RBC WEALTH MANAGEMENT

Global Insight

Focus Article

A new phase

The activation of key recessionary tripwires portends a new phase for equities—and investment strategy.

Allworth & Bogdanova

For important and required non-U.S. analyst disclosures, see page 9

All values in U.S. dollars and priced as of August 31, 2019, market close, unless otherwise noted.
Disseminated: Sept 4, 2019 16:40ET; Produced: Sept 4, 2019 11:36ET

Wealth Management

Focus article

A new phase

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

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

Propelled by the record-long economic expansion, the 10-year equity bull market has pushed past one milestone after another. But the activation of two of our key recessionary tripwires portends a new phase for equities—and investment strategy. Investors may need to get more defensive in coming months, as the risk-reward balance for equities could become less favorable.

The global equity market is entering a new phase—one that requires more deliberate, careful consideration of portfolio positioning.

During the past 10 years of the U.S. economic expansion and equity bull market, none of our major U.S. recession tripwires were activated. The indicators remained in the green despite temporary slowdowns and through periods of overseas instability, signaling that the economic expansion would persist and, in turn, would provide a firm foundation not just for the U.S. equity market but for global stock markets as well.

Since the end of the Great Recession in 2009, tracking these persistent signals has enabled us to stay fully invested in equities for all but four of 122 months, and to avoid the distractions of normal pullbacks and corrections. We reasoned that, as long as the U.S. economy seemed set for continued expansion, we could take market volatility in stride and keep equity weightings at a benchmark level or higher in portfolios. The S&P 500 Index has almost tripled during this period.

But the economic terrain is shifting. One of our six recession indicators—the yield curve—is now flashing red for the first time in the current expansion cycle. Another indicator that tracks the manufacturing sector—ISM New Orders minus Inventories—just shifted to a yellow cautionary signal.

RBC Wealth Management U.S. economic recession scorecard

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

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

The yield curve indicator has shifted to red and another indicator to yellow, signaling to us that recession risks have risen. However, our other four are still signaling economic expansion—for now.

With short-term Treasury yields higher than the 10-year note yield, and the gap between the two widening, the yield curve inversion has become more pronounced. The 2-year to 10-year portion of the curve briefly inverted in August, and we think the gap could widen. Historically, these yield curve movements have been harbingers of a recession arriving a year or so in the future.

These changes come at a time when the U.S. economic expansion is, admittedly, long in the tooth. Weak trends in Europe and Asia, notably in Germany and in China, are weighing on global growth. So too is the trade dispute between the U.S. and China with both sides layering on additional tariffs and more aggressive rhetoric. The longer the trade battle persists, the greater the risk that more consumer confidence data could erode and business confidence could sink further, all to the detriment of not just the global economy but, potentially, the U.S. domestic economy as well.

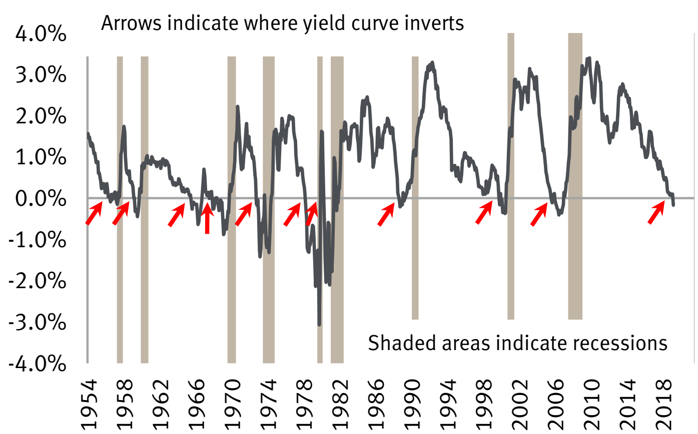
These developments have led us to become incrementally more cautious about equity positioning, with an eye toward recommending more defensive adjustments to portfolios in coming months.

Hazardous curve, or just a curveball?

Reasonable arguments can be made that the U.S. economic expansion and bull market can continue for some time. Our four other recession indicators are still in expansion mode, while the all-important consumer spending remains healthy, supported by steady wage growth and the confidence that comes with a tight labor market.

