December 12, 2019

RBC WEALTH MANAGEMENT

Global Insight

Weekly

The Fed’s “insurance” cuts look set to pay off

Thomas Garretson, CFA – Minneapolis

The Fed took a victory lap of sorts this week as most officials now believe that three rate cuts will prove sufficient to reduce economic uncertainty ahead, while a phase one trade deal finally appears to be actually at hand. But will either shift the investing landscape?

The final Federal Reserve meeting of 2019 confirmed what many officials have already pledged publicly in recent weeks: the Fed is well and truly on hold having delivered three “insurance” rate cuts in recent months. Additionally, there is no longer a rift at the Fed between those who wish to ease policy, and those who did not, as a clear majority—13 of 17 officials—now see policy rates unchanged through 2020—a consensus that markets viewed favorably.

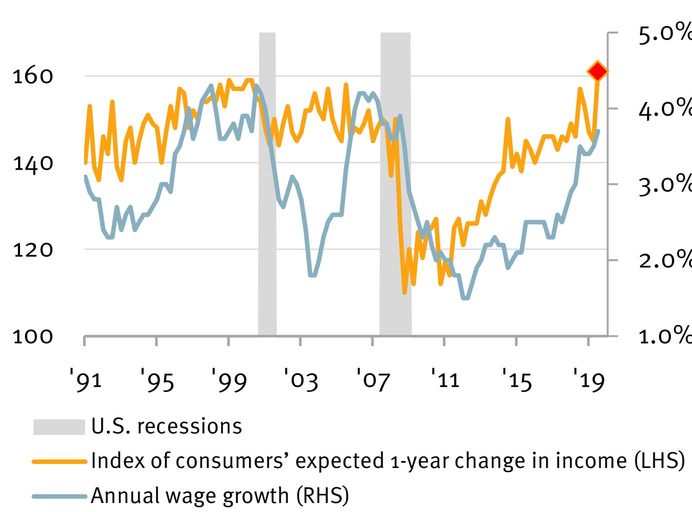
This meeting was by no means one of the more eventful ones in recent memory, but another key development came from the Fed’s official statement. Language referencing “uncertainties” about the outlook was dropped, while an acknowledgement of “muted inflation pressures” was added.

While removing the reference to uncertainties suggests the Fed will be in no rush to cut rates absent a material economic downturn, we simply see this as the Fed wanting to shift the narrative back to the fundamentals of inflation and U.S. labor markets, which Fed policy influences, and away from the ancillary fears of late around trade wars and other factors that it has less control over. This proved prescient as news reports late on Thursday afternoon suggested the U.S. has a trade deal in “principle” with China, and that President Donald Trump has signed off on it.

While we await complete details on any truce, we believe that such a deal has largely been priced into markets already. However, business confidence and investment, the parts of the U.S. economy that have borne the brunt of the impact of ongoing trade uncertainty, could improve in the first half of 2020.

Some like it hot

Consumers’ income growth expectations highest in decades



Source - RBC Wealth Management, Bloomberg, Bureau of Labor Statistics US Average Hourly Earnings Private Production & Non-supervisory Wage Index, University of Michigan Consumer Survey

Market pulse

3 It’s still a strong U.S. labor market
3 Canadian economy not quite firing on all cylinders
4 Election day in the UK
4 Japan’s economy grows much more than first thought

Click here for authors’ contact information. Priced (in USD) as of 12/12/19 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6**
Disseminated: Dec 12, 2019 17:15ET; Produced: Dec 12, 2019 16:48ET

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Regardless, the Fed can't stay on hold forever, and in fact, rarely does. But while our base case remains that the Fed will keep policy on hold, and that any bias remains toward further easing, what are the chances that the Fed cuts further, or even resumes the rate hike cycle?

The bar to hike

Somewhat curiously for a Fed coming off three consecutive rate cuts, much of the questions directed at Fed Chair Jerome Powell during the press conference centered on the prospects for a resumption of the rate hike cycle, rather than the prospects for further easing.

