November 29, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Leaning against risk

Global Portfolio Advisory Committee

The long-running economic expansion should show endurance in 2019. And while we remain constructive on the investment environment, we think it's appropriate to start taking steps to get ahead of any potential challenging times before they materialize.

Looking ahead to 2019, we think a constructive—yet vigilant—approach to financial markets and investment portfolios is warranted. From our vantage point, the appropriate posture is one of "leaning against risk." Said another way, it's prudent to pare back the riskiest and outsized equity and fixed income positions and focus more on higher-quality stocks and bonds.

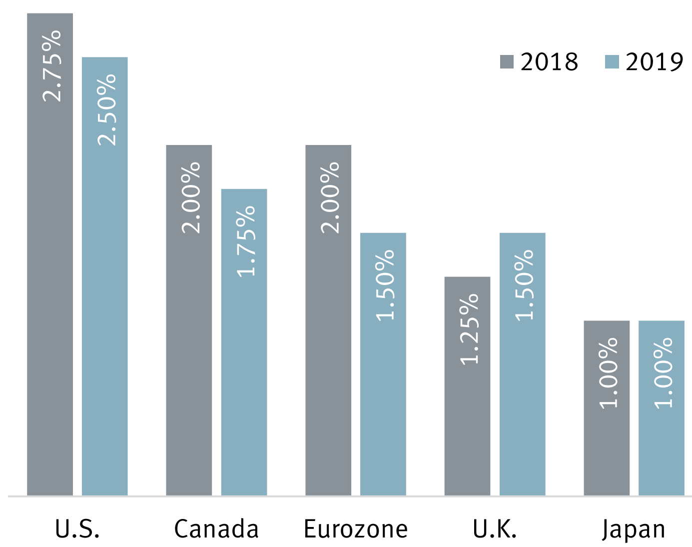
Evidence mounts that we are in the later stages of the economic cycle. This does not call for dramatic portfolio changes just yet, but we recommend moderately trimming equity exposure and shifting toward value areas of the market, while selectively reducing credit risk in fixed income.

Recently our team of analysts and strategists in the U.S., Canada, Europe, and Asia published the *Global Insight 2019 Outlook*, which elaborates on these investment strategies and provides RBC Wealth Management's views on the economy, equities, fixed income, and currencies. In the publication, we also examine three topics we expect will have an important bearing on the progress of the global economy beyond the current cycle: next-generation infrastructure development, the ongoing U.S.-China dispute, and transformative innovations spurred on by artificial intelligence. Following are highlights from the complete *2019 Outlook* report and links to each individual article.

2019 investment stance

Central banks may be the fulcrum for fixed income markets. Monetary policies could diverge as they adjust policies to varying stages of economic activity. We foresee continued growth in developed economies, and inflation holding near targets. The Fed is still forecasting three rate hikes in 2019. We

RBC's annual GDP growth forecasts for developed markets



Source - RBC Global Asset Management

Market pulse

Click here for authors' contact information.

Priced (in USD) as of 11/29/18 market close, EST (unless otherwise stated).

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Wealth Management

see it pausing after two hikes. This article provides thoughts on U.S., Canadian, U.K., European, and Asian fixed income positioning.

Equity prices have the potential to advance in 2019, in our view, because of low recession risks for major economies, particularly the U.S., and the likelihood corporate earnings growth will persist. But 2019 returns could be modest and delivered unevenly; therefore, we believe it is appropriate to trim equity exposure to a Market Weight level in global portfolios from a slight Overweight position. This article provides insights into the U.S., Canadian, U.K., European, and Asian markets.

Navigating the late cycle

The term "late cycle" has an aura of "living on borrowed time" about it. However, the world's largest economy is not yet "that late" in the late cycle. Reliable leading indicators do not yet point to the risk of an imminent economic downturn in the U.S. or other major economies, and 2019 global economic growth should still surpass that of the post-financial crisis average. We think this suggests corporate profits and equity prices have room to advance.

But because 2019 equity returns could be moderate and uneven, we discuss five things that should be on investors' agendas for the coming year: value over growth stocks; large caps over small caps; a focus on dividend-paying stocks; identify high operating leverage to GDP; and pay attention to the relative strength of sectors and industries.