Importantly, households and businesses still have easy access to credit as banks remain willing to lend. The Fed's most recent Senior Loan Officer Opinion Survey revealed that banks continue to ease lending standards for most types of business and mortgage loans. The latest monthly survey of small and medium-sized businesses by the National Federation of Independent Business found that, as has been true for several years, only a very small percentage of respondents (3% in

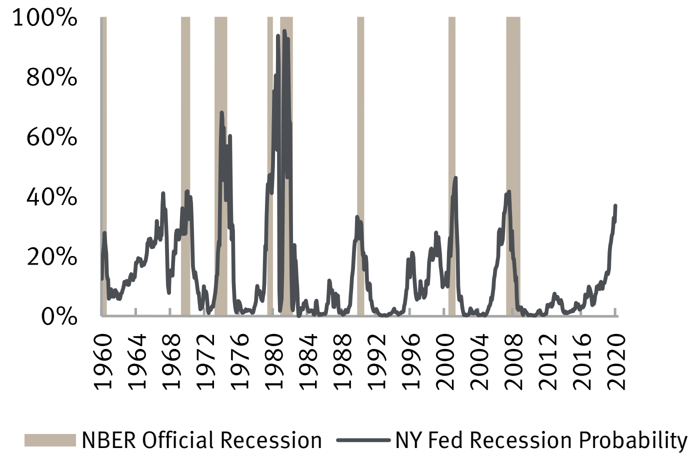
Yield differential between the U.S. 10-year and 1-year Treasury (%)



The yield curve has inverted for the first time this expansion cycle. This is a cautionary signal as all but one previous inversions preceded a recession.

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

New York Fed Recession Probability Index



Source - RBC Wealth Management, Bloomberg, New York Fed, National Bureau of Economic Research (NBER); data based on spread between 3-month Treasury bill and 10-year Treasury note yields

If we were to rely on one indicator, the yield curve (and we don't, we rely on six indicators), the New York Fed calculates a 37% probability of recession one year from now.

July) reported that not all their credit needs were met. Only 2% reported that their latest loan had been harder to get than the previous one.

Furthermore, there are circumstances in place that may make the Treasury yield curve a less valuable signal today. Some argue it is more reflective of global growth concerns than domestic U.S. risks, and that the present inversion is a technical anomaly reflecting a global stampede to the perceived safety of Treasuries, which offer relatively high yields compared to the $16T in negative-yielding sovereign bonds worldwide, especially in much of Europe and Japan.

As has often been the case during yield curve inversions, well-reasoned and compelling arguments like these are being offered in support of the thesis that yield curve inversion no longer matters—or, at least, that it doesn't matter this time. But when the U.S. economy begins to shift from expansion to contraction, there are almost always "unique" circumstances that can be cited to explain away the warning signals. Typically, recessions arrive nonetheless.

The yield curve has a track record as an economic indicator that is hard to ignore. It is usually the first of our indicators to flash a recession warning. But the "inversion signal" has always been hard for investors to get behind, precisely because it typically provides such a long early warning. An inversion is usually followed by several quarters of positive economic growth—the last such interval lasted almost two years.

On average, the yield curve has inverted 14 months before each of the last nine recessions since 1950. Only one false signal was given: in the mid-1960s, when the curve inverted but no recession materialized, although GDP growth slowed sharply to a standstill.

The S&P 500 has peaked about six months after each yield curve inversion, on average. But this is not a reliable market timing mechanism because the gap between inversion and market peak has varied widely, with the shortest occurring two months before inversion and the longest gap stretching to 21 months after inversion. On a number of occasions, the S&P 500 reached new highs *after* the yield curve inverted, and then shifted into a bear market before or during the ensuing recession.

A broader view of recession risks

Until just a few months ago, our other four recession indicators were unequivocally signaling no recession in sight. Today, while none of them have flipped, all of them are closer to doing so than they were months ago.

(For a look at all six of the U.S. recession indicators we follow, together with our assessment of what each is currently signaling, please see the appendix that follows this article.)

A cautionary tale?

