signs of a pickup in the economy** since last month's election.
- **UK Flash Purchasing Managers' Index data at the end of next week will be key** in providing a steer on whether there are signs of improvement in the economic data. Consensus estimates look for a print in expansionary territory at 50.7 for January, up from 49.3 in the prior month.



Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- **Asian equity markets traded mostly higher for the week, led by South Korea**. Positive investor sentiment, boosted by the prospect of the signing of the U.S.-China Phase 1 trade deal and the slightly better-than-expected macro data, helped to propel the KOSPI Index to a nine-month high.
- **The U.S. and China finally signed the "momentous" partial trade deal on January 15, putting the brakes on an 18-month-long trade dispute**. The agreement includes pledges from China to import an additional \$200 billion of U.S. products, adds protections for U.S. intellectual property, and introduces new enforcement mechanisms that allow Washington to quickly impose penalties should certain terms be breached, which Beijing cannot respond to. As expected, tariffs on nearly \$300 billion of Chinese imports remain in place. The latest study by the National Bureau of Economic Research suggests that American companies and consumers are paying almost the full cost of the U.S. tariffs. While the worst appears to be behind us, **we continue to expect the road ahead to be bumpy, with thornier Phase 2 negotiations on the table** and risks of the U.S. imposing fresh levies in the event of Chinese non-compliance.
- **Japan's core machinery orders soared 18% m/m in November, their biggest monthly expansion on record**. Core machinery orders are regarded as an indicator of capital spending in the coming two to three quarters. The latest reading reinforces our belief that **business spending can help to sustain a fragile economic recovery in Japan**. Economists believe the Bank of Japan will slightly revise up its economic forecast for the new fiscal year to reflect an expected boost from the government's latest spending package.
- **Ties between China and South Korea appear to be improving, as tour agencies in China have resumed selling tour packages to South Korea**. The anticipated arrival of Chinese visitors boosted the share prices of several Korean cosmetics producers, such as Amorepacific (090430 KS) and Kolmar Korea (161890 KS), and travel services companies, such as Modetour Network (080160 KS).



MARKET SCORECARD

Data as of January 16, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,316.81	2.7%	2.7%	26.8%	19.5%
Dow Industrials (DJIA)	29,297.64	2.7%	2.7%	21.0%	13.6%
NASDAQ	9,357.13	4.3%	4.3%	33.0%	29.5%
Russell 2000	1,705.22	2.2%	2.2%	17.2%	8.4%
S&P/TSX Comp	17,484.77	2.5%	2.5%	15.7%	7.3%
FTSE All-Share	4,222.79	0.6%	0.6%	12.0%	-0.9%
STOXX Europe 600	420.54	1.1%	1.1%	20.0%	5.6%
EURO STOXX 50	3,774.14	0.8%	0.8%	22.6%	4.2%
Hang Seng	28,883.04	2.5%	2.5%	7.4%	-9.5%
Shanghai Comp	3,074.08	0.8%	0.8%	19.6%	-10.5%
Nikkei 225	23,933.13	1.2%	1.2%	17.1%	-0.1%
India Sensex	41,932.56	1.6%	1.6%	15.4%	20.6%
Singapore Straits Times	3,278.00	1.7%	1.7%	1.5%	-7.7%
Brazil Ibovespa	116,704.20	0.9%	0.9%	23.6%	46.2%
Mexican Bolsa IPC	45,303.08	4.0%	4.0%	3.4%	-8.5%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,553.28	2.4%	2.4%	20.1%	16.1%
Silver (spot \$/oz)	17.95	0.5%	0.5%	15.1%	4.4%
Copper (\$/metric ton)	6,252.50	1.7%	1.7%	5.3%	-11.1%
Oil (WTI spot/bbl)	58.52	-4.2%	-4.2%	11.9%	-8.2%
Oil (Brent spot/bbl)	64.74	-1.9%	-1.9%	5.6%	-6.4%
Natural Gas (\$/mmBtu)	2.08	-5.1%	-5.1%	-38.6%	-33.6%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.806%	-11.2	-11.2	-91.6	-73.1
Canada 10-Yr	1.556%	-14.6	-14.6	-44.1	-61.7
U.K. 10-Yr	0.643%	-17.9	-17.9	-66.8	-66.0
Germany 10-Yr	-0.219%	-3.4	-3.4	-44.3	-78.1
Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.23%	0.7%	0.7%	9.4%	9.9%
U.S. Invest Grade Corp	2.77%	0.8%	0.8%	15.0%	12.9%
U.S. High Yield Corp	5.02%	0.7%	0.7%	11.7%	11.8%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.2980	0.9%	0.9%	1.3%	7.6%
CAD/USD	0.7667	-0.4%	-0.4%	1.6%	-4.7%
USD/CAD	1.3043	0.4%	0.4%	-1.6%	4.9%
EUR/USD	1.1137	-0.7%	-0.7%	-2.2%	-9.2%
GBP/USD	1.3074	-1.4%	-1.4%	1.5%	-5.2%
AUD/USD	0.6898	-1.8%	-1.8%	-3.8%	-13.4%
USD/JPY	110.1600	1.4%	1.4%	1.0%	-0.3%
EUR/JPY	122.6800	0.7%	0.7%	-1.3%	-9.4%
EUR/GBP	0.8518	0.7%	0.7%	-3.7%	-4.2%
EUR/CHF	1.0747	-1.0%	-1.0%	-4.8%	-8.6%
USD/SGD	1.3470	0.1%	0.1%	-0.6%	2.0%
USD/CNY	6.8789	-1.2%	-1.2%	1.8%	6.7%
USD/MXN	18.7771	-0.8%	-0.8%	-0.6%	0.0%
USD/BRL	4.1839	3.8%	3.8%	12.0%	29.8%

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 8:48 pm GMT 1/16/20.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -0.4% return means the Canadian dollar fell 0.4% vs. the U.S. dollar year to date. USD/JPY 110.16 means 1 U.S. dollar will buy 110.16 yen. USD/JPY 1.4% return means the U.S. dollar rose 1.4% vs. the yen year to date.

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			Count	Percent
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Hold [Sector Perform]	625	42.46	127	20.32
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