RBC Global Asset Management

The Global Investment Outlook

RBC GAM Investment Strategy Committee

SUMMER 2019

The RBC GAM Investment Strategy Committee

The RBC GAM Investment Strategy Committee consists of senior investment professionals drawn from all areas of RBC GAM. The Committee regularly receives economic and capital markets related input from internal and external sources. Important guidance is provided by the Committee's regional equity advisors (North America, Europe, Asia, Emerging Markets) and from the Global Fixed Income & Currencies sub-committee. From this, the Committee builds a detailed global investment forecast looking one year forward.

The Committee's view includes an assessment of global fiscal and monetary conditions, projected economic growth and inflation, as well as the expected course of interest rates, major currencies, corporate profits and stock prices.

From this global forecast, the RBC GAM Investment Strategy Committee develops specific guidelines that can be used to manage portfolios.

These include:

- the recommended mix of cash, fixed income instruments, and equities
- the recommended global exposure of fixed income and equity portfolios
- the optimal term structure for fixed income investments
- the suggested sector and geographic make-up within equity portfolios
- the preferred exposure to major currencies

Results of the Committee's deliberations are published quarterly in *The Global Investment Outlook*.

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Executive Summary

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The global economy is encountering challenges from protectionism, a maturing business cycle and fading U.S. fiscal support, but is being helped by stimulative government initiatives outside the U.S. and lower interest rates everywhere. Against this mixed economic backdrop, our base case scenario anticipates further advances in equity markets, although with perhaps less thrust than at earlier points in the cycle.

Global growth steadies at a moderate pace

The economic backdrop has shifted to a more mixed picture from earlier this year after negative impacts from the U.S. government shutdown and China's economic slowdown receded. Added to the mix were the new positive forces of a potentially rising economic speed limit and supportive governments and central banks. The balance of these suggests that the trajectory for global GDP is not all that bad, and we have raised our growth expectations slightly as a result. We now forecast 3.5 percent global growth for both 2019 and 2020, suggesting a stabilization in growth after two straight years of deceleration.

Risks to our benign outlook

In our view, the most current significant risk to the economy is protectionism. It looked like a trade deal between the U.S. and China was becoming increasingly likely as the year progressed. But negotiations pivoted in May and the U.S. raised tariffs, prompting China to retaliate. We don't expect that a meaningful deal will be achieved over the next few quarters and while tariffs don't hurt GDP much in the short term, they can still have an impact if they persist. That said, there have been some positive trade developments, which include the U.S. administration dropping tariffs on Canadian and Mexican steel, as well as pushing back the deadline on auto tariffs. In China, we are seeing mixed signals. For a brief period, it appeared that stimulus was beginning to stabilize China's economy, but the country's economic indicators have again begun to deteriorate. In Europe, a lack of clarity surrounding Brexit remains a challenge.

Business cycle grows older

Our scorecard approach to evaluating the state of the U.S. expansion continues to suggest that we are late in the economic cycle. The U.S. unemployment rate is at its lowest level in decades and the economic expansion is nearing the longest ever. While credit markets remain reasonably healthy, delinquency rates on auto loans have increased and demand for credit is declining. Another sign of a late-cycle environment – and one that is heavily debated – is the inverted yield curve. While many may find reasons why the yield curve is not a useful predictor of recession in the current environment (mostly due to distortions from quantitative easing), in the past analysts have wrongly dismissed yield-curve inversions and recessions ultimately followed. Taking these signals together, we gauge that the risk of recession is higher and our late-cycle assessment has motivated the decision to reduce risk in our portfolios.

U.S. dollar tailwinds fade and headwinds emerge

The U.S. dollar has moved steadily higher against a backdrop of low currency volatility. Stronger U.S. economic growth and a yield advantage have also supported the greenback. However, these cyclical factors may be fading, making structural negatives such as fiscal and current-account deficits much more relevant for investors. We have talked about an extended U.S.-dollar topping process in the past and that view still

prevails in our strategy. While the tailwinds could persist, the outlook and active management of currencies within our portfolios increasingly incorporates an expectation that further gains in the U.S. dollar will be limited. As a result, our forecasts imply a better outlook for the euro and the yen. The Canadian dollar and the British pound will likely underperform in this environment, although it will be tough for these currencies to post meaningful declines if the U.S. dollar weakens.

Central banks proceed with caution

Slowing growth and the drop in equity markets late last year prompted central banks to re-assess whether it was appropriate to continue raising interest rates. It appears that the sustainable interest rate is not only lower than in prior cycles, but perhaps lower than central bankers have realized. As a result, central banks have abandoned their prior tightening agendas for now. Our base case scenario is for no change to policy rates in most major developed markets over the coming year. If we are wrong in our view, it is likely because rates go lower rather than higher. In fact, rate cuts are already being largely priced in by fixed-income markets.

Valuation risk swells in sovereign bonds

Government bonds rallied in the past quarter as investors sought safe-haven assets in reaction to macroeconomic uncertainty. The yield on the U.S. 10-year bond fell to its lowest level since 2017 and now sits more than 100 basis points below its 2018 high. In Japan and Germany, 10-year government-bond yields fell further into negative territory and the 10-year bund yield reached a record low. At these levels, investors are pricing in dire outcomes for the economy and yields are unsustainably low if recession is avoided. Our own models suggest that the risk of fixed-income losses is elevated in all regions, particularly outside North America. The threat to sovereign-bond prices stems from the potential for a significant increase in real interest rates. Our models assume that real interest rates will inevitably rise to their long-term average, acting as a headwind for bond prices that could lead to low or even negative total returns in fixed income for a very long period into the future.

Stock rally stalled by protectionism and slowing earnings growth

This year's powerful stock-market rally took a step back in May after trade tensions between the world's two largest economies intensified. Subsequent declines in all major equity markets resulted in modest losses for most regions for the three-month period. At current levels, our models suggest that stocks rest at a decent distance below fair value. In our view, the near-term challenge for stocks is not valuations but the fact that earnings growth has stalled. Even though revenues have been accelerating, profits have been held back by profit margins declining from record levels. And while analysts expect earnings growth to recover toward the end of the year, rising revenues and stability/improvement in margins are critical to achieving those forecasts. A recession or an escalation in tariffs would likely lead to lower stock prices. However, our scenario analysis suggests it wouldn't be unreasonable for equities to deliver single- to low-double-digit gains in an environment of low interest rates and inflation should those fears not play out.

Trimming equity overweight and maintaining underweight in bonds

Our asset mix reflects the current balance of risks and potential rewards, taking into account a mature business cycle, slowing economic activity and stalled profit growth. Against this backdrop, we tactically reduced our overweight allocation to equities by half a percentage point in the past quarter, moving further along the path of de-risking our portfolios as the business cycle matures. That said, we think it's too early to move below a 'neutral setting' for equities since we believe we are in a secular bull market for stocks and our base case is for continued economic growth over the forecast horizon. We opted to shift the proceeds from the reduction in equities into cash instead of bonds because the valuation risk in fixed income is acute and cash yields are currently greater than those available on sovereign bonds. For a balanced, global investor, we currently recommend an asset mix of 57.5% equities (strategic neutral position: 55%) and 40% fixed income (strategic neutral position: 43%), with the balance in cash.

Economic & Capital Markets Forecasts

Economic forecast (RBC GAM Investment Strategy Committee)

	United States		Canada		Europe		United Kingdom		Japan		China		Emerging markets*	
	Summer 2019	Change from Spring 2019	Summer 2019	Change from Spring 2019	Summer 2019	Change from Spring 2019	Summer 2019	Change from Spring 2019	Summer 2019	Change from Spring 2019	Summer 2019	Change from Spring 2019	Summer 2019	Change from Spring 2019
Real GDP														
2018A	2.86%		1.88%		1.84%		1.37%		0.78%		6.58%		5.57%	
2019E	2.50%	0.25	1.25%	(0.25)	1.25%	N/C	1.50%	0.25	0.75%	(0.25)	6.25%	0.25	5.25%	N/C
2020E	2.00%	0.25	1.50%	N/C	1.25%	N/C	1.50%	0.25	0.50%	N/C	6.00%	0.25	5.25%	0.25
CPI														
2018A	1.95%		1.97%		1.55%		2.01%		0.30%		1.93%		2.37%	
2019E	2.00%	N/C	2.00%	N/C	1.50%	(0.25)	2.00%	(0.25)	1.00%	(0.25)	2.25%	N/C	3.00%	(0.25)
2020E	2.25%	N/C	1.75%	(0.25)	1.50%	(0.25)	2.25%	N/C	1.25%	(0.25)	2.25%	N/C	3.00%	(0.25)

A = Actual E = Estimate *GDP Weighted Average of China, India, South Korea, Brazil, Mexico and Russia.

Targets (RBC GAM Investment Strategy Committee)

	May 2019	Forecast May 2020	Change from Spring 2019	1-year Total Return estimate* (%)
Currency Markets against USD				
CAD (USD–CAD)	1.35	1.37	N/C	(1.6)
EUR (EUR–USD)	1.12	1.20	0.01	4.8
JPY (USD–JPY)	108.28	100.00	(2.00)	5.9
GBP (GBP–USD)	1.26	1.27	0.02	(0.7)
Fixed Income Markets				
U.S. Fed Funds Rate	2.50	2.50	N/C	N/A
U.S. 10-Year Bond	2.12	2.55	0.05	(1.6)
Canada Overnight Rate	1.75	1.75	N/C	N/A
Canada 10-Year Bond	1.49	1.75	(0.25)	(0.9)
Eurozone Deposit Facility Rate	-0.40	-0.40	N/C	N/A
Germany 10-Year Bund	-0.20	0.20	(0.05)	(4.2)
U.K. Base Rate	0.75	0.50	N/C	N/A
U.K. 10-Year Gilt	0.89	1.25	0.25	(2.5)
Japan Overnight Call Rate	-0.06	-0.10	N/C	N/A
Japan 10-Year Bond	-0.09	0.10	N/C	(2.0)
Equity Markets				
S&P 500	2752	2925	50	8.4
S&P/TSX Composite	16037	16700	200	7.3
MSCI Europe	124	134	4	11.7
FTSE 100	7162	7500	50	9.6
Nikkei	20601	22650	(150)	12.2
MSCI Emerging Markets	998	1070	(80)	10.3

*Total returns are expressed in local currencies with the exception of MSCI Emerging Markets whose return is expressed in USD.

Recommended Asset Mix

Asset mix – the allocation within portfolios to stocks, bonds and cash – should include both strategic and tactical elements. Strategic asset mix addresses the blend of the major asset classes offering the risk/return tradeoff best suited to an investor's profile. It can be considered to be the benchmark investment plan that anchors a portfolio through many business and investment cycles, independent of a near-term view of the prospects for the economy and related expectations for capital markets. Tactical asset allocation refers to fine tuning around the strategic setting in an effort to add value by taking advantage of shorter term fluctuations in markets.

Every individual has differing return expectations and tolerances for volatility, so there is no "one size fits all" strategic asset mix. Based on a 40-year study of historical returns[1] and the volatility[2] of returns (the range around the average return within which shorter-term results tend to fall), we have developed five broad profiles and assigned a benchmark strategic asset mix for each. These profiles range from very conservative through balanced to aggressive growth. It goes without saying that as investors accept increasing levels of volatility, and therefore greater risk that the actual experience will depart from the longer-term norm, the potential for returns rises. The five profiles presented below may assist investors in selecting a strategic asset mix best aligned to their investment goals.

Each quarter, the RBC GAM Investment Strategy Committee publishes a recommended asset mix based on our current view of the economy and return expectations for the major asset classes. These weights are further divided into recommended exposures to the variety of global fixed income and equity markets. Our recommendation is targeted at the Balanced profile where the benchmark setting is 55% equities, 43% fixed income, 2% cash.

A tactical range of +/- 15% around the benchmark position allows us to raise or lower exposure to specific asset classes with a goal of tilting portfolios toward those markets that offer comparatively attractive near-term prospects.

This tactical recommendation for the Balanced profile can serve as a guide for movement within the ranges allowed for all other profiles.

The value-added of tactical strategies is, of course, dependent on the degree to which the expected scenario unfolds.

Regular reviews of portfolio weights are essential to the ultimate success of an investment plan as they ensure current exposures are aligned with levels of long-term returns and risk tolerances best suited to individual investors.

Anchoring portfolios with a suitable strategic asset mix, and placing boundaries defining the allowed range for tactical positioning, imposes discipline that can limit damage caused by swings in emotion that inevitably accompany both bull and bear markets.

[1]**Average return**: The average total return produced by the asset class over the period 1979 – 2019, based on monthly results.

[2]**Volatility**: The standard deviation of returns. Standard deviation is a statistical measure that indicates the range around the average return within which 2/3 of results will fall into, assuming a normal distribution around the long-term average.

Global Asset Mix

	Benchmark Policy	Past range	Summer 2018	Fall 2018	New Year 2019	Spring 2019	**Summer 2019**
Cash	**2.0%**	1.0% – 16%	2.0%	2.0%	1.0%	1.0%	**2.5%**
Bonds	**43.0**	25.0 – 54.0	40.0%	40.0%	41.0%	41.0%	**40.0%**
Stocks	**55.0**	36.0 – 65.0	58.0%	58.0%	58.0%	58.0%	**57.5%**

Note: Effective September 1, 2014, we revised our strategic neutral positions within fixed income, lowering the 'neutral' commitment to cash from 5% to 2%, and moving the difference to bonds. This takes advantage of the positive slope of the yield curve which prevails over most time periods, and allows our fixed income managers to shorten duration and build cash reserves whenever a correction in the bond market, or especially an inverted yield curve, is anticipated.

Regional Allocation

Global Bonds	**WGBI* May 2019**	Past range	Summer 2018	Fall 2018	New Year 2019	Spring 2019	**Summer 2019**
North America	**42.8%**	18% – 47%	43.8%	45.5%	46.8%	46.7%	**40.3%**
Europe	**38.3%**	32% – 56%	36.2%	35.0%	34.0%	36.5%	**43.3%**
Asia	**19.0%**	16% – 35%	20.0%	19.5%	19.2%	16.9%	**16.5%**

Note: Past Range reflects historical allocation from Fall 2002 to present.

Global Equities	**MSCI** May 2019**	Past range	Summer 2018	Fall 2018	New Year 2019	Spring 2019	**Summer 2019**
North America	**64.4%**	51% – 63%	61.5%	63.1%	61.8%	61.5%	**61.9%**
Europe	**18.1%**	18% – 35%	18.5%	17.8%	18.6%	19.1%	**19.1%**
Asia	**10.3%**	9% – 18%	12.5%	11.7%	12.1%	11.9%	**11.6%**
Emerging Markets	**7.3%**	0% – 8.5%	7.5%	7.5%	7.5%	7.5%	**7.5%**

Our asset mix is reported as at the end of each quarter. The mix is fluid and may be adjusted within each quarter, although we do not always report on shifts as they occur. The weights in the table should be considered a snapshot of our asset mix at the date of release of the Global Investment Outlook.

Global Equity Sector Allocation

	MSCI May 2019**	RBC GAM ISC Spring 2019	**RBC GAM ISC Summer 2019**	Change from *** Spring 2019	Weight vs. Benchmark
Energy	5.74%	4.04%	3.74%	(0.30)	65.2%
Materials	4.46%	2.54%	3.46%	0.92	77.6%
Industrials	11.22%	11.14%	10.52%	(0.62)	93.8%
Consumer Discretionary	10.66%	11.34%	11.66%	0.32	109.3%
Consumer Staples	8.42%	8.50%	9.92%	1.42	117.8%
Health Care	12.19%	14.01%	12.19%	(1.82)	100.0%
Financials	16.13%	14.13%	14.63%	0.50	90.7%
Information Technology	16.33%	17.29%	18.33%	1.04	112.3%
Communication Services	8.43%	8.36%	9.13%	0.77	108.3%
Utilities	3.25%	5.37%	3.25%	(2.12)	100.0%
Real Estate	3.17%	3.29%	3.17%	(0.12)	100.0%

*FTSE World Government Bond Index **MSCI World Index ***As of the close on November 30, 2018, the Telecommunication Services Sector was broadened and renamed Communication Services. This modification in the classifications also impacted the Consumer Discretionary and Information Technology sectors.
Source: RBC GAM Investment Strategy Committee

At RBC GAM, we have a team dedicated to setting and reviewing the strategic asset mix for all of our multi-asset solutions. With an emphasis on consistency of returns, risk management and capital preservation, we have developed a strategic asset allocation framework for five client risk profiles that correspond to broad investor objectives and risk preferences. These five profiles range from Very Conservative through Balanced to Aggressive Growth.

Very Conservative

Asset Class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0%-15%	1.0%	2.5%
Fixed Income	78%	55%-95%	76.0%	75.0%
Total Cash & Fixed Income	80%	65%-95%	77.0%	77.5%
Canadian Equities	10%	5%-20%	11.3%	11.0%
U.S. Equities	5%	0%-10%	5.4%	5.3%
International Equities	5%	0%-10%	6.3%	6.2%
Emerging Markets	0%	0%	0.0%	0.0%
Total Equities	20%	5%-35%	23.0%	22.5%

	Return	Volatility
40-Year Average	8.5%	5.5%
Last 12 Months	6.2%	3.8%

Very Conservative investors will seek income with maximum capital preservation and the potential for modest capital growth, and be comfortable with small fluctuations in the value of their investments. This portfolio will invest primarily in fixed-income securities, and a small amount of equities, to generate income while providing some protection against inflation. Investors who fit this profile generally plan to hold their investment for the medium to long term.

Conservative

Asset Class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0%-15%	1.0%	2.5%
Fixed Income	63%	40%-80%	61.0%	60.0%
Total Cash & Fixed Income	65%	50%-80%	62.0%	62.5%
Canadian Equities	15%	5%-25%	16.0%	15.7%
U.S. Equities	10%	0%-15%	10.3%	10.2%
International Equities	10%	0%-15%	11.7%	11.6%
Emerging Markets	0%	0%	0.0%	0.0%
Total Equities	35%	20%-50%	38.0%	37.5%

	Return	Volatility
40-Year Average	8.8%	6.5%
Last 12 Months	5.6%	4.9%

Conservative investors will pursue modest income and capital growth with reasonable capital preservation, and be comfortable with moderate fluctuations in the value of their investments. The portfolio will invest primarily in fixed-income securities, with some equities, to achieve more consistent performance and provide a reasonable amount of safety. The profile is suitable for investors who plan to hold their investment over the medium to long term.

Balanced

Asset Class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0%-15%	1.0%	2.5%
Fixed Income	43%	20%-60%	41.0%	40.0%
Total Cash & Fixed Income	45%	30%-60%	42.0%	42.5%
Canadian Equities	19%	10%-30%	19.5%	19.3%
U.S. Equities	20%	10%-30%	20.2%	20.0%
International Equities	12%	5%-25%	13.9%	13.8%
Emerging Markets	4%	0%-10%	4.4%	4.4%
Total Equities	55%	40%-70%	58.0%	57.5%

	Return	Volatility
40-Year Average	9.1%	7.7%
Last 12 Months	4.8%	7.0%

The **Balanced** portfolio is appropriate for investors seeking balance between long-term capital growth and capital preservation, with a secondary focus on modest income, and who are comfortable with moderate fluctuations in the value of their investments. More than half the portfolio will usually be invested in a diversified mix of Canadian, U.S. and global equities. This profile is suitable for investors who plan to hold their investment for the medium to long term.

Growth

Asset Class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0%-15%	1.0%	2.5%
Fixed Income	28%	5%-40%	25.9%	25.0%
Total Cash & Fixed Income	30%	15%-45%	26.9%	27.5%
Canadian Equities	23%	15%-35%	23.3%	23.1%
U.S. Equities	25%	15%-35%	25.1%	24.8%
International Equities	16%	10%-30%	18.3%	18.2%
Emerging Markets	6%	0%-12%	6.4%	6.4%
Total Equities	70%	55%-85%	73.1%	72.5%

	Return	Volatility
40-Year Average	9.2%	9.4%
Last 12 Months	4.0%	8.6%

Investors who fit the **Growth** profile will seek long-term growth over capital preservation and regular income, and be comfortable with considerable fluctuations in the value of their investments. This portfolio primarily holds a diversified mix of Canadian, U.S. and global equities and is suitable for investors who plan to invest for the long term.

Aggressive Growth

Asset Class	Bench-mark	Range	Last quarter	Current recommendation
Cash & Cash Equivalents	2%	0%-15%	2.0%	2.0%
Fixed Income	0%	0%-10%	0.0%	0.0%
Total Cash & Fixed Income	2%	0%-20%	2.0%	2.0%
Canadian Equities	32.5%	20%-45%	31.6%	31.6%
U.S. Equities	35.0%	20%-50%	33.5%	33.5%
International Equities	21.5%	10%-35%	23.7%	23.7%
Emerging Markets	9.0%	0%-15%	9.2%	9.2%
Total Equities	98%	80%-100%	98.0%	98.0%

	Return	Volatility
40-Year Average	9.5%	12.1%
Last 12 Months	2.6%	12.0%

Aggressive Growth investors seek maximum long-term growth over capital preservation and regular income, and are comfortable with significant fluctuations in the value of their investments. The portfolio is almost entirely invested in stocks and emphasizes exposure to global equities. This investment profile is suitable only for investors with a high risk tolerance and who plan to hold their investments for the long term.

Capital Markets Performance

Milos Vukovic, MBA, CFA
V.P. & Head of Investment Policy
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The U.S. dollar showed renewed strength in the quarter ended May 31, 2019, as the greenback appreciated against most major currencies. Concerns about a global slowdown in economic growth and increasingly dovish central banks outside of the U.S. helped drive the U.S. dollar higher. The greenback finished the quarter up 4.9 percent versus sterling, 2.7 percent versus the loonie and 1.8 percent versus the euro. The pound depreciated the most among major currencies as continued Brexit uncertainty weighed on an already weakened British economy. During the same period, the Japanese yen rose 2.8 percent against the U.S. dollar as investors sought refuge in the 'safe haven' asset amid reignited trade tensions between the U.S. and China. For the latest 12-month period, the U.S. dollar gained over 4 percent versus the pound, euro and Canadian dollar, but was relatively unchanged versus the yen.

Global fixed-income markets recorded gains over the three-month period as the combination of weak economic data and leading indicators, as well as escalating protectionism triggered further downgrades in expectations for global economic growth. In this environment, major central banks remained on hold and the U.S. Federal Reserve (Fed) recently signaled it would be ready to cut rates should the economic expansion be threatened. The 10-year U.S. Treasury bond yield dropped to 2.12 percent as of May 31, 2019, down 38 basis points from a quarter ago and below the 3-month U.S. Treasury bill yield of 2.34 percent. Japanese and U.S. sovereign bonds, as represented by the FTSE Japanese Government Bond Index and FTSE U.S. Government Bond Index, were the best performers in the quarter, returning 4.3 percent and 3.8 percent, respectively, in U.S.-dollar terms. The laggard FTSE European Government Bond Index edged 0.5 percent higher over the same period.

The rally in stocks that began after the December 24, 2018 low persisted through March and April then faltered in May, coincident with the breakdown of trade negotiations between the U.S. and China. The imposition of higher tariffs and threats of additional tariffs by both sides dimmed the global growth and corporate earnings outlook and shook investor confidence. For the three-month period ended May 31, 2019, the hardest hit MSCI Emerging Markets Index suffered a 4.5 percent loss while the S&P 500 Index lost 0.7 percent. Even after a dismal month of May, the majority of equity indexes were up between January and the end of last month, with gains of 10.7 percent for the S&P 500 Index, 9.7 percent for the MSCI World Index and 4.1 percent for the MSCI Emerging Markets Index.

The stocks of larger companies outperformed their smaller peers in the latest three-month period as risk aversion was prevalent. The large-cap S&P 500 Index was down just 0.7 percent while the mid-cap S&P 400 Index lost 4.8 percent and the small-cap S&P 600 Index sank 8.4 percent. Growth stocks bettered value stocks once again in the quarter, as they tend to do when corporate-earnings prospects are poor. The Russell 3000 Growth Index was essentially flat and the Russell 3000 Value Index was down 2.8 percent. Six of the 11 sectors recorded losses over the three-month period. The largest declines came in more economically sensitive sectors like Energy, down 7.0 percent, and Materials, which recorded a 4.4 percent drop. Investors preferred the relative safety offered by more defensive sectors such as Real Estate and Consumer Staples, which were up 3.2 percent and 2.8 percent, respectively.

Exchange Rates

Periods ending May 31, 2019

	Current USD	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
USD–CAD	1.3516	2.71	(1.00)	4.24	1.01	4.50
USD–EUR	0.8951	1.82	2.56	4.65	(0.13)	4.06
USD–GBP	0.7910	4.91	0.82	5.15	4.64	5.80
USD–JPY	108.3650	(2.78)	(1.13)	(0.39)	(0.72)	1.26

Note: all changes above are expressed in US dollar terms

Canada

Periods ending May 31, 2019

	USD					CAD		
Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
FTSE Canada Univ. Bond Index TR	1.23	6.62	2.65	1.92	(0.73)	3.98	7.00	2.95

U.S.

Periods ending May 31, 2019

	USD					CAD		
Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
FTSE U.S. Government TR	3.82	4.84	6.41	2.51	2.71	6.64	10.93	3.41
Barclays Capital Agg. Bond Index TR	3.76	4.80	6.40	2.50	2.70	6.57	10.91	3.53

Global

Periods ending May 31, 2019

	USD					CAD		
Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
FTSE WGBI TR	2.45	3.34	3.30	1.88	0.93	5.23	7.69	2.77
FTSE European Government TR	0.49	1.35	(0.23)	1.16	(0.77)	3.21	4.01	2.18
FTSE Japanese Government TR	4.32	3.43	3.07	1.05	1.11	7.15	7.45	2.07

Canada

Periods ending May 31, 2019

	USD					CAD		
Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
S&P/TSX Composite	(1.59)	14.50	(1.16)	6.54	0.46	1.07	3.03	7.62
S&P/TSX 60	(0.97)	14.51	0.30	7.60	1.44	1.71	4.55	8.69
S&P/TSX Small Cap	(7.96)	6.89	(15.78)	(0.55)	(5.37)	(5.46)	(12.21)	0.45

U.S.

