July 2019

RBC WEALTH MANAGEMENT

Global Insight

Perspectives from the Global Portfolio Advisory Committee

Europe: Green shoots wilt

As the anticipated regional recovery remains elusive, investors in European equities face a complex political and economic landscape.

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RBC Wealth Management

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All values in U.S. dollars and priced as of market close, June 30, 2019, unless otherwise stated.

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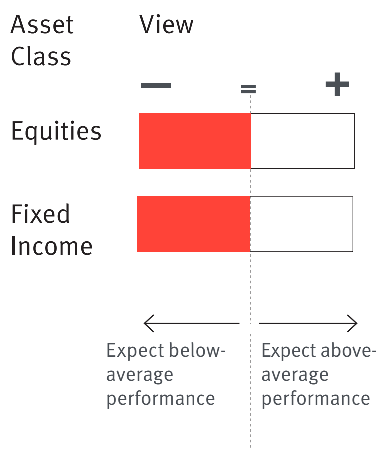


See “Views explanation” below for details

Source - RBC Wealth Management

Equities

- So goes the economy, so goes the equity market. This is our long-standing investment philosophy, and it comes in handy now as multiple uncertainties within and outside of financial markets vie for investors’ attention. Amidst the noise, we remain focused on U.S. and global economic momentum. They have slowed, validating the range-bound pattern most markets have delivered for many months, but we are not yet seeing signs that a recession is imminent.
- Until recession risks escalate, we believe equities deserve the benefit of the doubt and recommend holding global equity exposure at the long-term strategic recommended level, which equates to a Market Weight or benchmark position. While we think it’s too early to become overtly defensive by trimming equities below that level, it is prudent to upgrade the quality of holdings.

Fixed income

- The Federal Reserve is poised to begin reducing interest rates in coming months, and, in our opinion, a 50 basis point (bps) cut will occur at the Fed’s July meeting. And as the Fed moves to preempt potential economic weakness, we believe an additional 25 bps cut is likely this fall. Other major central banks are likely to follow suit with dovish policies. Sovereign yields in Europe and Japan have fallen deeper into negative territory, and the 10-year Treasury yield has slipped below 2%. We feel easier Fed policy, ongoing trade uncertainty, and slow growth mean the Treasury yield has settled into a 1.75%–2.00% range.
- We maintain our Market Weight positioning in global fixed income, and even with the feeding frenzy for yield across all fixed income sectors, we continue to recommend investors upgrade to higher-quality corporate bonds as we approach the later stages of the credit cycle.

Views explanation

(+/=/–) represents the Global Portfolio Advisory Committee’s (GPAC) view over a 12-month investment time horizon.

+ Overweight implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

= Market Weight implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

– Underweight implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

Focus article

Europe: Green shoots wilt

Frédérique Carrier
London, United Kingdom
frederique.carrier@rbc.com

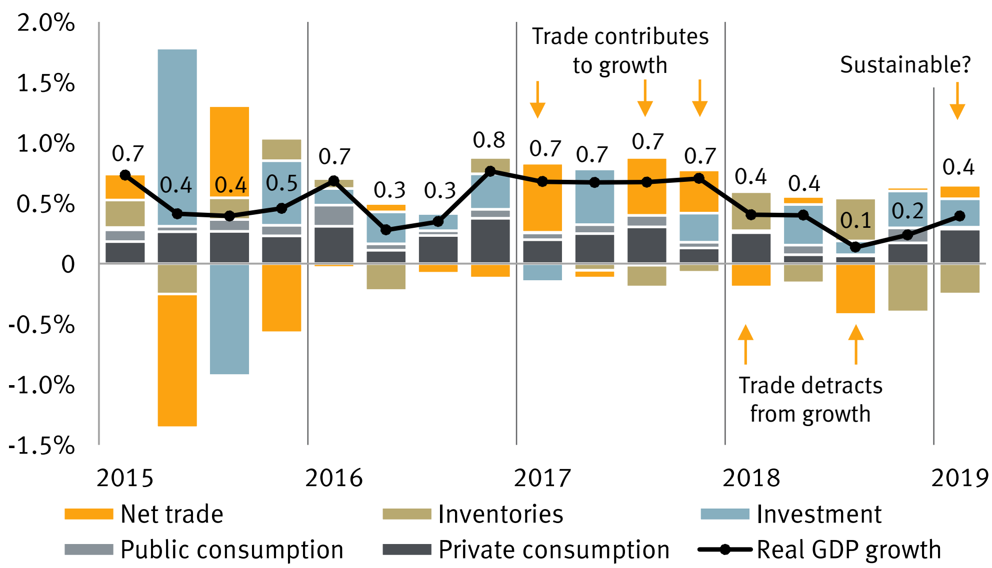
With trade tensions simmering and the economies of its largest trading partners slowing, the expected European economic recovery in the second half of 2019 will likely prove elusive. In our view, European equity valuations do not reflect political and economic factors including tariff negotiations, a reinvigorated populist Italian government, and Brexit uncertainty. We are downgrading European equities to Underweight.

Fading optimism for new growth

Our thesis on European recovery was two-pronged. We expected the temporary factors that had crimped growth in Q4 2018 and Q1 2019, such as new auto emissions testing standards and the Yellow Vest protests in France, to recede during 2019. We also expected a stabilization in global trade and growth during the second half of this year after a difficult 2018. Together, these developments would have enabled the sturdy roots supporting the Eurozone economy—falling unemployment, healthy loan growth to the private sector (6% for the euro area), and gently supportive fiscal policy in France, Italy, and Germany—to support new growth.

Trade's contribution to Q1 growth is unlikely to be sustainable

Euro area real GDP growth breakdown (q/q)



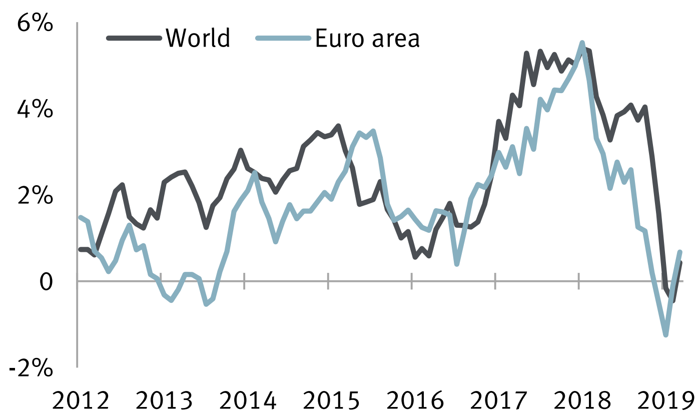
Source - Haver Analytics, RBC Capital Markets

As we move further into the second half of 2019, many of the temporary factors are indeed waning, albeit slowly. But given the recent ratcheting up of trade tensions, it seems unlikely that global trade will indeed stabilize in the near future. Even if relations between the U.S. and its trading partners thaw somewhat in the short term, tariffs will likely remain in place as negotiations continue. The uncertainty will continue to damage global growth prospects, in our opinion.

Europe's economy depends heavily on trade. Exports represent a high 44.4% of regional GDP, compared to 30.1% for the U.K, 18.6% for Canada, and 12.1% for the U.S., according to the World Bank. Of those exports, 39% go to Europe's three largest trading partners: the U.K. (16%), the U.S. (15%), and China (8%), according to European Commission data. Hence, slowdowns in the economic growth of major trading partners due to trade tensions and the spectre of a hard Brexit create substantial headwinds for the region.

Trade volumes rising, but for how long?

CPB World Trade Monitor 3-month rolling average, y/y



The March uptick may prove short-lived as trade disputes evolve.

Note: last data point is March 31, before the May escalation of the trade war
Source - RBC Capital Markets, Bloomberg, CPB World Trade Monitor

European economic data featured some green shoots in the spring, culminating in Q1 GDP growth of 0.4% q/q following a lackluster 0.2% in Q4 2018. However, recent releases have been less encouraging, with most falling short of consensus expectations. Consequently, the European Central Bank (ECB) has pared back its growth projections for FY 2020 and FY 2021.

