November 21, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

Vision will be anything but 20/20 in 2020

Thomas Garretson, CFA – Minneapolis

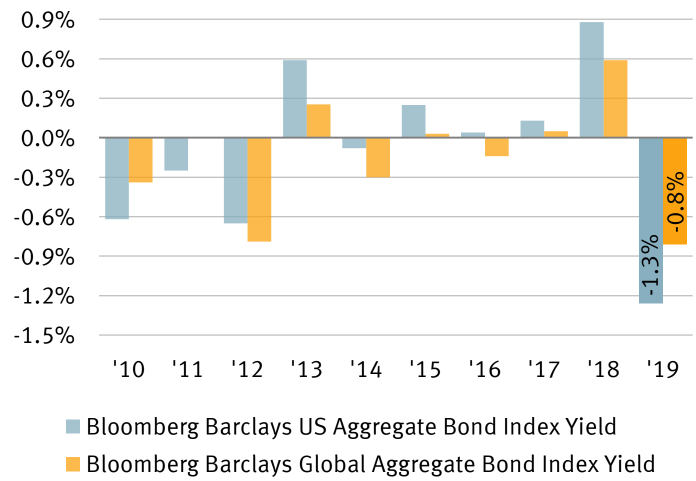
The collapse in global yields has delivered robust 2019 portfolio performance, but one that is unlikely to be repeated in 2020. We look at fixed income portfolio positioning amid an increasingly blurry outlook for 2020.

As the investment industry's annual tradition of year-ahead outlooks shifts into high gear, one thing is becoming clear, the outlook is anything but.

For fixed income investors, the outlook may be even more challenging. As the chart shows, the collapse in global yields over the last 12 months is the largest we have seen during the post-financial crisis period. But that drop in yields has also delivered outsized overall performance. Over that same time period, the Bloomberg Barclays U.S. Aggregate Bond Index has returned 11 percent, a performance rarely matched over the past 30 years. But while portfolio statements may look sublime for 2019, many investors are likely wondering if the only way is down from here.

So after what's looking to be a banner year for fixed income performance, and amid an uncertain outlook, here's a walk through how we are thinking about portfolio positioning for U.S. fixed income in the year ahead.

2019's vanishing yields set the stage for a challenging 2020



Source - RBC Wealth Management, Bloomberg; trailing 12-month change in yields from Nov. 21 to Nov. 20 of each year

2020 U.S. fixed income strategy

The chart on page 2 shows the total return performance of major U.S. fixed income sectors over the last five years. One thing to note is that often one year's best performer is the next year's worst.

We also show what we expect the order of performance might be in 2020. As you may also note, it's the same order as in 2015—a year when Treasury yields barely budged and credit spreads, or the yield compensation over Treasuries for credit risks, widened throughout the year as global growth fears rose. Sound familiar? That essentially forms the backdrop of how we expect 2020 to play out.