Periods ending May 31, 2019

	USD					CAD		
Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
S&P 500 TR	(0.67)	10.74	3.78	11.72	9.66	2.02	8.19	12.85
S&P 400 TR	(4.82)	9.60	(5.44)	8.36	7.31	(2.24)	(1.43)	9.46
S&P 600 TR	(8.35)	5.81	(10.47)	9.54	7.85	(5.87)	(6.68)	10.65
Russell 3000 Value TR	(2.84)	8.33	0.48	7.98	6.42	(0.21)	4.74	9.08
Russell 3000 Growth TR	0.20	13.54	4.42	15.06	12.02	2.92	8.85	16.22
NASDAQ Composite Index TR	(1.05)	12.33	0.15	14.63	11.93	1.63	4.40	15.79

Note: all rates of return presented for periods longer than 1 year are annualized. Source: RBC GAM

Global
Periods ending May 31, 2019

	USD					CAD		
Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
MSCI World TR *	(1.15)	9.75	(0.29)	9.00	5.62	1.47	3.91	10.21
MSCI EAFE TR *	(1.51)	7.64	(5.75)	5.82	1.27	1.10	(1.77)	6.99
MSCI Europe TR *	(1.50)	8.51	(5.17)	5.17	(0.06)	1.11	(1.17)	6.33
MSCI Pacific TR *	(1.43)	6.25	(6.71)	7.25	4.00	1.18	(2.78)	8.43
MSCI UK TR *	(2.87)	7.54	(7.60)	3.90	(1.15)	(0.30)	(3.71)	5.05
MSCI France TR *	(1.37)	8.72	(5.98)	7.97	1.65	1.24	(2.01)	9.16
MSCI Germany TR *	(1.64)	6.69	(12.45)	3.73	(1.24)	0.97	(8.76)	4.88
MSCI Japan TR *	(2.08)	3.86	(9.97)	5.86	4.77	0.52	(6.17)	7.03
MSCI Emerging Markets TR *	(4.51)	4.09	(8.70)	9.88	1.79	(1.98)	(4.85)	11.09

Global Equity Sectors
Periods ending May 31, 2019

	USD					CAD		
Sector: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
Energy TR *	(7.01)	5.33	(15.81)	1.85	(5.83)	(4.54)	(12.27)	2.97
Materials TR *	(4.38)	6.02	(10.57)	8.58	1.46	(1.84)	(6.80)	9.78
Industrials TR *	(2.70)	11.61	(3.41)	8.69	5.32	(0.12)	0.67	9.89
Consumer Discretionary TR *	(0.73)	9.63	(1.11)	10.16	7.83	1.90	3.06	11.37
Consumer Staples TR *	2.77	10.38	8.35	4.02	4.96	5.50	12.91	5.17
Health Care TR *	(4.10)	2.83	5.21	6.43	6.48	(1.56)	9.65	7.61
Financials TR *	(2.61)	8.49	(5.77)	8.41	3.86	(0.03)	(1.80)	9.61
Information Technology TR *	1.61	16.50	3.19	19.99	15.21	4.31	7.54	21.31
Communication Services TR*	2.36	12.04	10.95	1.74	2.01	5.08	15.63	2.86
Utilities TR *	0.97	8.72	12.47	7.34	5.08	3.65	17.21	8.53
Real Estate TR *	3.17	14.45	9.54	NA	NA	5.90	14.16	NA

* Net of taxes. Note: all rates of return presented for periods longer than 1 year are annualized. Source: Bloomberg/MSCI

Global Investment Outlook

Green shoots pruned by protectionism

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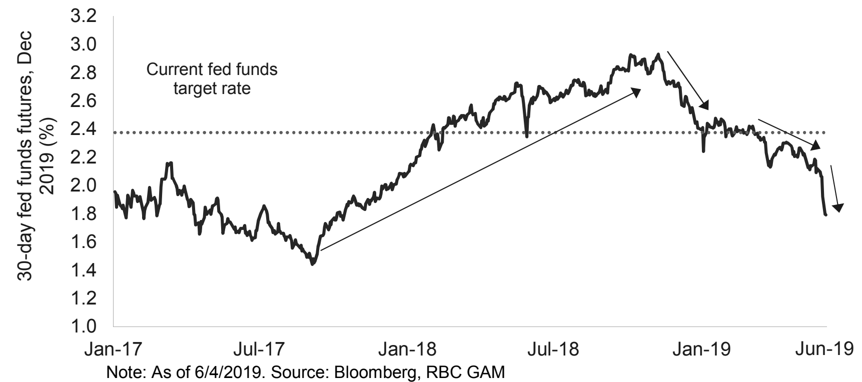
The first half of 2019 was marked by several sharp swings in sentiment. The year began with an intense swell of negativity, but this soon reversed into a happy period lasting several months. During that time, risk assets unwound the bulk of their losses, mainly because central banks had abandoned their tightening plans (Exhibit 1) and a smattering of economic green shoots were emerging after a long period of decelerating growth.

More recently, a renewal of protectionist rhetoric and anti-trade actions have again upended investor sentiment (Exhibit 2) and raised new questions about the durability of economic growth (Exhibit 3).

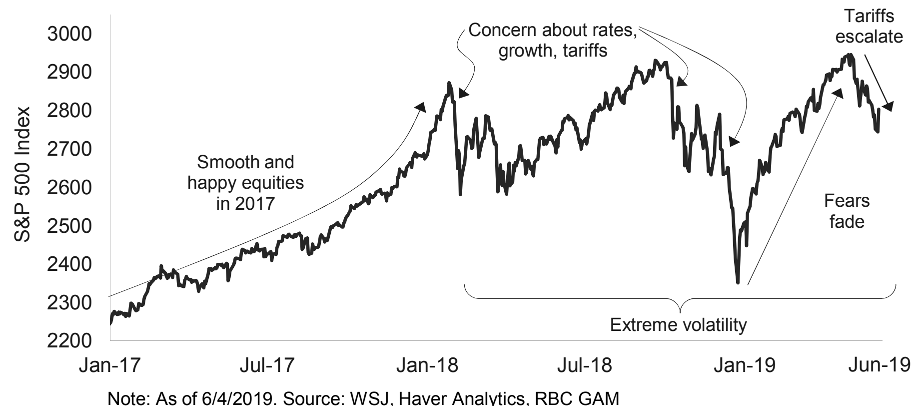
These various market reactions have appeared outsized at times, but the alternating pattern of good and bad forces slamming into the economic outlook have all been very real. What ultimately matters is how these various impulses net out. We arrive at a mixed macroeconomic outlook, one challenged beyond doubt by the woes of protectionism, the lateness of the business cycle and the loss of U.S. fiscal support. No less importantly, however, is an offsetting handful

Exhibit 1: Bond market now expects rate cuts in 2019



Note: As of 6/4/2019. Source: Bloomberg, RBC GAM

Exhibit 2: Stock market skitters up and down



Note: As of 6/4/2019. Source: WSJ, Haver Analytics, RBC GAM

of improved economic indicators including mounting global fiscal stimulus and lower interest rates. Our global growth outlook is, in aggregate, actually a hair more positive than it was a quarter ago.

Our base case financial-market outlook continues to anticipate further advances in equity markets, though not with the enthusiasm of the past decade, since the scope for rising valuations is now more limited. Equities remain an important component in an investment portfolio given the substantial risk premium they enjoy over bonds, and thus the promise of superior long-term returns offered by the asset class. But the state of the business cycle and the prospective damage of protectionism suggest that such exposure should probably be lower than it has been for most of the post-crisis period. We have slightly reduced our own equity allocation and shifted the proceeds into cash, representing the continuation of a gradual move away

from equities over the past few years for similar reasons.

More mixed macro impulses

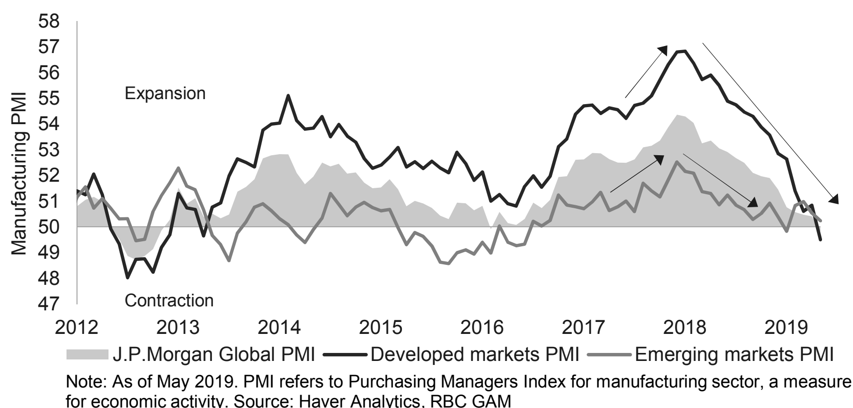
Whereas challenges dominated the economic landscape in early 2019, the environment has since shifted toward a more mixed landscape of competing negative and positive forces. This, in turn, has permitted the sprouting of a few hardy green shoots that argue the global growth trend is not all bad. Providing some support for this, the annual trend for global economic data has become notably less negative (Exhibit 4).

Obvious remaining headwinds include the advanced age of the business cycle, the drag of protectionist actions and fading U.S. fiscal stimulus. The collective effect of the latter two forces has transitioned from one of material support for economic growth in 2017 and 2018 to a slight drag in 2019 and an even greater friction in 2020 (Exhibit 5).

Fortunately, some prior headwinds have become less intense, including the fading effect of the record-long U.S. government shutdown in December and January, and the drag from a slowing Chinese economy (Exhibit 6).

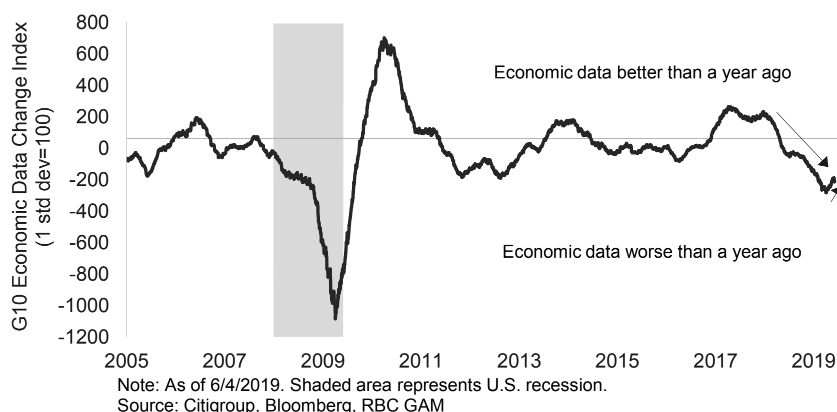
Furthermore, these headwinds have since been joined by outright positive forces: what we hope is a rising economic speed limit; the sympathetic response of mounting fiscal stimulus as an offset to diminished growth outside of the U.S.; and more supportive central banks. The last of these has allowed a sizeable drop in bond yields (Exhibit 7).

Exhibit 3: Global manufacturing activity is fading again after brief stabilization



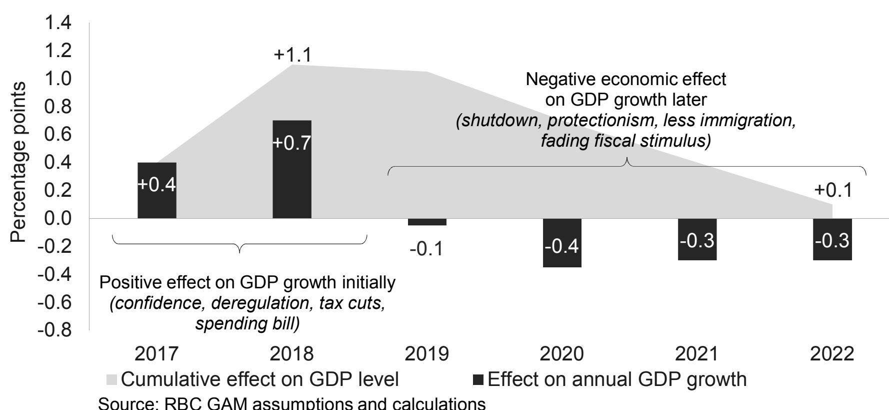
Note: As of May 2019. PMI refers to Purchasing Managers Index for manufacturing sector, a measure for economic activity. Source: Haver Analytics, RBC GAM

Exhibit 4: Global Data Change Index rebounded tentatively



Note: As of 6/4/2019. Shaded area represents U.S. recession. Source: Citigroup, Bloomberg, RBC GAM

Exhibit 5: Effect of fiscal policies on U.S. GDP



Source: RBC GAM assumptions and calculations

Some forecasts edge above consensus

It should come as no surprise that as the set of economic impulses has become less universally sour, our global growth forecasts have risen slightly. We now forecast 3.50 percent global growth for both 2019 and 2020. The decelerating global growth trend from 2017 through 2019 may finally be arrested in 2020.

To be sure, several of our macroeconomic forecasts are below the consensus, including those for emerging markets in both 2019 and 2020. However, our developed-world forecast for 2019 is now slightly above the consensus – a new development.

At the national level, we now sport above-consensus 2019 growth forecasts for the Eurozone, U.K. and Japan (Exhibit 8). We are roughly on-consensus for the U.S., while Canada has a below-consensus outlook. Among emerging markets, it is a more mixed affair. We are essentially on consensus for China (though this tilts to below-consensus for 2020), South Korea and Mexico; we are below consensus for India; and above for Brazil and Russia.

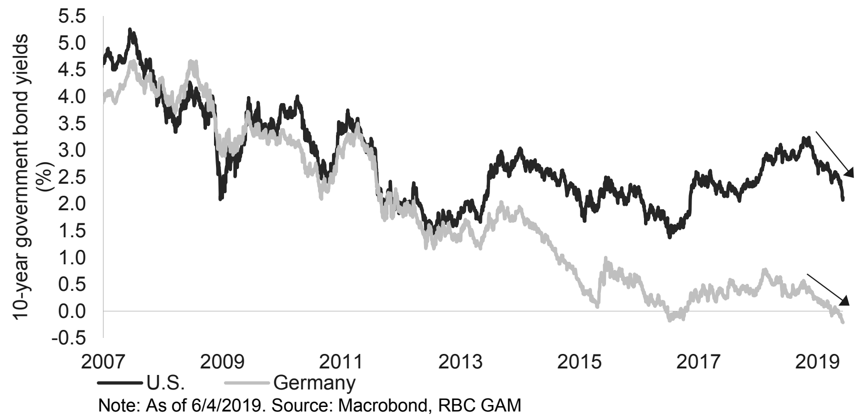
In absolute terms, U.S. growth is set to lead the way among developed countries (Exhibit 9). India should outpace other major emerging markets, with China not too far behind (Exhibit 10).

Exhibit 6: Growth headwinds have diminished, though not entirely gone

	Original impulse	Recent development
1.	Negative economic momentum	Green shoots / stabilization
2.	Tighter financial conditions	Now easing due to central banks
3.	More protectionism	Good: Auto tariffs delayed Good: Some steel and aluminum tariffs waived Good: NAFTA approval conceivable Bad: U.S.-China trade deteriorates
4.	Fading U.S. fiscal stimulus	More fiscal stimulus outside of U.S.
5.	U.S. government shutdown	Shutdown over, (small) drag vanishes now that beyond Q1 2019
6.	Slowing China	Chinese fiscal stimulus starts to click

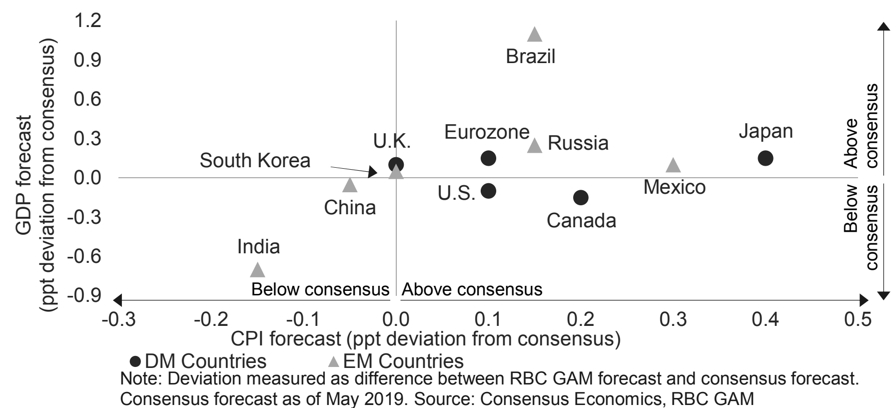
Source: RBC GAM

Exhibit 7: Yields fall on heightened trade tensions



Note: As of 6/4/2019. Source: Macrobond, RBC GAM

Exhibit 8: GAM forecasts vs. consensus for 2019



Note: Deviation measured as difference between RBC GAM forecast and consensus forecast. Consensus forecast as of May 2019. Source: Consensus Economics, RBC GAM

Macro risks

There are a variety of risks surrounding our base case forecast (Exhibit 11). Naturally, these extend in both negative and positive directions. The heaviest negative risks revolve around protectionism, the lateness of the business cycle and the sustainability of Chinese growth. Each of these commands its own section later in this report.

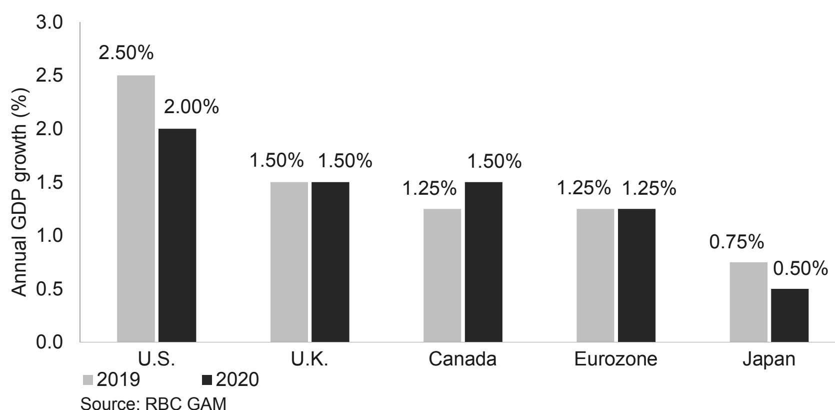
While generally less remarked upon, there are also upside risks – things that could go better than we presently assume. Some of these are simply the inverse of the aforementioned downside risks. While protectionism could be worse than we expect, it might also be better. The business cycle could extend for longer. China could defy its downward trend.

A prominent upside-specific risk is that secular stagnation may be fading. This is a technical way of saying that the speed limit on developed-world economic growth may be starting to decompress after roughly a decade of unusually slow productivity growth (Exhibit 12). If true, that would not only increase the rate at which the standard of living advances, but also potentially increase the sustainable rate of return for the stock market, and possibly even extend the business cycle.

Resurgent protectionism

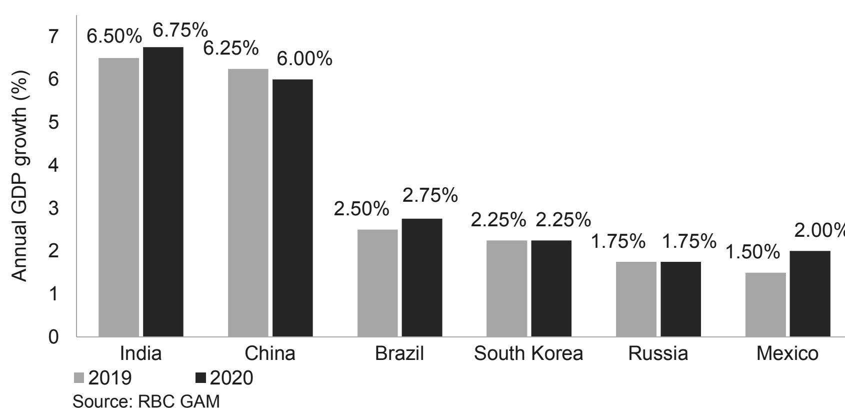
For the briefest of moments, the economic drag of protectionism had appeared to be waning. U.S. and Chinese negotiators were speaking optimistically to the media all spring, with a substantial trade agreement seemingly achievable. But everything changed in early May

Exhibit 9: RBC GAM GDP forecast for developed markets



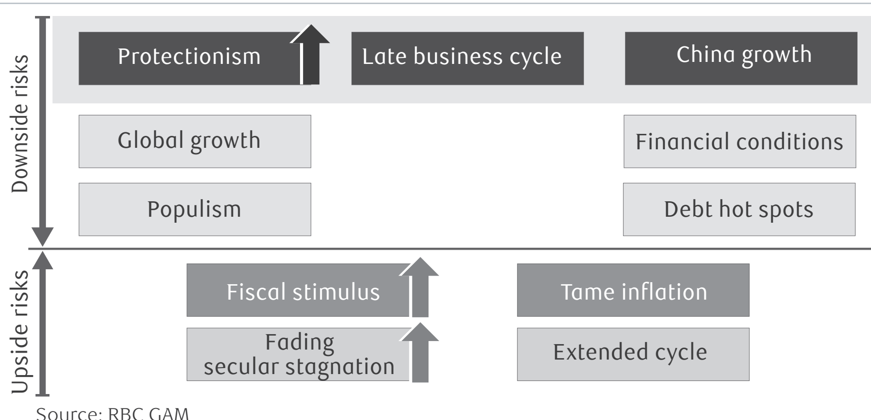
Source: RBC GAM

Exhibit 10: RBC GAM GDP forecast for emerging markets



Source: RBC GAM

Exhibit 11: Macro risks: Protectionism looms large among risks



Source: RBC GAM

when negotiations pivoted from the technocratic to the political level. Chinese President Xi could not abide many of the proposed changes and so excised nearly a third of the working document – in so doing, eliminating his country's most significant concessions plus the mechanisms needed to enshrine other elements into law.

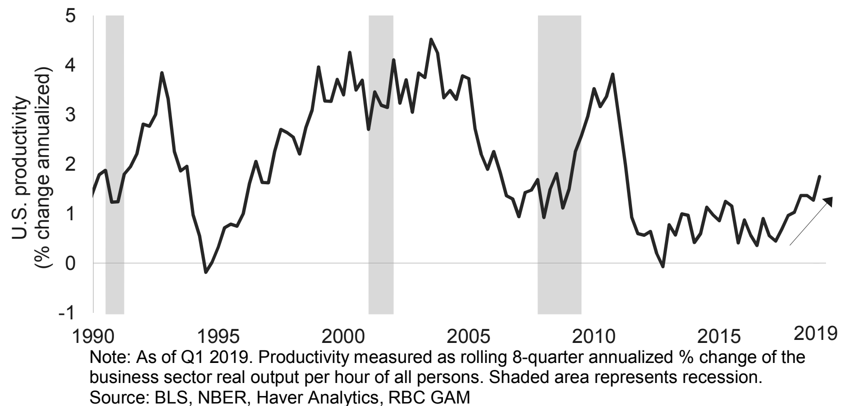
The U.S. rejected the revised text, and delivered on a long-delayed threat to increase tariffs on US$200 billion of Chinese products to 25 percent from 10 percent. China reciprocated with additional tariffs on US$60 billion of U.S. goods. The theoretical U.S. tariff rate has now tripled since 2017, though in practice corporate-level exemptions render the actual increase somewhat less (Exhibit 13).

Who's to blame for the negotiation breakdown?

From China's perspective, the country was being asked to make concessions that threatened to undermine its economic model by hobbling its state-owned enterprises, restricting its acquisition of intellectual property and easing capital controls, including the requirement that foreign firms enter into joint ventures with domestic ones.

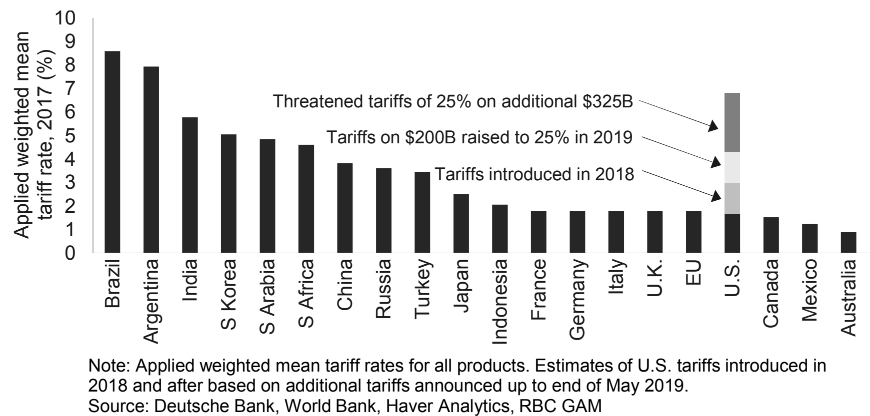
Meanwhile, from the U.S. perspective, China was merely being asked to change its laws so that they would align with those shared by the bulk of the World Trade Organization's members, a group into which China had been granted entry in 2001 on the expectation that it would voluntarily converge upon these shared principles over time.

Exhibit 12: U.S. productivity is gradually reviving



Note: As of Q1 2019. Productivity measured as rolling 8-quarter annualized % change of the business sector real output per hour of all persons. Shaded area represents recession.
Source: BLS, NBER, Haver Analytics, RBC GAM

Exhibit 13: U.S. tariff rate now substantially higher



Note: Applied weighted mean tariff rates for all products. Estimates of U.S. tariffs introduced in 2018 and after based on additional tariffs announced up to end of May 2019.
Source: Deutsche Bank, World Bank, Haver Analytics, RBC GAM

Given the substantial fault lines between the two camps and the complicated power dynamic of two economic heavyweights disinclined to admit defeat, our base-case scenario is that no significant deal will be achieved over the next few quarters. This aligns with the "negative" trade scenario depicted in Exhibit 14. U.S. GDP will likely be about 0.3 percent to 0.6 percent weaker than it would have been absent tariffs, and China should shed slightly more – 0.4 percent to 0.8 percent of GDP. Some of this damage has already accrued due to the tariffs initiated last year, but a sizeable chunk remains to be felt.

While the aforementioned tariff impact on GDP doesn't sound very large, protectionism still does considerable damage. The loss of up to 0.6 percent from U.S. GDP represents squandered economic output of US$126 billion annually, repeating every year that the tariffs remain in place.

Furthermore, the economic damage is likely somewhat higher than what traditional models calculate, as such models fail to capture the damage from rising non-tariff barriers (Exhibit 15). The U.S. and China have already started down that path, hammering one another's corporations with accusations and hindrances, and limiting the export of key technologies to one another.

Even with these additional effects penciled in, no scenario short of a full trade war seems capable of triggering a recession all by itself. While recent U.S.-China actions might feel an awful lot like a trade war, we reserve that definition for the worst-case scenario, which imagines not just a significant further increase in tariffs lobbed back and forth between the world's two economic superpowers, but tariffs also strewn globally, including on the crucial auto sector.

Lost in the noise of bad tariff news, it is important to acknowledge there have also been a handful of positive trade developments (Exhibit 16):

- Long-feared auto tariffs have been delayed until the fall.
- The U.S. has lifted steel and aluminum tariffs on Canada and Mexico.

The likelihood that the new North American free-trade agreement will be enacted has increased. Thanks to the removal of metals tariffs, Canada has expressed a willingness to ratify the deal, Mexico has been laying the legislative groundwork and U.S. Congressional Republicans are now more amenable as well. The agreement still has a difficult road ahead of

Exhibit 14: U.S. trade scenarios looking worse again

Scenario	Worst case	Negative	Slightly negative	Neutral	Best case
Likelihood	15%	40%	25%	10%	10%
Detail	Trade war	Substantial tariffs	Small tariffs	Trump tariffs unwind	Foreign barriers fall to pressure
Economic effect	U.S.: -2.1%	U.S.: -0.3 to -0.6%	U.S.: -0.1 to -0.2%	U.S.: 0.0%	U.S.: positive
	CN: -2.5%	CN: -0.4 to -0.8%	CN: -0.2 to -0.5%	CN: 0.0%	CN: ?
	CA: -2.0%	CA: -0.2 to -0.4%	CA: -0.1%	CA: 0.0%	CA: ?

Source: RBC GAM, Oxford, Bloomberg, OECD, Nomura, Goldman Sachs, UBS, Barclays, Fajgelbaum et al

Exhibit 15: Trade war ammunition extends well beyond tariffs

Tariffs:
- Universal
- Geographic filter
- Product filter

Non-tariff barriers:
- Import quota
- Domestic subsidy
- Border thickness
- Technical barrier
- U.S. blocking WTO judge appointments

Investments:
- Restrict inward capital flows
- Restrict inward corporate acquisitions
- Sell foreign holdings (China: U.S. bonds)

Export restrictions:
- Access to Chinese "rare earths"
- Access to advanced U.S. tech

Other pressure points:
- Immigration restrictions
- Constrain individual firms (ZTE, Huawei, Qualcomm, Micron, Apple)
- Access to $ clearance system
- Gov't procurement contracts
- Exchange rate manipulation
- Universal Postal Union
- Inflame public sentiment (boycott, tourism)
- Military posturing

Source: RBC GAM

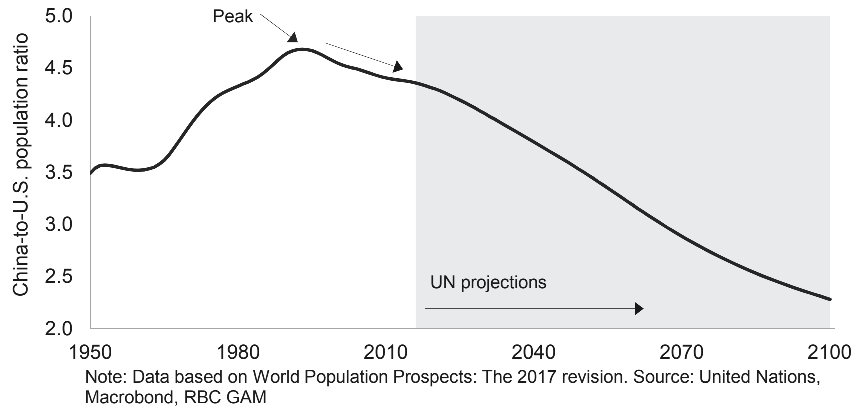
Exhibit 16: Key protectionist issues

Source: RBC GAM

it given the Democrat majority in the House of Representatives, but ultimate approval is becoming at least conceivable. The White House appears to be aiming to pass the legislation by this autumn, though that is far from assured.