ECB staff lowers 2020 and 2021 growth expectations again

ECB growth projections

	Dec 2018	Mar 2019	Jun 2019
2019	1.7%	1.1%	1.2%*
2020	1.7%	1.6%	1.4%
2021	1.5%	1.5%	1.4%

*Given robust Q1 2019 GDP data, the ECB tweaked upwards its 2019 estimates in June, though that estimate remains below the 1.7% it had calculated for 2019 back in December 2018.
Source - RBC Wealth Management

The market's inflation expectations have also fallen from 1.6% at the beginning of the year to 1.1% in mid-June.

Europe: Green shoots wilt

We believe consensus corporate earnings growth forecasts will need to be adjusted to reflect this new reality, as they are too high at 8% for this year and 10% for 2020. Slightly negative Q1 earnings-per-share (EPS) growth for the region will make those full-year estimates difficult to achieve, and we believe European equities will struggle to outperform as long as downward earnings revisions prevail.

The ECB has announced it is prepared to take bold steps to prop up inflation and to support the regional economy should it weaken further. Despite interest rates already in negative territory, RBC Capital Markets now expects two 10-basis point rate cuts this year, in September and December. It is also possible that the central bank will relaunch its quantitative easing programme next year.

The ECB's actions are unlikely to remove the key obstacle to the region's growth, in our view: the global trade dispute. As discussed in a recent *Global Insight Weekly* article, central banks' ability to boost economic expansion through ever-lower interest rates appears limited, at the margin. In a possible sign of things to come, U.S. President Donald Trump lashed out at ECB President Mario Draghi and the ECB for "making it unfairly easier for them to compete against the USA."

Political tensions return

Beyond this, we believe regional political tensions are likely to increase over the course of the next few months in three key areas.

U.S.-EU auto tariffs – The U.S. has postponed a decision on European auto tariffs until the autumn. But if President Trump were to attempt to use auto tariffs as a lever to open up the EU agricultural market, he would likely face stiff opposition from Europeans, who passionately protect their agricultural sector. Should the dispute escalate and the U.S. slap new tariffs on European auto imports, it would significantly impede growth given the importance of auto trade flows, in our view.

A bolstered populist government in Italy – The right-wing Lega is the main political force in Italy's coalition government, and the party's strong showing in the recent European Parliament elections has emboldened its leader, Matteo Salvini. He has resumed talk of breaching EU fiscal rules and issuing a parallel currency. So-called "mini-BOTS," named after the country's ordinary Treasury bonds, would be used to pay public sector bills, in a direct provocation to the ECB.

It is unclear at this stage whether Rome's dispute with Brussels will escalate. Our base case is that rising yields would act as a control mechanism to contain the crisis. Italian banks, which own 8% of the country's bonds, remain fragile due to non-performing loans reaching a high 9% of total loans. They would be weakened further by rising yields, something we believe most governments would prefer to avoid.

But the current government might opt for confrontation, and the vicious cycle of rising yields and credit rating downgrades that would likely ensue. Faced with that reality, the country's political leadership could decide to head further into the storm or to change course, much as Greece did in 2015. Either way, we believe the developing situation would weigh on business sentiment and further dampen growth.

Europe: Green shoots wilt

Brexit uncertainty – As things stand, the deadline for the U.K. to exit the EU is October 31, 2019. Whilst the EU would prefer to avoid the chaos of a no-deal Brexit, it is far from clear that Brussels would grant the UK another extension. Avoiding a no-deal Brexit would require the country's parliament to finally accept the Withdrawal Agreement negotiated by former Prime Minister Theresa May, which it has thrice rejected. In our view, the probability of a no-deal Brexit is not inconsiderable, at around 30%.

Equities have performed well, but …

After a strong rally in Q1 that brought European equity performance in line with the MSCI World Index, the MSCI Europe ex UK Index now trades at 13.4x 2020 earnings, in line with its long term average. Valuations are thus not low enough, in our view, to price in the challenges ahead. Moreover, when compared to the U.S. on a sector-adjusted basis that takes into account the lower representation of Tech in the European index, the discount of less than 4% appears minimal, and is not nearly as deep as the prevailing discount over the past 10 years. This doesn't leave the region much of a valuation buffer, and supports our move to an Underweight position in European equities.

Taking all of this into account, we maintain that there is room in portfolios for an allocation to select European companies with strong business models and which operate in niche markets buoyed by secular growth, are supported by a global revenue base, and generate strong cash flows. We find these opportunities particularly in Consumer sectors, Health Care, and some Industrials.

Focus
article

Debt, deficits, and Modern Monetary Theory—there is a connection

Craig Bishop
Minneapolis, United States
craig.bishop@rbc.com

A "new" concept, Modern Monetary Theory (MMT), suggests current deficits may be too small and an "inevitable" day of reckoning isn't necessarily a foregone conclusion. We remain in the camp that "there is no free lunch," and until Washington demonstrates the ability or willingness to exercise fiscal discipline, it is unlikely MMT moves from theory to practical application.

Rising deficits and increasing debt are a frequent cause of consternation for markets and investors. Each, historically, has often been politically charged, with major U.S. parties labeled as free spenders (Democrats) or deficit hawks (Republicans). But the passage of the Tax Cuts and Jobs Act of 2017 (TCJA) and its significant boost to future deficits has blurred the lines and may have made past labels irrelevant. In the 1930s, John Maynard Keynes asserted what was a radical idea at the time that governments should borrow and spend to bring the economy out of a deep downturn. (Crucially, he went on to say those debts should be paid down when good times returned.) Seven decades later, politicians had embraced deficit spending so wholeheartedly that then-U.S. Vice President Dick Cheney felt comfortable saying that "[President] Reagan proved deficits don't matter." Now a "new" concept—Modern Monetary Theory (MMT)—suggests this may be more truth than fiction. In fact, MMT advocates suggest current deficits may be too small and that an "inevitable" future day of reckoning isn't necessarily a foregone conclusion. Some clarity around this issue would be useful.

Debt and deficits: What's the difference?

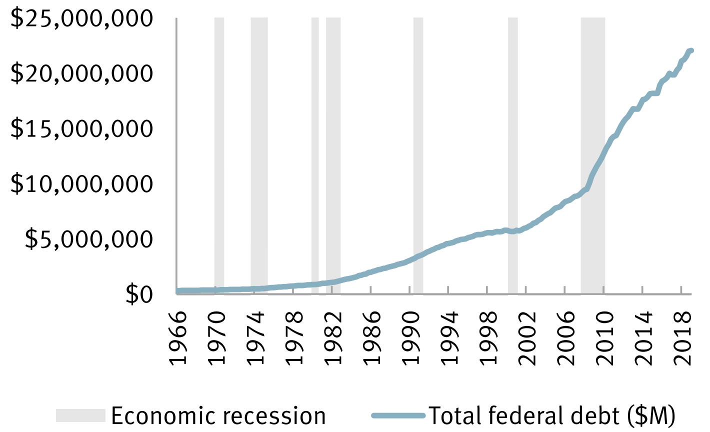
Investors often have questions on these terms, and the fact they are often used interchangeably creates confusion, but in the realm of public sector (government) fiscal policy these two words, while connected, describe different things.

U.S. government debt

- This is the amount of money the government owes to creditors. It represents the accumulated difference between any past annual deficits and any surpluses.
- The U.S. Treasury Department pegs the U.S. national debt at $22.03T as of June 19, 2019.
- The total federal debt-to-GDP ratio puts this number into useful perspective. The Congressional Budget Office (CBO) projects the debt will grow from 78% of GDP in 2019 to 92% in 2029—the largest share since 1947. The CBO thinks it could potentially reach 150% by 2049.

Debt accelerates post-Great Recession

Total federal public debt



The U.S. national debt level stood at $22.03T through June 19, 2019.

