September 17, 2020

RBC WEALTH MANAGEMENT

Global Insight Weekly

Lower for longer, until better than ever

Thomas Garretson, CFA – Minneapolis

The Fed now expects a nearly complete economic recovery by 2023, but we continue to expect an extended period of zero interest-rate policy beyond that as it may take economic conditions never before seen to kick start the next rate hike cycle.

The Fed meeting this week came and went with no major changes to policy, little in the way of new details with respect to the Fed's recently announced two percent average inflation targeting regime, or even much in the way of forward guidance. All of which was largely expected by markets as policymakers had been vocal in recent weeks about the lack of need to do more in way of policy stimulus at this juncture.

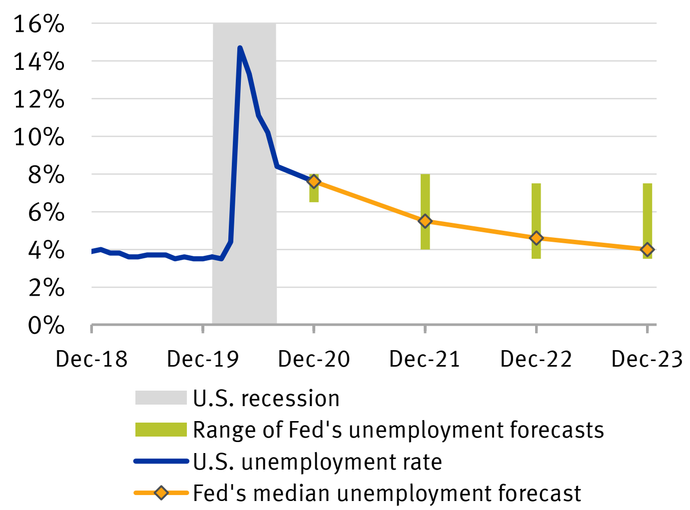
The star of the show was the Fed's first update to its economic projections since June amidst an economic recovery that has already progressed at a faster clip than policymakers had expected just three months ago, and which now include economic and interest rate forecasts through 2023.

Of particular note was the faster pace expected for the labor market recovery. The Fed estimated year-end unemployment of 9.3 percent following the June meeting, but policymakers now project 7.6 percent; it currently stands at 8.4 percent as of the August payrolls report.

How long could it take for the labor market to return to pre-pandemic levels? The Fed sees the unemployment rate returning to four percent by the end of 2023, just below the 4.1 percent rate the Fed estimates to be "full employment." On the inflation front, policymakers expect sub-two percent for the next couple of years, rising gradually to two percent by 2023.

And with maximum employment and two percent inflation expected to be achieved by 2023, the Fed's subsequent rate forecast for 2023 is … zero percent.

Fed sees faster job market recovery, still no rate hikes



Source - RBC Wealth Management, Bloomberg, U.S. Federal Reserve

Market pulse

In fact, only four of 17 Federal Open Market Committee members have a 2023 rate hike penciled in. To be sure, a world with unemployment below four percent and core inflation above two percent only existed for a handful of months over the past decade. To say that there's a high bar—some of the best economic conditions ever seen—for the next rate hike cycle to begin would be an understatement.

A new approach

This, of course, is explained by the Fed's new inflation strategy. In the past, those conditions would have marked the beginning of a rate hike cycle as the Fed has historically aimed to move preemptively ahead of higher inflationary environment driven by low unemployment. But as Fed Chair Jerome Powell noted in his press conference, record low unemployment in recent years hasn't fueled higher inflation, so employment levels beyond estimates of "full employment" will no longer jumpstart the Fed into action.

