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RBC WEALTH MANAGEMENT

Global Insight

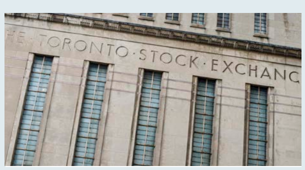
Perspectives from the Global Portfolio Advisory Committee

We're in the "correction" camp

While the market's deep drop put investors on edge, we see the correction giving way to a renewed advance in share prices.

Jim Allworth | Page 4

Focus article
Oil check: Key questions facing the oil market in 2019



Focus article
Oh Canada: Value emerging from an unloved market

Regional equity
Regional equity analysts' views of markets

Global fixed income
Ball of confusion

For important and required non-U.S. analyst disclosures, see page 26.

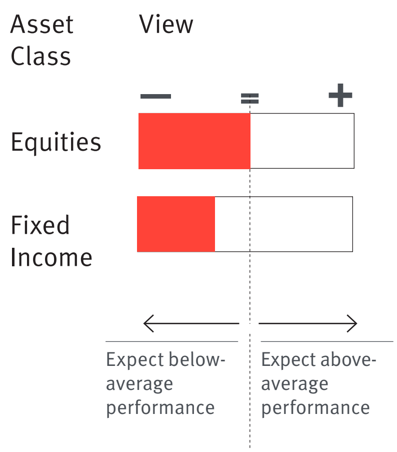
RBC Wealth Management

Table of contents

All values in U.S. dollars and priced as of market close, December 31, 2018, unless otherwise stated.

RBC's investment stance

Global asset views



See "Views explanation" below for details

Source - RBC Wealth Management

Equities

- Equity markets are weighing whether a recession is coming or whether the current weakening in certain economic indicators is nothing more than a "soft patch." While the business cycle is decidedly advanced, the U.S. economic growth rate is likely to settle closer to its five-year average after a stellar 2018. Leading indicators suggest the economic expansion is in its later stages. The risk, in our view, is market turmoil and policy risks on both sides of the Atlantic cause confidence to falter and consumers and businesses to rein in spending, but that is not our base case.
- For now, with equities having had their worst December since 1931, we believe the recent correction may be overdone. We maintain our Market Weight positions in equities.

Fixed income

- The interest rate environment has changed dramatically in recent weeks as uncertainty/confusion on a number of fronts—trade, central bank policy, economic growth, and politics—has led to increased volatility in financial markets. And with these issues likely to remain in play for the foreseeable future, continued volatility could be the "new normal." Sovereign yields should see diminished upward pressure and yield curves could experience continued flattening. As recession indicators, yield curves are nearing "cautionary" levels, in our view.
- Selling pressure and the attendant spread widening in the credit space hasn't deterred us from viewing this as our favorite sector, but it has hardened our recommended focus on quality. Our current fixed income Underweight suggests that remaining selective and shortening portfolio duration are prudent strategies.

Views explanation

(+/=/–) represents the Global Portfolio Advisory Committee's (GPAC) view over a 12-month investment time horizon.

+ Overweight implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

= Market Weight implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

– Underweight implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

We're in the "correction" camp

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While the market's deep drop put investors on edge, we see the correction giving way to a renewed advance in share prices. Several metrics argue this cycle has some life in it yet. We offer some thoughts on how to prepare portfolios for the challenges likely to come with an aging, slowing economic expansion.

Equity markets gave investors a rough ride from a late September peak all the way to a Christmas Eve capitulation. There has been something of a revival since then, but opinions are divided as to whether this will prove to be anything more than a brief respite from a downturn/bear market that will reassert itself within a few weeks or months. We are in the camp that holds this has been a correction that will give way to a renewed advance in share prices.

At the very least, the decline has dramatically improved the "internals" of the market. Gone is the complacency that prevailed throughout the summer when a wide majority of investors and forecasters saw no end in sight for the bullish advance in share prices. That persistent optimism gave way to confusion, worry, and several days/weeks of outright fear. By some measures "bears" came to outnumber "bulls" for the first time in years.

Valuations—price-to-earnings (P/E) ratios—also took a big hit but, in the process, became much more attractive. At the September peak the S&P 500 was flirting with a rich 19x earnings. By the December low it was trading at 14.5x. Historically for the S&P 14x–16x trailing earnings has been something of a sweet spot—the market has risen a high percentage of the time in the following 12 months, typically delivering double-digit returns in the process. P/Es fell to even lower, more compelling levels in Canada, the U.K., Europe, and Japan.

Bears are focused on monetary policy and the yield curve

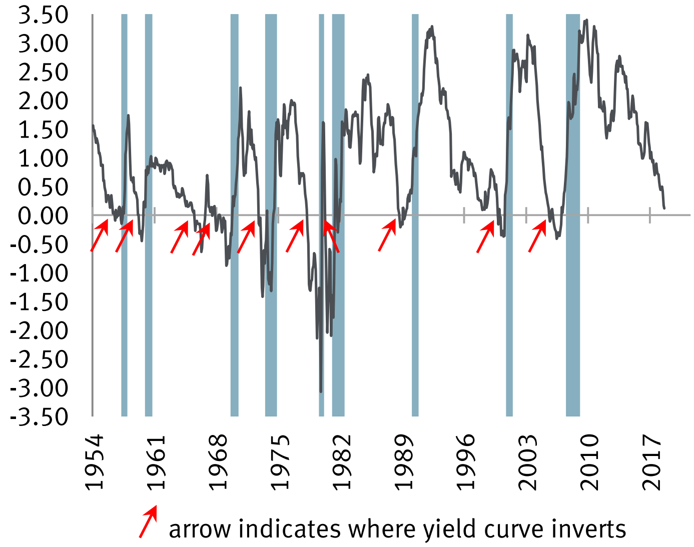
There are still plenty of bears out there. They point to a slowing global manufacturing economy—Purchasing Managers' Indexes (activity indexes) are off their (elevated) highs in Europe and North America while China's manufacturing sector has slipped back into contraction as tariffs bite. They worry the Fed has already gone too far in raising rates, making a U.S. recession inevitable which, they contend, the equity market has already begun to discount.

A great deal of attention has been given to the flattening of the yield curve—i.e., the narrowing of the spread between longer-term bond yields and short-term interest rates. If the curve were to invert, with short-term interest rates moving above the 10-year Treasury yield, then the historical record would argue that a recession is on the way with an expected start date about a year out. Since U.S. recessions have been associated with virtually every bear market, so the bearish case goes, a bear market decline would also be on the way and has probably already begun.

We're in the "correction" camp

The yield curve

Yield differential between the U.S. 10-year Treasury Note and the 1-year Note



Close to inversion but not there yet.

Note: Blue-shaded areas indicate recessions
Source - RBC Wealth Management, FRED Economic Data St. Louis Fed; data through 1/8/19

We are not in that camp. We would point out that the yield curve has not yet inverted (see chart) and it is not a forgone conclusion that it will in the near future. There have been a few near misses in the past and, for the record, there was one outright inversion in the mid-1960s that produced an economic slowdown but no recession. In that case the stock market endured a painful correction but no bear market.

We are not counting on a bullish exception from history to repeat itself. And we are concerned about how close to inversion the gap between the 1-year rate and the 10-year rate has come. Concerned enough to switch our rating of the yield curve from "positive"—i.e., supportive of the idea the U.S. economy could go on expanding for another year or more—to "neutral" (see table).

We note that it wasn't the Fed hiking rates by 25 basis points (bps) in December that accounted for most of the recent narrowing between short- and long-term rates;

RBC Wealth Management U.S. economic indicator scorecard

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

Expansion	Neutral	Recessionary

Slight slippage with yield curve now showing caution. Others still signaling expansion.

Source - RBC Wealth Management, Bloomberg, FRED Economic Data St. Louis Fed rather, it was the plunge in the 10-year Treasury yield from 3.22% to 2.56% between early November and year-end. This was mostly the result of investors running for cover into the "safe haven" of Treasuries as the debate raged about the correctness of Fed policy and the stock market went into free fall. As those fears have begun to subside, the 10-year yield has moved back up by 17 bps so far. We believe there may be room for the 10-year yield to move up further from here, moving the yield curve further away from the inversion that seemed so imminent just a few days ago.

