August 20, 2020

RBC WEALTH MANAGEMENT

Global Insight Weekly

The Fed goes on call

Thomas Garretson, CFA – Minneapolis

The Fed appears to be shying away from further policy action just when market expectations for more are reaching a crescendo. We don't yet see this as a problem for markets as conditions remain favorable, and as the Fed will stay on call should action be required.

Since the Fed last met in July, there has been a tone around the Fed's official comments that has raised some doubt about the need for, and perhaps the willingness of, the Fed to do more in terms of monetary policy at upcoming meetings, most notably from Minneapolis Fed President Neel Kashkari, one of the Fed's more dovish policymakers:

> *"The path of the virus is going to determine the path of the economy, so the most important thing anybody can do is get our arms around the virus. Until we get there, I'm not sure that there's a lot more for the Fed to do right now."*

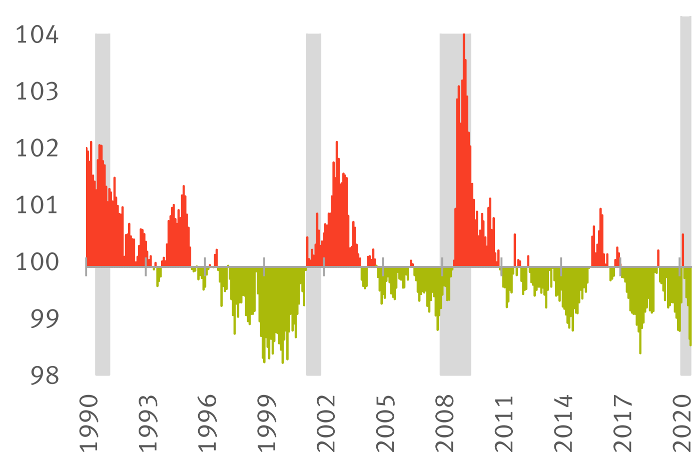
And this sentiment was broadly reflected in this week's release of the minutes from the Fed's July 28–29 meeting, which sparked modest consternation within markets ahead of what has been a highly anticipated September confab where market expectations for not only expanded policy tools, but also the potential for new ones, have run high. The first of the three key tools the market is focused on, yield curve control, appears to have been placed firmly on the back burner:

> *"A majority of participants commented on yield caps and targets as a monetary policy tool … most judged that yield caps and targets would likely provide only modest benefits in the current environment, as the Committee's forward guidance regarding the path of the federal funds rate already appeared highly credible and longer-term interest rates were already low."*

On that note, forward guidance, the second tool in focus, may not see any changes in September as Treasury yields remain

Breaking with past cycles, financial conditions remain historically easy

Goldman Sachs Financial Conditions Index



Note: shaded areas indicate U.S. recessions

Source - RBC Wealth Management, Bloomberg, Goldman Sachs

Market pulse

3 S&P 500 returns flip negative without Big Tech

3 Canada's housing market soars to a record high

4 Will job retention schemes in Europe be extended?

4 U.S.-China tensions flare up

Click here for authors' contact information. Priced (in USD) as of 8/20/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see** **page 6.**
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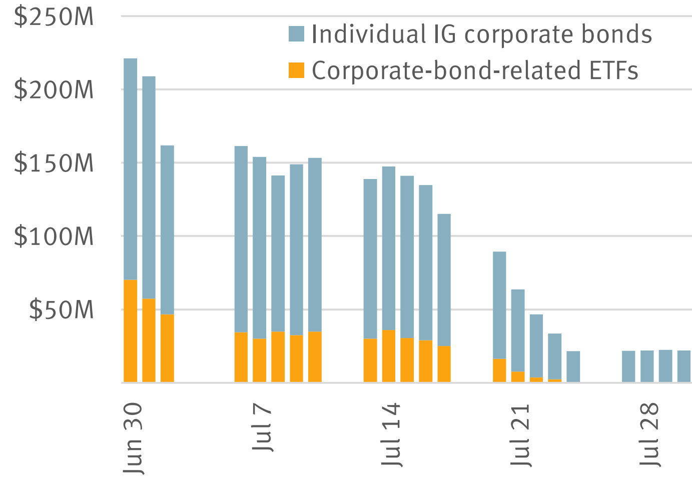
historically low across the curve, a reflection that market expectations are well-anchored with respect to the path of policy rates, thus reducing some urgency at the Fed to update its forward guidance on rates.

