November 8, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Midterms: Follow the North Star

Kelly Bogdanova – San Francisco

With the 2018 midterms the most anticipated in a generation, it's easy to get swept up in the political sideshows. But when it comes to setting the investment agenda, there's something else that supersedes the D.C. drama, and we look at what investors should set their compass to follow.

When U.S. elections occur, and certainly surrounding the recent midterms, Washington becomes larger than life. All eyes are focused on it around the world. It's easy to assume that Washington plays a vital role in shaping the U.S. stock market's path.

In reality, the natural ebb-and-flow of the economy, corporate earnings trends, and Federal Reserve policy play greater roles. The power of private sector businesses and American households should not be understated at times like this, and the power of Washington should not be overstated. The domestic economy remains our North Star, and we expect this long expansion to persist for the next year, at least.

So the fact that there will be a dramatic change in control of the House of Representatives does not change our view of the U.S. market and economy. We were constructive before the election and we're constructive now.

The Trump administration proposal that could impact the market the most has already been implemented: tax cuts. They won't be repealed, although the president opened the door to some modifications in exchange for a new middle income tax cut.

Even though the stock market is not at Washington's beck and call, with every election there are issues that can intersect with market performance that investors should consider. Following we discuss infrastructure spending, prescription drug pricing, trade, House investigations of President Trump, and risks of a government shutdown and debt ceiling battle.

Equities usually the winner of midterm elections

We interpret the election outcome to be more about gridlock than sweeping policy changes. Normally the equity market welcomes gridlock, otherwise known as split government or divided government.

A study by RBC Global Asset Management found that the S&P 500 outperformed in four of the past five instances of a split Congress, and rose 15.6% on average compared to a 7.7% average gain during all periods. A split Congress is less common than one might think. This is only the sixth instance since 1951.

The historical performance surrounding midterm elections is the strongest of the seasonal equity market cycles we track. In 21 midterm elections since 1934, the S&P 500 rose 15.7%, on average, in the year following the election compared to an 8.2% average gain in all years during this period.

Market pulse

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Priced (in USD) as of 11/8/18 market close, EST (unless otherwise stated).

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RBC Wealth Management

Any common ground to be had?

For the upcoming Congress, opportunities for compromise seem few and far between given the political and policy realities. Infrastructure and health care are potential areas of cooperation, but the path toward passing legislation seems narrow.

For infrastructure, just about everyone agrees there is great need to replace decaying structures and to build new innovative structures similar to what many other countries already have. But there is a fundamental philosophical disagreement about how to get it done.

Republicans seek to form an infrastructure "bank" and largely attract leveraged private sector funds with a small portion of federal dollars as seed money. In contrast, Democrats seek to fund infrastructure spending by issuing 30-year bonds, with the intention of paying them off from increases in federal and fuel taxes by indexing the latter to inflation. The end goal of this structure is to avoid adding to the national debt.

Perhaps the two sides will ultimately find a point of compromise, but it will likely take a lot of give-and-take and goodwill at a time when these traits are in short supply.

The high cost of pharmaceuticals is one issue an overwhelming proportion of voters care about, according to the Kaiser Family Foundation. There are points of agreement between some Democratic proposals for pharmaceutical price reform and President Trump's statements during the presidential campaign and soon thereafter.

We think there is more uncertainty about this issue than the pharmaceutical stocks reflected when they rallied immediately following the midterms. We're not convinced they will escape a new pricing regime, or at least a debate about one.

Status quo for trade

Trade policy is largely under the Trump administration's purview, so the change in House control will have little impact on tariffs overall or the U.S.-China dispute.