Fed ready to be patient

It helps that short-term interest rates appear to be increasingly anchored by a Fed that has recently gone out of its way to assure financial markets that it has not put policy on "autopilot" and that slower economic growth and tame inflation might forestall some of the rate increases pencilled in for this year and next. Futures markets have priced in no hikes at all for 2019.

The other component of credit conditions is banks' willingness to make loans. The most recent Senior Loan Officers' Survey from the Fed indicates that banks on average continue to lower standards for corporate loans and indeed for most types of loans. The same survey indicates reduced corporate demand for credit. Companies are generating more cash internally or are able to meet their credit needs elsewhere. Of the small and medium-sized businesses surveyed by the National Federation of Independent Business, only a very low 4% say they can't get the credit they need and a high 50% say they have no need for credit.

Expansion has further to run, so does the market

Of course, any reprieve may be temporary. So it's worth reminding ourselves that an inversion of the yield curve usually precedes the start of an ensuing recession by 11–14 months and typically precedes the peak of the stock market by 3–6 months. Our two other long-leading indicators—weekly unemployment claims and the Conference Board's Leading Index both suggest to us that the U.S. economy will go on expanding for at least another 9–12 months and conceivably longer.

Our own forecast has U.S. GDP growing at a more subdued 2.5% in 2020, arriving in the form of most quarters printing at a 2.0%–2.3% rate. If, in fact, the Fed is finished as the futures market believes, then it's not unreasonable to look for the economy to go on growing into and perhaps through 2020.

If the U.S. economy goes on growing, so too, in all likelihood, will corporate profits and the value of businesses (i.e., share prices).

If the U.S. economy goes on growing, so too, in all likelihood, will corporate profits and the value of businesses (i.e., share prices), in our view. While we can't rule out a retest of the recent lows, we also can't rule out the prospect for the market to move back up toward or even above its September all-time highs.

No breadth breakdown in sight

There is an additional market internal measure that argues for this more bullish outcome. Market breadth—what proportion of the stocks which make up the market is moving in the same direction as the broad averages—is captured in the so-called advance-decline (A/D) line: an index computed by tracking the number of stocks that go up (advance) on a given day minus the number of issues that decline. This index usually moves "in gear" with the broad averages—peaking when they peak and bottoming when they bottom. And that is what the A/D line has done in this latest instance—it peaked at a new high when the S&P 500 did the same in late September and bottomed with the index in late December.

However, looking back over many decades reveals an important exception to this rule. In the run-up to the final stock market peak before the onset of a bear market, the A/D line typically gives up the ghost several months, or even quarters, before the market does. In other words, the market, measured by a broad average like the S&P 500, goes on making new highs but fewer and fewer stocks are doing the heavy lifting. And by the time the S&P is setting its final high of the bull market, a significant number of stocks are already in well-established downtrends.

The good news is that no such negative divergence between the performance of the broad averages and the A/D line has yet appeared. In fact, the A/D line performed much better in the latest market downturn—down about 12% versus the S&P 500's nearly 20% decline.

Higher share prices likely ahead ...

We are persuaded that a durable advance in share prices will ultimately unfold due to a number of factors present today:

- The economic expansion looks to be intact, driven by growing employment, wages, and profitability
- Our forecast of positive but unremarkable GDP growth and tame inflation is likely to keep the Fed and all other central banks from overtly tightening credit
- Shares are trading at valuations that have usually delivered positive 12-month forward returns
- Measures of market pessimism have recently reached levels consistent with correction lows

This is a time to let established equity positions continue to work for the portfolio, hopefully by way of rising dividend payments and internal compounding of shareholders' equity.

... but it's not a time to pile in

We are comfortable having a full allocation (i.e., Market Weight) committed to equities in a balanced portfolio. But we are not persuaded this is a time to be piling in. Rather, it is a time to let established equity positions continue to work for the portfolio, hopefully by way of rising dividend payments and internal compounding of shareholders' equity.

In this late-cycle environment, faced with the prospect of positive but slowing growth, the price paid for current earnings and future growth matters. What appears to us to be very good value today may hold much less promise were we six months down the road with an index that was say 12%–15% higher.

We expect the coming 12 months will be most profitably spent preparing an equity portfolio for the future challenges likely to come with an aging, slowing economic expansion that at some point could slip into recession. Here are the items we think should be on the agenda:

- Favour value over growth
- Favour large caps over small caps
- Focus on (growing) dividends
- Reduce exposure to companies highly leveraged to GDP growth
- Focus on relative strength versus the market and sector peers
- Have a plan for playing defense and think in advance of how to implement it

Focus article

Oil check

Key questions facing the oil market in 2019

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Michael Tran is a Managing Director within the Energy Strategy Research team at RBC Capital Markets, focused on global energy markets including macro supply and demand fundamentals. Mr. Tran's energy views are frequently quoted in media outlets, and he advises various governments on energy policy and budgeting.

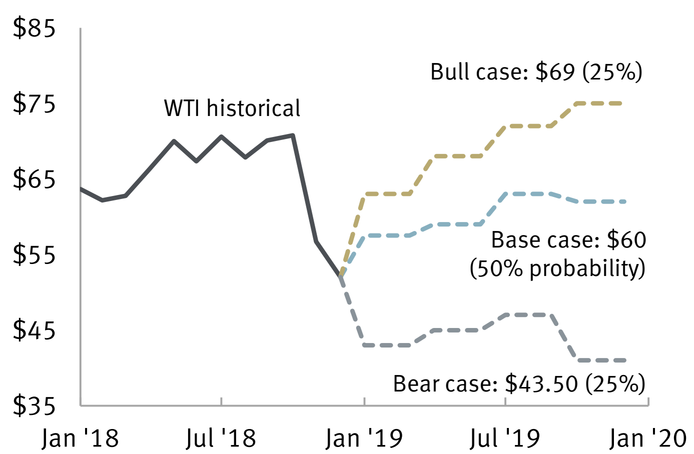
With no shortage of captivating subplots for the global oil market as 2019 kicks off, Michael Tran, RBC Capital Markets, LLC's Managing Director and Commodity Strategist, looks at what's in store for oil this year. He explains the risks and catalysts that he expects will drive the market, how he thinks the late stage of the economic cycle will affect demand, and what he thinks the No. 1 threat to the market is.

Q. How do you see the global oil market shaping up for the year ahead?

A. We see global supply and demand in fine balance this year with the market ebbing and flowing on either side of equilibrium. This compares to an extremely volatile period over recent years when the market grappled with bouts of over and undersupply. While there are many moving parts at play, OPEC's resolve, even in the face of unprecedented political pressure, should solidify investor confidence given its commitment to return the market to a balanced state. Whether that is enough to bring apprehensive investors back to the table remains the topic *du jour*. Given the combination of active market management, adequate non-OPEC supply, broad macroeconomic concerns, and dwindling conviction levels among the investor community, we anticipate supportive pricing but far from a runaway market. We see WTI and Brent averaging $60 and $68/barrel this year, respectively. While there is no shortage of captivating subplots ranging from OPEC policy to IMO to the role of U.S. oil exports re-shaping global trade, this year could be one in which prices gyrate over short periods without providing compelling indication on long-term direction.

WTI pricing scenarios: bull, bear, and base cases

Price per barrel



We anticipate supportive pricing but far from a runaway market with WTI averaging $60 per barrel in 2019.

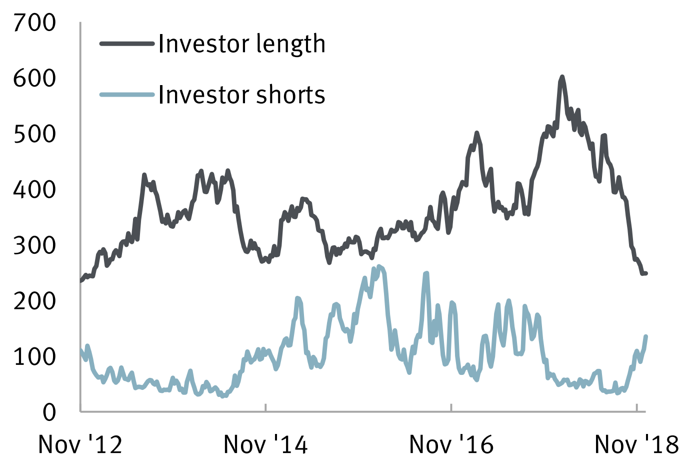
Source - RBC Capital Markets, Bloomberg; data as of 12/13/18

Q. Between OPEC, trade wars, technical trading, and fears for an impending recession, there are plenty of risk factors in the market. Are there any other broad risk factors that should be on the radar?