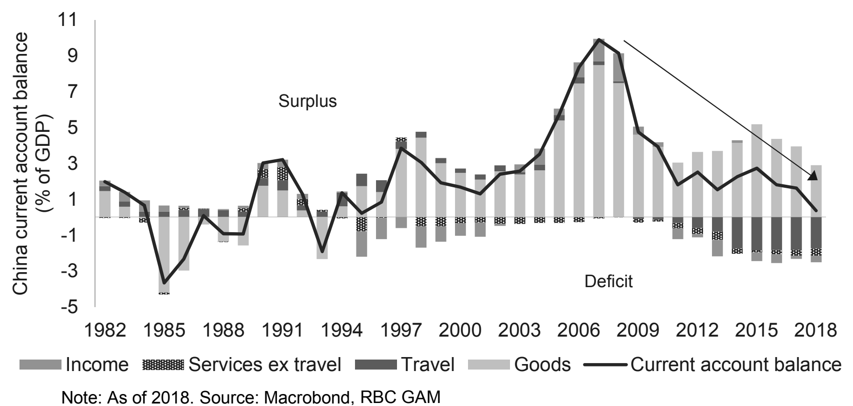
Viewed through a longer-term lens, we expect that frictions will regularly arise between the U.S. and China for many years to come. China's economic ascent challenges the U.S. hegemony that has prevailed for decades. History shows that the resulting multipolar era is frequently worse for globalization as competing cliques of nations form around the combatants, and this can exert a drag on global economic growth. But the observation that China has now ascended to the main stage does not mean that U.S. must exit stage left. In fact, one can mount a coherent demographic argument that the U.S. may even enjoy a second wind over the coming decades as China's population advantage falls from 4.3 times to just 2.3 times by the end of the century (Exhibit 17). Underlying this, the UN forecasts that China's population will collapse from 1.4 billion people today to just 1.0 billion by 2099 on the basis of net outward migration paired with an extremely low fertility rate that shows little sign of changing even after the country's one-child policy was lifted.

Exhibit 17: China's population advantage already shrinking



Note: Data based on World Population Prospects: The 2017 revision. Source: United Nations, Macrobond, RBC GAM

Exhibit 18: China's current-account surplus has almost vanished



Note: As of 2018. Source: Macrobond, RBC GAM

China's mixed signals

China now generates a third of global economic output, making it a central cog in the global economy's machinery. Today, it also represents a key fragility in the system. This is in part simply because it is so large that any stumble would reverberate around the world. Equally important, China is grappling with a variety of new structural challenges. By virtue of its own rising prosperity, China no longer enjoys the advantage it once offered as a low-cost producer. Moreover, the country's working-age population is declining. Structurally, then, China is likely to suffer slower economic growth over the long run.

It has gone little noted that China's current-account surplus – once among the largest in the world thanks to massive exports – has significantly shrunk, and may continue to (Exhibit 18). China still exports many goods, but it now also imports many services, and its citizens are increasingly spending their money on foreign holidays. This is rapidly closing what had been a massive financial imbalance in the world, and reduces the scope for China to acquire further U.S. Treasury bonds.

Turning from the structural to the cyclical, the Chinese economy stumbled significantly from the middle of 2018 into 2019, suffering the sting of U.S. tariffs and weaker global demand.

Chinese policymakers have responded in a measured but firm manner, depreciating the renminbi, cutting interest rates and delivering economic stimulus worth 1 percent to 2 percent of GDP (Exhibit 19).

For a moment, it appeared that this stimulus was beginning to stabilize China's 2019 growth, but the country's indicators have lately begun to descend once more (Exhibit 20). In fairness, the recent stimulus has not yet been fully absorbed and so may yet energize the economy over the remainder of 2019. Furthermore, policymakers could always deliver yet more stimulus, though they must balance any such temptation against managing already elevated debt levels.

Interestingly, the stimulus undertaken so far has tilted China toward tax cuts and away from its traditional emphasis on infrastructure spending. Tax cuts represent a more laissez-faire approach, but could prove less powerful for China given an extraordinarily high household savings rate of nearly 50 percent that may result in much of the tax cut being socked away rather than spent. Additionally, tax cuts deliver a short-lived economic boost, rather than the more sustained burn that comes from infrastructure spending. Thus, on both counts, Chinese growth seems likely to begin slowing again by 2020.

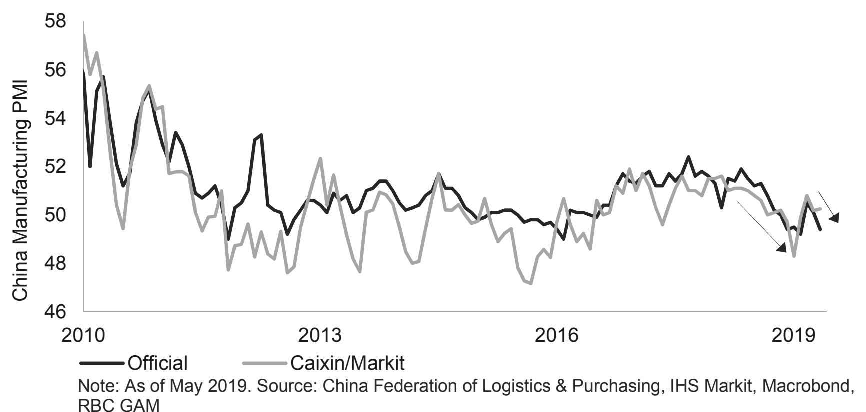
Overall, we forecast Chinese growth of 6.25 percent for 2019 – in the middle of the country's official 6.00 percent to 6.50 percent target range and broadly on consensus. We then assume

Exhibit 19: Chinese policymakers to the rescue, but short-lived?

Stimulus	Assessment
Currency	• Moderate depreciation over past year
Monetary policy	• Repeated rate cuts / money injections
Fiscal policy	• Fiscal stimulus worth 1-2% of GDP altogether • Local government infrastructure • Inducement for corporate cap ex • Personal income tax cuts • Corporate tax cuts: VAT & social security contribution • Encourage lending to manufacturers and small businesses
Regulations	• Easier housing market rules
Other considerations	
Prior track record	• Chinese policymakers historically among best in world • Have previously succeeded in restoring growth
Complications	• China's structural tailwinds fading • Trying not to re-inflate debt • New, unfamiliar, type of stimulus ➔ less infrastructure-driven
Bottom line	**• Stimulus should help to stabilize 2019 China growth • Watch Chinese debt for signs of excessive leveraging • Stimulus may be short-lived – growth concerns to return in 2020?**

Source: RBC GAM

Exhibit 20: China's manufacturing activity slipped after brief rebound



Note: As of May 2019. Source: China Federation of Logistics & Purchasing, IHS Markit, Macrobond, RBC GAM

Exhibit 21: U.S. is late cycle and moving forward

	Start of cycle	Early cycle	Mid cycle	Late cycle	End of cycle	Recession
Volatility			■			
Corporate profitability			■	■		
Prices			■	■		
Credit			■	■		
Business investment			■	■		
Employment			■	■	▒	
Inventories				■		
Housing				■		
Equities			▒	■	▒	
Sentiment			▒	■	▒	
Leverage				■	▒	
Economic trend				■	▒	
Consumer				■	■	
Economic slack				■	■	
Monetary policy				▒	■	
Cycle age					■	
Bonds				▒	■	▒
Scores for each stage of business cycle	0	0	7	14	7.5	0.5

Note: Dark shading indicates the most likely stage of business cycle (full weight); light shading indicates alternative interpretation (0.5 weight).
Source: RBC GAM

that growth drops to the bottom of that range, with below-consensus 6.00 percent growth penciled in for 2020. This is still fabulous by almost any other country's standards, but underwhelming for China.

Business cycle still reads late

Our business cycle scorecard for the bellwether U.S. market continues to advocate a "late cycle" conclusion (Exhibit 21). While this high-level interpretation has held steady for many quarters, the underlying inputs have continued to advance, such that the second most credible claim among the scorecard's inputs is now "end of cycle" rather than the tame "mid cycle" counterclaim that long commanded second place. The cycle is growing older.

Of the many ways to evaluate the state of the business cycle, many revolve in one fashion or another around the tightness of the economy. The U.S. now enjoys a rock-bottom 3.6 percent unemployment rate – the lowest in decades and the result of nearly a decade of uninterrupted economic growth. This is fabulous, but difficult to sustain: economies tend to become more accident-prone when they get this tight, as businesses struggle to find quality workers, inflation rears its head and high levels of risk appetite result in worse decision-making.

In a chronological sense, the current expansion is now near the longest ever (Exhibit 22). This should be no surprise, as recoveries tend to be especially lengthy after a deep recession like that of 2008-2009.

While credit markets remain reasonably healthy, we note that the U.S. delinquency rate on auto loans has increased significantly, and demand for credit is ebbing as it often does as the cycle grows late (Exhibit 23).

Arguably the most closely watched of business-cycle indicators is the slope of the yield curve. Some long-dated U.S. bond yields now trade below those of their shorter-dated counterparts (Exhibit 24). When this so-called curve inversion occurs, recessions have historically followed on average one year later, though with substantial variation.

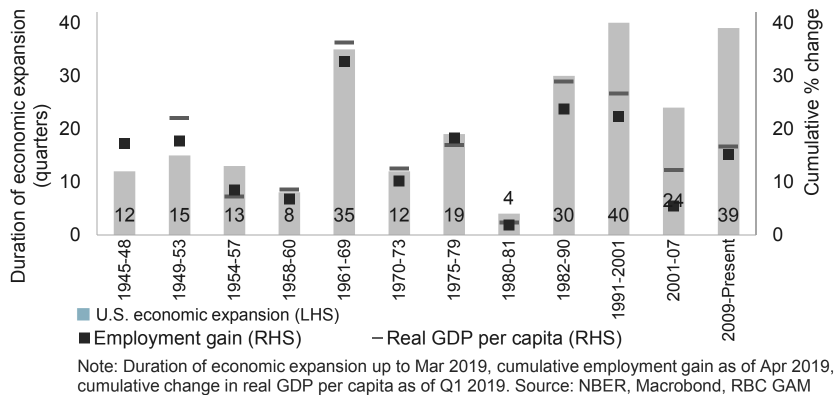
There is considerable debate as to whether the yield-curve signal can be considered reliable this time. Arguing against trouble ahead, the 3-month to 10-year curve has barely inverted, the 2-year to 10-year curve has not yet inverted at all, and the distortions resulting from quantitative easing mean that the curve may be exaggerating the extent of the risk.

However, the yield curve's latest warning still merits some attention. An alternative yield-curve metric has also inverted, and it can't be excused away by quantitative easing distortions. And there is a long history of analysts wrongly discounting prior curve inversions:

- In 2007, the global savings glut was said to be artificially depressing the long end of the yield curve, rendering the inverted yield curve meaningless.
- In 2000, fiscal surpluses and the resulting undersupply of bonds were said to be doing the same thing.
- In 1989, falling inflation was said to be artificially taming long-term yields, pulling them below shorter-term bonds.

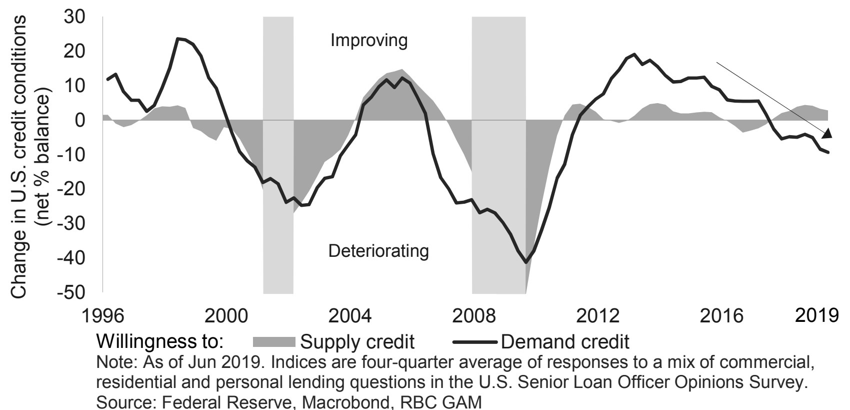
In each case, however, the signal was genuine: a recession ultimately followed.

Exhibit 22: Current economic expansion in historical context



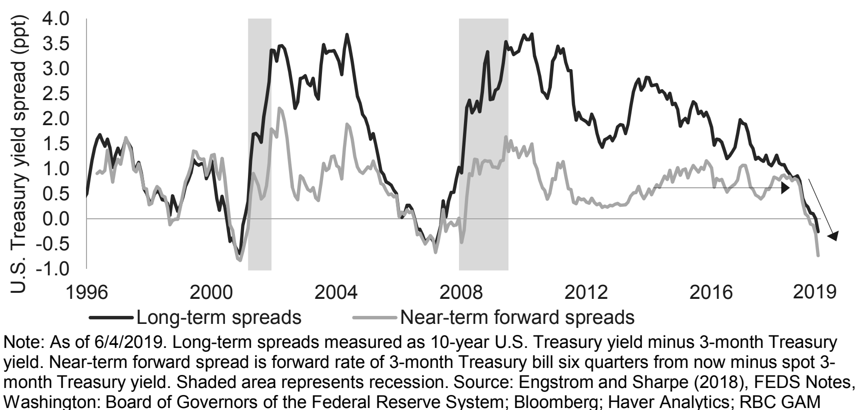
Note: Duration of economic expansion up to Mar 2019, cumulative employment gain as of Apr 2019, cumulative change in real GDP per capita as of Q1 2019. Source: NBER, Macrobond, RBC GAM

Exhibit 23: U.S. credit conditions going south



Note: As of Jun 2019. Indices are four-quarter average of responses to a mix of commercial, residential and personal lending questions in the U.S. Senior Loan Officer Opinions Survey. Source: Federal Reserve, Macrobond, RBC GAM

Exhibit 24: Yield curve signals rising recession risk



Note: As of 6/4/2019. Long-term spreads measured as 10-year U.S. Treasury yield minus 3-month Treasury yield. Near-term forward spread is forward rate of 3-month Treasury bill six quarters from now minus spot 3-month Treasury yield. Shaded area represents recession. Source: Engstrom and Sharpe (2018), FEDS Notes, Washington: Board of Governors of the Federal Reserve System; Bloomberg; Haver Analytics; RBC GAM

In summary, given the lateness of the cycle and the predictions embedded within the yield curve, the risk of recession is surely higher than usual, though neither imminent nor assured. This has provided a key motivation for the gradual reduction of risk-taking in our investment portfolios.

Inflation to edge higher

Although we have scaled our inflation forecasts back slightly in the latest quarter, we still mostly anticipate incrementally higher and modestly above-consensus inflation over the next two years. A variety of competing price pressures continue to vie for influence (Exhibit 25).

Inflation readings are already running warmer than they did for most of the post-crisis period, with tight economic conditions classically translating into brisker inflation. Wage growth is accelerating in the U.S. and elsewhere (Exhibit 26). In addition, protectionism almost inevitably leads to an increase in the price of goods.

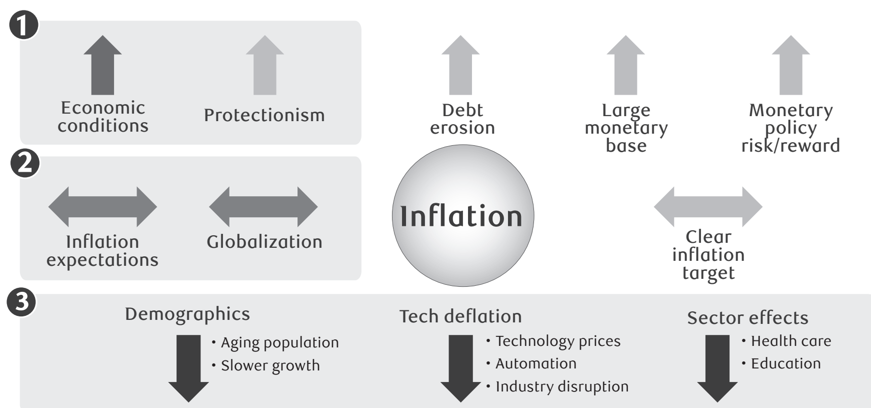
The reason we dare not forecast truly problematic inflation is that several structural dampeners continue to hold global prices in check. The first and arguably most powerful depressant is demographic. As Japan and increasingly Europe demonstrate, an aging population is not conducive to high inflation. Technological change represents a further structural deflationary force, not just because tech products become cheaper with time, but because automation is deflationary as well.

Accounting for these inflationary counterforces, we are left with developed-world inflation readings set to run in the 1.50 percent to 2.25 percent range, depending on the country and year (Exhibit 27). Japan is the exception, lying below that range, but even Japan appears to be managing a gradual increase in inflation over time after decades of deflation.

Central banks to the sidelines

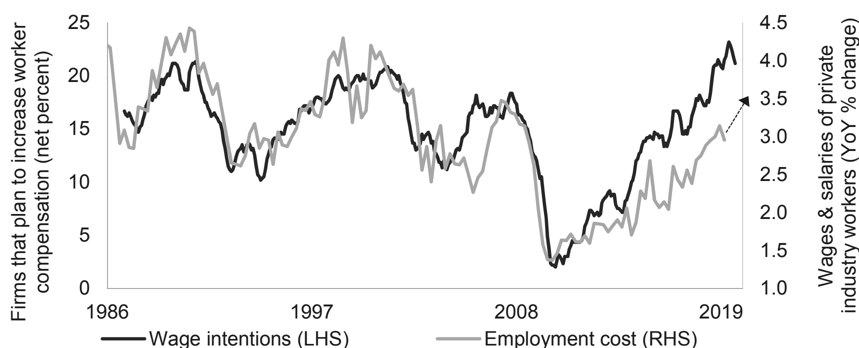
In response to ever-tighter economies and slightly higher inflation, developed-world central banks spent the past few years raising rates (in the U.S. and Canada) or at least positioning themselves more hawkishly (in the U.K. and the eurozone). However, everything changed at the end of 2018, when slowing growth and the plunge in financial markets signaled that higher interest rates were starting to do damage to the economy. It appeared that the sustainable interest rate was not only lower than in prior cycles, but possibly even lower than central bankers had realized.

Exhibit 25: Inflation barometer edging higher but still anchored



Source: RBC GAM

Exhibit 26: U.S. wages to continue to rise



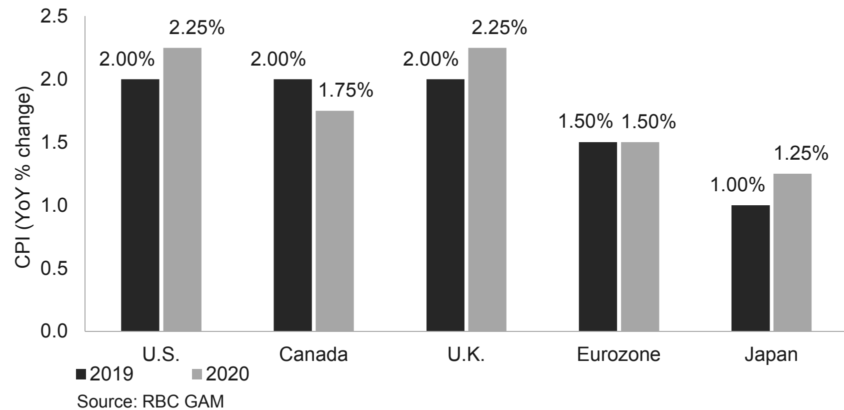
Note: 6-month moving average of intention to raise wages in next 3 months (Apr 2019) in 6-month lead. Wages and salaries as of Q1 2019. Source: NFIB Small Business Economic Survey, BLS, Haver Analytics, RBC GAM

To their immense credit, central banks responded to this new information by abandoning their rate-tightening agendas, and bond yields plummeted. Our base case scenario envisions no change to policy rates in most of the major developed markets over the coming year.

While there are conceivable scenarios involving a pivot back to rate hikes if growth proves unexpectedly buoyant, it is more likely that central banks could be pushed into delivering outright stimulus as they grapple with the perils of protectionism and an aging business cycle. Financial markets have tentatively priced in rate cuts for several central banks.

Lastly, a brief word on Modern Monetary Theory (MMT), a radical idea connected to the conduct of monetary policy that has lately achieved some traction on the leftmost wing of the Democratic Party. The idea is that, given central banks were able to print so much money during the financial crisis without stirring inflation, why not allow the Treasury Department to do the money printing instead, and directly fund major government initiatives with the proceeds? The problem is that government discipline would inevitably diminish and, eventually, problematic inflation would arise. Past attempts, ranging from ancient Rome to modern Venezuela, have ended in failure. Fortunately, MMT is unlikely to actually be implemented, in part because the candidates flirting with the idea are not especially likely to win the Democratic nomination for the 2020 election, and in part because Congress could always block any attempt to reconfigure the economic system.

Exhibit 27: RBC GAM CPI forecast for developed markets



U.S. keeps chugging along

Whereas many economies have been slowing palpably over the past 18 months, the U.S. has managed to limit its deceleration better than most. Illustrating this, U.S. GDP expanded 3.2 percent over the past year, the fastest clip in four years. Consumer demand and the service sector remain particular standouts.

However, the sailing has not been perfectly smooth. A material chunk of the recent GDP strength was due to rising inventory levels rather than demand, potentially exerting an undertow against future GDP advances. Business investment and manufacturing have also been weakening, whether measured as an input to GDP, in the form of durable goods orders, or via the ISM Manufacturing Index.

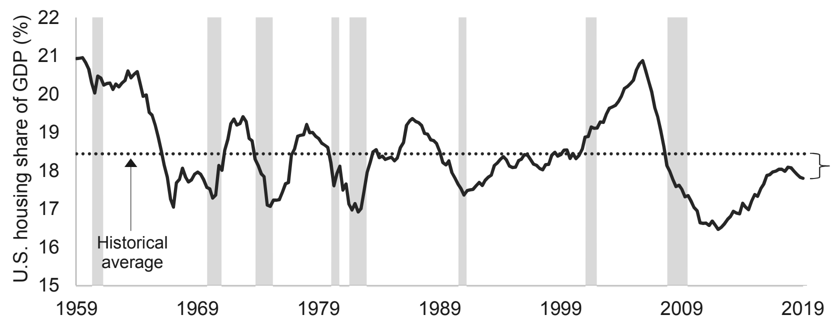
The U.S. housing market also continues to moderate, though no bubble exists in prices or the volume of construction (Exhibit 28). The recent dovish pivot by the U.S. Federal Reserve (Fed) could temper any further weakness in residential real estate. For the moment, we anticipate an unchanged fed funds rate over the coming year, though the Fed's bias tilts toward cuts should the economy or inflation require further help. After a long period of appreciation, we look for the U.S. dollar to begin a peaking process versus the world's other major currencies.

Looking forward, lower interest rates and what appears to be a rising economic speed limit are providing helpful support, while protectionism and fading U.S. fiscal stimulus are exerting the opposite influence. It adds up to decent though decelerating economic growth of 2.50 percent in 2019, followed by 2.00 percent in 2020 as the fiscal bite deepens. These forecasts position us around the consensus, though we note that a strong handoff from 2018 means that the remainder of 2019 need only achieve around 2.00 percent annualized growth per quarter to

achieve our forecast. Those growth rates should prove consistent with 2.00 percent inflation in 2019 and a slightly faster 2.25 percent in 2020 as the U.S. economy becomes even tighter.

U.S. politics warrant a moment of attention (Exhibit 29). Since the Democrats captured the House of Representatives last year in the midterm elections, the political narrative in the U.S. has been substantially altered. It is not that Democrats can suddenly legislate – they cannot given that Republicans are firmly in control of the Senate and White House. What has changed is that the legislative process is now effectively paralyzed. Do not expect any major legislative achievements in 2019 or 2020. Do expect bigger battles between the parties, including the possibility of another government shutdown this fall, potentially partnered with another debt-ceiling standoff and/or a year-end fiscal cliff. Looking beyond 2019, investors are beginning to pay attention to the 2020 presidential election. At present, they don't appear to like what they see, given the considerable number of leftist Democrats vying for the nomination versus the populist Republican incumbent. Markets generally prefer centrist politicians, of whom there are presently few.

Exhibit 28: U.S. housing is cooling



Note: As of Q1 2019. Housing share of GDP calculated as residential investment, housing rent (both actual and imputed for home owners), maintenance and repair of dwellings, utilities, plus half of furniture, textiles, appliances & equipment for house and garden, household utensils and supplies. Historical average from 1959 to present. Shaded area represents recession. Source: Haver Analytics, RBC GAM

Exhibit 29: Divided Congress in 2019 – 2020

1	2	3
Paralysis	**Bigger battles**	**Unaffected**
No tax cuts 2.0	Shutdown	Tariffs
No immigration reform	Debt ceiling	Foreign policy
No infrastructure reform	Fiscal cliff	Executive orders
No health care reform	USMCA approval	
	Trump hearings	

Presidential election 2020: markets fret over populist right vs. far-left scenario

Source: RBC GAM

U.K. gets even more complicated

The U.K. economy continues to be undermined by chronic Brexit uncertainty, as evidenced by a general weakening trend in business investment (Exhibit 30). Other British economic indicators mostly corroborate an unenthusiastic economic advance. Looking forward, we forecast 1.50 percent growth for both 2019 and 2020, a decent outcome by recent standards, if not relative to history. This forecast incorporates the combination of a favourable GDP handoff from the prior year, a substantial decline in the pound and our expectation that the worst Brexit outcomes are avoided.

However, let the record show that our base-case forecast of a soft Brexit is far from certain. In fact, as if the many twists and turns of the Brexit saga to date have not been enough, the level of uncertainty just took another leap higher with the resignation of British Prime Minister Theresa May. The next prime minister will be plucked from the Conservative Party by the end of July. At present, the leading candidate is former London mayor Boris Johnson,

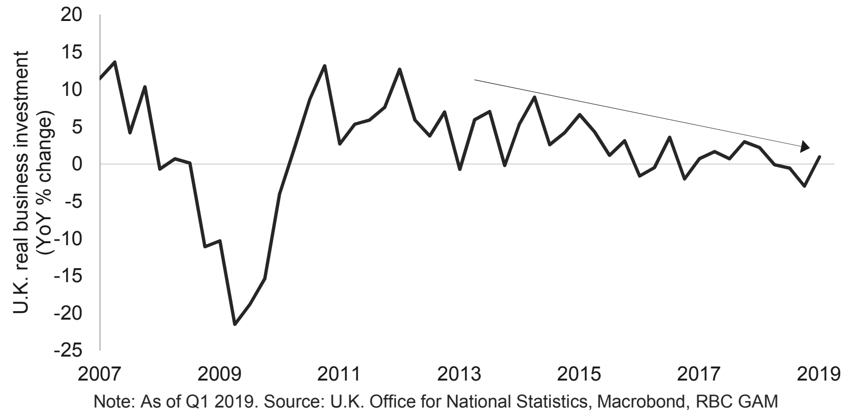
who strongly supports Brexit. Trailing him are candidates who mostly tilt even further to the right.

A kaleidoscope of possibilities emerge, depending on the outcome of the leadership race and the tack pursued by the next prime minister. The European Union (EU) does not appear capable of substantially altering its offer to the U.K., and time is growing short as an October 31, 2019, deadline approaches. The next prime minister could prove capable of jamming Theresa May's thrice rejected deal through parliament on the back of a fresh mandate, resulting in a fairly soft Brexit outcome. But, at the same time, the risk of a harder "no deal" Brexit has clearly risen. Conversely, a parliamentary vote of no confidence could interrupt that strategy, resulting in a general election, a fragmented parliament, and quite conceivably a second referendum as the price of forming a coalition. That scenario could well result in no Brexit at all.

The bottom line is that, three years after the Brexit vote, scant progress has been made in narrowing the range of possible future relationships between the U.K. and EU. The error bars around our economic forecasts are accordingly higher in the U.K. than almost anywhere else.

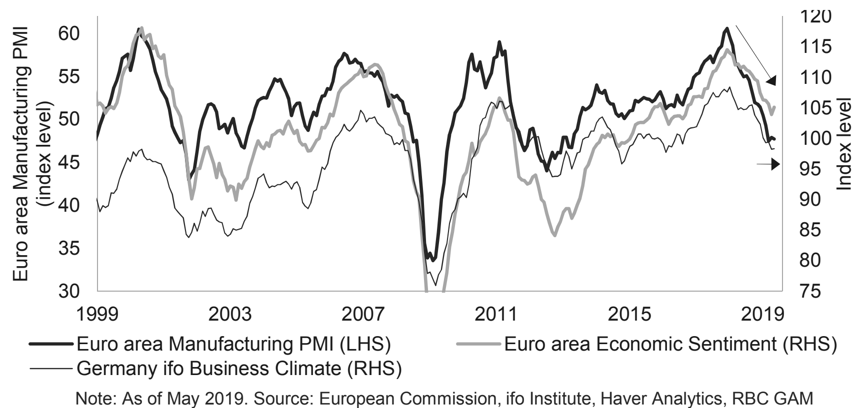
Returning to the details of the short-term forecast, we look for U.K. inflation readings of 2.00 percent and 2.25 percent in 2019 and 2020, respectively, a little higher than for most of the rest of the developed world, due in part to further anticipated weakness in sterling. The Bank of England appears likely to remain on the sidelines for the moment, but could spring into action should Brexit-related damage increase. Governor Mark Carney's term ends in January of 2020, meaning his replacement may be involved in any such action.

