RBC WEALTH MANAGEMENT

Global Insight Weekly

U.S. equities: Is the glass half full?

Frédérique Carrier – London

The U.S. equity market's mood has swung between enthusiasm and caution over the past month. Though central banks' intervention has been remarkably impactful, the shape of an economic recovery from COVID-19 is uncertain. We look to manage investment risk against a backdrop of volatility.

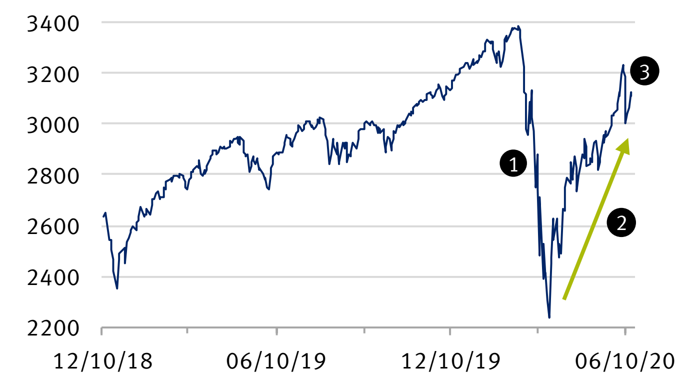
The volatility roller coaster

Over the past three months, markets have struggled to reconcile the sharpest-ever quarter-over-quarter decline in economic activity with the announcement of the largest economic stimulus packages in history, as well as interpreting short-term data and projecting them into long-term trends. The result has been high volatility, and we believe this will likely continue.

The S&P 500 fell more than six percent in the second week of June and recorded its worst week since March. Many observers blamed Federal Reserve Chair Jerome Powell, for suggesting the economic recovery would be a slow one and pouring cold water on the enthusiasm for a "V-shaped" recovery. They also pointed out that the weekly number of initial jobless claims was discouragingly elevated at 1.5 million, given the U.S. economy had started to reopen a full month earlier. The resurgence of COVID-19 in a few key U.S. states further frayed nerves.

Given these ongoing factors, one would be forgiven for being surprised at the strength of the rally just a few days later. Four explanations were put forward by market watchers. First, markets were invigorated by central banks reiterating they were there to help. The U.S. Federal Reserve announced the launch of its corporate bond buying plan, shifting from acquiring exchange-traded funds of investment-grade bonds to setting out to build a portfolio of individual bonds. The Fed's statement came only hours after the Bank of Japan (BoJ) signaled it would top up monetary support for its country's economy.

The S&P 500 roller coaster



❶ COVID-19 infection rates skyrocket, lockdowns imposed, economy shuts down
❷ Central banks pour liquidity into markets
❸ Fed Chair cautious on recovery, infections surge, initial jobless claims still high

Source - RBC Wealth Management, Bloomberg; data through 6/17/20

Market pulse

3 Credit rallies on Fed announcement
3 Canadian economy shows signs of improvement
4 Bank of England extends QE by £100 billion
4 China regulators ask banks to support economy

Click here for authors' contact information. Priced (in USD) as of 6/18/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6.**
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Second, a Bloomberg article reported that the Trump administration was considering introducing a $1 trillion infrastructure spending program.

Third, U.S. retail sales jumped by nearly 18 percent month-over-month in May as the economy reopened and the federal government's direct payments to individuals helped steady household incomes. This is the largest increase on record and more than double consensus expectations, suggesting a fast recovery may be in the offing. Many saw it as an indication that the fiscal medicine is working.

But it was UK scientists hailing a breakthrough in the search for COVID-19 treatments that may have contributed most to the positive sentiment. A trial led by Oxford University researchers found that the drug dexamethasone, an inexpensive and widely available generic steroid, helped save the lives of patients suffering from serious coronavirus infection. Scientists found that dexamethasone prevented one in eight deaths of patients on ventilators, and one in 25 deaths of patients receiving oxygen support. Patients not requiring ventilation or oxygen support were not helped by the drug.

All these are valid reasons for optimism, but on closer inspection, we believe a more muted reaction may have been warranted. An ambitious infrastructure program in the U.S. would be a welcome move to modernize the country' s ageing infrastructure, but we see a low probability of passing such a bill through Congress before the elections. The retail bounce is remarkable, but retail sales are still down six percent from a year ago. And the discovery that a widely available and inexpensive steroid can help acute cases of COVID-19 is no panacea for those fearing the debilitating symptoms the disease can bring. Many may believe only a widely available vaccine would remove the need for social distancing, ensure a quick return to normality and offer the best hope for the economy to return to full capacity.

Are central banks driving an equity rally?

Even the reactions to the announcements from the Fed and BoJ were somewhat surprising, as both central banks had telegraphed their strategies in advance. What investors have reason to cheer, in our view, is the sheer volume of liquidity being pumped into the system.