Perhaps this was simply a reflection of the recent stabilization in the economic backdrop, some progress on trade, and another strong jobs report in November that saw the unemployment rate dip back down to 3.5%. But Powell made one thing clear: he won't even entertain the idea of a rate hike until inflation returns to 2% on a "persistent" basis. And even in the face of historically low unemployment, he said the Fed still sees slack in labor markets that is depressing wage growth.

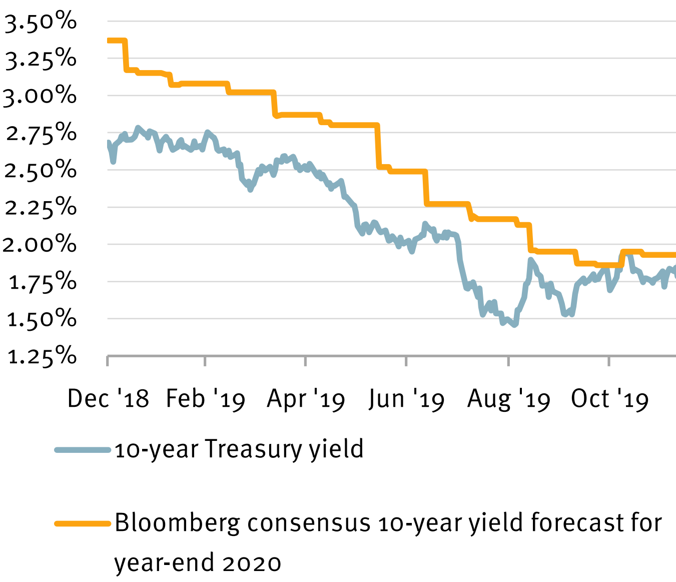
How long might that remain true? As we see in the chart on page 1, an index from the University of Michigan Consumer Survey released last week showed that the balance of consumers expecting higher household incomes over the next year, relative to those who think their incomes will be lower, is at one of the highest levels on record, while an index of wage growth has accelerated to 3.7%, essentially the fastest pace this cycle.

For now, this will be a welcome development at the Fed. But if there's one thing that might shift the Fed back into tightening mode, it would likely be a labor market showing signs of overheating.

The bar to cut

As Powell put it, it would take a "material reassessment" of the economic outlook for the Fed to cut rates further—which essentially means that the Fed may want to use rate cuts to fight the next recession when it eventually arrives—partly driven by the fact that the Fed can only deliver six rate cuts until interest rates are back at the 0.00%–0.25% range.

With the Fed on pause, yields likely to remain range-bound



Source - RBC Wealth Management, Bloomberg analyst survey

Our primary concern here is that if the Fed is reluctant to ease further in order to sustain the expansion that in itself could raise recessionary risks. Regardless, markets continue to price a roughly 80% chance that the Fed cuts rates again at some point in 2020.

With the Fed on the sidelines, take money off the sidelines

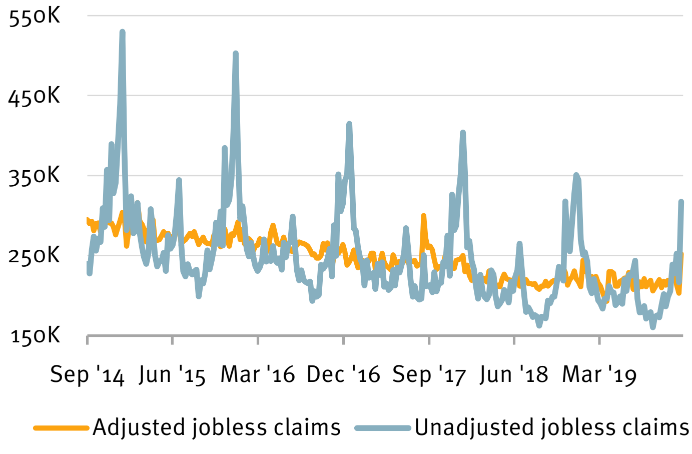
With the Fed on hold, we largely expect Treasury yields to trade around current levels for the foreseeable future. Even an unexpectedly strong jobs report and positive developments on the trade front have failed to send the 10-year Treasury yield back above 2%, a level below which it has held since the Fed delivered the first rate cut back on July 31. We continue to view 2% as the speed limit, meaning that any rise in yields toward that level would be an opportunity for fixed income investors to put money to work.

