October 31, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

See you in the spring?

Thomas Garretson, CFA – Minneapolis

After delivering three rate cuts in three meetings, the Fed now looks set to take a wait-and-see approach as it assesses the appropriate path ahead. However, we expect any pause to be short-lived, and the path to be much the same.

At the end of 2018, the Federal Reserve had plans to raise rates three times in 2019. But 2019 had other ideas, and the Fed has now *cut* rates three times this year, bringing the fed funds rate to a range of 1.50%–1.75%, down from a range of 2.25%–2.50% at the beginning of the year.

When the Fed began cutting rates in July, we expected that the rate cuts would continue until the yield curve inversions that had sparked much of the recent recession fears were reversed. And to that end, the objective has been achieved. As the chart shows, the 0.75% reduction in the fed funds rate has resteepened yield curves, including the benchmark 3-month-to-10-year curve that at its deepest inversion point in August was signaling a nearly 50% chance of recession within one year, according to the New York Fed's model.

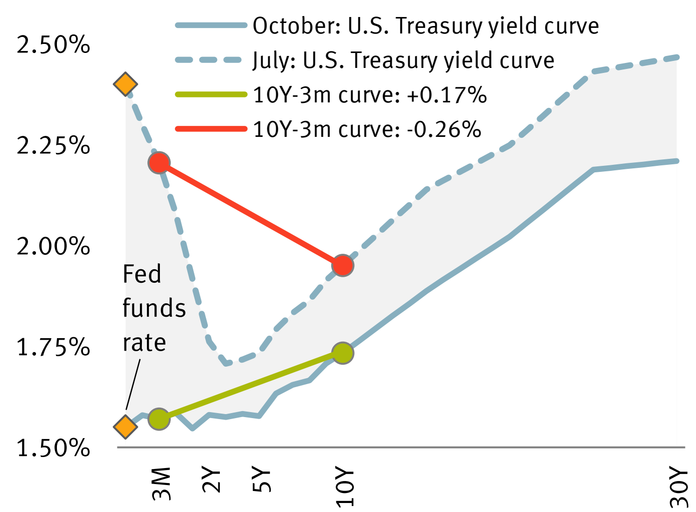
And the Fed seems to agree, signaling at the October 30 meeting that we've likely reached the end of this "mid-cycle adjustment" with Fed Chair Jerome Powell stating that the current stance of monetary policy is in a "good place," while removing the Fed's intent to "act as appropriate" with respect to interest rate adjustments from the official statement.

The widely anticipated pause in rate cuts appears to be in place, but for how long might it last?

The Fed's winter hibernation

For the first time in a while, the markets and the Fed are on the same page. The Fed has one last meeting this year in December,

Fed rate cuts remove yield curve inversion, is the coast clear?



Source - RBC Wealth Management, Bloomberg

Market pulse

with markets pricing a 75% chance that the Fed will take a pass on cutting rates. But even if the Fed can remain in hibernation through the winter without the markets poking it, the central bank will likely emerge to expectations for further rate cuts in the spring thaw.

As it stands, the market is looking at probabilities beyond 60% that the Fed will resume cutting interest rates at the March 2020 meeting, and, in our view, the bias is indeed toward further rate reductions.

Returning to the first chart, while yield curves have resteepened, it is only modestly so. We would also like to see a more sustained un-inversion before taking it as a positive signal that the growth outlook has steadied; the 90-day moving average of the 3-month-to-10-year yield curve remains inverted.

With respect to the outlook for yields, we don't believe that yield curves can steepen much further from current levels given ongoing growth concerns. Therefore, we believe the 10-year Treasury yield, currently trading around 1.70%, will hold below 2% for the foreseeable future. And with further rate cuts likely in store, the trajectory is likely to remain lower, continuing a trend that has been in place for one year now when the benchmark 10-year yield peaked at 3.24%.

