

Economic and Market Outlook

February 2018

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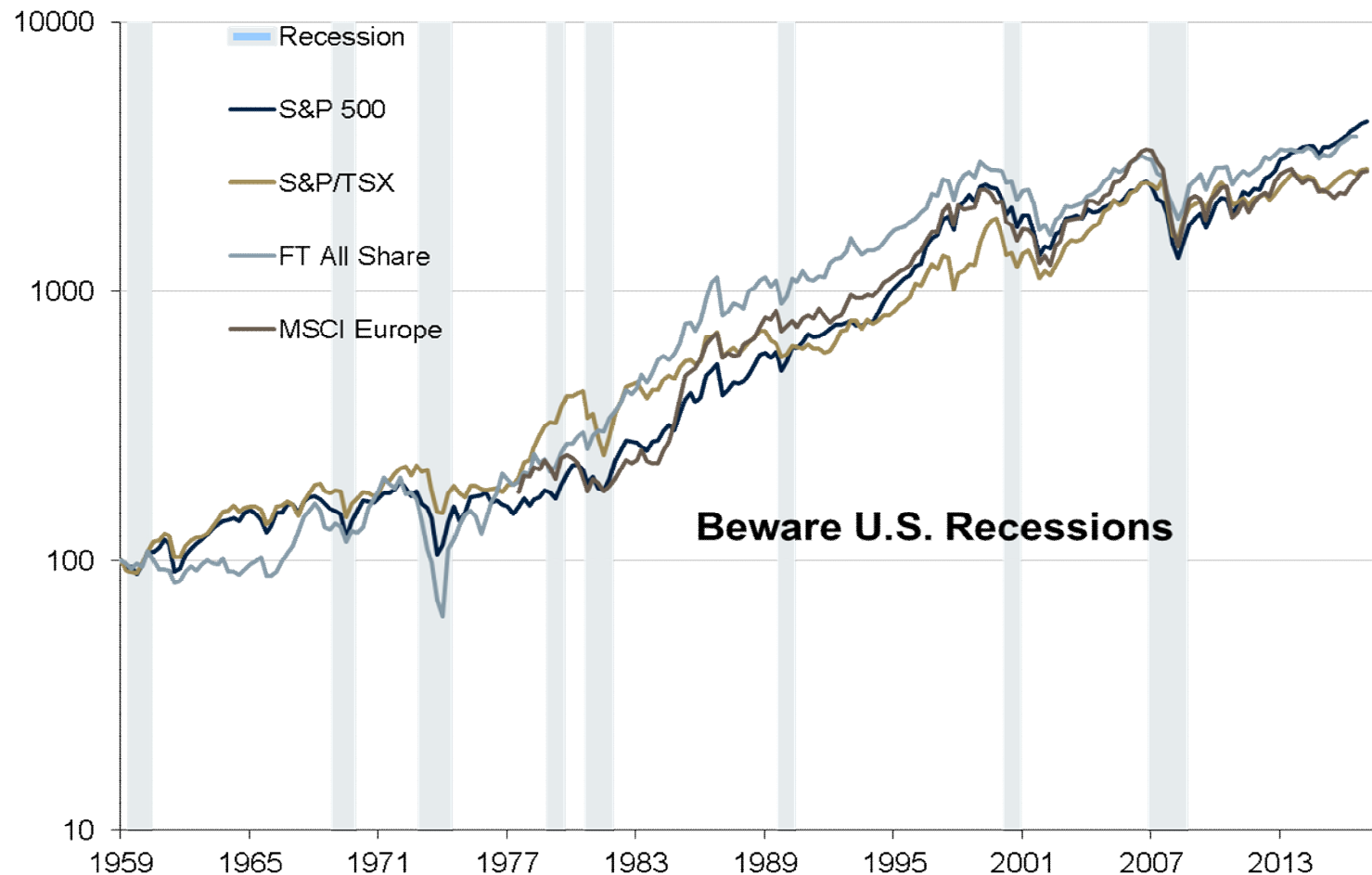
February 2018

Our Long-Term Operating Framework

- Credit conditions remain extremely accommodative
- Every U.S. recession but two in the past 100 years has been preceded by the arrival of “tight money”
- Every U.S. recession has been associated with a “bear market” for stocks
- It could be a year, probably longer, before credit tightens enough to make a U.S. recession inevitable
- Give equities the benefit of the doubt until then

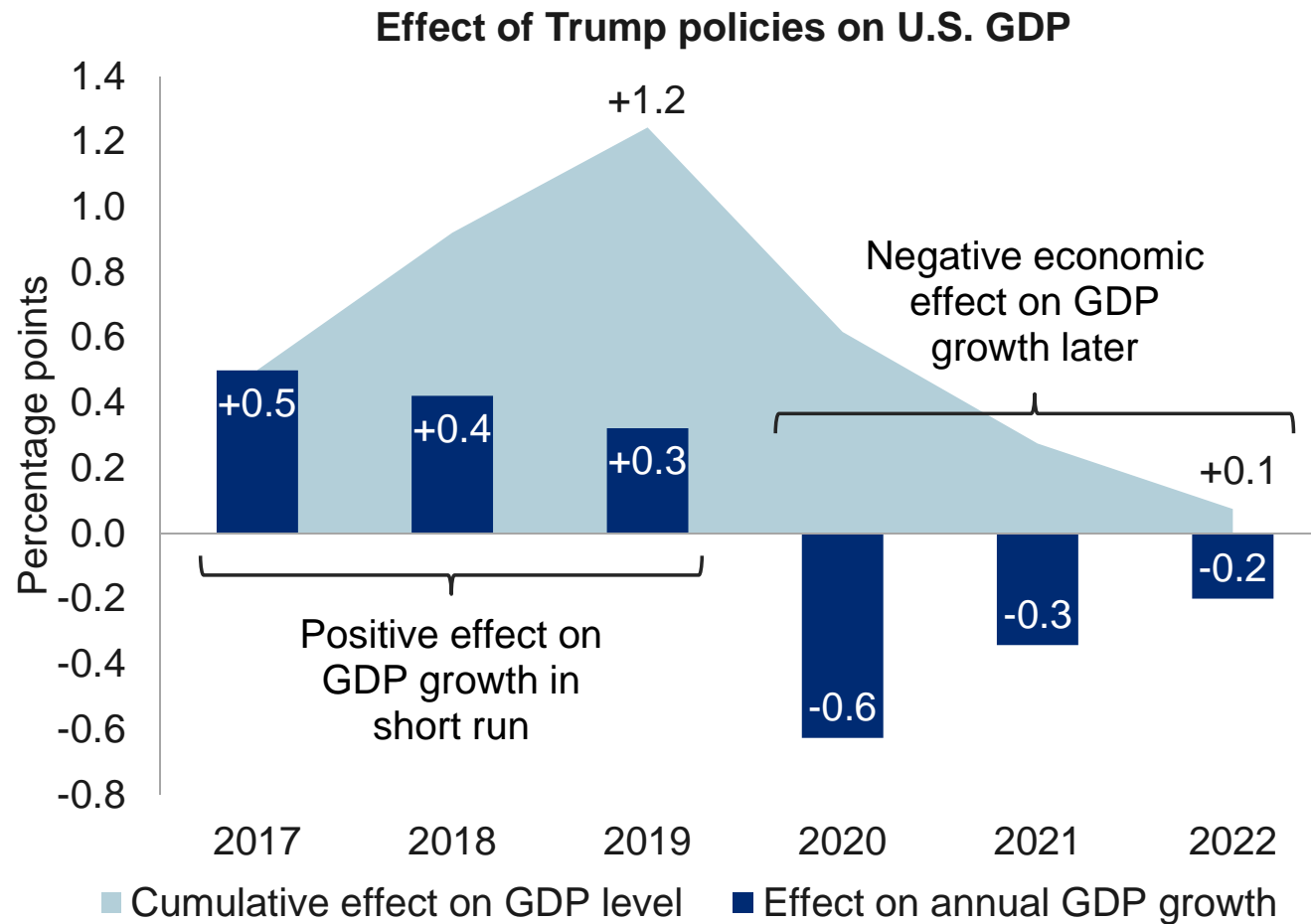


Bull markets don't die of old age....
...they are murdered by U.S. recessions



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Trump economic effect: short-term boost, longer-term drag