United States

Bill Kuehn, CFA – Minneapolis

- As we approach year-end, a small corner of the financial markets could flare up, creating newsworthy moves. **The market for repurchase agreements, or repo for short, has the potential to fall out of balance, and the interest rate on repos can suddenly spike** higher due to this imbalance. **The repo market acts as the lubrication for the U.S. financial system**, as it facilitates borrowers in need of cash to attain funding from lenders who have excess cash. In mid-September, the interest rate on overnight repo trades spiked from 2% to as high as 10%, as there was a large imbalance of borrowers and lenders due to corporate tax payments that were due on the same day an auction of Treasury debt was to settle.
- **Following September's repo market dislocation, the Federal Reserve took steps to prevent another spike in repo rates** through year-end, which historically is a busy time for repo trades. The Fed commenced repurchasing $60 billion in short-term Treasury bills through mid-December to add banking reserves back into the financial system. Additionally, the Fed opened up both overnight and term repo facilities for banks to provide longer-term liquidity. Prior to the September spike, repo trades were only transacted between market participants; now, however, banks can access the Fed repo facility, if necessary, for needed liquidity. While we aren't necessarily convinced this is a permanent solution to the issues in the repo market, we believe the term repos provide a **temporary solution that should at least tamp down any potential volatility and unintended consequences on repo rates through the end of the year**.
- **Initial jobless claims unexpectedly rose** for the week ending December 7, increasing by 49,000 from the week prior to 252,000, a two-year high. Consensus estimates were for jobless claims to rise slightly to 214,000, but as the chart shows, jobless claims data is historically very volatile in December due to seasonality issues surrounding retailers and the holiday shopping season. **Jobless claims data is one of the recession indicators we monitor closely, but one week does not make a trend**. We would need to see further deterioration for this indicator to shift into a cautionary zone. Overall, **the U.S. labor market remains strong** and employers are reluctant to dismiss workers amid a shortage of qualified labor, a sign the current economic expansion has room to run.

Jobless claims historically spike in December due to seasonality in the data



Source - RBC Wealth Management, Bloomberg; data through 12/12/19

Canada

Richard Tan, CFA & Christopher Girdler, CFA – Toronto

- There has been **a series of disappointing data releases** since the Bank of Canada (BoC) kept the policy rate unchanged last week. The unemployment rate jumped 0.4 percentage points to 5.9% after the November labour market report showed a loss of 71,200 jobs. Context is key as the Canadian economy has created over 285,000 new positions this year and wage growth is currently greater than 4%; however, the reading was notably weaker than expected. **Capacity utilization for the economy came in a little shy of market expectations for Q3, registering 81.7% and demonstrating the economy isn't quite firing on all cylinders** at present. With less than one rate cut priced into the yield curve and risks to the Canadian economy still in play for next year, we believe investors still have a good opportunity to put some cash to work in discount short- to intermediate-duration bonds.
- **Preferred shares continue to sit out the 2019 rally in equities and corporate bonds** as investors remain concerned over the impact of lower bond yields on a large portion of the market. **We are constructive on preferred shares given the level of compensation they currently provide**. Many issues have 6%-plus yields that are locked in for the next four to five years, and this represents a yield pickup of around 300–350 basis points (bps) over long-term corporate bonds from the same companies.
- **The Canadian banks wrapped up Q4 earnings, and the results generally fell short of consensus expectations** driven by softness in capital markets, higher credit provisions, margin pressures, and one-off restructuring charges. Unsurprisingly, net interest margins were points of contention given that the Federal Reserve reduced its

