

Global Insight

Perspectives from the Global Portfolio Advisory Committee

In conversation: Paying attention to the yield curve

What the yield curve may be saying about
the prospects for economic growth and the
direction of financial markets.

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The yield curve has reliably flagged the approach of U.S. recessions well in advance of their arrival. The next one is still some distance away, as the curve is probably a year or more from giving such an “early warning” signal.

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We prefer today’s combination of reasonable valuations and a building “wall of worry” over January’s stretched valuations and unbridled optimism. With moderately above-trend growth in the major economies and still very accommodative central bank policies, the expansion should continue for at least another year. We remain moderately Overweight equities.

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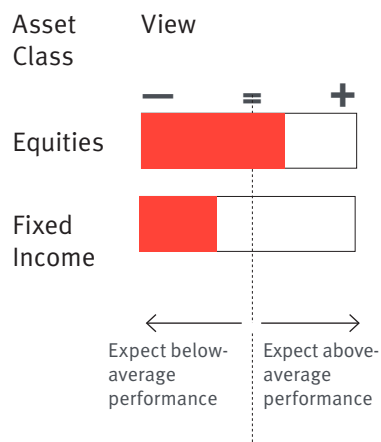
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All values in U.S. dollars and priced as of market close, May 31, 2018, unless otherwise stated.

RBC's investment stance

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See “Views explanation” below for details

Source - RBC Wealth Management

Equities

- A new risk materialized in May, as upheaval in Italian political circles worried investors that a euro crisis may be in the cards. This conclusion should not be too hastily embraced, in our view, as the European Central Bank now has in place a powerful toolkit to stem contagion. A government in Italy now seems to be in place, but uncertainty regarding its euroskepticism is likely to linger for a while longer. This, the threat of protectionism, geopolitics, and interest rate concerns will likely keep investors nervous.
- We would look to take advantage of opportunities this situation may offer. Earnings growth remains solid in the U.S., where valuations are less demanding than earlier in the year, while a weaker yen removes an important headwind to earnings in Japan.

Fixed income

- Numerous central bank meetings dot the horizon in June, but only the Federal Reserve is likely to produce any policy shifts; market consensus forecasts the second rate hike of 25 basis points in 2018. Though we expect to see new forecasts and “dots” at the meeting, comments from policymakers suggest little urgency in adding a fourth rate hike, which will ultimately depend upon the data. Data dependency has and will also be a factor in future global central bank decisions where soft numbers have already caused forecasts of rate hikes to shift out on the calendar.
- Interest rate volatility driven by trade issues and geopolitics could continue to be a near-term issue and when combined with flat yield curves will pose challenges for investors. Credit remains our favorite sector, but we caution investors to remain selective as we maintain our Underweight to fixed income.

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.

In conversation: Paying attention to the yield curve



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



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

The shape of the yield curve—or more specifically, the difference between long- and short-term interest rates—has become a much discussed topic of late. In the U.S., the gap between the yield on the 1-year Treasury note and that on the 10-year note has narrowed from a comfortably wide 160 basis points (1.60%) back in early 2017 to a narrower 70 basis points (0.70%) recently.

Some have suggested this narrowing means the U.S. economy is slowing and may be headed for recession. Here we discuss what the yield curve may or may not be saying about the prospects for economic growth and for the likely future direction of bond yields and stock prices.

Q: Can we gauge how close we are to the end of the cycle by looking at the yield curve?

Jim Allworth; Investment Strategist: The general idea is that a steepening yield curve, where long rates are rising faster than short rates, indicates that credit is easy to access and is regarded as a harbinger of faster economic growth to come. But a flattening curve signals that credit is becoming more difficult and expensive to access and that growth will slow. That's been more or less true over at least the past 70 years, although the relationship has not always been as tight as most would like.

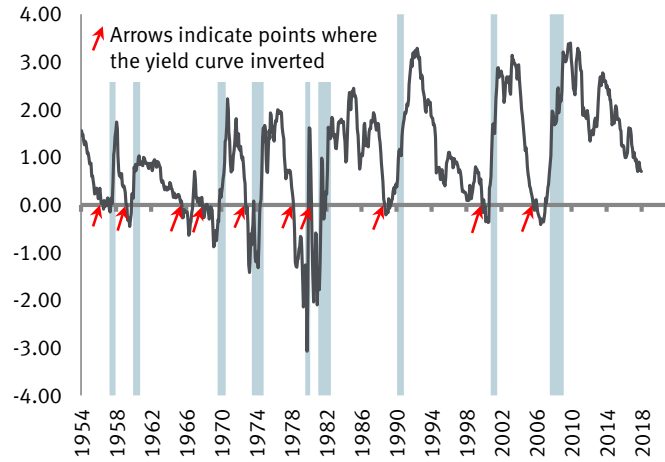
However, focusing solely on the U.S., there is a signal given by the yield curve that should not be ignored when it occurs and that's inversion—when short-term yields rise above the prevailing long-term bond rate it indicates credit conditions have become unusually restrictive and that there is a very high probability that a recession will arrive within about a year.

There hasn't been a recession in more than 60 years that wasn't preceded by an inversion of the yield curve. And there was only one time when an inversion wasn't followed by a recession—1965–66—but there was quite a dramatic slowdown in GDP growth around that time, from 10.2% in Q1 1966 to just 0.3% in Q2 1967.

On average, the yield curve has inverted 14 months prior to the onset of a recession (median 11 months). The shortest “early warning” was eight months. However, if you don't have inversion, flattening doesn't tell you much other than that the economy may be slowing down.

And, of course, nobody rings the bell when a recession starts. In fact, the National Bureau of Economic Research, which is charged in the U.S. with formally ruling

Yield differential between the U.S. 10-year Treasury note and the 1-year note



Yield curve inversions lead recessions by about a year on average.

