June 13, 2019

RBC WEALTH MANAGEMENT

Global Insight

Weekly

A closer look

Can central banks keep the party going?

Laura Cooper – London

As the global economy marks a decade of growth, investors are looking to the future with optimism tempered by caution. We consider the role of monetary policy and the issues facing central banks as they endeavor to extend the economic expansion.

The limits of monetary policy

The global economic expansion is marking its tenth birthday, yet celebrations have been dampened by some uninvited guests: ongoing U.S.-China trade tensions and disappointing economic data. Investors are growing apprehensive about a potential hangover, with financial markets anticipating the need for policy stimulus across advanced economies to keep the party going.

Major central banks have given investor enthusiasm a boost by signaling willingness to reach into their toolkits to sustain the expansion. The Fed and European Central Bank (ECB) have voiced their intention to keep the music playing, and markets anticipate that central banks in Japan, Canada, and other countries will follow suit. But with advanced economies still awash in accommodative conditions, pulling policy levers to prolong the cycle may not be as effective as in the past.

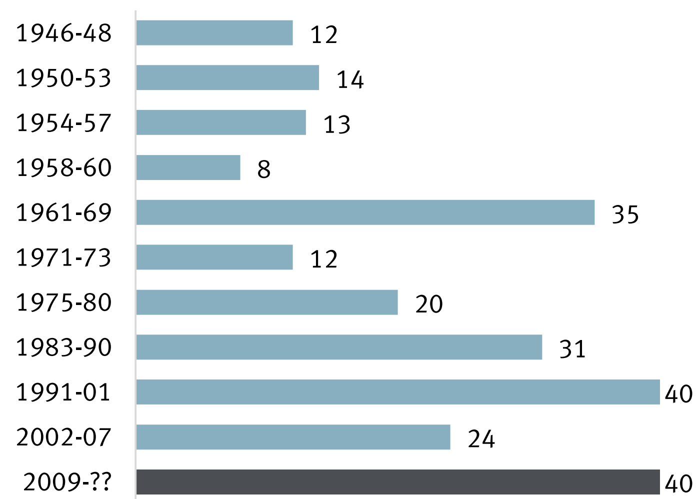
Central banks check their playbooks

The U.S. economic cycle is on track to become the longest on record, spanning ten years that saw central banks take extraordinary policy measures to stimulate growth in the aftermath of the global financial crisis. The balance sheets of major central banks have ballooned nearly five-fold over this period, while policy rates remain near historically low levels.

The amount of policy influence expended raises questions of how much more policymakers can do. The International Monetary Fund (IMF) has warned that there is limited policy space to counter a downturn should trade tensions escalate or a slowdown in global growth intensify.

The U.S. economic expansion celebrates its 10th birthday

Length in quarters from start of recovery to the onset of a recession



Source - Bloomberg, RBC Wealth Management; data through 6/12/19

Market pulse

Why? First, the impact of negative interest rates. Negative rates are meant to incentivize investors to seek higher returns in riskier assets, and to spur economic activity through borrowing. But against a backdrop of economic growth concerns and central bank caution, investors are increasingly doing the opposite and paying for the safety of government debt, pushing some yields deeper into negative territory. This is evident in the robust appetite across Europe and Japan for bonds with negative yields: the amount of negative-yielding debt has increased more than 20% year-to-date, climbing beyond $10T and approaching 2016 highs.

Second, the line connecting historically low rates and real economic activity appears blurry. In many advanced economies, low policy rates have shown limited capacity to spur economic growth, boost wages, and drive inflation higher. For example, the ECB has maintained a negative policy rate since 2014 but price pressures remain subdued and the growth recovery has stalled. Thus, the capacity for even lower rates to boost the economic expansion, at the margin, appears limited—especially in Europe.

Finally, financial markets are showing skepticism of central banks' ability to meet their mandates as inflation expectations slip lower across advanced economies. With policy rates exceptionally low, declining price growth expectations are, in turn, pushing up real yields. This implies a higher cost of borrowing, which could curb appetite for investment. Central banks may need to cut policy rates further just to offset the attendant tightening in financial conditions before they can expect any feed-through to growth.

Financial markets are increasingly anticipating the start of a synchronized cycle of policy easing by major central banks, with Australia and New Zealand having already cut. We believe there is scope for late-cycle monetary stimulus to provide some support, but note that markets are pricing in aggressive rate cuts, while major central banks will be wary of acting prematurely.

