March 7, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Crosscurrents and conflicting signals

Laura Cooper – London

Earlier fears of a growth slowdown and a Fed out of tune with financial markets have given way to a relief rally in markets, but darker economic clouds outside of the U.S. could still roll in. It's worth looking at what's on the radar for the global economy to gauge whether a growth storm will be averted.

Fears of a global growth slowdown and ongoing uncertainty around the U.S.-China trade spat sent shivers through equity markets in late 2018. A thaw came earlier than spring with financial markets rallying strongly so far in 2019. Optimism around trade developments supported the upswing while the Fed's abrupt dovish U-turn has pared back investors' U.S. recessionary angst.

Growth has cooled in the U.S., yet it is the darker economic clouds beyond its borders that appear to be keeping investors nervous about a brewing global growth storm. Rising geopolitical tensions, soft economic data in Europe and China, and trade uncertainty are underpinning the anxiety, but we see silver linings that should provide some calm before investors need to batten down the hatches.

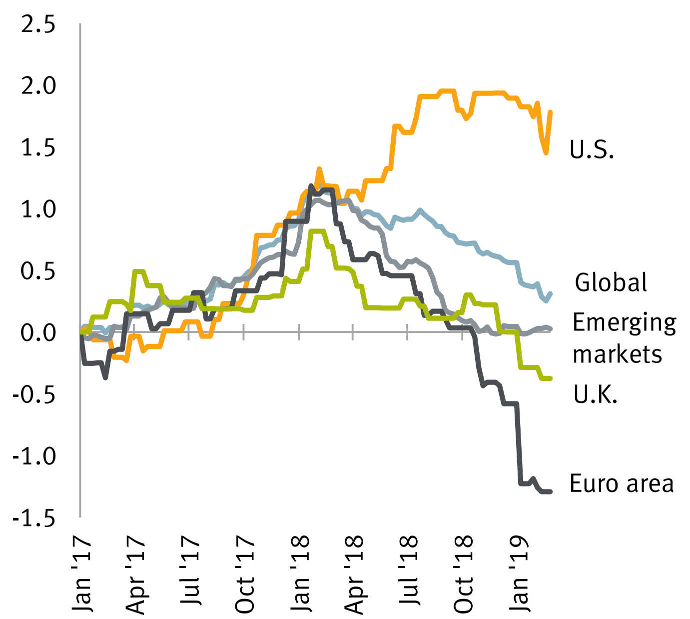
Powell's patience persists

The fading of U.S. recessionary fears on the back of the Fed's pivot has injected life into equity markets, while an easing away from the earlier tightening of financial conditions is leaving investors to bask in the Fed's embrace of patience. Comments from the central bank continue to point to a rate hike pause prevailing, and Fed Chair Jerome Powell alluded that the U.S. economy could be finding itself in a sweet spot.

In his semiannual testimony to Congress, Powell conceded that U.S. economic data has softened; however, excess slack in a still strong labor market should keep inflationary pressures "muted." These conditions have created an environment that is ripe, in his view, for patience towards policy decisions, notably as the U.S. economy has faced "crosscurrents and conflicting signals" over the past few months.

A clouded growth outlook captured in forecast revisions

JPMorgan Global Forecast Revision Index; cumulative change in %-points



Source - RBC Wealth Management, Bloomberg; data through 3/6/19

Market pulse

Navigating crosscurrents

A favorable U.S. economic outlook appears at odds with a confluence of factors and is underpinning the tug of war described by the Fed. Greater financial market volatility towards the latter part of 2018 alongside elevated political uncertainty is feeding into the Fed's caution. But Powell further flagged concerns about slowing growth across major foreign economies, advocating that it is a "good time" to watch and wait to gauge how the global outlook evolves.

Deteriorating growth prospects have dotted the global economy in recent months, led by slowdowns in Europe and China. Gauges of European economic activity sank to start 2019, signaling that the weakness seen in the latter half of 2018 was persisting. Germany's export exposure to a weaker external backdrop underpinned its growth slowdown, while Italy slumped into recession to end 2018 and French activity was weighed down by the "Yellow Vest" protests.

But bright spots are emerging. A sizeable improvement and stabilization in German and French services activity in February point to domestic demand recovering. This in turn should be sufficient to prevent the slowdown from worsening despite ongoing weakness amongst the region's key export markets, notably in Asia.

