Wealth Management
& Capital Markets Perspective

Wealth Management
Dominion Securities

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Funny money: Is the future of fixed income fixed expenses?

Written by Thomas Garretson

The sub-zero interest rate experiment has changed the way central banks fight recessions. And with central banks going deeper down the rabbit hole of negative rates, we look at how investors can navigate the upside down world of negative-yielding debt.

Negative-yielding debt … it's strange, right? There are few hard and fast rules when it comes to investing, but if anything has ever come close it would be that those willing to save in order to lend to those wanting to borrow should earn a positive rate of return.

But after years of negative-yielding debt appearing across the global landscape, and following the European Central Bank's (ECB) decision in September to push policy rates even further into negative territory, and on the back of recent reports that the Bank of Japan (BoJ) may be looking to do the same, and on top of a Danish bank offering the first mortgage with a negative rate, it's becoming increasingly clear that the negative interest rate experiments of recent years were more than just a bug in the system. They're now likely to feature in central bank policy toolkits, and in markets, for years to come.

And while the global stock of debt trading to negative yields pulled back modestly in September after ballooning to nearly $17 trillion over the course of August as global recession fears came to a head, the questions that everyone is trying to answer are: What will the fixed income landscape look like generally if negative yields are now a way of life? And what will it look like if and when a recession actually does occur, particularly for the largest issuer of debt in the world, the U.S.?

Stranger things

But before we dive into that, it probably pays to take a look at how this stuff even works. The table on the following page shows the lay of the land, beginning with central bank policy rates, followed by government yield curves, and then the total amount of debt for each region that is currently trading to negative yields. For our purposes, we'll focus on the central bank policy rates and 10-year

Continued on page 2

Funny money...
(continued from page 1)

The global yield landscape

	Central bank policy rate	Government yield curves				Total negative-yielding debt (USD, '000s)
		2Y	5Y	10Y	30Y	
China	2.55%	2.7%	2.9%	3.1%	3.7%	$7,396,494
U.S.	2.00%	1.6%	1.5%	1.6%	2.1%	$227,248,008
Canada	1.75%	1.5%	1.4%	1.3%	1.5%	$100,420,129
United Kingdom	0.75%	0.4%	0.4%	0.5%	1.0%	$181,380,973
Japan	-0.10%	-0.3%	-0.3%	-0.2%	0.3%	$7,138,715,457
Sweden	-0.25%	-0.6%	-0.6%	-0.3%	-	$285,660,639
Eurozone	-0.50%	-0.7%	-0.8%	-0.6%	-0.1%	$7,496,200,548
Switzerland	-0.75%	-1.1%	-1.2%	-0.9%	-0.5%	$252,321,184
Denmark	-0.75%	-0.8%	-0.8%	-0.6%	-	$165,517,133
						$15,854,860,565

Source - RBC Wealth Management, Bloomberg; data through 9/24/19; eurozone yield curve represented by German sovereign curve; U.S. negative-yielding debt comprises U.S. corporate debt issued in Europe

sovereign bonds.

At a high level, central banks set short-term rates, and market forces largely determine the yields on government debt, though the market's expectations for the future path of policy rates certainly play a role in those yields. So there can be negative short-term rates and negative-yielding longer-term debt, with both having different implications for savers and investors.

Negative policy rates: We'll use the ECB as an example. The ECB cut its overnight deposit rate to -0.5 percent from -0.4 percent in September. In a negative rate environment this is the rate that the ECB charges banks on their excess reserves— or the amount of money beyond regulatory requirements—parked in accounts at the ECB. Thus far, the cost of this charge has been mostly borne by the banks themselves, which eats into profits. To this point they have largely avoided passing on negative rates to retail customers, only charging fees for private clients and companies with large deposits beyond roughly €250,000, though German banks haven't been shy about their desire to charge all accounts, regardless of size, in order to offset the cost.

Negative-yielding 10-year bonds: It's here where we find one of the quirks brought on by the large increase in the amount of outstanding negative-yielding debt: most bond investors have actually done quite well for themselves in recent years. Investors who bought Germany's 10-year note in July 2017, which carried what appeared then to be an unacceptably low coupon of 0.50 percent, are sitting on a total return of 12 percent as the note they bought for €99.10 now trades at €109.90, for a yield of -0.71 percent (bond prices move inversely with yields). Not bad for a world of negative rates.

But we've started to see some pushback as Germany has begun to issue debt with zero percent coupons. To be sure, investors are not making payments to governments in a negative-yield world, they are simply paying premium prices for no future coupons. For example, in July, Germany issued its second 10-year note with a zero percent coupon; investors paid €102.64 at issuance and will receive par of €100 in 2029, delivering the investor a negative yield.

