September 5, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

The matters that matter

Kelly Bogdanova – San Francisco

The news cycles of late have been whipped around by a chaotic political blender. However, it's not the political sideshows themselves that drive the markets, but rather the economic and corporate earnings prospects that can be impacted by these situations. We see some caution signs on both fronts.

Equity markets are breathing a sigh of relief as three political developments boosted major indexes worldwide in recent trading sessions:

- The U.S. and China agreed to meet in October in Washington to restart trade negotiations
- The U.K. House of Commons moved closer to preventing a "no-deal" Brexit, at least for the near term
- Hong Kong's leader formally withdrew the controversial extradition bill

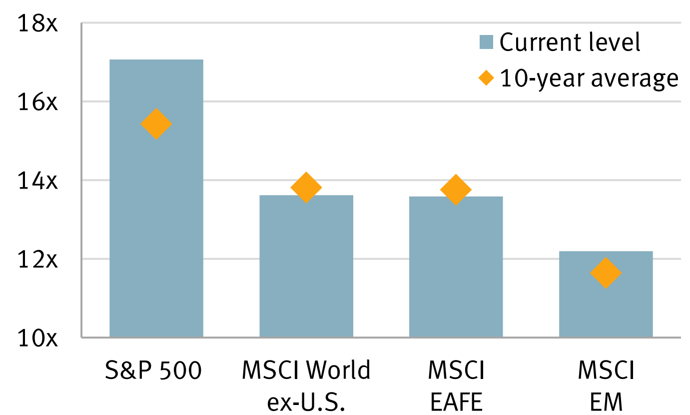
Markets' positive reaction has less to do with politics per se and more to do with the potential impact that public policy decisions can have on economic growth and corporate earnings.

The data are clear that the U.S.-China trade dispute has already constrained global economic growth and has begun to show up in U.S. sectors as well. It threatens to apply additional pressure if the conflict goes unchecked or escalates. So any development that calms the choppy tariff waters should be viewed constructively by markets, even if there are bigger geopolitical rivalries at play.

There is also no doubt to us that Brexit uncertainties have negatively impacted the U.K. and European economies. While there is a long way to go before this issue is resolved, the possible removal of a near-term messy exit from the EU is far better to us than the alternative.

The U.S. valuation is somewhat elevated; other regions are near average levels

12-month forward price-to-earnings ratios based on consensus forecasts



Source - RBC Wealth Management, Bloomberg; data through 9/4/19

Market pulse

The daily political headlines are eye-catching to be sure, and they can temporarily swing markets in either direction. We think it's prudent for long-term investors to focus primarily on economic and corporate earnings prospects that can be impacted by public policy decisions. In this connection, there are cautionary signals on both fronts.

Dents in the economic armor

We view the state of the global economy as fragile and the U.S. economy as relatively firmer but with some weak spots.

Growth in Europe and Asia has slumped and some countries in these regions are near recession.

Germany's economy—the world's fourth-largest—is flat on its back. GDP contracted slightly in Q2 q/q and the manufacturing sector has fallen deep into recession territory. The U.S.-China trade dispute has negatively impacted the once-stalwart German industrial sector, but Brexit uncertainties and domestic and EU structural imbalances have taken their toll as well.

Trade issues aside, China's economy is still working through a deleveraging process that has detracted from GDP growth.

In the U.S., one of our six recession indicators—the yield curve—began to flash a red recessionary warning sign in mid-August. Just recently, a leading indicator of manufacturing started to blink yellow.

Neither of these signals spells automatic gloom and doom for the U.S. economy, and our other four indicators are still forecasting that the 10-year expansion can persist. Key segments of the U.S. economy such as household spending and services remain healthy.

