November 15, 2018

RBC WEALTH MANAGEMENT

A closer look

Light at the end of the oil pipeline?

Laura Cooper – London

With October's stock market correction still fresh in everyone's minds, the oil selloff has further frayed already-taut market nerves. But we see conditions that should enable oil to claw back from the bear market, and we maintain a constructive outlook on oil prices.

The rapid fall in crude oil prices is rattling already-volatile financial markets, with investors' flight from Energy stocks dragging global equity markets lower. Following a rough October, the S&P 500 has risen only 0.7% so far in November as a correction in the Technology sector has been met by weakness in Energy stocks. The MSCI European Energy Index is tracking its worst quarterly performance since 2015, while declines in oil heavyweights in Asia have kept the Hang Seng Index and Shanghai Composite under pressure.

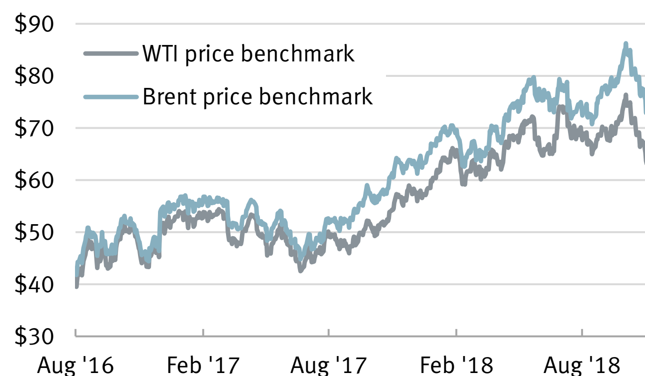
Crude oil prices have plunged deep into bear market territory with West Texas Intermediate (WTI), the U.S. benchmark, falling more than 25% from a four-year high on October 3 and recording its longest stretch of daily declines on record. Brent crude, the international benchmark price, recorded a commensurate drop over the same period, falling by around $20 per barrel to touch its lowest level since April.

Fear over fundamentals

Growing fears of softer oil demand are coming from a weaker global growth backdrop, which, alongside indications of an oversupplied oil market, have sent benchmark prices tumbling. A lack of commitment from OPEC and its allies to curb production at their recent meeting further aggravated the selloff; WTI recorded its largest one-day drop since 2014, falling 7% to slip below $55 for the first time since December 2017. The move contributed to one of the largest 5-day drops on record, of 21%, which sent technical indicators deep into oversold extremes and investor sentiment plummeting to multi-year lows.

Growing fears of imbalances in crude oil markets have sent prices tumbling

Price per barrel of crude oil



Source - RBC Wealth Management, Bloomberg; data through 11/15/18

Market pulse

3 Canadian bond market blues

4 U.S. value stocks gaining traction relative to growth

4 What the Brexit deal means

5 Chinese tech giant rebounds from disappointing quarter

The *Global Insight Weekly* will not be published next week. The next edition will be available November 29 in North America and November 30 in Europe and Asia.

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Wealth Management

The extent of the selloff appears difficult to reconcile with energy market fundamentals. RBC Capital Markets sees scope for crude oil prices to recover.

Clawing back from a bear market

Economic indicators pointing to a deceleration in global growth are feeding investor concerns that global commodity demand could wane. Data in China, Japan, and Europe have softened recently.

At the same time, signs that higher volumes of crude oil could outpace the expansion of demand have exacerbated price pressures. Rising U.S. shale production has propelled domestic supplies to record levels while Saudi Arabia and Russia, the world's other largest producers, ramped up production in recent months to make up for any Iranian barrels that could be pulled from the market due to renewed U.S. sanctions. But the Trump administration's recent decision to grant temporary sanction waivers for select countries that import Iranian oil has compounded fears of a market glut.

Signs of intervention by major oil producers to bring price relief, which could limit further downside in crude oil prices, are growing. Amid the accelerating crude oil selloff, some OPEC members expressed a willingness to curtail supply in advance of the organization's December 6 meeting. Russia hasn't yet tipped its hand, but has consistently expressed the importance of partnering with OPEC to steady the oil market.