Note: Shaded areas indicate recessions
Source - RBC Wealth Management, U.S. Federal Reserve, National Bureau of Economic Research

on when each recession starts and ends, usually makes those calls a year after the fact. In the intervening period, when the recession is actually underway but not yet officially acknowledged, there's usually a lot of diverging opinions between those who think that a recession has started and those who think that somehow or another one will be avoided.

Q: Would you call inversion the opening bell for the countdown to a recession?

Jim: Yes, but there are a number of other indicators, including unemployment insurance claims, which bottom a year or so before a recession starts, and the unemployment rate, which bottoms two or three months before a recession starts.

Considering the yield curve by itself, there are two things to note. One, that inversion has been a reliable precursor of recessions, and two, that even after inversion occurs, it's typically months or quarters before the economic downturn gets underway.

Q: Does the U.S. yield curve drive other curves around the globe?

Craig Bishop; Lead Strategist, U.S. Fixed Income Strategies: Not necessarily, but it may lead other sovereign curves to move in that direction. The shape of the curve depends more on levels of an economy's growth and central bank policies. The U.S. curve began to flatten really with the Fed's first rate hike in December 2015. As other central banks have moved to become less accommodative, the Bank of Canada for example, their respective curves have also flattened. Today, yield curves are flatter in both the U.S. and Canada than in the U.K. and Europe because the Fed and Bank of Canada are both further along the path to normalizing policy than other central banks, certainly ahead of the European Central Bank.

Our outlook has focused on the synchronization of global economies and changes in central bank policy. As a result, yield curve shifts in the U.S. should ultimately filter through to other regions.

Even after inversion occurs, it's typically months or quarters before the economic downturn gets underway.

Yield curve track record

Month yield curve inverts	Month recession begins	Interval (in months)
Dec '56	Sep '57	9
Sep '59	May '60	8
Apr '68	Jan '70	21
Mar '73	Dec '73	9
Sep '78	Jan '80	16
Sep '80	Jul '81	10
Feb '89	Jul '90	17
Apr '00	Mar '01	11
Jan '06	Dec '07	23
Average		14
Median		11

The yield curve has typically inverted about a year before a recession begins.

Source - RBC Wealth Management, U.S. Federal Reserve, National Bureau of Economic Research

Jim: If you actually plotted the yield curve of other economies, say, of Canada, the U.K., Germany, and Japan, and looked for a similar pattern to that in the U.S. where inversion consistently precedes a recession, you would be less confident in your conclusions. That is because trade and therefore the respective currencies are so much more important in those economies than for the U.S. Exports range between 30% and 40% of GDP for those countries but just 14% for the U.S.

Q: There's a lot of focus on the 10-year Treasury yield going through 3%. Why are investors fixated on that level?

Craig: Many investors, for some time, have been expecting rates to rise. The 3% level was an important psychological barrier that once pierced was looked at as confirming those bearish expectations. 10-year yields hadn't been that high since the "taper tantrum" of 2013.

Recently, expectations of higher inflation, strong growth, and a more aggressive Fed combined to push the 10-year yield to just over 3.10%, its highest level in seven years. We don't think yields will move very far past that level. They have since settled back to 2.90%, and longer term we see the Fed's forecast for a peak fed funds rate of 3.25%–3.50% by 2020 as a good guidepost for the peak in 10-year yields in this cycle.

It's worth remembering that the Fed doesn't tighten with the intention of inducing a recession; its unstated goal is to produce a "soft landing." To accomplish this, policymakers seek to head off the buildup of inflationary pressures while maintaining growth and employment.

Of course, the wild card is always inflation. Our forecast has inflation moving up to 2.5% this year before subsiding to 2.25% in 2019. The Fed has indicated it's not going to get too fussed about inflation running moderately above its long-term 2% target, which would suggest its deliberate, patient approach to normalizing rates is what we should expect.

The Fed doesn't tighten with the intention of inducing a recession; its unstated goal is to produce a "soft landing."

Yield curves aren't like dominoes in that they flatten, and then invert, with a recession to soon follow.

Q: What is the relationship between an inverted yield curve and equities?

Jim: There's always been a bear market when you have had an inverted yield curve, or if not a bear market, a retrenchment. So in that one instance in 1966 when the yield curve inverted but no recession ensued, there was an eight-month 22% decline in the S&P 500.

Generally speaking, if the yield curve inverts the economy contracts, and so do profits.

Profits are leveraged to economic growth, so they usually go up faster than the economy grows and they come down more quickly than the economy contracts. Recessions also tend to reduce confidence in the future, so the price-to-earnings (P/E) multiple comes down. You've got the "E" (earnings) coming down and the "P" (price) falls even faster because investors lose faith in the ability of the economy to recover.

Today's narrowing gap between short-term rates and longer bond yields puts us in a watchful, vigilant state of mind. We are not alarmed by the flatter yield curve—but but we'd like to get the bear market call right when one eventually arrives.

Q: There are several yield curves and we've cited a couple in this piece; which one should we look at?

Craig: The key to having confidence in using the yield curve as an indicator is the availability of data over a long period of time. The market and the Fed, as noted in the minutes of the Federal Open Market Committee's May meeting, are following movements in the 2-year/10-year curve, and in past research pieces the Fed has suggested the 3-month/10-year curve may be the best market barometer.

We will somewhat split the difference on the short end of the curve and use the 1-year/10-year curve, for which the Fed provides the longest stretch of consistent data. But we don't expect signals generated by any of these three curves will prove to be contradictory or meaningfully out of sync when viewed as possible recession indicators.

The final word

We are approaching uncharted waters across a number of fronts—the current U.S. economic expansion is moving into its 10th year and the Fed is continuing on its path to gradually raise rates in hopes of engineering a soft landing. Needless to say, investors are cautious and looking for indicators to guide them; history shows the shape of the yield curve to be one of the best. But, as we suggest, yield curves aren't like dominoes in that they flatten, and then invert, with a recession to soon follow. It takes time for this sequence of events to fully unfold, if that's what's going to happen, which affirms to us the next recession is not on the near-term horizon.

