

Global Insight

Perspectives from the Global Portfolio Advisory Committee

Collision course?

While a diplomatic off-ramp may emerge for the U.S. and Iran, the hawks appear to be circling, which leaves oil's risk premium set to take center stage.

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**Wealth
Management**

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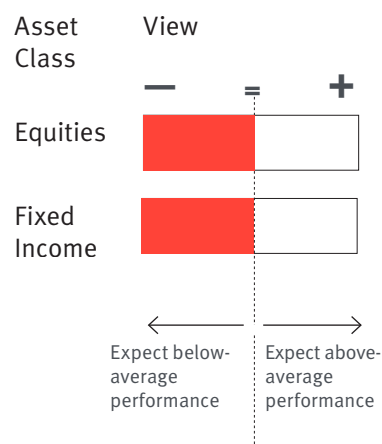
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All values in U.S. dollars and priced as of market close, July 31, 2019, unless otherwise stated.

RBC's investment stance

Global asset views



See “Views explanation”
below for details

Source - RBC Wealth Management

Equities

- We maintain our Market Weight in Equities. While manufacturing has softened in much of the world, services and the all-important U.S. consumer continue to be resilient, the latter sustained by a tight labor market and a healthy savings rate. Moreover, most central banks have recently eased or are planning to. Markets look capable of delivering positive all-in returns over the coming 12 months.
- Volatility may well return, however, with Iran tensions, tariff disputes and Brexit possibly all coming to a head over the next few months. We are Overweight in Japan, where domestic indicators are still positive and valuations very attractive; we are Underweight in Europe, where valuations are slightly demanding after a good run and do not reflect the ongoing economic slowdown and the region's political risks, in our view.

Fixed income

- Federal Reserve policymakers delivered a late-July rate cut to ensure the current economic expansion continues in the face of slowing global growth and benign inflation. The Federal Open Market Committee (FOMC) did not commit to further cuts and, while we agree this is not the start of a prolonged easing cycle, we foresee additional cuts ahead. Implied probabilities predict a near-95% likelihood of another cut at the September meeting. Accordingly, the general direction of U.S. Treasury yields should be to lower levels. Other major central banks are likely to join the Fed by implementing dovish policies.
- We maintain our Market Weight in global fixed income. The prevailing view, given late-cycle issues, is that investors are best served by a continued focus on quality. And with the likelihood of lower rates, reinvestment risk should remain a concern.

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.

Collision course?



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With hardliners in both the U.S. and Iran holding sway, the two longtime adversaries remain locked in a bellicose standoff that threatens to boil over. While a diplomatic off-ramp may yet emerge, we believe the current oil price does not really reflect the degree of risk that potential incidents represent. Investors shouldn't see the escalating conflict as "business as usual."

Though trade war concerns have roiled the oil market at times recently, we continue to contend that events in the Middle East warrant very close attention.

While many oil market participants see the recent security incidents as business as usual for the region, we see an abundance of escalation risks in large part because the U.S. sanctions are subjecting Iran to almost unprecedented economic pain.

U.S. President Trump continues to insist publicly that he is not seeking regime change in Iran, rather merely a better nuclear deal. However, from Tehran's vantage point there is probably an extremely thin line between measures designed to cause an economic collapse and explicit calls for new leadership.

If Washington holds the line on the sanctions and sticks with its hardline conditions for economic relief, it is difficult to envision a diplomatic breakthrough emerging in the near term, particularly given the marked preference of Iran's supreme leader, Ayatollah Ali Khamenei, for showing strength and avoiding concessions during a crisis.

While both the White House and Iranian leadership insist they do not want a war, we maintain that there remain several red lines that if crossed could be a catalyst for a military conflict.

Key Iranian nuclear sites



If Iran resumes spinning second-generation centrifuges at Natanz, it could significantly shrink the timeline to assemble a crude nuclear device.

Source - Harvard Kennedy School Belfer Center, RBC Capital Markets

In our view, a precondition for de-escalation is a resumption of some oil export waivers, enabling Iran's government to stay afloat and stave off social unrest. That said, the White House seems reluctant to frontload any economic concessions to kick start diplomatic talks; thus, we see no end to the cycle of escalation in the near term.

Depending on the exact outcome, an increasingly worrying security crisis could unfold in a manner not yet fully appreciated by the oil market.

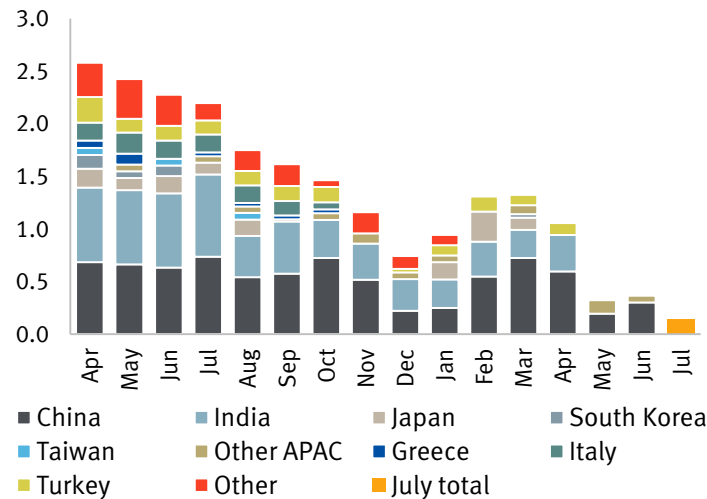
Maximum pressure, maximum tension

We believe that escalation of this crisis will likely be the order of the day as long as the U.S. continues its “maximum pressure” policy and insists that Iran completely abandon its revolutionary agenda in order to receive economic relief.

The White House's decision in April to eliminate all exemptions for importers of Iranian oil has dealt a crippling blow to Iran's economy. According to the International Monetary Fund, oil accounts for almost 80% of Iran's tax revenue. The country has already lost \$10B since the U.S. sanctions took effect in November 2018.

Iranian oil exports

Millions of barrels per day, monthly, since April 2018



Source - Petro-Logistics SA, Harvard Kennedy School Belfer Center, RBC Capital Markets

Hardline elements in Iran have become ascendant since the U.S. exited the 2015 JCPOA nuclear deal (Joint Comprehensive Plan of Action) last year, and they have vowed a more forceful response to the U.S. measures that they contend are designed to cause an economic collapse and trigger regime change.

Qassem Soleimani, commander of the elite Quds Force of Iran's Revolutionary Guard, and described by a former CIA officer in Iraq as the “single most powerful operative in the Middle East,” may not want a full-blown shooting war, but he may be willing to push the region to the brink of one to get the U.S. and its allies to reconsider their course of action.

U.S. Secretary of State Mike Pompeo detailed 12 demands in May that Iran would need to accept in order to receive relief from sanctions and normalize relations with the U.S. If accepted, they would essentially end the revolutionary nature of the Iranian regime. Hence, we believe they are a non-starter for Supreme Leader Khamenei, who is the ultimate decider on Iran's nuclear program and its military posture. Enmity toward America is one of Khamenei's core organizing principles, as is a belief that one should never compromise under pressure.

Crossing the enrichment red line

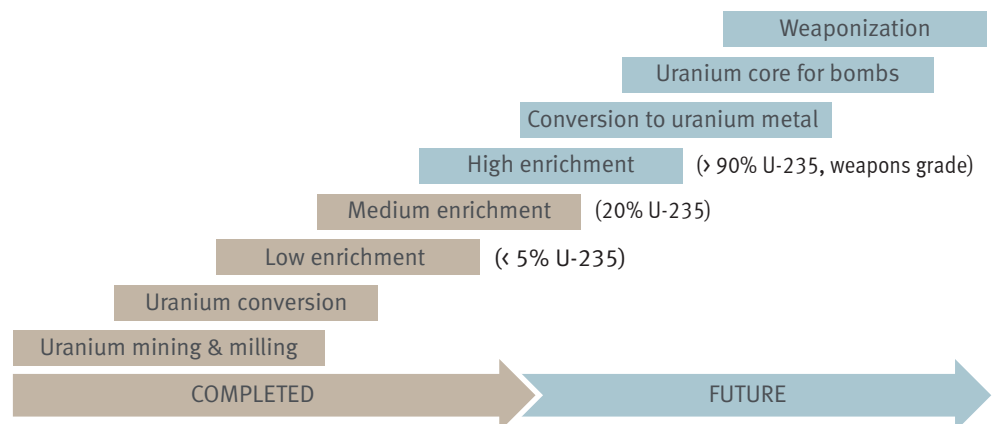
In response to Washington's maximum pressure campaign, Tehran has raised the specter of once again enriching uranium at levels close to weapons grade and spinning the high-speed centrifuges that will sharply shrink the time needed to assemble a crude nuclear device.

