March 8, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

# A walk on the wild side

Tom Garretson – Minneapolis

**A wild week in Washington resulting in trade tariffs has added another layer of uncertainty for markets, and complicates the outlook for what we expect to be the most important Fed meeting of 2018 this month.**

It has been another wild week in Washington D.C., with the departure of National Economic Council Director Gary Cohn on March 6 opening the door for the protectionist wing of the White House, and to the formal signing of steel and aluminum tariffs on March 8. It will take weeks and months to gauge the impact, and there are simply too many variables at the moment to form a cogent outlook, but we take a more detailed look at the potential ramifications on page 3.

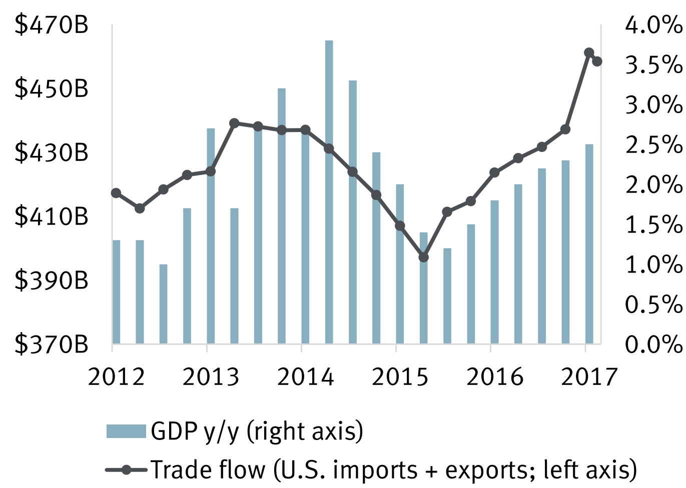
Suffice it to say that few analysts and economists see any positives from walking down the path of tariffs, and potentially stoking trade battles. But as the chart shows, there is a strong correlation between U.S. trade flows and economic growth. Both U.S. imports and exports have been on the rise—a reflection not only of domestic economic strength, but also of an improving global economic backdrop—and a decline in activity as a result of escalating trade wars would undoubtedly be a negative for global growth.

And while we foresee considerable uncertainty ahead, we walk through our latest thoughts on the upcoming Fed meeting, where we expect that same uncertainty to weigh on what is a widely anticipated meeting.

### Three rate hikes still the base case for 2018

The Fed's March 20–21 meeting might prove to be the most important of 2018. This will be the first to feature updated economic projections under new Chair Jay Powell, and more importantly, the first to feature those projections following the passage of the tax reform package in December.

Trade flows signal faster U.S. growth ahead, for now ...




Source - RBC Wealth Management, Bloomberg; GDP y/y data through December 2017, trade flow data through 1/31/18

## Market pulse





RBC Wealth Management

As the top chart shows, economic growth expectations have accelerated thus far in 2018, with the current consensus of 2.7% for the year now above the range that the Fed had expected at the December confab. At issue for the market is whether this will light a fire under the Fed, and lead officials to signal the need for four rate hikes this year, up one from their current forecast of three. Complicating matters for the Fed is that while tariffs could weigh on growth, they could also stoke inflationary pressures.

While we acknowledge that a pickup in growth could fuel an acceleration in inflation toward the Fed's target of 2%, and drive further gains in the labor market, we think the Fed will want to wait for more data, with the uncertainty around growth following President Trump's actions on tariffs only adding to our conviction that the Fed will keep the pace of rate hikes in 2018 steady at three for the time being.

