June 11, 2020

RBC WEALTH MANAGEMENT

Global Insight Weekly

No V-shaped recovery for interest rates

Thomas Garretson, CFA – Minneapolis

Well, with the Fed's punch bowl here to stay, investors are looking at another multiyear period of low interest rates. We explore why this one may be even more challenging than the last, and look at how to position fixed income portfolios in the low-yield world.

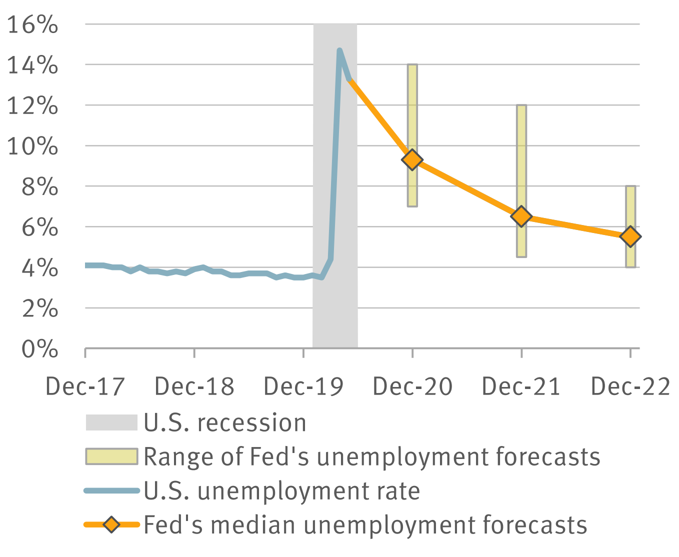
Perhaps it was nothing more than a formality at this point, but this week the Fed made clear that interest rates will remain at zero percent through at least 2022—the Fed's current forecast horizon—even as tentative signs mount that the economic reopening is progressing, which has given way to some notion that the Fed may consider pulling back on the reins.

To wit, following the meeting of the Federal Open Market Committee, Fed Chair Jerome Powell stated in his press conference on June 10 that "We're not thinking about raising rates. We're not even thinking about thinking about raising rates." And all indications are that the Fed won't start thinking about thinking about it for quite some time as there was near-unanimous consensus among officials that rates will need to remain at zero percent for years to come.

However, there was considerably less consensus about the economic outlook—which should be expected given what will remain heightened uncertainty—while this week's stock market selloff serves as a reminder that the road back will be rocky. But even with all of the monetary and fiscal stimulus delivered thus far, the Fed expects GDP to drop by 6.5 percent this year, followed by a five percent rebound next year. One half of the Fed's dual mandate—price stability—isn't expected to be achieved over the Fed's entire forecast horizon as inflation is seen falling short of the two percent target. The other half of the mandate—maximum employment—and the key focus for the Fed, risks falling well short for years as well.

As the chart at right shows, unemployment is only seen falling to 5.5 percent by the end of 2022, which would still be a full

Labor market recovery not expected for years



Source - RBC Wealth Management, Bloomberg, Federal Reserve

Market pulse

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3 Slower recovery for Canada's slumping home sales?
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Click here for authors' contact information. Priced (in USD) as of 6/11/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see** **page 6.**
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two percent above the 2019 low of 3.5 percent. However, there is considerable variability around the Fed's forecasts. While unemployment is expected to end this year around 9.3 percent, the individual forecasts from Fed officials span from seven percent all the way to 14 percent. The same holds true in the years ahead, but even the most optimistic forecast has the unemployment rate at four percent by the end of 2022; the Fed continues to estimate "full employment" for the economy as being approximately 4.1 percent. Our view remains that the bar for raising rates is a return to four percent unemployment.

Finally, the chart on the previous page also indicates that the U.S. has officially entered a recession as of February—as determined this week by the Business Cycle Dating Committee of the National Bureau of Economic Research. RBC Economics continues to expect a 35 percent decline in GDP this quarter, followed by a 20 percent rebound in Q3. Should that hold, this recessionary period should last roughly six months—shorter than average, but far deeper.

With unemployment expected to remain elevated, combined with low inflation and growth uncertainty, we believe the Fed is only focused on adding further stimulus rather than pulling back in any way. We look for policy changes at the September policy meeting when officials will have more data, and hopefully a more reopened domestic and global economy to support.