The key thing to watch, in our view, will be the pace at which Iran ramps up enrichment. Prior to signing the JCPOA deal, Iran was enriching uranium at the 20% level, which is 90% of the way to weapons grade. Hence, we believe a resumption of 20% enrichment would represent a critical development that would likely precipitate a very strong response from Washington and its regional allies such as Israel.

The type of centrifuges Iran uses will also be critical. Iran is allowed to enrich uranium with its first-generation IR 1M devices, but it has much faster second-generation centrifuges under lock and key at the Natanz enrichment facility. If it breaks the seals and resumes spinning the IR 2M, Iran will be able to significantly shrink the timeline to reaching "breakout" capability and being able to quickly assemble a crude nuclear device.

Also worrisome, some senior officials have hinted that Iran could exit the 1968 Nuclear Non-Proliferation Treaty (NPT). While the NPT recognizes the "inalienable right" of states to research, develop, and use nuclear energy for civilian purposes, signatories agree to forgo developing or acquiring nuclear weapons. Hence, an Iranian withdrawal would be an explicit signal that its nuclear programs have a military dimension, and could cause a security crisis, one that many in the oil market had seemingly written off or at least shrugged off for now.

Iran's path to a nuclear weapon



Source - Harvard Kennedy School Belfer Center, Nuclear Threat Initiative, RBC Capital Markets

The war whisperers

A “Guns of August” scenario is by no means inevitable, as Trump continues to display an aversion to Middle East military entanglements. Yet, there are U.S. officials who appear willing to push the envelope to the brink of war in order to advance their strategic objectives. For example, U.S. National Security Advisor John Bolton has spearheaded the effort to isolate Iran and pushed for coercive policies, and has never hidden his desire to see the current Iranian government fall.

Some seem willing to risk an actual war, believing it would be short in duration due either to an overwhelming conventional military advantage or a perception that their adversary does not have the stomach for a protracted, asymmetrical struggle. In an environment where lines of back channel communication are closing, a “fog of war” scenario can take hold and major miscalculations can occur.

There is a corner of the oil market that dismisses the latest Iran warnings as a continuation of the overhyped fear-mongering machine. These voices point to the absence of a prior conflict as evidence that one will not occur in the future.

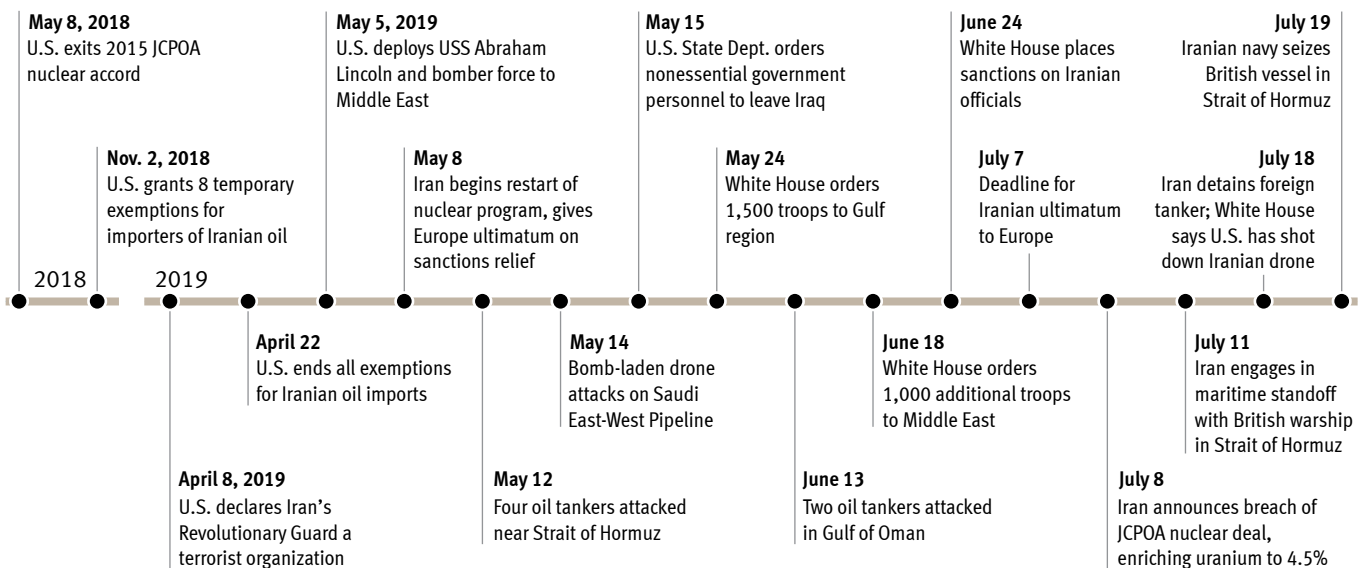
From our vantage point, the current situation feels qualitatively different due in large part to who is sitting in the seats of power in the U.S. and Iran. The hawks appear to be in ascendancy and individuals urging restraint have seen their influence eroded.

Regional tripwires

While Trump has insisted that he only wants a more robust nuclear deal, events surrounding the crisis may force him to use military options.

Iran would have a very hard time closing the Strait of Hormuz due to the presence of the U.S. Navy’s Fifth Fleet in Bahrain. The strait is the world’s most important energy chokepoint, with around 30% of the world’s seaborne barrels traveling

Timeline of the evolving situation



Source - RBC Capital Markets

through the narrow waterway every day. Its security is of paramount importance for Middle Eastern energy exporters and the U.S.

However, despite the Fifth Fleet's presence, Iran has the strategic depth to stage one-off attacks on vessels—and has already been accused of doing so—not just in the strait but also in the relatively open waters of the Persian Gulf and the Gulf of Oman, and can leverage both its proxies and asymmetric capabilities.

Other potential regional flashpoints also warrant close monitoring:

- Iran can work through proxies like the Houthis, who are often portrayed by the Trump administration as the Yemeni equivalent to Hezbollah. Last year, the Houthis were linked to two attacks on Saudi tankers in the Red Sea. The Iranians have reportedly provided a range of missile technology to the Houthis. If a Saudi tanker was actually sunk or a major civilian target within Saudi Arabia was struck, we believe the risk of a direct military response from Riyadh and/or Washington would be very high.
- There is rising concern in U.S. and Israeli security circles that the Revolutionary Guards have been transferring advanced missile technology to Shia militias in Iraq. These reports were part of the reason for the evacuation of nonessential employees from the U.S. embassy in Baghdad in May. Definitive evidence of cross-border missile proliferation and/or a rocket attack by one of these proxies would undoubtedly inflame tensions.
- Similarly, a major attack on American military personnel in Iraq by one of these Iranian-linked groups would likely serve as a catalyst for conflict.

Risk reality

While a diplomatic off-ramp may yet emerge, the hawks appear to be circling, which leaves oil's risk premium set to take center stage.

We believe the current oil price does not really reflect the degree of risk that potential incidents represent and that an Iranian attack resulting in the death of U.S. military personnel or a major nuclear restart (especially a withdrawal from the NPT) would provoke a robust U.S. military response, including air strikes on Iranian targets such as the Natanz enrichment facility.