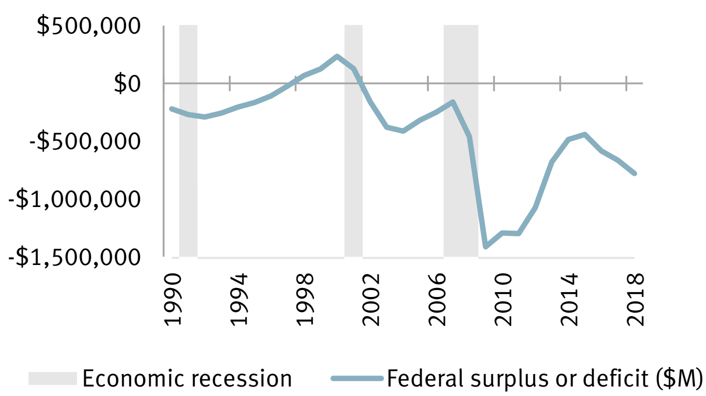
Source - Federal Reserve Bank of St. Louis (FRED) data through 1/1/19, U.S. Treasury data 1/2/19–6/19/19, RBC Wealth Management

While 150% is a large number, we note that Japan's debt-to-GDP ratio currently hovers near 250%, and Eric Lascelles, chief economist at RBC Global Asset Management, doesn't feel a 150% debt-to-GDP ratio is necessarily unsustainable. Key to this, in his opinion, is the U.S. dollar's reserve currency status, which ensures the U.S. government should still be able to borrow at a relatively low rate, as well as the fact that the U.S. debt and financial markets are the deepest and most liquid in the world.

U.S. government budget deficit

- This results from the government spending more money in a given fiscal year than it takes in and is financed through the issuance of debt.
- Over the last two decades, the U.S. government has run a deficit every year except for a period from 1998–2001 during the Clinton administration.
- The CBO projects an $896B deficit in fiscal year 2019 and forecasts future deficits of $1T a year beginning in 2022 and rising thereafter.

Budget surpluses are rare



In the last 20 years, the U.S. reported a budget surplus only from 1998 to 2001.

Source - FRED economic data - Federal Reserve Bank of St. Louis, RBC Wealth Management; data through 9/30/18

Debt, deficits, and MMT

Traditional economic orthodoxy is that high deficits result in increased government debt issuance, which then leads to higher interest rates that eventually suppress economic growth. But as we've seen during the U.S. economy's record-long expansion, interest rates have remained contained even amidst increased issuance of U.S. government debt, which makes it reasonable to ask whether the traditional debt/deficit concerns are misplaced and whether this sets the table for broad adoption of MMT.

MMT to the (deficit) rescue?

While often referred to as "new," MMT is really an evolving chain of economic thought going back over 100 years. It has seen increased popularity as a result of recent political policy proposals in the U.S., such as the Green New Deal, increased infrastructure spending, and as a means to expand the social safety net through Medicare for All and job guarantees. Furthermore, in an environment of rising budget deficits/federal debt as a result of tax reform and fiscal stimulus, MMT does make it seem like it's possible for us to "have our cake and eat it too."

The media has focused on the theory's assertion that budget deficits in and of themselves aren't necessarily bad. Stephanie Kelton, professor of public policy and economics at Stony Brook University and a prominent MMT proponent, stated in a recent CNBC interview that "MMT starts with a really simple observation and that is that the U.S. dollar is a simple public monopoly ... And therefore, it [the U.S. government] can never run out of money … It never has to worry about finding the money in order to be able to spend." Unlike our own personal finances where our ability to spend is ultimately limited by what we earn, under MMT government spending would not be constrained by the need to raise taxes or borrow money, it could turn on the printing presses and simply spend the money in the economy.

"The main reason inflation never arose over the last decade despite a lot of money printing and debt financing is that the economy had a great deal of slack and because of new bank regulations."

– Eric Lascelles
Chief Economist
RBC Global Asset Management

BIG GOVERNMENT, little fed

MMT puts the government front and center in implementing policy, entrusting it to exercise sound, disciplined fiscal measures. Fiscal policy emanates from Congress, so it would be expected to act as the regulator, judging whether potential new spending runs the risk of accelerating inflation and if so, then avoid doing that. This discipline should, according to the theory, allow the U.S. to essentially self-finance future deficits, although important to this will be the U.S. dollar retaining its reserve currency status.

Fiscal discipline is a key requirement since Kelton and others look to perceived levels of inflation over time as something that would make deficits matter. The discipline from Congress to limit inflation comes, according to Kelton, in its ability to craft the appropriate policy tools, which could arise in several forms—raising taxes, increasing regulations to limit overcapacity, and tightening lending standards, to name a few.

The Fed and traditional monetary policy are all but sidelined under MMT, as the theory presumes the natural rate of interest to be 0%. Furthermore, since, as MMT advocates suggest, the theory promotes full employment and stable prices (inflation), this means it all but subsumes the Fed's dual mandates. The concept advocates for the Fed to have the ability to directly fund government expenditures, though to do so would require amending the Federal Reserve Act.

"MMT would probably weaken the dollar significantly, which ultimately would reduce U.S. purchasing power, reduce U.S. clout in the world, and likely hasten the shift away from the U.S. dollar as the world's reserve currency."

– Eric Lascelles

Can that "MMT dog" hunt?

A recent *Barron's* article on MMT states that "there is no country that perfectly follows the MMT model of political economy." But the article quotes Bill Mitchell, a professor at Australia's University of Newcastle and a coauthor (with L. Randall Wray and Martin Watts) of a new MMT textbook on macroeconomics as saying that China comes closest to following the MMT model for demonstrating "the opportunities that they have as a monopoly supplier of their currency."

Japan, the world's third-largest economy, has been credited with being a real-time MMT success story as the government has effectively been able to print money to stimulate the economy without igniting inflation and keeping interest rates low while its debt-to-GDP ratio hovers near 250%. Yet in April 2019, both Japan's minister of finance and the governor of the Bank of Japan dispelled the notion they are following an MMT strategy.

Professor Kelton suggests the U.S. is currently following MMT, with some of the pieces of the puzzle in place—growing deficits, low unemployment, low interest rates, and low inflation—financed by its strong reserve currency. It seems a bit premature to us to reach this conclusion, and clearly the Fed is showing little inclination to relinquish or modify its role, with Fed Chair Jerome Powell saying MMT is "just wrong."

There have been other countries that have attempted to self-finance deficits by printing money—most notably Germany in the 1920s, and more recently Venezuela, Zimbabwe, and Greece—and as we know these episodes ended badly.

Fiscal discipline, anyone?

How do you reconcile the highly charged debate over MMT versus traditional economic orthodoxy, especially when each side can call on its own roster of financial and political heavyweights for support?

Rather than MMT being "garbage" as per Blackrock's Larry Fink, Bridgewater Associates founder Ray Dalio suggests there could be a middle ground, "a third generation monetary policy." Dalio has labeled this "MP3," saying it will involve "fiscal and monetary policy coordination" similar to that prescribed by MMT with some variances.

We remain in the camp that "there is no free lunch," believing that unlimited money printing eventually creates problems in the form of more inflation, higher interest rates, and a weaker currency. Furthermore, until Washington demonstrates the ability or willingness to exercise fiscal discipline, we believe it is unlikely that MMT moves from theory to practical application.

Global equity

Steady but ready

Our portfolio investment approach is straightforward:

- To get financial markets right you need to get the economy right;
- The economy that investors need to get right above all others is the U.S. economy, far and away the largest in the world and the one that sets the cyclical rhythm for the global economy;
- As long as there is no U.S. recession/global economic downturn looming, an investor should remain committed to holding equities at some pre-determined, long-term target exposure in a portfolio; and
- Once the path shifts decisively toward an eventual U.S. recession, equities should be approached more cautiously and defensively.

We use a number of indicators to assess the likelihood of a U.S. recession arriving. Six of these are rated in our recession scorecard (see table on following page). Until just a few months ago all six were unequivocally signaling no recession in sight. Recently one indicator, the closely watched gap between short- and long-term interest rates, crossed a threshold that would indicate a U.S. recession could be underway in about a year. Two others—the ISM New Orders Minus Inventories measure and the Conference Board Leading Economic Index—have moved closer to, but so far have not crossed, their respective negative signal boundaries. Three others have not yet approached a negative turning point.

None of these indicators has a "perfect" historical track record—although some come close. And even if one did, there can always be a first time for everything. But, followed as a group over time, these have given a reliable reading of how the recession probabilities are shifting.

