March 21, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

The Fed aims to keep the party alive

Tom Garretson, CFA – Minneapolis

Federal Reserve Chair Jay Powell appears to have done his best impression of Jay Gatsby, as the Fed's focus seems to have shifted from its two official mandates of steady prices and full employment, to simply keeping the good times rolling.

The Great Gatsby, a meditation on the end of an era in American history following a decade of unprecedented prosperity and excess, may capture the state of mind of Fed officials entering the March 20 meeting of the policymaking Federal Open Market Committee (FOMC).

As fears have grown in recent months that the current 10-year economic expansion might be at risk amid rising recession worries as we near the end of this decade, Fed Chair Powell stated at the opening of his prepared remarks: "My colleagues and I have one overarching goal: to sustain the economic expansion with a strong job market and stable prices, for the benefit of the American people."

And the Fed took significant steps in the hope of achieving that goal. The key development is that Fed officials now expect no further rate hikes in 2019, down from the two it had forecasted at the December 2018 meeting. Officials still see one more hike in 2020 to get policy rates to 2.75%, which officials continue to view as the "neutral" policy level—or the level at which interest rates are neither boosting economic growth nor restricting it. However, we believe the current rate hike cycle is effectively over and that the Fed will now fine-tune policy as needed, which could include both rate hikes and rate cuts.

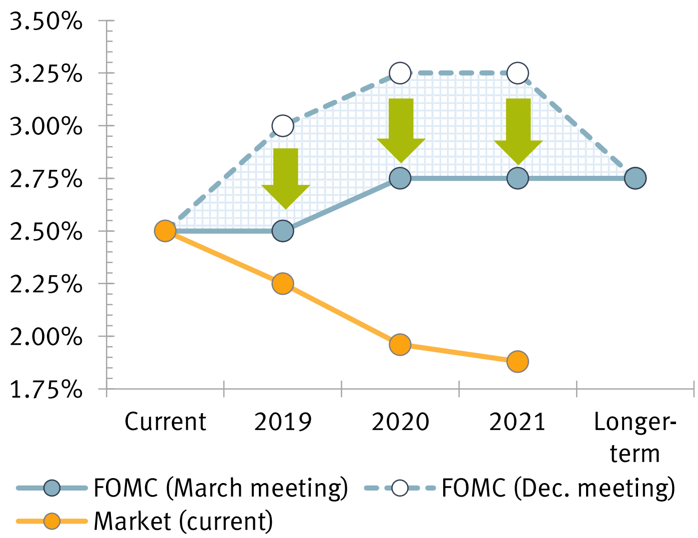
"Can't repeat the past? Why of course you can!"

So how should we think about the Fed's outlook now? We have often looked to the 1990s as a sort of guidepost to how the Fed might approach policy this cycle. It was a time of steady growth and stable inflation and one of the longest expansions on record.

The Fed raised rates relatively quickly in 1994, the equivalent of 12 hikes of 25 basis points before stating that it had largely

The Fed sharply lowered its rate hike forecast, but markets are still pricing in rate cuts

Fed now sees just one more rate hike in 2020



Source - RBC Wealth Management, Bloomberg, Federal Open Market Committee Summary of Economic Projections; market data based on overnight indexed swap rates

Market pulse

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Priced (in USD) as of 3/21/19 market close, EST (unless otherwise stated).
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achieved its objectives. From there it adjusted policy rates both up and down, before again raising rates at a sustained pace at the end of the decade as the economy began to overheat.

So that's likely how the Fed will approach policy over the coming years in an effort to sustain the current economic expansion. While the data will dictate whether the next move in rates will be higher or lower, the market is increasingly pricing higher chances of the next move being a rate cut.

Prior to the March 20 meeting, markets were pricing about a 30% chance of a rate cut within one year; after the meeting those chances spiked to nearly 50%.

