RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Geopolitical gyrations

Laura Cooper – London

Geopolitical angst and other factors have made for quite the mercurial market of late. But investors shouldn't be vexed by the volatility as we think markets are suffering from a bout of indigestion that will take some time to get over, and the economic cycle should have further to run.

It was a turbulent October with the swoon in global equities erasing year-to-date gains across indexes. Markets found welcome relief near month-end on the back of U.S. earnings beats and easing geopolitical tensions; however, the reprieve failed to unwind the broad October selloff that saw roughly $8 trillion in global market value wiped out.

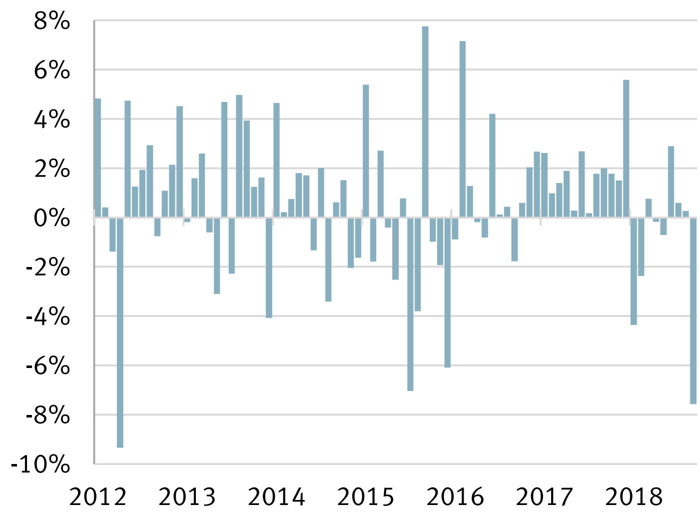
The S&P 500 shed 6.9% of its value during the month to record its worst monthly performance since September 2011. The tech-heavy NASDAQ sank close to correction territory, down 9% from its early October peak. Investor fears of tightening financial conditions and a global growth slowdown were exacerbated when earnings calls signaled growing headwinds facing U.S. companies.

The market jitters extended beyond the U.S. with European equities posting the worst month since early 2016. The MSCI AC Asia Pacific Index sank to April 2017 lows, while emerging market pressures were evident with the MSCI Emerging Markets Index falling close to 8%.

The global rout rattled investor confidence and raised concerns that the bull market for equities has tipped. In our view, markets are in a transition period, suffering from a bout of indigestion that typically occurs 4–6 months after peak U.S. earnings growth, and are at the same time absorbing other risks. RBC Capital Markets, LLC's Head of U.S. Equity Strategy Lori Calvasina suggests that while a further leg lower is possible as markets recalibrate to the shifting backdrop, still positive U.S. earnings growth and solid economic fundamentals point to the cycle having more room to run.

Global stocks post worst monthly loss since 2012

Monthly performance of the MSCI All-Country World Index



Source - RBC Wealth Management, Bloomberg; month-over-month change through 10/31/18

Market pulse

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Priced (in USD) as of 11/1/18 market close, EST (unless otherwise stated).
For important disclosures and required non-U.S. analyst disclosures, see page 8.

Not out of the woods yet

In assessing the events of October, beyond Federal Reserve policy uncertainties, earnings missteps, and a growth slowdown, geopolitics appear to be increasingly weighing on investor nerves. From U.S.-China trade tensions and deteriorating relations between Saudi Arabia and the U.S. to Italian budget fears and Brexit, risk appetite is taking greater guidance from political developments—a theme that could persist beyond the U.S. midterm elections.

From fiscal fears …

Politics has been at play in Europe with investor nerves frayed by a clash emerging around the Italian government's budget plan. The EU officially rejected the country's draft budget proposal on October 23, taking the unprecedented step of demanding that a member state revise its plan. The move exacerbated funding pressures in Italy with Italian 10-year government bond yields punching higher and keeping the spread with German 10-year Bunds at its widest levels since mid-2013.

Eroding risk appetite in the region has weighed on European assets with the euro and Italian bank stocks coming under pressure. The mid-November deadline to submit a revised budget plan points to challenges persisting in the near term. But with further spread widening likely to put unsustainable strain on Italian banks, the incentive to reach an agreement appears to be strong, in our view.

