July 22, 2016

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

# Take small steps

Kelly Bogdanov – San Francisco

**As we look for equity opportunities amid a backdrop of sputtering earnings growth and somewhat unappealing valuations, we're reminded that some big things can come in small packages.**

More than seven years into the rally and with S&P 500 earnings growth stalled, one of the main challenges is that there aren't many pockets of value in the U.S. market.

The S&P 500 trades at above-average price-to-earnings (P/E) ratios: 18.7x trailing earnings and 17.1x forward estimates based on Thomson Reuters I/B/E/S data.

Some of the uber-defensive sectors with attractive dividend yields—Utilities and Consumer Staples—are at lofty P/E levels, and a number of other sectors have above-average multiples. Financials are cheap but they are, as the old saying goes, "cheap for a reason" due to ultralow interest rates.

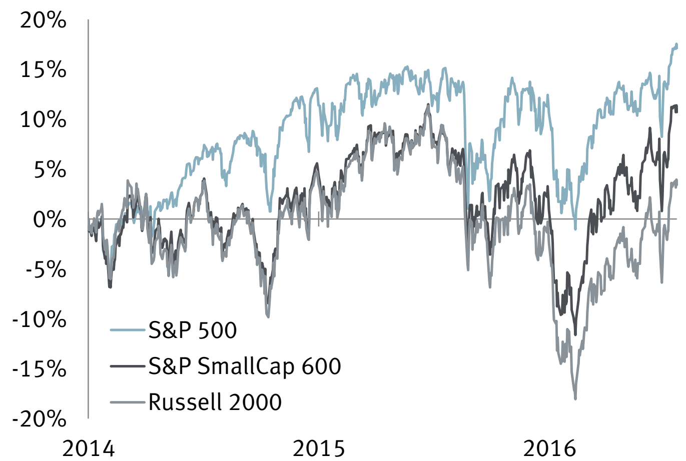
But there is an area of the market that we believe offers relative value and attractive attributes compared to other segments—small-cap stocks.

## Small world

Small-cap momentum has been quietly building. The S&P SmallCap 600 Index came within a whisker of reaching a new all-time high during the week. Small-cap benchmarks have outperformed their large-cap cousins since the February low, and the S&P SmallCap 600 is leading the S&P 500 by 330 basis points (3.3%) year to date.

From our vantage point, the challenging global economic environment is better suited for small caps as their earnings are more domestically oriented. While the U.S. economy is certainly not growing like gangbusters, it is stronger than other major developed economies. Small caps are less vulnerable to slumps in global industrial production and dollar strength, both of which could persist or intensify.

U.S. large- vs. small-cap equity performance




Source - RBC Wealth Management, Bloomberg; data through 7/21/16

## Market pulse



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Priced (in USD) as of 7/22/16 market close, EST (unless otherwise stated).
For important and required non-U.S. analyst disclosures, see Page 6.

As a group, small-cap balance sheets seem sturdy. Cash ratios are higher and net debt ratios are lower than midcaps and large caps. For example, the median cash-to-assets ratio for the Russell 2000 is roughly 13.5%, almost double the S&P 500 (ex-Financials). Net debt-to-capital is about 26% for the Russell 2000 compared to almost 41% for the S&P 500 (ex-Financials).

Growth prospects are also more attractive. For the next 12 months, earnings are projected to climb 11.7% y/y for the S&P SmallCap 600 versus 8.0% for the S&P 500, according to consensus estimates. While revenue growth forecasts are fairly close at 4.8% and 4.3%, respectively, we believe small caps have room to surprise to the upside.