A. Investor positioning matters! We see the recent retracement in oil prices as oversold and describe our 2019 outlook as a moderately constructive, OPEC-driven view with our eyes wide open toward downside risk. However, the parade of fundamentally driven energy-dedicated traders exiting the space presents a structural issue that muddles how investors interpret the signal-to-noise ratio. As we mentioned, OPEC+ has indicated that it will defend a price floor, but the recent retracement is a keen reminder that investor sentiment, government energy policy, and market fundamentals can all undergo seismic shifts over extremely short lengths of time. Investor long positions in the WTI benchmark remain at multiyear lows and while the shorts have piled up over recent weeks, the aggregate short position is not nearly as high as seen in previous years. This means that short covering will not have as profound an impact as in the past, leaving the bulls to do much of the legwork to muscle prices higher.

WTI managed money futures and options position

Thousands of contracts



Short positions are below prior highs and suggest that oil bulls will be needed to propel crude prices higher.

Source - RBC Capital Markets, CFTC, Bloomberg; data through 12/18/18

Q. What are the bullish catalysts to look out for?

A. Supply outages from geopolitical hotspots remain a clear and present danger for a market that has become complacent about disruption risk. Upcoming Nigerian elections and the recent disruptions in Libya are important reminders that we can see acute, episodic issues, while outages in other regions, like Venezuela, remain structural. In a similar vein, the market is pricing as if the worst-case scenario for Iran is already behind us, but it is important to remember that even though Iranian production has already fallen by some 700 thousand barrels per day (kb/d) from spring levels, November 4 marked the start of sanctions, certainly not the end.

Q. **Given the concerns about how late we are in the economic cycle, how do you factor the broad macroeconomic concerns into your thoughts surrounding oil demand?**

A. Despite headlines of a slowing global macro backdrop, we anticipate status quo steady-enough oil consumption growth near 1.2 million barrels per day (mb/d) for this year. Global demand growth has averaged a robust annualized rate of 1.5 mb/d since the oil price collapse of 2014. During that period, OECD oil demand growth contributed an annualized rate of 475 kb/d, accounting for nearly one-third of global growth. This past year, the developed world contributed less than 270 kb/d, and we see little to stem the slowing trend in the years ahead. The years following the oil price collapse saw three pillars for oil consumption growth: the U.S., Europe, and Emerging Asia. With U.S. consumption near full capacity and Europe set for further contractions, we think the world will soon be left with Emerging Asia as the sole major contributor to oil demand growth. The truth is that OECD oil demand peaked a decade ago before the financial crisis and efficiency gains will continue to soften regional oil demand in the OECD region. Broadly speaking, w think the engine of global oil demand growth can ultimately be distilled down to China, India, and the rest of Emerging Asia. This subset of countries accounted for nearly two-thirds of global growth so far this decade. This concentration risk presents an asymmetric risk profile to the downside.

With U.S. consumption near full capacity and Europe set for further contractions, the world will soon be left with Emerging Asia as the sole major contributor to oil demand growth.

Q. **How concerning is the rise of electric vehicles for the future of oil demand?**

A. Let's use the example of China. China is both the global leader in oil demand growth and also the world's largest automobile growth market, including the foremost region for electric vehicle (EV) sales. EV sales in China have been on the rise and recently made up some 6% of total Chinese vehicle sales, but while EV sales have been increasing, SUV sales have also increased. SUVs constituted 7% of total Chinese vehicle sales back in 2010, but have since increased to 35%. This means that every incremental mile driven in China has a higher energy intensity than ever before. Simply put, EVs have been on the rise, but so have gas guzzlers.

Broad electrification is certainly a concern for oil demand, but the reach goes beyond cars. For example, there are major cities in China, like Shenzhen, where the entire bus fleet became electrified over a short four-year period. We believe one of the biggest threats to the current trajectory of future Chinese oil demand growth is mass migration to regions with large-scale electrified public transit options. The trajectory of oil demand is being reshaped by Chinese government policy.

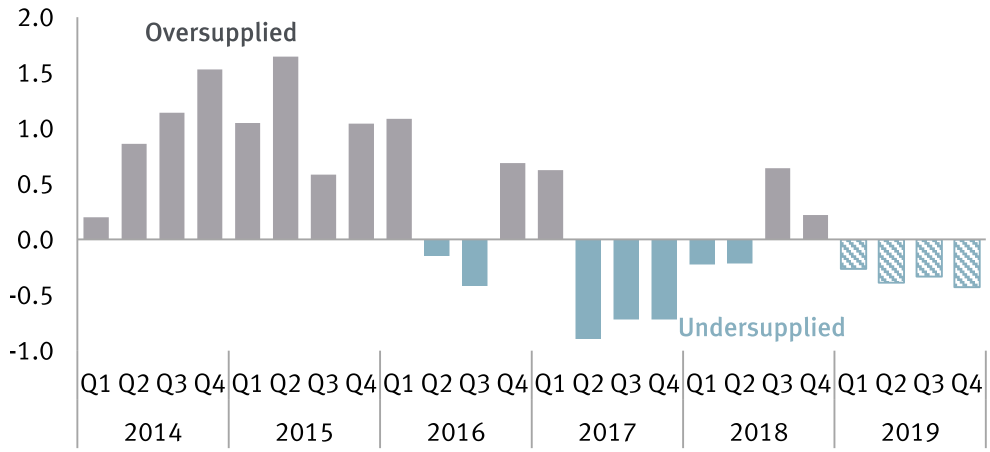
Q. **What is the biggest downside threat to the oil market this year?**

A. In our opinion, the biggest potential downside threat to the global oil market for this year is not a crude problem, but rather a gasoline issue that begins with China. While we believe the Asian giant will be counted on to once again support the oil market this year, a paradox exists. Chinese refinery throughput is higher by 8% y/y, which has played a major role in absorbing global crude that would otherwise have difficulty clearing the market. On the other hand, the heavy refinery runs have resulted in an oversupplied regional gasoline market. Slowing refinery throughput would clean up the gasoline overhang, but in turn exacerbate an already soggy crude market. Alternatively, continuing down the path of the current elevated refinery run rate would intensify gasoline balances that are already spiraling downward and potentially kick off a domino effect in which a gasoline glut created in the East ultimately reverberates westward and results in an oil market led lower by an oversupply of refined product.

We see supply and demand in a fine balance this year with the market ebbing and flowing on either side of equilibrium.

Global oil supply and demand balances

Millions of barrels per day



Source - RBC Capital Markets, Petro-Logistics SA, International Energy Agency, U.S. Energy Information Administration, Joint Organizations Data Initiative, company and government sources

Focus article

Oh Canada: Value emerging from an unloved market

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While Canadian equities are getting the cold shoulder from investors, we think they're failing to see a salient fact—the Canadian market has rarely been this cheap. We acknowledge that the market outlook remains challenging, but we explain how this valuation opportunity has piqued our interest.

Nobody knows you, when you're down and out – Jimmy Cox

Investors in Canadian equities will be forgiven if the temptation to "throw in the towel" on Canada's market and buy more U.S. (or, frankly, anything else…how is bitcoin doing?) feels like the right approach. Investor sentiment towards Canada is terrible. That makes this a time when it may pay to consider the contrarian view. We discuss the headwinds facing the Canadian economy and look at the valuations of the TSX on both an absolute and a relative basis. Although the Canadian market outlook doesn't engender much excitement at the moment, the multiple compression of the TSX over the past two years reflects very pessimistic expectations, in our view. The "wall of worry" is clearly in place. Things may only need to get incrementally better for the TSX to recover some of its mojo.