The debate continues over how exactly to do this, whether by tying future interest rate moves to inflation goals, labor market goals, calendar-based outcomes, or some combination or all of these. While changes could come at the September meeting, the minutes only stated that this guidance for markets would only be needed “at some point” in the near term.

Finally, the third tool, asset purchases, is unlikely to see any changes come September. The minutes acknowledged that the current structure of $80 billion per month in Treasuries and $40 billion in mortgage-backed securities is likely already providing accommodation beyond simply providing market liquidity via lower Treasury yields, and that already-low yields limit the need for further accommodation.

The Fed's corporate bond purchases slow to a trickle

Daily Federal Reserve purchases of corporate bonds ($ millions)



Source - RBC Wealth Management, U.S. Federal Reserve

Hurry up and wait

So does all this raise the risk that the Fed could disappoint the markets? We don’t believe so. At this stage the Fed is probably right in its assessment that there’s little urgency to build upon and expand its current suite of policy tools until the paths of the pandemic and the economic reopening are clearer.

As the chart on page 1 shows, financial conditions—or a broad measure of market accommodation based on the level of interest rates, the dollar, equity markets, and corporate bond credit spreads—remain not only near the easiest levels on record, but the stress typically seen during U.S. recessions never really materialized, largely due to the Fed’s quick and decisive action.

The Fed’s aim in March was to keep markets functioning and to buy the economy time. Those actions also bought the Fed time in assessing the next phases for monetary policy. The Fed remains “all in,” and will continue to do all it can to support the recovery and markets. The key risk, and the Fed has been atypically vocal about this, is the need for further fiscal stimulus—and progress there into the first half of September will likely dictate the outcome of the Fed’s September meeting more than anything else. Beyond policy, the Fed will be updating its economic projections for the first time since June and could be at risk of a downgrade absent fiscal support.

Corporate bonds

Lastly, and largely unnoticed, the Fed’s much-vaunted corporate bond buying and lending facilities launched at the early stages of the pandemic have been gradually slowing down in recent weeks as credit markets have essentially recovered to pre-pandemic levels of strength and liquidity. The Fed has completely ended the purchase of corporate bond exchange-traded funds (ETFs), and is only buying individual corporate bonds at a daily pace of $20 million, down sharply from month-ago levels and barely a fraction of the $20 billion that trades in U.S. corporate bond markets on any given day.

We see the Fed maintaining this token pace as it wants to maintain as much market-based pricing of risk in credit markets as possible, where an increase in corporate bond buying is only likely in the event of another bout of illiquidity to support market functioning.

The Fed goes on call

The Fed remains an integral part of the economic recovery and market functioning, but at this stage the Fed is right in its assessment that monetary policy remains well-positioned and accommodative as structured, in our view. Markets can expect the Fed to step back in more forcefully should conditions warrant it, but like the rest of us, the Fed awaits clarity on the trajectory of the public health crisis. The Fed will remain on call, if and when needed.

United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets have advanced, and the 2020 leaders have reasserted themselves this week** after value-oriented stocks surged last week. The S&P 500 is 0.4% higher this week, with the NASDAQ even better and the Dow Jones Industrial Average and Russell 2000 worse. Sector leadership is evident in Communication Services, Consumer Discretionary, and Information Technology, while Energy is the clear-cut laggard, followed by Financials and Industrials.
- **For all of the consternation that 2020 returns being positive and setting new all-time highs has caused, it's important to understand some of the forces behind the moves.** Specifically, the S&P 500 was 5.8% higher on a total-return basis as of the close on Wednesday, Aug. 19 after the prior day's all-time closing high. However, it's important to realize that six of the largest and most technologically advanced companies in the world have had an outsized impact on 2020 returns. These companies are Facebook, Apple, Amazon.com, Netflix, Google-parent Alphabet, and Microsoft (FAANGM). Collectively, they account for nearly 160% of the S&P 500's annual gain. Put differently, if an investor held the S&P 500 without the FAANGM complex and instead allocated to the remaining 494 companies in the index, the hypothetical 2020 S&P 500 return would be -4.2%. Understanding this point is imperative as investors try to wrap their minds around the state of the world and the index returns that appear to have decoupled from reality. The bottom line is that U.S. equities, excluding the largest tech-oriented companies in the world that have actually thrived during COVID-19, are **not as disconnected from the pandemic and economic narrative as headline returns would cause them to appear to be**.