Source: RBC GAM assumptions and calculations



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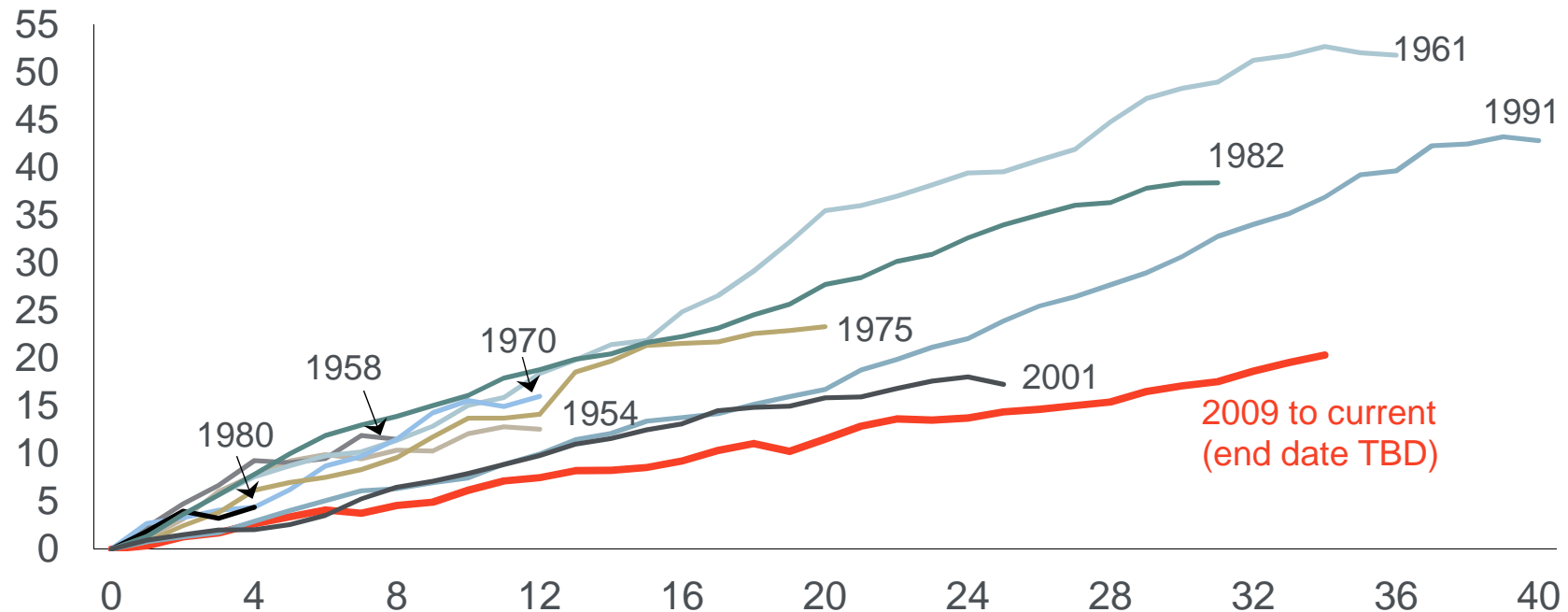
Watch the U.S. consumer – 71% of GDP

- Unemployment rate near 20 lows (50 year lows reachable), UI claims recently at all time lows, nearly 6 million jobs going begging
- Last month 59% of small/medium businesses tried to hire but 92% unable to find qualified applicants - only 3% say credit is a problem.
- \$9+ trillion (50% of GDP) sitting in bank accounts owned by individuals earning nothing. More than twice that in money, bond, and stock funds, in ETFs, and in direct ownership of securities.
- Labour tightness gradually pushing wage inflation higher – average hourly wages of “job stayers” growing at 4%+ - but so far the Fed looks to be ahead of the curve.



This is a long-lasting, but slow-growing recovery

of quarters each recovery lasted



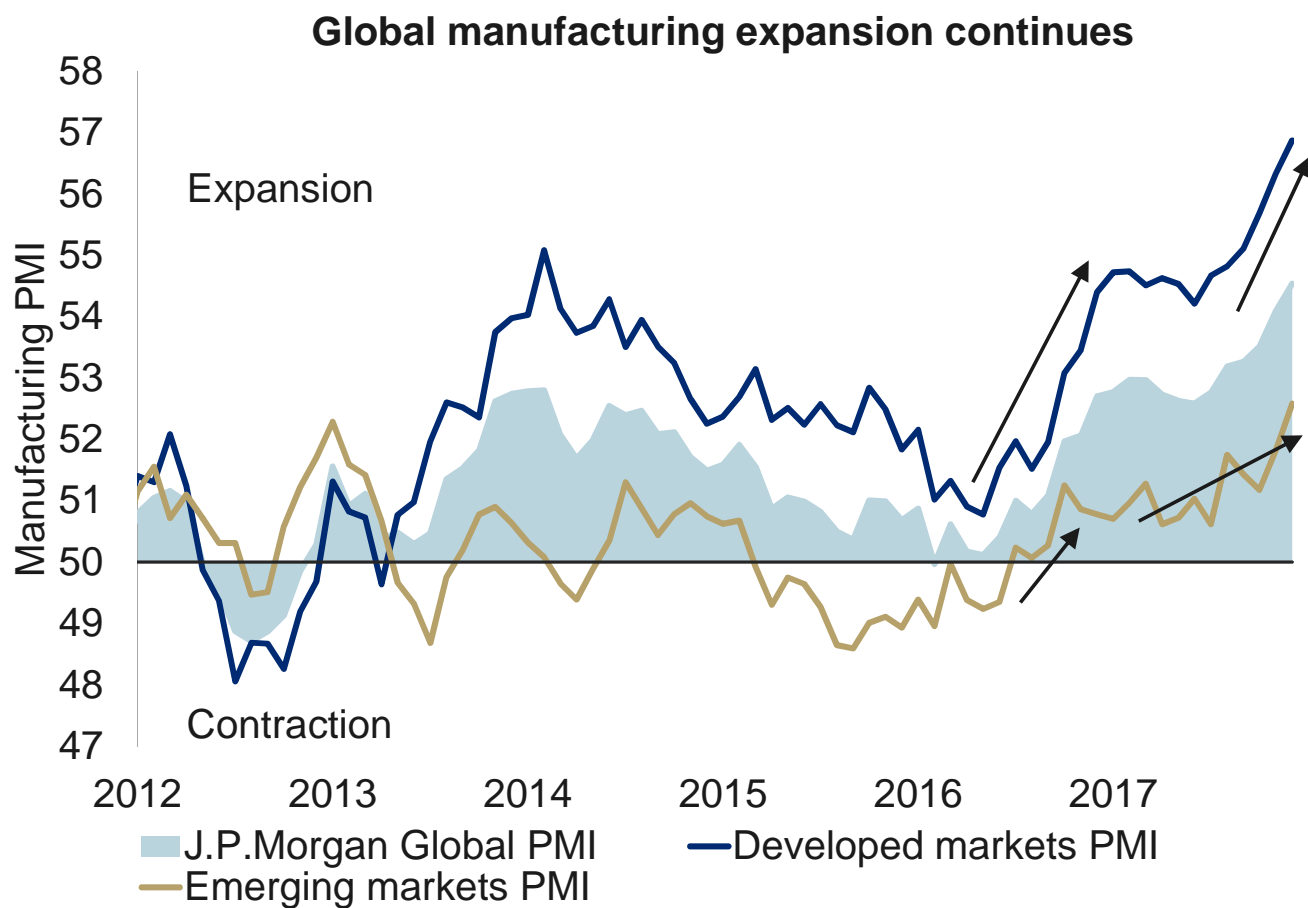
No Boom, No Bust?

Source: U.S. Bureau of Economic Analysis



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Global economies cranking up



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



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Global trade picked up, but moderating?



Note: Year-over-year % change of quarterly world merchandise exports. Nominal exports in U.S. dollars. Source: WTO, RBC GAM



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Keep structural headwinds to economic growth in mind

