July 23, 2020

RBC WEALTH MANAGEMENT

Global Insight

Weekly

The high price of low rates

Thomas Garretson, CFA – Minneapolis

A confluence of several factors has pushed the average yield on U.S. investment-grade corporate bonds below 2% for the first time, while premiums for those bonds have risen to previously unseen heights. But despite market rallies, we believe pockets of value remain, particularly in preferred shares.

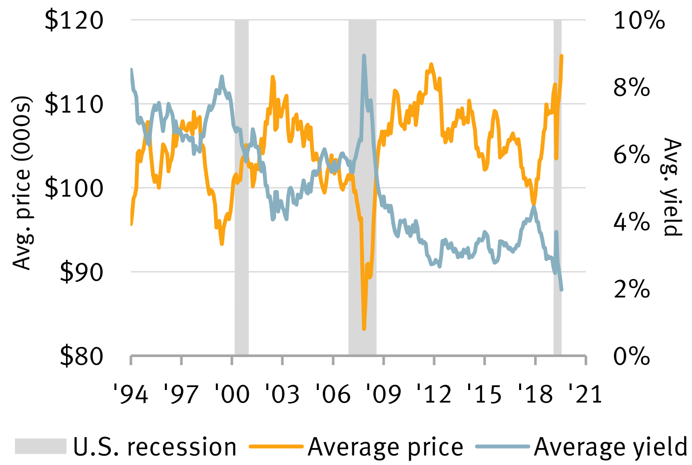
U.S. fixed income markets had another milestone week as the average yield on investment-grade corporate bonds slipped below 2% for the first time on record, while the average price of a bond in the ICE BofA US Corporate Index has swelled to an also-record $1,150, a hefty premium to par values of $1,000. Bond yields and prices move inversely.

A number of factors drove the plunge, with the Fed's ongoing corporate bond purchase program receiving much of the credit—or perhaps the blame, depending on one's point of view—but to date the Fed has purchased just $43 billion of corporate bonds, a fraction of the $750 billion authorized size of the program. While the Fed's backstop for the corporate bond market is a factor, it's not the full story, in our view.

Treasury yields are back on the move lower as well, with the 10-year Treasury yield back below 0.60% for one of the first times since the market volatility of March and April, having ascended as high as 0.90% in June. At the same time, credit spreads—or the yield premium over Treasuries for credit risks—have faded to just 1.29%, also the lowest since March and largely due to the stock market rally that has reduced risk premiums and corporate credit concerns.

Additionally, personal savings rates for U.S. consumers have skyrocketed in recent months, reaching as high as 32% of disposable income in April, well above the 6.6% average since 1990, only adding to the problem of too much cash chasing too few "safe assets" despite all of the corporate and government debt issuance this year.

U.S. corporate bond prices reach record highs; yields at record lows



Source - RBC Wealth Management, Bloomberg, ICE BofA US Corporate Index; data through 7/22/20

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All told, it has been a perfect storm fueling the recent run lower in corporate bond yields. But with record low yields, companies are increasingly able to call away bonds from investors and refinance at ever-lower rates, a positive to corporate balance sheets, but a challenge for investors who then have to reinvest at lower rates or in outstanding bonds that carry increasingly high premiums to par values.

Repositioning portfolios

While rallies across many markets have raised valuation concerns, seemingly limiting investment opportunities, one sector we continue to see some value in is preferred shares, particularly those issued by financial institutions, and more specifically the hybrid preferreds that feature fixed-to-floating rate coupon structures.

