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RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

There's no such thing as normal—stop investing like it

Tom Garretson, CFA – Minneapolis

The idea that there exists a "normal" state with respect to interest rates, or central bank policy, or any number of things may do more harm than good when investing. Accepting that there is no such thing as normal may even help to drive better investment decisions.

The idea of "normalization" has been a constant theme for investors since the financial crisis of 2008. The market impact and the steps taken in response—particularly by global central banks—were so extreme that there now seems to exist in the psyche of investors some form of pre-crisis normalcy that we're all trying to get back to.

But what even is normal? The Federal Reserve has been leading the charge in this respect, and has regularly used that verbiage. It is currently "normalizing" the balance sheet and has been raising short-term rates since 2015 to get to "more normal" levels.

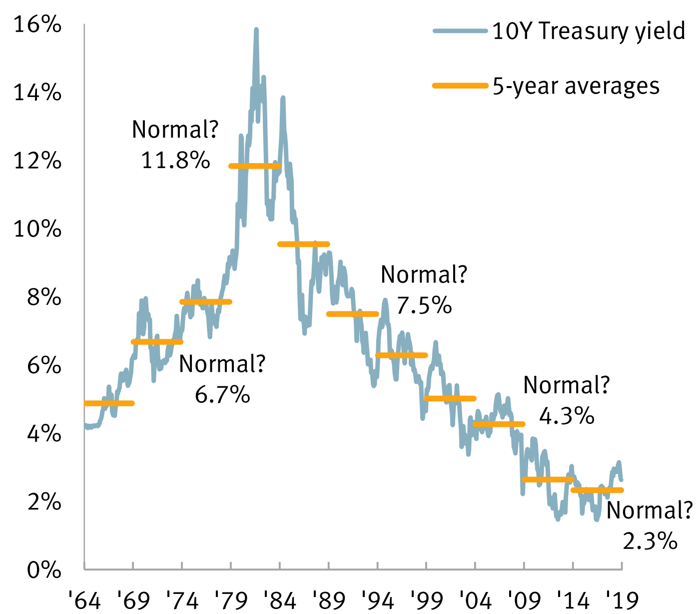
Perhaps it's just human nature to view the past as the correct representation of what's normal. For example, another oft-cited case, and complaint, is that economic growth in the U.S. this cycle has been slower than it was during most past economic expansions. While true, few think of it in terms of it being the case that it was historical growth that was abnormal, and this type of growth normal.

For equity investors, this framework of thinking has regularly featured in headlines as justification to take comfort. As the thinking went, interest rates were well below historical norms, so there was no reason yet to fear the Fed. But in December that all changed as U.S. equity markets neared bear market territory following the Fed's decision to raise short-term rates to just 2.50%, with fears only heightened that the Fed might even push rates beyond that.

For fixed income investors, this idea of normal has likely had even more of a direct impact on investment decisions, and, in our view, suboptimal ones. There has been no shortage of ink spilled about investing in a "rising rate environment," but we

What even is normal?

The 10-year Treasury yield since 1964



Source - RBC Wealth Management, Bloomberg; data through 1/31/19

Market pulse

think it's now clear that the best way to navigate fixed income markets is to accept that there is no such thing as normal. And those waiting for things to return to some state of normal may risk missing out on investment opportunities.

The long and the short of it

Investing in fixed income in a rising interest rate environment is always tricky, perhaps even more so when starting from 0% interest rates. The natural inclination is to find safety in the front end of the curve where there's little interest rate risk.

But as the top chart at right shows, this has been a losing strategy since the Fed started raising rates in December of 2015. The Bloomberg Barclays US Aggregate Bond Index comprises most major fixed income sub-asset classes. Had you only invested in 1–3 year maturities from the day the Fed first raised rates on December 16, 2015, your total return would have been just 4.2%. The long end of the curve, beyond 10 years and supposedly posing greater risk in a rising rate environment, on the other hand has posted a total return of 15%.

As the top chart shows there's more volatility in long-dated securities, but for buy-and-hold fixed income investors, that should be of little concern. Barring defaults, you know where your bond is going to end up.