S&P 500 returns flip negative without FAANGM

2020 year-to-date returns and attribution

	2020 to date	
Index or company	Total return	% of S&P 500 return
S&P 500	5.8%	100.0%
Tech sector	26.3%	127.6%
FAANGM	43.7%	158.5%
Facebook	27.9%	11.3%
Apple	58.7%	49.3%
Amazon.com	76.5%	48.3%
Netflix	49.7%	6.3%
Microsoft	34.0%	34.4%
Alphabet	15.5%	9.0%
S&P 500 ex Tech	-2.1%	NMF
S&P 500 ex FAANGM	-4.2%	NMF

Note: FAANGM stands for Facebook, Apple, Amazon.com, Netflix, Microsoft, and Google-parent Alphabet collectively. NMF = not meaningful.

Source - RBC Wealth Management, FactSet; data through 8/19/20

- **Economic data this week was largely disappointing**, highlighted by initial unemployment claims resurging above the 1 million mark to 1.1 million. This comes on the heels of last week's print of 971,000 and marks the largest weekly increase in new claims since March. Regional activity indexes from both Philadelphia and New York (Empire State) also failed to meet expectations in recent days. Taken together, we think these data points indicate **an economy that is still in the recovery phase with a long road ahead** before regaining pre-COVID-19 levels.

Canada

Arete Zafiriou & Carolyn Schroeder – Toronto

- **Canada's housing market soared to a record high in July.** The COVID-19 pandemic muted 2020's spring market and shifted activity into the summer, a traditionally slower period. Home resale activity surged 26% m/m and 30.5% y/y across Canada to a new all-time high of 637,000 units (annualized) in July. **Virtually all local markets recorded strong increases**, albeit from weak levels in June, fueled in large part by pent-up demand created by COVID-19 lockdowns. Canada's MLS Home Price Index (HPI) rose 7.4% y/y, the fastest rate of increase in more than 30 months, as Ottawa and Montreal continued to lead the country with sales up 18.4% and 14.1% y/y, respectively. Although RBC Economics expects housing demand to cool later this year due to the phasing out of the Canada Emergency Response Benefit and other financial support programs, high unemployment, and lower in-migration, it believes there's still pent-up demand left to satisfy.
- Ahead of Canadian bank earnings season, which kicks off with Bank of Montreal's results on Aug. 25, **RBC Capital Markets increased its core earnings per share (EPS) estimates for the large banks**. It estimates core EPS for the group will fall around 14% y/y on average in fiscal Q3, up from the prior forecast of an approximate 25% y/y decline, and largely **attributes the upward revision to lower assumed provisions for credit losses** (PCLs). While the Canadian unemployment rate remains high, it fell to 10.9% at the end of July from 13.0% at the end of April. Credit card and mortgage delinquency rates have also declined since the end of Q2 2020. In RBC Capital Markets' view, PCLs on performing loans peaked last quarter for most of the banks, and the extension of deferral and government programs introduced early in the crisis are working as desired and will likely push out the peak of impaired loan PCLs into mid-2021.