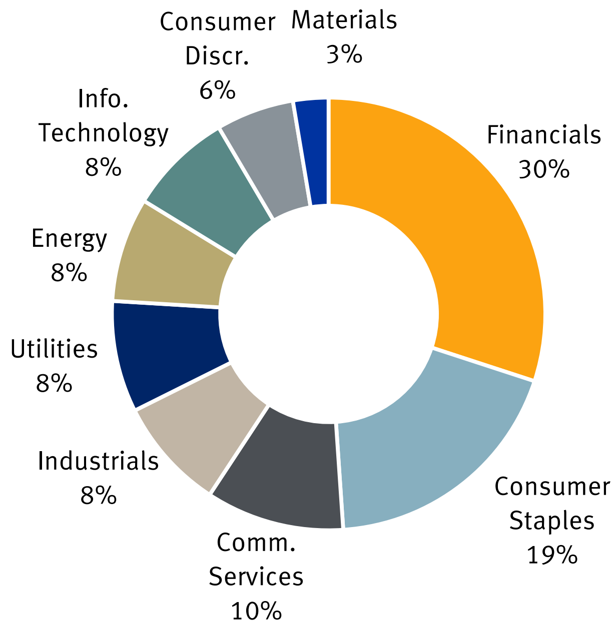
As the chart shows, debt issued by financial firms is the largest constituent of investment-grade corporate bond indexes, and likely also accounts for a large proportion of the holdings in individual fixed income portfolios as well—meaning there may be opportunities to swap between bonds and preferred shares while staying within the Financials sector and, therefore, only incrementally increasing credit risk, but adding attractive yield to portfolios at a time when quality income is hard to find.

The average yield on an index of banking sector debt with an average maturity of about four years currently stands at just 1.0%, with an average price of approximately $1,060. Compare that to an index of banking sector preferred shares with a similar duration (or interest rate sensitivity) of four years and a dollar price of $1,070, but with an average yield of 4.4%. That yield advantage of about 3.4% is the greatest since early 2014. Preferred shares fall lower in the capital structure, between senior unsecured bonds and common shares, but we think that yield pickup offers adequate compensation for slightly higher credit risk. Investors in traditional senior unsecured bonds would likely have to look to the speculative-grade corporate bond market to find similar yields.

While low interest rates and loan quality concerns will remain as challenges for the banks through the COVID-19 pandemic, we continue to see strength in bank balance sheets. As RBC Capital Markets, LLC Financials analyst Gerard Cassidy recently stated, "We continue to believe this crisis will be an earnings issue for the banks, rather than a balance sheet issue similar to 2008–09."

All signs point to another period of lower-for-longer interest rates and yields. And while we always caution against "reaching for yield" outside of individual risk tolerances, an active approach to finding attractive risk-reward opportunities and yield can help to manage fixed income portfolios through this period.

The Financials sector accounts for majority of U.S. investment-grade corporate debt



Source - RBC Wealth Management, Bloomberg; U.S. corporate debt weighted by GICS sectors; data through 7/22/20

