RBC Capital Markets

GLOBAL | RESEARCH

Top 30 Global Ideas for 2017

Company Profiles and Macro Perspectives

DECEMBER 2016

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Introduction

As the leaders of Global Research at RBC Capital Markets, we are pleased to present the ***Top 30 Global Ideas for 2017***. The ***Top 30*** is another example of the collective value of bringing together global thought leadership under one team and one firm. Our equity research analysts, informed by the views of our macro strategists across asset classes, sought to identify the most attractive investment ideas for the coming year. This report presents an investment summary of each of these recommendations, as well as the perspectives of our cross-asset macro strategists, who provide a broader context for the investing landscape.

Over the past several months, the investment landscape has dramatically changed. Following the Brexit lows, inflation expectations and interest rates started to move higher on the back of a tighter US labor market and the promise of greater global fiscal measures and pro-growth policies. Our strategists and economists predict this shift in backdrop to be more favorable to equity investors. RBC's Chief Equity Strategist Jonathan Golub "believes that rising earnings and multiples will push equity returns into the double digits from our previous single-digit baseline". Consistent with this view, he forecasts the S&P 500 to trade at 2500 by year-end 2017, driven by an acceleration in earnings growth and upside to forward multiples.

The composition of this year's ***Top 30 Global Ideas*** reflects this macro outlook. While the majority of the high conviction names on this list directly benefit from **(1) cyclical opportunities** and **(2) higher rates**, undervalued businesses with **(3) competitive advantages** should continue to re-rate.

1) **Cyclical Opportunities – AL, AVGO, DOW, MGA, NBL, NOW, NWL, ROP, WHR, AC, ATD.B, SU, TRP, WCN, ENI, RWEG, OSH.** Global expectations for nominal GDP have inflected higher, reflecting the promise of pro-growth policies. The election of Trump further aided this acceleration, helped by the potential for deregulation and lower taxes. While primarily a US phenomenon, the success of populist candidates globally supports further gains.
2) **Higher Rates – PNC, NA, ALV, LLOY.** Rates hit their post-recession lows in July and have been renormalizing since. The futures market indicates this trend will continue. Banks and other Financials should benefit handsomely from this move in yields.
3) **Competitive Advantages – ARMK, IPG, MA, NFLX, BAM, ABF, NESN, RYA, TIT.** Over the past several years, companies with superior brands have thrived. While these stocks have generally done well, this isn't fully reflected in their multiples. We believe that undervalued business with sustained advantages should outperform despite the more cyclical bias of the market.

The ***Top 30 Global Ideas for 2017*** is not intended to be a relative product, having been created to capture RBC Capital Markets' best ideas on an absolute basis. However, we compare the performance of the ***Top 30*** to the MSCI Developed World Index (MSDUWI) to provide context for its returns. Performance by that measure in 2016 was positive, with the ***Top 30* +11.4% vs. +5.9% for the MSDUWI.**

As always, we encourage you to reach out to our Research Team to continue the dialogue regarding their investment ideas. On behalf of the Global Research Team at RBC Capital Markets, we wish you a successful and profitable year in 2017.

Marc Harris – Head of US Research
Andre-Philippe Hardy – Head of Canadian Research
Rufus Grantham – Head of European & APAC Research
Jonathan Golub – Chief Equity Strategist

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All values in US dollars unless otherwise noted.
Priced as of market close, ET on December 12, 2016 unless otherwise noted.

For Required Non-US Analyst and Equity Conflicts Disclosures please see page 71.
For Required Fixed Income & Currency Strategy Conflicts Disclosures please see page 73.

Top 30 Global Ideas for 2017 — Pricing Data

Company	Ticker	Analyst	Rating, Risk	Trading Currency	Closing Price (12/12/2016)	Market Cap (MM)	Price Target	Dividend Yield (%)	Implied All-in Return (%)
Air Canada	AC	Walter Spracklin	Top Pick, Spec	CAD	14.50	4,060	18.00	0.0	24.1
Air Lease Corporation	AL	Jason Arnold	Top Pick	USD	35.91	3,979	77.00	0.8	115.3
Alimentation Couche-Tard	ATD.B	Irene Nattel	Outperform	CAD	62.02	35,221	83.00	0.6	34.4
Allianz SE	ALV	Paul De'Ath	Outperform	EUR	154.70	70,358	190.00	4.9	27.7
Aramark	ARMK	Gary Bisbee	Top Pick	USD	36.02	9,009	41.00	1.0	14.8
Associated British Foods	ABF	Richard Chamberlain	Outperform	GBp	2,646.00	20,903	3,300.00	1.3	26.0
Broadcom Limited	AVGO	Amit Daryanani	Top Pick	USD	178.16	79,638	200.00	2.3	14.5
Brookfield Asset Management Inc.	BAM	Neil Downey	Top Pick	USD	33.65	32,270	40.00	1.5	20.4
ENI SpA	ENI	Biraj Borkhataria	Outperform	EUR	14.78	53,548	18.00	5.4	27.2
Lloyds Banking Group PLC	LLOY	Robert Noble	Outperform	GBp	61.38	42,184	70.00	3.7	17.7
Magna International Inc.	MGA	Steve Arthur	Outperform	USD	46.78	18,197	55.00	2.1	19.7
MasterCard Inc.	MA	Daniel R. Perlin	Outperform	USD	103.28	113,505	115.00	0.7	12.1
National Bank of Canada	NA	Darko Mihelic	Outperform	CAD	54.62	18,625	57.00	4.2	8.5
Nestlé S.A.	NESN	James Edwardes Jones	Top Pick	CHF	70.80	225,781	82.00	3.2	19.0
Netflix Inc.	NFLX	Mark Mahaney	Outperform	USD	122.83	53,849	150.00	0.0	22.1
Newell Brands Inc.	NWL	Nik Modi	Top Pick	USD	46.48	23,101	60.00	1.5	30.6
Noble Energy Inc	NBL	Scott Hanold	Outperform	USD	39.84	17,118	49.00	1.0	24.0
Oil Search Ltd	OSH	Ben Wilson	Outperform	AUD	7.15	10,887	8.00	0.4	12.3
Roper Technologies, Inc.	ROP	Deane Dray	Outperform	USD	184.89	18,674	214.00	0.7	16.4
RWE AG	RWEG	John Musk	Outperform	EUR	11.57	141	17.50	4.3	55.6
Ryanair Holdings plc	RYA	Damian Brewer	Outperform	EUR	14.45	18,298	17.50	0.0	21.1
ServiceNow, Inc.	NOW	Matthew Hedberg	Top Pick	USD	77.88	13,551	95.00	0.0	22.0
Suncor Energy Inc.	SU	Greg Pardy	Outperform	CAD	42.77	71,191	50.00	2.7	19.6
Telecom Italia S.p.A.	TIT	Julio Arciniegas	Outperform	EUR	0.76	14,663	1.12	0.0	48.1
The Dow Chemical Company	DOW	Arun Viswanathan	Top Pick	USD	58.27	65,694	68.00	3.2	19.9
The Interpublic Group of Companies, Inc.	IPG	Steven Cahall	Top Pick	USD	24.02	9,752	27.00	2.5	14.9
The PNC Financial Services Group, Inc.	PNC	Gerard Cassidy	Top Pick	USD	114.07	55,666	130.00	1.9	15.9
TransCanada Corporation	TRP	Robert Kwan	Outperform	CAD	58.97	50,932	72.00	3.8	25.9
Waste Connections, Inc.	WCN	Derek Spronck	Outperform	USD	77.99	13,711	90.00	0.9	16.3
Whirlpool Corporation	WHR	Robert Wetenhall	Top Pick	USD	176.20	13,497	200.00	2.3	15.8

Notes: Past performance is not necessarily indicative of future performance. Price performance does not take into account relevant costs, including commissions and interest charges or other applicable expenses that may be associated with transactions in these shares.

Spec = Speculative risk.

Source: RBC Capital Markets, Bloomberg

Top 30 Global Ideas for 2017 – Company Profiles

Air Canada (TSX: AC)

RBC Dominion Securities Inc.

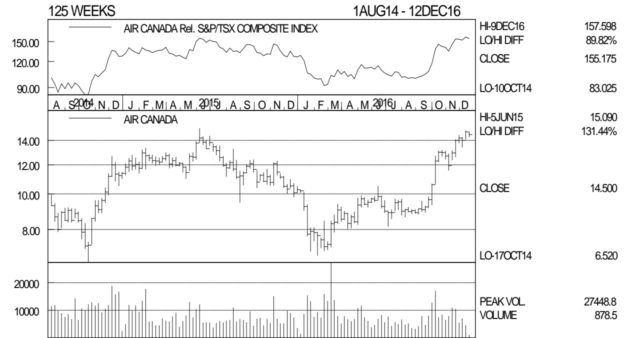
Walter Spracklin (Analyst) (416) 842-7866; walter.spracklin@rbccm.com

Rating, Risk: Top Pick, Speculative Risk

Closing Price: CAD 14.50

Price Target: CAD 18.00

Implied All-in Return (%): 24.1



Investment opinion

Having achieved a groundbreaking labour deal in 2013 that gave management the tools and flexibility to completely restructure operations, Air Canada remains in the early stages of executing on a major structural transformation of the company. The result is an opportunity to reduce per-unit costs by as much as 21% or more by 2018 (from 2012 levels), with additional cost savings identified into 2021. This cost transformation has already brought about improved financial results and significant operational flexibility. And while we believe the capacity and fleet transformation have opened the door to significant growth, we believe we have likely reached the apex on these measures, which should allay fears that AC is growing too fast. What this means is that as we crest this capacity and capex apex, we expect a meaningful improvement in free cash flow and significant balance sheet deleveraging as we approach 2021. Our view is if management is successful in achieving this, the share price upside potential is considerable.

Valuation

We apply an EV/EBITDAR multiple of 4.2x on our 2018 EBITDAR estimate to derive our price target of $18.00. Our EBITDAR multiple remains in line to the peer legacy group average and the lower end of the historical multiple range. Our base case reflects the following assumptions: (1) modest yield declines due to changing business mix related to AC's strategic transformation; (2) fleet expansion and strong demand to drive traffic growth; and (3) jet fuel prices track to the existing forward booking curve. The return to our price target supports our Top Pick rating. Due to high debt leverage and operating in a cyclical sector, we believe a Speculative Risk qualifier is warranted.

Risks to rating and price target

Risks to our target and rating include but are not limited to very high operating leverage given a fixed cost structure, above-average sensitivity to the economy, exposure to volatile fuel prices and the risk of external shocks (terrorism, epidemics, etc.). We note that Air Canada is only partially hedged to changes in jet fuel prices.

Air Lease Corporation (NYSE: AL)

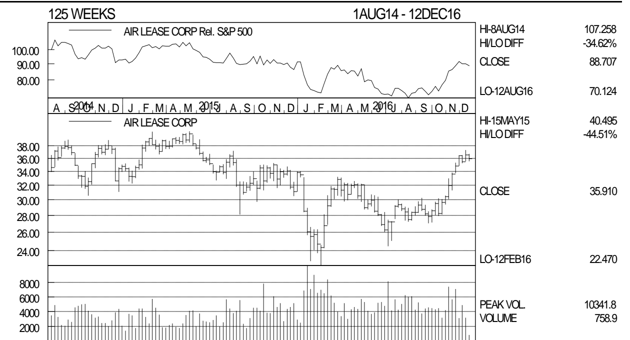
RBC Capital Markets, LLC
Jason Arnold, CFA (Analyst) (415) 633-8594; jason.arnold@rbccm.com

Rating: Top Pick

Closing Price: USD 35.91

Price Target: USD 77.00

Implied All-in Return (%): 115.3



Investment opinion

Our Top Pick rating on Air Lease Corp is driven by the following key fundamental factors, along with the currently very attractive valuation of just 5.4x 2017E pre-tax EPS:

- **Leading aircraft lessor:** Air Lease is well positioned as a leader in the aircraft leasing sector, with a sizable and growing fleet of new and in-favor aircraft leased to global airlines. Purchasing new aircraft in volume offers the advantage of attaining best price on high-demand equipment, while new deliveries are 82% pre-placed through 2019. $127B of new aircraft financing globally estimated for 2016, which is anticipated to grow at a 6%+ CAGR over the next several years. Outstanding management team furthers our outlook.
- **Growing portfolio and EPS outlook:** Anticipating continued portfolio expansion on aircraft deliveries to support continued strong revenue expansion and robust 15–20%+ EPS upside. Additionally, we expect the company's Blackbird JVs to further accelerate revenue expansion.
- **Highest ROE and lowest leverage in sector:** High-teens ROE anticipated as well-above peers and most financial companies, while leverage is below peers at just 2.6x D/E. Significant cash flow goes toward financing new aircraft.

Valuation

Our $77 price target reflects our view that AL shares should trade at roughly 12x 2017E pretax EPS, present valued. We see this multiple as conservative given our consistently strong and peer-leading ROE outlook for business. Upper-teens + tax-adjusted ROE, and 20%+ EPS growth expectations in the year ahead remain easily achievable, in our view, while risk is at the low end of the peer group given new aircraft focus and low 2.6x D/E leverage. Our price target supports our Top Pick rating.

Risks to rating and price target

Air Lease Corp is exposed to two primary risk factors that could lead to the shares falling short of our price target and rating: commercial aircraft demand and interest rate risk. Commercial aircraft demand is sensitive to broader macroeconomic conditions, particularly consumer air travel demand and fuel prices, either of which could expand/impair our earnings expectations and result in the shares exceeding/falling short of our price target. AL had fixed-rate borrowings of 80% of total as of 3Q16, significantly limiting interest rate risk exposure, although traumatic imbalances in the shape of the yield curve or availability of attractive funding in the broader markets could limit performance.

Alimentation Couche-Tard (TSX: ATD.B)

RBC Dominion Securities Inc.
Irene Nattel (Analyst) (514) 878-7262; irene.nattel@rbccm.com

Rating: Outperform

Closing Price: CAD 62.02

Price Target: CAD 83.00

Implied All-in Return (%): 34.4

Investment opinion

Through a combination of tailwind of prior period acquisitions and solid organic performance and potential acquisitions, we expect ATD to deliver sector-leading financial results. ATD continues to deliver solid results from underlying operations and is actively participating in the c-store industry consolidation globally, with a demonstrated ability to significantly enhance the profitability of acquisitions post-transaction. Looking ahead, earning growth in F17-19 should continue to benefit from prior period/recent acquisitions, and the pipeline remains robust with potential transactions of varying size in both existing and new geographies.

Our Outperform rating is predicated on: i) **multiple routes to future growth,** including surfacing incremental synergies from recent acquisitions, sharing of best practices across geographies to drive sales and optimize margin/productivity, increased activity on new store openings, namely execution on the CST NTI strategy and potential acquisitions; ii) **Solid underlying operating performance** with fresh food and coffee initiatives generating traffic and basket growth, global branding initiative, and re-branding of stores in the Southeast US; iii) **Favourable macro backdrop** with low fuel prices driving higher miles driven/gas volume sales and in-store traffic; iv) Geographic diversification with ~85% of GP$ generated outside Canada; v) **Strong BS + FCF profile** with forecasted FCF in excess of $1.5 b annually to fund rising dividends, debt repayment and future acquisitions; vi) **Consolidation opportunities across geographies.**

Valuation

Taking the midpoint of 18x F19E EPS ($84) and 11x F19E EBITDA ($82) drives our price target of $83, which supports our Outperform rating. The slight premium to current trading ranges reflects our expectation for ongoing strong underlying performance and benefits from prior period and pending M&A as 2017 unfolds. We believe the multiples are also appropriate relative to our c-store coverage universe based on relative investment attributes.

Risks to rating and price target

Deteriorating economic activity in North America and/or Western Europe, difficulty integrating prior acquisitions or surfacing synergies, rising interest rates and the impact on M&A financing, dearth of acquisition opportunities, rising bulk gasoline prices and the related impact on traffic, credit card fees and margins could result in earnings and share price that are below expectations. We also note that the expansion into Western Europe has altered the risk profile of the business given the multiple geographies and currencies, and economic and operating environments.

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Allianz SE (XETRA: ALV)

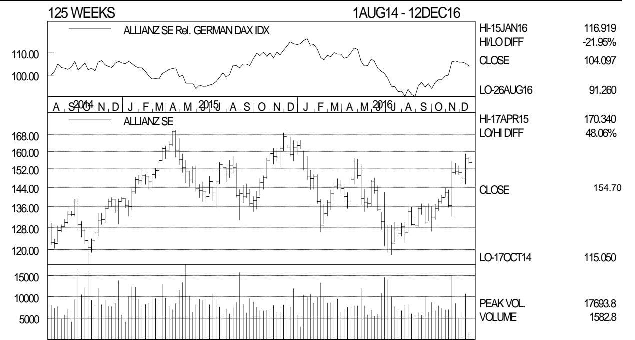
RBC Europe Limited
Paul De'Ath (Analyst) +44 207 029 0761; paul.de'ath@rbccm.com

Rating: Outperform

Closing Price: EUR 154.70

Price Target: EUR 190.00

Implied All-in Return (%): 27.7



Investment opinion

We believe that 2017 will be a strong year for Allianz. The P&C and Life businesses should continue to post strong performances and we expect a €2.5bn buyback to boost EPS and DPS.

P&C to benefit from improving pricing environment. Allianz has been experiencing an upturn in pricing in many of its markets in 2016 and we expect this to be a continued theme in 2017E. This increase in pricing has come across a broad spectrum of businesses with only Italy and AGCS (Allianz's global corporate business) showing continued poor pricing momentum. Allianz is keen to grow its P&C business and this would be significantly easier to do in a hardening rate environment, in our view. The yield environment remains very low despite recent uplifts and therefore we expect the main market participants to maintain pricing discipline. If the motor market in Italy is also starting to turn, as has been suggested by Generali, this could provide another boost to future earnings, in our view.

Life business mix transformation to continue. The low interest rate environment continues to apply pressure to life businesses in Europe. Despite this, Allianz's life business has seen solid growth over 2016 and we expect a continuation of this theme into 2017. Allianz has embraced the shift away from traditional guaranteed savings and is making dramatic progress on increasing the proportion of capital efficient products (42% of sales in 3Q16). Despite the still very low interest rate environment, the investment margin in the life business has remained strong, improving 4bps from 1Q16 to 25bps in the quarter. We forecast that investment margin will remain more resilient than the market expects as 1) the German back book is fully matched for 30 years and 2) capital-efficient business earns double the investment margin of traditional business.

Valuation

We derive our price target of €190 using a sum-of-the-parts model with price earnings (P/E) multiples of post-tax 2018E IFRS operating profit to value each of the business lines. We use a P/E of 11.1x to value the life business, 11.1x for the non-life businesses, and we apply a multiple of 10.5x to value the asset management business. Our P/E multiples are generated using discount rates and growth rates assumed for each line of business and our discount rates are derived via CAPM. As a result, our P/E multiples are sensitive to the growth rates and discount rates we have assumed. Our price target supports our Outperform rating.

Risks to rating and price target

Disproportionate losses from natural catastrophes, reserve deficiencies, adverse regulatory changes and investment losses are some of the factors that could affect our price target and lead us to reconsider our stance on Allianz.

Aramark (NYSE: ARMK)

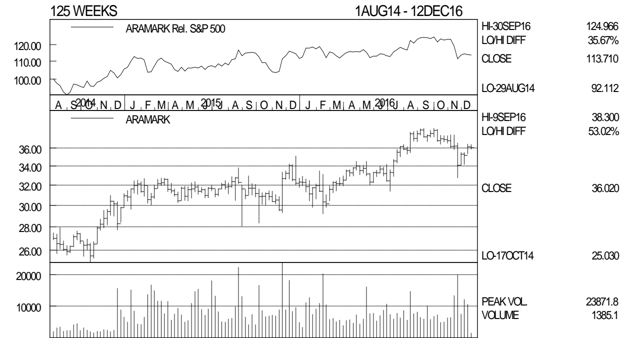
RBC Capital Markets, LLC
Gary Bisbee (Analyst) (212) 299-9842; gary.bisbee@rbccm.com

Rating: Top Pick

Closing Price: USD 36.02

Price Target: USD 41.00

Implied All-in Return (%): 14.8



Investment opinion

Aramark is a good business with an attractive operational improvement story that we expect to be successfully executed. We forecast low-double digit or better EPS growth in the next few years, and see room for modest multiple expansion, which should drive market-beating returns. We rate Aramark Top Pick. Key points to our thesis include:

Solid and stable business model. Aramark is a market leader in the stable and growing outsourced dining/catering/facilities services industry. It has a high quality and diversified client base and good visibility through ~94% client retention and repeatable revenue. Aramark generates healthy and consistent free cash flow, and has proven more defensive than average, with revenue and profits falling at half the rate of the overall market in the 2008-2009 recession.

Confident in margin story, long runway remains. We remain bullish on Aramark's potential to drive meaningful food and labor cost savings as it implements technology and simplified/ standardized processes across these two big cost categories. Aramark expects 100 bps of expansion in FY16-FY18 (the company was on track in F2016 achieving ~35 bps of margin expansion) and we see healthy gains continuing beyond this period. We believe that positive estimate revisions over time are possible as ARMK closes the margin gap with competitors.

Good growth story, reasonable valuation. Aramark's long-term projection is for 3–5% organic revenue growth, high-single-digit operating income, and low-double digit EPS and cash flow growth. In the near-term, its capital allocation priorities include growing the dividend and retiring debt, though we expect buybacks to become part of the mix in FY18 and beyond. ARMK trades at 18.5x CY17E adjusted EPS, which we find reasonable for a quality growth story.

Valuation

Our $41 price target applies a 23x multiple to our CY17E adjusted EPS estimate (after expensing stock compensation costs) of $1.78. This is a premium to the company's ~21x average since IPO, though we believe that the margin expansion and double digit profit growth outlook supports this higher valuation as well as our Top Pick rating.

Risks to rating and price target

Key risks to our rating and target include failure to deliver on cost efficiency strategies, share price volatility resulting from occasional poor communication, fairly high financial leverage (~3.8x) that could limit financial flexibility, and moderate cyclicality.

Associated British Foods (LSE: ABF)

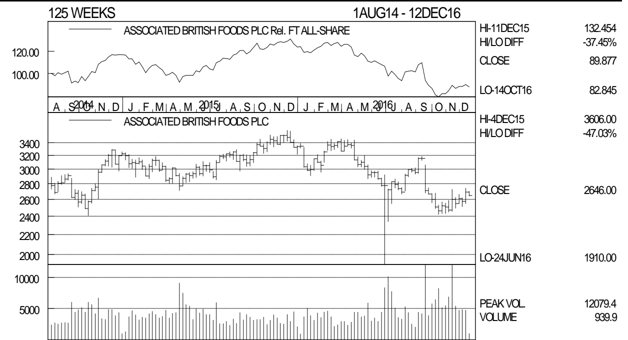
RBC Europe Limited
Richard Chamberlain (Analyst) +44 20 7429 8092; richard.chamberlain@rbccm.com

Rating: Outperform

Closing Price: GBp 2,646.00

Price Target: GBp 3,300.00

Implied All-in Return (%): 26.0



Investment opinion

The implied valuation for **Primark** de-rated sharply in 2016 (40x to 25x CY17 P/E) which we think gives investors an opportunity to buy into a relatively scarce, international rollout story. We view Primark as a best-in-class discounter with a buying and pricing advantage, high sales densities and an attractive in store environment and level of fashionability given its extremely low price points. We see an opportunity for Primark to reassure investors as to the durability of its growth in Europe and the US in 2017. We also think higher Sugar profitability and a weaker sterling trend versus the Euro will lead to a return to double-digit earnings growth. Finally ABF has a strong balance sheet with a net cash position which it can use potentially to accelerate EPS growth in time.

Valuation

We use a DCF analysis backed up by a sum-of-the-parts analysis to arrive at our price target of 3,300p for ABF which supports our Outperform rating on the shares. For our DCF we model a 10-year sales CAGR of 7%, an EBIT CAGR of 8% and a free cash flow CAGR of 11%. We use a WACC of 7% as ABF is relatively defensive with its diversity and low gearing. We also use a terminal growth rate of 2.5% as ABF has strong international growth potential mainly through Primark (international sales are c.60% of ABF's total sales and c.50% of Primark's sales). In our sum-of-the-parts, for Primark we use a FY17E EV/EBITDA multiple of 14x, in between that of Inditex (16x) and H&M (12). For Grocery we use an average of Nestle and Unilever's EV/EBITDA multiples (12.5x) to value Twinings Ovaltine and place the rest on a 20% discount. We value Sugar at 10x EV/EBITDA, a premium to Suedzucker including ABF's 100% stake in Illovo and value Ingredients and Agriculture at 16x and 10x respectively, broadly in line with peers.

Risks to rating and price target

The biggest rating and price target impediments for ABF, in our view, are if:

1. Primark achieves weaker LFL sales than we expect or worse returns from new space.
2. Primark's margin outlook weakens owing to a stronger dollar trend, higher input costs or higher-than-expected markdown.
3. If Sugar profits rise less than we anticipate owing to higher than expected inventories or a weaker pricing environment.

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Broadcom Limited (NASDAQ: AVGO)

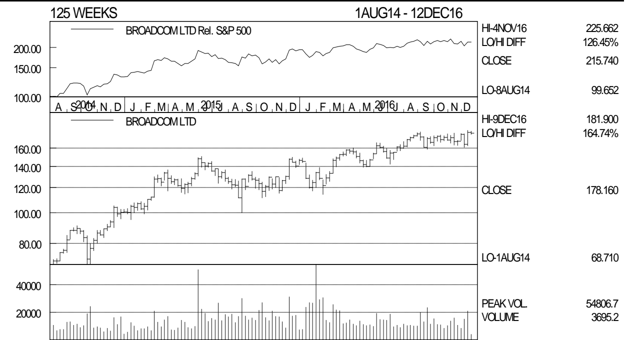
RBC Capital Markets, LLC
Amit Daryanani, CFA (Analyst) (415) 633-8659; amit.daryanani@rbccm.com

Rating: Top Pick

Closing Price: USD 178.16

Price Target: USD 200.00

Implied All-in Return (%): 14.5



Investment opinion

Management and impressive M&A philosophy: Through M&A and organic revenue growth driven by FBAR buildouts, AVGO has beat Street quarterly EPS estimates every quarter since its IPO. Management is disciplined in M&A, focusing on slower-growing companies that compete in oligopolistic industries with cost-cutting potential.

Attractive RF growth: AVGO's Wireless segment (31% of revenues in FY17E) remains a growth engine, and the segment should materially outgrow the broader industry as the need for high-performance filters only magnifies in 4G and LTE environments, which must possess the ability to process multiple frequencies and the subsequent need for more complex filters.

Broadcom acquisition: The Broadcom acquisition should be accretive to AVGO's EPS, and we believe there is upside to its $750M cost-synergy target. We conservatively estimate that Broadcom could contribute $2.00+ to Avago's EPS by CY17, when the expected $750M+ in run-rate synergies are fully achieved. Fundamentally, we think there is potential for further upside, as gross margins expand beyond 60% and operating margins beyond 40%.