Economic growth in focus

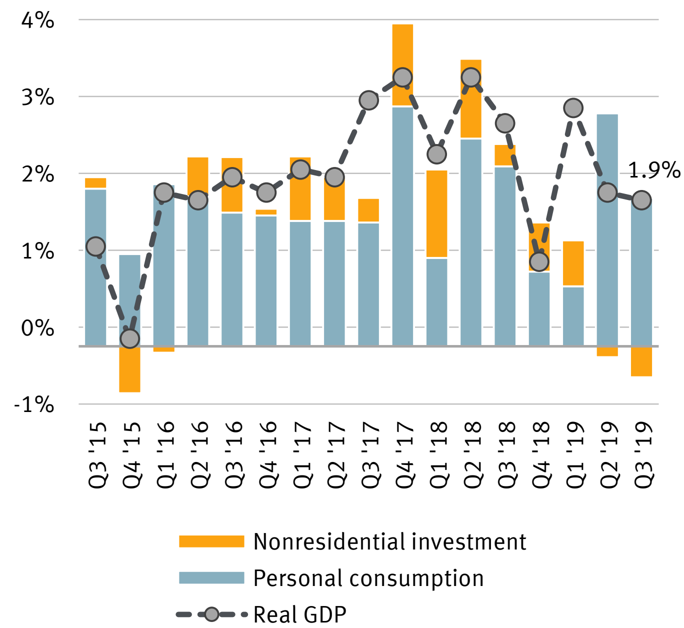
The first estimate of Q3 U.S. GDP released this week just prior to the Fed meeting provided a perfect encapsulation of the challenges the Fed—and the economy—faces while also justifying the Fed's rate cuts to this point.

The first look at GDP showed that ongoing trade wars and generally elevated levels of uncertainty are fueling declines in business spending and investment—as indicated by the -0.40% drag from nonresidential investment—which contributed to headline GDP growth slipping below 2% in the first estimate. Business investment has now been negative for the last two quarters and for the first time since 2015–2016, which was during the last round of global recession fears.

On the flip side, consumers continue to provide the offsetting support to the global manufacturing slowdown with strong consumption numbers, partly as a result of lower interest rates as the national average 30-year mortgage rate has declined by more than 1% over the past year. This has led to a positive 0.18% contribution from residential investment, a metric that has been negative for the past six quarters.

Like investors, the Fed is awaiting any type of resolution to a number of global issues. As noted in the official statement, policymakers plan to monitor developments as they assess the "appropriate path" for interest rates ahead. To us, that could mean the bar for further rate cuts is quite high.

Business investment drags U.S. GDP lower, offset by consumer strength



Source - RBC Wealth Management, Bloomberg; data shows contribution to quarterly GDP; not all GDP components shown

The clock is still ticking

Our base case remains that the Fed's efforts to this point to sustain the current economic expansion will be effective in stabilizing growth. But with short-term rates now just 1.75% away from the 0% levels that prevailed in the aftermath of the financial crisis, the Fed may be loath to deliver further stimulus absent an actual economic downturn as it has little room to do so—with the Fed's reluctance itself potentially adding to recession risks.

It will take months, and even quarters, for the Fed's recent easing efforts to work their way through the economy, giving the Fed a runway to judge the incoming data. But our view remains that yield curve inversions began the countdown on the current economic cycle. Though the Fed is moving to the sidelines, and some economic data has steadied, the risks remain to the downside, and investors should remain vigilant.