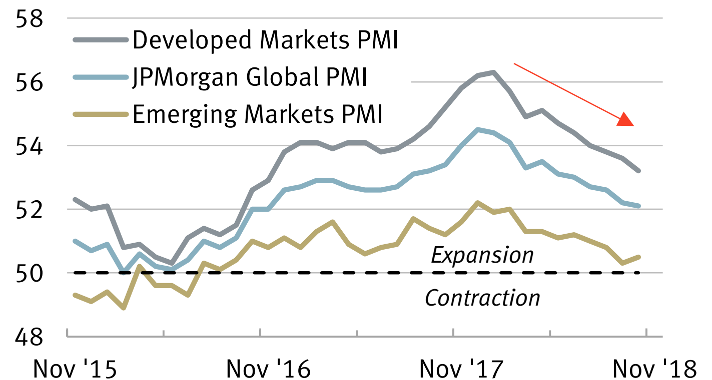
With balance in the crude oil market crucially dependent on Saudi Arabia, the country's recent vow to do "whatever it takes" to contain price weakness further points to a price recovery, in our view. This steadfast approach should remain despite escalating pressure from the Trump administration to maintain current elevated production levels to ensure prices remain low.

RBC Capital Markets, LLC Commodity Strategist Michael Tran maintains a constructive outlook for prices, arguing that the magnitude of the pullback is not warranted by current market fundamentals. Iranian sanctions could ultimately spur a more material supply pullback, especially as the temporary exemptions expire. Meanwhile, Saudi Arabia could quickly turn off its production taps, and heightened geopolitical tensions could limit the degree of imbalance in the market.

On the demand side, with China accounting for 35% of total global oil consumption growth since 2010, a domestic economic slowdown is dampening prospects for global oil demand. Even so, Tran sees bright spots in Chinese demand because the economy is more dependent on gasoline for autos than ever before, and that demand is sticky. Also, surging air travel is a key demand component, and the most underappreciated, according to Tran. Finally, the gradual feed-through of fiscal stimulus should support the economy and crude oil demand over time.

A weaker global growth backdrop is raising concerns of softer oil demand

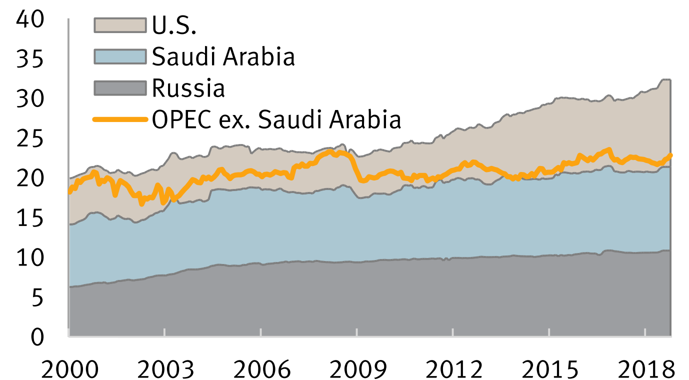
Purchasing Managers' Indexes for the manufacturing sector



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

The world's largest oil producers have ramped up production

Million barrels per day



Source - RBC Wealth Management, U.S. Department of Energy, Bloomberg; data through 10/31/18

Maintaining constructive outlook

The speed of the drop in crude oil prices is exacerbating already-fragile market nerves in the wake of last month's equity market correction; however, the price downturn pales in comparison to that seen in mid-2014 when the downdraft fuelled a profit recession in the S&P 500.

If anything, recent shifts in the oil market could provide tailwinds to overall equity market performance. Notably, the alleviation of headline inflation pressures from the price drop could temper fears of the need for aggressive Federal Reserve tightening. Market expectations for future hikes have slipped since the oil price correction.

Concerns dominating the largely healthy fundamentals should reverse course and bring relief to the crude oil market, in our view. RBC Capital Markets sees scope for crude oil prices to trend higher with its latest forecasts targeting WTI breaking above $75 per barrel and Brent climbing to $85 per barrel by year-end 2019

Canada in focus

Canadian bond market blues: Short-term pain

Joseph Wu, CFA – Toronto

2018 has been a disappointing year for many fixed income investors as it is on track to be only the fourth down year for the broad Canadian bond market since 1981. While we believe the macro environment for bonds could remain challenging in the near term, we see ample investment opportunities in short-term, high-quality bonds to justify investors maintaining a disciplined allocation to the asset class.

A reality check

Negative returns for the Canadian bond market have been a rare occurrence. Since 1981, there have been just three instances in which calendar-year returns for the FTSE TMX Canada Universe Bond Index were in the red (see chart). Although this index is down just roughly 1% year to date, the perception for investors is likely to be much worse, owing to the fact that bonds have reliably generated positive returns for nearly 40 years.