… to desert storms

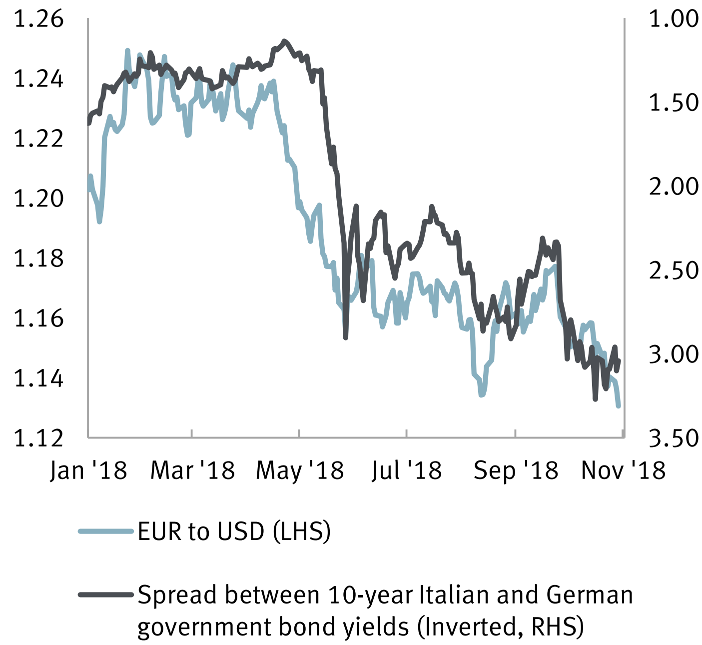
A potential collision course is not limited to within Europe. U.S. President Donald Trump recently escalated his criticism of the Fed and the pace of interest rate increases. However, markets focused instead on the busy U.S. earnings calendar and high-profile misses and warnings. Wage pressures and rising labor costs are emerging as the greatest headwinds being cited by companies, followed closely by commodity prices (see lower chart).

Crude oil prices have come off of recent highs, yet with the U.S. considering imposing punitive measures on Saudi Arabia following the death of *Washington Post* journalist Jamal Khashoggi, rising tensions in the region could impact the oil market. Global oil supply depends on Saudi Arabia increasing production further to counter Iranian oil being removed from the market. Therefore, if the Saudis scale back production this could push an already bullish outlook for crude oil prices to uncomfortable levels for the global economy.

Trade tensions deepening …

Geopolitical tensions around the U.S.-China trade dispute and the deepening, multi-faceted rivalry between the two countries are also spilling over into earnings season with a more negative tone emerging around tariffs. The accompanying squeeze to company margins from the rise in

Italian political pressures weighing on risk sentiment



Source - RBC Wealth Management, Bloomberg; data through 10/31/18

Key headwinds emerging from U.S. earnings calls

Number of companies reporting

Source - RBC US Equity Strategy, Alphasense; based on companies reporting as of 10/25/18 input costs is aggravating existing headwinds from U.S. dollar strength, and underpinning growing investor caution.

At the same time, dollar strength has been bolstered by the confluence of geopolitical developments contributing to investors seeking relative safety in U.S. assets. This trend of sustained dollar gains alongside the impact of trade tariffs is exerting strains beyond earnings reports: emerging markets came under renewed pressure in October.

Chinese equities tumbled in October, and prompted political intervention to ease market fears. Comments from China's central bank, the China Securities Regulatory Commission, and Vice Premier Liu He provided temporary support to the market, with greater political intervention likely needed to restore investor confidence, in our view, especially as economic indicators have weakened further.

… as Brexit frictions brew

Political pressures emanating from the negotiations of the U.K.'s departure from the EU continue to grip investor attention. Fading optimism that a withdrawal agreement will be reached and then ratified by the 27 EU member states and the U.K. House of Commons is weighing across assets. The FTSE 100 and British pound against the U.S. dollar both slipped to multi-month lows in October alongside a rally in U.K. Gilts.