Outlook set at “constructive”

At its peak back in January the S&P 500 was trading at a full-ish 18.8x consensus forward earnings. Today the index is 5% below that high and earnings have rolled forward by almost six months, putting the price-to-earnings (P/E) multiple at a more attractive 16.2x forward consensus. While P/E multiples in other developed economy markets were not as rich at the peak as in the U.S., they too have come down over the same interval.

Rising earnings and lower P/Es should mean some risk has come out of equity markets—and we think it has. But investors, apparently, aren't so sure. Widespread feelings of “nothing but blue skies ahead,” so prevalent in December/January, have given way to mounting worries about: a ratcheting up of protectionist rhetoric and accompanying tariff impositions; geopolitical turmoil (Iran, Korea); renewed existential threats within the European Union; and an unsettling move higher in bond yields.

All of the foregoing can be viewed against a backdrop of strong Q1 earnings in most major markets

Equity views

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

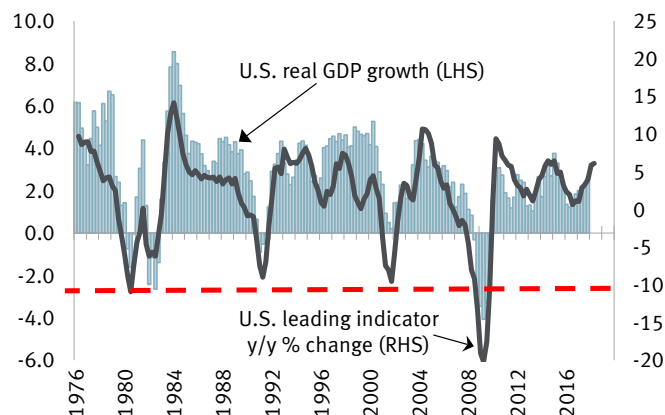
+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

accompanied by a preponderance of upbeat management guidance about the remainder of the year.

We prefer today's combination of reasonable valuations and a building “wall of worry” over January's stretched valuations and unbridled optimism. We look for the broad averages to work higher with earnings, and expect them to post new highs sometime in the second half.

Our confidence rests on projections for moderately above-trend growth in the major economies this year and next, underpinned by still very accommodative central bank policies.

Leading index points to more growth



This leading series flags U.S. recessions in advance. No downturn in sight.

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

Source - Conference Board, U.S. Dept. of Commerce, RBC Wealth Management

We expect this very long economic advance will eventually end when credit becomes prohibitively expensive and difficult to get. As things stand, that looks to be a year or more off, in our opinion. Meanwhile, other reliable, non-credit-related indicators—employment, new orders, housing, corporate profits—corroborate the idea this expansion has further to run.

We remain moderately Overweight equities in a global portfolio. We recently upgraded the U.K. to Market Weight from Underweight on the basis of unusually compelling valuations more than offsetting any headwinds facing the U.K. economy. Europe is our only recommended Overweight for now, though we would be highly selective. All other markets—the U.S., Canada, and Japan—are at benchmark settings.

Regional highlights

United States

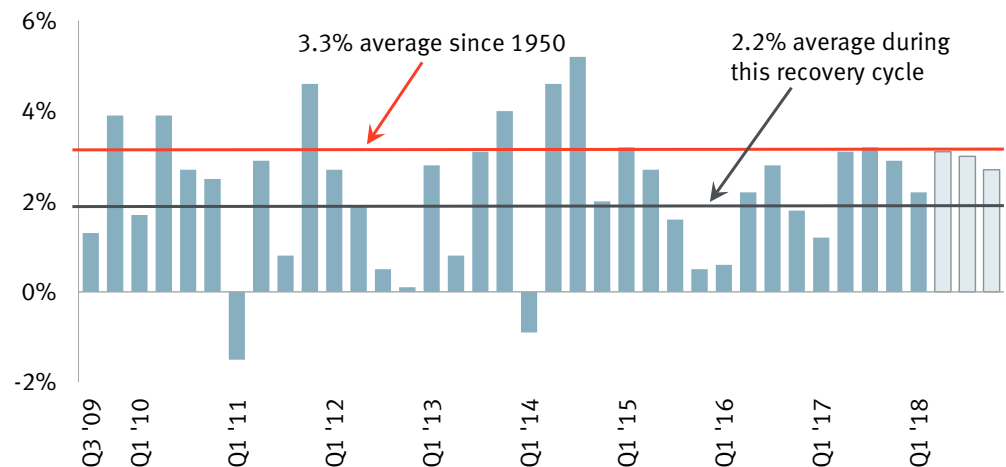
- Just when the U.S. market began to regain its footing, political instability in Italy and heightened trade tensions came to the fore, knocking

down the major averages. Even though much of the Italy stress has receded, trade uncertainties linger. Tariff disputes are anathema to many export-oriented U.S. corporations and industry organizations. Any shift away from the global trade framework that has been in place for decades generates uncertainties, at best, and could impact operations or profits, at worst.

- The larger point is that a number of risks continue to swirl around the U.S. equity market—from trade disputes, to rising inflation, to yield curve flattening, to geopolitical hazards, and more—making it likely this choppy period will persist over the near term.
- We would continue to hold a Market Weight position in U.S. equities and would look for opportunities as the consolidation/correction phase that began in February plays out. We believe the secular bull market will remain intact because domestic fundamentals are strong. Q2 GDP growth is tracking ahead of the 2.2%

U.S. GDP is shaping up to accelerate in the second quarter and finish the year better than it started

GDP growth quarter-over-quarter annualized rate (%)



Note: Q1 2018 GDP growth of 2.2% is the first revision and subject to one more revision. The gray bars represent consensus estimates for the remaining three quarters in 2018.