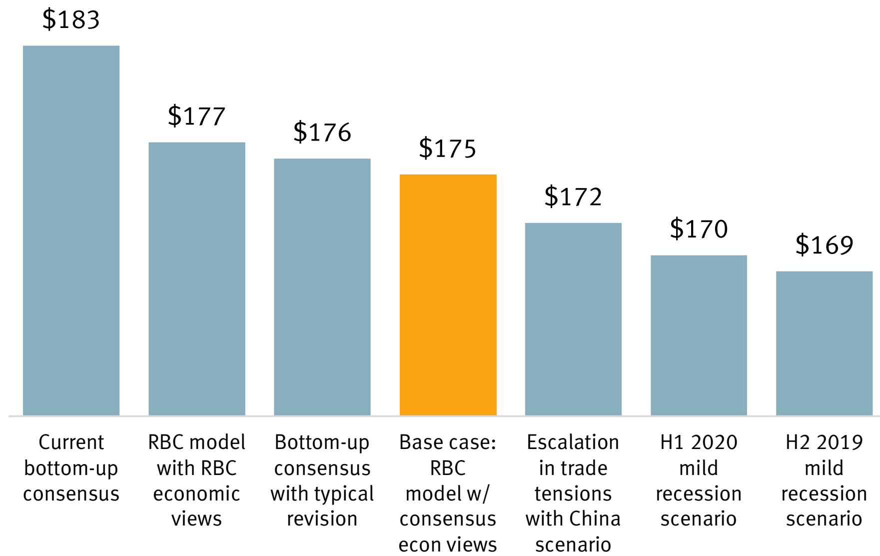
But some of our recession indicators could potentially deteriorate in the months ahead. Taken as a group, rather than individually, they have given us a reliable picture of how the recession probabilities are shifting. For a breakdown of where each indictor currently stands, see the September *Global Insight* article, "A new phase."

2020 earnings estimates earn attention

Regarding corporate earnings, there is not much risk to 2019 S&P 500 estimates, in our view. RBC Capital Markets forecasts $166 per share, which is slightly above the consensus forecast. This would represent 2.5% y/y growth—not great, but acceptable given it comes on top of a 23% earnings surge in 2018. If manufacturing trends deteriorate further, RBC's 2019 forecast could come down modestly given this highly cyclical sector tends to be positively correlated with changes in earnings estimates.

There's a wide gap between earnings scenarios for next year

RBC Capital Markets stress test of S&P 500 earnings-per-share scenarios for 2020



Source - RBC Capital Markets U.S. Equity Strategy, Bloomberg, FactSet, RBC Wealth Management, Refinitiv I/B/E/S (current bottom-up consensus); data as of 9/5/19

2020 earnings estimates have a wider range of outcomes, according to the RBC Capital Markets study shown in the chart. The consensus forecast of $183 per share is too lofty, in our view. This outcome only seems possible if the domestic and global economies rebound meaningfully. We don't see signs that this will occur. We anticipate the 2020 consensus estimate will come down over the next few months, at least, as management teams provide their outlooks for next year. There is anecdotal evidence that many institutional investors expect this.

The other, more realistic scenarios for 2020 are on both sides of RBC's $175 per share forecast, with the lowest scenario coming in at $169 per share. At this level, the S&P 500's price-to-earnings ratio of 17.6x is elevated, but is not sky-high.

Heed the signs

We remain cautiously constructive on global and U.S. equities given economic and earnings growth scenarios are still in view, and we believe the path to new highs remains open for most developed-economy stock markets. We still recommend Market Weight (benchmark) equity exposure.

However, if more U.S. recession indicators start to flash caution signs and/or the 2020 earnings outlook were to deteriorate notably, the risk-reward balance for equities would shift to less favorable terms. This would warrant defensive adjustments to equity portfolios.

