January 25, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Stocks haven’t been slowed by the yield sign

Kelly Bogdanov – San Francisco

In a bit of a twist, the global equity rally is not yielding to rising bond yields. We’re seeing this somewhat atypical behavior as yields are up for the “right reasons” and we don’t think equities will be bothered by bond yields until the “wrong reasons” emerge.

Bond yields are up around the world and have made big moves recently, yet the global equity market is undeterred, rising higher and higher.

The 10-year Treasury yield has jumped 53 basis points to 2.62% since the September low. Meanwhile, the S&P 500 has surged 15.2% in the same period. Markets in Europe and Asia show similar patterns.

The simultaneous upward movement in yields and stocks doesn’t always play out this way. Many times the two move in opposite directions. When government bond yields push up forcefully (and bond prices fall), equity indexes often decline as investors fear that bond markets might be sending negative signals.

The “right” reasons

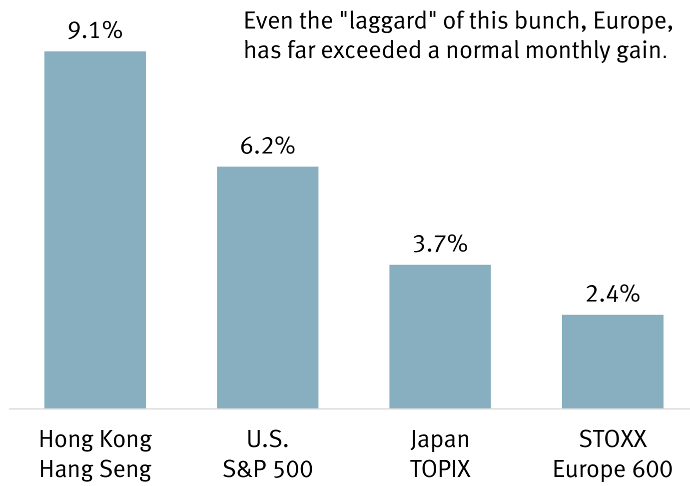
This go-around, however, we believe the global equity market is undeterred because bond yields are rising for the “right” reasons.

Economic foundations in North America, Europe, and Asia are sturdier than they have been in years and they are finally moving forward in sync.

Consumer inflation data across regions are signaling that disinflation/deflation pressures that captured economies for so long and constrained corporate profit margins have finally given way to healthy, more normal increases in inflation. U.S. core inflation (ex food and energy) has bounced off of the low levels of last summer and should push higher in coming months. Eurozone and Japanese inflation are also moving in the right direction. If this persists at a moderate pace, some industries could experience pricing power for the first time

Equity markets have surged higher in January

Year-to-date performance (in local currencies)



Source - RBC Wealth Management, Bloomberg; data through 1/25/18

Market pulse

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Priced (in USD) as of 1/25/18 market close, EST (unless otherwise stated).

For important disclosures and required non-U.S. analyst disclosures, see page 6.

Wealth Management

during the post-financial crisis recovery cycle—a positive for profit margins.

Prospects for continued corporate earnings growth is another vote of confidence in the global economy—and another reason bond yields *and* equities have risen.

The "wrong" reasons

Equity markets are unlikely to be bothered by bond yields unless they start rising for the "wrong" reasons.

It is one thing for inflation to increase moderately, like it is now, back toward central banks' target levels. It would be quite another thing if inflation were to surge well beyond those targets. Equity markets would likely have a more difficult time handling an unexpected surge in inflation because it would stoke fears that central banks could tighten monetary policy aggressively, potentially choking off economic growth.

Overly aggressive central bank actions related to issues other than inflation, such as red-hot economic growth, could also upset the equity applecart. And it goes without saying that an outright trade war would mean trouble. But we don't anticipate these scenarios or an inflation surge playing out in 2018.

We would not be concerned about the potential impact that rising bond yields could have on the U.S. stock market unless the 10-year Treasury yield were to climb to 3.5%–4.0% or higher for the "wrong" reasons.

Our fixed income strategies team thinks that's a long way off and may not even occur during this recovery cycle. In previous tightening periods, the 10-year yield peaked at a rate near the Fed's target terminal fed funds rate. The Fed is currently targeting 3.0% as its terminal rate, well below our line in the sand.