According to Bloomberg, the balance sheets of the G4 central banks—the Fed, the BoJ, the European Central Bank, and the Bank of England—together have grown from some $14.8 trillion at the end March to $20 trillion at the end of May. More is coming. This powerful injection of liquidity has pushed yields down and lifted risk assets such as equities.

But the fact that central banks are stepping in so forcefully suggests they are worried about the future. Why intervene unless they are concerned about indebted companies and the prospect of a slow grind to recovery, during which many small businesses would be likely to fail and unemployment to stagnate?

Eric Lascelles, chief economist at RBC Global Asset Management Inc., expects the economy to climb back to its prior peak at the very end of 2021 and to reach its full potential by the second half of 2022. But Lascelles notes that, "as per the updated Fed forecast, this could just as easily happen at a later date, potentially even several years later."

Managing investment risk amid volatility

Central banks' liquidity infusions are driving risk assets, but unless the economy catches up with markets and economic progress continues at a brisk pace, the risk of subdued returns or a pullback from here remains, in our view. Many economic indicators suggest caution for now. Volatility is likely to remain at a high level, as investors weigh short term data and try and extrapolate them into long term prospects.

This leaves us invested in equities but maintaining a prudent stance via a modest Underweight relative to the benchmark. We prefer to allocate risk in areas benefitting directly from central banks' largesse, such as corporate credit, and high-yield corporate bonds in particular.

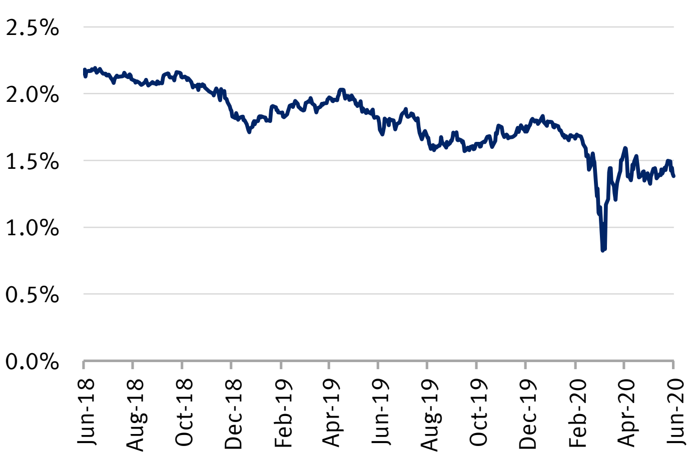
United States

Atul Bhatia, CFA – Minneapolis

- **Credit rallied on Monday's surprise announcement the Fed would begin buying individual corporate bonds**. The move was unexpected as any recent credit spread widening was orderly, primary market debt sales were robust, and there were few signs increased Fed intervention was necessary. Fed Chair Jerome Powell later clarified that the change did not signify an increase in purchases; instead the central bank was simply **following through on prior commitments** and ensuring readiness for any necessary future support. The rally in credit, even if due to a miscommunication, was certainly convenient for the Fed's goal to facilitate employer funding.
- The Fed also announced the **imminent launch of its Main Street Lending Program** targeted at firms too large to benefit from the Paycheck Protection Program and too small to issue bonds. The main facility allows banks to sell up to 95% of loans made to these corporations to the Fed. **There are concerns** the terms—especially the minimum amount and the fees—may impede widespread utilization; the Fed has modified requirements twice already, and we would expect continued flexibility.
- **One reason the Fed can be so accommodative to market wishes is the lack of inflation**. The Fed focuses on the 5-year forward, 5-year breakeven inflation rate, the market's expectation of annual inflation over a five-year period beginning five years from now. Although the measure has ticked up slightly, it remains well below the Fed's long-term 2% inflation goal and pre-COVID-19 levels. The Fed's mandate to maximize employment consistent with stable prices gives it a strong incentive to act aggressively in the face of sub-optimal inflation expectations and massive employment losses.
- Looking ahead, **we expect continued strong credit markets and a bifurcated rates market**: sub-5-year maturities are largely capped by the Fed, either explicitly through the two-year no rate hike guidance or implicitly through potential yield curve control. **Further out on the curve, we see greater volatility and a slight bias to higher rates beyond the 15-year maturity point**.

