RBC Global Asset Management

Executive summary

FALL 2019

Financial markets face an evolving set of macroeconomic headwinds and, against this challenging backdrop, central banks are now offering support through monetary stimulus. Our base case is for continued economic growth, albeit at a slowing pace but we recognize that the downside risks have increased.

Economic growth continues to downshift

Global growth slowed in the past quarter, extending a trend that began at the start of 2018. Manufacturing weakness has been the main cause of the slowdown as services have experienced only a minor deceleration and consumption has held up reasonably well. Other factors hindering economic growth have been the elevated uncertainty from protectionism and Brexit, fading fiscal stimulus and the slowing Chinese economy. Although central banks are attempting to offset some of these negatives by cutting interest rates, we note that the economic boost from each individual rate cut is fairly small. Weighing the positives and negatives, we look for slower growth in 2019 versus 2018, and for a further deceleration in 2020 in both developed and emerging markets. Our forecasts were downgraded modestly from last quarter and they are now in line with the consensus for 2019 and modestly lower for 2020.

Downside risks are mounting, but we should also consider the possibility of upside surprises

On the trade front, several new rounds of U.S.-China tariffs have been announced and there are a number of ways the trade war could unfold. While the U.S. election in 2020 could encourage a resolution, the most likely scenario is that the tariffs announced so far are fully implemented and that the U.S-China relationship does not improve. Such a negative scenario would subtract a cumulative 0.60% to 0.80% from U.S. GDP and 0.75% to 0.95% from Chinese GDP over the next several years. Other downside risks include the deteriorating geopolitical environment, Brexit and various debt hot spots. Offsetting these are the potential for fiscal stimulus and improved productivity growth, which could represent sources of upside for economies.

U.S. business cycle is late and advancing

The economic expansion is mature and is now officially the longest on record. While business cycles don't die of old age, we should recognize that the longer an expansion lasts the more likely it is to stumble. Other signs suggesting that we are in the later stages of the business cycle are an extremely low unemployment rate and yield curves that are inverted. While yield-curve inversions don't by themselves guarantee that a recession is coming, they tend to coincide with an increased risk of an economic downturn six months to two years into the future.

U.S. dollar buoyed in the near term, but we expect a weaker greenback to emerge

Most policymakers today prefer weaker currencies to stimulate their domestic economies and President Trump has been quite vocal in expressing this view for the U.S. dollar. However, tariffs have been relatively more damaging for non-U.S. markets, weakening global currencies and pushing the U.S. dollar higher against Trump's wishes. While trade tensions act to temporarily extend the U.S. dollar's topping process, we do think the greenback will eventually be weighed down by longer-term factors such as twin deficits

and narrowing yield differentials. Over the next 12 months, we expect an environment of higher volatility, where the euro and yen outperform the loonie and pound.

A monetary easing cycle gets underway

Central banks have now pivoted to monetary stimulus in a synchronized fashion, with some having already delivered rate cuts and others hinting at easing measures to come. The U.S. Federal Reserve cut interest rates by 25 basis points in July, China and India have also eased, and the European Central Bank has indicated action is imminent. This monetary stimulus should be seen as supportive for economies and risk assets, but we recognize that the capacity for easing is limited. The futures market suggests that the Fed may cut as many as four more times over the next year, while our own forecast is for three.

Extraordinarily low bond yields stoke valuation concerns

Global sovereign bonds have extended their rally and our valuation models are signaling caution as yields declined to record lows. German bund yields fell below zero across all maturities and the total size of negative-yielding debt across the globe has ballooned to over US$17 trillion. According to our valuation models, yields have fallen through the bottom of their equilibrium channels in all major markets including North America. Even in markets where yields remain positive, real yields (i.e. the nominal yield minus inflation) have fallen below zero indicating that investors are accepting a guaranteed loss in purchasing power should they hold their sovereign fixed-income investments to maturity. Slower economic growth and aging demographics may be depressing real interest rates, but we don't think negative real rates are sustainable indefinitely. The pressure on real rates over time will likely be higher and, for this reason, the possibility of a bond bear market, in which returns are low or even negative as yields rise for many years, cannot be dismissed.

Earnings will be critical to sustaining higher stock prices

Global equities rallied in June and July, but stumbled in August as trade tensions escalated between the U.S. and China. The MSCI Emerging Markets Index underperformed, falling as much as 10% in August and wiping out gains from earlier in the quarter, whereas most other major markets held onto slight advances. Our models suggest that stocks are relatively attractive outside of the U.S. However, we note that the S&P 500 Index is situated slightly above fair value and is at a level that has historically been associated with lower returns and higher levels of volatility. Corporate profit growth is critical to push U.S. stocks higher. In an environment of moderate earnings growth, low interest rates and low inflation, stocks can deliver gains in the mid-single to low-double digits. In a recessionary scenario, however, the damage to profits and investor confidence would send stock prices meaningfully lower.

Dialing back equity overweight, raising cash reserve

The macroeconomic outlook is murky, the business cycle is aging and U.S. equity valuations are not as attractive as they have been at earlier points in the cycle. We have increased our odds of recession to approximately 40% within the next year, high by any standard, but still not our central outcome. We continue to expect stocks to outperform bonds over the longer term and remain overweight equities and underweight fixed income as a result. However, we don't feel that this is the time to be running substantial risk positions. We have trimmed exposure to stocks again this quarter by half a percentage point, moving the proceeds to cash. To reduce our equity weight any further we would have to have a higher conviction that a recession will unfold. For a balanced, global investor, we currently recommend an asset mix of 57.0% equities (strategic neutral position: 55%) and 40% fixed income (strategic neutral position: 43%), with the balance in cash.

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