

# Global Insight

## Weekly



A closer look

## It's a mad, mad world

Kelly Bogdanova – San Francisco

Global equity markets remain stuck in the spin cycle as investors have had to deal with one “challenge du jour” after another. The first of our key recession signals has turned red, and while we’re cautiously constructive on the U.S. market, our appetite for equities outside of North America is diminishing.

Market pullbacks rarely play out over a handful of days, and with this episode, it seems like more volatility is in the offing.

The latest jolt to financial markets occurred after global economic risks came to the fore with two of the world’s largest economies, Germany and China, losing further momentum.

For the time being, equity markets seem to be held captive by bond markets. Even though the S&P 500 hit an all-time high less than three weeks ago, it has struggled of late as recession risks have risen, retreating 5.9% from the peak. Global indexes have declined by similar magnitudes.

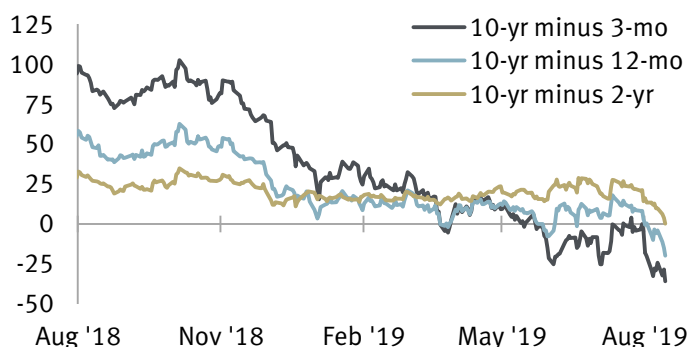
With global growth in doubt and \$16T in sovereign bonds trading at negative yields, investors around the world continued to rush into “safe-haven” U.S. Treasuries with relatively higher yields—despite the fact these yields are at or near historical lows.

Amid the feeding frenzy, the 30-year Treasury note dropped to its lowest yield in history at 1.97%, and more segments of the Treasury yield curve inverted, signaling that U.S. recession risks have risen.

Staying focused on recession indicators throughout this 10-year expansion cycle has allowed us to stay invested in equities and avoid the distractions of midcycle slowdowns and market corrections. While reasonable arguments can be made that the economic expansion (and bull market) can continue for some time, for the first time in a decade recession risks have risen

### Yield curve inversion points to economic risks

Difference (spread) between various points on the U.S. Treasury yield curve in basis points



Note: Inversion occurs when the 10-year Treasury yield is below shorter-maturity yields (difference is below zero)

Source - RBC Wealth Management, Bloomberg; daily data as of 8/14/19

### Market pulse

- 4 Making the case for U.S. equities
- 4 Improved expectations for Canadian banks
- 5 Euro area growth expectations contract
- 5 Instability, trade issues dent Hong Kong growth prospects

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materially. We believe this should not be ignored, and the risks should be factored into equity positioning.

### Crossed signals

Softer global trends illustrate that the U.S.-China trade war is not without consequences. Uncertainties about the endgame and the White House's shifting tactics are taking a toll.

CEOs of large and small multinational companies with exposure to China, whether domiciled in the U.S. or elsewhere, are increasingly cautious about their next moves. In some cases, supply chain relationships are in flux and capital spending plans are being altered. Business confidence is below last year's levels based on a number of metrics.

President Trump's recent gesture to push back tariffs on roughly \$156B in Chinese consumer goods from September to December in order to avoid negatively impacting the holiday shopping season boosted equities for one day. But the holiday gift quickly lost its appeal, in our view, because pushing out the deadline fails to quell the uncertainties about whether or when a trade deal will be inked. If anything, it is yet another signal the trade dispute could drag on and on. The erosion in corporate confidence will likely persist.

Trump's recent tweet seemingly tying a resolution to the Hong Kong violence and protests to a trade deal is another abrupt shift that sends mixed messages and raises uncertainties. Just hours after a key trade official, Commerce Secretary Wilbur Ross, said on CNBC that developments in Hong Kong are an "internal matter," Trump tweeted, "... Of course China wants to make a [trade] deal. Let them work humanely with Hong Kong first!"