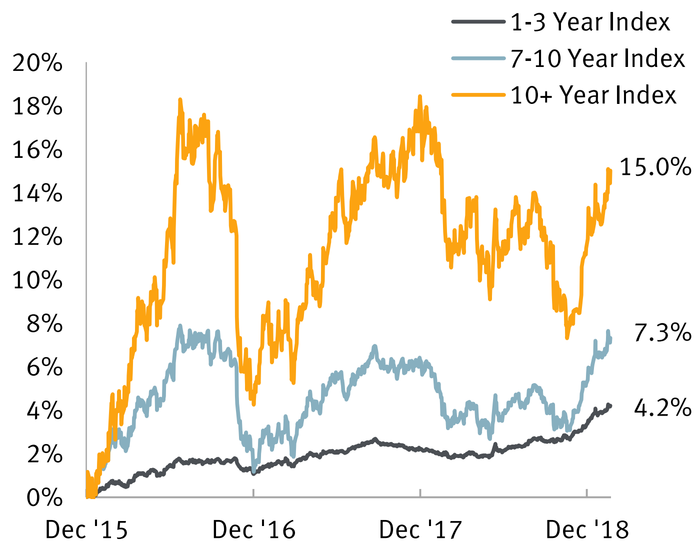
Get out of your comfort zone

We have long advocated the "lower for longer" mantra with respect to rates this cycle, and to not be afraid of extending on the yield curve. That story was relatively easy to sell five years ago when short-term securities paid almost nothing, and yield curves were steep everywhere. But now that short-term instruments have yields nearing 3%, as in the case of certificates of deposit, and with the flattening of the Treasury yield curve dominating headlines, investors are asking why they should, or even need to, buy longer-dated securities when similar levels of yield can be found in short-dated ones.

The reason is that it's called "reinvestment risk" for a reason. It's not called reinvestment opportunity, though many investors hope to reinvest at higher rates and steeper yield curves. But the point remains that there is risk in focusing only on short-term maturities, particularly as the market is still pricing a greater chance of a rate cut in one year, than it is for a rate hike.

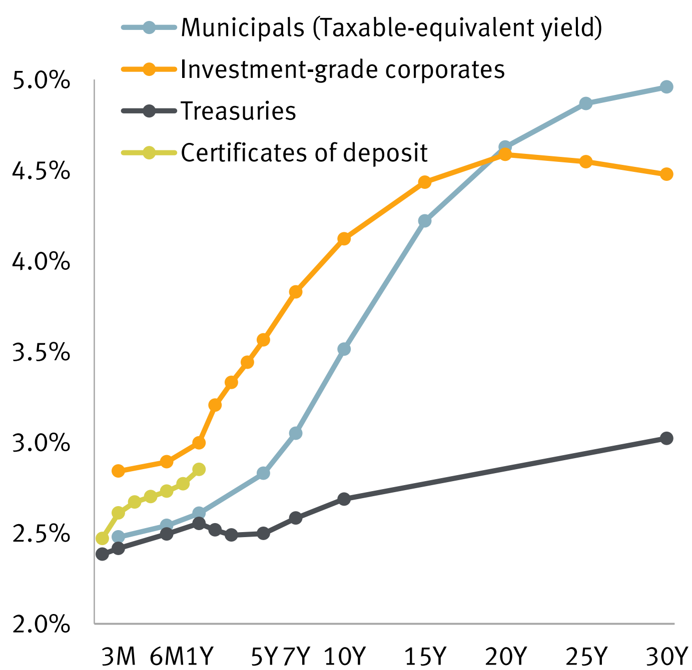
While there may not be much incremental yield found in moving out on the curve, investors are locking in that yield for longer. And as we maintain our view that the Fed is likely already at the end of this rate hiking cycle, we think that's reason enough to not ignore the long end of yield curves. Like nearly all cycles that have come before, the next phase of yield curve steepening will likely be driven by falling yields at the front end, not rising yields at the long end.