Exhibit 30: U.K. business investment had been decelerating



Note: As of Q1 2019. Source: U.K. Office for National Statistics, Macrobond, RBC GAM

Exhibit 31: Eurozone's downshift stabilizing?



Note: As of May 2019. Source: European Commission, ifo Institute, Haver Analytics, RBC GAM

Eurozone in slow-growth mode

After a long period of weakening growth, some eurozone economic indicators are now tentatively pointing to stabilization (Exhibit 31). The continent stands to benefit from a bit of additional fiscal stimulus, and it remains the case that the Eurozone is not as far along in its business cycle as the U.S, highlighting the possibility that the region could enjoy a longer growth trajectory ahead.

That said, it is not at all clear that the Eurozone would be resilient enough to sidestep any U.S. slowdown, rendering its advantageous positioning in the cycle potentially moot. Furthermore, the fact that the European Central Bank's (ECB) policy rate remains jammed in negative territory and that it was never able to shrink its distended balance sheet could seriously limit any effort to recover

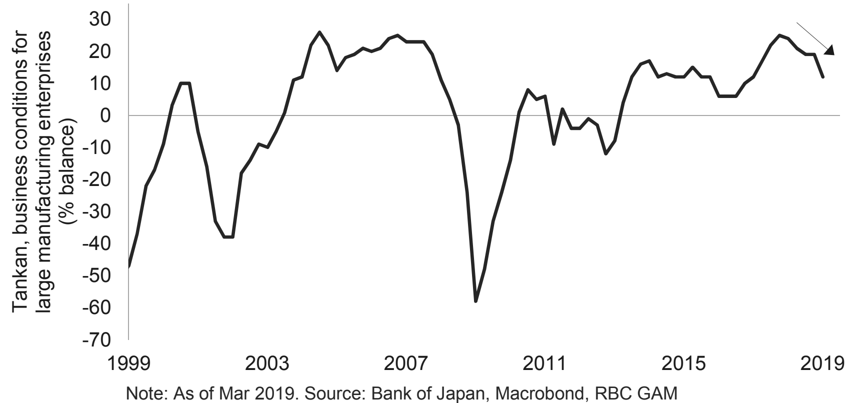
from a future downturn. For the moment, the ECB is likely to keep its policy rate on hold, but it has already increased its liquidity provisions and there is a rising chance that it delivers additional stimulus.

The eurozone's fundamental problem is that it appears to be suffering from a mild form of Japanification – the condition whereby an old population paired with a low fertility rate translates into slow growth, low inflation and rock-bottom interest rates. This development partly accounts for our forecast for eurozone GDP growth of just 1.25 percent in 2019 and 2020. Although hardly inspiring, our forecast is actually slightly above consensus for 2019 and not a bad outcome relative to the Eurozone's current economic speed limit. Of course, the possible arrival of U.S. auto tariffs represents a downside risk, though we are more inclined to view these tariff threats as a bargaining tactic than a permanent millstone.

Eurozone politics remain difficult. Economic growth stands to be affected by whatever Brexit path is eventually pursued, and populism, notably in Italy, has not yet peaked on the continent. The recent EU elections weakened the Eurozone's political centre while bolstering far-left and far-right movements. That said, Greek risks may be starting to shrink based on expectations that an imminent election could yield a more centrist government. Overall, it is reassuring that a solid majority of Eurozone residents still prefer remaining within the pact.

In part for aforementioned Japanification reasons, eurozone inflation is set to continue lagging most of the developed world, hovering in the range of 1.50 percent for both 2019 and 2020. Part of this weakness may arise from the euro, which we expect to appreciate versus the dollar.

Exhibit 32: Japanese business conditions deteriorating



Note: As of Mar 2019. Source: Bank of Japan, Macrobond, RBC GAM

Japan braces for tariffs and tax hikes

The Japanese economy has an extremely low sustainable economic-growth rate, by virtue of its own aging population, low fertility and limited immigration. In this context, the country's GDP growth of 0.8 percent over the past year is far from disastrous.

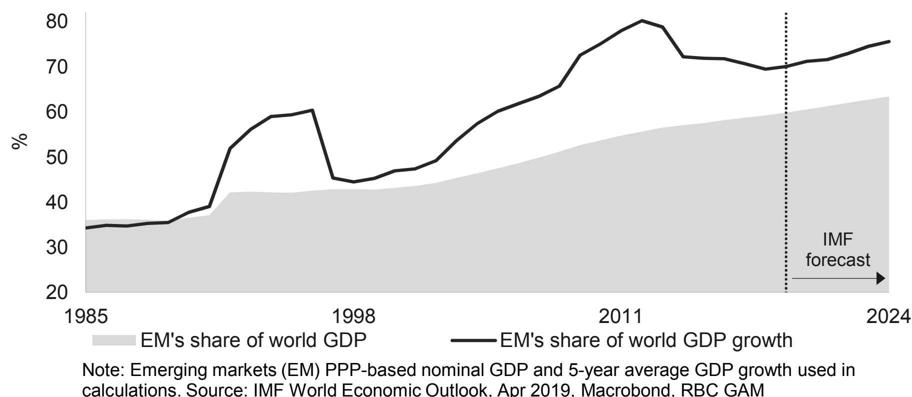
However, the latest economic performance is nevertheless underwhelming when considered in the context of efforts by Prime Minister Abe over the past several years to implement labour, trade and governance reforms in the hope of unleashing sustainable growth of more than 1 percent. Alas, the full extent of the theoretical gains have not been realized, in part because the reforms are still very much incomplete.

The recent weakening of Japan's business outlook is indicative of several challenges (Exhibit 32). First, the Chinese economy has been slowing, which may hit Japan via trade flows. Second, the U.S. is threatening Japan with auto tariffs. The most likely eventual outcome is a new trade agreement between the two countries, with Japan agreeing to limit auto exports to the U.S. Third, Japan plans to increase its sales-tax rate this fall, with the intent of helping to close the country's large fiscal deficit. However, as demonstrated by the country's first sales-tax increase as a part of Abenomics, Japanese consumers go on a buying spree before the increase and then sit on their wallets for a lengthy period thereafter. This translates into so-so GDP growth (by Japanese standards) of 0.75 percent in our 2019 forecast, and then merely 0.50 percent in 2020 as the buyer's strike weighs.

The sales-tax hike should also increase inflation, with the implication that Japanese inflation may hit a semi-respectable 1.00 percent in 2019 and 1.25 percent in 2020. The underlying

inflation trend will not have increased to the same extent, of course, but we do detect a gradual upward tendency on that front as well – a welcome development for the Bank of Japan (BOJ). That said, there is still no urgency for the BOJ to tighten as the 2 percent inflation target has not yet been met. Negative rates and ongoing quantitative easing thus remain likely. This exposes Japan to the same vulnerability as the eurozone: the market has limited means of mustering policy support if confronted with a global economic downturn.

Exhibit 33: Emerging markets matter for the world



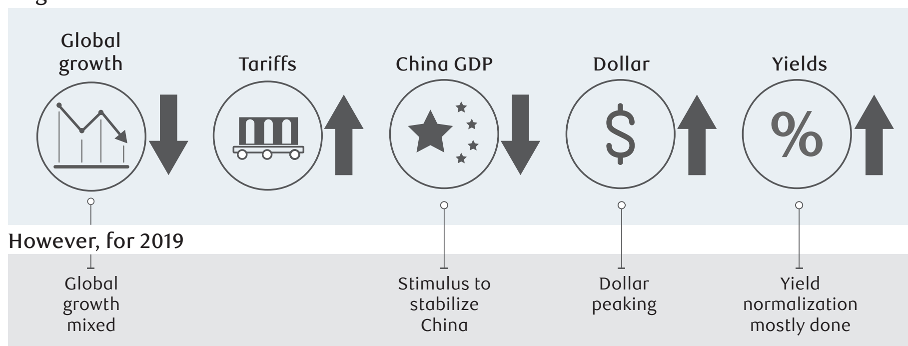
Note: Emerging markets (EM) PPP-based nominal GDP and 5-year average GDP growth used in calculations. Source: IMF World Economic Outlook, Apr 2019, Macrobond, RBC GAM

Emerging-market growth advantage to increase

Emerging-market economies remain key contributors to global economic output and growth, led by China (Exhibit 33).

Emerging-market economies encountered a slew of macroeconomic challenges in 2018, limiting their subsequent performance (Exhibit 34). These adversities included decelerating global growth, rising tariffs, a slowing Chinese economy (of significance both because China is an emerging-market nation and because it is a key buyer from other emerging-market countries), a stronger U.S. dollar and higher interest rates.

Exhibit 34: Emerging-market challenges significant, but diminished



Source: RBC GAM

Not all of these issues have been dealt with, but several have. We see some signs that the erosion of global growth has been stabilized and Chinese stimulus efforts could bear fruit. We forecast that the U.S. dollar soon stops appreciating, and we believe interest rates can drift mostly sideways from here. These developments hardly add up to an emerging-market economic boom, but they do offer a slightly more stable foundation. We forecast GDP growth of 5.25 percent in both 2019 and 2020 for our basket of six emerging-market economies, down from prior years, but achieving a degree of stability that was elusive in recent years.

Possibly of greater importance, the IMF anticipates that the emerging-market growth advantage over developed nations will expand materially in 2019 and 2020 (Exhibit 35). An expanding gap has historically been associated with the outperformance of emerging-market equities.

Canadian macro challenges

The Canadian economy is sending conflicting signals. GDP-related metrics flag an economy that has slowed considerably over the past six months (Exhibit 36). However, job creation has done the opposite, accelerating at an unusually brisk pace. This is a curious divergence as it suggests Canadian businesses are eagerly adding workers who are

not producing much. We suspect the dissonance will not persist for long, with reported job creation likely to slow and reported growth to modestly revive. The economy is still likely to remain fairly soft, with the Bank of Canada therefore unable to deliver on its prior rate-hiking aspirations.

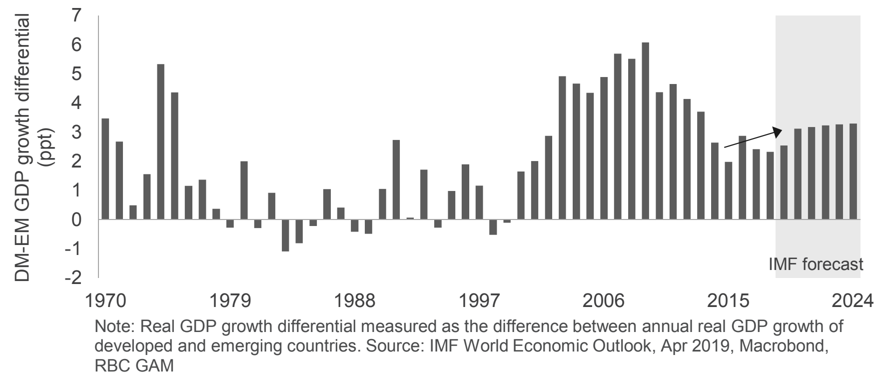
The economy's growth challenges are fourfold (Exhibit 37). First, U.S. growth has slowed somewhat, and this is the single best predictor for the Canadian economy.

The second headwind is Canada's limping oil market. Although the global price of oil has improved on more balanced oil inventories (Exhibit 38) and the Canadian oil spread no longer yawns wide, transporting Canadian oil to market is still an issue and the broader regulatory environment is not conducive to capital expenditures in the sector.

Third, Canada's housing market is no longer the growth driver that it once was. Home prices, housing starts, household credit growth and existing home sales are all softer (Exhibit 39). Arguing that this weaker market may persist, interest rates have risen from their lows and housing regulations have been materially tightened in recent years. Furthermore, Canadian consumers have a diminished ability to absorb future bad economic developments than do Americans, as articulated by high household debt levels and a household-savings rate that is less than half that of the U.S., and accordingly lower consumer confidence readings (Exhibit 40).

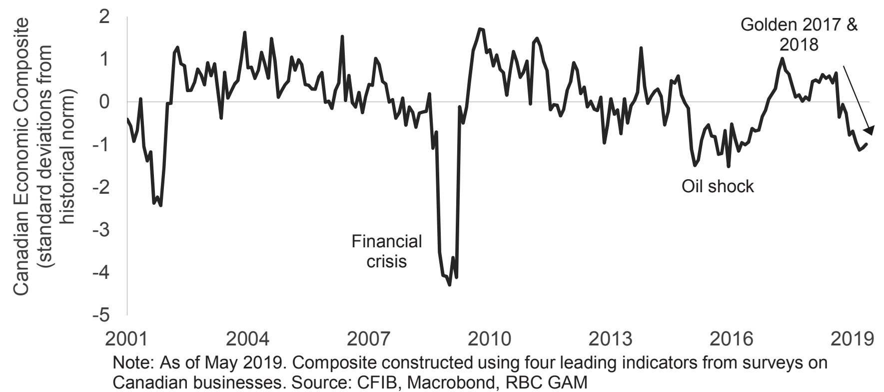
Fourth, Canada's economy continues to be held back by higher income-

Exhibit 35: Emerging-market growth advantage to increase



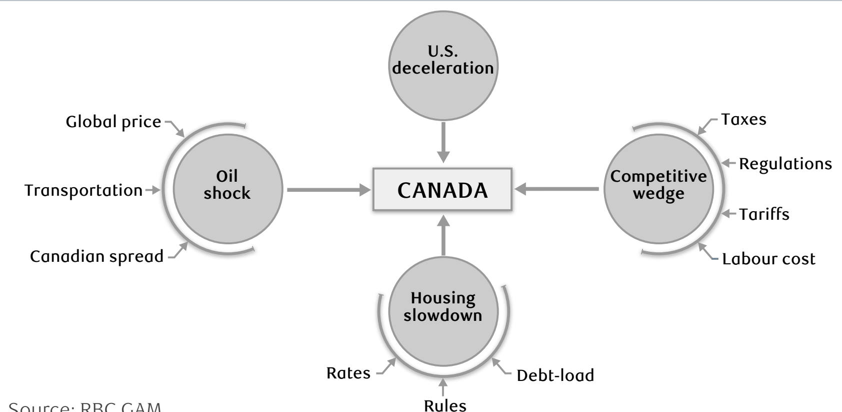
Note: Real GDP growth differential measured as the difference between annual real GDP growth of developed and emerging countries. Source: IMF World Economic Outlook, Apr 2019, Macrobond, RBC GAM

Exhibit 36: Leading indicators predict muted growth for Canada



Note: As of May 2019. Composite constructed using four leading indicators from surveys on Canadian businesses. Source: CFIB, Macrobond, RBC GAM

Exhibit 37: Canadian macro challenges



Source: RBC GAM

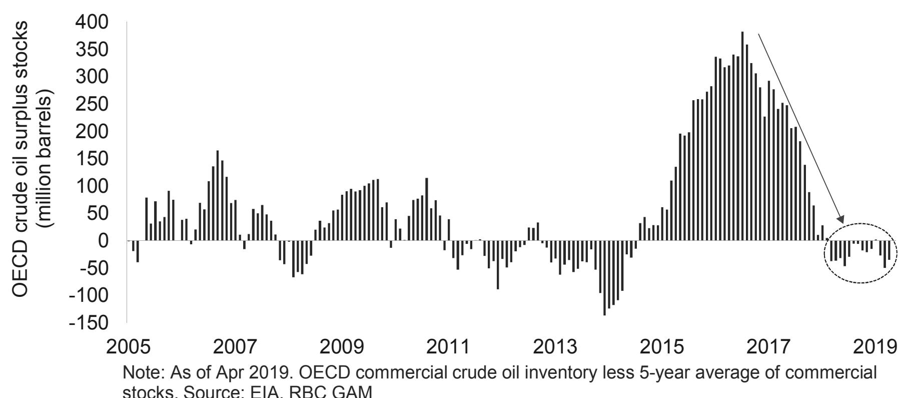
tax rates and a larger regulatory burden on companies than is faced in the U.S. The latest polling on the federal election this fall points to the possibility of a more business-friendly government, though any hope of significant new stimulus may be limited by the desire to tame the country's longstanding fiscal deficit.

On the basis of recent economic weakness and ongoing challenges, we have lowered our 2019 GDP forecast to 1.25 percent from 1.5 percent and left our 2020 forecast unchanged at 1.50 percent. Canadian inflation should be around 2.0 percent in 2019, followed by 1.75 percent in 2020. The Canadian dollar can likely soften slightly further in this environment.

Plummeting bond yields reintroduce valuation risk

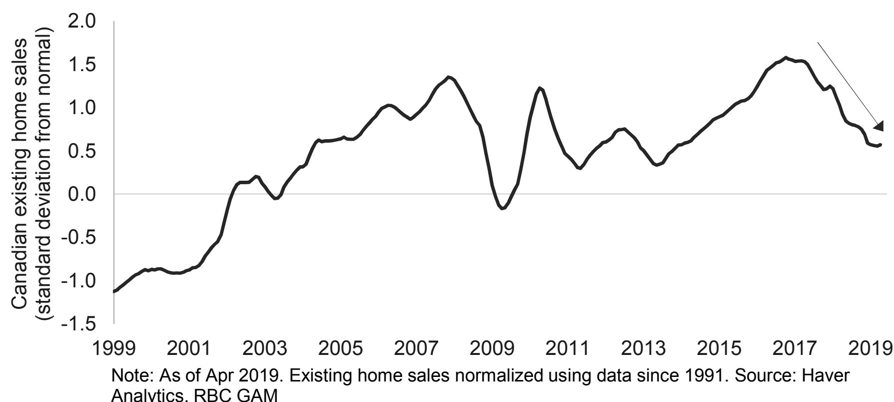
Government-bond yields plunged in the three months ended May 31, 2019, as investors sought safe havens against a mixed macroeconomic backdrop and intensifying protectionist actions. The yield on the U.S. 10-year bond fell 60 basis points between the beginning of March and the end of May to its lowest level since 2017 and now sits more than 100 basis points below its 2018 high (Exhibit 41). Yields on 10-year government bonds in Japan and Germany fell further into negative territory and the German 10-year bund yield touched its lowest level on record. At these levels, investors are pricing in dire outcomes, and yields appear unsustainably low if a recession is avoided. Our own models suggest that bond yields are well below their equilibrium levels and that the risk of fixed-income losses is elevated in all regions,

Exhibit 38: Global oil inventory normalized, now in deficit



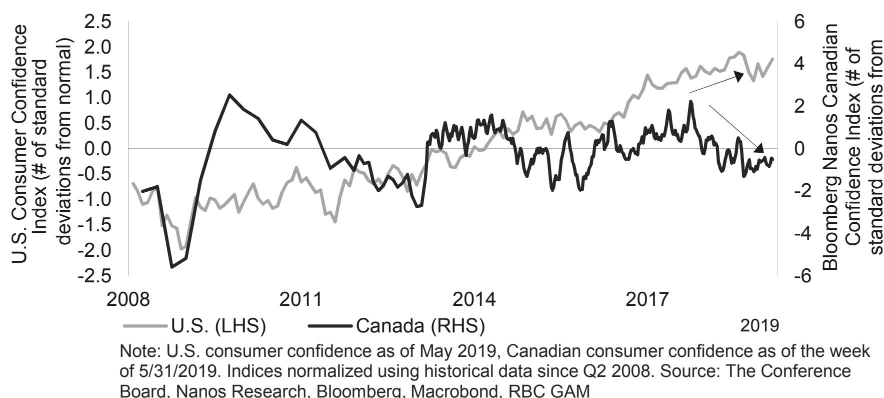
Note: As of Apr 2019. OECD commercial crude oil inventory less 5-year average of commercial stocks. Source: EIA, RBC GAM

Exhibit 39: Existing home sales have declined considerably



Note: As of Apr 2019. Existing home sales normalized using data since 1991. Source: Haver Analytics, RBC GAM

Exhibit 40: U.S. and Canadian consumers on different paths



Note: U.S. consumer confidence as of May 2019, Canadian consumer confidence as of the week of 5/31/2019. Indices normalized using historical data since Q2 2008. Source: The Conference Board, Nanos Research, Bloomberg, Macrobond, RBC GAM

but more so outside North America (page 38).

In our view, the threat to sovereign-bond prices stems from the potential for a significant increase in real interest rates. Separating our nominal bond model for U.S. Treasuries into its two components – an inflation premium and real rate of interest – helps illustrate this point (Exhibit 42). The inflation premium embedded in our model is around 2 percent, not far from where we expect inflation to be over the next several years, but the real (or after-inflation) yield is unsustainably low. With no real return on offer, investors are not being rewarded for saving, and we think that over time investors will inevitably demand a return for deferring consumption. Our model assumes real interest rates revert to their historical average of 2.1 percent and that this increase occurs gradually. Such an increase in real yields, even if stretched over many years, would act as a headwind for bond prices and could lead to low or even negative total returns in fixed income for a very long period of time.

Volatility remains, but other signs of stress are limited

Economic growth is sluggish, but signs of stress in capital markets are hard to find. Volatility has increased, but this is to be expected in a late-cycle environment where the yield curve is flat. Exhibit 43 plots the VIX alongside the slope of the yield curve as measured by the spread between 2-year and 10-year Treasury yields. The yield curve in the chart is flipped upside down and advanced 30 months,

Exhibit 41: 10-year government bond yields

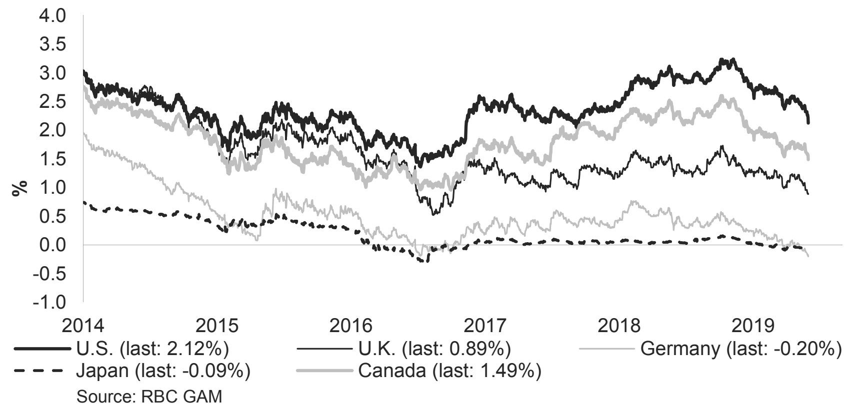
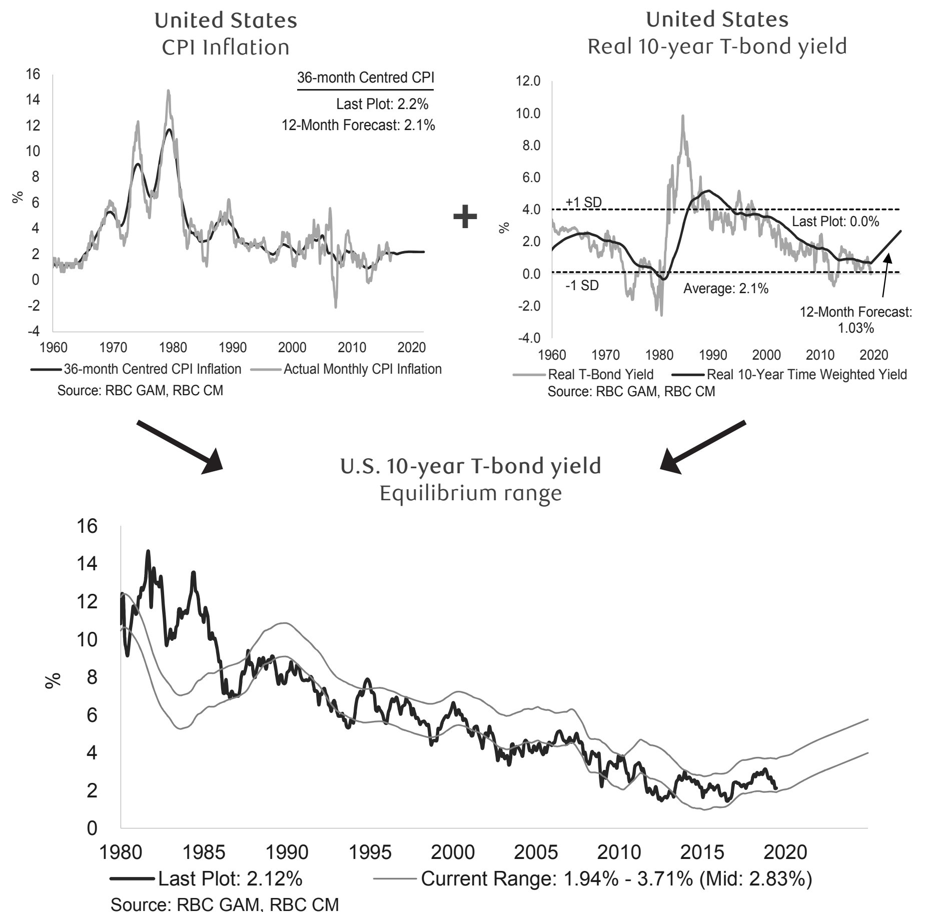


Exhibit 42: U.S. 10-year bond yield
Fair-value estimate composition



suggesting that the volatility markets are experiencing today is the result of the flattening in the curve that began in 2015. The fact that the yield curve remains extremely flat suggests that we should expect more bumpiness in financial markets going forward.

But volatility is not necessarily a cause for concern unless it's accompanied by other negative signals. We consider the behaviour of credit markets to be a good early warning signal for trouble ahead. While credit spreads have widened slightly from their narrowest in 2018, they remain tighter than historical averages and default rates are near record lows (Exhibit 44). The fact that credit spreads are so narrow suggests corporations are in good financial health and that investors are not overly concerned about the ability of companies to meet their debt obligations.