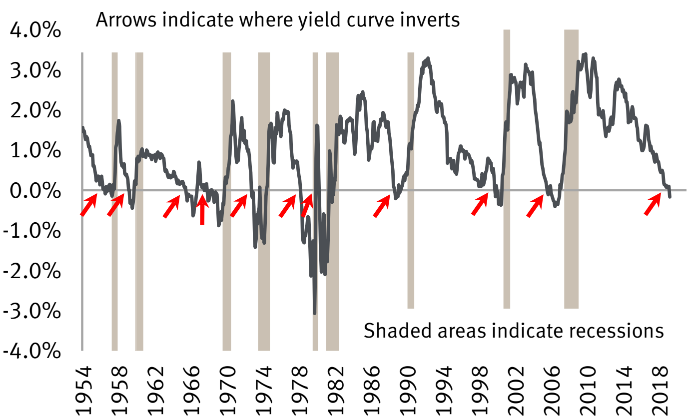
None of these six indicators has a perfect track record—although some come close. And even if one indicator had performed perfectly to date, there's a first time for everything. But looking at these indicators as a group, rather than individually, has given us a reliable picture of how the recession probabilities are shifting.

With the yield curve indicator now flashing red, the manufacturing reading at yellow, and some indicators showing the potential to shift in the months ahead, we think some additional caution is warranted.

While the S&P 500 could conceivably reach another all-time high, as it has after some of the previous yield curve inversions, we think the market has entered a new phase. In one important respect, and within the historical context, the inverting of the yield curve can be seen as opening the door to the arrival of a potential bull market peak for the first time in 10 years. We believe the risk-reward balance for global and U.S. equities will shift to less favorable terms as more recession indicators start to flash caution signs. Once the economy's path shifts decisively toward an eventual U.S. recession, a more cautious and defensive approach to U.S. and global equities will be called for.

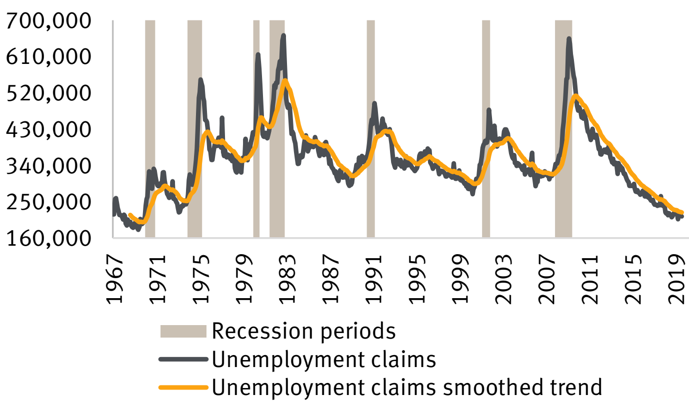
RBC Wealth Management's recession scorecard: The state of the indicators

Following are the six major economic indicators we use to gauge recession risks, along with explanations of what each is currently signaling.



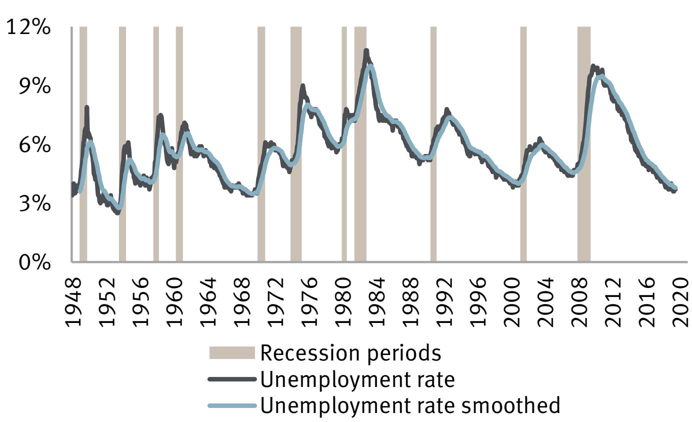
Source - RBC Wealth Management, Bloomberg, U.S. Federal Reserve, National Bureau of Economic Research

Yield curve: The gap between the 10-year and 1-year Treasury yields usually inverts several quarters before a U.S. recession begins. The monthly data inverted in August, suggesting a U.S. recession could get underway in the late summer or autumn of 2020. The yield curve usually inverts because the Fed is pushing short-term rates higher in an effort to cool down an overheating economy. This time, however, the inversion was caused by the 10-year Treasury yield plummeting as European and Japanese investors, dissatisfied with negative yields in their home debt markets, rushed into U.S. Treasuries, pushing the price of those bonds higher and the yields they offer sharply lower. There are few, if any, signs that credit conditions have tightened in the U.S. or elsewhere.