Valuation

Our $200 price target supports our Top Pick rating and is based on ~14x NTM earnings, which is slightly above the ~13x historical average but within the 8–20x six-year historical range since Avago's IPO. Notably, we believe a slight premium is appropriate for the company given: (1) positive performance from historical acquisitions; and (2) trust in the company's ability to reduce OPEX. We believe our applied multiple is warranted by potential upside to earnings over the next two years (Broadcom integration).

Risks to rating and price target

The rise of a new FBAR/high-end BAW filter: In the current environment, Avago has the best FBAR filter in the marketplace and is the premier BAW filter in smartphones. There is a risk that competitors develop an FBAR/high-end BAW filter solution that rivals or is technologically superior to Avago's solution.

Smartphone demand weakens: Smartphone unit volumes could weaken, resulting in a downward revision in wireless communications revenue estimates.

M&A integration issues: Given Avago's high M&A volume over the past two years, it could have issues integrating the teams of its various acquisitions together, resulting in market share loss in key segments. Top-line growth could be constrained because of cost-cutting efforts.

Brookfield Asset Management Inc. (NYSE: BAM; TSX: BAM.A)

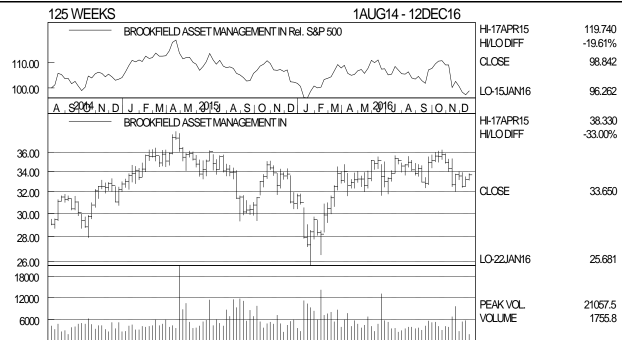
RBC Dominion Securities Inc.
Neil Downey, CFA, CA, CPA (Analyst) (416) 842-7835; neil.downey@rbccm.com

Rating: Top Pick

Closing Price: USD 33.65

Price Target: USD 40.00

Implied All-in Return (%): 20.4



Investment opinion

Real asset themes have staying power, in our view – We expect global allocations to real assets will continue to grow due to: **1)** global savings trends; **2)** the growing size of institutions and the compounding of their returns; and, **3)** the need for returns that are in excess of fixed income yields, which, even under a moderately higher rate scenario we believe will be unsatisfactory to many (particularly on an after tax basis).

An asset manager which thinks like (and *is*) an asset owner – Through its private funds and flagship listed limited partnerships, BAM is a major owner of property, renewable power, infrastructure, and private equity investments around the globe. We see BAM's asset management business growing its share of a globally growing pool of institutional allocation to real and private market assets due to the *Brookfield Advantage*, which we summarize as:

1. **Global presence** – With a presence in >30 countries, BAM's global network (700 investment professionals) gives it strong access to (in some cases, proprietary) deal flow;
2. **Large scale capital** – BAM's strong balance sheet and ready-access to large scale capital ($111B of FBC) enables it to complete transactions of a size that sets it apart;
3. **Operational expertise** – BAM started as an owner/operator of real assets and it continues to apply operational expertise (55,000 operating employees across the globe) to enhance cash flows and drive values and long-term returns;
4. **Contrarian investment approach** – BAM's experience is that the best investment opportunities are often found in out-of-favor regions or sectors and, with its global presence, BAM has the ability to allocate capital accordingly;
5. **Focusing upon capital preservation** – BAM understands that protecting the capital to which it is entrusted should be at the forefront as to how it thinks about risk; and,
6. **Alignment** – BAM typically is a 25%-30%-plus investor within its private funds and listed LPs (which differentiates BAM from competitors and aligns interests with investors.)

Valuation

Our $40 price target equates to parity with our estimated IV/share one-year hence (and implies an ~18x our 2018E Operating FFO). Based on risk-adjusted relative return prospects, we rate BAM's shares Top Pick.

Risks to rating and price target

Risks include rapidly rising interest rates, a hard cyclical downturn in the commercial property sector (BAM's largest industry exposure), or credit-related shock which might cause lending spreads to widen or financial market liquidity to seize.

RBC Capital Markets

ENI SpA (MILAN: ENI; NYSE: E)

RBC Europe Limited
Biraj Borkhataria, CFA (Analyst) +44 20 7029 7556; biraj.borkhataria@rbccm.com

Rating: Outperform

Closing Price: EUR 14.78

Price Target: EUR 18.00

Implied All-in Return (%): 27.2

Investment opinion

Eni is our preferred way to play a higher oil price in 2017. Key reasons for our positive stance are below:

2017 is the year of delivery: Following a disappointing 2016 fraught with operational hiccups, we expect a strong improvement in volumes and cash flow as we move into the new year, which should help Eni generate 70% more cash flows in 2017 at our oil price forecast ($58/bbl Brent in 2017). We see the start-up of the long awaited Kashagan project, as well as the continued ramp up at other key projects such as Goliat as particularly significant given the oil-weighted exposure and leverage to higher oil prices.

Divestments bring in cash, whilst also reducing Eni's capex burden: Divestments are a key part of our investment case for Eni. While it is admittedly a tough time to be an upstream asset seller, we believe there should be continued demand for high quality projects and discoveries, and this should be the differentiator for Eni. The company recently sold c50% of its Zohr discovery in Egypt (previously 100% owned), to BP and Rosneft in two separate deals worth c$2bn. In addition to the cash received, the deals also allow Eni to reduce its capex spend on the project, which should support the free cash flow framework. On our numbers, the sales could reduce Eni's capex on Zohr by over €1bn in both 2017 and 2018. We expect similar deals to occur with Eni's other concentrated positions (i.e. Mozambique).

Poor share price performance in 2016: Eni has been the biggest underperformer in the peer group year to date dragged down by macro concerns in Italy, in our view. While peers may offer more defensiveness, we think the valuation discount is attractive, and therefore rate the shares Outperform.

Valuation

On our numbers, Eni trades on 6.1x 2017 EV/DACF, versus the sector average at 7.4x. Eni offers investors a levered play on the oil price, whilst also paying the highest cash dividend yield in our coverage universe. Our price target of €18 is based on our blended valuation of DCF, EV/DACF and NAV, which supports our Outperform rating.

Risks to rating and price target

The principal risks to our rating and price target include: movements in the oil price, especially Brent; production volume, project delivery including Kashagan, exploration success and achieving commercial terms in Mozambique; and low gas demand in Italy, especially in the industrial and power-generation segment.

Lloyds Banking Group PLC (LSE: LLOY)

RBC Europe Limited

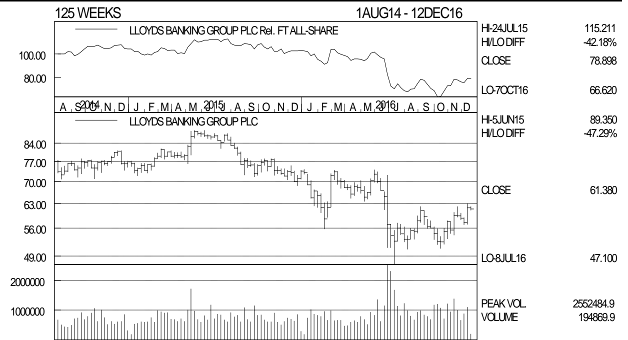
Robert Noble, CFA (Analyst) +44 20 7029 0786; robert.noble@rbccm.com

Rating: Outperform

Closing Price: GBp 61.38

Price Target: GBp 70.00

Implied All-in Return (%): 17.7



Investment opinion

We see LLOY as the least interest rate sensitive of the UK banks due to its high cost liability structure; low reliance on current account funding; and relatively small structural hedge. Our expectation in the UK is that base rates do not change in 2017 or 2018 and on a relative basis we would expect LLOY's margin to show more stability. We believe the 2.7% flat NIM guidance for 2017 is achievable, contrary to consensus.

Asset quality in the UK is very benign and nearly all UK banks report falling rather than rising impairments. Despite this consensus expects cost of risk to rise to 38bps compared to currently 14bps and guidance for 2016 of <20bps. We believe that if unemployment remains below 6.5-7% in the UK (currently 4.9% and falling) that cost of risk could be much better than consensus expectations due to LLOY's low risk, low LTV mortgage book.

LLOY is above its 13% capital target and has shown a willingness to pay down to this target through ordinary and special dividends. We see substantial dividend growth potential at LLOY as one offs, which were mostly PPI related, fall dramatically and free up more capital. Our forecasts on DPS are 30% ahead of consensus in 2017 and imply a yield of 7%. Dividend growth could be lower than our expectations if LLOY wins the bid for the credit card firm, MBNA; however, a credit card business acquisition in a low rate for longer environment could potentially be very valuable, in our view, but it is clearly price dependent.

Valuation

We value LLOY with a linear residual income model on our 2018 estimates giving the value for excess capital above a 13% threshold. This results in a 70p fair value for the shares discounted to end-2017 using a 10% cost of equity. This justifies our Outperform recommendation.

Risks to rating and price target

Impediments include: Changes to the regulatory framework that could reduce the stock of 'free' capital in the group and put our dividend forecasts at risk; rising unemployment and falling house prices together could push up cost of risk and reduce loan growth; a second Scottish independence referendum—post the EU referendum the SNP will likely seek a second independence referendum. LLOY is headquartered in Scotland and uncertainty would be negative for our price target; a further cut in UK base rates could have a substantially negative impact on NIM.

Magna International Inc. (NYSE: MGA; TSX: MG)

RBC Dominion Securities Inc.

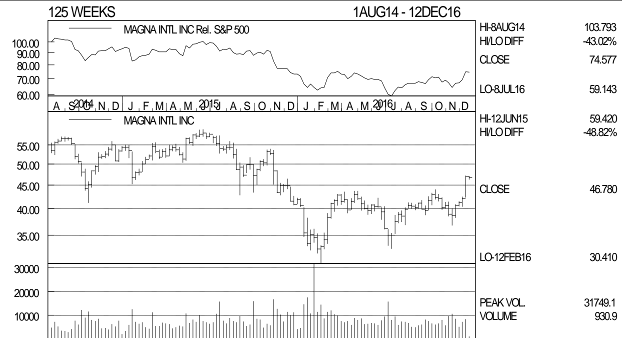
Steve Arthur (Analyst) (416) 842-7844; steve.arthur@rbccm.com

Rating: Outperform

Closing Price: USD 46.78

Price Target: USD 55.00

Implied All-in Return (%): 19.7



Investment opinion

North American auto sales are generally considered to be at or near peak levels (a situation reflected in our base case forecast), though we continue to see multiple drivers of earnings and share price growth, including:

- **Continued volume and content growth around the globe:** North American volume is important, but we continue to expect auto production growth in Europe and Asia. Further, macro drivers in the US also give some optimism that our North American forecasts may prove to be conservative.
- **Magna Steyr – growth in Assembly & Design/Engineering functions:** Magna Steyr is expected to almost triple revenue by 2018E (from ~$2B to $5.5B) with the launch of the BMW 5-series and programs for Jaguar Land Rover. Further, Steyr is building its business to assist OEMs in the design and engineering of advanced functions, in particular hybrid and electric drive systems.
- **Watch for trade/taxation changes:** With the changing political landscape in the US, potential changes to NAFTA can clearly impact the auto industry. Decades have been spent optimizing the supply chain across borders; any added tariffs or other trade friction could impact Magna (changes in industry volumes, margins, taxation, etc.). We will obviously monitor this as policies are unveiled.
- **Attractive value for solid performance & growth outlook:** MGA trades at an attractive 4.5x 2018E EBITDA, below the peer group at 5.4x. We see this discount as unwarranted, and believe that MGA should trade at least in line with the group.

Valuation

Our $55 target price is based on a 5.0x EV/EBITDA and a 9.0x P/E multiple to a rolling four-quarter earnings forecast, starting in one year (Q4/17E-Q3/18E), and average these with a DCF calculation. These multiples are generally in line with where the peer group is currently trading. Our target supports our Outperform rating.

Risks to rating and price target

1) Weaker macro assumptions in North America or Europe
2) Taxation or trade changes with the new US administration

RBC Capital Markets

MasterCard Inc. (NYSE: MA)

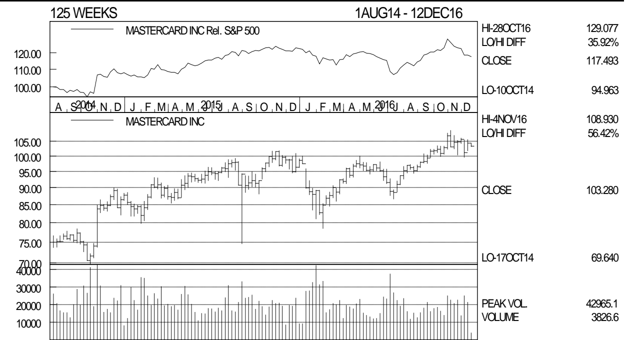
RBC Capital Markets, LLC
Daniel R. Perlin (Analyst) (410) 625-6130; daniel.perlin@rbccm.com

Rating: Outperform

Closing Price: USD 103.28

Price Target: USD 115.00

Implied All-in Return (%): 12.1



Investment opinion

MasterCard remains one of our best ideas in the space given our belief that investors should look to focus on long-term, secular-driven, stories that provide solid organic growth with opportunities for margin expansion and capital redeployment. As MA expands the constituencies it serves (increasingly moving outside financial services), so too does the need for additional services increase outside its legacy core business. We believe the investment cycle necessary to grow its services business will continue for the next several years, which offers both increased secular growth and new adjacent market opportunities.

Additionally, for the near term, we believe (1) that MA is coming out of trough earnings as macro weakness in oil, emerging markets, and weaker global travel abates. (2) Operating expense growth is slowing after a series of investments and acquisitions, while revenues are now accelerating. (3) A new innovation agenda could enhance long-term revenue growth. Valuations, in our opinion, have rotated towards pure financial companies, putting MA at a discount, which we think will close later in the year. Finally, MA is an inflation hedge as a significant portion of revenue is based on the face value of a transaction.

Valuation

Our price target of $115 is 26x our CY17 EPS estimate, in line with where the shares have traded in the past in a similar environment and its closest peer. Underlying our estimates are expectations for: (1) mid-teens growth in purchase volumes with modest pricing and secular growth; (2) mid-teens increases in transaction revenues; (3) a similar level of cross-border revenue growth; and (4) relatively flat client incentives as a percentage of gross revenues. Our price target supports our Outperform rating.

Risks to rating and price target

A slowdown in payment volumes and cross-border travel or a pushback from large financial institutions on pricing could impede our price target objective and our rating. Increased regulatory scrutiny, inability to maintain pricing structure, and prolonged global recession could cause the stock to perform below our expectations and impede achievement of our price target objective.

RBC Capital Markets

National Bank of Canada (TSX: NA)

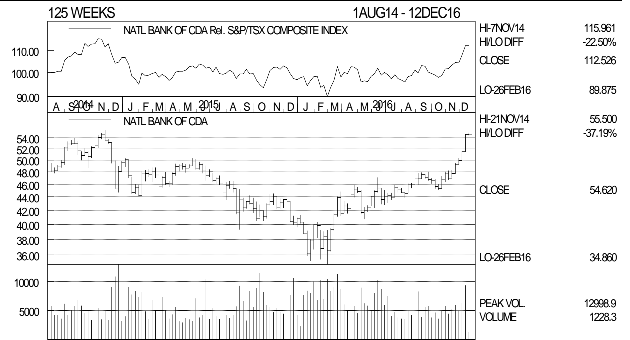
RBC Dominion Securities Inc.
Darko Mihelic (Analyst) (416) 842-4128; darko.mihelic@rbccm.com

Rating: Outperform

Closing Price: CAD 54.62

Price Target: CAD 57.00

Implied All-in Return (%): 8.5



Investment opinion

We believe NA's stock is attractive given a favourable risk-reward trade-off. NA currently trades at a -12% discount to peers on our 2017 core EPS, which remains below its historical average discount to peers of -10%. We expect NA's relative valuation to improve to historical levels as concerns over credit and capital continue to subside.

We believe NA has adequately ring-fenced its oil and gas credit issues with a sectoral provision for oil and gas loans and its relatively low consumer exposure to oil regions and focus in Central Canada (Quebec and Ontario represent 82% of NA's total loans) gives us comfort on credit quality going forward. NA has $204 million remaining in its sectoral provision (~$0.45 per share), which in our view, in a sustained higher oil price environment could be released back into earnings. We are forecasting NA's capital ratio to improve to its peer average by mid-2017 and are forecasting the company to reinstate a share buyback program beginning in Q4/17 but prior to this we believe it is also likely NA would raise dividends at a more aggressive pace than in the recent past. Furthermore, Credigy's recently announced deal with Lending Club could provide further upside to NA's earnings. We estimate that the deal can generate as much as $0.12 per share of earnings if it can meet Credigy's minimum targeted return on assets of 2.5% but we have not added any incremental earnings to our estimates at this time given it is still early days.

Valuation

Our 12-month price target of $57, which supports an Outperform rating, is based on a P/E multiple of 10.5x our 2018E EPS estimate. The target multiple is at the low end of the target range of 10.5–12.0x that we use for the big Canadian banks, reflecting lower exposure to retail banking earnings.

Risks to rating and price target

Risks to our price target and rating include the health of the overall economy and the Quebec economy in particular, sustained deterioration in the capital markets environment, integration risk of acquisitions, an unexpected acquisition, and a change in the competitive or political environment in Quebec. Additional risks include regulatory and political risk including tax rates, rising business loan losses, greater than anticipated impact from off-balance sheet commitments, additional write-downs related to ABCP, and litigation risk.

Nestlé S.A. (VX: NESN)

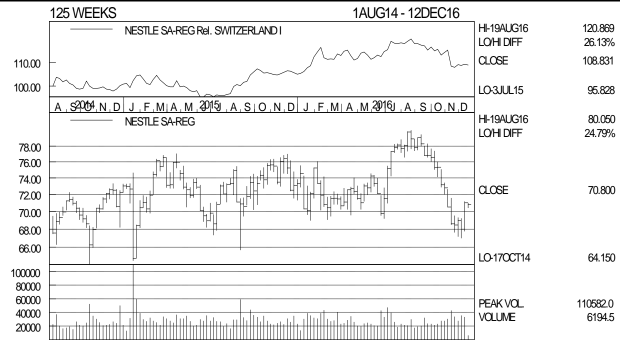
RBC Europe Limited
James Edwardes Jones (Analyst) +44-207-002-2101; james.edwardesjones@rbccm.com

Rating: Top Pick

Closing Price: CHF 70.80

Price Target: CHF 82.00

Implied All-in Return (%): 19.0



Investment opinion

It's so big and diverse that investors often regard Nestlé as a surrogate for the consumer staples sector as a whole in our view. In a period of rising bond yields, reflation, challenging emerging market dynamics and uninspiring sales growth this doesn't sound like a recipe for outperformance. But in 2017 there's something that will set Nestlé apart: the appointment of its first external CEO for almost a century: Mark Schneider starts work on 1st January. One might ask what changes one person can effect in a business with 335,000 employees. Operationally we think there's very little, at least in the short term. But at a 'bigger picture' level we think there are two things that should be at the top of his inbox.

Culture/profitability. In our view Nestlé's culture can be described as introverted and lackadaisical, especially in its attitude towards cost control and profitability. A number of US companies have adopted a more assertive attitude in these respects, partly in emulation of/perceived threat from 3G Capital following its acquisitions of Kraft Heinz. We would like to see Nestlé, prompted by Mr. Schneider, adopting a more urgent attitude here.

Asset allocation. We see no justification for Nestlé's ownership of 23% of L'Oréal. We think it's there 'because it always has been' and a new CEO could get rid of it in short order. We also think the confectionery business, comprising 10% of group sales, is ripe for disposal. We estimate that some 60% of Nestlé's businesses have ceded market share over the last five years and confectionery is a significant element of this, while ticking few boxes strategically, competitively or financially. The most frequent pushback we receive from investors is 'what would they do with the money?'. That's easy: distribute it to investors.

Valuation: We believe that consumer staples stocks lend themselves to a DCF valuation methodology owing to the relative strength and predictability of their cash flow together with—in some instances—a significant mismatch between capital expenditure and depreciation charged through the profit and loss account, meaning that P&L-based valuation metrics (PE and EV/EBITDA ratios) can be misleading. We use a derivative of a traditional DCF calculation called adjusted present value (APV) whereby the business's operating cash flows are discounted at its cost of equity (8% for Nestlé) and tax shield at the cost of debt (2.9%). We assume a terminal growth rate of 2.5% from 2030. Under these assumptions, we derive an APV of CHF78 per share. Discounting the APV forward by one year at the cost of equity yields a 12-month price target of CHF82 net of our forecast dividend payment. Our price target supports our Top Pick rating.

Risks to rating and price target: Deteriorating sales growth; management unwillingness to tackle cost base and expand margins; failure to consider disposing of elements of Nestlé's portfolio; and, inability of senior management to implement operational changes in light of Nestlé's vast scale (335,000 employees at the end of 2015).

RBC Capital Markets

Netflix Inc. (NASDAQ: NFLX)

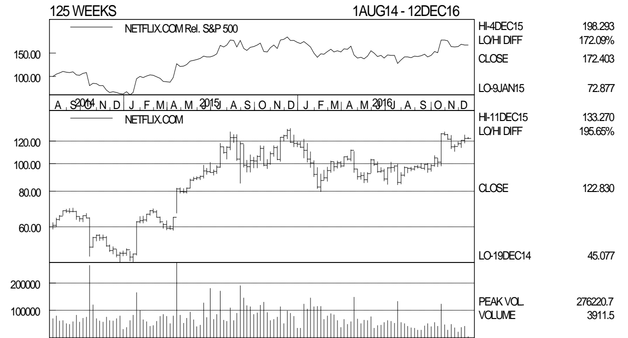
RBC Capital Markets, LLC
Mark S.F. Mahaney (Analyst) (415) 633-8608; mark.mahaney@rbccm.com

Rating: Outperform

Closing Price: USD 122.83

Price Target: USD 150.00

Implied All-in Return (%): 22.1



Investment opinion

We continue to reiterate our Outperform rating, our thesis being: 1. Dramatic Secular Shift away from Linear TV (1B pay TV subs today) to Internet TV (perhaps 100MM subscribers today) – these numbers could swap places; 2. Netflix is the Dominant Subscription Leader – perhaps 8X more subs than the closest competitor…and this is a scale game; 3. Netflix proving out US Profitability – Contribution Margin rising from 16% in '12 to 36% in '16; 4. Netflix proving our Universal Appeal – 10% household broadband penetration within 3 years in every market launched; 5. Netflix proving out International Profitability – Pre-'14 Markets scaling like US did; & 6. One of the Best Management Teams on the Net, in our view. And we still see up to $10 in EPS by 2020, implying a potential doubling in NFLX shares over a 3-year time frame.

Valuation

Our base case price target of $150 is based on a sum-of-the-parts methodology on our 2018 estimates. In order to reach our price target, we use a 23x P/E multiple on our Domestic Streaming GAAP EPS, a 10x multiple on our Domestic DVD GAAP EPS, and a 6x P/S multiple on our International Streaming revenue. We believe that these multiples are commensurate with the segments' relative growth rates. Our price target supports our Outperform rating.

Risks to rating and price target

Very broad and deep competitive set: Netflix could lose share to competitors, resulting in reduced revenue growth and increased marketing spend.

Increasingly long-term and fixed-cost nature of content acquisition: Netflix's streaming content obligations consist of arrangements to acquire and license streaming content—these obligations could be larger than forecasted. There is also the potential for rising content costs.

Uncertain long-term international profitability: International markets could fail to meaningfully adopt Netflix, hindering the company's ability to take share abroad. Higher-than-expected execution costs associated with multiple international launches could also create issues.

RBC Capital Markets

Newell Brands Inc. (NYSE: NWL)

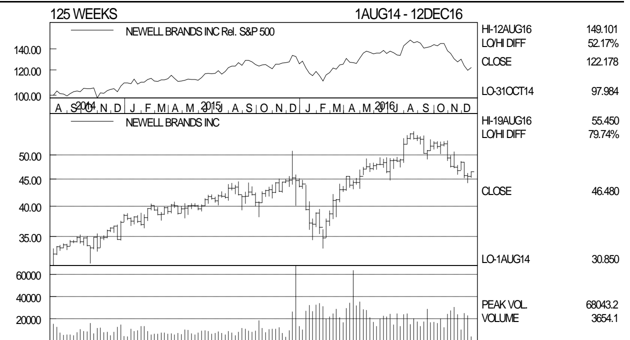
RBC Capital Markets, LLC
Nik Modi (Analyst) (212) 905-5993; nik.modi@rbccm.com

Rating: Top Pick

Closing Price: USD 46.48

Price Target: USD 60.00

Implied All-in Return (%): 30.6



Investment opinion

We rate Newell Top Pick, where our pro forma DCF model implies a $60 share value. More importantly, we believe NWL could double in 3 years behind three phases: 1) cost synergy realization (which we believe are conservative); 2) top-line synergy realization (not included in synergy guidance); and 3) Project Renewal 2.0 execution (we believe there is meaningful opportunity by leveraging some of NWL's best operating practices into JAH's businesses, thereby realizing significant increase in profit per employee).

Valuation

Our base-case DCF valuation of $60 assumes a 4.5% topline CAGR (post full implementation of the deal) and 21% peak margins through 2025, as we expect the company to deliver ahead of cost synergy guidance and realize meaningful revenue synergies as well. We also expect Project Renewal to provide further opportunity for reinvestment in advertising. Our DCF assumes a WACC of 8% and a terminal growth rate of 2%. Our $60 price target implies 20x 2017 EPS, a multiple in-line with our broader staples coverage. Our price target supports our Top Pick rating.

Risks to rating and price target

1. A slowdown in the US housing recovery or a serious constraint on consumer durable purchases.
2. Continued currency headwinds, especially in Europe and key emerging market economies.
3. Lower-than-anticipated margin improvement realization from Project Renewal and Jarden integration synergies.
4. Integration risk of the Jarden acquisition.
5. A sell-off in the broader consumer sector against a rising rate macro backdrop (though we suspect NWL would be more immune here compared to larger cap, higher yielding names in our coverage.

RBC Capital Markets

Noble Energy Inc. (NYSE: NBL)

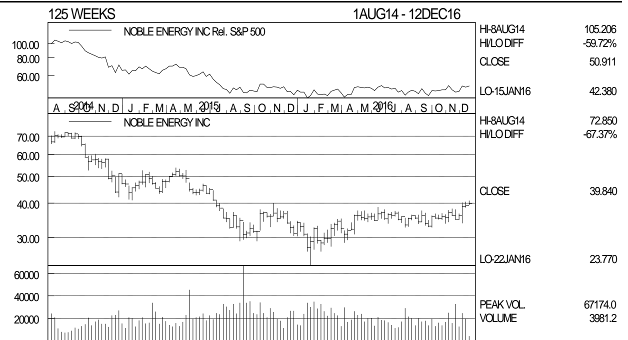
RBC Capital Markets, LLC
Scott Hanold (Analyst) (512) 708-6354; scott.hanold@rbccm.com

Rating: Outperform

Closing Price: USD 39.84

Price Target: USD 49.00

Implied All-in Return (%): 24.0



Investment opinion

Noble Energy is an independent oil & natural gas exploration & production company with a high-quality and diversified portfolio in the US onshore and global offshore. The company's valuation is compelling and there are several catalysts through 2017.

