December 9, 2016

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

The first domino to wobble

Frédérique Carrier – London

The political establishment was rocked again by the resounding victory of the "No" vote in the Italian referendum. Though largely expected and discounted in financial markets, the country now finds itself in political limbo, and the consequences of the vote could significantly reverberate across Europe.

Italians decisively rejected the constitutional reforms championed by Prime Minister Matteo Renzi. He had argued these reforms would have improved the country's governability, thereby strengthening the economic reform effort and enhancing Italy's paltry growth profile.

The "No" vote dealt a crushing blow to Renzi's economic reform agenda. The referendum was also, in effect, a vote on Renzi's mandate to govern and he followed through on his threat to resign if "No" prevailed. President Sergio Mattarella, the ceremonial head of state, is now expected to cobble together a caretaker government to hold the fort until the general elections scheduled to take place no later than Q2 2018.

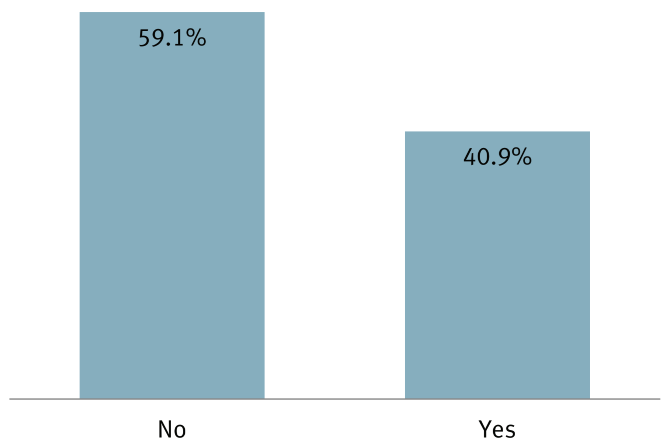
Italy's banks: Handle with care

Stalling reforms are a negative for any economy, but particularly so for a country which is stagnating, highly indebted, and burdened with a dysfunctional banking system crippled by €360B in impaired loans, which represent a high 13% of GDP. Italy, as the eurozone's third-largest economy, is a core member of the EU, and, unlike Greece, much too large to bail out.

Moreover, the referendum result comes at a time when the country's banks are trying to recapitalise. Monte dei Paschi di Siena (MPS), Italy's third-largest lender, had been trying to engineer a €5B rights issue—a tall order for any bank with a market cap of €0.6B. Investors are dithering, understandably preferring to wait for a new government before committing.

Renzi's resounding defeat

Italian referendum results



Source - RBC Wealth Management, Bloomberg

Market pulse

Click here for authors' contact information.
Priced (in USD) as of 12/9/16 market close, EST (unless otherwise stated).
For important and required non-U.S. analyst disclosures, see Page 6.

The state is of little help. Not only is it already heavily indebted, but recent EU rules bar governments from bailing out banks, prescribing bail-ins instead, in which shareholders and bondholders take on heavy losses.

The problem is that in Italy, 50% of banks' debt is owned by small individual investors. Therefore, following this route would wipe out private investors' savings—not a popular move.

If no solution is found, the MPS situation could spiral out of control and drag down the Italian banking system with it. Should the banking crisis spread, contagion to the rest of the eurozone cannot be ruled out.

It doesn't need to come to that as Italy and the EU have shown the agility to come up with creative solutions in the past. Establishing a bank to hold bad loans, selective bail-ins, debt/equity swaps, and bank mergers may all be on the table. Restoring confidence in the banking system is key, in our view—but not easy to do with no government in place. The suggestion that the Italian Treasury was about to apply to the European Stability Mechanism for a €15B loan to support the banking system, though downplayed by the authorities, was greeted with much enthusiasm.

Not caught off-guard

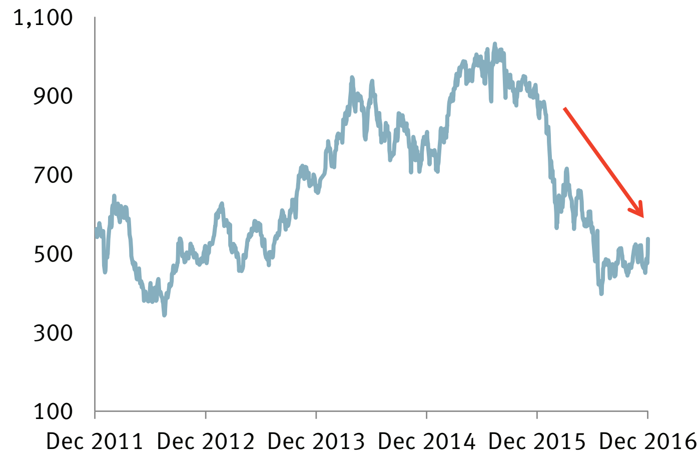
Unlike the Trump victory or the Brexit vote, which were "surprise" outcomes, the "No" victory in the Italian referendum had been well telegraphed and had been partially discounted in financial markets.