De-risking fixed income portfolios

The later stage of the economic cycle is the time to start formulating a plan to de-risk fixed income portfolios, in our view. Economic growth remains solid and most indicators we monitor suggest a recession is still some ways off, but it's best to prepare for choppier waters while the seas remain calm. We believe some of the riskier parts of fixed income portfolios that investors have crowded into in search of higher yields are an appropriate place to start the overall de-risking process. Compensation for taking those risks is currently minimal and credit quality has weakened.

Infrastructure investing

Infrastructure investment offers an attractive near-term opportunity, in our opinion. The global demand for new, refurbished, and replacement infrastructure assets is immense—particularly in the world's two largest economies (the U.S. and China)—and the private sector appears poised to play a greater role than ever before. Infrastructure investments can offer valuable diversification benefits. Most deliver an income stream from low-risk, stable assets, so they could hold up better than the overall market in a downturn.

U.S. business cycle scorecard

	Start of cycle	Early cycle	Mid cycle	Late cycle	End of cycle	Recession
Inventories		●	○			
Consumer durables		●	●			
Housing			●	●		
Prices			●	●		
Bonds			●	●		
Monetary policy			●	●		
Equity profitability			●	●		
Leverage			●	●	○	
Economic trend			○	●	○	
Credit			○	●	○	
Sentiment				●		
Business investment				●	○	
Employment				●	○	
Equity direction			○	●	●	
Economic slack				●	●	
Volatility				○	●	
Cycle age					●	
Votes for each stage of business cycle	0	2	9	13.5	6.5	0

Legend: ● = most likely stage of business cycle; ○ = alternative interpretation.
Source - RBC Global Asset Management

U.S.-China: Unchartered territory

The U.S. and China are involved in much more than a trade dispute. It is primarily a clash over national security, underpinned by ideological differences. Beneath the visible bilateral tensions lies a deeper shift from 30 years of U.S. hegemonic supremacy to a multipolar world, with implications for economic growth and financial markets.

Artificial intelligence

We think artificial intelligence has the potential to substantially increase global wealth and prosperity in the coming decades. Those companies that pursue the transformative opportunities and understand the competitive threats AI may pose will likely fare better than those that ignore it.

United States

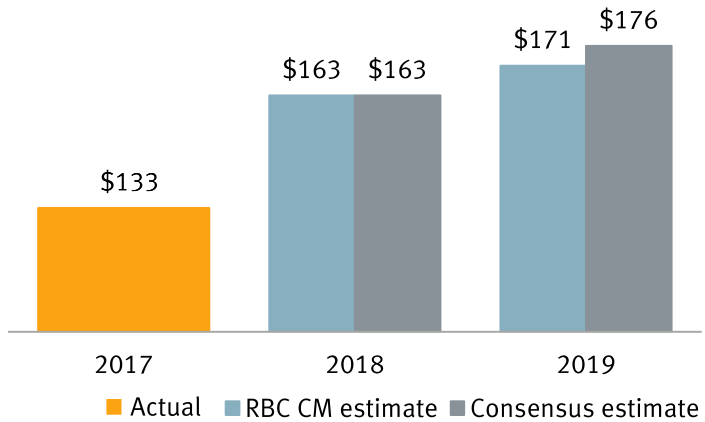
Ben Graham, CFA – Minneapolis

- **U.S. equity markets are rallying into the end of November** after a very challenging start to Q4. Despite gains topping 4% for the NASDAQ, Dow Jones Industrial Average, and S&P 500 thus far for the week, major indexes remain well below their all-time highs. For example, the NASDAQ and S&P 500 have pulled back nearly 12% and 8% from their respective peaks.

- We think much of the rally can be at least **partially attributed to commentary from Fed Chair Jerome Powell that the market interpreted as more dovish than it expected**. When he stated that rates appear to be "just below" the neutral range, market participants bid equities higher on a belief that the pace of interest rate hikes is now more likely to moderate in 2019. However, the central bank maintained its plans to hike rates once more in 2018 at the December meeting and then three additional times in 2019. Yet market participants believe the recent communication on the pace of rate hikes hints at an incrementally slower pace from what had been previously expected. These events **fit well with our view, held for some time, that the Fed will hike once more in December and just twice in 2019**.