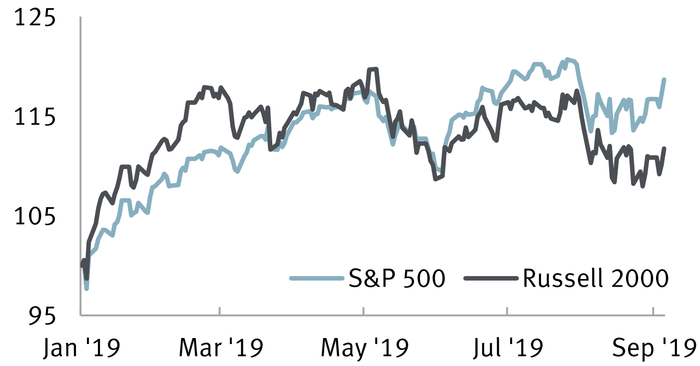
United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets have recouped some of August's losses during the week** as the trade narrative shifts direction once again and high-level U.S. and Chinese officials prepare to meet in October. Economic data released during the week were mixed with a slightly negative bias. **The ISM Manufacturing PMI fell into contractionary territory** at 49.1 and missed consensus estimates; the New Orders component was even worse at 47.2, and the closely watched New Orders minus Inventories data showed a cautionary signal as well. But jobs data was far stronger, with ADP employment numbers showing **the U.S. economy added 195,000 jobs in August, ahead of consensus expectations of 148,000**.
- **Weekly equity sector performance saw stocks largely shake off the PMI release as risk-on, economically sensitive sectors showed leadership.** The Energy sector leads all peers so far during the week, with Info Tech, Financials, and Consumer Discretionary close behind. Weekly laggards include the lower-risk bond proxies of Consumer Staples, Utilities, and Real Estate; all are higher for the week, but trail the S&P 500.
- **Small caps are still struggling to make gains relative to the S&P 500** as the relationship of domestic recessionary fears to globally easing trade tensions is less favorable for small caps than large. The S&P 500 has climbed nearly 19% YTD, while the Russell 2000 has gained only 11%. Small caps led large caps as recently as mid-June, but the trend has reversed as recession fears increase. To be clear, while economic data in the U.S. has clearly weakened, it has not deteriorated enough to change **our recommendation to hold a Market Weight position in U.S. equities with a portfolio tilt toward high-quality companies**.
- **Treasury rates also moved higher during the week** on the announcement of the U.S.-China meeting; the 10Y Treasury rate climbed to an intra-week high of 1.59% on the news. However, **we remind investors to keep their optimism for higher rates in check** as there are still few signs of a trade breakthrough.

Small caps have underperformed large caps since May

S&P 500 and Russell 2000 year-to-date performance, indexed to 100



Source - RBC Wealth Management, Bloomberg; data as of 9/5/19, 12:00 PM CST

Canada

Carolyn Schroeder & Arete Zafiriou – Toronto

- **Canada's GDP increased 3.7% on an annualized basis in Q2. For the first time in two years, Canada's quarter-to-quarter GDP growth beat the U.S.**, 3.7% to 2.0%. According to RBC Economics, **the stronger-than-expected Q2 result was due to a 5.4 percentage point contribution to growth from net trade** that more than compensated for the drag from net trade in Q1. The GDP-by-industry breakdown showed an almost 3% Q2 jump in output from non-commodity industries, mostly services. Other recent Canadian data has been positive: **employment increased by almost 250,000 over the first six months of the year and wage growth strengthened in Q2**. Foreign direct investment inflows also had the strongest first half of a year in 2019 since 2013. However, some data were less encouraging, as **business investment declined and consumer spending was soft** over the quarter. From the Bank of Canada's (BoC) perspective, the Q2 report will do nothing to alleviate **concerns that an increasingly uncertain growth backdrop will slow the Canadian economy going forward**.
- **On September 4, the BoC held the overnight rate steady at 1.75%**, as was widely expected. In its statement accompanying the announcement, the bank noted that U.S.-China trade tensions are "weighing more heavily on global economic momentum" than it had anticipated in July's Monetary Policy Report, and also stated that the stronger-than-expected Q2 GDP growth will likely prove temporary. RBC Economics notes that record levels of household debt provide good reason for the BoC not to lower interest rates unnecessarily while core inflation is at target and wage growth has started to increase, and believes global developments will be central to the BoC's future rate decisions. **The market is pricing in a roughly 50% probability of a rate cut at October's meeting, while RBC Economics forecasts a rate cut in January.**

Europe

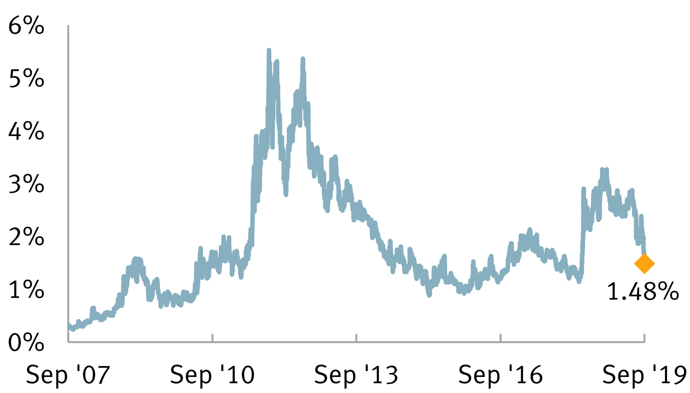
Frédérique Carrier & Thomas McGarrity, CFA – London