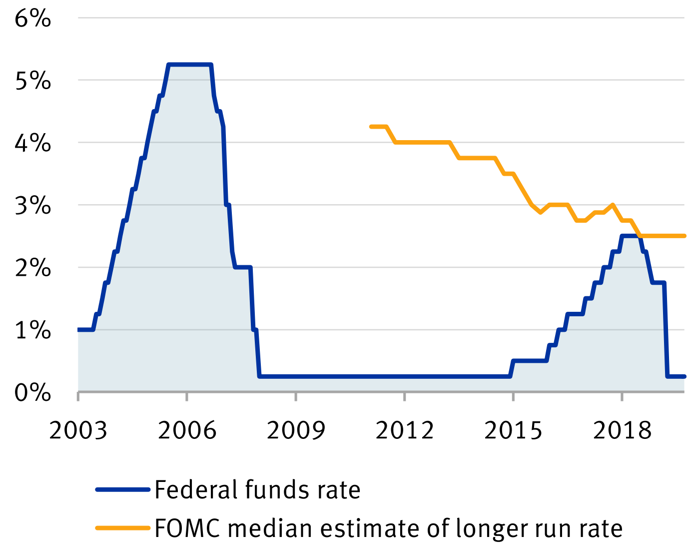
The Fed expects inflation to continue to fall short of two percent for the next few years, after which the Fed will let inflation run slightly north of two percent for a period of time, thus returning inflation to an average of two percent over what remains an unspecified timeframe, but which we judge to be a full business cycle. Whether the Fed can even generate those higher inflation levels after a decade of failing to reach two percent is a topic for another day.

Questions remain about the extent to which these more robust economic projections assume additional fiscal stimulus, particularly at a time when the chances of another fiscal package prior to the November election appear to be fading, though Powell again put the onus on Congress to deliver more in the way of fiscal support to aid the economic recovery.

Lower for longer in pursuit of higher for longer

For fixed income investors who will again have to manage through another extended stretch of zero interest-rate policy, the only light at the end of the tunnel appears to be the potential for rates to move higher. In this respect, the Fed's latest forecasts still show that it believes the longer-run "neutral rate" that neither restricts nor boosts economic growth is around 2.5 percent. As the chart shows, while that estimate—which began in 2012—has moved lower in recent years, it has remained at 2.5 percent since 2019 even as the Fed has taken policy rates back to zero percent.

Despite rate cuts back to 0%, the Fed still sees rates returning to around 2.5%—someday



Source - RBC Wealth Management, Bloomberg, Federal Reserve; FOMC = Federal Open Market Committee

We harbor some reservations that that rate is slightly lower, around two percent. But the Fed's goal of targeting higher inflation on average in an effort to re-anchor inflation expectations is aimed at raising the potential for higher "neutral rates" as that gives it more room to provide accommodation during period of economic stress. Regardless, it keeps potentially higher interest rates on the table for when the economy fully recovers.

Dusting off the lower for longer playbook, again

With the Fed on hold and only in accommodation mode for at least a few years, we continue to lean into risk within fixed income markets, maintaining a positive outlook on U.S. high-yield corporate bonds, preferred shares, and emerging market debt, where indexes for each sector currently yield 5.5 percent, 4.5 percent, and four percent, respectively. We shifted recently to a modestly negative outlook for U.S. investment-grade corporate bonds where index yields remain near record lows under two percent. We remain neutral on Treasuries as we see low ceilings for yields, and the sector will continue to provide defensive ballast for portfolios.

