RBC Global Asset Management

RBC GAM Investment Strategy Committee

SEPTEMBER 2019

Market Update – Economy/markets face meaningful challenges. Trimming equity overweight/increasing cash reserve

Leading indicators of global growth have extended their decline and the majority of the world's PMIs are now below 50 suggesting a broad-based deceleration in economic activity (Exhibit 1). Escalating trade tensions, slowing Chinese growth and uncertainty related to Brexit are all factors weighing on economies, but central banks are offering support in the form of monetary stimulus. We have lowered our economic growth forecasts slightly and, while we don't see a recession over our one-year forecast horizon, we recognize that downside risks have increased.

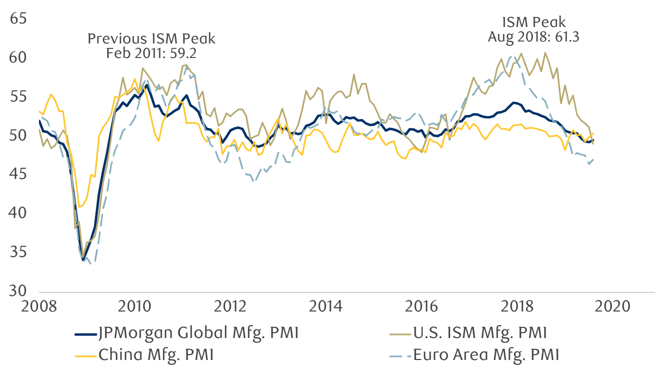
U.S. business cycle is mature

The longest streak of uninterrupted U.S. growth is showing its age. Diminished economic slack and low unemployment rates suggest little room for upside surprise. Moreover, the U.S. yield curve, a reliable indicator of past recessions, is inverted and financial market volatility has appropriately increased against this backdrop (Exhibit 2). Overall, our assessment is that the U.S. expansion is in its later stages with an increasing possibility that the end of the cycle is near, although we still weight the probability below 50% for the year ahead.

Central banks are now actively delivering monetary stimulus

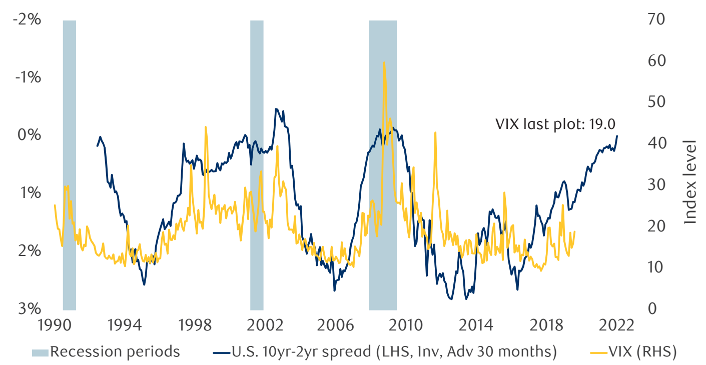
Consistent with an end-of-cycle narrative is the fact that many global central banks are now actively cutting interest rates and/or have hinted that further monetary easing is forthcoming. The U.S. Federal Reserve cut interest rates by 25 basis points at the end of July as insurance against mounting trade tensions and slowing growth outside the U.S. We expect the Fed will deliver several more rate cuts over the year ahead. In Europe, the central bank hinted at pushing interest rates further into negative territory and possibility resuming

Exhibit 1: Global purchasing managers' indices



Source: Haver Analytics, RBC GAM

Exhibit 2: U.S. yield curve vs. VIX volatility



Source: Bloomberg, RBC GAM

quantitative easing. All this monetary stimulus should ultimately provide a boost to growth, but history suggests it could take some time before the impact from rate cuts is felt by the economy.

Valuation risk in fixed income markets is elevated

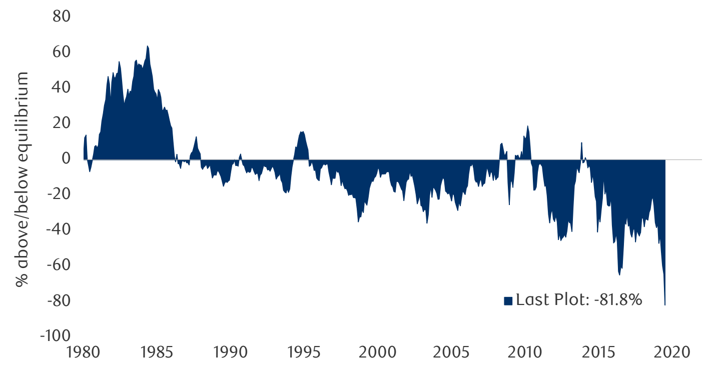
Bond yields plummeted to record levels in the past quarter, reflecting slowing growth, increasing downside risk to the economy and dovish central banks. German bund yields of all maturities up to 30 years are now below zero and more than US$16 trillion of global fixed-income assets are trading with negative yields. The U.S. 30-year yield fell below 2.00% to its lowest level on record and the 10-year Treasury yield is approaching its 2016 low. Our global sovereign-bond composite situates yields at their lowest level ever relative to our modelled estimate of equilibrium and suggests valuation risk is elevated everywhere, particularly outside North America (Exhibit 3).

Stocks encounter challenges, but can deliver decent gains if recession is avoided

Equity markets encountered volatility following a strong start to the year and performance has been much more varied over the summer. Developed market equities have declined slightly but still feature double digit gains year to date. Increasing trade tensions appear to be taking a larger toll on emerging markets, however, with EM equities having erased year-to-date gains and are trading near their 2018 lows (Exhibit 4). According to our models, U.S. equities are hovering close to fair value but non-U.S. markets offer relatively attractive risk premiums.