Inflation expectations are well contained

5Y/5Y forward breakeven inflation



Source - Bloomberg, Federal Reserve Bank of St. Louis; data through 6/12/20

Canada

Arete Zafiriou & Sayada Nabi – Toronto

- With daily new COVID-19 cases trending lower and parts of its economy beginning to reopen, **Canada is showing signs of improvement after a sharp decline in output during March and April**. Consumer spending, home resales, and business sentiment indicators have ticked up from recent lows. The labour market added 290,000 jobs in May, reversing 10% of its losses during the previous two months. RBC Economics notes that these signs of improvement are positive, but predicts the recovery will be slow and will depend on developments on the coronavirus front. It forecasts a 32% annualized decline in output in the second quarter, followed by a slow increase in activity in the second half of the year, with some industries—including energy, hospitality, and tourism—remaining weak through 2021. While more employees will return to work, **RBC Economics expects the unemployment rate to remain above pre-crisis levels at the end of 2020**.
- Canadian home sales in May reversed one-third of the drop the country saw in the March–April period. As the Canadian economy took steps towards reopening, **sales activity in the housing market increased 57% in May from the April low**. According to RBC Economics, sellers made the move to reenter the market in May, causing a 69% surge in listings from the lowest point in April. This brought the country's ratio of sales to new listings down to 0.59 in May, compared with 0.63 in April. The move also improved supply and demand conditions that were in a tight spot amid the pandemic. While the delay in spring listings will boost supply this summer, RBC Economics notes this will come at a time when home buyer demand is still at a low point. **The economic shock from the pandemic will throw a wrench into the plans of Canadians looking to become homeowners in the near future**. According to RBC Economics, this fallout will be most significant in oil-producing regions, where high levels of unemployment will keep demand depressed.

Europe

Thomas McGarrity, CFA & Alastair Whitfield – London

- **Pan-European equities pushed higher during the week** following the prior week's pullback, with the STOXX Europe 600 Index up around 3%. **The top-performing subsector was Construction & Materials, up over 5%**, boosted by reports the U.S. administration was considering introducing a $1 trillion infrastructure spending package.
- **The Bank of England (BoE)** delivered on consensus expectations by maintaining its benchmark rate at 0.1%, while **extending its quantitative easing programme by a further £100 billion** in response to the fallout from the COVID-19 pandemic.
- This comes at a time when the UK economy is in need of significant stimulus, with **GDP having contracted 25% cumulatively over March and April**. At the same time, inflation has continued to trend to its lowest level in four years in response to the disinflationary effect of the crisis, with **CPI at just 0.5% y/y in May**. One piece of economic data that does not yet capture the full extent of the impact is the unemployment rate. **The latest unemployment figure, at 3.9%, is in line with the three-month average since April and includes a period before the lockdown started**. Observers will thus have to wait for future unemployment data to see the full ramifications of the pandemic. The number is further flattened by the government's job retention scheme, to which 8.9 million people, or 30% of all UK workers, are now signed up. The claimant count, which has risen by almost 1.6 million since the start of the crisis to its highest level since 1993, better represents current labour market stress, in our view.
- As a result, we anticipate that the BoE may need to delve further into its toolbox in the coming months. The Organisation for Economic Co-operation and Development (OECD) forecasts that **the UK could see one the deepest contractions in output amongst developed countries in 2020**.

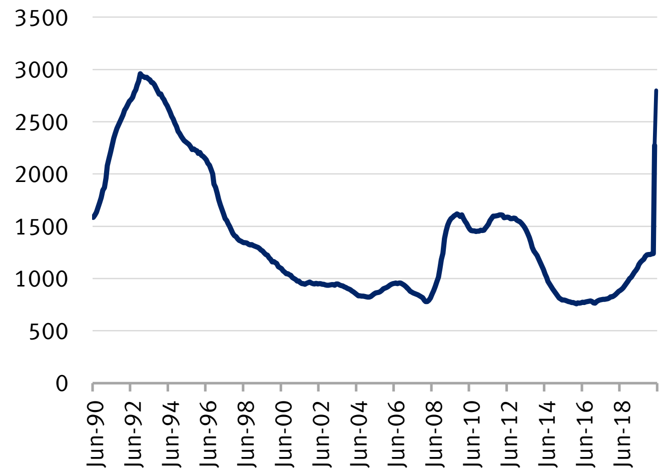
Asia Pacific

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

- **Asian equities were somewhat choppy during the week**. Investors are examining the severity of the COVID-19 outbreak in Beijing. On Tuesday the city raised its emergency response to Level 2 from Level 3 and said people will have to be tested for the virus before being allowed to leave the city. The government further canceled scores of domestic flights in and out of Beijing on Wednesday.