It is never comfortable to sit through losses, but the underappreciated silver lining from the recent price weakness in bonds is that yields are now considerably higher than they have been for some time. The implications of higher starting yields are two-fold. First, they imply more room for yields to fall to provide "cushion" for equity drawdowns. This increases the scope of diversification that bonds can deliver for a portfolio during periods of sharp risk aversion. Second, they help to boost longer-term return expectations, as there is a strong correlation between starting bond yield levels and subsequent bond returns. In fact, bond investors with a maturity profile that is shorter than their investment horizon should benefit from a higher rate as this could enable them to realize a higher return over their full horizon.

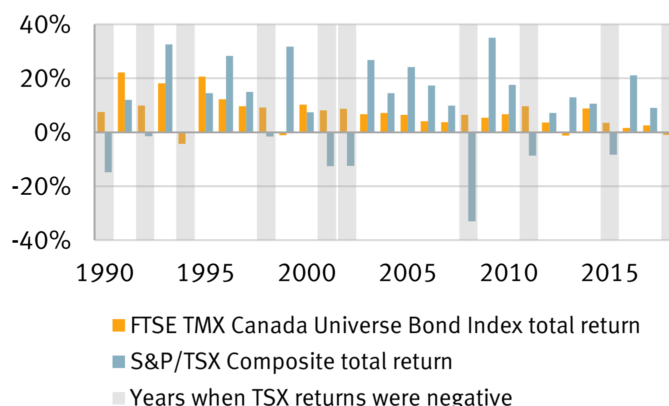
While there are invariably times when bonds' diversifying attributes are tested—such as in 1994—the shaded areas in the chart illustrate plainly that bonds remain an effective diversifier for equity drawdown risk over the long term, reliably acting as a "shock absorber" when the TSX has struggled.

The playbook

With the Canadian economy on a solid footing and the Bank of Canada in the midst of a rate-hike cycle, we believe the balance of risk for bond yields remains biased to the upside on a 12-month horizon. Against this outlook, we suggest investors continue to focus on the following guidance in positioning their bond portfolios:

Annual and 2018 year-to-date total returns

Canadian universe bond index and TSX Composite



Source - Bloomberg; data through 10/31/18

- **Focus on short duration:** Given the meagre compensation for extending term, a focus on short-to-intermediate maturities (i.e., 1–10 years) remains prudent, in our view. Shorter-dated bonds are by no means immune to rising rates, but their returns tend to be less volatile, while coupon payments and matured principal can be reinvested at prevailing higher-yielding bonds more frequently and sooner. Moreover, expectations of an additional three 25 basis points rate hikes are already reflected in short-term Government of Canada bond yields.
- **Improve credit quality:** Narrow credit spreads denoting paltry compensation for taking on credit risk means investors are not giving up much yield by moving up the quality ladder. With the risk-reward trade-off favouring higher-grade bonds, we continue to advocate investors upgrade quality across their bond portfolios (e.g., high yield to investment grade (IG) and IG to government).
- **Explore discount bonds:** In contrast to recent years when many bonds were trading above par value (i.e., locking in capital losses as prices usually move to par at maturity), the rising rate environment over the past 24 months has led to an increase in the opportunity set of bonds trading below par value (i.e., potential for capital gains as prices usually move to par at maturity). These discount bonds could appeal particularly to taxable investors, given lower tax rates on capital gains versus interest income.