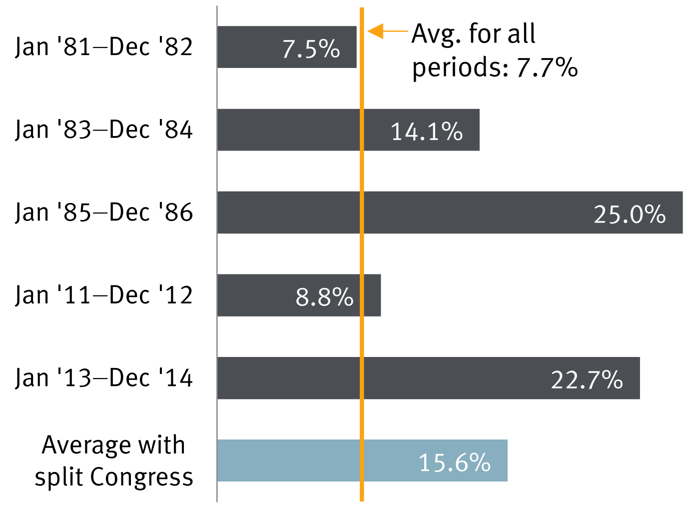
Congress does play a role once trade agreements are struck. We think the updated North American trade deal, otherwise known as USMCA, will ultimately pass in the new Congress because there is bipartisan support for regional trade and the overwhelming majority of states benefit. But Democrats could push for concessions in the legislation to implement the trade agreement.

Investigations affect politics more than economics

There could be multiple showdowns between House Democrats and President Trump if oversight hearings and investigations begin.

Senior House members who are likely to assume leadership roles in powerful committees have previously signaled that

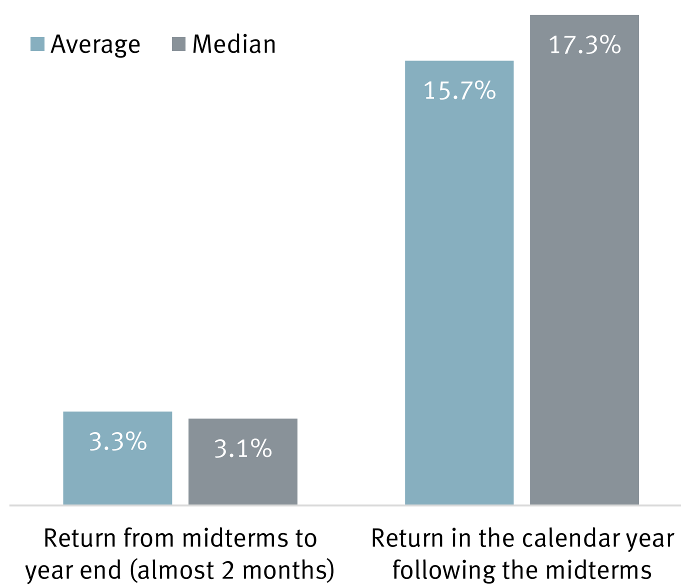
S&P 500 annual returns under a split Congress



Source - RBC Global Asset Management, Bloomberg; Data from January 1, 1951 to October 31, 2018. Reflective of S&P 500 price returns (excluding dividends).

Post-midterm performance has been strong historically

S&P 500 returns after midterm elections (1934–2015)



Note: Average annual return for all years in the study is 8.2%
Source - RBC Wealth Management, Bloomberg

hearings and investigations would occur on various fronts ranging from allegations of irregularities at administrative agencies, to President Trump's tax returns, to events surrounding the 2016 election, and more. Committee leaders have broad subpoena power. At this stage it's unclear if the soon-to-be speaker of the House will proceed cautiously over these grounds, aggressively, or somewhere in between.

This could create bouts of volatility for the equity market, but we doubt it would impact economic momentum much, if at all, unless something serious is revealed that isn't already known.

Fiscal follies

We believe the new divided government increases the risks of a debt ceiling battle and/or a government shutdown given that budget and spending priorities differ meaningfully between the two parties.

Government shutdowns are transitory events. In the past, the market usually experienced a brief pullback, and then resumed its previous trajectory. After the government resumed full operations, little to no discernable economic impact was detected in recent shutdowns, according to RBC Capital Markets.

This current lame-duck Congress will need to pass a bill to fund the government, at least on a temporary basis, by December 7 or many functions will shut down. After that funding deadline is dealt with, another one will likely be established, possibly in the spring of 2019, for the new Congress to handle.