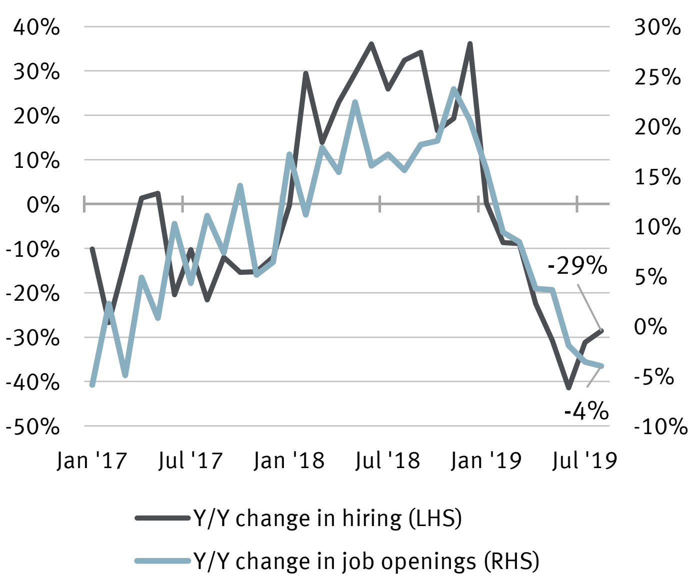
United States

Bill Kuehn, CFA & Bob Dickey – Minneapolis

- **The S&P 500 Index is in the news as it hits new all-time highs**, and with that comes expectations from some that the uptrend is just beginning. However, we think the internal market readings of a broader list of stocks suggest it is **actually the end of a rally, not the start of something bigger** on the upside. The number of advancing stocks and stocks hitting new highs has not kept up with the strength of the S&P 500, and then there are the other indexes like the Transports and small-cap Russell 2000 that are not confirming the strength in the large-cap indexes. **We think it's a time to be more conservative than aggressive** as far as stock selection goes, and **we expect continued volatility in both directions** over the next few months.
- While still at elevated levels by historical standards, **the Conference Board's Consumer Confidence survey has stalled** from its uptrend in 2018, and the anticipated rebound in October's reading fell flat, missing expectations of 128.0 and coming in at 125.9. **Consumers' assessment of their present situation remains near cyclical highs**, driven by growing wages; however, consumers' **expectations of the future continue to decline**. We anticipate current consumer optimism will translate into continued spending through the holiday shopping season; however, we will be watching the labor market into 2020 to get a sense of consumers' ability to spend and the continuing economic expansion for quarters to come.
- **It is still too early to make an outright call that the labor market is materially deteriorating; however, the pace of hiring along with new job openings has turned negative**, and paired with a bottoming of initial jobless claims is pointing to a cooling of 2018's labor market. The reduction in job openings suggests to us that hiring managers are less confident about the future, while a slowdown in the pace of hiring is reinforcing that view. **October's non-farm payrolls report is expected to decline to below 100,000 net new hires**, but we caution that the strike of General Motors workers along with a reduction in temporary workers related to the 2020 census are likely to skew the data. Regardless, a continuation of the slowdown in hiring trends suggests to us that we are in the later stages of this decade's long economic expansion.

Are labor markets cracking or just aging?

Pullback in job openings could signal reluctance to increase payrolls amid uncertainty



Source - RBC Wealth Management, Bloomberg; data through 10/31/19

Canada

Richard Tan, CFA & Callum Scott – Toronto

- **The Bank of Canada (BoC) held the overnight lending rate steady at 1.75%.** Although there was an acknowledgement of better-than-expected growth thus far this year, with improvements in the housing market and a stronger employment picture, **the accompanying statement and Monetary Policy Report were littered with the risks surrounding the outlook for next year and beyond**. The BoC's dovish tilt was boosted by concerns that weakening global growth forecasts and ongoing trade conflicts are restraining business investment and trade that could soon take a toll on the domestic economy as well. The statement also made a rare reference to the strength of the Canadian dollar, indicating that the risks of a stronger loonie are on the minds of BoC policymakers. After the news, the short end of the Canadian yield curve was down slightly more than the long end of the curve as the statement resurrected expectations for a rate cut in the next 12 months.
- In short, banks benefit by borrowing short (e.g., accepting customer deposits) and lending long (e.g., making mortgage loans). This model works well when long-term rates exceed short-term rates (i.e., the yield curve has a positive slope) because banks can earn a positive spread. An inverted yield curve has negative implications for the banking industry because it compresses the ability of the banks to expand net interest margins. As a result, **monetary policy moves and the resulting impact on the yield curves in both Canada and the U.S. remain in focus for bank investors**. Going into Q4 earnings, RBC Capital Markets is calling for earnings growth of approximately 5% y/y for the Canadian banks on

