June 7, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Short story

Tom Garretson, CFA – Minneapolis

Concerns about the flat Treasury yield curve aren't going away anytime soon, but in our view, it's not going to steepen anytime soon either. Based on the last Fed rate hike cycle, the current flatness of the curve might be signaling to investors that it's finally time to shorten duration.

Treasury yields have mostly recovered over the past week after a sharp move lower following geopolitical risks surrounding Italy, but despite the 10-year Treasury once again nearing the 3% level, investors are still facing the flattest yield curves since 2007. The yield curve continues to dominate headlines for its potential economic implications, but we are looking at the current flatness of the yield curve as an opportunity to shift strategy for bond buyers.

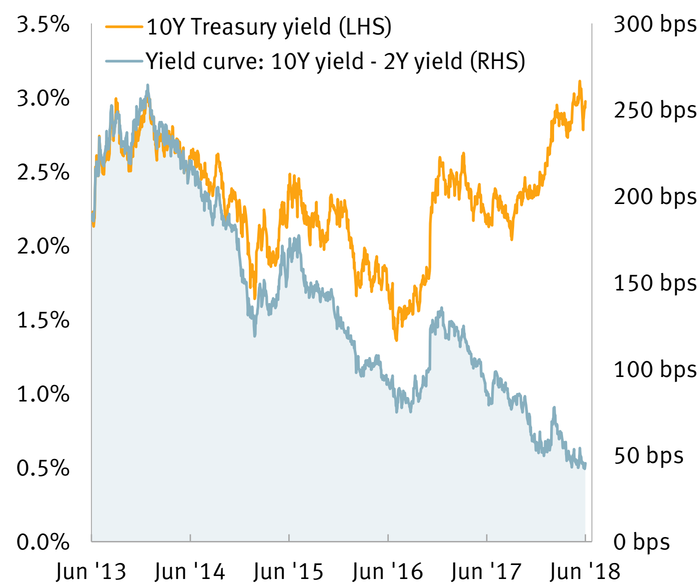
Singing a different tune

For much of this economic cycle we have advocated for maintaining a long duration bias in portfolios on expections of limited upside for yields, and for the curve to flatten as the Fed embarked on raising short-term rates. This has worked over the past five years with the Bloomberg Barclays US Aggregate 10+ Year Bond Index returning 20.4%, compared to just 4.1% on the US Aggregate 1-3 Year Index.

But while investors have been able to ride a flattening yield curve to outperformance thus far, at what point might the curve be flat enough that this relationship reverses and the short end of the curve starts to outperform?

There have only been roughly four periods of sustained Fed rate hike cycles since 1980, hardly enough to draw statistically significant conclusions from, so for simplicity we looked at the Fed's most recent 2004–06 cycle. As the top chart on the next page shows, it wasn't until the yield curve, as measured by the yield difference between 10-year and 2-year Treasuries, dipped below 50 basis points (bps) that the short end of the curve began to outperform the long end, as measured by the two indexes previously mentioned. With the 10-year to 2-year yield curve at 44 bps, we would now recommend that investors begin to put money to work at the short end of yield curves.

Yield curve flatness at 5Y low, even as 10Y yield hits 5Y high



Source - RBC Wealth Management, Bloomberg; data through 6/6/18

Market pulse

Click here for authors' contact information.

Priced (in USD) as of 6/7/18 market close, EST (unless otherwise stated).

For important disclosures and required non-U.S. analyst disclosures, see page 6.

RBC Wealth Management

The curve is unlikely to steepen

At this stage, the only scenario, in our view, that is likely to steepen the yield curve would be the Fed signaling that it's going to slow the pace of rate hikes, or further down the road, deliver the next rate cut. Even in a scenario where late-cycle dynamics begin to play out—higher commodity prices, inflation, and growth—which would likely push the 10-year Treasury yield higher, we believe it would likely be met with faster Fed rate hikes, pushing front-end yields higher in lockstep. In that scenario, the short end should still outperform due to lower duration, or lower interest rate sensitivity.