Equity views

Region	Prior	Current
Global	=	=
United States	=	=
Canada	=	=
Continental Europe	=	↓ –
United Kingdom	=	=
Asia (ex-Japan)	=	=
Japan	+	+

+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

The indicator that has moved out of the positive column into a more cautionary rating is the so-called "shape of the yield curve," much discussed in the financial press. Simply put, the gap between short-term interest rates and long-term ones, normally comfortably wide in favour of the latter, has reversed with short-term Treasury bill rates now higher than the 10-year Treasury note yield. Such an "inversion" has almost always been a harbinger of a recession arriving a year or so down the road.

Predictably, many opinions—often well-reasoned and compelling—are being offered as to why a yield curve inversion no longer matters, or at least doesn't matter in this instance. In our experience, such opinions have always appeared at the time of previous inversions, but, typically, recessions arrived nonetheless.

For our part, we are treating this occurrence as a "shot across the bow" for equity investors—one that should

Jim Allworth
Vancouver, Canada
jim.allworth@rbc.com

Kelly Bogdanova
San Francisco, United States
kelly.bogdanova@rbc.com

Patrick McAllister, CFA
Toronto, Canada
patrick.mcallister@rbc.com

Frédérique Carrier
London, United Kingdom
frederique.carrier@rbc.com

Judith Oliver
Singapore
judith.oliver@rbc.com

RBC Wealth Management U.S. economic indicator scorecard

Indicator	Status		
	Expansion	Neutral	Recessionary
Yield Curve (12-month to 10-year)	–	✓	–
Unemployment Claims	✓	–	–
Unemployment Rate	✓	–	–
Conference Board Leading Index	✓	–	–
ISM New Orders Minus Inventories	✓	–	–
Fed Funds vs. Nominal GDP Growth	✓	–	–

5 "green lights," 1 on "caution"

Source - RBC Wealth Management, Bloomberg, FRED Economic Data St. Louis Fed

provoke an extra degree of vigilance. Were more indicators to lose their positive rankings in the coming months, our defensive leanings would intensify. Virtually all bear markets have been associated with U.S. recessions, and usually the stock market has set its final peak for the cycle some months before the recession begins. So, within this historical context, the yield curve inversion in May can be seen as opening the door to the potential arrival of a bull market peak for the first time in 10 years.

All that said, the other five indicators we track have yet to raise any alarm. The U.S. economy continues to grow, especially the all-important and dominant consumer sector. Credit conditions remain largely accommodative—i.e., interest rates are low and banks are willing to lend. The corporate earnings outlook is constructive, if not buoyant, while price-to-earnings multiples—17.8x this year's consensus earnings forecast for the S&P 500, 15.2x for the TSX, 14.7x in Europe, and 12.8x for Japan's TOPIX—are not particularly demanding, ranging from "moderate" to "cheap."

Nor are the market's "internals" particularly worrying, in our view. The majority of stocks have been moving up in gear with the broad averages. This is not a case where the indexes are being propelled higher by a handful of fast-rising, large-cap favorites. While there are some narrow pockets of speculative activity—tech IPOs come to mind—the broad-based "get-in-at-any-cost," unsustainable market froth, characteristic of many market tops, seems to us to be absent. If anything, investor attitudes are mostly cautious and somewhat downbeat.

In what we expect will be a repeated theme in this space in the coming quarters, we counsel investors to revisit the question of "risk appetite" should an economic and earnings downturn play out sometime in the coming year or so. Focusing on the quality of holdings also seems more than usually appropriate.

We remain Market Weight equities within all major market regions except: Europe, where we have recently moved our recommended exposure down to Underweight as slower-than-expected GDP growth has reduced earnings expectations, while Brexit uncertainties, Italian bank woes, and renewed political fractiousness are pressuring valuations (see "Europe: Green shoots wilt"); and Japan, where our Overweight commitment reflects valuations that are depressed even as the earnings outlook is reasonably constructive.

We believe it's too early to become overtly defensive in equity portfolios. But thoughtful readiness and preparation for a change in the investment landscape, which might arrive unannounced or from an unexpected quarter, is always the correct approach.

Regional highlights

United States

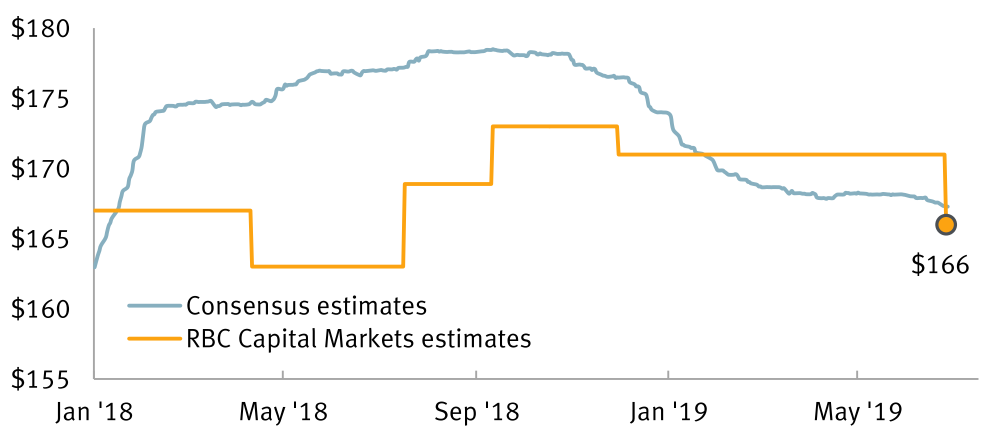
- The S&P 500 reversed course and rallied to a new all-time high in June after the Federal Reserve hinted (and later signaled) it could cut interest rates this year while the U.S. and China lowered their adversarial tariff rhetoric. The quality of the rally was mixed. Bellwether transportation and small-cap stocks lagged, and have yet to confirm the rally has staying power.
- While the equity market is signaling it welcomes rate cuts, the Fed's rationale for easing may be nearly as important as the cuts themselves. If the market perceives that rate cuts are "insurance" to prevent further slowing in economic momentum and, by extension, that they could prolong the expansion, equities should respond positively. If, however, the Fed signals that cuts are necessary because it perceives recession risks have risen materially, the equity market would likely be less enthusiastic. Our economic indicators are pointing toward the former scenario rather than the latter. Therefore, the old mantra "don't fight the Fed" still applies.
- Uncertainties surrounding the upcoming Q2 earnings season have increased due to the ongoing U.S.-China trade/tech dispute and related manufacturing slowdown. We anticipate earnings surprises will be less robust than recent quarters and forward guidance more conservative. The consensus forecast is for S&P 500 earnings to grow 0.2% y/y in Q2 and 2.8% for the full year. Both estimates seem beatable, in our view, absent further escalation of trade tensions.

Canada

- The federal government reapproved the Trans Mountain pipeline expansion after its previous permit was ruled invalid by a Federal Court of Appeal. Prime Minister Justin

S&P 500 2019 EPS estimates continue their decline

Consensus estimates are bottom-up



Source - RBC Wealth Management, FactSet; data through 6/27/19

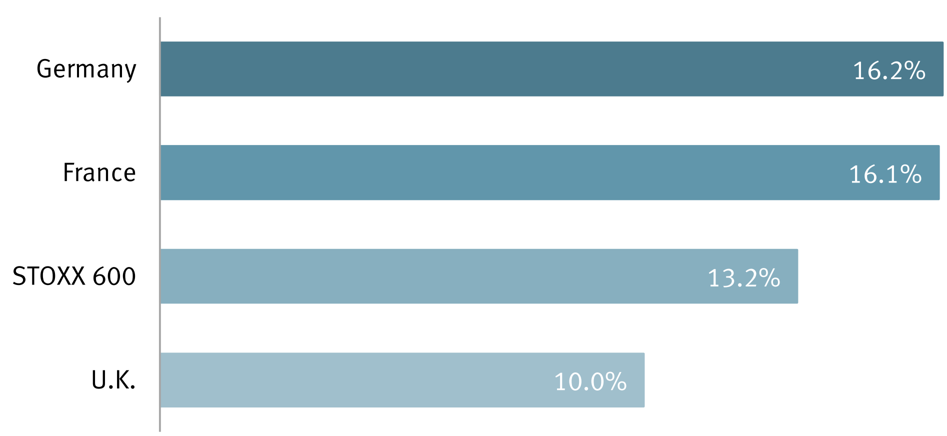
Trudeau indicated that construction will start this summer, but we expect timelines to remain fluid as the crown corporation responsible for the project moves to secure local permits and mobilize contractors. Of note, the decision to press forward with the project was not accompanied by an expected in-service date. RBC Capital Markets believes the expansion project could be online in the 2022–2023 timeframe, with the ever-present risk of further delay.

