RBC Global Asset Management

RBC GAM Investment Strategy Committee

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Market Update – Financial markets contend with slowing economic growth and heightened macroeconomic uncertainty

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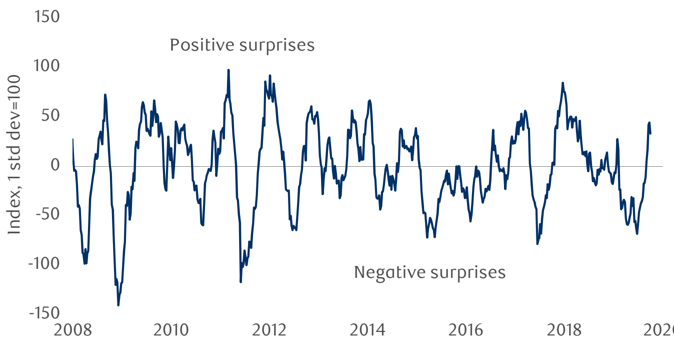
Heightened macroeconomic uncertainty and shifting narratives on global trade and Brexit have made for a difficult investing environment as a wide range of potential outcomes are possible. While global economic growth is indeed slowing, data has not been as bad as initially feared as evidenced by the improvement in economic surprise indices (Exhibit 1). Moreover, trade tensions between the U.S. and China eased and the risks associated with a no-deal Brexit have diminished, but these issues remain moving targets. The economy and markets continue to face a variety of challenges including an aging business cycle, yield curves that are flat or inverted and leading indicators of economic growth that are weak and falling in most major regions (Exhibit 2). All things considered, we recognize that the chance of recession is higher than usual but we are also mindful of the still-reasonable possibility that the outlook could improve, ultimately rewarding owners of risk assets.

Slowing growth and macro uncertainty prompt further central-bank easing

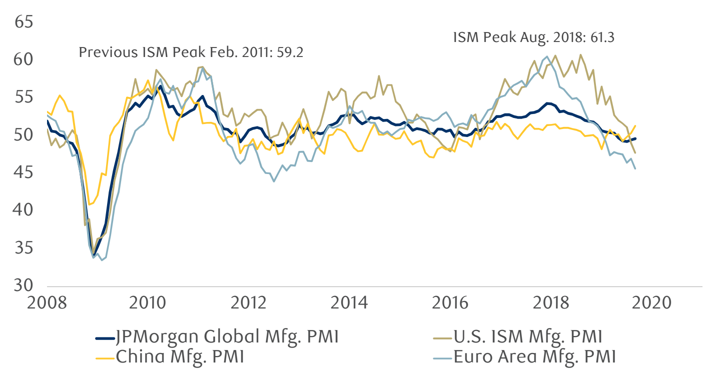
Against this backdrop of slowing growth and heightened uncertainty, central banks followed through on their promise to deliver additional monetary stimulus. The U.S. Federal Reserve (Fed) cut interest rates by another 25 basis points in September and reiterated that monetary policy is flexible and that it would react to incoming data as needed. While the Fed's latest projections don't suggest any further easing on the horizon, pricing in the futures market suggests two to three more U.S. rate cuts are coming over the next year, in line with our own forecast (Exhibit 3). Overseas, the European

Exhibit 1: United States
Citi Economic Surprise Index



Note: As of Sept. 30, 2019. Source: Citigroup Global Markets Inc., RBC GAM

Exhibit 2: Global purchasing managers' indices



Note: As of Oct. 1, 2019. Source: Haver Analytics, RBC GAM

Central Bank lowered its deposit facility rate to -0.50% from -0.40%, and announced the resumption of bond purchases at a pace of 20 billion euros per month starting in November. Absent any inflation pressures, central banks can remain accommodative to bolster growth, though the impact of monetary easing could take some time to work its way through the economy.