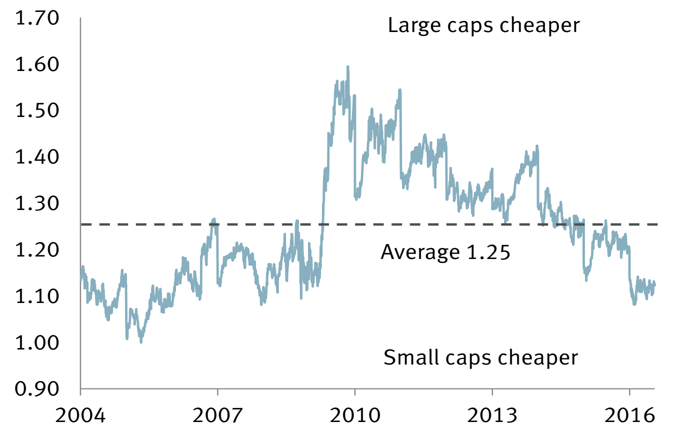
On a relative basis, small caps are trading at the lower end of the long-term P/E range versus large caps, and are just off their lowest level since the economic recovery began in March 2009 (see chart). A majority of small-cap industries are more attractively valued than their large-cap peers with energy, retailing, transportation, software, and biotech as standouts.

Small-cap valuations also score well based on robust proprietary multifactor models that not only include P/E ratios, but also incorporate price-to-book, price-to-sales, and free cash flow yields.

In our view, there is enough fundamental support from stronger earnings prospects and better relative valuations to warrant a position in U.S. small caps for investors with growth-oriented portfolios and above-average risk tolerances. We would use any market weakness to add small-cap exposure.

### Small caps attractively valued vs. large caps

Ratio of S&P SmallCap 600 to S&P 500 price-to-earnings (SML/SPX PEs)




Source - RBC Wealth Management, Bloomberg; 12-mo. forward data through 7/20/16

## What's moving markets

### Carry on

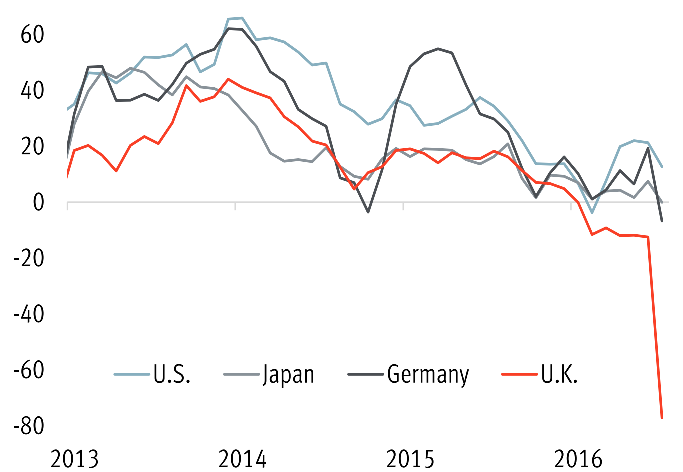
The global equity market has largely pushed Brexit off to the side, as Continental Europe is the only region in negative territory since the vote occurred. But there are still signs of ripple effects elsewhere:

- Sentiment about future economic growth has plunged in the U.K., retreated in Germany, and pulled back slightly in the U.S. and Japan since the Brexit vote (see chart).
- The greenback's advance has yet to stall. The U.S. Dollar Index has risen for four straight weeks by a total of 4.1%—a sizeable, swift move for the world's reserve currency.
- WTI and Brent crude oil have retreated 11.6% and 10.2%, respectively, as the dollar has advanced and because of high U.S. inventories and global growth jitters.
- Sovereign bond yields in most markets remain below where they were when the U.K. decided to leave the EU.

Should investors heed these signals? We think equity markets and the sentiment readings have it right—Brexit is mainly an issue that will generate headwinds for the U.K. and Continental Europe, and other regions should be able to manage around it. But we are keeping an eye on the dollar. If it continues to trade higher, it could negatively impact earnings revisions trends for U.S.-based multinationals.

