RBC WEALTH MANAGEMENT

Global Insight

Perspectives from the Global Portfolio Advisory Committee

Funny money: Is the future of fixed income fixed expenses?

As central banks go deeper down the rabbit hole of negative rates, we look at how investors can navigate the upside down world of negative-yielding debt.

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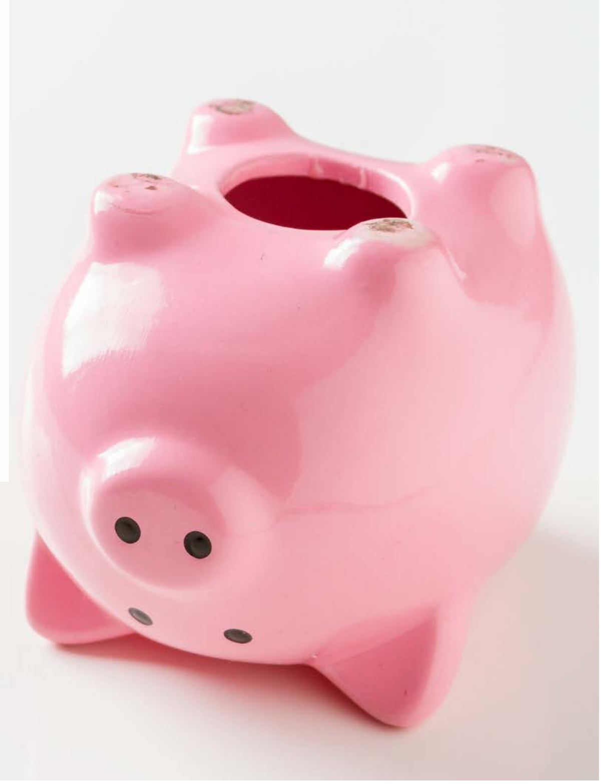

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For important and required non-U.S. analyst disclosures, see page 22.

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All values in U.S. dollars and priced as of market close, September 30, 2019, unless otherwise stated.

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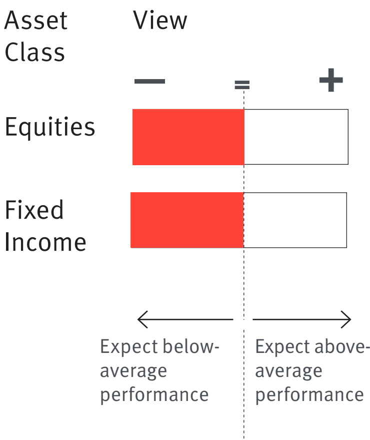

See "Views explanation" below for details

Source - RBC Wealth Management

Equities

- Equities extended gains, as global economic data surprised on the upside. More recently, the main concerns for the market seem to have faded, with the mood music on the U.S.-China trade war improving, the price of oil retreating, and the possibility of an imminent no-deal Brexit receding. These are welcome developments, but we are mindful that this progress could reverse abruptly, while the implications of the impeachment process in the U.S. may cause volatility to return.
- We would continue to focus on the two key points that matter most: the global economy and corporate earnings. Economic growth remains sufficient in most regions to enable companies to grow profits and for stocks to move forward, in our view. We maintain our Market Weight stance in global equities, though we would nevertheless start to prepare portfolios at the margin for when times may be more challenging.

Fixed income

- The Fed's 25 basis point (bps) rate cut in September should be followed by one more in 2019, market expectations indicate a 72 percent chance of a rate cut at the December meeting of the Federal Open Market Committee. Despite some improvement in U.S. economic data, trade and global growth concerns will continue to drive Fed and other global central bank policy actions. The market volatility, which produced an approximate 70 bps roundtrip swing in 10-year Treasury yields last month, will likely continue, but we see lower yields and flat/inverted curves in the months ahead.
- We maintain our Market Weight recommendation for global fixed income. Even though we've seen a slight improvement in risk sentiment, late-cycle economic concerns remain, and investors are best served by a continued focus on quality, in our opinion. And with the likelihood of rates drifting even lower in the future, reinvestment risk remains a concern.

Views explanation

(+/=/–) represents the Global Portfolio Advisory Committee's (GPAC) view over a 12-month investment time horizon.

+ Overweight implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

= Market Weight implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

– Underweight implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

Focus article

Funny money: Is the future of fixed income fixed expenses?

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The sub-zero interest rate experiment has changed the way central banks fight recessions. And with central banks going deeper down the rabbit hole of negative rates, we look at how investors can navigate the upside down world of negative-yielding debt.

Negative-yielding debt … it's strange, right? There are few hard and fast rules when it comes to investing, but if anything has ever come close it would be that those willing to save in order to lend to those wanting to borrow should earn a positive rate of return.

But after years of negative-yielding debt appearing across the global landscape, and following the European Central Bank's (ECB) decision in September to push policy rates even further into negative territory, and on the back of recent reports that the Bank of Japan (BoJ) may be looking to do the same, and on top of a Danish bank offering the first mortgage with a negative rate, it's becoming increasingly clear that the negative interest rate experiments of recent years were more than just a bug in the system. They're now likely to feature in central bank policy toolkits, and in markets, for years to come.

And while the global stock of debt trading to negative yields pulled back modestly in September after ballooning to nearly $17 trillion over the course of August as global recession fears came to a head, the questions that everyone is trying to answer are: What will the fixed income landscape look like generally if negative yields are now a way of life? And what will it look like if and when a recession actually does occur, particularly for the largest issuer of debt in the world, the U.S.?

Stranger things

But before we dive into that, it probably pays to take a look at how this stuff even works. The table on the following page shows the lay of the land, beginning with central bank policy rates, followed by government yield curves, and then the total amount of debt for each region that is currently trading to negative yields. For our purposes, we'll focus on the central bank policy rates and 10-year sovereign bonds.

At a high level, central banks set short-term rates, and market forces largely determine the yields on government debt, though the market's expectations for the future path of policy rates certainly play a role in those yields. So there can be negative short-term rates and negative-yielding longer-term debt, with both having different implications for savers and investors.

Negative policy rates: We'll use the ECB as an example. The ECB cut its overnight deposit rate to -0.5 percent from -0.4 percent in September. In a negative rate environment this is the rate that the ECB *charges* banks on their excess reserves—or the amount of money beyond regulatory requirements—parked in accounts

The global yield landscape

	Central bank policy rate	Government yield curves				Total negative-yielding debt (USD, '000s)
		2Y	5Y	10Y	30Y	
China	2.55%	2.7%	2.9%	3.1%	3.7%	$7,396,494
U.S.	2.00%	1.6%	1.5%	1.6%	2.1%	$227,248,008
Canada	1.75%	1.5%	1.4%	1.3%	1.5%	$100,420,129
United Kingdom	0.75%	0.4%	0.4%	0.5%	1.0%	$181,380,973
Japan	-0.10%	-0.3%	-0.3%	-0.2%	0.3%	$7,138,715,457
Sweden	-0.25%	-0.6%	-0.6%	-0.3%	-	$285,660,639
Eurozone	-0.50%	-0.7%	-0.8%	-0.6%	-0.1%	$7,496,200,548
Switzerland	-0.75%	-1.1%	-1.2%	-0.9%	-0.5%	$252,321,184
Denmark	-0.75%	-0.8%	-0.8%	-0.6%	-	$165,517,133
						$15,854,860,565

Source - RBC Wealth Management, Bloomberg; data through 9/24/19; eurozone yield curve represented by German sovereign curve; U.S. negative-yielding debt comprises U.S. corporate debt issued in Europe

at the ECB. Thus far, the cost of this charge has been mostly borne by the banks themselves, which eats into profits. To this point they have largely avoided passing on negative rates to retail customers, only charging fees for private clients and companies with large deposits beyond roughly €250,000, though German banks haven't been shy about their desire to charge all accounts, regardless of size, in order to offset the cost.