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

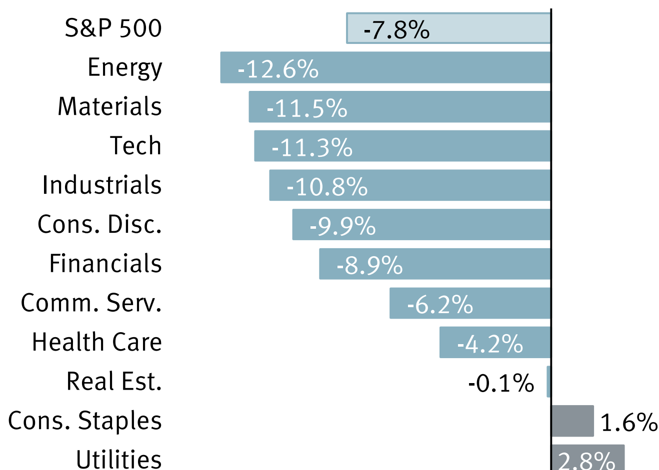
United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets are broadly lower,** declining 3% or more in most major indexes so far this week. Losses have been widespread with the Consumer Discretionary, Tech, and Health Care sectors leading the way lower. The recent underperformance in these groups has assisted in the reversal of the style trade, as value stocks continue to gain traction relative to growth stocks and the recent selloff brings growth's year-to-date outperformance back to May 2018 levels. Put differently, **the outperformance that growth generated relative to value from June to September has been erased** in recent weeks as value stocks take their turn to lead.
- After accounting for nearly all of the H1 2018 S&P 500 attribution, **the FAANGM Complex** of Facebook, Apple, Amazon, Netflix, Alphabet (Google), and Microsoft has **shed its leadership role.** These companies accounted for **94% of the S&P 500's first six months return.** Since then, the complex has delivered an **equal-weighted average return of -9.6%** vs. the 0.6% decline for the S&P 500. Microsoft and Apple are the only two firms trading higher than their June 30 closing prices with Netflix being the worst performer in the group, down 26.8%. The difference in the performance of these stocks at the start of the year versus now nearly perfectly mirrors the growth and value trends evolving in the market at this time.
- **Economic data continues to highlight an expanding economy driven by a healthy U.S. consumer.** Retail sales were robust in October and inflationary data, as measured by the Consumer Price Index, was in line with expectations. Given this backdrop and the fact that our indicators are not signaling a recession in the next 12 months, we would continue to give equities the benefit of the doubt and **hold Market Weight positions** in U.S stocks.

U.S. sector returns have been under pressure since the September highs

S&P 500 price returns by sector, since 9/20/2018



Source - RBC Wealth Management, FactSet; data through 11/14/18

Canada

Diana Di Luca – Toronto

- **Bank of Canada (BoC) Governor Stephen Poloz doesn't see rising yields and a flattening curve as particularly worrisome for the Canadian economy**, according to comments he made in a speech to the U.K. Chamber of Commerce on November 5. "These characteristics do not point to a gloomy economic outlook by any means—rather, they are welcome symptoms of normalization," he said, adding that "investors can no longer expect yields to be suppressed by extraordinary monetary policies." The speech **continues a recent trend from Poloz** who, after making comments about the necessity of the Overnight Lending Rate reaching neutral (estimated at 2.5%–3.5%) at the BoC's latest rate announcement, is doing his part to prepare Canadians for a future of higher borrowing costs.
- **The market is currently pricing in three further BoC hikes (to 2.50%)**, which is at the bottom end of what Poloz is suggesting the terminal rate for this credit cycle will be. RBC Economics has released its **updated interest rates forecast,** calling for two rate hikes in 2019 and another two in 2020, bringing the Overnight Lending Rate to 2.75% by Q2 2020. With the markets still not fully pricing in what Poloz has been messaging, **we see more downside than upside for the long end of the yield curve.** We continue to **advocate staying short on duration** until the yield curve re-steepens and offers the opportunity to put money to work at higher yields. The next rate hike is priced in for January, with a December hike a possibility, although unlikely, in our view.
- The **TSX Preferred Share Index has sold off considerably in recent weeks,** with October ending 3.2% lower and November 1.3% lower so far. The selloff appears to have been driven largely by a risk-off tone in equity markets, wider credit spreads, and increased exchange-traded fund redemptions. **The selloff has created some pockets of value** in the preferred share market; however, we favour active management through single-line products versus managed solutions.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **U.K. and EU negotiators have agreed on a draft of a provisional Withdrawal Agreemen**t for the U.K. to formally leave the EU. This is a positive development,

though the probability of a "no deal" scenario—currently at some 20%—will likely not decline until it is clear that the current government and Parliament support the agreement.

- **The 585-page document includes: the Brexit bill** (provisions for the £39B owed to the EU and EU citizen rights); **plans for a transition that maintains the status quo until up to 2021** with a possible one-off extension to an undefined date; **the outline of a future trading relationship** including a free trade agreement on goods and some services; and **the "backstop plan"** that aims to ensure no hard border with Ireland by keeping the whole of the U.K. in a customs union with the EU until an alternative trading arrangement that avoids a border is reached.
- U.K. Cabinet approval of the Withdrawal Agreement means a specially convened EU summit can now take place on November 25 for the EU to sign off on the deal, after which a vote in the U.K. Parliament can occur. As **the deal is very contentious**, this is now the big hurdle, **given the U.K. government's thin 13-seat working majority**. The possibility of staying in the customs union is anathema to passionate Brexiteers, while many pro-European Conservatives oppose the truncated future relationship with the U.K.'s major trading partner.
- As such, headline risk will be acute for a while. **Prime Minister Theresa May could face a no-confidence vote.** We would expect her to survive it, and our base case remains that Parliament will eventually approve the deal. If she doesn't survive, the situation becomes even more complex and uncertain as it raises the specter of elections. Unless Article 50 (the two-year window for the U.K. to negotiate the terms of its exit from the EU) is extended, the U.K. would leave the EU on March 29, 2019, with or without a transition in place.
- **For now, we would expect the drama to be felt mostly in currency markets.** In the event the deal goes through, a relief rally in U.K. equities, particularly for stocks with meaningful domestic exposure, would be likely given current low valuations. Until then, domestic stocks are likely to stay out of favour and we maintain our bias to stocks with international revenues.