Even on this front, despite China facing medium-term structural issues, a string of recent fiscal and monetary stimulus measures should provide a cyclical lift to the country's growth, in our opinion. Thus, the risk of further spillover to developed markets should diminish later this year.

Risky (geopolitical) business

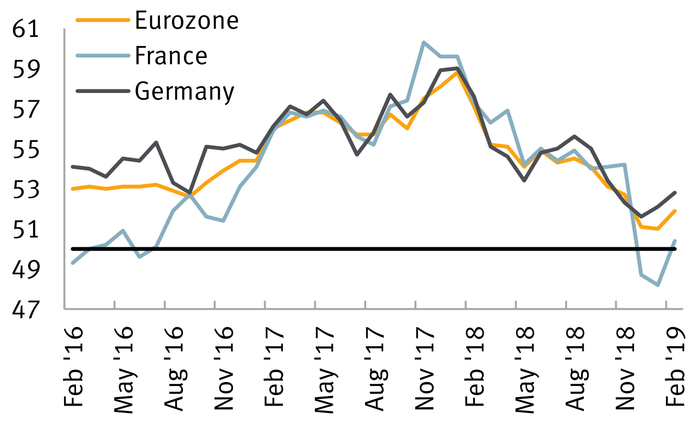
Risks still remain that the global economic expansion could falter further led by heightened political uncertainty. Ongoing trade negotiations come top of mind with the U.S.-China dispute yet to be resolved. There also remains the threat that the U.S. could announce tariffs on auto imports within 90 days following the submittal of the U.S. Commerce Department's investigation of the effects of imports on national security to the White House on February 17. Meanwhile, the Brexit saga in the U.K. endures and a U.S. debt ceiling will need to be tackled, likely before this autumn.

However, signs are emerging that tensions could be easing somewhat. The extension of the March 1 trade deadline by the Trump administration—that would have seen tariffs rise sharply on Chinese imports—points to a potential deal in the offing. The truce could prove to be superficial with structural issues persisting, yet the development could provide some relief to investors' global growth worries.

Across the pond, the risk of the U.K. leaving the EU without a deal in place declined materially recently. Prime Minister Theresa May conceded on February 26 to opening the door to an extension of the March 29 exit date, allowing for mid-March votes in the U.K. Parliament that could rule out a "no-deal" scenario. Greater clarity on the outcome would help to lift the "fog of Brexit" that the Bank of England warned is weighing on domestic economic activity.

Euro area slowdown showing signs of steadying

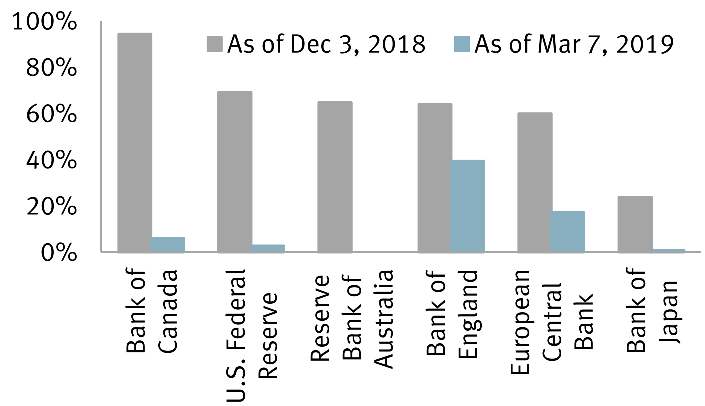
Markit Composite PMIs



Source - RBC Wealth Management, Bloomberg; data through 3/6/19

Policy rate hike expectations have plunged since the market turmoil of late 2018

Market-implied odds of at least one policy rate increase by Dec 31, 2019



Source - RBC Wealth Management, Bloomberg; data through 3/7/19

Policy to provide a push

On account of the global growth slippage, central banks around the globe have mirrored the cautious stance of the Fed. As a result, financial markets have lowered expectations for tighter policy paths, in turn alleviating pent-up investor fears that a global growth downturn portends an end to the bull run in financial markets.

Storm clouds are likely to roll in at some point, in our view, yet the widespread embrace of data dependency by central banks should support global growth conditions. We remain Market Weight on global (total) equities, which equates to being invested up to the benchmark strategic allocation in portfolios.