In our view, a withdrawal agreement between the U.K. and EU will likely be reached later this year. However, the challenge of getting such a deal through the U.K. House of Commons and the potential flare-up of political frictions within the current government point to pressures likely persisting. The fluidity of the situation and uncertainty around the outcome suggest greater volatility as the political drama plays out.

Don't be vexed by volatility

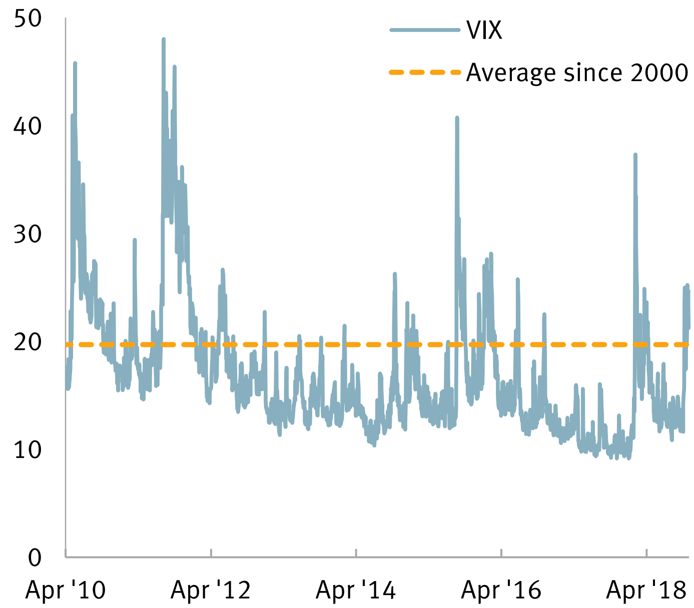
Heightened uncertainty around the U.S. midterm election outcome could drive further bouts of market volatility. But this is similar to what often occurs surrounding midterm elections, regardless of how high the stakes are or which party wins.

Even so, despite geopolitics contributing to the choppy market terrain that lies ahead, this reflects a return to volatility that is more in line with what we would expect after a period of ultralow volatility.

The events of October highlight the recalibration of investor expectations that is warranted as the U.S. business cycle advances to the "late cycle" and because of the possibility the Fed could shift gears to a more aggressive approach. Tightening financial conditions are contributing to recession risks creeping somewhat higher, yet indicators still point to the probability of a U.S. downturn remaining low. Geopolitical risks are adding to the speed bumps that lie ahead for equity markets; however, we do not see a slamming of the brakes on market performance for now.

Volatility: getting back to normal

S&P 500 Volatility Index (VIX)



Source - RBC Wealth Management, CBOE, Bloomberg; data through 10/31/18

Canada in focus

Canadian Utilities: A reset in valuations

Joseph Wu, CFA – Toronto

The Utilities sector has been at the centre of the rout in interest rate-sensitive stocks as rising bond yields have triggered an indiscriminate rotation out of so-called "bond proxies" in equity markets. For risk-averse investors focused on income or seeking to shore up portfolio resilience for periods of market volatility, we believe the recent stretch of poor performance in the Utilities sector has created potential pockets of opportunity to add exposure to companies with solid outlooks for stable dividend growth.

A rates-driven swoon

Rising interest rates are typically not conducive to the performance of dividend equities because they bolster the attractiveness of safer alternatives, such as government bonds, and diminish the relative appeal of income-producing stocks. Given its status as the premier "bond proxy," the S&P/TSX Utilities Index has borne the brunt of the adverse impact of higher rates on traditional dividend sectors, slumping roughly 10% year to date as yields on 10-year Government of Canada (GoC) bonds rose to approximately 2.50% from 2.05%.