overnight rate by 75 bps versus the BoC's unchanged policy in 2019. Overall, **we maintain a modest Underweight position in the Canadian banks** relative to the S&P/TSX Composite Index due to challenges within the macro environment and the aging business cycle. On average, the Canadian banks continue to trade below their historical price-to-earnings multiple of 11.5x and have lagged the S&P/TSX Composite year-to-date.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- At the time of writing, **UK voters are selecting their new prime minister. While polls have narrowed, they still indicate a Conservative majority**. This would be the most market-friendly outcome, in our view, though **any rally in equities and sterling is likely to be modest** given much has already been discounted in prices. Under this scenario, we would expect Boris Johnson's Withdrawal Agreement (WA) to pass swiftly into law. Attention would then soon turn to whether the Conservatives can negotiate a free trade agreement (FTA) with the EU before the WA-imposed deadline of December 2020. Our view is that this may only be possible if the FTA is very limited in scope and if the UK were to commit to a regulatory level playing field with the EU—something a Conservative government is likely to resist.
- Alternatively, **if the Conservatives fall short of a majority by a handful of votes**, we believe their only option would be to **turn to their former allies, Northern Ireland's Democratic Unionist Party** (DUP). In exchange for its support, the DUP would likely demand a stronger voice regarding regulatory alignment with the EU.
- Finally, **if all parties aside from the Conservatives and the DUP have the majority** of seats in Parliament, we would expect Labour, the Scottish National Party, and the Liberal Democrats to form an **alliance with the aim of reopening Brexit negotiations and orchestrating a second referendum**. This process would likely be challenged in the courts.
- **Regardless of the outcome, uncertainty will remain**, or at best, disappear for a short time, and will likely continue to cloud economic prospects.
- In the corporate sector, the share price of Inditex, one of the world's largest fashion retailers, rose over 5% after the company released Q3 results on December 11. Net income grew 14% y/y to €1.17 billion in the quarter, 2.5% ahead of the consensus estimate. The key driver of the beat was a higher-than-expected gross margin, which the company's chairman attributed to Inditex's use of radio-frequency identification technology to enhance its inventory management capability, helping to maximize full price sales.

Asia Pacific

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

- **Asian markets traded mostly higher during the week, led by South Korea and Taiwan**. Both the KOSPI and TAIEX indexes posted fresh 2019 highs on hopes of a potential delay in the planned U.S. tariffs on Chinese goods set to take effect this weekend.
- Despite tensions over the clashes in Hong Kong and the issues surrounding Muslim Uighurs in the western Xinjiang region, Bloomberg reported that **trade officials from the U.S. and China were moving closer to agreeing on the amount of tariffs that would be rolled back in a phase one trade deal**. In the latest sign of easing trade tensions, Beijing said it would offer a tariff waiver to "some" imports of U.S. soybeans and pork.
- **Consumer prices in China grew 4.5% y/y in November, the fastest acceleration in almost eight years**. The sharp increase was mainly driven by higher pork prices (+110.2% y/y) as the African swine fever epidemic weighed on supply. The crisis also sent prices of beef, lamb, and eggs higher as consumers switched to other sources of protein. Against the backdrop of slower economic growth, we believe **higher food prices may lead to more cautious consumer spending**.
- **Japan's economy grew much more than first thought in Q3**. Growth was revised up to 1.8% q/q (seasonally adjusted annualized rate) compared to the preliminary reading of 0.2%, as **corporate investment and household consumption were stronger than initially reported**. While some economists on the Street expect a backlash in Q4 as consumption slows following the hike in the consumption tax in October, we believe the fiscal stimulus package recently announced by the government can offset some of the downside risks to consumption and the economy.