"So we beat on, boats against the current …"

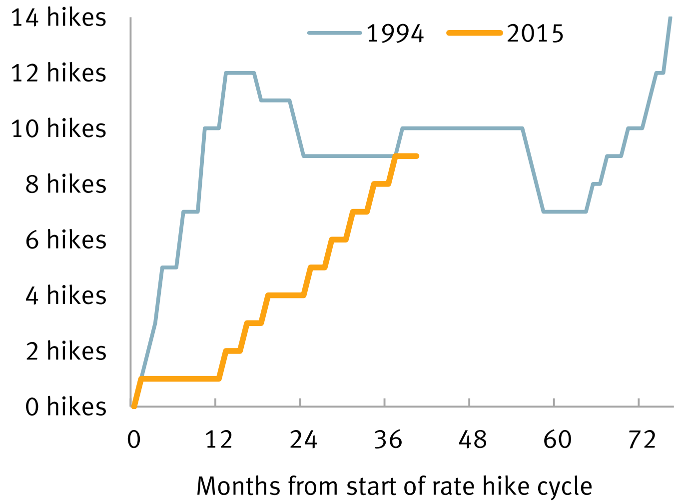
To be sure, the Fed is just one piece of the puzzle in an economic expansion. And while the Fed looks set to do what it can to row into currents in the face of the inevitability of the next recession, we are not yet ready to dismiss rising recession risks. Even after the Fed slashed its rate hike forecasts, yield curves continue to flatten and are on the edge of inversion.

The benchmark yield curve, the spread between 3-month Treasury bills and 10-year Treasury yields, collapsed to just 0.04% in the aftermath of the announcement, and is down sharply from over 1% just six months ago. Based on the New York Fed's yield curve model, that level of flatness puts the chances of a recession within one year at nearly 30%. On top of that, economic surprise indexes remain negative as incoming data has been mixed. And as the bottom chart shows, economic growth is likely to hit a soft patch to start 2019, with tracking estimates below 2%.

The Fed can only do so much, but we believe the steps taken earlier in the week are moves in the right direction to keep the economic party going.

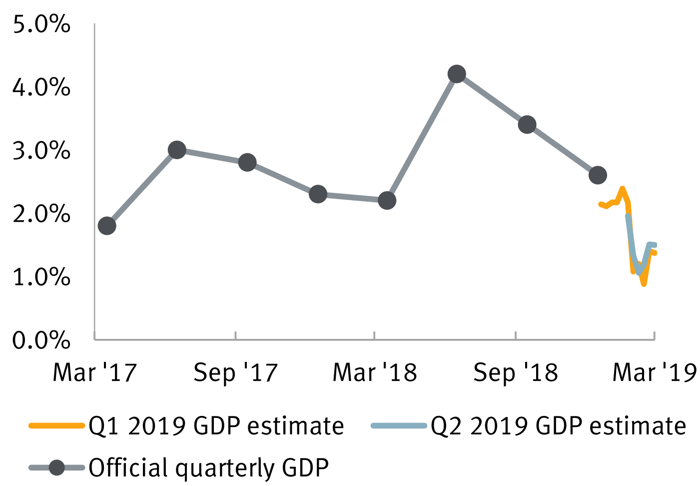
The '90s playbook?

Look for the Fed to fine-tune policy from here



Source - RBC Wealth Management, Bloomberg, Federal Reserve

Growth estimates for 2019 are fading, supporting the Fed's dovish turn



Source - RBC Wealth Management, Bloomberg, estimates from the Federal Reserve Bank of New York, *Nowcasting Report*

United States

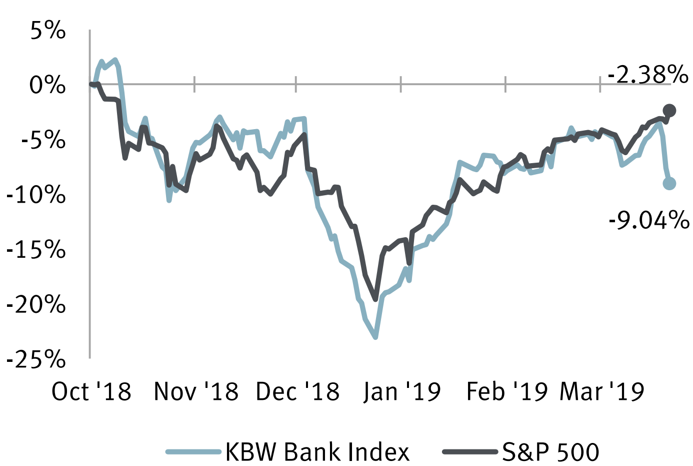
Bill Kuehn, CFA – Minneapolis

- **Corporate bonds have had a hot start to 2019**, with investment-grade (IG) bonds up 3.90% YTD, and high-yield (HY) up 6.81% YTD. **However, an increase in the supply of new debt is taking steam out of the rally**. IG credit spreads, which tightened 32 basis points (bps) in the first two months of the year despite a deluge of supply, narrowed just 2 bps the week of March 11 as approximately $27B in new bonds were issued in the primary market.