- **Industry leading returns.** Noble has a balanced inventory of capital-efficient US unconventional onshore and large international offshore development projects which provide industry-leading returns at current prices.
- **Resource potential.** The company has significant resource potential in its core operating areas including the DJ Basin (Niobrara), Eagleford Shale, Delaware (Permian) Basin, and the Marcellus Shale. NBL also has significant development potential in the deepwater Gulf of Mexico, Eastern Mediterranean, and West Africa.
- **Robust production growth.** We expect double-digit production growth through 2020 with spending near cash flow (excl. dividends). Noble has a large US onshore inventory that is economic at $40/Bbl and $2/Mcf providing production growth visibility. Several large projects should provide momentum in 2017+.
- **Strong financial liquidity.** NBL's balance sheet is positioned well compared to many of its peers. We believe NBL will maintain its debt-to-EBITDA ratio below 2.5x through 2018 while maintaining financial liquidity in excess of $5 billion.

Valuation

Our $49/share price target reflects a 5% discount to our Net Asset Value (NAV) assessment. The discount is consistent with the peer average of 5-10%. Our $51/share NAV is a risked assessment of 3P reserves using the RBC commodity price outlook. We haircut identified locations based on company/industry results, geology, and conservatism. NBL shares imply a long-term oil price of $59/bbl (WTI) compared to $62/bbl for our average stock coverage. Our price target supports our Outperform rating.

Risks to rating and price target

Weaker-than-expected commodity prices could cause the stock to perform below our expectations and impede achievement of our price target objective. Future growth and value will likely be predicated on the continued success of the DJ, Permian, and Eagleford shales. If well performance does not meet expectations, this could cause NBL shares to underperform the company's peers. The Eastern Mediterranean holds significant value potential that is partially valued into NBL shares however exposes the company to increased geopolitical risk.

Oil Search Ltd. (ASX: OSH)

Royal Bank of Canada - Sydney Branch

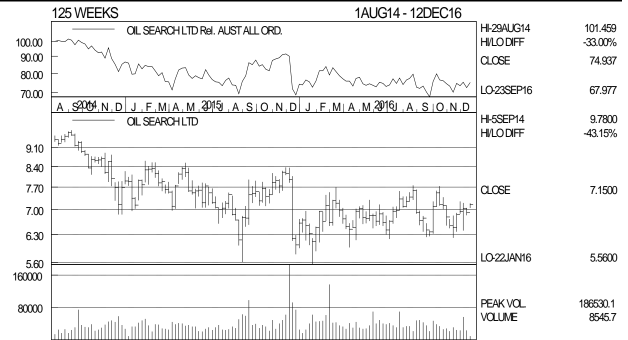
Ben Wilson (Analyst) +61290333066; ben.wilson@rbccm.com

Rating: Outperform

Closing Price: AUD 7.15

Price Target: AUD 8.00

Implied All-in Return (%): 12.3



Investment opinion

We view Oil Search as a high quality LNG production and growth story. Its foundation producing PNG LNG project is exceeding expectations amid what is an improving year-on-year LNG market. LNG pricing is firming both in terms of long-term contract pricing via the strong linkage to oil price and the spot/short-term contract market, which is gaining on Asian winter demand. In addition to strong operating leverage, Oil Search has interests in gas resources that underpin some of the lowest cost LNG expansions in the world. Over the course of CY17 we expect Exxon, TOTAL, Oil Search and the PNG Government to jointly forge definitive commercial arrangements regarding the development of additional trains in PNG. Oil Search has exploration upside via the currently drilling Muruk-1 well (target 1-3tcf gross) and further delineation and exploration around the Elk/Antelope resource.

Valuation

Our A$8.00/sh price target is based on our DCF valuation (10% WACC) of A$7.89/sh rounded to the nearest $0.50 and supports an Outperform rating. Key inputs to our DCF valuation include, RBC's global energy team Brent oil price deck (long term real price ~US$74/bbl) and US$/A$ forward strip to CY19 inclusive and 0.75US$/A$ thereafter.

Risks to rating and price target

Timing risk around commercial framework. Key JV participants in PNG including Exxon, TOTAL, Oil Search and the PNG Government are targeting formal commercial arrangements regarding an additional 2 trains at the PNG LNG site. Most recently the process has been stalled by the hold up in completing Exxon's takeover of Interoil (key equity participant in the Elk/Antelope resource). With a midyear general election in PNG due in CY17, the risk of delays in government processes presents timing risk around the formation of commercial arrangements.

Oil prices. Oil Search has strong leverage to oil prices owing to the very high percentage of its product sales linked to oil. While we forecast a recovering oil price, the recovery trajectory will likely be volatile, which will in turn impact Oil Search's share price.

Landowner/sovereign risk. The vast majority of Oil Search's assets are based in PNG and while the country is a stable democracy, it is still a developing nation and therefore warrants additional consideration regarding sovereign and landowner risk. While we believe the risk of meaningful landowner disturbances is remote, the prospect presents a downside risk.

RBC Capital Markets

Roper Technologies, Inc. (NYSE: ROP)

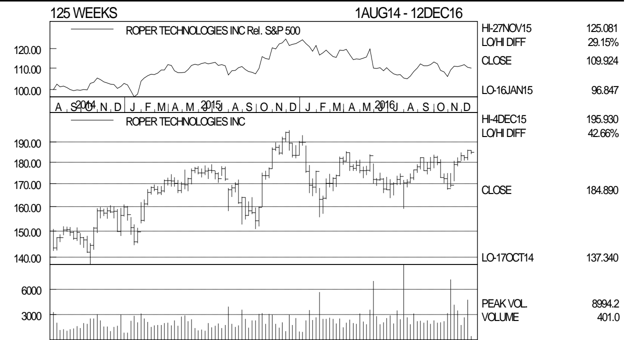
RBC Capital Markets, LLC
Deane Dray, CFA (Analyst) (212) 428-6465; deane.dray@rbccm.com

Rating: Outperform

Closing Price: USD 184.89

Price Target: USD 214.00

Implied All-in Return (%): 16.4



Investment opinion

High-quality Multi-Industry name with unique SaaS and M&A growth story. Roper ranks among the highest-quality names in the Multi-Industry sector, leading the pack with nearly 30% EBIT margin and 130% free cash flow conversion. Roper has also achieved among the highest organic and total revenue CAGRs in the sector, and its business model is unique on a number of key aspects: (1) unwavering focus on asset-light, high FCF businesses; (2) +50% revenue mix from recurring revenues thanks to aftermarket and subscription fees; and (3) self-funded M&A focused on SaaS and network-based businesses.

Acquisition of Deltek is attractively levered to Trump infrastructure stimulus. On Dec-6, Roper announced it was acquiring SaaS/ERP solutions provider Deltek for $2.8 bil, the largest acquisition in company history. The implied multiples of 14x EBITDA and 5.2x Sales are both within the ballpark for typical high-margin SaaS deals. On a GAAP basis, EPS accretion in 2017 will be minimal, but on free cash flow, the deal is expected to contribute +$80 mil in 2017, or ~8% upside vs. our estimates, including financing costs. Importantly, with a project-based customer mix (60% government contractors and <25% architecture & engineering), Deltek looks well-positioned to benefit from Trump's infrastructure spending stimulus mandate.

Should benefit from Trump tax policy. Roper should be among the Multi-Industry group's biggest beneficiaries from any rollback in US corporate tax rates, given its +70% US earnings mix and 34% average US tax rate. Additionally, the majority of Roper's business is SaaS offerings, suggesting headwinds from any inter-border tax treatment adjustments would be contained. That said, ROP stock has lagged the sector average by 80 bps in the past three weeks, due to the market's risk-on preference for cyclical, lower-quality names.

Valuation

We expect Roper to command a 15% premium to our target group P/FCF multiple, implying 21.9x on 2017, near the high-end of its (20%)-20% historical relative P/FCF range given it sustainably achieves the highest FCF conversion in the sector. We estimate $9.78 of 2017 FCF per share, deriving our $214 price target and supporting our Outperform rating. The pending acquisition of Deltek would add ~8% of incremental free cash flow to FY2017 estimates.

Risks to rating and price target

Following the Deltek deal, Roper's near-term balance sheet capacity will be mostly exhausted, potentially capping investor enthusiasm in this growth-by-acquisition story until its balance sheet is reloaded. On operations, the biggest risk factor is Roper's 12% oil & gas exposure, which drove most of the downside in 2015 and 2016.

RBC Capital Markets

RWE AG (FSE: RWEG; XETRA: RWEG)

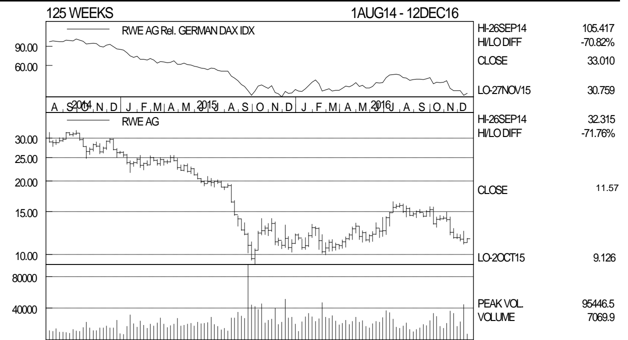
RBC Europe Limited
John Musk (Analyst) +44 20 7029 0856; john.musk@rbccm.com

Rating: Outperform

Closing Price: EUR 11.57

Price Target: EUR 17.50

Implied All-in Return (%): 55.6



Investment opinion

The recent IPO of innogy (now 76.8% owned by RWE) improved the balance sheet and gave visibility to the majority of the RWE valuation. Furthermore, the impending handover of nuclear waste provisions to Government reduces risk and significantly enhances EPS. Our EPS forecasts sit up to 50% above consensus.

Generation assets undervalued – recent power price recovery across Europe is beneficial to RWE, and we do not believe the improved outlook is reflected in RWE's share price. Within our RWE Price Target we include innogy at a Price Target of €34.5/sh. This implies ~10% capital upside in innogy, and it makes around one-third of the capital upside we see in RWE. The other two-thirds falls within 'RWE rump' where we believe the current RWE share price values Generation assets at less than ~3x EBITDA. We see this as excessively low, compared to our own conservative valuation at ~5x EBITDA (and peers like Uniper at ~4.5x).

Nuclear clarity to also benefit – a draft law for the transfer of nuclear waste provisions to Government is agreed and final contractual terms are being negotiated. We assume a ~€2bn increase in the ~€5bn of provisions that will be transferred. This will have the dual benefit of increased clarity and higher EPS. Post transfer, ongoing provision charges in the RWE P&L will reduce by €200-250m resulting in an EPS uplift of ~€0.25/sh.

Dividend to be reinstated – an improved generation outlook & changes in nuclear provisions mean RWE is now able to reintroduce dividends after a one-year hiatus. We position our forecasts at a payout ratio of 40-50%, but ensure the resultant dividend is broadly covered by cashflow post capex. As such we see DPS of €0.50/sh for 2016 and €0.6/sh for 2017E & 2018E, which is significantly ahead of consensus of €0.30-0.35/sh over the three years.

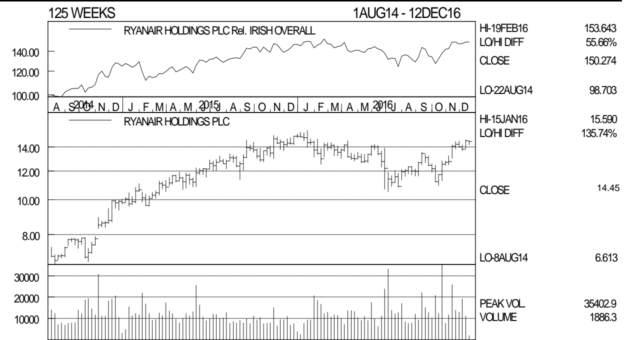
Valuation: We use sum of the parts that relies on our separate valuation of innogy for 85% of the EV. For the remaining Generation and Trading segments that form the majority of the 'RWE rump', we use DCFs with a WACC of 7.2% (post-tax nominal). Within generation, we run DCFs for each major geography out to 2050 to capture the commodity and regulatory drivers in each country as well as the specific age and dynamics of the assets. This results in a valuation of €17.5/sh with an implied total return of ~56% and hence our Outperform rating.

Risks to rating and price target: The energy markets in which RWE operates are generally mature and slow growing; however, demand fluctuations and underlying commodities could out-turn below our expectations, which would reduce power price forecasts. Given that each €1/MWh on our power price forecasts is worth around €1/sh to the RWE valuation, we see power prices as the major risk to our recommendation. In addition, if RWE fails to reintroduce a dividend we would need to reconsider the investment case.

Ryanair Holdings plc (ISE: RYA; LSE: RYA)

RBC Europe Limited
Damian Brewer (Analyst) +44 20 7653 4900; damian.brewer@rbccm.com

Rating: Outperform
Closing Price: EUR 14.45
Price Target: EUR 17.50
Implied All-in Return (%): 21.1



Investment opinion

We rate Ryanair Outperform due to its long-term competitive strengths: We think a tough fare environment is ahead, but already expected. In the long run, we think staff productivity, airport costs (and choice of airport) and the unit cost of aircraft used remain differentiating competitive factors. To us, Ryanair's (180) aircraft order at US$ unit costs 'not dissimilar' to the 2003-05 order is critical in securing one of these competitive advantages.

The company is accelerating supply – even into tougher conditions. In future periods, we see summer growth opportunities opening up (as new aircraft are delivered) while the low operating costs and low incremental aircraft ownership costs leave the carrier well-placed to gain share as the unprofitable short haul operations of Europe's legacy carriers continue to face pressure.

Ryanair is still generating (lots of) cash – building headroom for the next order or capital return. Our forecast suggests Ryanair may remain equity FCF positive in future years (to over 9% yield by 2018/19E), with net cash continuing to build even as progress payments and new aircraft are paid for (before share buy backs). In our view, this gives headroom to both remain tactically competitive on ticket pricing (to gain share) and/or building cash reserves to pay for a follow-on order, or return more cash to shareholders via buy-backs, or dividends.

The shares trade at ~13.5x YA PER with ~11% 2017E-2020E EPS CAGR (base case), while YA EV/EBITDAR of ~8x remains well below 3-year trailing average of ~10x, but close to previous recession trough levels.

Valuation

We base our scenario analysis around a SoTP valuation with an EV/EBITDAR basis. Future economic outlook could affect both volume growth demand in the market and potentially achievable yield and so we take a probability-weighted approach to price target setting. We use a 75% chance our base case forecasts are likely, a 15% risk of more bearish scenario (-6% GDP) development and a 10% chance of more bullish 'Blue Skies' outlook evolving to derive our €17.5 price target. Our PT implies 17x 2016/17E PER, ~16.4x YA PER, and ~15.8x 2017/18E vs. 2002-2016 average exit PER of 16.3x. Our price target supports our Outperform rating.

Risks to rating and price target

Our price target and rating are subject to a number of risks and uncertainties, including labour relations, kerosene prices, exchange rates, business confidence, geopolitical risks, socio-political risks, geological risks, intergovernmental relations and macroeconomic outlook.

ServiceNow, Inc. (NYSE: NOW)

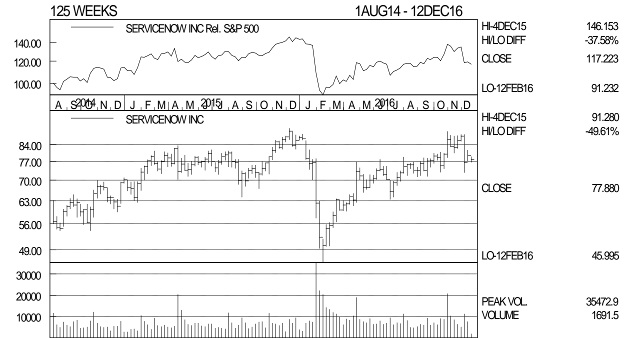
RBC Capital Markets, LLC
Matthew Hedberg (Analyst) (612) 313-1293; matthew.hedberg@rbccm.com

Rating: Top Pick

Closing Price: USD 77.88

Price Target: USD 95.00

Implied All-in Return (%): 22.0



Investment opinion

We think their improved execution continues into 2017: Based on conversations with management, we believe sales cycles, while long, are becoming more predictable. We also believe the company isn't seeing any change in linearity or abnormal pull-ins or push-outs.

Above market growth opportunity from large customers: We believe NOW will claim 50% of the Global 2000 as customers by 2020 (705 as of Q3/16 and requires ~18 per qtr vs 24 per qtr they've averaged over the past four quarters) and generate ~$2M in ACV from each ($997K as of Q3/16). Assuming large customers account for ~50% of business, to us this paints the path to $4B+ in revenue, which we view as achievable.

Conservative expectations: We believe 2017 consensus revenue growth of 30% remains conservative following an estimated 38%+ in 2016. We believe the company should be able to grow billings 30%+ in 2017 following an estimated 36% in 2016. Both revenue and billings could re-accelerate on a q/q basis in Q1/17.

New products kicking in and could re-accelerate growth: In Q3/16, 29% of new ACV growth came from products outside of ITSM and ITOM vs 14% y/y. Similar to when Salesforce.com become a multi-product platform and re-accelerated, we believe ServiceNow could do the same with products including Security, HR and Customer service.

Opportunity for LT margin expansion: We expect margins to improve with revenue and approach 30%+ at scale. With 2017E free cash flow margins of 25%+ (and expected to be 30-32% by 2020), we believe investors should value shares on a multiple of FCF.

Valuation

Our $95 price target warrants our Top Pick rating and assumes shares trade at 28.7x our 2018 FCF estimate, or a discount to its current 29.7x multiple on our 2017 estimates.

Risks to rating and price target

Impediments to our price target and rating could include changes in the macro environment, moderating IT spending, or should acceptance of the company's products change. Shares may trade with volatility. Margin pressures or failure to meet expectations, including hiring new sales executives, may pressure shares and valuation.

Suncor Energy Inc. (TSX: SU; NYSE: SU)

RBC Dominion Securities Inc.

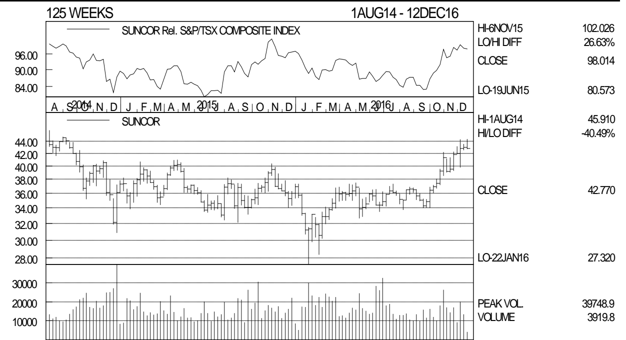
Greg Pardy (Analyst) (416) 842-7848; greg.pardy@rbccm.com

Rating: Outperform

Closing Price: CAD 42.77

Price Target: CAD 50.00

Implied All-in Return (%): 19.6



Investment opinion

Best in Breed. Suncor Energy has re-engineered itself into a best-in-breed, global integrated oil company adhering to capital discipline, cost improvement, and superior execution. We believe that Suncor has emerged as the Canadian integrated name of choice, with well-defined production growth, a strong balance sheet, and the removal of an M&A overhang (allowing investors to capitalize the significant free cash flow set to materialize in 2017 and 2018) serving as distinguishing features.

Growth Preservation. Suncor is preserving its longer-term upstream growth profile through the advancement of its Hebron (21% wi) development off-shore Newfoundland, and Fort Hills (50.8% wi) oil sands mining project – both of which are expected online at the end of 2017 and will collectively add about 123,000 bbl/d net to Suncor.

Free Cash Flow Potential. By adhering to long cycle-time projects at Fort Hills and Hebron, Suncor has poured the foundation of substantial free cash flow generation in 2017 and beyond. Under our base outlook, we peg free cash flow (before dividends of $1.9 billion) at $6.7 billion in 2017 (US$56/bbl WTI) and $6.4 billion in 2018 (US$63/bbl WTI). As such, shareholder distributions in the form of dividend growth and share repurchases should once again emerge in Suncor's playbook.

COS Acquisition Provides Torque. We believe Suncor's counter-cyclical $6.9 billion take-over of Canadian Oil Sands affords it with upside potential down the road predicated upon improving oil prices and Syncrude operating efficiencies.

Valuation

Our price target of $50 per share reflects a 60% weighting toward a multiple of 1.0x our estimated NAV and a 40% weighting toward an implied 2018E debt-adjusted cash flow multiple of 10.0x at mid-cycle commodity prices. The multiples we have chosen reflect Suncor's above-average execution capability, extensive RLI, and production visibility secured by its large oil sands resource base. Our price target supports an Outperform rating.

Risks to rating and price target

The most significant risk to our price target and rating is unexpected changes in crude oil and natural gas prices. The ability to develop major projects (i.e., Fort Hills and Hebron) on time and on budget also poses a risk to investors. The valuation of oil and gas assets is subject to risk with respect to reservoir performance, including production rates and expected recovery factors. Suncor is also exposed to downstream margin volatility. Other risks include the effect of foreign exchange and government legislation as it relates to royalties, income taxes, and environmental policy.

Telecom Italia S.p.A. (MILAN: TIT)

RBC Europe Limited

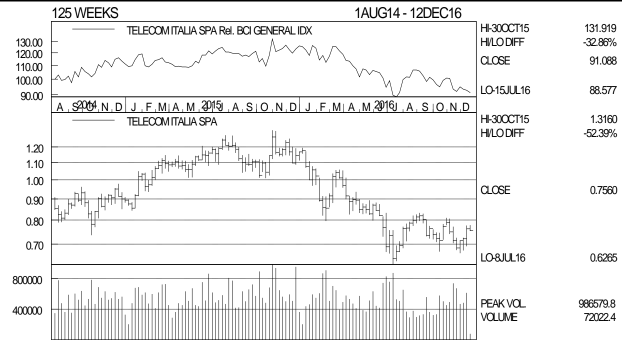
Julio Arciniegas (Analyst) +44 20 7429 8461; julio.arciniegas@rbccm.com

Rating: Outperform

Closing Price: EUR 0.76

Price Target: EUR 1.12

Implied All-in Return (%): 48.1



Investment opinion

Telecom Italia's plan to upgrade its fixed network creates value in our view as it reverses a near decade of underperformance versus peers. The investment should drive broadband penetration (one of the lowest in Europe), increase top line growth and offset the risk of Iliad's entrance in 2018. The positive fixed broadband outlook, solid TIM Brasil results and attractive valuation support our Outperform recommendation. TI trades on 5.1x 2017E EV/EBITDA, below peers on 6.7x.

Fixed/broadband dynamics positive. Telecom Italia is leading FTTx deployment in Italy with c60% coverage vs. ENEL with c4%. Improving speed and quality of fixed broadband networks will unlock value, in our view. Italian broadband penetration is well below the European average at 56% vs 76% (of homes) respectively. We believe Telecom Italia's infrastructure plan will drive penetration up from the current 7.1m broadband customers toward 8.5m by 2020E, adding c€0.8bn extra revenues (see The Apprentice).

…but market focused on potential mobile deterioration… Telecom Italia underperformed the sector by c30% in the first half of 2016, reflecting uncertainties around mobile consolidation. Our view is that Telecom Italia's mobile revenues, which are currently growing, will come under pressure in 2018. However, we believe that this negative effect is already priced in. Telecom Italia has commented that they will launch a low cost brand (using a recently acquired MVNO) to combat and prepare for Iliad's entry; we see this as evidence that mobile price repair will be at risk and expect mobile subscriber losses and ARPU erosion of c-3.0% per year (2017-2020E).

Valuation

Our price target for TI ordinary shares is €1.12/share and €0.96 per saving share class. We believe that a better trend especially in its domestic business is not factored in by the market. Telecom Italia, with an EBITDA CAGR 2016-2020E of c2%, currently trades on 5.1x EV/ EBITDA 2017E below the peer range at 6.7x. Our DCF- and SOTP-based price target implies a 6.3x EV/EBITDA. Our price target supports an Outperform recommendation.

Risks to rating and price target

TI domestic trends remain volatile, with fixed and mobile reported revenue trends exhibiting high levels of volatility. A deterioration in pricing stability or a change in competitive behaviour from competitors Vodafone, Wind/Hutchison and Fastweb/Swisscom who are also investing in fibre/4G/LTE would impact negatively. Additionally, further Italian political instability could increase the cost of capital with a negative impact on the share price.

RBC Capital Markets

The Dow Chemical Company (NYSE: DOW)

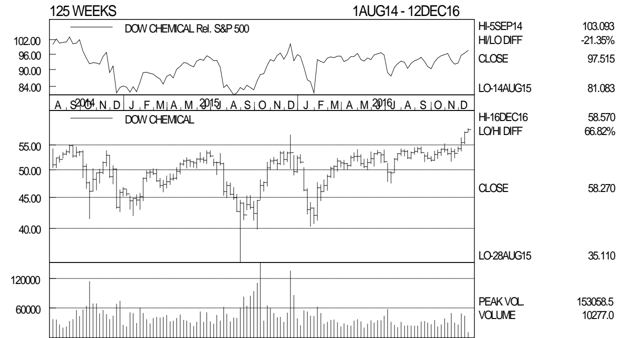
RBC Capital Markets, LLC
Arun Viswanathan, CFA (Analyst) (212) 301-1611; arun.viswanathan@rbccm.com

Rating: Top Pick

Closing Price: USD 58.27

Price Target: USD 68.00

Implied All-in Return (%): 19.9



Investment opinion

We are positive on Dow given the following factors: 1) Strong and sustainable above-market volume and margin growth; 2) solid growth pipeline of oncoming EBITDA (Sadara, TX-9, Enlist); 3) self-help; 4) DowDuPont merger catalysts; and 5) meaningful optionality to a higher oil-to-gas ratio.

Above market growth in Auto, Packaging, and Construction end markets persist as Dow continues to execute well on its consumer-focused strategy. Dow aims to add $3B of mid-cycle EBITDA from growth projects (Sadara, TX-9) over the next few years. Self-help execution will contribute approximately $300M of savings in 2016 and $3.1B of DowDuPont synergies are on the horizon (merger close by Q1/17). Dow has more bullish view for polyethylene prices in 2017 which could add additional upside (we believe soft PE expectations are already embedded in the stock and consensus).

Dow continues to reward shareholders seemingly no matter what the environment. The only thing consistent about the underlying commodity markets in which Dow plays is their volatility, but Dow has demonstrated the ability to generate earnings growth in a variety of conditions. 2017/18 could represent a free cash flow inflection point relative to 2015/16 levels as Dow will have completed major capex projects (more dry powder for buybacks and dividends). Potential conversion of the Dow preferred shares are another positive catalyst on the horizon.

Valuation

We apply an 8x fwd EV/EBITDA multiple to our 2017E EBITDA of $11.1B to arrive at a target price of $68, which supports our Top Pick rating. We believe Dow's portfolio transition over the last decade, petrochemical asset flexibility, and robust pipeline warrant a higher multiple. That said, we are only using 8x which is at the lower end of Dow's historical 7-10x range. Our estimates are 5-10% above consensus reflecting Dow's strong execution, more resilient downstream business model, and record of posting results above expectations over the last 2 years.