Negative-yielding 10-year bonds: It's here where we find one of the quirks brought on by the large increase in the amount of outstanding negative-yielding debt: most bond investors have actually done quite well for themselves in recent years. Investors who bought Germany's 10-year note in July 2017, which carried what appeared then to be an unacceptably low coupon of 0.50 percent, are sitting on a total return of 12 percent as the note they bought for €99.10 now trades at €109.90, for a yield of -0.71 percent (bond prices move inversely with yields). Not bad for a world of negative rates.

But we've started to see some pushback as Germany has begun to issue debt with zero percent coupons. To be sure, investors are not making payments to governments in a negative-yield world, they are simply paying premium prices for no future coupons. For example, in July, Germany issued its second 10-year note with a zero percent coupon; investors paid €102.64 at issuance and will receive par of €100 in 2029, delivering the investor a negative yield.

The banks don't really want your money

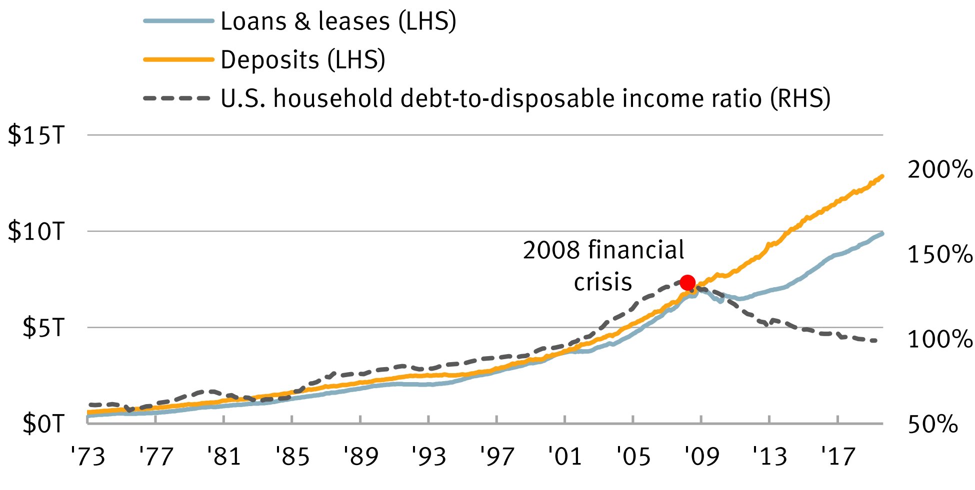
Central banks cut rates to boost borrowing and investment in order to fuel growth, full employment, and inflation. But all of the global factors that have pushed interest rates well below historical levels in recent decades—the global savings glut, aging demographics, slowing global trend GDP growth, etc.—has meant that zero percent simply isn't low enough to achieve central bank objectives.

The very basic function of a bank is to attract short-term deposits at a certain rate of interest and to then make a longer-term loan at a higher rate of interest. But the

money that banks pay you for your deposits has to come from somewhere, and flat yield curves, and a relative lack of demand for new borrowings, have made for a more challenging environment.

The chart shows how this basic relationship has broken down in the U.S. after the financial crisis. Deposits, loans, and the debt-to-disposable income ratio all rose in tandem to 2008. But as consumers shied away from taking on new debt since then, bank lending has struggled to keep pace with the rise in deposits.

Bank lending hasn't kept pace with deposits as U.S. consumers cut back on borrowing



Source - RBC Wealth Management, Bloomberg, Board of Governors of the Federal Reserve System; data through 8/1/19; loans, leases, and deposits for all commercial banks

Banks are still paying for deposits, but it's lower than it has been in the past—only about half of the fed funds rate this cycle when deposits have equaled fed funds in previous rate hike cycles. In Europe, savers aren't paid anything, and could soon be charged for that privilege. But as foreign as that may feel, if we take a step back, perhaps it's not all that absurd. There are storage costs for lots of things. You could buy gold, but then you would have to find space to put it, maybe in a safe deposit box, but banks already charge for those. You could simply take your money out of the bank and put it under the proverbial mattress, but that isn't terribly safe, and therefore you would probably want to buy a safe.

In a world with plenty of cash, and little demand for it, the banks will still take your money and store it, but it shouldn't be all that surprising if they start charging you for it.

Will the negative yield plague spread?

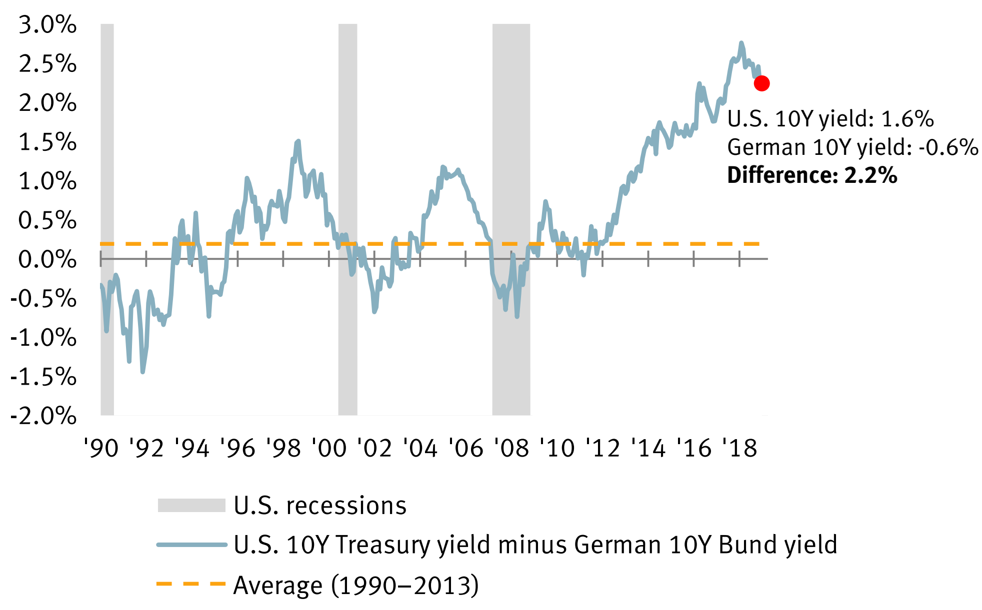
As the global stock of negative-yielding debt has again neared $16 trillion, the next question is whether the same fate awaits the U.S. market, where the Treasury and investment-grade corporate debt markets total roughly $25 trillion.