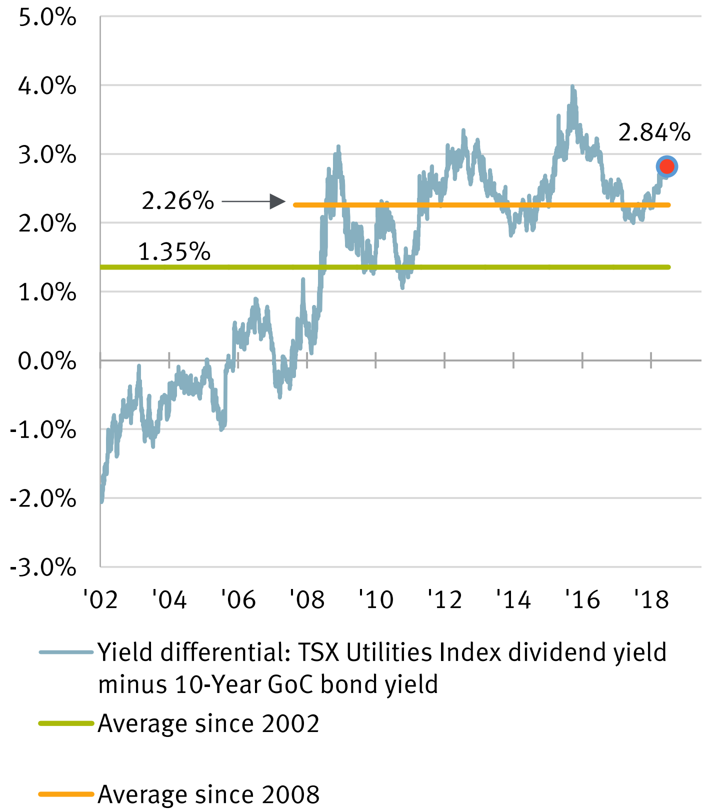
This near 50 basis point uptick in long-term GoC bond yields has facilitated a desirable reset in valuations, in our view. The yield advantage of the S&P/TSX Utilities Index relative to the S&P/TSX Composite has widened to 2.20%, up from 1.40% at the onset of the year and above the long-term average of 1.86%. Relative to long-term GoC bond yields, the Canadian Utilities sector now possesses a yield advantage of 2.84% based on trailing 12-month dividends, up from 2.10% at the start of the year (see chart).

Be selective

An environment of higher bond yields has caused investors to recalibrate their expectations in rate-sensitive Utilities stocks. The upshot is that the risk/reward profile for Canadian Utilities stocks has meaningfully improved.

In addition to the mid-single-digit dividend growth penciled in by the consensus for 2019, the sector now boasts a more enticing dividend yield of 5.33%, up from 4.14% at the start of the year and less than 4% as recently as mid-2017. Looking beneath the surface, more than half of the constituents in the 16-member S&P/TSX Utilities Index are down in excess of 10% year to date. We believe this broad-based pullback offers income-oriented investors an opportunity to evaluate potential bargains in an unloved sector where near-term sentiment appears to be washed out.

Dividend yield advantage of Canadian Utilities sector over GoC bond yields has expanded to more attractive levels



Source - Bloomberg; data through 10/31/18

Nevertheless, while the bulk of the recent backup in bond yields is arguably already reflected in the current valuations of the Utilities sector, our prevailing view that rates are likely to retain an upward bias over the coming year suggests the macro backdrop could remain a headwind for the sector's performance for a while longer. Investors should exercise patience and selectivity when appraising opportunities in the Canadian Utilities sector, focusing on companies with stronger balance sheets, lower funding needs, and above-average cash flow and dividend growth visibility.

Pricing in this article as of 10/31/18, unless otherwise stated.

United States

Ben Graham, CFA – Minneapolis

- **Investors should be glad to see October in their rear view mirrors,** as the **S&P 500's 6.9% decline** was its worst calendar month since the 7.2% selloff in September 2011. To be fair, the **peak-to-trough decline in January and February of this year was 10.2%**, compared to a drop of 9.9% for the current selloff.
- In terms of recent trading sessions, after hitting an intraday bottom on October 29, **U.S. equities bounced into month end**. The **NASDAQ jumped more than 3.6%** into the end of the month while the worst-performing major U.S. index during this correction, the small-cap **Russell 2000, gained 2.3%**. The rallies were led by outperformance in the Financials, Materials, and Communications Services sectors. **Bond proxies struggled in recent days** as a risk-on sentiment returned during the final trading sessions of October. Despite the end-of-month bounce, **many stocks remain in correction territory**. In fact, 70% of S&P 500 companies are trading more than 10% below their 52-week highs and a surprising 39% are in full-blown correction territory, defined as trading more than 20% below their 52-week highs.
- From a rates perspective, **the yield curve held up better than equities**. Despite the negative moves that stocks experienced, the spread between 2-year and 10-year Treasury yields held steady at 25 basis points (bps) throughout much of the equity correction, and the yield spread widened to 29 bps with the bounce in equities in recent days.
- Recently released economic data has demonstrated the **ongoing durability of the U.S. economy that is underpinning financial markets**. Third-quarter GDP of 3.5% q/q annualized came in ahead of consensus expectations of 3.3%, and while the ISM Manufacturing PMI of 57.7 missed the consensus forecast, it remains elevated and **indicative of an expanding economy**.