Risks to rating and price target

Our primary risk factors include: 1) Sustained retracement in crude prices (oil-to-gas ratio compression and lower overall integrated polyethylene chain margins); 2) rising raw materials (ethane/propane); 3) weakening macros (global industrial production, autos, housing, and electronics); 4) weak Ag fundamentals (low commodity prices and high channel inventories for corn and soy); 5) DowDuPont merger falling through; and 6) FX.

RBC Capital Markets

The Interpublic Group of Companies, Inc. (NYSE: IPG)

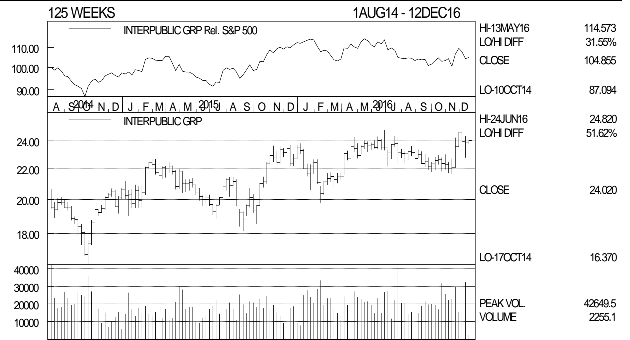
RBC Capital Markets, LLC
Steven Cahall (Analyst) (212) 618-7688; steven.cahall@rbccm.com

Rating: Top Pick

Closing Price: USD 24.02

Price Target: USD 27.00

Implied All-in Return (%): 14.9



Investment opinion

IPG is at a sweet spot in its corporate development. From previously dark days, we believe that CEO Michael Roth and his team have transformed IPG into a high quality agency holding company. But while overall agency quality is on par with peers, in our view IPG is still in the earlier innings of its margin ramp-up, which arguably leaves more headroom for margin expansion (and upside) with 2015 EBIT margins of 11.5% vs. a target of 13.0%, and moving towards the target at a pace of around 50bps per year.

IPG's margin story starts with organic growth and primarily US nominal GDP given the US is around 60% of sales. Economists now expect both nominal GDP and consumer spending to accelerate in 2017, and this should create upside risk to IPG's topline. New business wins provide IPG with some additional growth tailwinds, and we do not expect 2017 to be a disruptive year for agency reviews. Topline growth and/or margin expansion ahead of expectations offer upside potential given IPG's discount to peers like OMC.

Finally, while not core to our thesis we think IPG could be an acquisition target for non-US agencies such as Japan's Dentsu. We like this optionality and think it's confirmed by IPG's underlevered balance sheet, which makes the stock cheaper on EV/EBITDA.

Valuation

At a modest valuation of 15.5x CY17 P/E and 8.3x EV/EBITDA IPG trades at a discount to peer OMC (17x P/E, 10x EV/EBITDA) and to the S&P500. This is despite IPG's double-digit EPS growth + solid dividend and FCF yields. IPG's CY17 PEG is 1.0. We think IPG remains very attractively valued given macro tailwinds, growth metrics and relative valuation. This drives a $27 target price and supports our Top Pick rating.

Risks to rating and price target

Economic growth could drive lower-than-expected underlying organic growth. Growth in advertising spending and broader marketing communications spending depend largely on GDP growth and other macroeconomic factors; Account losses/wins could impact organic growth estimates; Margins could underperform our estimates; Loss of key personnel at the subsidiary agencies may hamper growth.

The PNC Financial Services Group, Inc. (NYSE: PNC)

RBC Capital Markets, LLC

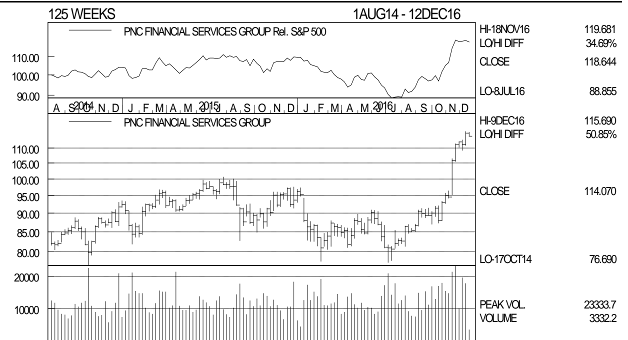
Gerard S. Cassidy (Analyst) (207) 780-1554; gerard.cassidy@rbccm.com

Rating: Top Pick

Closing Price: USD 114.07

Price Target: USD 130.00

Implied All-in Return (%): 15.9



Investment opinion

We rate PNC shares Top Pick for the following reasons:

- **Well positioned for rising interest rates**: In PNC's 3Q16 10-Q, a 12-month, gradual 100 basis points parallel shift in interest rates would result in net interest income increasing 3.0%. Another 100 basis points increase in the second year over the preceding 12 months would increase net interest income by 6.1%.
- **Underserved, higher-growth markets**: PNC believes it can "fill out" its presence in the Southeast from the RBC Bank (USA) acquisition and gain market share.
- **Well-balanced business mix highly tied to an improving economy**: Most of PNC's business is focused on traditional banking, with a commercial/consumer loan breakout of ~65%/35%. An improving economy should lead to solid loan growth.
- **High level of recurring fee revenues**: Noninterest income accounts for approximately 45% of PNC's total revenues, in line with top-performing peers of 40–50% or higher.
- **A Continued Focus on Reducing Operating Expenses:** Bill Demchak has brought PNC's efficiency ratio down to the low-60% range by closing redundant branches and focusing on alternative banking channels. Currently, 50% of deposits are transacted through non-teller channels. We believe these channels will eventually exceed 50%. The company's rollout of its universal branch model to 475 branches supports this strategy.
- **Strong capital**: PNC's CET1 ratio of 10.2% at 3Q16 well exceeds the 8.5% level that we believe the company needs to run a conservative but highly profitable bank. The company was approved to repurchase $2.0 billion in shares for the CCAR 2016 cycle.
- **Deferred Tax Liability**: The company has about $2.0 billion in deferred tax liabilities arising from its investment in Blackrock, Inc. Assuming corporate tax rates are reduced by the incoming Trump Administration, the tax liability would be reduced by as much as $1.0 billion which would lead to an estimated $2.00 per share increase in its book value.

Valuation

We value PNC at $130 per share based on the expected price to book value ratio and the company's reported 3Q16 and our estimated 3Q17 book value per share estimate. The expected price to book value ratio for PNC is based on the discounted value of future economic profits (i.e., the value that a company generates above its cost of equity).

Risks to rating and price target

Our price target is contingent upon a steady rise in interest rates, the expectation for lower regulation and corporate tax rate in the next two years, GDP increasing to 3-4% per year or higher, and credit quality remaining relatively stable. Any deviation from our expectations could impede achievement of our price target.

TransCanada Corporation (TSX: TRP; NYSE: TRP)

RBC Dominion Securities Inc.

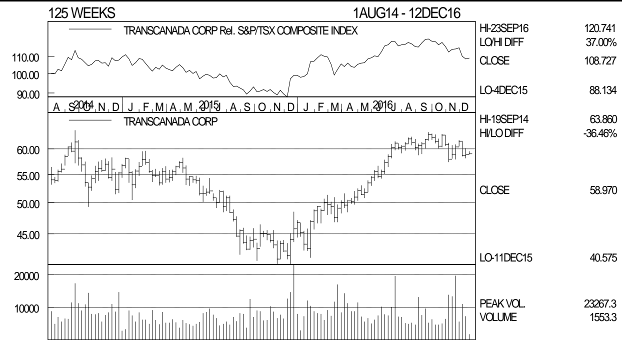
Robert Kwan (Analyst) (604) 257-7611; robert.kwan@rbccm.com

Rating: Outperform

Closing Price: CAD 58.97

Price Target: CAD 72.00

Implied All-in Return (%): 25.9



Investment opinion

Superior growth underpinned by visible regulated/long-term contracted projects. We expect TransCanada will be able to deliver an annual dividend growth rate of roughly 10% through 2020, which is at the high end of our coverage universe and driven by highly visible regulated/long-term contracted projects. We also positively view the CPGX acquisition as it adds a strategic footprint in the Marcellus/Utica gas plays and we believe there is a powerful story to play out with respect to the optimization of gas flows on TransCanada's systems, which could result in new projects that further extend/enhance dividend growth post-2020.

Multiple funding options to support the capital program that do not involve discrete common equity. With the capital plan consisting almost entirely of regulated and/or long-term contracted projects, we view those initiatives as highly financeable. Outside of new debt, we see numerous funding options to meet the capital requirements including free cash flow, the DRIP, hybrids, dropdowns into TC PipeLines LP, further asset sales/partial monetizations and, if necessary, an at-the-market (ATM) equity program.

Attractive valuation relative to its peers. We believe TransCanada is well-positioned relative to our pipeline/midstream coverage with the stock trading at a similar valuation multiple to the midstream peers, but with a superior growth rate (magnitude and duration of visibility), minimal commodity price or volume exposure (more than 90% of EBITDA derived from regulated assets or long-term contracts) and a more conservative payout ratio.

Valuation

Our price target for TransCanada of $72.00 per share is based on a 14x forward DCF multiple, which is in line with what we use for the premium-valued Canadian peers along with a 23x forward P/E, which is at the high-end of the 10-year P/E range. On the P/E, we believe that the "new" TransCanada is more attractive than how the company's outlook has been at any point during the past 10 years, particularly when also framed against the historically low 10-year bond yield environment. We believe that the risk-adjusted expected total return to our price target supports our Outperform rating for the shares.

Risks to rating and price target

There is risk to our price target and rating from reduced gas flows and discretionary revenue generation on the Canadian Mainline, the company investing in new projects that fail to gain the support and confidence of its shareholders, and the ability to fund new growth projects at reasonable costs of capital.

Waste Connections, Inc. (NYSE: WCN; TSX: WCN)

RBC Dominion Securities Inc.
Derek Spronck (Analyst) (416) 842-783; derek.spronck@rbccm.com

Rating: Outperform

Closing Price: USD 77.99

Price Target: USD 90.00

Implied All-in Return (%): 16.3

Investment opinion

Waste Connections acquired Toronto-based Progressive Waste Solutions (BIN) in June of 2016. From a strategic perspective, we see no better buyers of BIN's assets. The combined entity creates the third-largest solid waste company, with a broad breadth of regional waste assets. While consolidation at the SG&A level provide for the initial synergies, it is Waste Connections' strong management team and proven track record of execution that are poised to deliver more material operating synergies, resulting in an inflection in EBITDA and FCF well into 2018. This anticipated step-wise function in earnings and FCF growth is further enhanced by improving underlying industry trends, expected tuck-ins and acquisitions, a significant share-buyback program, and the benefits from the potential lowering of the US tax rate and fiscal stimulus increases. We believe that the markets have yet to price in the full anticipated upside coming by way of operating synergies from the BIN merger, and are underestimating WCN’s ability to further enhance its growth profile as it deploys the significant FCF we see the company generating on a run-rate basis.

Valuation

Our $90 price target is based on an applied 12.5x EV/EBITDA multiple on our 2018 EBITDA estimate. We believe this provides for an attractive one-year return and is the basis of our Outperform rating. Owing to the company's best-in-class EBITDA growth and FCF generation, we value WCN shares at a 12.5x multiple, and while above the forward peer multiple at ~10x, it remains in line with WCN's current forward multiple and the historical premium WCN has enjoyed. We see this premium being sustained as management leverages the Progressive Waste merger and completes additional acquisitions, driving above-industry EBITDA growth and FCF generation on a sustainable basis.

Risks to rating and price target

Market expectations for additional operating synergies resulting from the Progressive merger remain high. As such, should these additional operational synergies fail to materialize, we believe WCN stock could reflect lower earnings growth and a potential reduction in the applied valuation multiple. Another risk comes from potential changes in environmental regulations, which could result in increased landfill capping, closure, post closure, and other remediation activity costs. Additionally, changes to the hazardous classification of waste could present both opportunities (coal ash) and/or additional land-filling requirements.

Whirlpool Corporation (NYSE: WHR)

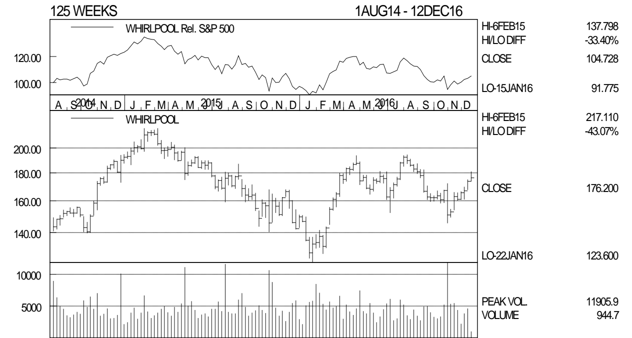
RBC Capital Markets, LLC
Robert Wetenhall (Analyst) (212) 618-3251; robert.wetenhall@rbccm.com

Rating: Top Pick

Closing Price: USD 176.20

Price Target: USD 200.00

Implied All-in Return (%): 15.8



Investment opinion

WHR is the leading global manufacturer of major home appliances. Solid fundamentals in the core North American market, the potential realization of acquisition synergies in Europe and Asia, and robust growth prospects if emerging markets recover position the company for strong earnings growth and incremental free cash flow generation. In the near term, competitive dynamics in North America are poised to benefit from the favorable resolution of a pending anti-dumping suit as well as heightened levels of protectionism. Additionally, we believe that investor concerns regarding rising costs for cold rolled steel are excessive given the company's long history of using hedges and negotiated contracts to protect margin performance during periods when raw material costs surge and/or foreign exchange headwinds strengthen. Sustained revenue growth, operating margin expansion, and improving free cash flow generation support our Top Pick rating.

Valuation

Our price target of $200/share represents a TEV/EBITDA multiple of 7.9x based on FY17E EBITDA of $2.6 BN. We believe that improving competitive dynamics and strong free cash flow growth justify a valuation for WHR in line with the historical sector average for branded home products of 7.0x to 12.0x TEV/EBITDA.

Risks to rating and price target

Improving volumes across the portfolio are the primary driver of organic growth through FY18. Sluggish volume growth that comes in below expectations would impact both EPS performance and the multiple at which the company trades. Other risks in the core North American business include increased promotional activity and higher steel prices which each have the potential to impact gross margin performance negatively. Finally, FX headwinds in the LatAm, EMEA, and Asia segments could hinder the company's ability to meet investor expectations.

Macro Perspectives

2017 Outlook: The Trump Playbook

RBC Capital Markets, LLC
Jonathan Golub, CFA (Chief Equity Strategist) (212) 618-7634; jonathan.golub@rbccm.com

Trump On Rally

Interest rates and inflation expectations have jumped over the past five months on the back of a tight labor market and the promise of Trump's pro-growth policies. While the market's recent rotation might seem abrupt, the S&P 500 is up only 6% since election day, leaving it with substantial potential upside.

2017 S&P 500 Price Target of 2,500

In our post-election report "**A Whole New World – Biggest Paradigm Shift Since Reagan**", we wrote, "we believe that rising earnings and multiples will push equity returns into the double digits from our previous high-single-digit baseline." Consistent with this view, we initiated a 2017 price target of 2,500, representing 10.6% potential upside (before dividends) from current levels.

EPS to Reaccelerate (2016: $119, 2017: $128, 2018: $140)

Following two years of near-zero growth, we expect profits to re-accelerate. A better operating environment for Financials and Energy should contribute to faster growth in 2017 (+7.6%). 2018 EPS growth (+9.4%) assumes a 2–3% impact from Trump policies. This place holder for changes in taxes, regulation, and spending is quite modest, in our view, as an adjustment to corporate taxes alone could easily double this impact.

Upside to Multiples

Our 2017 year-end target is predicated on a 17.9x multiple on 2018E profits. We believe multiples will advance more quickly than earnings over the near term, as analysts wait for clarity on Trump policies before adjusting estimates.

Markets Advance/Rotation in the Early Innings

Small Caps and Financials are leading the broader market, up 16.1% and 18.5%, respectively, since the election. The market has been quick to reward low-P/E stocks and those with higher price volatility, as well as names with higher effective tax rates and more domestic business models.

10-year Treasury yields are up 61 bps since election day, 111 bps since July's low. Bund and JGB yields have not kept pace with Treasuries, resulting in a stronger dollar.

Key Themes of a Trump Presidency

An Anemic Recovery

- Since 2006, US GDP has averaged just 1.6% (vs. 3.5% for the prior 50 years)
- Inflation and rates been well below average throughout the recovery

The Stage Was Set for Reflation

- Labor market conditions have already begun to tighten as the recovery cycle matures
    - Unemployment at 4.9%
    - Wage inflation at 2.8%
    - Job creation at 175k/mo vs. 85k new entrants/mo into the labor force

Pro-Growth Policies

- Corporate tax cuts could easily add 5–7% to profits annually going forward
- Deregulation should increase economic growth through greater productivity
- Financials would be the greatest beneficiary of less onerous regulations
- Fiscal spending, while a positive, would have a delayed impact on growth
- Consumer spending should improve as wages rise and savings rates fall
- Higher rates should positively impact Banks and consumer spending (paradox of thrift)

A New Investment Regime / Market Leadership

- Asset Allocation
    - Rates to continue rising; credit spreads to tighten
    - Equities to rise on stronger earnings and higher multiples
    - Small Caps and Value to outperform
    - Dollar to continue strengthening as US yields outpace global rates
    - Volatility to rise, correlations to remain low
- Sectors
    - Financials most attractive
    - Bond-proxies and Staples to remain under pressure
    - Economically sensitive groups (Energy, Materials, Industrials) to outperform
    - IP companies with strong fundamentals to keep pace with market
- Factors
    - Low P/E, domestically oriented, and high-tax companies to outperform
    - Low vol to lag

RBC S&P 500 Price and Earnings Targets

2017 price target of 2,500 implies 10.6% upside from current levels

Exhibit 1: S&P 500 Price and Earnings Targets

S&P 500 Price Level	Price	% Change
Current (as of 12/09/2016)	2,260	
2017 Year-End Target Price	2,500	10.6%
Operating Earnings	**EPS**	**YoY Growth**
2015 Actual	118.20	-0.5%
2016 Estimate	119.00	0.7%
2017 Estimate	128.00	7.6%
2018 Estimate	140.00	9.4%
P/E Multiple	**Current**	**Change**
Current on NTM RBC EPS Estimates	17.7x	
Year-end 2017 on RBC 2018 EPS	17.9x	0.1x

Source: S&P, Thomson Financial, FactSet, and RBC Capital Markets estimates

Financials should benefit most, bond-proxies least, from reflationary policy

Exhibit 2: Sector Recommendations

Overweight		Market Weight		Underweight	
Financials	(prev: MW)	Technology	(prev: OW)	Staples	(prev: OW)
Health Care		Discretionary	(prev: OW)	Utilities	
Energy	(prev: MW)			Telecom	
Materials	(prev: UW)			REITs	
Industrials	(prev: UW)				

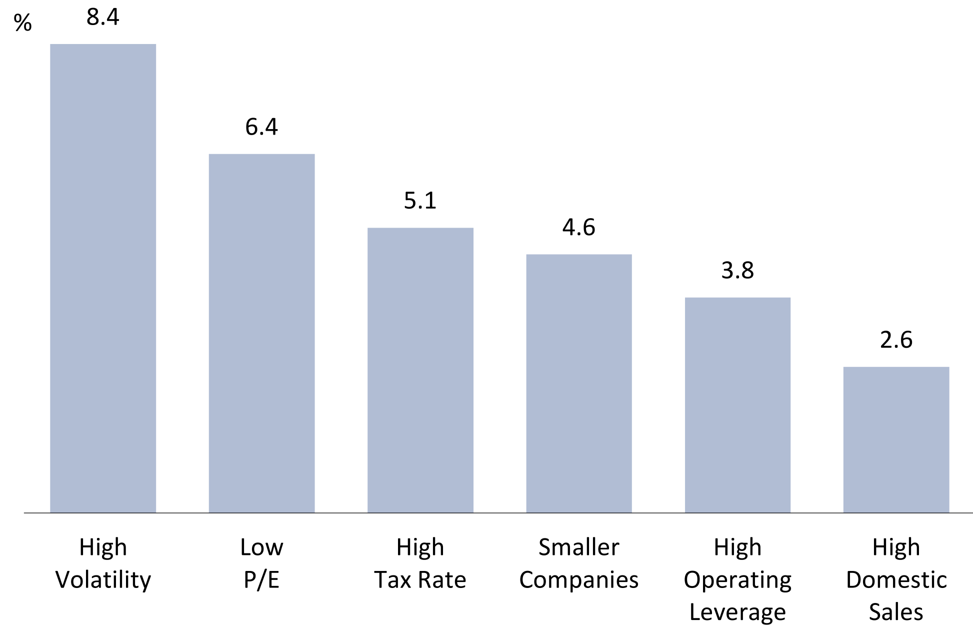
Source: S&P and RBC Capital Markets

Post-Election Performance

Key factors likely to outperform under pro-growth policy:

High Volatility, Value, High Tax, Domestic Orientation, and smaller size

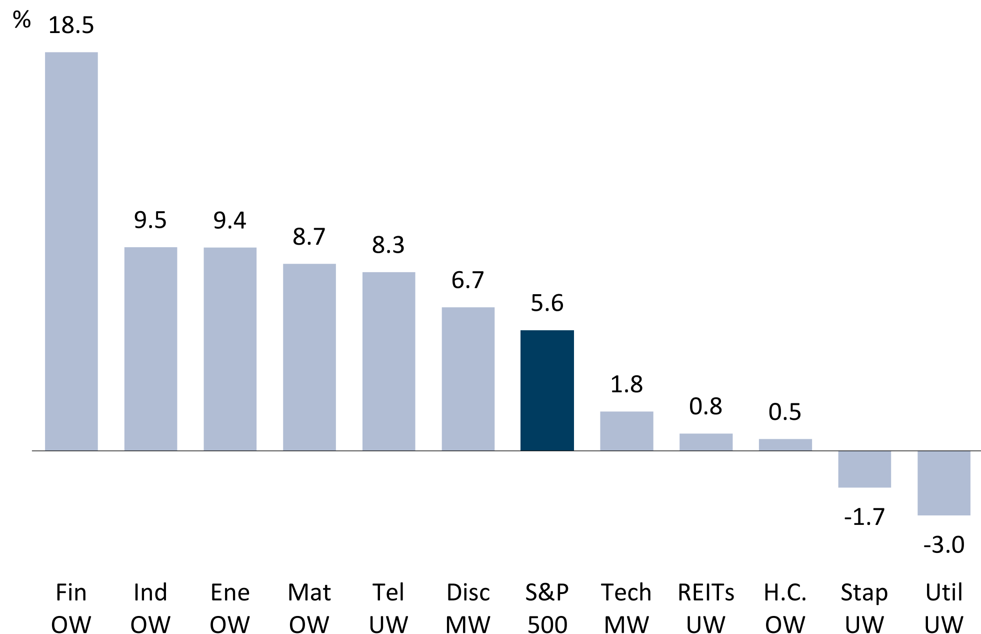
Exhibit 3: Post-Election Factor Performance



Note: Daily tertiled (top vs. bottom third) factor performance; high vs. low 1-year trailing daily price volatility; high vs. low forward earnings yield; high vs. low effective tax rate (taxes paid / pre-tax income); high vs. low domestic vs. foreign sales (industry-group neutral); high vs. low trailing 3-year operating leverage (EBIT vs. revenue); large vs. small market cap; Priced 12/9/16
Source: S&P, Thomson Financial, Compustat, FactSet, and RBC Capital Markets

Market rotation should continue throughout 2017

Exhibit 4: Post-Election Sector Performance



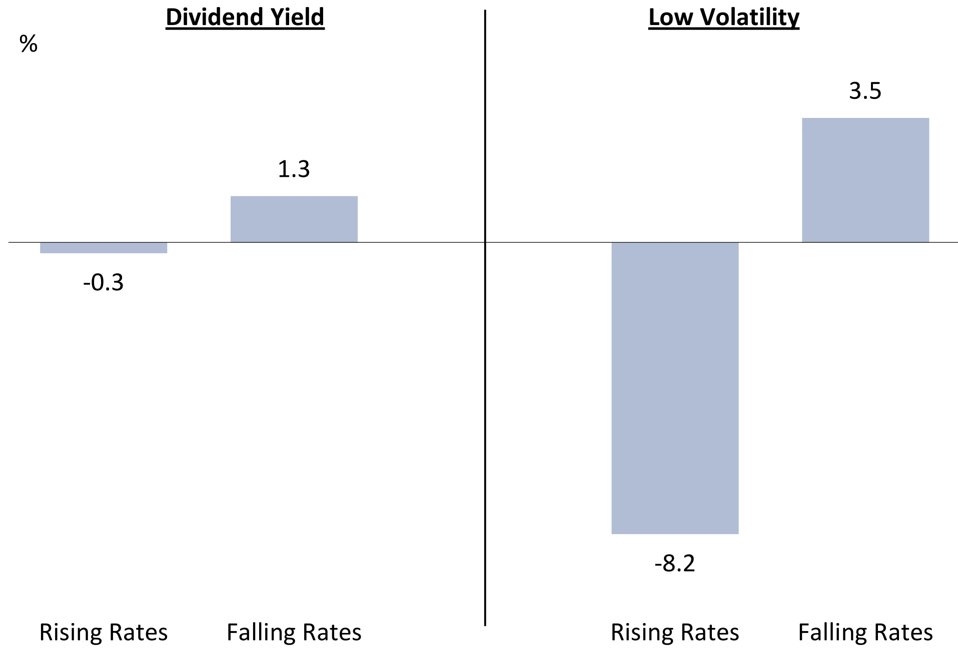
Source: S&P, Thomson Financial, Compustat, FactSet, and RBC Capital Markets

Note: Priced 12/9/16

Factor Behavior

Low-vol stocks are more sensitive to rising rates than high-div names

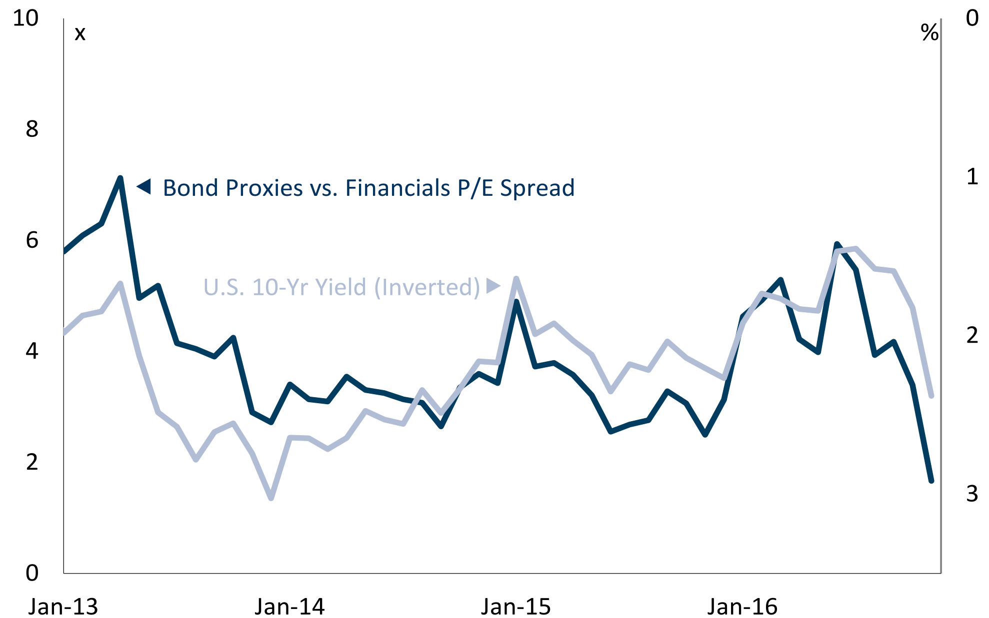
Exhibit 5: Performance of High-Div and Low-Vol Stocks by Interest Rate Environment