A common refrain in recent years is that low/negative global yields have dragged U.S. Treasury yields lower. But as the chart on the following page shows, that hasn't exactly been the case as the 10-year Treasury has opened up a sizeable gap over the comparable German 10-year Bund compared to historical norms. While the

divergence is easy to explain—the U.S. economy has been expanding with the Fed raising rates when Europe has been slowing with the ECB cutting rates—we wonder what happens if/when the U.S. economy hits a downturn.

Prior to reaching escape velocity, the U.S. 10-year Treasury yield averaged about 0.20 percent over the German 10-year Bund yield. With a German 10-year yield of about -0.60 percent, that would put the U.S. yield in negative territory based on current levels. This is not our expectation, however. We believe the gap will close from here as we've likely seen peak U.S. growth, and with some chance that the European picture starts to improve with further ECB policy easing. In our view, the risk of negative yields in the U.S. remains minute for the foreseeable future. However, even if that gap closes modestly, we believe the U.S. 10-year yield could slip below 1.0 percent without much trouble, as it already traded as low as 1.46 percent in September. Our view remains that U.S. yields are likely to continue to trend lower.

U.S. yields achieved escape velocity—when will they return to earth?



Source - RBC Wealth Management, Bloomberg; data through 9/24/19

With respect to the Fed and the potential for negative policy rates as a tool to fight the next downturn, officials have shown little interest in the past, having studied the issue in 2010. But, now that the ECB and the BoJ have both set the precedent, we wouldn't rule it out in the future. However, our base case in the event of a recession is that the Fed returns rates to zero percent and employs forward guidance and quantitative easing as it did previously.

Fixed income investing outlook

Or maybe that should read *"divesting"* outlook, as it were, in a negative-rate world. But what's the average investor to do? We believe the key things to remember are that fixed income investing is largely about capital preservation, and that investing in general is a relative process—balancing the risks and rewards within the available universe of investment options and potential outcomes.

While low rates offer little in the way of income, bonds still offer ballast for portfolios in a world of rising uncertainty. As we have seen over the last 10 years, low yields can become no yields, and no yields can become negative yields. Who would lock in a German 10-year Bund yield of -0.60 percent or a 10-year Treasury yield of 1.60 percent? Stock markets can face much larger negative returns than that, and in such an event, a well-diversified portfolio between the two asset classes is likely to continue to offer the offsetting ballasts that it has historically.

Our mantra for some time now regarding U.S. fixed income has been to lock in coupons and yields where possible, and for as long as possible. Though volatility is likely to remain high, we believe the downside risks for yields remain greater than the upside risks at this stage of the cycle. In Europe, the average yield on investment-grade corporate debt is 0.41 percent, hardly a yield to retire on, but it's still about 1.12 percent over comparable European government debt and equal to the five-year average.

Questions remain about whether negative yields are sustainable on a long-term basis, but for now they're likely to remain a feature of markets and investors will have to adjust, as they always have to changing markets.

As good as it gets?

Worry was the order of the day through much of the summer. Concerns focused on the manufacturing sectors of most economies, where production and new orders weakened. U.S. investor sentiment readings soured to deeply pessimistic levels previously seen at the bottom of last year's August-to-December stock market rout and not far above the panic levels plumbed at the depths of the European sovereign debt crisis in 2012 and the global financial crisis in 2009.

Equity views

Region	Current
Global	=
United States	=
Canada	=
Continental Europe	–
United Kingdom	=
Asia (ex-Japan)	=
Japan	+

\+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

However, we note that manufacturing accounts for just 10% of U.S. GDP. The Purchasing Managers' Index (PMI) readings for the non-manufacturing 90% of the economy, already firmly in positive territory, surged over the summer led by new orders. A similar divergence between weak manufacturing and still-strong services PMIs is apparent in China, Japan, and the euro area.

Since July, economic data on balance has come in better than expected. Labour markets in North America remain very tight with U.S. and Canadian unemployment rates at multi-decade lows. This has produced a confident consumer with money to spend. In the U.S., new housing construction permits have surged recently while home sales have climbed higher. New mortgage applications to purchase a home are also higher than a year ago.

Most importantly, in the U.S. and throughout the developed world, credit conditions remain accommodative. The latest Senior Loan Officer Survey from the Federal Reserve reveals that a majority of banks continue to lower lending standards on almost all categories of loans, both commercial/industrial and consumer. Businesses report no trouble getting credit.

Historically low interest rates, banks that are prepared to lend, confident consumers able to sustain spending, and corporations that are delivering high profitability and record levels of free cash flow: this is very close to as good as it gets. And therein lies the problem. It is usually the case that the economy looks unstoppable before it peaks. The turn most often comes when inflation—frequently a product of an "unstoppable" economy experiencing labour shortages—moves up to levels demanding more aggressive tightening by the central bank.

That said, the accumulation of inflationary pressures great enough to compel central banks to act and then the subsequent buildup of monetary tightness sufficient to produce an economic downturn will take time, in our view. For our part, we expect the North American economies and corporate profits will continue to grow over the coming 12 months, perhaps beyond. Share prices should also

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advance from here in response to that growth.

An important part of portfolio construction is building in a margin for error were one to be proven wrong about the future direction of the course of the economy, share prices, and interest rates. Re-assessing whether that margin is sufficient would be useful while earnings and share prices look set to move higher in the coming months.

Regional highlights

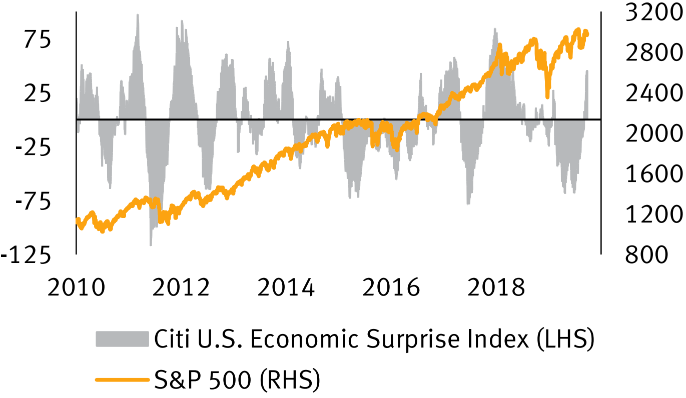
United States

- Just when it looked like the biggest outside issue facing the market—the trade war—was on pause and the market could breathe on its own, two other outside forces burst onto the scene: the renewed Middle East conflict and the impeachment investigation into President Donald Trump. The latter will no doubt distract the U.S. equity market from time to time, in our assessment, and create periodic volatility. Political battles of this magnitude tend to generate uncertainty. Whether the investigation will become something more for the market is less clear given it's only in the germination stage.
- We think investors should focus on economic and earnings trends, as these are the primary factors that drive equities over the medium-to-long term, and they ultimately reflect any material impact from outside forces. The economy is on better footing than it was a month ago as data improved, including in the manufacturing sector which had been the Achilles heel. RBC Capital Markets lowered its S&P 500 earnings estimates a bit more for this year and next to $165 and $174 per share, respectively. Both forecasts are signaling modest year-over-year improvement.
- As long as the trajectories of the global and domestic economies and corporate earnings remain at least in slow-growth modes, we are comfortable holding U.S. equities at the Market Weight or benchmark level in portfolios.