We're also mindful there are external risks in the background that could ultimately impact the global economy and equity markets: a "no-deal" Brexit, additional Hong Kong developments, Argentina's renewed debt and currency risks, the new phase in India's conflict with Pakistan over Kashmir, and the ongoing clash between the U.S. and Iran. Geopolitical risks are almost always with us to varying degrees, and financial markets can largely afford to ignore them—unless they intensify.

The U.S. has a relatively insulated economy that is not dependent on exports, and domestic economic momentum has been stronger than its peers. But the U.S. is not an island unto itself. It's unclear whether overseas weakness will ultimately push the domestic economy into recession.

### The first domino?

We continue to look to key economic indicators to gauge the degree to which U.S. recession risks have risen and what that might mean for the equity market.

The further inversion of the Treasury yield curve, an important indicator that typically moves first among others we monitor,

### U.S. Treasury yield curve track record

12-month to 10-year yield curve

**U.S. economy:** The yield curve has typically inverted before a recession begins

Month yield curve inverts	Month recession begins	Interval (in months)
Dec '56	Sep '57	9
Sep '59	May '60	8
Apr '68	Jan '70	21
Mar '73	Dec '73	9
Sep '78	Jan '80	16
Sep '80	Jul '81	10
Feb '89	Jul '90	17
Apr '00	Mar '01	11
Jan '06	Dec '07	23
Average		14 months
Median		11 months

**Stock market:** The S&P 500 has peaked about six months after inversion, on average, but the timing has varied considerably

Month yield curve inverts	Month S&P 500 peaks	Interval (in months)
Dec '56	Jul '57	7
Sep '59	Aug '59	-1
Apr '68	Dec '68	8
Mar '73	Jan '73	-2
Sep '78	Sep '78	0
Sep '80	Dec '80	3
Feb '89	Jul '90	17
Apr '00	Mar '00	-1
Jan '06	Oct '07	21
Average		5.8 months
Median		3 months

Source - RBC Wealth Management, Bloomberg, Federal Reserve, National Bureau of Economic Research

underscores to us that U.S. recession risks have indeed risen. This indicator has been flashing a “yellow” caution signal for months. In our assessment, it is now flashing “red.”

When the yield curve is inverted, short-term rates are higher than long-term rates, opposite of what normally occurs. Key segments of the yield curve have become more inverted recently, and the 2-year to 10-year portion briefly inverted on Wednesday for the first time since June 2007, six months before the last recession began.

Yield curve inversions often precede recessions by a number of months. Since the 1950s, it took 14 months, on average, for a U.S. recession to begin after an inversion of the 12-month to 10-year yield curve (see upper table on the previous page). During this time only one false signal was given, in the mid-1960s, when the curve inverted but no recession materialized.

Historically, the S&P 500 peaked about six months after inversion, on average. The timing varied considerably, from -2 to 21 months, so this is not a reliable market timing mechanism (see lower table on the previous page). On a number of occasions the S&P 500 moved to new highs after inversion, and then shifted into a bear market before or during the forthcoming recession.

RBC Capital Markets U.S. Economics points out there are a number of circumstances in place that may make the yield curve a less valuable signal today, including the unusually low (and negative) yields globally. As a result, the Treasury yield curve can be viewed as more of a referendum on global trends than U.S. growth. Furthermore, credit is not tight in the U.S.; businesses and households find it easy to borrow. Tight credit normally accompanies an inverted yield curve and heightened recession risks.

These factors are important to consider, but we generally caution against fully embracing a “this time it’s different” thesis given each period is shaped by unique contours. We think investors should heed the inversion signal given its strong historical track record.