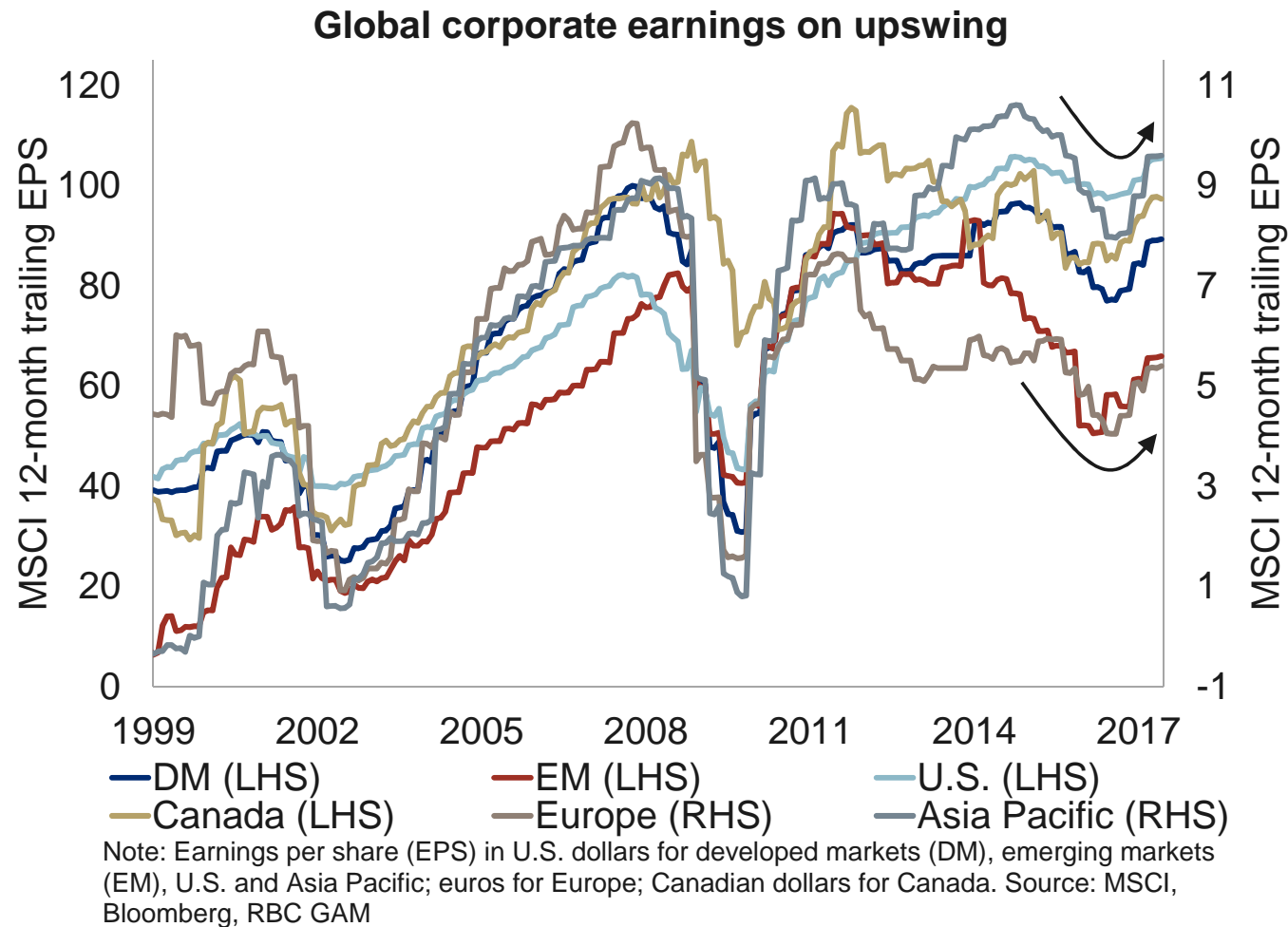
Human factors	Economic structure	Post-crisis
<ul style="list-style-type: none">• Demographics:<ul style="list-style-type: none">• Slower pop. growth• Rising retired %• Decelerating gains in:<ul style="list-style-type: none">• Education• Health• Urbanization• Rising complacency:<ul style="list-style-type: none">• Low labor mobility• More segregated• Less risk-taking• Falling societal trust	<ul style="list-style-type: none">• Fading globalization• Declining creative destruction:<ul style="list-style-type: none">• Lower firm turnover• Higher firm concentration• Goods → services• Maturing EM economies <div>Technology</div> <ul style="list-style-type: none">• Running out of big new innovations?	<ul style="list-style-type: none">• Populism/protectionism• Secular stagnation:<ul style="list-style-type: none">• Diminished expectations• Less business investment• Skill decay• Debt excesses<ul style="list-style-type: none">• Servicing• Deleveraging

Source: RBC GAM



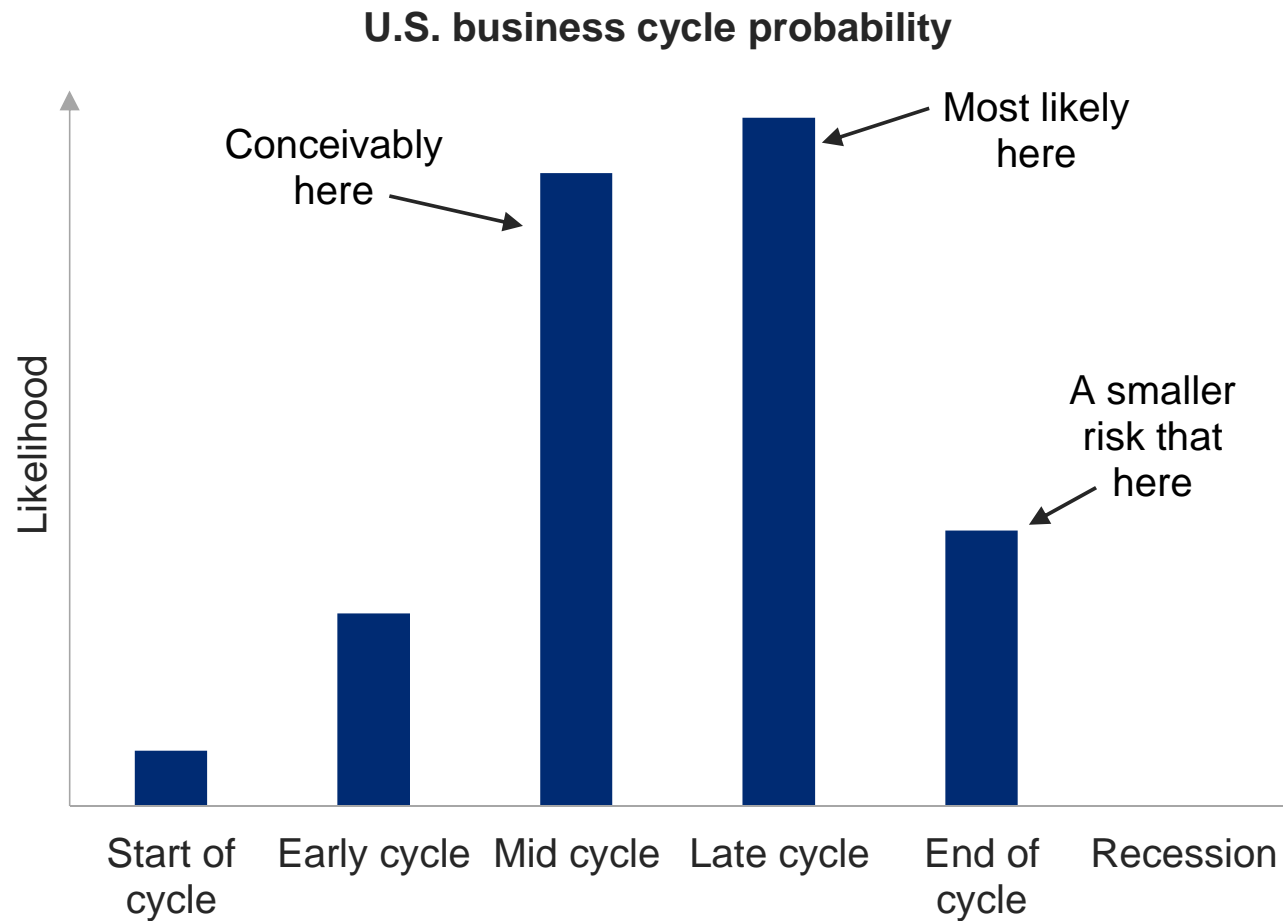
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Corporate profits rising, even before tax cut



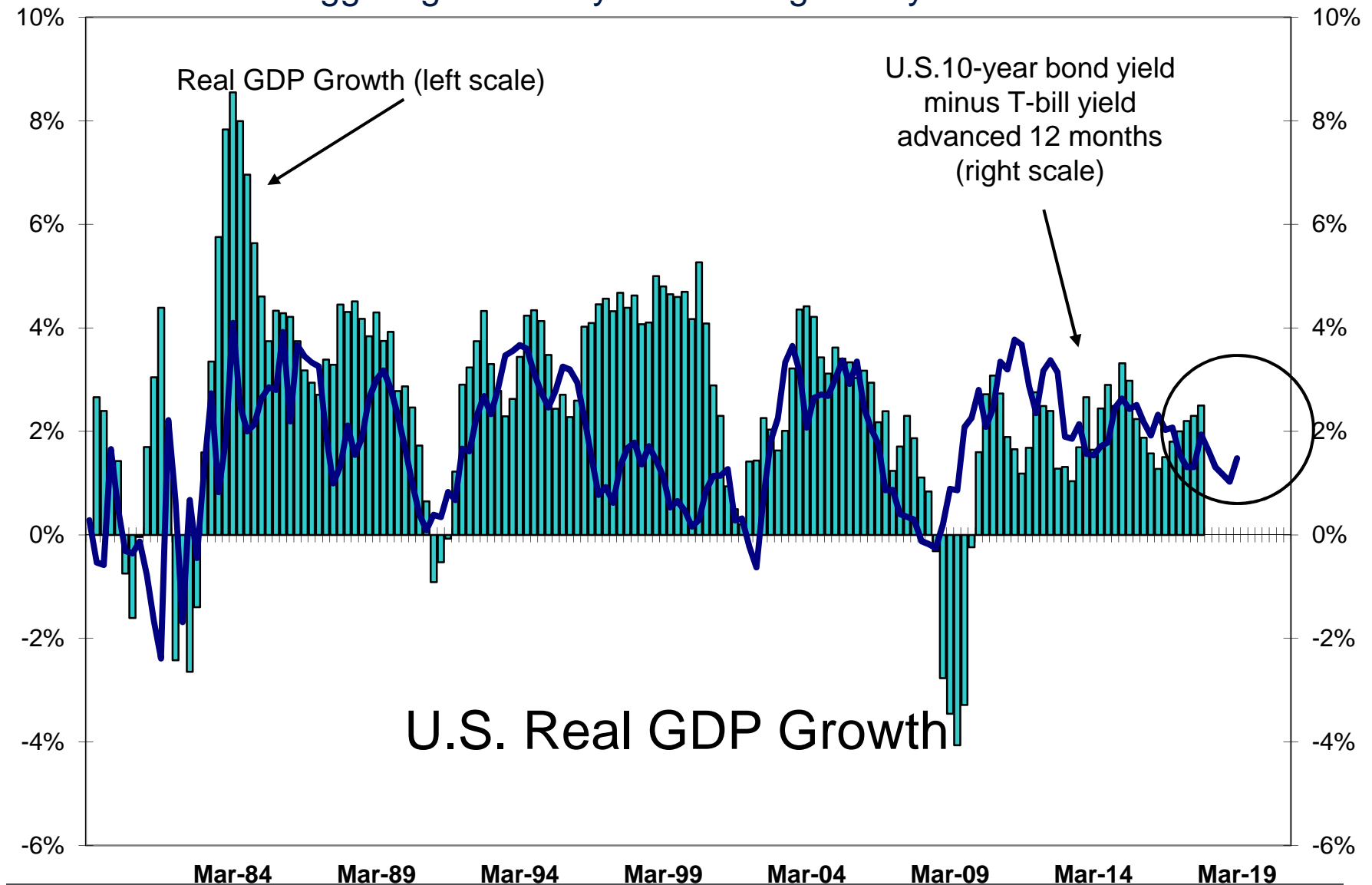
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U.S. economy most probably in late cycle



Note: Calculated via scorecard technique by RBC GAM. Source: RBC GAM

The yield curve is not signalling a recession,
but it does suggest growth may slow through this year.