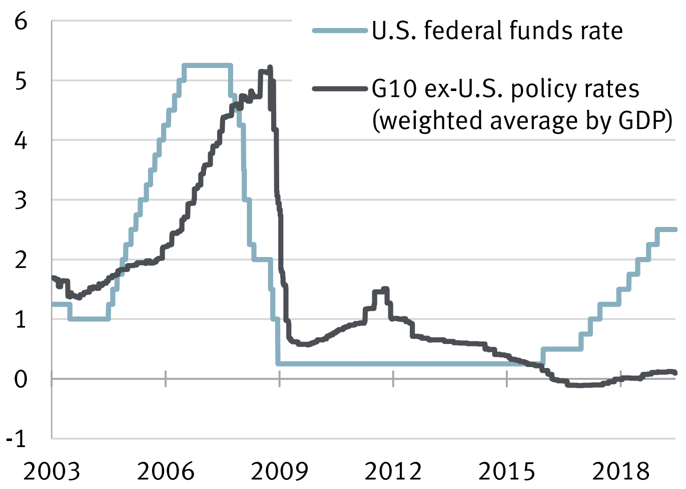
Government spending to the rescue?

Given the potential limits on the effectiveness of further monetary stimulus, fuel for the engines of economic growth also may need to come from somewhere other than central banks should conditions deteriorate.

Government spending is blowing wind into the sails of advanced economies in 2019, a trend that appears set to reverse when the boost from U.S. fiscal stimulus fades in 2020. But advanced economies have not yet fully restored their fiscal positions after deficit spending during the global financial crisis. Persistent deficits and elevated debt loads compared to a decade ago point to a limited capacity for fiscal policy to prolong the expansion, in our view.

The Fed has more room to ease than other G10 central banks

Comparing the U.S. policy rate to those of the rest of G10 central banks



Source - Bloomberg, RBC Wealth Management; data through 6/12/19

The addition of elevated global policy uncertainty, largely coming from hardline rhetoric on the trade front, could further limit governments' capacity to prop up growth. Cautious businesses and consumers could be hesitant to respond to stimulus measures, dampening the effect of expansionary fiscal policy.

The Fed can call the tune

We believe the expressed willingness of central banks to pursue a path of easing policy if conditions warrant suggests that the economic expansion has more room to run, even if the banks' capacity to boost global growth is limited. Crucially, though, the Fed is likely to play a leading role as it has the greatest scope to act among G10 central banks (see chart).

Recent comments from key Fed policymakers suggest the central bank will monitor ongoing trade risks and the evolution of economic data to gauge the need for rate cuts, and will act if conditions warrant. The Federal Open Market Committee meeting on June 18 and 19 will be pivotal in setting the tone for policy expectations going forward.

Our fixed income strategists believe two rate cuts are likely in the second half of the year, with perhaps one more in early 2020 if needed. Unless conditions deteriorate significantly, they think the Fed will be hesitant to cut rates further ahead of the presidential election.

The limited capacity of central banks and governments to stoke growth in response to a downturn is reason for vigilance, but does not portend an imminent end to the near-record economic expansion, in our view. Although economic growth has slowed and downside risks are present, prudent policy—led by the Fed and followed by other major central banks—could keep the equity bull market dancing for another song before it's time to go.