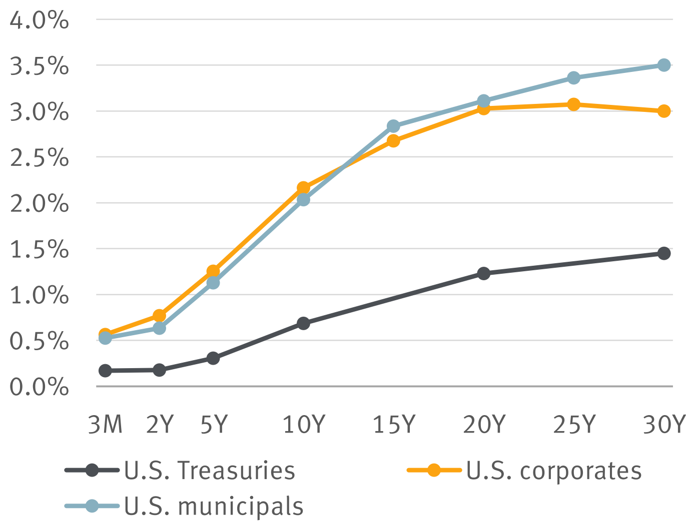
Lower for longer. Again.

While zero percent interest rates are necessary to support the economic recovery, this environment likely ushers in another multiyear period of low interest rates for investors—and we believe this one may be even more challenging than the last in some ways.

During the last stretch of zero-interest-rate Fed policy from 2009 through 2015, the 10-year Treasury yield averaged approximately 2.6 percent; it currently yields just 0.6 percent. Low Treasury yields also mean near-record low yields for other asset classes like corporate and municipal bonds.

With respect to yield curve positioning, we shifted to a Neutral stance this week following an extended period of favoring long-duration exposure as yields have declined over the past 18 months. At this point, the outlook for Treasury yields is now roughly balanced, in our view, with the prospect of further quantitative easing, along with the chance that the Fed launches a yield curve control program, likely to anchor rates at or below current levels—while the prospect of improving

With the Fed likely stuck at 0%, investors can extend and lock in coupons



Source - RBC Wealth Management, Bloomberg; tax-equivalent yield shown for municipals assuming 40% tax rate, but will differ based on individual investor tax rates

growth and higher inflation on the back of massive stimulus could offset that and fuel modestly higher yields. At this stage, we are comfortable remaining near benchmark duration targets, or focusing on the intermediate portion of yield curves—approximately between 7–20 years.

Notably, we would highly recommend avoiding short-duration maturities and rolling over bonds as reinvestment risk will likely remain high. Another way to approach portfolios, and to think about interest rate risk in a low-yield world, is to take advantage of relatively steep yield curves. Using Treasuries as an example, instead of buying a 5-year Treasury that currently yields 0.30 percent, investors can buy a 10-year Treasury that yields near 0.70 percent, and in five years' time rolls down to become a 5-year security priced to a yield closer to zero percent, particularly if the Fed remains on hold. Investors benefit from both the higher income and the price appreciation of the bond over that horizon—which could then be sold and reinvested. The benefit is more pronounced for higher-yielding credit products.

In a low-yield world, fixed income portfolios will require a more active approach to generate income and total return. But ultimately, bonds will still provide ballast for portfolios, and act as a source of capital preservation in times of volatility.

