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RBC WEALTH MANAGEMENT

Global Insight

Focus Article

2019 investment stance

While it's late in the game, the economic expansion should have stamina. A constructive—yet vigilant—approach to financial markets is warranted.

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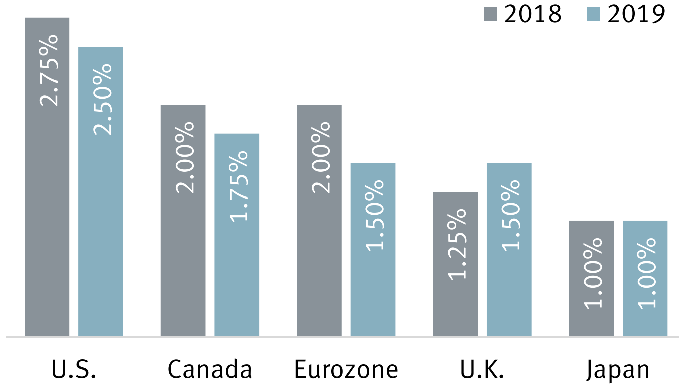
All values in U.S. dollars and priced as of November 6, 2018, market close, unless otherwise noted.

2019 investment stance

Reliable indicators are signaling that developed economies have the stamina to keep growing through 2019. Recession risks remain low despite uneven trends across borders as well as trade and tariff uncertainties. For equities, this should support earnings growth, though at a slower pace. Central bank decisions should be the linchpin for fixed income market performance.

The global and U.S. economic expansions are now in their later stages. While GDP growth seems likely to slow for a number of major economies including the "big 3"—the U.S., Europe, and China—the underlying strength of the U.S. makes it possible this already very extended stretch of growth could last longer than one might think. Central banks will play key roles in determining just how long the expansion plays out. This late cycle stage does not call for dramatic portfolio changes just yet, in our view, but we are moderately trimming equity exposure and shifting toward value areas of the market, while also dialing back credit risk in fixed income. Following are our thoughts about portfolio positioning for 2019.

RBC's annual GDP growth forecasts for developed markets



Source - RBC Global Asset Management

Fixed income

Central banks may diverge as they adjust policies to varying stages of economic activity. We foresee continued growth in developed economies, and inflation holding near targets. This will allow gradual policy adjustments to continue, but the U.S. Federal Reserve and the Bank of Canada may approach their "neutral rate" targets just as the European Central Bank (ECB) begins raising rates later in 2019. Credit will continue to provide selective opportunities, but "late cycle" signs warrant attention to quality and portfolio positioning.

United States

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- The Fed is forecasting three rate hikes in 2019. We see the Fed pausing after two hikes when short-term interest rates reach their "neutral rate" target of roughly 3%. Wildcards could be inflation and trade developments.

- The burst of GDP growth in H2 2018 will, in our opinion, give way to slower momentum as the impact from fiscal stimulus wanes. But even if growth pulls back to 2.5%–3.0%, recession risks would remain low.

- 10Y Treasury yields are in a 3.10%–3.40% range and we maintain that 3.50% is likely the speed limit for the 10-year in this economic cycle. Yield curves should remain flat, but not invert, in 2019 as the Fed moves toward pausing.

- Credit spreads will remain subject to equity market volatility. Until five-year average spreads of 125 basis points for IG and 435 basis points for HY are exceeded, we will hold our modest Overweight on IG and Underweight on HY. We recommend preferreds for attractive returns and maintain our bias for 15–20 year higher-coupon munis.

Europe/United Kingdom

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- As the ECB comes to the end of its purchase programme, further signs of moderating GDP could unsettle markets in 2019, although ECB President Mario Draghi is unlikely to delay the withdrawal of monetary accommodation. For now, despite a QE slowdown, we see the ECB's stock of holdings and planned reinvestment strategy continuing to support yields and credit spreads.

- For the UK, rate hike expectations have shifted forward slightly given the possibility of PM Theresa May's government reaching an agreement with EU leaders. We doubt the path of future interest rate hikes will change much, given estimates of weaker GDP appearing by the end of 2018 or in early 2019. Another notable risk that may materialise after March 2019 is the potential for a leadership challenge within the Conservative party and a general election. This could weigh on UK fixed income; Consumer Cyclicals and Financials would be most at risk.

Canada

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- The Canadian economy is widely expected to grow at or slightly above its potential in 2019. With core inflation already near the Bank of Canada's 2% target, the removal of monetary stimulus should continue.