Note: Interest rate environments are based on US 10-Year; Factor is LTM dividend yield and 1-year trailing daily price volatility; 1-year rolling average tertiled (top vs. bottom third) factor returns; Priced 11/30/16
Source: S&P, Thomson Financial, Compustat, FactSet, Haver, and RBC Capital Markets

While Financials have rerated relative to bond proxies, this is likely to continue as long as rates are on the rise

Exhibit 6: Forward P/E Spread – Bond Proxies Less Financials

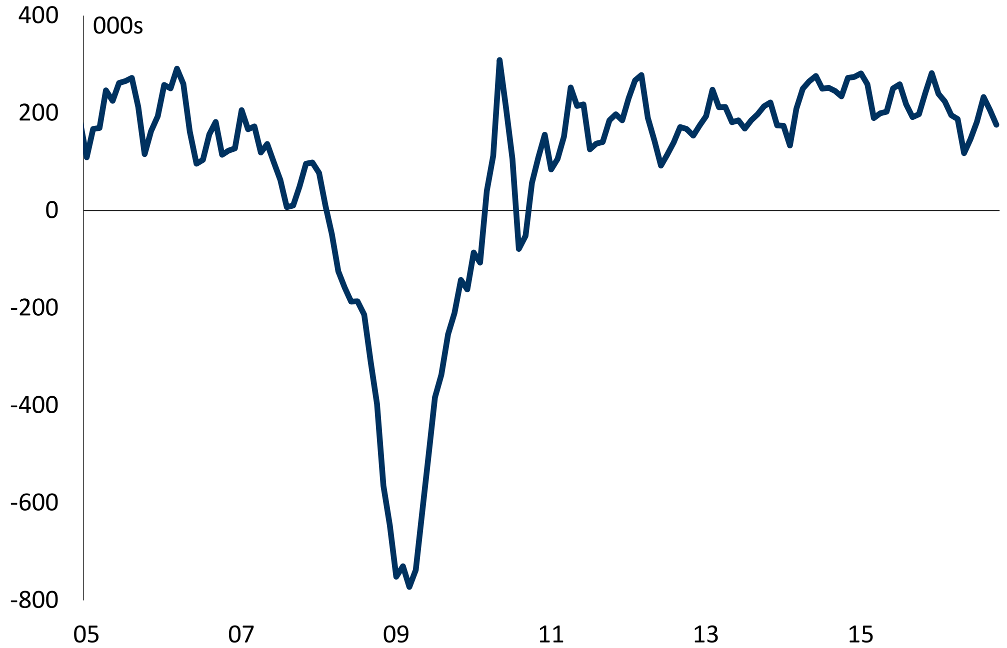


Note: NTM P/E; Bond Proxies are Utilities, Telecom, and REITs; Priced 11/30/16
Source: S&P, Thomson Financial, Compustat, FactSet, and RBC Capital Markets

Reflation – Employment

Non-Farm Payrolls growth has outpaced work force growth, resulting in a decline in unemployment

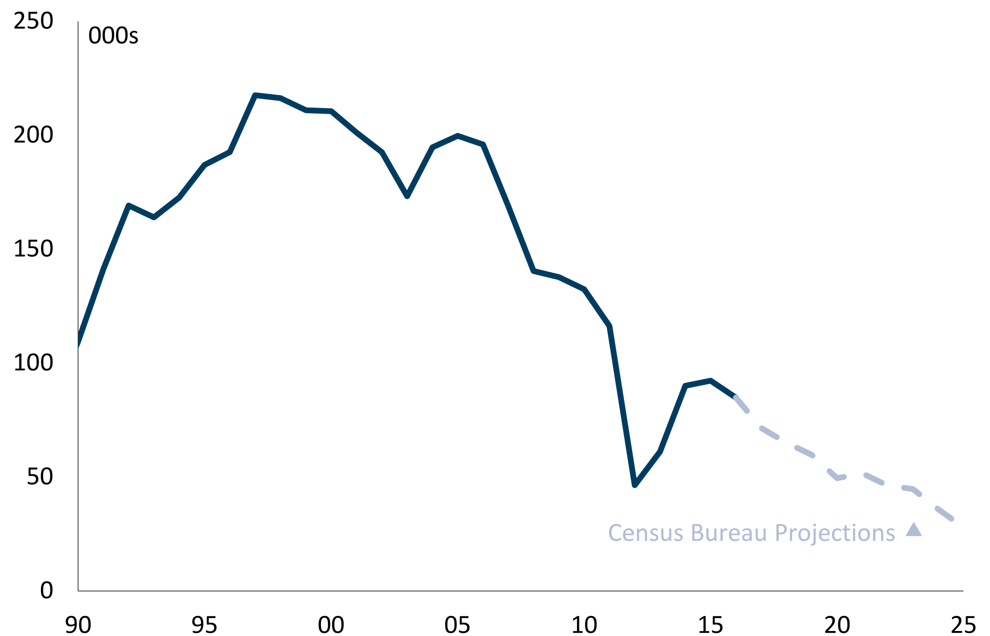
Exhibit 7: Non-Farm Payrolls



Source: BLS, Haver, and RBC Capital Markets

Note: 3-Month Moving Average

Exhibit 8: Job Growth Required to Keep Unemployment Constant



Source: Census Bureau, Haver, and RBC Capital Markets

Note: Working Age Population Growth per Month

Reflation – Wage Inflation

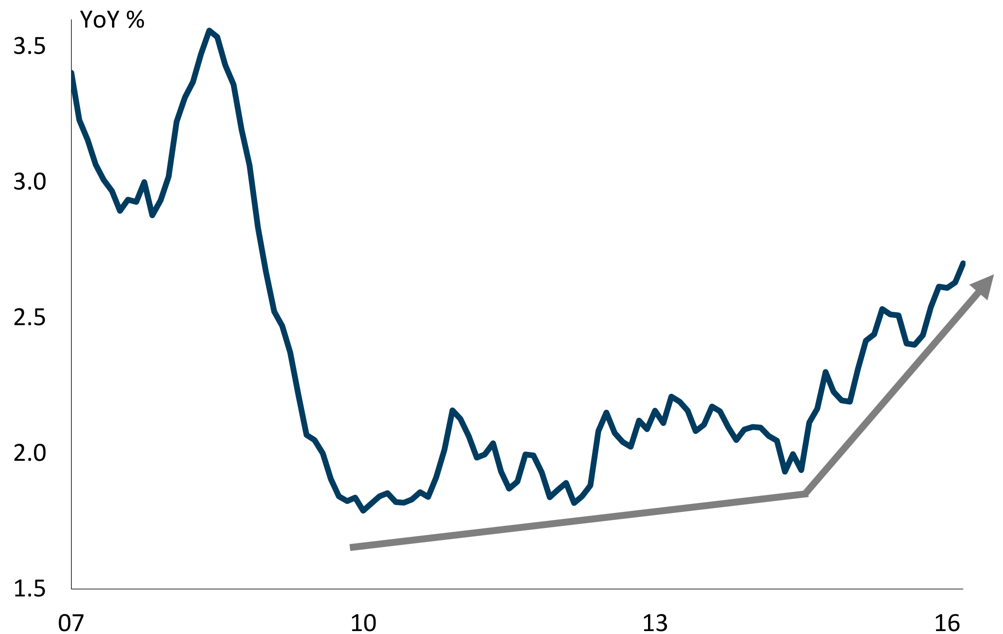
Labor market tightness is likely to put upward pressure on wages

Exhibit 9: Wage Inflation vs. Unemployment Rate (Advanced 1 Year)

Source: BLS, Haver, and RBC Capital Markets

Note: 3-Month Moving Average

Exhibit 10: Wage Inflation



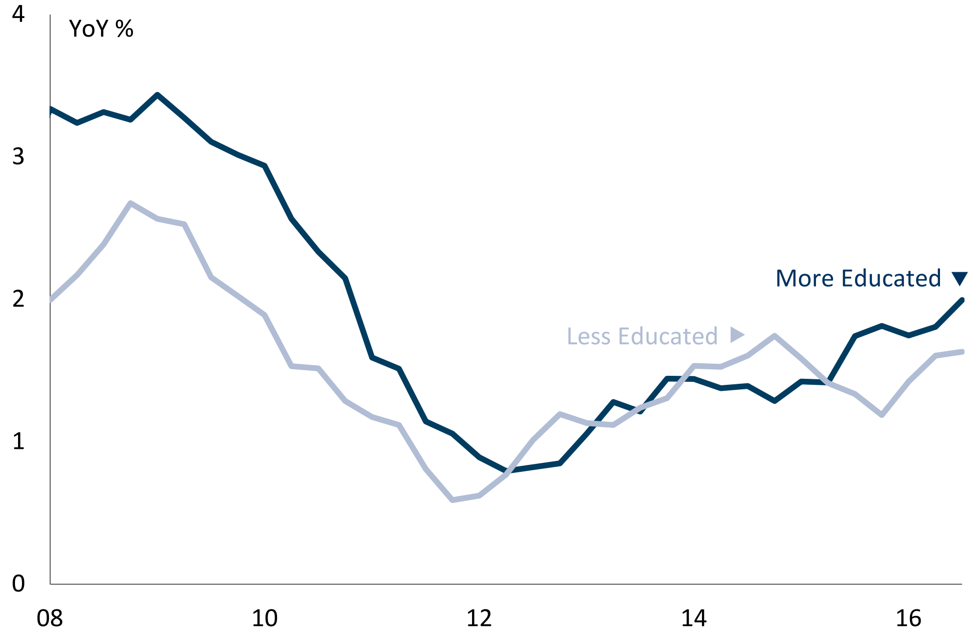
Source: BLS, Haver, and RBC Capital Markets

Note: 3-Month Moving Average

Reflation – Wage Inflation

More and less educated Americans have experienced wage increases over the past several years

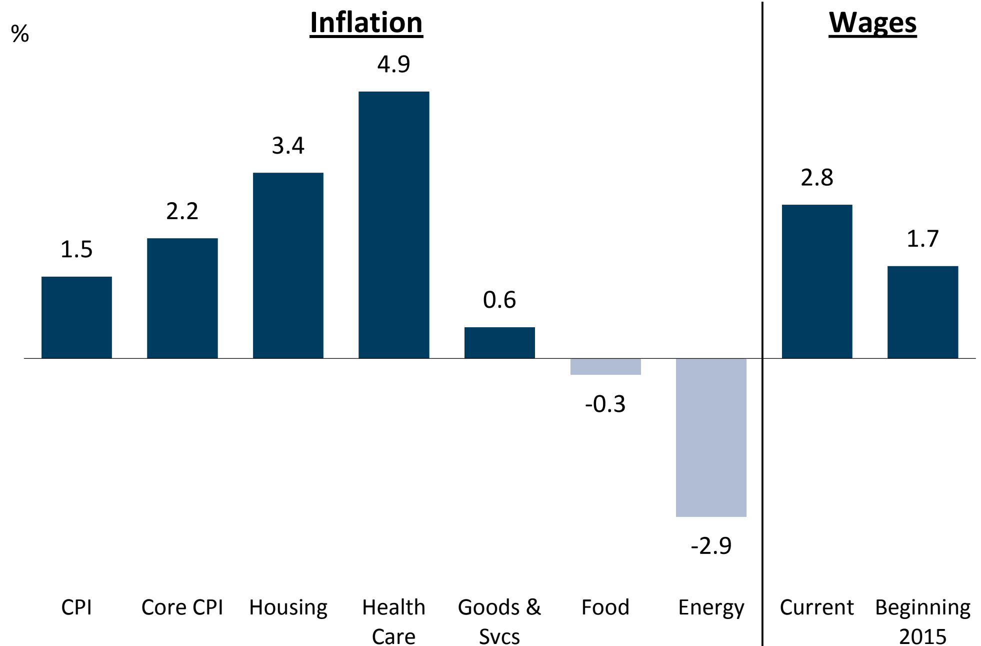
Exhibit 11: Median Wage Gain by Educational Attainment



Note: More Educated is College Degree or Greater; Less Educated is Some College and Below; 3-Year MA
Source: BLS, Haver, and RBC Capital Markets

We believe a stronger consumer will put upward pressure on anemic goods and services inflation

Exhibit 12: Inflation Detail

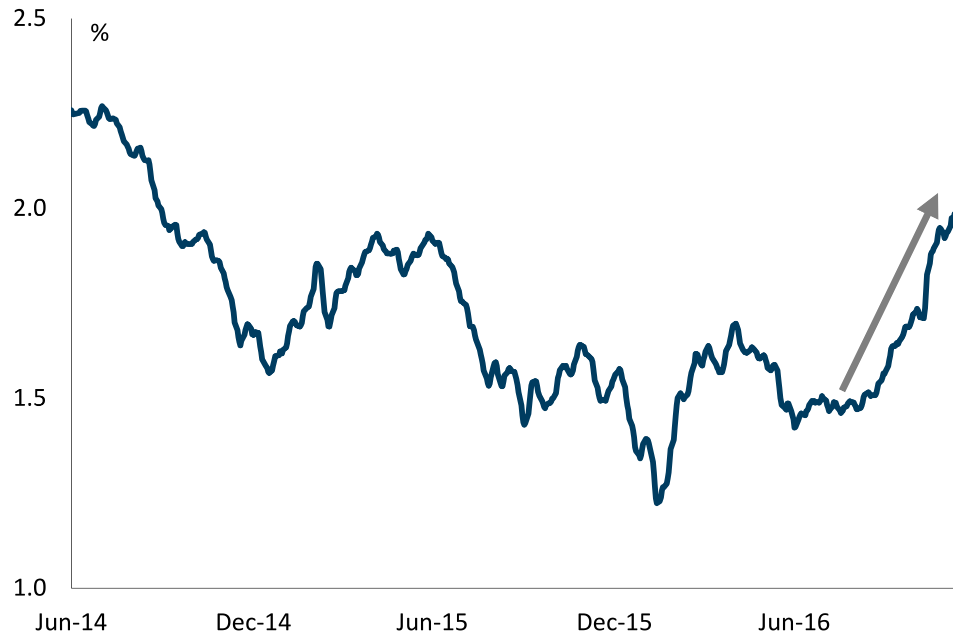


Source: BLS, Haver, and RBC Capital Markets

Reflation – Inflation

Inflation and interest rate expectations are on the rise

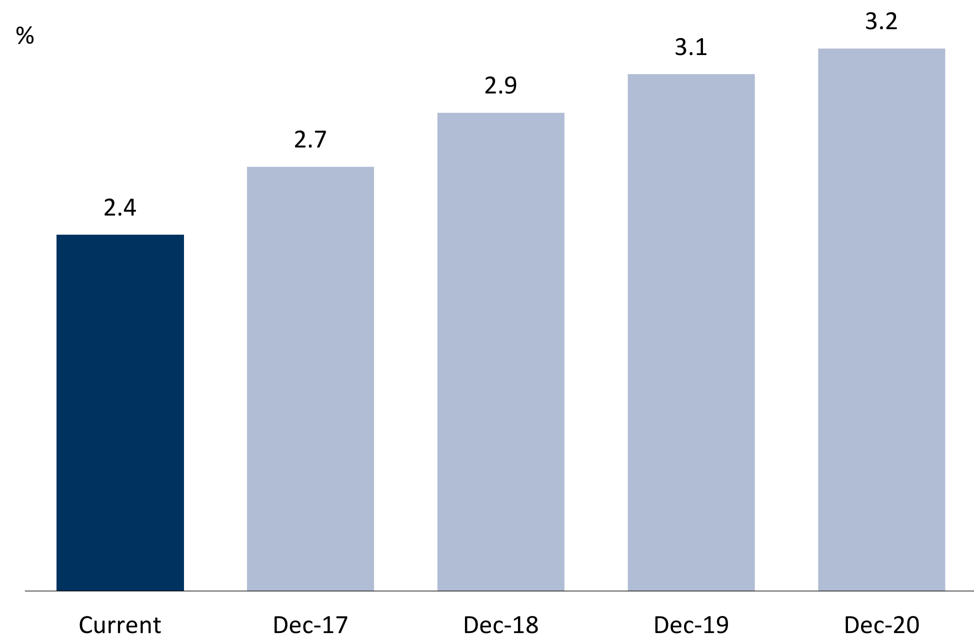
Exhibit 13: 10-Year Inflation Expectations



Source: Bloomberg and RBC Capital Markets

Note: 10-Year Breakeven; 5-Day MA; Priced 12/9/16

Exhibit 14: 10-Year Treasury Yield Forward Expectations



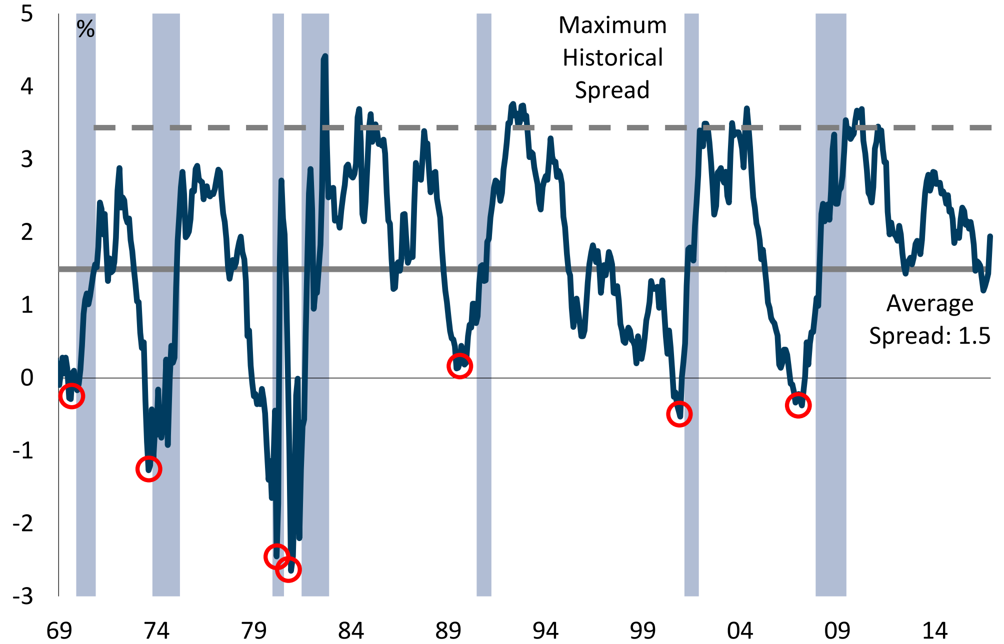
Source: Bloomberg, and RBC Capital Markets

Note: Priced 11/30/16

Reflation – Interest Rates

The yield curve has recently steepened

Exhibit 15: Yield Curve

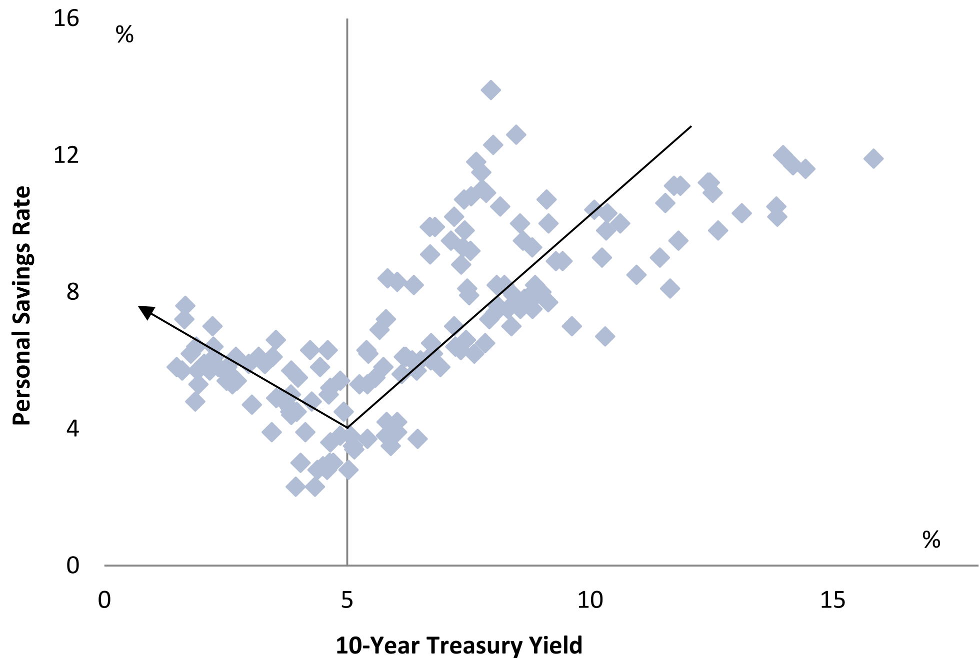


Source: Federal Reserve, Haver, and RBC Capital Markets

Note: 3M–10Y Spread

The recent pick-up in interest rates should result in more robust consumer spending

Exhibit 16: Savings Rate Response to Interest Rates



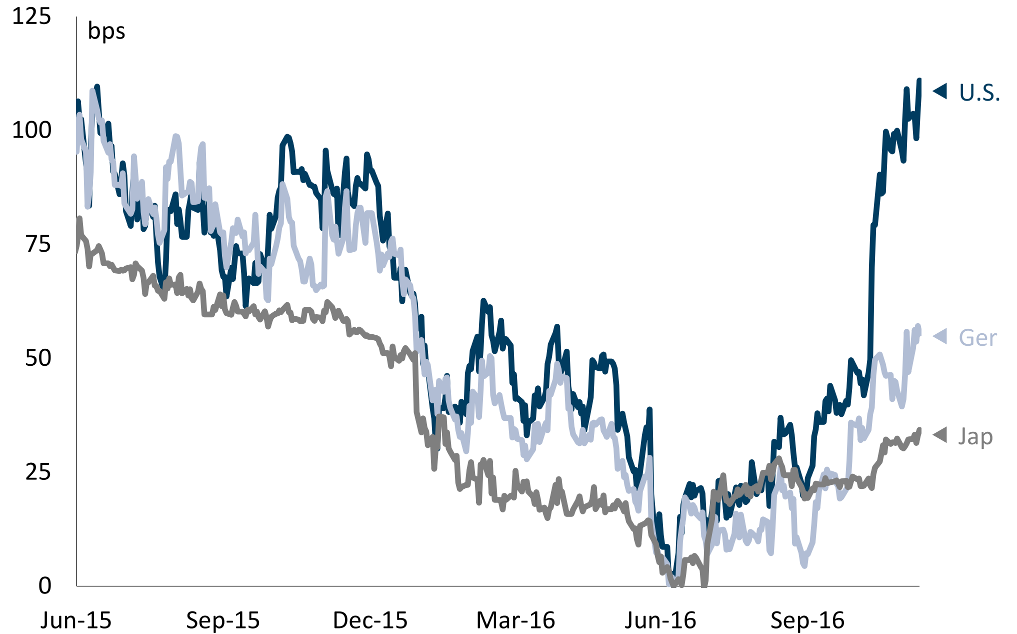
Source: Federal Reserve, BEA, Haver, and RBC Capital Markets

Note: Quarterly data; 1975 to present

Reflation – Interest Rates and Dollar

The pro-growth environment is very much an American phenomenon

Exhibit 17: Change in 10-Year Government Bond Since July Low

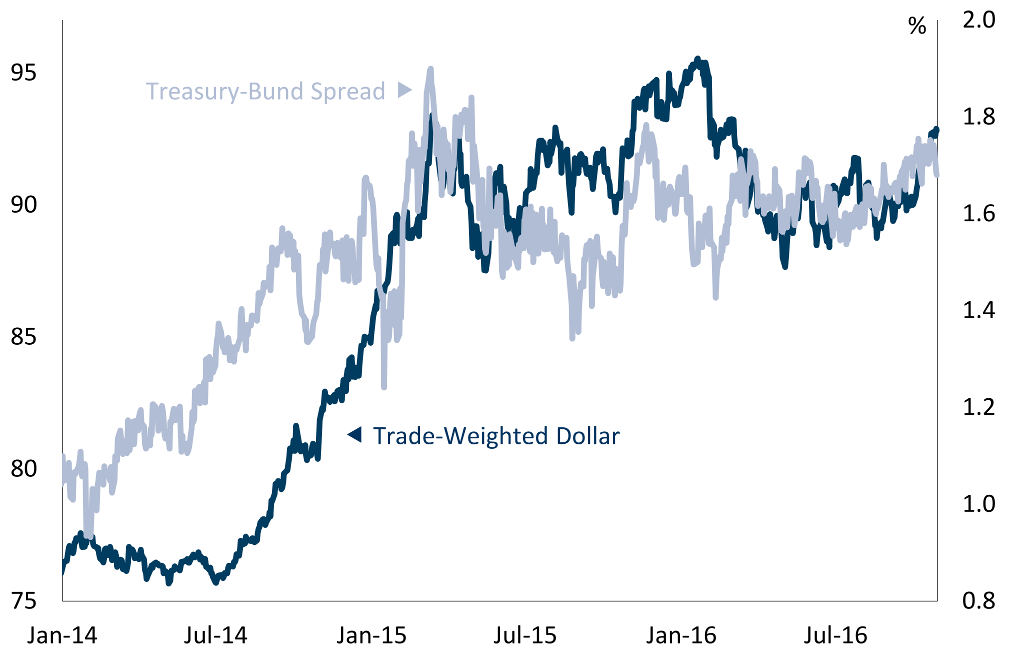


Source: Bloomberg and RBC Capital Markets

Note: July 7, 2016 low; Priced 12/9/16

Stronger U.S. rates should lead to dollar strength

Exhibit 18: Trade-Weighted Dollar vs. 10-Year Treasury-Bund Spread



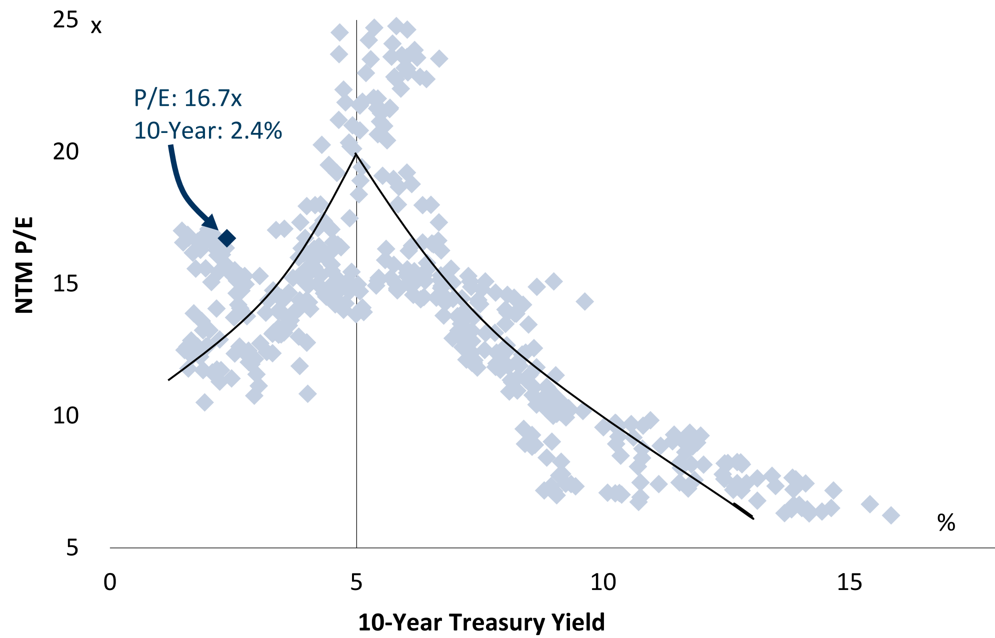
Source: Federal Reserve, Bloomberg, Haver, and RBC Capital Markets