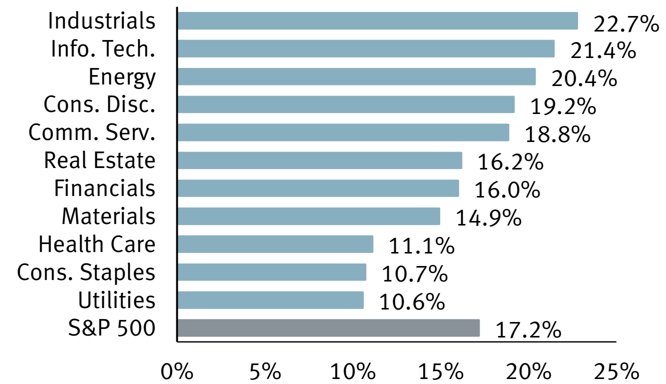
United States

Ben Graham, CFA – Minneapolis

- **U.S. equities are on pace for their worst week in 2019,** evidenced by the S&P 500's 2.0% decline in recent days. The NASDAQ has traded in line with the S&P 500, while the Dow Jones has actually held up better. Small-caps lag as **the Russell 2000** is down 4.2% recently, though it **still leads other U.S. indexes by a considerable margin** in 2019 with a 13.0% YTD return.
- **Health Care stocks have been in investors' crosshairs recently,** declining by nearly 4% in recent sessions as Insurers and Providers retreat on headlines that continue to be negative for the industry. Managed Care Organization (MCO) stocks are down more than 11% in the last two weeks as RBC Capital Markets, LLC analyst Frank Morgan points out that the **"Medicare For All" narrative continues to gain traction as a Democratic initiative,** but has a low probability of materializing. Another concern denting the sector recently is the launch of the nonprofit Haven Health Care, a joint venture of Berkshire Hathaway, JPMorgan Chase, and Amazon. Frank Morgan also notes that the ongoing weakness here is likely a sector rotation out of the stocks as investors weigh the mosaic of headline risks against future prospects.
- **The other laggards in recent days are the Industrials and Financials sectors**; leadership could be found in Real Estate, Consumer Discretionary, and Communication Services.

Near-term volatility can't mask a rally from late December lows

S&P 500 sector returns since 12/24/18



Source - RBC Wealth Management, FactSet; data through 3/7/19 at 11:35 a.m. CST; returns are price returns

Canada

Diana Di Luca, Carolyn Schroeder, & Arete Zafiriou – Toronto

- **The Bank of Canada (BoC) kept the overnight lending rate unchanged at 1.75%** on March 6. It is unsurprising that the BoC has joined other central banks in highlighting the somewhat challenging outlook for both global and domestic growth this year; however, the latest statement by the bank's Governing Council omits a phrase that has appeared in recent communiqués indicating the move to a neutral rate—estimated to be between 2.5% and 3.5%—is justified over time. While we have often debated the meaning of "over time" (one year? three years?), the Council has now opted to say the "outlook continues to warrant a policy interest rate that is below its neutral range." This may be just a different way of **reminding us that monetary policy remains accommodative,** but the choice of words in combination with an acknowledgement of "increased uncertainty about the timing of future rate increases" suggests **the BoC is in no rush to hike the overnight lending rate unless the data improves from here.** All this may come as no surprise to those who have been watching the recent economic data releases, but **we believe the BoC's conviction that the economy will bounce back in the second half of the year has clearly deteriorated**.
- **Canadian GDP growth was 0.4% in Q4 2018, down from 2.0% in Q3 and softer than the expected 1.0% increase.** GDP fell 0.1% m/m in December, the second consecutive monthly 0.1% decline and the third in the last four months. Last quarter's GDP growth was weighed down by **weakness in the oil and gas sector amid lower oil prices and a drop in drilling activity** due to the mandated production cuts in Alberta. However, **even excluding the oil and gas sector, GDP only increased by 1%.** Over the quarter, **consumer spending growth slowed** to 0.7% and **residential investment posted its sharpest decline since Q1 2009** as new construction spending fell. Business investment growth was also revised lower, resulting in a mere 1.7% increase for all of 2018. On a positive note, **Canadian labour markets appear healthy and household disposable income increased by 3.3% in Q4.** RBC Economic Research expects household spending to rebound off December lows, but remain subdued throughout 2019.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- Faced with weaker momentum, **the European Central Bank (ECB) opted to give the European economy extra support.** Its statement following the policy meeting on March 7 was more dovish than markets expected. In addition to delaying interest rate hikes, a measure which had been well telegraphed, the ECB surprised markets by announcing a **new long-term liquidity injection** (TLTRO III), starting in September 2019 and running until March 2021. In an important sign for markets, both decisions were unanimous.