No love for the TSX

Despite delivering levels of earnings growth similar to the S&P 500 since 2016 (see the table below), the TSX is actually down 6% on a price basis compared to a 13% gain for the S&P 500 in CAD terms. Over the past two years the Canadian index has suffered a 23% haircut on its forward P/E ratio against a more benign 14% squeeze for the U.S. benchmark.

TSX earnings growth and forward P/E ratio between Dec. 2016 and Jan. 2019

	Trailing EPS			Index Level			Forward P/E		
	30-Dec-16	04-Jan-19	Δ	30-Dec-16	04-Jan-19	Δ	30-Dec-16	04-Jan-19	Δ
TSX Composite	$669.04	$914.06	37%	15,288	14,427	-6%	16.5	12.8	-23%
S&P 500	$142.79	$196.20	37%	3,011	3,393	12%	17.0	14.7	-14%

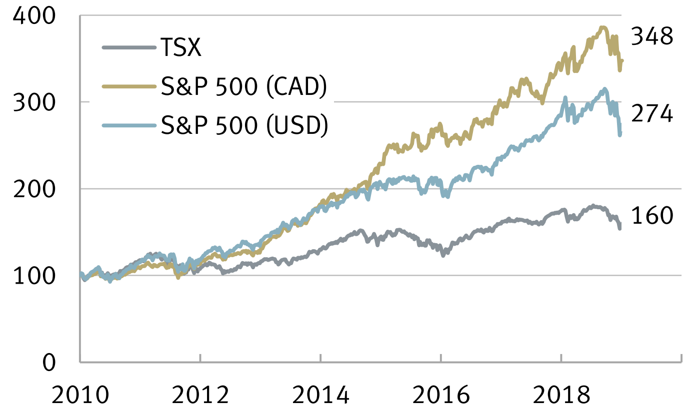
Source - Bloomberg; all data in CAD; "Δ" (delta) indicates percentage change over the time period shown.

The poor relative performance goes back even further. Aside from a few countertrend rallies, the TSX has reliably lagged the U.S. market over the last seven years as shown in the chart on the next page. While the Canadian economy and corporate earnings have recovered smartly from the oil-price-induced crunch four years ago, sentiment towards Canadian equities has remained unusually depressed.

Diagnosing the Canadian market

In our view, this poor relative performance stems from three broad concerns.

TSX total returns vs. S&P 500



Aside from a few countertrend rallies, the TSX has reliably lagged the U.S. market over the last seven years.

Source - Bloomberg; 1/1/10 indexed to 100; data through 1/4/19

- **Eroding relative competitiveness:** Most notably, the relative competitiveness of Canadian corporations has been hit by the big cut in U.S. corporate tax rates. Once much higher than the posted Canadian rate, the U.S. rate is now somewhat lower. Additionally, the Trump administration has pursued an aggressive deregulatory agenda since 2017, while the regulatory burden in Canada has moved in the opposite direction, as environmental commitments and labour laws have become less business-friendly. At the same time, all provinces have raised the minimum wage.
- **Indebted households:** Canadian household debt levels have surged to around 170% of annual income as of Q3 2018, up from around 130% at the start of 2006. The rise has been driven by ultra-low interest rates that have pushed debt servicing costs to historically low levels, together with a strong bull market in real estate prices. Results have included larger mortgages and, to a lesser extent, debt-financed consumption. This has raised concerns about future financial system vulnerability (e.g., loan defaults) and long-term growth prospects. These concerns have important implications for the economy and stock market because the Financials sector comprises over a third of the TSX, and personal consumption accounts for nearly 60% of Canadian GDP.

Without the tailwind of higher commodity prices, the TSX has struggled to keep up with the S&P 500 since 2011.

- **Commodity dependence:** The commodities complex is crucial for the TSX. Despite the correction in commodity prices in recent years, natural resource stocks still make up almost 30% of the TSX. Without the tailwind of higher commodity prices, the TSX has struggled to keep up with the S&P 500 since 2011. The Energy sector is contending with inadequate pipeline capacity to move Canadian crude to export markets, forcing producers to ship greatly reduced volumes via more-expensive rail and truck and at heavily discounted prices. Given pipeline constraints are unlikely to be resolved in the near future, all this means Canadian oil could continue to trade at a deeper-than-usual discount compared with WTI, while investor interest in Canadian Energy companies is likely to remain listless.

Half empty or half full?

There is a growing temptation to “throw in the towel” on Canadian equities, and buying more U.S. equities may seem like the right approach. However, we are reminded of the words of wisdom from the father of value investing, Benjamin Graham:

Value in the Canadian market

“In the short run, the market is like a voting machine—tallying up which firms are popular and unpopular. But in the long run the market is like a weighing machine—assessing the substance of each company.”

Nine of the 10 past years have seen foreign investors continue to allocate capital to the Canadian market.

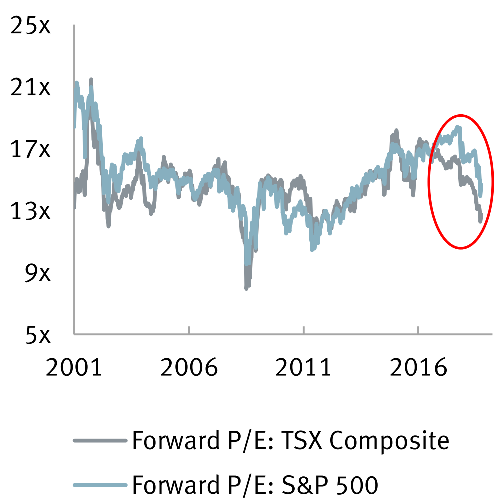
In this case, almost all of Canada is universally unpopular at the present time. Yet despite this, nine of the 10 past years have seen foreign investors continue to allocate capital to the Canadian market: net foreign purchases of Canadian equities have held up well in recent years, amounting to CAD183B since 2013.

Because stock markets are discounting mechanisms, many of the headwinds facing the Canadian market are already meaningfully priced into the valuations of Canadian businesses. Can things go from bad to worse? That’s always possible. But an investor should assess opportunity across a range of reasonable outcomes, giving heavy consideration to what one is paying for a basket of high-quality Canadian businesses.

From an absolute valuation standpoint, the TSX trades at roughly 13x forward earnings, an 11% discount compared to its long-term average of 14.6x; that’s almost one standard deviation below the historical average. On a relative basis, while the forward P/E multiples for the TSX and the S&P 500 have tended to move in sync historically, a big gap has opened up, as shown in the charts below. The TSX currently trades at an extraordinarily deep 13% discount to the S&P 500 on a forward P/E basis.

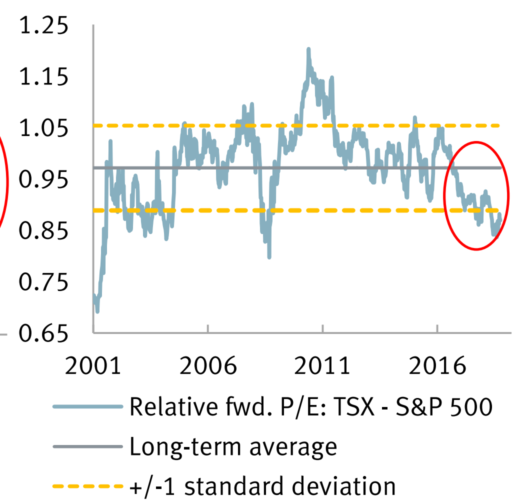
P/E multiples for TSX and S&P 500

Forward P/E multiples for TSX and S&P 500 tended to move together...



Relative forward P/E: TSX – S&P 500

...but valuations have dramatically diverged since 2016.



Source - Bloomberg; data through 1/4/19

At current valuations, the Canadian market has rarely been this cheap. If we ignore the global financial crisis (because it was *the* global financial crisis), we have to go back to the early 2000s to find the last time Canada looked this cheap relative to the U.S. However, at that time the U.S. market was still dealing with the hangover of the dot-com era and valuations were very expensive—Walmart was trading at 57x earnings. It wasn’t so much about Canada trading cheaply as it was the U.S. trading at historically expensive multiples.