## The Fed's "dot plot"

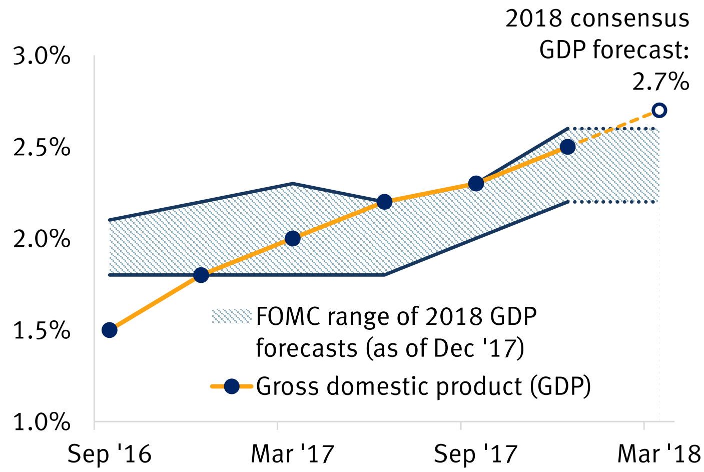
While we do not believe the Fed will desire to send a signal of four rate hikes this year to the markets at this meeting, we do think it will raise its rate hike forecasts for 2019 and 2020—adding one rate hike in each as a reflection of stronger growth and tighter labor markets over the next few years.

What might this mean for the 10-year yield outlook following the jump in yields to start 2018? Our long-held belief has been that the peak in the fed funds rate is likely to form a ceiling for the 10-year Treasury—as the 10-year did not trade above peak short-term rates during the last two rate hike cycles of the late 1990s and mid-2000s. The middle chart updates this view with our expectations for the Fed's rate hike forecast. If the Fed sees a fed funds rate of 3.25%–3.50% in 2020 following the March meeting, that could be the new ceiling for the 10-year over the near term; we don't think it's a coincidence that the current Bloomberg consensus now calls for a 10-year yield of 3.50% by 2020 as well.

## What can you do now?

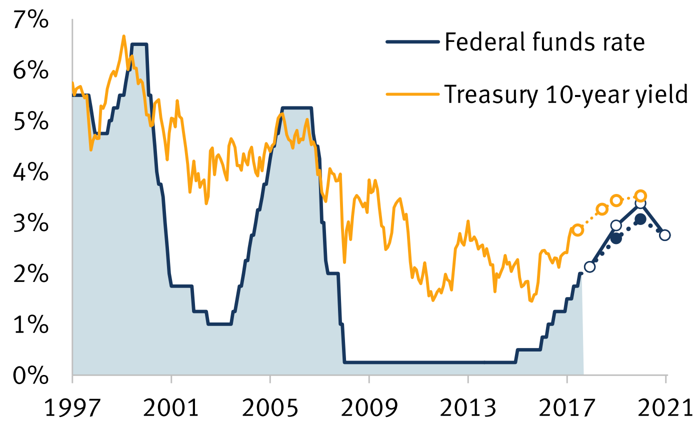
As we don't see much further upside risk for the 10-year Treasury yield for the rest of the year, we think the jump that we have already seen has opened up extremely attractive entry points into preferred shares, as shown in the bottom chart. Prices have fallen to some of the lowest levels in five years, and preferreds are now our favorite place to put money to work in fixed income.

2018 growth expectations running ahead of Fed forecasts



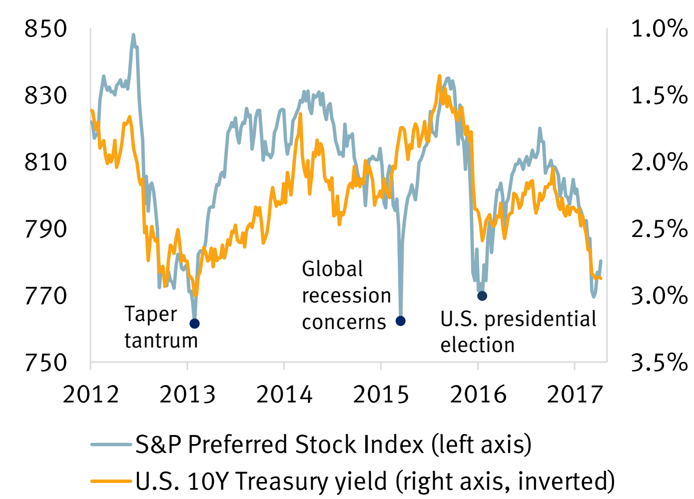

Source - RBC Wealth Management, Bloomberg February Consensus Survey, Federal Reserve

