RBC WEALTH MANAGEMENT

Global Insight

Weekly

A closer look

The Fed cuts rates—only to raise uncertainty

Thomas Garretson, CFA – Minneapolis

The Fed delivered the rate cut that the market has long awaited, but after yet another escalation on the trade war front, paired with Fed Chair Powell's track record of hawkish rhetoric, it may not have been enough and raises risks the Fed could fall behind the economic curve.

If you had looked only at the market gyrations of July 31, you might have thought the Fed actually raised rates following its latest meeting. Major U.S. stock indexes fell by more than 1%, near-term Treasury yields spiked—driving yield curves both flatter and more inverted—and the dollar rallied to a two-year high. And yet, the Fed actually moved to cut interest rates for the first time in more than 10 years.

Of course, markets had been anticipating this rate cut since May, so perhaps it could simply be written off as a classic case of the old adage "buy the rumor, sell the news." But while the rate cut, paired with the Fed's statement that indicated it will "continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion," delivered what the market wanted, and expected, it was once again Fed Chair Jerome Powell's own words that fueled concerns that the Fed may be closer to making a policy error than it is to acting "as appropriate."

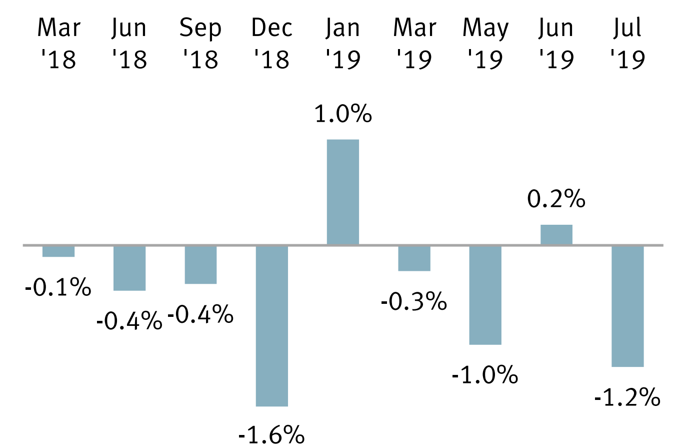
A muddled message

By this point, it is well documented that Powell has struggled to deliver the Fed's message during his press conferences, appearances that have largely been interpreted by markets as being on the hawkish side. As the chart shows, the S&P 500 has finished down on the day following most press conferences since his tenure began at the start of 2018.

Following the July 31 decision to cut rates, Powell again fumbled his way through the Q&A session in not only

Stocks typically fall following Powell's press conferences

S&P 500 performance the day of Fed Chair Powell's press conferences



Source - RBC Wealth Management, Bloomberg

Market pulse

Click here for authors' contact information. Priced (in USD) as of 8/1/19 market close, EST (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6** justifying the rate cut, but also in providing clear guidance as to what investors and markets might expect going forward. Markets focused on his "mid-cycle adjustment" comment as meaning that this rate cut was likely a "one-and-done" move, rather than the first in what may be a series of easing adjustments. He then had to walk that back by stating that the Fed is open to further rate cuts this year.

To be sure, the Fed is between a rock and a hard place, facing pressure from markets and the White House, while trying to maintain its independence. But all of that is just noise, in our view, as the case for cutting rates—as always—is based on the fundamentals.

Forget the headlines, the case for rate cuts remains a fundamental one

In the run-up to the Fed's move to cut rates at the July 31 meeting, much of the narrative was centered on the idea that the markets—and commentary out of the White House—were forcing the Fed's hand. While U.S. labor markets and consumer spending remain solid, we have seen historically sharp decelerations in a wide swath of economic data in the U.S. and, especially, globally.