- **RBC Capital Markets now expects a first 0.1% rate hike in December 2019** followed by another in March 2020, bringing the deposit rate back up to 0%. At that point it anticipates the ECB will pause.
- **Importantly, the ECB believes the recovery, while slowing, is not reversing.** Yet even after the policy decisions, ECB President Mario Draghi maintained his view that the risks to the economy are tilted to the downside given Brexit uncertainty, U.S.-EU trade discussions, and the slowdown in China.
- The central bank revised its growth forecasts more dramatically than the consensus had expected, given the slowdown seen in the second half of 2018 spilled into this year. For 2019, the ECB now expects growth of 1.1% vs. 1.7% previously. It barely touched its 2020 forecast (tweaked to 1.6% from 1.7%) as **the ECB continues to expect that the expansion will reassert itself.** The growth forecast for 2021 was maintained at 1.5%.
- **Inflation projections were also reduced** for the entire three-year forecasting period, and in particular to 1.2% for 2019 vs. a previous forecast of 1.6%.
- The ECB's dovishness and lower 2019 growth forecasts put **some pressure on the euro**, which fell close to a four-month low at 1.12 to the U.S. dollar.
- In the U.K., important Brexit votes are expected to take place from March 12. As things stand, **the U.K. government looks likely to again lose the vote on Prime Minister Theresa May's Withdrawal Agreement by a noticeable margin,** given there has been no breakthrough in negotiations with the EU on the issue of the Irish backstop. The Brexit saga continues, weighing on business sentiment.

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **Chinese Premier Li Keqiang delivered his work report** to the annual National People's Congress. The economic growth target was reduced from 6.5% to 6.0%–6.5%, as expected.
- Li noted that **China "will face a graver and more complicated environment."** Li has often been forthright in acknowledging risks to the economy. Given the challenges, the authorities have moved to **a more pro-growth stance** in comparison to 2018, where there was more focus on financial deleveraging, or curbing the rate of credit growth.
- **Tax cuts through the year totaling around RMB2T ($298B) were announced.** Li stated that one goal is to reduce the tax burden for companies. The VAT rate for manufacturers was reduced to 16% from 17% in 2018. The new rate will be 13%.
- A driving force behind tax reductions, which will improve corporate profitability, is to **support the job market.** Employment conditions have faced headwinds from wage growth, higher costs, and, more recently, the trade dispute.
- **Overall, the work report is supportive for markets in 2019,** in our view, although items such as increasing the quotas for local government bond issuance, a major source of debt in China, cast some doubt on debt levels going forward. However, the government has said that there will not be large-scale stimulus, for example in the form of significantly loosening monetary policy.
- **We expect the Chinese economy to continue on its path of gradual deceleration.** The authorities are acutely aware of the risks in multiple areas and are attentive. For example, in the housing market, government policy (particularly at the local level) has been highly adaptive over the years to changing market conditions, whether this has been to tighten or to support the housing market. That said, they are not magicians: properly curtailing credit growth will come at a cost to the broader economy over time.
- **Equity markets in Asia were muted** over the week. The solid 2019 rally—albeit following a torrid time in Q4—seems to have finally lost steam. Optimism of a good trade deal between the U.S. and China has soured a bit as investors begin to question what the details of such a deal may be.
- The stakes may have been raised for both sides in the trade dispute as the U.S. reported a 10-year-high trade deficit of $621B. About two-thirds ($419B) of the deficit is with China. **The trade deficit with China hit a record high in 2018, despite tariffs.**
- **It's not only China that is seeing slower growth. Australia's Q4 GDP print was 2.3% y/y (forecast: 2.5%).** Growth was propped up by government consumption. Residential construction was a headwind, unsurprising given the ongoing correction in house prices in Sydney and Melbourne, home to a significant chunk of the country's housing stock. Sydney's house prices have declined by low double digits from the top, the largest such decline in several decades. Currently, the average discount on prices from their initial listing is around 8%, the biggest since 2009.
- With respect to monetary policy, RBC Capital Markets notes that the "underlying growth pulse is clearly weaker" than the Reserve Bank of Australia thought. It also notes that residential construction has peaked and expects **housing to drag on growth throughout 2019 and 2020.** While RBC Capital Markets forecasts the overnight rate to remain unchanged at 1.5% during 2019 and 2020, these latest data points mean that the risk to this base case is shifting to the downside, in its view. Indeed, the market forecasts that there is a greater probability of a rate cut in H2 2019 than there is no change.