Stocks tumble on intensifying protectionism and slower earnings growth

This year's powerful stock-market rally came to an end in May as President Trump increased tariffs on China, slashing hopes that the world's two largest economies would strike a trade deal. Subsequent declines in all major equity markets resulted in modest losses for most regions for the three-month period ended May 31, 2019. Emerging-market equities were hit the hardest by intensifying protectionism and related gains in the U.S. dollar, with the MSCI Emerging Markets Index falling as much as 10 percent from its April 2019 peak. Other regions declined less and the S&P/TSX Composite Index

Exhibit 43: U.S. yield curve vs. VIX volatility

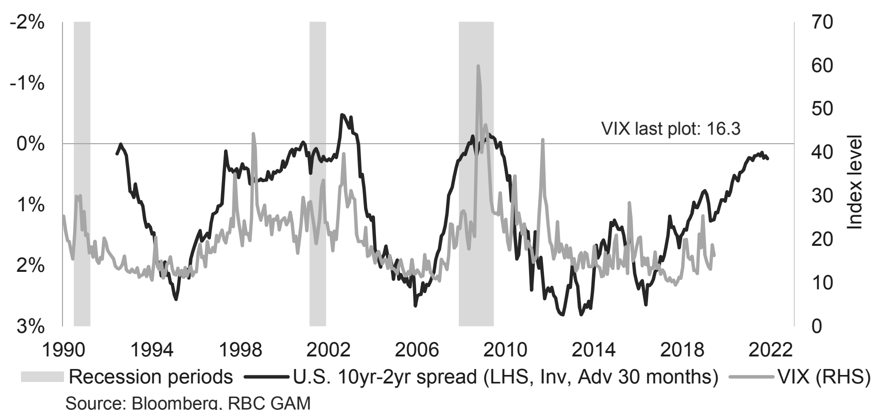


Exhibit 44: High-yield bond spread

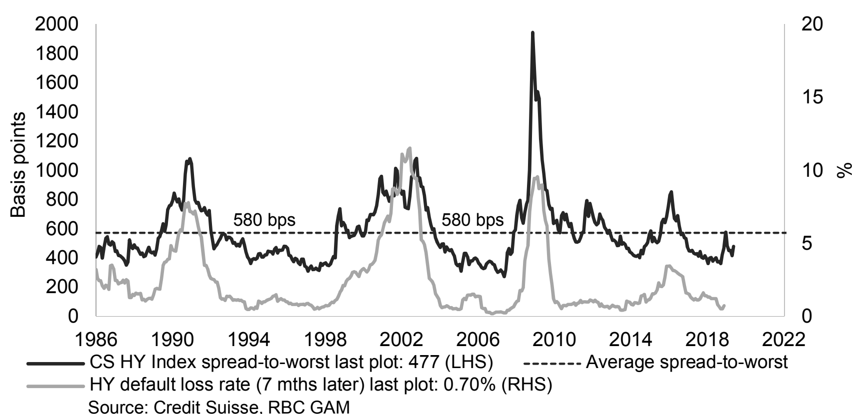
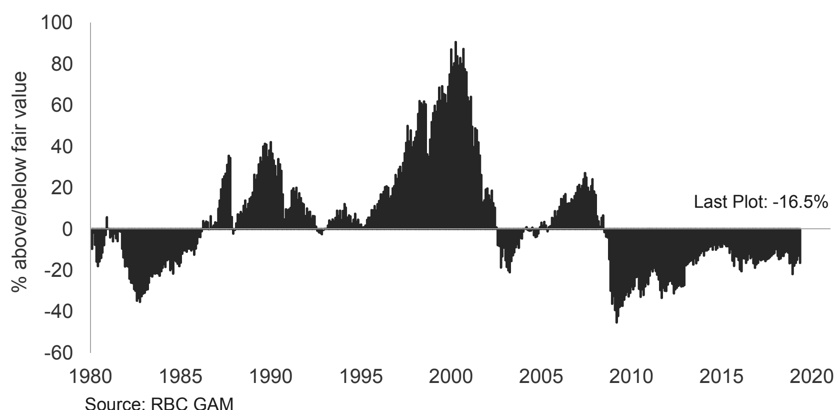


Exhibit 45: Global stock-market composite
Equity-market indexes relative to equilibrium

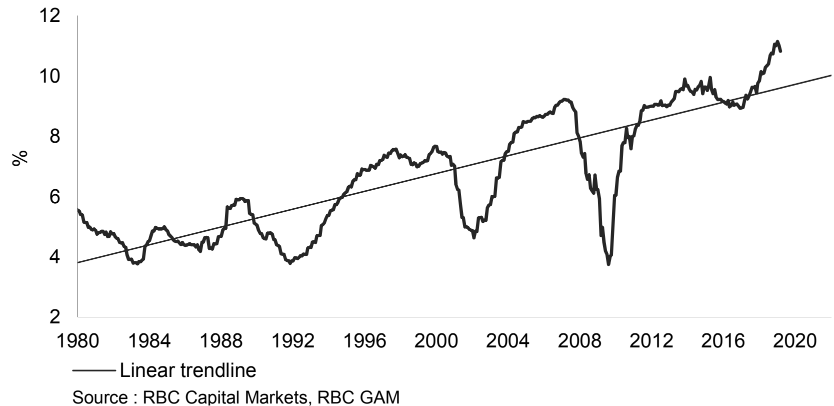


managed to eke out a gain over the period.

According to our valuation models, the S&P 500 Index remains the market with the highest valuation among major regions but it is still slightly below our modelled estimate of fair value (page 39). On this basis, other regions are more attractive and our global composite of equity markets suggests that stocks remain at a decent distance below fair value (Exhibit 45).

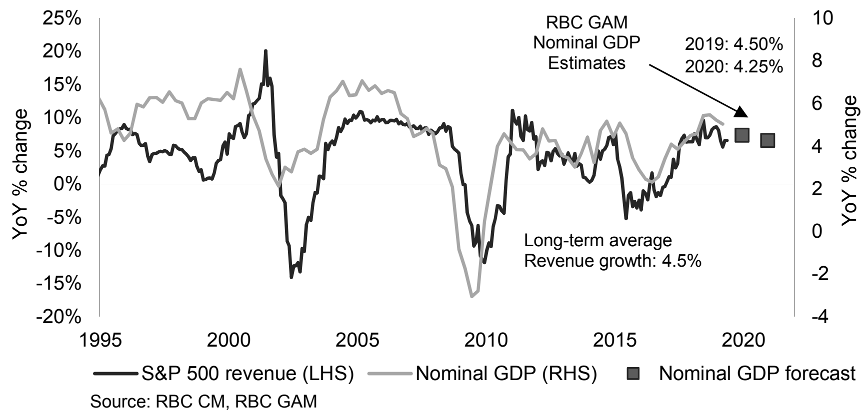
The challenge for equity markets is not valuations, but the fact that earnings growth has stalled. Aggregate S&P 500 earnings grew just 1.5 percent on a year-over-year basis in the first quarter, markedly slower than last year's 20 percent advance on the back of stronger economic growth and corporate-tax cuts. Widening profit margins has been a major tailwind to earnings for several years, but they reversed course in the past quarter (Exhibit 46). The result is that even though year-over-year revenue growth has been solid at 5.6 percent, rising costs mean that less of the extra revenue flows to the bottom line. We expect revenue growth to remain in the mid-single-digit range consistent with our nominal GDP forecasts for this year and next (Exhibit 47). Earnings growth stands to re-accelerate if margins stabilize at current levels. In fact, analyst estimates suggest that the narrowing in profit margins is likely to prove transitory and that earnings growth may re-accelerate toward the end of the year, providing fundamental support for the bull market (Exhibit 48) Nevertheless, rising revenues and

Exhibit 46: S&P 500 Index
Net margin



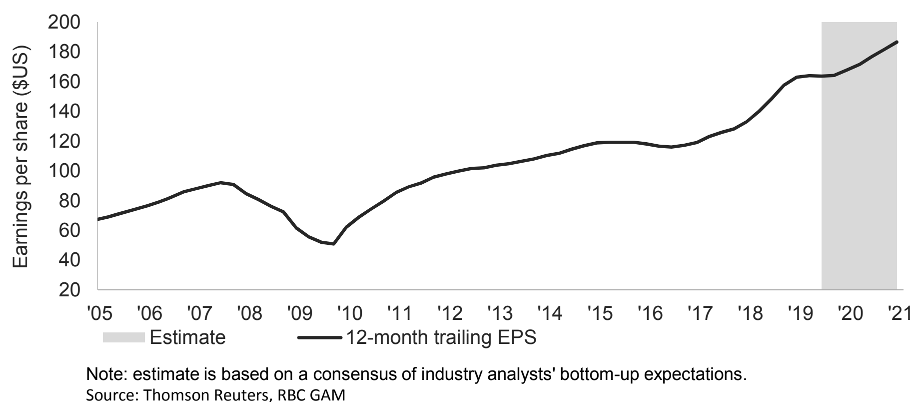
Source : RBC Capital Markets, RBC GAM

Exhibit 47: United States
S&P 500 revenue and nominal GDP



Source: RBC CM, RBC GAM

Exhibit 48: S&P 500 Index
12-month trailing earnings per share



Note: estimate is based on a consensus of industry analysts' bottom-up expectations.
Source: Thomson Reuters, RBC GAM

stability/improvement in margins are critical to achieving those forecasts.

Stocks offer decent upside under reasonable assumptions

Even modest earnings gains should be enough to sustain higher stock prices in an environment of low interest rates and inflation. Exhibit 49 outlines a variety of combinations for S&P 500 earnings and price-to-earnings ratios (P/E), helping gauge the potential for stocks over the next two years. Our models suggest 18.6 is an appropriate (equilibrium) P/E given current interest rates, inflation and corporate profitability. The consensus of top-down estimates forecasts US$169.80 in earnings per share for the S&P 500 by the end of this year. Should the S&P 500 trade at our modelled equilibrium P/E and produce the consensus estimate for earnings in 2019, the index would trade at 3,164 by year-end, generating a 15 percent increase from the close on May 31, 2019. Looking ahead to 2020, the combination of an 18.6 P/E and the top-down earnings estimate of US$186.60 would put the S&P 500 at 3,474 for a 26 percent increase over the next 19 months! Of course it is also possible that earnings come in lower than expected, due potentially to a further escalation in tariffs and/or the onset of a recession. In such scenarios, investor confidence would likely also be challenged, resulting in lower P/E ratios and a very different outcome for stock prices. If, however, these fears don't play out it's not unreasonable to look for stocks to deliver attractive gains over the next year or two.

Exhibit 49: Earnings estimates and alternative scenarios for valuations and outcomes for the S&P 500 Index

		Consensus			
		2019 Top down	2019 Bottom up	2020 Top down	2020 Bottom up
	P/E	$169.8	$166.3	$186.5	$184.9
+1 Standard Deviation	22.8	3877.0	3797.3	4256.5	4220.1
+0.5 Standard Deviation	20.7	3520.5	3448.1	3865.1	3832.0
Equilibrium	18.6	3164.0	3098.9	3473.7	3444.0
-0.5 Standard Deviation	16.5	2807.5	2749.8	3082.3	3055.9
-1 Standard Deviation	14.4	2451.0	2400.6	2690.9	2667.9

Source: RBC GAM

Exhibit 50: Relative style performance
S&P 500 Value TR Index / S&P 500 Growth TR Index

The outperformance of growth stocks is extreme

More than a decade of sluggish economic growth has led to sizeable outperformance of growth stocks relative to value stocks. A reversal in that trend, whenever it occurs, will have a meaningful impact on equity portfolios. It makes sense that investors have gravitated to growth stocks in the post-financial-crisis era because firms that can propel earnings in the absence of robust economic expansion stand apart from the rest. But the gap in performance has expanded to 40 percent after nearly 12 straight years of underperformance by value stocks (Exhibit 50). While the current backdrop of slow growth continues to favour growth stocks, we recognize that this trade may be vulnerable. To be clear, we are not calling for an imminent reversal in value relative to growth performance,

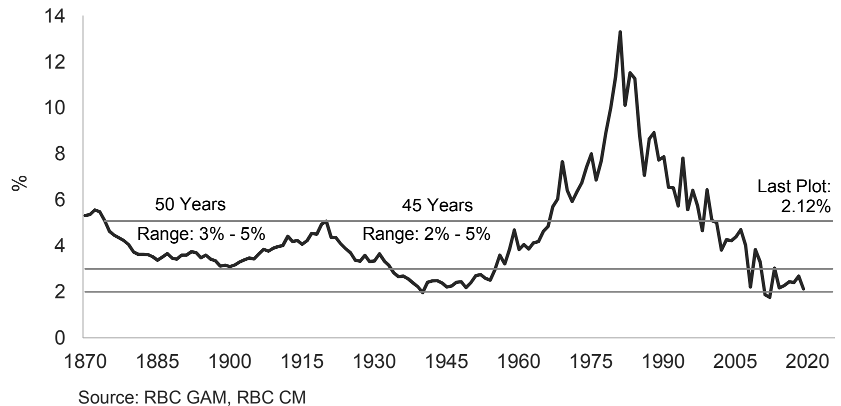
but acknowledge the possibility of a style rotation. After such a substantial period of growth dominating value and with the performance gap approaching a historic extreme, a swing in the opposite direction could be intense. Therefore, investors should pay particular attention to their exposures to growth stocks versus value stocks.

Asset mix – trimming equity overweight and maintaining underweight in bonds

Global growth is slowing and the decade-long economic expansion is facing a variety of challenges. Protectionism is arguably the largest threat to the global economy, but other risks include European politics and decelerating Chinese growth. Even if the business cycle is in its later stages, it is not clear that recession is imminent as several positives remain in place. Financial conditions have improved as a result of declining bond yields, U.S. consumer confidence is robust, central banks have paused monetary tightening and several global governments are now actively deploying fiscal stimulus.

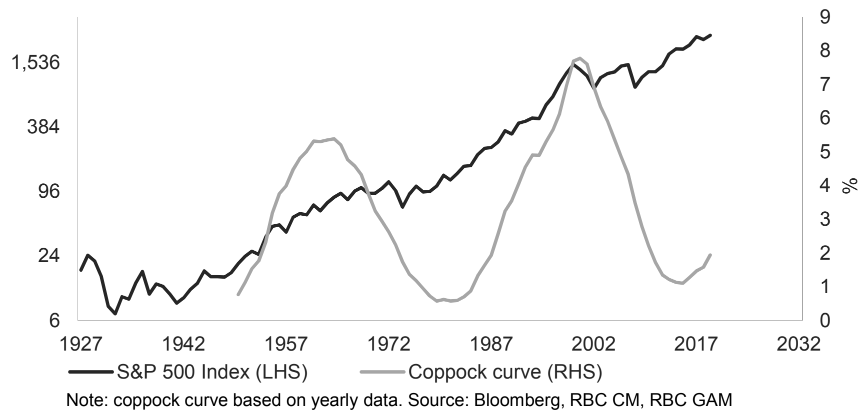
In this environment, we don't see a pressing need for central banks to provide additional stimulus, but fixed-income markets are pricing in high odds of rate cuts as evidenced by inverted yield curves in many regions. Government-bond yields are historically low and the U.S. 10-year yield has retreated close to the lower limit of its past 150-year range (Exhibit 51). While yields could move lower in the near term, it is unlikely that, in the absence of recession, they will remain at these levels for an extended period. Prospective returns for fixed income are accordingly low and as a result we remain underweight fixed income in our asset mix.

Exhibit 51: U.S. 10-year bond yield



Source: RBC GAM, RBC CM

Exhibit 52: S&P 500 Index
Long-term price momentum



Note: coppock curve based on yearly data. Source: Bloomberg, RBC CM, RBC GAM

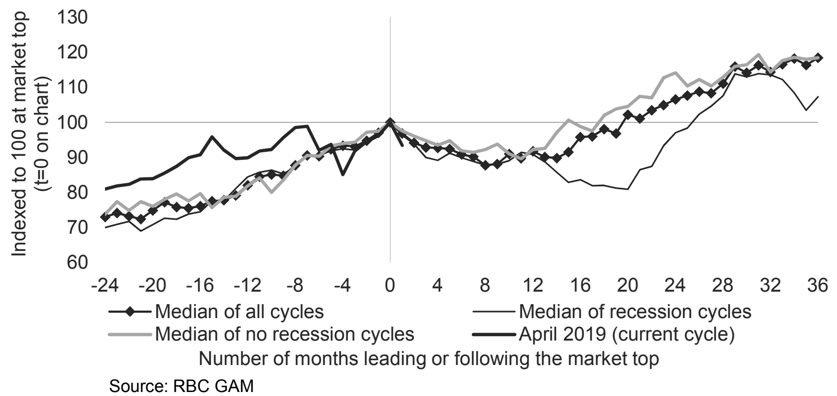
Although we look for single-digit returns for stocks, the equity market remains very compelling relative to fixed income. Our models indicate that stock valuations range from average to attractive relative to long-term 'fair value'. As long as the economy continues to grow, corporate profits should provide a tailwind for stock prices.

If we are wrong in our constructive view and stocks head lower, we don't think the damage would be particularly severe or long-lasting. Our long-term price momentum indicator suggests that, after the back-to-back bear markets of the early 2000s, the S&P 500 has entered into a secular bull market that could last decades (Exhibit 52). This secular backdrop is important because corrections in the primary trend tend to be less severe in secular bull markets than in secular bears, a conclusion stemming from an analysis

of 34 market cycles dating back to 1870 (exhibits 53 to 55). Our analysis shows that stocks declined 8 percent in the 12 months following a market peak in secular bull markets compared with a 17 percent drop if the backdrop was a secular bear. In secular bull markets, stocks reached new highs an average of 24 months following their prior peak except in times of recession. In secular bear markets, however, stocks were well below their prior peaks two years later regardless of the economic backdrop.

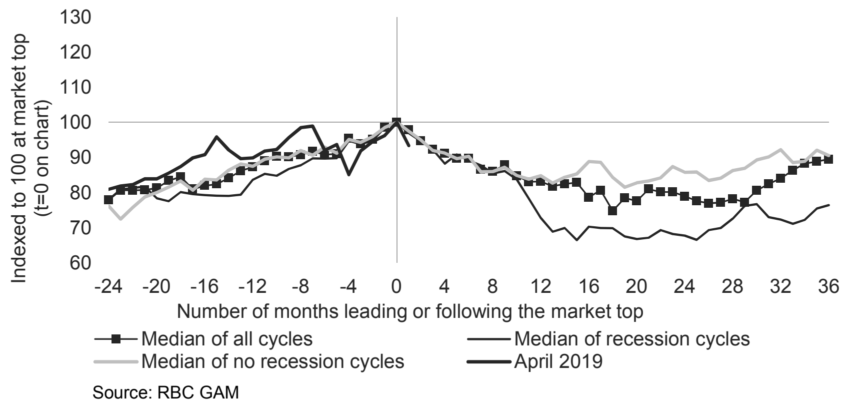
Our asset mix reflects the current balance of risks and potential rewards and takes into account a mature business cycle, slowing economic activity and stalled profit growth. Against this backdrop, we tactically reduced our equity-overweight allocation by half a percentage point in the past quarter, shifting the proceeds to cash. Over the past several quarters, we have been gradually de-risking our portfolios as the business cycle matures, and this move brings us further along that path. That said, we think it's too early move to below a 'neutral' setting for equities since we believe we are in a secular bull market for stocks and our base case is for continued economic growth over the forecast horizon. We opted to shift the funds from the reduction in equities into cash instead of fixed income because the valuation risk in fixed income is acute and cash yields are currently greater than those available on sovereign bonds. For a balanced, global investor, we currently recommend an asset mix of 57.5 percent equities (strategic neutral position: 55 percent) and 40 percent fixed income (strategic neutral position: 43 percent), with the balance in cash.

Exhibit 53: S&P 500 Index
Cyclical tops in secular bull-market regimes



Source: RBC GAM

Exhibit 54: S&P 500 Index
Cyclical tops in secular bear-market regimes



Source: RBC GAM

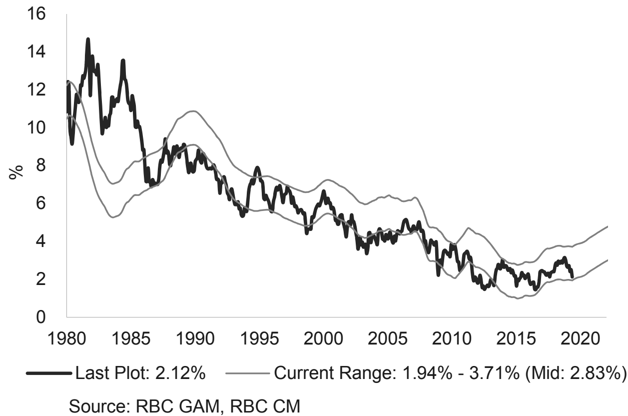
Exhibit 55: S&P 500 return statistics prior to and following cyclical peaks
Data since January 1870

	# of observations	Median trailing returns (%)* 24 months	Median trailing returns (%)* 12 months	Market peak	Median forward returns (%)* 12 months	Median forward returns (%)* 24 months	Median forward returns (%)* 36 months
Any regime							
All cycles	34	16.2	15.5		-12.3	-3.6	0.3
No-recession cycles	20	14.6	14.7		-12.0	0.7	2.0
Recession cycles	14	17.2	18.7		-15.1	-8.5	-4.1
Within secular bulls only							
All cycles	21	17.1	21.8		-8.3	3.2	5.8
No-recession cycles	11	16.4	22.2		-7.8	6.8	5.8
Recession cycles	10	19.5	18.5		-9.2	-1.5	2.4
Within secular bears only							
All cycles	13	13.3	14.6		-16.8	-11.2	-3.6
No-recession cycles	8	14.6	14.3		-15.2	-7.4	-3.3
Recession cycles	5	13.2	19.5		-27.3	-17.7	-8.6
April 2019	**1**	**11.2**	**11.2**		**N/A**	**N/A**	**N/A**

*Periods greater than 12 months are annualized. Source: Robert J. Shiller, RBC CM, RBC GAM

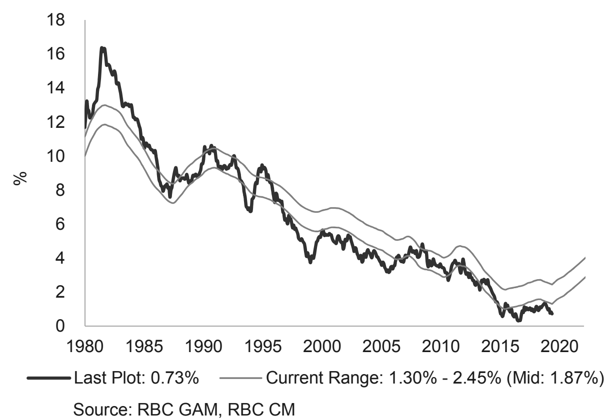
Global Fixed Income Markets

U.S. 10-Year T-Bond Yield
Equilibrium range



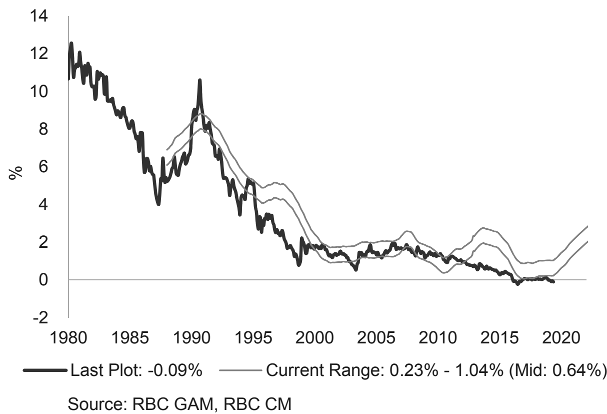
Source: RBC GAM, RBC CM

Eurozone 10-Year Bond Yield
Equilibrium range



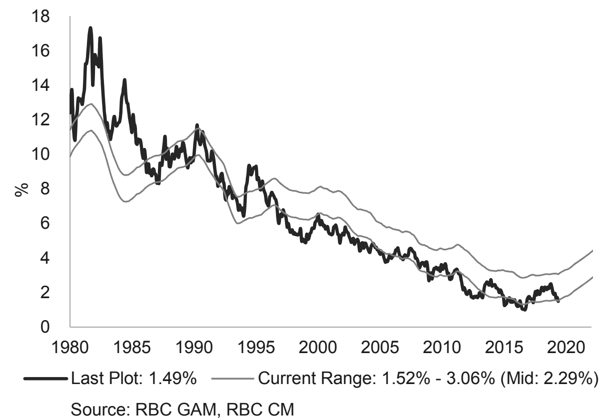
Source: RBC GAM, RBC CM

Japan 10-Year Bond Yield
Equilibrium range



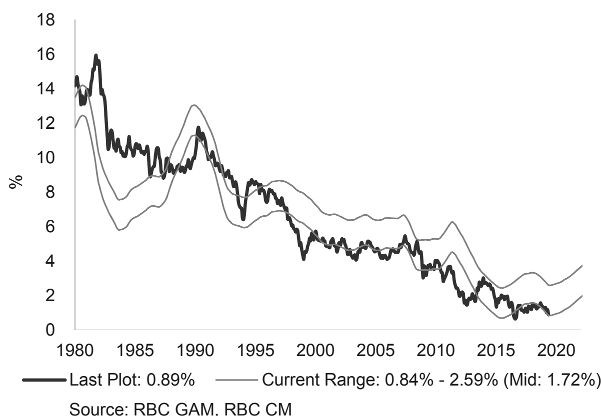
Source: RBC GAM, RBC CM

Canada 10-Year Bond Yield
Equilibrium range



Source: RBC GAM, RBC CM

U.K. 10-Year Gilt
Equilibrium range

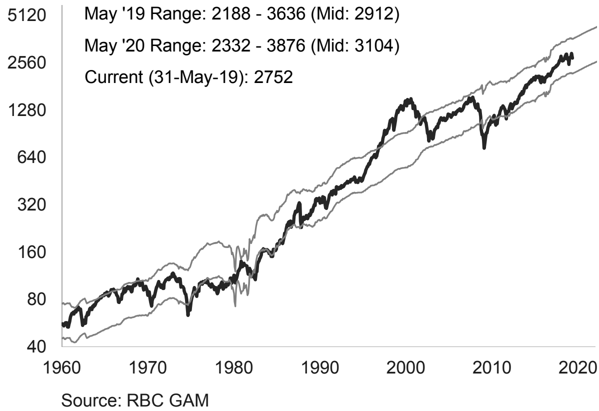


Source: RBC GAM, RBC CM

"Our own models suggest that bond yields are well below their equilibrium levels and that the risk of fixed-income losses is elevated in all regions, but more so outside North America."

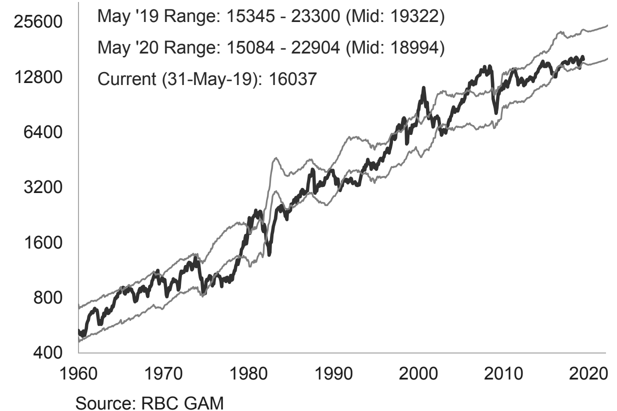
Global Equity Markets

S&P 500 Equilibrium
Normalized earnings and valuations



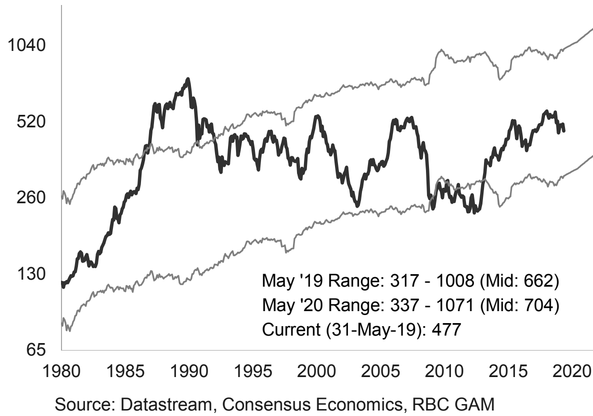
Source: RBC GAM

S&P/TSX Composite Equilibrium
Normalized earnings and valuations



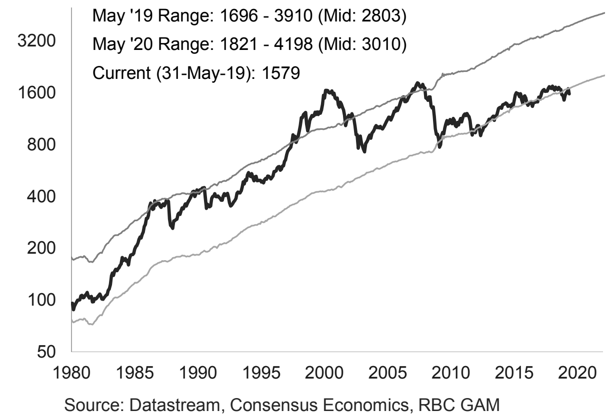
Source: RBC GAM

Japan Datastream Index
Normalized earnings and valuations



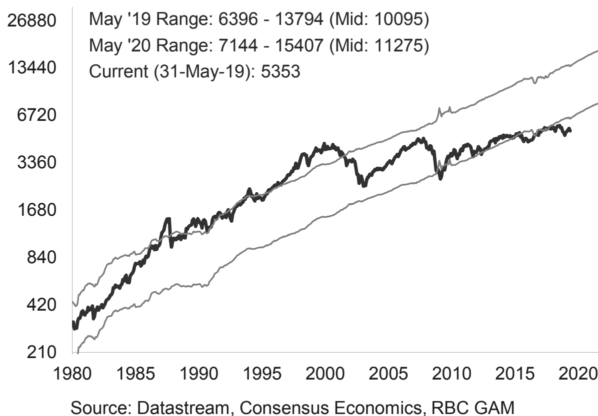
Source: Datastream, Consensus Economics, RBC GAM

Eurozone Datastream Index
Normalized earnings and valuations



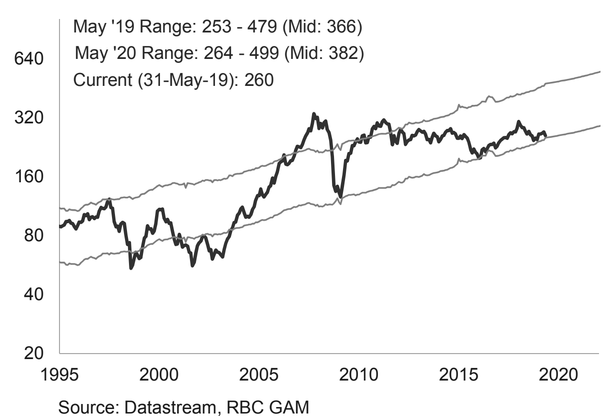
Source: Datastream, Consensus Economics, RBC GAM

U.K. Datastream Index
Normalized earnings and valuations



Source: Datastream, Consensus Economics, RBC GAM

Emerging Market Datastream Index
Normalized earnings and valuations



Source: Datastream, RBC GAM

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Global Fixed Income Markets

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The bond-market outlook

Global bonds continue to reflect the unsteady path of financial markets as economic growth has slowed and inflation has shown signs of weakening. Among the factors influencing bond yields is the deteriorating tone of trade talks between the U.S. and China. As a result, central banks have changed their guidance about future rate hikes. In light of these developments, it makes sense that bond yields across the globe are lower than they were a year ago, and we expect them to remain at these lower levels for at least the next 12 months.