Trump continues to warn Tehran against further escalations and is vowing to impose additional sanctions, but at the same time insists he is willing to restart talks. We see slim chances of a diplomatic breakthrough in the near term as the Iranian leadership continues to insist on the lifting of sanctions as a precondition for returning to the negotiating table.

A safe harbor may yet emerge—especially if Tehran takes up Trump's offer for negotiations—but it does not appear to be on the immediate horizon as we navigate these dangerous waters.



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The new rules of the global oil market

Michael Tran, Managing Director and Commodity Strategist with RBC Capital Markets, LLC, provides his take on what factors could influence crude prices over the rest of 2019. While OPEC remains committed to balancing the market, this will prove more challenging in the years ahead as we transition to a demand-driven market.

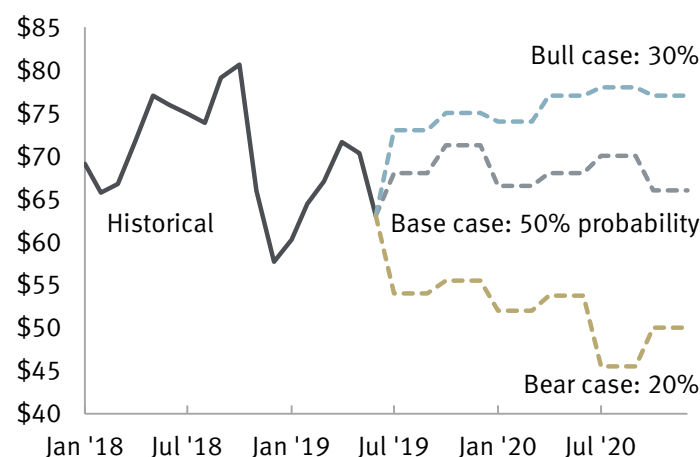
Q. How do you see the global oil market shaping up for the rest of the year?

A. Not all markets are created equal. Rebalancing a supply-driven market is materially easier than finding equilibrium in a market driven by demand weakness. The past five years featured the former, while the years ahead will likely center on the latter. Furthermore, global refinery runs peak in the summer, and while this is bullish for crude demand over the season, refinery utilization rates warrant close attention given that refining margins are weak in many regions, particularly in Asia and the Mediterranean. This signals either softening end-user demand for refined products, a regional excess of supply, or both.

The rules of bullishness are different in a demand-driven market. Production outages are headline bullish, but in a softening-demand market, a major supply outage from a geopolitical hotspot triggering a rally in crude prices could squeeze refining margins from both ends (i.e., higher crude input costs and weak product selling prices) and result in widespread cuts in refinery runs and lower crude demand.

Brent crude pricing scenarios: bull, bear, and base cases

Historical and projected price per barrel



Crude prices will likely remain rangebound in H2 2019, with Brent averaging \$69.50/bbl and WTI \$63/bbl.

Source - RBC Capital Markets

The market will likely oscillate within a range through the balance of the year, with Brent and WTI prices averaging \$69.50/barrel (bbl) and \$63/bbl, respectively. We also anticipate that WTI will outperform Brent in Q3 2019 given the weakening demand backdrop for Brent-linked barrels, while firming U.S. exports anchor a tightening North American balance. The opposite is likely to be true in Q4 when rising Permian production is expected to pressure Gulf Coast port capacity and thereby prompt Brent to outpace its North American counterpart.

Q. What are the bullish catalysts to look out for?

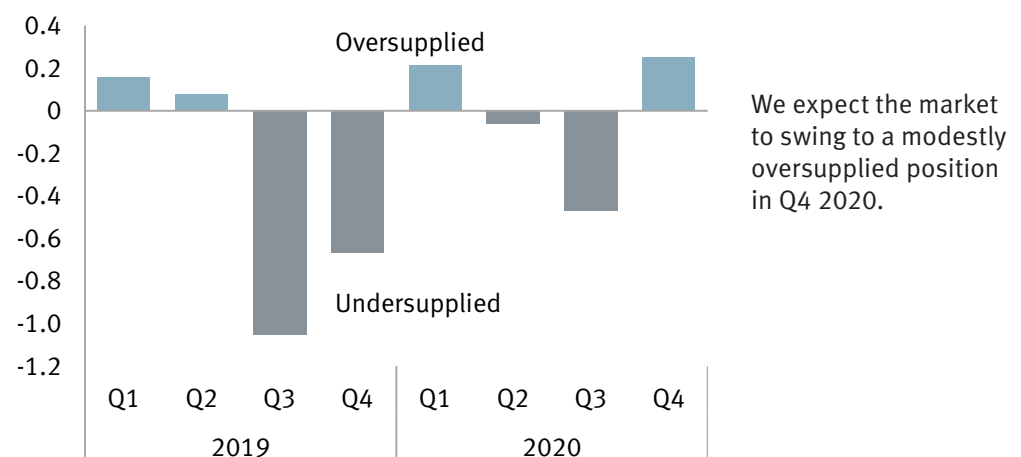
A. The most structurally bullish crude price scenario for the next cycle is one in which poor margins lead to several Asian or European refineries shutting (resulting in an expansion of refining margins and increased global utilization) together with a sizable and sustainable crude production outage in a geopolitically fraught country. In other words, sloppy product balances must be cleaned up before crude can stage a sustainable and material rally. Such a development would be constructive for the entire oil complex, even with a softer crude demand growth backdrop. Ultimately, while we see room for oil prices to improve, underpinned by a plethora of geopolitical risk factors, we anticipate that rallies will be capped unless product demand improves.

Q. What are the forward-looking implications of the most recent OPEC+ meeting?

A. By establishing a clear, tangible, and meaningfully lower target for inventories, OPEC+ (the coalition formed by OPEC and certain non-OPEC partners to manage production volumes) drew a line in the sand for what could prove to be a multi-quarter—but more likely a multi-year—rebalancing process. Given the exogenous factors at play, the path of ridding the market of some 160 million barrels and guiding OECD crude inventories back to 2010–2014 levels will be a long, drawn-out process. One should not question OPEC's resolve or commitment to rebalancing the market, but the path to this goal and the time required remain ambiguous.

Global oil supply and demand balances

Millions of barrels per day



Source - RBC Capital Markets, IEA, Petro-Logistics SA, EIA, JODI, company and government sources

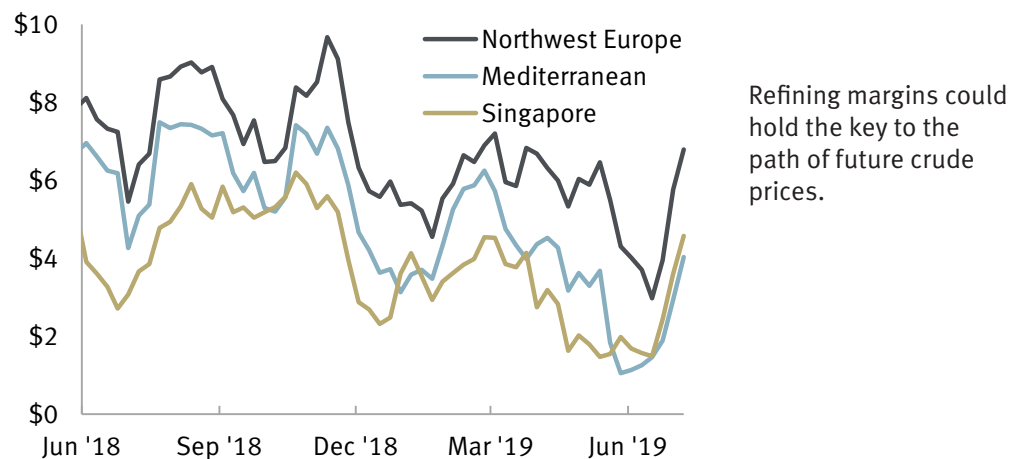
How difficult it will be to return inventories to prior levels also remains an open question, but again one must consider that not all markets are created equal. It is easier for the group to rebalance a market defined by excess supply by reducing output than to rebalance a market driven by demand weakness.