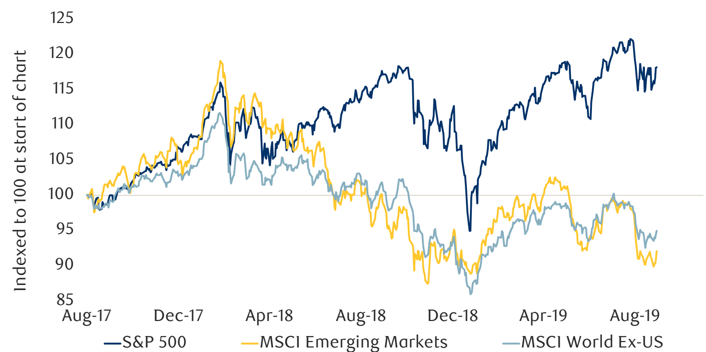
Shifting investor sentiment has been the main source of market volatility and renewed earnings growth is a pre-condition to higher prices. S&P 500 profits have seen little to no growth in 2019 as compared to the 20%+ gains from 2018 supported by tax cuts and stronger economic growth. Looking ahead, the consensus of analyst expectations indicates relatively flat earnings for the remainder of 2019, but a re-acceleration into 2020 (Exhibit 5). In an environment of low interest rates and inflation and reasonable valuations even moderate corporate profit growth should ultimately be sufficient to push stocks higher. However, should economies enter recession and/or the trade situation escalates into a full-blown trade war, both the profit pool and valuations would likely decline and lead to materially lower prices.

Exhibit 3: Global bond market composite
10-year government bond yields relative to eqilibrium



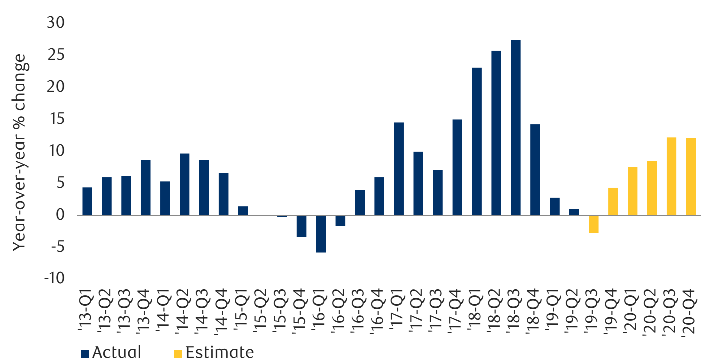
Source: RBC GAM

Exhibit 4: Relative performance
Price levels, indexed to 100 at start of the chart



Source: MSCI, Bloomberg, RBC GAM

Exhibit 5: S&P 500 Index earnings per share
Quarterly earnings % change from same quarter in prior year



Source: Thomson Reuters, RBC GAM

Asset mix – trimming equity overweight/increasing cash reserve

Our base case is for the economy to continue expanding at a moderate pace but our scenario analysis places a higher-than-normal chance of recession and a bearish outcome for risk assets. We also recognize that bond yields are extremely low and that prospective returns in fixed income are quite unattractive. Equities continue to offer superior total-return potential versus bonds over the longer term and we continue to favour stocks over bonds in our asset mix. Recession odds are now higher than they have been at earlier points in the cycle, so we feel it is appropriate to move further along the path of de-risking our portfolios that we have been following as the cycle has matured. We lowered our equity weight by half a percentage point this quarter, placing the proceeds to cash. Our current recommended asset mix for a global balanced investor is 57.0% equities (strategic: “neutral”: 55%), 40.0% bonds (strategic “neutral”: 43%) and 3.0% in cash.

Disclosure

All data as of August 30, 2019 unless otherwise stated.

This report has been provided by RBC Global Asset Management Inc. (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM. It is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. The investment process as described in this report may change over time. The characteristics set forth in this report are intended as a general illustration of some of the criteria considered in selecting securities for client portfolios. Not all investments in a client portfolio will meet such criteria. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when printed. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

Any investment and economic outlook information contained in this report has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

All opinions and estimates contained in this report constitute our judgment as of the indicated date of the information, are subject to change without notice and are provided in good faith but without legal responsibility. Interest rates and market conditions are subject to change. Return estimates are for illustrative purposes only and are not a prediction of returns. Actual returns may be higher or lower than those shown and may vary substantially over shorter time periods. It is not possible to invest directly in an unmanaged index. Our fair value and equilibrium range estimates are based on current estimates of normalized earnings. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks.

A Note on Forward-looking statements:
This report may contain forward-looking statements about future performance, strategies or prospects, and possible future action. The words “may,” “could,” “should,” “would,” “suspect,” “outlook,” “believe,” “plan,” “anticipate,” “estimate,” “expect,” “intend,” “forecast,” “objective” and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance. Forwardlooking statements involve inherent risks and uncertainties about general economic factors, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement made. These factors include, but are not limited to, general economic, political and market factors in Canada, the United States and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological changes, changes in laws and regulations, judicial or regulatory judgments, legal proceedings and catastrophic events. The above list of important factors that may affect future results is not exhaustive. Before making any investment decisions, we encourage you to consider these and other factors carefully. All opinions contained in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility.

® / ™ Trademark(s) of Royal Bank of Canada. Used under licence.
© RBC Global Asset Management Inc. 2019