Fed likely to raise rate hike forecasts at March meeting




Source - RBC Wealth Management, Bloomberg consensus data, Federal Reserve Summary of Economic Projections; data through 3/8/18

Entry points: Preferred share prices at multiyear lows




Source - RBC Wealth Management, Bloomberg; data as of 9:30 am ET 3/8/18

In focus

# Protectionism rears its ugly head

Frédérique Carrier – London

The prospect of trade wars, dormant for months, reappeared with President Trump slapping tariffs on steel and aluminum. The resignation of his chief economic adviser, Gary Cohn, suggests the globalists within the administration are struggling to influence the president. The situation remains fluid even on the heels of the tariff proclamation being signed by President Trump, so we await the global response.

## Sabre-rattling

On March 1, the U.S. announced it would levy new tariffs of 25% on steel and 10% on aluminum imports from all countries. This may not be so consequential for the U.S. economy, as these imports represent a mere 0.25% of U.S. GDP, but it raises the prospect of a trade war if other countries retaliate.

This action comes on the heels of tariffs on softwood lumber, aerospace, solar panels, washing machines, and a "Buy American" campaign, while NAFTA is being renegotiated. Despite some signs of progress, recent news flow has been ominous, according to RBC Global Asset Management Chief Economist Eric Lascelles. He estimates there is a 40% probability of a bad NAFTA outcome (35% chance it is torn up, 5% chance a bad deal is struck).

## Trade wars and economies

The tariffs will initially include exemptions for Canada and Mexico, while other countries will be able to apply for exemptions. Regardless, we still foresee significant global risks following these measures.

As for the U.S., assessing the economic impact of tariffs depends on assumptions regarding domestic supply and demand, the currency response, and the scale of retaliation, among others.

Broadly, tariffs tend to be negative for growth. Lascelles points to the 2002 U.S. experience, when the Bush administration imposed tariffs on steel and other countries retaliated. Today, given that steel imports are worth a mere 0.25% of U.S. GDP, he calculates no more than a 0.1% or 0.2% hit to U.S. GDP.

Protectionism also tends to increase inflation. Deprived of imports, a country must either rely on scarce domestic products or pay punitive duties for imported products, though the extent of the increase in inflation depends on any currency adjustment. Theoretically, U.S. protectionism should be dollar positive, but prior episodes were negative for the dollar.

### The protectionist landscape in 2018

| Protectionism delivered | Protectionism pending |
|---|---|
| **United States** | **United States** |
| • Killed TPP trade deal | • NAFTA renegotiation |
| • Softwood lumber tariff | (40% chance of bad outcome) |
| • Bombardier tariff (rescinded) | • Trade war brewing? |
| • Washing machines tariff | • Chinese intellectual property |
| • Solar panels tariff | • Chinese trade more generally |
| • Steel & aluminum tariffs | • Korean FTA renegotiation |
| • "Buy American" | |
| **United Kingdom** | **United Kingdom** |
| • Brexit vote | • Brexit outcome |
| **Globally** | **Canada** |
| • Non-tariff barriers rising | • Provincial trade war? |
| **... Fighting back** | **... Counterpoints** |
| • Canada retaliates via WTO, Chapter 19, "Buy Canadian" | • 11 countries sign CPTPP Cdn CETA & interprovincial deal |

Source - RBC Global Asset Management

With higher inflation, U.S. monetary policy would have to be adjusted accordingly, potentially shortening the business cycle.

## Cooler heads should prevail

A full-blown trade war is not inconceivable, but it is a low probability event, in our view. Too many countries realize its perils, even though the EU has pledged to "react firmly" and China could consider retaliatory options (e.g., against Boeing, agriculture, tech, stopping Treasury purchases).

