September 20, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

U.S. & China dig in for protracted trade battle

Jay Roberts, CFA – Hong Kong

With the trade row ramping up as fresh tariffs are set to kick in, both sides look like they're hunkering down for the long haul. We think the dispute goes far beyond trade, and we look at what the latest salvo could mean for both sides.

The U.S. imposed a third set of tariffs on China, imposing a 10% tax on $200B of imports from China, commencing on September 24. This will rise to a 25% tax from January 1 unless the two sides can come to an agreement. Combined with the earlier tariffs on $50B of goods, the U.S. has imposed tariffs on approximately half of all imports from China.

China responded immediately with a 5% to 10% tax on $60B of imports from the U.S., also commencing September 24. Combined with the earlier tariffs, also on $50B of goods, China has imposed tariffs on approximately 85% of imports from the U.S.

The Hong Kong and China equity markets greeted the latest salvo in the trade dispute with a surprising rally. Perhaps this was because the tariff level was not as high as some feared. Additionally, such bounces in stocks are also quite normal in the course of bear markets. In our view, the Hang Seng Index, whose market capitalization is made up mostly of mainland China companies, will remain under pressure for the foreseeable future, although much of the weakness in stock prices may already be in the bag. We continue to prefer higher-yielding, defensive stocks.

Will China stage an intervention?

One way for China to offset the punitive effect of tariffs, which make its products more expensive to U.S. buyers, would be to engineer a weaker currency. It is debatable that China would do so. True, after the initial set of tariffs was announced in May, the renminbi dropped from around USDCNY6.4 to 6.85 in just a couple of months as investors digested the fact that tariffs were real and moved into a "risk-off" mode.

After a notable selloff, China's renminbi has leveled off

USDCNY exchange rate

Note: With the USDCNY currency pair, a rising trend indicates a rising dollar and falling Chinese renminbi. A falling trend indicates a falling dollar and rising renminbi.
Source - RBC Wealth Management, Bloomberg; data through 9/20/18

Market pulse

3 Major realignment of U.S. equity sector designations
4 Will milk sour the NAFTA negotiations?
4 U.K.-EU divorce: Deal or disorder?

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Priced (in USD) as of 9/20/18 market close, EST (unless otherwise stated).
For important disclosures and required non-U.S. analyst disclosures, see page 6.

Wealth Management

However, the currency has remained steady since then. Speaking at the World Economic Forum in Tianjin, a major Chinese city, Premier Li Keqiang stated, "Persistent depreciation of the RMB will only do more harm than good to our country." We agree. A depreciating currency might once again lead to capital outflows, arguably a bigger threat to China than the trade dispute. He also noted that China is facing a range of challenges leading to "greater difficulties in keeping stable performance of the Chinese economy."

Trade dispute, tech dispute, or more?

Going forward, there is little chance of a favourable outcome to the trade dispute any time soon, in our view. We continue to believe that the U.S. is punishing China for engineering technology transfer, which the U.S. perceives as unfair, via a range of means from forcing companies into joint ventures all the way to state-sponsored cyber theft (see *In the trenches of the trade dispute*).

Nor are these concerns and allegations new, having also been discussed during the Obama administration. Indeed, the current approach to China is bipartisan, meaning that what transpires during the U.S. midterm elections may have little impact on policy thereafter. There is even a line of thinking that the U.S.'s new, hard line on China is to attempt to restrict the country from becoming a superpower and protect U.S. hegemony.

In any event, the changes to China's laws, regulations, and behaviours that the U.S. is demanding mean that the gap between the two sides at the negotiating table—when indeed they are actually at the table at all—is particularly hard to bridge. China has been sending successively lower-ranked officials to negotiate with the U.S. Vice Premier Liu He attended the talks in June. The forthcoming talks will be attended by Vice Commerce Minister Wang Shouwen. Prospects dwindle, in our view.