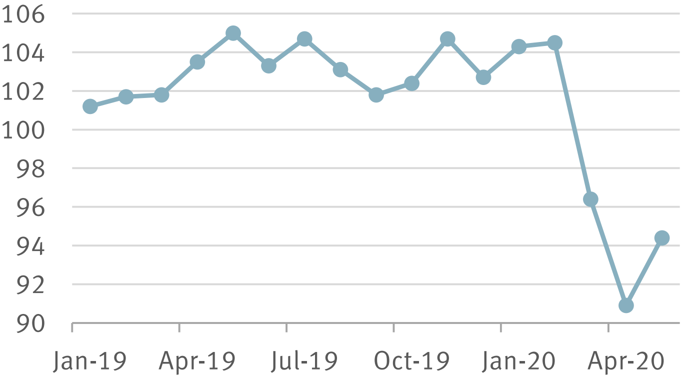
United States

Alan Robinson – Seattle

- **The National Bureau of Economic Research unsurprisingly made its official determination the economy is in recession**, with February 2020 marking the peak of the longest American economic expansion on record. The bigger issue in our minds is the likely timeline to recovery. RBC Global Asset Management, Inc. Chief Economist Eric Lascelles estimates the economy will not regain its pre-COVID-19 level of economic output until 2022.
- Consequently, **equity markets took a turn for the worse** during the week as better news from small businesses, and resilience in Technology stocks, were outweighed by lofty stock valuations and worsening COVID-19 news.
- **The cumulative number of COVID-19 cases in the U.S. reached the grim milestone of 2 million on June 10**, as active community spread accelerated in locations that largely avoided the first round of infections. Summer activities combined with lockdown fatigue contributed to COVID-19 hospitalizations increasing by a third in Arizona and Texas since Memorial Day. The impact of widespread protests may exacerbate transmission, although this may not become evident until later in the month. **A potential second wave of cases may dampen the partial recovery the market currently expects to unfold in 2021, in our view.**
- The dramatic rebound in stock prices since the low of March 23 had pushed valuation multiples to uncomfortable levels at the start of the week, with the S&P 500 trading near a 21x multiple of consensus earnings forecasts for 2021. Traders also noted **pockets of speculative excess on the part of retail investors**, with lower-quality stocks increasingly in favor.

Small business owners' outlook turning positive

NFIB Small Business Optimism Index



Source - National Federation of Independent Business, RBC Wealth Management; monthly data through May 2020

- It was not all bad news during the week, as **Technology stocks set new all-time highs before succumbing to the overall market decline**. The NASDAQ closed above 10,000 for the first time on June 10, as the Tech sector is viewed as a long-term beneficiary of post-COVID-19 work habits.
- Additionally in May, the **Small Business Optimism Index increased by the most since 2017** as business conditions improved with the easing of lockdown restrictions. However, optimism remains significantly below pre-pandemic levels from February.

Canada

Carolyn Schroeder & Richard Tan, CFA – Toronto

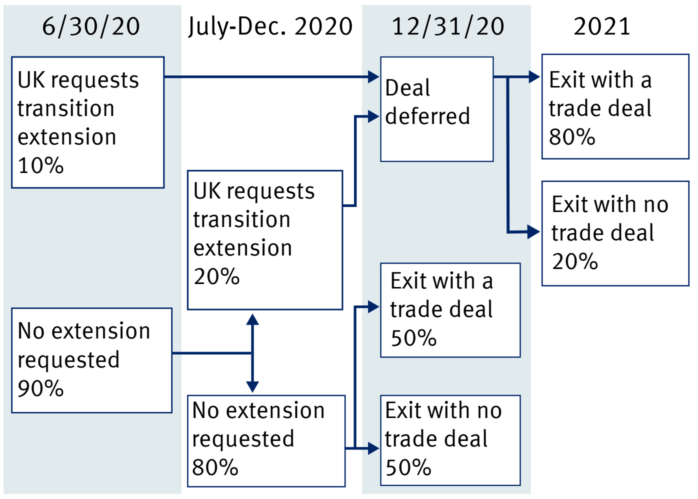
- **Positive steps continue across Canada as all provinces are now gradually reopening parts of their economies.** Barring any setbacks in containing the spread of COVID-19, RBC Economics believes the reopening process will set the stage for a meaningful economic recovery over the second half of this year and into 2021, although the pace of the recovery will likely vary across the country. Some provinces are lifting lockdown restrictions a little more quickly than others, in part reflecting various levels of progress in containing the pandemic. According to RBC Economics, this will give British Columbia, Manitoba, and New Brunswick a head start on their recoveries. **Statistics Canada's Labour Force Survey for May showed an earlier-than-expected pickup in jobs and hours worked.** Other economic indicators, including housing starts and RBC's proprietary consumer card spending data, also point to some near-term resilience or strengthening. **Regardless, a full economic recovery will be a long and bumpy road for all provinces**, stretching beyond 2022 in some cases, in our view, due to some forms of social distancing remaining in place, permanent business closures, weakened balance sheets, and lower internal migration.
- Despite low interest rates and the seasonally strong spring period, **home resales plummeted to a 30+ year low in April** in key geographies such as Toronto, Vancouver, and Calgary. On July 1, the largest mortgage insurer (the Canadian Mortgage Housing Corporation, or CMHC) is set to adopt stricter underwriting policies (e.g., lower debt service levels and banning "non-traditional" sources of down payments such as tapping lines of credit). This in turn should improve the credit quality of Canadian home buyers, but will also likely lead to a slower recovery in home resales, in our opinion. The CEO of the CMHC also publicly stated that **home prices could retrace by 9%–18% over the next 12 months**, with more pronounced declines in oil-sensitive regions or areas that have experienced accelerated capital appreciation. Lastly, with mortgage deferral programs scheduled to expire by September, **housing could see some additional turbulence** in the months ahead unless the labour market improves.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **After a risk-on rally**, which lifted the STOXX Europe 600 ex UK Index more than 40% and the FTSE All-Share Index by some 35%, both in local currency terms, **investors took profits**. In Europe, sub-sectors that had led the rally, such as Insurance, Industrials, and Construction, suffered profit taking to the largest extent.
- **EU-UK Brexit negotiations came to naught.** Conventional wisdom that a last-minute agreement to extend the current transition period, ensuring the status quo until December 31, 2020, will be hammered out before the June 30 deadline is being put to the test. Without such an extension, **trade between the EU and UK would fall onto unfavourable World Trade Organization terms and would be an additional unwelcome challenge** at a time the economy is already suffering due to COVID-19. There is a small chance the end-of-June deadline to request an extension is less binding than it appears, though RBC Capital Markets puts this at a low 20%. Without such an extension, the possibility of a no-trade-deal Brexit at the end of 2020 would become the base-case scenario. Should this occur, RBC Capital Markets expects it would translate into downside for GBPUSD of between 5% and 7%.
- **Consumer goods giant Unilever announced a new proposal to unify its dual legal structure into a single legal entity**—Unilever plc, based in the UK. An earlier proposal to allow for unification into the Dutch NV entity was withdrawn in October 2018 as it would have resulted in Unilever plc losing its FTSE listing in the UK. Under the new proposal Unilever expects to remain a constituent of the Dutch AEX Index. The company's board stated the move would bring significant benefits by "increasing Unilever's strategic flexibility for portfolio evolution", as well as "removing complexity and further strengthening Unilever's corporate governance".

