January 17, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Another brick in the wall of worry

Tom Garretson, CFA – Minneapolis

Risk assets have had a strong start to the year as Fed rate hike fears have been removed from investors' wall of worries. However, rising corporate leverage is quickly replacing those fears, creating an opportunity for fixed income investors in 2019.

Risk assets, including U.S. stocks and speculative-grade corporate bonds, have come out of the gate running to start 2019, and it's at least partly due to a much more cautious tone from Fed officials since they raised rates in December.

As the chart shows, while equity markets have recovered from the December lows, market-based expectations of a rate hike this year have not. With the market expecting the Fed to be on the sidelines, equity markets have been given room to breathe.

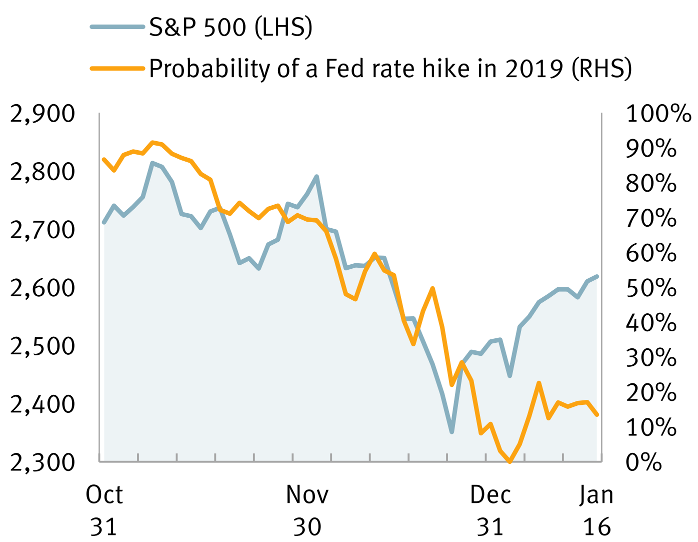
And the reason markets are no longer expecting rate hikes in 2019 is largely due to a number of public comments from Fed officials since the December meeting, including Fed Chair Jerome Powell, that have stressed the idea of being patient at this point, culminating earlier in the week when one of the most hawkish members, Kansas City Fed President Esther George, essentially threw in the towel on rate hike plans for the time being, stating: *"A pause in the normalization process would give us time to assess if the economy is responding as expected with a slowing of growth to a pace that is sustainable."*

We maintain our view that the Fed will be on hold for the balance of 2019, leaving investors one less thing to worry about. But as always with markets, whenever one brick in the wall of worry is taken out, there's always another brick waiting to replace it.

B-B-B afraid?

And that brick has increasingly become the growing size of the U.S. corporate debt market, and particularly the BBB-rated bonds that fall at the bottom rung of the investment-grade spectrum. The top chart on the following page certainly confirms this fear, as the BBB bucket has grown by more than 200% to $3.2T, or about 50% of the entire investment-grade

Stock markets recover as Fed rate hike expectations do not



Source - RBC Wealth Management, Bloomberg; market probability based on fed funds futures; date range: 10/31/18 – 1/16/19

Market pulse

market, compared to the AA bucket, which has increased by just 40%, to $600B.

Here's how the basic story goes. Since the end of the Great Recession in 2009, companies have been able to load up on debt due to low interest rates, and that debt has largely been used to fund share repurchases instead of for more productive purposes and investments. And as companies have loaded up on debt and increased the size of their balance sheets, they have been downgraded from the A-tier and into BBB. The risk then becoming that should interest rates rise, they won't be able to afford the costs, or in the case of a recession, be at risk of being downgraded to junk status.

But that's not the full story. In our view, concerns have been overblown as downgrades of formerly A-rated companies to BBB have accounted for less than 25% of the increase in the size of that market; the largest driver has simply been an increase in the number of firms issuing debt since 2009. Effectively, new companies have matured to the point that they can issue debt, spreading the size of the investment-grade corporate market across a larger number of firms; leverage and interest expense coverage ratios have ticked higher in recent years but remain reasonable, so we don't see widespread credit risks.

In fact, we actually think increased supply has created a better technical backdrop for investment-grade bond investors. As the top chart also shows, the speculative-grade market has shrunk in recent years, with demand far outpacing new supply.

We believe that supply/demand dynamic has created better relative value in investment-grade corporate bonds over speculative-grade bonds, and that forms the basis of our fixed income portfolio positioning views for 2019.