- **RBC Capital Markets, LLC Chief U.S. Equity Strategist Lori Calvasina released her initial outlook for 2019**. She lowered her S&P 500 2019 earnings per share (EPS) estimate from $173 to $171 and initiated a year-end 2019 price target of 2900. This implies mid-single-digit returns (excluding dividends) over the next 13 months, a number her team believes fits well into the context of 2020 GDP growth in the 1%–2% range. The consensus estimate for 2019 EPS is comparatively higher at $176, according to Thomson Reuters I/B/E/S, but is down from $178 just weeks ago. Our view is that Calvasina is appropriately **cautious about potential 2019 earnings growth and equity returns**, and we agree with her preference for **value over growth stocks**. We anticipate the consensus forecast will continue to be revised moderately lower in coming months.

S&P 500 calendar year EPS estimates show continued, but slowing, growth



Source - RBC Wealth Management, RBC Capital Markets (RBC CM), Thomson Reuters I/B/E/S; data as of 11/29/18

Canada

Arete Zafiriou & Richard Tan, CFA – Toronto

- **Canadian banks are in the midst of reporting Q4 2018 earnings**. Investors are likely to put particular emphasis on the degree of oil and gas exposure within the banks' loan books given that West Texas Intermediate (WTI) crude oil has tumbled approximately 30% since the beginning of October and WTI-West Canadian Select differentials are sitting around $34/bbl. Under **new accounting rules** adopted earlier this year, banks will need to incorporate a longer-term view of the impact of lower crude prices into their calculation of credit provisions. Our base case continues to call for a **gradual normalization in banks' credit losses off of cyclical lows**; however, highly indebted consumers, stretched affordability in key housing markets, and weak energy prices introduce some downside risk to that outlook.

- **The landscape for Canadian restaurants has become increasingly competitive**, particularly with the growth of **online food delivery aggregators**. RBC Capital Markets illustrated why it believes restaurants are **partnering up with these platforms** and the potential longer-term implications for the industry. Food aggregators provide an opportunity for consumers to access multiple restaurants within the comfort of their homes. This **increases the total addressable market for restaurants**. What's the catch? Restaurants are able to generate **higher sales**, but it comes at the expense of **lower profit margins**. According to RBC Capital Markets, aggregators can charge restaurants 10%–25% in commission and consumers up to $9 per order in delivery fees. The high commission structures initially caused restaurants to back away, but popularity has grown over time as restaurants weighed the benefits of the "takeout" market. Data collected by food aggregators allows restaurants to optimize their menus, make staffing decisions, and improve supply management. RBC Capital Markets believes that the **growth of available food delivery options and aging demographics** (as millennials tend to order food delivery more often) **will increase food delivery sales**. Survey results from RBC Capital Markets suggest usage of food aggregators will increase in the next 12 months; 46% of respondents have used aggregators in the past, and 50% expect to use them within the next year.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **European economic activity shows signs of weakening**. The eurozone November Purchasing Managers' Indexes (PMIs) disappointed, with the composite PMI falling to 52.4, still in expansionary territory, but below both consensus expectations and the prior-month level. It seems to us as though the domestic economy is holding up reasonably well, but is **struggling to offset weakness in exports**. RBC Capital Markets recently revised down its 2019 GDP growth forecast to 1.6% from 1.8%, but does not expect a change in the European Central Bank's monetary policy stance given the subdued inflation environment.

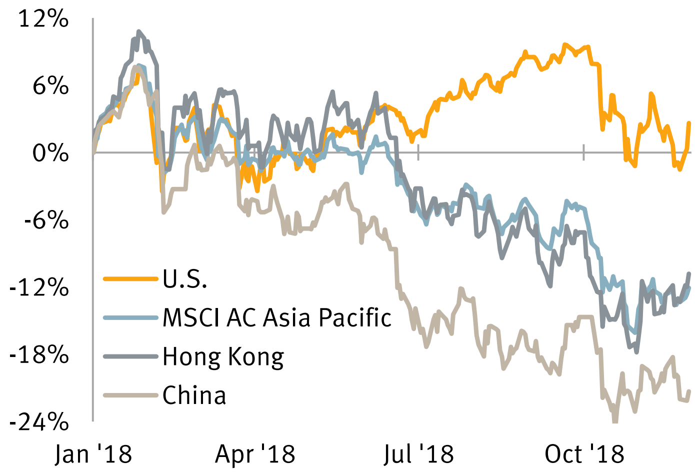
- **The Italian government may be in the process of softening its stance regarding EU fiscal requirements** and is considering reducing the suggested budget deficit from 2.4% of GDP to some 2.1%, according to Bloomberg. The Italian 10-year government bond yield spread over the German 10-year Bund narrowed by 40 basis points (bps) to 326 bps, a still-elevated level.