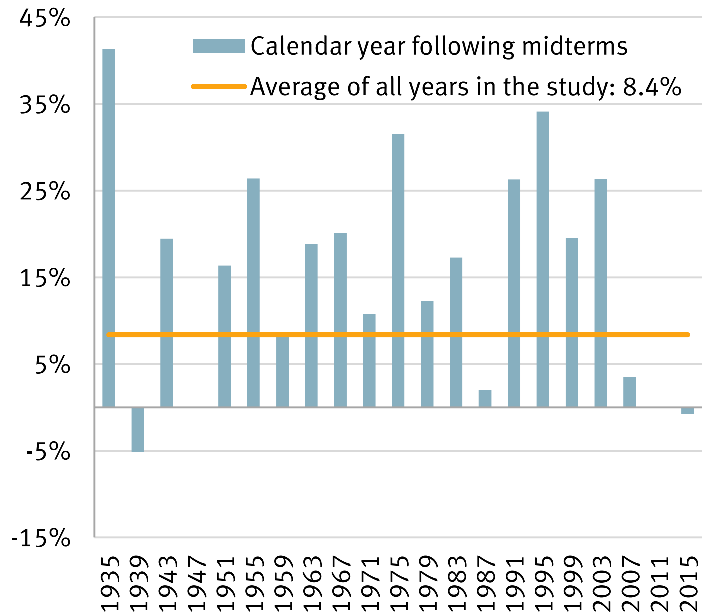
In our view, debt ceiling battles—another matter entirely—can only go so far given the stakes are so high. Key players on both sides of the aisle have said as much previously. Debt default is not a practical option for a country that claims to be leading the world. Elected officials have tremendous incentives to raise the debt ceiling, although it can be a torturous process to get there. The debt ceiling will become an issue again in Q1 2019 as it needs to be raised in early March.

Keep your bearings

From a portfolio standpoint, rather than focusing on Washington, the more important task is to keep the compass pointed toward the North Star—the domestic economy. As long as the major forward-looking indicators continue to signal that growth can persist, these public policy and political issues can be managed. It's the economy, corporate earnings, and the Fed that will define this late cycle period, in our view.

Post-midterm performance well above average in most years

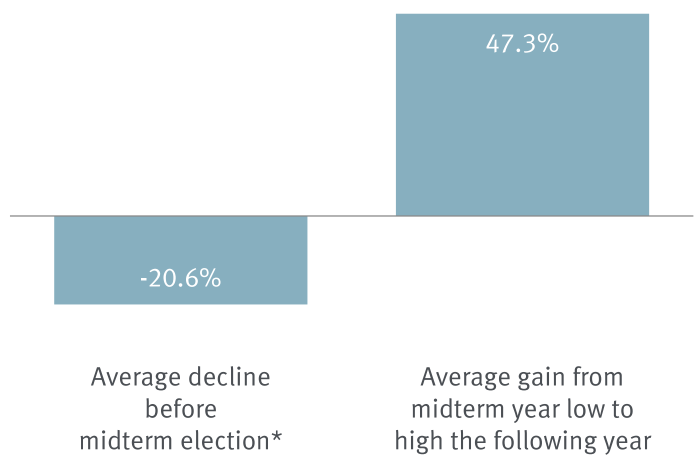
S&P 500 annual returns in the calendar year after the midterms (1935–2015)



Source - RBC Wealth Management, Bloomberg

Corrections are common in midterm years, and so are follow-on rallies

S&P 500 returns surrounding midterm elections (1934–2015)



* Measured from the peak within 12 months before the midterm election year low, to that low.
Source - RBC Wealth Management, Bloomberg; performance before and after 21 midterm election years

United States

Ben Graham, CFA – Minneapolis

- **The removal of the headwind that had been midterm elections fueled the relief rally** that equity markets have experienced in recent days. After the elections played out as expected, with the Democrats taking the House and Republicans holding the Senate, stocks rose multiple percentage points. The S&P 500 is up 3.1% since the day before the election and the Dow Jones Industrial Average has climbed 3.6%. Both small caps and the NASDAQ are trading more than 2.0% higher.