Q. What are the downside risks for the oil market?

A. Outside of the Trump wildcard that could roil many markets, in our opinion, the biggest potential threat to the global oil market for the balance of year is that refining could be drawn into a vicious cycle of falling margins and lower demand. The summer months typically see peak refinery runs as units around the world return from maintenance. This should be bullish for crude demand, but refinery utilization rates bear watching given that margins are weak in many regions, particularly in Asia and Europe. For example, Asian refining margins have weakened over recent months to the point that certain crack spreads have been flirting with negative territory. This means that continuing to produce end-use product is a money-losing proposition.

Regional hydroskimming refinery margins

Dollars per barrel



Refining margins could hold the key to the path of future crude prices.

Source - RBC Capital Markets, Bloomberg, industry reporting, Chinese Customs General Administration

We have been conditioned to assume that production outages are bullish for crude balances, and this is typically the case, but in a softening-demand market, a major outage and a subsequent rally in crude prices could pinch refining margins and result in cuts to refinery runs and lower crude demand. Overall, Asia has added refining capacity over recent quarters and unless product demand improves markedly, the most likely scenario is that regional margins will remain merely firm enough to sustain reasonable run rates. Excess product balances can only be absorbed during the spring and fall refinery maintenance seasons. This is the vicious cycle.

Q. Is there a release valve that can allow gasoline margins to rise?

A. The recent closure of the Philadelphia refinery (PES) following a fire is bearish for crude but can be seen as a temporary release valve for a saturated gasoline

New rules of the oil market

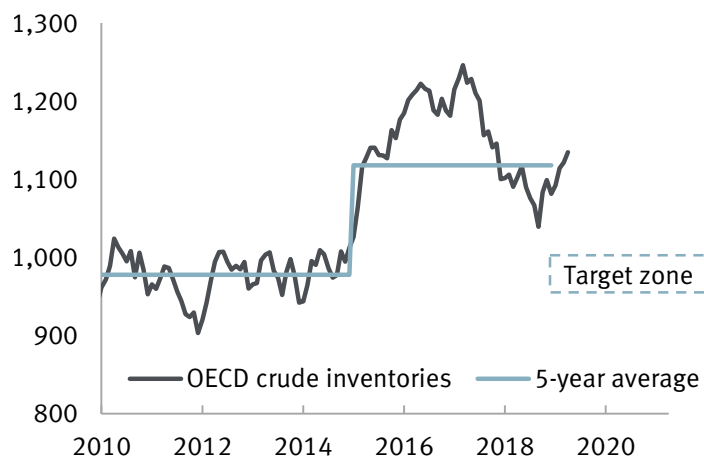
market. Naturally, shutting a refinery destroys crude demand, and the 235,000 barrels per day (bbl/d) of light crude that PES imported will be left behind in the Atlantic Basin (hence the recent physical weakness and soft Brent spreads). Most of the crude consumed by PES was of a grade typically imported from the North Sea and West Africa. Those barrels will need to find alternative homes. On the bullish front, gasoline makes up nearly 50% of the U.S. East Coast refinery yield; without PES, the region will be left short of gasoline and forced to lean heavily on imports from across the Atlantic. Sourcing additional gasoline domestically is difficult because major pipelines operate near capacity and regulatory requirements make shipping up the East Coast economically undesirable. The region currently imports some 500,000 bbl/d of gasoline, mainly from Europe, a figure set to rise with the PES closure. We believe the East Coast will pull otherwise stranded barrels of gasoline across the Atlantic, temporarily supporting gasoline margins that are generally lackluster on a global basis.

The bottom line

We believe the OPEC+ effort to balance the oil market by guiding global crude inventories down to 2010–2014 levels will take time. It is a welcome and necessary development given that refining economics have weakened in Asia and parts of Europe. The status quo should allow Brent and WTI prices to average \$69.50/bbl and \$63/bbl, respectively, over the balance of 2019. A truly bullish outcome would require a combination of stronger product demand and a meaningful, sustained disruption in crude production.

OECD crude oil inventories

Millions of barrels



OPEC+ has set a meaningfully lower inventory target, but the path to rebalancing is likely to span years.

Source - RBC Capital Markets, IEA

Wanted: Growth clarity

When the big U.S. corporate tax cut arrived on the scene in the Tax Cuts and Jobs Act of late 2017, consensus earnings estimates for 2018 and 2019 surged higher, mostly in response to enthusiastic forward guidance emanating from CEOs.

The optimism around 2018 results was borne out—S&P earnings per share jumped by a startling 23% to \$162. But for 2019? Not so much. Consensus estimates for 2019 peaked at \$179 per share in October of last year. They have been receding ever since and now sit at \$165, up a skinny 2% from the posted 2018 result.

That leaves the S&P 500 trading at a reasonable, if somewhat fully priced, 18.2x this year's expected earnings. The market can certainly move higher from here, in our view. If it does, that probably will signal investor conviction is growing that next year's consensus earnings estimate of \$175–\$180 will be delivered. Such conviction has been lacking largely because management guidance has been either not forthcoming or qualified, usually because of “trade uncertainty” or “tariffs.”

Most other developed economy stock markets are trading at significant discounts to the S&P on the basis of price-to-earnings ratios—exacerbated in almost every case by currencies that are weaker than a year ago. In our view, the wide valuation gap is explained by the fact that all the underlying economies—Europe, Canada, the U.K., and Japan—are significantly more exposed to global trade than is the U.S. economy.

Equity views

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

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

Trade uncertainty, if anything, is more elevated than it was six months or a year ago. And many believe the deeper into the U.S. presidential election season we go the less likely it will be that any substantive deals with China or Europe will be reached, or that any deals which are concluded will pass congressional muster.

For our part, we expect that stock markets will go on climbing this “wall of worry” that has plenty of other bricks in it beyond just trade. We recommend Market Weight exposure to global equities (we are Overweight Japan and Underweight Europe). As is often mentioned in this space, our principal defensive focus is on seeing the next U.S. recession coming ahead of time. So far, the risks of one arriving in the next 12 months remain acceptably low.

Regional highlights

United States

- With the major U.S. equity indexes sitting near all-time highs, we recommend staying invested at the long-term strategic level, which equates to Market Weight or benchmark positioning.

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- Economic and corporate earnings momentum could remain muted in the near term, yet they are more stable than in most developed countries and do not show signs of tipping into recession. Q2 GDP rose 2.1% q/q annualized, below 3.1% in Q1, but was supported by strong consumer spending. The Federal Reserve's 25 basis point rate cut in July should support the economy, and additional cuts could be in the offing if global growth remains weak and trade/tariff threats linger.
- S&P 500 Q2 earnings growth is tracking at 1.3% y/y, better than the slightly negative consensus forecast when the earnings season began. We anticipate modest earnings growth will repeat in Q3 and Q4, which would be normal following the blockbuster 23% y/y surge in profits in 2018.
- Among segments of the U.S. market, we think small-cap equities are particularly attractive. The valuation disparity between large and small caps has widened recently, with the latter becoming even cheaper on a relative basis. Small caps also have less exposure to trade/tariff and global growth uncertainties due to

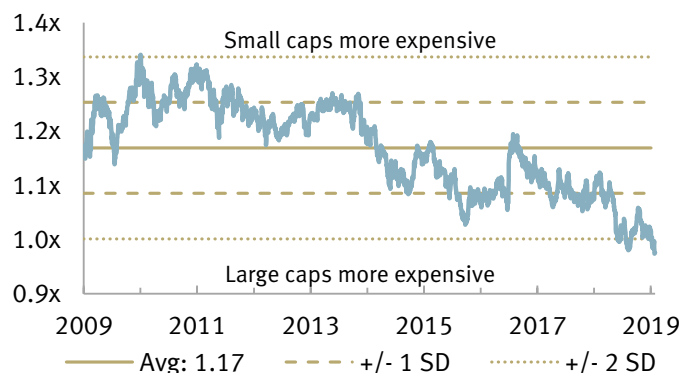
a lower proportion of international revenues. Earnings revision trends have been more resilient than large-cap indexes, and margin pressures seem to be in the rearview mirror.