- The Bank of Canada recently signaled there will be more hikes beyond 2019 than the market is currently pricing in. If this becomes the likely outcome, we believe yields would be set to rise across the yield curve. We are more comfortable buying short to intermediate maturities that offer lower expected volatility of returns, good liquidity, and an opportunity to reinvest at more attractive rates if the central bank follows through.

- Our Canadian credit outlook is mixed. Corporate bond valuations have improved somewhat after reaching the most expensive levels in a decade, but this hasn't changed our view. We continue to recommend upgrading credit quality and liquidity within portfolios. Preferred shares suffered bouts of volatility this year, and with much more reasonable valuations we view any weakness as a buying opportunity.

Asia

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- China represents half of the USD-denominated Asian credit market. In our view, fundamentals and market sentiment in China are two of three key drivers of Asian bonds. The third is the Fed's interest rate policy.

- Onshore funding liquidity in China is tight and issuers struggle to refinance their debt as the government treads along its deleveraging path. The significant market correction in 2018 has opened up selective investment opportunities, but overall we remain cautious and prefer to see a stabilization of liquidity and market confidence before turning risk-on.

- We are also cautious on Indonesia and India. Both run current account and fiscal deficits, and are more exposed to the Fed's rate hike cycle and a stronger U.S. dollar. We don't expect a turnaround at least until their elections are held in the first half of 2019.

- We advise sticking to quality and are Overweight defensive countries like Singapore, South Korea and Hong Kong.

Equity

The corrections in 2018 exposed stresses in the global equity market but also reset valuations to more reasonable levels. We think the market has the capacity to absorb economic cooling, ongoing tariff risks, and monetary tightening, albeit with volatility. Our constructive view hinges on low recession risks for major economies, particularly the U.S., and the likelihood corporate earnings growth will persist. But 2019 returns could be modest and delivered unevenly; therefore, it is appropriate to trim equity exposure to a Market Weight level in global portfolios from a slight Overweight position.

United States — Market Weight

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	Forward P/E	10-yr Avg.
S&P 500	15.6	14.8
S&P Small Cap 600	16.3	17.9

- Two factors that influence U.S. stock prices the most over time—economic and earnings growth—will likely be firm enough to push the market at least modestly higher in 2019. We think the economy has the potential to grow above the 2.3% average rate. All of our forward-looking indicators are signaling the expansion will persist for the next 12 months or beyond.

- Earnings growth is set to slow in 2019 because the boost from tax cuts will fall out of the data, and year-over-year comparisons to 2018's white-hot growth rates will be challenging to jump over. Furthermore, higher input prices due to tariffs, wage growth, and a strong dollar could constrain profit margins. Even with these challenges, we think S&P 500 earnings can grow in the mid-to-high single digits due to strength in the economy.

- A market shift toward value stocks and away from growth stocks seems likely, in our view. Value tends to outperform when the 10-year Treasury yield rises, inflation expectations move higher, and GDP growth strengthens, as well as during the latter stage of a bull market cycle.

Canada — Market Weight

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	Forward P/E	10-yr Avg.
S&P/TSX	13.2	14.6

- We recommend a Market Weight allocation to Canadian equities. Valuations remain discounted relative to the U.S., which we believe provides appropriate compensation for domestic-specific challenges, namely, the impact of higher interest rates on highly leveraged consumers and the housing market, a lack of adequate oil pipeline capacity, and waning economic competitiveness.

- Resolution of free trade negotiations with the U.S. and Mexico appears poised to reduce uncertainty and potential downside risk to the domestic economy. However, the agreed accord must now be passed into law by the three signatories, which cannot be taken for granted in this contentious political climate.

- Our outlook for key sectors remains somewhat subdued. Bank valuations have improved on an absolute basis but remain in-line relative to the broader Canadian market and U.S. banks. We remain comfortable with a modest underweight in Canadian banks given our expectation for slowing earnings growth. The outlook for Energy is dimmed by pipeline constraints and an increasingly self-sufficient U.S. oil market.

Europe/United Kingdom — Market Weight

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	Forward P/E	10-yr Avg.
STOXX Europe 600	12.7	12.9
FTSE All-Share	11.9	12.5

- European equities should continue to be supported by modestly improving fundamentals, including cyclical low unemployment as well as stronger capital investment and lending environments, while a weak currency should underpin the export sector. Uncertainty regarding the Italian budget is likely to linger, perhaps until the European Parliament elections in May as we suspect European politicians would prefer to avoid conflict before then. Equity valuations are not demanding, trading back in line with long term averages and the steep discount to U.S. valuations remains. We favour the Health Care and Industrials sectors, which benefit from structural trends such as infrastructure spend and digitalization.