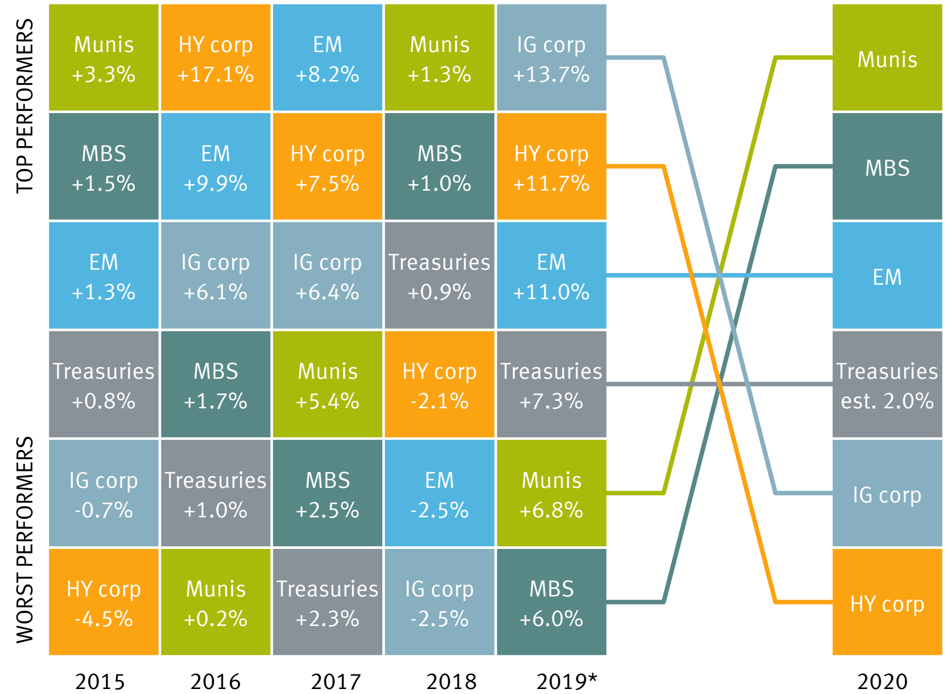
Market pulse

The next edition of the *Global Insight Weekly* will be published on December 5.

As always, the direction of Treasury yields will dictate the performance of most fixed income assets classes in 2020 given most are priced in some way off of Treasuries, though to varying degrees.

So starting with our expectations for Treasury returns. We think the 10-year Treasury yield, currently around 1.75 percent, will end 2020 near that level, if not slightly lower. In that scenario, Treasuries should return roughly two percent for the year. So against that benchmark, we see three sectors outperforming Treasuries, and two sectors lagging.

Ranked returns: We see 2019's worst performers setting the pace in 2020



Note: MBS = Agency mortgage-backed securities, EM = Emerging market government debt, IG corp = Investment-grade corporates, HY corp = High-yield corporates
Source - RBC Wealth Management, Bloomberg Barclays bond indexes; *2019 returns through 11/19/19

Our three outperformers*

Municipals – current yield: 1.83 percent; duration of five years

Investor demand for munis has been robust in 2019, while new supply has failed to keep pace. Though supply should increase next year, we think demand will remain. The relative value in munis appears favorable at the moment, as 10-year munis yield about 88 percent of Treasuries, in line with recent averages, while the defensive nature of the sector should continue to draw investor flows.

Agency mortgage-backed securities (MBS) – current yield: 2.50 percent; duration of three years

The setup for agency MBS should be quite favorable in 2020, in our view. Despite economic headwinds and uncertainty, the tailwinds for the U.S. housing market should overpower with low unemployment, rising wages, and low mortgage rates. The sector benefits from lower duration, the full backing of the U.S. government, and attractive relative value with a +0.50 percent yield advantage over Treasuries—near the highest levels seen since 2013.

Emerging market (EM) government debt – current yield: 5.05 percent; duration of six years

U.S. dollar-denominated EM debt may seem like a sector at odds with an uncertain global outlook, but we think there is value at the moment, while all of the policy easing by global central banks over the course of 2019 could bear fruit in 2020, with EM debt likely to benefit. In a world of disappearing yields, the 5.05 percent yield for EM is near the average of the last five years, and this could be a space to add income to portfolios for investors with appropriate risk tolerances.

Our two underperformers

Investment-grade corporates – current yield: 2.87 percent; duration of eight years

As the chart shows, investment-grade corporates led the way with a 14 percent return in 2019, a performance that will be nearly impossible to match next year. The sector currently yields just 1.06 percent over comparable Treasuries, which is well below average. Should economic risks rise, so too might that spread, which could cause total returns to trail Treasuries.

High-yield corporates – current yield: 5.81 percent; duration of three years

Finally, while high-yield corporates do not carry a lot of interest rate risk, they carry elevated credit risk and valuations that look somewhat rich at the moment as the sector yields below six percent and only four percent over Treasuries—near the lowest levels in years.

Coping with the market's ups and downs

While many expect greater market volatility in 2020, fixed income investors have the luxury of knowing that the future value of their investment—barring a default—is par. We think the month-to-month and year-to-year gyrations of bond prices should be of little concern for buy-and-hold investors. But at times of elevated uncertainty, understanding risk exposures from year-to-year can help maintain solid performance.