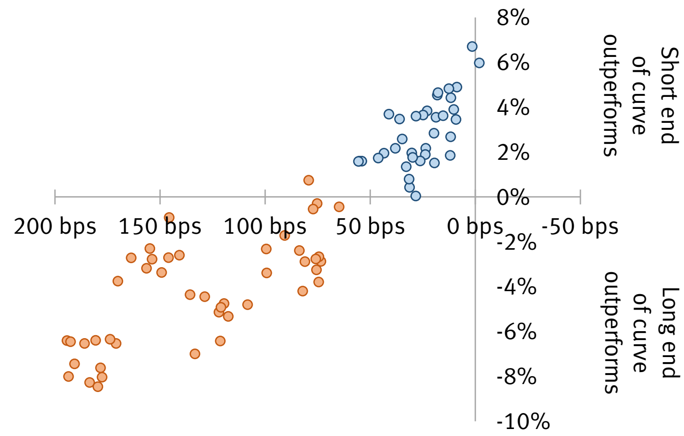
Barbell work

To be sure, we are not recommending a wholesale shift to short duration. As with any portfolio, there is value in diversification. But between the short (1–5 years), intermediate (5–10 years), and long (10+ years) parts of the curve, we think the most uncertainty lies in the intermediate section.

Therefore, investors may find value in a barbell approach to putting money to work in fixed income, or focusing on the short and long end. Investors will likely benefit from rising short-term yields, while we see the 30-year Treasury as anchored around current levels—it has failed to trade above 3.25% since 2015, compared to a yield of 3.12% as of June 6.

All told, we think the front end of the curve currently offers a win-win proposition for investors: the opportunity to reinvest at higher yields should the Fed maintain the march to higher rates, or the chance for bond prices at the front end to rally higher should the Fed ease off the rate hike throttle in the face of flat yield curves.

Short duration starts to outperform long duration when yield curve flattens below 50 bps



Source - RBC Wealth Management, Bloomberg; shows total return on Blomberg Barclays US Aggregate 1-3Y Index minus return on US Aggregate 10+ Year Bond Index for the 6 months following various yield curve levels during the 2004-2006 rate hike cycle; data through 6/6/18

What's moving markets

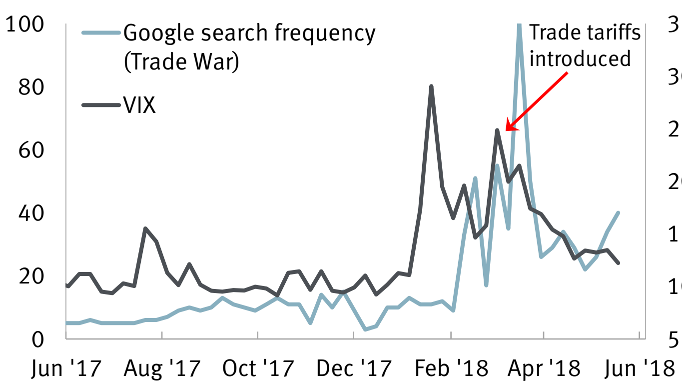
Trade winds

The exemptions from steel and aluminum tariffs granted to select U.S. allies have expired, prompting responses from Mexico, Canada, and the EU, including retaliatory tariffs on an estimated $3B, $12.8B, and $3.3B of U.S. goods, respectively. The new tariffs complicate ongoing NAFTA negotiations. RBC Global Asset Management currently sees a 55% chance of a new deal, a 20% chance it is left in its current form, and a 25% chance it is torn up altogether.

While RBC Global Asset Management projects a mere 15% chance of an all-out trade war, the uncertainty of prolonged negotiations could drag on growth. Regional business surveys have shown sustained confidence in the economic outlook, but comments suggest uncertainty around tariffs boosting prices and disrupting supply chains. Companies must weigh whether to invest in new production as potentially costly trade policies loom, prompting considerations of curbed production or delayed investment, just as business investment in the U.S. starts to pick up.

The bottom line is that trade is a developing story, but markets appear to have become accustomed to threats of new tariffs. The VIX Index, which measures expected equity volatility, averaged 14.2 in May, the lowest monthly average since January, despite ongoing trade negotiations. Investors have,

Equity markets growing accustomed to trade threats



Source - RBC Wealth Management, Bloomberg; data through 6/3/18

however, sought shelter in the form of domestic-focused small-cap stocks, which have outperformed the S&P 500 by 7.6% since March 1.

Despite concerns, we remain constructive on the growth outlook of the U.S. economy. The Atlanta Fed projects Q2 GDP growth of 4.5%, as spending rebounds and corporate investment accelerates, and as RBC Global Asset Management recently noted, "U.S. tax cuts currently provide a much greater U.S. tailwind than protectionist actions do a headwind."