The bond market is coming to grips with the fact that the global economy appears to face two stark potential outcomes over the short to intermediate term. The first scenario is that economic growth will stabilize over the second half of 2019, permitting policymakers to resume raising interest rates in 2020 and beyond. The second scenario is that a recession descends over the global economy, requiring aggressive interest-rate cuts and central-bank bond purchases. For now, investors are doing what they do when faced with extreme uncertainty: they compromise. In this case, the compromise is manifested in the fact that interest rates traded in a relatively tight range between January and April, before the breakdown of the China-U.S. trade talks. We expect bond yields to fluctuate based on the ebb and flow of economic data and the course taken by the trade dispute.

Investors were essentially betting on the U.S. Federal Reserve (Fed) keeping interest rates stable over the next 12 months instead of being forced into more extreme actions should growth accelerate or decelerate significantly. Why is the bond market so concerned about the prospect of a recession? For one thing, the rate of global economic growth has decreased by about half a percentage point since this time last year. Second, the view of our economics team is that we are in the latter stages of the economic cycle, meaning a recession is more likely to arrive sometime in the next one to three years. Another warning sign is the flattish slope of the yield curve – the gap between short-term and longer-term interest rates. A flat or inverted yield curve signals that lenders are not demanding much of a premium in exchange for the risk of lending for longer periods. When the premium becomes too small, banks start to restrict lending, weighing on economic activity. In fact, the 10-year bond yield briefly fell below the 3-month yield in March of this year – the dreaded yield-curve inversion that has historically preceded recessions.

We are not predicting that a recession is imminent. We are, however, mindful that recession risks appear to be rising, and that a flat or inverting yield curve means the final rate hike of the cycle is behind us. The inverted yield curve has in the past served as a reliable indicator that economic headwinds are gaining strength. We believe that central banks will be on hold until it is clear that the global economy has regained its momentum, and our hope is that, in so doing, they will allow economic growth to stabilize and inflation to rise closer to central-bank targets near 2 percent.

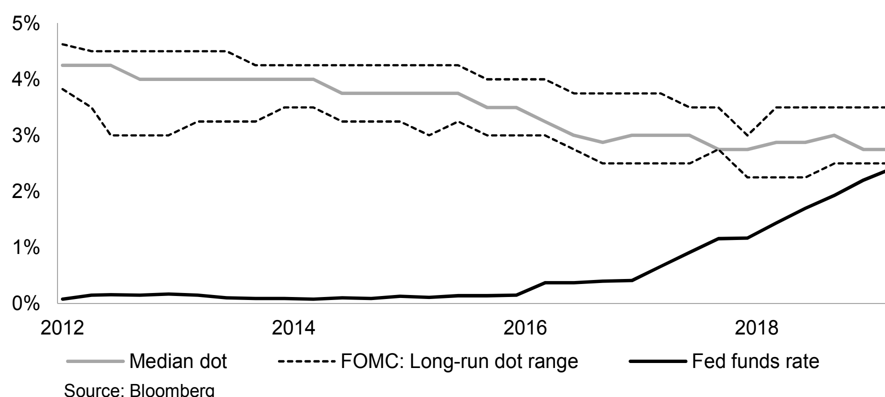
Finally, we should note a longer-term development that is unfolding quietly alongside economists' intense focus on shorter-term recession risks: investors have become much more aware that lower potential economic-growth rates and chronically low inflation have left central banks with a limited ability to respond to economic downturns using traditional monetary policy. Representative of this new reality, the Fed is conducting a year-long review of its policy framework, which could result in an emphasis on keeping interest rates low indefinitely. The implication is that bond yields are likely to stay low for a very long time.

Direction of rates

U.S. – The most likely scenario remains, in our view, that the Fed remains on hold. However, our conviction in this position has weakened given the absence of a resolution of the trade dispute between of the U.S. and China and related slowdown in global economic growth. The Fed's open-market committee, the panel that sets short-term U.S. rates, has indicated that it is aware of financial-market concerns that the pace of tightening over the past two years may have been too fast for the rate of economic growth. In

addition to paring its outlook for rate hikes, the Fed has slowed the pace at which it is reducing the size of its balance sheet. The case for the Fed to remain on hold is fairly strong, as the overnight interest rate target is near most estimates of "neutral," the level at which rates in theory neither stimulate nor depress economic growth (Exhibit 1). In the absence of persistently faster inflation, we think the Fed will be happy to leave interest rates where they are while economic activity stabilizes, and that investors' expectations of as many as three rate reductions within the next two years will not be fulfilled. Long-term challenges to substantially higher bond yields remain in place. As a result, we expect U.S. 10-year bond yields to fluctuate around 2.50%.

Exhibit 1: Fed funds rate is near most estimates of "neutral"



Source: Bloomberg

Europe – Policymakers at the European Central Bank (ECB) are also unlikely to hike rates over the next year since slowing economic activity has been much more pronounced in the Eurozone. Moreover, inflation in Europe remains fairly muted as technological advances and increased competition offset tight labour markets and evidence of accelerating pay growth. As a consequence, rate hikes that the market had initially pencilled in for the fall of 2019 have been pushed back to the mid-2020s. Moreover, the ECB appears to be addressing banks' complaints that negative interest rates hurt their profits, suggesting that they will find a way to keep short-term interest rates low indefinitely. All of the above point to fairly low bond yields in the Eurozone. We have reduced our 12-month forecast for the 10-year bund yield to 0.20 percent from 0.25 percent. Europe seems destined to follow Japan into the realm of perpetually low yields.

Japan – The Bank of Japan (BOJ) indicated recently that it continues to expect short- and long-term interest rates to remain historically low through the spring of 2020. But even against a global backdrop of historically loose monetary policy since 2008, the BOJ stands alone among the major central banks. The BOJ is not only the dominant holder of Japanese government bonds (JGBs), but has also built up substantial stakes in Japanese companies through ETF purchases. Given that the BOJ is committed to a course that both favours inflation and is required to counter chronically weak growth, we consider it unlikely that the BOJ will change its short-term policy rate over the next 12 months. A continuation of current policy indicates that yields on 10-year JGBs will remain in a range between -0.20 percent and 0.20 percent.

Canada – The Bank of Canada (BOC) last raised interest rates in October, and recently cited uncertainty related to trade and the domestic oil and housing industries for its decision to put off further hikes. While BOC Governor Poloz has said he expects the economy to strengthen in the second half of this year, he believes that the trade war between China and the U.S. remains a significant risk. Our view is that the BOC, like the Fed, will delay interest-rate hikes until policymakers are comfortable that economic growth is solid. Moreover, the fact that the gap between domestic 3-month and 10-year yields is very narrow and is again close to inverting indicates that growth may not be as promising as the BOC would like investors to believe.

International investors are currently favouring provincial bonds over those issued by the federal government due to the higher yields available on provincial securities and more frequent issues of securities in U.S. dollars and euros. The yield on Ontario's 10-year bond is 75 basis points higher than the 1.55 percent yield on the Government of Canada benchmark. We expect Canada's benchmark rate to remain at 1.75 percent well into 2020 and we

have cut our forecast for the 10-year government bond by 25 basis points to 1.75 percent.

The U.K. – Lingering uncertainty surrounding Brexit and concerns about the trade war between China and the U.S. are holding down gilt yields. The U.K. labour market, however, remains resilient, and the current situation whereby wage growth exceeds inflation is favourable for consumption and economic growth. We expect unemployment to continue to decline, which would warrant a more hawkish position by the Bank of England were it not for the political headwinds. We do not expect any changes to monetary policy until there is a resolution to the Brexit impasse. We have increased our 10-year gilt-yield forecast to 1.25 percent from 1.00 percent, a compromise between the needs of a resilient economy and the caution demanded by Brexit.

Regional preferences

We recommend overweighting German bunds by 5 percent, and underweighting U.S. Treasuries by the same amount. We expect German bunds to provide higher returns from income after hedging away currency risk.

Interest rate forecast: 12-month horizon
Total Return calculation: May 23, 2019 – May 22, 2020

U.S.

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.50%	2.45%	2.45%	2.55%	2.95%	0.70%
Change to prev. quarter	0.00%	0.00%	0.00%	0.05%	0.35%	
High	3.00%	3.30%	3.40%	3.50%	3.75%	(3.90%)
Low	2.00%	1.80%	1.80%	2.00%	2.35%	4.40%
Expected Total Return US$ hedged: 0.60%						

Germany

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.40%)	(0.40%)	0.00%	0.20%	0.65%	(1.90%)
Change to prev. quarter	0.00%	0.00%	0.10%	(0.05%)	(0.10%)	
High	(0.20%)	0.00%	0.40%	0.75%	1.00%	(5.90%)
Low	(0.40%)	(0.40%)	(0.30%)	(0.10%)	0.40%	0.93%
Expected Total Return US$ hedged: 0.30%						

Japan

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.10%)	(0.05%)	(0.05%)	0.10%	0.65%	(1.49%)
Change to prev. quarter	0.00%	0.00%	0.00%	0.00%	(0.05%)	
High	0.00%	0.10%	0.10%	0.20%	0.80%	(3.68%)
Low	(0.10%)	(0.10%)	(0.10%)	(0.15%)	0.50%	0.90%
Expected Total Return US$ hedged: 1.00%						

Canada

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	1.75%	1.75%	1.75%	1.75%	2.00%	0.36%
Change to prev. quarter	0.00%	(0.05%)	(0.15%)	(0.25%)	(0.20%)	
High	2.25%	2.50%	2.50%	2.75%	2.90%	(7.33%)
Low	1.25%	1.20%	1.20%	1.25%	1.60%	4.73%
Expected Total Return US$ hedged: 0.90%						

U.K.

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.50%	0.80%	1.00%	1.25%	1.80%	(2.53%)
Change to prev. quarter	0.00%	0.20%	0.25%	0.25%	0.10%	
High	0.75%	1.00%	1.20%	1.40%	1.90%	(4.13%)
Low	0.00%	0.10%	0.20%	0.50%	1.40%	4.40%
Expected Total Return US$ hedged: (0.40%)						

Source: RBC GAM

Global Fixed Income Markets: Introducing Chinese bonds

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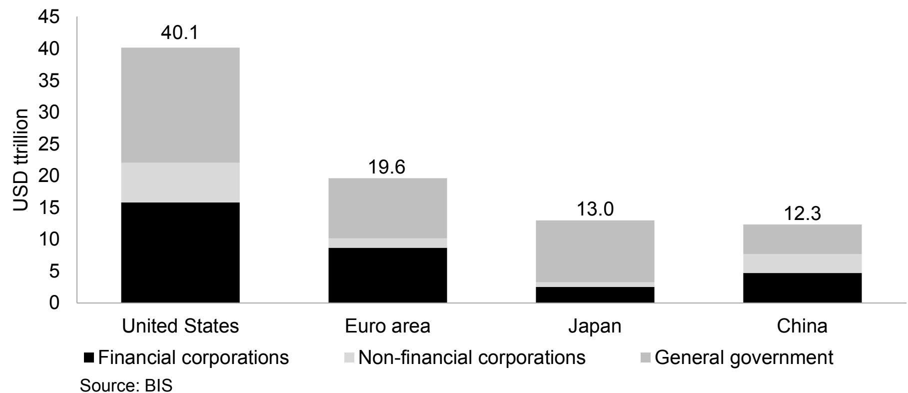
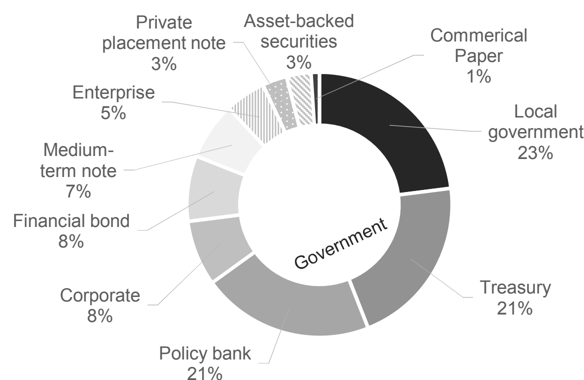
Exhibit 1: China is the world's third-largest bond market
Total value of bonds outstanding at Q3 2018



Source: BIS

Exhibit 2: Government securities make up 40% of stock of bonds



Source: IMF: *The Future of China's Bond Market,* Mar 2019, WIND Economic Database

While China's economy was expanding by more than 6 percent for most of the past three decades, the country's bond market was languishing in obscurity. That's about to change.

On April 1 of this year, the Bloomberg Barclays Global Aggregate Bond Index officially included Chinese government bonds denominated in renminbi, a massive market that has been off-limits to non-Chinese investors. Two other major indexes – the FTSE World Government Bond Index and JPM GBI-EM Global Diversified Index – indicated that they plan to follow suit by the first quarter of 2020. A few years from now, China's US$12.3 trillion bond market, the world's third-largest national market behind the U.S. and Japan (Exhibit 1), will house a significant portion of investors' fixed-income portfolios.

The game changer that made China more accessible to private international investors occurred in 2017, when the so-called Bond Connect program set procedures under which fixed-income trading of Chinese bonds via Hong Kong was allowed and limits on capital flows by foreign accredited investors were removed. The steps were among efforts to create a freely trading currency and open up China's economy to private investors.

The initial wave of foreign investment will most likely find its way into government bonds, which account for about 40 percent of China's fixed-income market (Exhibit 2). Private investors are essentially catching up with the investment opportunities already available to central banks and sovereign-wealth funds, which have been buying Chinese bonds since 2011. By the first quarter of 2020, China could account for 5 percent to 6 percent of the government-index universe. According to Goldman Sachs, foreign investors will pour about US$250 billion into Chinese bonds over the next 12 to 18 months, increasing foreign ownership of the country's fixed-income market to about 3 percent from about 1.6 percent now. That compares with the 25 percent of total U.S. debt held by foreigners. (Exhibit 3).

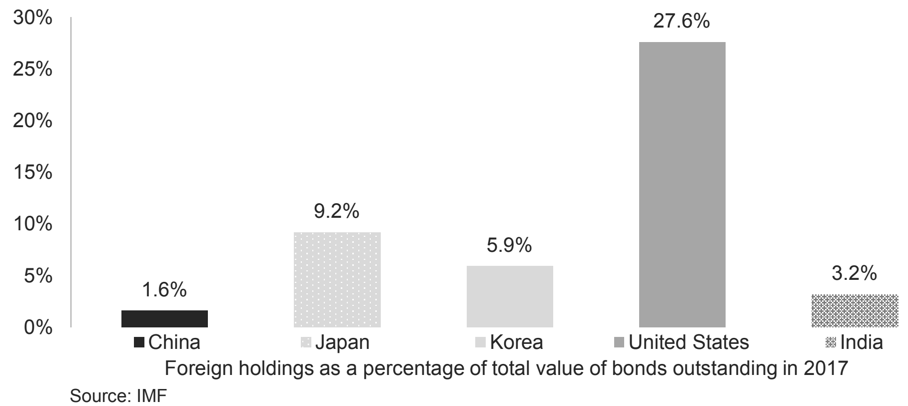
As investors rejig portfolios to include the sizable Chinese fixed-income market, concerns will arise about whether sales of U.S., Eurozone and Japanese bonds to finance purchases of Chinese bonds could drive up yields. Our view is that the impact will be minimal. For one thing, the estimated US$250 billion injection into Chinese bonds represents just 1 percent of the US$22 trillion global government fixed-

income market. More importantly, China's policy of recycling capital into bonds issued by western governments will likely blunt market impacts.

Where do Chinese bonds fit in a fixed-income portfolio? Their low correlation with other bonds means they provide significant diversification benefits (Exhibit 4), although these correlations are less reliable due to the closed nature of China's bond market. Moreover, the ability to hedge currency risk, a key consideration for any global bond investor, is more manageable nowadays thanks to the increasing sophistication of renminbi trading. Hedging costs, which used to be high and highly variable, have stabilized since 2018 (Exhibit 5). We expect the Chinese government-bond market to evolve to include the wider use of interest-rate derivatives for hedging.

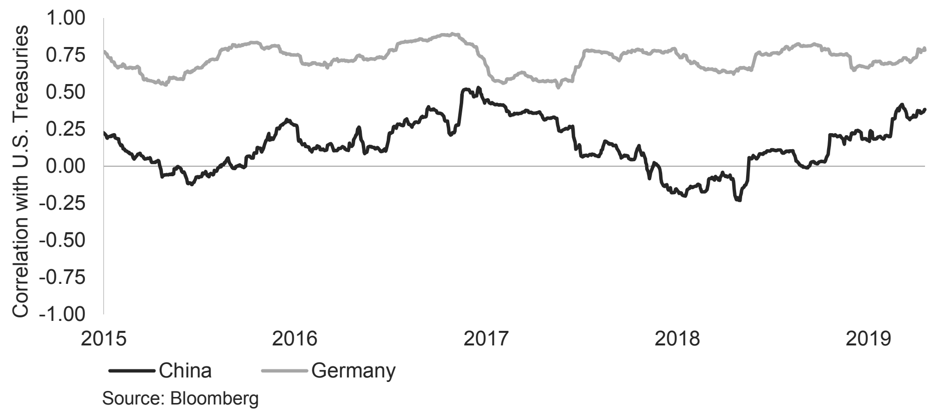
Whether Chinese bonds will prove a solid investment is obviously impossible to say, but this market will become an important segment of the global bond universe – of that we are certain. The 10-year benchmark Chinese bond yielded 3.32 percent on May 28 of this year and 2.63 percent on a currency-hedged basis, compared with a 2.27 percent yield for the U.S. 10-year Treasury bond. According to the Chinese government's latest reading, in April, inflation is running around 2.5 percent, compared with U.S. inflation of 2.0 percent. For now, anyway, the inflation-adjusted return on the 10-year Chinese benchmark is comparable with that on the comparable U.S. bond. In view of a lack of transparency and investor protection, bond holders will have to place a lot of faith in how successfully China manages the liberalization of its financial markets.

Exhibit 3: China's bond market is dominated by domestic players



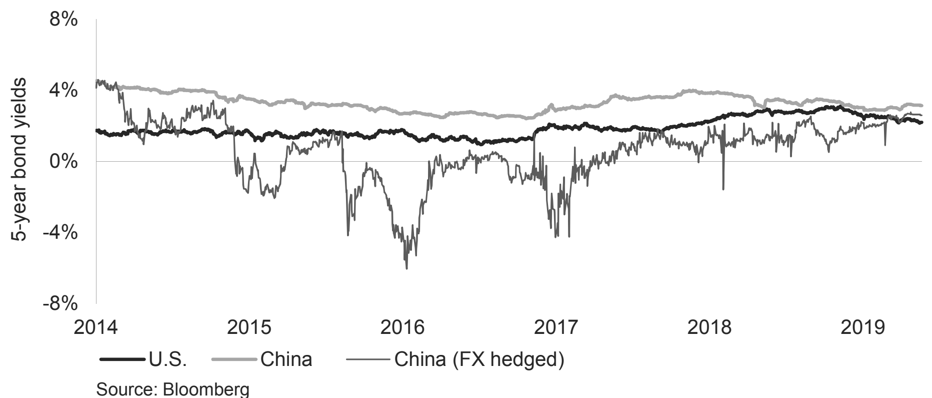
Source: IMF

Exhibit 4: Chinese government bonds are less correlated with Treasuries



Source: Bloomberg

Exhibit 5: Currency-hedging mechanism has been maturing since 2018



Source: Bloomberg

Currency Markets

A little too quiet?

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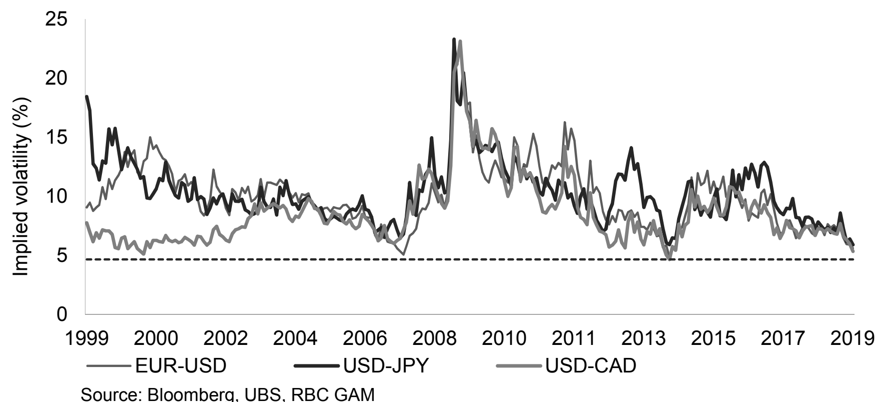
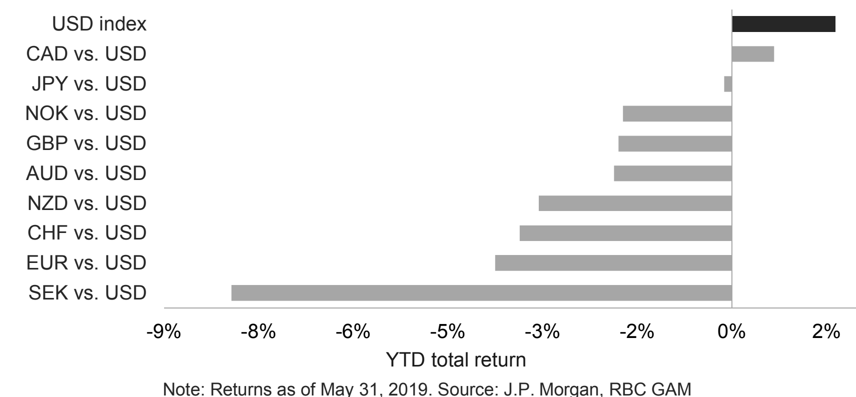
The foreign-exchange world has been quiet. So quiet, in fact, that the lull has unsettled traders accustomed to stomach-churning swings in currency markets. Those traders are now disoriented by motionless markets as currency volatility tumbles to near multi-decade lows (Exhibit 1). Currencies are normally volatile because they are buffeted by a multitude of factors and because they are able to adjust more quickly than other financial instruments when economic and political surprises occur. While stock exchanges open and close in line with a typical work day, foreign-exchange traders never sleep: it's a 24-hour over-the-counter market. In the course of a trading day, exchange rates are pushed and pulled as they absorb successive waves of capital flowing between countries. The fact that exchange rates are not fluctuating as wildly right now may be reflective of smaller capital flows in line with diminished global trade volumes. Low volatility may also be the product of central-bank interference – their tendency to pre-empt any sign of trouble with promises to combat tighter financial conditions. However, there's only so much that monetary policy can do. We must also consider that presidential tweets and on-again-off-again Brexit headlines may have tempered risk appetites among currency traders. Whatever the true combination of reasons underlying the low volatility in foreign-exchange markets, experience tells us that it's not a permanent state. Volatility cannot stay muted forever, and the over-parenting of markets by monetary policymakers will only amplify the inevitable turbulence when it arrives.

Exhibit 1: Volatility implied by 3-month options contracts



Source: Bloomberg, UBS, RBC GAM

Exhibit 2: G10 total returns



Note: Returns as of May 31, 2019. Source: J.P. Morgan, RBC GAM

In the meantime, quiet markets have been friendly to the higher-yielding U.S. dollar. The greenback has been grinding steadily higher and is now the top performer among developed-market currencies this year through the end of May (Exhibit 2). In addition, the U.S. dollar has been helped by developments abroad, where central banks have kept yields low and economies have been dented by global trade wars.

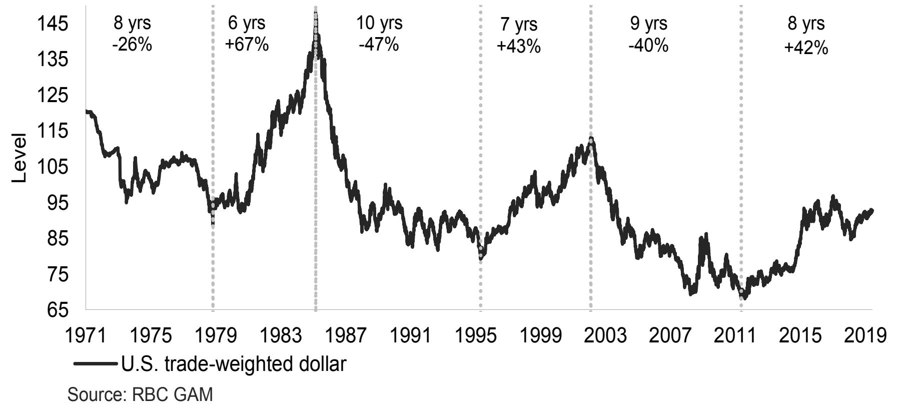
We noted in prior editions of the *Global Investment Outlook* that the U.S. dollar's eight-year uptrend is looking mature (Exhibit 3), but that in the absence of extreme overvaluation the greenback may take more time to complete its extended topping process. Cyclical positives such as stronger

economic growth and a widening yield advantage pushed aside structural negatives like fiscal and current-account deficits. With these cyclical factors fading now, the structural negatives may garner more attention. Also noteworthy is a renewed preference among global reserve managers, who direct US$11 trillion in assets, to diversify away from the U.S. dollar into euros, Japanese yen and the Chinese renminbi (Exhibit 4). Rather than try to pinpoint the exact timing of the U.S.-dollar inflection, we highlight the metrics that we are watching and share insights on how these underlying developments are prolonging the topping process.

Investors can earn an extra 3 percent by using hedging contracts that swap euros for dollars, an attractive proposition for U.S. holders of European bonds. Such carry strategies are popular, not only for bondholders but also for currency-focused investors who remain overweight the U.S. dollar against virtually all lower-yielding developed-market currencies (Exhibit 5). The risk to this strategy is that the U.S. interest-rate advantage begins to narrow.