More than 70% of companies remain more than 10% below their 52-week highs

S&P 500

Distance below 52-wk. high	Number of firms	Percent of S&P 500
Less than 5%	55	11.0%
›5% and ‹10%	94	18.7%
›10% and ‹15%	78	15.5%
›15% and ‹20%	80	15.9%
›20% and ‹25%	62	12.4%
›25% and ‹30%	54	10.8%
Greater than 30%	79	15.7%

Source - RBC Wealth Management, FactSet; data through 10/31/18

Canada

Arete Zafiriou & Carolyn Schroeder – Toronto

- **The large Canadian banks reported solid third-quarter results**, with most beating EPS consensus estimates. Looking ahead, RBC Capital Markets anticipates **slower growth** for the Canadian banks **in 2019–2020**. RBC Capital Markets forecasts an average return on equity of approximately 16% during that period and expects EPS growth to slow to roughly 5% on average in 2019/2020 (compared to 11% EPS growth achieved in 2017). Among other factors, the slowdown reflects RBC Capital Markets' expectation of a deceleration in Canadian consumer loan growth due to elevated consumer debt levels, slower GDP growth, and rising interest rates.
- Because banks represent a significant portion of the Canadian market, they have a meaningful impact on Canadian market performance and earnings trends. **The Big Six Banks account for approximately 23.6% of the S&P/TSX Composite Index**. That weight is modestly **below its peak of 24%** in the beginning of 2018 and up from its low of 15% in late 2008. According to RBC Capital Markets, the Canadian banks **have delivered solid total returns (including dividends) to shareholders** over the medium and long term, with returns growing at an average compound annual growth rate of 12% in the last three years, 10% in the last five years, and 13% in the last 10 years.
- In RBC Capital Markets' view, the **Canadian banks differ from each other more today than they have in the past**—business mixes are not as homogenous, performance within business lines can vary materially, and geographic sources of revenues are evolving. The Big Six **have generally traded in a fairly narrow price-to-earnings (P/E) range**, with the gap between the most highly valued bank and the lowest valued bank typically around 2–3 P/E multiple points. While the P/E ratio is typically the most commonly used method to value banks, RBC Capital Markets points out price-to-book multiples should not be ignored as their importance increases when the earnings outlook is murky.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The U.K. budget contained no real surprises**, as expected. Two much-discussed measures put forward by the chancellor of the exchequer were a **2% tax on digital services and a new plastics tax**. **The former** is intended to ensure that the amount of tax paid reflects the value companies derived from their U.K. assets. It is **aimed at large U.S. tech firms that operate in the U.K. but pay little in taxes** and at business-to-business digital activity, such as online advertising. Analysts believe U.K. online retailers will benefit from double taxation relief.

- As for the **plastics tax**, few details are available, though it will likely **impact large users of plastics, such as consumer goods companies (e.g., Unilever, Danone)** as well as some packaging firms. Those focusing on sustainable packaging, however, should benefit from the move, in our view.
- There was much discussion among market participants surrounding the **changing German political landscape**, with Chancellor Angela Merkel stepping down as head of the Christian Democratic Union party. A change of government is now increasingly likely over the next two years. It would be the end of an era after the 13-year tenure of such a commanding political figure. However, **we do not foresee a material change in either domestic policy** (Germany enjoys a budget surplus of 1% of GDP) **or international policy** (in particular with regards to Brexit).
- **55% of STOXX Europe 600 companies expected to report have now released Q3 results**. So far, 52% have beaten earnings per share (EPS) estimates, broadly in line with the historical median, while overall EPS growth is running at 10% y/y, 1% ahead of consensus expectations. With EPS growth of 59% y/y the **Energy sector is giving a notable boost** to the aggregate growth figure. Stripping this out, overall EPS growth for the STOXX Europe 600 would be a more modest 4%.
- Somewhat reassuringly, **revenue growth remains relatively healthy** at 6% y/y, with **eight of the 11 sectors recording positive sales growth**, though again boosted by the Energy sector. Ex-Energy aggregate sales growth would be 3% y/y. The Financials and Consumer Staples sectors, which constitute around 20% and 13% of the STOXX Europe 600, respectively, are printing -1% and -4% y/y sales growth. Low interest rates in Europe continue to impact banks' top-line growth, while currency volatility in emerging markets, where many Consumer Staples companies generate a significant proportion of sales, has impacted the Consumer Staples sector in Q3.