average. The U.S./international segments are expected to grow but at a decelerated pace, while business lines such as capital markets are projected to experience a degree of softness. The Canadian banks gathered momentum in the second half of 2019 but continue to lag the S&P/TSX Composite Index year to date.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Parliament agreed to the UK holding a general election on December 12**. According to current polls, a Conservative government is likely to win a small majority, though given the unusually large number of parties and the "first-past-the-post" system (the candidate with the most votes in each constituency wins the seat), the outcome remains opaque. **The hope is that the election will break Parliament's Brexit impasse**. Candidates who subscribe to their parties' policies are running solidly, as opposed to those Members of Parliament who evolved as dissidents as their parties' policies have become more extreme.
- **Should the Conservatives emerge with a small majority, we would expect UK equities to react positively**, particularly domestically focused stocks, as it would point to an orderly Brexit on January 31, 2020, and remove the possibility of a hard-left Labour government led by Jeremy Corbyn. Moreover, as the Conservatives have already earmarked some fiscal spending to support the economy, some areas, such as the consumer and infrastructure sectors and those related to building materials, may benefit. We would then expect inflation pressures to build and for the Bank of England to adopt a hiking bias.
- **Uncertainty regarding the UK's long-term trading relationship with the EU would remain**. As things stand, we are mindful that according to the current terms of Prime Minister Boris Johnson's withdrawal deal, **a no-deal Brexit could still occur at the end of December 2020** if a trade deal with the EU has not been consummated. It is possible that the transition period could be extended.
- Economic data in Europe remains subdued. According to October flash Purchasing Managers' Indexes, **German manufacturing is at its worst point since 2009 and the manufacturing recession is now affecting the services sector**. In France, thanks to fiscal support to stem the "Yellow Vest" protests, the services sector, consumer confidence, and hiring intentions all remain strong despite stagnating manufacturing. **Overall European economic activity is at its weakest since 2013** with both the manufacturing and services sectors showing no improvement.
- As an open economy, **the EU is particularly vulnerable to trade tensions and a slowdown in China's economy**. Easing trade tensions, stabilization in China, some fiscal easing, and loose monetary policy should eventually help the region recover, in our opinion.

Asia Pacific

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

- **Asia equity markets traded mostly higher during the week**, led by India and the Philippines. The India Sensex Index hit an all-time high on October 31, driven by massive foreign fund inflows and the U.S. Federal Reserve's decision to cut interest rates for the third straight time.
- **The U.S. and China** continued to make progress on trade negotiations, with officials saying they were **"close to finalizing" some parts of a trade agreement** and that deputy-level talks would proceed "continuously." According to Reuters, Beijing wants Washington to cancel some existing U.S. tariffs on Chinese imports, in return for stepping up its purchases of U.S. commodities. Washington, on the other hand, wants Beijing to commit to buying these products at a specific time and price, while Chinese buyers would like the discretion to buy based on market conditions. While Chile's decision to pull out of hosting the APEC summit amid mass anti-government protests was a setback for the mini-deal, some observers believe this development could allow more time to iron out the deal.
- **Hong Kong fell into a technical recession**, as Q3 GDP data showed two successive quarters of contraction. Economists are now predicting that Hong Kong will undershoot the government's full-year growth target of 0%–1%, and that **the pain could spill into next year**.
- **Japan retail sales jumped 9.1% y/y in September, the fastest pace in 5.5 years**, as consumers spent more ahead of a hike in the consumption tax. A few economists raised the alarm about a potential pullback in demand following the last-minute buying. Policymakers, however, played down the risk of a swing in consumption given the various tax benefits and incentives in place to cushion the impact of the hike.
- **Alibaba Group (BABA US) is eyeing a Hong Kong listing** after Singles Day (a Chinese shopping holiday on November 11 akin to Black Friday and Cyber Monday in the U.S.) **to raise up to $15 billion**, according to Reuters. The listing **would be the world's biggest equity deal of the year** and boost Hong Kong's status as a major capital markets hub.