A pause shouldn't be unexpected

Even though bond yields are rising for the "right" reasons and equity markets are performing well, that doesn't mean equities can keep up this torrid pace.

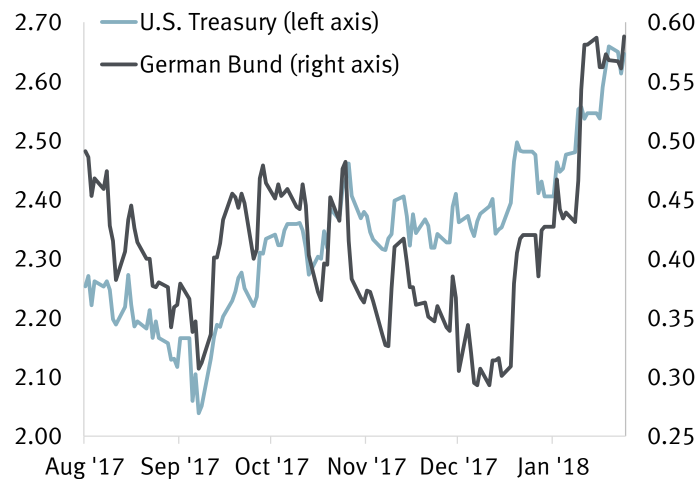
For a number of markets, including Hong Kong, the U.S., Japan, and Europe, the January returns have already delivered roughly half or more than half of a full year's worth of gains. For example, the S&P 500's 6.2% year-to-date rally is almost equal to the average 7.2% annual return of all years since 1954, and is more than half of the 11.4% annual gains in non-recessionary strong years (see lower chart).

It doesn't take much to recognize that such a forceful advance, month in and month out, is not sustainable.

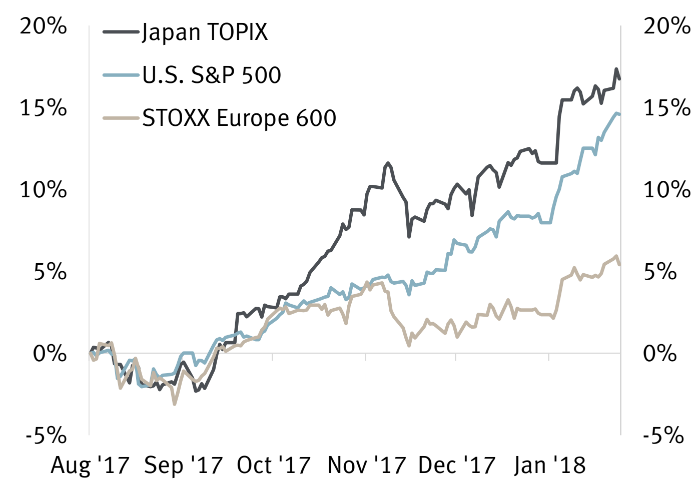
Equity markets have traveled a long way and for a long time without a pullback or a correction. While we still expect additional gains in 2018 and believe the long-term bull market will persist for another year, at least, there are bound to be bumps, a pullback, or even a correction in coming months.

Bond yields push higher, meanwhile equities undeterred

10-year government bond yields (%)



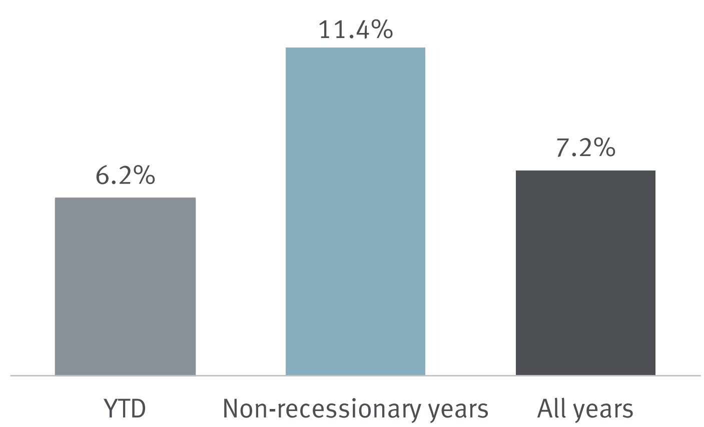
Equity index performance



Source - RBC Wealth Management, Bloomberg; data through 1/24/18

Strong January returns approaching full-year levels

S&P 500 price returns since 1954



Source - RBC Wealth Management, Bloomberg; non-recessionary and all years data reflects average annual returns; data through 1/25/18