MARKET SCORECARD

Data as of December 12, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,168.57	0.9%	26.4%	17.4%	20.5%
Dow Industrials (DJIA)	28,132.05	0.3%	20.6%	12.4%	16.3%
NASDAQ	8,717.32	0.6%	31.4%	21.8%	28.9%
Russell 2000	1,644.81	1.3%	22.0%	11.1%	8.4%
S&P/TSX Comp	16,946.90	-0.5%	18.3%	11.6%	6.5%
FTSE All-Share	4,033.41	-0.8%	9.8%	6.4%	0.1%
STOXX Europe 600	407.58	0.0%	20.7%	15.0%	5.4%
EURO STOXX 50	3,706.35	0.1%	23.5%	17.7%	3.8%
Hang Seng	26,994.14	2.5%	4.4%	0.7%	-6.4%
Shanghai Comp	2,915.70	1.5%	16.9%	10.0%	-11.7%
Nikkei 225	23,424.81	0.6%	17.0%	6.9%	3.5%
India Sensex	40,581.71	-0.5%	12.5%	13.1%	23.7%
Singapore Straits Times	3,194.67	0.0%	4.1%	1.2%	-7.1%
Brazil Ibovespa	112,199.70	3.7%	27.7%	26.0%	54.7%
Mexican Bolsa IPC	43,195.19	0.9%	3.7%	3.1%	-9.0%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,469.71	0.4%	14.6%	18.8%	16.1%
Silver (spot $/oz)	16.94	-0.5%	9.3%	16.9%	5.2%
Copper ($/metric ton)	6,127.25	4.9%	3.0%	-0.8%	-5.9%
Oil (WTI spot/bbl)	59.18	7.3%	30.3%	11.9%	2.7%
Oil (Brent spot/bbl)	64.33	3.0%	19.6%	4.5%	2.3%
Natural Gas ($/mmBtu)	2.34	2.6%	-20.4%	-47.6%	-19.7%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.897%	12.2	-78.7	-101.6	-45.4
Canada 10-Yr	1.670%	20.7	-29.7	-46.3	-22.5
U.K. 10-Yr	0.820%	12.3	-45.7	-49.5	-43.7
Germany 10-Yr	-0.269%	9.1	-51.1	-54.6	-58.9
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.30%	0.1%	8.9%	10.4%	9.0%
U.S. Invest Grade Corp	2.85%	0.4%	14.6%	15.5%	12.0%
U.S. High Yield Corp	5.39%	0.7%	12.8%	10.1%	10.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.3020	-1.0%	1.2%	0.2%	4.2%
CAD/USD	0.7583	0.7%	3.4%	1.3%	-3.8%
USD/CAD	1.3189	-0.7%	-3.3%	-1.2%	3.9%
EUR/USD	1.1129	1.0%	-2.9%	-1.9%	-5.9%
GBP/USD	1.3161	1.8%	3.2%	3.4%	-2.1%
AUD/USD	0.6906	2.1%	-2.0%	-5.0%	-9.2%
USD/JPY	109.3000	-0.2%	-0.4%	-3.4%	-2.9%
EUR/JPY	121.6400	0.9%	-3.3%	-5.3%	-8.7%
EUR/GBP	0.8456	-0.7%	-5.9%	-5.1%	-3.9%
EUR/CHF	1.0962	-0.5%	-2.6%	-3.1%	-6.1%
USD/SGD	1.3546	-1.0%	-0.6%	-0.9%	0.6%
USD/CNY	6.9849	-0.7%	1.5%	1.9%	5.5%
USD/MXN	19.0604	-2.4%	-3.0%	-7.0%	1.5%
USD/BRL	4.0910	-3.5%	5.6%	5.8%	26.2%

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 8:35 pm GMT 12/12/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 3.4% return means the Canadian dollar rose 3.4% vs. the U.S. dollar year to date. USD/JPY 109.30 means 1 U.S. dollar will buy 109.30 yen. USD/JPY -0.4% return means the U.S. dollar fell 0.4% vs. the yen year to date.

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Hold [Sector Perform]	618	42.74	126	20.39
Sell [Underperform]	80	5.53	3	3.75

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