

Global Insight

Weekly

The challenging path forward for yields

Thomas Garretson, CFA – Minneapolis

As the potential catalysts to a higher yield environment continue to disappear, we still see a gradually higher, albeit muted, path ahead over the long run, with potential for near-term volatility.

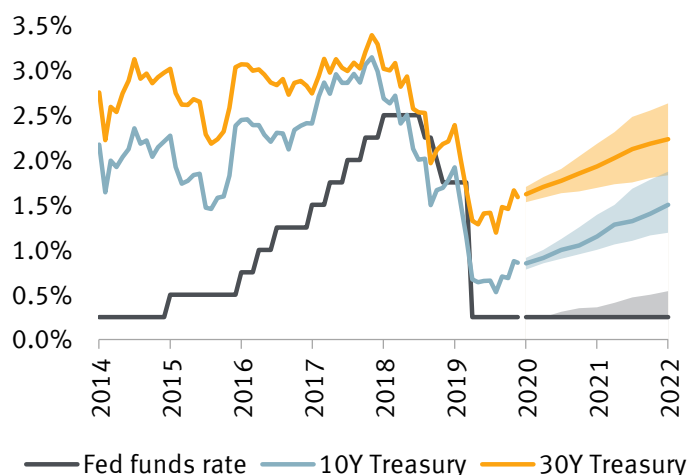
Sovereign yields, in the U.S. and globally, have largely remained stagnant since the March lows, struggling to move materially higher. But November was supposed to bring a number of catalysts, particularly in the U.S., that had the potential to change that.

Two of those major catalysts to higher yields: the prospects for fiscal expansion on presidential election results, and positive developments on the COVID-19 vaccine front are now seemingly priced out of the market, and mostly into the market, respectively. Not only has the benchmark U.S. 10-year Treasury yield failed to break above the key one percent level for what would be the first time since March, it has pulled back to some of the lowest levels seen in recent weeks.

The first chart shows that the path to higher yields is still expected to be a slow and arduous process. These forecasts, comprising approximately 50 analysts and compiled by Bloomberg in early November, at best incorporate some of the election and vaccine outcomes, but given how markets have reacted since, we suspect they would be little-changed at this point. The 10-year yield is first seen breaching one percent by the middle of next year, and only rising to around 1.5% by the end of 2022. Although COVID-19's onset took just two months to drive the 10-year Treasury yield sharply below 1.5%, it could take more than two years to get back to that level. 30-year Treasury yields are also expected to trend higher on improving growth and inflation expectations.

Of course, these being forecasts and all, the only thing we can say for certain is that they will likely be wrong. However,

With few catalysts left on the horizon, the rate outlook remains subdued



Source - RBC Wealth Management, November Bloomberg Survey; Forecast period of Q4 2020 to Q4 2022 shows median estimates, shaded regions represent central range of forecasts.

Market pulse

- 3 U.S. small-cap equities outperform
- 3 Canada's inflation rate edged higher in October
- 4 European fiscal package likely despite vetoes
- 4 Japan on "maximum alert"

The next edition of the Global Insight Weekly will be published on December 3.

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Management

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while analysts perennially forecast higher rates ahead despite decades of declines, we think this is broadly how investors should think about the path forward and at the early stage of an economic recovery.

Lower for longer

On the fiscal support front, a split Congress next year limits the scope for further fiscal aid—though markets won't know the final makeup of the Senate until the Jan. 5, 2021, runoff elections for two Senate seats in Georgia. The base case is that Republicans will retain control. Should those two seats flip to the Democratic candidates, markets would likely rapidly reprice fiscal stimulus prospects, and higher yields as a result. All told, political gridlock is the base case and in this type of environment where economic and public health uncertainty remains elevated, it is only likely to also lead to gridlock on the yield front.

While the multiple positive developments on a vaccine are good for markets, though obviously far more important from a public health perspective, we think it remains a longer-term process that puts any potential return to “normalcy” 12–18 months out, which may be why Treasury yields have only had a moderate reaction on the news.

Finally, if the last rate hike cycle was gradual, we think the next one will be glacial. While a few analysts have rate hikes penciled in, without fiscal support, the burden of the economic recovery will once again fall upon the Fed, and that only means lower policy rates for longer. We maintain our view that even in the most optimistic scenarios, the Fed will keep policy rates at the current 0%–0.25% until 2023 at the earliest.