Sovereign bond yield spreads of peripheral eurozone countries had already moved wider while the Italian stock market and bank shares had fallen 20% and 40% year to date, respectively, before the vote. Current financial markets' resilience may also be due to aggressive short covering and to the expectation the European Central Bank (ECB) would extend its quantitative easing programme. It obliged and, while reducing monthly purchases from €80B to €60B, tacked on another nine months to the scheme to December 2017, longer than anticipated. It also reiterated it is ready to step in should market action make it necessary.

Our Underweight position in European equities, initiated after the Brexit vote, has worked well, with the region underperforming other markets. One reason for our stance is the unusually high level of political uncertainty in the region over the next 12 months. While we maintain this view for now, we will follow the next development in this Italian saga with great interest.

The risk of the referendum was largely discounted

Italian Banks Index



Source - RBC Wealth Management, Bloomberg; data period: 12/7/11 – 12/7/16

A recapitalisation below peak price?

Monte dei Paschi share price (€)

Source - RBC Wealth Management, Bloomberg; data through 12/8/16

United States

Kelly Bogdanov – San Francisco

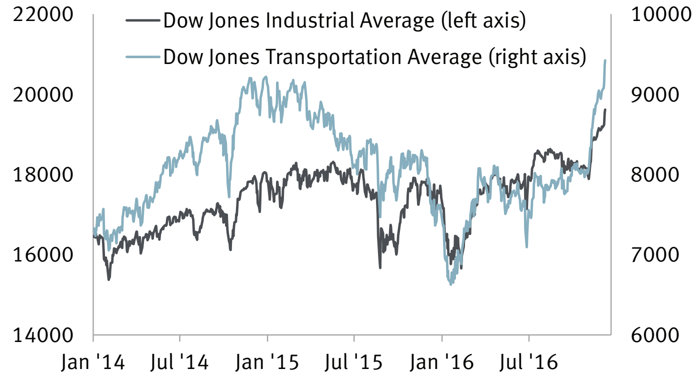
- The S&P 500's 3.1% move during the week and 5.6% rally since the election have included numerous positive signals along the way. For those who respect market history, especially the "Dow Theory," **the best signal of all** occurred on Wednesday when the **transportation group reached an all-time high** for the first time in two years. This isn't any ordinary new high. It comes only four months after the Dow Jones Industrial Average (the "Dow") reached the first in a string of new highs.
- This is **notable to market participants who adhere to or respect the "Dow Theory"** like we do. The nearly concurrent, technically significant price action in transportation stocks and the Dow **can signal forthcoming market trends**. To Dow Theorists, the transports' new high just four months after the Dow's initial new high confirms the bull market has legs. While pullbacks can and likely will occur in coming months, **we now have even greater confidence the broader market will deliver additional gains** over the medium to long term.
- **Biotech and pharmaceutical stocks** have been sore spots for the market. They rallied after the election, but have since **sold off on renewed concerns about drug price controls.** *Time* magazine reported that President-elect Donald Trump said, "I'm going to bring down drug prices. I don't like what's happened with drug prices." While we acknowledge industry self-regulation or limited federal regulation could be imposed, **we believe the Republican-led House will protect these industries from harsh, overly restrictive price controls** because key leaders strongly believe it would stifle drug innovation. Given the numerous free-market champions Trump will nominate for his cabinet, including Health and Human Services nominee Representative Tom Price, we doubt Trump is signaling a forthcoming war on the these industries. **We are buyers of biotech and pharma stocks**.

Canada

Farazeh Mahboob & Alicia Buckiewicz – Toronto

- Since the U.S. presidential election, on November 8, the **S&P/TSX Composite** has performed **roughly in-line with the S&P 500** and outperformed the MSCI All Country World Index by approximately 200 basis points.
- Two themes were prevalent as the **domestic banks** reported strong Q4 results: **improving credit loss trends and positive operating leverage** tied to cost containment initiatives. The average valuation for the group has

Both indexes critical to a positive "Dow Theory" signal have reached new highs



Source - RBC Wealth Management, Bloomberg; data through 12/8/16

expanded to a modest premium to the long-term average at 11.7x forward earnings relative to the long-term average of 11.4x. RBC Capital Markets believes **valuations can be sustained and could expand** if that credit remains benign, excess capital continues to build, and higher rates lead to net interest margin expansion. RBC Capital Markets **forecasts 5% EPS growth for 2017 followed by 7% in 2018** for the large banks under its coverage.