United States

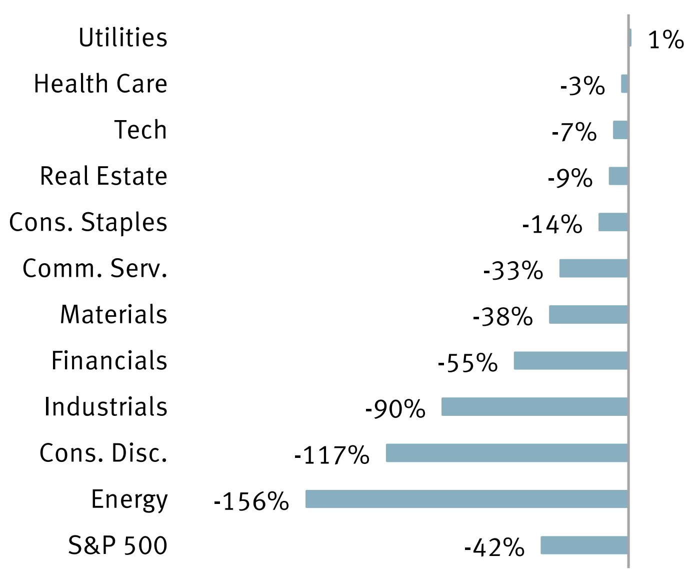
Ben Graham, CFA – Minneapolis

- **U.S. equity markets have been generally higher this week**, with gains reaching the low single digits. The S&P 500 and Dow Jones Industrial Average are higher by similar amounts, while the Nasdaq lags them, and the small-cap Russell 2000 leads large caps. Value has slightly outperformed growth in the S&P 500 this week, with Energy and Financials the best-performing sectors. Communication Services and Real Estate are lower on the week while Tech is higher but lagging the broader index. RBC Capital Markets, LLC Chief Equity Strategist **Lori Calvasina raised her S&P 500 year-end price target** to 2900 from 2750. However, Calvasina **remains concerned about a second-half pullback** given her belief that valuations are elevated and next year's earnings estimates are too high, and due to election-related risks. (The index closed at 3235.66 as of this writing.)

- With nearly 26% of the S&P 500 having reported quarterly results, **the trend is for corporate earnings to be better than feared**. In fact, earnings are on schedule to be 14% higher than consensus expectations despite being on track for a 42% y/y decline. **Health Care and Information Technology are the only sectors on course to deliver revenue growth**, while Energy and Industrials will most likely show the worst revenue trends.

Despite earnings contractions, quarterly results are better than feared

S&P 500 EPS growth expectations, Q2 2020



Source - RBC Wealth Management, FactSet; data through 7/23/20

- **Data released this week showed mixed economic activity**. The Chicago Fed National Activity Index's June reading of 4.1 beat expectations; the index rose for the second straight month after hitting a bottom of -17.9 in April. However, the Chicago regional data were offset by the Kansas City Fed's manufacturing index, which was lower than hoped for, and by unemployment trends. For the week ending July 18, initial unemployment filings hit 1.4 million, which was higher than consensus expectations of 1.3 million. This also marked the **first time since late March that weekly initial jobless claims climbed relative to the prior week**.

Canada

Ryan Harder – Toronto

- **The inaugural issue of the new Limited Recourse Capital Note** (LRCN) $1,000-par structure was met with strong interest from buyers this week. **Demand was well in excess of the large deal size**, resulting in the issue pricing at a rate below the initial price talk. The LRCN structure is an institutional alternative to $25-par preferred shares that was announced last week after receiving approval from the bank regulator. Going forward, we believe the presence of the new structure **should meaningfully reduce issuance in the preferred share market**, as banks will be incentivized to instead issue LRCNs because they provide tax advantages from the banks' perspective. The introduction of the new structure also **raises the likelihood of redemption at par for existing bank preferred issues with high reset spreads**, which has in turn pulled prices higher for the rest of the preferred share market over the past week.

- **Canadian retail sales and inflation data released this week showed that economic activity continued to rebound** in the spring as economies across the country cautiously reopened in stages. Nonetheless, both retail sales and inflation are tracking well below pre-pandemic levels, and the near-term outlook contains further challenges. Retail sales increased by 18.7% in May, just below economists' expectations for 20% growth, while CPI increased by 0.7% y/y, ahead of economists' expectations for 0.2% price growth. **May and June are likely to show the sharpest rebounds** in economic data relative to the rest of the year, so investors will be keen to observe how consumer behavior evolves throughout the summer months in a Canadian economy that has mostly—but not entirely—reopened.