Source - RBC Wealth Management, Bloomberg; data period: Q3 2009 through Q4 2018

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

Jay Roberts, CFA
Hong Kong, China
jay.roberts@rbc.com

pace in Q1. S&P 500 companies reported stellar earnings and revenue results in Q1, on balance, and seem well positioned for the remainder of the year. We think 2018 earnings will grow between 14% and 20% y/y, depending on the performance of the U.S. and global economies.

Canada

- NAFTA negotiations remain an ongoing saga after the three signatory nations missed U.S. House of Representatives Speaker Paul Ryan's May 17 deadline to vet a revised agreement with Congress ahead of November's midterm elections. Finding an agreement on automotive manufacturing has emerged as the focal point of deliberations, with other sticking points relegated to the backburner until auto matters are resolved. The imposition of steel and aluminum tariffs is a manageable headwind to the Canadian economy but a negative signal on the status of negotiations and the willingness of the U.S. administration to resort to high-pressure tactics.
- Higher mortgage rates and stress tests on uninsured mortgages continue to exert a cooling influence on the Toronto housing market. Resale activity has declined markedly, but a similar drop in inventory has effectively resulted in balanced market conditions. Detached home prices fell 10% y/y in April as prices in the relatively more affordable condo segment rose 10%. RBC Economics believes the risk of a major nationwide home price correction is contained, as solid economic and demographic fundamentals provide steady support.
- The global oil market has rebalanced more quickly than RBC Capital Markets expected, with sustained

West Texas Intermediate crude prices around \$65 per barrel. The domestic Energy sector has responded to higher commodity prices by outperforming the S&P/TSX Composite since the end of March. With geopolitical factors reasserting their influence on prices and RBC Capital Markets forecasting a deceleration in production growth in 2019, there is reason for continued optimism on crude prices. With that said, we expect the discount on Canadian heavy crude production to persist, which could blunt the impact of higher headline prices for certain producers.

Continental Europe & U.K.

- We maintain our Overweight in Europe though we acknowledge the picture is becoming somewhat more complicated. Economic momentum, while remaining healthy, has slowed more than the consensus of analysts expected. The political situation in Italy adds uncertainty and could lead to a deterioration in the health of the third-largest economy in the region.
- Yet, valuations are less stretched than they are elsewhere and corporate profits should continue to benefit from a relatively healthy global economy. We prefer core economies' equity markets to those of the periphery.
- We recently upgraded the U.K. to Market Weight. Ferocious government infighting continues to make it difficult to have any visibility on post-Brexit Britain, but relative valuations have reached levels not seen in years. This suggests to us that investors have been largely discounting fears of an economic slowdown. The U.K.'s large exposure to defensive sectors with earnings that respond comparatively less

to changes in global industrial momentum position it well at this later stage of the business cycle.

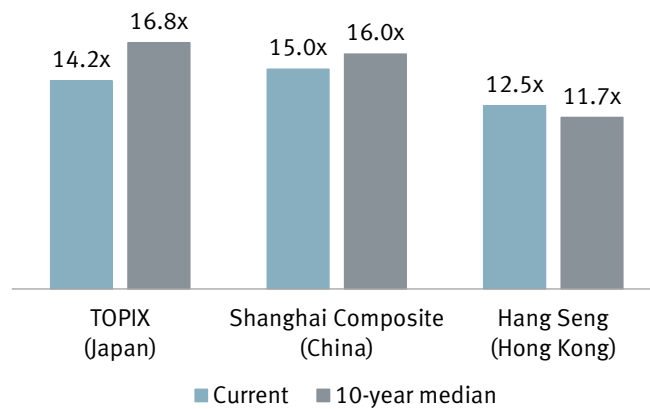
- We find good value in the Energy, Financials, and Telecom sectors. Retail and Utilities also trade at low valuation levels, but we are concerned about online disruption for the former and regulatory and political pressure for the latter.

Asia

- Asian markets continue to tread water. We think the prospects for Asian equities are reasonable given the background of global economic growth and robust earnings growth in the region. However, the uncertainty created by the U.S.-China trade negotiations is weighing on stocks. Asian equities have also been consolidating after strong gains in 2017 and the correction in February. Asian bonds have weakened due to rising bond yields in the U.S.

- At present, it is not clear what the goals of the U.S. are with respect to the trade dispute with China. We suspect the situation will drag on for quite a while. The China trade hawks in President Donald Trump's administration will sense their opportunity to create meaningful change in the trade relationship. China, however, will be no pushover.
- We continue to have a preference for Japanese equities among the major Asian equity markets based on valuations, earnings prospects, and economic data. The recent rally in the dollar has helped reduce the headwind of a stronger yen on Japanese earnings. However, the decline in Prime Minister Shinzo Abe's popularity is a concern as the Liberal Democratic Party will hold its leadership contest in September.

Major Asian index trailing price-to-earnings (P/E) ratios

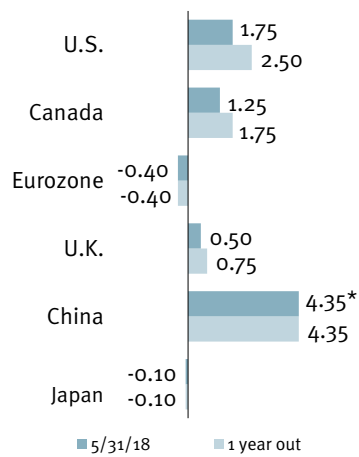


Asian valuation trends support our preference for Japan, although valuations for the region as a whole appear reasonable.

Source - RBC Wealth Management, Bloomberg; data through 5/31/18

One size may not fit all

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

Six months into 2018, the concerted effort by global central banks to remove policy accommodation may be less synchronized than earlier thought. The Federal Reserve appears to be charging ahead, albeit gradually, but others may be hitting some hurdles. Here is a quick preview of upcoming meetings:

Federal Reserve (June 12–13) – This meeting will feature revisions to the “dot plot” and economic forecasts, a (Fed Chair) Jerome Powell press conference, and, by most measures, the second rate hike this year. Inflation is near the Fed’s 2% target (core PCE is 1.8%), yet recent comments of having a “symmetric target” and a willingness to let inflation exceed 2% suggest the Fed will not move immediately, if at all, to add another rate hike this year.