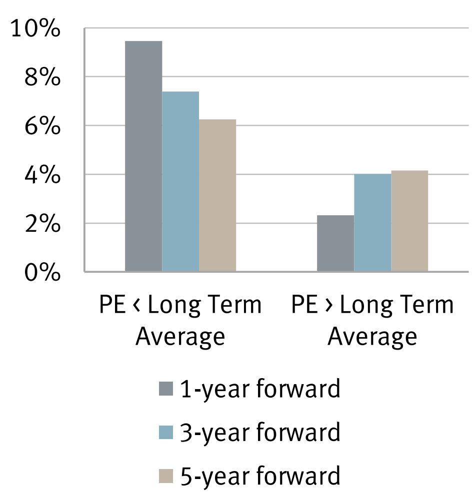
Value in the Canadian market

Valuations are seldom useful for timing entry points, but they are strong determinants of future long-term return potential. The chart at left below shows the 1-, 3- and 5-year forward returns for the TSX based on entry points that were either above or below the historical average. Unsurprisingly, forward return prospects were, on average, quite a bit more attractive across all time horizons if one had invested in the TSX when its forward P/E was below the historical average.

What about performance versus the S&P 500? The TSX has tended to outperform the S&P 500, on average, across all time horizons when it trades at discounts in excess of 10% compared to the U.S. market on a forward P/E basis, as shown in the chart at right below. In stark contrast, the TSX has meaningfully lagged after trading more expensively than the S&P 500.

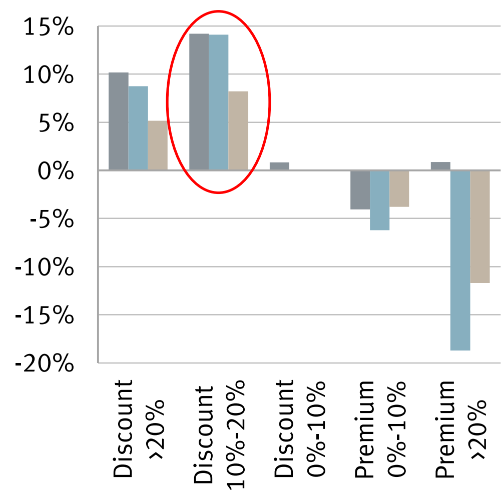
TSX returns when investing below and above historical average P/E

Lower starting valuations elevate average future return potential



Average annualized relative performance of the TSX vs. the S&P 500

Valuations eventually matter... in the longer term



Source - Bloomberg; based on price index; data through 11/30/18

Parting thoughts on Canada

Investor sentiment towards Canada remains quite negative. That said, we think the unusually wide valuation gap that has opened up between the TSX and the S&P 500 warrants looking at the Canadian market through contrarian eyes. We acknowledge that some headwinds facing the Canadian market are unlikely to abate in the short term, but we contend that the market is fully reflecting investor concerns and discounting very little in the way of potential positive outcomes.

We contend that the market is fully reflecting investor concerns and discounting very little in the way of potential positive outcomes.

Perhaps some combination of OPEC and Alberta production cuts and/or progress on pipeline approvals will re-energize the energy market. Or perhaps a split U.S. Congress will soften the Trump administration's hardline trade stance. And soon, the leaders of both countries will turn their sights towards reelection, which may result in market-friendly policies in the near term. These are three possible outcomes to which the market is essentially assigning a zero probability. Investors are already behaving as if not much can get better, which is piquing our interest. Remember, in the words of Warren Buffett: be greedy only when others are fearful.

Global equity

The market has been jolted by economic, trade, and monetary policy risks that could linger in coming months. We are persuaded that a durable advance in share prices will ultimately unfold given recession risks remain muted, corporate fundamentals are stable, and valuations are attractive. We recommend holding a Market Weight position in equities, although there are nuances to consider in particular markets (see regional comments below). For a fuller discussion on the equity market see "We're in the 'correction' camp" on page 4.

Equity views

Region	Current
Global	=
United States	=
Canada	=
Continental Europe	=
United Kingdom	=
Asia (ex-Japan)	=
Japan	+

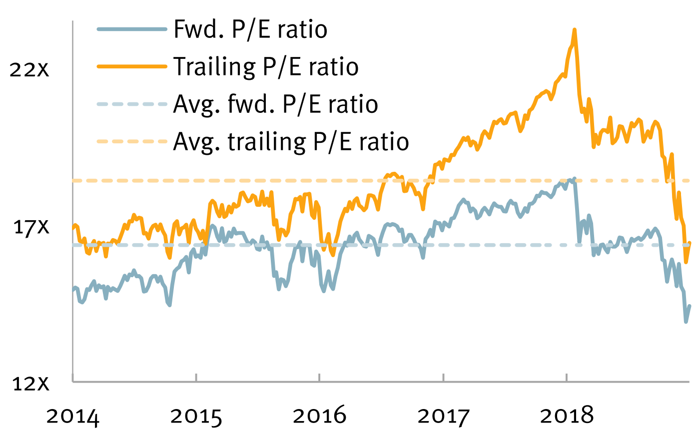
+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

Regional highlights

United States

- The U.S. market was relatively late to the global equity correction but managed to "catch up" as the S&P 500 dropped 9% in December and 14% in Q4. The declines illustrate that challenges have mounted. The domestic and global economies seem more vulnerable, revenue and earnings growth more uncertain, and political crosscurrents in Washington more difficult to see past than they were six months ago. Add to this, there are concerns the Fed has already committed or soon could commit a policy error that would hasten the end of the business cycle. Little wonder the S&P 500 fell 6% in 2018, just the second negative year since the recovery began in 2009.
- The fundamental backdrop paints a murky picture. Some key segments of the U.S. economy have lost ground recently, such as housing, auto sales, and manufacturing activity, and business sentiment has slipped. However, most leading indicators continue to signal GDP growth will persist for at least the next year. Consumer activity, roughly two-thirds of the economy, remains robust. Employment indicators

S&P 500 price-to-earnings (P/E) ratios below averages



The silver lining to the market's decline has been the easing in equity market valuations, which are communicating less onerous expectations in the coming months.

Note: Forward P/E ratio based on next-twelve-month EPS estimates; trailing P/E ratio based on trailing-twelve-month realized EPS
Source - RBC Wealth Management, FactSet; 5 years of weekly data through 12/31/18

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are firm. At this stage, RBC Capital Markets anticipates S&P 500 profits will rise in the mid-single digits in 2019 on top of tough comparisons from 2018. Earnings reports in coming weeks should shed light on full-year corporate prospects.

- While it may take more time to work through this correction, the market has already discounted a lot of bad news, in our assessment. The trailing price-to-earnings ratio—a conservative measure—dropped from around 20x at the September 2018 market peak to a below-average level of 15.8x at the end of the year. Investor sentiment is quite negative, which is often a contrary indicator. We would continue to Market Weight U.S. equities in portfolios.

Canada

- The forward price-to-earnings (P/E) multiple of the S&P/TSX Composite (currently 12.6x) remains discounted relative to its long-term historical average (roughly 16x) as well as the multiple ascribed to the S&P 500 (currently 14.4x). As Canada grapples with several domestic challenges (e.g., household indebtedness, oil & gas pipeline capacity, and economic competitiveness), we believe the P/E discount provides appropriate compensation for the challenges. We maintain a Market Weight recommendation.
- Traditionally defensive sectors outperformed the S&P/TSX Composite in Q4 2018. The outperformance of Consumer Staples, Communication Services, and Utilities is not surprising given their historical record of providing ballast amid corrections. We believe investors looking to add a measure of defensiveness to portfolios can still find opportunities in these sectors.
- Mixed Q4 2018 results capped a surprisingly strong year of earnings for the Canadian banks. Average 2018 EPS growth of nearly 12% handily beat consensus expectations at the outset of the year. We expect lower earnings growth in 2019 based on our expectations for slowing loan growth, diminishing returns from cost efficiency initiatives, and gradually rising credit losses.
- Plunging benchmark prices coupled with record discounts for Canadian oil prompted the Province of Alberta to take extreme action in the form of a roughly 9% mandatory production cut until provincial storage levels are restored to normal. This should alleviate pressure on Canadian crude oil discounts in 2019; however, we believe a long-term sustainable solution to the mismatch between production and transportation capacity is still required.