Bond market total returns by maturity since the Fed began "normalizing" interest rates



Source - RBC Wealth Management, Bloomberg Barclays US Aggregate Index; data through 2/5/19

Not all curves are flat, lock in yields while you can



Source - RBC Wealth Management, Bloomberg; Muni taxable-equivalent yields calculated on 37% tax rate; data as of 5:20 pm GMT 2/6/19

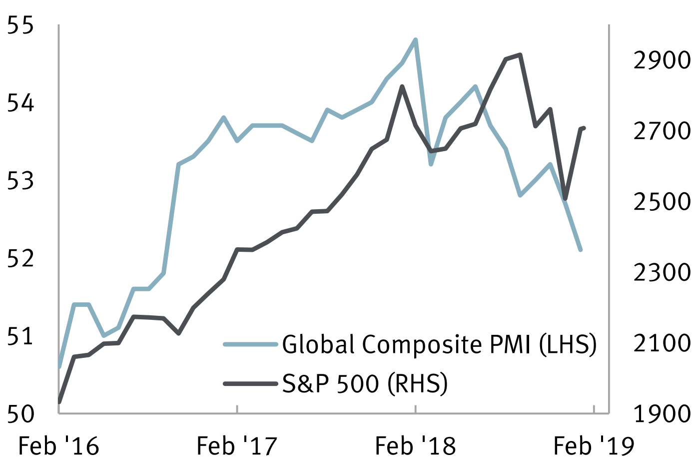
Though yields remain historically low, that doesn't mean they are abnormal—there is no such thing as normal, in our view. Thinking there is may cause investors to leave money on the table.

United States

Bill Kuehn, CFA – Minneapolis

- The labor market continues to be strong as the U.S. economy added 304,000 new jobs during January, well above the six-month average pace of 223,000. The unemployment rate increased for the second consecutive month to 4%, although the increase was a result of a rise in labor force participation as cycle-high wage growth continues to draw more people back into the labor force. **The increase in the size of the labor force put downward pressure on wage growth;** along with the downward revision to December's hiring data by 90,000, **we believe this will give Fed officials comfort in holding interest rates unchanged through the summer.**
- While the government shutdown does not directly impact the monthly hiring data from the Bureau of Labor Statistics, weekly jobless claims data from the Labor Department does capture federal contractors who filed for unemployment benefits during the shutdown. Unsurprisingly, jobless claims jumped by 53,000 to 253,000 claims for the week ending January 25. Although the jump didn't fully reverse following the government reopening, **the labor market continues to point toward a continued economic expansion bolstered by continued consumer spending.**
- While it made for interesting headlines, **the longest government shutdown in U.S. history had relatively little impact on the consumer,** as U.S. consumer sentiment fell by less than forecast in January and confidence remains relatively elevated compared to historical levels. Consumers' assessment of their current situation understandably declined amid the government shutdown, but consumers became more optimistic about the future as the typical impact of such an event has historically been short-lived. Consumer sentiment exhibits positive correlations to stock market performance and the smaller-than-expected decline in January sentiment was likely attributable to a 7.87% gain in the S&P 500 during January, the index's best start to a year since 1987.
- As domestic equities continue to rally off the Christmas Eve lows, now up 15.10% in 30 trading days, investors are pondering the next direction for stocks. **RBC Capital Markets, LLC Technical Strategist Bob Dickey** believes the big rally the markets saw last month is having the effect of convincing some investors the market may be back in an uptrend pattern for the year. But he **views this price action as all part of the bottoming process that will likely be spread out over many months and include a good deal of testing of the low area along the way.** We maintain a Market Weight stance on U.S. equities as global economic indicators are signaling the expansion should persist, albeit more slowly than 2018's robust pace. RBC Capital Markets, LLC Chief U.S. Equity Strategist Lori Calvasina has a 2019 year-end price target of 2900, equating to 7.16% additional upside from current levels.