Note: Major Currencies Index; Priced 11/30/16

Reflation – Market Response

In low-yield environments, rising rates result in higher multiples

Exhibit 19: S&P 500 NTM P/E vs. 10-Year Yield



Note: Monthly data; 1975 to present
Source: Federal Reserve, S&P, Thomson Financial, FactSet, Haver, and RBC Capital Markets

The market prefers higher rates

Exhibit 20: US Equity Returns on Up and Down Interest Rate Days

%		Equity Return on Days When			
	All	Change in 1-Year Yield		Change in 10-Year Yield	
	Days	Higher	Lower	Higher	Lower
S&P 500	**10.3**	**38.8**	**-20.5**	**54.4**	**-28.5**
Financials	20.7	100.6	-39.8	143.3	-50.4
Energy	22.6	63.4	-25.0	128.8	-46.4
Materials	13.0	51.4	-25.3	65.5	-31.7
Industrials	18.9	49.1	-20.3	60.4	-25.9
Technology	11.0	39.6	-20.5	51.4	-26.7
Discretionary	5.9	39.3	-24.0	45.8	-27.4
Health Care	-2.8	19.6	-18.8	38.7	-29.9
Staples	4.1	11.1	-6.3	14.5	-9.0
Telecom	15.3	8.6	6.2	19.7	-3.7
REITs	2.0	1.2	0.8	7.2	-4.8
Utilities	12.7	-0.6	13.3	-9.6	24.6
% of Days	***100***	***53***	***47***	***50***	***50***

Source: S&P, Federal Reserve, FactSet, Haver, and RBC Capital Markets

Note: Last 12 months; Priced 12/9/16

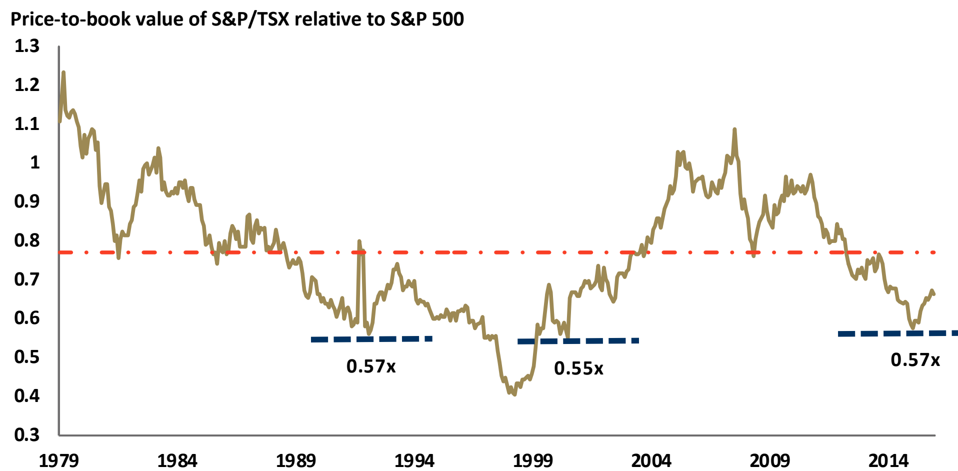
Canada: Well positioned for shifting themes

RBC Dominion Securities Inc.
Matt Barasch (Canadian Equity Strategist) (416) 842-7857; matt.barasch@rbc.com

Remain overweight the S&P/TSX

After nearly 5 years of underperformance, Canadian stocks reasserted themselves in 2016, outperforming most global indices both in local and US dollar terms. The primary drivers of this resurgence in our view were: 1) relative valuation on the S&P/TSX had reached historic extremes; and 2) cyclical factors such as significant Chinese stimulus (begun in 2015) and a more dovish Federal Reserve than was discounted as 2016 began.

Exhibit 1: The S&P/TSX had reached extreme relative levels in early 2016

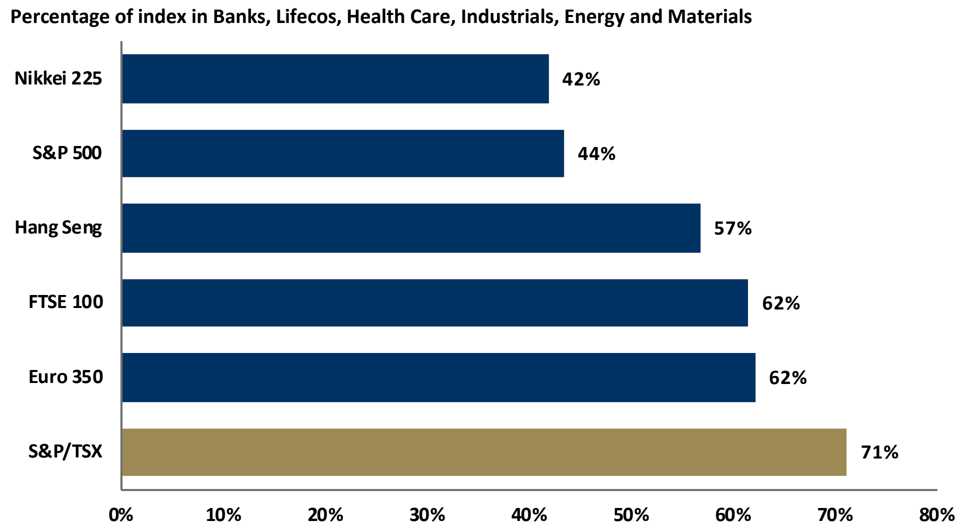


Source: RBC Capital Markets Quantitative Research

While valuation is still below historic relative norms and earnings are set to recover smartly on the back of recovering oil prices, our argument has been that the inevitable throttling back of Chinese stimulus and/or a shift in tone from the US Fed may be enough to "close the window" so to speak on TSX outperformance. However, in our view, the election of Donald Trump has potentially extended this "window".

President-elect Donald Trump has put forward an ambitious economic plan that combines across the board tax cuts (personal, corporate and repatriation) with infrastructure spending, a more liberal energy policy and a reduction in regulations. On the surface, these policies should be supportive to Canadian stock performance, as the S&P/TSX is heavy in those stocks that benefit from steeper yield curves (banks and lifecos), not to mention the potential for increased resource demand on the back of a stronger US economy.

Exhibit 2: The S&P/TSX has a heavy weighting to "good" Trump



Source: Bloomberg; RBC CM Canadian Equity Strategy

2017 sets up well for Canadian stocks in our view. We maintain our overweight recommendation and recently raised our 18-month price objective on the S&P/TSX to 16,300 (previously 15,800) representing ~12% upside from current levels. We provide more details on the rationale for this overweight below.

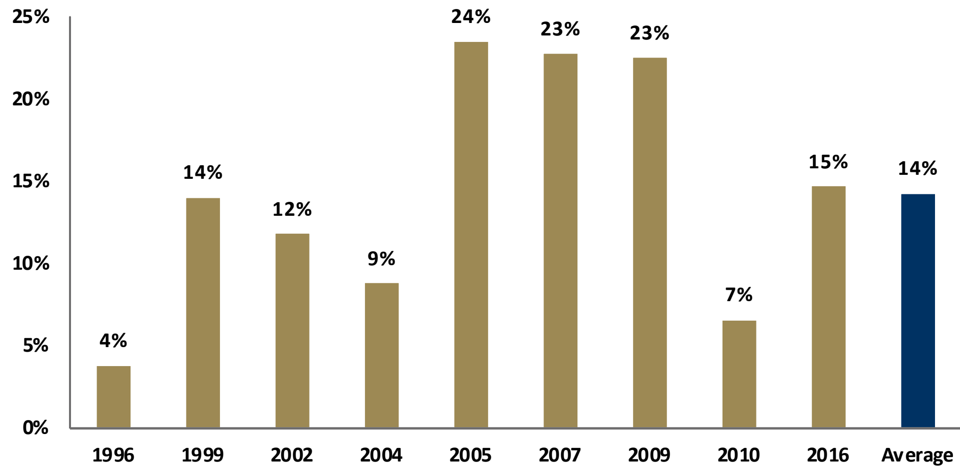
Our view is that the shift from a narrative primarily driven by monetary policy to one driven by a combination of monetary and fiscal policy present a compelling potential set-up for Canadian stocks. However, at the same time, in our view, the range of outcomes has become much wider than it was previously. For the better part of 7 years, we were on a low growth path that offered very little variability, but was at the very least fairly reliable. US recession risks remained low for the most part, while at the same time, big upside economic surprises were essentially non-existent.

With the election of Donald Trump, not to mention Brexit and other upcoming votes in Europe and around the world, the potential for an up-shift in US and global growth has increased in the view of RBC economists. However, so have the downside risks, as policy missteps become a greater risk. Put another way, the amplitude of the US and global economy has been fairly narrow for more than half a decade; we would not be surprised to see this amplitude widen considerably.

Our overweight Canada recommendation rests on several pillars

Positive leverage to continued commodity recovery: Over the past two-decades, the S&P/TSX has been a strong absolute and relative performer in years in which oil prices have risen 10%+. This stems largely from the TSX's significant direct (Energy accounts for ~20% of the index) and indirect exposure to oil. Our Commodity Strategy team sees oil prices continuing to push higher into year-end 2017 on the back of slowing global supply growth and consistent demand growth, potentially lifted further by a pick-up in US growth.

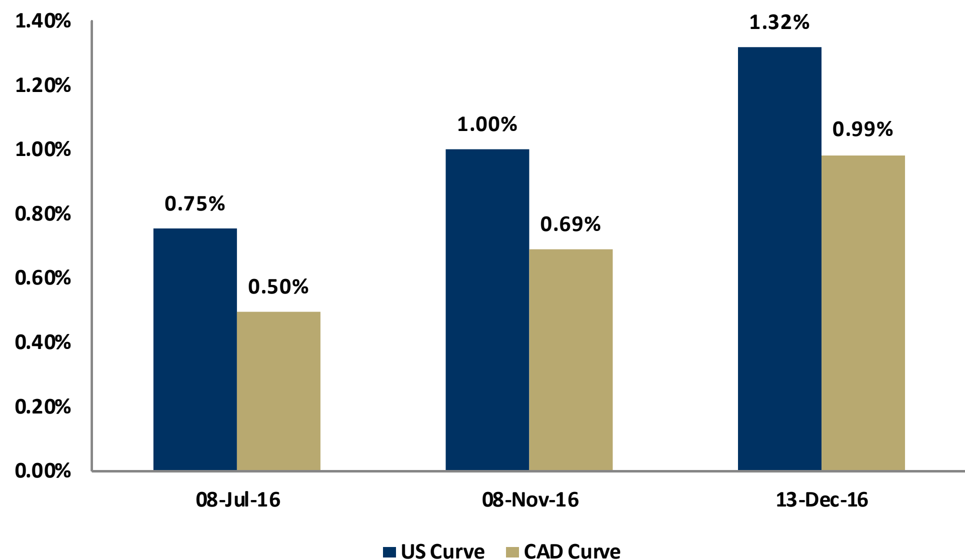
Exhibit 3: The S&P/TSX has consistently outperformed in 10%+ oil years



Source: Bloomberg; RBC CM Canadian Equity Strategy; Priced as at 12/9/2016.

Significant yield curve exposure: Over the past several months, yield curves both in Canada and the US have steepened significantly. The Canadian banks, which account for close to 1/4th of the weighting of the S&P/TSX generate roughly half of their earnings on average from net interest margins. Further, life insurance stocks account for ~5% of the index and also stand to benefit both through balance sheet relief and potentially through higher sales as annuity sales tend to be positively correlated to rising rates.

Exhibit 4: ~30% of the S&P/TSX is positively exposed to higher long rates

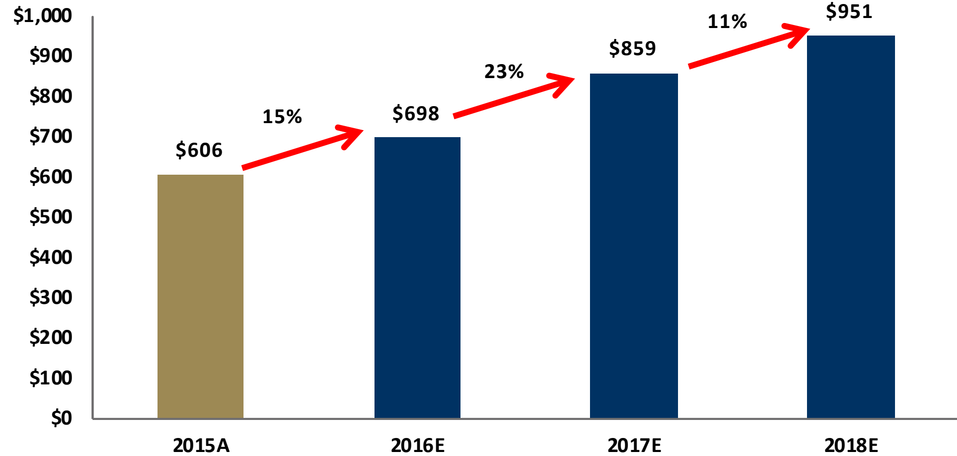


Source: Bloomberg; RBC CM Canadian Equity Strategy; Through 12/13/16

Strong earnings recovery likely: On the back of recovering oil and commodity prices, not to mention the potential for higher long rates, earnings for the S&P/TSX have the potential to rebound smartly in 2017 and 2018. We utilize a combination of top down and bottom up estimates (both RBC CM and consensus) to arrive at earnings estimates for the current year (now 2017) and next year (2018 – discounted 5% to reflect added uncertainty).

Exhibit 5: Oil recovery and higher long rates should drive a continued recovery in TSX earnings

Actual and estimated EPS for S&P/TSX

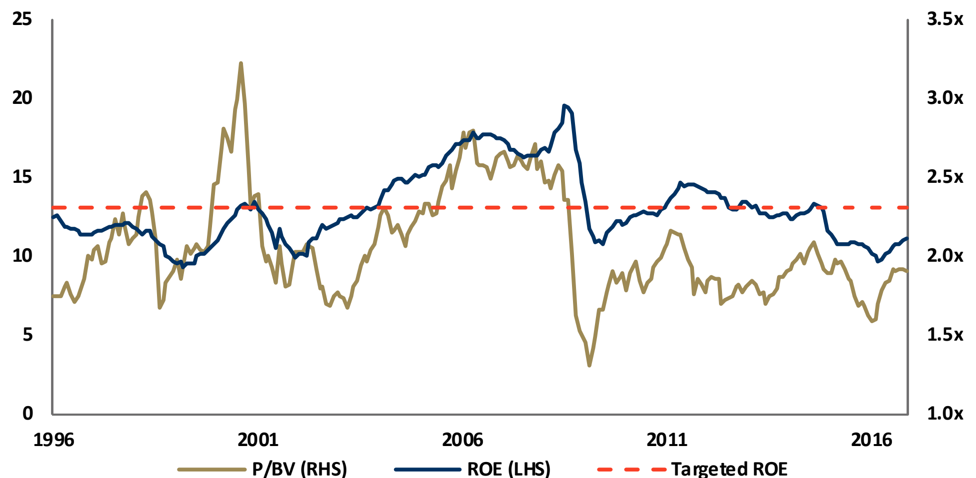


Source: Bloomberg; RBC CM Quantitative Research; RBC CM; Note: 2016 and 2017 are an average of Consensus, RBC CM's bottom up and top down estimates. 2018 is based on RBC CM's bottom up and top down estimates discounted 5%.

In order to generate a target price objective for the market, we look at historic normalized ROE's for the S&P/TSX to generate a targeted price-to-book multiple for the market.

Exhibit 6: ROE's have begun to converge toward the long-term average

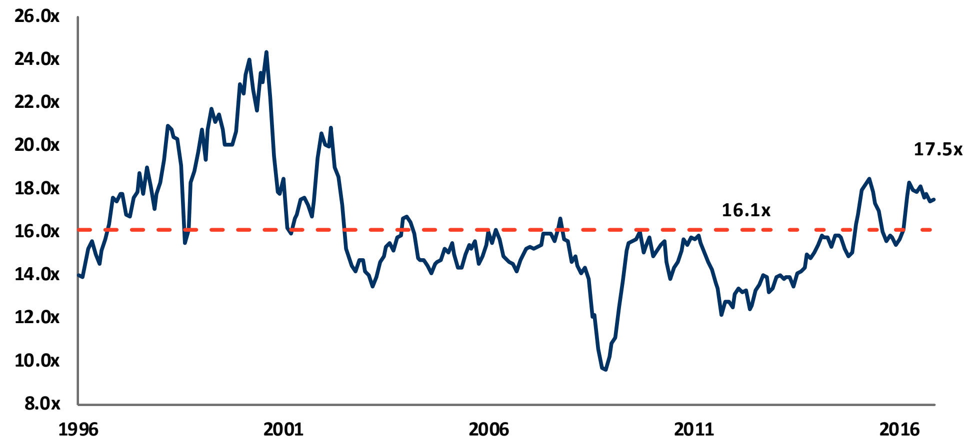
Price-to-book value for the S&P/TSX vs. ROE (%)



Source: RBC CM Quantitative Research

Based on a 13% targeted ROE and a 2.1x price-to-book value multiple (currently 1.9x), we arrive at an 18-month price objective of 16,300 for the S&P/TSX (~12% upside from current levels). As a check against this, we look at the S&P/TSX versus a blend of current year expected earnings and next year's expected earnings.

Exhibit 7: The TSX is roughly 1-turn above its long-term average on a forward multiple basis



Source: RBC CM Quantitative Research; Through 11/30/16

Our 16,300 objective equates to 18x a blend of our 2017 and 2018 estimates. This would represent about a two-multiple point premium to historic averages and roughly a half-point premium to current levels, which we believe is appropriate considering the S&P/TSX's exposure to the themes described above.

Overweight Sectors/Subsectors

- **Lifecos:** we raised the Canadian lifecos to overweight in late summer on the back of attractive relative valuations both to historic norms and relative to Canadian banks and US lifecos. Our view remains that valuations still offer a compelling entry point, while the backdrop of higher rates could drive significant earnings upside relative to current consensus.
- **Auto Parts:** we raised the Canadian auto parts subsector to overweight with the release of our 2017 Year Look-ahead. While the group faces potential risks from any trade barriers that President-elect Trump might erect, valuations both in our view and in the view of RBC Dominion Securities Inc.'s fundamental analyst, Steve Arthur, already discount close to a worst case scenario for the group.
- **Energy producers:** we have recommended overweight exposure on the E&P and Integrated subsectors since early spring on the back of compelling valuations (price to book multiples remain below historic norms) and our Commodity Strategy team's view that oil prices would rise throughout 2016 and into 2017. We would add that looking back over the prior five OPEC output cut cycles, both E&P and Integrateds have been strong performers in the ensuing 12-months from the first cut announcement in four of five cycles.
- **Gold Stocks:** we have recommended overweight exposure to gold stocks since early spring on the back of compelling valuations relative to historic norms and the uncertain global macro backdrop. While the call has clearly not worked, our view remains that the combination of global macro risks, the potential for higher inflation on the back of renewed global stimulus and historically low valuations should be supportive of the subgroup going forward.

Key risks

Key risks to our call include the following:

President-elect Trump's policies do not have the desired impact or passage proves difficult: even under a "good Trump" scenario, there is the risk that US growth does not respond in a meaningful way. While personal tax cuts would likely provide some boost, most of them would accrue to the wealthiest Americans, who are least likely to spend them. Further, corporate tax cuts should provide some boost; however, corporate profits have suffered more from top-line issues since the Financial Crisis as opposed to issues of margins.

More "bad" Trump than feared: markets have taken a very positive stance toward the policies that we are likely to get from President-elect Trump. However, Mr. Trump likely did not get elected on the back of big tax cuts for the wealthy nor for fewer financial regulations. Rather, his anti-trade, anti-immigration stances likely played some role in his election. Should he aggressively pursue the stances that he took during the election as they pertain to trade and immigration, risks would rise significantly in our view, especially given the TSX's heavy reliance on commodities.

Interest rate increases cause an "accident": higher rates should prove to be positive for the Canadian stock market overall; however, higher rates could pose a headwind not only for the Canadian economy, but also most global economies. While Canadians have taken on significant debts over the past decade, this has been buffered by the continuous decline in interest rates.

Should rates continue to back-up, there is a risk that this would take a significant enough bite out of already low domestic and international growth so as to cause problems of some sort. To put it in perspective, a 100-basis point increase in overall borrowing rates for Canadians would drain roughly as much out of the Canadian economy as the Canadian government's stimulus plan would add.

Oil prices fail to recover: Our positive call on Canada rests in part on a continued recovery in oil prices. Should oil prices fail to recover, not only would this negatively impact our forecasted earnings for the S&P/TSX, but it would also likely impact the overall performance of the market as many sectors and subsectors in Canada benefit indirectly from higher oil prices.

Geopolitics: If 2016 taught us anything, it is that no political result is certain. As mentioned, several important votes will be held in 2017, including elections in Germany and France. While the market absorbed these votes quite well in 2016, it is possible that the next adverse outcome to the established norm, should one occur, could prove more difficult for markets to overcome.

Europe in 2017: Reflation, Brexit and political risks

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2017 is likely to bring higher bond yields driven primarily from higher US inflation expectations. A decent US growth outlook and already rising wages coupled by fiscal stimulus and some protectionist tendencies are likely to be the catalysts. In Europe, however, the UK and the euro area economies face their own, very unique headwinds. The Brexit process will hold back the UK while poor trend growth and political risks should weigh on the euro area. Both the BoE and the ECB are likely to administer more monetary stimulus. US-EUR spread widening and curve steepening are the likely outcomes and European equity markets are expected to lag behind the US.

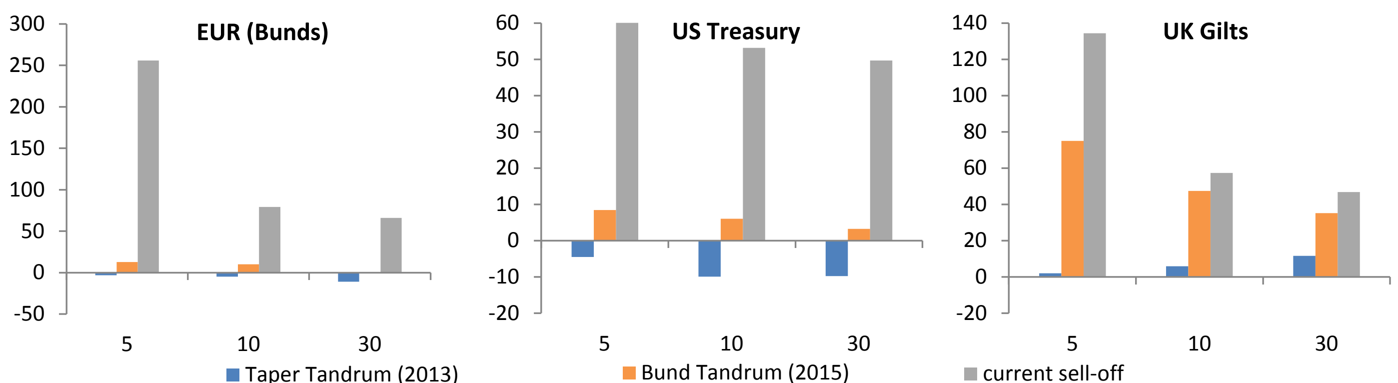
From deflation to reflation… but not inflation yet

Higher nominal bond yields driven through higher inflation expectations out of the US lead to US-EUR spread widening and steeper curves.

2017 is likely to prove a year of transition away from an ultra-low yield environment towards a moderately higher one – driven predominantly by the UST market. The US economy is fairly healthy and wage pressure has been building. Already prior to the US elections, and particularly since, inflation expectations have increased substantially in international bond markets. Promises of less regulation, tax cuts and fiscal stimulus are being interpreted as supportive for the economy while indications of a less open stance on international trade is seen as inflationary.

This is a trend that was already in place before the US elections and is quite distinctly different from the market behaviour over the last 3 years. Exhibit 1 illustrates this in comparison with the 2013 (Taper Tantrum) and 2015 sell-off (Bund Tantrum). While in both previous instances the sell-off was driven by real yields and thus represented a financial tightening, this is not the case this time around. Exhibit 1 depicts the percentage contribution of inflation expectations to the aforementioned and recent sell-offs and shows the difference quite clearly. Already in a special note labelled The Big Picture – Is this time different? published before the US elections, we argued that increases in inflation expectations, if sustained and extended, could mean that global bond yields have seen their lows. Crucially, if through higher inflation expectations, real bond yields are allowed to stay low, we think this would be a 'good reason' for higher nominal bond yields which is likely to support other riskier asset classes, too. This would be true even if the Fed continues to normalise its monetary policy as our US colleagues expect – as long as that process remains gradual. Currently, we expect only two rate increases of 25bp each in 2017 after a 25bp rate increase in December.

Exhibit 1: Contribution of b/e inflation to nominal yield increase in % of total in 2013, 2015 and today



Source: Bloomberg, RBC Capital Markets

It is no coincidence in our opinion, therefore, that the recent increase in bond yields has been accompanied by higher equity markets, too. In a recently published note called '**Seven themes for 2017'** we elaborate in more detail what this environment means specifically for European fixed income markets.

European political risks ahead – Brexit and a host of Continental elections

UK: watch the inflation rate overtake the growth rate.