Moreover, Republican leaders are trying to persuade President Trump to reconsider and the WTO is the arbiter of such disputes—the Bush steel tariffs were unwound 10 months later, as the WTO deemed them out of bounds.

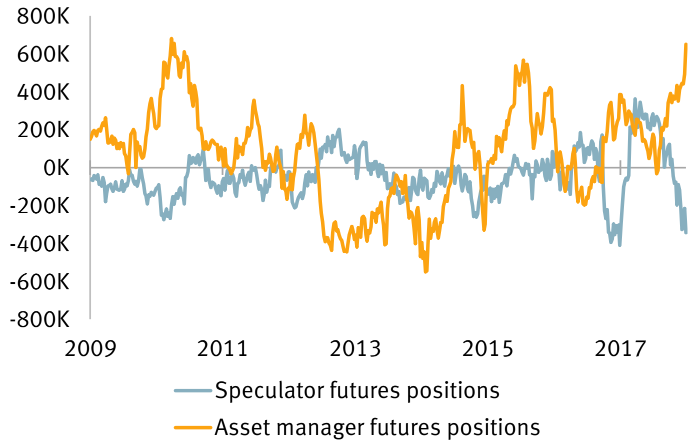
Stock and bond markets do not seem to be pricing in much risk of a trade war, though the Canadian dollar's precipitous fall suggests it has priced in a negative outcome. The U.S. tax cuts and a resilient U.S. economy have been the driving force of U.S. financial markets. A full NAFTA withdrawal would send a powerful message to financial markets about protectionism and a major trade war would darken economic prospects.

## United States

Bill Kuehn & Sam Renikoff – Minneapolis

- The primary debt market was tested during the week with the **third-largest corporate bond issuance ever**, as CVS Health Corp. (Baa1 Negative/BBB Stable) issued $40B of debt on March 6, in order to finance its acquisition of health insurer Aetna Inc., after initially raising $49B in bridge loans in late 2017. The issuance was widely perceived as a **test of buyer demand** in the highest rate environment since 2012, and based on the 3x oversubscribed deal and subsequent $450M rally in market value for the newly issued debt, **it appears investor appetite for corporate credit remains strong**.
- **A showdown has built up between long-term asset managers and shorter-term hedge fund speculators in the Treasury futures market**, with the gap between the number of outstanding futures positions reaching its widest level since 2007. According to the Commodity Futures Trading Committee (CFTC), asset managers have built up 650,000 long positions in 10-year Treasury futures, while speculators have compiled 343,000 short positions. This points to the view that most long-term money managers still see value in bonds despite the recent run-up in yields, while speculators see further short-term pain in the bond market. To us, this tilts the risk to yields to the downside, as any lower-than-expected inflation data will likely trigger a rush from speculators to cover their short positions, driving downward pressure on bond yields.
- **The U.S. trade deficit widened by 5% in January**, more than forecast by the consensus and to the **widest levels since October 2008**. Expectations were for a surge in imports into the U.S. as companies attempted to bring in raw materials and other goods ahead of steel and aluminium tariffs enacted by President Trump on March 8, especially after small tariffs were enacted on solar panels and washing machines in January. However, the widening of the trade deficit was **a result of a 1.3% decline in exports abroad, while imports remained little changed**.
- This trade data plays right into the president's hands on imposing tariffs in the face of widening trade deficits—especially after a swelling trade deficit in Q4 subtracted 1.13% from GDP, breaking the two-quarter streak of +3% q/q GDP growth. **The Atlanta Fed GDP Now model reduced the estimate for Q1 2018 economic growth from 3.5% to 2.8%**, citing the decline in the contribution of net exports from -0.43% to -0.59% on the trade balance release.