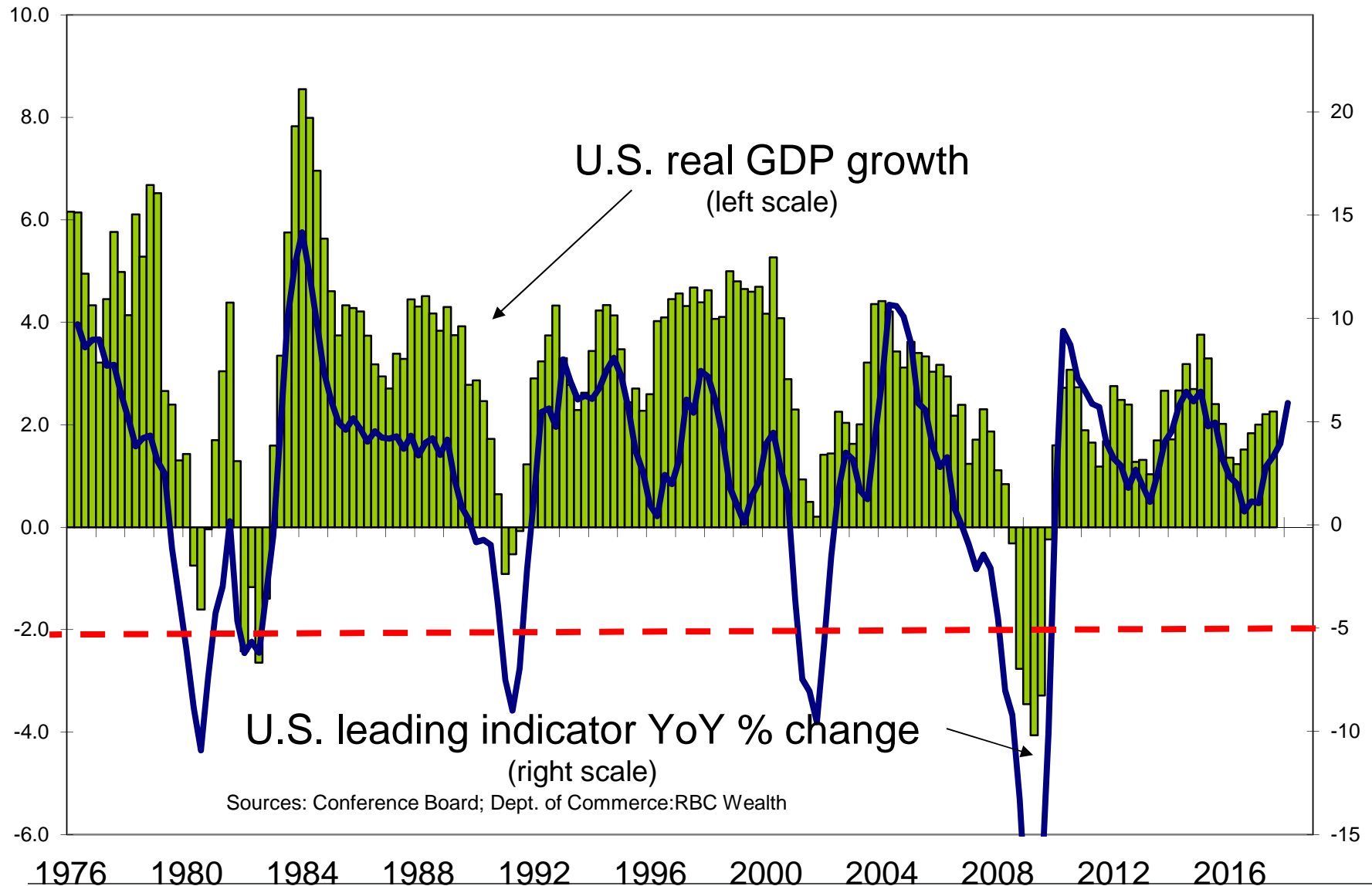


Source: U.S. Bureau of Economic Analysis; U.S. Federal Reserve



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The Leading Indicator suggests GDP growth should stay solid through the first half.



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Monetary stimulus has passed its peak



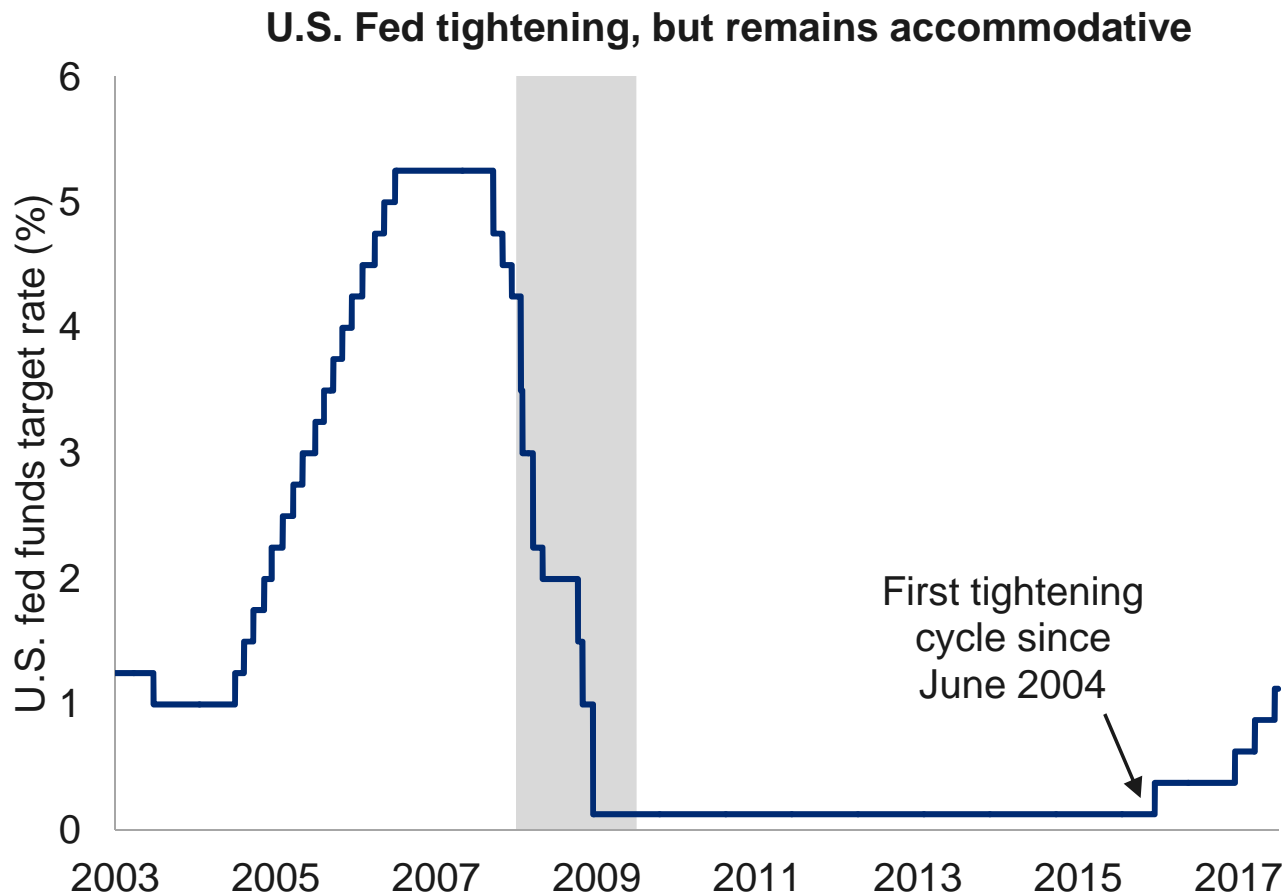
- Improving growth/inflation
- Diminishing economic slack
- Fed rate hikes, staged balance sheet decline
 - BoE QE ending next year?
- ECB QE monthly purchases cut in half, ending next year?
 - Rising yields?