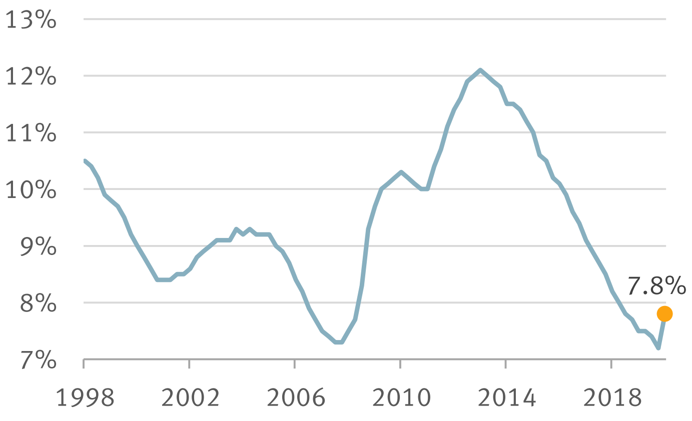
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- August is typically a quiet month in the UK and Continental Europe. With trading volumes below average and few major headlines, **both the STOXX Europe 600 ex UK Index and the FTSE All-Share Index drifted downwards**. The oil and gas space and the Utilities sector were the worst performers, the latter dragged down by German utility RWE announcing a capital increase of 10% to raise some €2 billion to accelerate its expansion into renewable energy. Prior to the announcement, RWE's share price had surpassed its 2020 high, with the company noting: "The current market environment allows for equity raising at attractive valuation levels for our shareholders."
- **European COVID-19 cases continued to rise**, and are back at the elevated levels of last April in Spain and France. **Additional measures to control the virus are being taken.** Spain ordered nightclubs to close while Greece imposed a curfew for bars and restaurants. Italy followed suit, broadening rules for wearing masks.
- **The debate as to whether job retention schemes should be extended started in earnest.** Initially developed in Germany, these government programmes subsidize companies that put employees on shorter hours. The idea is that the cost of subsidizing is less than the cost of firing and rehiring workers. Thanks to these schemes, which have been adopted in many European countries, **the euro area unemployment rate has barely budged this year**.
- But many of the measures are coming to an end, with some set to expire at the end of 2020. Some countries are extending their schemes—France in particular will subsidize until 2022. In Germany, Finance Minister Olaf Scholz is looking to extend the short-time work programme to 24 months from the current 12 months. **Were the schemes not to be extended, the euro area unemployment rate could return to the low double-digit highs reached during the 2012 European sovereign debt crisis.**

Part-time work schemes put lid on Europe's unemployment

Eurostat eurozone unemployment rate



Source - RBC Wealth Management, Bloomberg, Eurostat; data through 6/30/20

Asia Pacific

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

- **Asia equities remained volatile, driven by headlines of ongoing U.S.-China tensions.** On Monday, **the U.S. added 38 Huawei affiliates in 21 countries to an economic blacklist**, aiming to cut the company's access to commercially available chips. The restrictions are **likely to further hit Huawei's 5G base stations and smartphone businesses** because the company heavily relies on foreign chips to make them. According to Bloomberg, Huawei's stockpiles of certain self-designed chips will run out by early 2021.
- **Share prices of Huawei suppliers in Asia declined**, but the impact may be manageable for some as orders from Huawei's competitors could increase, especially in the smartphone area. **Taiwan stocks briefly fell the most in five months** on Aug. 20 due to investors' concerns China's 5G network expansion will slow.
- In addition, the U.S. State Department has **asked American colleges and universities to divest their holdings of Chinese companies from their endowments**. The agency warned that Chinese companies could face a "wholesale delisting" from the U.S. by the end of 2021.
- Furthermore, **the U.S. suspended its extradition treaty with Hong Kong and ended reciprocal tax treatment on shipping**, which may be more of a symbolic action to add pressure on China.
- Regarding U.S.-China trade relations, shortly after President Trump said "I don't want to talk to China right now," Bloomberg and other news agencies reported **the two countries could hold trade talks soon**. But we doubt anything meaningful could be agreed upon in the discussions.
- **JD.com (JD)**, the second-largest e-commerce player in China, reported **robust Q2 2020 results**. Total revenue surged 34% y/y to RMB 201 billion. JD's self-run logistics network powered it through the COVID-19 lockdown, gaining users as rivals struggled to deliver their goods to customers. Its annual active customer accounts rose by about 30% y/y to reach 417 million, the fastest pace in two years.