- **Canadian automakers have had a bumpy ride** over the past month. After the U.S. election, they experienced some weakness stemming from **concerns** President-elect Donald Trump could withdraw the U.S. from **NAFTA** and impose **punitive tariffs on Mexico**. However, the automakers have shown some strength in the past week as **investors reassess the potential for an acceleration** in short-term economic growth tied to tax cuts and fiscal stimulus.
- **OPEC's freshly-minted deal to curtail crude oil production faces its first real test** on December 10 when the cartel will seek firm production cut commitments from non-OPEC counterparts. OPEC has invited representatives from 14 countries to meet in Vienna where it will ask them to collectively slash 600,000 barrels per day of output. Crude oil prices have rallied over the past week and **failure to agree on further production cuts could dampen sentiment**. RBC Capital Markets forecasts a North American benchmark price of $56 per barrel in 2017.

Europe

Frédérique Carrier & Thomas McGarrity – London

- The **STOXX Europe 600 rallied 4.7%** during the week, helping the index reach **its highest level since January** amid further supportive policies from the European Central Bank and a surge in the banking sector on hopes of a state-backed rescue for struggling Italian banks.

- The **race to acquire Actelion Ltd.**, the Swiss biotech company, **heated up** with reports that French pharmaceutical giant **Sanofi** was considering countering U.S. competitor **Johnson & Johnson's** (J&J) bid. J&J has reportedly offered more than $27B.
- **Capita plc**, the U.K. outsourcing company, **fell 11.4%** during the week, after announcing **a second profit warning in less than three months**. The company has been impacted by clients' cost-saving measures, resulting in lower discretionary spend in a number of areas, such as training. Many outsourcing businesses have highlighted that their clients have restricted budgets and delayed decisions due to post-Brexit uncertainty.
- The **Supreme Court hearing** on whether U.K. members of parliament (MPs) need to vote on the triggering of **Article 50** took place during the week, following the High Court ruling against the government last month. While the verdict is not expected until January, **Prime Minister Theresa May has won the overwhelming backing of MPs for her timetable** for triggering Brexit talk. She has agreed to publish an outline of the government's negotiating objectives as well as a vote for MPs on the final Brexit deal.

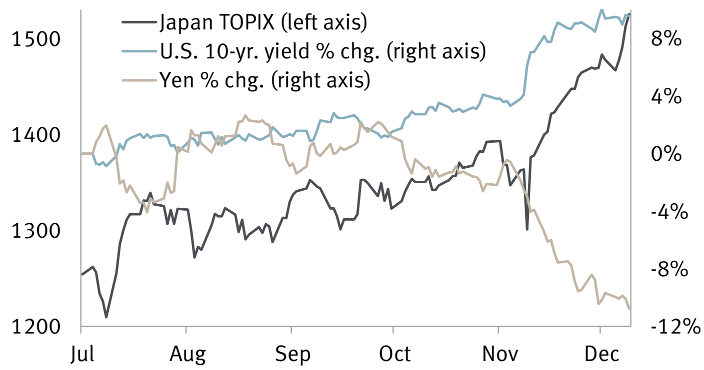
Asia Pacific

Jay Roberts – Hong Kong

- **Asian equities rose during the week** as local markets recovered from the negative effect of the post-election rally in the dollar and U.S. bond yields. **Japanese equities** continued their run **deeper into bull market** territory. The **TOPIX has risen over 26%** from its summer low, helped by a reversal in the yen and **much-improved investor sentiment** toward Japanese stocks as shown by a recent spate of upgrades from equity strategists.
- The **rise in U.S. bond yields and inflation expectations is positive** for Japanese stocks. Over the past 10 years, the relative performance of Japanese stocks versus global stocks has moved closely with yields on 10-year U.S. Treasury Inflation Protected Securities (TIPS). Also, an environment of rising U.S. 10-year bond yields relative to Japan Government Bond 10-year yields is typically negative for the yen, which in turn is positive for Japanese stocks. Finally, **the decline in the yen and the rise in energy prices should help to generate a degree of inflation in 2017**.
- **Capital outflow from China was again the news** as the country's FX reserves declined by $69B in November. This was the **largest move since the start of the year** when fears of major capital outflows were a key reason for the global equity correction. However, the decline in China's FX reserves does not translate directly into capital outflow.