Source: RBC GAM



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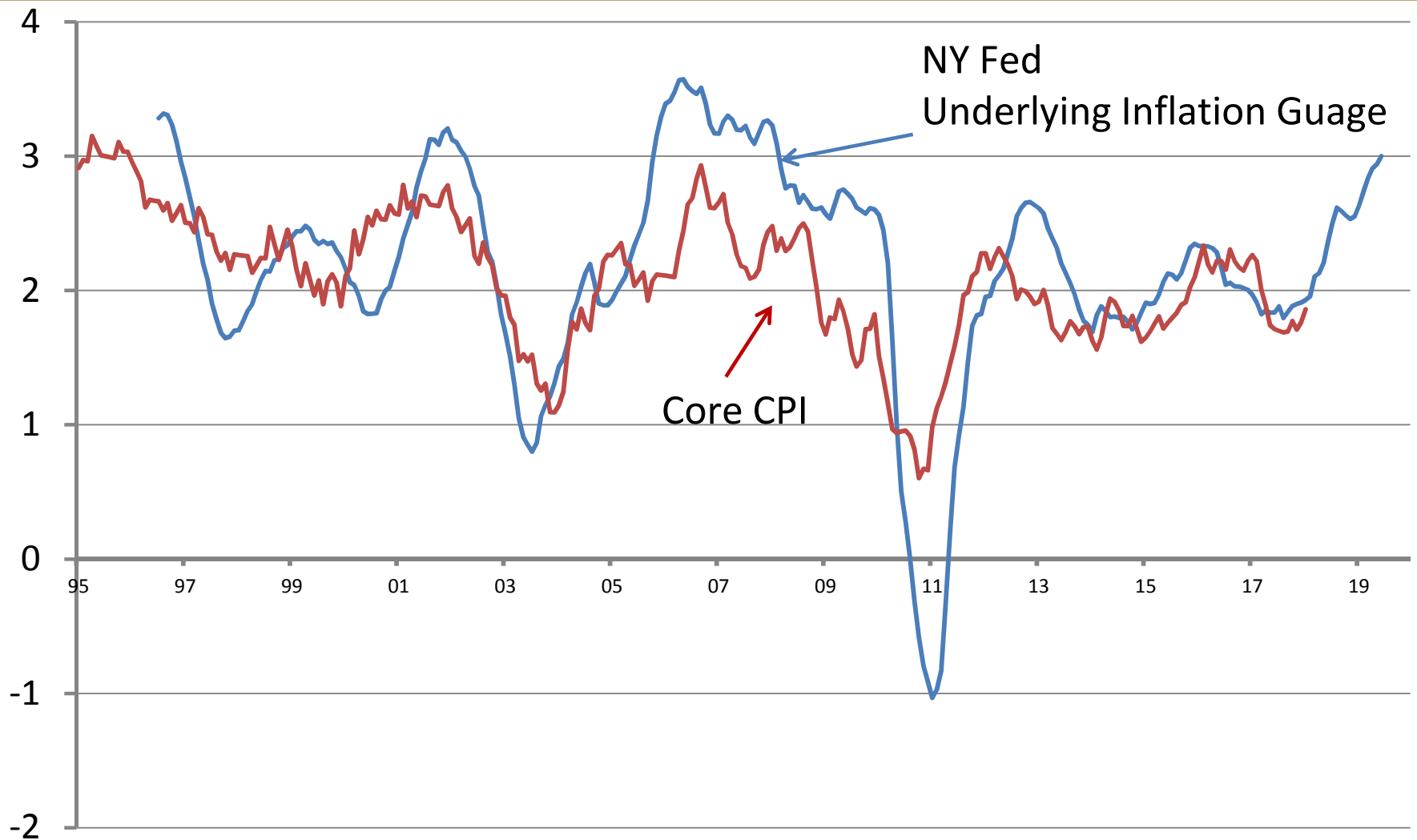
U.S. rate hikes continue to putter along



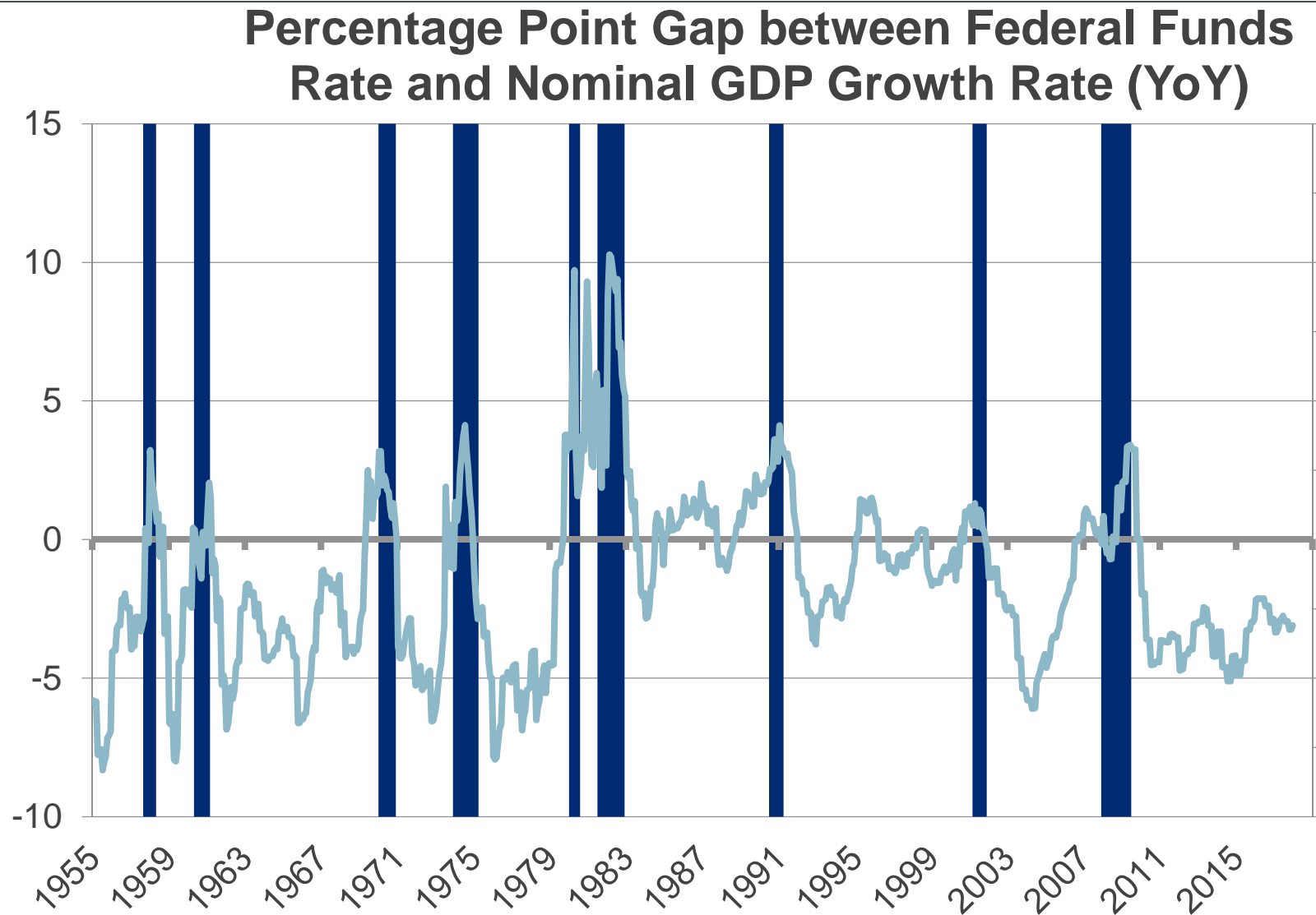
Note: Shaded area represents recession.