Source - RBC Wealth Management, U.S. Bureau of Labor Statistics

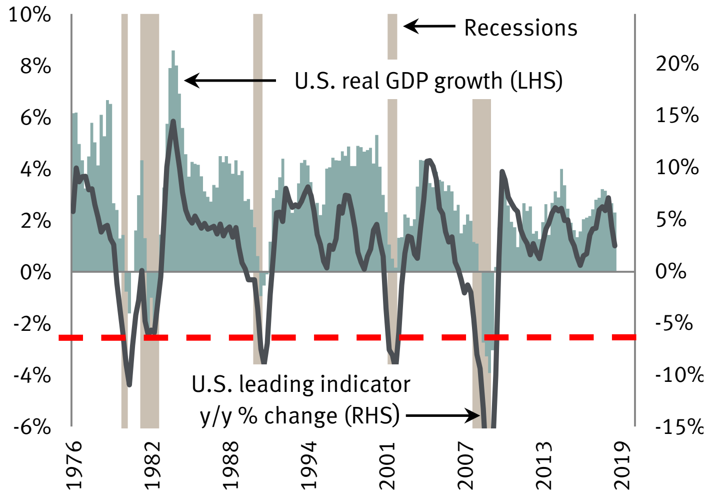
Unemployment Insurance claims: A bottoming of unemployment claims has reliably preceded the arrival of a U.S. recession, with the cycle low typically occurring several quarters before the recession's onset. Currently, the smoothed trend of weekly claims continues to move lower. The lowest weekly posting since 2007 was back in April, so if the trend were to turn higher from here without a new weekly low being set, then history suggests a recession would most likely materialize in the spring or summer of 2020.



Source - RBC Wealth Management, U.S. Bureau of Labor Statistics

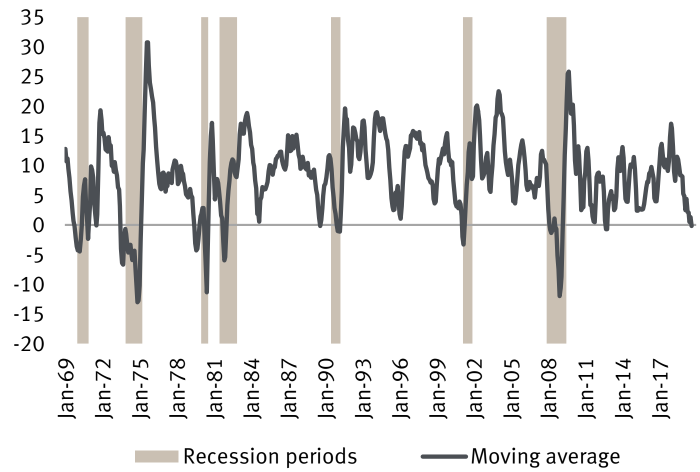
Unemployment rate: Once the unemployment rate turns the corner and begins trending higher, the start of a recession is typically two to six months away. While recent data puts the unemployment rate only one tick above its most recent low of 3.6%, which was the lowest posting in almost 50 years, we note that unemployment has been sitting below 4% for almost a year. It would take only a couple of monthly readings at 3.9% or higher to shift this indicator out of expansionary territory. However, given Labor Department estimates of 7.3 million unfilled jobs in the U.S. versus six million unemployed, it seems quite possible the unemployment rate is not yet ready to turn higher. In our view, further declines in the unemployment rate can't be ruled out—stay tuned.