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **Asian equities moved slightly lower during the week** but, overall, have remained relatively steady following the sharp selloff in October, a month that capped poor performance for Asian stocks in 2018. **Most markets are down more than 10% for the year.**
- There were **some gains in Chinese stocks** on news that China may outline a series of concessions on trade to the U.S. We think there is no short-term solution to the problem. We believe that reports regarding trade discussions diverted attention from what is arguably **the more important issue facing the Chinese economy—financial deleveraging**. As a result of this necessary policy to curb excessive growth in lending in non-standard channels, credit growth in China continues to decelerate consistently.
- **Total social financing** (TSF) is a term used to describe aggregate credit growth in China. The People's Bank of China revised the definition of TSF twice this year to include some new sources of credit growth such as local government special bond issuance (most spending takes place at the local government, not central government level) and certain asset-backed securities. Adjusting for these new items, TSF in October **rose by 9.1% y/y**. While this may appear high, it is the **lowest ever growth rate** since the TSF data series was initiated.
- In currencies, **the Chinese renminbi did not weaken over USDCNY7.00** but rather held on to its recent, modest gain to 6.92. However, we forecast the currency to resume its downward trend in 2019.
- The **Japanese yen gave up some of its gains** against the dollar to USDJPY113.5. Weakness in the yen is largely positive for the Japanese equity market. **We view the TOPIX index as attractive overall** at this level and **maintain an Overweight rating** on that market.
- Chinese internet giant **Tencent** (700 HK), which operates dominant businesses in online gaming and social media in the world's largest internet market by users, in addition to having significant investment in other internet firms, **announced Q3 results.** This was closely watched because the company had reported a surprising miss in the prior quarter. **Earnings surged 30% y/y** in Q3, which was better-than-expected but also significantly **impacted by a sizeable, one-time item from the IPO of Meituan** (3690 HK).
- **Earnings growth was propelled by online advertising profits,** which rose by 47% y/y. This helped to offset relative weakness in the gaming sector, which has long been the principal driver of the stock. **The gaming business is facing uncertainty** due to changing regulations in China, in part to address addiction to online gaming.
- At a 9% weighting, Tencent is one of the largest stocks in the Hang Seng Index. On balance, the **results were viewed positively** by investors with the stock gaining 5.8% on the day. Tencent shares had more than doubled in 2017 and then declined by approximately 45% since January.