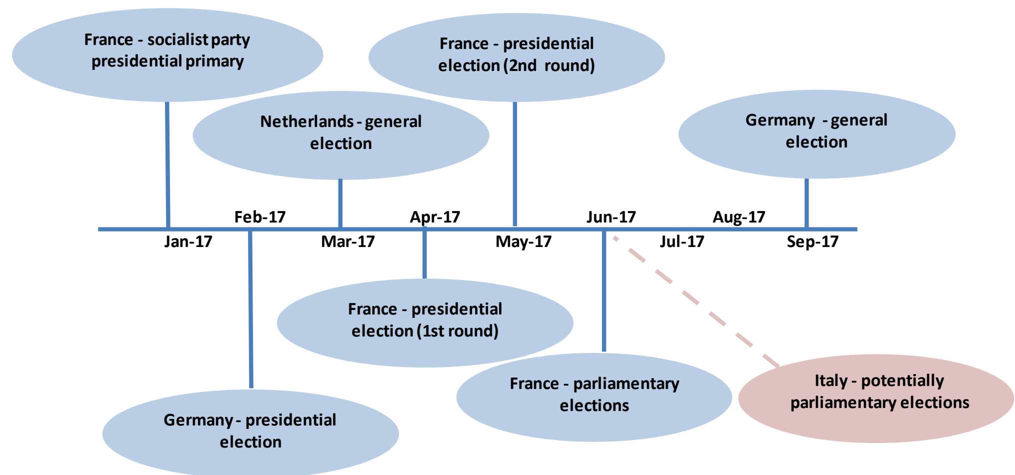
That being said, however, in Europe, 2017 will also be a year determined by big political decisions: the UK is likely to trigger 'Article 50' and formally start the process to leave the EU – which will bring its own challenges. These will come on top of other headwinds we have identified, namely an erosion of disposable income due to rising imported inflation and a reduction in investment due to uncertainty about the UK's trading relationships with the EU. And whilst fiscal spending will be a topic, the already weak budget position will limit the UK chancellor's leeway. We thus expect a slow growing UK economy (approx. 1.1% y/y) despite a rather elevated inflation picture (peaking at approx. 2.6% y/y). This will leave the UK in a somewhat unique position: while in the US, GDP growth is likely to be strong and inflation expectations are rising, the increase in UK inflation is coupled with a low growth headwind in the wake of the planned EU exit.

On Brexit, uncertainty is the only certainty…

The BoE's hard line on inflation could soften in 2017.

This implies that the BoE is likely to face substantial pressure to raise rates, which we ultimately do not expect to pan out. Quite to the contrary: we firmly believe that the BoE will keep rates at present levels. We even think there is a substantial chance that the BoE will revert to another round of QE in the second half of 2017 to counteract the economic slowdown we foresee. This might well also imply another rate reduction.

Exhibit 2: The European electoral calendar



Source: RBC Capital Markets

Political uncertainty - important elections due in the euro area.

And whilst the Brexit uncertainty has to be dealt with, we think an even bigger uncertainty arises from the continental European political situation. Exhibit 2 shows a timeline of crucial political events that will occur between now and December 2017. The coming six months in particular will keep markets anxious. The lost Italian referendum and subsequent resignation of reformist PM Renzi might well have been the foretaste of things to come. Markets are also awaiting the Dutch general elections and the French presidential elections apart from potential early elections in Italy. In all these cases, the fear is that 'protest votes' will carry the day. This is particularly true following the successes of the Brexit and Trump campaigns with many market participants fearing that similar strategies could be employed, and prevail,

in continental Europe too. We expect that markets will have to imply higher probabilities for a flare up of the European crisis again which might calm or accelerate over the course of the year depending on the outcomes of the various political events.

Weak but positive euro area growth and little inflation.

This comes against the backdrop of a rather benign euro area growth environment to begin with. The euro area should continue to exhibit positive growth rates: we see them hovering around current levels in the beginning of the year. Yet, we expect a slowdown in H2. This should be due to a combination of fall-out from the Brexit process, poor investment rates amidst the political uncertainty mentioned above, a reduction in external trade contributions to GDP growth as well as a lack of consumption growth – which remains the standard bearer for growth in the euro area – due to low wage increases. A less supportive borrowing environment, particularly in southern Europe, should also take its toll. And while the still positive growth rates should drive unemployment closer to a level associated with wage growth, the latter is likely to remain elusive in 2017. Inflation should pick up, but core inflation rates in particular are unlikely to rise much above 1% in 2017.

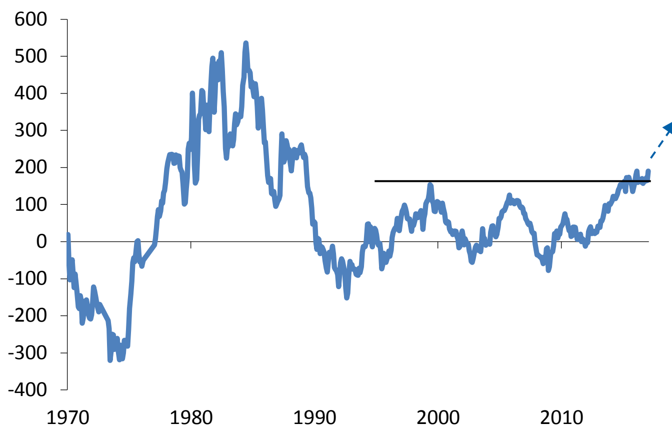
ECB policy in 2017 - an extension after the extension.

The now popular topic of 'fiscal stimulus' is unlikely to make a significant contribution to the euro area's growth rates in 2017. If anything, we can only see a change in fiscal policy after the German elections which are not due until September 2017. This should leave the focus squarely on the ECB to provide more stimulus measures – likely even beyond the new end date that has been set in last week's meeting of December 2017. Hence, we think that the ECB's QE programme is likely to continue not only throughout 2017 but also into 2018. Whether by the second half of 2017 some reduction in purchases (i.e. 'tapering') can even be contemplated remains to be seen.

Summary, strategy implications short vs. medium-term views

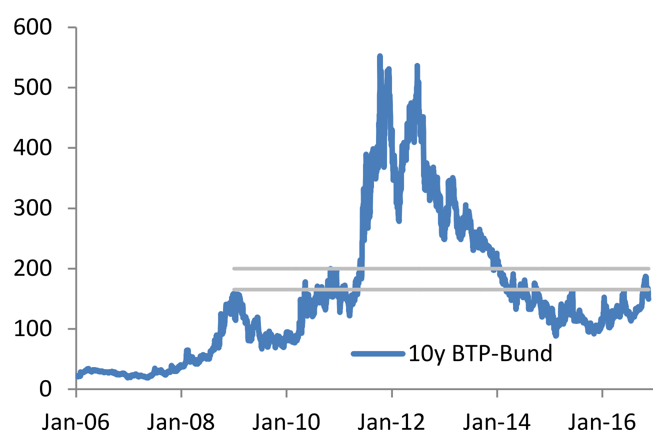
Against this backdrop, it is important to stress that yield increases in European markets, driven by higher inflation expectations as outlined above, will be somewhat different to those in the US. For a start, with the ECB and the BoE anchoring the front end of the curves, we think any yield increase in short end tenors will have to remain limited, leaving bond yield curves little alternative but to steepen as a response to US-led yield increases. And while we do expect some further increases in Bund and Gilt yields in absolute terms, the spreads vis-à-vis the UST market are likely to widen sharply (see Exhibit 3). European equity markets are likely to continue lagging behind their US peers – particularly the Southern European ones.

Exhibit 3: 5y US-Bund could rise to levels last seen in the 80s



Source: Bloomberg, RBC Capital Markets

Exhibit 4: 10y BTP-Bund spread closer to crisis levels again



Source: Bloomberg, RBC Capital Markets

In fact, within the euro area, the picture looks daunting. It can be shown, particularly in the case of Italy, that the combination of higher US yields and political risks have triggered substantially higher spreads already (see Exhibit 4) – which brings memories of the European debt crisis and will have a negative impact on economic performance going forward. For years, we have been positive on spread products in the euro area. With corporate spreads tight and risks mounting, for the first time since the middle of 2012 we do not recommend being overweight corporate and sovereign exposure particularly in Southern Europe – at least until the key risk events are out of the way.

Forecasts

Exhibit A: RBC UK economic forecasts

United Kingdom	2016	2017				2018				2016	2017	2018
RBC forecasts	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	annual averages		
Real GDP, % q/q	**0.3**	**0.3**	**0.1**	**0.1**	**0.1**	**0.4**	**0.4**	**0.5**	**0.5**	…	…	…
Real GDP, % y/y	**1.9**	**1.7**	**1.2**	**0.8**	**0.6**	**0.7**	**1.0**	**1.4**	**1.7**	**2.0**	**1.1**	**1.2**
Private consumption, % q/q	*0.5*	*0.3*	*0.0*	*-0.1*	*0.1*	*0.3*	*0.4*	*0.5*	*0.5*	*2.8*	1.3	1.0
Government consumption, % q/q	*0.0*	*0.2*	*0.6*	*0.5*	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	1.1	1.0	1.0
Gross capital fixed formation, % q/q	*0.1*	*-1.0*	*-1.3*	*-0.8*	*-0.7*	*0.3*	*0.3*	*0.3*	*0.3*	0.8	-2.0	-0.5
Net exports (contribution), ppt	*-0.1*	*0.2*	*0.2*	*0.2*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	-0.4	0.2	0.2
Bank of England, % y/y (Nov-16)	**2.1**	**1.8**	**1.4**	**1.2**	**1.2**	**1.3**	**1.5**	**1.6**	**1.6**	**2.2**	**1.4**	**1.5**
CPI inflation (average, % y/y)												
	1.2	2.1	2.5	2.4	2.4	2.3	2.3	2.2	2.1	0.7	2.4	2.2
Bank of England (Nov-16)	1.3	1.8	2.4	2.6	2.7	2.8	2.8	2.8	2.7	0.7	2.4	2.8
Bank Rate (%, end of period)												
	0.25	0.25	0.25	0.10	0.10	0.10	0.10	0.10	0.10			

Source: Bank of England; RBC Capital Markets' estimates

Exhibit B: Euro area GDP forecasts 2016-2018

Euro area	2016	2017				2018				2016	2017	2018
RBC forecasts	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	annual averages		
Real GDP, % q/q	**0.3**	**0.4**	**0.3**	**0.2**	**0.2**	**0.4**	**0.4**	**0.4**	**0.4**	…	…	…
Real GDP, % y/y	**0.3**	**1.4**	**1.4**	**1.3**	**1.2**	**1.2**	**1.3**	**1.5**	**1.8**	**1.6**	**1.3**	**1.5**
Private consumption, % q/q	*0.3*	*0.4*	*0.3*	*0.3*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*1.6*	1.3	1.6
Government consumption, % q/q	*0.2*	*0.5*	*0.4*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	1.7	1.3	1.2
Gross capital fixed formation, % q/q	*0.6*	*0.7*	*0.6*	*0.6*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	3.2	2.6	2.1
Net exports (contribution), ppt	*0.0*	*0.0*	*0.0*	*-0.1*	*-0.2*	*0.0*	*0.0*	*0.0*	*0.0*	-0.1	-0.2	-0.1
Real GDP, % q/q												
Germany	*0.5*	*0.3*	*0.3*	*0.2*	*0.2*	*0.5*	*0.4*	*0.5*	*0.5*	*1.9*	1.4	1.6
France	*0.2*	*0.4*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	1.2	1.0	1.3
Italy	*0.2*	*0.2*	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	0.8	0.7	0.8
Spain	*0.6*	*0.6*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	3.2	2.3	2.1
HICP inflation (average, % y/y)												
	0.7	1.6	1.5	1.4	1.2	1.3	1.4	1.4	1.4	0.2	1.4	1.4

Source: Haver, RBC Capital Markets estimates

Canadian Rates Strategy: New players, same tune for 2017?

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- There are a host of uncertainties tied to US policy after the recent election results. However, on fiscal policy there seems to be at least some common ground on potential personal and corporate tax cuts between President-elect Trump and Congressional Republicans. We have assumed that some of these will be in place by the second half of 2017 and, alongside, we'll see a somewhat firmer growth and inflation profile in the US. This simply reinforces our earlier assumption of higher longer-term yields and steeper curves in both the US and Canada.
- Canada's economic outlook depends upon three crucial themes: i) prospects for non-energy exports; ii) the impact of past (and possibly future) fiscal actions; and iii) the dynamics of an expected slowdown in housing activity. The first issue depends not only on any fiscal stimulus delivered under the Trump administration, but also on how trade policy evolves and the implications for Canadian competitiveness.
- At this stage, we see nothing to alter our view that the Bank of Canada will be on hold throughout 2017 and that, at least early in the year, markets are more likely to lean towards a rate cut rather than a rate hike. Longer-term yields will be under pressure for domestic considerations – moderate deficits and rising headline inflation – and indirectly from rising Treasury yields. A weak Canadian dollar should provide a partial offset to the tighter financial conditions brought about by rising bond yields.
- The risks around our outlook are greater than normal, with heightened policy uncertainty in the US an obvious wildcard. Our base case assumes no significant increase in trade barriers or a "thickening" of the Canada/US border, though that is an obvious threat. Other considerations include the outlook for commodity prices and energy, though with capital spending more "right-sized" the growth impact may be less than in recent years from any commodity price volatility.

A new (and uncertain) deal in the US

In the wake of the US election and the subsequent re-pricing in bond markets, we have been assessing the implications for Canada's economic and financial outlook in 2017. Canadian term yields have risen in sympathy with the rise in Treasury yields –up some 30bp in the ten-year sector from pre-election levels – though not on a one-for-one basis and in an uneven fashion across the curve. Our US analysts argued in a recent **Weekly Dashboard** that tax cuts (where there is the most common ground between Congressional Republicans and President-elect Trump) could boost 2017 GDP growth by as much as 0.4pp-0.6pp. However, we are unlikely to see any impact before the second half of next year and there is some question about what stronger growth in the US may ultimately mean for Canada.

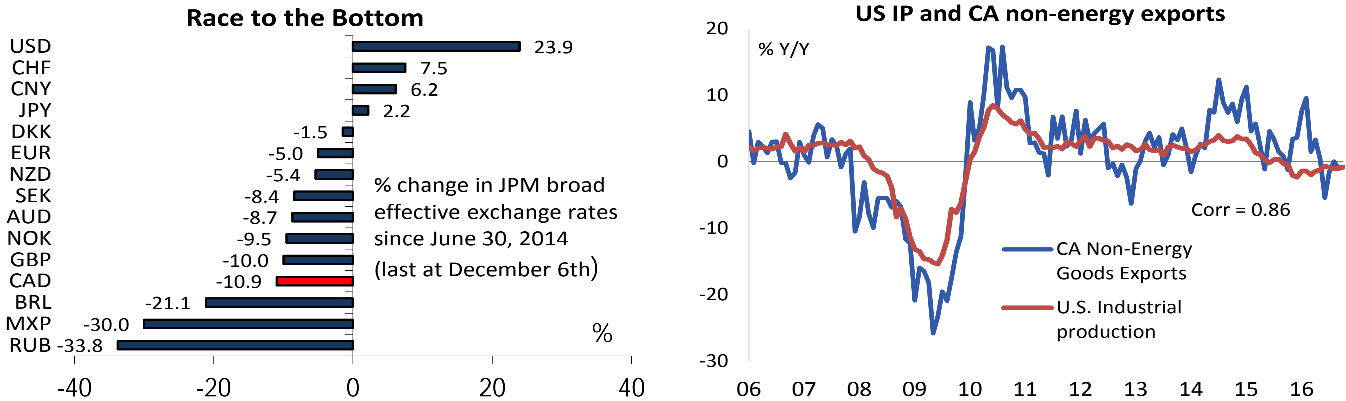
Theme 1: The Trade Conundrum (redux)...

Domestically, Canada's export conundrum has become less of a puzzle of late as more research has gone into the issue, but the results have been no more palatable. Non-energy export trends remain moribund: volumes remain below year ago levels (-0.8% in October) and, while there has been a decent response in what are deemed to be "exchange rate sensitive sectors" after the 11% trade-weighted depreciation since mid-2014, Canada continues to lose competitive ground to a number of important competitors – notably Mexico (see Exhibit 1).

If we look at the sectors broadly classified as "non-exchange rate-sensitive", flows are relatively tightly tied to overall US industrial production (IP) – a relationship we have noted in the past (see Exhibit 1). With industrial production still negative on a year-ago basis, the

composition of the US recovery remains a concern. Our base-case assumption is that Canadian real exports are likely to grow some 2.6% in 2017, with net exports overall having a roughly neutral impact on 2017 GDP growth (see Exhibit 2). For comparison purposes, export growth has averaged some 3.7% since 2010 (net exports overall contribution flat, with trade a drag on growth early in the recovery period, a positive contributor averaging 0.7pp in the most recent four years). In the meantime, heightened policy uncertainty associated with the incoming administration is likely to act as a retardant to investment.

Exhibit 1: Sizeable CAD depreciation outstripped by MXN; CA non-energy goods exports heavily tied to US IP



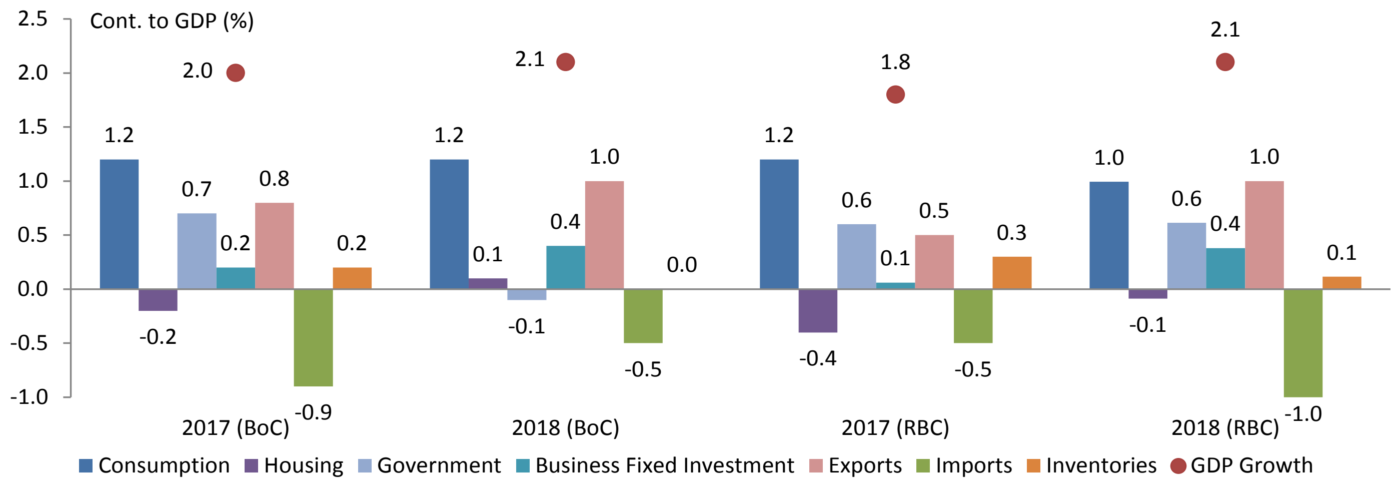
Source: Bloomberg, JP Morgan, Haver Analytics, Statistics Canada, US Bureau of Economic Analysis, Haver Analytics, RBC Capital Markets

… and a more subversive export threat

One of the priorities outlined by President-elect Trump during the election campaign was to renegotiate or abrogate current and prospective trade deals. There has been no clear roadmap post-election on plans to re-negotiate or withdraw from NAFTA, though our understanding is that the president would have the power to withdraw from NAFTA on six-month's notice and that he would have wide discretionary powers to apply customs duties. Even in the absence of increased tariffs, the threat from increased non-tariff measures is real. The economic cost to Canada from any trade actions would be hard to estimate with a lot of accuracy.[1] Canada's multi-factor productivity grew ~0.6% in the early stages of NAFTA, which is indicative of some trade benefits accruing over that period of time though it would be hard to pinpoint the exact contribution from trade liberalization (and similarly, its role in the productivity slowdown over the past decade). It would be reasonable to assume some renewed downward pressure on productivity in the event of a significant increase in tariffs. One can argue that the impact may be more significant in any unwind as Canadian exporters have seen more of their products being used as intermediate goods for US production in recent years (from ~5% in 2000 to over 12% in 2011).

[1] One study by Canada's Export Development Corporation looked at the impact of a 3.5 percent tariff on all Canadian goods and services, "which the government-owned trade finance agency forecast would shrink the economy by C$38.3 billion ($28.5 billion) annually and cost 362,000 "person years," or a 2 percent reduction in total employment." See Bloomberg, "For Canadian Trade Insiders, Trump is All Talk on Killing Nafta", November 10, 2016.

Exhibit 2: Housing set to detract in 2017 and 2018, while the government sector contribution comes in force



Source: Bank of Canada, RBC Economics

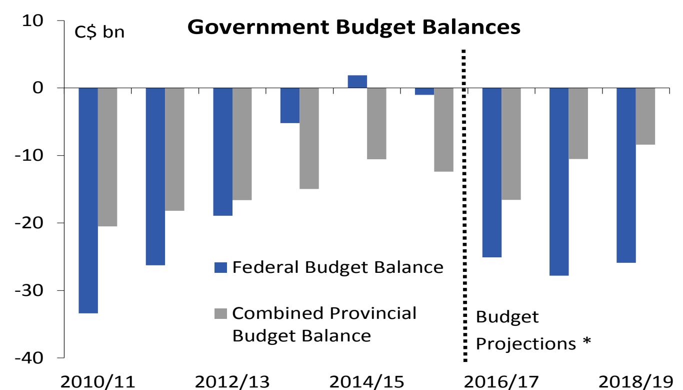
Theme #2: Fiscal Lifelines: Past, Present and Future

With all the focus on President-elect Trump's potential tax and spending plans, it is easy to forget that Canada is ahead in the fiscal stimulus parade, delivering some C$26.5bn (~1.3% of GDP) in new initiatives over a two-year period in Budget 2016, a little less than half of the amount coming in the current fiscal year ending March 2017. Government estimates placed the incremental impact of the new measures at 0.5% of GDP in each of 2016 and 2017, though we argued at the time that the impact would only likely be half as strong (please see RBC Economics' full review of Budget 2016). In the event, there has been only modest evidence of even this more meagre impact felt through 2016Q3. The impact of the Canada Child Benefit (full-year net cost estimated at C$5.4bn) has perhaps begun to show up (services consumption up 3.7% q/q annualized in Q3), while there have been few signs of the ~C$10bn increase in infrastructure spending over the next two years taking hold. Over time, infrastructure spending is expected to have a stronger fiscal multiplier than the Budget's transfers and tax measures (see Exhibit 3), but the impact might not show up with any force until later in 2017. Our forecast assumes the government sector (spending and capital investments) contributes 0.6pp to expected average GDP growth next year of 1.8%.

Exhibit 3: Infrastructure multipliers are among the highest; General government deficits set to fall after current fiscal year

Expenditure and Tax Multipliers

	2016–17	2017–18
Housing investment measures	1	1.5
Infrastructure investment	0.9	1.4
Personal income tax measures	0.2	0.6
Measures for modest- and low-income	0.8	1.3
Other spending measures	0.9	1.4
Corporate income tax measures	0	0.1



Source: Department of Finance Canada, Haver Analytics, Statistics Canada, RBC Capital Markets

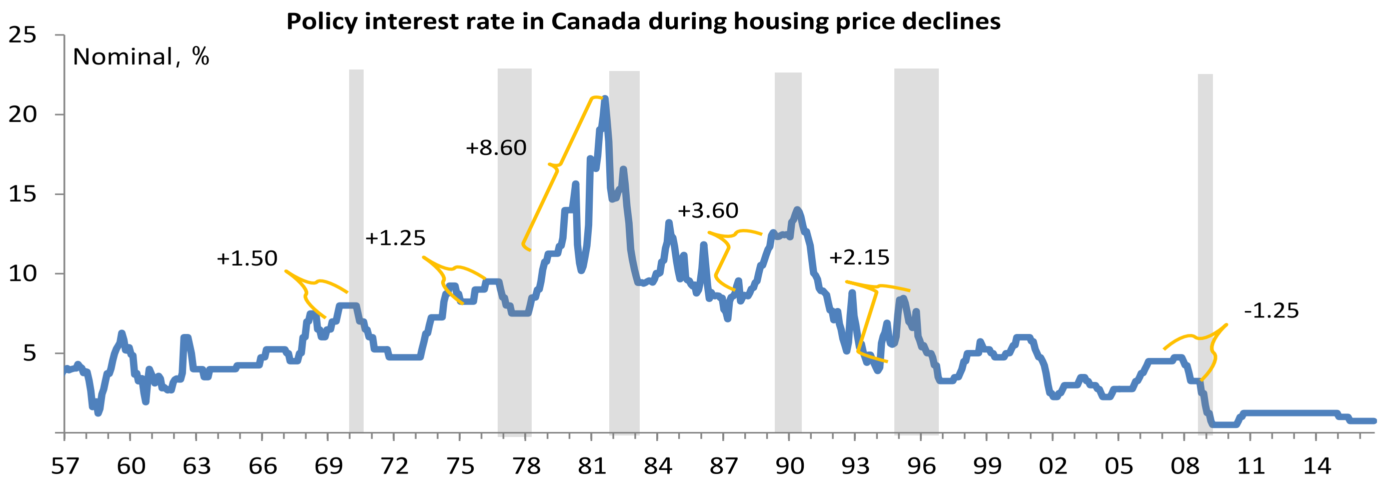
In the past, we have looked at the relationship between changes in the cyclically-adjusted budget balance, against movements in various term yields, (see the Nov. 7, 2016 edition of the **Canadian Relative Value Weekly**) and found only a weak link. Aggregate debt levels, the stance of monetary policy, economic slack and inflation expectations seemed to be more useful guides for the level of yields and the slope of the yield curve. With respect to the federal government's borrowing plans for the 2017/18 fiscal year, we believe gross bond issuance will be similar to the levels planned in the current year (of ~C$133bn) and should remain concentrated in shorter-dated maturities – recall some 60% of issuance comes in the 2-year and 3-year sector.

As a final note on fiscal stimulus, it is worth considering two other factors. First, provincial plans can serve to strengthen or work against efforts at the federal level. Second, if there is evidence of weaker-than-expected growth early in 2017, we would not rule out the possibility that the Liberal government provides a little more in the way of fiscal stimulus (arguably less likely to occur at the provincial level).

Theme #3: The much-anticipated housing slowdown – what might it look like?

One of our central assumptions is that term yields will rise in both Canada and the US in 2017, though we see the Bank of Canada's policy rate, the overnight target, unchanged at 0.50% through 2017. Already, five year GoC yields have jumped more than 25bp over the past month and some mortgage rates have risen alongside. These yields are now approaching their highest levels since the beginning of 2015 (though more than 60bp below the average level through 2013-14). Any impact from such a move on housing is likely to be minimal at this stage, though our profile for rates sees some additional pressure over the next year (5-year GoC yields rising another 75bp to stand at 1.75% in 2017Q4).