Source: Federal Reserve Board, Haver Analytics, RBC GAM

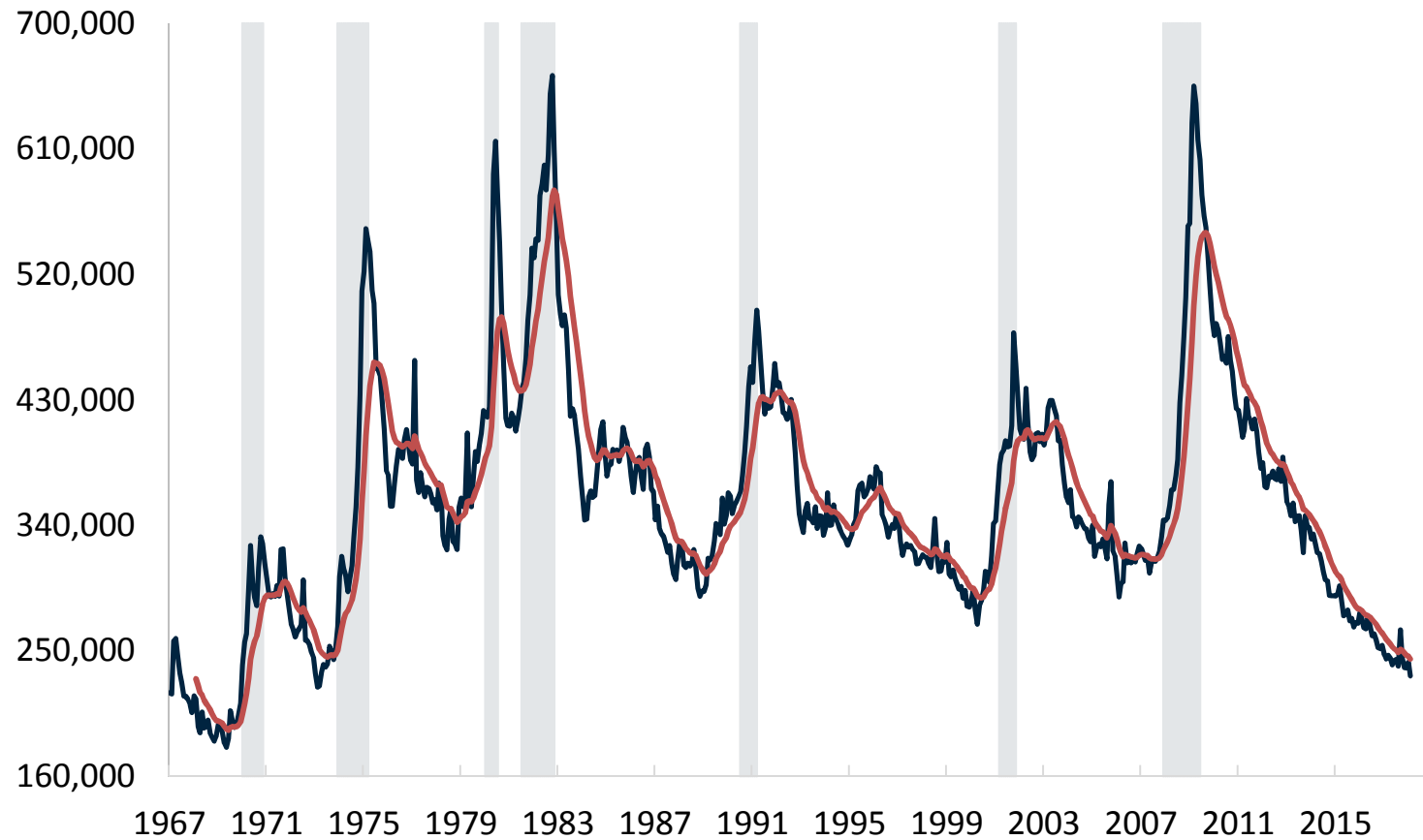
Inflation could surprise to the upside forcing the Fed's hand



How high do rates have to go?



Unemployment claims bottom long before a recession begins

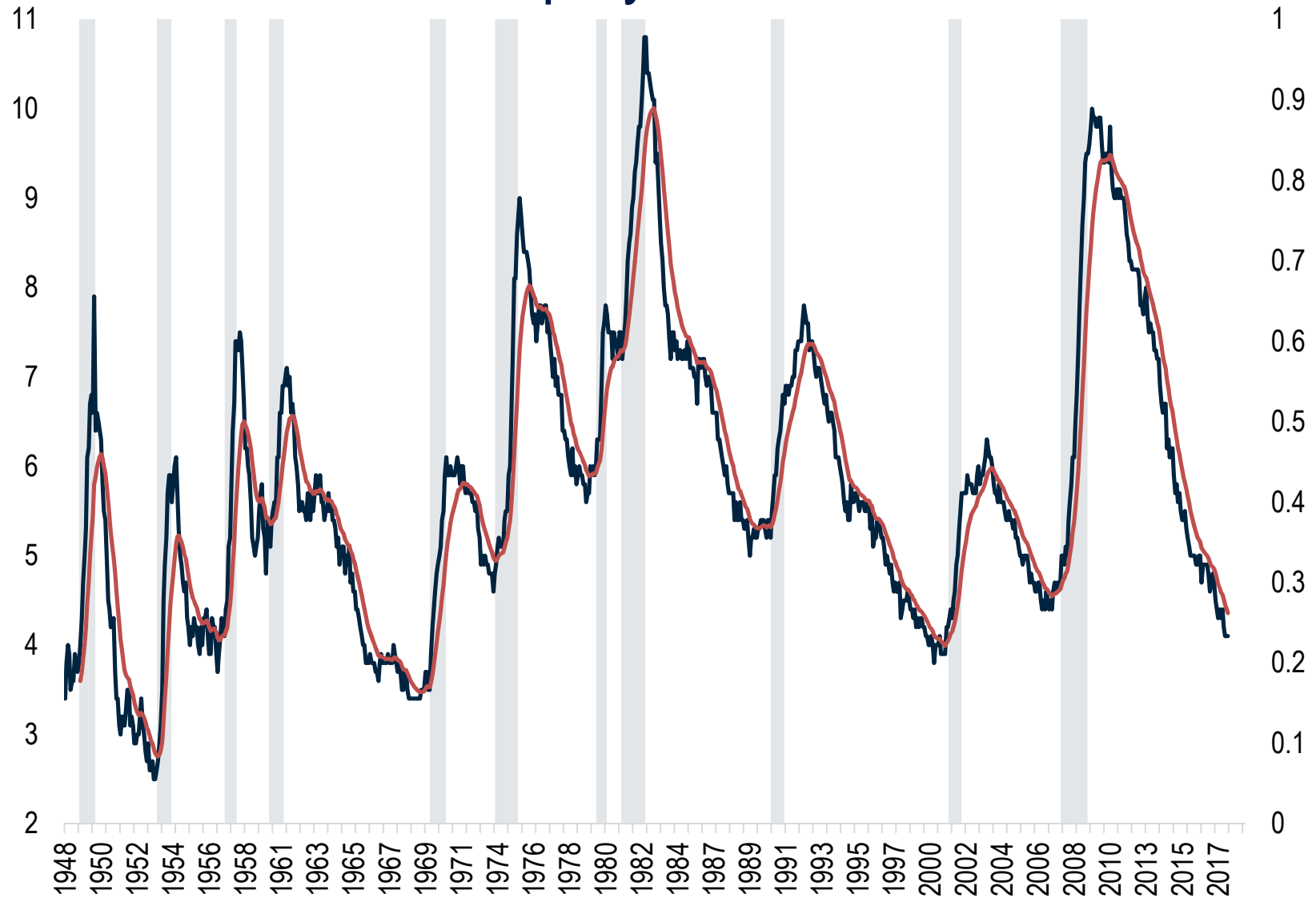


■ Recession periods — Unemployment claims — Unemployment claims smoothed trend



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U.S. Unemployment Rate



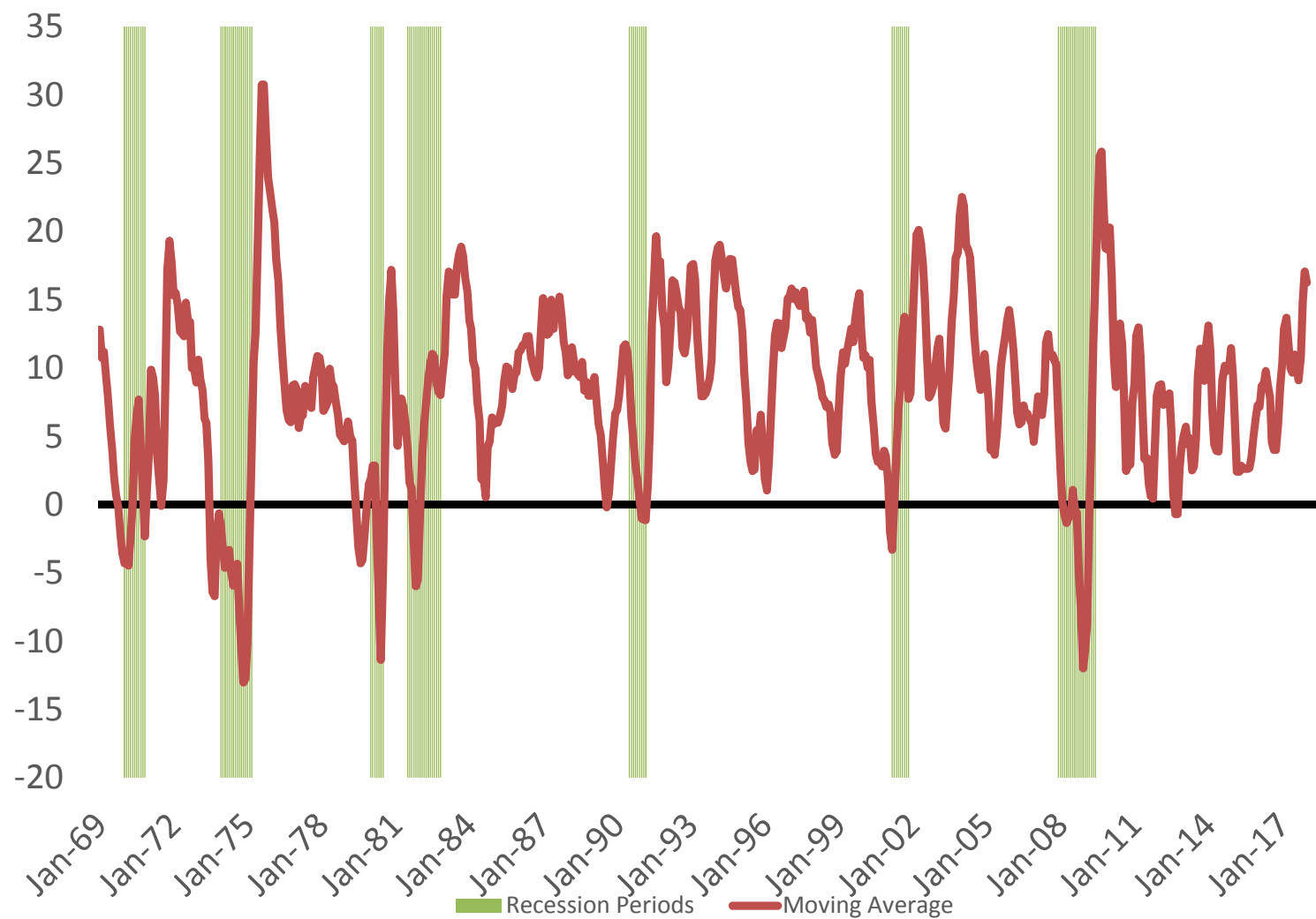
Source: U.S. Dept. of Labor; National Bureau of Economic Research