Continental Europe & U.K.

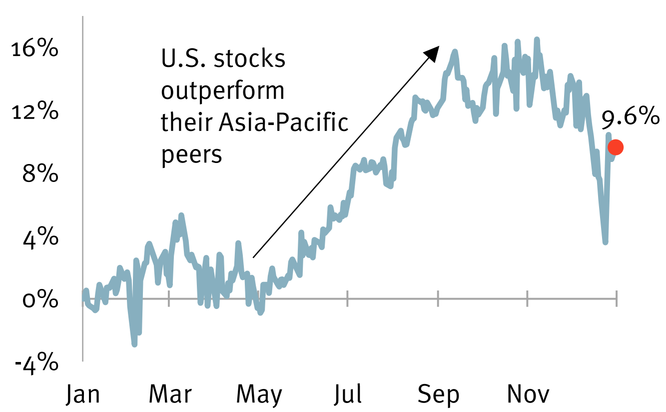
- We are Market Weight both U.K. and Europe equities. While the U.K. economy is holding up reasonably well for now, we believe Brexit negotiations will continue to be the real driver for financial markets. Visibility remains very low. We would expect U.K. equities to underperform in a "hard Brexit" scenario, but should our base case of a "soft Brexit" materialize, an upward rerating is likely given the low 2019 P/E ratio of less than 11.5x 2019 earnings and attractive dividend yield of some 5%. We continue to favour Energy, Health Care, and Life Insurance.
- Macroeconomic data in Europe are slightly disappointing given unemployment at a cyclical low, healthy lending, and capital expenditure recovering. Yet with concerns about global growth and

trade tensions, the economy may struggle to regain its momentum in the short term, in our view. It is not all bad news, as the resolution of the Italian budget impasse lifts uncertainty. We continue to favour Health Care in particular as valuations are not overly demanding.

Asia

- Asian equities remain somewhat weak, although we note the relative outperformance of Asian stocks versus U.S. stocks in December. At this point, we believe much of the current developments is priced into Asian equities. Valuations are becoming supportive in certain markets, such as Japan. Hence, we maintain a neutral stance on the equity market. Within Asia, we maintain a preference for Japan, especially in light of the recent decline in share prices.
- Chinese President Xi Jinping's speech marking the 40th anniversary of China's economic reforms did not deliver any new policy initiatives. However, comments from People's Bank of China Governor Yi Gang indicated that monetary policy will remain supportive given the ongoing deceleration in the economy. Importantly, there may be an increased focus on supporting growth over measures to rein in riskier areas of credit growth. This would be seen as a positive development by markets in the short-to-medium term, in our view.
- Even so, there are clear risks from the ongoing trade dispute between the U.S. and China, and we believe the dispute will set the narrative for the Asian markets in the first quarter of 2019. We believe it is possible that some kind of deal will be done. However, trade is just one item in a complex relationship that continues to cause tension.

2018 relative performance: S&P 500 to MSCI Asia Pacific



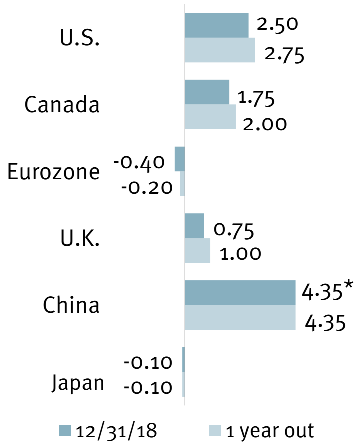
U.S. stocks outperformed the MSCI Asia Pacific Index by 17 percentage points through November before sharply reversing course and ending the year 9.6% better than Asian equities after seeing the performance gap shrink all the way to 3.6% on Christmas.

Note: Relative performance defined as S&P 500 returns minus MSCI Asia Pacific returns
Source - RBC Wealth Management, FactSet; data through 12/31/18

Ball of confusion

(That's what central bank policy is today)

Central bank rate (%)



*1-yr base lending rate for working capital, PBoC
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management

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With apologies to the Temptations, the title of their 1970 classic, in our view, provides an apt description of current central bank policy following the December Federal Reserve meeting. Starting with the winding down of quantitative easing in 2013 and the subsequent first rate hike in late 2015, the Fed has led major central banks in efforts to remove the excess stimulus that had been provided in response to the financial crisis. Now, with the growing possibility the Fed may be done for this cycle, this leadership could take a new turn—toward a global pause in policy tightening. The confusion lies in the fact that some central banks are still hoping to commence (or at least continue) tightening cycles of their own when in actuality these plans could face challenges.

More than a pause

We believe a pause in 2019 could signal the end to Fed rate hikes for this cycle. "Pause" typically indicates a short break, which was what then Fed Chair Ben Bernanke suggested to Congress in April 2006 when he said, "a decision to take no action at a particular meeting does not preclude actions at subsequent meetings." The Fed "paused" after a rate hike in June 2006; the next action, however, was a 50 basis point cut in September 2007.

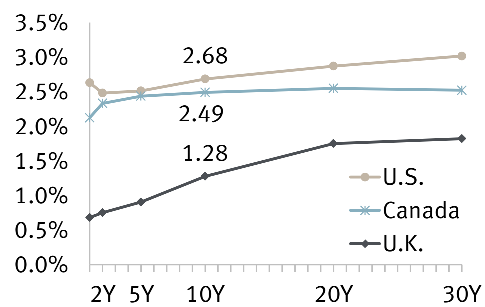
Certainly the market believes the Fed is done. It is currently pricing in no further hikes in 2019 and a start to rate cutting in 2020. Of course, the "market" often changes its mind. At the end of 2017 it looked for just two hikes in 2018

Fixed income views

Region	Gov't Bonds	Corp. Credit	Duration
Global	–	+	5–7 yr
United States	–	+	7–10 yr
Canada	=	=	3–5 yr
Continental Europe	=	+	5–7 yr
United Kingdom	=	=	5–7 yr

+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

Sovereign yield curves



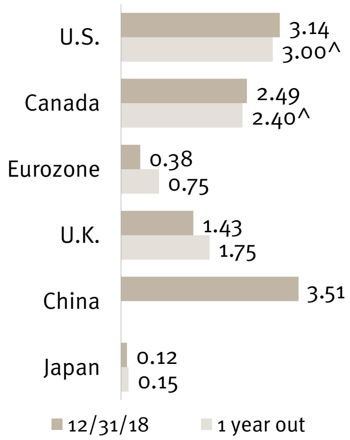
Source - Bloomberg

(there were four) and none thereafter through 2020.

Policy mandate progress report

Global central banks have mandates to direct monetary policy. By and large they have similar priorities focused on maintaining stable prices (inflation) and growth. Additionally, some banks promote maintaining confidence in their domestic currencies. Faster growth and rising inflation concerns in North America that fueled rate hikes by the Fed and the Bank of Canada in 2018 have since cooled such that both are

10-year rate (%)



Note: Eurozone utilizes German Bunds.
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management
^Under review

signaling the end (for rate hikes) may be near—at least for now. In the United Kingdom and Europe, weak growth and low inflation have the Bank of England and the European Central Bank re-iterating that any rate increases from here won't happen before late 2019 at the earliest. As for Asia, the Bank of Japan shows little movement toward tighter policy and the People's Bank of China has been easing.

The Fed "pausing" may delay tightening or shorten the length of tightening cycles by all central banks.