### Economic attitudes have slipped, especially in the U.K.

ZEW Indexes - Expectations of economic growth




Source - RBC Wealth Management, Bloomberg; data through 7/19/16

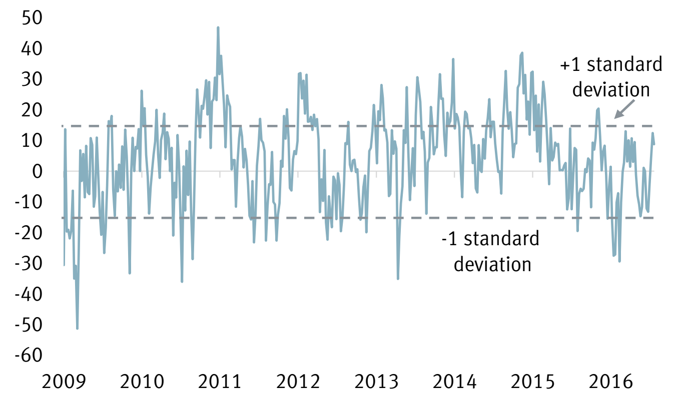
## United States

Kelly Bogdanov – San Francisco

- The S&P 500 managed to creep up 0.6% for the week even though the rally began to lose steam. **It seems like the market needs some time to rest**. The S&P 500 has risen 2.9% since the Brexit vote. Health Care, Utilities, and Technology have led and sector performance has broadened with all but Energy trading higher. More impressive, the market has **surged 18.9% since the February low**.
- **One of the knocks against the rally is that investor sentiment has become quite bullish**. Sentiment is typically a contrary indicator—when it's too bullish the market is vulnerable to a correction, and vice versa when it's too bearish. At this stage, **sentiment concerns seem overstated to us**. True, bullish attitudes have increased while bearish views have decreased lately, which has pushed overall sentiment higher. But even with this shift toward optimism, sentiment remains within the "normal" zone (within +/- one standard deviation of the mean). **There are only about 9% more bulls than bears**, which is not so high as to hinder the market, in our view (see chart). It typically takes a bull-bear spread of 30%+ to make us uncomfortable.
- **Better-than-expected Q2 earnings reports and forward guidance** are among the reasons investors have become more optimistic. With 25% of S&P 500 companies having reported so far, 68% have exceeded consensus earnings expectations and 54% have beaten revenue projections, similar to the averages of the past four quarters. The S&P 500 blended earnings growth rate—a combination of companies that have reported so far and estimates for those that have yet to report—is tracking at -3.0% y/y, according to Thomson Reuters I/B/E/S. **Excluding Energy (-79% y/y), earnings growth bumps up to 1.0%**. The coming week should sort out whether these trends hold as 40% of S&P 500 companies are scheduled to report.
- **Key takeaways so far this earnings season:** (1) There have been no dire warnings from U.S.-based multinationals about Brexit's potential impact, but some companies have signaled that **global growth remains challenging**, including industrial giant Honeywell, which lowered its 2016 forecast; (2) **Big banks** have reported **better-than-feared** results with solid loan and deposit growth and subdued net interest margins amid a very difficult interest rate environment; and (3) Select **Tech companies that are transitioning to new technologies** all the while attempting to grow their legacy "old tech" products and services **are making progress**, such as Microsoft and IBM, but others are still struggling, such as Intel.

**Equity sentiment is within the typical range**

U.S. individual investors bull-bear spread (% of bulls minus % of bears)




Source - RBC Wealth Management, American Association of Individual Investors, Bloomberg; weekly data through 7/21/16

## Canada

Patrick McAllister & Diana Di Luca – Toronto

- **The S&P/TSX Composite extended its recent rally** as non-resource sectors advanced.
- The **Canadian banks** are trading at a **price-to-earnings** valuation roughly **in line with the long-term average** but offer historically **attractive dividend yields**. We believe the group remains more **attractive for income-oriented investors** relative to those with a total return mandate.
- **Canadian Pacific Railway** reported **Q2 results** in line with management's prior guidance. Management expressed **confidence in stronger volumes** later this year. Industry-wide demand conditions have been soft in comparison to 2014's record volumes. **A return to volume growth could result in substantial earnings growth** for rail companies as many have significantly reduced their cost base.
- The **Canadian CPI increased** 1.5% y/y in June, **stronger** than the 1.4% expected by economists. **Inflation** was driven by a **rise in passenger vehicle prices** (+5.6% y/y) and **home prices** (+3.5%).
- **Canadian retail sales rose** 0.2% m/m in May, **beating** economists' estimates for flat sales. Sales were driven by a 2.3% increase in gasoline sales, partially offset by a 2% decline in car sales. Year-to-date retail sales have risen 4.9%, the **best start to the year in six years**.
- The **preferred share market** is up roughly 2.5% over the past two weeks and sits at the **highest level since January**. The market has been moving higher as a **lack of new issue supply and narrow credit spreads** have helped **push secondary market prices higher**. Cross-asset class relative value analysis also appears to be driving demand.