A new phase: Appendix



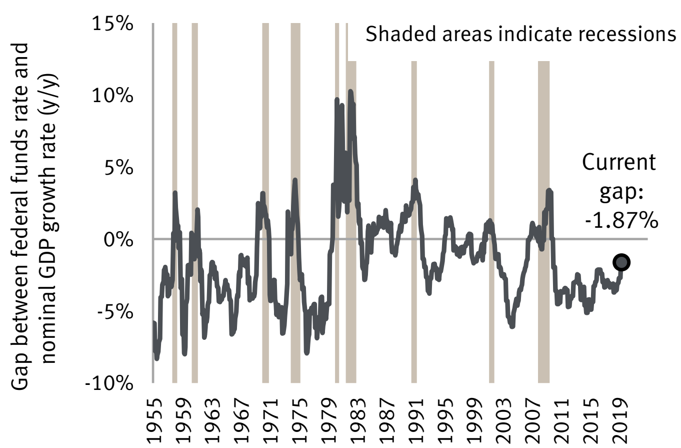
Source - RBC Wealth Management, Conference Board, Department of Commerce

Conference Board Leading Economic Index (LEI): This indicator is something of a hybrid; it is put together by the Conference Board using 10 monthly economic variables. Three of these (Unemployment Insurance claims, the yield curve, and ISM New Orders) figure in the calculation of our "Recession scorecard," so there is a bit of double counting here; we don't know exactly how much, because the Conference Board's method of dynamically weighting the 10 variables is proprietary. Whenever the LEI has fallen below where it was a year earlier (shown as negative values on the chart), a recession has always followed—typically, about six months later. Currently, the LEI sits about 1.6% above where it was a year ago. We think it would take two to three months of weakening data from here to push the year-over-year change into negative territory. Were this scenario to unfold, we think a recession would be likely to start in the summer of 2020.



Source - RBC Wealth Management, Bloomberg, Institute for Supply Management

ISM New Orders minus Inventories: The ISM Manufacturing Index is often referred to as a leading indicator, but, in our view, it has not been very useful—having missed some important turns in the economy by wide margins. But two components of the index, taken together, have a good track record of signaling recessions as they begin or shortly before they begin. The difference between the New Orders component and the Inventories component has fallen below zero near the start of most U.S. recessions. But it has also occasionally registered a false positive, signaling that a recession was imminent when none occurred. Therefore, we view this as a corroborative indicator—one to pay attention to if other, longer-term indicators are saying a recession is on the way. It has just fallen fractionally below zero and bears watching.



Source - RBC Wealth Management, Federal Reserve, Bureau of Economic Analysis

Fed funds rate vs. nominal GDP growth: Since the federal funds rate came on the scene in the early 1950s, there has never been a U.S. recession that was not preceded by the fed funds rate rising above the year-over-year nominal growth rate of the economy (the growth rate before adjusting for inflation). In Q2 2019, the nominal GDP growth rate was about 4%. The fed funds rate is sitting at 2.25%—that's 1.75% below the run rate of the economy, or seven 25 basis point Fed rate hikes from here. This indicator is saying borrowing rates are just not high enough to choke off growth in the U.S. economy. And in our view, they don't look likely to get there anytime soon.

Research resources

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

Global Portfolio Advisory Committee members:

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

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

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

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

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

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

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

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

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

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

Michael Schuette, CFA – Multi-Asset Portfolio Strategist, RBC Wealth Management Portfolio Advisory Group – U.S., RBC Capital Markets, LLC

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

The RBC Investment Strategy Committee (RISC) consists of senior investment professionals drawn from individual, client-focused business units within RBC, including the Portfolio Advisory Group. The RISC builds a broad global investment outlook and develops specific guidelines that can be used to manage portfolios. The RISC is chaired by Daniel Chornous, CFA, Chief Investment Officer of RBC Global Asset Management Inc.

Required disclosures

Analyst Certification
All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.

Important Disclosures
In the U.S., RBC Wealth Management operates as a division of RBC Capital Markets, LLC. In Canada, RBC Wealth Management includes, without limitation, RBC Dominion Securities Inc., which is a foreign affiliate of RBC Capital Markets, LLC. This report has been prepared by RBC Capital Markets, LLC which is an indirect wholly-owned subsidiary of the Royal Bank of Canada and, as such, is a related issuer of Royal Bank of Canada.