MARKET SCORECARD

Data as of March 7, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,748.93	-1.3%	9.7%	0.8%	16.1%
Dow Industrials (DJIA)	25,473.23	-1.7%	9.2%	2.7%	21.7%
NASDAQ	7,421.46	-1.5%	11.8%	0.3%	27.2%
Russell 2000	1,523.63	-3.3%	13.0%	-3.2%	10.8%
S&P/TSX Comp	16,056.51	0.4%	12.1%	3.8%	2.9%
FTSE All-Share	3,926.03	1.0%	6.8%	-0.7%	-1.7%
STOXX Europe 600	373.88	0.3%	10.7%	0.3%	0.4%
EURO STOXX 50	3,308.85	0.3%	10.2%	-2.0%	-2.3%
Hang Seng	28,779.45	0.5%	11.4%	-4.7%	21.5%
Shanghai Comp	3,106.42	5.6%	24.6%	-5.1%	-4.2%
Nikkei 225	21,456.01	0.3%	7.2%	1.0%	10.9%
India Sensex	36,725.42	2.4%	1.8%	11.2%	26.6%
Singapore Straits Times	3,229.48	0.5%	5.2%	-6.4%	3.2%
Brazil Ibovespa	94,340.17	-1.3%	7.3%	10.4%	41.5%
Mexican Bolsa IPC	41,641.84	-2.8%	0.0%	-12.6%	-12.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,285.40	-2.1%	0.2%	-3.0%	5.7%
Silver (spot $/oz)	15.03	-3.7%	-3.0%	-8.9%	-14.1%
Copper ($/metric ton)	6,499.50	-0.9%	9.3%	-5.9%	12.9%
Oil (WTI spot/bbl)	56.66	-1.0%	24.8%	-7.3%	6.6%
Oil (Brent spot/bbl)	66.11	0.1%	22.9%	2.8%	18.2%
Natural Gas ($/mmBtu)	2.86	1.8%	-2.6%	3.1%	1.4%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.639%	-7.6	-4.5	-24.3	12.1
Canada 10-Yr	1.764%	-17.8	-20.3	-47.4	2.4
U.K. 10-Yr	1.172%	-13.0	-10.5	-32.2	-2.1
Germany 10-Yr	0.067%	-11.6	-17.5	-58.8	-25.2
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.20%	0.1%	1.1%	3.4%	4.6%
U.S. Invest Grade Corp	3.90%	0.2%	2.8%	3.2%	6.0%
U.S. High Yield Corp	6.62%	-0.1%	6.2%	4.5%	9.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.6490	1.6%	1.5%	8.9%	-4.1%
CAD/USD	0.7435	-2.0%	1.4%	-4.0%	-0.3%
USD/CAD	1.3451	2.1%	-1.4%	4.2%	0.3%
EUR/USD	1.1191	-1.6%	-2.4%	-9.8%	5.9%
GBP/USD	1.3081	-1.4%	2.6%	-5.9%	7.2%
AUD/USD	0.7014	-1.1%	-0.5%	-10.4%	-7.6%
USD/JPY	111.6400	0.2%	1.8%	5.3%	-2.1%
EUR/JPY	124.9500	-1.4%	-0.7%	-5.1%	3.7%
EUR/GBP	0.8555	-0.2%	-4.8%	-4.2%	-1.2%
EUR/CHF	1.1323	-0.2%	0.6%	-3.3%	5.8%
USD/SGD	1.3610	0.7%	-0.1%	3.6%	-3.6%
USD/CNY	6.7150	0.3%	-2.4%	6.2%	-2.7%
USD/MXN	19.5569	1.4%	-0.5%	4.5%	0.3%
USD/BRL	3.8759	3.2%	-0.1%	19.5%	24.6%

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 3/7/19.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 1.4% return means the Canadian dollar rose 1.4% vs. the U.S. dollar year to date. USD/JPY 111.64 means 1 U.S. dollar will buy 111.64 yen. USD/JPY 1.8% return means the U.S. dollar rose 1.8% vs. the yen year to date.

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Hold [Sector Perform]	642	40.25	111	17.29
Sell [Underperform]	77	4.83	7	9.09

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