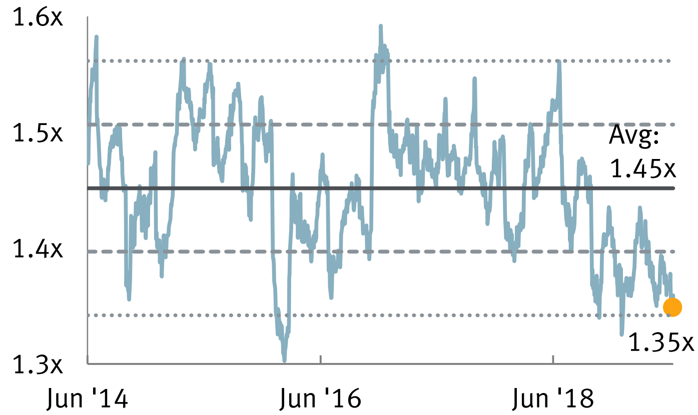
United States

Ben Graham, CFA – Minneapolis

- U.S. equity markets continued their June rally after dismal May returns. **Large-cap equities continue to lead small caps and the valuation discount of small to large persists**, as is common later in economic cycles. However, it is interesting to note **the gap between the two has widened in recent weeks, making small caps appear relatively more attractive**. From a sector perspective, Consumer Discretionary stocks have seized the weekly leadership mantle with their 2.0% gain more than double the next closest sector return of 0.9% in the Materials group. Industrials was noticeably weak, being the only sector to trade lower for the week, and bond proxies were relative laggards with their smaller but positive week-to-date returns.
- Inflation data headlined economic news, with the Consumer Price Index (CPI) missing consensus expectations. The unadjusted CPI registered 0.1% m/m, below expectations of 0.2% and assisted in furthering the Fed rate cut narrative. However, RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli believes that **trade relations between the U.S. and China are measuring far higher on the Fed's priority list in making interest rate decisions than the monthly CPI data**. In fact, he states that "inflation trends are not even in the same universe at this point" in reference to the Fed's focus on trade between the U.S. and China. Furthermore, he indicates that the biggest drag on inflation recently—namely, used car sales—appears to be at an inflection point higher.
- **Crude oil prices have officially entered bear market territory**, with the commodity down nearly 23% from its late April highs as of the close on June 12. However, on June 13, commodity prices rose more than 2% after two oil tankers were reportedly attacked in the Gulf of Oman. This news is, at least for one day, diverting attention away from fears of commodity oversupply amid diminishing demand. RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina recently downgraded the Energy sector to Market Weight due to fund flows working against the sector, sentiment that was poor and worsening, and global trade concerns.

Small caps look inexpensive relative to large

Relative valuation of the Russell 2000 to the S&P 500



Note: Relative next-twelve-month forward P/E ratio; the gray lines represent the average and +/- 1 and 2 standard deviations
Source - RBC Wealth Management, Bloomberg; data as of 5:00 pm GMT 6/13/19

Canada

Christopher Girdler, CFA – Toronto

- **Government of Canada bond yields continue to languish** as the market prices in expectations that the next move from the Bank of Canada (BoC) will be a shift to lower rates. In fact, **every Canadian government bond that exists is currently trading with a yield at or below the BoC's policy rate** of 1.75%. Concerns over an escalation of the ongoing U.S.-China trade spat, as well as potential knock-on effects on business investment and consumer spending, appear to be driving global government bond yields.
- **The labour market remains the main bright spot for Canada**, as it is for the majority of developed economies, although wages are not yet growing fast enough to push inflation meaningfully higher. **Household income growth is outpacing inflation**, though, helping households deal with the rising costs of record levels of debt. Data from Statistics Canada showed that **the debt service ratio**, defined as required payments of principal and interest on debt as a proportion of household disposable income, **edged up to 14.9% during the first three months of the year**, from 14.1% in Q1 2017.
- **Mortgage rates have been falling recently, offering some assistance to borrowers** who are rolling into new terms over the course of the year, although the declines do little to address the bigger problem of large debt balances. **Average household debt as a percentage of disposable income remained approximately 178% in Q1**, giving the BoC plenty of reason to tread carefully with respect to possible changes in monetary policy.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- June figures suggested **the labour market remains resilient despite GDP contracting 0.4% in April**. The unemployment rate held steady at 3.8% and wages (excluding bonuses) rose 3.4% y/y for the three months through the end of May. The strength of wage growth will probably catch the eye of **the Bank of England (BoE), which may view it as inflationary**.

- **For now, monetary policy in the U.K. will continue to be dependent on the Brexit outcome**. But with **BoE Governor Mark Carney's term coming to an end** in January 2020, this may change. The process of selecting his successor has started in earnest. **One of the three favourites** to take over, former Reserve Bank of India Governor Raghuram Rajan, is known for his focus on inflation and **could set a more hawkish tone** at the central bank.
- The list of favourites could change, however. **The new Prime Minister is likely to be a Brexit supporter, and is widely expected to replace the current Chancellor**, Remainer Philip Hammond, after taking over in July. As it is the Chancellor who appoints the Governor of the BoE, new names could enter the frame late in the process.
- **Ten-year Bund yields are trading close to their 2019 low**, at -0.24%. With inflation expectations for the region continuing to plummet, **yields may well stay negative for some time if growth and inflation disappoint and investors seek perceived safe havens** such as Bunds. Following its recent meeting, we see scope for the European Central Bank to take additional steps to support the economy should it weaken further. This seems likely, as **April industrial production contracted by 0.5% m/m** to start Q2 on a weak footing.