- In the U.K., attention continues to focus on Brexit, and the very challenging parliamentary arithmetic required for a successful vote in the House of Commons on the **Withdrawal Agreement** on December 11. The agreement has been heavily criticized by both the "Remain" and "Brexit" camps and looks **unlikely to pass in its current form initially, in our view**. We expect political uncertainty to continue to mount in the short term, weighing on economic activity and the currency.

- At the request of the U.K. government, **the Bank of England (BoE) published its analysis of the estimated impact of various Brexit scenarios**. With BoE Governor Mark Carney explaining that he aims "not to hope for the best, but prepare for the worst," in the **worst-case scenario** of a no-deal Brexit, the BoE expects the economy to enter a recession from Q2 2019, which would **shrink the economy by 8%–9%**, a contraction more extreme than that seen during the financial crisis. Under this scenario the BoE expects inflation would reach 6.5%. The release of the BoE's stress tests on U.K. banks using these assumptions revealed that the U.K. banking system should be able to withstand these conditions.

Asian equities lag in 2018 on trade and tariff concerns

YTD returns



Source - RBC Wealth Management, Bloomberg; data through 11/28/18; Shanghai Composite, Hang Seng Index, MSCI Asia Pacific Index, and S&P 500

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **Asian stocks have held their ground recently** with the October low still marking the low for the year. The MSCI AC Asia Pacific Index is down 12.1% in 2018. The Asian market response to the powerful, one-day rally in the U.S. was, however, muted. Mainland China stocks declined by 2% on Thursday as the possibility of further tariffs approaches.

- **A long-awaited meeting between U.S. President Trump and Chinese President Xi Jinping will take place on Saturday, December 1** at the Group of 20 (G20) meeting in Argentina. In our view, the best that can be hoped for is some kind of agreement for a short-term ceasefire, or rather no further escalation, in the trade dispute. In an interview with *The Wall Street Journal*, Trump said that he is prepared to impose tariffs on a further $267B of Chinese imports, including iPhones, if there is no deal at the G20. This would effectively impose taxes on all China-made goods coming to the U.S. The taxes would be between 10%–25%. He added that U.S. consumers could "very easily" deal with a 10% increase in the price of iPhones.

- Additionally, recent comments from **U.S. Trade Representative Robert Lighthizer** and Vice President Mike Pence underscore the strong stance that the U.S. is taking. Earlier in the week, Lighthizer **stated he was examining "all available tools" to increase tariffs on cars made in China**. China currently levies a punitive tariff on U.S. car imports.

- Two weeks ago, the Asia-Pacific Economic Cooperation (APEC) summit, an annual meeting started in 1993, became an arena for the airing of grievances between the U.S. and China across a number of issues. **Xi Jinping, speaking at the event,**[1] **opined that putting up barriers and working "against the laws of economics" is a short-sighted approach** that is "doomed to failure." He contended that "we should say no to protectionism and unilateralism." Xi also noted that history shows cold wars, hot wars, or trade wars produce no winners.

- **Vice President Pence**, speaking at APEC[2] after Xi, carried on from the critical tone of his October 4 speech in Washington against China. "We don't drown our partners in a sea of debt. We don't coerce or compromise your independence. We do not offer a constricting belt or a one-way road." The latter barb is a reference to China's One Belt, One Road strategy aimed at building out infrastructure across Asia. Mentioning tariffs and the possibility of doubling the existing size of tariffs against China, Pence later asserted, **"The U.S. will not change course until China changes its ways."**

- For the first time, no final statement was released at the end of the summit due to a disagreement on wording between the U.S. and China. In our view, the comments at APEC were an **unsurprising continuation of the frosty rhetoric** between the two sides of late and underscore the significant and potentially long-lasting differences between the two sides. This is explored further in our article China and U.S. relations are heading into uncharted territory.

- In corporate developments, **Chinese technology hardware giant Xiaomi (1810 HK) released better-than-expected results in Q3**. Revenue rose by 49% y/y. Net income of CNY2.48B ($360M) was well above forecast. Shipments of Xiaomi phones rose by 21% y/y versus a decline in the global total of phones sold. The stock, which had performed poorly since listing in Hong Kong in the summer, rallied.

- **The head of Japanese car company Nissan (7201 JP), Carlos Ghosn**, one of the most recognized executives in the industry, was **arrested in Japan on accusations of fraud**, namely that he understated his compensation to the securities regulator in Tokyo and made use of company assets. He was later fired by Nissan's board. The shares dropped 5% to the lowest level since 2016 but have since regained some ground.