Non-U.S. Analyst Disclosure: Jim Allworth, Mark Bayko, Christopher Girdler, and Patrick McAllister, employees of RBC Wealth Management USA's foreign affiliate RBC Dominion Securities Inc.; and Frédérique Carrier and Alastair Whitfield, employees of RBC Wealth Management USA's foreign affiliate Royal Bank of Canada Investment Management (U.K.) Limited contributed to the preparation of this publication. These individuals are not registered with or qualified as research analysts with the U.S. Financial Industry Regulatory Authority ("FINRA") and, since they are not associated persons of RBC Wealth Management, they may not be subject to FINRA Rule 2241 governing communications with subject companies, the making of public appearances, and the trading of securities in accounts held by research analysts.

In the event that this is a compendium report (covers six or more companies), RBC Wealth Management may choose to provide important disclosure information by reference. To access current disclosures, clients should refer to https://www.rbccm.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?EntityID=2 to view disclosures regarding RBC Wealth Management and its affiliated firms. Such information is also available upon request to RBC Wealth Management Publishing, 60 South Sixth St, Minneapolis, MN 55402.

References to a Recommended List in the recommendation history chart may include one or more recommended lists or model portfolios maintained by RBC Wealth Management or one of its affiliates. RBC Wealth Management recommended lists include the Guided Portfolio: Prime Income (RL 6), the Guided Portfolio: Dividend Growth (RL 8), the Guided Portfolio: ADR (RL 10), and the Guided Portfolio: All Cap Growth (RL 12). RBC Capital Markets recommended lists include the Strategy Focus List and the Fundamental Equity Weightings (FEW) portfolios. The abbreviation 'RL On' means the date a security was placed on a Recommended List. The abbreviation 'RL Off' means the date a security was removed from a Recommended List.

Distribution of Ratings
For the purpose of ratings distributions, regulatory rules require member firms to assign ratings to one of three rating categories - Buy, Hold/Neutral, or Sell - regardless of a firm's own rating categories. Although RBC Capital Markets, LLC ratings of Top Pick/Outperform, Sector Perform, and Underperform most closely correspond to Buy, Hold/Neutral and Sell, respectively, the meanings are not the same because our ratings are determined on a relative basis.

Explanation of RBC Capital Markets, LLC Equity Rating System
An analyst's "sector" is the universe of companies for which the analyst provides research coverage. Accordingly, the rating assigned to a particular stock represents solely the analyst's view of how that stock will perform over the next 12 months relative to the analyst's sector average.

Distribution of Ratings - RBC Capital Markets, LLC Equity Research
As of June 30, 2019

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	772	53.57	215	27.85
Hold [Sector Perform]	588	40.80	114	19.39
Sell [Underperform]	81	5.62	2	2.47

Ratings: Top Pick (TP): Represents analyst's best idea in the sector; expected to provide significant absolute total return over 12 months with a favorable risk-reward ratio. **Outperform (O):** Expected to materially outperform sector average over 12 months. **Sector Perform (SP):** Returns expected to be in line with sector average over 12 months. **Underperform (U):** Returns expected to be materially below sector average over 12 months. **Restricted (R):** RBC policy precludes certain types of communications, including an investment recommendation, when RBC is acting as an advisor in certain merger or other strategic transactions and in certain other circumstances. **Not Rated (NR):** The rating, price targets and estimates have been removed due to applicable legal, regulatory or policy constraints which may include when RBC Capital Markets is acting in an advisory capacity involving the company.

Risk Rating: The **Speculative** risk rating reflects a security's lower level of financial or operating predictability, illiquid share trading volumes, high balance sheet leverage, or limited operating history that result in a higher expectation of financial and/or stock price volatility.

Valuation and Risks to Rating and Price Target
When RBC Wealth Management assigns a value to a company in a research report, FINRA Rules and NYSE Rules (as

incorporated into the FINRA Rulebook) require that the basis for the valuation and the impediments to obtaining that valuation be described. Where applicable, this information is included in the text of our research in the sections entitled "Valuation" and "Risks to Rating and Price Target", respectively.