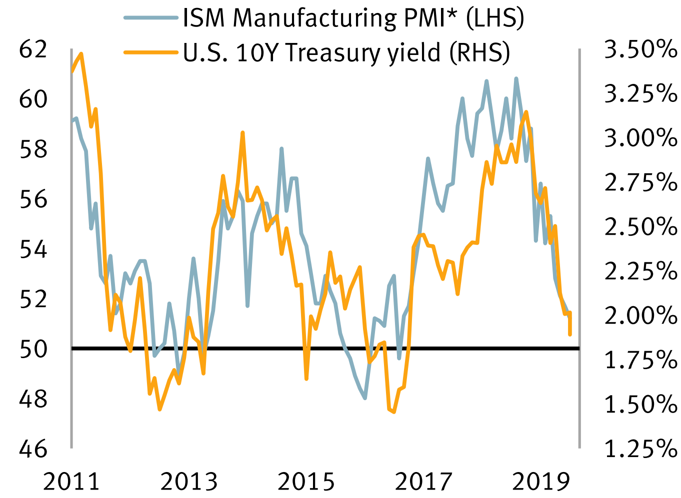
The August 1 release of the Institute of Supply Management's (ISM) Purchasing Managers' Index (PMI)—a measure of manufacturing sentiment that is somewhat correlated with economic growth—showed a further deterioration to 51.2, the lowest print since 2016. It is now hanging precariously above the key level of 50 that separates expansion from contraction in manufacturing, and has yet to show any signs of stabilizing since last year. A similar index of global manufacturing is currently below 50, and has been since May, a sign of ongoing contraction in global activity.

But Treasury yield curves remain our focus. As the chart shows, the 10-year Treasury yield—still a barometer of growth and inflation expectations—is highly correlated with the ISM PMI. On the back of the latest decline, and on the Fed's hawkishness which is neither positive for growth nor inflation, the 10-year is back below 2% and at the lowest level since November 2016. With the Fed only cutting short-term rates to a range of 2.00%–2.25%, that means that many yield curves remain inverted, a signal that monetary policy is still too restrictive, and that recession risks remain somewhat elevated, at least by this measure.

Ahead of the curve

We have been clear that we think the Fed should be aggressive in adjusting policy ahead of potential economic weakness and uncertainty, as the risks of falling behind the curve appear greater to us. And this view is only emboldened following President Trump's tweet that he would institute a 10% tariff

10-year Treasury yield back below 2% as the growth outlook weakens further



* The 50 level differentiates expansion & contraction; Source - RBC Wealth Management, Bloomberg, Institute for Supply Management

on the remaining $300B of imports from China, to potentially begin on September 1.

But here too, with respect to trade war fears, we believe Powell missed the mark during his press conference, failing to inspire confidence that the Fed has a plan to react preemptively to escalating global concerns. Powell said, "The thing is, there is not a lot of experience in responding to global trade tensions. So it is something that we have not faced before and that we are learning by doing."

The perception that the world's de facto central bank is flying by the seat of its pants may only serve to raise uncertainty further.

Will the Fed have to play catch-up?

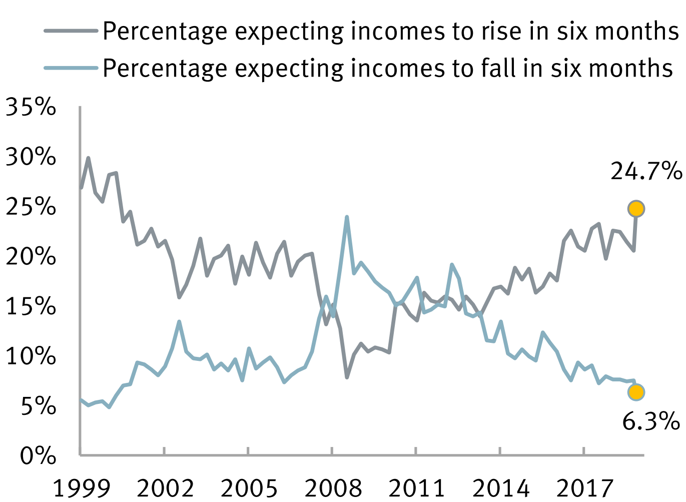
Our view remains that the Fed will cut rates by a total of 0.75% by the end of the year, bringing short-term rates to a range of 1.50%–1.75%. However, our primary concern remains that should the Fed move gradually in cutting rates, as it did in raising rates, the risk is heightened that it will have to eventually cut rates faster and by a greater degree than it otherwise would have.