Recommend Market Weight to equities amid softening global economic indicators



Source - RBC Wealth Management, Bloomberg; data through 2/7/19; PMI above 50 indicates economic expansion, below 50 indicates recession

Canada

Diana Di Luca – Toronto

- **A delve into rate hike expectations.** There have been sizeable moves lower in yield for U.S. Treasuries and Government of Canada (GoC) bonds over the past three months, with GoC bonds outperforming U.S. Treasuries. Rate hike expectations have been pared back in both markets, with the forward market pricing in less than one hike in Canada over the foreseeable future. RBC Economics, on the other hand, expects two this year, one next year, and then a pause. Both the **Bank of Canada and RBC Economics expect to see a rebound in growth, wages, and inflation in the year ahead,** but the market appears sceptical.
- Following a lull in corporate bond issuance in late 2018, **the Canadian primary market has been very active thus far in 2019,** with over CA$8B in supply coming to market, including a pair of bank offerings that were well-received and tightened in the secondary market. The extent to which spreads narrowed in Canada lagged the U.S. market, but it was a strong start to the year. As we edge towards the end of the cycle, **we continue to view playing defense as a worthwhile strategy within fixed income.** This means a higher allocation to federal bonds, a smaller allocation to corporate credit, and a bias towards higher-quality credits.

- **The preferred share new issue market has also been active,** with four new issues totaling CA$875M having launched in January, ending a nearly three-month supply lull. Following a late-2018 selloff, we believe investors can position themselves for a potential recovery in the preferred share market by reorienting their preferred share holdings into lower-priced issues, rather than increasing allocations. Given current pricing dynamics, lower-priced issues offer similar yields and more upside potential. In our view, this shift provides investors with the opportunity for **greater participation in a recovery, adds minimal incremental downside risk,** and **maintains the flexibility to increase exposure** if this turns into a full-scale 2015–16 redux.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The corporate earnings season in Europe and the U.K. is in full swing.** In Health Care, **Smith & Nephew** reported sales and operating profit up 3% and 7% y/y, respectively, both broadly in line with consensus expectations. **Management's FY2019 profit guidance piqued investors' interest,** with the midpoint ahead of current market consensus, suggesting small upgrades could be forthcoming.
- **GlaxoSmithKline's (GSK) results announcement was newsworthy,** but not due to its Q4 results, which beat expectations, nor its 2019 guidance that is in line with consensus. In its latest step to strengthen its oncology pipeline, GSK announced a **strategic alliance with German pharma company Merck KGaA** to jointly develop and commercialise an immunotherapy asset currently in clinical development for multiple difficult-to-treat cancers. Since July, through its own internal R&D development, the $5.1B acquisition of biotech firm Tesaro, and the Merck KGaA alliance, GSK has doubled its oncology pipeline assets in clinical development from eight to 16.
- Meanwhile, **Roche posted results that beat consensus expectations,** driven by both the Pharma and the Diagnostics divisions, and provided guidance for core earnings per share to grow in the "low-to-mid-single-digit range" in 2019. Both contributed to small upgrades to consensus earnings estimates for the year ahead.
- **Oil sector results were reassuring,** in our view. BP delivered Q4 results above consensus expectations, thanks to both upstream and downstream divisions. The company expects full-year 2019 production to be higher than 2018 due to new major projects as well as the contribution from the recently acquired BHP assets. French competitor Total also delivered profit ahead of consensus expectations for Q4.
- **Results were more mixed in the banking industry,** with ING reporting Q4 results that were ahead of expectations across the board, whereas BNP Paribas missed expectations largely due to its trading arm.
- **The shares of French advertising agency Publicis fell sharply (approximately 14%)** after reporting a 0.3% y/y drop in Q4 sales versus consensus expectations for 2.5% growth. The company noted "higher-than-expected attrition in traditional advertising … mainly from several FMCG [fast moving consumer goods] clients in the US".