**Duration is a measure of sensitivity to yield movements, i.e., a duration of five years means that a one percent rise in yields would cause bond prices to fall by approximately five percent, and vice versa.*

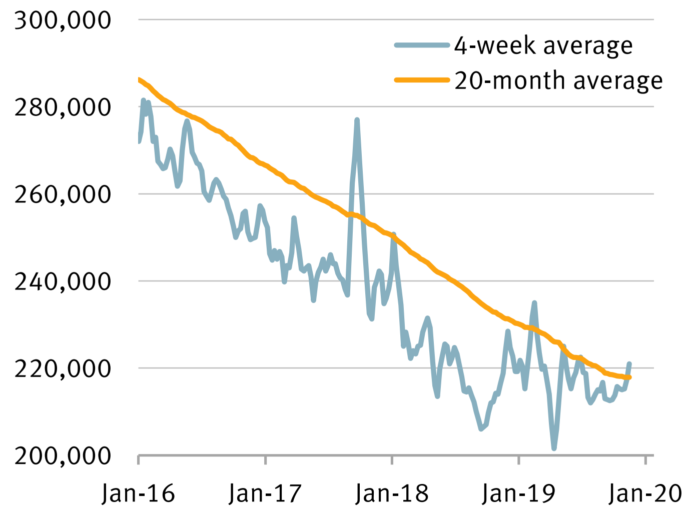
United States

Alan Robinson – Seattle

- U.S.-China trade negotiations were in the spotlight again after the **U.S. Congress passed a bill that could withdraw Hong Kong's special trading rights if the territory is judged to be insufficiently autonomous from China**. Stocks sold off on this news, but not dramatically. On the surface, this seemed surprising given the negative implications of a deterioration in trade negotiations that might have arisen due to an increase in tensions with China. But this relatively **mild reaction in the market signals to us that investors believe both sides are still looking for a trade "win"** to take the attention away from the domestic issues of the impeachment inquiry in the U.S. and unrest in Hong Kong. This point was underlined by China downplaying retaliation over the bill and, according to Bloomberg, China's chief trade negotiator indicating cautious optimism over a potential deal.
- **RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina published an update on hedge fund equity holdings** for the third quarter ended September 2019. We pay attention to this survey because it often flags notable shifts in investment flows with implications for sector and style performance over the medium term. The recent review is the first to include the September period, in which we saw a rotation from growth to value stocks. Calvasina's study suggests that the "smart money" is still underinvested in value stocks, and that **if the rotation out of growth and back to value persists, then hedge funds will likely be a major incremental buyer of value stocks**.
- **Initial claims for unemployment benefits rose** to 227,000 for the week ended Nov. 16. This data has a **good historical record of indicating changes in the economy**, and is one of six key indicators we track to monitor the likelihood of a U.S. recession. The recent uptick was notable in that it **broke a long streak of "lower lows"** in the data, and importantly ticked above the 20-month moving average for the fifth time this year. One data point doesn't make a trend, but we will be watching this series more closely given the age of the current economic expansion.

Potential trend change for key labor market indicator

First-time claims for unemployment benefits



Source - RBC Wealth Management, U.S. Department of Labor; weekly data series through 11/16/19, seasonally adjusted

Canada

Arete Zafiriou & Sayada Nabi – Toronto

- **Canadian manufacturing sales fell to CA$57.4 billion in September, a 0.2% decrease from August and a 1.2% decrease from September 2018**. Sales were weighed down by the clothing manufacturing; electrical equipment, appliance and component; and printing and related support activities industries. Ten out of 21 industries saw sales decrease in September, representing approximately 62% of the Canadian manufacturing sector. According to Statistics Canada, the United Auto Workers strike in September and October impacted a number of motor vehicle plants, and the petroleum and coal product industry was hurt by partial shutdowns for maintenance. RBC Economics believes these factors are transitory, but that the auto sector may continue to see weakness through the winter. Going forward, **RBC Economics expects U.S.-China trade to be a key factor driving Canadian manufacturing sales, as anything that helps the U.S. manufacturing sector also helps cross-border production chains**.
- **It was a tighter October for the Canadian housing market, but home prices were still able to pick up some steam**, according to RBC Economics. The national Home Price Index increased at a rate of 1.8% y/y and 1.3% m/m in October. RBC Economics notes the value of homes sold is rising at a faster pace and the rate of the increase has been noticeably quicker over the past four months. Despite the value of homes sold increasing, the number of units available for resale was relatively flat following seven consecutive months of growth. Compared to September, housing inventories contracted by 1.8%, which limited supply and options for buyers in the market. This, in turn, pulled the nationwide sales-to-new-listings ratio higher to 0.64, indicating tighter demand and supply conditions in the market. Although the different parts of Canada face differing challenges in their respective housing markets, RBC Economics believes home buyer demand has returned to normal levels, demand-supply conditions are tight, and prices are increasing at a moderate

rate. Looking ahead to the next year, **RBC economic expects low interest rates, strong labour markets, and rapid population growth to continue the recovery**.