Regional highlights

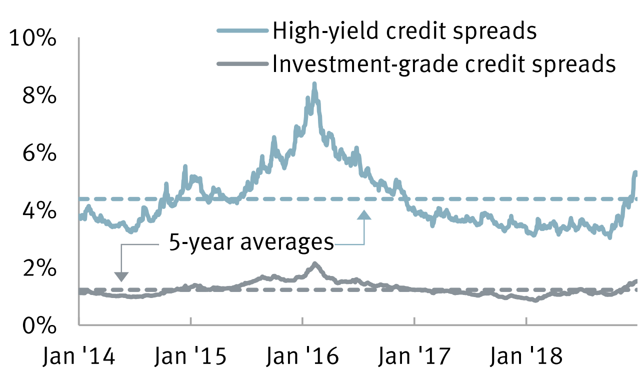
United States

- The Federal Reserve raised the fed funds rate 25 basis points (bps) to a range of 2.25%–2.50%, its fourth rate hike in 2018 and ninth of the cycle. Despite lowering the projected rate hikes in 2019 to two hikes from three, the meeting was more hawkish than the market anticipated. Officials lowered the projection for the "neutral" level of policy rates that neither restricts nor boosts economic activity to 2.75% from 3.00%, which means the Fed is saying policy is now just one hike from neutral.
- In our view, the December rate hike raises the risk of a monetary policy misstep, which is priced in by inversions of segments on the yield curve, and as a result we do not expect the Fed to hike rates in 2019.
- The credit spreads on the Bloomberg Barclays Investment Grade Corporate Bond Index and the Bloomberg Barclays High Yield Corporate Bond Index have surged to as wide as 143 bps and 475 bps over Treasuries, respectively. But concerns about economic growth and a potential Fed overstep have triggered a rally in Treasuries, with the 10-year yield falling as low as 2.75% from 3.24% in November. In our view, investors should opt for higher-quality credit at this stage in the cycle, to shelter from ongoing risks.

Canada

- Government of Canada yields were 25–30 basis points lower through December on concerns over the robustness of both Canadian and global growth. At the same time, plummeting oil prices dampened Canadian inflation expectations. The market is now barely pricing in another hike from the Bank of Canada, and the yield curve remains incredibly flat. At this stage, we are comfortable recommending short to intermediate discounted Federal bonds that offer lower expected

Credit spreads surge on concerns about economic growth and the Fed



Source - RBC Wealth Management, Bloomberg; data through 12/31/18

We recommend investors opt for higher-quality credit at this stage in the cycle, to shelter from ongoing risks.

volatility of returns and a source of liquidity as we edge closer towards the end of the cycle. We expect to get another opportunity to extend duration at more attractive levels in 2019.

- Investment-grade spreads have continued to trend wider as investors seek quality over yield. The primary market has been effectively closed throughout the market turbulence, and we will be watching the banks closely over the next couple of months as they have significant senior capital to raise. We believe this issuance could set the tone for Canadian credit markets in 2019.
- Preferred shares hit fresh two-and-a-half-year lows in December as investors continue to de-risk portfolios. The widespread selling has opened up opportunities thanks to implied credit spreads being at historically wide levels.

Continental Europe & U.K.

Europe

- The European Central Bank (ECB) ended its net asset purchase programme at the end of December. We believe its recent meeting commentary of "continuing confidence with increasing caution" points to interest rates remaining unchanged for much of 2019, and a potentially more gradual path of future monetary policy tightening.
- Reinvestment of maturing assets from the purchase programme, expected to continue beyond the ECB's first rate hike, should provide support to the market. This has led RBC Capital Markets to lower its forecast for European rates. German 10-year Bund yields are now estimated to remain within last year's range of 0.24% to 0.57% for much of 2019, with a push higher to 0.80% late in the year as the ECB puts its first rate hike in place. We recommend Market Weight exposure to European fixed income and a modest Overweight on corporate credit.

U.K.

- The Bank of England referenced the further intensifications of Brexit uncertainties as reason for maintaining "gradual and limited" guidance on interest rates. A ratification around Brexit would possibly push Gilt yields higher, and supports our preference for the 3- to 5-year duration bucket in the U.K. However, given the weaker GDP trends at the end of 2018, we maintain a Market Weight on U.K. Gilts and credit for now. RBC Capital Markets expects the next rate hike in August 2019, with 10-year U.K. Gilts reaching 2% by year-end from the current 1.2%, when markets are likely to price the next move higher in the bank rate.

Currencies

Currency forecasts

Currency pair	Current rate	Forecast Dec 2019	Change*
Major currencies			
USD Index	96.17	97.38	1%
CAD/USD	0.73	0.75	3%
USD/CAD	1.36	1.33	-2%
EUR/USD	1.14	1.16	2%
GBP/USD	1.27	1.25	-1%
USD/CHF	0.98	1.03	5%
USD/JPY	109.6	125.0	14%
AUD/USD	0.70	0.67	-4%
NZD/USD	0.67	0.63	-6%
EUR/JPY	125.8	145.0	15%
EUR/GBP	0.89	0.93	4%
EUR/CHF	1.12	1.20	7%
Emerging currencies			
USD/CNY	6.87	7.50	9%
USD/INR	69.77	80.00	15%
USD/SGD	1.36	1.44	6%

* Defined as the implied appreciation or depreciation of the first currency in the pair quote.
Examples of how to interpret data found in the Market Scorecard.
Source - RBC Capital Markets, Bloomberg

U.S. dollar: Running out of steam

The U.S. dollar advanced against nearly every major currency in 2018 as U.S. growth outperformance and rising yields boosted appetite for the currency. These supportive factors are poised to fade through 2019 as the economy slows to a more sustainable pace and the Fed looks to ease up on its path of monetary tightening. There is still scope for modest dollar gains in early 2019, in our view, in advance of growth conditions improving elsewhere and other major central banks tightening policy.

Euro: Cautiously optimistic

A loss of economic growth momentum alongside an escalation of political tensions contributed to the euro trending broadly lower in 2018. The tides should shift for the currency in 2019, however, with a spillover of rising wages to inflation likely to spur the European Central Bank to raise its key policy rate in the latter half of the year. Narrowing rate spreads with the U.S. should provide some support to the euro, in our view.

British pound: Bracing for Brexit

The British pound bore the brunt of Brexit headlines in 2018, swinging from fresh post-referendum highs in April to near two-year lows in December. The currency appears likely to continue to take its guidance from unfolding Brexit developments in 2019. A smooth transition underpins our base case scenario, although we believe the pound is likely to remain at relatively depressed levels due to lingering uncertainty around the U.K.'s future relationship with the EU.

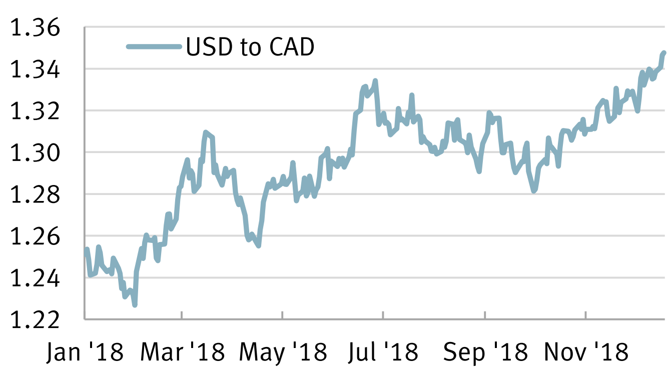
Canadian dollar: Oil woes

The Canadian dollar was battered by a confluence of factors in 2018, with only a modest recovery anticipated later in 2019. Plunging crude oil prices aggravated earlier pressures emanating from rate dynamics that favored the U.S. dollar. The diminished growth outlook on the back of depressed energy prices will likely keep the Bank of Canada from raising policy rates in early 2019, in our view, limiting any near-term upside for the currency.

Japanese yen: Maintain course

The yen ended 2018 close to where it began the year against the U.S. dollar. Headwinds facing the currency could expand in 2019 as highly accommodative monetary policy will likely remain in place against a backdrop of tepid inflation and subdued growth. Risk-off sentiment due to increased financial market volatility could spur investor appetite for the perceived safety of the yen and provide some offset, in our view.

The Canadian dollar was battered by a confluence of factors in 2018



Depressed crude oil prices and rate dynamics favouring the U.S. dollar could limit a recovery in 2019.