Canada

- The S&P/TSX Composite's strong year-to-date performance has reasserted itself since May's broader weakness in global equity markets. The domestic benchmark has managed a total return of 14.6%, trailing the MSCI World and S&P 500 indexes at 16.6% and 18.9%, respectively. The price of WTI crude is well off its April high but is nevertheless up 29.6% from its year-end 2018 level. Despite the commodity price tailwind, Energy remains the S&P/TSX Composite's worst-performing sector year to date.
- The confluence of expectations for dovish monetary policy and geopolitical risks has pushed gold prices to \$1,428/oz., the highest level in six years. This is notably above the forecast of RBC Capital Markets' gold equity research team of \$1,326/oz. and \$1,350/oz. for 2019 and 2020, respectively. RBC Capital Markets' gold forecast is predicated on its expectation the global economy

U.S. small-cap versus large-cap forward P/E ratios

iShares Core S&P Small-Cap ETF versus iShares Core S&P 500 ETF



Small caps look cheap compared to large caps.

Source - RBC Wealth Management, FactSet; SD = standard deviation

remains in expansion mode and geopolitical risks subside. However, the group acknowledges that gold equities will trade around Fed rate expectations and market sentiment in the near term.

- RBC Economics believes Canadian policymakers must be pleased with recent housing market data. On a national level, June resale activity was essentially flat both sequentially and year over year, while benchmark prices have closely mirrored year-ago levels for the past six months. To be sure, national metrics cloud pockets of regional weakness (i.e., Vancouver prices declined nearly 10% y/y in June), but the overall picture is reassuring for policymakers looking to address the issues of housing affordability and household debt.

Continental Europe & U.K.

- The U.K.'s new prime minister, former foreign secretary and "Leave" campaign leader Boris Johnson, is inheriting the same challenges that felled his predecessor. The government, even propped up by Northern Ireland's Democratic Unionist Party, has a wafer-thin majority and Parliament is still largely opposed to a "no-deal" Brexit. Meanwhile, the October 31 exit deadline is looming.
- Visibility as to how Brexit will unfold has not improved, and a no-deal Brexit, while not our base-case scenario, cannot be assumed away. A delay in delivering Brexit, due to a general election in the autumn, is the most likely outcome, in our view.
- We remain Market Weight U.K. equities thanks to attractive valuations, with the MSCI United Kingdom Index trading at 12x 2020 consensus earnings estimates and

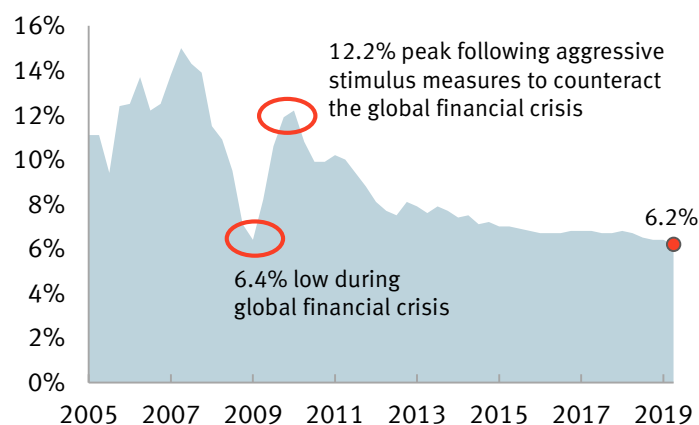
having a dividend yield of 4.8%. We suggest investors focus on globally diversified companies.

- We downgraded our stance on European equities to Underweight in June (from Market Weight) as the global economic slowdown takes its toll on this export-dependent region. After the strong equity rally year to date, we believe valuations no longer reflect political and economic headwinds such as trade conflicts and Brexit uncertainty.
- Nevertheless, we maintain there is room in portfolios for an allocation to include well-managed European companies with strong business models and secular growth drivers. In our view, these opportunities can be found in the Consumer Discretionary, Consumer Staples, and Health Care sectors, as well as in some Industrials companies.

Asia

- Within Asia-Pacific ex-Japan, we are neutral on the China and Hong Kong markets. While valuations are comparatively undemanding when matched against European and U.S. indexes, upside potential might be capped due to serious U.S.-China trade frictions remaining unresolved. Economic uncertainty, therefore, continues to be an overhang, particularly in light of deceleration in China's GDP growth.
- In our view, investors should focus on sectors not directly exposed to tariff risk. We prefer Chinese banks given their stable dividend payouts and undemanding valuations. Any cuts to the reserve requirement ratio should benefit the group because liquidity would be boosted. Also, within Financials, we think insurance companies present attractive

China quarterly GDP growth (y/y %)



China's economic momentum has steadily decelerated since its post-financial crisis surge. Trade and tariff tensions, combined with structural economic challenges, have weighed on growth recently.

Source - RBC Wealth Management, Bloomberg; data from Q1 2005 through Q2 2019

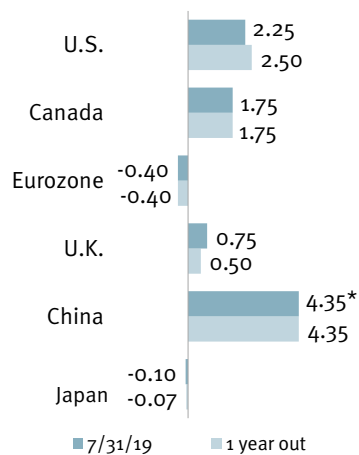
investment opportunities owing to strong value of new business (VONB) growth, friendly demographics, and an expanding middle class in certain countries, particularly China and parts of Southeast Asia. We also favor Telecommunication Services issues and select property developers.

- For Japan, our Overweight view reflects: (1) that the Bank of Japan is continuing to lend support through the injection of capital into exchange-traded funds; (2) a trade deal is being mapped out between Japan

and the U.S., including a settlement involving the agriculture and auto industries; (3) the country's political environment being stable with Prime Minister Shinzo Abe enjoying lofty approval ratings, particularly among young voters; and (4) the TOPIX being unusually attractively valued at 12.5x forward earnings (vs. a 15.6x five-year average). Data indicate that share repurchases so far this year have come to 5.825 trillion yen, more than doubling the amount recorded in the year-earlier period.

Prepare for the not-so-silly season

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

The silly season, or dog days, is a time, particularly in late summer, when the mass media often focuses on trivial or frivolous matters for lack of major news stories. However, with some important central bank meetings at the end of July/early August—at the Federal Reserve, European Central Bank, and Bank of England—the outcomes of these meetings could delay or cancel this year's seasonal silliness.

Policy convergence is finally beginning, although it may not be as envisioned a couple of years ago when central banks were expected to tighten policy in tandem. With the Fed leading the way with the July rate cut (more should be expected into year-end) and signals that many other central banks in both developed and emerging countries are likely to follow suit in coming months, the serious (and not silly) message is that the global concerns of slow growth and low inflation will prolong the current low rate environment.

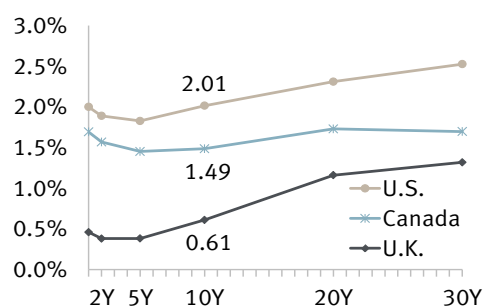
Where the silliness might enter into the central bank discussion, specifically for the Fed, is with questions about the need to aggressively ease policy when the economy, by some measures, seems to be doing well. To his credit, Fed Vice Chair Richard Clarida recently stepped in to provide the necessary seriousness by saying that while he sees “nothing of great concern,” the Fed must stand ready to act preemptively against an economic slowdown if needed. This same level of seriousness and foresight in current policy deliberations, we suggest, is also being demonstrated by other central bank leaders.