European Central Bank (June 14) – Before the first rate hike, the ECB will need to decide the future of its quantitative easing program. ECB President Mario Draghi’s comments following the April meeting suggested it may be “premature” to make any decisions in June, leaving the July meeting as the next opportunity to unveil plans that many expect to become operative in September. As for the first rate hike, it is still over a year away.

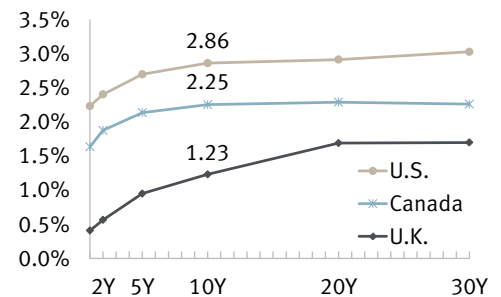
Bank of Japan (June 15) – The minutes from the March meeting indicated an intent/desire by policymakers to normalize or gradually reduce the degree of monetary accommodation “in the future.” Current economic data suggests, however, the June meeting will be too early to produce any policy changes.

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	–	=	5–7 yr

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

Sovereign yield curves



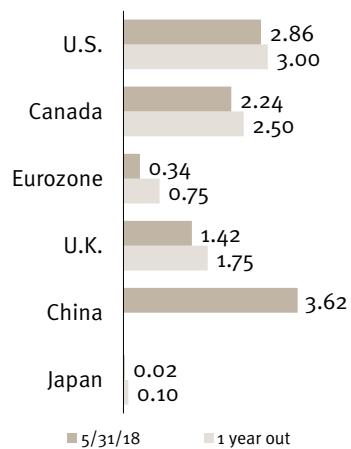
Source - Bloomberg

Bank of England (June 21) – Citing a sudden drop-off in inflation and weak growth, BoE Governor Mark Carney held the BoE back from an expected rate hike last month. Just one month later, a rate hike is unlikely. However, our regional experts suggest August may be teed up for that action.

Central banks may be moving in the same direction to remove policy stimulus, but the process will likely be subject to many fits and starts and produce a flatter trajectory to rate hike expectations.

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

10-year rate (%)



Note: Eurozone utilizes German Bunds
Source - RBC Investment Strategy
Committee, RBC Capital Markets, Global
Portfolio Advisory Committee, RBC Global
Asset Management

Regional highlights

United States

- We believe the Federal Reserve is all but certain to raise rates when it meets on June 13, but are we already nearing the end of this rate hike cycle? The minutes from the May 2, meeting showed that officials are discussing making changes to the official statement to reflect that policy rates may no longer be accommodative. Should the Fed deliver the seventh hike since 2015 later this month to bring the Fed Funds rate to 1.75%–2.00%, we will have crossed the halfway point of the tightening cycle as the Fed currently expects six more hikes by 2020.

However, the market still expects just three more by then, which is more in line with our view. Though investors may think rates are low, we may soon be close to the end of the tightening cycle.

- The Bloomberg Barclays US Investment Grade Corporate Bond Index recently crossed the 4% threshold for the first time since 2011. Rising Treasury yields and modest wider credit spreads—the yield compensation for credit risk over Treasuries—have provided investors with some of the best entry points into corporate bonds in years. We favor BBB-rated credits in the 7- to 10-year part of the yield curve.
- The lack of new supply in the municipal markets continues to pressure yields lower relative to Treasuries. The 10Y part of the curve looks particularly expensive, as munis there now yield just 83% of comparable Treasuries, barely above the eight-year low of 81%, and compared to an average of 98%. The 30Y munis are more attractive, yielding 98%, or below average, but still well north of the 2012 low of 87%.

Canada

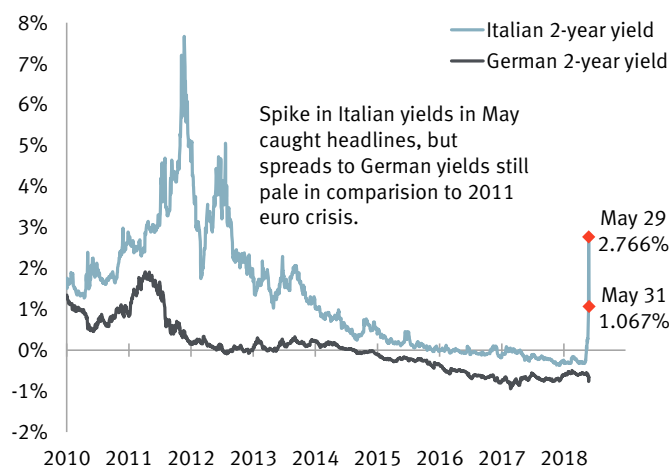
- The Government of Canada (GoC) bond yields climbed in sympathy with U.S. Treasury yields in May as surging commodity prices lifted inflation expectations. It's been a lower-altitude climb in yields in Canada as high levels of household indebtedness have retrained the BoC in raising rates, though GoC bond yields still reached the highest levels since 2011–2015 at various points along the yield curve. We believe the move higher in rates should be viewed as both an opportunity and a warning shot.
- Shorter-term bonds now provide a good alternative to cash because their yields have climbed significantly more than savings account rates recently, pointing to an increased opportunity cost to hold cash. A 2020 federal bond that yielded less than 1% in 2016 now yields approximately 2.25%. Investors can also find a number of highly rated 3-6 year bonds that offer 2.50%–3% yields trading well below par.
- The warning shot being sent is for longer-duration Canadian bonds. Despite the recent rise in yields, the 10-year and 30-year GoC yields are still barely above the rate of inflation and 60–70 basis points (bps) below their equivalent maturity U.S. government bond counterparts. We don't think bonds in this part of the curve offer a compelling risk-reward profile and a flat yield curve provides an opportunity to reduce interest rate risk without sacrificing much yield. We estimate a 0.5% move higher in the 10-year yield to RBC Economics' 3% Q2 2019 target would result in a price decline on this bond of some 5%.