The credit investing landscape in 2019

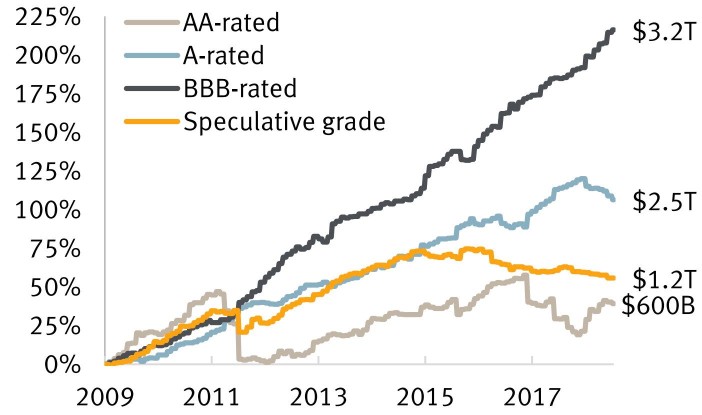
While U.S. stock markets are off to a hot start in 2019, up 4.4% on the S&P 500, speculative-grade bonds aren't far behind, already up 3.5% for easily the best start in the last 10 years; investment-grade corporates are up just 0.40%.

In our view, speculative-grade corporates again look rich following that rally. Since the end of the 2009 recession, investment-grade investors have been paid, on average, 1.47% over Treasuries for credit risk, equal to what investors are currently being paid.

On the other hand, speculative-grade bonds have offered, on average, 5.07% over Treasuries since 2009; today that yield compensation for credit risk stands at just 4.36%.

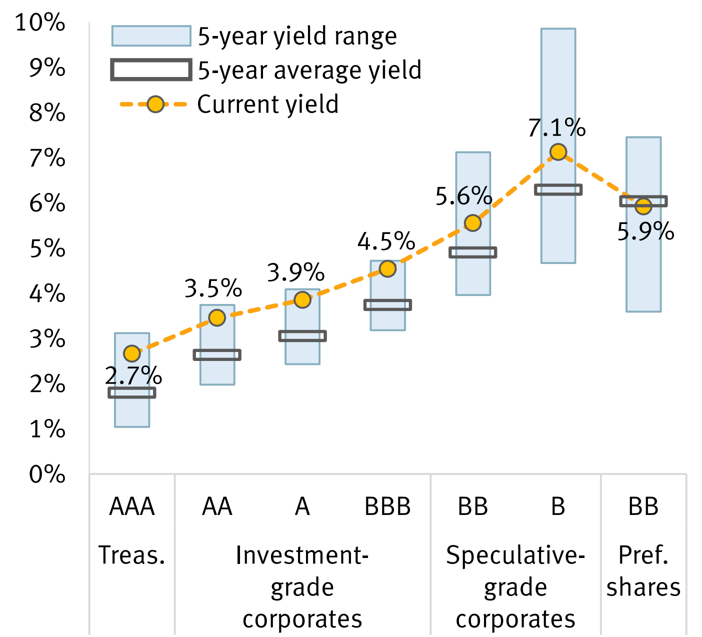
As the bottom chart shows, investment-grade yields are near the highest levels of the past five years, while speculative-grade yields are well below the top ends of their ranges. And at this stage of the expansion, amid rising recession risks, we would hold a bias toward quality, over the higher yields offered at the moment in speculative grade.

Growth in corporate debt since the end of the financial crisis



Source - RBC Wealth Management, Bloomberg, Bank of America Merrill Lynch Indexes; growth indexed to 6/30/09; data through 1/11/19

The yield landscape: Yields for quality bonds near 5-year highs



Source - RBC Wealth Management, Bloomberg Barclays Indexes, Bank of America Merrill Lynch Indexes; data through 1/16/19

So we maintain a modestly positive view on the investment-grade sector and a modestly negative view on the speculative-grade space, while our favorite sector remains preferreds. While we believe a pause in Fed rate hikes should support risk assets, it should also serve to keep a lid on yields. Additionally, preferreds tend to be issued by financial institutions, and with banks up 11% this year on the back of solid earnings, compared to 4.4% for the S&P 500, that performance has helped to boost the S&P Preferred Stock Index by 3%.