Fixed income views

Region	Gov't Bonds	Corp. Credit	Duration
Global	=	+	5–7 yr
United States	=	+	7–10 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

Regional highlights

United States

- The Fed delivered a widely expected 0.25% rate cut at its July 31 meeting to bring the fed funds rate to a range of 2.00%–2.25%, and signaled that it will continue to monitor the incoming data as it contemplates the future path of interest rates. However, the market reaction—yield curve flattening and a stock market selloff—suggests that, once again, the Fed has erred on the hawkish side. We believe the Fed made a mistake in not taking more aggressive action

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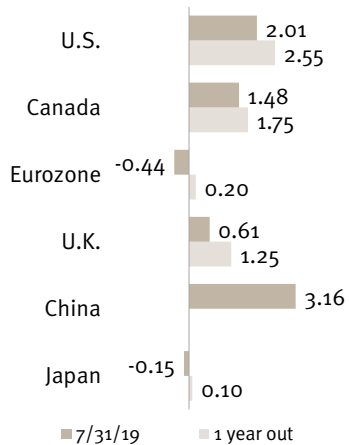
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Global fixed income

10-year rate (%)



Note: Eurozone utilizes German Bunds.

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

given ongoing weakness in economic data and further softness in inflationary pressures. We therefore expect a sustained series of rate cuts, beginning with another 0.25% rate cut at the September 18 meeting.

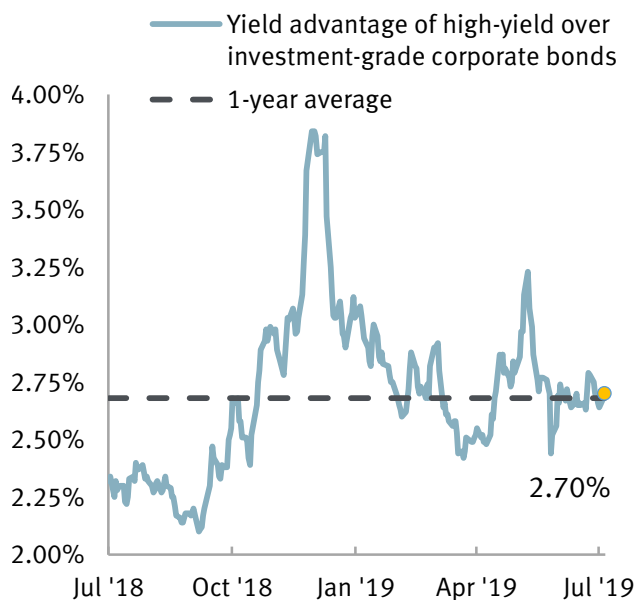
- High-yield corporates are beginning to look more attractive relative to their investment-grade counterparts, in our view. Over the last three months, investment-grade corporates have rallied 4.1% compared to just 1.6% for high-yield, according to Bloomberg Barclays indexes. As a result, high-yield now offers 2.7% of incremental income over investment-grade—equal to the one-year average, and up from a one-year low of 2.1%. Based on better valuations and with the tailwind of support from easier Fed policy, we have upgraded our outlook for the high-yield sector to Neutral, from slightly negative previously.
- Fund inflows into municipals have stretched to 29 consecutive weeks, continuing to fuel historically rich valuations. The short end of the

municipal bond yield curve (inside of five years) now yields just 64% of Treasuries' yield—the second-lowest level since 2000 and down from 80% of Treasuries' yield at the start of the year. A bump in supply is forecasted for August, and this may help create better entry points in the sector; however, with expensive valuations and the Fed beginning to cut rates, we continue to recommend investors extend maturities.

Canada

- The Bank of Canada (BoC) bucked the trend in July and kept its policy rate unchanged. That said, the policymaking Governing Council repeatedly noted that the ongoing trade conflict materially clouds its outlook for growth in Canada and beyond. Backing this stance, staff analysis showed that if the trade conflict worsens, Canadian growth would be hit twice as hard as the rest of the world. On top of this, the BoC staff demonstrated that the downside scenario, in which 25% tariffs are unilaterally imposed by all trading

Yield pickup of high-yield versus investment-grade bonds



We have upgraded our outlook for U.S. high-yield bonds to Neutral based on valuations and easier Fed policy.

Source - RBC Wealth Management, Bloomberg; data through 7/30/19

partners, would have three times the effect on the future output level than a positive resolution, in which the current tariffs are removed. With this in mind and after a few weaker data points released in July, Government of Canada bond yields slowly worked their way lower throughout the month.

- Low government bond yields continue to push investors towards higher-yielding assets, and Canadian corporate bonds are reaping the benefits. The additional compensation for owning corporate bonds over government bonds of similar maturity (approximately seven years) moved to 1.10% in July, the lowest level in 10 months. We find Guaranteed Investment Certificates (GIC) an attractive alternative for domestic investors willing to accept a lower liquidity profile.
- Canadian preferred shares bounced off their lows but remain deeply discounted, reflecting expectations of a weaker economic environment. Value has opened up for medium-term investors, in our view, especially when compared to corporate bonds, although it remains challenging to call a low point for this small, illiquid market.

Continental Europe & U.K.

- At the recent European Central Bank (ECB) meeting, President Mario Draghi followed through on his rhetoric from the June Sintra conference by establishing the framework for a range of measures to be implemented as soon as September.
- Draghi highlighted the possibility of further cuts to the deposit rate (currently -0.4%), supported by

a deposit tiering mechanism to improve the effectiveness of those cuts, and suggested the potential for a new net asset purchase program. There was also a change in forward guidance, as the ECB will from now on look at both actual inflation and inflation expectations.

- We see these measures as supportive for valuations and remain Market Weight government bonds and modestly Overweight corporate credit.
- In the U.K., the switch to more dovish guidance did not emerge and the Bank of England (BoE) continues to maintain a bias for potentially tighter monetary policy. The latest meeting instead only delivered a minor caveat to the previous language and did not reflect the “sea change” that Governor Mark Carney was talking about just last month.
- At present, given that the BoE’s Monetary Policy Committee (MPC) is maintaining an outlook based around a deal being negotiated by the Brexit deadline of October 31, it is likely that the next meeting in September may be a similarly muted affair. But if the U.K. leaves the EU without a deal, the November Inflation Report and subsequent meeting will likely see a notable shift, more closely reflecting recent market pricing.
- We anticipate a continuing demand for the perceived safe haven of government bonds up to at least the current Brexit deadline, and therefore maintain our 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; however, we counsel a selective approach.

Asia

- Economic activity in Asia has slowed this year, as it has in Europe and North America. However, a dovish Fed has catalyzed an easing bias among Asian central banks, and we believe this should support growth in the region. The Reserve Bank of India cut its policy rate from 6.00% to 5.75% in June. This was followed by cuts of 25 basis points (bps) by Bank Indonesia and the Bank of Korea, bringing their respective policy rates to 5.75% and 1.50%.
- Asian credit had a very strong first half of 2019. We have favored high-yield over investment-grade bonds since the beginning of the year, and the Bloomberg Barclays Asia USD High Yield Bond Index has achieved an 11% return year to date.
- We maintain our preference for Asia high-yield despite this outperformance, because attractive valuations offer a credit risk premium of around 470 bps over the U.S. risk-free rate. This, in our view, adequately compensates investors for the risk they take.
- However, we advocate a relatively defensive positioning within Asia high-yield as we expect volatility to pick up. The main risk we see would be a tightening of liquidity in China's onshore market. A deterioration on the trade front, a continued drop in global economic activity, and a strengthening of the U.S. dollar despite a dovish Fed stance could also create troublesome headwinds.