Europe

Thomas McGarrity, CFA & Alastair Whitfield – London

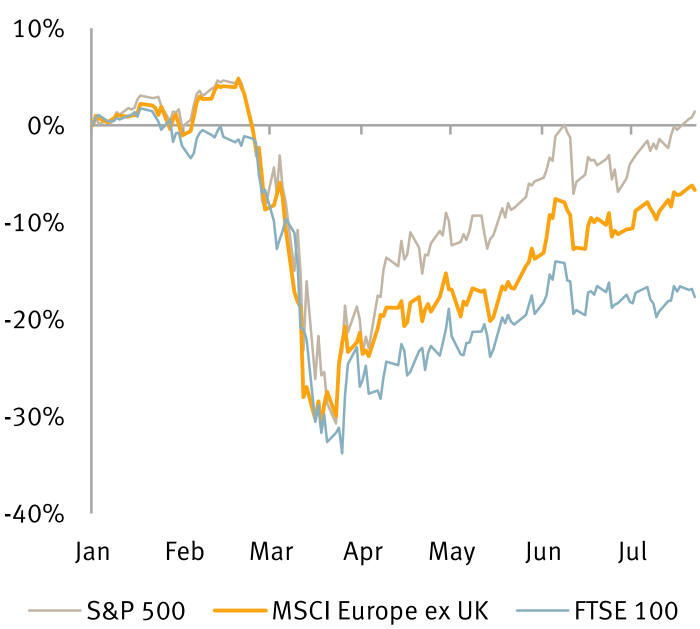
- Moves in Europe this week have largely been dominated by the **European Council agreement on the structure of the European Recovery Fund**. Despite the talks being extended by an extra two days to allow for an agreement to be reached on the €750 billion fund, support was given based on €390 billion in grants and €360 billion of loans versus the proposed split of €500 billion/€250 billion. We do not believe the lower allocation to grants in order to gain support from the "frugal four" (Austria, Denmark, the Netherlands, and Sweden) detracts significantly from the efficacy of the fund. Ultimately, this agreement marks a **key development of greater fiscal union for the region**, allowing the transfer of capital from more prosperous northern countries to southern and eastern member states. Additionally, this is likely to result in the euro area breakup risk premium being priced out of markets over time.

- We see this as being **positive for riskier assets across equities and fixed income**, and has been seen in market moves following the announcement. Italian government bond yield spreads relative to Germany have narrowed towards pre-COVID-19 levels of just 1.47%, while Greek government bond yield spreads have narrowed to 1.53%, the lowest levels since early 2010. Moreover, the step towards greater fiscal union within the EU was one of the key factors behind our recent upgrade of European equities to Market Weight.

- **Second-quarter earnings season in Europe kicked off in earnest this week**. **Unilever's** share price jumped almost 8% after reporting better-than-expected sales, with an organic sales decline of 0.3% y/y compared to the consensus estimate of a 4.3% decline, with the beat driven by heightened levels of demand for its hygiene and "in home" food products. Swiss pharma groups **Roche** and **Novartis** both reported a more negative impact than expected by consensus to their Q2 sales as a result of COVID-19.

Non-UK European equities gain on recovery fund talks

Year-to-date performance



Source - RBC Wealth Management, FactSet; data through 7/22/20

Asia Pacific

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

- **Sentiment on Asia equities has largely been positive this week** despite tensions between the U.S. and China increasing at the diplomatic level.

- The threat of U.S. sanctions on China's Financials sector has been **pushing more and more U.S.-listed Chinese companies, especially the Tech names, back to listing in Hong Kong**. The city's Hang Seng Indexes Company announced it will **launch the Hang Seng TECH Index on July 27**. The new index will track the 30 largest Technology companies listed in Hong Kong, including Alibaba (9988 HK), Tencent (700 HK), and Meituan Dianping (3690 HK). New-economy stocks rallied following the announcement. The city's major index, the Hang Seng, has been criticized for having too many old-economy stocks, e.g., Financials and Real Estate. Launching the TECH Index **could boost market liquidity and new fund flows** of the Hong Kong market.

- **Singapore Exchange (SGX SP) announced it will extend its partnership with Nasdaq Inc.** to help companies access capital in both jurisdictions. The framework allows documents required for the SGX listing to be based on information contained in the U.S. listing and subsequent filing documents to the U.S. Securities and Exchange Commission and/or Nasdaq, together with additional disclosure in compliance with Singapore's rules.

- **Ant Group**, China's largest financial technology company, and an affiliate of e-commerce giant Alibaba, said it **plans to list on the Hong Kong Stock Exchange and Shanghai's STAR board**, a Nasdaq-style venue for China's homegrown Tech companies. Ant Group was last valued at $150 billion, according to an unnamed source in a Wall Street Journal report (7/21/20), when it raised US$14 billion from private investors in 2018. Ant did not comment on the valuation.