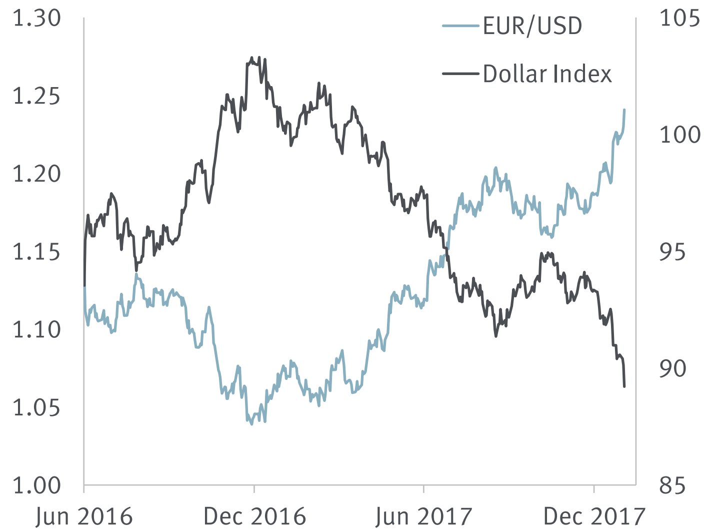
United States

Kelly Bogdanov – San Francisco

- **Treasury Secretary Steven Mnuchin's unexpected comments** about the short-term economic benefits of a weak dollar **pressured the greenback further**, extending its year-long slide. The U.S. Dollar Index (DXY) fell to its lowest level since late 2014, while the euro and yen both surged further against the dollar, particularly after Europe's chief central banker didn't push back on the currency moves. **We think the greenback can recover modestly in 2018** on firm domestic growth, rising interest rate expectations, and repatriation of overseas cash. However, a specific catalyst for an inflection point is not yet visible.
- The strong Q4 earnings season and **significant upward tax-related earnings revisions** are helping to extend the equity rally. Thus far, 83% of companies that have reported have revised their tax guidance for 2018. On average, these companies have noted a **6.4 percentage point decline in their tax burden, at the same time their 2018 consensus earnings estimates have risen 8.4%**, according to our national research correspondent. Some firms are recording sizeable lifts from the tax cuts. For example, health insurance giant **UnitedHealth Group's** effective tax rate will fall to 24% compared to a three-year median rate of 40.7%. The tax change helped boost the consensus earnings forecast by 15.1% in 2018.
- **A couple of wrinkles in the equity rally caught our attention**. (1) The bellwether **semiconductor indexes have underperformed**, sparked by Texas Instruments' forward profit and revenue projections that fell short of aggressive estimates. (2) The **Dow Jones Transportation Average is also lagging** the S&P 500 and Dow Industrials lately. If these groups continue to underperform, it could be a signal that it's time for the market to finally take a breather.