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

Mikhail Pasic, CFA
Toronto, Canada
mikhail.pasic@rbc.com

Jamie Hayes
London, United Kingdom
jamie.hayes@rbc.com

Italian 2-year yields spike 240 basis points in 5-days



We expect Italian yield spreads to remain wide and volatile, thus favor European credit risk.

Spike in Italian yields in May caught headlines, but spreads to German yields still pale in comparison to 2011 euro crisis.

Source - RBC Wealth Management, Bloomberg; data through 5/31/18

Continental Europe & U.K.

Europe

- Political developments in Italy ignited risk sentiment throughout the continent, and spreads on Italian government bonds to German Bunds ended the month much wider. A clear manifestation of investor fear was clearly seen in Italian 2-year debt, where yields increased a remarkable 240 bps over just a five-day period. Peripheral European debt followed suit, but moves were substantially more muted.
- Whilst the situation in Italy continues to evolve rapidly, however, at the time of this writing, our central thesis suggests that yields on Italian government bonds are likely to remain elevated and spreads will remain wide and volatile. Consequently, we see the risk-reward profile as un compelling.
- Similarly, spreads in the corporate bond market have moved wider in response to the risk-off tone. Beyond the political risk, softness in European economic data appears transitory. We continue to like European credit risk, favouring

financials and subordinated bonds.

- Beyond an accommodative European Central Bank and the prospect of the first hike in this cycle in H2 2019, European bonds are likely to remain supported by material reinvestment flows by the central bank.

U.K.

- The Bank of England kept the base rate on hold at its May meeting. Inflation slowing faster than anticipated and a weak GDP growth print appeared to be the key drivers of its decision. This pushes our expectation for a hike to the August meeting with “all members” agreeing that increases will need to be at a “gradual pace” and to a “limited extent.”
- Sterling credit spreads have continued to widen, largely reflecting concerns about the U.K.’s inclusion in the EU customs union and soft economic data. Credit provides a decent yield pick-up relative to Gilts, and many Sterling issuers are global companies isolated from domestic concerns. We favor a selective approach.

Commodity forecasts

	2018E	2019E
Oil (WTI \$/bbl)	63.00	65.00
Natural Gas (\$/mmBtu)	2.89	2.85
Gold (\$/oz)	1,307	1,300
Copper (\$/lb)	3.24	3.25
Corn (\$/bu)	3.83	4.00
Wheat (\$/bu)	4.73	4.89

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

Fallout from the U.S. pullout of the Iran deal

The U.S. decision to pull out of the Iran nuclear deal, an agreement that was established in 2015 along with the U.K., France, China, Russia, and Germany, has implications for the oil market. With economic sanctions set to be imposed again, Iranian oil shipments will be constrained. But the real question is whether new supply will come online, and if so, from whom?

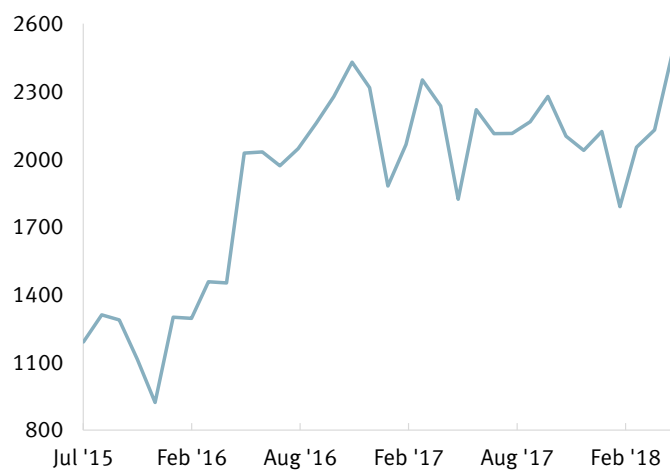
RBC Capital Markets anticipates that the reintroduction of sanctions could reduce global supply by 200,000–300,000 barrels per day, which could take place later this year or early 2019. In response to the possible reduction, crude initially rallied, but then pulled back as key OPEC members and Russia (OPEC+) indicated a willingness to at least discuss loosening their production caps to potentially cover the lost barrels.

Historically, the U.S. has looked toward its Middle Eastern ally, Saudi Arabia,

to help curb oil prices. However the International Monetary Fund estimates that Saudi's fiscal breakeven price is around \$86 per barrel, which suggests that it would likely be in the kingdom's best interest to let oil prices climb higher. That said, the Saudis and Russia indicated in late May that they would use an upcoming meeting to discuss the possibility of slowly relaxing production limits. Reportedly some Russian producers are already attempting to ship more crude.

Looking beyond the next few months, senior Iranian officials had previously pledged to resume their nuclear activities in the event the U.S. exited the deal. This could push Saudi Arabia to reinitiate its own nuclear program. If this were to occur, it would heighten the probability of a Middle East arms race and would likely spark another catalyst for crude to rally.

Iranian crude exports (kb/d)



Iranian crude exports have more than doubled since economic sanctions were lifted in 2015.