- **We are shifting to a modestly wider outlook on credit spreads** following the rally that has pushed IG spreads to just 120 bps over Treasuries, and HY to 386 bps over—both near the tightest levels of this cycle. **We don't expect credit spreads to move markedly wider with the Fed on hold**; but in the later stages of this cycle, we expect corporate bond buyers to demand higher yield compensation over Treasuries for credit risks. We recommend investors take advantage of the rally in HY and swap up into higher-quality credit.

- Despite the run in equities, **we continue to recommend an Overweight to U.S. bank stocks in portfolios**. Bank stocks have not participated in the rally to the same extent as other sectors, underperforming the S&P 500 by 6.66% since October but opening up an attractive entry point, in our view. We believe valuations remain attractive, both on an absolute basis and relative to the market. The KBW Bank Index currently trades at a 10.55x forward price-to-earnings multiple versus the S&P 500 at 17.15x.

Bank stocks have underperformed the S&P 500 by 6.66% since October



Source - RBC Wealth Management, Bloomberg; data through 3/21/19

- **Deregulation should also be a tailwind, in our view**, now that banks with assets between $50B and $250B will no longer have to participate in the annual stress test or be subject to the associated capital use restrictions. In fact, RBC Capital Markets, LLC **banking analyst Gerard Cassidy expects most of the newly exempt banks to post combined dividends and buybacks in excess of earnings in 2019**, as they move toward an ultimate objective of a 40% dividend payout ratio.

Canada

Diana Di Luca – Toronto

- Following the Bank of Canada's (BoC) rate decision on March 6 and given the recent string of softer data in Canada, **RBC Economic Research has pushed its forecast for BoC rate hikes out by one quarter**. RBC Economic Research now expects **one hike in Q4 2019 and another in Q1 2020**. This would take the overnight rate to 2.25%. If, on the other hand, the bond market is correct, we are closer to a cut than a hike from the BoC, suggesting a more material slowdown in the Canadian economy than many are forecasting. With no rate hikes priced into the market and a flat yield curve, we maintain a shorter duration bias. **Guaranteed investment certificates look increasingly compelling versus bonds**, but discounted bonds remain effective.

- On March 19, the **Canadian government announced CA$21B of new spending** over the next five fiscal years across a range of **measures aimed at pleasing voters**. The measures include, but are not limited to, credits for training and education; a first-time home buyers plan; advanced reconciliation with indigenous peoples; creation of a national drug agency to negotiate drug prices; enhancements to guaranteed income supplements for seniors; and a goal to ensure all Canadians have access to high-speed internet. The government is **expected to post a CA$14.9B deficit for the fiscal year 2018-19**, effectively in line with where the government projected the shortfall to be back in the fall.

- **The government also expects more fiscal headroom for years two through five of its forecasts** compared to its projections in the fall of 2018. There are about CA$20B of annual shortfalls forecast for the next two years after which the deficits are slowly reduced to approximately CA$10B in the fifth year. With the government's projections for nominal GDP over the next five years, this implies a ratio of federal debt-to-GDP of just above 30% over the next couple of years, steadily decreasing to 28.6% by the fifth year. As RBC Economic Research notes, however, the government's projection of nominal GDP growth of between 3.5% and 4.0% over the next five years appears lofty. If the government is proven to have been too optimistic with its forecasts, the debt-to-GDP ratio, which it places more weight on than the outright level of debt, runs the risk of not looking quite as attractive.