Canada

- Energy was the strongest S&P/TSX sector performer in the days following the September 14 drone and missile attack on Saudi Arabia's energy infrastructure. West Texas Intermediate and Brent Crude prices spiked in subsequent days as the

U.S. equities and economic surprise trends



U.S. stocks typically perform well when economic data surprises positively. It's yet to be determined if the recent shift in economic surprise data to positive territory is a lasting trend or a momentary respite.

Source - RBC Wealth Management, Bloomberg; data through 9/27/19

markets scrambled to balance out the supply shock, but prices eased shortly thereafter. Demand for Canadian Energy equities rallied alongside crude prices, particularly for companies with zero or limited hedges in place. Although energy producers benefit from a higher price environment, a lack of transportation capacity remains the key overhang for the Canadian energy patch, from our perspective. In light of the structural headwinds, we continue to recommend higher-quality companies that have the capabilities to operate within an environment of lower crude oil prices.

- Canadian banks trade at 10.5x earnings, a slight discount to their historical average price-to-earnings ratio of 11.5x. Year to date, the group has underperformed the S&P/TSX Composite Index. The Federal Reserve cut its overnight rate for the second time this year, and as a result, banks that have greater U.S. exposure are more likely to experience compression in net interest margins. That said, Canadian banks generate more income through fees than U.S. banks, on average, mitigating this effect somewhat. Furthermore, RBC Capital Markets believes credit provisions are normalizing. Nevertheless, we maintain a modest Underweight in Canadian banks relative to the benchmark.

Continental Europe & UK

- We are Market Weight UK equities. Observers are still on tenterhooks. In September, when Parliament wrested control from the government before being suspended, the probability of a no-deal Brexit fell markedly. Since being robbed of this alternative, Prime Minister Boris Johnson's rhetoric has focused on delivering a deal—though scant details have been divulged, raising suspicions that little is being achieved. Our base-case scenario is a Brexit deadline extension and a general election in the autumn. This may give the Conservatives the mandate to pursue a hard-Brexit policy.
- In a world where parliamentary machinations may alter the course of UK history, we believe equity investors must remain nimble. UK equity valuations are not demanding, and the MSCI United Kingdom Index trades on 12.1x 2020 earnings and offers a well-covered dividend yield of 4.9%. We maintain our bias towards companies which generate revenues abroad, and would hold positions in select domestic stocks. We would expect volatility to spike in the event of a hard Brexit, which could offer nimble investors the opportunity to pick up oversold stocks.
- We are Underweight European equities. The region's economy continues to struggle and there is evidence that weakness in manufacturing and exports may be bleeding into the domestic economy.
- Despite this challenged outlook, we see attractive opportunities in well-managed companies with strong business models and whose prospects are buoyed by secular growth. Such firms often also enjoy pricing power and strong cash flow generation. In particular, we find opportunities in the Consumer, Health Care, and Industrials sectors.

Asia

- We remain cautious on Hong Kong stocks as protests persist despite the government's motion to withdraw the extradition bill and as the China-U.S. trade war continues. Indeed,

Asian index performance, YTD

Source - RBC Wealth Management, Bloomberg; data through 9/27/19

Hong Kong equities struggle to gain traction as recessionary fears loom.

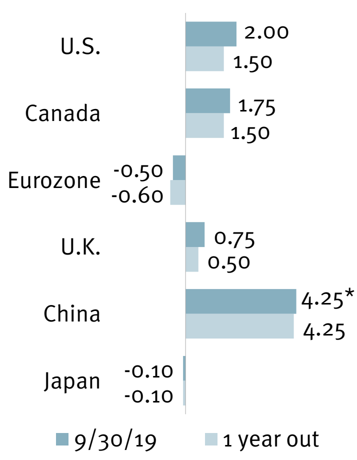
a range of economic indicators weakened significantly in July and August, signaling the city could fall into recession later in the year. Markit Hong Kong Whole Economy Purchasing Managers' Index data for August retreated further from 43.8 to 40.8 while tourist arrivals plunged by 40% in the same month. In spite of the unemployment rate remaining at 2.9%, there are still fears of a dramatic rise in the upcoming months. Adding to the woes, Fitch Ratings downgraded Hong Kong's credit rating from AA+ to AA with negative outlook for the first time since 1995. On the corporate front, analysts forecast a company earnings recession is on the horizon.

- As for mainland China, policymakers are trying hard to balance the trade war's economic and political implications with stimulus packages. While trade negotiations with the U.S. have resumed, a comprehensive agreement including lifting the ban on Huawei appears to be far-fetched for now. However, economic figures published since early September illustrate some degree of stabilisation. Besides, the People's Bank of China still has plenty of ammunition to combat downside risks and had, on September 6, announced a 50 basis point cut in the reserve requirement ratio for all banks alongside an additional 100 basis point trim for qualified city commercial banks. The measures aim at releasing some 900 billion yuan of additional liquidity. We believe investors may lift exposure to dividend-paying equities in light of economic uncertainty.

Global fixed income

Central bankers to politicos: "Do your jobs!"

Central bank rate (%)



*1-yr base lending rate for working capital, PBoC

Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management

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In some respects, we are entering a quiet period for central bank activity in October—especially compared to September. And even though October will finish with meetings by the European Central Bank (ECB), Federal Reserve, and the Bank of Canada (BoC), few fireworks are expected. ECB President Mario Draghi fired his last (mini-) bazooka in September before handing the reins to Christine Lagarde on November 1; the Fed is widely expected to cut rates once more in 2019, most likely in December; and the BoC appears likely to move at some point, but on its own schedule. The Bank of England has all but teed up a rate cut, in our view, as Brexit issues loom large.

Policy initiatives always grab the headlines, but there is another message emanating from central bank leaders to their political counterparts: The ability of monetary policy to move economies has its limits.

Fiscal policy vs. monetary policy

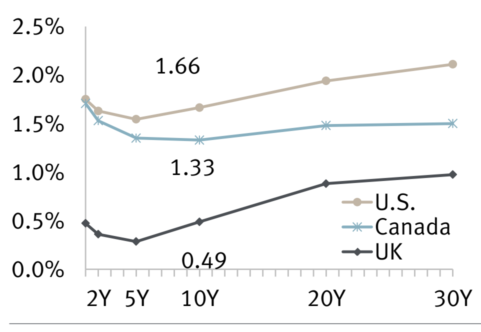
Monetary policy—changes in short-term interest rates—is typically implemented by a central bank, while fiscal policy decisions—tax law changes, increases or decreases in spending—are made by the national government. Both types of policy may be used to influence the performance of an economy in the short run. Stimulative policies, in general, are expected to increase an economy's growth rate, whereas restrictive policies are designed to slow an economy's growth.