United States

Bill Kuehn, CFA & Sam Renikoff – Minneapolis

- **Oil prices declined** early in the week on a one-two punch of the **largest rise in domestic inventories since 2009 as well as the U.S. asking Saudi Arabia to increase oil production by 1 million barrels per day** to offset the reduction in supply from Iran. While the market is focused on the potential for increased Saudi output, RBC Capital Markets' commodities strategist still believes **the biggest driver of oil prices will be Iran's reaction to the U.S. withdrawal from the Joint Comprehensive Plan of Action**, aka the Iran nuclear deal. Iran's supreme leader warned that the country will resume its nuclear activities unless Europe continues to purchase Iranian crude oil. Worryingly, some Iranian officials have discussed exiting from the Nuclear Non-Proliferation Treaty, which explicitly implies the country's nuclear activity is for military purposes. **RBC Capital Markets recommends an Overweight position on Energy equities** given the backdrop for oil.
- In April, there were **more open jobs than total unemployed workers**, according to JOLTS jobs data. There were a reported 6.698 million help wanted signs in the U.S., the highest level on record, in contrast to only 6.065 million unemployed workers. The data points to how tight the labor market has become, in addition to highlighting the **massive structural mismatch between worker skill level and business labor needs**. This report comes on the heels of May's nonfarm payrolls report that showed another 223,000 workers were hired in May, pushing the hiring rate up to 3.8%—the fastest pace of this cycle and drastically reducing the pool of available workers. The **"tightness" in the labor market increases the likelihood of upward wage pressure** as *qualified* workers on average now have more than one open job available to them, giving active labor market participants negotiating power for higher wages that has not been seen in decades. Faster wage growth increases the risk that we could see a more hawkish Fed at the June 13 meeting.

U.S. job openings outweigh the unemployed

Source - RBC Wealth Management, Bloomberg; data through 4/30/18

Canada

Diana Di Luca – Toronto

- At its May meeting, **the Bank of Canada (BoC) provided a clear message that it will continue to raise interest rates gradually until the economy shows signs that it cannot take any more**. The market thinks this point will be reached when the overnight lending rate hits 2.25%, an additional four 25 basis point rate hikes from today. We think the BoC is more likely to be slower to raise rates, rather than faster, which leads us to believe there is appropriate compensation for interest rate risk in short-to-intermediate maturity bonds. We also think this approach is more likely to generate inflationary pressure, which could lead to higher bond yields in the longer end of the curve.
- When thinking about the government finance challenges Europe faces at the moment, a domestic concern that comes to mind is Canadian provincial debt. While not a perfect parallel, the story in Europe centres around overly indebted governments, and we believe the provinces are the weak link in the Canadian government debt chain. **With Ontario's election upon us, questions about the province's budget will follow regardless of the winner. This could soften the broader market tone in the provincial bond market**, as Ontario represents approximately 15% of the Canadian bond index. As credit spreads on provincial bonds versus federal bonds are near the narrowest level in a decade, we think it is timely to rotate away from provincial bonds into federal bonds.
- **Following a lull of over two months, three preferred share new issues came to market in Canada in late May**, for a total of CA$850M. The preferred share market reached a two-month high in mid-May, but has since declined as the risk-off tone in global markets led to a decline in Government of Canada bond yields. Lower interest rates decrease the cash flow profile of the approximately 80% of the preferred share market that is comprised of rate-reset and floating-rate issues beyond the next reset date.

Europe

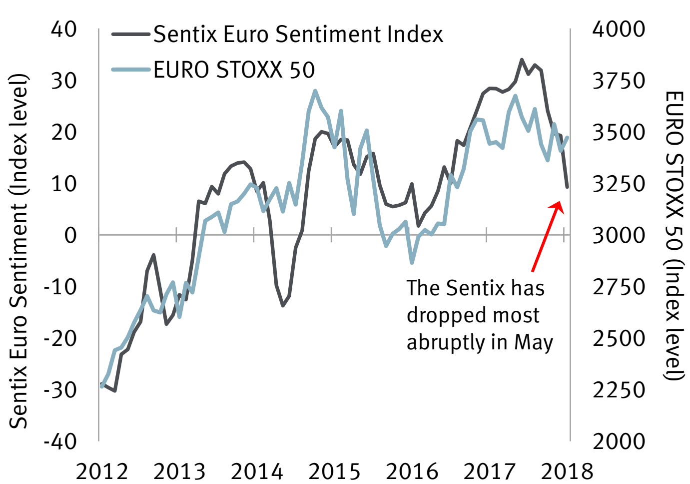
Frédérique Carrier & Thomas McGarrity, CFA – London