Even with elevated risks from the yield curve inversion, a recession is not a fait accompli. We take some comfort that our other U.S. recession indicators have yet to flash red or even yellow. Employment data, leading economic indicators, and the level of manufacturing new orders versus inventories are still signaling that GDP growth should persist for at least the next 12 months (see table). In addition, consumer spending is strong and wages are elevated.

### Diminishing appetite

With an important recession indicator now flashing “red,” and the others still in the “green” zone, we think some additional caution is warranted, with an eye toward potentially making more defensive adjustments to equity portfolios in coming months.

### Yield curve indicator shifts from yellow to red

RBC Wealth Management U.S. economic indicator scorecard

Indicator	Status		
	Green	Yellow	Red
Yield Curve (12-month to 10-year)	–	–	✓
Unemployment Claims	✓	–	–
Unemployment Rate	✓	–	–
Conference Board Leading Index	✓	–	–
ISM New Orders Minus Inventories	✓	–	–
Fed Funds vs. Nominal GDP Growth	✓	–	–

Expansion	Neutral	Recessionary
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Source - RBC Wealth Management, Bloomberg, FRED Economic Data St. Louis Fed



## United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets were pushed lower during the week by deteriorating global economic data, domestic yield curve fears, and rising trade uncertainties.** The S&P 500 has shed nearly 2.5% since the beginning of the week and is down almost 6% from its all-time high in late July. The more economically sensitive Dow Jones Industrial Average is lagging the S&P 500, while the NASDAQ is largely in line. Small caps have been slightly weaker than large caps, evidenced by the Russell 2000 declining 3.4%.
- **Sector leadership could be found in the lower-risk bond proxies:** Consumer Staples and Utilities are actually higher so far this week, while Real Estate has declined less than 1% and outpaced the broad index. **Weakness has been concentrated in cyclical sectors;** Energy is the biggest laggard, declining sharply on poor corporate earnings and a deterioration in investor confidence that the industry's free cash flow narrative is progressing satisfactorily. Financials have also struggled amid yield curve woes, while Materials and Industrials also lagged as the German economy shrank in Q2 and Chinese industrial production hit its lowest level in 17 years.
- **Despite market jitters, a constructive case can be made for U.S. equities** based on a comparison of the S&P 500 dividend yield to the 10-year Treasury rate. Historically, when equity yields exceed U.S. government yields, stock returns have been quite favorable during the ensuing 12 months. **Since 1960, the S&P 500 has returned 19.0%, on average, in the 12 months after dividend yields exceed bond yields to the degree they do now.** In 35 of those 37 monthly instances, returns were positive 12 months later. That being said, the ratio of dividend yield to Treasury yield has not quite reached the levels seen in 2008, 2012, or 2016, implying that near-term volatility may be present for the next several months. In our opinion, **our Market Weight recommendation in U.S. equities properly balances the near-term risks to equity markets with our still-constructive longer-term views.**



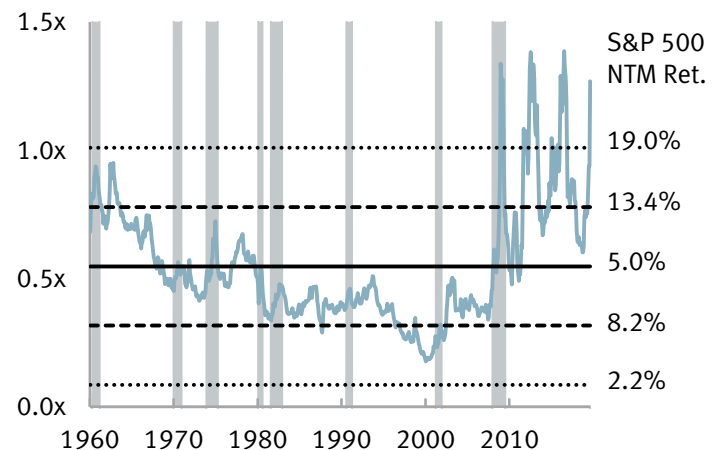
## Canada

Arete Zafiriou & Richard Tan, CFA – Toronto

- Canadian banks are scheduled to begin reporting Q3 2019 earnings on August 21. **RBC Capital Markets increased its earnings estimates for all banks** in its coverage universe, driven by its expectation for solid revenue growth, modest improvement in efficiency (i.e., operating expenses as a percentage of revenues), and stabilization in the provision