- Among sectors, **Health Care has seen the sharpest relief trade**, as it has jumped more than 4.9% for the week with help from the fact that Democrats did not sweep the elections and win both chambers of Congress. Energy was the second-best-performing sector for the week in which U.S.-led sanctions snapped back into place on Iran. RBC Capital Markets' commodity strategists believe that this loss of Iranian production will be hard for OPEC and non-OPEC affiliates to completely replace, with this likely result being a positive for U.S. firms. Communication Services remains the worst-performing sector for the week while also evidencing the breadth of the relief trade as the group has climbed more than 1.2%.

- The statement from the largely uneventful Fed meeting on Thursday, November 8, contained two notable points: the economy continues to strengthen and the lack of a comment on the recent equity market selloff. Both concepts are favorable for rate hike proponents. However, the market and Fed anticipate one additional 2018 rate hike being delivered in December, and there will be hawkish additions to the voting bloc in 2019. These **hawks will likely continue to use declines in unemployment in their efforts to advocate for further hikes while "neutrals" and doves will use the decelerating economic and earnings backdrop in their counterargument**. The Fed's official stance remains at three more hikes in 2019, after the December 2018 hike, while our view is that the modest deceleration we're experiencing across the economy and markets will cap the eventual 2019 rate hikes at two.

Canada

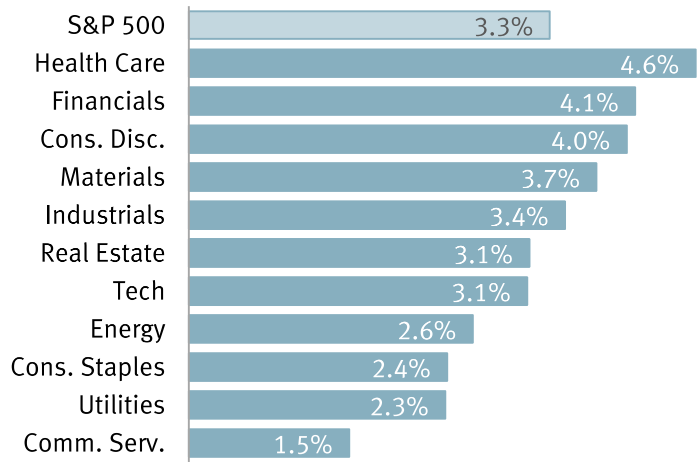
Carolyn Schroeder & Richard Tan, CFA – Toronto

- RBC Capital Markets conducted a **survey of the e-commerce shopping habits** of roughly 1,200 Canadians. The results showed that **56% of respondents visited retail websites at least once per week** and 19% of respondents made an online purchase at least once per week. Younger respondents, particularly those living in larger cities, are more likely to make online purchases. The 25–34 year-old cohort tends to be more active in e-commerce than those between the ages of 18–24. RBC Capital Markets attributes this to the former likely having greater disposable income and larger households. Interestingly, there were **no material differences with respect to the frequency of visits to e-commerce sites and the frequency of online purchases between men and women**. Canada trails in e-commerce penetration compared to the U.S. and U.K., but RBC Capital Markets believes adoption will increase as the younger generation ages.

- Online grocery shopping has received much attention of late but remains a relatively small portion of total Canadian grocery sales. RBC Capital Markets believes **domestic grocers remain one of the retailers most isolated from e-commerce trends** given that the bulk of respondents (approximately 68%) showed strong preferences in handpicking their own produce and food products in-store. Furthermore, product availability, cost, and/or speed of delivery were not key factors in the low adoption rate of online grocery shopping amongst Canadian consumers, according to the survey. RBC Capital Markets estimates total online grocery expenditure at approximately CA$2B per annum, which represents only 2% of the roughly CA$100B Canadian grocery market. However, RBC Capital Markets forecasts the market will double to almost CA$4B in the next couple of years. **Despite low penetration, major Canadian grocers have been investing in this emerging channel** as e-commerce represents not only a threat but also an opportunity, albeit one that presents near-term costs and execution risk.