Fixed income views

Region	Gov't Bonds	Corp. Credit	Duration
Global	=	+	5–7 yr
United States	=	+	7–10 yr
Canada	=	=	3–5 yr
Continental Europe	=	+	5–7 yr
United Kingdom	=	=	3–5 yr

+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

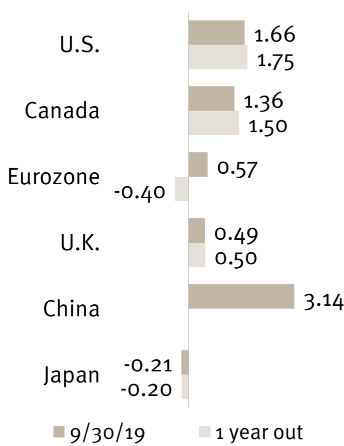
Sovereign yield curves



Source - Bloomberg

In the aftermath of the Great Recession, global central banks took extraordinary measures to steady and stimulate their nations' economies. But many central banks have mandates—on employment, growth, or inflation—that drive and/or limit their policy actions. Now, with economic expansions showing signs of old age and central bankers scraping the bottoms of their monetary policy toolkits, we see an opportunity for fiscal policy to provide a leg-up.

Global fixed income



Note: Eurozone utilizes German Bunds.

Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management

Political dithering

In his news conference following the September meeting, the ECB president said it was "high time for fiscal policy" to flex its muscles to shore up the economy. Yet in Europe, calls for fiscal stimulus from the German government have received a lukewarm response. In the U.S., Fed Chair Jerome Powell has taken the opportunity to cite the economic uncertainty fomented by President Donald Trump's trade policies; his reward was to be referred to as an "enemy" by the president. As for the UK and Brexit, the political machinations are enough to cause one's head to spin. And so we join central bankers in reminding political leaders that monetary policy has its limits, and it's up to them to implement sound fiscal policies.

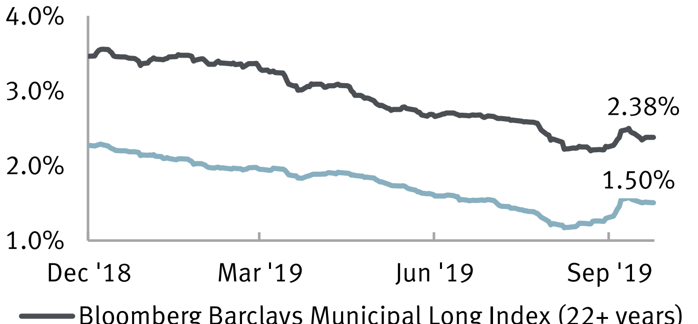
Regional highlights

United States

- The Fed delivered the widely-expected rate cut at its September meeting to bring the fed funds rate to a 1.7 percent–2.00 percent range, but the Fed—and markets—are split on what comes next. The market sees a 72 percent likelihood of another cut this year, but only 7 of 17 Fed officials see the same. The economic data has improved modestly in recent weeks, the yield curve remains inverted, and we think the latter may ultimately drive one additional cut this year, which should steepen the curve, assuming the 10-year yield remains near current levels.
- Risk sentiment has improved in the U.S. on the back of central bank actions, including a resumption of quantitative easing by the European Central Bank—a program that includes European corporate debt purchases. U.S. Credit spreads—or the yield compensation over risk-free Treasuries—continue to tighten. High-yield corporates are now yielding just 3.6 percent over Treasuries, well below the 5-year average of 4.4 percent. Investment-grade corporate bond yields have slipped below 3 percent again as Treasury yields have moved lower, but this remains about 2.5 percent higher than European corporates, which should continue to drive foreign demand for U.S. credit, ultimately adding support to the asset class.
- In municipal markets, new supply handily outpaced projections, which has helped push yields higher.

Municipal bond yield curve flattest since 2007 as front-end yields move higher

Municipal bond index yields to worst



We anticipate municipal bonds will perform well into year's end as new bond supply fades.

Source - RBC Wealth Management, Bloomberg; data through 9/30/19

However, the bulk of the move higher has been seen at the front end, where 5-year muni index yields are now 1.5 percent, compared to 2.4 percent beyond 22 years. That 0.9 percent differential marks a new low for this cycle. The last time the muni curve was this flat was back in 2007, when it bottomed at just 0.5 percent. New supply is expected to fade later in the year, which could once again fuel outperformance in the muni market.

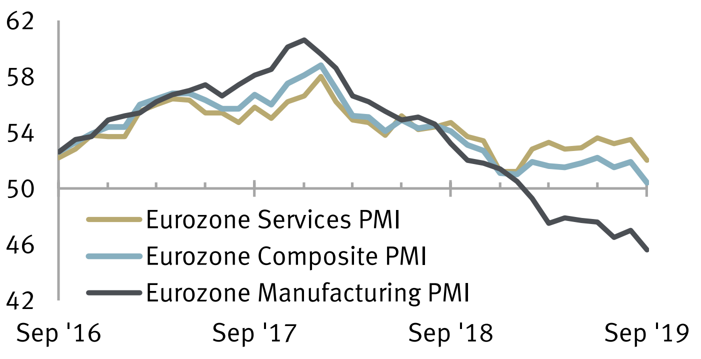
Canada

- The Bank of Canada (BoC) kept its policy rate unchanged in September, opting to not join its developed-market peers in providing fresh monetary stimulus. The current strength of the Canadian economy provides reason for the BoC to stand pat for now. Government of Canada bond yields moved higher over the month and despite the yield curve remaining inverted, the bond market is only pricing in 25 basis points of easing from the BoC over the next 12 months. If the bond market is correct, Canada is set to have the highest policy rate within the G7 next year.
- Given Canada is a small open economy, which is not be immune to a deteriorating global growth picture, we think the current environment offers an opportunity to lock in reasonable yields for the next few years. Canada completes its lion's share of trade with the United States, which makes the outlook on the U.S. economy, as well the currency pair, particularly important. We find it challenging to see the BoC remaining on the sidelines if the Fed were to continue moving rates lower in response to slower growth, particularly if the Canadian dollar was to strengthen.
- Canadian preferred shares remain an incredibly unloved asset class. Recent ETF data showed that August had the second-largest monthly outflows over the past five years. For investors who are coming up to tax-loss selling season and are considering their options, we note that the outlook for future returns is improved by a long period of underperformance. For example, there are a number of securities offering 6 percent or higher yields for the next five years. While this doesn't guarantee positive returns in the short term, one should consider the relative yield advantage that is left behind when exiting.