United States

Bill Kuehn, CFA – Minneapolis

- **The first release of Q2 GDP showed the U.S. economy expanded by 2.1% q/q**, firmer than the consensus projection of 1.8% q/q. As expected, Q1's **inventory buildup and net export growth dragged Q2 growth**—the latter a key concern for the Federal Reserve given global growth concerns, but the consumer did the heavy lifting as **personal consumption grew by 4.3% q/q**. Personal spending rose 0.3% m/m in June, fueled by 0.4% m/m growth in personal incomes as the labor market continues to be supportive of wage growth.
- Looking forward, expectations are for **personal consumption to continue to be the driver of economic growth through year end**, as trade uncertainty continues to be a drag on business investment. Despite all of the political noise and uncertainty, the Conference Board's **Consumer Confidence Index rose to 135.7 in July** from 125.0 in June as solid wage growth, lower borrowing rates, and near record high stock prices are giving Americans something to cheer about. Consumers remain the most optimistic about growing incomes in two decades, and we anticipate this optimism will translate into continued consumer spending. However, we have seen political and economic policy uncertainty weigh on consumer optimism over the past year, so the recent escalation on the trade war front could again impact consumer psyche in the months ahead.
- Historically, **flattening yield curves**, the difference between shorter-term and longer-term interest rates, have been **bad for bank earnings** because they decrease a bank's net interest margins. The immediate impact of the **25 basis point interest rate cut** by the Fed on July 31 was a continued flattening of the yield curve. However, **regional and small banks could benefit from the interest rate cut** as they generally have a higher cost of funding than the large money center banks. **We continue to recommend bank stocks** and RBC Capital Markets cites **three medium-term catalysts**: stronger returns on excess capital, the potential for a steepening yield curve if the Fed continues to cut short-term interest rates, and positive operating leverage. Additionally, RBC Capital Markets analysts believe bank stocks are under-owned by institutional investors, and as the Fed works to extend the economic expansion, institutional investors could step in and drive prices higher.

Consumers remain optimistic about growing wages, fueling H2 economic growth



Source - RBC Wealth Management, Bloomberg; data through 7/31/19

Canada

Christopher Girdler, CFA & Richard Tan, CFA – Toronto

- The primary economic release in an otherwise light week for Canadian data was the **May GDP report**, which surprised to the upside. Headline monthly growth came in at 0.2% versus the consensus forecast for 0.1%, the **third consecutive month that growth has surpassed expectations**. Growth was relatively broad-based, but manufacturing was a big contributor, expanding 1.2% m/m and completely erasing April's decline. Doubts remain over the resilience of the Canadian manufacturing sector given the high cross-border integration between the U.S. and Canada and the slowdown that is being experienced south of the border, although we believe the **broad-based nature of the growth will help to lift the economic mood** in the near term.
- A better-than-expected GDP reading in May also indicates **Q2 growth might come in well above the Bank of Canada's (BoC) recent 2.3% forecast** and gives the central bank some clearance to take a patient approach. How long the BoC can do so may depend on the actions by central banks elsewhere given the Federal Reserve eased policy on July 31 and other developed country central banks have either started the easing process already, or strongly indicated an intention to do so in the near future. We continue to believe investors sitting in cash can avoid the effects of potentially lower rates in the near term by buying Canadian federal agency bonds which mature in 2021/22 that are priced below par.
- The Canadian earnings season is well underway with approximately 38% of the companies in the S&P/TSX Composite Index having reported thus far. **The Materials sector experienced the greatest positive earnings surprise quarter-to-date**. This is not a shock, in our view, given that gold prices have rallied to a five-year high