Source - RBC Capital Markets, Bloomberg; data through 4/30/18

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

Currency forecasts

Currency pair	Current rate	Forecast Jun 2019	Change*
Major currencies			
USD Index	93.97	91.89	-2%
CAD/USD	0.77	0.79	3%
USD/CAD	1.29	1.26	-2%
EUR/USD	1.16	1.22	5%
GBP/USD	1.32	1.31	-1%
USD/CHF	0.98	1.02	4%
USD/JPY	108.82	115.00	6%
AUD/USD	0.75	0.73	-3%
NZD/USD	0.70	0.69	-1%
EUR/JPY	127.23	140.00	10%
EUR/GBP	0.87	0.93	6%
EUR/CHF	1.15	1.24	8%
Emerging currencies			
USD/CNY	6.41	7.20	12%
USD/INR	67.4	65.20	-3%
USD/SGD	1.33	1.46	10%

* 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: Rallies as yields rise –

The dollar strengthened to its highest level so far this year in May, shaking off the downtrend that was in place throughout 2017. 10-year Treasury yields climbing to multiyear highs on the back of higher inflation expectations underpinned the rally, while both a reprieve from trade tensions and negative data surprises outside the U.S. provided further support. Momentum should fade, in our view, yet the dollar is likely to remain supported by attractive economic conditions throughout 2018.

Euro: Sentiment fades as growth slows –

A slowdown in economic activity alongside an abrupt escalation of political tensions drove the euro to fresh 2018 lows in May. The slowing growth likely reflected harsh winter weather, and the euro could trend range-bound as markets await confirmation on the health of the economy. We anticipate that a winding down of the ECB's bond purchase program by year-end will put the central bank in a position to raise interest rates in the second half of 2019, which in turn should support the euro trending higher next year.

British pound: Tumbles to fresh 2018 lows –

A soft outturn in economic data and surprisingly dovish comments from the Bank of England brought the pound under pressure in mid-April. Market

participants' doubts that the central bank would follow up its November rate increase with another this year sent the pound tumbling from post-Brexit referendum highs. A modest growth rebound should spur renewed market optimism for a hike in 2018, although lingering Brexit risks and economic headwinds will likely see pound pressures persist, in our view.

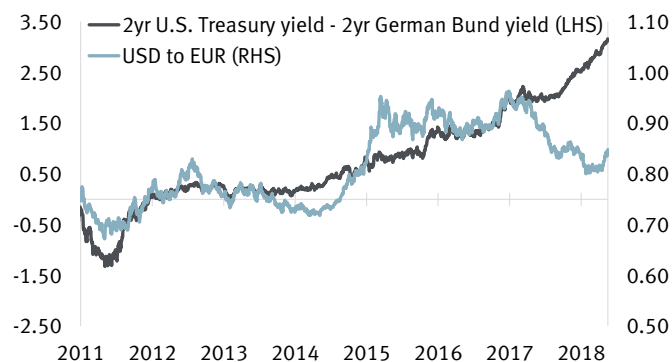
Canadian dollar: Headwinds persist –

An earlier selloff in the Canadian dollar owing to a surprisingly cautious Bank of Canada gathered momentum in May. Widening rate spreads in favor of the U.S. weighed on the currency with rising crude oil prices providing only a modest offset. Underlying inflation trends are firming, teeing up rate hikes for later this year, which should buoy the currency, although risks around NAFTA negotiations remain.

Japanese yen: Under pressure –

Rising Treasury yields abetted yen weakness against the dollar, with further support coming from a modest return of risk appetite. Uncertainty around a brewing political scandal could pressure yen performance, contributing to our tempered outlook for the currency. The risk to our neutral view stems from a flare-up of geopolitical tensions that could see investors flee to the safety of the yen.

Dollar rallies to highest level seen in 2018, narrowing gap with yield spreads



U.S. 10-year Treasury yields climbing to multiyear highs underpinned a sharp and sudden upswing in the dollar.

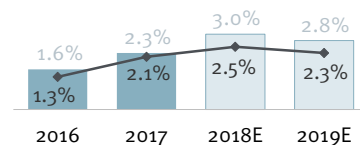
Laura Cooper
London, United Kingdom
laura.cooper@rbc.com

Source - RBC Wealth Management, Bloomberg

Real GDP growth Inflation rate

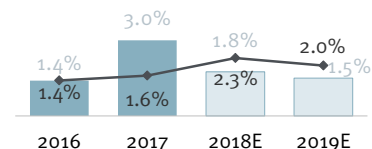
United States — Rate hike likely

- FOMC held rates, but meeting minutes show confidence in a 25 bps hike this month. Hiring reaccelerated from April's lull, pushing the unemployment rate to 3.8%. Manufacturing rebounded on back of strong new orders. Headline inflation continued to firm to 2.5% y/y, but mainly a result of sharp increase in the price of gasoline; Fed still not worried about runaway inflation. Rising mortgage rates beginning to weigh on consumer sentiment & home selling activity.



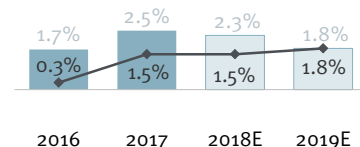
Canada — NAFTA negotiations weigh

- GDP posted reasonable Q1 after weak January start. Extractive industries offset weakness in real estate and rental & leasing. NAFTA negotiations continue to weigh on economic activity, with majority of economic data unchanged from April; Citi economic surprise index remains in negative territory. Bank of Canada held rates at May meeting, markets watching how GDP evolves to gauge future monetary policy.



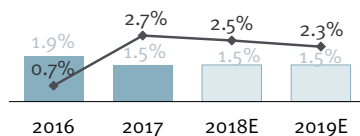
Eurozone — Balancing act

- Germany continues to shower the eurozone with good economic data; inflation exceeded the ECB's target. While no meeting in May, ECB likely balancing Italy's "crisis" and plans on unwinding monetary stimulus. Eurozone retail sales fell to 0.8% m/m from 1.8%. GDP estimates have eased as regional PMIs soften.