- Sentiment towards Canadian Energy remains depressed, and we believe tangible progress on the pipeline will be required to convince corporate and equity investors alike that the sector's prospects are set to improve. We remain wary that court challenges brought by the pipeline's opponents could raise significant hurdles to the project's development. Visible progress alongside a more constructive commodity price environment could provide a rising tide for the entire sector, with particular upside for companies most exposed to activity levels in Western Canada and heavy oil differentials.
- Such is the state of Canadian Energy that as we hopefully await progress with one transportation solution we see others plunged into further uncertainty. Enbridge's Line 3 Replacement Project saw its environmental permit invalidated by the Minnesota Court of Appeals, while the State of Michigan has threatened to shut down the existing Line 5 pipeline. The path forward for the former is uncertain, while the latter is now subject to legal action brought by the company. We continue to monitor both situations and highlight that it is not just Canadian opposition that is impeding the pipeline development plans of Canadian companies.

Continental Europe & U.K.

- In the U.K., the two finalist candidates for the Conservative leadership will be put to grassroots members for selection late this month. Former London Mayor and Foreign Secretary Boris Johnson is the favourite to become the next prime minister given his much wider support.
- Johnson has toned down his hard-Brexit rhetoric somewhat recently, but it remains unclear what he actually stands for. He is likely to maintain his pledge to reopen the Brexit Withdrawal Agreement and

Year-to-date returns (local currency)



Source - RBC Wealth Management, Bloomberg; data through 6/30/19 modify the Irish backstop, popular ideas with members. But whoever emerges as prime minister will face the same difficulties as those faced by former Prime Minister Theresa May. Should it be Johnson, as discounted in markets, he will have less political capital in Brussels than his predecessor, given his long history of skepticism towards the EU. This, and the EU's well-publicized stance against renegotiating the Withdrawal Agreement, makes the prospect of desired renegotiations rather remote, particularly by the tight October 31 Brexit deadline.

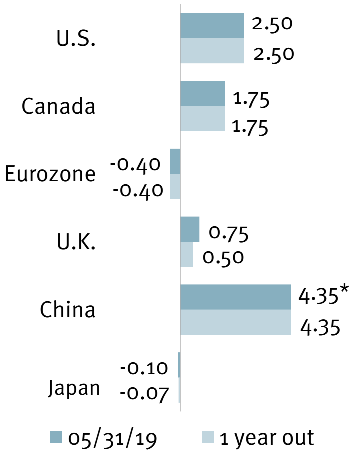
- Despite lingering business uncertainty, the combination of robust wage growth, full employment, and little prospect of rate hikes is enabling the U.K. economy to grow modestly for now. Valuations are inexpensive based on a price-to-earnings ratio of 12x the 2020 consensus earnings estimate, and we maintain our bias towards globally diversified companies.

Asia

- A dovish Federal Reserve and a weaker U.S. dollar are positives for Asia ex-Japan equities, which typically struggle when the greenback is strengthening. An accommodative Fed provides Asian central banks with room to cut interest rates and also lowers borrowing costs for corporates with dollar-denominated debt.
- The main driver for Asia ex-Japan, however, remains the ongoing trade tension between the U.S. and China. The market had been focused on the tariff war, but following the U.S. placing Huawei on the restricted entity list, the market is also factoring in non-tariff risks.
- China is too deeply integrated into the U.S. and global economy for a Soviet-style Cold War to be declared, but we could be at the beginning of a "Tech Cold War" and Huawei was the opening shot. The company is dominant in 5G, the technology that will power the Internet of Things. The U.S. administration has also identified artificial intelligence and surveillance technology as areas of security concern.
- Against this background, we prefer companies that are less exposed to both tariff and non-tariff risks. The risks lie not just with China corporates but across the Asian technology supply chain.
- For Japan, the prospect of a Fed rate cut has driven further appreciation of the yen, and this will likely slow down the equity market. We nevertheless remain positive on Japanese equities. Valuations are attractive, and we see encouraging signs that the country stands a reasonable chance of breaking out of deflation, a development that should lead to a re-rating of the Japanese market.

"Maximum pressure"

Central bank rate (%)



*1-yr base lending rate for working capital, PBoC

Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management

With the U.S. administration prone to hyperbole, we've come to see "maximum pressure" as a favorite phrase used to describe foreign policy initiatives, the aim being to encourage various countries in the short run to better align their interests/actions with the administration's objectives. In the past few months, we think it can be said that President Trump is also applying this in his policy suggestions to Federal Reserve Chair Jerome Powell, as he seeks to have Fed policy support his goals for the U.S. economy, especially important with an election year looming.

It takes a village of central bankers ...

… and their willingness to act prudently/independently to raise and tend to an economic expansion. This month the U.S. economic expansion becomes the longest on record and a common characteristic throughout the past 10+ years has been supportive central banks willing to take the necessary policy actions to manage the global economic recovery.

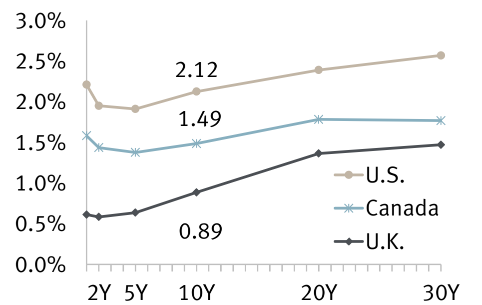
And since we've often said economic expansions don't die of old age—but rather from an external event(s)—it should come as no surprise that just last month the leaders of the Fed, European Central Bank (ECB), and the Bank of England (BoE) indicated they will take the appropriate measures to extend the current economic expansion—the Fed will likely cut rates, while the ECB and the BoE have pushed their plans for rate hikes further out on the calendar.

Fixed income views

Region	Gov't Bonds	Corp. Credit	Duration
Global	=	+	5–7 yr
United States	=	+	5–7 yr
Canada	=	=	3–5 yr
Continental Europe	=	+	5–7 yr
United Kingdom	=	=	3–5 yr

+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

Sovereign yield curves



Source - Bloomberg

Let the market forces be with you

We consider market expectations for interest rates to be a good barometer for future direction even though there can often be a wide chasm between them and official central bank forecasts. And as central bankers continue to monitor global economic data points and geopolitical developments/risks, we believe they will adjust policies to meet any challenges that arise rather than bend to maximum pressure driven by short-term political goals.

Craig Bishop
Minneapolis, United States
craig.bishop@rbc.com

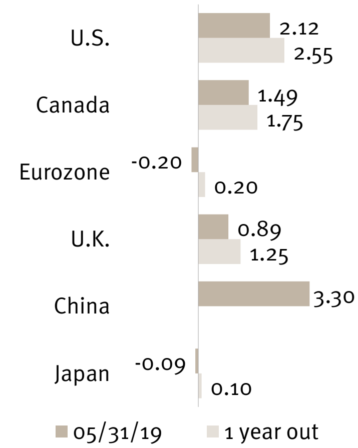
Tom Garretson, CFA
Minneapolis, United States
tom.garretson@rbc.com

Christopher Girdler, CFA
Toronto, Canada
christopher.girdler@rbc.com

Alastair Whitfield
London, United Kingdom
alastair.whitfield@rbc.com

Global fixed income

10-year rate (%)



Note: Eurozone utilizes German Bunds.

Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management
^Under review

Regional highlights

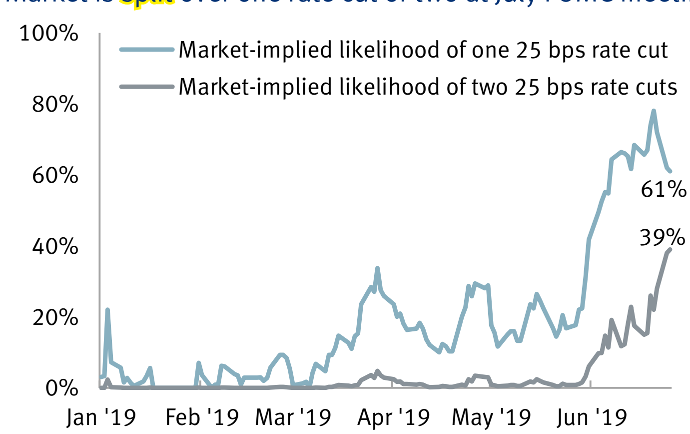
United States

- Unless the economic backdrop picks up markedly through July, we think the Federal Reserve is all but certain to deliver a rate cut at its July 31 meeting. While the market is priced for a 100% chance the Fed will lower rates from the current upper bound of 2.50%, the only question remaining is by how much. The market is split on whether it's just one rate cut of 0.25%, or if the Fed will deliver an aggressive 0.50% reduction. In our view, the Fed will move by 0.50% in an effort to get ahead of any potential economic weakness, followed by another 0.25% cut in September.
- As yield curves remain inverted, we think Fed rate cuts will help to resteepen them. The low point on the Treasury yield curve is the 3-year, at just 1.69%. Should the Fed deliver 0.75% of rate cuts to bring the fed funds rate to a 1.50%–1.75% range, it should be sufficient to get yield curves back to a more normal shape. What does that mean for the benchmark 10-year yield? While we expect curves to resteepen, they are likely to remain relatively flat; therefore, we see the 10-year yield settling into a range between 1.75% and 2.00% over the near term.
- With Fed rate cuts in the pipeline, there has been a feeding frenzy for yield across all fixed income sectors, particularly in the riskier parts of the market as investors stretch for yield. This hunt for income has driven the yield on the Bloomberg Barclays US Corporate High Yield Index to just 5.75%, down sharply from 6.62% at the beginning of June, the lowest level since 2017. We continue to favor quality via investment-grade corporates, and seek to add income to portfolios via preferred shares, which continue to look attractive on a relative value basis.

Canada

- Unemployment at a new record low and core inflation back at the Bank of Canada's target both helped keep Government of Canada (GoC) yields firm in June. This has occurred while U.S. Treasury yields, which often set the direction of travel for Canadian yields, fell dramatically over the month as expectations grew that the Federal Reserve would cut rates as soon as this month.

Market is split over one rate cut or two at July FOMC meeting



We believe the Fed will cut by 0.50% in an effort to get ahead of any potential economic weakness.

Source - RBC Wealth Management, Bloomberg; data through 6/25/19

- Every GoC bond offers a yield that is lower than the BoC's 1.75% overnight lending rate, driving the expectation that rate cuts are forthcoming. However, their timing has been pushed back a little by improving data. The next policy decision occurs on July 10 along with the release of fresh BoC growth and inflation forecasts. The committee considers domestic conditions as well as external factors. We expect the tone of the upcoming meeting will set the direction of bond yields over the coming months.
- Low government bond yields are pushing investors towards higher-yielding assets. Corporate bonds remain popular within this environment, as judged by the minimal level of compensation being offered to own them. Preferred shares are the exception to the rule and continue to trade with very wide credit spreads as investor sentiment remains incredibly weak. We see value opening up after their recent underperformance. We recommend maintaining current allocations or increasing exposure within accounts that accept a higher risk tolerance.

Continental Europe & U.K.

- After an unconvincing attempt at setting a dovish tone at the last European Central Bank (ECB) meeting, President Mario Draghi delivered a retake of his "whatever it takes" speech from almost seven years earlier at the June ECB conference in Portugal. He scaled up his messaging regarding the potential for further easing unless economic conditions improve, with additional rate cuts and loosening of restrictions around its quantitative easing programme being considered.
- The introduction of deposit rate tiering could prove more effective given both the deposit and refinancing rates are already in negative territory. We see the mention that the quantitative easing programme has "considerable headroom" as clear guidance the central bank would ease further to support the euro area economy.
- With a reversal on expectations towards potentially looser ECB monetary policy, we remain Market Weight in government bonds and modestly Overweight in credit.
- The Bank of England (BoE) remains one of the few global central banks pointing towards a tightening bias in its monetary policy, although retaining its "limited and gradual" guidance for raising rates. Given the Bank's assumption of a smooth transition after Brexit, an unconvinced market has priced in the possibility of a rate cut rather than a hike.
- For now, we maintain a Market Weight view on U.K. government bonds with short-duration positioning. We also see the yield pickup in U.K. corporate credit as attractive and retain a Market Weight allocation, preferring a selective approach.

Currencies

Currency forecasts

Currency pair	Current rate	Forecast Jun 2020	Change*
Major currencies			
USD Index	98.08	95.02	-3%
CAD/USD	0.75	0.74	-1%
USD/CAD	1.34	1.36	1%
EUR/USD	1.11	1.17	5%
GBP/USD	1.27	1.33	5%
USD/CHF	1.01	0.98	-3%
USD/JPY	110.3	114.0	3%
AUD/USD	0.69	0.67	-3%
NZD/USD	0.65	0.63	-3%
EUR/JPY	122.9	133.0	8%
EUR/GBP	0.88	0.88	0%
EUR/CHF	1.13	1.15	2%
Emerging currencies			
USD/CNY	6.91	7.50	9%
USD/INR	69.7	75.00	8%
USD/SGD	1.38	1.44	4%

* Defined as the implied appreciation or depreciation of the first currency in the pair quote. Examples of how to interpret data found in the Market Scorecard.

Source - RBC Capital Markets, Bloomberg

U.S. dollar: Losing patience

Indications from the Federal Reserve that interest rate cuts are likely forthcoming shook the U.S. dollar from its throne in June. The greenback had been brushing up against its highest levels seen amongst its G10 peers since mid-2017 with dollar demand supported by renewed risk-off sentiment. U.S.-China trade tensions look poised to persist, yet it will be challenging for the dollar to remain supported amid a less favorable interest rate backdrop, in our view.

Euro: Opening the toolkit

The euro battled whiplash in June with the currency bouncing around from near two-year lows against the U.S. dollar to multi-month highs. Broader U.S. dollar performance underpinned the moves, although a surprise announcement from the European Central Bank that policy easing was forthcoming ostensibly aggravated the swings. The deployment of stimulus measures could curb appetite for the currency, although the downside could be capped by other central banks embarking on easing cycles.

British pound: The battle for Brexit

The British pound shed close to 5% of its value against the U.S. dollar from early May to mid-June before finding firmer footing. Uncertainty around the Conservative party leadership challenge added to the hanging cloud of Brexit anxiety, as leading candidates embraced the possibility of a "hard Brexit." We anticipate that this outcome will ultimately be avoided, but the lack of clarity is likely to limit any upside for the currency with greater volatility ahead, in our view.

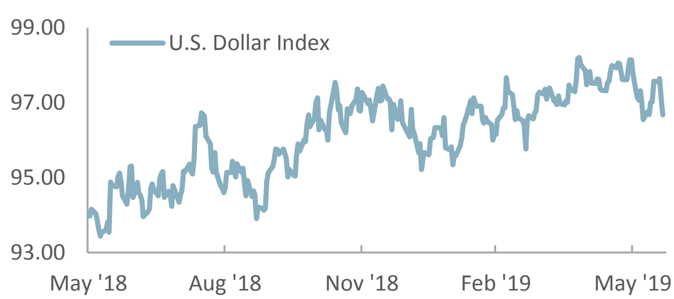
Canadian dollar: Breaking out

The Canadian dollar broke free in June from the relatively narrow trading range seen since March against the U.S. dollar. A signal from the U.S. Fed that it will likely embark on a path of rate cuts contrasted with the neutral guidance of the Bank of Canada, spurring a sharp narrowing in interest rate differentials, and an attendant boost to the Canadian dollar. The outperformance will likely be short-lived with further gains likely to be capped by ongoing trade tensions, in our view.