Feeling the bite

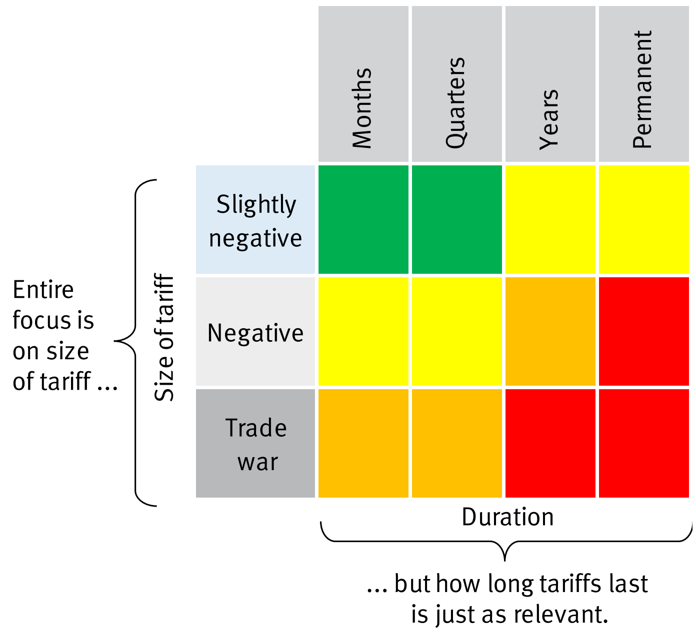
Market impact has been fairly rapid and deep in the Chinese and Hong Kong equity markets. As the dispute expands in size to cover hundreds of billions of dollars of goods, potentially impacting global supply chains, the question becomes what impact this may have on overall economic growth.

For the U.S., this is likely still limited as it exports four times less to China than it imports—although one wonders if the U.S. equity market may finally hiccup.

For China, the impact is larger but, we would argue, manageable at present. However, should the U.S. end up taxing all $500B of its imports from China, the impact could knock over 0.5% off of China's GDP growth, a material amount. Fang Xinghai, vice chairman of the China Securities Regulatory Commission, estimated that taxing all of China's U.S. exports might remove 0.7% from China's GDP growth. In his view, this is not significant, a point that we would disagree with.

A second dimension to tariff math: Duration

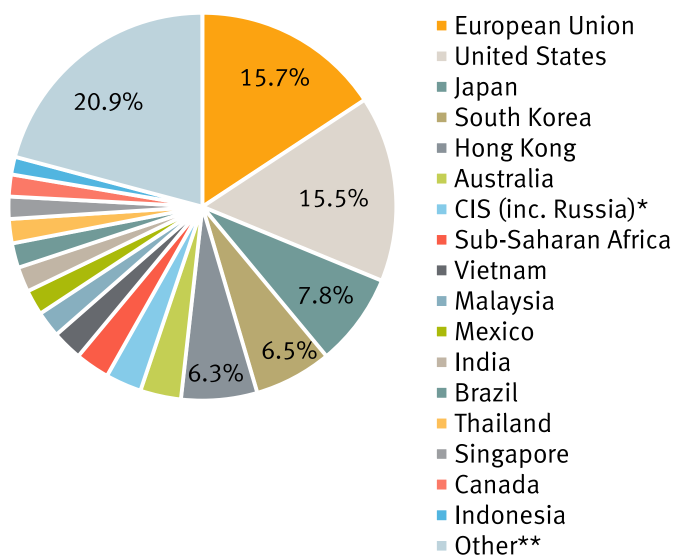
Heat map of cumulative tariff pain – green is modest impact; red is meaningful impact



Source - RBC Global Asset Management

Trade with the U.S. important to China, but it's not everything

Mainland China's largest trading partners as a % of China's total trade (includes exports and imports by country/region)



* Commonwealth of Independent States; ** The sum of many countries with relatively small levels of trade with China
Source - RBC Wealth Management, Bloomberg Intelligence, International Monetary Fund; 2017 data