The banks don't really want your money

Central banks cut rates to boost borrowing and investment in order to fuel growth, full employment, and inflation. But all of the global factors that have pushed interest rates well below historical levels in recent decades—the global savings glut, aging demographics, slowing global trend GDP growth, etc.—has meant that zero percent simply isn't low enough to achieve central bank objectives.

The very basic function of a bank is to attract short-term deposits at a certain rate of interest and to then make a longer-term loan at a higher rate of interest. But the money that banks pay you for your deposits has to come from somewhere, and flat yield curves, and a relative lack of demand for new borrowings, have made for a more challenging environment.

Banks are still paying for deposits, but it's lower than it has been in the past—only about half of the fed funds rate this cycle when deposits have equaled fed funds in previous rate hike cycles. In Europe, savers aren't paid anything, and could soon be charged for that privilege. But as foreign as that may feel, if we take a step back, perhaps it's not all that absurd. There are storage costs for lots of things. You could buy gold, but then you would have to find space to put it, maybe in a safe deposit box, but banks already charge for those. You could simply take your money out of the bank and put it under the proverbial mattress, but that isn't terribly safe, and therefore you would probably want to buy a safe.

In a world with plenty of cash, and little demand for it, the banks will still take your money and store it, but it shouldn't be all that surprising if they start charging you for it.

Will the negative yield plague spread?

As the global stock of negative-yielding debt has again neared $16 trillion, the next question is whether the same fate awaits the U.S. market, where the Treasury and investment-grade corporate debt markets total roughly $25 trillion.

A common refrain in recent years is that low/negative global yields have dragged U.S. Treasury yields lower. That hasn't exactly been the case as the 10-year Treasury has opened up a sizeable gap over the comparable German 10-year Bund compared to historical norms. While the divergence is easy to explain—the U.S. economy has been expanding with the Fed raising rates

when Europe has been slowing with the ECB cutting rates—we wonder what happens if/when the U.S. economy hits a downturn.

Prior to reaching escape velocity, the U.S. 10-year Treasury yield averaged about 0.20 percent over the German 10-year Bund yield. With a German 10-year yield of about -0.60 percent, that would put the U.S. yield in negative territory based on current levels. This is not our expectation, however. We believe the gap will close from here as we've likely seen peak U.S. growth, and with some chance that the European picture starts to improve with further ECB policy easing. In our view, the risk of negative yields in the U.S. remains minute for the foreseeable future. However, even if that gap closes modestly, we believe the U.S. 10-year yield could slip below 1.0 percent without much trouble, as it already traded as low as 1.46 percent in September. Our view remains that U.S. yields are likely to continue to trend lower.

With respect to the Fed and the potential for negative policy rates as a tool to fight the next downturn, officials have shown little interest in the past, having studied the issue in 2010. But, now that the ECB and the BoJ have both set the precedent, we wouldn't rule it out in the future. However, our base case in the event of a recession is that the Fed returns rates to zero percent and employs forward guidance and quantitative easing as it did previously.

Fixed income investing outlook

Or maybe that should read "divesting" outlook, as it were, in a negative-rate world. But what's the average investor to do? We believe the key things to remember are that fixed income investing is largely about capital preservation, and that investing in general is a relative process—balancing the risks and rewards within the available universe of investment options and potential outcomes.

While low rates offer little in the way of income, bonds still offer ballast for portfolios in a world of rising uncertainty. As we have seen over the last 10 years, low yields can become no yields, and no yields can become negative yields. Who would lock in a German 10-year Bund yield of -0.60 percent or a 10-year Treasury yield of 1.60 percent? Stock markets can face much larger negative returns than that, and in such an event, a well-diversified portfolio between the two asset classes is likely to continue to offer the offsetting ballasts that it has historically.

Questions remain about whether negative yields are sustainable on a long-term basis, but for now they're likely to remain a feature of markets and investors will have to adjust, as they always have to changing markets.

Mending the market's mood?

Written by Frédérique Carrier

The global economy is showing signs of stabilizing though country performance is uneven. Imminent threats seem to have faded somewhat but certainly have not gone into the ether. Vigilance remains the watchword and investors should focus on the upcoming economic trends and corporate earnings season.

Could the worst be over?

The mood of global equity markets took a turn for the better, as central banks' many recent dovish policy moves should help underpin the business cycle, while positive economic surprises provided a lift. We've seen a bump in positive surprises recently, not only for the G10 as a whole, but also in particular for the U.S., Canada, the UK, and Japan. This does not mean necessarily that these economies are humming along, though the U.S. is faring well, just that they're doing better than widely expected.