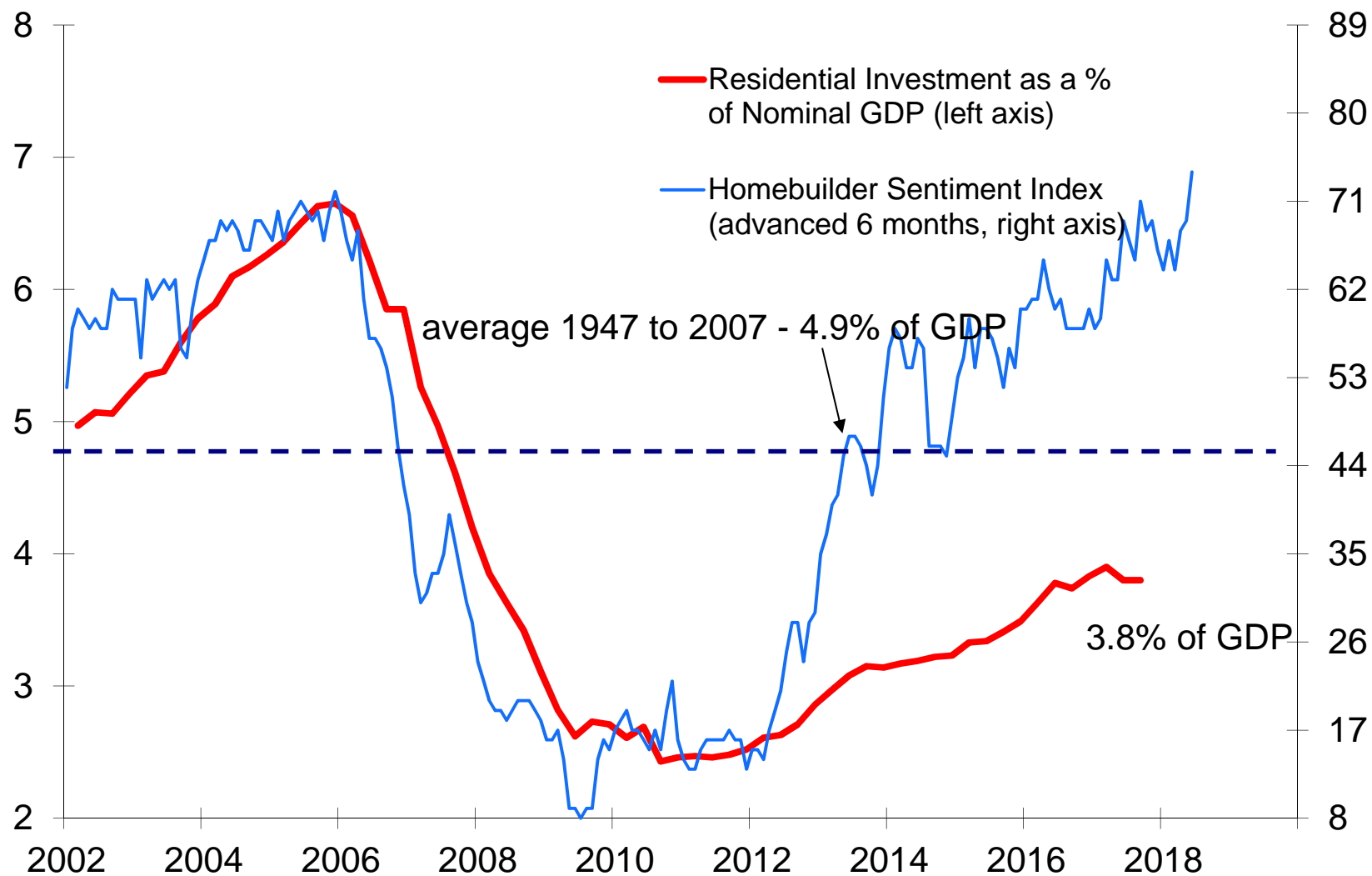
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Difference between ISM New Orders Index and ISM Inventories Index

3 month moving average – source: Institute for Supply Management



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Chinese policymakers hit the brakes