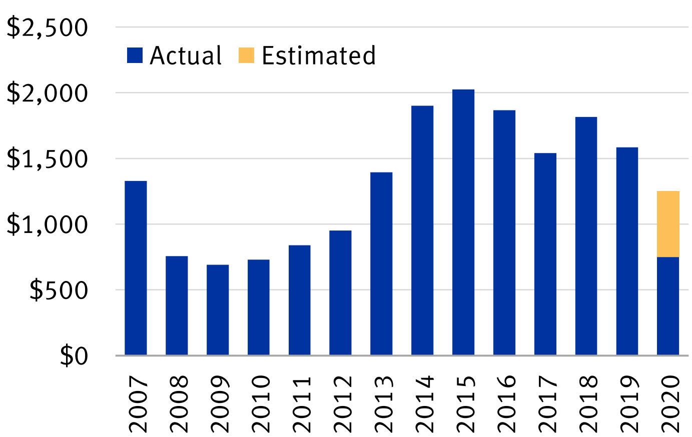
United States

Alan Robinson – Seattle

- Stocks received a boost at the start of the week on a **flurry of new merger and acquisition (M&A) announcements. The biggest deal was NVIDIA's (NVDA) acquisition of British chipmaker Arm Holdings from SoftBank Group** (SFTBY) for $40 billion. Chips based on Arm's architecture are used in more than 90% of the world's smartphones, and NVIDIA hopes to combine its own artificial intelligence computing platform with Arm's ecosystem to leverage its exposure to the rapidly growing Internet of Things.
- However, **this deal raised international concerns** as Arm's geopolitical neutrality has allowed it to build long-term relationships with global chipmaking and smartphone companies. Its acquisition by a U.S. company may put Chinese companies at a disadvantage, and may disrupt European tech companies' Asian supply chains.
- **Other deals** announced during the week included **Gilead's** (GILD) acquisition of **Immunomedics** (IMMU) for $21 billion, **Oracle's** (ORCL) proposed acquisition of a 20% stake in **TikTok**, **Verizon's** (VZ) purchase of prepaid phone company **TracFone** for $6.3 billion, and **MetLife's** (MET) bid to buy **Versant Health** for $1.7 billion.
- **These deals were generally well received, but other potential deals met with skepticism, including Illumina's (ILMN) proposal to buy Grail Inc.**, which contributed to a 14% fall in Illumina's share price.
- M&A deals had slowed significantly during the first half of the year due to the COVID-19 recession, but we view this pickup in Q3 as an **encouraging sign of normalcy returning to the market**, triggered by pent-up demand, equity market strength, and low funding costs. The fact that these deals are mainly strategically driven, rather than financially driven, suggests to us that this acquisition cycle is still only in the middle innings.
- Initial public offerings (IPOs) have also experienced a resurgence. **Snowflake (SNOW), a cloud software firm, raised nearly $3.4 billion** on Sept. 16, and we expect other tech IPOs to debut before year-end. Not all tech firms enjoyed good news during the week, as reports from Bloomberg and others suggested **Facebook (FB) may face an antitrust lawsuit** from the Federal Trade Commission based on its past acquisitions of potential competitors.

U.S. M&A volumes down, but not out, due to pandemic

Value of U.S. merger and acquistion deals ($ billions)



Source - Statista, RBC Wealth Management estimates; 2020 figure includes actual deals announced year-to-date and estimates through year's end.

Canada

Arete Zafiriou & Carolyn Schroeder – Toronto

- **Canada's annual inflation rate remained at 0.1% in August** as rising food prices were offset by lower gasoline costs, Statistics Canada reported, emphasizing how much damage the COVID-19 outbreak has done. Growth in food prices continued to outpace other components, albeit at a slower pace, up 1.8% y/y vs. 2.2% y/y in July. Energy prices fell 6.3% m/m in August and have remained sharply lower from a year ago as gasoline prices edged lower; that's after rebounding for three consecutive months since the April trough. Overall, **Consumer Price Index growth is still being weighed down** by subdued demand for services. Prices remained particularly soft for travel-related services as the pandemic disrupted normal seasonal travel patterns. In the meantime, the **Bank of Canada's preferred core inflation measures**, which exclude more volatile components, **held up better than expected** and were little changed, averaging 1.7% in August but still lower than the central bank's 2% target.
- **Canadian home resales increased 6.2% from July to August, reaching a record high of 672,000 units (annualized).** Last month was the fourth consecutive with positive growth, more than making up for the steep declines in March and April. New listings were up 10.6% m/m, led by a 29% increase in the Toronto region. **Growing resales and low mortgage rates put upward pressure on prices**, with Canada's MLS Home Price Index rising 9.4% y/y in August. RBC Economics notes that pent-up demand due to the pandemic shifted the usual seasonal activity from spring to summer, but expects home sales to slow as we enter the fall. While it expects prices to further appreciate over the coming months, RBC Economics says it will be watching for a divergence across housing categories; the single-detached home segment has been a standout as preferences lean towards larger, less crowded spaces. Meanwhile, the existing condo supply in core urban areas has been increasing.