Relief trade: equities strong in the wake of midterms

S&P 500 sector returns, week of November 5



Source - RBC Wealth Management, Bloomberg; data as of 5:20 pm GMT 11/8/18

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

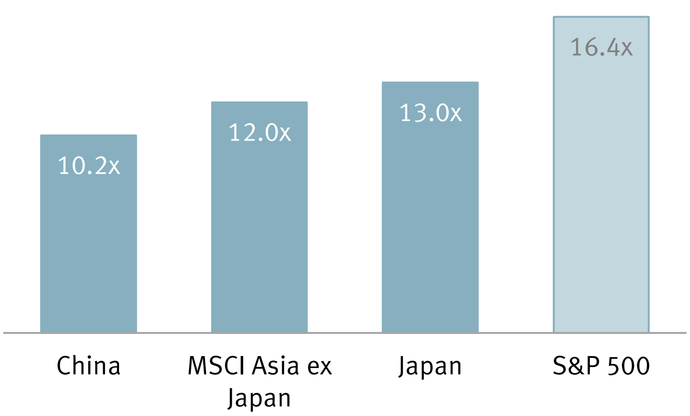
- **More economic data suggested Q4 in the U.K. and Europe is off to a soft start**. In the U.K., the October services Purchasing Managers' Index (PMI) fell sharply from 53.9 to 52.2, confirming the trend observed in the manufacturing sector. The U.K. composite PMI retreated from 54.1 to 52.1, as business uncertainty due to both Brexit and the overall global environment weighed on sentiment. Clarification on Brexit negotiation outcomes could help improve sentiment.

- **Italy became the first country in the euro area where the composite PMI fell below 50 in October, suggesting Italian GDP will likely contract in Q4**. Both manufacturing and services were hurt by the political uncertainty in the country. Data was better elsewhere, with the Spanish services PMI staging a strong recovery from 52.5 to 54 in October, indicating the soft patch in Spanish domestic activity may be over. German industrial production gained 0.2% m/m in September, just beating consensus expectations. The European Commission published its revised forecast for euro area GDP growth of 1.9% for 2019 (previously 2.0%). This is a little optimistic, according to RBC Capital Markets economists who currently expect growth of 1.7% next year.

- With earnings season drawing to an end, a **notable Pan-European trend has been disappointments in the Consumer Discretionary sector where almost 60% of companies missed Q3 consensus expectations**.

Asian valuations remain low despite the relief rally

Next 12-month forward P/E ratios



China is defined as the Shanghai Composite and Japan as the TOPIX
Source - RBC Wealth Management, Bloomberg; data as of 11/7/18

The misses, as well as guidance disappointments, have been spread across various subsectors, including Autos (disruption from tougher European emissions testing, sales downturn in China), Media (weak TV advertising), Retail (weakening sales growth), and Travel and Leisure (rising wages pressuring margins). We believe it is important for investors to focus on companies with leading market positions and strong brands in the Consumer Discretionary space.

Asia Pacific

Jay Roberts, CFA – Hong Kong

- After a miserable October, the worst month of the year by far for stocks, Asian equities rallied at the beginning of November. **The MSCI Asia Pacific Index has risen by 5% from its low on October 29**. Some markets, such as South Korea and India, saw particular strength in stocks. China's renminbi advanced against the dollar while the yen weakened.

- **The Asian equity market also responded well to the U.S. midterm election results. The exception to this was mainland China**, which actually declined. In our view, the election result **doesn't make much difference to the U.S. view on, and strategy towards, China**. This is one of the few issues that enjoys bipartisan support in Washington. It is possible that there could be some kind of piecemeal agreement between Presidents Trump and Xi at the G20 summit later this month, for example to delay imposing the next round of tariffs due to start in January or to agree to re-enter negotiations, but nothing beyond that kind of thing, in our view.

- **Toyota Motor** (7203 JP), the world's largest automaker by market capitalization, said it **expects to maintain profit at a similar level to last year** amid some positive forecasts from the company. Toyota may be a beneficiary of the U.S.-China trade dispute. Mainland China, the largest car market in the world, is an important market for Toyota.

- **SoftBank Group** (9984 JP), which owns a unique combination of telecom assets along with major investments in technology firms such as Alibaba (BABA) and NVIDIA (NVDA), **reported quarterly earnings that were much better than forecast**. The beat was mainly due to an increase in value in some of its technology investments such as India's OYO Rooms and NVIDIA. SoftBank's stock price had been weak recently due to events in Saudi Arabia, the largest investor in the SoftBank Vision Fund, a $100B tech investment fund.