A showdown is brewing in the U.S. Treasury market



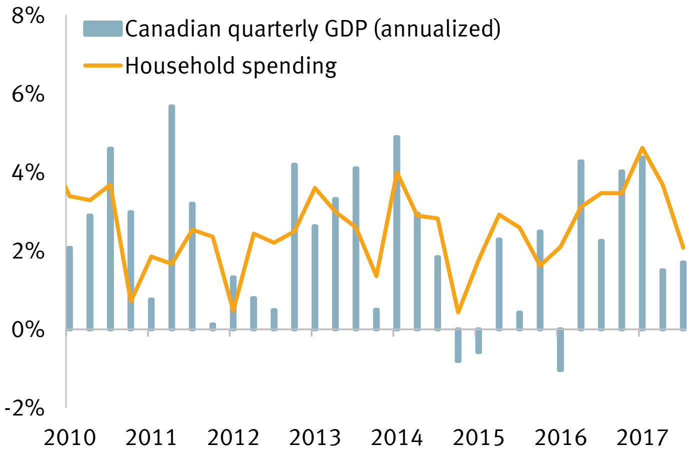

Source - RBC Wealth Management, Bloomberg; data through 3/5/18

## Canada

Richard Tan & Farazeh Mahboob – Toronto

- The new tariffs proposed by the U.S. on steel and aluminum have indefinitely exempted Canada. It is worth noting that Canada is the largest exporter of both steel and aluminum to the U.S., and these exports make up 0.7% of Canada's GDP. **The conversation around the uncertainty of tariffs levied against other trade partners serves to further exacerbate heightened tensions** between the two regions amid NAFTA renegotiations.
- **Real GDP increased by an annualized rate of 1.7% in Q4, capping off a 3% growth rate in 2017** and outpacing 2016's 1.6%. Although Q4 GDP was below the market's expectation of 2.0%, a moderation of growth was expected following outsized growth in Q1 and Q2 of last year. However, NAFTA uncertainty and corporate tax reform in the U.S. pose sizeable risks to Canadian trade and competitiveness, and thus a risk to GDP growth going forward (see chart on following page).
- **The Bank of Canada kept interest rates on hold**, as was largely expected, citing trade policy developments as a growing source of uncertainty to its outlook. The governing council acknowledged Q4 GDP was slower than expected, as **household credit growth decelerated** for three consecutive months amidst higher interest rates and record high levels of debt. Uncertainties to trade and how the housing market reacts to recently introduced lending rules, at a time when the output gap is effectively closed, is likely to keep the central bank heavily data dependent and in a **gradual hiking pattern over the course of the year**.
- Despite the uptick in oil prices year to date, RBC Capital Markets believes that **oil producers may be unwilling**

### Growth cools off in Canada on deceleration in household spending




Source - RBC Wealth Management, Bloomberg; data through 3/2/18

**to invest in capital-intensive long-term projects given depressed futures prices**, which remain anchored in the low-to-mid-$50 per barrel range. RBC Capital Markets believes that outside of short-cycle shale, the majority of global oil projects are planned and budgeted based on the dated portion of the futures curve, which is a discount to current oil prices.

## Europe

Frédérique Carrier & Thomas McGarrity – London

- It has been an **eventful 10 days regarding Brexit**. While our base case continues to be that the U.K. will eventually negotiate a trade deal with the EU, we would now assign a slightly lower probability to that outcome (some 65% vs. 75%). In turn, we believe the probability of other outcomes, such as a chaotic Brexit or Brexit being abandoned altogether, have both increased over the 10-day period.
- Against the backdrop of an uncompromising EU, U.K. **Prime Minister Theresa May adopted a conciliatory tone** and suggested in a keynote speech **her vision of Brexit**, i.e., leaving the single market and customs union, while aiming to stay aligned with EU regulation where possible. The **EU is unmoved**, and the lack of detail, such as no indication of how a hard border in Ireland can be avoided, highlights how **both parties are still**, even this late in the game, **so far apart**. We estimate the probability of a hard Brexit at some 25%.
- Meanwhile, we believe the **probability of no Brexit has also edged up** to some 10%, due to the recent crystallisation of a loose alliance of Labour and Conservative members of Parliament who want to stay in the customs union, a new challenge for Prime Minister May.
- Politics were also the key focal point in Europe. The **Italian elections were inconclusive** though the larger-than-expected gains by the Five Star Movement (32% of the vote) suggest a **sizeable support for populism**. It falls to the president of Italy, Sergio Mattarella, to orchestrate coalition negotiations. While the case for investing in Europe remains, we acknowledge that **political risk has intensified** somewhat at a time when economic growth momentum, while still high, is no longer accelerating.