Continental Europe & UK

- The European Central Bank (ECB) took a step further than what was widely anticipated at its September meeting, with ECB President Mario Draghi delivering on an array of measures as a departing gift before Christine Lagarde takes the helm. In line with our expectations, the deposit rate was cut by 10 basis points to -0.5%, and a framework was provided for both a tiered deposit rate and the re-start of quantitative easing from the beginning of November at a pace of €20 billion per month. There were also amendments to its forward guidance, allowing for a continuation of rates at current or lower levels for the foreseeable future, as well as more favourable terms for its upcoming round of targeted longer-term refinancing operations. Draghi also stepped across the monetary line by signalling that "(looser) fiscal policy should be the main tool" going forward. This suggests to us that it is unlikely the bank will want to act further in the near term.
- We see these extensive measures as supportive for valuations, with

Eurozone Purchasing Managers' Indexes deteriorate



Source - RBC Wealth Management, Bloomberg; data through 9/24/19

Weakness in the manufacturing sector is spilling into the service sector.

yields continuing to track at low levels and spreads tightening further. We maintain our Market Weight in government bonds and modest Overweight in Credit.

- In the UK, the Bank of England (BoE) made a slight dovish shift at its September meeting given the prospect of a further weakening of growth due to a prolonged Brexit process, despite maintaining its policy rate at 0.75%. This provides the basis for the BoE to potentially downgrade its forecasts at its November meeting and allows flexibility for a shift in forward guidance if warranted. The bank can keep its powder dry for now, and has positioned itself to be able to act depending on how the coming weeks play out.

- We maintain a Market Weight view on UK government bonds with short-duration positioning. We also see the yield pickup in UK corporate credit as attractive and retain a Market Weight allocation, though we would adopt a selective approach.

Asia

- Asia Central banks maintained their dovish bias amid the ongoing volatility induced by the U.S.-China trade war. The People's Bank of China (PBOC) announced a 50 basis point cut in the Reserve Rate Requirement which should boost liquidity within the banking system by around RMB 900 billion (about $126 billion). The move gave a positive tone to the market, but investors are still adopting a wait-and-see attitude towards a resumption of trade negotiations (possibly this month).

- The Bloomberg Barclays Asia Ex-Japan USD Credit Corporate Index was only slightly higher despite U.S. Treasury yields moving sharply higher after both the U.S. and China showed goodwill leading up to trade talks. Within the index, we saw the trend reverse in September with high-yield bonds outperforming investment-grade bonds thanks to the risk-on sentiment as well as a sizable move upwards in rates.

- Looking ahead, we think Chinese growth is likely to moderate, as suggested by the weak Industrial Production print which came in at 4.4 percent year over year vs. the 5.2 percent year over year consensus estimate reported in August. This should keep the PBOC dovish which should benefit the healthier part of the credit market. As such, we would continue to invest in better-quality high-yield bonds to mitigate the potential pickup in default rates.

Currencies

Currency forecasts

Currency pair	Current rate	Forecast Sep 2020	Change*
Major currencies			
USD Index	99.38	99.54	0%
CAD/USD	0.76	0.76	0%
USD/CAD	1.32	1.32	0%
EUR/USD	1.09	1.10	1%
GBP/USD	1.23	1.18	-4%
USD/CHF	1.00	1.04	4%
USD/JPY	108.1	110.0	2%
AUD/USD	0.68	0.66	-2%
NZD/USD	0.63	0.62	-1%
EUR/JPY	117.8	121.0	3%
EUR/GBP	0.89	0.93	5%
EUR/CHF	1.09	1.14	5%
Emerging currencies**			
USD/CNY	7.15	7.20	1%
USD/INR	70.9	72.00	2%
USD/SGD	1.38	1.38	0%

* Defined as the implied appreciation or depreciation of the first currency in the pair quote. Examples of how to interpret data found in the Market Scorecard.

Source - RBC Capital Markets, Bloomberg

U.S. dollar: Fed fanfare

The U.S. dollar has rallied to its highest levels in more than two years as a modest improvement in economic data shows signs of resilience in the U.S. economy despite the ongoing trade war. As widely anticipated, the Fed announced a 0.25% rate cut in September, and delivered a mixed message on future policy. Absent deep policy easing, we see potential for late-cycle demand to support the U.S. dollar.

Euro: ECB easing

The European Central Bank (ECB) announced its highly anticipated stimulus package, introducing a 0.10% cut in the deposit rate and reinstating its asset purchase program. The euro strengthened modestly following the announcement, but remains within a tight range around the two-year lows touched in early September. The ECB's dovish stance could persist for some time, in our view, and contain gains catalyzed by signs of a potential growth recovery in the euro area.

British pound: Bouncing back

The British pound recovered from post-referendum lows after Parliament passed legislation aimed at preventing a no-deal Brexit. An extension and November election is now the most likely scenario, in our view. Accordingly, sterling is poised to take direction from polls and what they imply for a hard Brexit or second referendum. Uncertainty remains high, and we believe Brexit headlines will continue to drive sterling performance until more clarity emerges.

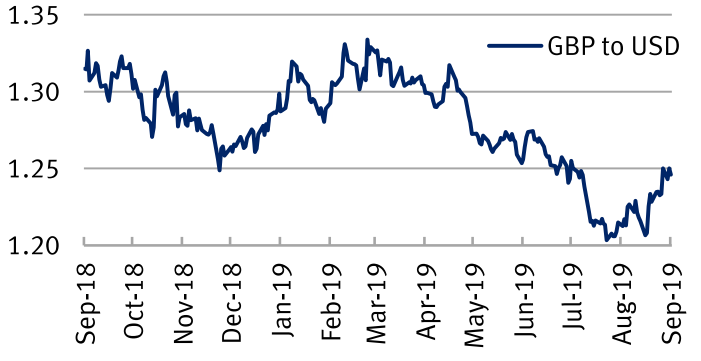
Canadian dollar: Nice and neutral

The Canadian dollar has steadied through Q3, supported by a September policy message from the Bank of Canada that was more neutral than expected. However, the statement emphasized global trade concerns and we believe an eventual rate cut is possible. The U.S.-Canada divergence in central bank policy tone that has supported the currency could fade, but with Canada's firm economic fundamentals and a strong yield compared to G10 peers, we see range-bound performance into early 2020.

Japanese yen: Swinging sentiment

The yen pulled back from 2019 highs as improved global risk sentiment and optimism for U.S.-China trade progress diminished safe-haven demand. The Bank of Japan declined to deploy stimulus at its September meeting, but the accompanying statement signaled it is ready to act as early as October if necessary. This could limit bouts of strength from swings in risk sentiment, in our view.

The British pound recovers from multiyear lows



Fresh optimism that the UK will leave the EU in an orderly fashion drove a recovery in the battered British pound.