Japanese yen: Risk-off rally

The yen extended its recent advance in June, strengthening to levels last seen against the U.S. dollar over a year ago. A surprise pivot from the U.S. Fed signaling a likely cycle of monetary easing alongside rising geopolitical tensions underpinned robust demand for the perceived safety of the yen. Further gains are likely to be capped, however, with the Bank of Japan joining the chorus of central bankers in citing the need for persistent easing ahead.

The king of currencies has been dethroned amid Fed rate cuts



The U.S. dollar came under pressure on the Fed signaling its openness to easing policy.

Source - Bloomberg, RBC Wealth Management, data through 6/20/19

Laura Cooper
London, United Kingdom
laura.cooper@rbc.com

Commodities

Commodity forecasts

	2019E	2020E
Oil (WTI $/bbl)	$63.88	$65.88
Natural Gas ($/mmBtu)	$2.80	$2.75
Gold ($/oz)	$1,326	$1,350
Copper ($/lb)	$2.78	$3.00
Soybean ($/bu)	$9.15	$9.45
Wheat ($/bu)	$4.94	$4.98

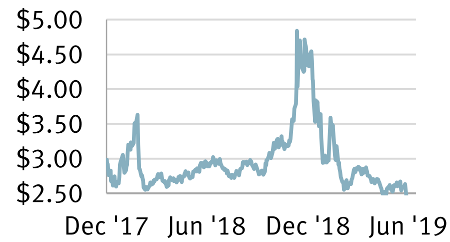
Source - RBC Capital Markets forecasts (oil, natural gas, gold, and copper), Bloomberg consensus forecasts (soybean and wheat)

WTI – U.S. exports may surge

U.S. inventories have been building during a period that typically experiences seasonal drawdowns. WTI prices declined about 17% m/m. However, RBC Capital Markets' commodity strategists believe U.S. exports could retest the all-time high of 3.6 million bbl/d in the coming weeks based on an increased number of crude carriers located in the U.S. Gulf. Iranian sanctions have led to a ramp-up in stockpiles in Asia, which has tightened the physical market, putting a floor under prices for now.

Natural gas – Deal or no deal

Effective June 1, China implemented its 25% tariff on U.S. natural gas. Unsurprisingly, prices have struggled, down about 9% m/m, continuing the downtrend since the start of the year. China represents the largest growth market for LNG exporters globally, but we are unlikely to see any new deals between U.S. LNG projects and Chinese importers while the trade war lingers, according to RBC Capital Markets' commodity strategists.

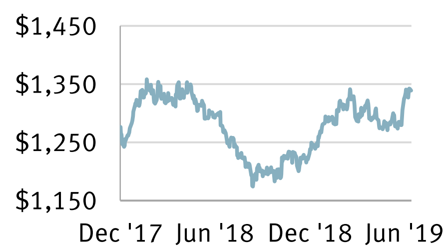


Copper – Getting physical

Trade disputes continue to be top of mind as the conversation between the U.S. and China intensifies. Global inventories are sitting at 2.9 weeks of global consumption, which suggests a tight physical market, according to RBC Capital Markets' analysts. Copper prices have averaged around $2.75/lb when inventories dip below three weeks of global demand. Sentiment has weakened along with copper prices, which have declined approximately 3% m/m.

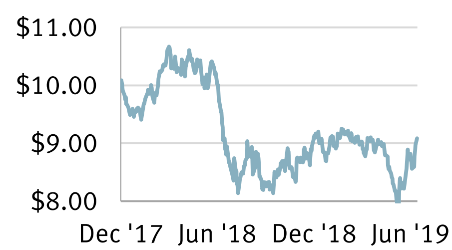
Gold – Bring on the cut

The current environment continues to skew favourably for gold, in our view. The Fed maintained its benchmark rate on June 19, but hinted that a cut would be considered if the economic outlook weakens. Although inflation continues to languish, a rate cut could be a catalyst for further upside in gold prices. Prices increased by approximately 5% m/m and are now hovering near a two-year high.



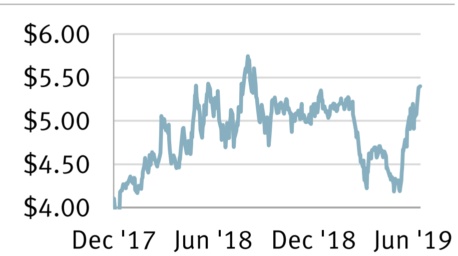
Soybeans – Higher

Global inventories declined to 112.5 million tonnes versus consensus expectations of 115 million tonnes. As a result, prices rebounded by about 11% m/m but remain below the 2019 high of $9.25/bushel. The USDA also lowered its 2018/2019 export forecast by 75 million bushels to 1.7 billion bushels, driven by intensification in the U.S.-China trade dispute. The 2019/2020 forecast was left unchanged.



Wheat – Cornering the market

Despite higher-than-expected global ending inventories, wheat prices experienced a sharp 16% m/m rally, driven in part by concerns over unfavourable weather in the U.S. and global yield uncertainties from areas such as Canada and Australia. A slower-than-anticipated start to the corn planting season may increase the usage of wheat in feed, which could create additional price support, in our view.



Source - RBC Wealth Management, Bloomberg; date range: 12/4/17–6/17/19

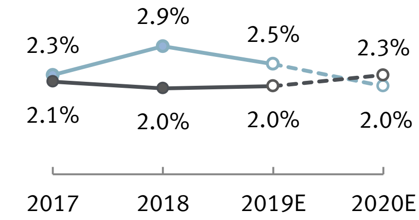
Richard Tan, CFA
Toronto, Canada
richard.tan@rbc.com

Key forecasts

Real GDP growth Inflation rate

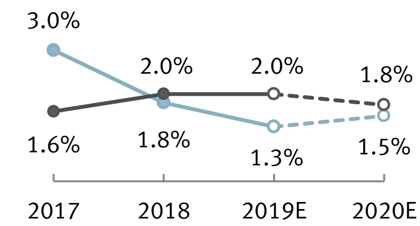
United States – Growth outlook questions

Hiring in May slowed to just 75,000 new jobs, well below consensus expectations of 175,000. Despite this, the unemployment rate remained 3.6%, the lowest in 50 years, keeping labor market sentiment intact. However, regional and national manufacturing indexes continue to signal slowing economic momentum, while consumer confidence has waned in recent months, raising questions about the growth outlook for the second half of the year.



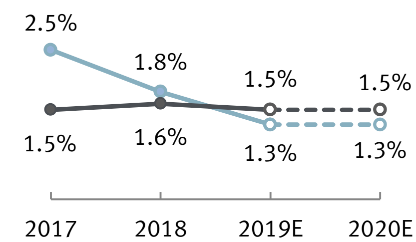
Canada – Labor stays strong

Canada's labor market continued its strong run of job gains with the unemployment rate reaching a fresh low, showing the country's economy is emerging from a recent slowdown. Job gains have accelerated to 453,000 jobs in the last 12 months, with the unemployment rate falling to 5.4%, the lowest since 1976.



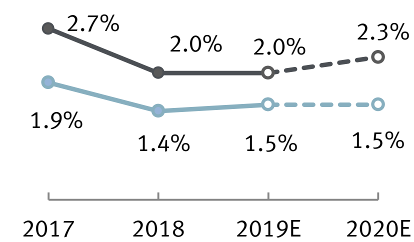
Eurozone – Uncertainty grows

Manufacturing activity remains mixed in the Eurozone. The Markit Manufacturing Purchasing Managers' Index has been stuck below 50 (signaling contraction) since February, while the Services PMI was stronger at 53.4. Retail sales growth is lagging, declining to -0.4%, indicating consumers are spending less as uncertainty grows. With sluggish GDP growth and subdued inflationary pressures, expectations are growing that the ECB will cut rates deeper into negative territory before the end of the year.