## Asia Pacific

Jay Roberts – Hong Kong

- **The Reserve Bank of Australia (RBA) kept its benchmark interest rate unchanged at 1.5%**, as forecast. This means the benchmark has been unchanged for 19 consecutive months. RBC Capital Markets is keeping to its base case for no change to the rate for the rest of 2018, with the RBA remaining patient despite policy changes from global counterparts. Notably, the RBA mentioned in its statement that the **housing markets in both Sydney and Melbourne had slowed**.
- **The Japanese economy capped off a good performance in 2017 with Q4 growth of 1.6% y/y**, quite a bit higher than the preliminary reading of 0.5%. This marked the eighth consecutive quarter of expansion in Japan, the longest stretch in 30 years. However, some economic indicators have been softer in 2018, while the strength of the yen is proving to be a headwind for Japanese stocks.
- **The yen strengthened further** after comments from Bank of Japan Governor Haruhiko Kuroda about a **possible timetable for policy normalization**, the first time he has made such comments. Kuroda stated, "Right now, the members of the policy board and I think that prices will move to reach 2% in around fiscal 2019. So it's logical that we would be thinking about and debating exit at that time too."
- Chinese bank stocks trading in Hong Kong, such as ICBC (1398.HK) and China Construction Bank (939 HK), received a boost on news that **Chinese authorities may relax rules regarding provisioning requirements against nonperforming loans**. The bad-loan coverage ratio will be reduced to 120% from 150%, which could free up capital for banks.

## MARKET SCORECARD

### Data as of March 8, 2018

| Equities (local currency) | Level | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| S&P 500 | 2,738.97 | 0.9% | 2.4% | 15.9% | 38.4% |
| Dow Industrials (DJIA) | 24,895.21 | -0.5% | 0.7% | 19.4% | 46.8% |
| NASDAQ | 7,427.95 | 2.1% | 7.6% | 27.2% | 59.8% |
| Russell 2000 | 1,571.97 | 3.9% | 2.4% | 15.1% | 47.2% |
| S&P/TSX Comp | 15,538.70 | 0.6% | -4.1% | 0.3% | 16.7% |
| FTSE All-Share | 3,979.76 | 0.0% | -5.7% | -0.3% | 18.3% |
| STOXX Europe 600 | 376.62 | -0.8% | -3.2% | 1.1% | 11.6% |
| EURO STOXX 50 | 3,413.28 | -0.7% | -2.6% | 0.7% | 13.7% |
| Hang Seng | 30,654.52 | -0.6% | 2.5% | 28.9% | 53.2% |
| Shanghai Comp | 3,288.41 | 0.9% | -0.6% | 1.5% | 13.3% |
| Nikkei 225 | 21,368.07 | -3.2% | -6.1% | 11.0% | 27.3% |
| India Sensex | 33,351.57 | -2.4% | -2.1% | 15.4% | 35.2% |
| Singapore Straits Times | 3,480.44 | -1.1% | 2.3% | 10.7% | 25.3% |
| Brazil Ibovespa | 84,984.61 | -0.4% | 11.2% | 31.3% | 73.1% |
| Mexican Bolsa IPC | 48,240.00 | 1.7% | -2.3% | 1.5% | 8.4% |