MARKET SCORECARD

Data as of February 7, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,706.05	0.1%	7.9%	0.9%	18.0%
Dow Industrials (DJIA)	25,169.53	0.7%	7.9%	1.1%	25.3%
NASDAQ	7,288.35	0.1%	9.8%	3.4%	28.4%
Russell 2000	1,505.63	0.4%	11.6%	-0.2%	10.6%
S&P/TSX Comp	15,703.36	1.0%	9.6%	2.4%	1.3%
FTSE All-Share	3,884.26	1.5%	5.7%	-3.0%	-0.7%
STOXX Europe 600	360.08	0.4%	6.6%	-5.3%	-0.7%
EURO STOXX 50	3,150.76	-0.3%	5.0%	-8.8%	-2.6%
Hang Seng	27,990.21	0.2%	8.3%	-7.7%	20.0%
Shanghai Comp	2,618.23	1.3%	5.0%	-20.9%	-17.0%
Nikkei 225	20,751.28	-0.1%	3.7%	-4.1%	9.7%
India Sensex	36,971.09	2.0%	2.5%	8.5%	30.5%
Singapore Straits Times	3,200.64	0.3%	4.3%	-5.4%	4.2%
Brazil Ibovespa	94,405.59	-3.1%	7.4%	14.1%	47.1%
Mexican Bolsa IPC	43,624.55	-0.8%	4.8%	-10.9%	-6.6%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,310.07	-0.8%	2.2%	-0.6%	6.2%
Silver (spot $/oz)	15.74	-2.0%	1.6%	-3.9%	-11.1%
Copper ($/metric ton)	6,260.50	1.8%	5.2%	-8.4%	8.3%
Oil (WTI spot/bbl)	52.64	-2.1%	15.9%	-14.8%	0.9%
Oil (Brent spot/bbl)	61.63	-0.4%	14.6%	-5.9%	12.0%
Natural Gas ($/mmBtu)	2.57	-8.7%	-12.6%	-4.9%	-17.9%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.654%	2.4	-3.1	-18.2	26.1
Canada 10-Yr	1.877%	-0.2	-9.0	-49.6	18.4
U.K. 10-Yr	1.177%	-4.2	-10.0	-37.4	-11.2
Germany 10-Yr	0.115%	-3.4	-12.7	-63.0	-23.5
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.20%	-0.2%	0.9%	2.8%	3.9%
U.S. Invest Grade Corp	3.92%	0.1%	2.4%	1.8%	5.5%
U.S. High Yield Corp	6.74%	0.7%	5.2%	3.2%	8.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	96.5760	1.0%	0.4%	7.0%	-3.7%
CAD/USD	0.7516	-1.4%	2.5%	-5.5%	-0.9%
USD/CAD	1.3306	1.4%	-2.4%	5.9%	0.9%
EUR/USD	1.1339	-1.0%	-1.1%	-7.5%	6.1%
GBP/USD	1.2950	-1.2%	1.5%	-6.7%	3.5%
AUD/USD	0.7104	-2.3%	0.8%	-9.2%	-6.9%
USD/JPY	109.8300	0.9%	0.1%	0.5%	-2.3%
EUR/JPY	124.5500	-0.1%	-1.0%	-7.1%	3.7%
EUR/GBP	0.8756	0.3%	-2.6%	-0.9%	2.6%
EUR/CHF	1.1367	-0.1%	1.0%	-1.8%	6.6%
USD/SGD	1.3565	0.8%	-0.5%	2.4%	-4.3%
USD/CNY	6.7454	0.7%	-1.9%	7.4%	-2.0%
USD/MXN	19.0958	-0.1%	-2.8%	1.6%	-7.4%
USD/BRL	3.7171	1.9%	-4.1%	13.6%	19.1%

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 2/7/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 2.5% return means the Canadian dollar rose 2.5% vs. the U.S. dollar year to date. USD/JPY 109.83 means 1 U.S. dollar will buy 109.83 yen. USD/JPY 0.1% return means the U.S. dollar rose 0.1% vs. the yen year to date.

Authors

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

Bill Kuehn, CFA – Minneapolis, United States
william.kuehn@rbc.com; RBC Capital Markets, LLC

Diana Di Luca – Toronto, Canada
diana.diluca@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.mcgarrity@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

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Sell [Underperform]	77	4.83	7	9.09

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