Source - RBC Wealth Management, Bloomberg; data through 9/18/19

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Commodities

Commodity forecasts

	2019E	2020E
Oil (WTI $/bbl)	$60.20	$61.76
Natural Gas ($/mmBtu)	$2.63	$2.63
Gold ($/oz)	$1,400	$1,500
Copper ($/lb)	$2.78	$3.00
Soybean ($/bu)	$8.92	$9.02
Wheat ($/bu)	$4.90	$4.75

Source - RBC Capital Markets forecasts (oil, natural gas, gold, and copper), Bloomberg consensus forecasts (soybean and wheat)

WTI – Supply shock

Oil prices surged (+19%) on September 16 following the drone strikes in Saudi Arabia, sidelining about 5.7 million barrels of production (roughly 6% of global supply). The kingdom expects production to be back online by the end of September and stated it would tap into reserves to maintain export commitments. According to RBC Capital Markets' commodity strategists, Saudi Arabia has about four weeks of inventory to cover its export demands.

Natural gas – Short squeeze

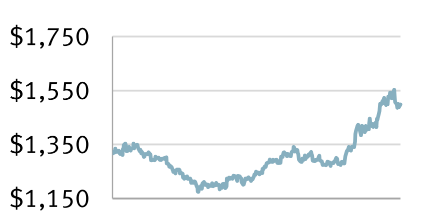
Natural gas prices experienced a sharp rally, up over 21% m/m. Part of the rise can be attributed to lower U.S. production volumes, cooler-than-expected weather, and a lift in sentiment as new LNG export facilities started operations. We believe the positioning of market participants is the more likely cause of the spike. Since mid-August, net short positions have decreased by approximately 33%.

Copper – Indian infusion

In August, India announced plans to spend about $1.4 trillion to double the size of its economy over the next five years. Specific plans related to infrastructure and housing projects should drive up demand for copper wiring as the nation looks to improve power supply in rural areas. On the trade front, China intends to raise tariffs on U.S. copper scraps from 25% to 30% in December 2019. Prices are up about 2% m/m.

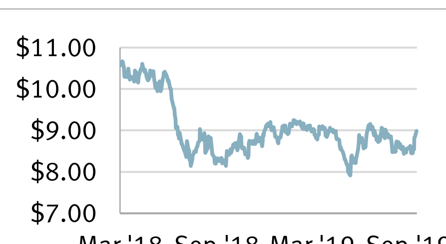
Gold – Banking on support

Central banks' monetary policies continue to be accommodative in light of slowing global growth. The Fed and European Central Bank both reduced their overnight rates in September. Real rates in the U.S. remain low, which is often considered the opportunity cost for owning a non-yielding asset like gold. RBC Capital Markets' equity analysts have increased their 2020 gold price forecast to $1,500. Prices are down roughly 1% m/m.



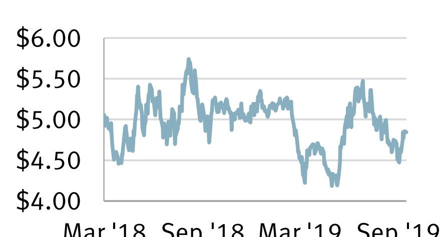
Soybeans – Playing nice

As a gesture of good faith, the U.S. and China have both taken steps to de-escalate trade tensions. The U.S. postponed additional tariffs until mid-October, while China has agreed to restart purchases of U.S. soybeans and to suspend tariffs on goods such as pork and soybeans. The USDA announced that 204,000 tonnes of soybeans were subsequently sold to China. Prices are up a modest 2% m/m.



Wheat – Australian abandonment

The USDA expects Australian wheat production to decline by approximately 2 million tonnes in the 2019/2020 season. Unusually dry weather in eastern Australia did not allow for wheat development and led to the abandonment of various fields. As a result, the USDA is lowering its 2019 global wheat production forecast by 2.5 million tonnes to 766 million tonnes. Wheat prices rose 3% m/m.



Source - RBC Wealth Management, Bloomberg; date range: 3/1/18–9/16/19

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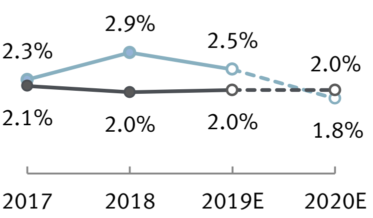
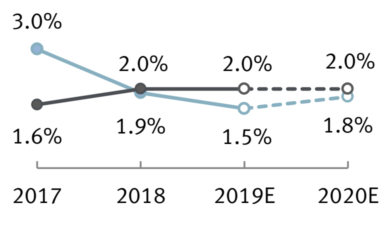
Key forecasts

Real GDP growth   Inflation rate

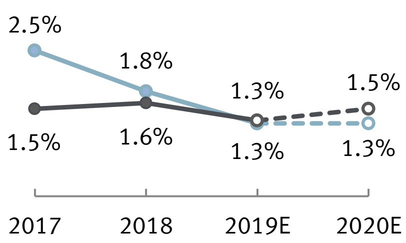
United States – Consumer drives growth
The Fed cut by 25 basis points and gave few signals of future direction. Markets expect further cuts. Temporary shock to the repo market suggests the Fed will resume balance sheet expansion earlier than anticipated. Hiring remains solid with 130,000 new hires in August; the pace has slowed from 2018. Trade tariffs and uncertainty have weighed on business investment; personal consumption, up 4.6% q/q (annualized) in Q2, continues to drive GDP growth.



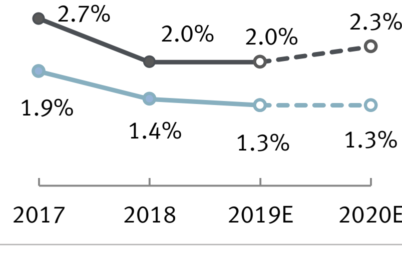
Canada – Leveraged consumer
The Bank of Canada (BoC) held interest rates, bucking the trend of monetary easing by central banks. BoC researchers found economic growth in recent years was driven by spending from households that accessed home equity via lines of credit or refinancing. This extraction of home equity could leave the Canadian economy more vulnerable to external shocks such as a sharp decline in house prices. The labor market remains strong, adding 81,100 jobs in August.



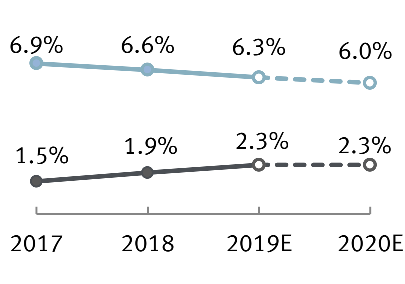
Eurozone – Slump in manufacturing
PMIs continue mixed: the Markit Eurozone Manufacturing PMI fell further into contractionary territory at 45.6 in September, while the Markit Eurozone Services PMI remained expansionary at 52.0. Germany's industrial production fell 4.2% y/y in July while factory orders plummeted 5.6% y/y. Trade uncertainty and the global slowdown brought German auto production down by 12% y/y. The European Central Bank cut the deposit rate by 10 basis points to negative 50 basis points.