| Commodities (USD) | Price | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| Gold (spot $/oz) | 1,322.37 | 0.3% | 1.5% | 9.4% | 4.8% |
| Silver (spot $/oz) | 16.50 | 0.5% | -2.6% | -4.3% | 7.5% |
| Copper ($/metric ton) | 6,909.75 | 0.2% | -4.1% | 20.2% | 41.6% |
| Oil (WTI spot/bbl) | 60.12 | -2.5% | -0.5% | 19.6% | 64.7% |
| Oil (Brent spot/bbl) | 63.86 | -2.9% | -4.5% | 20.2% | 61.1% |
| Natural Gas ($/mmBtu) | 2.75 | 3.0% | -7.0% | -5.3% | 60.4% |

| Govt bonds (bps chg) | Yield | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| U.S. 10-Yr Tsy | 2.855% | -0.5 | 45.0 | 29.6 | 102.7 |
| Canada 10-Yr | 2.224% | -1.1 | 17.9 | 44.6 | 104.2 |
| U.K. 10-Yr | 1.474% | -2.7 | 28.4 | 25.6 | 8.9 |
| Germany 10-Yr | 0.628% | -2.8 | 20.1 | 25.8 | 44.6 |

| Fixed Income (returns) | Yield | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| U.S. Aggregate | 3.18% | -0.1% | -2.2% | 1.4% | 1.9% |
| U.S. Invest Grade Corp | 3.76% | -0.3% | -2.8% | 3.2% | 7.8% |
| U.S. High Yield Corp | 6.19% | -0.3% | -0.5% | 4.6% | 23.2% |

| Currencies | Rate | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| U.S. Dollar Index | 90.1310 | -0.5% | -2.2% | -11.7% | -7.3% |
| CAD/USD | 0.7750 | -0.6% | -2.6% | 4.6% | 3.9% |
| USD/CAD | 1.2904 | 0.6% | 2.6% | -4.4% | -3.8% |
| EUR/USD | 1.2311 | 1.0% | 2.5% | 16.8% | 11.8% |
| GBP/USD | 1.3809 | 0.4% | 2.2% | 13.5% | -2.9% |
| AUD/USD | 0.7786 | 0.3% | -0.3% | 3.4% | 4.7% |
| USD/JPY | 106.1900 | -0.5% | -5.8% | -7.1% | -5.7% |
| EUR/JPY | 130.7300 | 0.5% | -3.4% | 8.5% | 5.4% |
| EUR/GBP | 0.8915 | 0.6% | 0.4% | 2.9% | 15.1% |
| EUR/CHF | 1.1709 | 1.7% | 0.1% | 9.5% | 6.8% |
| USD/SGD | 1.3175 | -0.6% | -1.4% | -7.1% | -4.9% |
| USD/CNY | 6.3422 | 0.2% | -2.5% | -8.3% | -2.5% |
| USD/MXN | 18.6592 | -0.9% | -5.1% | -5.1% | 4.1% |
| USD/BRL | 3.2645 | 0.5% | -1.4% | 3.0% | -13.1% |

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX and 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 9:49 pm GMT 3/8/18.

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 106.19 means 1 U.S. dollar will buy 106.19 yen. USD/JPY -5.8% return means the U.S. dollar fell 5.8 vs. the yen year to date.

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Distribution of Ratings - RBC Capital Markets, LLC Equity Research
As of December 31, 2017

| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| Buy [Top Pick & Outperform] | 868 | 52.42 | 281 | 32.37 |
| Hold [Sector Perform] | 683 | 41.24 | 155 | 22.69 |
| Sell [Underperform] | 105 | 6.34 | 8 | 7.62 |

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### Ratings:

Top Pick (TP): Represents analyst's best idea in the sector; expected to provide significant absolute total return over 12 months with a favorable risk-reward ratio. Outperform (O): Expected to materially outperform sector average over 12 months. Sector Perform (SP): Returns expected to be in line with sector average over 12 months.

Underperform (U): Returns expected to be materially below sector average over 12 months.

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