## U.S. stocks look attractive relative to Treasuries

Ratio of S&P 500 dividend yield to 10Y Treasury rates



Note: NTM Ret. = next 12-month returns; gray bars represent recessions; horizontal lines represent standard deviations; higher readings indicate higher relative attractiveness for U.S. equities

Source - RBC Wealth Management, Bloomberg; data through 8/15/19

for credit losses. On the latter, RBC Capital Markets believes the **credit environment has improved** to a degree that may allow Canadian banks to slow the rate of increase in loan loss reserves. That said, investors may welcome some reserve building in the spirit of conservatism late in the economic cycle. RBC Capital Markets expects the **U.S. and International segments to grow at a double-digit pace** year over year for the majority of the Canadian banks. The banks' **Capital Markets divisions** are also anticipated to be a source of positive contribution, **driven by increased M&A volumes and debt issuances.** Canadian banks as a group have underperformed the S&P/TSX Composite Index by over 700 basis points year to date and trade at 9.6x forward earnings, below their historical average price-to-earnings multiple of roughly 11.5x. We advocate a modest Underweight position in banks but acknowledge that valuations are beginning to indicate some compensation for domestic risks.

- RBC Economics believes **risks for the Canadian housing market are easing.** Long-term interest rates have declined in anticipation of central bank rate cuts, mitigating the associated risks in higher-priced markets like Vancouver and Toronto. Demand-supply conditions have improved in the Prairies and Calgary and remain balanced in Toronto and Vancouver. However, affordability is still a significant issue in Toronto, Vancouver, and increasingly in Montreal. Ownership costs as a percentage of household income are starting to come off a long-term high in Vancouver, but remain elevated in Toronto. **In the West, uncertainty regarding crude oil transportation is weighing on the regional economic backdrop, but job market conditions seem to be improving** as indicated by a decline in the unemployment rate. Given the signs of recovery in softer

markets, RBC Economics believes the probability of a housing downturn over the next year has decreased.



## Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Europe and U.K. equities suffered further losses during the week.** Both were down more than 2%, with Banks and Technology the most affected sectors.
- **The euro area reported disappointing numbers, with industrial production falling 1.6% in June,** slightly worse than consensus expectations. Meanwhile, **employment growth decelerated somewhat across the region, with growth of 0.2% q/q in Q2 compared to 0.4% in the prior period.** Should this trend continue, we believe it could limit consumer spending growth going forward.
- **A German GDP contraction of 0.1% q/q in Q2 made headlines,** arriving on the heels of 0.4% q/q growth in Q1. **While the domestic sector appears resilient, net trade seems to have been a drag on growth.** Consensus expectations for 2019 euro area growth have slid to 1.1% from 1.6% at the beginning of the year, according to Bloomberg.
- At the level of individual stocks, **the worst performer during the week was Austrian semiconductor company ams AG** following its announcement of a €4.3B bid for German lighting manufacturer **Osram Licht**. The deal would involve a €1.5B rights issue alongside €2.7B in bond issuance. The stock was **down more than 20% during the week, retracing gains made in July** when results proved much better than consensus expectations.
- **Prudential expects to complete the demerger of its U.K. and European life insurance and asset management operations in Q4 2019,** the company confirmed. The demerged business will be listed on the London Stock Exchange as M&G plc.
- **Schindler,** a global leader in the manufacture and installation of elevators and escalators, reported Q2 results slightly below consensus expectations. Although the company believes its end markets “may slightly weaken over the remainder of the year”, it **continues to expect revenue growth of between 4% and 6% y/y in 2019.**