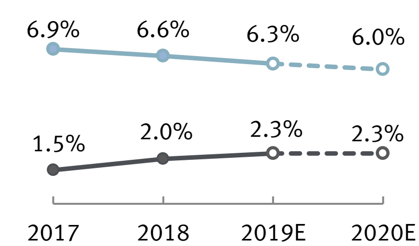
United Kingdom – Production sags

Industrial production fell 3% to -2.7% m/m, as did manufacturing production, which fell to -3.9% m/m. We believe Brexit chaos is largely to blame, as businesses and investors wait for a final outcome. Housing prices saw another slight decline as well, also due in part to Brexit uncertainty combined with unaffordable prices after two decades of rapid gains.



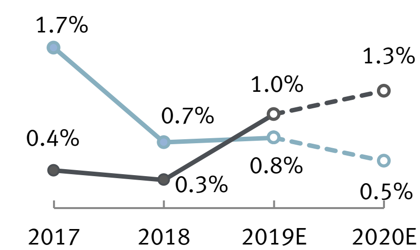
China – No resolution in sight

Despite the U.S.-China trade dispute, China's industrial production and trade balance beat estimates, mainly due to pre-existing orders. However, the outlook is for further deterioration in trading activity over the coming months as there is no clear path to a resolution in sight. Imports suffered in May, with an 8.5% decline y/y. China may decide to focus trading efforts outside the U.S., including Europe and Japan.



Japan – Better than expected

Industrial production through May shows that the economy is holding up better than expected amid ongoing pressure from the U.S.-China trade dispute. However, despite a labor market that will struggle to get any tighter, inflationary pressures are as muted as ever. Weakening external demand and low inflation may put pressure on the Bank of Japan to act, particularly as other central banks are expected to ease policy stances modestly this year.



Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management

Market scorecard

Index (local currency)	Level	1 month	YTD	12 month
S&P 500	2,752.06	-6.6%	9.8%	1.7%
Dow Industrials (DJIA)	24,815.04	-6.7%	6.4%	1.6%
NASDAQ	7,453.15	-7.9%	12.3%	0.1%
Russell 2000	1,465.49	-7.9%	8.7%	-10.3%
S&P/TSX Comp	16,037.49	-3.3%	12.0%	-0.1%
FTSE All-Share	3,923.87	-3.5%	6.8%	-7.1%
STOXX Europe 600	369.06	-5.7%	9.3%	-3.7%
EURO STOXX 50	3,280.43	-6.7%	9.3%	-3.7%
Hang Seng	26,901.09	-9.4%	4.1%	-11.7%
Shanghai Comp	2,898.70	-5.8%	16.2%	-6.4%
Nikkei 225	20,601.19	-7.4%	2.9%	-7.2%
India Sensex	39,714.20	1.7%	10.1%	12.4%
Singapore Straits Times	3,117.76	-8.3%	1.6%	-9.1%
Brazil Ibovespa	97,030.32	0.7%	10.4%	26.4%
Mexican Bolsa IPC	42,749.16	-4.1%	2.7%	-4.3%
Bond yields	**5/31/19**	**4/30/19**	**5/31/18**	**12 mo. chg**
US 2-Yr Tsy	1.922%	2.266%	2.427%	-0.51%
US 10-Yr Tsy	2.125%	2.502%	2.859%	-0.73%
Canada 2-Yr	1.429%	1.563%	1.918%	-0.49%
Canada 10-Yr	1.488%	1.712%	2.244%	-0.76%
UK 2-Yr	0.600%	0.764%	0.610%	-0.01%
UK 10-Yr	0.886%	1.185%	1.230%	-0.34%
Germany 2-Yr	-0.659%	-0.584%	-0.656%	0.00%
Germany 10-Yr	-0.202%	0.013%	0.341%	-0.54%
Commodities (USD)	**Price**	**1 month**	**YTD**	**12 month**
Gold (spot $/oz)	1,305.45	1.7%	1.8%	0.5%
Silver (spot $/oz)	14.57	-2.5%	-6.0%	-11.3%
Copper ($/metric ton)	6,486.50	-9.7%	-2.4%	-15.2%
Uranium ($/lb)	20.90	-0.5%	-12.6%	-7.7%
Oil (WTI spot/bbl)	53.50	-16.3%	17.8%	-20.2%
Oil (Brent spot/bbl)	64.49	-11.4%	19.9%	-16.9%
Natural Gas ($/mmBtu)	2.45	-4.7%	-16.5%	-16.9%
Agriculture Index	273.20	9.5%	3.1%	-6.2%
Currencies	**Rate**	**1 month**	**YTD**	**12 month**
US Dollar Index	97.7500	0.3%	1.6%	4.0%
CAD/USD	0.7398	-0.9%	0.9%	-4.1%
USD/CAD	1.3516	1.0%	-0.9%	4.3%
EUR/USD	1.1169	-0.4%	-2.6%	-4.5%
GBP/USD	1.2629	-3.1%	-1.0%	-5.0%
AUD/USD	0.6938	-1.6%	-1.6%	-8.3%
USD/JPY	108.2900	-2.8%	-1.3%	-0.5%
EUR/JPY	120.9600	-3.2%	-3.9%	-4.9%
EUR/GBP	0.8841	2.8%	-1.6%	0.5%
EUR/CHF	1.1178	-2.2%	-0.7%	-3.0%
USD/SGD	1.3748	1.0%	0.9%	2.8%
USD/CNY	6.9050	2.5%	0.4%	7.7%
USD/MXN	19.6165	3.5%	-0.2%	-1.5%
USD/BRL	3.9232	0.1%	1.3%	5.4%

Dovish central banks buoyed equities in June, reversing May's losses.

The U.S. Treasury yield curve steepened and the two-year yield dropped in June as the market priced in Fed rate cuts.

WTI crude oil rallied sharply in June amid increased tensions in the Persian Gulf.

The U.S. dollar weakened in June, although still flat YTD, as the Fed took a dovish turn and interest rates fell.

Equity returns do not include dividends, except for the Brazilian Ibovespa. Equity performance and bond yields in local currencies. U.S. 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. Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -4.1% return means the Canadian dollar has fallen 4.1% vs. the U.S. dollar during the past 12 months. USD/JPY 108.29 means 1 U.S. dollar will buy 108.29 yen. USD/JPY -0.5% return means the U.S. dollar has fallen 0.5% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 6/30/19.

Research resources

This document is produced by the Global Portfolio Advisory Committee within RBC Wealth Management's Portfolio Advisory Group. The RBC Wealth Management Portfolio Advisory Group provides support related to asset allocation and portfolio construction for the firm's investment advisors / financial advisors who are engaged in assembling portfolios incorporating individual marketable securities. The Committee leverages the broad market outlook as developed by the RBC Investment Strategy Committee, providing additional tactical and thematic support utilizing research from the RBC Investment Strategy Committee, RBC Capital Markets, and third-party resources.

Global Portfolio Advisory Committee members:

Jim Allworth – Co-chair; Investment Strategist, RBC Dominion Securities Inc.

Kelly Bogdanova – Co-chair; Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group U.S., RBC Capital Markets, LLC

Frédérique Carrier – Co-chair; Managing Director, Head of Investment Strategies, Royal Bank of Canada Investment Management (U.K.) Limited

Mark Bayko, CFA – Head, Portfolio Management, RBC Dominion Securities Inc.

Craig Bishop – Lead Strategist, U.S. Fixed Income Strategies Group, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

Laura Cooper – Head of FX Solutions and Strategy, Royal Bank of Canada Investment Management (U.K.) Limited

Janet Engels – Head of Portfolio Advisory Group U.S., RBC Wealth Management, RBC Capital Markets, LLC

Tom Garretson, CFA – Fixed Income Portfolio Strategist, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

Christopher Girdler, CFA – Fixed Income Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group, RBC Dominion Securities Inc.

Patrick McAllister, CFA – Canadian Equities Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Dominion Securities Inc.

Alan Robinson – Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group – U.S. Equities, RBC Capital Markets, LLC

Alastair Whitfield – Head of Fixed Income - British Isles, Royal Bank of Canada Investment Management (U.K.) Limited

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Additional Global Insight authors:

Judith Oliver – Business Development Analyst, Royal Bank of Canada, Singapore Branch

Richard Tan, CFA – Canadian Equities Associate Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Dominion Securities Inc.

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