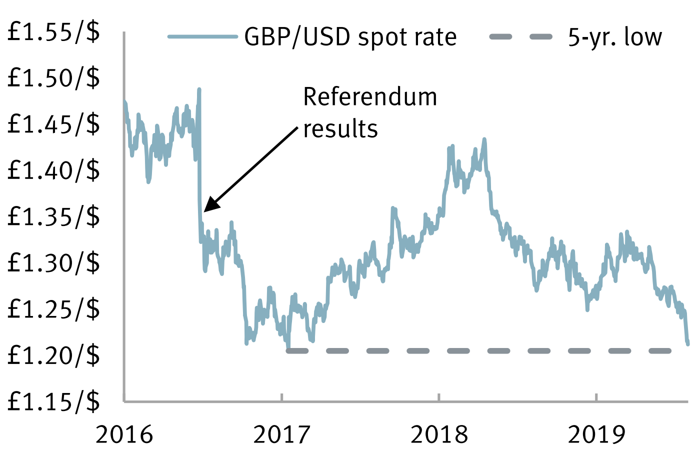
on the back of accommodative monetary policies from various central banks and a pickup in global geopolitical risk. On the flip side, **the Financials sector has had the worst earnings surprise quarter-to-date**, notably the life insurers. The Canadian banks will begin reporting earnings on August 21; we continue to favour banks with a greater presence in the U.S. given the expectation of further deceleration in domestic loan growth and elevated household debt in Canada.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The British pound has tumbled more than 3% against the U.S. dollar since Prime Minster Boris Johnson took office** in late July. Markets worry about his firm commitment to a hard Brexit, which they see as an act of self-harm that could tip the country, already weakened by uncertainty, into recession. Markets are also concerned this strategy could lead to a general election, given the government's precarious arithmetic in Parliament. Current polls suggest the election outcome would be either a Brexit Party/Conservative coalition—which would continue to consider a "no-deal" Brexit—or a Labour-led coalition with far-left Jeremy Corbyn as prime minister. The pound/dollar exchange rate is **perilously close to its 5-year post-Brexit referendum low** of 1.2047. The Bank of England's Monetary Policy Committee kept interest rates on hold at its August 1 meeting.
- Oil supermajor **Royal Dutch Shell undershot consensus expectations** with its Q2 results. The company described "challenging macroeconomic conditions" which especially impacted the trading environment for its petrochemicals business. Peer **BP**'s Q2 earnings, on the other hand, **came in ahead of consensus**. The beat was primarily driven by the upstream business, which benefitted from lower-than-expected exploration expenses.
- **Just Eat**, the U.K.-based online food delivery marketplace, was one of the top performers in the week, with the **shares up almost 20%** following the announcement of a **proposed merger with Dutch-based Takeaway.com** in the latest move towards consolidation in the online food delivery market. The possible combination would create one of the largest online food delivery companies in the world.

Pound tumbles close to a 5-year low



Source - RBC Wealth Management, Bloomberg; data through 7/31/19

Asia Pacific

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

- **Asia equities closed out a difficult July**, with the MSCI AC Asia Pacific Index down 1% during the month. The U.S.-China trade dispute and concern about the slowing Chinese economy still weigh on the market. **It seems little or no progress was made during brief trade negotiations** in Shanghai, the first formal meeting since negotiations failed in May. This outcome was largely expected by the market. The two parties **plan to meet again in September** in the U.S.
- Investor sentiment about the Hong Kong market worsened meaningfully as protests became more frequent and severe. **Transport disruption, social gatherings, and protests have been organized every day during the week except for Wednesday** when a typhoon hit the city. The **Hang Seng Index has fallen 2.9% so far during the week**, the worst performance in the region. **Hong Kong retailers and the property sector have been under pressure**. It is unclear when and how protests will end. We expect the market selloff to last in the short term if protests escalate.
- **Huawei announced its H1 2019 results**, the first report after U.S. sanctions were implemented. **Revenue surged 23.2% y/y** to RMB 401.3B and **smartphone shipments jumped 24% y/y** to 118 million units. The company conceded **growth will slow down in the short term** and **expects additional sanctions-related business pressure** until 2020. Huawei has restored a small amount of non-core component supplies from the U.S., but key component and product supplies have not yet started. The company reiterated it will not give up overseas markets because of the restrictions.
- **DBS Group**, a Singapore-based financial services firm, **reported Q2 2019 results that exceeded consensus expectations** amid macro headwinds and slower domestic activity during the quarter. Management expects **a modest impact from lower interest rates** in H2 2019. Despite the strong beat, management left **guidance unchanged**, which led some market participants to expect a somewhat softer second half.