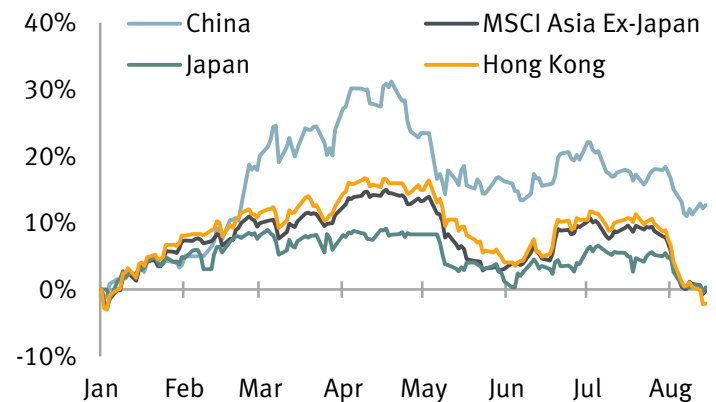
## Asia Pacific

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

- **U.S.-China trade tensions and Hong Kong political unrest are still the two major factors driving Asian stocks.** The inverted U.S. Treasury yield curve also contributes to volatility.

## Hong Kong equities weaker than Asian peers recently

Year-to-date returns, local currency



Note: China index is Shanghai Composite, Japan is TOPIX, Hong Kong is Hang Seng. Source - RBC Wealth Management, Bloomberg; data through 8/14/19

- **The U.S. decided to delay 10% tariffs on select Chinese goods** (including mobile phones, laptops, and video games) **from September to December** in an effort to minimize impact on holiday shopping. **However, tariffs are still scheduled to take effect on other goods in September.** China said it will take necessary countermeasures as it believes the U.S. has derailed efforts to resolve disputes through negotiation. **Asian equities sold off** on concerns the tariff dispute will be an ongoing issue and as German and Chinese economic data weakened, partly due to the trade conflict.
- **Hong Kong is still the worst-performing market in the region** as protests persist. Hong Kong International Airport was forced to shut down on Monday and Tuesday as protestors occupied the facility. A total of 979 flights were cancelled, which affected roughly 100,000 passengers according to the government's estimate. **Political and social instability is also affecting the city's IPO market;** according to Bloomberg, some Chinese companies are rethinking their Hong Kong fundraising plans. **Alibaba,** which filed an application for a Hong Kong listing, has not commented on its intentions. Considering the internal and external challenges facing the Hong Kong economy, **the government revised down its 2019 GDP growth estimate to 0%–1%.**
- Chinese social media giant **Tencent (700 HK) reported mixed Q2 results.** Earnings growth was largely in line with expectations, but **revenue growth of 20.6% y/y missed by 5% on lower-than-expected revenue from PC games and online advertising.** While the company has a strong pipeline of games, **online advertising could remain under pressure in the second half of 2019** due to the tough macro environment, inventory oversupply, and intense competition.