- **In Italy, the coalition government of far-left and far-right parties was appointed and a non-eurosceptic finance minister put forward**. **Markets were relieved** and the Italy-

German 10-year Bund spread narrowed from +290 basis points (bps) to a level still higher than a month ago of +210 bps. However, as this populist government is bent on fiscal profligacy and reversing economic reforms, **the risk of a funding crisis remains**.

- Political uncertainty in Italy over the last month caused the June **Sentix Euro Index, which measures investor confidence over the next six months, to fall from 19.2 in May to 8.3**, its lowest level since November 2016. The recent loss of European momentum might not be over yet.
- Contrastingly, the **U.K. produced firm economic data in May** with the services Purchasing Managers' Index (PMI) increasing in expansionary territory from 52.8 in April to 54.0, whilst the manufacturing PMI rose from 53.9 to 54.4. The market is now pricing an approximate 55% probability of a 25 bps August rate hike, up from 40% the prior week.
- Brexit continues to offer very low visibility and an increasingly demanding timeline. On June 12, **the House of Commons will consider and vote on no less than 15 amendments made by the House of Lords to the EU withdrawal bill**. They aim at softening the U.K. government's stance on Brexit, and include exploring the possibility of staying in a customs union, and forcing the government to follow the lead of Parliament in the event of "no deal."
- Some of these votes are too close to call. If the government loses any of them, it may not necessarily guarantee a change of tack, but it would be a **barometer of support within the House of Commons for a softer Brexit stance**.
- Separately, the *Financial Times* reported on June 5 that **Prime Minister Theresa May will not release a detailed plan on the future trading relationship with the EU ahead of the June 28 EU summit**, as her cabinet still disagrees on the matter. This could put much pressure on the October EU summit, when the final exit deal is supposed to be agreed upon.

Sentiment Index tumbles



Source - RBC Wealth Management, Bloomberg; data through 6/6/18

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **While Asian equities outside Japan have continued to trade sideways**, performance in the month of May was **notably better than other emerging markets**. The MSCI Emerging Market Index fell by 3.8% in May, underperforming the flat performance of the MSCI World Index by 4%. Weakness in certain currencies was a key factor.
- **Emerging market Asia declined by 1.5%** in May, while Latin America endured a 14% decline in the month and Europe, Middle East, and Africa declined by 6%. The declines in Greece (-19%) and Brazil (-16%) were severe. **MSCI China actually rose by 1.5%**.
- **The meeting between President Trump and Kim Jong-un of North Korea may take place in Singapore on June 12**. What comes of this unusual meeting is anyone's guess. In our view, it is quite unlikely that North Korea will move towards full denuclearization. This path has been well trodden and the regime has reneged on any previously agreed move in that direction. That said, the **unpredictable nature of Trump is a novel ingredient in the mix**. In terms of the optics of this meeting, **our view is that it is a win, and a big one at that, for Kim** insofar as a face-to-face meeting with the U.S. president is unprecedented, puts Kim on a par with other globally important leaders, and gives him significant face.
- As the U.S.-China trade dispute continues, **the Trump administration threw embattled Chinese telecom and networking company ZTE (763 HK) a lifeline** by allowing it to resume purchases of U.S. technology goods subject to certain stringent conditions. **ZTE will pay a $1B fine, change its executive team, and allow a U.S. compliance team to inspect company operations**. Over one-quarter of the components that ZTE, a major Chinese company, uses for its products come from the U.S. Following the ban imposed by the U.S. on ZTE for doing business with North Korea and Iran, the company had effectively halted production, hamstringing a company that is strategically important for China. Perhaps in response to this olive branch, **China may increase its purchases of U.S. goods by around $25B this year**. However, the overall situation remains fluid and still represents a meaningful source of risk for markets.
- **The Reserve Bank of Australia once again kept its benchmark interest rate unchanged** at a record low of 1.5%. The market expects this policy to persist, pricing in only a small chance of a rate hike over the next year. **RBC Capital Markets thinks that the Australian economy's fairly strong start to the year will not be sustained** "given the unfolding moderation in the housing sector and the added challenge this poses to household consumption."