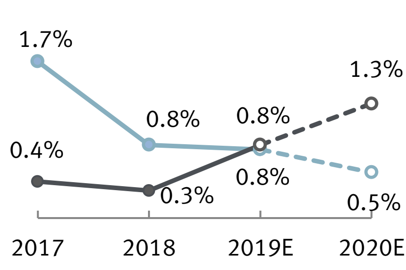
United Kingdom – Heightened political uncertainty
The Bank of England held interest rates at 0.75%, as the Brexit showdown leaves considerable policy uncertainty. Prime Minister Boris Johnson says the UK will leave the EU with or without a deal on October 31, leaving the BoE in limbo and the fate of the economy very unclear. The BoE revised economic growth forecasts lower, while the OECD warned of recession risks.



China – Trade-induced slowdown
Tariffs continue to weigh, with industrial output falling to a 4.4% y/y pace in August, the slowest growth since 2002. Retail sales missed expectations as did fixed investment. Private investment growth lagged public investment for the sixth consecutive month. The People's Bank of China lowered the amount of cash banks must hold as reserves but has held off cutting interest rates. The U.S. and China remain far away from a deal.



Japan – More monetary accommodation
The Bank of Japan (BoJ) left monetary policy unchanged. The BoJ is likely to remain accommodative as pressure on exporters threatens to slow growth despite domestic demand that has held up. Headline inflation in August declined due to lower food and oil prices; however, core inflation remains fairly steady at 0.7% m/m. While core inflation remains stubbornly below the 2% target, BoJ officials should take comfort in the rise from sub-zero readings in 2017.



Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management

Market scorecard

Index (local currency)	Level	1 month	YTD	12 month
S&P 500	2,976.74	1.7%	18.7%	2.2%
Dow Industrials (DJIA)	26,916.83	1.9%	15.4%	1.7%
NASDAQ	7,999.34	0.5%	20.6%	-0.6%
Russell 2000	1,523.37	1.9%	13.0%	-10.2%
S&P/TSX Comp	16,658.63	1.3%	16.3%	3.6%
FTSE All-Share	4,061.74	2.8%	10.5%	-1.6%
STOXX Europe 600	393.15	3.6%	16.4%	2.6%
EURO STOXX 50	3,569.45	4.2%	18.9%	5.0%
Hang Seng	26,092.27	1.4%	1.0%	-6.1%
Shanghai Comp	2,905.19	0.7%	16.5%	3.0%
Nikkei 225	21,755.84	5.1%	8.7%	-9.8%
India Sensex	38,667.33	3.6%	7.2%	6.7%
Singapore Straits Times	3,119.99	0.4%	1.7%	-4.2%
Brazil Ibovespa	104,745.30	3.6%	19.2%	32.0%
Mexican Bolsa IPC	43,011.27	0.9%	3.3%	-13.1%
Bond yields	**9/30/19**	**8/30/19**	**9/28/18**	**12 mo. chg**
US 2-Yr Tsy	1.622%	1.504%	2.819%	-1.20%
US 10-Yr Tsy	1.665%	1.496%	3.061%	-1.40%
Canada 2-Yr	1.580%	1.354%	2.214%	-0.63%
Canada 10-Yr	1.361%	1.164%	2.427%	-1.07%
UK 2-Yr	0.369%	0.401%	0.824%	-0.46%
UK 10-Yr	0.488%	0.479%	1.573%	-1.09%
Germany 2-Yr	-0.766%	-0.927%	-0.523%	-0.24%
Germany 10-Yr	-0.571%	-0.700%	0.470%	-1.04%
Commodities (USD)	**Price**	**1 month**	**YTD**	**12 month**
Gold (spot $/oz)	1,472.38	-3.2%	14.8%	23.5%
Silver (spot $/oz)	17.00	-7.5%	9.7%	15.6%
Copper ($/metric ton)	6,486.50	0.7%	-4.3%	-9.1%
Uranium ($/lb)	20.90	-0.5%	-12.6%	-7.7%
Oil (WTI spot/bbl)	54.07	-1.9%	19.1%	-26.2%
Oil (Brent spot/bbl)	60.78	0.6%	13.0%	-26.5%
Natural Gas ($/mmBtu)	2.33	2.0%	-20.7%	-22.5%
Agriculture Index	273.20	6.0%	-1.0%	1.4%
Currencies	**Rate**	**1 month**	**YTD**	**12 month**
US Dollar Index	99.3770	0.5%	3.3%	4.5%
CAD/USD	0.7553	0.5%	3.0%	-2.5%
USD/CAD	1.3241	-0.5%	-2.9%	2.6%
EUR/USD	1.0899	-0.8%	-5.0%	-6.1%
GBP/USD	1.2289	1.1%	-3.6%	-5.7%
AUD/USD	0.6750	0.3%	-4.2%	-6.6%
USD/JPY	108.0800	1.7%	-1.5%	-4.9%
EUR/JPY	117.8000	0.8%	-6.4%	-10.7%
EUR/GBP	0.8869	-1.9%	-1.3%	-0.4%
EUR/CHF	1.0875	-0.1%	-3.4%	-4.6%
USD/SGD	1.3819	-0.4%	1.4%	1.1%
USD/CNY	7.1483	-0.1%	3.9%	4.1%
USD/MXN	19.7344	-1.6%	0.4%	5.4%
USD/BRL	4.1562	0.3%	7.3%	2.6%

The Nikkei 225 rallied sharply in September as the U.S. and Japan signed a trade-enhancement agreement.

Global yields rose in September as global economic data halts recent declines.

Oil remained volatile in September, following a mid-month attack on a Saudi Arabian oil refinery, and closed slightly higher on supply shortage concerns.

The euro continues to decline against the dollar as European economies continues to slump.

Equity returns do not include dividends, except for the Brazilian Ibovespa. Equity performance and bond yields in local currencies. U.S. 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. Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -2.5% return means the Canadian dollar has fallen 2.5% vs. the U.S. dollar during the past 12 months. USD/JPY 108.08 means 1 U.S. dollar will buy 108.08 yen. USD/JPY -4.9% return means the U.S. dollar has fallen 4.9% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 9/30/19.

Research resources

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As of September 30, 2019

Rating	Count	Percent	Investment Banking Services Provided During Past 12 Months Count	Percent
Buy [Top Pick & Outperform]	748	51.73	208	27.81
Hold [Sector Perform]	618	42.74	126	20.39
Sell [Underperform]	80	5.53	3	3.75

Ratings: Top Pick (TP): Represents analyst's best idea in the sector; expected to provide significant absolute total return over 12 months with a favorable risk-reward ratio. **Outperform (O):** Expected to materially outperform sector average over 12 months. **Sector Perform (SP):** Returns expected to be in line with sector average over 12 months. **Underperform (U):** Returns expected to be materially below sector average over 12 months. **Restricted (R):** RBC policy precludes certain types of communications, including an investment recommendation, when RBC is acting as an advisor in certain merger or other strategic transactions and in certain other circumstances. **Not Rated (NR):** The rating, price targets and estimates have been removed due to applicable legal, regulatory or policy constraints which may include when RBC Capital Markets is acting in an advisory capacity involving the company.

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