MARKET SCORECARD

Data as of October 31, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,037.56	2.0%	21.2%	12.0%	18.0%
Dow Industrials (DJIA)	27,046.23	0.5%	15.9%	7.7%	15.7%
NASDAQ	8,292.36	3.7%	25.0%	13.5%	23.3%
Russell 2000	1,562.45	2.6%	15.9%	3.4%	4.0%
S&P/TSX Comp	16,483.16	-1.1%	15.1%	9.7%	2.9%
FTSE All-Share	3,993.46	-1.7%	8.7%	2.3%	-3.0%
STOXX Europe 600	396.75	0.9%	17.5%	9.7%	0.4%
EURO STOXX 50	3,604.41	1.0%	20.1%	12.7%	-1.9%
Hang Seng	26,906.72	3.1%	4.1%	7.7%	-4.7%
Shanghai Comp	2,929.06	0.8%	17.4%	12.5%	-13.7%
Nikkei 225	22,927.04	5.4%	14.6%	4.6%	4.2%
India Sensex	40,129.05	3.8%	11.3%	16.5%	20.8%
Singapore Straits Times	3,229.88	3.5%	5.3%	7.0%	-4.3%
Brazil Ibovespa	107,219.80	2.4%	22.0%	22.6%	44.3%
Mexican Bolsa IPC	43,337.28	0.8%	4.1%	-1.4%	-10.9%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,512.81	2.7%	18.0%	24.5%	19.0%
Silver (spot $/oz)	18.12	6.6%	16.9%	27.2%	8.4%
Copper ($/metric ton)	5,882.25	3.3%	-1.1%	-2.6%	-13.7%
Oil (WTI spot/bbl)	54.18	0.2%	19.3%	-17.0%	-0.4%
Oil (Brent spot/bbl)	60.23	-0.9%	12.0%	-20.2%	-1.9%
Natural Gas ($/mmBtu)	2.63	13.0%	-10.4%	-19.3%	-9.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.684%	1.9	-100.0	-146.0	-69.5
Canada 10-Yr	1.412%	5.1	-55.5	-108.2	-53.9
U.K. 10-Yr	0.629%	14.1	-64.8	-80.8	-70.3
Germany 10-Yr	-0.407%	16.4	-64.9	-79.2	-77.0

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.33%	-0.2%	8.3%	10.9%	8.6%
U.S. Invest Grade Corp	2.93%	0.0%	13.2%	14.6%	11.2%
U.S. High Yield Corp	5.61%	0.4%	11.9%	8.5%	9.6%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.3230	-2.1%	1.2%	0.2%	2.9%
CAD/USD	0.7596	0.6%	3.6%	-0.1%	-2.1%
USD/CAD	1.3165	-0.6%	-3.5%	0.1%	2.1%
EUR/USD	1.1150	2.3%	-2.8%	-1.4%	-4.3%
GBP/USD	1.2945	5.3%	1.5%	1.4%	-2.5%
AUD/USD	0.6894	2.1%	-2.2%	-2.5%	-10.0%
USD/JPY	108.0000	-0.1%	-1.5%	-4.4%	-5.0%
EUR/JPY	120.4300	2.2%	-4.3%	-5.7%	-9.0%
EUR/GBP	0.8613	-2.9%	-4.2%	-2.8%	-1.8%
EUR/CHF	1.1001	1.2%	-2.3%	-3.6%	-5.3%
USD/SGD	1.3604	-1.6%	-0.2%	-1.8%	-0.2%
USD/CNY	7.0391	-1.5%	2.3%	0.9%	6.1%
USD/MXN	19.2307	-2.6%	-2.1%	-5.4%	0.4%
USD/BRL	4.0171	-3.4%	3.5%	7.9%	22.8%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 8:49 pm GMT 10/31/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 3.6% return means the Canadian dollar rose 3.6% vs. the U.S. dollar year to date. USD/JPY 108.00 means 1 U.S. dollar will buy 108.00 yen. USD/JPY -1.5% return means the U.S. dollar fell 1.5% vs. the yen year to date.

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As of September 30, 2019

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Hold [Sector Perform]	618	42.74	126	20.39
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