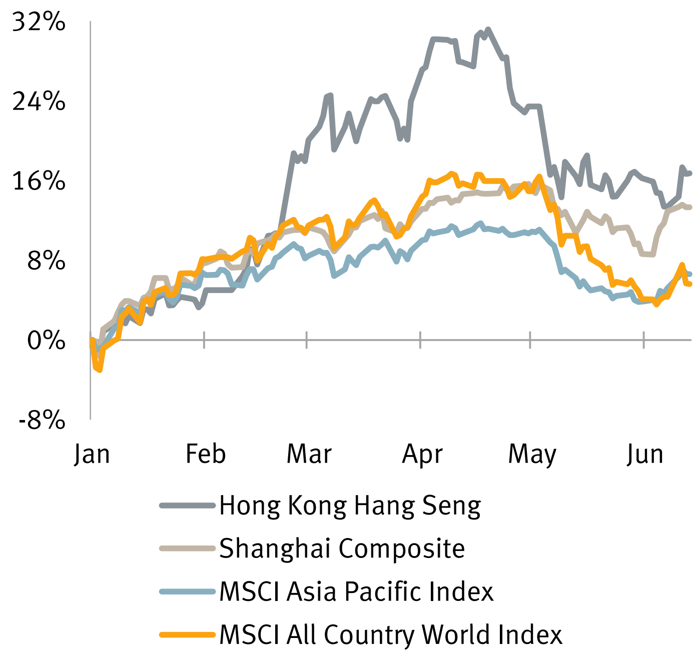
Asia Pacific

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

- **The Asian market had a nice rebound at the beginning of the week** after the U.S. suspended plans for tariffs on Mexico. The Trump administration also deferred tariffs on some Chinese products until June 15. **Chinese A-shares outperformed in the region** as the market expects the government to announce further stimulus to support the economy. The Shanghai Composite Index has rallied 2.9% so far during the week.
- **Chinese construction and material stocks surged** on news Beijing will allow local governments to use a portion of proceeds from special bond sales as capital for qualified projects, such as railway and national highway construction. The move signals that **China still relies on infrastructure spending to support the economy as trade tensions escalate**.
- **For Hong Kong equities, the main source of volatility was local political uncertainty** rather than trade disputes.

Asian indexes rally on moderately easing global tensions

2019 returns to date



Source - RBC Wealth Management, Bloomberg; data through 6/13/19

Peaceful demonstrations against a proposed extradition bill turned violent on Wednesday. The proposed bill would allow criminal defendants to be extradited from Hong Kong to mainland China. Critics of the bill believe it will threaten Hong Kong's rule of law, the independence of the judiciary, and most importantly, the "One Country, Two Systems" principle. The Hang Seng Index (HSI) tumbled 1.7% on Wednesday. At this stage, there is little visibility on how the situation may be resolved. While conditions have calmed down a bit, **there are few signs that either side will back down** on the extradition bill.

- Recall that during the Occupy Central protest in Hong Kong from late September to early December 2014, the HSI fell 1.9% on the first day of the protest and slid as much as 4.8% during the period. But the index recovered and resumed its uptrend shortly after the protest ended. We expect heightened volatility in the short term. **But as in 2014, buying opportunities will likely emerge for high-quality stocks with fundamentals that are not affected**.
- **Alibaba** (BABA) **has filed confidentially for a Hong Kong listing**, according to an unsubstantiated Bloomberg report, which cited estimates the listing could raise as much as $20B, making it one of Hong Kong's largest share sales.