In the past six months, Japanese equities have risen on the U.S. yield spike and depreciating yen

TOPIX Index, normalized U.S 10-yr. yield & normalized YEN/USD cross



Source - RBC Wealth Management, Bloomberg; data through 12/9/16.
U.S. treasury yield and YEN/USD cross normalized as percent change, +/- 6%

A large part of the decline was the valuation impact from the **surge in the dollar** in November. Second, the sharp rise in Treasury yields (i.e., Treasury prices fell) negatively impacted China's U.S. Treasury holdings, which are well over $1T. Accounting for these, **actual capital outflow may have been around $40B**, still a large number, but about the same as prior months and totaling around 1.3% of China's FX reserves, which are just over $3T.

- China's capital **outflow may persist for a while longer**. One driver has been the gradual depreciation of the renminbi against the dollar since August 2015. RBC Capital Markets forecasts further declines in 2017. However, investors should note that **the weaker currency has also provided a tailwind to parts of China's economy**. China's steady economic data for most of 2016 has been a boon to global equity markets.
- Separately, even though the currency has weakened, China has probably spent over $500B propping it up over the past 18 months to avoid a more-rapid decline. Thus, **labelling China a currency manipulator**, a term reserved for countries that seek to actively weaken their currencies, **would be a stretch**.
- There were two important political events in Asia. **New Zealand Prime Minister John Key**, in office for eight years, unexpectedly announced he **will step down** to spend more time with family. Deputy Prime Minister Bill English will succeed him. The kiwi was steady against the dollar through the week.
- **In South Korea, parliament voted overwhelmingly to impeach President Park Geun-hye**. Park has been under pressure, including huge public demonstrations, on **allegations of corruption**. A constitutional court will have 180 days to make a decision. Hwang Kyo-ahn has become the acting president.

MARKET SCORECARD

Data as of December 9, 2016

Equities (local currency)	Level	1 week	MTD	YTD	12 mos
S&P 500	2,259.53	3.1%	2.8%	10.5%	10.3%
Dow Industrials (DJIA)	19,756.85	3.1%	3.3%	13.4%	12.9%
NASDAQ	5,444.50	3.6%	2.3%	8.7%	8.4%
Russell 2000	1,388.07	5.6%	5.0%	22.2%	21.1%
S&P/TSX Comp	15,312.20	1.7%	1.5%	17.7%	18.4%
FTSE All-Share	3,775.80	3.0%	2.3%	9.6%	11.7%
STOXX Europe 600	355.38	4.7%	3.9%	-2.9%	-2.4%
German DAX	11,203.63	6.6%	5.3%	4.3%	5.8%
Hang Seng	22,760.98	0.9%	-0.1%	3.9%	4.4%
Shanghai Comp	3,232.88	-0.3%	-0.5%	-8.7%	-6.9%
Nikkei 225	18,996.37	3.1%	3.8%	-0.2%	-5.3%
India Sensex	26,747.18	2.0%	0.4%	2.4%	6.8%
Singapore Straits Times	2,956.13	1.3%	1.8%	2.5%	3.3%
Brazil Ibovespa	60,500.62	0.3%	-2.3%	39.6%	31.2%
Mexican Bolsa IPC	46,913.47	5.3%	3.5%	9.2%	10.7%

Commodities (USD)	Price	1 week	MTD	YTD	12 mos
Gold (spot $/oz)	1,159.19	-1.5%	-1.2%	9.2%	8.1%
Silver (spot $/oz)	16.88	0.8%	2.1%	21.8%	19.2%
Copper ($/metric ton)	5,781.25	0.4%	-0.6%	22.9%	26.2%
Oil (WTI spot/bbl)	51.50	-0.3%	4.2%	39.0%	38.6%
Oil (Brent spot/bbl)	54.27	-0.3%	7.5%	45.6%	35.3%
Natural Gas ($/mmBtu)	3.72	8.4%	11.1%	59.3%	80.6%
Agriculture Index	293.58	0.7%	-0.2%	3.5%	0.8%

Govt bonds (bps chg)	Yield	1 week	MTD	YTD	12 mos
U.S. 2-Yr Tsy	1.133%	3.7	2.0	8.5	21.0
U.S. 10-Yr Tsy	2.466%	8.3	8.5	19.6	24.9
Canada 2-Yr	0.739%	0.8	3.6	25.8	19.7
Canada 10-Yr	1.732%	11.3	14.7	33.8	24.3
U.K. 2-Yr	0.141%	3.0	1.3	-51.0	-46.6
U.K. 10-Yr	1.453%	7.3	3.5	-50.7	-42.3
Germany 2-Yr	-0.753%	-1.8	-2.6	-40.8	-43.4
Germany 10-Yr	0.365%	8.4	9.0	-26.4	-23.5