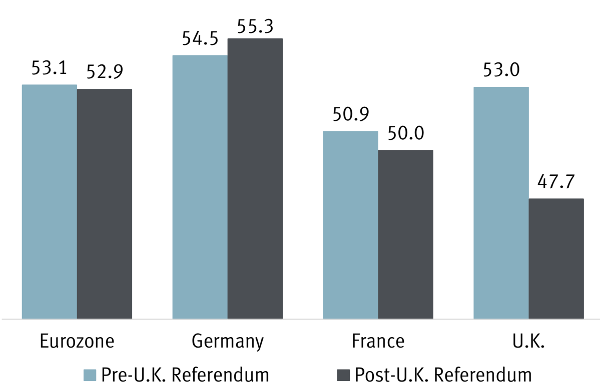
## Europe

Frédérique Carrier & Thomas McGarrity – London

- **European equity markets nudged moderately higher** again for the week. The **Technology** sector was the **significant outperformer** following the announcement that U.K. microchip **designer ARM Holdings** is to be **acquired** for £24.3B by Japanese conglomerate **SoftBank**. The deal represents the largest acquisition of a European-listed technology company ever.
- The **first post-Brexit economic data points were released**, with the Markit flash PMI surveys. The **U.K. Composite** indicator, which includes both manufacturing and services sectors, suffered its **biggest fall on record**, plunging to 47.7 in July from 52.4 in June. All headline PMIs fell conclusively below 50, indicating a contraction in output levels. These readings highlight the immediate negative impact the Brexit vote has had on the **U.K. economy**, which is on track to **significantly slow, or even shrink, in Q3**.
- **Eurozone PMIs exceeded economists' expectations**, with the Composite index easing only slightly to 52.9 from 53.1 in June, indicating that the **U.K.'s vote to leave the EU has had little immediate negative impact** so far. While all the eurozone readings remained comfortably above 50, signalling continued expansion, the **European economic recovery remains fragile**, with any shocks threatening the already sluggish levels of growth.
- The **European Central Bank** (ECB) kept its **stimulus program unchanged**. It emphasised it would **wait until more information** is available to assess the economic fallout inflicted by Brexit before deciding the appropriate policy response. A **substantial announcement** from the ECB is **unlikely before September**, in our view.

Despite U.K. referendum, Continental European PMIs are mostly expansionary

Select Composite PMIs




Source - RBC Wealth Management, Bloomberg; data as of 5/31/16 for Pre-U.K. Referendum PMIs and flash data as of 7/22/16 for Post-U.K. Referendum PMIs

- German software giant **SAP** delivered a **very good set of Q2 results**. The performance was driven by strong software license revenue growth, while its **next-generation business suite** S/4HANA continued to see **positive momentum**, adding more than 500 new customers in the quarter.
- **Vodafone**, Europe's biggest telecom company, reported **robust Q1 results** ahead of consensus expectations. The company saw an **improved performance in Europe**, its biggest market, helped by its "more-for-more" pricing strategy in which customers receive higher data allowances and additional features, together with an increase in monthly tariffs.

## Asia Pacific

Jay Roberts – Hong Kong

- **Asian equities** rallied to a **new high for 2016** during the week, led by Japan. Earlier in the year, a number of major equity markets in Asia, including Hong Kong, Singapore, South Korea, and Japan, were trading at particularly low valuations. Despite the rally, **valuations remain undemanding**.
- The **total value of new homes sold in China** in June **rose by 22% y/y**. However, this marked a slowdown over previous months. The value of property sold was RMB1T ($150B) in the month. The **strong housing market rebound in China**, which has been underway for quite a while, has been helped by various stimulus measures. These have included a series of **interest rate cuts** and **a reduction in down payment requirements** for mortgages from previous high levels.
- The strength in the **housing market in China**, both in terms of the volume of sales as well as prices, has led to some of China's largest cities **reintroducing tightening measures**. Some other cities in China are now following suit. This is beginning to have a **cooling effect on the market**. In June, house prices rose in 55 of 70 major cities, down from 60 in May.
- The **New Zealand dollar fell to a six-week low** after the central bank stated that further **interest rate cuts** may be **needed to boost inflation**. The benchmark lending rate currently stands at 2.25%.
- In a **major corporate deal**, Japan's **SoftBank Group** (9984 JP) will **buy U.K. technology company ARM Holdings** (ARM LN) for £24.3B ($32B), a 43% premium to ARM's closing share price on July 15. ARM's technology is widely used in smartphones and is breaking ground in the emerging "Internet of Things" category.