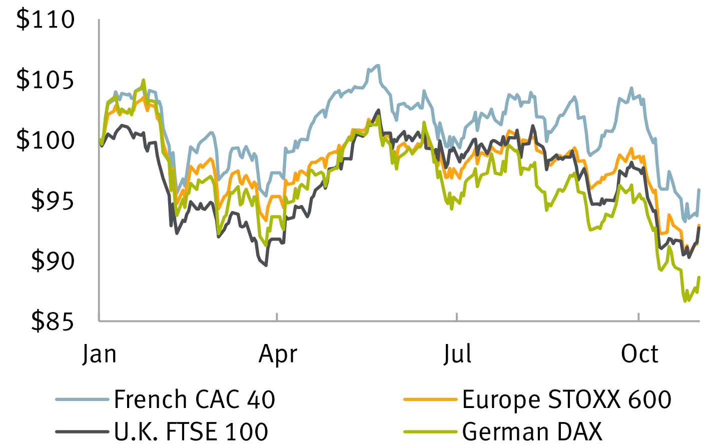
Asia Pacific

Jay Roberts, CFA – Hong Kong

- **The MSCI AC Asia Pacific Index posted its worst month of the year in October** and entered a bear market. Year to date, the index was down 22% from its January high before rallying later in the week. The **decline of Asian equities**, spearheaded by Chinese stocks, **should be framed against a powerful rally** in Asian equities in 2017. The index is back to its level of April 2017.

2018 returns for various European indexes

Hypothetical local currency returns indexed to $100



Source - RBC Wealth Management, Bloomberg; data through 10/31/18

- **Japanese equities gave up the good gains achieved in September**. The **TOPIX declined by 10.2%** in October. The index has fallen in 6 out of 10 months in 2018 with the drop in October by far the largest. The **Shanghai Composite** has also posted a **negative performance** in six separate months. However, among Asia's largest bourses, the **Hang Seng Index** holds the dubious distinction of the **most monthly declines**, falling in 8 out of 10 this year.
- In last week's *Global Insight Weekly* (pages 6-7), we discussed how **equity valuations**, largely irrelevant in 2018, **have started to come into play again** in certain markets due to the size of the selloff. Among these is Japan, which we recently upgraded to Overweight.
- South Korean electronics giant **Samsung Electronics (005930 KS) posted a slight earnings beat**, aided by strength in its memory chip business, with earnings of KWR13T ($11.4B). Shares rose. The stock has been fairly weak this year following a particularly strong year in 2017.
- **HSBC** (5 HK), the largest bank in Europe and Hong Kong, announced **better-than-expected results**. Loan growth improved along with margins while the bank also showed decent control of costs. The stock rallied strongly having declined nearly 30% from its peak in January.
- The **big China banks also reported reasonable earnings**, showing modest loan growth and reasonable credit quality. The sector has corrected meaningfully since tariffs were introduced by the U.S. in May. **Bank of China (3988 HK) announced that it will raise as much as CNY120B ($17B)** via a sale of preferred shares to improve its capital position as tougher global capital standards come into effect in 2019.