Exhibit 4: Policy interest rate rises usually precede housing price declines



Source: Bank of Canada, RBC Economics Research, CREA, Haver Analytics

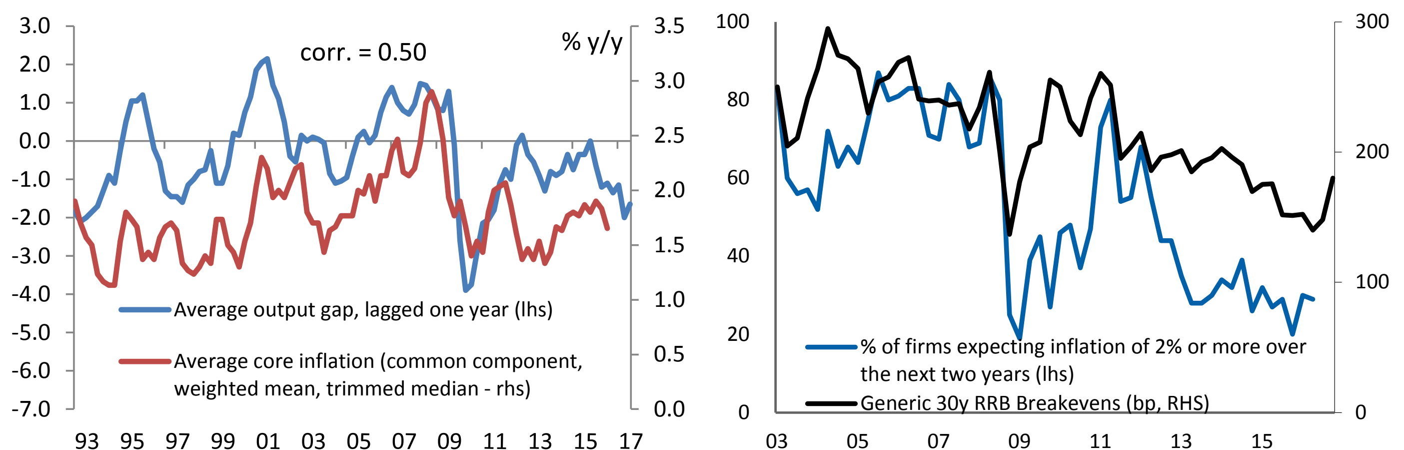
An aggregate move in rates of this magnitude – some 60bp above average 2015 levels – is, on its own, unlikely to generate a sharp correction in house prices. RBC Economics has looked at six episodes of price corrections in Canada – defined as a real price decline of more than 5% – dating back to the mid-1950s. In only one of these cases (the most recent recession) had the policy rate failed to increase in the preceding twelve months by less than 125bp and the median increase has been more than 200bp (see Exhibit 4). In the absence of a rate "trigger", with the BoC expected on hold in 2017, we would likely need to see either a sharp weakening in labour markets, a significant fallout from macro-prudential measures, or some combination of the two to cause a sharp correction in house prices. We do not have either in our base outlook. Arguably, the more serious threat to house prices comes from the

interaction of the various macro-prudential policies enacted in recent months to reduce some of the risks from high household debt. This year alone, new measures include higher downpayment requirements on homes over C$500k to qualify for government mortgage insurance and a more stringent "stress test" applied for insured mortgages.[2] These measures build on other policies adopted in recent years (see our equity analysts' **Canadian Mortgage Industry report** for a full list). The interaction between all these policies remains uncertain. However, in aggregate, the policies should increase funding costs for mortgages and slow mortgage credit growth. Our equity analysts **reduced their outlook for mortgage credit growth** to an estimated 2.3% over the next year, down from an earlier estimated pace of 6.0% prior to the most recent government initiatives, with an assumed reduction in home prices of 5% and a 10% decline in home sales. RBC Economics is currently forecasting a decline of 1% to 2% in resale house prices through the end of next year, which would still leave annual average prices up 1.6% in 2017 (and resale activity down an assumed 11.5% on average). However, in both cases, these projections have wide confidence intervals around them.

Mind the gaps: Summing up what it all means

If we are correct in our assumption of modestly stronger-than-potential growth in 2017 and 2018 – with about a third of the stimulus expected to come from the government sector – core inflation pressures should be relatively mute. Headline inflation is currently running at 1.5% (October 2016), with the BoC's "old" core measure, CPIX8, running at 1.7%. The new core measures adopted by the BoC under their renewed five-year inflation mandate agreement – common component, trimmed mean and weighted median – also averaged 1.7% most recently. These figures are below the 2% inflation target and primarily reflect the impact of still-sizable slack in the Canadian economy, in terms of both output and the labour market. The BoC follows two measures of the output gap, a more mechanical extended multivariate filter used most in the past and a newer structural approach. Augmented by information from the Business Outlook Survey, the Bank deems the current output gap to be ~1.5%. The output gap typically works with about a full year lag to core inflation and this would suggest that core inflation could hold firmly in the bottom half of the Bank's 1% to 3% reference range from this factor alone (see Exhibit 5).

Exhibit 5: Lag between core inflation and output gap suggests sub-2% inflation persisting…inflation expectations have dipped



Source: Statistics Canada, Bank of Canada, Bloomberg, Haver Analytics, RBC Capital Markets

[2] All insured homebuyers must qualify at an interest rate that is the greater of their contract rate or the BoC's conventional 5-year fixed posted rate (currently 4.64%)

In labour markets, there is also evidence of moderate slack. The unemployment rate (6.8%) is still about a full percentage point above the lows seen in the pre-recession period, and expected by RBC Economics to hold around this level through 2017. This suggests that wages, already having eased from 3.0% y/y to 1.5% currently, are unlikely to unseat inflation expectations, which remain low by recent standards (see Exhibit 5).

In the absence of inflation pressures, we see the BoC comfortably on hold throughout 2017 and not beginning the hiking process until 2018Q2. Given the sizable degree of slack still in the Canadian economy, any growth disappointment early in the year still leaves the door open for a potential cut in rates (particularly if Budget 2017 sees no additional fiscal stimulus). In contrast, markets are currently pricing in modest odds of a rate hike – ~15% chance of a 25bp increase by mid-2017. However, as the year goes on and the US economy begins to see some benefit from potential tax cuts late in the year, the feed-through to Canada should become a little more evident. Our base-case forecast assumes no measures adopted in terms of trade restrictions against Canada – a notable downside risk to the forecast.

Further out the curve, Canadian term yields have been dragged higher alongside rising Treasury yields, but remain well below historical or most model "fair value" levels. We see these pressures easing in only a gradual fashion, with 10-year GoC yields rising to close 2017 at 2.30% (and to near 3.00% by the end of 2018).

Canada macroeconomic and rates forecasts

Canada	2017				2018				Annual Averages	
RBC Forecasts	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2017	2018
Real GDP (% q/q annualized)	1.9	1.8	1.6	2.0	2.1	2.5	1.9	1.7	1.8	2.1
Household Consumption (% q/q annualized)	2.2	2.1	2.0	1.7	1.7	1.7	1.6	1.7	2.1	1.7
Government spending (% q/q annualized)	1.8	1.5	1.5	1.5	2.5	2.5	2.5	2.5	1.6	2.1
Government fixed investment (% q/q annualized)	8.5	8.5	7.0	5.0	2.5	3.5	3.5	3.5	6.6	4.3
Business Fixed Investment (% q/q annualized)	0.1	-0.9	-0.1	1.2	2.1	2.7	2.0	2.3	-1.5	1.6
Net Exports (ppt contribution)	-0.7	-0.5	-0.4	0.1	0.0	0.4	0.0	-0.3	0.0	0.0
Headline CPI (% y/y)	2.2	2.4	2.7	2.7	2.4	2.2	2.2	2.2	2.5	2.2
Core (CPIX) CPI (% y/y)	1.9	1.9	2.1	2.3	2.3	2.1	2.2	2.1	2.0	2.2
BoC Overnight rate target (%)	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	-	-
GoC 10y yield (%)	1.70	1.90	2.15	2.30	2.40	2.50	2.70	2.90	-	-

Source: RBC Economics, RBC Capital Markets estimates

CAD Rate Forecasts		2017				2018			
%	Spot	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
2yr	0.72	0.75	0.80	0.85	0.90	1.05	1.15	1.25	1.40
5yr	1.02	1.05	1.30	1.55	1.75	1.85	2.00	2.10	2.25
10yr	1.65	1.70	1.90	2.15	2.30	2.40	2.50	2.70	2.90
30yr	2.28	2.30	2.40	2.60	2.80	2.90	3.05	3.20	3.40
(bps)									
2s5s	30	30	50	70	85	80	85	85	85
5s10s	63	65	60	60	55	55	50	60	65
10s30s	63	60	50	45	50	50	55	50	50
5s30s	126	125	110	105	105	105	105	110	115
10y CA-US	-74	-75	-70	-60	-55	-55	-55	-45	-35

Source: RBC Capital Markets estimates

US Economics: The 2017 US economic narrative was constructive even before Trump

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While the shifting economic narrative has been centered on the potential impact from the GOP sweep (and commensurate fiscal package), we have to be cognizant of the fact that the US economy was already building momentum well ahead of the election. Thus, heading into 2017 we were already poised for an economic backdrop that was likely to see real GDP growth advance ahead of the post-recession average. In round numbers, we were baking in a 2.5% growth profile for the year-ahead even with the auspice of political gridlock. For starters, what the outcome of the election does is take a relatively decent starting point for the economy and really dilute the downside risks. Further down the road, with the potential for significant fiscal policy in-tow, it has potential to really alter the trajectory of growth for a number of years.

The healthy state of US households had been and remains the crux of our broad economic thinking. Not only are households benefiting from an incrementally tighter labor market (which has obvious implications for wage pressures), but from a balance sheet standpoint, households show no sign of any significant imbalance. As a case in point, household liabilities are growing at a y/y rate that is still lower than any prior cycle low (including recessions). This, and the boost in aggregate incomes, has helped continue the de-levering process all the way through what is typically defined as the latter stages of the recovery. The creation and subsequent correction of imbalances has ushered in the demise of most expansions. We seem to be a very long way away from that.

Note too that from an “ammunition” standpoint, households have been relatively big savers in recent years as well. Our work shows that given economic fundamentals, the savings rate, currently at 6%, is 2.5 percentage points above where it theoretically should be. Our sense is this also reflects an increased need for savings which is both a function of demographics and historically low rates on fixed income product. This “excess savings” is a testament to the level of frugality exhibited this cycle by US households, in sharp contrast to other periods—a phenomenon that, on its own, can prolong the economic expansion. Should households now all of a sudden receive a significant cash flow injection, by way of individual tax reform, we could be poised for a non-trivial behavioral shift in savings. Something that on its own could significantly boost real consumption growth.

But anything regarding tax relief policy and its impact on the backdrop is pure conjecture at this point. While we have a very detailed proposal from the House GOP in-hand, we are not yet certain if or how the coming negotiation process will dilute this framework. Still, the sentiment swing on the heels of the election has been palpable and on its own has the potential to boost economic growth above our “gridlock baseline” between now and fiscal policy implementation. In terms of impact next year, from a consumer perspective alone, the tax cuts if implemented in H2 would easily add near 0.5ppts to our baseline in 2017 alone (more on that below).

From the consumer standpoint, sentiment metrics in the wake of the election have been nothing short of impressive. Consider these facts. Conference Board consumer confidence surged to 107.1 from 100.8 prior and handily took out the prior cycle high. The University of Michigan sentiment index was even better. Critically, current conditions, which tells you more about spending trends in the here-and-now, shot up to 112.1, which is not only a fresh cycle high but is now flirting with the peak of the last cycle--and took a monumental housing

bubble to get there back then. Note too that hitting this level on U Mich current conditions for the first time in the cycle (i.e. "from below") is more consistent with the mid-cycle part of the economic expansion, not the tail-end. The fact that this sentiment shift is occurring for a US household sector that has been nothing short of frugal this cycle and thus has the wherewithal to accelerate spending is significant—even before we get any actual movement on tax rates.

Business confidence has also witnessed a sharp move higher in the wake of the election. Not only did the ISM composite rise to the best level in over a year (and again, a level consistent with the mid-cycle stage of the expansion), but the even more critical small business sector just printed the sharpest upswing in sentiment ever. Although the headline numbers are impressive, the NFIB actually conducted a bifurcated small business sentiment survey for the month of November and the post-election results were even better. Broadly speaking, the net share of small firms expecting the economy to improve after the election swung an eye-popping 44 points to +38%—which is the best read since Nov 2004.

This renewed optimism on the economic backdrop also came with a sharp increase in hiring plans. For those that need a reminder, the small business community does a significant chunk of the net new hiring in the US so their stance here matters. And this hiring metric jumped to a new record high of +23%. It takes out the prior record of +22% set back in Dec 1999. This leads the unemployment rate historically. Finally, the share of small firms expecting higher real sales ahead also shot up markedly—this is obviously a key ingredient to firming optimism. This metric rose by 16 points to a fresh cycle high of +20%. It is also now back to the pre-crisis range. Sequential moves of this magnitude (across all the metrics we just covered) is usually something you only witness in the very early stages of the expansion—given the shallow launching point from the recession. That the small business sector might only now begin to participate in earnest in the current recovery is another important element that extends the cycle.

We think the reaction we have seen in markets also represents this dilution of the downside risks and not yet a fundamental reassessment of the economic profile going forward. This is especially true for both rates and equity markets. Despite what on a short-term basis has doubtless been a remarkable move in yields (with 10s taking out 2.5%), the truth is we are now sitting a grand total of ~30 basis points above where 10-year Treasury yields were sitting at this time last year. And while we continue to hear about the Trump rally ad nauseam, there needs to be a distinction between the Trump relief rally and a re-pricing of equity markets based on potentially very expansionary fiscal policy. You'll get no argument from us that the former has indeed occurred. But the reality is that even with the sharp move higher in recent weeks, the S&P 500 is now up a ~3% from the pre-election 2016 high close set back in August. Back then Clinton was widely expected to win and the outcome in the Senate was at best a 50/50 proposition for the GOP. In other words, we were near these levels on Treasury yields and S&P 500 with a base case for potentially four more years of political gridlock in the United States.

So the bottom line is that despite the sharp sentiment shift, we are still a ways away from the markets reflecting a materially firmer GDP profile over the course of the next few years. The question is whether this shift is enough to give the economy a boost between now and actual fiscal policy implementation. Investors have been looking at the potential impact on the US economy from the prospective fiscal package as a wait-and-see phenomenon. In other words, we'll have to wait until concrete policy initiatives have a high probability of being passed before we entertain the notion of marking up economic projections (and pricing this into asset values). The upside risk is that we get a re-pricing of assets based on some follow-through from sentiment to activity—especially on the household side.

Note that if we get something close to the current GOP framework, the economic lift could be very substantial. Critically, both the GOP framework and the incoming Trump administration agree on the broad strokes of individual and corporate tax relief. We think tax policy alone has potential to increase GDP growth by 0.4-0.6% in 2017 and 0.7-0.9% in 2018—or low 3% real GDP growth over the next two years, in round numbers. This assumes we get some tax policy in-hand by the time we kick off the second half of the year—which may or may not be optimistic. So the 2017 tax policy impact is really a call on timing. Regulatory reform and infrastructure spending are the other elements of the plans that could have meaningful growth implications, but the details/common ground on these continues to evolve. We will have more to say on those elements as we get more clarity on proposals. But we will leave you with this for those counting on infrastructure in particular: go in with low expectations as a starting point. Leader of the house (and controller of the government purse strings) Paul Ryan has built his reputation on being a deficit hawk. He will not blindly sign off on a massive infrastructure program without a definitive plan to pay for it. That's the first hurdle. Moreover, the numbers are changing. Trump originally floated a $1t plan but leaders of the GOP are pushing back and a plan about half that size is now being talked about. Built out over 10 years, a number of ~$50b/year is modest in the context of infrastructure spending that is multiples that any given year. In other words, the number being talked about moves the economic needle little in the immediate term.

The interesting thing about the timing of this tax policy is that it is coming at what is presumed to be the mature stage of the expansion. Meaningful declines in effective tax rates typically occur during the recessionary/early stage of the cycle and act as a stabilizer against underperforming GDP growth. We are currently poised for significant tax relief in an environment where GDP growth remains well north of potential. An increase in household disposable income is likely to have an even more meaningful impact when the previous recession is a distant memory and confidence levels are high, and rising.

In terms of the corporate tax reform, we would note that given the tight labor market, it is conceivable that more of the corporate tax reduction makes its way to labor vs. capital. Thus, reinforcing an already strong narrative for US households.

But while this note has largely represented a positive outlook (our base case) from the election outcome, there is an obvious potential negative that is noteworthy. We will preface this by saying that we view this as a low probability event, but should infighting result between the Trump administration and the GOP (similar to the discord we witnessed during the campaign phase) this would significantly diminish the prospects for meaningful fiscal policy and with it the sentiment upswing we have witnessed both in the consumer/business metrics and the markets. Moreover, a willingness to take trade protectionism from mere campaign rhetoric to actual policy increases the risk that we go from an outlook of firming economic prospects with modestly up-trending inflation, to a stagflation forecast.

The constant in both the best and worst case scenarios is firming domestic inflation. We get a pretty standard demand driven inflationary impulse from the former. And with the protectionist scenario we get the potential for some significant upside price pressures in goods, driven by firmer import prices—which have been outright deflating since early 2012. This would come in an environment where the domestic-sensitive areas of the US economy are already witnessing consumer inflation north of 3% y/y (just look at ex energy services CPI as an example). Thus, both the positive and adverse scenarios would probably usher in a much faster Fed tightening profile than what is currently being priced in.

Commodity Strategy: New Year, new beginning for geopolitics, oil and gold

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- **OPEC has come out of hibernation with its recent deal, just in time for the start of 2017. Besides the deal, which we think will hold, there are a number of geopolitical themes in 2017 to watch, namely the continued challenges for our 'fragile five,' developments in Saudi Arabia and Russian cooperation, and a possible snap back of US sanctions on Iran.**
- **Our view has always been that oil's global rebalancing process would be a two-step process, and 2017 should prove pivotal. Going forward, the slope of the price path is key, as a sharp move higher in prices could inadvertently resurrect price-sensitive non-OPEC production. In that context, we maintain our current price view.**
- **Trump was a game changer for gold, making 2017 a very interesting proposition. Since the election, both gold prices and ETF holdings have fallen measurably, something we long cautioned, but given the binary and unpredictable nature of 2017 risks, our current recommendation is to buy gold as a risk-overlay allocation.**

Geopolitics: Whatever it takes

This was the year that OPEC came out of hibernation and reemerged as a major force in the market. The sovereign producer organization provided the initial catalyst for the rally in January by floating the idea of a freeze when prices plunged to $26/bbl and then forcibly firmed the case for $50/bbl when they announced a 1.2 mb/d **production cut**, effective in January 2017. Not content to bear the burden of adjustment alone, OPEC was able to secure an agreement from a collection of non-OPEC countries to curb output by an additional 538 kb/d, the largest such commitment by the non-cartel oil producers. A number of market participants remain skeptical about compliance, given the track record of some OPEC countries freeriding on the cuts made by Saudi Arabia and the other GCC states. However, we do not believe that cheating will be a big factor this time around because there are not a ton of spare barrels floating around to commit the oil equivalent of infidelity. Production in many of the usual cheating suspect countries remains imperiled by serious challenges that show no sign of ending anytime soon (i.e. Libya and Nigeria) or are experiencing output declines due to economic challenges (i.e. Venezuela).

Figure 1: OPEC Watch List – Relative risk scale

	Oil production (mb/d)		Geopolitical risk		
Country	2015 avg	Last month	Past year	This year	Comment
Saudi Arabia	10.24	10.53	6	6	MBS unveils ambitious reforms, but implementation is in question.
Iraq	4.03	4.58	10	9	How long can oil remain immune from rising instability?
Iran	2.81	3.67	3	5	The prospect of renewed hostilities with Washington poses risk.
UAE	2.88	3.13	2	2	Flush with cash and few citizens, UAE sits in the sweet spot.
Kuwait	2.85	2.95	2	3	Financially flush but the population does not want austerity.
Venezuela	2.36	2.08	8	10	With few economic options left, oil production now looks at risk.
Angola	1.80	1.69	5	6	Public criticism mounts as financial troubles deepen.
Nigeria	1.94	1.68	8	10	The militancy in the delta has taken oil offline in the country.
Algeria	1.10	1.16	7	8	Political uncertainty and high security challenges.
Indonesia	0.79	0.73	2	3	Not the biggest oil story but has good economic prospects.
Qatar	0.67	0.62	2	2	Reliant on LNG, Qatar's challenge will emerge later this decade.
Libya	0.39	0.58	10	9	Being the IS fallback option could push it back up on our watch list.
Ecuador	0.54	0.55	6	5	The president remains popular given his strong track record.
Gabon	0.21	0.21	4	6	Low production but rising political risk over the course of the year.
Scale:			*High -> Low*	*High -> Low*	

Note: Geopolitical risk rankings are based on our own in-house RBC Commodity Strategy methodology based on both quantitative and qualitative factors. All rankings are updated as deemed necessary and all numbers are subject to revision. Source: Bloomberg (interim production data), RBC Capital Markets

As we have noted previously, even a recovery to the $50s does not significantly improve the political and security outlook for the most fragile producers, leaving them at continued risk for outages in 2017. Moreover, we believe the continual drumbeat about a wall of impending crude from Libya and Nigeria remains one of the biggest bearish red herrings in the market – simply put, these countries are not Norway.

Saudi Arabia's strong backing of the agreement is another reason we think that OPEC will largely abide by its commitments in 2017. In our view, the sharp shift in the Saudi oil policy this year was driven by its leadership's desire to see their key Vision 2030 priorities realized, most notably the planned IPO of Saudi Aramco. A higher oil price also may help avoid costly credit ratings downgrades as the Kingdom continues to ramp up borrowing. Equally important, higher oil prices could help the country's young defacto ruler, Mohammad bin Salman, shore up public sentiment – something that was trending south due to painful austerity measures. We see oil minister Khaled al-Falih's recent statement that Saudi would consider further cuts as a clear indication of the leadership's determination to do whatever it takes to make this policy work and bring the rebalancing forward. Towards this end, Saudi Arabia seems to have found a powerful ally in Russia. At critical junctures, Russia has acted in concert with OPEC, getting on board with the freeze in January and most recently agreeing to cut production by 300 kb/d. As is the case with MBS, we believe that President Putin's desire for higher prices stems from a desire for additional revenue to fund key social programs and to maintain public support amidst tough economic times. We see this new energy axis as one of the most important developments to watch in 2017 and contend that it may represent the real new oil order.

Finally we advise keeping a close eye on the potential reinstatement of US sanctions on Iran in 2017. With the election of Donald Trump, the sanctions relief dividend is no longer guaranteed and Trump's victory has raised the likelihood of renewed hostilities between Washington and Tehran – troublesome given that US congressional sanctions are extraterritorial. In fact, US congressional sanctions target foreign investment in the energy sector and mandate that consuming countries make reductions in their Iranian imports. These measures could snap back if President Trump refuses to certify Iran as fully compliant with the agreement during the quarterly review process.

Oil: There is a fine line

Our view has always been that oil's global rebalancing process would be a two-step process, and 2017 should prove pivotal. The first step consists of ridding the market of the daily supply imbalance, which we believe has largely occurred. The second step, which was likely kicked off by OPEC's recent action, involves running down the significant global storage surplus to historically normal levels, a feat that will likely remain elusive until late 2017, in our view. As we have previously suggested, the price path forward is extremely critical to the sustainability of the rally. While many market participants will undoubtedly view the recent OPEC deal as just an attempt by cartel members to shore up fiscal balances (among other things), there is much at play. In fact, it is important to remember that OPEC's experiment continues, as the Saudi-led cartel continues to gather data points on non-OPEC production growth at varying price points, particularly from US shale plays. A slow and steady move higher in prices ultimately wins the sustainable recovery, in our view, and we continue to see prices grinding upwards over the coming quarters rather than gapping significantly higher. Global oil balances remain fragile, caught in a push-pull situation where the global rebalancing act repeatedly proves it is indeed a lengthy process, while the elasticity of US shale has proven itself a quicker process. In other words, a sharp move higher in prices could inadvertently resurrect price-sensitive non-OPEC production. As such, we maintain our view that WTI will average $56.40/bbl next year with H1 2017 averaging in the low $50s before inching into the low $60/bbl range by late next year.

Figure 2: Global Oil Supply & Demand Balance and Price Forecasts

Oil balance (mb/d)	Q1 16	Q2 16	Q3 16 E	Q4 16 F	2016 F	Q1 17 F	Q1 17 F	Q3 17 F	Q4 17 F	2017 F
Total Supply	96.6	95.9	96.7	96.9	96.5	95.5	95.8	97.3	97.4	96.5
Total Demand	95.2	95.4	96.6	96.7	96.0	96.3	96.5	97.7	97.8	97.1
Stock Change	1.4	0.5	0.1	0.2	0.5	-0.8	-0.7	-0.5	-0.4	-0.6
Call on OPEC	31.9	32.8	33.2	32.9	32.7	33.3	33.2	33.6	33.3	33.4
WTI ($/bbl)	**34**	**46**	**45**	**51**	**44**	**53**	**54**	**58**	**61**	**56**
Brent ($/bbl)	**35**	**47**	**47**	**53**	**46**	**55**	**56**	**61**	**65**	**59**

Note: Price forecasts (published as averages) draw from RBC Commodity Strategy's in-house fundamental methodology. Annuals in this table are published as averages. All inputs and outputs are subject to revision and other adjustments as deemed necessary. Source: Petro-Logistics SA, IEA, EIA, JODI, company and government sources, RBC Capital Markets

Gold: Game changer

Trump was a game changer for gold, and not in the way that many expected prior to the election, making 2017 a very interesting proposition. Since the election, both gold prices and ETF holdings have fallen measurably, something we **long cautioned** as the one-legged, investor-driven nature of the rally did not look sustainable, in our view. While gold rallied over the course of election night, it has been in a tailspin ever since. It seems that the market has priced in economic bliss (essentially) and a ramp-up in US rates expectations. That said, this election does present a number of unknowns for gold. Over the longer term, how a host of new economic policies play out (ranging from tax policy and regulation to trade) could certainly affect the ultimate path for Fed decision-making and benchmark interest rates in the US and thus gold. What will be key is whether or not economic uncertainty proliferates, or if certainty prevails. In our view, a significant shift in trade policy and what that means for economic growth and certainty will also be key. Additionally, over the next four years, there is potential for meaningful shifts in US security policy and international relations (some of which is already at play), which in turn could affect volatility and risk appetite. We have mentioned a **whole host of potential shifts** as they relate to energy, but larger risk appetite and general market volatility can and likely will be affected on a global basis. Overall, given the binary and unpredictable nature of these risks, our current recommendation is to buy gold as a risk-overlay allocation.

Figure 3: Global Gold Supply & Demand Balance and Price Forecasts

Gold balance (t)	Q1 16	Q2 16	Q3 16 E	Q4 16 F	2016 F	Q1 17 F	Q1 17 F	Q3 17 F	Q4 17 F	2017 F
Total Supply	1173	1147	1181	1209	4711	1046	1078	1141	1175	4440
Total Demand	1190	1001	1137	951	4279	1005	929	938	997	3869
Balance	-16	146	44	258	432	41	149	203	177	571
Price ($/oz)	**1184**	**1259**	**1335**	**1278**	**1264**	**1272**	**1258**	**1221**	**1216**	**1241**

Note: Price forecasts (published as averages) draw from two primary methodologies, 1) a macroeconomic model and 2) physical balance forecasts. Price forecasts are at least partially based on a standard OLS regression which utilizes a number of macroeconomic variables sourced from RBC forecasts, market consensus forecasts, and official forecasts. All inputs and outputs are subject to revision and other adjustments as deemed necessary. Source: Thomson Reuters Eikon, GFMS, WGC, Bloomberg, company and government sources, RBC Capital Markets

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