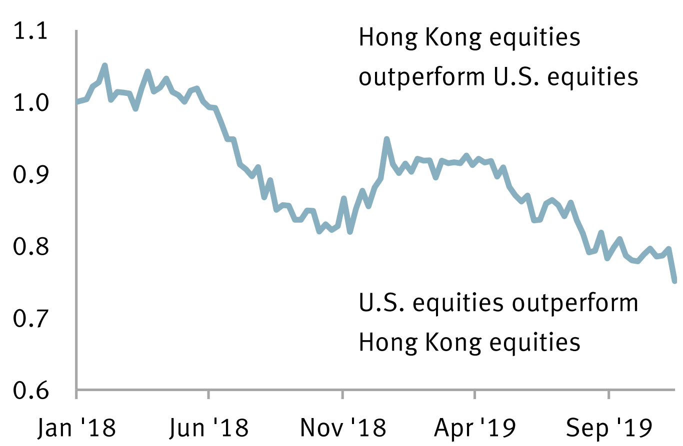
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- The past week made up for a dearth of macroeconomic data by producing a rich flow of corporate news.
- In Europe, **French luxury goods powerhouse LVMH**, whose market capitalisation is almost as large as that of the top four continental banks combined, **revised upwards its bid for Tiffany**, the U.S. jeweler best known for its engagement rings. The owner of Moët champagne and TAG Heuer watches increased its offer to just under $16 billion, or $130 per share according to the *Financial Times*—some 30% above the share price before the two companies began talks. **This is a bold move given LVMH derives one-third of its sales from Asia, where economic growth is decelerating**.
- **Meanwhile in the UK, the Labour Party vowed to nationalise BT Group's Openreach division if it wins the December general election**, as part of its pledge to provide every home and business in the country free full-fibre broadband by 2030. **This would be a significant negative for BT, but we believe it is unlikely** as a Labour-majority government is a low-probability scenario according to current polls. As highlighted in last week's *Global Insight Weekly* focus article, "Breaking the Brexit impasse?", we believe Labour's most extreme policies, such as its nationalisation agenda, are unlikely to be enacted in the scenario of a Labour-led minority government.

Hong Kong equities continue to decline on unrest

Hang Seng Index returns relative to the S&P 500



Source - RBC Wealth Management, Bloomberg; weekly data from 1/1/18 through 11/15/19

- Elsewhere, **British American Tobacco (BATS) shares gained 3%** as news emerged that the U.S. Department of Health and Human Services had dropped plans to limit the nicotine levels in cigarettes to non-addictive levels. The company generates over 40% of its profits in the U.S.
- At its capital markets day, **Aviva presented a strategic update focused on simplification and improved execution within its existing businesses**, rather than on a major shift in the shape of the group that had been widely expected by market participants. The relatively new CEO stated that he is "committed to running Aviva better."
- **Sage Group's full-year results were broadly in line with consensus expectations.** After announcing that it would sell its Sage Pay payments business, the company announced a £250 million capital return.

Asia Pacific

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

- Asian equities were largely driven by the news of trade talks this week. Bloomberg reported that **China's chief negotiator, Vice Premier Liu He, said he was "cautiously optimistic" about reaching a phase one trade deal with the U.S. However, the U.S. Congress passed the Hong Kong Human Rights and Democracy Act**, which would require the State Department to conduct an annual review on whether Hong Kong remains sufficiently autonomous to justify its special trade privileges and give the U.S. president a mandate to protect U.S. citizens and others in Hong Kong from rendition or abduction to China through measures including sanctions on mainland officials. President Donald Trump may sign the bill, which adds uncertainty to the U.S.-China relationship.
- **Hong Kong's economic data continues to deteriorate. The city's unemployment rate from August to October jumped to 3.1%** from 2.9% in July to September. The unemployment rate for those working in food and beverage services rose to 6.1%, the highest in more than six years. Separately, data compiled by Bloomberg shows passenger numbers on the city's metro system plunged 25.6% y/y to 108.5 million in October. MTR Corp. (66 HK) recently has been closing its subway lines as early as 6:00 p.m. to repair facilities damaged by protesters. We expect upcoming economic data to show further weakness.
- **To lower borrowing costs and shore up the economy, China pruned the new benchmark rate**, the loan prime rate (LPR), on Nov. 20. The 5-year LPR, on which many lenders base their mortgage rates, was cut to 4.80% from 4.85%. The 1-year LPR was lowered to 4.15% from 4.20%.