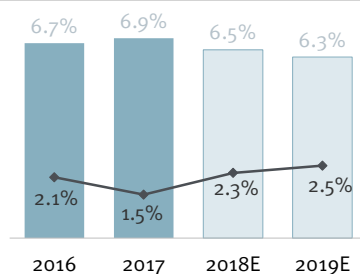
United Kingdom — Uncertainty ahead

- Bank of England held rates steady and may not hike again until 2019. Q1 GDP growth was a tepid 0.1% q/q as consumer spending contributed little to the economy. Consumer confidence is falling, as fears of job security emerge amongst continuing Brexit uncertainty. Price inflation rose just 2.4% y/y, the slowest pace in a year, but real average weekly earnings also moderated to 2.6% from 2.8% y/y.



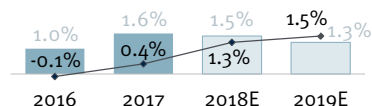
China — Everything in moderation

- Economic growth was mixed relative to expectations, retail sales increased 9.4% y/y, down from 10.1% y/y, though industrial production picked up to 7.0% y/y from 6.0% y/y in March. Fixed asset investment growth slowed to 7.0% y/y, the slowest pace in 18 years as the government tightens fiscal policy in order to combat rising debt levels.



Japan — Bump in the road

- For the first time in 2 years, GDP contracted in Q1, with output shrinking 0.6% q/q annualized as capital investment dipped and consumption stayed flat. Yet, better weather and export growth are expected to drive a rebound in Q2. Inflation dipped to 0.5%, leaving the BoJ little option but to keep policy historically loose.



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	2,705.27	2.2%	1.2%	12.2%
Dow Industrials (DJIA)	24,415.84	1.0%	-1.2%	16.2%
NASDAQ	7,442.12	5.3%	7.8%	20.1%
Russell 2000	1,633.61	5.9%	6.4%	19.2%
S&P/TSX Comp	16,061.50	2.9%	-0.9%	4.6%
FTSE All-Share	4,222.20	2.3%	0.0%	2.6%
STOXX Europe 600	383.06	-0.6%	-1.6%	-1.8%
EURO STOXX 50	3,406.65	-3.7%	-2.8%	-4.2%
Hang Seng	30,468.56	-1.1%	1.8%	18.7%
Shanghai Comp	3,095.47	0.4%	-6.4%	-0.7%
Nikkei 225	22,201.82	-1.2%	-2.5%	13.0%
India Sensex	35,322.38	0.5%	3.7%	13.4%
Singapore Straits Times	3,428.18	-5.1%	0.7%	6.8%
Brazil Ibovespa	76,753.62	-10.9%	0.5%	22.4%
Mexican Bolsa IPC	44,662.55	-7.6%	-9.5%	-8.5%
Bond yields	5/31/18	4/30/18	5/31/17	12 mo. Chg
US 2-Yr Tsy	2.427%	2.488%	1.282%	1.15%
US 10-Yr Tsy	2.859%	2.953%	2.203%	0.66%
Canada 2-Yr	1.918%	1.893%	0.694%	1.22%
Canada 10-Yr	2.244%	2.307%	1.416%	0.83%
UK 2-Yr	0.610%	0.776%	0.131%	0.48%
UK 10-Yr	1.230%	1.418%	1.046%	0.18%
Germany 2-Yr	-0.656%	-0.586%	-0.713%	0.06%
Germany 10-Yr	0.341%	0.559%	0.304%	0.04%
Commodities (USD)	Price	1 month	YTD	12 month
Gold (spot \$/oz)	1,298.52	-1.3%	-0.3%	2.3%
Silver (spot \$/oz)	16.42	0.5%	-3.1%	-5.3%
Copper (\$/metric ton)	6,844.75	1.1%	-5.0%	21.0%
Uranium (\$/lb)	22.25	7.9%	-5.7%	14.8%
Oil (WTI spot/bbl)	67.04	-2.2%	11.0%	38.7%
Oil (Brent spot/bbl)	77.59	3.2%	16.0%	54.2%
Natural Gas (\$/mmBtu)	2.95	6.8%	0.0%	-3.9%
Agriculture Index	311.99	1.1%	10.6%	9.8%
Currencies	Rate	1 month	YTD	12 month
US Dollar Index	93.9790	2.3%	2.0%	-3.0%
CAD/USD	0.7717	-0.9%	-3.0%	4.2%
USD/CAD	1.2958	0.9%	3.1%	-4.0%
EUR/USD	1.1693	-3.2%	-2.6%	4.0%
GBP/USD	1.3298	-3.4%	-1.6%	3.2%
AUD/USD	0.7568	0.5%	-3.1%	1.9%
USD/JPY	108.8200	-0.5%	-3.4%	-1.8%
EUR/JPY	127.2300	-3.7%	-6.0%	2.1%
EUR/GBP	0.8794	0.2%	-1.0%	0.8%
EUR/CHF	1.1528	-3.7%	-1.5%	5.9%
USD/SGD	1.3376	0.9%	0.1%	-3.3%
USD/CNY	6.4106	1.2%	-1.5%	-6.0%
USD/MXN	19.9117	6.4%	1.3%	6.9%
USD/BRL	3.7239	6.2%	12.6%	15.4%

Domestic-focused small-cap stocks outperformed amidst simmering geopolitical concerns.

U.K. bond yields dropped on soft Q1 growth and diminished rate hike prospects.

The oil rally came to a halt as Saudi Arabia and Russia announced plans to revive production.

Political uncertainty and tepid economic data drove the euro lower.

Equity returns do not include dividends, except for the German DAX and 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 0.77 means 1 Canadian dollar will buy 0.77 U.S. dollar. CAD/USD 4.2% return means the Canadian dollar has risen 4.2% vs. the U.S. dollar during the past 12 months. USD/JPY 108.82 means 1 U.S. dollar will buy 108.82 yen. USD/JPY -1.8% return means the U.S. dollar has fallen 1.8% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 5/31/18.

Research resources

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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.

Jay Roberts, CFA – Head of Investment Solutions & Products, RBC Wealth Management Hong Kong, 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:

Jamie Hayes, CFA – Fixed Income Strategist, Royal Bank of Canada Investment Management (U.K.) Limited

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

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			Count	Percent
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