**Tighter
monetary
policy**

**Tighter
fiscal
policy**

**Tighter
housing
rules**

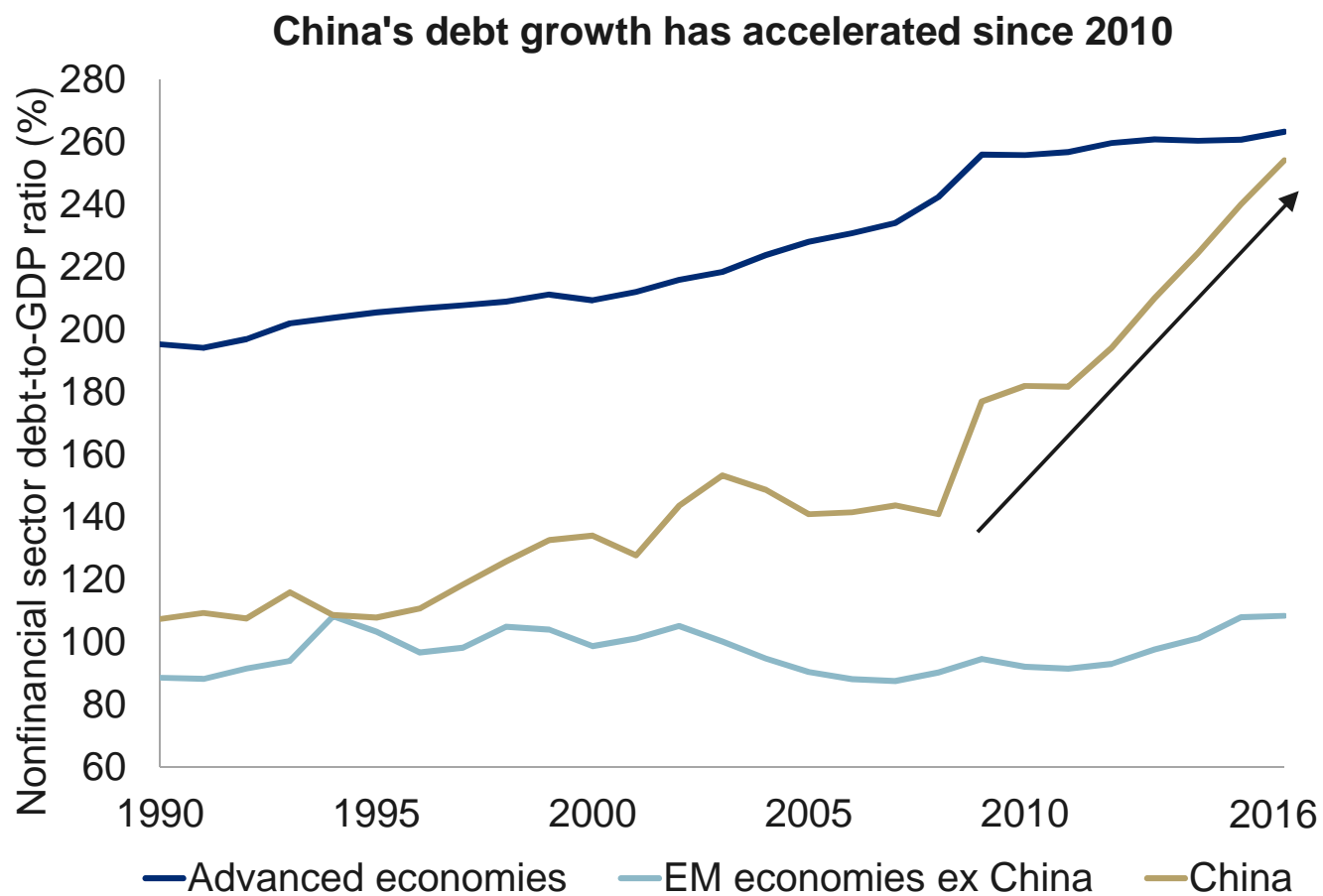
**Higher
auto
tax**

Source: RBC GAM



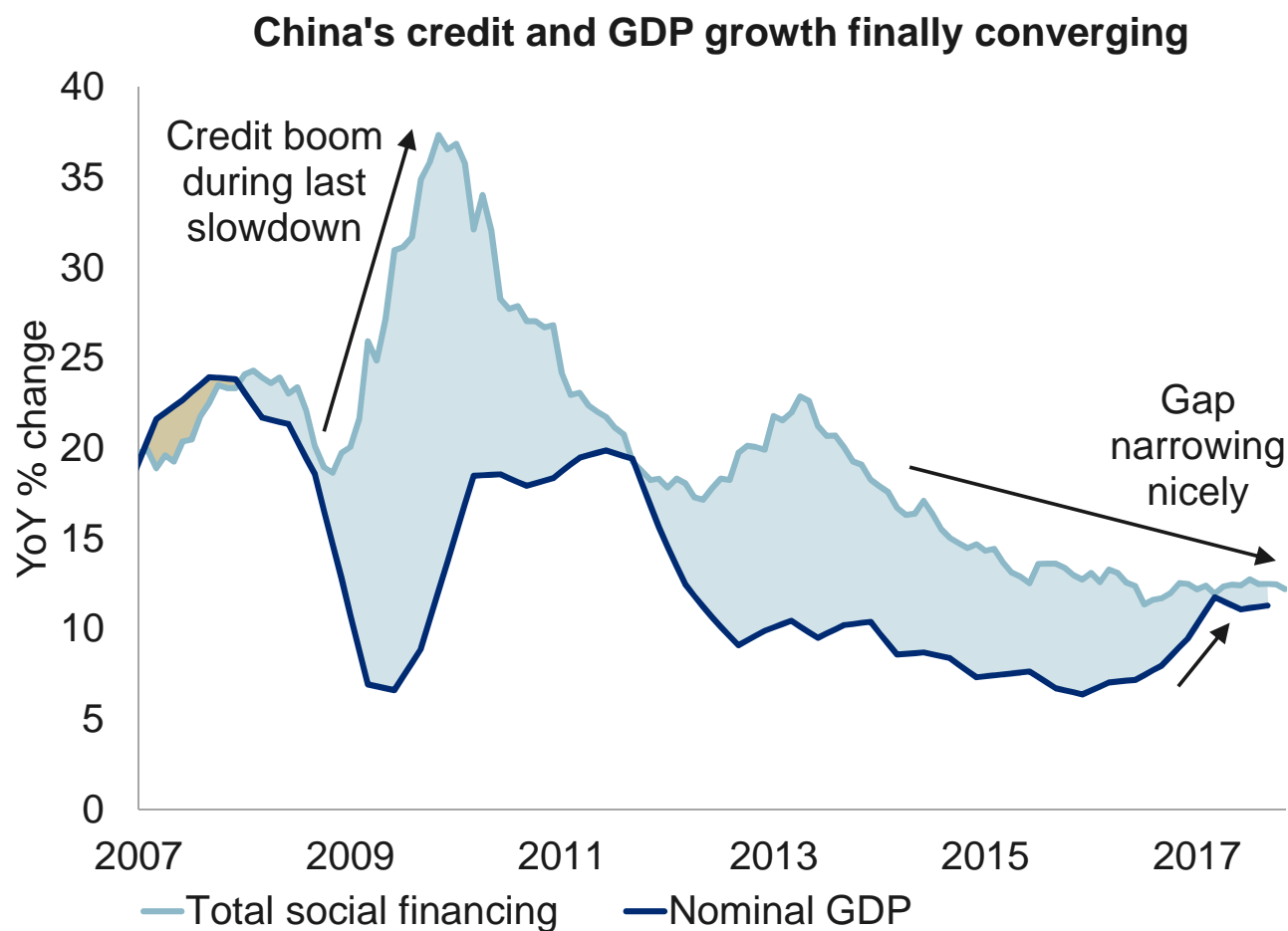
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China's debt level still a concern



Note: Nonfinancial sector debt of G20 countries includes government, household and nonfinancial corporation debt. Source: IMF GFSR October 2017, RBC GAM

Chinese credit excesses are growing less quickly lately



Source: China National Bureau of Statistics, PBoC, Haver Analytics, RBC GAM

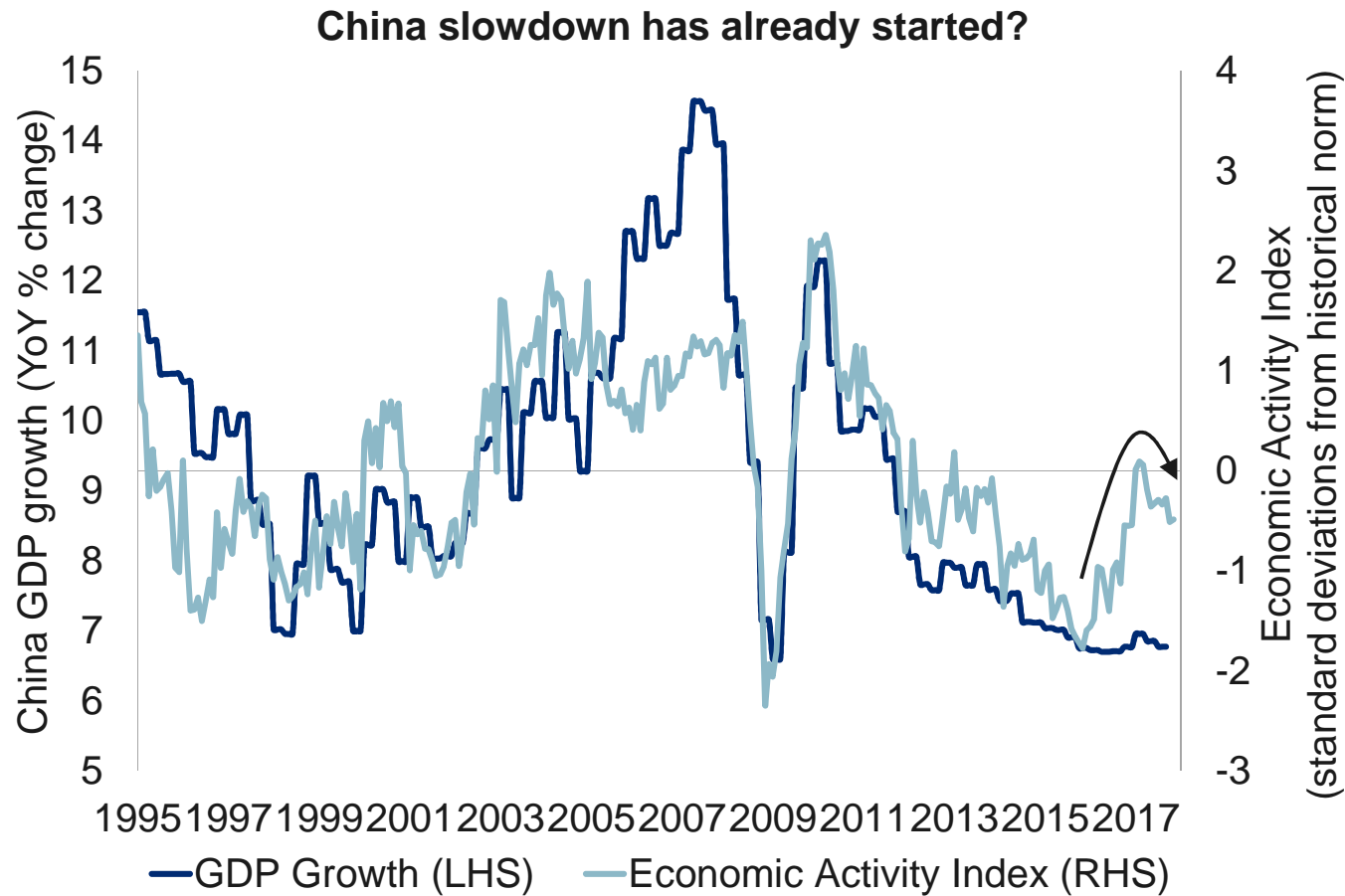
China cutting excess capacity in heavy industries



Note: Steel output includes steel, steel products and corrugated steel bars.

Source: CNBS, Haver Analytics, RBC GAM

Chinese economy to shift away from “quantity” of growth



Note: Index constructed using sixteen proxies for real economic activity in China.

Source: Bloomberg, Haver Analytics, RBC GAM

Threats to Canada's housing boom

Threat	Higher interest rates	Economic recession	Tighter regulations	Parabolic home price increase
Why	<ul style="list-style-type: none"> › Hurts affordability › Higher mortgage default rate 	<ul style="list-style-type: none"> › Increases unemployment › Higher mortgage default rate › Canada's next recession to be extra deep? 	<ul style="list-style-type: none"> › Constrains access to or desirability of home buying › Actions spanning national and regional gov'ts 	<ul style="list-style-type: none"> › Prices out buyers › What goes up must come down › A bit less acute than in 2016-H1 2017
Near-term risk	MEDIUM	MEDIUM	HIGH	HIGH

Source: RBC GAM

Summary Thoughts

Bull market intact and likely to be so until a recession arrives – probably not before 2019, perhaps beyond. Give equities the benefit of the doubt.

Watch Fed, unemployment, credit availability.

Likely at least one correction before bear market arrives.

Market oscillating between an attractive 16X earnings and a riskier 20X earnings.

Focus on rebalancing, culling/replacing stocks that no longer earn high conviction.



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