MARKET SCORECARD

Data as of November 21, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,103.54	2.2%	23.8%	17.1%	19.4%
Dow Industrials (DJIA)	27,766.29	2.7%	19.0%	13.5%	17.7%
NASDAQ	8,506.21	2.6%	28.2%	22.0%	24.0%
Russell 2000	1,583.99	1.4%	17.5%	6.4%	4.3%
S&P/TSX Comp	16,999.19	3.1%	18.7%	12.6%	5.7%
FTSE All-Share	4,002.37	0.2%	8.9%	3.7%	-1.7%
STOXX Europe 600	402.22	1.4%	19.1%	13.3%	3.6%
EURO STOXX 50	3,679.66	2.1%	22.6%	16.7%	2.8%
Hang Seng	26,466.88	-1.6%	2.4%	1.9%	-11.2%
Shanghai Comp	2,903.64	-0.9%	16.4%	9.5%	-14.9%
Nikkei 225	23,038.58	0.5%	15.1%	7.1%	2.8%
India Sensex	40,575.17	1.1%	12.5%	15.3%	21.2%
Singapore Straits Times	3,192.21	-1.2%	4.0%	5.1%	-6.8%
Brazil Ibovespa	107,496.70	0.3%	22.3%	23.2%	44.1%
Mexican Bolsa IPC	43,255.43	-0.2%	3.9%	4.2%	-10.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,464.67	-3.2%	14.2%	19.5%	14.4%
Silver (spot $/oz)	17.11	-5.5%	10.4%	18.0%	0.9%
Copper ($/metric ton)	5,855.00	1.5%	-1.6%	-6.6%	-14.9%
Oil (WTI spot/bbl)	58.53	8.0%	28.9%	7.5%	3.2%
Oil (Brent spot/bbl)	63.66	5.7%	18.3%	0.3%	1.7%
Natural Gas ($/mmBtu)	2.59	-1.7%	-12.0%	-41.9%	-14.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.771%	8.0	-91.4	-129.2	-58.5
Canada 10-Yr	1.477%	6.5	-49.0	-88.2	-44.2
U.K. 10-Yr	0.754%	12.5	-52.3	-64.2	-52.0
Germany 10-Yr	-0.325%	8.2	-56.7	-70.1	-67.6
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.27%	-0.1%	8.8%	11.0%	9.1%
U.S. Invest Grade Corp	2.87%	0.0%	13.9%	15.4%	12.0%
U.S. High Yield Corp	5.81%	-0.1%	11.6%	9.5%	9.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.9710	0.6%	1.9%	1.3%	4.3%
CAD/USD	0.7529	-0.9%	2.7%	-0.4%	-3.8%
USD/CAD	1.3283	0.9%	-2.6%	0.4%	4.0%
EUR/USD	1.1060	-0.8%	-3.5%	-2.8%	-5.8%
GBP/USD	1.2906	-0.3%	1.2%	1.0%	-2.5%
AUD/USD	0.6787	-1.6%	-3.7%	-6.6%	-10.4%
USD/JPY	108.6100	0.5%	-1.0%	-3.9%	-3.4%
EUR/JPY	120.1200	-0.3%	-4.5%	-6.7%	-9.0%
EUR/GBP	0.8570	-0.6%	-4.7%	-3.8%	-3.4%
EUR/CHF	1.0984	-0.2%	-2.4%	-3.0%	-5.6%
USD/SGD	1.3630	0.2%	0.0%	-0.7%	0.6%
USD/CNY	7.0289	-0.1%	2.2%	1.5%	6.0%
USD/MXN	19.3884	0.8%	-1.3%	-4.3%	3.3%
USD/BRL	4.1950	4.4%	8.3%	10.5%	28.9%

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 11/21/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 2.7% return means the Canadian dollar rose 2.7% vs. the U.S. dollar year to date. USD/JPY 108.61 means 1 U.S. dollar will buy 108.61 yen. USD/JPY -1.0% return means the U.S. dollar fell 1.0% vs. the yen year to date.

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Buy [Top Pick & Outperform]	748	51.73	208	27.81
Hold [Sector Perform]	618	42.74	126	20.39
Sell [Underperform]	80	5.53	3	3.75

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