## MARKET SCORECARD

### Data as of July 22, 2016

| Equities (local currency) | Level | 1 week | MTD | YTD | 12 mos |
|---|---|---|---|---|---|
| S&P 500 | 2,175.03 | 0.6% | 3.6% | 6.4% | 2.9% |
| Dow Industrials (DJIA) | 18,570.85 | 0.3% | 3.6% | 6.6% | 4.0% |
| NASDAQ | 5,100.16 | 1.4% | 5.3% | 1.9% | -1.4% |
| Russell 2000 | 1,212.89 | 0.6% | 5.3% | 6.8% | -3.6% |
| S&P/TSX Comp | 14,600.66 | 0.8% | 3.8% | 12.2% | 2.1% |
| FTSE All-Share | 3,643.80 | 1.0% | 3.7% | 5.8% | 0.1% |
| STOXX Europe 600 | 340.33 | 0.7% | 3.2% | -7.0% | -15.0% |
| German DAX | 10,147.46 | 0.8% | 4.8% | -5.5% | -11.9% |
| Hang Seng | 21,964.27 | 1.4% | 5.6% | 0.2% | -13.1% |
| Shanghai Comp | 3,012.82 | -1.4% | 2.8% | -14.9% | -25.2% |
| Nikkei 225 | 16,627.25 | 0.8% | 6.7% | -12.6% | -17.1% |
| India Sensex | 27,803.24 | -0.1% | 3.0% | 6.5% | -2.5% |
| Singapore Straits Times | 2,945.35 | 0.7% | 3.7% | 2.2% | -12.3% |
| Brazil Ibovespa | 57,002.08 | 2.6% | 10.6% | 31.5% | 12.0% |
| Mexican Bolsa IPC | 47,537.28 | 1.8% | 3.4% | 10.6% | 6.4% |

| Commodities (USD) | Price | 1 week | MTD | YTD | 12 mos |
|---|---|---|---|---|---|
| Gold (spot $/oz) | 1,323.11 | -1.1% | 0.1% | 24.7% | 20.9% |
| Silver (spot $/oz) | 19.63 | -3.0% | 4.9% | 41.6% | 32.5% |
| Copper ($/metric ton) | 4,966.50 | 1.3% | 2.6% | 5.5% | -7.0% |
| Oil (WTI spot/bbl) | 43.49 | -5.4% | -10.0% | 17.4% | -11.0% |
| Oil (Brent spot/bbl) | 45.71 | -4.0% | -8.0% | 22.6% | -18.6% |
| Natural Gas ($/mmBtu) | 2.78 | 0.8% | -5.0% | 18.8% | -4.1% |
| Agriculture Index | 292.93 | -2.7% | -5.6% | 3.3% | -2.3% |

| Govt bonds (bps chg) | Yield | 1 week | MTD | YTD | 12 mos |
|---|---|---|---|---|---|
| U.S. 2-Yr Tsy | 0.703% | 3.5 | 12.1 | -34.5 | -0.4 |
| U.S. 10-Yr Tsy | 1.565% | 1.4 | 9.5 | -70.5 | -75.9 |
| Canada 2-Yr | 0.567% | 0.0 | 4.9 | 8.6 | 13.3 |
| Canada 10-Yr | 1.097% | 1.4 | 3.6 | -29.7 | -44.6 |
| U.K. 2-Yr | 0.131% | -3.5 | 3.2 | -52.0 | -51.7 |
| U.K. 10-Yr | 0.798% | -3.6 | -6.9 | -116.2 | -123.2 |
| Germany 2-Yr | -0.612% | 4.0 | 4.9 | -26.7 | -38.6 |
| Germany 10-Yr | -0.030% | -3.6 | 10.0 | -65.9 | -77.7 |