Subjective probabilities of Brexit deal scenarios



Source - RBC Capital Markets, RBC Wealth Management; sum of probabilities to exit with a trade deal = 58%, sum to exit without a trade deal = 42%

Asia Pacific

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

- **The Asia-Pacific equity market traded sharply lower on June 11**, weighed down by concerns of a second wave of virus infections, ending the eight-day winning streak for the MSCI Asia Pacific Index.
- **China's exports contracted 3.3% y/y in May** as global COVID-19 lockdowns continued to depress demand. The decline was, however, **better than the 7% drop forecast** in a Reuters poll of economists. On the other hand, imports fell 16.7% y/y, worse than the 9.7% estimate. Economists attributed this sharper decline to insufficient domestic demand and weaker commodity prices. Both official and private factory surveys for May showed sub-indexes for export orders remained in deep contraction. **Bright spots like exports of medical supplies, of which China has dominated the supply chain, have masked the strong headwinds faced by other exporters** stuck with unsold stock from cancelled orders and diminished demand from abroad. We think the outlook for exports, in particular new orders, will gradually improve with the easing of lockdowns across the EU and U.S.
- **The tit-for-tat actions between the U.S. and China continue.** The U.S. is weighing plans to treat more Chinese media outlets as "foreign missions," according to the Wall Street Journal. This would require them to declare their staff and assets in the U.S. and abide by similar rules as diplomatic entities. Meanwhile, the U.S. also plans to limit China's airlines to two weekly round-trip flights in response to Beijing restricting American carriers to one flight per week. While we expect such back-and-forth retaliations to continue, **we do not expect a sharp escalation as both the U.S. and Chinese economies are in a recession and we doubt either side wants to make things worse**.
- **Cathay Pacific Airways (293 HK) announced a recapitalisation plan worth HK\$39 billion (US\$5.03 billion)** led by the Hong Kong government to help it weather the COVID-19 pandemic. According to Hong Kong's financial secretary, **the goal of the bailout is to protect Hong Kong's role as a global aviation hub** and ensure the city's long-term economic development, while generating a reasonable return for the government.