MARKET SCORECARD

Data as of November 1, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,740.37	1.1%	2.5%	6.2%	29.8%
Dow Industrials (DJIA)	25,380.74	1.1%	2.7%	8.3%	40.7%
NASDAQ	7,434.06	1.8%	7.7%	10.7%	44.3%
Russell 2000	1,544.98	2.2%	0.6%	3.5%	31.2%
S&P/TSX Comp	15,150.15	0.8%	-6.5%	-5.5%	2.5%
FTSE All-Share	3,907.10	0.1%	-7.5%	-5.2%	4.2%
STOXX Europe 600	363.08	0.4%	-6.7%	-8.5%	8.3%
EURO STOXX 50	3,204.21	0.2%	-8.6%	-13.3%	6.0%
Hang Seng	25,416.00	1.7%	-15.1%	-11.1%	9.8%
Shanghai Comp	2,606.24	0.1%	-21.2%	-23.3%	-16.5%
Nikkei 225	21,687.65	-1.1%	-4.7%	-3.3%	24.3%
India Sensex	34,431.97	0.0%	1.1%	2.5%	23.5%
Singapore Straits Times	3,060.85	1.4%	-10.1%	-9.8%	8.8%
Brazil Ibovespa	88,419.05	1.1%	15.7%	19.8%	39.6%
Mexican Bolsa IPC	45,446.83	3.4%	-7.9%	-6.0%	-3.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,233.27	1.5%	-5.4%	-3.2%	-4.3%
Silver (spot $/oz)	14.73	3.4%	-13.0%	-14.1%	-19.8%
Copper ($/metric ton)	6,036.50	0.0%	-16.2%	-12.5%	23.0%
Oil (WTI spot/bbl)	63.69	-2.5%	5.4%	17.3%	36.5%
Oil (Brent spot/bbl)	72.74	-3.6%	8.8%	20.3%	51.1%
Natural Gas ($/mmBtu)	3.25	-0.5%	9.9%	12.2%	11.9%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	3.130%	-1.3	72.5	75.8	130.3
Canada 10-Yr	2.481%	-1.3	43.6	50.8	127.3
U.K. 10-Yr	1.455%	1.8	26.5	11.2	17.4
Germany 10-Yr	0.399%	1.4	-2.8	2.6	22.0
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.59%	0.0%	-2.4%	-2.0%	-1.2%
U.S. Invest Grade Corp	4.28%	0.0%	-3.8%	-3.0%	0.3%
U.S. High Yield Corp	6.86%	0.0%	0.9%	0.9%	10.5%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	96.2970	-0.9%	4.5%	1.6%	-1.4%
CAD/USD	0.7637	0.5%	-4.0%	-1.7%	2.2%
USD/CAD	1.3094	-0.5%	4.2%	1.8%	-2.2%
EUR/USD	1.1409	0.9%	-5.0%	-1.8%	3.2%
GBP/USD	1.3005	1.9%	-3.8%	-1.8%	6.2%
AUD/USD	0.7203	1.8%	-7.8%	-6.2%	-5.9%
USD/JPY	112.6600	-0.2%	0.0%	-1.3%	8.2%
EUR/JPY	128.5300	0.6%	-5.0%	-3.1%	11.6%
EUR/GBP	0.8773	-1.0%	-1.2%	0.0%	-2.8%
EUR/CHF	1.1436	0.2%	-2.3%	-1.9%	6.1%
USD/SGD	1.3765	-0.7%	3.0%	1.1%	-0.9%
USD/CNY	6.9233	-0.8%	6.4%	4.9%	2.3%
USD/MXN	20.1344	-1.0%	2.4%	5.6%	4.9%
USD/BRL	3.7016	-0.6%	11.7%	13.3%	14.5%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 8:35 pm GMT 11/1/18.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -4.0% return means the Canadian dollar fell 4.0% vs. the U.S. dollar year to date. USD/JPY 112.66 means 1 U.S. dollar will buy 112.66 yen. USD/JPY 0% return means the U.S. dollar is flat against the yen year to date.

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Distribution of Ratings - RBC Capital Markets, LLC Equity Research
As of September 30, 2018

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	859	54.33	251	29.22
Hold [Sector Perform]	646	40.86	125	19.35
Sell [Underperform]	76	4.81	5	6.58

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An analyst's "sector" is the universe of companies for which the analyst provides research coverage. Accordingly, the rating assigned to a particular stock represents solely the analyst's view of how that stock will perform over the next 12 months relative to the analyst's sector average.

Ratings:

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