MARKET SCORECARD

Data as of August 20, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,385.51	3.5%	4.8%	15.7%	20.0%
Dow Industrials (DJIA)	27,739.73	5.0%	-2.8%	5.6%	10.1%
NASDAQ	11,264.95	4.8%	25.5%	40.5%	44.1%
Russell 2000	1,564.30	5.7%	-6.2%	3.6%	-6.6%
S&P/TSX Comp	16,606.76	2.7%	-2.7%	1.6%	2.2%
FTSE All-Share	3,354.33	2.2%	-20.1%	-15.3%	-20.1%
STOXX Europe 600	365.64	2.6%	-12.1%	-1.8%	-5.0%
EURO STOXX 50	3,273.98	3.1%	-12.6%	-2.5%	-4.0%
Hang Seng	24,791.39	0.8%	-12.1%	-1.9%	-11.3%
Shanghai Comp	3,363.90	1.6%	10.3%	20.3%	20.7%
Nikkei 225	22,880.62	5.4%	-3.3%	11.9%	4.7%
India Sensex	38,220.39	1.6%	-7.4%	3.4%	1.5%
Singapore Straits Times	2,527.92	-0.1%	-21.6%	-19.7%	-22.1%
Brazil Ibovespa	101,467.90	-1.4%	-12.3%	-1.8%	30.9%
Mexican Bolsa IPC	38,707.24	4.6%	-11.1%	-1.9%	-20.6%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,950.66	-1.3%	28.6%	29.9%	63.4%
Silver (spot $/oz)	27.37	12.2%	53.3%	61.3%	82.5%
Copper ($/metric ton)	6,698.75	4.3%	8.9%	15.4%	9.4%
Oil (WTI spot/bbl)	42.58	5.7%	-30.3%	-25.4%	-36.6%
Oil (Brent spot/bbl)	44.90	3.7%	-32.0%	-26.8%	-38.2%
Natural Gas ($/mmBtu)	2.35	30.7%	7.4%	9.5%	-19.8%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.653%	12.4	-126.5	-105.1	-222.6
Canada 10-Yr	0.562%	9.5	-114.0	-67.9	-173.9
U.K. 10-Yr	0.225%	12.1	-59.7	-26.9	-102.7
Germany 10-Yr	-0.496%	2.8	-31.1	11.3	-80.7
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.14%	-0.7%	7.0%	7.7%	17.7%
U.S. Invest Grade Corp	1.95%	-1.2%	7.1%	9.1%	22.4%
U.S. High Yield Corp	5.59%	0.1%	0.9%	4.8%	11.2%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	92.7470	-0.6%	-3.8%	-5.2%	-3.8%
CAD/USD	0.7587	1.8%	-1.4%	0.3%	-0.4%
USD/CAD	1.3180	-1.7%	1.5%	-0.3%	0.4%
EUR/USD	1.1862	0.7%	5.8%	6.2%	4.0%
GBP/USD	1.3217	1.0%	-0.3%	9.6%	3.5%
AUD/USD	0.7195	0.7%	2.5%	5.8%	-1.0%
USD/JPY	105.7800	0.0%	-2.6%	-0.9%	-4.4%
EUR/JPY	125.4800	0.6%	3.0%	5.2%	-0.7%
EUR/GBP	0.8975	-0.3%	6.1%	-3.1%	0.4%
EUR/CHF	1.0765	0.1%	-0.8%	-1.3%	-5.0%
USD/SGD	1.3671	-0.5%	1.6%	-1.2%	-0.6%
USD/CNY	6.9158	-0.9%	-0.7%	-1.8%	0.4%
USD/MXN	22.0962	-0.8%	16.7%	14.0%	15.6%
USD/BRL	5.5443	6.2%	37.6%	46.7%	42.8%

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 9:35 pm GMT 8/20/20.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -1.4% return means the Canadian dollar fell 1.4% vs. the U.S. dollar year to date. USD/JPY 105.78 means 1 U.S. dollar will buy 105.78 yen. USD/JPY -2.6% return means the U.S. dollar fell 2.6% vs. the yen year to date.

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As of June 30, 2020

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