Source - Bloomberg, RBC Wealth Management; data through 12/19/18

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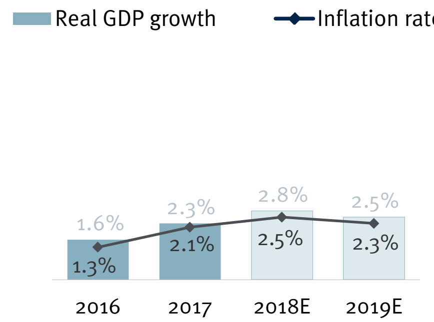
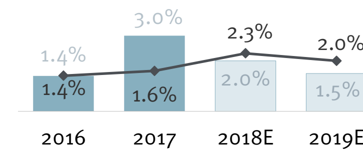


United States — 2019 slowdown

- Leading indicators point to slower growth in 2019; both consumer and business confidence fell sharply from multi-decade highs to end 2018. Weaker oil and a strong dollar are keeping inflation subdued. November's housing data rebounded, but higher mortgage rates and a lack of affordable inventory remain headwinds. Hiring and wage growth continue strong, providing a boost to retail sales and a robust Q4 spending season.

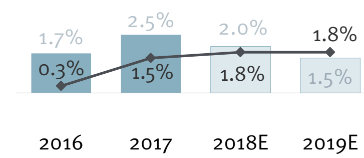
Canada — Dovish hold

- The Bank of Canada kept rates unchanged in December, acknowledging slowing growth. The unemployment rate fell to 5.6%, the lowest level on record. Wages continue to grow marginally faster than inflation, but retail sales data has softened as over-leveraged households continue to adjust to higher interest rates.



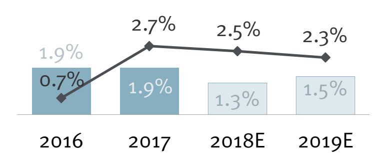
Eurozone — End of QE

- Eurozone PMIs continued to decline into year's end. Q3 GDP growth, at 1.6%, was the slowest since 2014. The European Central Bank will end its bond buying program in 2019, although it plans to reinvest the principal and interest from its balance sheet at least through the summer. QE helped boost household borrowing by 3.3% y/y and commercial borrowing by 4% y/y in November.



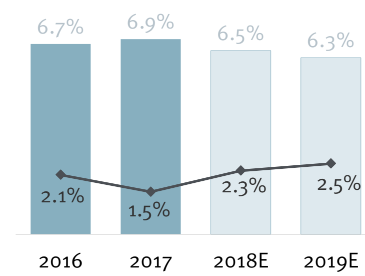
United Kingdom — Kick the Brexit can

- British politicians took a break from Brexit negotiations after U.K. Prime Minister Theresa May called off a Dec. 11 parliamentary vote on a withdrawal agreement that was headed for certain defeat. Retail sales reaccelerated in November at a 1.2% m/m pace. Q3 GDP growth of 0.6% q/q was the fastest pace in almost two years. Core inflation continued its slide to 1.8% y/y following a post-Brexit-referendum spike to 2.7% y/y.



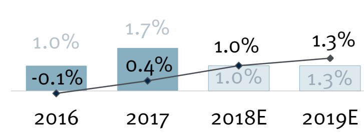
China — Manufacturing slowdown

- The trade dispute with the U.S. is weighing on manufacturing activity. Industrial production fell to 5.4% y/y and the manufacturing PMI slipped into retraction territory for the first time since economic slowdown concerns in early 2016. The PBoC is adjusting the calculation of some banks' reserve ratios to boost the impact of previous monetary easing steps amid the growth slowdown.



Japan — Negative bond yields

- Ten-year Japanese bond yields fell below 0.0% for the first time since September 2017 as inflation gauges all continued to slide into year's end; core CPI fell to 0.6% m/m while weakness in other inflation measures emerged due the stronger yen. While bond yields remain in the Bank of Japan's target range, the decline in yields is symptomatic of increasing challenges for the BoJ's effort to stoke inflation back towards the 2% target.



Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management

Market scorecard

Index (local currency)	Level	1 month	YTD	12 month
S&P 500	2,506.85	-9.2%	-6.2%	-6.2%
Dow Industrials (DJIA)	23,327.46	-8.7%	-5.6%	-5.6%
NASDAQ	6,635.28	-9.5%	-3.9%	-3.9%
Russell 2000	1,348.56	-12.0%	-12.2%	-12.2%
S&P/TSX Comp	14,322.86	-5.8%	-11.6%	-11.6%
FTSE All-Share	3,675.06	-3.9%	-13.0%	-13.0%
STOXX Europe 600	337.65	-5.5%	-13.2%	-13.2%
EURO STOXX 50	3,001.42	-5.4%	-14.3%	-14.3%
Hang Seng	25,845.70	-2.5%	-13.6%	-13.6%
Shanghai Comp	2,493.90	-3.6%	-24.6%	-24.6%
Nikkei 225	20,014.77	-10.5%	-12.1%	-12.1%
India Sensex	36,068.33	-0.3%	5.9%	5.9%
Singapore Straits Times	3,068.76	-1.6%	-9.8%	-9.8%
Brazil Ibovespa	87,887.26	-1.8%	15.0%	15.0%
Mexican Bolsa IPC	41,640.27	-0.2%	-15.6%	-15.6%
Bond yields	**12/31/18**	**11/30/18**	**12/29/17**	**12 mo. chg**
US 2-Yr Tsy	2.488%	2.787%	1.883%	0.60%
US 10-Yr Tsy	2.684%	2.988%	2.405%	0.28%
Canada 2-Yr	1.863%	2.160%	1.689%	0.17%
Canada 10-Yr	1.967%	2.268%	2.045%	-0.08%
UK 2-Yr	0.752%	0.777%	0.438%	0.31%
UK 10-Yr	1.277%	1.364%	1.190%	0.09%
Germany 2-Yr	-0.610%	-0.596%	-0.627%	0.02%
Germany 10-Yr	0.242%	0.313%	0.427%	-0.19%
Commodities (USD)	**Price**	**1 month**	**YTD**	**12 month**
Gold (spot $/oz)	1,282.45	4.9%	-1.6%	-1.6%
Silver (spot $/oz)	15.50	9.3%	-8.5%	-8.5%
Copper ($/metric ton)	5,949.00	-4.5%	-17.5%	-17.5%
Uranium ($/lb)	20.90	-0.5%	-12.6%	-7.7%
Oil (WTI spot/bbl)	45.41	-10.8%	-24.8%	-24.8%
Oil (Brent spot/bbl)	53.80	-8.4%	-19.5%	-19.5%
Natural Gas ($/mmBtu)	2.94	-36.3%	-0.4%	-0.4%
Agriculture Index	283.88	-2.3%	0.6%	0.6%
Currencies	**Rate**	**1 month**	**YTD**	**12 month**
US Dollar Index	96.1730	-1.1%	4.4%	4.4%
CAD/USD	0.7332	-2.5%	-7.8%	-7.8%
USD/CAD	1.3637	2.6%	8.5%	8.5%
EUR/USD	1.1467	1.3%	-4.5%	-4.5%
GBP/USD	1.2754	0.0%	-5.6%	-5.6%
AUD/USD	0.7049	-3.5%	-9.7%	-9.7%
USD/JPY	109.6900	-3.4%	-2.7%	-2.7%
EUR/JPY	125.8300	-2.0%	-7.0%	-7.0%
EUR/GBP	0.8990	1.3%	1.2%	1.2%
EUR/CHF	1.1255	-0.5%	-3.8%	-3.8%
USD/SGD	1.3629	-0.7%	2.0%	2.0%
USD/CNY	6.8785	-1.2%	5.7%	5.7%
USD/MXN	19.6504	-3.5%	0.0%	0.0%
USD/BRL	3.8745	0.2%	17.1%	17.1%

Worst December since the Great Depression erased 2018 gains in U.S. equities.

Global yield curves continued to flatten as markets price in a slowdown in economic growth.

Oil continued sharp declines amid fears of global oversupply and a slowdown in global growth.

U.S. dollar among world's best-performing currencies as the Fed raised rates four times in 2018.

Equity returns do not include dividends, except for the Brazilian Ibovespa. Equity performance and bond yields in local currencies. U.S. 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. Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -7.8% return means the Canadian dollar has fallen 7.8% vs. the U.S. dollar during the past 12 months. USD/JPY 109.69 means 1 U.S. dollar will buy 109.69 yen. USD/JPY -2.7% return means the U.S. dollar has fallen 2.7% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 12/31/18.

Research resources

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