But it has proven more difficult for other countries and regions to beat consensus expectations. In China, exports and imports for August fell by one percent and six percent year over year, respectively, while industrial production growth slowed to a meager 4.4 percent. Yet after months of declines, recent developments in the Middle Kingdom point to a possible stabilization, though at a low level. The August Caixin manufacturing and non-manufacturing Purchasing Managers' Indexes (PMIs) have both recently ticked up and hover above the key expansion threshold of 50.

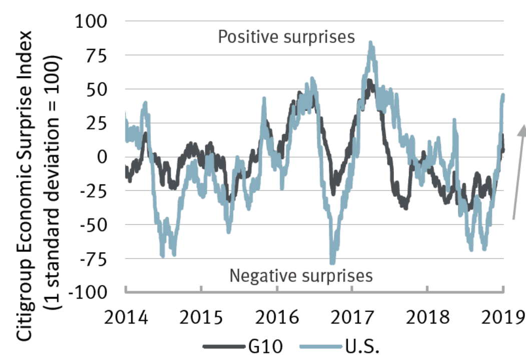
In the eurozone, economic data also surprised, but on the downside. Eurozone activity indicators disappointed across the board in September, falling sharply from the month prior. The manufacturing sector's decline since December 2017 continued, and the non-manufacturing sector weakened—though it remains in expansion territory. This suggests the slowdown in manufacturing might be starting to bleed into the domestic service sectors. That Europe should be hit by the trade war should not come as a shock to anyone—it is not only a very open economy with exports as a percentage of GDP at 43 percent (close to 50 percent for Germany), but it is also very exposed to manufacturing at a high 17 percent of GDP (over 20 percent in Germany).

Much will hinge on …

The main risks to the struggling economies—an escalation of the U.S.-China trade war, a Saudi-Iran confrontation triggering an oil price surge, and the prospect of an

Continued on page 4

Global economic surprises rebound



Source - RBC Wealth Management, Citigroup, Bloomberg; data range 9/25/14 – 9/25/19

imminent no-deal Brexit—seem to have receded somewhat of late, though they have not vanished altogether.

The narrative of the U.S. trade dispute has improved with both China and the U.S. offering olive branches ahead of the upcoming negotiations in October. China has exempted large importers from tariffs on U.S. pork and soy products, while the U.S. has mentioned rolling back its most recent round of tariffs.

This improved backdrop puts the upcoming talks on a firmer footing, though a breakthrough is far from assured. After all, it would be more advantageous for President Donald Trump to strike a deal closer to the election in November 2020. Meanwhile, the Chinese may not necessarily want to aid in his re-election.

And should some deal be eventually consummated, the next question would be whether it would hold. Moreover, an agreement on this front may also free up the Trump administration to focus on the next big issue—the EU-U.S. trade negotiations. Trump has already voiced his displeasure at the weakness of the euro.

As for the Saudi-Iran confrontation, the oil price is close to its pre-attack level. But RBC Capital Markets suggests the crisis is far from over. Sustainably higher oil prices would hurt countries that are net importers of oil, and growth in Japan and the eurozone in particular would likely moderate should prices spike again.

Finally, the risk of an imminent no-deal Brexit, which would have wounded the UK and European economies, has retreated somewhat after recent events but may not be entirely off the table.

Keep your eye on the ball

We would suggest investors take the volatility in stride and focus on what really matters: economic trends and corporate earnings. The consensus continues to expect modest earnings growth, which seems achievable to us in most regions given the decent economic backdrop.

Benchmarks

Equity market 12-month trailing return (for month ending September 30, 2019)	
S&P/TSX composite total return index	7.1%
S&P 500 total return (C$)	7.0%
S&P 500 total return (U$)	4.3%
DJIA total return (C$)	6.9%
DJIA total return (U$)	4.2%
Nasdaq composite price return (C$)	2.0%
Nasdaq composite price return (U$)	-0.6%

RBC Capital Markets Canadian Bond Market indexes 12-month trailing return (for month ending September 30, 2019)	
Short-term index	4.4%
Intermediate-term	9.5%
Three-month T-Bill (C$)	1.7%
Three-month T-Bill (U$)	2.4%

Introducing Karen Murphy

Karen has been working in the financial industry for over 14 years. She joined RBC Dominion Securities in May 2013 after working at another major international bank. Karen provides administrative support to all members of our team, while her extensive familiarity with technology places her in an ideal position to support clients with any inquiries regarding RBC DS Online. In addition, Karen is involved with special projects that support our overall client service commitment. When not in the office, Karen spends time with her son Oliver and husband James, exploring Toronto and all it has to offer.

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