MARKET SCORECARD

Data as of June 11, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,002.10	-1.4%	-7.1%	4.0%	7.9%
Dow Industrials (DJIA)	25,128.17	-1.0%	-11.9%	-3.5%	-0.8%
NASDAQ	9,492.73	0.0%	5.8%	21.4%	23.9%
Russell 2000	1,356.22	-2.7%	-18.7%	-10.7%	-19.0%
S&P/TSX Comp	15,050.92	-0.9%	-11.8%	-7.4%	-7.5%
FTSE All-Share	3,363.63	0.0%	-19.8%	-16.8%	-21.1%
STOXX Europe 600	353.07	0.8%	-15.1%	-7.3%	-9.0%
EURO STOXX 50	3,144.57	3.1%	-16.0%	-7.5%	-9.6%
Hang Seng	24,480.15	6.6%	-13.2%	-11.9%	-21.2%
Shanghai Comp	2,920.90	2.4%	-4.2%	-0.2%	-4.3%
Nikkei 225	22,472.91	2.7%	-5.0%	6.0%	-1.5%
India Sensex	33,538.37	3.4%	-18.7%	-16.1%	-5.5%
Singapore Straits Times	2,704.21	7.7%	-16.1%	-15.7%	-21.4%
Brazil Ibovespa	94,686.00	8.3%	-18.1%	-4.3%	30.9%
Mexican Bolsa IPC	36,827.36	2.0%	-15.4%	-15.8%	-20.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,728.55	-0.1%	13.9%	30.3%	32.9%
Silver (spot $/oz)	17.65	-1.2%	-1.1%	19.7%	4.3%
Copper ($/metric ton)	5,885.00	10.0%	-4.3%	0.5%	-18.9%
Oil (WTI spot/bbl)	36.34	2.4%	-40.5%	-31.8%	-45.0%
Oil (Brent spot/bbl)	38.16	8.0%	-42.2%	-38.7%	-50.1%
Natural Gas ($/mmBtu)	1.82	-1.6%	-16.9%	-24.1%	-38.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.663%	1.0	-125.5	-148.1	-228.9
Canada 10-Yr	0.520%	-1.4	-118.2	-100.8	-178.6
U.K. 10-Yr	0.198%	1.4	-62.4	-66.1	-120.9
Germany 10-Yr	-0.414%	3.3	-22.9	-18.2	-90.7
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.30%	0.2%	5.7%	9.5%	17.5%
U.S. Invest Grade Corp	2.23%	1.3%	4.3%	11.0%	20.6%
U.S. High Yield Corp	6.40%	2.9%	-2.0%	2.9%	9.2%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	96.8050	-1.6%	0.4%	0.1%	3.4%
CAD/USD	0.7337	1.1%	-4.7%	-2.5%	-4.8%
USD/CAD	1.3630	-1.1%	4.9%	2.6%	5.0%
EUR/USD	1.1290	1.7%	0.7%	-0.3%	-4.2%
GBP/USD	1.2589	2.0%	-5.0%	-1.1%	-5.9%
AUD/USD	0.6847	2.7%	-2.5%	-1.7%	-10.0%
USD/JPY	106.9000	-0.9%	-1.6%	-1.5%	-2.8%
EUR/JPY	120.6900	0.8%	-0.9%	-1.8%	-6.9%
EUR/GBP	0.8968	-0.3%	6.0%	0.8%	1.8%
EUR/CHF	1.0660	-0.1%	-1.8%	-5.2%	-8.2%
USD/SGD	1.3933	-1.4%	3.5%	2.1%	4.4%
USD/CNY	7.0650	-1.0%	1.5%	2.2%	10.4%
USD/MXN	22.7214	2.5%	20.1%	18.8%	10.3%
USD/BRL	4.9750	-6.8%	23.4%	31.7%	34.0%

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 9:35 pm GMT 6/11/20.

Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -4.7% return means the Canadian dollar fell 4.7% vs. the U.S. dollar year to date. USD/JPY 106.90 means 1 U.S. dollar will buy 106.90 yen. USD/JPY -1.6% return means the U.S. dollar fell 1.6% vs. the yen year to date.

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As of March 31, 2020

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Buy [Outperform]	755	51.64	220	29.14
Hold [Sector Perform]	619	42.34	126	20.36
Sell [Underperform]	88	6.02	11	12.50

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