| Currencies | Rate | 1 week | MTD | YTD | 12 mos |
|---|---|---|---|---|---|
| U.S. Dollar Index | 97.39 | 0.8% | 1.3% | -1.3% | -0.2% |
| CAD/USD | 0.76 | -1.3% | -1.6% | 5.3% | -0.8% |
| USD/CAD | 1.31 | 1.3% | 1.7% | -5.0% | 0.8% |
| EUR/USD | 1.10 | -0.6% | -1.2% | 1.0% | 0.4% |
| GBP/USD | 1.31 | -0.7% | -1.6% | -11.1% | -16.1% |
| AUD/USD | 0.75 | -1.5% | 0.2% | 2.5% | 1.2% |
| USD/CHF | 0.99 | 0.5% | 1.2% | -1.5% | 2.9% |
| USD/JPY | 106.17 | 1.2% | 2.9% | -11.7% | -14.4% |
| EUR/JPY | 116.51 | 0.7% | 1.7% | -10.8% | -14.0% |
| EUR/GBP | 0.84 | 0.2% | 0.4% | 13.7% | 19.7% |
| EUR/CHF | 1.08 | -0.2% | 0.0% | -0.4% | 3.3% |
| USD/SGD | 1.36 | 0.8% | 0.9% | -4.2% | -0.5% |
| USD/CNY | 6.68 | -0.2% | 0.5% | 2.9% | 7.6% |
| USD/BRL | 3.26 | -0.7% | 1.4% | -17.8% | 1.1% |

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX. Bond yields in local currencies. Copper and Agriculture Index data as of Thursday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 8:35 pm GMT 7/22/16.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD 5.3% return means the Canadian dollar rose 5.3% vs. the U.S. dollar year to date. USD/JPY 106.17 means 1 U.S. dollar will buy 106.17 yen. USD/JPY -11.7% return means the U.S. dollar fell 11.7% vs the yen year to date.

## UPCOMING EVENTS

**200 S&P 500 companies are scheduled to report earnings during the week of July 24.**

**Sun, Jul 24**
- Japan Trade Balance
- Japan Exports and Imports

**Mon, Jul 25**
- Germany IFO Expectations

**Tue, Jul 26**
- China Industrial Profits
- U.S. Markit Composite PMI
- U.S. Markit Services PMI
- U.S. Consumer Confidence (95.5)

**Tue, Jul 26 cont.**
- U.S. New-Home Sales (560K)

**Wed, Jul 27**
- U.K. GDP (0.5% q/q, 2.1% y/y)
- U.K. Services Index (0.1% m/m)
- U.S. Durable Goods (-1.1% m/m)
- U.S. Pending-Home Sales (1.1% m/m)
- Fed Meeting

**Thu, Jul 28**
- Japan CPI (-0.4% y/y, 0.5% core)

**Thu, Jul 28 cont.**
- Japan Industrial Prod. (0.5% m/m)
- Eurozone Consumer Confidence
- Germany Unemployment
- Germany CPI
- U.K. Housing Price Index (0.1% m/m)
- U.K. Consumer Confidence (-7)

**Fri, Jul 29**
- BoJ Meeting
- Eurozone Unemployment

**Fri, Jul 29 cont.**
- Eurozone CPI and GDP
- U.S. Q2 GDP (2.6% q/q ann.)
- U.S. GDP Revisions
- U.S. Personal Consump. (4.1% q/q)
- U.S. Core PCE
- U.S. Univ. of Mich. Sentiment (90.2)
- Canada May GDP (-0.5% m/m)

**Thu, Aug 4**
- BoE Meeting

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

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Distribution of Ratings - RBC Capital Markets, LLC Equity Research
As of June 30, 2016

| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| Buy [Top Pick & Outperform] | 878 | 50.51 | 246 | 28.02 |
| Hold [Sector Perform] | 741 | 42.64 | 129 | 17.41 |
| Sell [Underperform] | 119 | 6.85 | 10 | 8.40 |

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