MARKET SCORECARD

Data as of June 7, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,770.37	2.4%	3.6%	13.9%	31.2%
Dow Industrials (DJIA)	25,241.41	3.4%	2.1%	19.2%	40.7%
NASDAQ	7,635.07	2.6%	10.6%	21.2%	53.9%
Russell 2000	1,667.78	2.1%	8.6%	19.4%	41.3%
S&P/TSX Comp	16,192.78	0.8%	-0.1%	5.3%	12.7%
FTSE All-Share	4,245.88	0.6%	0.6%	3.9%	22.9%
STOXX Europe 600	385.94	0.8%	-0.8%	-0.8%	11.5%
EURO STOXX 50	3,459.77	1.6%	-1.3%	-2.5%	13.8%
Hang Seng	31,512.63	3.4%	5.3%	21.3%	47.8%
Shanghai Comp	3,109.50	0.5%	-6.0%	-1.0%	5.9%
Nikkei 225	22,823.26	2.8%	0.3%	14.2%	36.9%
India Sensex	35,463.08	0.4%	4.1%	13.4%	31.3%
Singapore Straits Times	3,473.08	1.3%	2.1%	7.5%	21.9%
Brazil Ibovespa	73,851.47	-3.8%	-3.3%	16.9%	46.3%
Mexican Bolsa IPC	45,476.57	1.8%	-7.9%	-7.7%	-1.4%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,296.96	-0.1%	-0.5%	0.8%	4.3%
Silver (spot $/oz)	16.71	1.8%	-1.3%	-5.1%	2.0%
Copper ($/metric ton)	7,211.25	5.4%	0.1%	29.0%	58.0%
Oil (WTI spot/bbl)	65.95	-1.6%	9.2%	44.2%	31.0%
Oil (Brent spot/bbl)	77.30	-0.4%	15.6%	60.8%	50.3%
Natural Gas ($/mmBtu)	2.93	-0.7%	-0.7%	-2.9%	18.5%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.926%	6.7	52.1	75.3	120.8
Canada 10-Yr	2.286%	4.2	24.1	87.7	106.5
U.K. 10-Yr	1.400%	17.0	21.0	39.9	13.3
Germany 10-Yr	0.484%	14.3	5.7	21.5	43.4

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.35%	-0.8%	-2.2%	-1.3%	-0.2%
U.S. Invest Grade Corp	4.02%	-0.9%	-3.6%	-1.0%	2.5%
U.S. High Yield Corp	6.35%	0.4%	0.2%	2.6%	15.8%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	93.4410	-0.6%	1.4%	-3.4%	-0.4%
CAD/USD	0.7706	-0.1%	-3.1%	4.1%	-1.9%
USD/CAD	1.2978	0.2%	3.2%	-3.9%	1.9%
EUR/USD	1.1803	0.9%	-1.7%	4.9%	3.9%
GBP/USD	1.3422	0.9%	-0.7%	3.6%	-7.7%
AUD/USD	0.7623	0.7%	-2.4%	1.0%	2.2%
USD/JPY	109.7100	0.8%	-2.6%	-0.1%	2.2%
EUR/JPY	129.4900	1.8%	-4.3%	4.7%	6.2%
EUR/GBP	0.8794	0.0%	-1.0%	1.2%	12.6%
EUR/CHF	1.1570	0.4%	-1.1%	6.5%	5.5%
USD/SGD	1.3339	-0.3%	-0.2%	-3.5%	-1.3%
USD/CNY	6.3921	-0.3%	-1.8%	-5.9%	-2.7%
USD/MXN	20.4979	2.9%	4.3%	12.5%	11.7%
USD/BRL	3.9166	5.2%	18.2%	19.8%	13.8%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX and 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 6/7/18.

Examples of how to interpret currency data: CAD/USD 0.77 means 1 Canadian dollar will buy 0.77 U.S. dollar. CAD/USD -3.1% return means the Canadian dollar fell 3.1% vs. the U.S. dollar year to date. USD/JPY 109.71 means 1 U.S. dollar will buy 109.71 yen. USD/JPY -2.6% return means the U.S. dollar fell 2.6% vs. the yen year to date.

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Buy [Top Pick & Outperform]	865	53.49	275	31.79
Hold [Sector Perform]	667	41.25	147	22.04
Sell [Underperform]	85	5.26	7	8.24

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