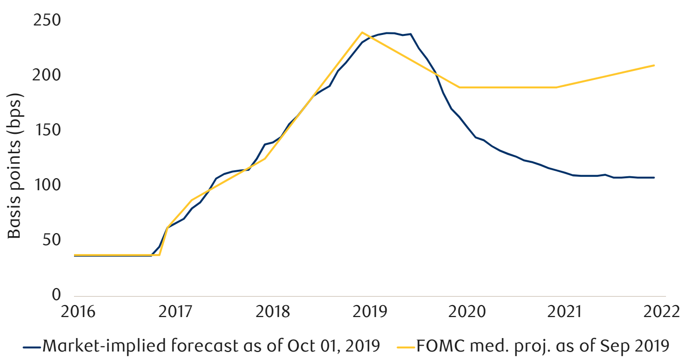
Sovereign-bond markets encounter brief hiccup

Global government bonds sold off aggressively at the beginning of September but have since recovered much of their losses. Progress on resolving U.S.-China trade tensions and the prospect that monetary stimulus will eventually boost economic growth propelled the U.S. 10-year yield 45 basis points higher to 1.90% in the first two weeks of September, but the increase proved short-lived as yields drifted lower with the return of demand for safe-haven assets. At the current 1.66%, the U.S. 10-year yield is again situated below the bottom of our modelled equilibrium channel and suggests sovereign-bond valuations are stretched (Exhibit 4). In a scenario where the U.S. economy avoids recession, we would expect the yield on the U.S. 10-year bond to rise over time, tracking our equilibrium channel higher as real interest rates are eventually drawn toward their long-term norm. A factor that could limit increases in the U.S. 10-year yield is that yields elsewhere are much lower and even negative in some regions (Exhibit 5). Of the major global sovereign-bond markets we track, 10-year Treasuries are the highest yielding and could therefore attract funds from international investors.

Some positive signs in underlying stock-market trends

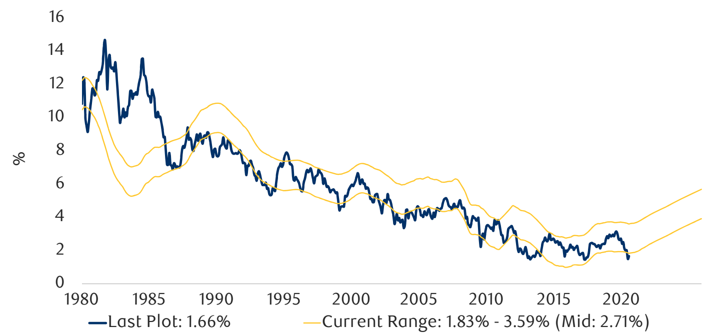
Stocks rose in September after a volatile August and certain characteristics of the rally could be seen as positive for the outlook. Value stocks outperformed growth stocks by 3.3 percentage points in September and, with this move, value has recouped all of its relative losses to the growth style since April of this year (Exhibit 6). While it is still too

Exhibit 3: Implied fed funds rate
12-months futures contracts



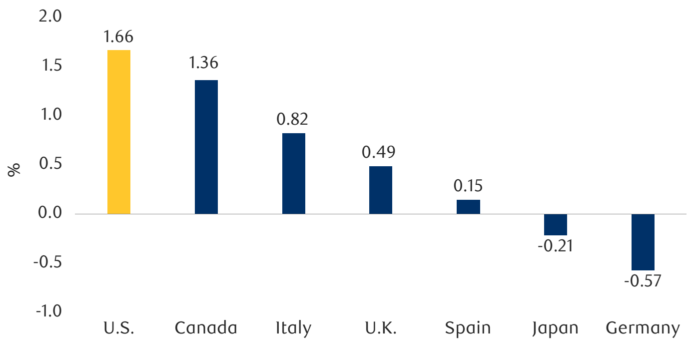
Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 4: U.S. 10-year T-Bond yield
Equilibrium range