MARKET SCORECARD

Data as of June 13, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,891.64	5.1%	15.3%	4.3%	19.0%
Dow Industrials (DJIA)	26,106.77	5.2%	11.9%	3.8%	23.5%
NASDAQ	7,837.13	5.2%	18.1%	1.9%	24.9%
Russell 2000	1,535.80	4.8%	13.9%	-8.4%	10.1%
S&P/TSX Comp	16,239.26	1.3%	13.4%	0.3%	5.0%
FTSE All-Share	4,022.84	2.5%	9.5%	-5.3%	-2.0%
STOXX Europe 600	380.33	3.1%	12.6%	-1.7%	-2.3%
EURO STOXX 50	3,390.50	3.4%	13.0%	-2.0%	-4.6%
Hang Seng	27,294.71	1.5%	5.6%	-12.7%	6.2%
Shanghai Comp	2,910.74	0.4%	16.7%	-6.6%	-6.4%
Nikkei 225	21,032.00	2.1%	5.1%	-7.0%	5.3%
India Sensex	39,741.36	0.1%	10.2%	13.0%	27.4%
Singapore Straits Times	3,220.66	3.3%	4.9%	-7.1%	-0.5%
Brazil Ibovespa	98,773.70	1.8%	12.4%	29.8%	56.9%
Mexican Bolsa IPC	43,483.20	1.7%	4.4%	-3.8%	-11.7%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,342.08	2.8%	4.6%	3.5%	3.7%
Silver (spot $/oz)	14.91	2.3%	-3.8%	-10.6%	-15.8%
Copper ($/metric ton)	5,823.00	0.3%	-2.1%	-19.3%	4.2%
Oil (WTI spot/bbl)	52.28	-2.3%	15.1%	-19.2%	8.5%
Oil (Brent spot/bbl)	61.32	-4.9%	14.0%	-18.6%	22.3%
Natural Gas ($/mmBtu)	2.33	-5.0%	-20.7%	-19.5%	-23.4%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.091%	-3.4	-59.3	-88.1	-5.4
Canada 10-Yr	1.452%	-3.6	-51.5	-85.6	5.9
U.K. 10-Yr	0.835%	-5.1	-44.2	-53.9	-14.9
Germany 10-Yr	-0.241%	-3.9	-48.3	-70.6	-49.3
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.65%	0.2%	5.0%	7.5%	5.9%
U.S. Invest Grade Corp	3.39%	0.4%	7.7%	8.9%	7.5%
U.S. High Yield Corp	6.16%	1.3%	8.8%	6.4%	9.1%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.0580	-0.7%	0.9%	3.7%	0.4%
CAD/USD	0.7500	1.4%	2.3%	-2.9%	0.9%
USD/CAD	1.3334	-1.3%	-2.2%	3.0%	-0.9%
EUR/USD	1.1274	0.9%	-1.7%	-4.2%	0.0%
GBP/USD	1.2676	0.4%	-0.6%	-5.5%	-1.8%
AUD/USD	0.6913	-0.4%	-1.9%	-9.8%	-7.9%
USD/JPY	108.3800	0.1%	-1.2%	-1.6%	-0.9%
EUR/JPY	122.1900	1.0%	-2.9%	-5.8%	-1.0%
EUR/GBP	0.8894	0.6%	-1.1%	1.3%	1.8%
EUR/CHF	1.1209	0.3%	-0.4%	-3.5%	3.3%
USD/SGD	1.3668	-0.6%	0.3%	2.6%	-0.9%
USD/CNY	6.9216	0.2%	0.6%	8.3%	1.0%
USD/MXN	19.1861	-2.2%	-2.4%	-5.5%	5.2%
USD/BRL	3.8604	-1.6%	-0.4%	0.2%	17.8%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 8:35 pm GMT 6/13/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 2.3% return means the Canadian dollar rose 2.3% vs. the U.S. dollar year to date. USD/JPY 108.38 means 1 U.S. dollar will buy 108.38 yen. USD/JPY -1.2% return means the U.S. dollar fell 1.2% vs. the yen year to date.

Authors

Laura Cooper – London, United Kingdom
laura.cooper@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

Ben Graham, CFA – Minneapolis, United States
benjamin.graham@rbc.com; RBC Capital Markets, LLC

Christopher Girdler, CFA – Toronto, Canada
christopher.girdler@rbc.com; RBC Dominion Securities Inc.

Frédérique Carrier – London, United Kingdom
frederique.carrier@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

Thomas McGarrity, CFA – London, United Kingdom
thomas.mcgarrity@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

Jasmine Duan – Hong Kong, China
jasmine.duan@rbc.com; RBC Investment Services (Asia) Limited

Nicholas Gwee, CFA – Singapore
nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

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Hold [Sector Perform]	589	40.07	107	18.17
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