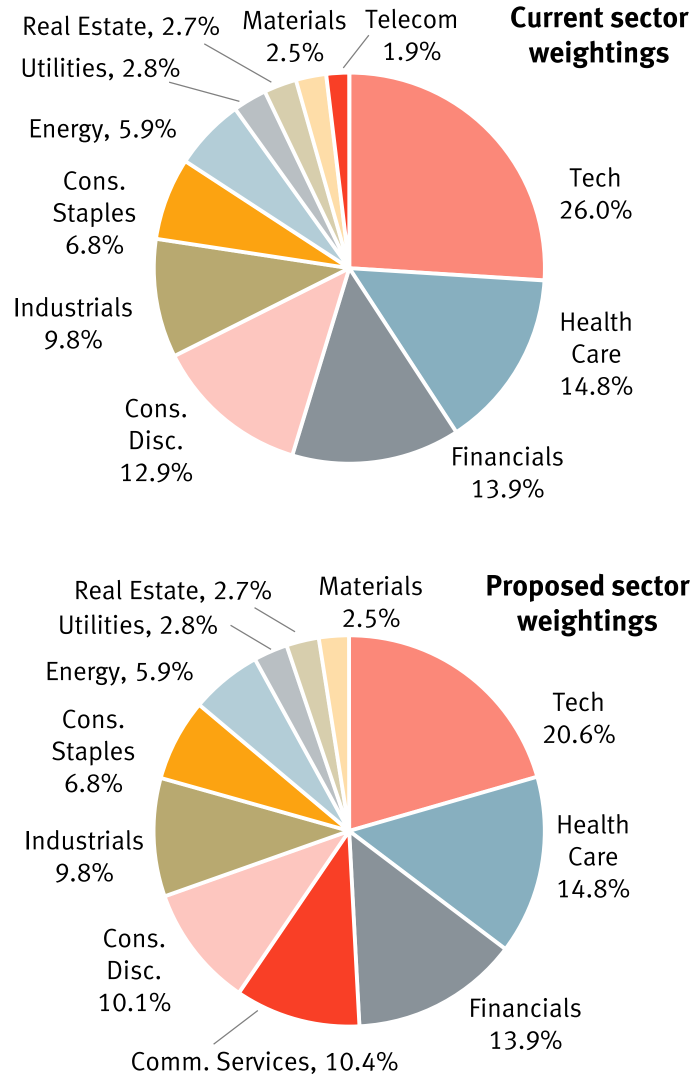
United States

Ben Graham, CFA – Minneapolis

- **The announcements of another round of tariffs** from both the U.S. on $200B in Chinese goods and from China on $60B in U.S. goods **were not the shock to U.S. equity markets that many feared**. We view this new round as having largely been priced into U.S. markets in advance, and the Trump administration's 10% tariff was much lower than the 25% rate it initially signaled. The S&P 500 held steady throughout the week, even eking out a small gain through Thursday, while the megacap internationally focused Dow Jones Industrial Average gained nearly 1%.
- Not all U.S. indexes were so fortunate. The Russell 2000 has declined nearly 1% in recent days while the NASDAQ has traded flat to slightly lower. NASDAQ weakness was largely caused by underperformance in the Information Technology sector, with pressure mainly coming from the Hardware, Internet, and Semiconductor groups, which have declined almost 2% so far in September. Furthermore, **the week's trading underscores the potential style shifts taking place within the U.S. market**. Starting in September, value stocks have begun to show signs of strength versus growth stocks, and the previously strong small-cap Russell 2000 has lagged large-cap indexes. While it's too soon to declare that these trends are now locked in place, in our view, they are worth monitoring. We believe value will ultimately capture the leadership role at some point in coming months.
- The gold standard in U.S. equity market sector designations, the **Global Industry Classification Standard (GICS)**, will implement its much anticipated **sector classification changes** on September 28. Affected sectors are Consumer Discretionary, Information Technology, and Telecommunications. **The entirety of the Telecom sector and select pieces of Tech and Discretionary will be folded into a newly created sector, labeled Communication Services**. Media, digital streaming, internet services, and home entertainment software are the verticals from Discretionary and Tech that will shift into this new sector. The Communication Services sector's largest constituents, in alphabetical order, will be Activision Blizzard, Google parent Alphabet, AT&T, Comcast, Disney, Electronic Arts, Facebook, Netflix, TripAdvisor, and Verizon. This new sector will constitute about 10% of the S&P 500 and will replace the Telecom sector to maintain 11 total sectors. This is the first time GICS has adjusted sectors since 2016 when the Real Estate sector was separated from Financials (see chart for a comparison of old and new sectors).

New Communication Services sector triggers changes to Tech, Discretionary and Telecom

S&P 500 sector weightings



Note: Proposed weighting changes affect the Tech, Telecom, and Consumer Discretionary sectors (red and pink shading).
Source - RBC Wealth Management, Bloomberg, Global Industry Classification Standards (GICS)

- Ahead of the next Fed meeting on September 26, **Treasury yields are rising and the yield curve is steepening**. After the 2-year to 10-year Treasury yield spread hit a post-Great Recession low of 18 basis points (bps) in August, it has since expanded to 26 bps with the increase driven by the rise in the 10-year beyond the 3% threshold in recent sessions. Reverberations in U.S. equity markets could be felt in the stocks commonly known as bond proxies. This rise and the steepening in the yield curve transpired in tandem with a nearly 2% correction in REITs and losses approaching 1% in Utilities. **In our view, Consumer Staples and Utilities appear to be attractively positioned bond proxies at this time.**