- The fortunes of UK equities will be influenced by the Brexit negotiations' outcome. Should the UK secure a deal with a transition period ensuring the status quo—our base case scenario—we would expect domestic stocks to enjoy a relief rally. An upward rerating is likely given a 2019 P/E ratio of 11.7x and a dividend yield of some 4.5%. Should negotiations fail, and the UK leave the EU without such a transition, the currency would likely weaken, though the

Equity, continued

usual inverse relationship with equities could well break. After all, exporters would have lost tariff-free access to one of their largest markets. Our preferred sectors remain Energy and Life Insurance where cash flows are improving and valuations are attractive.

Asia ex-Japan/Japan — Market Weight/Overweight

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	Forward P/E	10-yr Avg.
Hang Seng	10.0	11.3
Shanghai Comp	9.8	12.0
TOPIX	12.2	14.7

- Asian equities had a tough year in 2018 after a very good year in 2017. Most of the weakness came from markets in North Asia, especially China.

- In 2019, we expect that the trade dispute, which in reality encompasses much more than simply trade, may deepen, or at least continue, and will set the narrative for Asian markets. However, we expect China to roll out policies to support its markets and economy, both of which have been impacted by the dispute and by China's worthy attempts to rein in riskier areas of credit growth. Even though Chinese stocks have declined considerably, we maintain a neutral stance on the equity market given ongoing risks such as U.S. policy, a slowing economy and concerns about the currency. Different to Japan, a weaker Chinese currency is not perceived favourably by investors.

- We recently moved Japanese equities to an Overweight position. The valuation discount of Japanese stocks relative to global peers is attractive. Economic and earnings trends are generally supportive. We forecast the currency to weaken, aiding stocks. Meanwhile, Prime Minister Abe won his party's leadership election in September. We expect the Bank of Japan to maintain its highly accommodative interest rate policy. Risks include a strong currency and the impact of the VAT increases slated for later in 2019.

Note: Data in the equity section reflects forward price-to-earnings (P/E) ratios based on Bloomberg consensus earnings forecasts for the next 12 months. Data as of 11/15/18.

Currencies

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United States dollar – Still see scope for strength

Rising U.S. yields on the back of monetary tightening was a predominant driver of U.S. dollar outperformance in 2018 while a dampening of risk appetite due to a ratcheting-up of U.S.-China trade tensions provided further support. Looking to 2019, supportive factors for sustained dollar strength through the early part of the year remain intact, in our view. Robust economic growth against a tight labour market point to the need for further rate increases by the Federal Reserve. The resultant attractiveness of the U.S. dollar could fade later in 2019, however, when other countries' central banks look poised to withdraw accommodative policy stimulus.

Euro – Low for longer

Eroding risk appetite in the wake of 2018 political developments appears likely to fade; however, pressure on the euro could persist in 2019, in our view. Signs of softer growth in the region due to rising protectionism alongside subdued core inflation suggest the European Central Bank is unlikely to be in a positon to alter its current policy stance until later in 2019. As such, with policy rates likely to remain unchanged until Q3 2019, the widening rate differential favouring the U.S. dollar points to euro weakness persisting.

Canada dollar – More hikes in the pipeline

Diminished trade uncertainty in the wake of the USMCA agreement alongside an economy expanding above potential should tee up for the Bank of Canada to raise policy rates twice more in early 2019. The uplift to the currency from rate dynamics could fade, however, with the central bank likely to then pause to assess the impact on elevated household indebtedness.

British pound – All about Brexit

The British pound appears poised to take guidance from the evolving relationship between the UK and the EU in 2019. In our view, pragmatism will prevail with a Brexit deal being reached across the parties. However, lingering uncertainty around the future trading relationship through the planned transition period is likely to keep the pound at depressed levels throughout the year.

Japanese yen – Pressure may prevail

Domestic economic conditions and a cautious outlook from the Bank of Japan suggest ultra-easy monetary policy could persist in 2019. Accordingly, the yen is likely to take direction from external drivers. Notably, rising hedging costs from relatively higher U.S. rates point to Japanese investors further rolling off currency hedges, and in turn, dampening demand for the Japanese yen in 2019.

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