Currencies

Currency forecasts

Currency pair	Current rate	Forecast Jun 2020	Change*
Major currencies			
USD Index	98.52	95.95	-3%
CAD/USD	0.76	0.76	1%
USD/CAD	1.32	1.31	-1%
EUR/USD	1.11	1.15	4%
GBP/USD	1.22	1.31	8%
USD/CHF	0.99	1.00	1%
USD/JPY	108.8	114.0	5%
AUD/USD	0.68	0.67	-2%
NZD/USD	0.66	0.63	-4%
EUR/JPY	120.5	131.0	9%
EUR/GBP	0.91	0.88	-3%
EUR/CHF	1.10	1.15	4%
Emerging currencies**			
USD/CNY	6.88	6.81	-1%
USD/INR	68.8	69.50	1%
USD/SGD	1.37	1.35	-2%

* 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: Easing does it

The U.S. dollar found renewed support in July, with ongoing weakness in the global economy spurring demand for the greenback. A dovish tilt coming from other major central banks ostensibly offset what would typically be downward pressure on the dollar amid growing expectations for policy easing from the Fed. But given that the Fed has the greatest scope to ease policy amongst G10 central banks, and with rate cuts that could total 0.75%, in our view, the downside risks to the dollar appear to be building.

Euro: Ready for rate cuts

Ongoing economic weakness and signs from the European Central Bank that it is willing to reopen the stimulus taps have kept the euro under pressure against the U.S. dollar. Interest rates being driven deeper into the red or another round of bond purchases to spur growth remain possibilities. We see the former as more likely at this juncture; however, this could have a muted effect on the euro, with renewed dollar weakness poised to dominate the currency pair should the Fed deliver rate cuts as we expect.

British pound: Boris and Brexit

The British pound tumbled to early 2017 lows against the U.S. dollar in July amid an escalation in political

rhetoric around the U.K. leaving the EU without a deal at the end of October. The expressed willingness of new Prime Minister Boris Johnson to keep a “no-deal” Brexit on the table is keeping uncertainty elevated. With a chaotic exit remaining a possibility and political uncertainty persisting, pressure on the pound could build, in our view.

Canadian dollar: Loving the loonie

The Canadian dollar is the top-performing G10 currency year to date. A string of positive domestic economic data led the Bank of Canada to maintain its neutral policy guidance in July, which contrasted with the Fed acting on rate cuts. A narrowing between Canadian and U.S. rates thus drove the advance; however, the outperformance could have a short shelf life, with further gains likely to be capped by a dialing back of optimism from the Bank of Canada, in our view.

Japanese yen: Fading rally

A rally in the Japanese yen versus the U.S. dollar seen since April was supported by a pronounced shift in market expectations for the Fed to embark on an aggressive path of rate cuts. While the Fed did cut in July, any further easing appears priced into the dollar, which should keep the yen from moving materially higher, in our view.

British pound remains under pressure with Brexit deadline looming



Source - Bloomberg, RBC Wealth Management; data through 7/24/19

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Commodities

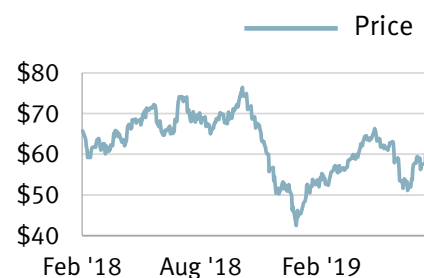
Commodity forecasts

	2019E	2020E
Oil (WTI \$/bbl)	\$60.20	\$61.76
Natural Gas (\$/mmBtu)	\$2.63	\$2.63
Gold (\$/oz)	\$1,326	\$1,350
Copper (\$/lb)	\$2.78	\$3.00
Soybean (\$/bu)	\$9.10	\$9.35
Wheat (\$/bu)	\$4.97	\$4.75

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

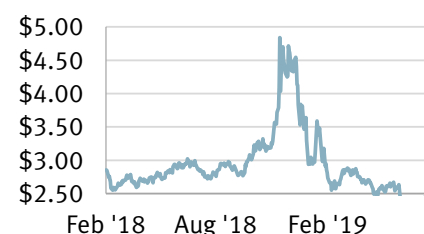
WTI – Strength in numbers

OPEC and its partners agreed to sustain their 1.2 million bbl/d curtailment program for an additional nine months (through March 2020) to rebalance the market. RBC Capital Markets' commodity strategists contend that rebalancing a market with weakening demand is incrementally more challenging than a supply-driven one (see [article](#) on page 9). The commodity team also believes the years ahead will likely feature more of the former. Prices increased 9% m/m.



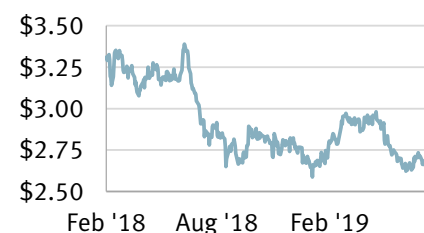
Natural gas – Price pressure

RBC Capital Markets' analysts have trimmed their 2019 forecast to \$2.63/mmBtu (from \$2.80/mmBtu), reflecting their view that growing gas production in the Permian could suppress prices in the near-to-medium term. That said, new Permian pipelines could offset some pricing pressure if they come online in H2 2019–2020. U.S. injections into storage have increased by approximately 50% y/y and are on pace to leave inventories above their historical average by late 2019.



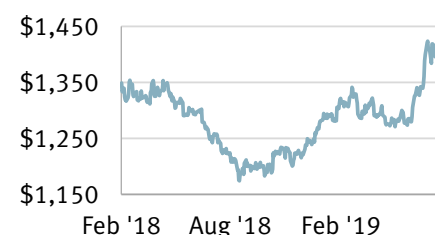
Copper – Cautiously optimistic

Copper prices are modestly higher, up approximately 2% m/m. The physical market remains tight with global inventories sitting at 2.8 weeks of global consumption. RBC Capital Markets' analysts remain cautiously optimistic as they believe key macro concerns (i.e., a slowing Chinese economy) are largely priced in. In the event of weaker economic data, RBC Capital Markets' analysts do not believe prices will decline significantly given current inventory levels and anticipation of growing supply deficits through 2024.



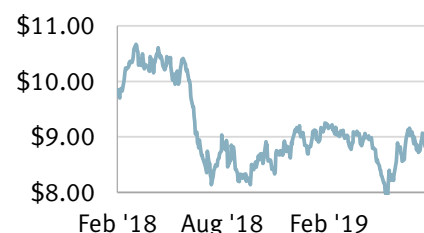
Gold – Higher lows

With the market pricing in Fed rate cuts, the prospects for gold have improved, in our view. In response to dovish central banks and heightened geopolitics, RBC Capital Markets' analysts have increased their 2019 and 2020 forecasts to \$1,326/oz. and \$1,350/oz., respectively. Prices are up approximately 6% m/m, and gold remains near the highs of its five-year range.



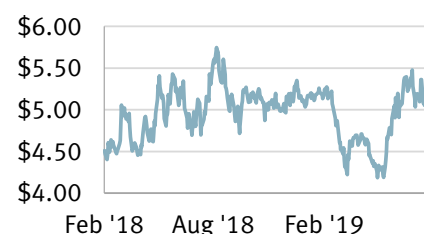
Soybeans – Enter the motherland

American soybean exports to China have slowed to a snail's pace, driven by the lingering trade spat and lower demand in animal feed due to the swine fever outbreak. China has also initiated measures to become less reliant on the U.S. by increasing its domestic production capabilities and by entering into an agreement to import soybeans from Russia. Prices declined by approximately 3% m/m.



Wheat – Crop it like it's hot

Persistent hot and dry climate conditions have led to lower production across Russian and European crops, which, in turn, enhances the prospects for U.S. exports, according to the USDA. The USDA trimmed its 2019/2020 global production forecast to 772 million tonnes. Despite this, total production figures are expected to be approximately 6% higher y/y. Prices declined by roughly 6% m/m.

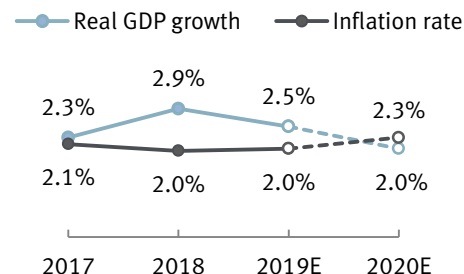


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Source - RBC Wealth Management, Bloomberg; date range: 2/1/18–7/17/19

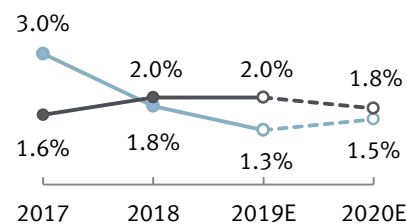
United States – Consumers lead

Strong consumer and government spending offset weak capex and inventory growth, leading to better-than-expected Q2 2019 GDP growth of 2.1%. The consumer is showing no signs of faltering, supported by a tight labor market and accommodative credit. Businesses concerned about policy uncertainty.