Canada

Carolyn Schroeder – Toronto

- **The Canadian dairy industry**—a tiny fraction of Canada's economy, generating perhaps one-third of one percent of GDP—is seemingly a **central sticking point for a new NAFTA deal between the U.S. and Canada**. According to the World Trade Organization (WTO), approximately 99.4% of U.S. imports of Canadian agricultural products are tariff-free relative to 97.5% of Canadian imports of U.S. agricultural products. In other words, there are limited trade barriers surrounding agricultural goods. The WTO notes that the difference, in large part, is supply management. Thus, the Canadian dairy industry is a logical target for tariff reduction, according to RBC Global Asset Management.
- Is it important to note, this is not the first time that the dairy industry has preoccupied trade negotiators: Canada also defended the sector at the expense of other concessions when the country penned recent European and Pacific trade deals. Negotiations continue ahead of the October 1 deadline with **Canada seemingly poised to make some concessions**. In RBC Global Asset Management's view, conceding Class 7 milk and granting incremental access to the Canadian market is consistent with the approach of the Comprehensive Economic and Trade Agreement and the Trans-Pacific Partnership. U.S. President Donald Trump has previously indicated to Congress that he intends to move forward with a new trade agreement with or without Canada. At this stage, it remains difficult to assess whether Congress will entertain the potential of a bilateral deal with Canada.
- **RBC Capital Markets' Global Metals & Mining Q4 2018 outlook is adopting a more cautious stance as China's economic growth becomes more uncertain**. RBC Capital Markets has lowered its 2018 price forecasts for copper, silver, and gold given China's escalating trade dispute with the U.S. Furthermore, **metals have struggled to gain traction due to the strong U.S. dollar** and the consensus expectation for the Federal Reserve to continue hiking rates. The global economy remains relatively healthy and RBC Capital Markets believes these macro concerns likely have been discounted into metals prices; however, it thinks a cautious approach is warranted.

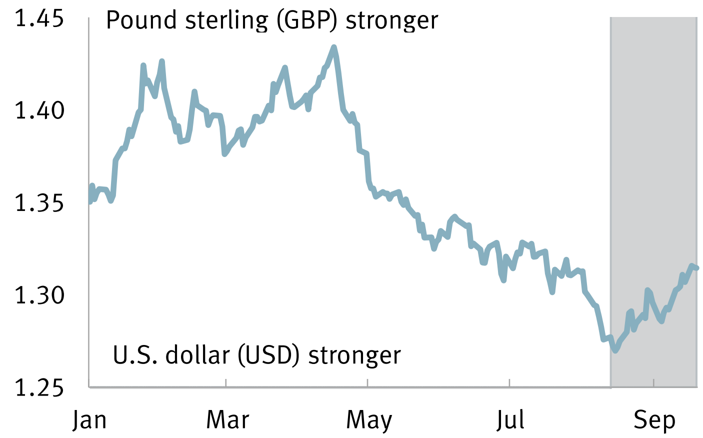
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- Michael Gove, a Brexiteer in the U.K. Cabinet, recently **suggested a future U.K. government would be able to alter any agreement outlining the future relationship between the U.K. and the EU**, its main trade partner. This put EU negotiators on alert, and they continued to put pressure on the U.K. to define its position at an informal EU summit in Salzburg, reiterating October would be the "moment of truth."
- EU negotiators perceive a major obstacle to a desirable smooth Brexit remains the wide divide within British political factions and understand the challenge Prime Minister Theresa May faces at the upcoming Conservative Party Conference at the end of the month. **EU officials seem willing to soften their stance somewhat on the issue of avoiding a hard border between Northern Ireland and Ireland**—the sticking point to finalizing the Withdrawal Agreement. For example, they seem to be considering that certain checks on goods en route for Ireland could be carried out by the U.K., rather than EU officials.
- **A disorderly Brexit would not only have negative consequences for the U.K. economy but also for the EU**, and this at a time when the region will undergo several political tests. In 2019, the EU will face elections to the European Parliament, an event which is increasingly becoming a debate between pro-EU and euroskeptic groups. Moreover, leaders at several EU institutions will be replaced, including the EU Commission, the European Central Bank, and the European Council.
- While being conciliatory ahead of the Conservative Party Conference, EU negotiators will also probably **look for assurances that whatever is agreed upon does not risk becoming vulnerable to a change in the U.K. government**. The more positive headlines concerning Brexit contributed to lifting the pound almost 4% vs. the U.S. dollar since August. We would expect negotiations to become more heated later this autumn and for sterling weakness to resume.