[1] http://www.xinhuanet.com/english/2018-11/17/c_137613904.htm
[2] https://www.whitehouse.gov/briefings-statements/remarks-vice-president-pence-2018-apec-ceo-summit-port-moresby-papua-new-guinea/

MARKET SCORECARD

Data as of November 29, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,737.80	1.0%	2.4%	4.3%	24.2%
Dow Industrials (DJIA)	25,338.84	0.9%	2.5%	5.8%	32.5%
NASDAQ	7,273.08	-0.4%	5.4%	6.6%	35.2%
Russell 2000	1,525.39	0.9%	-0.7%	-1.1%	14.8%
S&P/TSX Comp	15,194.04	1.1%	-6.3%	-4.8%	1.3%
FTSE All-Share	3,853.36	-1.3%	-8.7%	-5.3%	4.5%
STOXX Europe 600	358.10	-1.0%	-8.0%	-7.7%	5.0%
EURO STOXX 50	3,174.16	-0.7%	-9.4%	-11.6%	4.5%
Hang Seng	26,451.03	5.9%	-11.6%	-10.7%	16.3%
Shanghai Comp	2,567.44	-1.4%	-22.4%	-23.1%	-21.8%
Nikkei 225	22,262.60	1.6%	-2.2%	-1.5%	21.6%
India Sensex	36,170.41	5.0%	6.2%	7.6%	37.0%
Singapore Straits Times	3,109.44	3.0%	-8.6%	-9.6%	8.0%
Brazil Ibovespa	89,709.56	2.6%	17.4%	23.4%	47.1%
Mexican Bolsa IPC	41,913.45	-4.6%	-15.1%	-12.0%	-7.6%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,224.08	0.8%	-6.1%	-4.7%	3.0%
Silver (spot $/oz)	14.31	0.4%	-15.5%	-13.5%	-13.9%
Copper ($/metric ton)	6,244.00	3.4%	-13.4%	-7.2%	9.7%
Oil (WTI spot/bbl)	51.45	-21.2%	-14.8%	-10.2%	13.8%
Oil (Brent spot/bbl)	59.42	-21.3%	-11.1%	-5.8%	28.1%
Natural Gas ($/mmBtu)	4.58	40.6%	55.2%	44.2%	38.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	3.030%	-11.4	62.4	64.2	73.9
Canada 10-Yr	2.304%	-19.0	25.9	42.1	79.4
U.K. 10-Yr	1.367%	-7.0	17.7	2.9	-0.3
Germany 10-Yr	0.321%	-6.4	-10.6	-6.4	10.0

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.55%	0.5%	-1.9%	-1.6%	1.5%
U.S. Invest Grade Corp	4.35%	-0.1%	-3.9%	-3.1%	2.7%
U.S. High Yield Corp	7.24%	-1.0%	-0.1%	0.3%	9.6%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	96.7980	-0.3%	5.1%	3.9%	-4.1%
CAD/USD	0.7527	-1.0%	-5.4%	-3.2%	1.1%
USD/CAD	1.3285	1.0%	5.7%	3.3%	-1.1%
EUR/USD	1.1389	0.7%	-5.1%	-3.9%	6.9%
GBP/USD	1.2784	0.1%	-5.4%	-4.7%	2.3%
AUD/USD	0.7318	3.5%	-6.3%	-3.3%	-2.2%
USD/JPY	113.4400	0.4%	0.7%	1.3%	0.9%
EUR/JPY	129.1900	1.1%	-4.5%	-2.6%	7.9%
EUR/GBP	0.8909	0.5%	0.3%	0.8%	4.5%
EUR/CHF	1.1346	-0.5%	-3.0%	-2.7%	5.3%
USD/SGD	1.3704	-1.1%	2.6%	1.7%	-3.8%
USD/CNY	6.9425	-0.5%	6.7%	4.9%	0.5%
USD/MXN	20.2684	-0.3%	3.1%	9.2%	-1.7%
USD/BRL	3.8525	3.5%	16.4%	18.8%	13.6%

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 11/29/18.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -5.4% return means the Canadian dollar fell 5.4% vs. the U.S. dollar year to date. USD/JPY 113.44 means 1 U.S. dollar will buy 113.44 yen. USD/JPY 0.7% return means the U.S. dollar rose 0.7% against the yen year to date.

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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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