The wall of worry will always exist for investors, in our view, but as bricks are replaced, we look to be opportunistic. And the market volatility of late has created opportunities for fixed income investors in 2019.

United States

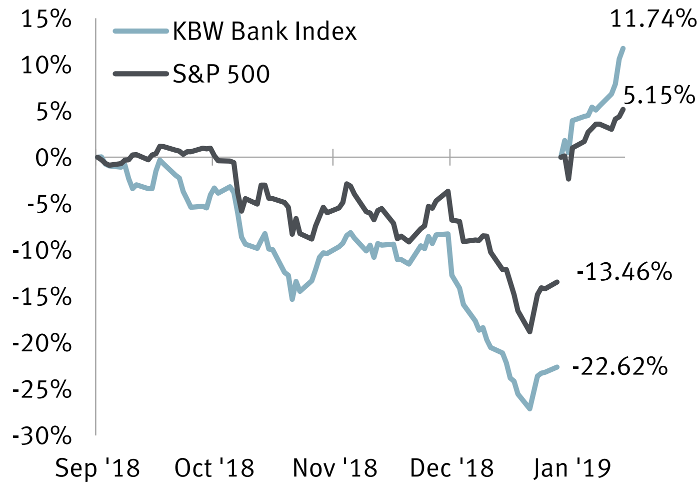
Bill Kuehn, CFA – Minneapolis

- **U.S. equities have continued to march higher in 2019**, and have thus far tallied the **best performance during any government shutdown dating back to 1976**. The S&P 500 is higher by 9.1% since the shutdown began on December 22, 2018, with the help of modestly positive Q4 corporate earnings reports. **Bank earnings have been the biggest uncertainty** with quarterly results being mixed with fixed income, currencies, and commodities trading falling well short of expectations; however, sentiment on the sector was so poor and expectations so low after underperforming beginning in fall 2018 that banks have traded higher following Q4 results and forward guidance and have outperformed the S&P 500 year to date.

- RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina has a **2900 price target on the S&P 500** for year end 2019 based on her estimate of $171 in earnings per share at a 17x price to earnings multiple assumption. This would represent 10.1% upside from the current 2636 closing level. Additionally, Calvasina **prefers value stocks over growth stocks** and recommends an overweight position on Consumer Staples, Health Care, Energy, and Financials. **We maintain a Market Weight view on U.S. equities** as we believe the economy is not headed into a recession in 2019, but rather a slowdown in growth from 2018's stronger pace.

- The results of **January's Philadelphia Fed *Manufacturing Business Outlook Survey*** have bucked the trend of sharp declines in numerous regional manufacturing activity surveys that have shown signs of a significant slowdown in recent months. The **general business conditions component jumped to 17.0** from 9.1 and, more importantly, the **new orders component**, which has been an accurate predictor of future economic activity, **soared to 21.3** from 13.3, perhaps signaling a slightly better outlook.

After underperforming in 2018, bank stocks outperform to start 2019



Source - RBC Wealth Management, Bloomberg; data through 1/17/19

Canada

Diana Di Luca – Toronto

- **The Bank of Canada (BoC) kept the overnight lending rate unchanged at 1.75%**, as the market expected. The BoC released its statement accompanying the policy decision, alongside its updated *Monetary Policy Report*, in which it acknowledged **consumer spending and investment in housing have been weaker than expected** but the **Canadian economy has been performing well overall**. The BoC is also clearly conscious of market dynamics (flat yield curve, tightening of financial conditions), which leads us to believe that it **will tread carefully** against a backdrop of global growth concerns and weaker energy prices. The market is expecting the BoC to remain on hold this year.

- We acknowledge that we are **edging closer to the end of the economic cycle** and, therefore, would **maintain shorter-duration positioning** with a bias to higher-rated, higher-quality bonds. We continue to recommend discounted Federal bonds that offer lower expected volatility of returns and a source of liquidity. As far as 2019 goes, we believe a more cautious BoC should give time for curves to re-steepen as inflation expectations rebuild into the market. This should provide better levels to buy longer-dated bonds.