Europe

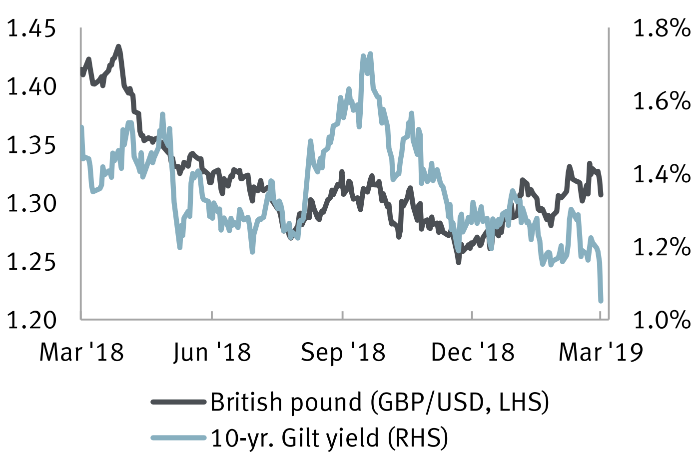
Frédérique Carrier & Thomas McGarrity, CFA – London

- Data released by the Office for National Statistics showed the **U.K. labour market was shrugging off any Brexit uncertainty**. Despite other recent data that pointed to a waning of hiring intentions, the economy added 222,000 jobs in the three months to the end of January, pushing the unemployment rate down to 3.9%, a 44-year low. As a result of the tight labour market, wage growth remained firm at 3.4% y/y in the same period.

- Under normal circumstances, such data might have led to a strengthening of the currency and higher Gilt yields. In fact, **Gilt yields fell** to 1.084% while **the pound retreated** 1.5% versus the U.S. dollar due to political uncertainty.

- **With just over a week before the March 29 deadline, there is still little visibility as to how or whether the U.K. would leave the EU**. Prime Minister Theresa May has requested a short extension until June 30 to Article 50 (the legal process for Britain to leave the EU). She hopes her Withdrawal Agreement will eventually pass in the House of Commons, having been rejected by 230 votes on January 15 and then by 140 votes on March 12. May's strategy is to try and entice more Members of Parliament (MPs) to vote for this deal in order to avoid alternative scenarios.

Both the pound and 10-year Gilt yield fell after labour report due to political uncertainty



Source - RBC Wealth Management, Bloomberg; data through 3/21/19

For ardent Brexiteers, these are the possibility of a long extension or a softer Brexit. For Europhile MPs, it means the possibility of an accidental hard cliff-edge Brexit.

- **A statement** by European Council President Donald Tusk and European Commission President Jean-Claude Juncker **regarding the granting of an extension is expected** as we go to press.

- Meanwhile, the **Bank of England** (BoE) kept the interest rate at 0.75% and will continue to take its cue from Brexit developments—**postponing a potential rate hike until uncertainty dissipates**. An eventual long extension to Article 50 would likely be seen by the market as an opportunity for the BoE to resume its tightening cycle.

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **Asian equity markets posted a moderately positive response to the Federal Reserve's** interest rate decision and outlook.

- That there was only a modest uptick may have been due in part to the strong bounce in stocks that has already occurred in Q1. It may also have been due to **U.S. President Donald Trump** commenting, on the same day as the Fed announcement, that he **plans to keep existing tariffs on Chinese goods in place even if there is a trade deal**.

- In the clearest guidance yet regarding what has become an increasingly discussed topic—if some kind of trade deal is struck, **what level of tariffs will remain in place, and for how long**—Trump stated: "We're not talking about removing them, we're talking about leaving them … for a substantial period of time because we have to make sure that if we do the deal with China that China lives by the deal." Of course, this view could change.

- **China's premier, Li Keqiang, again acknowledged that the economy is slowing**. He noted that the solution is to cut taxes and reduce regulation rather than to pump money into the economy. **China recently announced a significant reduction** of RMB2T ($300B) **in corporate VAT rates**, particularly for smaller companies.

- Chinese internet giant **Tencent** (700 HK), with businesses spanning gaming to social media, **missed consensus earnings forecasts for Q4**. Net income was RMB14.1B ($2.11B), below forecast of RMB17.55B ($2.62B). Revenue rose by 5% y/y to RMB84.9B ($12.7B) and adjusted earnings per share were RMB2.07. One of the headwinds facing Tencent in 2018 was the government's freeze on the approval of new games.