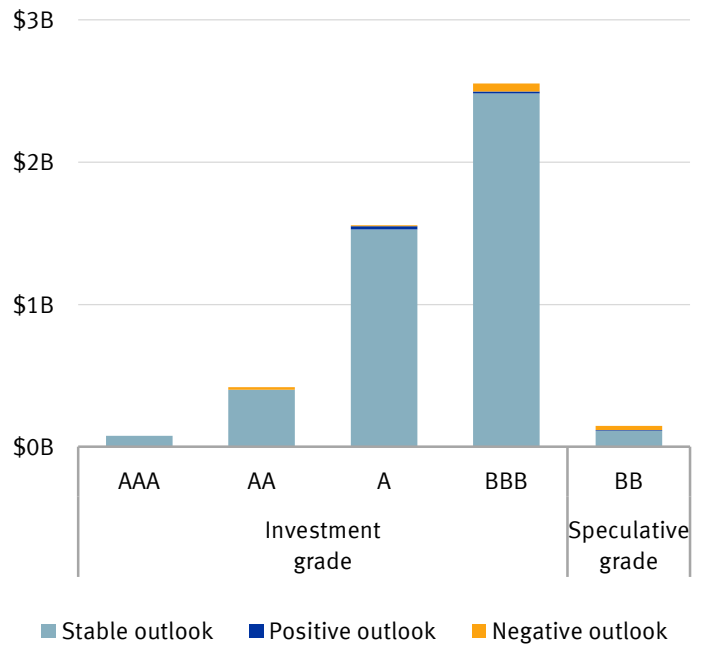
A November to remember

While our view is there are now few, if any, catalysts ahead that could spark higher yields, which is one less thing for investors to worry about, it also means the fixed income investing landscape will be a challenging one in the months and years ahead.

The combination of low Treasury yields, and the subsequent hunt for yield, combined with fading policy uncertainty on the election outcomes, has driven yields in many sectors to fresh all-time lows. The Bloomberg Barclays US Corporate High Yield Index set a new record low of just 4.56% on Nov. 9, eclipsing the previous low of 4.83% from 2014. It was a similar story for emerging market debt, where the Bloomberg Barclays Emerging Market USD Aggregate yield declined more than 0.30% to a new record low of just 3.78%. We reduced our outlook for both sectors back toward Neutral from Overweight, but in a lower for longer interest rate environment, we remain positive on the outlook for preferred shares as a way to add income to portfolios.

What does the Fed own?

Corporate bond portfolio by credit quality



Source - RBC Wealth Management, Bloomberg, Federal Reserve; based on Standard & Poor's ratings

Things to watch

While we think the importance of the Fed's corporate bond buying facility has been overstated, particularly as it relates to the recent and ongoing rallies in credit markets, as the corporate bond facility still stands at just \$15 billion compared to total potential size of \$750 billion, some politicians are already calling for the facilities to be shut down as they feel market functioning has returned to “normal.” But as Fed Chair Jerome Powell said this week, “When the right time comes, and I don't think that time is yet or very soon, we will put those tools away.”

Nearly all of the Fed's emergency facilities are set to expire at year end, with the Fed needing the approval of the Treasury Secretary for extension. Thus far, current Treasury Secretary Steven Mnuchin hasn't signaled his support one way or the other, while the lack of transition coordination with the Biden administration may cause uncertainty with respect to the fate of the Fed facilities. For credit investors, and markets generally, this could be a source of volatility. They remain important backstops for markets should bouts of illiquidity occur, even if the Fed's current activity in corporate bond markets is minimal. Ultimately, we expect they will be extended.