MARKET SCORECARD

Data as of November 15, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,730.20	0.7%	2.1%	6.5%	25.2%
Dow Industrials (DJIA)	25,289.27	0.7%	2.3%	8.7%	33.6%
NASDAQ	7,259.03	-0.6%	5.2%	8.2%	37.6%
Russell 2000	1,524.12	0.8%	-0.7%	4.1%	17.0%
S&P/TSX Comp	15,144.88	0.8%	-6.6%	-4.6%	2.6%
FTSE All-Share	3,857.13	-1.2%	-8.6%	-4.6%	4.3%
STOXX Europe 600	358.43	-0.9%	-7.9%	-6.2%	5.7%
EURO STOXX 50	3,190.31	-0.2%	-9.0%	-10.0%	4.6%
Hang Seng	26,103.34	4.5%	-12.8%	-9.5%	16.9%
Shanghai Comp	2,668.17	2.5%	-19.3%	-21.6%	-16.8%
Nikkei 225	21,803.62	-0.5%	-4.2%	-1.0%	23.4%
India Sensex	35,260.54	2.4%	3.5%	7.6%	34.0%
Singapore Straits Times	3,054.53	1.2%	-10.2%	-9.3%	9.2%
Brazil Ibovespa	85,973.06	-1.7%	12.5%	21.4%	44.1%
Mexican Bolsa IPC	41,450.65	-5.7%	-16.0%	-13.1%	-7.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,213.32	-0.1%	-6.9%	-5.1%	-1.3%
Silver (spot $/oz)	14.30	0.4%	-15.6%	-15.9%	-16.3%
Copper ($/metric ton)	6,107.50	1.2%	-15.3%	-9.3%	10.4%
Oil (WTI spot/bbl)	56.46	-13.6%	-6.6%	2.0%	23.2%
Oil (Brent spot/bbl)	66.70	-11.6%	-0.3%	7.8%	42.1%
Natural Gas ($/mmBtu)	3.92	20.1%	32.6%	27.1%	44.5%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	3.110%	-3.3	70.5	78.8	89.1
Canada 10-Yr	2.390%	-10.4	34.5	47.8	85.4
U.K. 10-Yr	1.373%	-6.4	18.3	8.7	-0.6
Germany 10-Yr	0.360%	-2.5	-6.7	-1.6	5.2
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.59%	0.2%	-2.2%	-1.9%	0.9%
U.S. Invest Grade Corp	4.29%	0.1%	-3.6%	-2.6%	2.7%
U.S. High Yield Corp	7.04%	-0.5%	0.5%	1.8%	10.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.0550	-0.1%	5.4%	3.5%	-3.2%
CAD/USD	0.7585	-0.2%	-4.7%	-3.2%	2.0%
USD/CAD	1.3184	0.2%	4.9%	3.3%	-2.0%
EUR/USD	1.1332	0.2%	-5.6%	-3.9%	5.7%
GBP/USD	1.2780	0.1%	-5.4%	-3.0%	2.6%
AUD/USD	0.7277	2.9%	-6.8%	-4.1%	-3.7%
USD/JPY	113.6100	0.6%	0.8%	0.6%	4.0%
EUR/JPY	128.7400	0.8%	-4.8%	-3.3%	9.9%
EUR/GBP	0.8867	0.1%	-0.2%	-0.9%	3.0%
EUR/CHF	1.1405	0.0%	-2.5%	-2.1%	6.2%
USD/SGD	1.3755	-0.7%	3.0%	1.4%	-2.7%
USD/CNY	6.9392	-0.5%	6.6%	4.8%	1.2%
USD/MXN	20.2207	-0.6%	2.9%	5.0%	-0.2%
USD/BRL	3.7848	1.7%	14.4%	14.2%	10.2%

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 11/15/18.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -4.7% return means the Canadian dollar fell 4.7% vs. the U.S. dollar year to date. USD/JPY 113.61 means 1 U.S. dollar will buy 113.61 yen. USD/JPY 0.8% return means the U.S. dollar rose 0.8% against the yen year to date.

Authors

Laura Cooper – London, United Kingdom
laura.cooper@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

Joseph Wu, CFA – Toronto, Canada
joseph.wu@rbc.com; RBC Dominion Securities Inc.

Ben Graham, CFA – Minneapolis, United States
benjamin.graham@rbc.com; RBC Capital Markets, LLC

Diana Di Luca – Toronto, Canada
diana.diluca@rbc.com; RBC Dominion Securities Inc.

Frédérique Carrier – London, United Kingdom
frederique.carrier@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

Thomas McGarrity, CFA – London, United Kingdom
thomas.mcgarrity@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

Jay Roberts, CFA – Hong Kong, China
jay.roberts@rbc.com; RBC Investment Services (Asia) Limited

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References to a Recommended List in the recommendation history chart may include one or more recommended lists or model portfolios maintained by RBC Wealth Management or one of its affiliates. RBC Wealth Management recommended lists include the Guided Portfolio: Prime Income (RL 6), the Guided Portfolio: Dividend Growth (RL 8), the Guided Portfolio: ADR (RL 10), and the Guided Portfolio: All Cap Growth (RL 12), and former lists called the Guided Portfolio: Large Cap (RL 7), the Guided Portfolio: Midcap 111 (RL 9), and the Guided Portfolio: Global Equity (U.S.) (RL 11). RBC Capital Markets recommended lists include the Strategy Focus List and the Fundamental Equity Weightings (FEW) portfolios. The abbreviation 'RL On' means the date a security was placed on a Recommended List. The abbreviation 'RL Off' means the date a security was removed from a Recommended List.

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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:

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. **Restricted (R):** RBC policy precludes certain types of communications, including an investment recommendation, when RBC is acting as an advisor in certain merger or other strategic transactions and in certain other circumstances. **Not Rated (NR):** The rating, price targets and estimates have been removed due to applicable legal, regulatory or policy constraints which may include when RBC Capital Markets is acting in an advisory capacity involving the company.

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