The analyst(s) responsible for preparing this research report have received (or will receive) compensation that is based upon various factors, including total revenues of RBC Capital Markets, LLC, and its affiliates, a portion of which are or have been generated by investment banking activities of RBC Capital Markets, LLC and its affiliates.

Other Disclosures

Prepared with the assistance of our national research sources. RBC Wealth Management prepared this report and takes sole responsibility for its content and distribution. The content may have been based, at least in part, on material provided by our third-party correspondent research services. Our third-party correspondent has given RBC Wealth Management general permission to use its research reports as source materials, but has not reviewed or approved this report, nor has it been informed of its publication. Our third-party correspondent may from time to time have long or short positions in, effect transactions in, and make markets in securities referred to herein. Our third-party correspondent may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any company mentioned in this report.

RBC Wealth Management endeavors to make all reasonable efforts to provide research simultaneously to all eligible clients, having regard to local time zones in overseas jurisdictions. In certain investment advisory accounts, RBC Wealth Management or a designated third party will act as overlay manager for our clients and will initiate transactions in the securities referenced herein for those accounts upon receipt of this report. These transactions may occur before or after your receipt of this report and may have a short-term impact on the market price of the securities in which transactions occur. RBC Wealth Management research is posted to our proprietary Web sites to ensure eligible clients receive coverage initiations and changes in rating, targets, and opinions in a timely manner. Additional distribution may be done by sales personnel via e-mail, fax, or regular mail. Clients may also receive our research via third-party vendors. Please contact your RBC Wealth Management Financial Advisor for more information regarding RBC Wealth Management research.

Conflicts Disclosure: RBC Wealth Management is registered with the Securities and Exchange Commission as a broker/dealer and an investment adviser, offering both brokerage and investment advisory services. RBC Wealth Management's Policy for Managing Conflicts of Interest in Relation to Investment Research is available from us on our website at https://www.rbccm.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?EntityID=2. Conflicts of interests related to our investment advisory business can be found in Part 2A Appendix 1 of the Firm's Form ADV or the RBC Advisory Programs Disclosure Document. Copies of any of these documents are available upon request through your Financial Advisor. We reserve the right to amend or supplement this policy, Part 2A Appendix 1 of the Form ADV, or the RBC Advisory Programs Disclosure Document at any time.

The authors are employed by one of the following entities: RBC Wealth Management USA, a division of RBC Capital Markets, LLC, a securities broker-dealer with principal offices located in Minnesota and New York, USA; by RBC Dominion Securities Inc., a securities broker-dealer with principal offices located in Toronto, Canada; by RBC Investment Services (Asia) Limited, a subsidiary of RBC Dominion Securities Inc., a securities broker-dealer with principal offices located in Hong Kong, China; and by Royal Bank of Canada Investment Management (U.K.) Limited, an investment management company with principal offices located in London, United Kingdom.

Third-party disclaimers

The Global Industry Classification Standard ("GICS") was developed by and is the exclusive property and a service mark of MSCI Inc. ("MSCI") and Standard & Poor's Financial Services LLC ("S&P") and is licensed for use by RBC. Neither MSCI, S&P, nor any other party involved in making or compiling the GICS or any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability and fitness for a particular purpose with respect to any of such standard or classification. Without limiting any of the foregoing, in no event shall MSCI, S&P, any of their affiliates or any third party involved in making or compiling the GICS or any GICS classifications have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

References herein to "LIBOR", "LIBO Rate", "L" or other LIBOR abbreviations means the London interbank offered rate as administered by ICE Benchmark Administration (or any other person that takes over the administration of such rate).

Disclaimer

The information contained in this report has been compiled by RBC Wealth Management, a division of RBC Capital Markets, LLC, from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC Wealth Management, its affiliates or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report constitute RBC Wealth Management's judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. Nothing in this report constitutes legal, accounting or tax advice or individually tailored investment advice. This material is prepared for general circulation to clients, including clients who are affiliates of Royal Bank of Canada, and does not have regard to the particular circumstances or needs of any specific