MARKET SCORECARD

Data as of November 8, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,806.83	3.5%	5.0%	8.2%	31.2%
Dow Industrials (DJIA)	26,191.22	4.3%	6.0%	11.2%	42.9%
NASDAQ	7,530.89	3.1%	9.1%	10.9%	45.0%
Russell 2000	1,578.21	4.4%	2.8%	6.5%	32.1%
S&P/TSX Comp	15,357.47	2.2%	-5.3%	-4.6%	4.8%
FTSE All-Share	3,923.32	0.5%	-7.1%	-5.2%	5.6%
STOXX Europe 600	367.08	1.5%	-5.7%	-6.9%	9.6%
EURO STOXX 50	3,237.60	1.3%	-7.6%	-11.4%	7.1%
Hang Seng	26,227.72	5.0%	-12.3%	-9.3%	14.5%
Shanghai Comp	2,635.63	1.3%	-20.3%	-22.8%	-16.3%
Nikkei 225	22,486.92	2.6%	-1.2%	-1.9%	31.0%
India Sensex	35,237.68	2.3%	3.5%	6.1%	27.7%
Singapore Straits Times	3,093.24	2.5%	-9.1%	-9.6%	9.7%
Brazil Ibovespa	85,620.13	-2.1%	12.1%	15.1%	33.5%
Mexican Bolsa IPC	44,190.25	0.6%	-10.5%	-9.5%	-8.8%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,223.41	0.7%	-6.1%	-4.5%	-4.1%
Silver (spot $/oz)	14.43	1.3%	-14.8%	-15.3%	-21.4%
Copper ($/metric ton)	6,171.00	2.2%	-14.4%	-9.6%	18.2%
Oil (WTI spot/bbl)	60.67	-7.1%	0.4%	6.8%	34.9%
Oil (Brent spot/bbl)	70.77	-6.2%	5.8%	11.5%	53.7%
Natural Gas ($/mmBtu)	3.56	9.1%	20.5%	12.1%	35.2%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	3.239%	9.6	83.4	90.5	138.5
Canada 10-Yr	2.545%	5.1	50.0	62.5	127.2
U.K. 10-Yr	1.565%	12.8	37.5	34.0	32.8
Germany 10-Yr	0.457%	7.2	3.0	13.1	26.9

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.64%	-0.1%	-2.5%	-2.4%	-1.1%
U.S. Invest Grade Corp	4.29%	0.2%	-3.6%	-3.0%	0.7%
U.S. High Yield Corp	6.71%	0.6%	1.6%	2.0%	11.1%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	96.6590	-0.5%	4.9%	1.9%	-1.2%
CAD/USD	0.7604	0.1%	-4.4%	-3.2%	1.0%
USD/CAD	1.3151	0.0%	4.6%	3.3%	-1.0%
EUR/USD	1.1365	0.5%	-5.3%	-2.0%	3.1%
GBP/USD	1.3063	2.3%	-3.3%	-0.4%	5.5%
AUD/USD	0.7258	2.6%	-7.1%	-5.5%	-6.5%
USD/JPY	114.0600	1.0%	1.2%	0.2%	8.5%
EUR/JPY	129.6400	1.5%	-4.2%	-1.8%	11.8%
EUR/GBP	0.8700	-1.8%	-2.0%	-1.6%	-2.3%
EUR/CHF	1.1434	0.2%	-2.3%	-1.4%	6.1%
USD/SGD	1.3756	-0.7%	3.0%	1.0%	-0.8%
USD/CNY	6.9345	-0.6%	6.6%	4.6%	2.2%
USD/MXN	20.1843	-0.8%	2.7%	5.8%	10.2%
USD/BRL	3.7608	1.0%	13.7%	15.7%	18.6%

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 11/8/18.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -4.4% return means the Canadian dollar fell 4.4% vs. the U.S. dollar year to date. USD/JPY 114.06 means 1 U.S. dollar will buy 114.06 yen. USD/JPY 1.2% return means the U.S. dollar rose 1.2% against the yen year to date.

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As of September 30, 2018

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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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