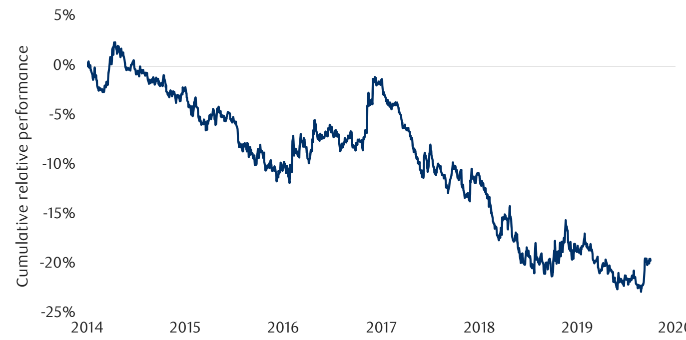
Note: As of Sept. 30, 2019. Source: RBC GAM, RBC CM

Exhibit 5: Global bond yields
10-year government bonds



Note: As of Sept. 30, 2019. Source: Bloomberg, RBC GAM

Exhibit 6: Value to growth relative performance
S&P 500 Value Index / S&P 500 Growth Index



Note: As of Sept. 30, 2019. Source: Bloomberg, RBC GAM early to tell if this recent period of value outperformance is the start of a trend, its emergence is often associated with better economic prospects ahead as investors prefer to buy cheaper companies in an environment where economic growth is accelerating. Other positive signs for the market were broad participation in the rally from global markets and, in particular, the outperformance of European equities since the middle of August (Exhibit 7). In Canada, the TSX Composite climbed to a record, helped by its heavy weighting in financials, which performed well in September. Should these trends remain in place and prove sustainable, equities could be setting up for a further leg higher.

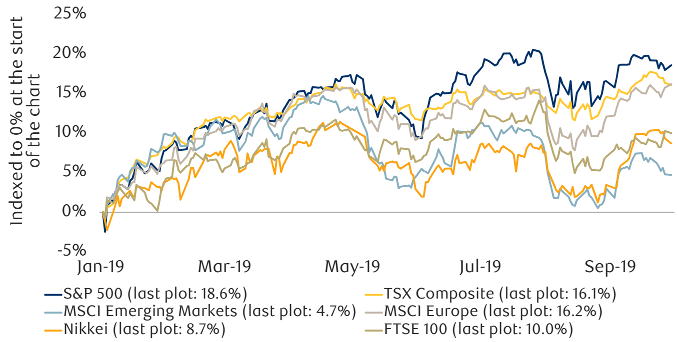
Profit growth is becoming increasingly critical to sustaining further advances in stocks

The September rally pushed the S&P 500 Index briefly above our modelled estimate of fair value, making stocks more vulnerable to earnings disappointments (Exhibit 8). Expanding valuations could continue to be a source of gains for equities but, as price-to-earnings multiples rise, stocks become more dependent on corporate profit growth to sustain the rally. Earnings have been challenged by a variety of factors including slowing global growth, rising tariffs and shrinking profit margins. It is now widely expected by analysts that S&P 500 profits for 2019 will be flat versus 2018. Exhibit 9 plots the consensus of analysts' earnings estimates over time and shows that profit forecasts have been consistently ratcheted lower month after month for the past year. But looking forward, the large gap between the 2019 and 2020 projections on the chart suggests a re-acceleration in profit growth next year. It's worth keeping this upside potential in mind as the economy and markets face a long list of threats. Our models suggest stocks could rise by mid-single to low-double digit rates over the year ahead if the negative scenarios don't play out and current earnings forecasts are met.