Currencies	Rate	1 week	MTD	YTD	12 mos
U.S. Dollar Index	101.61	0.8%	0.1%	3.0%	4.4%
CAD/USD	0.76	0.8%	2.0%	5.0%	3.0%
USD/CAD	1.32	-0.9%	-1.9%	-4.8%	-3.0%
EUR/USD	1.06	-1.0%	-0.3%	-2.8%	-4.3%
GBP/USD	1.26	-1.2%	0.6%	-14.6%	-17.1%
AUD/USD	0.74	-0.1%	0.9%	2.2%	3.0%
USD/CHF	1.02	0.7%	0.0%	1.6%	3.5%
USD/JPY	115.32	1.6%	0.8%	-4.1%	-5.0%
EUR/JPY	121.73	0.5%	0.4%	-6.8%	-9.1%
EUR/GBP	0.84	0.0%	-0.9%	13.9%	15.6%
EUR/CHF	1.07	-0.4%	-0.3%	-1.3%	-0.9%
USD/SGD	1.43	0.7%	-0.2%	0.8%	1.8%
USD/CNY	6.91	0.4%	0.3%	6.4%	7.5%
USD/BRL	3.38	-2.8%	-0.2%	-14.7%	-9.9%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX. Bond yields in local currencies. Copper and Agriculture Index data as of Thursday's close. 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. Data as of 8:35 pm GMT 12/9/16.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD 5.0% return means the Canadian dollar rose 5.0% vs. the U.S. dollar year to date. USD/JPY 115.32 means 1 U.S. dollar will buy 115.32 yen. USD/JPY -4.1% return means the U.S. dollar fell 4.1% vs the yen year to date.

UPCOMING EVENTS

Mon, Dec 12

China Industrial Prod. (6.1% y/y)

China Retail Sales (10.2% y/y)

China Fixed Assets (8.3% y/y)

Tue, Dec 13

Japan Tankan Surveys

Japan Industrial Prod.

Eurozone ZEW Survey

Germany ZEW Survey

U.K. CPI (1.1% y/y, 1.3% core)

Tue, Dec 13, cont.

U.K. House Price Index (7.2% y/y)

Wed, Dec 14

Japan Nikkei Manuf. PMI

Eurozone Industrial Prod.

U.K. ILO Unemployment (4.8%)

U.K. Employment Chg. (50K, 3m/3m)

FED Meeting

U.S. Advance Retail Sales (0.3% m/m)

U.S. Industrial Prod. (-0.2% m/m)

Wed, Dec 14, cont.

U.S. Capacity Utilization (75.1%)

Thu, Dec 15

Eurozone Markit Manuf. PMI

Eurozone Markit Services PMI

Eurozone Markit Composite PMI

Germany Markit Manuf. PMI

Germany Markit Services PMI

BoE Meeting

U.S. CPI (0.2% m/m, 1.7% y/y)

Thu, Dec 15, cont.

U.S. Real Avg. Weekly Earnings

U.S. Markit Manuf. PMI

Canada Manuf. Sales (0.7% m/m)

Canada Existing Home Sales

Fri, Dec 16

Eurozone CPI

U.S. Housing Starts (1.23M, -7.0% m/m)

Tue, Dec 20

BoJ Meeting

The dates reflect North American time zones. All data reflect Bloomberg consensus forecasts where available.

Authors

Frédérique Carrier – London, United Kingdom
frederique.carrier@rbc.com; Royal Bank of Canada Investment Management (UK) Ltd.

Kelly Bogdanov – San Francisco, United States
kelly.bogdanov@rbc.com; RBC Capital Markets, LLC

Farazeh Mahboob – Toronto, Canada
farazeh.mahboob@rbc.com; RBC Dominion Securities Inc.

Alicia Buckiewicz – Toronto, Canada
alicia.buckiewicz@rbc.com; RBC Dominion Securities Inc.

Thomas McGarrity, CFA – London, United Kingdom
thomas.mcgarrity@rbc.com; Royal Bank of Canada Investment Management (UK) Ltd.

Jay Roberts – Hong Kong, China
jay.roberts@rbc.com; RBC Dominion Securities Inc.

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As of September 30, 2016

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Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	848	50.62	255	30.07
Hold [Sector Perform]	719	42.93	133	18.50
Sell [Underperform]	108	6.45	10	9.26

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