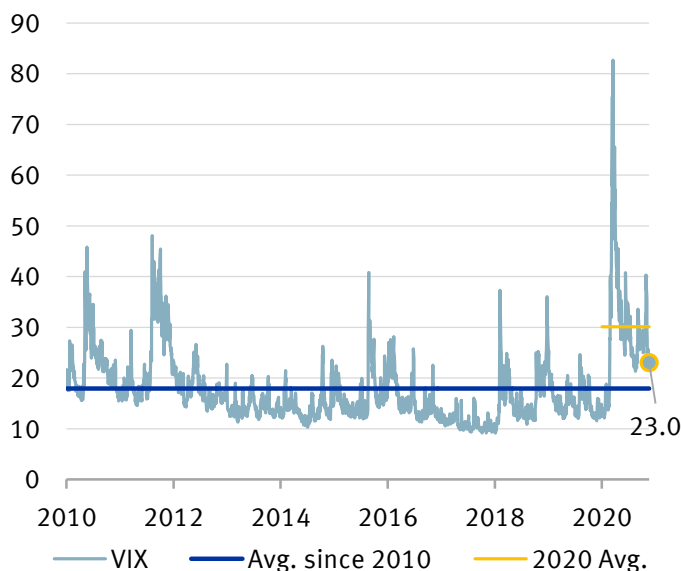
United States

Ben Graham, CFA – Minneapolis

- **U.S. equities have largely held onto their November gains during the week**, with the S&P 500 and Dow Jones Industrial Average declining by less than 0.2% thus far. The Nasdaq has risen 0.6% while **the small-cap Russell 2000 has been the standout**, rising 16.0% so far in November and hitting a new all-time record this week for the first time since August 2018. Aligning with small-cap outperformance, **cyclicals have led this week** with Energy the best-performing sector, followed by Financials, Materials, and Industrials. On the other side of the coin, the relatively defensive sectors of Utilities and Health Care have been the clear laggards, with both down more than 2.8%.
- The **CBOE Volatility Index (VIX)** has reached another potential fork in the road after falling back to its August lows this month. The question now is whether volatility will continue to move lower to a post-pandemic low that is more in line with historical averages, or move higher on rising COVID-19 cases and localized shutdowns. While it's unclear what direction the VIX will ultimately take, **declining volatility remains one of the biggest potential catalysts that could extend the current bull market, in our view.** This year has seen above-average volatility, and if 2021 sees lower levels of volatility, we believe equity markets are likely to benefit given the strong historical correlation between positive equity returns and low volatility.

Volatility: Will 2020 prevail again or will volatility move lower and power equities?

CBOE Volatility Index (VIX)



Source - RBC Wealth Management, FactSet; data as of 11:10 am CST 11/19/20

- **Economic data were mixed to slightly negative after initial jobless claims rose for the first time in five weeks**, to 742,000. This was higher than expectations. Retail sales were also weaker than hoped for, and several regional activity indexes were below consensus expectations. Slightly offsetting some of these negative data points were a stronger-than-expected existing home sales reading of 6.85 million and a Philadelphia Fed Activity Index that beat consensus expectations.



Canada

Sayada Nabi & Arete Zafiriou – Toronto

- **Canada's Consumer Price Index edged higher in October, growing 0.7% y/y.** This follows a 0.5% y/y rise in September. After trending lower in previous months, food prices moved up 2.3% y/y. On the other hand, energy prices continued their downtrend and are 6% lower y/y; however, this is still above the spring bottom of -23.7%. Excluding food and energy, prices increased 0.8% in October, which matched the reading in September. While mortgage interest rates fell 0.7% m/m, the decline coincides with an increase in demand for single-family homes that has pushed the cost of new housing higher. The homeowners' replacement cost index, which is calculated on the basis of new housing prices and represents essential expenses related to restoring the lost value associated with normal depreciation, rose 1.4% m/m—the largest monthly increase since June 1991. Unsurprisingly, **the significantly lower demand for hospitality and travel limited price growth for the services sector**, as the industry remains under pandemic-related pressures.
- **Canadian home resale volume was up 32.1% y/y in October. All major markets posted double-digit increases**, led by Montreal with a 35.9% gain. New listings were more modest, up 15.9% y/y at the national level. Toronto led this category with over 36% more new listings than last year, primarily due to the rising supply of downtown condos for sale. **The pandemic is drawing buyers to the suburbs** as they spend more time living and working at home. The MLS Composite Home Price Index grew at its fastest rate in more than three years, driven by strong growth in single detached home prices. On the other hand, **condo markets remain a weak spot** as home buyers move out of downtown locations. Condo prices are flat to lower in Toronto and Vancouver compared to the spring. **RBC Economics expects condo prices to continue to fall in the shorter term**, given the outlook for little immigration and high unemployment.



Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Hungary and Poland vetoed the EU's latest budget and rescue package**, objecting to the detailed conditions attached to them. In July, EU leaders agreed to the concept of linking disbursements of the €1.07 trillion budget for 2021–2027 and the €750 billion rescue package backed by joint debt to national policies, the rule of law, and upholding common EU values. Unanimous voting is now required to adopt the seven-year budget and to allow the European Commission to issue joint bonds.
- **A long deadlock could undermine the image of cohesion the EU has portrayed in this crisis**, raising the populist spectre. The block has been aggressive and efficient in finding a solution to support sectors and economies struggling to cope with COVID-19. A deadlock would mean hard-hit countries, such as Italy and Spain, would be unable to access the funds consensus expects to be disbursed by the end of Q2 2021. Such delays would be disappointing, but manageable so long as funding remains available at a low cost in financial markets.
- **We believe the willingness to compromise will eventually prevail.** Poland and Hungary have received substantial funds from the EU in past years, and both could receive considerable support from the rescue package. Blocking procedures would be tantamount to shooting themselves in the foot. Moreover, the European Council is currently headed by Germany whose leader, Angela Merkel, still has substantial influence and will want this joint debt mechanism to be her legacy. Currency markets agree with our view: the euro has been flat over the week.
- **Spanish-listed bank Banco Bilbao Vizcaya Argentaria (BBVA) announced it will sell U.S. subsidiary BBVA Bancshares to PNC Financial Services Group for €9.7 billion.** The sale price represents a price-to-earnings multiple of almost 20x trailing earnings, and a price to tangible book value of 1.34x, a substantial premium to BBVA group valuation, helping BBVA's share price rise over 15% on Monday, Nov. 16, following the announcement. Subsequently, BBVA announced it is in preliminary discussions with Spanish rival Banco de Sabadell about a potential merger between the two entities, pushing the shares of the latter up 24% during the week.
- **Further domestic in-market mergers and acquisitions (M&A) activity is a positive development for the European**

banks subsector, but we do not believe it will trigger a significant wave of consolidation, and remain skeptical on the likelihood of big cross-border deals. Rather, we believe it is likely we'll see more M&A in fragmented markets, such as Spain and Italy.



Asia Pacific

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

- **Asia Pacific equity markets have traded mostly higher during the week** on the back of positive news flow on COVID-19 vaccines and the recent signing of the Regional Comprehensive Economic Partnership (RCEP). The RCEP is a free trade agreement, the largest of its kind, spanning 15 Asia-Pacific countries with roughly 2.2 billion people, making up nearly 30% of the world's GDP. It is estimated that RCEP could add \$500 billion to world trade over the next 10 years, according to the Peterson Institute. We view the deal as a triumph for the Association of Southeast Asian Nations' middle-power diplomacy and at the same time, a major win for China, economically and from a public relations standpoint.
- **Prime Minister Yoshihide Suga said Japan is on "maximum alert" after the country posted a record number of daily COVID-19 infections.** Tokyo raised its alert to the highest of four levels as the capital is set to record more than 500 new cases for the first time. The greater Tokyo region accounts for about a third of the Japan's GDP, and we think any limitations on businesses to contain COVID-19 will have an outsize effect on the economy. That said, as the government lacks the legal means to restrict business activity, **we do not anticipate any harsh lockdown measures.**
- **The Securities and Exchange Commission (SEC) is pushing ahead with a plan that threatens to delist Chinese companies from U.S. stock exchanges.** The SEC intends to propose a regulation that would lead to the delisting of companies for not complying with U.S. auditing rules, according to a Bloomberg report. While the plan is not expected to be ready anytime soon, observers expect broad-based support for it as cracking down on China appeals to Republicans and Democrats.
- **SoftBank Group (9984 JP) has \$80 billion cash to use for investment opportunities and share buybacks.** The cash became available after SoftBank sold some investments due in part due to concern over the continued spread of COVID-19, according to CEO Masayoshi Son.