MARKET SCORECARD

Data as of July 23, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,235.66	4.4%	0.2%	7.7%	15.3%
Dow Industrials (DJIA)	26,652.33	3.3%	-6.6%	-2.5%	6.4%
NASDAQ	10,461.42	4.0%	16.6%	26.8%	33.4%
Russell 2000	1,490.20	3.4%	-10.7%	-4.2%	-12.3%
S&P/TSX Comp	16,018.65	3.2%	-6.1%	-3.3%	-2.4%
FTSE All-Share	3,441.55	0.9%	-18.0%	-16.6%	-18.2%
STOXX Europe 600	373.65	3.7%	-10.1%	-4.6%	-2.9%
EURO STOXX 50	3,371.74	4.3%	-10.0%	-4.6%	-2.4%
Hang Seng	25,263.00	3.4%	-10.4%	-11.3%	-10.6%
Shanghai Comp	3,325.11	11.4%	9.0%	14.7%	16.3%
Nikkei 225	22,751.61	2.1%	-3.8%	5.2%	1.6%
India Sensex	38,140.47	9.2%	-7.5%	0.4%	3.9%
Singapore Straits Times	2,612.35	0.9%	-18.9%	-22.6%	-20.7%
Brazil Ibovespa	102,293.30	7.6%	-11.5%	-1.4%	31.2%
Mexican Bolsa IPC	37,433.30	-0.8%	-14.0%	-8.6%	-23.4%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,885.89	5.9%	24.3%	33.0%	54.0%
Silver (spot $/oz)	22.53	23.8%	26.2%	37.4%	46.5%
Copper ($/metric ton)	6,503.00	8.3%	5.8%	9.4%	6.7%
Oil (WTI spot/bbl)	41.10	4.7%	-32.7%	-27.4%	-40.9%
Oil (Brent spot/bbl)	43.29	5.2%	-34.4%	-32.2%	-40.7%
Natural Gas ($/mmBtu)	1.78	1.7%	-18.6%	-22.6%	-34.5%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.576%	-8.0	-134.2	-150.5	-237.8
Canada 10-Yr	0.503%	-2.5	-119.9	-99.4	-172.0
U.K. 10-Yr	0.124%	-4.8	-69.8	-56.7	-114.8
Germany 10-Yr	-0.481%	-2.7	-29.6	-12.6	-88.7

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.14%	1.1%	7.4%	10.0%	18.9%
U.S. Invest Grade Corp	1.90%	2.9%	8.1%	12.6%	24.6%
U.S. High Yield Corp	5.55%	3.6%	-0.3%	3.4%	10.7%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	94.8190	-2.6%	-1.6%	-3.0%	0.2%
CAD/USD	0.7455	1.2%	-3.2%	-2.1%	-1.8%
USD/CAD	1.3415	-1.2%	3.3%	2.1%	1.8%
EUR/USD	1.1592	3.2%	3.4%	3.9%	-0.9%
GBP/USD	1.2733	2.7%	-4.0%	2.4%	-2.8%
AUD/USD	0.7097	2.8%	1.1%	1.3%	-3.8%
USD/JPY	106.8400	-1.0%	-1.6%	-1.3%	-4.1%
EUR/JPY	123.8600	2.2%	1.7%	2.6%	-4.9%
EUR/GBP	0.9104	0.5%	7.6%	1.5%	2.0%
EUR/CHF	1.0734	0.9%	-1.1%	-2.3%	-7.5%
USD/SGD	1.3864	-0.5%	3.0%	1.5%	1.5%
USD/CNY	7.0041	-0.8%	0.6%	1.8%	3.0%
USD/MXN	22.5247	-2.0%	19.0%	17.4%	19.3%
USD/BRL	5.2240	-4.5%	29.6%	38.3%	38.1%

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 7/23/20.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -3.2% return means the Canadian dollar fell 3.2% vs. the U.S. dollar year to date. USD/JPY 106.84 means 1 U.S. dollar will buy 106.84 yen. USD/JPY -1.6% return means the U.S. dollar fell 1.6% vs. the yen year to date.

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Sell [Underperform]	92	6.12	12	13.04

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