UK unemployment: not unprecedented, certainly unwelcome

Total claims for UK jobless benefits (thousands)



Source - Bloomberg, UK Office for National Statistics; monthly data through 5/31/20

- **We don't think Beijing will have a lockdown similar to Wuhan**, as the social, economic, and political costs of imposing an across-the-board shutdown are too high, in our opinion. Besides, Beijing's population (around 21 million) is much larger than Wuhan's (around 11 million). Currently, Beijing has restricted movement only in areas where new cases have been found.
- **China's financial regulators are asking banks to keep profit growth below 10% this year** to support the economy. China will push financial institutions to sacrifice RMB 1.5 trillion ($212 billion) in profit this year to support enterprises by offering lower lending rates and fees and deferring loan repayments, Premier Li Keqiang said on Wednesday.
- **Singapore is emerging from months-long "circuit breaker" measures** to combat COVID-19, and the **economy will be opening in phases**. As announced by the government, the country will enter Phase 2 this Friday, earlier than expected, and almost all businesses will resume operation. Economists noted that while the phased reopening may reduce the risk of another wave of infection, it **will likely extend the recession** into the third quarter and possibly delay the recovery.
- **The Straits Times Index (STI) has rebounded by around 20% from the bottom on March 23**. It is currently trading at a 12.3x FY2021E P/E and 4.49% gross forward dividend yield. With the economy reopening, **market sentiment could continue to improve**.

MARKET SCORECARD

Data as of June 18, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,115.34	2.3%	-3.6%	6.8%	12.3%
Dow Industrials (DJIA)	26,080.10	2.7%	-8.6%	-1.5%	4.4%
NASDAQ	9,943.05	4.8%	10.8%	25.0%	28.3%
Russell 2000	1,427.08	2.4%	-14.5%	-7.9%	-15.7%
S&P/TSX Comp	15,479.83	1.9%	-9.3%	-6.2%	-5.5%
FTSE All-Share	3,449.45	2.6%	-17.8%	-15.1%	-18.0%
STOXX Europe 600	363.41	3.7%	-12.6%	-5.6%	-5.8%
EURO STOXX 50	3,249.90	6.5%	-13.2%	-5.9%	-6.3%
Hang Seng	24,464.94	6.5%	-13.2%	-11.0%	-19.3%
Shanghai Comp	2,939.32	3.0%	-3.6%	1.7%	-2.7%
Nikkei 225	22,355.46	2.2%	-5.5%	6.6%	-1.4%
India Sensex	34,208.05	5.5%	-17.1%	-12.4%	-3.8%
Singapore Straits Times	2,665.66	6.2%	-17.3%	-17.7%	-19.8%
Brazil Ibovespa	96,125.20	10.0%	-16.9%	-3.3%	37.7%
Mexican Bolsa IPC	37,632.89	4.2%	-13.6%	-12.8%	-19.3%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,724.10	-0.4%	13.6%	28.0%	34.9%
Silver (spot $/oz)	17.39	-2.6%	-2.6%	15.9%	5.6%
Copper ($/metric ton)	5,741.00	7.3%	-6.6%	-3.1%	-17.6%
Oil (WTI spot/bbl)	38.84	9.4%	-36.4%	-27.9%	-41.0%
Oil (Brent spot/bbl)	41.51	17.5%	-37.1%	-33.2%	-44.9%
Natural Gas ($/mmBtu)	1.64	-11.4%	-25.1%	-29.6%	-44.5%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.707%	5.4	-121.1	-135.3	-221.0
Canada 10-Yr	0.525%	-0.9	-117.7	-89.9	-167.7
U.K. 10-Yr	0.228%	4.4	-59.4	-57.9	-109.6
Germany 10-Yr	-0.407%	4.0	-22.2	-8.7	-80.5
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.32%	0.3%	5.8%	9.0%	17.3%
U.S. Invest Grade Corp	2.17%	1.7%	4.8%	10.7%	21.0%
U.S. High Yield Corp	6.27%	2.9%	-1.9%	2.7%	9.0%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.4500	-0.9%	1.1%	-0.2%	2.8%
CAD/USD	0.7352	1.3%	-4.5%	-1.6%	-2.9%
USD/CAD	1.3602	-1.3%	4.7%	1.7%	3.0%
EUR/USD	1.1209	1.0%	0.0%	0.1%	-3.6%
GBP/USD	1.2428	0.7%	-6.3%	-1.0%	-6.2%
AUD/USD	0.6851	2.8%	-2.4%	-0.4%	-7.7%
USD/JPY	106.9700	-0.8%	-1.5%	-1.4%	-3.2%
EUR/JPY	119.8900	0.1%	-1.5%	-1.2%	-6.7%
EUR/GBP	0.9019	0.3%	6.6%	1.2%	2.8%
EUR/CHF	1.0662	-0.1%	-1.8%	-4.8%	-7.8%
USD/SGD	1.3945	-1.3%	3.6%	2.0%	3.2%
USD/CNY	7.0893	-0.7%	1.8%	2.7%	10.1%
USD/MXN	22.7706	2.7%	20.3%	19.1%	11.0%
USD/BRL	5.3715	0.7%	33.3%	42.2%	43.4%

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 6/18/20.

Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -4.5% return means the Canadian dollar fell 4.5% vs. the U.S. dollar year to date. USD/JPY 106.97 means 1 U.S. dollar will buy 106.97 yen. USD/JPY -1.5% return means the U.S. dollar fell 1.5% vs. the yen year to date.

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