Asset mix – maintaining mild overweight exposure to stocks and underweight in bonds

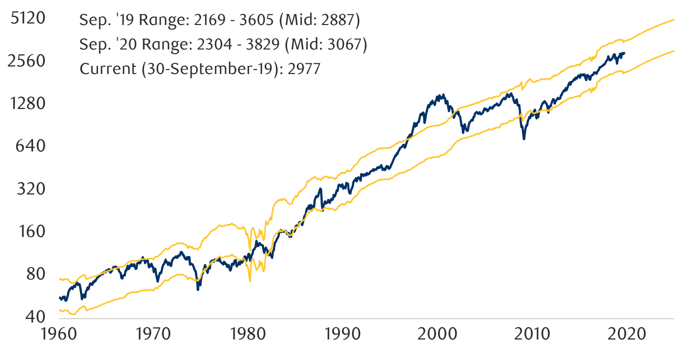
The global economy faces a number of challenges related to slowing growth, geopolitical risks and an aging business cycle. In our view, the chance of recession remains higher than usual but our base case scenario has the economy continuing to expand at a moderate, albeit slowing, pace. It is possible that an even better outcome plays out should risks dissipate and headwinds fade. Balancing the positives and negatives, we are maintaining our allocation to stocks at slightly above the neutral setting, having reduced exposure

Exhibit 7: Major equity market indices
Cumulative price returns indices



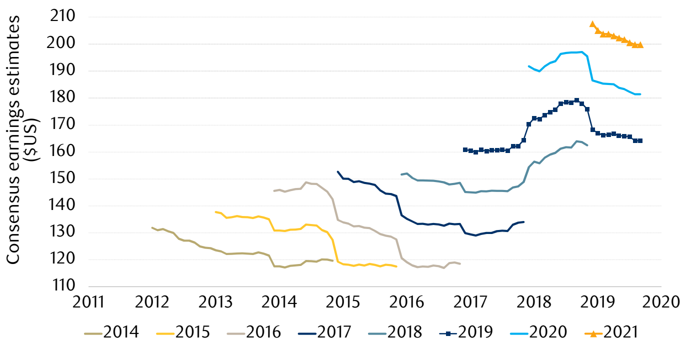
Note: As of Sept. 30, 2019. Price returns computed in local currencies, except MSCI Emerging Markets Index, which is in USD. Source: Bloomberg, RBC GAM

Exhibit 8: S&P 500 equilibrium
Normalized earnings & valuations



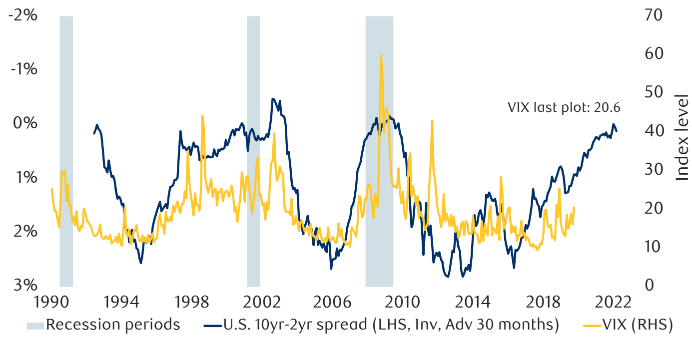
Note: As of Sept. 30, 2019. Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM

Exhibit 9: S&P 500 Index
Consensus earnings estimates



Note: As of Sept. 30, 2019. Source: Thomson Reuters, Bloomberg substantially through the past several quarters. We are also keeping our mild underweight in fixed income and a small cash cushion. We continue to expect stocks to outperform bonds over the longer term but don't think it is appropriate to run particularly large risk positions in the current macro environment. Flat and/or inverted yield curves suggest that elevated levels of volatility are likely to persist (Exhibit 10), and should any of the previously mentioned risks intensify or if evidence of slowing global growth becomes more prominent, stocks would be vulnerable. While we are seeing a number of positives including style leadership and a variety of technical indicators, we prefer to wait for the trends to show signs of sustainability before dialing up the degree of risk in our portfolios. 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.

Exhibit 10: U.S. yield curve vs. VIX volatility



Note: As of Oct. 2, 2019. Source: Bloomberg, RBC GAM

Disclosure

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

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