MARKET SCORECARD

Data as of November 19, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,581.87	9.5%	10.9%	14.8%	33.1%
Dow Industrials (DJIA)	29,483.23	11.3%	3.3%	5.5%	17.9%
Nasdaq	11,904.71	9.1%	32.7%	38.9%	69.4%
Russell 2000	1,784.13	16.0%	6.9%	11.6%	19.2%
S&P/TSX Comp	16,909.81	8.5%	-0.9%	-0.6%	12.2%
FTSE All-Share	3,578.41	13.6%	-14.7%	-11.6%	-6.7%
STOXX Europe 600	387.60	13.2%	-6.8%	-4.4%	9.1%
EURO STOXX 50	3,451.97	16.7%	-7.8%	-6.6%	9.2%
Hang Seng	26,356.97	9.3%	-6.5%	-2.7%	-0.1%
Shanghai Comp	3,363.09	4.3%	10.3%	14.6%	24.4%
Nikkei 225	25,634.34	11.6%	8.4%	10.1%	17.5%
India Sensex	43,599.96	10.1%	5.7%	7.7%	21.9%
Singapore Straits Times	2,777.00	14.6%	-13.8%	-14.3%	-9.4%
Brazil Ibovespa	106,669.90	13.5%	-7.8%	0.8%	21.4%
Mexican Bolsa IPC	41,868.82	13.2%	-3.8%	-4.0%	-1.1%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,867.36	-0.6%	23.1%	26.8%	52.5%
Silver (spot \$/oz)	24.11	1.9%	35.0%	40.6%	67.1%
Copper (\$/metric ton)	7,069.50	5.4%	15.0%	20.7%	12.3%
Oil (WTI spot/bbl)	41.74	16.6%	-31.6%	-24.4%	-26.5%
Oil (Brent spot/bbl)	44.37	18.4%	-32.8%	-27.2%	-33.6%
Natural Gas (\$/mmBtu)	2.60	-22.5%	18.7%	3.5%	-44.7%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.841%	-3.3	-107.7	-94.2	-222.2
Canada 10-Yr	0.682%	1.9	-102.0	-76.4	-167.4
U.K. 10-Yr	0.323%	6.1	-49.9	-41.0	-105.5
Germany 10-Yr	-0.571%	5.6	-38.6	-23.2	-94.4
Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.20%	0.6%	6.9%	7.1%	19.3%
U.S. Invest Grade Corp	1.89%	1.8%	8.4%	9.2%	25.3%
U.S. High Yield Corp	4.80%	3.2%	4.4%	6.8%	14.4%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	92.2610	-1.9%	-4.3%	-5.7%	-4.1%
CAD/USD	0.7660	2.0%	-0.5%	1.6%	0.9%
USD/CAD	1.3055	-2.0%	0.5%	-1.6%	-0.9%
EUR/USD	1.1877	2.0%	5.9%	7.2%	3.7%
GBP/USD	1.3269	2.5%	0.1%	2.7%	3.2%
AUD/USD	0.7292	3.8%	3.9%	6.8%	0.0%
USD/JPY	103.7600	-0.9%	-4.5%	-4.4%	-7.8%
EUR/JPY	123.2400	1.1%	1.2%	2.5%	-4.4%
EUR/GBP	0.8951	-0.5%	5.8%	4.4%	0.5%
EUR/CHF	1.0814	1.2%	-0.4%	-1.5%	-5.0%
USD/SGD	1.3443	-1.6%	-0.1%	-1.2%	-2.0%
USD/CNY	6.5840	-1.6%	-5.4%	-6.3%	-5.2%
USD/MXN	20.1511	-4.8%	6.5%	4.2%	-1.1%
USD/BRL	5.3087	-7.6%	31.7%	40.5%	41.2%

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 8:35 pm GMT 11/19/20.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -0.5% return means the Canadian dollar fell 0.5% vs. the U.S. dollar year to date. USD/JPY 103.76 means 1 U.S. dollar will buy 103.76 yen. USD/JPY -4.5% return means the U.S. dollar fell 4.5% vs. the yen year to date.

Authors

Thomas Garretson, CFA – Minneapolis, United States
tom.garretson@rbc.com; RBC Capital Markets, LLC

Ben Graham, CFA – Minneapolis, United States
benjamin.graham@rbc.com; RBC Capital Markets, LLC

Sayada Nabi – Toronto, Canada
sayada.nabi@rbc.com; RBC Dominion Securities Inc.

Arete Zafiriou – Toronto, Canada
arete.zafiriou@rbc.com; RBC Dominion Securities Inc.

Frédérique Carrier – London, United Kingdom
frederique.carrier@rbc.com; RBC Europe Limited

Thomas McGarrity, CFA – London, United Kingdom
thomas.mcgarritty@rbccm.com; RBC Europe Limited

Jasmine Duan – Hong Kong, China
jasmine.duan@rbc.com; RBC Investment Services (Asia) Limited

Nicholas Gwee, CFA – Singapore
nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

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			Count	Percent
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Sell [Underperform]	81	5.44	11	13.58

Ratings:

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