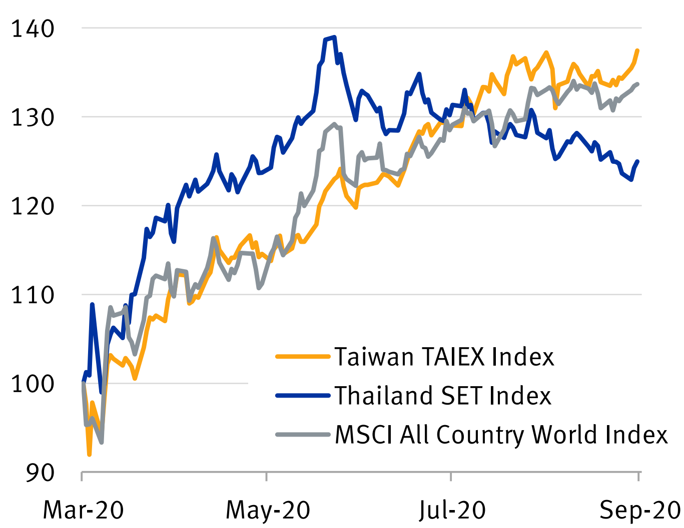
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- In Britain, **Prime Minister Boris Johnson won an initial vote in the House of Commons on the controversial Internal Market Bill** that seeks to override sections of the Withdrawal Agreement, the divorce deal that he signed with the EU last year and that Parliament passed in January 2020. The bill is seen in the EU—and in some parts of Johnson's Conservative Party—as a breach of an international treaty which could have long-lasting consequences as the country tries to position itself among the global leaders. U.S. presidential candidate Joe Biden waded into the controversy by confirming that **a transatlantic trade deal, key to Brexit Britain, could be blocked unless the Withdrawal Agreement was preserved**. Having declined more than 4% in early September, the pound struck a more positive tone in the week, though this does not seem sustainable.
- **The unemployment rate for the three months ending in July was a low 4.1%**, capped by the government's furlough scheme. Some three million workers, or just over 10% of the workforce, are now furloughed, down from nine million in early May. **If the furlough scheme is allowed to expire**, as seems to be the plan now, **some two-thirds of furloughed employees stand to become unemployed** and the unemployment rate could reach 9%. Reports that Chancellor of the Exchequer Rishi Sunak is considering some targeted action designed to help the sectors most affected by COVID-19 have not been confirmed by the government.

Thai stocks surrender their Asian leadership

Relative performance



Source - Refinitiv, RBC Wealth Management; daily close over last six months through 9/16/20, normalized with 3/17/20 = 100

- **The Bank of England kept interest rates at 0.1% and made no changes in its asset purchase programme** at its September meeting. With the effects of the furlough scheme waning, prospects of a no-trade-deal Brexit increasing, and lack of testing leading to a resurgence of COVID-19 infection rates, the UK economy is likely to need more support in the months to come. Negative interest rates were not ruled out; however, **we anticipate further quantitative easing before the end of the year**, with the potential for interest rates to be later cut to zero if deemed necessary.

Asia Pacific

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

- **The Asia-Pacific equity market traded mostly higher during the week, led by Taiwan and Thailand.** The Taiwan TAIEX Index is making another attempt to push through its all-time high set in late July. The rally is being driven by semiconductor stocks. Elsewhere, despite the brief rebound, the Thailand SET Index backed off after investor confidence hit a five-month low, as measured by the Federation of Thai Capital Market Organizations, as rising political turbulence in the country adds to concerns about a weak economy.
- **The latest batch of macro data from China suggests the economic recovery remains underway.** Industrial production grew 5.6% y/y in August, up from 4.8% in July, and leading indicators are pointing to further recovery in factory activity. **Retail sales expanded for the first time this year**, up 0.5% y/y in August, supported by growth from consumer staples and some non-essential goods. As new COVID-19 cases in China continue to trend lower, along with more relaxed social distancing measures, we believe the upward trend in consumption can be sustained. Finally, fixed asset investment shrank at a slower pace of -0.3% y/y in August. **Notwithstanding the positive data, we caution that challenges remain. Recent flooding was the worst in decades, causing major disruptions to local economies.** Meanwhile, the relationship with the U.S. remains strained. We expect Chinese monetary policy will remain flexible and do not rule out further cuts to banks' reserve requirement ratios.
- **Japan's parliament has elected Yoshihide Suga as the new prime minister.** Suga has signaled his intention to maintain the pro-growth policies of his predecessor known as "Abenomics" and **he will consider putting together another economic stimulus package by the end of this year** to "put the pandemic to an end and shift the economy to a new stage." Suga has repeatedly criticized the high cost of mobile phone services in Japan and his recent comments about lower fees have accelerated the selloff in the top telcos, NTT Docomo (9437 JP), KDDI (9433 JP), and SoftBank (9434 JP).