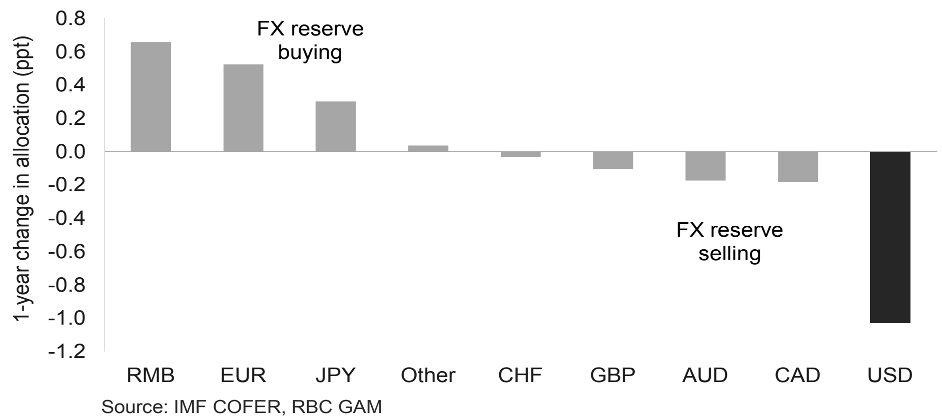
For Asian and European investors, on the other hand, to invest in higher-yielding U.S. bonds means taking currency risk because the cost of hedging would wipe out the extra yield. These unhedged carry trades would suffer losses if currency volatility returned. Even a relatively modest decline in the U.S. dollar could trigger outflows as it would quickly outweigh the interest-rate advantage. Such a move would likely widen euro ranges, which have been at their tightest in

Exhibit 3: Long-term cycles of the U.S. dollar



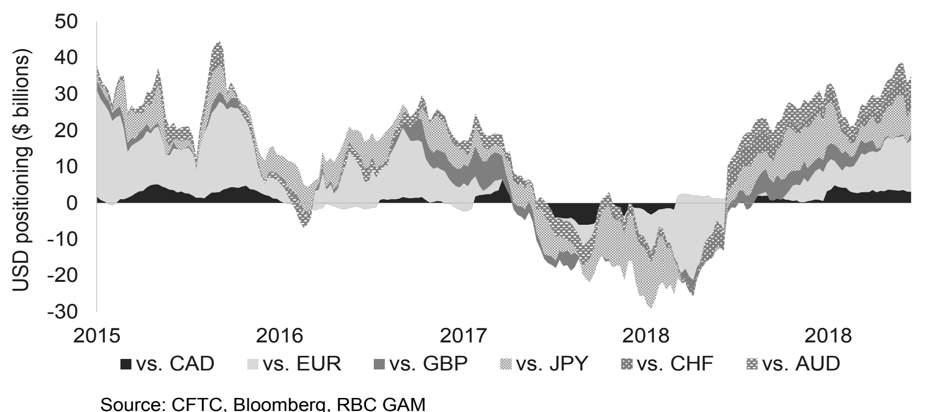
Source: RBC GAM

Exhibit 4: 1-year change in FX reserve composition



Source: IMF COFER, RBC GAM

Exhibit 5: FX market is overweight U.S. dollar



Source: CFTC, Bloomberg, RBC GAM

several decades (Exhibit 6). We're keeping an eye on volatility measures as a precursor to position unwinds and quick, short-term selloffs in the U.S. dollar.

For several years, negative yields and quantitative easing by the European Central Bank (ECB) have driven Europeans to invest abroad. Over the past decade, they have accumulated some 2 trillion euros in foreign bonds and equities (Exhibit 7), almost half of which is invested in the U.S. As we discussed above, most of these investments are not currency-hedged and therefore vulnerable to a turn in the U.S. dollar. What else could put the tide of capital flows in reverse? A sustained demand for European stocks and bonds would require higher returns on assets in the eurozone fueled by better economic prospects. Instead, the greenback has benefited since the eurozone crisis from a U.S. expansion whose momentum has outstripped other economies (Exhibit 8). Europe's underperformance has been amplified by its higher sensitivity to global trade tensions, and in particular to Chinese demand. This was demonstrated most strikingly by recent weak German trade data.

ECB President Mario Draghi has conceded that Europe is going through a soft patch but counters that, aside from trade, domestic economic activity in the eurozone has actually been fairly resilient. Lending support to his argument are Citibank's "hard" data-change indexes which are based on industrial activity and production volumes. These indicators show much more robust activity than do the "soft" economic indicators, which gauge

Exhibit 6: Muted EUR-USD volatility

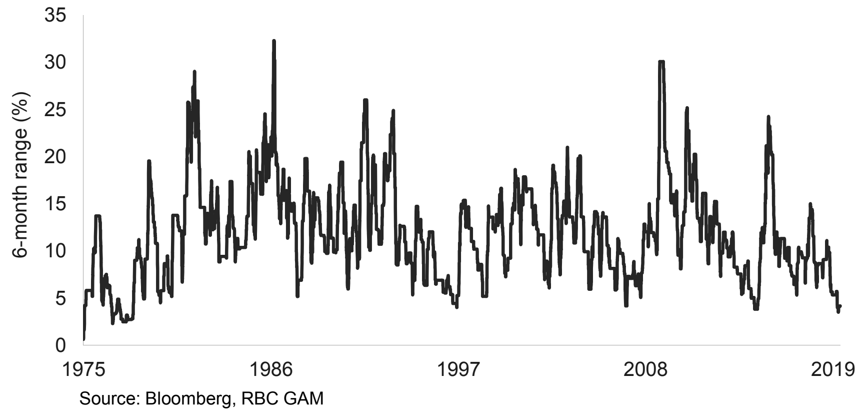


Exhibit 7: Eurozone outbound portfolio flows

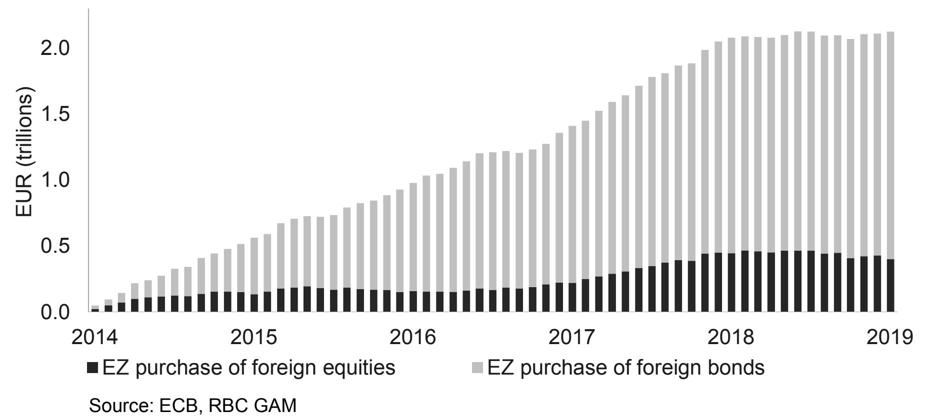
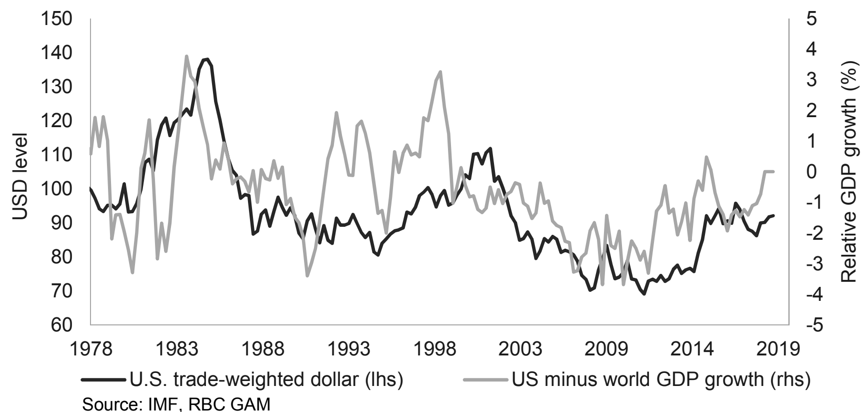
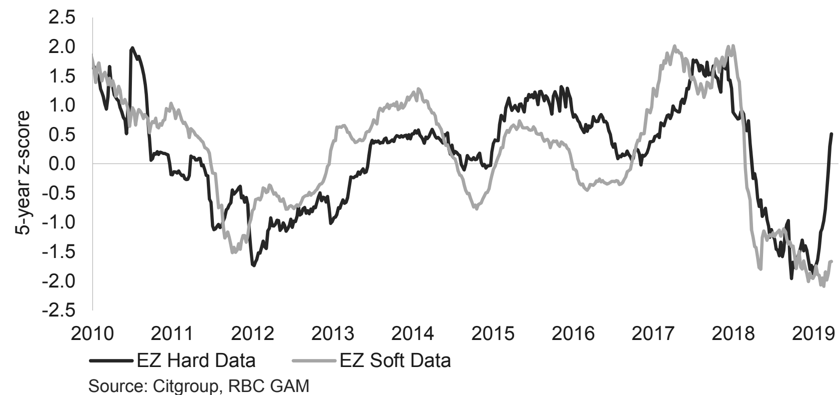


Exhibit 8: Growth differential vs. U.S. trade-weighted dollar



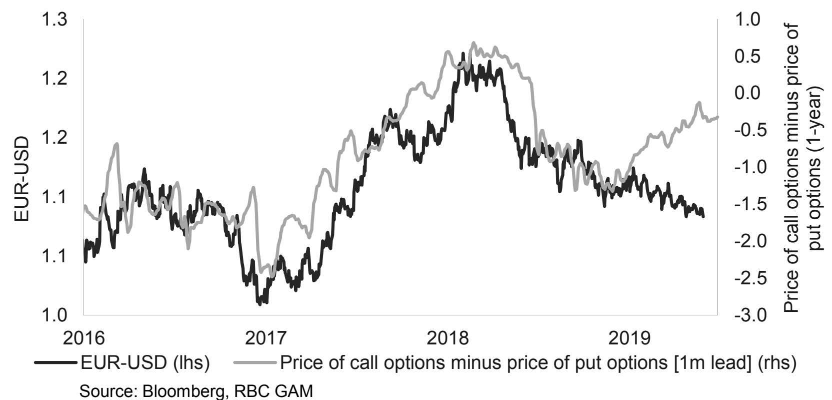
business and consumer confidence and which can be negatively affected by trade headlines or geopolitical uncertainty (Exhibit 9). Given higher projected fiscal spending, a cheap euro and low interest rates, we have reason to doubt claims that Europe is doomed to sluggish growth. In an environment of depressed expectations, a positive surprise from Europe would not be a difficult hurdle to meet and could certainly boost investment inflows and drive the euro higher.

Exhibit 9: Eurozone hard- and soft-data changes



Source: Citgroup, RBC GAM

Exhibit 10: Option skew vs. EUR-USD



Source: Bloomberg, RBC GAM

Our outlook and active management of currencies within our portfolios increasingly incorporates an expectation that the U.S. dollar has already peaked or that further gains will be limited. Many of the factors supporting the greenback are losing their effectiveness in propelling further strength at the same time as new U.S.-dollar negatives emerge. As a result, our forecasts imply a brighter picture for the euro and yen. The Canadian dollar and British pound will likely underperform in this environment, although it will be tough for these currencies to post meaningful declines if the U.S. dollar weakens.

Euro

In addition to the growth dynamics mentioned above, the euro is being depressed by a series of never ending political dramas, including Brexit negotiations to the north and an Italian fiscal standoff to the south. Across the Atlantic, a trade spat between Europe and the U.S. looms, though auto tariffs have been sidelined until mid-December. While these three issues are well known, the more pressing concern for investors may be the turnover of power within Europe as German Chancellor Merkel weighs stepping down and as key leadership posts come up for renewal in the European Parliament, the European Commission and ECB. With the currency market betting so heavily against the single currency, we wonder whether these political concerns are overdone. Finally, we observe Europe's sensitivity to Chinese economic data and domestic consumption, in particular. Germany's exports to China have doubled over the past decade, so the 2018 slowdown reverberated in Europe for sure. But as China implemented a number of measures to stimulate domestic consumption, further weakness from that source is unlikely. While the spot exchange rate has been depressed by the confluence of these negatives, options markets seem to be looking beyond the fog (Exhibit 10) with the difference in cost of calls versus puts no longer showing as much pessimism.

Japan

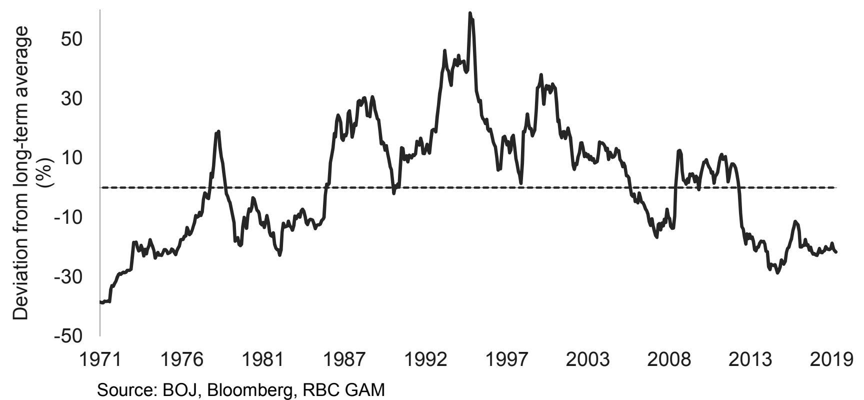
We are less sanguine about Japan's economic outlook than we are about Europe's. The Bank of Japan (BOJ) has

cut its growth and inflation forecasts again, making clear that it will maintain loose monetary policy indefinitely. As a consequence, the Japanese currency is unlikely to stand out on central-bank policy. What makes the yen attractive to us is a large current-account surplus that provides consistent support for the currency. The yen is also among the most undervalued currencies in the G10 based on the BOJ's own metric (Exhibit 11) and its safe-haven qualities make it a good place to hide during times when risk sentiment sours, as it did in late May. Slowing global growth and a pick-up in volatility could trigger renewed appreciation of the yen.

British pound

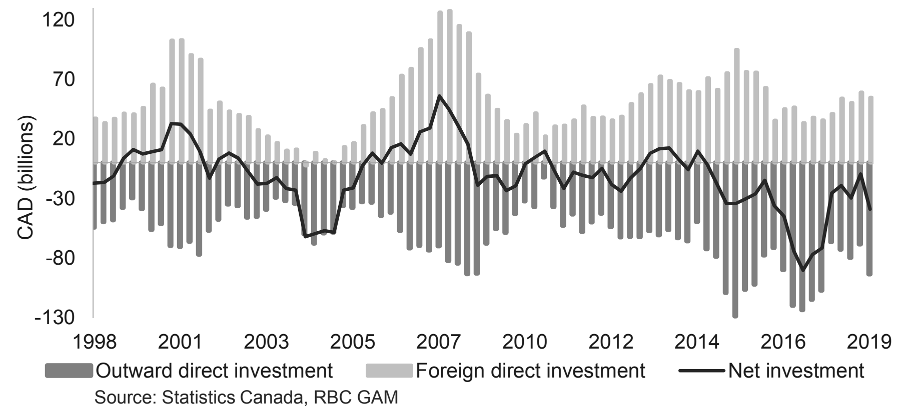
U.K. businesses have held back making new investments as they await resolution of the three-year-old Brexit drama. There will no doubt be a wave of hiring and capital expenditures once an agreement is struck with the EU, prompting at least one 25-basis-point interest-rate hike from the Bank of England. Beyond the short-term boost of a Brexit resolution, the longer-term consequences of the previous uncertainty will continue to weigh on growth as consumers have depleted savings and policymakers have neglected other important national issues. In the meantime, U.K. inventories have been increased ahead of the Brexit deadline, a development that borrowed economic growth from subsequent quarters. This would make for a dour outlook on the pound if not for our expectation that the U.S. dollar will give up some ground later in the year. Our forecast of 1.27 is still lower than the consensus and implies a currency roughly unchanged over the next 12 months.

Exhibit 11: Bank of Japan real effective yen exchange rate



Source: BOJ, Bloomberg, RBC GAM

Exhibit 12: Canadian net foreign direct investment flows



Source: Statistics Canada, RBC GAM

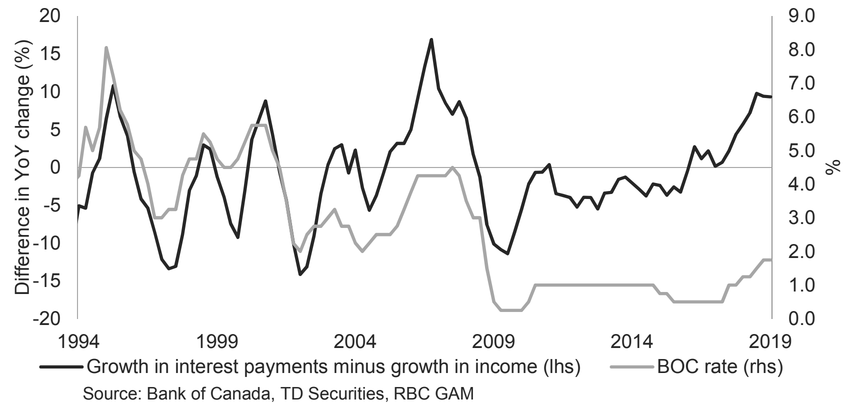
Canada

We have long been bearish on the Canadian dollar and still believe it will weaken over the course of the year. However, our stance has softened considerably as economic green shoots emerge and as the market acknowledges the structural negatives we had been touting. Among our concerns has been Canada's lagging competitiveness, with lower R&D spending and fewer patents per capita than other developed nations. That said, the country's well-established liberal democracy and welcoming attitude toward immigrants has put Canada in position to be the first choice for those with the skills to push forward in areas like artificial intelligence. We refer to this as Canada's immigration dividend. While a growing technology focus in some of the country's biggest cities is a positive sign, Canada continues to lose successful start-ups to the U.S. This is evident in outbound foreign direct investment flows, where start-ups and other established Canadian businesses have been finding better

opportunities abroad (Exhibit 12). For the immigration dividend to pay off, more-business-friendly government policies may be required.

A shorter-term concern is the impact on consumers of interest-rate hikes over the past year and measures aimed at reining in housing excesses. Even with relatively low interest rates, household debt-servicing costs are nearing their highest levels in two decades (Exhibit 13). Acknowledging that consumers won't be able to sustain economic growth by themselves, the Bank of Canada (BOC) had been forecasting a pickup in two other areas of the economy: business investment and exports. With little improvement in either category thus far, the central bank has cut its 2019 growth forecast to 1.2 percent from 1.7 percent and abandoned its preference for higher interest rates. That removed a layer of support from under the loonie. These forecast changes and the BOC's pivot toward a less optimistic stance now looks to be untimely, given it has been followed by the recent removal of steel and aluminum tariffs by the U.S. and reports that the three parties to the U.S.-Canada-Mexico trade deal are nearing ratification of the agreement.

Exhibit 13: Debt-service costs rising for Canadian households



Source: Bank of Canada, TD Securities, RBC GAM

Exhibit 14: Number of investment-bank forecasts by USD-CAD bracket

USD-CAD brackets	Date of forecast				
	May 2018	Aug. 2018	Nov. 2019	Feb. 2019	May 2019
1.36- 1.37	1	1	1	0	2
1.34- 1.35	0	2	1	5	9
1.32- 1.33	1	1	1	7	12
1.30- 1.31	2	6	5	11	13
1.28- 1.29	5	6	8	10	10
1.26- 1.27	1	0	3	6	4
1.24- 1.25	10	11	10	7	6
1.22- 1.23	6	6	9	4	1
1.2- 1.21	10	10	7	4	3
1.18- 1.19	7	7	7	7	6
1.16- 1.17	1	0	0	0	0
1.14- 1.15	2	0	0	0	0
1.12- 1.13	2	1	0	0	0

Source: Bloomberg, RBC GAM

Market participants have also lowered their expectations for both the Canadian economy and currency in acknowledgement of the country's long-standing economic challenges. Exhibit 14 shows an increase in the number of forecasters calling for a stronger U.S. dollar over the past year. The Canadian dollar may be undervalued at a current exchange rate of C$1.35 per U.S. dollar based on short-term drivers such as interest rates, oil prices and equity markets, giving us greater confidence that the prevailing Canadian-dollar negatives are largely priced in. We keep our C$ 1.37 forecast unchanged with an expectation that the loonie will remain mostly within a C$1.30-C$1.40 range over the next 12 months.

Regional Outlook – U.S.

Brad Willock, CFA
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

The S&P 500 Index had a volatile ride over the three months ended May 31, 2019, as gains of 1.8 percent in March and 3.9 percent in April were followed by a 6.4 percent decline in May. The market set an all-time high on the last day of April, but began its month-long retreat after trade negotiations between the U.S. and China fell apart during the first weekend of May. Markets had priced in a positive resolution to the dispute, so the surprise breakdown led investors to recalibrate the potential impact of a prolonged trade conflict on economic growth, inflation, corporate earnings and asset prices.

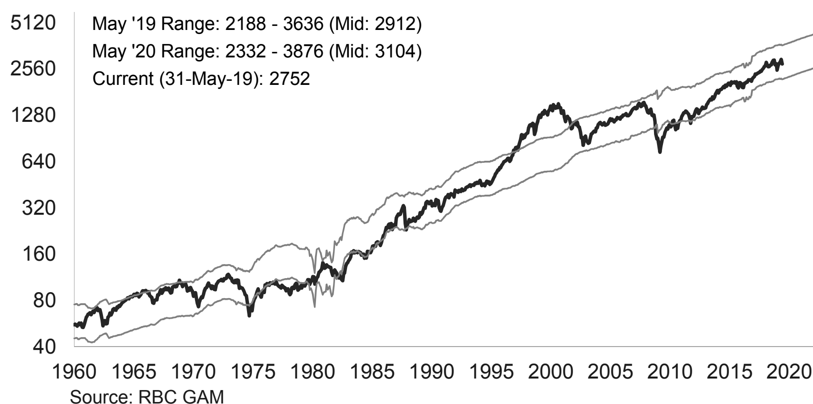
Making matters worse, President Trump tweeted on the last day of May that he would subject Mexican exports to an escalating tariff starting at 5 percent and rising to 25 percent by the end of October in an effort to force Mexico to control a flood of migrants trying to enter the U.S. from the south. Investors could not anticipate that the administration would open up another front in the trade war with one of its closest allies and biggest trading partners, particularly when Mexico's legislature is in the process of considering ratification of the revised North American trade agreement known as USMCA. Investors' response to the uncertainty was to boost exposure to bonds and decrease exposure to stocks.

United States – Recommended sector weights

	RBC GAM Investment Strategy Committee May 2019	Benchmark S&P 500 May 2019
Energy	4.1%	4.9%
Materials	2.3%	2.7%
Industrials	8.9%	9.4%
Consumer Discretionary	10.3%	10.1%
Consumer Staples	7.6%	7.5%
Health Care	13.7%	14.2%
Financials	12.3%	13.3%
Information Technology	23.3%	21.3%
Communication Services	11.0%	10.0%
Utilities	3.5%	3.4%
Real Estate	3.2%	3.2%

Source: RBC GAM

S&P 500 Equilibrium
Normalized earnings and valuations



Given the roughly 6 percent decline in stocks from the all-time high, it is now time to reassess how to structure our U.S. equity portfolios. First, surveys of global manufacturing activity indicate that economic growth is slowing. Many industrial metals such as copper and nickel have been falling for 18 months and the price of oil has come under pressure recently on the back of slowing growth in China, the trade war and a generally stronger U.S. dollar. In the U.S., economic growth is slowing, and the employment picture continues to be robust with the unemployment rate below 4 percent, wage growth exceeding 3 percent and the economy generating roughly 200,000 new jobs

per month on average. In our opinion, consumers remain in good shape with manageable debt levels and their wages growing faster than inflation. Consumer confidence has held up so far, but consumption could suffer if the trade fight drags on through the fall and tariffs lead to measurably higher retail prices.

For companies, the typical sources of risk come in the form of excessive capital spending or borrowing. It appears that, in aggregate, any excesses in these areas are not troublesome. Public companies that have taken on significant debts over the past decade have locked in low fixed interest rates and for the most part have plenty of cash to cover interest costs. While corporate-bond spreads increased this spring, we do not believe the market is signaling any unusual vulnerability at present. In fact, the cost of borrowing for top investment-grade corporate borrowers dropped to 4.55 percent at the end of May from 5.30 percent in November of last year. While corporations are in good shape overall, the trade battle has thrown sand in the gears of global trade and the uncertainty surrounding trade is causing many management teams to rethink capital spending and hiring plans. Companies with supply chains in China, such as capital-goods manufacturers and makers of technology hardware, face higher costs and/or expenses linked to moving supply chains to other parts of Asia and Mexico – even perhaps back to the U.S.

With the outlook on trade souring, investors have scrambled to lower their earnings-growth forecasts. In our opinion, a major risk for the stock market is that earnings estimates for the second quarter and, more importantly, for the remainder of the year will be scaled back as analysts contemplate the potential of a protracted trade war. A second risk is that, as the headwinds to growth and earnings increase, valuations for risky assets are likely to fall. Currently, the S&P 500 trades at roughly 16 times the next 12 months' estimated earnings. Since last fall, the stock market has traded between 18 times at the high in September 2018 and 13.5 times at the low on Christmas Eve 2018, when investors began pricing in the likelihood of a recession. It seems prudent to expect both lower earnings and lower valuations until the prospects for global growth are restored.

The impact of the U.S.-China trade dispute on GDP won't be particularly significant, at least in the immediate term. However, higher tariff-related costs could soon result in a hit to S&P 500 earnings of about 5 percent if the current tariffs on US$250 billion of Chinese exports persist and perhaps 10 percent if the U.S. follows through on its threat to apply 25 percent tariffs to an additional US$300 billion of Chinese exports.

While our base case is for stocks to rise modestly over the next year, there are several scenarios that could lead to different outcomes. In the upside scenario, the expansion would remain intact through 2021, perhaps because the U.S. Federal Reserve remains on the sidelines or cuts interest rates, the U.S. and China agree to eliminate trade tariffs and the Chinese economy reaccelerates in the near term. In the downside scenario, global growth would continue to slow, likely because the U.S.-China dispute escalates further, corporate earnings continue to be revised lower and rising geopolitical risks cause investors to reduce valuations of risky assets. Our latest assessment is that the odds of the downside scenario have increased, particularly with the new threat of tariffs to Mexican exports by early June.

Regional Outlook – Canada

Sarah Neilson, CFA
Portfolio Manager
RBC Global Asset Management Inc.

Irene Fernando, CFA
Portfolio Manager
RBC Global Asset Management Inc.

The S&P/TSX Composite Index outperformed global equity markets between January and May of this year, gaining 13.7 percent, while the S&P 500 Index gained 12.2 percent and the MSCI global index rose 9.7 percent. A number of macroeconomic drivers continue to be the focus of equity investors, including the outlook for global trade, the path and pace of global economic growth, and their combined impact on corporate earnings. The uncertain economic backdrop has resulted in central banks moving to a more cautious approach on monetary policy, which has supported equity valuations.

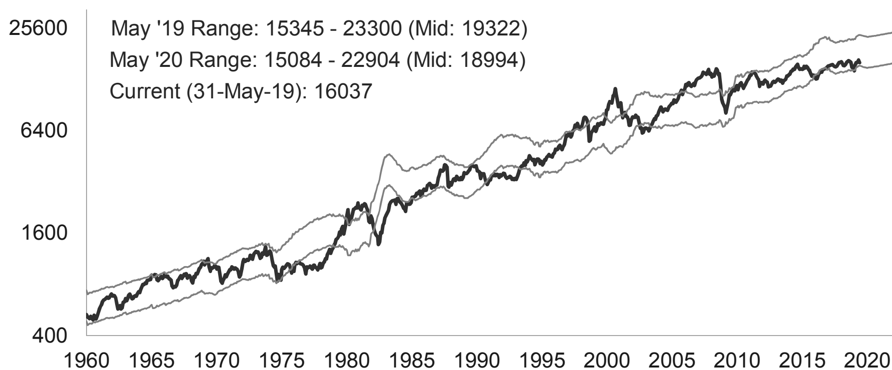
Canada's economic outlook reflects the trade uncertainty, moderating housing activity and the considerable pressure on the energy sector due to weak and volatile commodity prices and the Alberta's government-mandated reduction in production volumes that took effect at the start of the year. Consensus forecasts for Canada's GDP growth now sit at 1.5 percent for 2019, down from 1.9 percent at the beginning of the year. As a result, the Bank of Canada (BOC) maintained the benchmark interest rate at 1.75 percent at its latest meeting, leaving rates unchanged since its last increase in October 2018. The BOC has lowered its forecast for 2019 GDP growth to 1.2 percent from 1.7 percent but said there could be some recovery in the economy in the second half of the year due to easing financial conditions and increasing exports.

Canada – Recommended sector weights

	RBC GAM Investment Strategy Committee May 2019	Benchmark S&P/TSX Composite May 2019
Energy	16.5%	17.2%
Materials	10.0%	10.3%
Industrials	12.0%	11.4%
Consumer Discretionary	4.0%	4.0%
Consumer Staples	5.0%	4.1%
Health Care	1.0%	2.0%
Financials	32.0%	32.1%
Information Technology	5.0%	5.1%
Communication Services	7.0%	5.9%
Utilities	4.0%	4.4%
Real Estate	3.5%	3.5%

Source: RBC GAM

S&P/TSX Composite Equilibrium
Normalized earnings and valuations



Source: RBC GAM

Earnings-growth expectations for 2019 have shifted considerably, driven predominantly by swings in oil prices and volatility in energy-sector profit estimates. Commodity futures are implying that the price of West Texas Intermediate (WTI) crude oil could average US$57 per barrel in 2019, with analysts basing their earnings estimates on a crude-oil price of US$59. Energy-company earnings estimates are likely to be stable in the near term. Materials-sector earnings have been lowered to reflect declines in base-metals prices resulting from global trade uncertainty. Analysts expect 2019 TSX earnings of $1,102, a gain of 7 percent year over year,

but down from an 11 percent growth target earlier in the year. Looking to 2020, TSX earnings are forecast to rise 11 percent to $1,222, with significant growth expected in the Health Care, Materials, Industrials and Information Technology sectors.