British pound rallies on easing Brexit headlines

U.S. dollar (USD) exchange rate to pound sterling (GBP)



Note: Shaded area represents when headlines began to ease
Source - RBC Wealth Management, Bloomberg; data through 9/19/18

MARKET SCORECARD

Data as of September 20, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,930.75	1.0%	9.6%	16.8%	37.0%
Dow Industrials (DJIA)	26,656.98	2.7%	7.8%	18.9%	47.0%
NASDAQ	8,028.23	-1.0%	16.3%	24.4%	53.2%
Russell 2000	1,720.18	-1.2%	12.0%	19.0%	40.0%
S&P/TSX Comp	16,214.75	-0.3%	0.0%	5.4%	11.7%
FTSE All-Share	4,072.14	-0.8%	-3.5%	2.0%	9.3%
STOXX Europe 600	382.63	0.1%	-1.7%	0.2%	12.2%
EURO STOXX 50	3,403.12	0.3%	-2.9%	-3.5%	14.8%
Hang Seng	27,477.67	-1.5%	-8.2%	-2.3%	16.8%
Shanghai Comp	2,729.24	0.1%	-17.5%	-18.9%	-9.7%
Nikkei 225	23,674.93	3.5%	4.0%	16.6%	43.6%
India Sensex	37,121.22	-3.9%	9.0%	14.6%	30.1%
Singapore Straits Times	3,180.43	-1.0%	-6.5%	-1.2%	11.4%
Brazil Ibovespa	78,116.01	1.9%	2.2%	2.8%	35.3%
Mexican Bolsa IPC	49,510.78	-0.1%	0.3%	-1.7%	6.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,207.44	0.5%	-7.3%	-7.2%	-8.2%
Silver (spot $/oz)	14.32	-1.5%	-15.5%	-17.4%	-25.6%
Copper ($/metric ton)	6,096.50	2.2%	-15.4%	-5.9%	27.8%
Oil (WTI spot/bbl)	70.80	1.4%	17.2%	40.4%	63.0%
Oil (Brent spot/bbl)	78.58	1.5%	17.5%	39.6%	71.3%
Natural Gas ($/mmBtu)	2.96	1.5%	0.2%	-4.4%	-2.9%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	3.063%	20.2	65.7	79.5	137.3
Canada 10-Yr	2.428%	20.0	38.3	32.4	126.4
U.K. 10-Yr	1.585%	15.8	39.5	24.3	77.9
Germany 10-Yr	0.471%	14.5	4.4	2.8	48.9
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.49%	-1.0%	-1.9%	-1.6%	-1.0%
U.S. Invest Grade Corp	4.10%	-0.9%	-2.8%	-1.5%	1.3%
U.S. High Yield Corp	6.24%	0.4%	2.4%	3.2%	13.2%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	93.8910	-1.3%	1.9%	1.5%	-2.2%
CAD/USD	0.7748	1.1%	-2.6%	-4.5%	2.2%
USD/CAD	1.2909	-1.0%	2.7%	4.8%	-2.1%
EUR/USD	1.1777	1.5%	-1.9%	-1.0%	5.6%
GBP/USD	1.3269	2.4%	-1.8%	-1.7%	2.2%
AUD/USD	0.7291	1.4%	-6.6%	-9.2%	-3.5%
USD/JPY	112.4700	1.3%	-0.2%	0.2%	10.6%
EUR/JPY	132.4600	2.8%	-2.1%	-0.7%	16.8%
EUR/GBP	0.8876	-0.9%	-0.1%	0.7%	3.4%
EUR/CHF	1.1296	0.5%	-3.5%	-2.1%	3.5%
USD/SGD	1.3646	-0.5%	2.1%	1.2%	0.2%
USD/CNY	6.8467	0.2%	5.2%	4.1%	2.6%
USD/MXN	18.8151	-1.4%	-4.3%	5.9%	-5.0%
USD/BRL	4.0742	0.5%	23.1%	30.0%	25.0%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday'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 9/20/18.

Examples of how to interpret currency data: CAD/USD 0.77 means 1 Canadian dollar will buy 0.77 U.S. dollar. CAD/USD -2.6% return means the Canadian dollar fell 2.6% vs. the U.S. dollar year to date. USD/JPY 112.47 means 1 U.S. dollar will buy 112.47 yen. USD/JPY -0.2% return means the U.S. dollar fell 0.2% vs. the yen year to date.

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Sell [Underperform]	74	4.65	6	8.11

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