MARKET SCORECARD

Data as of August 1, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,953.56	-0.9%	17.8%	4.5%	19.2%
Dow Industrials (DJIA)	26,583.42	-1.0%	14.0%	5.0%	20.7%
NASDAQ	8,111.12	-0.8%	22.2%	4.0%	27.5%
Russell 2000	1,550.76	-1.5%	15.0%	-7.8%	9.8%
S&P/TSX Comp	16,377.04	-0.2%	14.3%	-0.2%	7.3%
FTSE All-Share	4,132.23	0.0%	12.4%	-0.8%	1.6%
STOXX Europe 600	387.68	0.5%	14.8%	0.3%	2.4%
EURO STOXX 50	3,490.03	0.7%	16.3%	0.6%	0.9%
Hang Seng	27,565.70	-0.8%	6.7%	-0.5%	-0.2%
Shanghai Comp	2,908.77	-0.8%	16.6%	5.1%	-11.5%
Nikkei 225	21,540.99	0.1%	7.6%	-4.3%	7.3%
India Sensex	37,018.32	-1.2%	2.6%	-0.4%	14.0%
Singapore Straits Times	3,291.75	-0.3%	7.3%	0.2%	-1.7%
Brazil Ibovespa	102,125.90	0.3%	16.2%	28.2%	52.1%
Mexican Bolsa IPC	40,346.80	-1.3%	-3.1%	-17.8%	-21.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,444.75	2.2%	12.7%	19.6%	14.1%
Silver (spot $/oz)	16.34	0.5%	5.5%	6.7%	-1.4%
Copper ($/metric ton)	5,902.25	0.0%	-0.8%	-3.4%	-6.6%
Oil (WTI spot/bbl)	53.95	-7.9%	18.8%	-21.8%	8.8%
Oil (Brent spot/bbl)	61.06	-6.3%	13.5%	-16.9%	16.6%
Natural Gas ($/mmBtu)	2.17	-2.8%	-26.2%	-22.9%	-22.8%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.911%	-10.4	-77.4	-107.5	-36.0
Canada 10-Yr	1.399%	-7.8	-56.8	-96.8	-54.1
U.K. 10-Yr	0.594%	-1.7	-68.3	-78.3	-64.2
Germany 10-Yr	-0.450%	-1.0	-69.2	-91.0	-93.6
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.52%	0.0%	6.3%	8.2%	7.0%
U.S. Invest Grade Corp	3.16%	0.0%	10.5%	10.6%	9.3%
U.S. High Yield Corp	5.88%	0.0%	10.6%	6.9%	9.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	98.3400	-0.2%	2.3%	3.3%	5.9%
CAD/USD	0.7568	-0.2%	3.2%	-1.4%	-4.9%
USD/CAD	1.3214	0.2%	-3.1%	1.5%	5.1%
EUR/USD	1.1091	0.1%	-3.3%	-4.3%	-6.5%
GBP/USD	1.2136	-0.2%	-4.8%	-6.8%	-8.2%
AUD/USD	0.6804	-0.6%	-3.5%	-7.6%	-14.6%
USD/JPY	107.4100	-1.3%	-2.1%	-3.8%	-3.0%
EUR/JPY	119.1200	-1.1%	-5.3%	-7.9%	-9.3%
EUR/GBP	0.9139	0.3%	1.7%	2.7%	1.9%
EUR/CHF	1.0981	-0.3%	-2.4%	-4.8%	-4.6%
USD/SGD	1.3770	0.2%	1.0%	0.6%	1.3%
USD/CNY	6.8987	0.2%	0.3%	0.8%	2.6%
USD/MXN	19.2572	0.6%	-2.0%	3.3%	8.1%
USD/BRL	3.8444	0.8%	-0.8%	2.5%	23.5%

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 8/1/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 3.2% return means the Canadian dollar rose 3.2% vs. the U.S. dollar year to date. USD/JPY 107.41 means 1 U.S. dollar will buy 107.41 yen. USD/JPY -2.1% return means the U.S. dollar fell 2.1% vs. the yen year to date.

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Hold [Sector Perform]	588	40.80	114	19.39
Sell [Underperform]	81	5.62	2	2.47

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