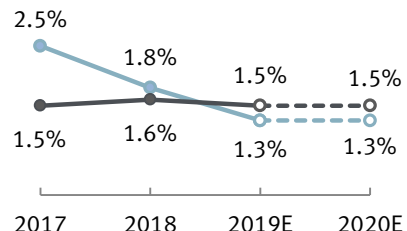
Canada – Perking up

Manufacturing sales volumes and exports were stronger in Q2, retail and wholesale sales weaker. Q2 GDP growth is tracking close to a stronger-than-expected 3% annualized. Medium-term concerns continue to center around global growth risks and the impact on Canadian exports and investment; the CFIB small business confidence indicator dipped. Trade balance is expected to slip back into a deficit.



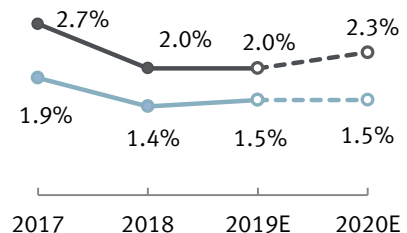
Eurozone – Slowdown deepens

ECB President Mario Draghi's stark warning that the economic outlook in the euro area is "getting worse and worse" was underscored by GDP data which showed Q2 growth of only 0.8% annualized. The ECB decided to wait on revisiting cutting rates until its September meeting. With manufacturing in the eurozone contracting, and German bunds falling to record lows, the ECB is likely to act.



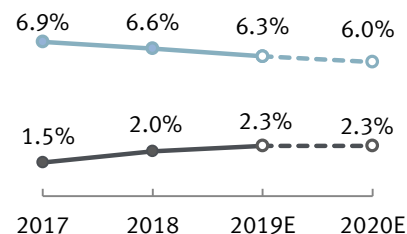
United Kingdom – Waiting, nervously

The BoE stated it will hold rates where they are "until the road becomes clearer." Brexit remains the dominant concern, with some BoE members stating that a smooth Brexit would justify limited and gradual rate increases. The pound has been tumbling and hit a two-year low as the probability of a no-deal exit from the EU has risen with the arrival of a new prime minister.



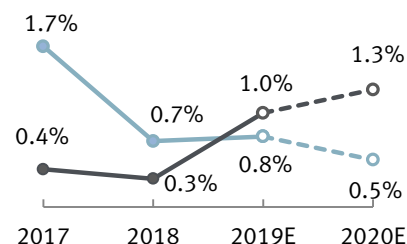
China – Soft

The economy has continued to weaken as worries regarding China-U.S. trade linger. Weaker overseas demand for Chinese shipments has caused imports and exports data to remain negative at -7.3% and -1.3%, respectively. Conditions reported by purchasing managers have weakened due to low business confidence, especially in the manufacturing sector.



Japan – Weaker trade

The BoJ opted to make no policy updates at its July 30 meeting, awaiting the impact of the Federal Reserve's decision on July 31. BoJ Governor Haruhiko Kuroda made it clear the BoJ wouldn't hesitate to do more if needed. Japan's trade deficit was notably lower than expected, but the decline in imports versus exports offered little comfort in terms of economic outlook. Exports fell 6.7% y/y, with semiconductor products plummeting more than 20% y/y.



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	2,980.38	1.3%	18.9%	5.8%
Dow Industrials (DJIA)	26,864.27	1.0%	15.2%	5.7%
NASDAQ	8,175.42	2.1%	23.2%	6.6%
Russell 2000	1,574.61	0.5%	16.8%	-5.8%
S&P/TSX Comp	16,406.56	0.1%	14.5%	-0.2%
FTSE All-Share	4,134.03	1.9%	12.5%	-2.8%
STOXX Europe 600	385.77	0.2%	14.3%	-1.5%
EURO STOXX 50	3,466.85	-0.2%	15.5%	-1.7%
Hang Seng	27,777.75	-2.7%	7.5%	-2.8%
Shanghai Comp	2,932.51	-1.6%	17.6%	2.0%
Nikkei 225	21,521.53	1.2%	7.5%	-4.6%
India Sensex	37,481.12	-4.9%	3.9%	-0.3%
Singapore Straits Times	3,300.75	-0.6%	7.6%	-0.6%
Brazil Ibovespa	101,812.10	0.8%	15.8%	28.5%
Mexican Bolsa IPC	40,863.09	-5.3%	-1.9%	-17.8%
Bond yields	7/31/19	6/28/19	6/30/18	12 mo. chg
US 2-Yr Tsy	1.872%	1.755%	2.669%	-0.80%
US 10-Yr Tsy	2.014%	2.005%	2.960%	-0.95%
Canada 2-Yr	1.545%	1.474%	2.069%	-0.52%
Canada 10-Yr	1.477%	1.466%	2.310%	-0.83%
UK 2-Yr	0.437%	0.620%	0.772%	-0.34%
UK 10-Yr	0.611%	0.833%	1.330%	-0.72%
Germany 2-Yr	-0.778%	-0.750%	-0.570%	-0.21%
Germany 10-Yr	-0.440%	-0.327%	0.443%	-0.88%
Commodities (USD)	Price	1 month	YTD	12 month
Gold (spot \$/oz)	1,413.78	0.3%	10.2%	15.5%
Silver (spot \$/oz)	16.26	6.2%	4.9%	4.8%
Copper (\$/metric ton)	6,486.50	-1.3%	-0.8%	-6.0%
Uranium (\$/lb)	20.90	-0.5%	-12.6%	-7.7%
Oil (WTI spot/bbl)	58.58	0.2%	29.0%	-14.8%
Oil (Brent spot/bbl)	65.17	-2.1%	21.1%	-12.2%
Natural Gas (\$/mmBtu)	2.23	-3.2%	-24.0%	-19.7%
Agriculture Index	273.20	-5.7%	-1.0%	-5.1%
Currencies	Rate	1 month	YTD	12 month
US Dollar Index	98.5160	2.5%	2.4%	4.2%
CAD/USD	0.7580	-0.7%	3.4%	-1.4%
USD/CAD	1.3191	0.7%	-3.3%	1.4%
EUR/USD	1.1076	-2.6%	-3.4%	-5.3%
GBP/USD	1.2159	-4.2%	-4.7%	-7.4%
AUD/USD	0.6845	-2.5%	-2.9%	-7.8%
USD/JPY	108.7800	0.9%	-0.8%	-2.8%
EUR/JPY	120.4700	-1.8%	-4.3%	-7.9%
EUR/GBP	0.9111	1.7%	1.3%	2.3%
EUR/CHF	1.1011	-0.8%	-2.2%	-4.9%
USD/SGD	1.3743	1.6%	0.8%	0.9%
USD/CNY	6.8844	0.3%	0.1%	1.0%
USD/MXN	19.1480	-0.4%	-2.6%	2.7%
USD/BRL	3.8148	-0.9%	-1.5%	1.5%

The tech-heavy NASDAQ outperformed all other major indexes in July on strength from Apple & Alphabet.

Global bond yields remain lower amid a dovish shift by global central banks.

Silver, a key component of semiconductors, led all commodities as signs point to improving demand for chips.

The dollar outperformed major currencies in July as global central banks follow the Fed's dovish turn.

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 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -1.4% return means the Canadian dollar has fallen 1.4% vs. the U.S. dollar during the past 12 months. USD/JPY 108.78 means 1 U.S. dollar will buy 108.78 yen. USD/JPY -2.8% return means the U.S. dollar has fallen 2.8% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 7/31/19.

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.

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