- **The chances of imminent negative outcomes receded in both the U.K. and Italy over the week.** In the U.K., the **House of Commons** recently wrestled control of parliamentary business from the government by voting to **force Prime Minister Boris Johnson to request an extension from the EU to delay Brexit until January 31, 2020**, unless a deal on the terms of the exit is approved by Parliament. By doing this, the Members of Parliament who voted for the bill hope to avoid a "no-deal" Brexit on October 31. The bill now passes to the upper house of Parliament, the House of Lords, where final approval could be gained on September 9 before the proroguing, or suspension, of Parliament.

- The bill was passed in the House of Commons thanks to 21 Conservative Party rebels. In retaliation, Johnson expelled them from the party, losing his working majority in the process. With his "leave the EU on October 31, do or die" plans in tatters, **Johnson tried to call an early election but was rebuffed** as the opposition feared that calling an election now could thwart their plans to force Johnson to ask for an extension.
- However, as Johnson heads an unstable minority government, **we still expect an election to be called relatively soon**. Its outcome remains as unclear as ever, given how divided the country is and because the "first-past-the-post" (or winner-take-all) system means the translation of votes into Parliament seats is uncertain.
- If an election is called, **we would expect the pound to respond to the various polls and oscillate according to the probabilities of the two extreme outcomes**: i.e., a majority Conservative government and the possibility of a no-deal Brexit (negative for sterling), or a Labour/Liberal Democratic coalition government that could possibly pursue a second referendum (positive for sterling).
- **In Italy**, grass-root members of the 5-Star Movement agreed to their party forming a coalition with the center-left Democratic Party, and a new government was sworn in. This **coalition is seen as relatively more market-friendly** than its predecessor given its less confrontational attitude towards the EU. As a result, spreads between Italian government bond yields and their German equivalent receded to their post-European debt crisis average.

Italian spreads narrow as market-friendly coalition forms in Italy

Spread between Italian and German 10-year government bond yields



Note: Spread measured by subtracting the German yield from the Italian yield
Source - RBC Wealth Management, Bloomberg; data through 9/5/19

Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- Despite the implementation of additional tariffs by both the U.S. and China, **Asian markets rose during the week, led by New Zealand and Hong Kong**.
- **The S&P/NZX 50 Index broke the 11,000 mark for the first time**. Attractive dividend yields and a weak currency boosted demand for New Zealand equities.
- **Hong Kong shares jumped to a 1-month high** after the *South China Morning Post* reported that Hong Kong Chief Executive Carrie Lam would **withdraw the contentious extradition bill**. Lam later confirmed that the bill would be permanently shelved; its withdrawal had been one of the main demands of protesters. Observers were split on the impact on future protests, with some arguing the move was "too little, too late," according to the *New York Times*. We believe the rebound in the stock market is mainly driven by sentiment and short-covering. **We remain cautious on the Hong Kong market and believe investors should stay defensive in terms of stock selection.**
- **Chinese officials said they will meet their U.S. counterparts in early October in Washington** to continue the trade negotiations. The prospect of talks was received positively by markets after the recent escalation of tension between the two sides.
- **China's State Council**, the chief administrative authority of the country, **is calling for a "timely" reduction in banks' required reserve ratios** to support the slowing economy. A growing number of private economists had recently lowered their 2020 China GDP growth forecasts to below 6% as a result of increasing risks from the trade war.
- **Japan's manufacturing activity contracted for the fourth month, but services activity expanded at the fastest pace in approximately two years.** Economists expect resilient domestic demand to offset some of the strong external trade-related pressures.
- **Singapore's economy is expected to expand by 0.6% in 2019, down from the previous forecast of 2.1%**, according to the latest survey of private economists by the Monetary Authority of Singapore. Escalating U.S.-China trade tensions remain the top downside risk. Meanwhile, the next general election in Singapore will likely take place in the next 10 months following the formation of the electoral boundaries committee.