- **The Canadian preferred share market is up approximately 7% from the December lows**. This comes as corporate bond spreads have narrowed from the widest levels since 2016. Corporate bond supply has responded to strong demand at wider spread levels in early 2019, setting a positive tone to credit markets, helping to narrow credit spreads on secondary market preferred shares. Against this backdrop, the Canadian preferred share market saw the **first new issue since October during the week.**

Europe

Laura Cooper – London

- **U.K. Prime Minister Theresa May suffered a crushing defeat** on January 15 when the U.K. **House of Commons voted overwhelmingly—432 to 202—against her plan outlining the U.K.'s departure from the EU**. This was the worst defeat by any government in close to 100 years. The defeat was widely expected, though not its magnitude. As a result, **the British pound sold off on the extent of the opposition** to the agreement.

- In the immediate aftermath of the vote, which was deferred from December 11, the Labour Party put forward a no-confidence motion in an attempt to trigger a general election. The proposal ultimately failed in a narrow 325-306 vote on the evening of January 16; however, **further no-confidence motions are likely**, in our opinion. Therefore, the chance of a general election coming to pass could see the Labour Party shift its policies towards a permanent customs union with the EU or uniting around a second Brexit referendum to bolster support.

- The lack of consensus on how the U.K. should proceed with its Brexit plans has ostensibly thrown the country into turmoil. With the clock continuing to tick down to the planned March 29 exit date, **Prime Minister May vowed to work with government party leaders to seek amendments to the current Withdrawal Agreement**. A revised plan is due to be proposed on January 21.

- In the absence of material concessions coming from the EU, it is looking increasingly likely that tweaks to the current Withdrawal Agreement will still not be palatable to the U.K. Parliament. Accordingly, **we anticipate that the government will seek an extension to Article 50 negotiations—the mechanism that legally binds the U.K. to leave the EU on March 29**—to allow for more time to draft and gain approval on a revised agreement. Prospects for this development are, in turn, underpinning support for the pound while U.K. Gilt yields are modestly retracing from their earlier low levels.

- Politics is poised to continue to overshadow the flow of economic data in the U.K. The U.K. inflation rate ended 2018 slightly above target, coming in at 2.1%. **The Bank of England (BoE) is likely to remain on the sidelines until greater clarity emerges around Brexit**, however. In comments on January 16, BoE Governor Mark Carney assessed that the central bank will be "prudent not passive" in gauging Brexit progress, asserting that it has the tools needed for whatever form Brexit takes.

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **Asian stocks continue to move steadily higher**. The MSCI AC Asia Pacific Index fell to a low for 2018 of 142 on December 25. The index has since risen by 10 points, or 7%. Stocks have been buoyed by an improvement in performance in the U.S. market, developments from the trade talks between the U.S. and China, and signs of policy easing in China.

- **China posted weaker trade data in December**. Exports declined by 4.4% y/y and imports by 7.6%. Even so, China's exports to the U.S. rose by 11.3% in 2018 while imports from the U.S. rose by less than 1%. Consequently, **China's trade surplus with the U.S. rose** by approximately $50B to $323.3B, a record high. Notably, **China's global trade surplus actually fell** in 2018 by 16% to $351.8B. Exports rose by 9.9% while imports expanded by 16.2%. Trade negotiations between the U.S. and China are ongoing.

- **China has responded to economic deceleration with policy support**. Although benchmark lending rates have remained unchanged, the People's Bank of China (PBoC) has been helping to ease interbank borrowing rates via cash injections. The PBoC has also lowered the required reserve ratio for banks, freeing up capital to lend. Tax cuts are also expected. Chinese authorities are striking a balance between reducing riskier areas of credit growth in the economy while also providing overall support.

- **Market expectations that the Hong Kong authorities will relax measures put in place to the cool the property market were laid to rest**, at least temporarily, by Financial Secretary Paul Chan, who noted that there is no need for the government to support the market. Prices in the secondary market (i.e., not new property) have consistently declined since August and are down by around 9% from the peak. Even though prices have registered their longest losing streak since 2008—the 3.5% decline in November was the largest monthly drop since November 2008—they remain 47% higher than five years ago and far higher still than 10 years ago. It remains unknown whether the current phase is a correction or the start of a bear market in the world's most expensive residential real estate market.

- **Shares of Chinese smartphone company Xiaomi** (1810 HK) continue to weaken in Hong Kong, falling by 5.8% during the week. The stock is **down around 40% since listing on the Hong Kong exchange six months ago**. Recent weakness has in part been caused by the expiration of a lockup period for early investors. A range of companies, including several large Chinese vendors, Apple, and Samsung, also produce high-quality devices, resulting in stiff competition.