MARKET SCORECARD

Data as of March 21, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,854.88	2.5%	13.9%	5.3%	21.8%
Dow Industrials (DJIA)	25,962.51	0.2%	11.3%	5.2%	25.6%
NASDAQ	7,838.96	4.1%	18.1%	6.7%	35.3%
Russell 2000	1,562.41	-0.8%	15.9%	-1.1%	16.0%
S&P/TSX Comp	16,244.59	1.5%	13.4%	3.6%	6.1%
FTSE All-Share	4,020.51	3.4%	9.4%	3.2%	0.2%
STOXX Europe 600	380.69	2.1%	12.7%	1.5%	1.3%
EURO STOXX 50	3,367.40	2.1%	12.2%	-1.0%	-1.8%
Hang Seng	29,071.56	1.5%	12.5%	-7.5%	18.2%
Shanghai Comp	3,101.46	5.5%	24.4%	-5.5%	-4.9%
Nikkei 225	21,608.92	1.0%	8.0%	1.1%	11.1%
India Sensex	38,386.75	7.0%	6.4%	15.8%	30.2%
Singapore Straits Times	3,213.65	0.0%	4.7%	-8.5%	1.7%
Brazil Ibovespa	96,729.08	1.2%	10.1%	13.8%	53.6%
Mexican Bolsa IPC	43,251.19	1.0%	3.9%	-9.0%	-11.0%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,309.32	-0.3%	2.1%	-1.7%	5.2%
Silver (spot $/oz)	15.47	-0.9%	-0.2%	-6.7%	-11.8%
Copper ($/metric ton)	6,483.50	-1.1%	9.0%	-4.1%	12.8%
Oil (WTI spot/bbl)	59.83	4.6%	31.8%	-8.1%	26.4%
Oil (Brent spot/bbl)	67.70	2.5%	25.8%	-2.5%	32.8%
Natural Gas ($/mmBtu)	2.82	0.3%	-4.0%	6.9%	-8.8%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.535%	-18.0	-14.9	-34.8	11.8
Canada 10-Yr	1.668%	-27.4	-29.9	-59.0	-3.6
U.K. 10-Yr	1.064%	-23.8	-21.3	-46.3	-18.9
Germany 10-Yr	0.041%	-14.2	-20.1	-55.1	-41.8

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.05%	1.1%	2.1%	4.5%	5.1%
U.S. Invest Grade Corp	3.76%	1.3%	3.9%	4.7%	6.8%
U.S. High Yield Corp	6.50%	0.5%	6.8%	5.4%	10.4%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	96.3890	0.2%	0.2%	7.4%	-3.4%
CAD/USD	0.7478	-1.5%	2.0%	-3.5%	-0.2%
USD/CAD	1.3373	1.5%	-1.9%	3.6%	0.2%
EUR/USD	1.1370	0.0%	-0.8%	-7.8%	5.2%
GBP/USD	1.3101	-1.2%	2.7%	-7.4%	5.0%
AUD/USD	0.7110	0.2%	0.9%	-8.4%	-7.6%
USD/JPY	110.8100	-0.5%	1.0%	4.5%	-0.8%
EUR/JPY	125.9900	-0.5%	0.1%	-3.7%	4.3%
EUR/GBP	0.8679	1.2%	-3.5%	-0.5%	0.2%
EUR/CHF	1.1286	-0.6%	0.3%	-3.7%	5.0%
USD/SGD	1.3494	-0.2%	-1.0%	2.8%	-3.6%
USD/CNY	6.6993	0.1%	-2.6%	5.9%	-2.7%
USD/MXN	18.8739	-2.1%	-4.0%	2.4%	-1.2%
USD/BRL	3.8036	1.2%	-1.8%	16.2%	23.2%

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 3/21/19.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 2.0% return means the Canadian dollar rose 2.0% vs. the U.S. dollar year to date. USD/JPY 110.81 means 1 U.S. dollar will buy 110.81 yen. USD/JPY 1.0% return means the U.S. dollar rose 1.0% vs. the yen year to date.

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