MARKET SCORECARD

Data as of September 17, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,357.01	-4.1%	3.9%	11.7%	16.2%
Dow Industrials (DJIA)	27,901.98	-1.9%	-2.2%	2.9%	7.1%
Nasdaq	10,910.28	-7.3%	21.6%	33.3%	38.2%
Russell 2000	1,542.60	-1.2%	-7.5%	-2.3%	-9.4%
S&P/TSX Comp	16,246.72	-1.6%	-4.8%	-3.5%	1.0%
FTSE All-Share	3,380.28	1.1%	-19.4%	-16.1%	-16.3%
STOXX Europe 600	371.23	1.3%	-10.7%	-4.6%	-1.9%
EURO STOXX 50	3,316.57	1.3%	-11.4%	-5.8%	-0.9%
Hang Seng	24,340.85	-3.3%	-13.7%	-9.1%	-9.6%
Shanghai Comp	3,270.44	-3.7%	7.2%	9.8%	23.3%
Nikkei 225	23,319.37	0.8%	-1.4%	6.0%	1.0%
India Sensex	38,979.85	0.9%	-5.5%	6.8%	3.7%
Singapore Straits Times	2,500.78	-1.3%	-22.4%	-21.4%	-20.4%
Brazil Ibovespa	100,097.80	0.7%	-13.4%	-4.3%	30.4%
Mexican Bolsa IPC	36,130.92	-1.9%	-17.0%	-16.8%	-26.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,947.03	-1.1%	28.3%	29.7%	62.1%
Silver (spot $/oz)	27.07	-3.8%	51.6%	50.3%	90.9%
Copper ($/metric ton)	6,793.40	1.4%	10.5%	17.3%	14.8%
Oil (WTI spot/bbl)	40.97	-3.8%	-32.9%	-31.0%	-40.5%
Oil (Brent spot/bbl)	43.35	-4.3%	-34.3%	-32.8%	-44.5%
Natural Gas ($/mmBtu)	1.99	-24.2%	-8.9%	-25.3%	-29.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.689%	-1.6	-122.9	-111.3	-229.8
Canada 10-Yr	0.576%	-4.6	-112.6	-87.3	-176.4
U.K. 10-Yr	0.185%	-12.6	-63.7	-51.2	-135.1
Germany 10-Yr	-0.491%	-9.4	-30.6	-1.7	-94.9
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.17%	0.1%	7.0%	8.1%	18.1%
U.S. Invest Grade Corp	1.94%	0.4%	7.4%	9.9%	22.7%
U.S. High Yield Corp	5.45%	-0.1%	1.6%	3.9%	11.1%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	92.8980	0.8%	-3.6%	-5.5%	-1.7%
CAD/USD	0.7603	-0.8%	-1.2%	0.7%	-0.8%
USD/CAD	1.3154	0.8%	1.3%	-0.7%	0.9%
EUR/USD	1.1850	-0.7%	5.7%	7.0%	1.4%
GBP/USD	1.2984	-2.9%	-2.1%	3.9%	-1.3%
AUD/USD	0.7314	-0.8%	4.2%	6.5%	1.8%
USD/JPY	104.7000	-1.1%	-3.6%	-3.2%	-6.4%
EUR/JPY	124.0800	-1.8%	1.9%	3.6%	-5.1%
EUR/GBP	0.9127	2.2%	7.9%	3.0%	2.8%
EUR/CHF	1.0762	-0.2%	-0.9%	-2.1%	-4.3%
USD/SGD	1.3570	-0.2%	0.8%	-1.2%	-1.1%
USD/CNY	6.7638	-1.2%	-2.9%	-4.6%	-1.4%
USD/MXN	20.8567	-4.7%	10.2%	7.7%	10.7%
USD/BRL	5.2336	-4.7%	29.9%	38.5%	26.6%

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 9/17/20.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -1.2% return means the Canadian dollar fell 1.2% vs. the U.S. dollar year to date. USD/JPY 104.70 means 1 U.S. dollar will buy 104.70 yen. USD/JPY -3.6% return means the U.S. dollar fell 3.6% vs. the yen year to date.

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