- **Sinopec** (386 HK), one of the big three Chinese oil and gas companies, **may have received approval from China's State Council to list its retail unit** later in 2019, according to Bloomberg. Sinopec Marketing's retail operations include over 30,000 gas stations and nearly as many convenience stores.

MARKET SCORECARD

Data as of January 17, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,635.96	5.2%	5.2%	-5.9%	16.2%
Dow Industrials (DJIA)	24,370.10	4.5%	4.5%	-6.7%	22.9%
NASDAQ	7,084.46	6.8%	6.8%	-2.9%	27.9%
Russell 2000	1,467.25	8.8%	8.8%	-7.5%	8.5%
S&P/TSX Comp	15,211.22	6.2%	6.2%	-6.8%	-1.5%
FTSE All-Share	3,757.86	2.3%	2.3%	-11.4%	-4.0%
STOXX Europe 600	350.73	3.9%	3.9%	-11.9%	-3.2%
EURO STOXX 50	3,069.35	2.3%	2.3%	-15.0%	-6.6%
Hang Seng	26,755.63	3.5%	3.5%	-16.3%	17.1%
Shanghai Comp	2,559.64	2.6%	2.6%	-25.7%	-17.7%
Nikkei 225	20,402.27	1.9%	1.9%	-14.5%	8.4%
India Sensex	36,374.08	0.8%	0.8%	3.7%	33.6%
Singapore Straits Times	3,214.44	4.7%	4.7%	-9.2%	6.7%
Brazil Ibovespa	95,351.09	8.5%	8.5%	17.4%	48.2%
Mexican Bolsa IPC	43,932.08	5.5%	5.5%	-11.7%	-4.5%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,291.97	0.7%	0.7%	-2.7%	6.2%
Silver (spot $/oz)	15.52	0.2%	0.2%	-8.7%	-9.7%
Copper ($/metric ton)	5,938.25	-0.2%	-0.2%	-15.1%	3.6%
Oil (WTI spot/bbl)	52.07	14.7%	14.7%	-18.6%	-0.8%
Oil (Brent spot/bbl)	61.22	13.8%	13.8%	-11.8%	10.4%
Natural Gas ($/mmBtu)	3.41	16.1%	16.1%	5.6%	0.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.747%	6.3	6.3	15.6	42.2
Canada 10-Yr	1.993%	2.6	2.6	-21.1	32.6
U.K. 10-Yr	1.337%	6.0	6.0	2.9	2.8
Germany 10-Yr	0.243%	0.1	0.1	-31.9	-7.8

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.29%	0.1%	0.1%	0.7%	2.9%
U.S. Invest Grade Corp	4.16%	0.4%	0.4%	-1.6%	3.2%
U.S. High Yield Corp	7.12%	3.5%	3.5%	0.5%	7.6%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	96.0620	-0.1%	-0.1%	6.1%	-4.3%
CAD/USD	0.7532	2.7%	2.7%	-6.4%	-1.8%
USD/CAD	1.3277	-2.6%	-2.6%	6.7%	1.8%
EUR/USD	1.1389	-0.7%	-0.7%	-6.5%	6.3%
GBP/USD	1.2986	1.8%	1.8%	-6.1%	4.6%
AUD/USD	0.7191	2.0%	2.0%	-9.8%	-5.0%
USD/JPY	109.1800	-0.5%	-0.5%	-1.9%	-3.1%
EUR/JPY	124.3500	-1.2%	-1.2%	-8.3%	3.1%
EUR/GBP	0.8770	-2.4%	-2.4%	-0.5%	1.6%
EUR/CHF	1.1318	0.6%	0.6%	-3.8%	5.5%
USD/SGD	1.3553	-0.6%	-0.6%	2.3%	-4.2%
USD/CNY	6.7764	-1.5%	-1.5%	5.3%	-1.0%
USD/MXN	19.0095	-3.3%	-3.3%	1.6%	-11.6%
USD/BRL	3.7460	-3.3%	-3.3%	16.2%	16.7%

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 9:35 pm GMT 1/17/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 2.7% return means the Canadian dollar rose 2.7% vs. the U.S. dollar year to date. USD/JPY 109.18 means 1 U.S. dollar will buy 109.18 yen. USD/JPY -0.5% return means the U.S. dollar fell 0.5% vs. the yen year to date.

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Hold [Sector Perform]	642	40.25	111	17.29
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