MARKET SCORECARD

Data as of September 5, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,976.00	1.7%	18.7%	3.0%	21.1%
Dow Industrials (DJIA)	26,728.15	1.2%	14.6%	2.9%	22.9%
NASDAQ	8,116.83	1.9%	22.3%	1.5%	27.3%
Russell 2000	1,510.75	1.1%	12.0%	-12.6%	7.9%
S&P/TSX Comp	16,574.81	0.8%	15.7%	2.7%	9.8%
FTSE All-Share	3,990.65	1.0%	8.6%	-2.1%	-1.3%
STOXX Europe 600	385.92	1.7%	14.3%	2.7%	3.3%
EURO STOXX 50	3,484.70	1.7%	16.1%	5.1%	1.9%
Hang Seng	26,515.53	3.1%	2.6%	-2.7%	-4.4%
Shanghai Comp	2,985.87	3.5%	19.7%	10.4%	-11.8%
Nikkei 225	21,085.94	1.8%	5.4%	-6.6%	8.8%
India Sensex	36,644.42	-1.8%	1.6%	-3.6%	15.2%
Singapore Straits Times	3,147.06	1.3%	2.6%	-0.3%	-3.2%
Brazil Ibovespa	102,243.00	1.1%	16.3%	36.2%	41.7%
Mexican Bolsa IPC	42,731.48	0.3%	2.6%	-12.1%	-15.0%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,518.23	-0.1%	18.4%	26.8%	13.3%
Silver (spot $/oz)	18.64	1.4%	20.3%	31.4%	4.2%
Copper ($/metric ton)	5,724.25	1.2%	-3.8%	-2.2%	-16.7%
Oil (WTI spot/bbl)	56.30	2.2%	24.0%	-18.1%	15.7%
Oil (Brent spot/bbl)	60.80	0.6%	13.0%	-21.3%	13.9%
Natural Gas ($/mmBtu)	2.43	6.5%	-17.2%	-12.9%	-18.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.564%	6.8	-112.1	-133.9	-49.6
Canada 10-Yr	1.266%	10.2	-70.1	-97.5	-59.4
U.K. 10-Yr	0.600%	12.1	-67.7	-84.2	-42.6
Germany 10-Yr	-0.594%	10.6	-83.6	-97.4	-93.2

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.06%	0.3%	9.4%	10.8%	9.0%
U.S. Invest Grade Corp	2.77%	0.2%	14.2%	14.0%	12.1%
U.S. High Yield Corp	5.79%	0.0%	11.0%	6.7%	10.1%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	98.4010	-0.5%	2.3%	3.4%	6.7%
CAD/USD	0.7558	0.6%	3.1%	-0.4%	-6.5%
USD/CAD	1.3231	-0.6%	-3.0%	0.4%	6.9%
EUR/USD	1.1036	0.5%	-3.8%	-5.1%	-7.4%
GBP/USD	1.2330	1.4%	-3.3%	-4.5%	-5.4%
AUD/USD	0.6816	1.2%	-3.3%	-5.2%	-14.8%
USD/JPY	106.9800	0.7%	-2.5%	-4.1%	-1.7%
EUR/JPY	118.0600	1.1%	-6.2%	-9.0%	-8.9%
EUR/GBP	0.8951	-1.0%	-0.4%	-0.7%	-2.1%
EUR/CHF	1.0887	0.0%	-3.3%	-3.7%	-4.3%
USD/SGD	1.3841	-0.2%	1.6%	0.6%	2.3%
USD/CNY	7.1492	-0.1%	3.9%	4.7%	9.3%
USD/MXN	19.7309	-1.7%	0.4%	2.0%	10.2%
USD/BRL	4.1134	-0.8%	6.2%	-0.8%	32.0%

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 9:35 pm GMT 9/5/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 3.1% return means the Canadian dollar rose 3.1% vs. the U.S. dollar year to date. USD/JPY 106.98 means 1 U.S. dollar will buy 106.98 yen. USD/JPY -2.5% return means the U.S. dollar fell 2.5% vs. the yen year to date.

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Hold [Sector Perform]	588	40.80	114	19.39
Sell [Underperform]	81	5.62	2	2.47

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