## MARKET SCORECARD

## Data as of August 15, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,847.60	-4.5%	13.6%	1.0%	15.5%
Dow Industrials (DJIA)	25,579.39	-4.8%	9.7%	1.7%	16.3%
NASDAQ	7,766.62	-5.0%	17.1%	-0.1%	22.6%
Russell 2000	1,461.65	-7.2%	8.4%	-12.5%	5.7%
S&P/TSX Comp	16,012.53	-2.4%	11.8%	-0.8%	6.1%
FTSE All-Share	3,865.55	-6.5%	5.2%	-6.2%	-4.5%
STOXX Europe 600	365.09	-5.4%	8.1%	-3.8%	-3.0%
EURO STOXX 50	3,282.78	-5.3%	9.4%	-2.3%	-5.2%
Hang Seng	25,495.46	-8.2%	-1.4%	-6.7%	-6.2%
Shanghai Comp	2,815.80	-4.0%	12.9%	3.4%	-13.4%
Nikkei 225	20,405.65	-5.2%	2.0%	-8.1%	3.3%
India Sensex	37,311.53	-0.5%	3.4%	-1.5%	19.5%
Singapore Straits Times	3,126.09	-5.3%	1.9%	-3.3%	-5.1%
Brazil Ibovespa	99,056.91	-2.7%	12.7%	28.5%	44.9%
Mexican Bolsa IPC	38,574.18	-5.6%	-7.4%	-20.6%	-24.9%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,524.38	7.8%	18.9%	29.7%	19.9%
Silver (spot \$/oz)	17.26	6.2%	11.4%	19.5%	3.8%
Copper (\$/metric ton)	5,739.00	-2.8%	-3.5%	-0.3%	-9.5%
Oil (WTI spot/bbl)	54.47	-7.0%	20.0%	-16.2%	14.6%
Oil (Brent spot/bbl)	58.27	-10.6%	8.3%	-17.7%	14.7%
Natural Gas (\$/mmBtu)	2.22	-0.5%	-24.5%	-24.5%	-24.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.500%	-51.4	-118.4	-136.2	-77.3
Canada 10-Yr	1.081%	-39.6	-88.6	-118.8	-82.5
U.K. 10-Yr	0.408%	-20.3	-86.9	-81.7	-67.6
Germany 10-Yr	-0.713%	-27.3	-95.5	-101.7	-114.6
Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.23%	2.0%	8.5%	9.7%	9.2%
U.S. Invest Grade Corp	2.92%	2.3%	13.0%	12.5%	12.3%
U.S. High Yield Corp	6.22%	-1.0%	9.5%	5.7%	9.2%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	98.0990	-0.4%	2.0%	1.5%	4.5%
CAD/USD	0.7509	-0.9%	2.4%	-1.3%	-4.2%
USD/CAD	1.3318	1.0%	-2.3%	1.3%	4.4%
EUR/USD	1.1113	0.3%	-3.1%	-2.0%	-5.3%
GBP/USD	1.2107	-0.4%	-5.1%	-4.6%	-5.9%
AUD/USD	0.6777	-1.0%	-3.9%	-6.4%	-13.3%
USD/JPY	106.0200	-2.5%	-3.3%	-4.3%	-4.2%
EUR/JPY	117.8200	-2.2%	-6.4%	-6.2%	-9.3%
EUR/GBP	0.9179	0.7%	2.1%	2.7%	0.7%
EUR/CHF	1.0847	-1.5%	-3.6%	-3.8%	-5.0%
USD/SGD	1.3887	1.0%	1.9%	0.6%	1.6%
USD/CNY	7.0340	2.2%	2.3%	1.4%	5.2%
USD/MXN	19.6141	2.4%	-0.2%	2.5%	10.1%
USD/BRL	3.9904	4.6%	3.0%	2.2%	25.9%

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 8/15/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 2.4% return means the Canadian dollar rose 2.4% vs. the U.S. dollar year to date. USD/JPY 106.02 means 1 U.S. dollar will buy 106.02 yen. USD/JPY -3.3% return means the U.S. dollar fell 3.3% vs. the yen year to date.

## Authors

**Kelly Bogdanova – San Francisco, United States**

kelly.bogdanova@rbc.com; RBC Capital Markets, LLC

**Ben Graham, CFA – Minneapolis, United States**

benjamin.graham@rbc.com; RBC Capital Markets, LLC

**Arete Zafiriou – Toronto, Canada**

arete.zafiriou@rbc.com; RBC Dominion Securities Inc.

**Richard Tan, CFA – Toronto, Canada**

richard.tan@rbc.com; RBC Dominion Securities Inc.

**Frédérique Carrier – London, United Kingdom**

frederique.carrier@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

**Thomas McGarrity, CFA – London, United Kingdom**

thomas.mcgarritty@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

**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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Rating	Count	Percent	Investment Banking Services Provided During Past 12 Months	
			Count	Percent
Buy [Top Pick & Outperform]	772	53.57	215	27.85
Hold [Sector Perform]	588	40.80	114	19.39
Sell [Underperform]	81	5.62	2	2.47

### Ratings:

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