The TSX's gain so far in 2019 has reversed all of the losses from 2018. The Materials sector has meaningfully underperformed the index this year, with falling copper and lumber prices offsetting the positive impact of increased merger activity in the gold-mining industry. Investors continue to favour sectors that are less exposed to the pace of economic growth, including Real Estate, Consumer Staples and Utilities. A noticeable rebound in the Energy sector in the first few months of the year was driven by higher WTI prices. Energy stocks subsequently pulled back but performed in line with the index. Transportation stocks boosted the performance of the Industrials sector, beating the TSX by a healthy margin. Information Technology has remained one of the top-performing sectors in Canada for many months, and Health Care has been the strongest sector overall given the rebound in cannabis stocks.

The Financials sector has delivered a 9.3 percent return since the beginning of the year, underperforming the TSX by 2.6 percentage points. Life-insurance stocks have risen 15.8 percent since January, erasing most of the losses posted in 2018. Banks, though, have lagged the index due to concern about a housing-market slowdown and high consumer leverage. Credit provisions have been increasing from historically low levels but there are no signs of widespread deterioration. The reluctance of central-bank policymakers in Canada and the U.S. to pursue further interest-rate hikes has had a bit of a dampening effect on investor expectations for bank profits, given that banks tend to have expanding profit margins during periods when rates are rising. The consensus forecast for bank earnings is a 4 percent increase for 2019 and 7 percent for 2020, reflecting assumptions of slower growth in domestic banking. Banks stocks should, in our view, continue to trade at the lower end of their historical P/E valuation range of 9 to 12 given the concerns about the sustainability of economic growth and the possible impact on borrowers of a significant economic downtown.

Crude-oil prices have generally risen in 2019 as speculation that supplies may be insufficient to meet demand has emerged after a glut at the end of last year. Global supply moderated due to OPEC reductions and U.S. sanctions imposed on Venezuela and Iran, both of which are major oil suppliers. Oil demand has remained resilient as increasing use in China and India, the two fastest-growing major economies, has more than offset the negative impact on demand of declining global economic growth.

The TSX Energy sector has gained 11.7 percent so far this year, outperforming U.S. peers, which have gained 2.7 percent. However, oil equities have underperformed the 21 percent rise in crude prices. While the surge in crude-oil prices in early 2019 was a tailwind, geopolitical tensions and trade conflicts have lately become headwinds to further increases. In a more uncertain macroeconomic environment, Canada's energy industry benefits from the relatively low break-even prices required by Canadian oil producers to generate free cash flow, as well as attractive valuations.

Regional Outlook – Europe

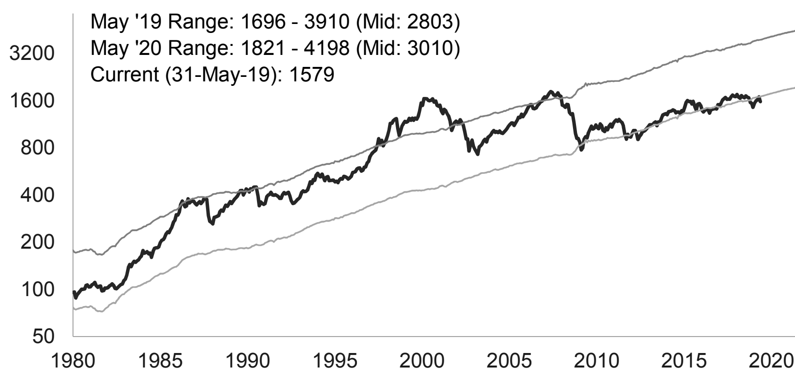
David Lambert
Senior Portfolio Manager
RBC Global Asset Management (UK) Limited

Europe – Recommended sector weights

	RBC GAM Investment Strategy Committee May 2019	Benchmark MSCI Europe May 2019
Energy	7.0%	8.0%
Materials	7.0%	7.4%
Industrials	13.8%	13.3%
Consumer Discretionary	10.0%	9.3%
Consumer Staples	15.5%	14.9%
Health Care	13.0%	12.9%
Financials	17.7%	18.1%
Information Technology	6.0%	5.7%
Communication Services	4.6%	4.8%
Utilities	4.0%	4.2%
Real Estate	1.5%	1.4%

Source: RBC GAM

Eurozone Datastream Index Equilibrium
Normalized earnings and valuations



Source: Datastream, Consensus Economics, RBC GAM

Europe's leading economic indicators have deteriorated gradually over the past year, and earnings forecasts have been pared over the past 12 to 18 months. However, these indicators appear to have stopped falling, with economic statistics including Germany's Purchasing Managers' Index for manufacturing at or below levels that we have seen in previous corrections, and from this position a rebound is likely given how far they have declined. The broader IFO business-climate index is also showing stabilization, and Europe's unemployment rate continues to improve.

It should be remembered that Europe's growth cycle has tended to lag the global cycle rather than lead it, and we see no reason why this shouldn't continue to hold true. We are therefore optimistic that the slow erosion in earnings expectations may be coming to an end and possibly even turn up from here.

Since the 2008-2009 global financial crisis, European earnings have lagged the U.S. considerably. This development has been accounted for mainly by sectors that rely on domestic business for a good part of their revenues, and we expect these areas to continue to be a drag on financial markets. The domestic sectors include Financials and Utilities, which are subject to high levels of regulation and are capital-intensive. In short, these areas of the market are not ones where we expect to find many good long-term investment opportunities. If we exclude the domestically oriented and commodity-linked stocks – which mainly comprise large globally competitive companies – we see that the European earnings cycle has actually been similar to the U.S. since 2008. This non-domestic part of the universe is the area of the market on which we continue to focus.

One other encouraging signal of late is the reaction of stock prices after companies report, something we have always found useful in gauging the market's appetite for risk. Companies beating expectations are being rewarded at or above historical

averages, and at the same time many companies that missed estimates or have lowered guidance are trading better than usual. This bodes positively for risk and chimes nicely with what we see in the Bank of America Merrill Lynch Macro Composite Leading Indicator.

This year, the majority of the earnings growth in Europe has come from the Information Technology sector, followed by Energy, Health Care and the consumer areas, all of which are in general more exposed to the global market. We project aggregate 2019 earnings growth in the mid-single digits, slightly slower than the historical average. However, we do not consider equity valuations particularly stretched relative to other regions, or versus corporate bonds.

Clearly, the big factor that is affecting all global markets is the potential escalation of trade wars and the impact this could have on global trade and the disruptive threat that it poses to the cycle. However, we would add the caveat that geopolitical events tend to have a short-lived impact on equity markets.

European politics, as ever, retain their unpredictable hold on the region's economy. While in many countries political parties of the extreme left and the extreme right continue to steal influence at the expense of the traditional centre, the political headlines that they generate have had less of an impact on companies and their operations than many investors might have expected. As always, the biggest political hot potato in Europe is Brexit, which recently took its latest victim in the form of the resignation of British Prime Minister Theresa May. We suspect that the next prime minister will be a hard-liner who can speed up the Brexit proceedings and provide clarity for financial markets.

European price-to-earnings and price-to-book ratios continue to sit at multi-decade lows relative to the U.S. However, adjusting for sector differences between the two regions – the U.S. is technology-heavy and Europe more exposed to financial services – the comparative price-to-earnings ratio is much closer, with Europe looking only slightly below fair value. We can argue that the valuation differences between Europe and the U.S. are largely explained by sector composition. Another thing making stocks attractive is returns from dividends, which are offering more yield than investment-grade bonds, a departure from the norm. According to JPMorgan, dividend yields in Europe currently exceed investment-grade bond yields by 2.6 percent, whereas the norm is for investment-grade bonds to offer a 0.4 percent yield premium versus dividends.

At the corporate level, balance sheets in Europe remain robust as companies continue to deleverage. Moreover, capital spending is lagging on a historical basis, so there is room for higher capital expenditures in the Eurozone to spur economic growth.

How are we positioning our portfolios from this point? There's a good chance that, given the stabilization in leading indicators, sector rotation may begin to favour companies that benefit from a faster-growing economy. As leading indicators become less negative, we tend to enter a 'recovery' phase of the market from a style perspective. In this phase, risk and value stocks begin to perform better at the expense of quality and growth. These transitions must be monitored closely, as confirmation of the transition only comes after multi-month stabilization and/or improvement. The key is to be positioned on the correct side of earnings momentum.

From a sector perspective, we have a favourable view of the consumer areas, but are increasing exposure to companies that would benefit from a faster economic expansion through allocations to the Industrials sector. We do not have a strong view on the Financials sector, but hold a more positive view of companies classified as diversified financials. In our view, banks offer less opportunity given their domestic focus and capital intensity.

Regional Outlook – Asia

Chris Lai
Analyst, Asian Equities
RBC Investment Management (Asia) Limited

Asian equities posted overall declines during the three months ended May 31, 2019, as trade tensions between the U.S. and China ramped up, reversing gains made earlier in the period. With many economies in the region exposed to the trade dispute between the world's two largest economies, Asian equities underperformed the MSCI World Index. Asian currencies depreciated in general against the U.S. dollar due to the trade frictions and slowing global economic growth.

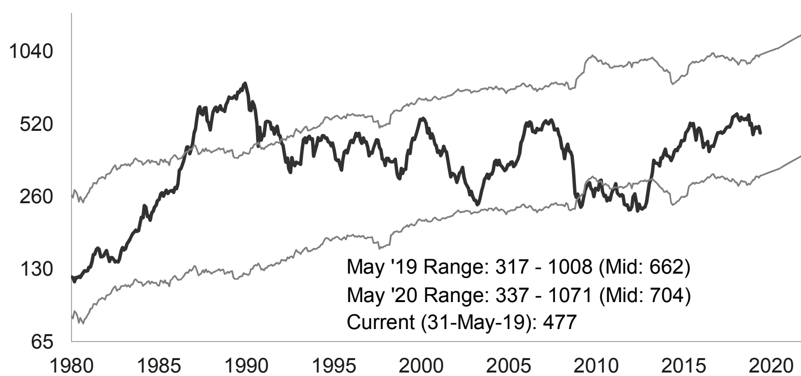
Chinese equities underperformed, retreating in May after President Trump announced that the U.S. would increase tariffs on a range of imports to 25 percent from 10 percent. Trump also placed Huawei, the largest Chinese technology company, on a list that may require U.S. suppliers to obtain a license to do business with the company. In India, Prime Minister Narendra Modi was re-elected with his parliamentary majority remaining intact. The fresh mandate will allow Modi to continue a policy platform aimed at expanding the middle class and bolstering infrastructure development. Australian shares rose after the ruling Conservative Party's surprise victory. Australia's central bank is likely to maintain an accommodative monetary policy to support economic growth. So far this year, South Korea and other markets in Southeast Asia have lagged the regional benchmark.

Asia – Recommended sector weights

	RBC GAM Investment Strategy Committee May 2019	Benchmark MSCI Pacific May 2019
Energy	2.8%	3.3%
Materials	5.8%	6.5%
Industrials	11.8%	12.3%
Consumer Discretionary	14.5%	14.1%
Consumer Staples	7.0%	6.5%
Health Care	6.0%	6.0%
Financials	20.0%	20.7%
Information Technology	13.3%	12.3%
Communication Services	10.0%	9.8%
Utilities	3.3%	2.7%
Real Estate	5.8%	5.8%

Source: RBC GAM

Japan Datastream Index Equilibrium
Normalized earnings and valuations



Source: Datastream, Consensus Economics, RBC GAM

Across the region, the best performing sectors were Real Estate, Information Technology and Health Care, while Utilities and Consumer Staples underperformed.

Japan

Japan's economy appears to be more resilient than other Asian countries to the U.S.-China trade war given strong economic and political ties between the U.S. and Japan and the large size of Japan's domestic market. Nonetheless, Japan will be hurt by trade frictions as Japanese companies have increasingly looked to China to expand revenue in recent years. The growth of the Chinese middle class has bolstered demand for Japanese consumer and industrial goods. Also holding back the Japanese economy are slowing exports to countries other than China and weak

domestic consumption. In the medium term, the decision by Prime Minister Abe to raise the consumption tax in 2019 has the potential to undermine economic growth.

The outlook for Japanese exports and domestic manufacturing should improve as corporate inventories have declined significantly over the past three months amid Japan's mixed macroeconomic environment, and the Bank of Japan continues to reaffirm its accommodative policy stance as inflation remains shy of the central bank's targets. The positive outlook for Japanese equities remains intact on the back of solid earnings growth and market reforms that should support stocks over the longer term. Moreover, valuations are attractive and corporate profitability is outpacing other major markets. Signs of better corporate governance are evidenced by large corporate buybacks and a greater focus on capital efficiency, both of which should act as tailwinds for Japanese stocks.

Asia Pacific ex-Japan

The region's increasingly fragile outlook and global trade uncertainty has us focusing on companies that can grow sustainably and that are less affected by macroeconomic concerns.

The main factor driving the Chinese economy is government stimulus. Chinese policymakers acknowledge that trade uncertainty will lead to slower growth, but we expect Chinese GDP growth to remain above 6 percent. China's efforts to stimulate its economy have relied mainly on boosting credit and consumption, in part through corporate and personal income-tax reductions. The tax steps and the People's Bank of China decision to lower the reserve requirement for commercial banks are showing early signs of success, as retail sales expanded 8.7 percent in March and first-quarter GDP beat expectations. The Chinese central bank has signaled, however, that the stimulus will be measured to avoid a bubble in the housing market and excessive credit growth.

Over time, we expect increased foreign capital flows into China's domestic share market (A shares). Both MSCI's A-share index and MSCI emerging-market indexes are set to increase the amount represented by Chinese large-cap stocks to 20 percent by 2020 from the current 5 percent in three stages, and we expect the changes to add roughly US$80 billion of foreign inflows.

Indonesian equities have underperformed in 2019 after political instability preceding national elections, a worsening trade picture and moves by investors to shift a portion of their assets to China given the bigger index weight. Looking ahead, President Jokowi won a second five-year term. We view the victory as a strong endorsement of his economic agenda, which over the past five years has focused on developing physical infrastructure. More importantly, Jokowi now has a mandate to emphasize capital spending and exports. This orientation should sustain economic growth and be positive for Indonesian equities.

Australian equities have outperformed most of their regional peers, led by financial services and consumer stocks. The election victory of Prime Minister Scott Morrison leads us to expect that the government will scale back levies that stand to significantly reduce bank earnings. Morrison also supports income-tax cuts, which would benefit consumer stocks. Iron-ore prices have jumped following supply cuts in Brazil, aiding Australia's Rio Tinto and BHP in the all-important mining industry. On monetary policy, there is an increased likelihood that the Reserve Bank of Australia will cut rates to kick-start the slowing economy. The economy remains highly dependent on China, which accounts for about a third of Australia's exports.

Regional Outlook – Emerging Markets

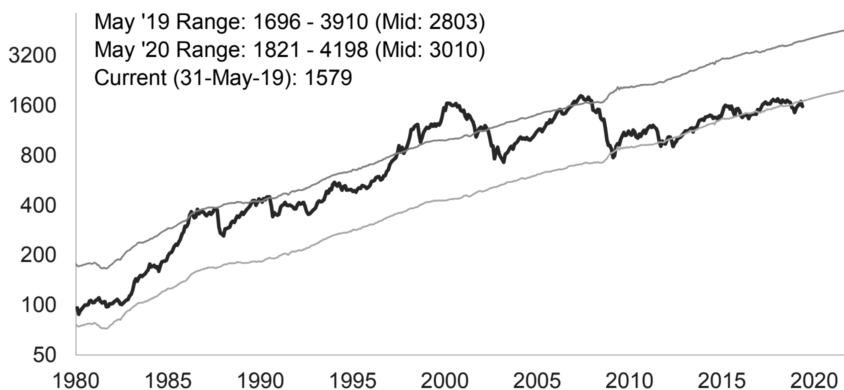
Christoffer Enemaerke
Portfolio Manager
RBC Global Asset Management (UK) Limited

Emerging-market equities had good momentum in March and April but corrected significantly beginning in May, driven by the escalating trade war between China and the U.S. The trade conflict resurfaced in the headlines after the U.S. announced in early May that it would hike tariffs on US$200 billion of Chinese goods to 25 percent from 10 percent. Emerging-market equities were up by more than 12 percent between January and April, but after the May selloff, the gain for the year came down to about 3 percent in U.S. dollar terms.

In the short term, trade-war discussions are likely to continue to move financial markets. In the longer term, however, the big question is where we are in the economic cycle that started when emerging-market equities bottomed at the beginning of 2016. Last year was a difficult year for emerging markets, which significantly underperformed developed markets because of the strong performance of the U.S. economy and the U.S. dollar. Our view is that emerging markets are still in the early to middle part of the cycle, and that emerging-market stocks can continue to do well relative to developed-markets equities if decent GDP and earnings growth unfold.

A key long-term driver of emerging-market relative performance is the difference in the rate of economic growth in emerging markets

Emerging Market Datastream Index Equilibrium
Normalized earnings and valuations



Source: Datastream, Consensus Economics, RBC GAM

versus developed markets. The underperformance of emerging markets between 2010 and 2016 coincided with contraction in the growth differential. However, since 2016, the gap has started to widen in favour of emerging markets. While emerging-market equities underperformed in 2018, IMF forecasts suggest an expansion in the growth differential until at least 2021, which would be positive for emerging markets based on the strong historical correlation. Brazil, India, Mexico and some other large economies are forecast to grow more quickly, somewhat offsetting the slowdown in China, and at the same time the IMF expects developed markets such as the EU and U.S. to slow.

Emerging-market earnings-per-share forecasts have fallen continuously in 2019, from 8.9 percent at the beginning of the year to around 4 percent currently. The declines have been driven almost entirely by the Information Technology sector, especially because of weakness in semiconductors. Among emerging-market countries, technology-dependent South Korea has experienced the largest earnings downgrades since the start of 2019. We believe that we have seen the worst of the downgrades and that earnings could start to recover in the second half of the year, unless a global recession arrives.

There are a couple of reasons to be cautiously optimistic about emerging-market equities. One is attractive valuations. Emerging-market equities currently trade at 1.45 times their price-to-book value, a level that has historically provided good downside protection, and a 31 percent discount to developed markets. An important reason for this discount has been that returns on equity in emerging markets have been worsening relative to developed markets. Any improvement, which could come from higher profit margins or asset turnover, would be encouraging.

Another reason to be positive is that emerging-market currencies look cheap at the moment, an important

consideration because currency and equity markets in emerging markets tend to move in the same direction. For one thing, emerging-market currencies are undervalued relative to developed-market currencies based on purchasing power parity, a long-term measure of currency valuation. In fact, the level of undervaluation is not far from where it was in October 2002 and exists even after the U.S. Federal Reserve has signaled that the probability for additional tightening in 2019 is low. This state of affairs should support a continued recovery in emerging-market currencies.

Recent developments in India are important because the Indian equity market represents one of the largest country exposures in the emerging-market team's strategies. In the May 23 election, incumbent Prime Minister Narendra Modi and his BJP party won a strong mandate from Indian voters, expanding the party's majority since the last election in 2014 to 303 of the legislature's 545 seats. It was the first time since 1984 that a political party had been able to win a majority in consecutive elections. We view this as a positive development, as it means a stable political and policy environment, and makes us optimistic that widespread economic reforms are now more likely. The government has undertaken reforms in the past five years covering the goods-and-services tax, bankruptcy law, real-estate regulation and steps to foster a cashless economy. Looking forward, we expect the government to prioritize infrastructure spending, with a particular focus on housing; maintain low inflation; continue with changes to the goods-and-services tax; and strive to increase farmers' incomes.

We view the top-down outlook for India very favourably. The IMF forecasts that India will be the fastest-growing major emerging-market country over the next five years. It is likely that India's economic growth will be driven chiefly by growing domestic consumption. India presently has a very low per-capita GDP of less than US$2,000 per year, but as incomes rise the growing middle class will spend more on necessities and increase discretionary consumption. In addition, India stands to benefit from increasing urbanization, as it has one of the lowest rates in emerging markets at about 30 percent. With more Indians migrating to cities, productivity is likely to increase, providing a boost to incomes and consumption. India also has one of the youngest populations among emerging countries. The median age in the country is 28 years, compared with 37 in China, 38 in the U.S., 41 in the U.K. and 47 in Japan. This should support high GDP growth for years to come.

RBC GAM Investment Strategy Committee

Members

Daniel E. Chornous, CFA

Chief Investment Officer
RBC Global Asset Management

Chair, RBC GAM Investment Strategy Committee

Dan Chornous is Chief Investment Officer of RBC Global Asset Management Inc., which has total assets under management of approximately $454 billion*. Mr. Chornous is responsible for the overall direction of investment policy and fund management. In addition, he chairs the RBC Investment Strategy Committee, the group responsible for global asset-mix recommendations and global-fixed income and equity portfolio construction for use in RBC Wealth Management's key client groups including retail mutual funds, International Wealth Management, RBC Dominion Securities Inc. and RBC Phillips, Hager & North Investment Counsel Inc. He also serves on the Board of Directors of the Canadian Coalition for Good Governance and is Chair of its Public Policy Committee. Prior to joining RBC Asset Management in November 2002, Mr. Chornous was Managing Director, Capital Markets Research and Chief Investment Strategist at RBC Capital Markets. In that role, he was responsible for developing the firm's outlook for global and domestic economies and capital markets as well as managing the firm's global economics, technical and quantitative research teams.

* AUM in CAD as of April 30, 2019.

Stephen Burke, PhD, CFA

Vice President and Portfolio Manager
RBC Global Asset Management

Stephen is a fixed-income portfolio manager and Head of the Quantitative Research Group, the internal team that develops quantitative research solutions for investment decision-making throughout the firm. He is also a member of the PH&N IM Asset Mix Committee. Stephen joined Phillips, Hager & North Investment Management in 2002. The first six years of his career were spent at an investment-counselling firm where he quickly rose to become a partner and fixed-income portfolio manager. He then took two years away from the industry to begin his Ph.D. in Finance and completed it over another three years while serving as a fixed-income portfolio manager for a mutual-fund company. Stephen became a CFA charterholder in 1994.

Dagmara Fijalkowski, MBA, CFA

Head, Global Fixed Income & Currencies
RBC Global Asset Management

As Head of Global Fixed Income and Currencies at RBC Global Asset Management, Dagmara leads investment teams in Toronto, London and Minneapolis in charge of almost $100 billion in fixed income assets. In her duties as a portfolio manager, Dagmara heads management of several bond funds, manages foreign-exchange hedging and active currency overlay programs across a number of funds. Dagmara chairs the Fixed Income Strategy Committee. She is also a member of the Investment Policy Committee, which determines asset mix for balanced and multi-strategy products, and the RBC Investment Strategy Committee. In 2016, she was appointed to the RBC GAM Executive Committee. Dagmara, who began her investment career in 1994, holds an MBA from the Richard Ivey School of Business in Canada and a Master's degree in economics from the University of Lodz in Poland. Dagmara has been a CFA charterholder since 1997.

Stuart Kedwell, CFA

Senior Vice President and
Senior Portfolio Manager
RBC Global Asset Management

Stu co-leads the North American Equity team and is a member of the RBC GAM Investment Strategy Committee, which is responsible for establishing the firm-wide global asset mix for mutual funds and for institutional and high net worth private clients. Stu began his career in 1996 with RBC Dominion Securities in the firm's Generalist program, a two-year internship in which participants rotate through different areas of the firm. In 1998, he joined the RBC Investments Portfolio Advisory Group, which provides investment ideas and recommendations to RBC DS Investment Advisors. He was also a member of the RBC DS strategy & focus list committees. Stu has been with the firm since 2002 and is a CFA charterholder.

Eric Lascelles

Chief Economist
RBC Global Asset Management

Eric is the Chief Economist for RBC Global Asset Management Inc. (RBC GAM) and is responsible for maintaining the firm's global economic forecast and generating macroeconomic research. He is also a member of the RBC GAM Investment Strategy Committee, the group responsible for the firm's global asset-mix recommendations. Eric is a frequent media commentator and makes regular presentations both within and outside RBC GAM. Prior to joining RBC GAM in early 2011, Eric spent six years at a large Canadian securities firm, the last four as the Chief Economics and Rates Strategist. His previous experience includes positions as economist at a large Canadian bank and research economist for a federal government agency.

Hanif Mamdani

Head of Alternative Investments
RBC Global Asset Management

Hanif Mamdani is Head of both Corporate Bond Investments and Alternative Investments. He is responsible for the portfolio strategy and trading execution of all investment-grade and high-yield corporate bonds. Hanif is Lead Manager of the PH&N High Yield Bond and Alternative strategies, including a multi-strategy hedge fund. He is also a member of the Asset Mix Committee. Prior to joining the firm in 1998, he spent 10 years in New York with two global investment banks working in a variety of roles in Corporate Finance, Capital Markets and Proprietary Trading. Hanif holds a master's degree from Harvard University and a bachelor's degree from the California Institute of Technology.

Martin Paleczny, CFA

Vice President and
Senior Portfolio Manager
RBC Global Asset Management

Martin Paleczny, who has been in the investment industry since 1994, began his career at Royal Bank Investment Management, where he developed an expertise in derivatives management and created a policy and process for the products. He also specializes in technical analysis and uses this background to implement derivatives and hedging strategies for equity, fixed-income, currency and commodity-related funds. Since becoming a portfolio manager, Martin has focused on global allocation strategies for the full range of assets, with an emphasis on using futures, forwards and options. He serves as advisor for technical analysis to the RBC GAM Investment Strategy Committee.

Sarah Riopelle, CFA

Vice President and
Senior Portfolio Manager
RBC Global Asset Management

Since 2009, Sarah has managed the entire suite of RBC Portfolio Solutions. Sarah is a member of the RBC GAM Investment Strategy Committee, which sets global strategy for the firm, and the RBC GAM Investment Policy Committee, which is responsible for the investment strategy and tactical asset allocation for RBC Funds' balanced products and portfolio solutions. In addition to her fund management role, she works closely with the firm's Chief Investment Officer on a variety of projects, as well as co-manages the Global Equity Analyst team.

William E. (Bill) Tilford

Head, Quantitative Investments
RBC Global Asset Management

Bill is Head, Quantitative Investments, at RBC Global Asset Management and is responsible for expanding the firm's quantitative-investment capabilities. Prior to joining RBC GAM in 2011, Bill was Vice President and Head of Global Corporate Securities at a federal Crown corporation and a member of its investment committee. His responsibilities included security-selection programs in global equities and corporate debt that integrated fundamental and quantitative disciplines, as well as management of one of the world's largest market neutral/overlay portfolios. Previously, Bill spent 12 years with a large Canadian asset manager, where he was the partner who helped build a quantitative-investment team that ran core, style-tilted and alternative Canadian / U.S. funds. Bill has been in the investment industry since 1986.

Milos Vukovic, CFA

Vice President, Investment Policy
RBC Global Asset Management

Milos, who joined RBC in 2003, oversees investment-management activities including new-fund launches, performance analytics and trade-cost analysis. He is also responsible for developing and monitoring investment mandates and implementing tactical asset allocation for the RBC GAM investment solutions. Milos earlier worked for a Big 4 accounting firm and two top-tier securities firms. He earned an MBA at the Schulich School of Business and has held the CFA designation since 2004. He is a board member of both the Canadian Buy-Side Investment Management Association and the Canadian Advocacy Council for Canadian CFA Institute Societies, and recently joined IIROC's Market Structure Advisory Committee.

Brad Willock, CFA

Vice President and
Senior Portfolio Manager
RBC Global Asset Management

Brad Willock joined RBC Global Asset Management in July 2002 and is a Senior Portfolio Manager and CFA charterholder. In his current role, Brad has responsibility for RBC Global Asset Management's core and income-oriented U.S. equity strategies. He joined RBC in May 1996 after receiving a bachelor's of commerce degree with distinction from the University of Calgary. Prior to that, Brad obtained a bachelor's of science degree at the University of British Columbia and represented Canada at the 1992 Barcelona Summer Olympics in volleyball.

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