U.S. dollar weakening, euro strengthening

Price levels since Brexit



Source - RBC Wealth Management, Bloomberg; data through 1/24/18

Canada

Christopher Girdler & Farazeh Mahboob – Toronto

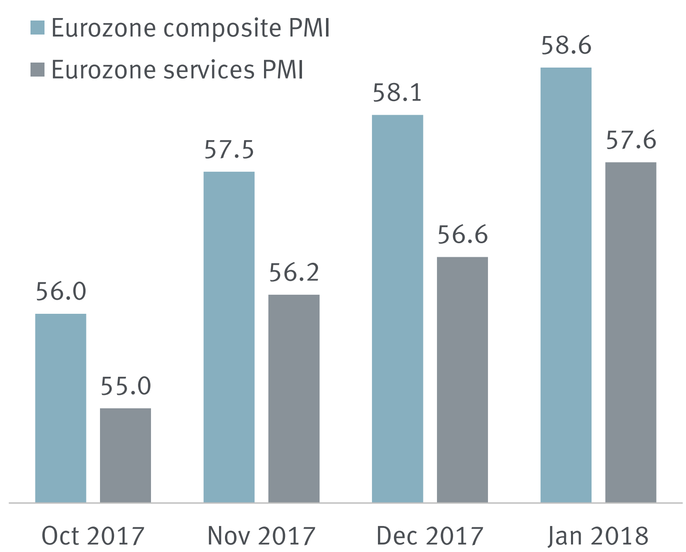
- With the **recent increase in oil prices, the Canadian airlines have seen share price pressure** as investors have anticipated downward earnings revisions. RBC Capital Markets contends that **the group's fundamentals remain robust**, with the airlines reporting very healthy traffic numbers alongside their ability to meaningfully pass on higher fuel prices with higher fares. RBC Capital Markets remains conservative relative to consensus estimates and **advises investors to be opportunistic with regard to share prices weakness** for the Canadian airlines.
- Despite the upward trend in crude oil prices, **small and medium-sized Canadian oil & gas producers** within RBC Capital Markets' coverage universe have significantly underperformed their peers more heavily weighted towards oil on a year-to-date basis. It appears that the **selloff in natural gas prices has led to share price weakness for those in the group with production exposure tilted towards natural gas**. RBC Capital Markets' outlook is for Canadian-based natural gas prices to continue to trade at a discount to other benchmark natural gas prices (i.e., Henry Hub) into 2019, driven by a combination of robust producer production forecasts, pipeline constraints, and reduced demand from warmer-than-anticipated weather patterns this winter. We believe an eventual return to normalized natural gas prices will help small and medium-sized Canadian oil & gas producers and potentially lead to a rally in their share prices. Furthermore, **we recommend that investors remain patient with the group and focus on companies with stronger balance sheets**.
- **The Bank of Canada will be reassured by the continued strength of the consumer**, in the face of higher interest rates, **after retail sales gained in November following a particularly strong October print**. The monthly gain was behind consensus, but the majority of that can be attributed to weaker automobile and related part sales. On another positive note, retail sales volumes were higher over the month and higher when compared to the same period last year.

Europe

Laura Cooper & Thomas McGarrity – London

- **The British pound (GBP) punched higher against the U.S. dollar** on the back of a surprisingly strong U.K. employment report. The market move accelerated the recent upswing with the currency breaching its highest levels since the Brexit referendum in June 2016. **Recent market moves are, in our view, likely more reflective of broader dollar weakness than increased confidence in the strength of the U.K. economy**. Remarks from U.S. Treasury Secretary Steven Mnuchin on Wednesday characterising ongoing dollar weakness as being "good for us" spurred a dollar selloff, further adding to the pound's upward momentum against the dollar.
- The anticipated emergence of softer U.K. economic data and the resumption of still-challenging Brexit negotiations underpin our bearish longer-term GBP view, although the near-term risks for the pound against the dollar remain skewed to the upside. **While economic data coming out of the U.K. has remained resilient thus far**, despite the headwinds emanating from Brexit negotiations, **the consumer is coming under increasing pressure as inflation continues to outstrip wage growth**. Accordingly, we do not expect any U.K. base rate rises until 2019, while the market is pricing in just over one hike in 2018.
- Euro area flash Purchasing Managers' Indexes (PMIs) continued their upward momentum, with activity indicated to have risen further in January, with the composite PMI rising to 58.6 from 58.1 in December. **The improving strength of the euro area economy is one of the key reasons for our Overweight view on European equities**.

Continental European PMIs accelerate to cycle highs



Source - RBC Wealth Management, Bloomberg; January PMIs are flash numbers and are subject to revision

- **The euro rallied against the dollar on Thursday to breach levels not seen since late 2014**. The surprising market move came **on the back of the European Central Bank's (ECB) decision to keep policy steady**, with ECB President Mario Draghi expressing some confidence in the economic expansion and constructive inflationary backdrop. Dollar weakness has added to the currency pair's upswing in recent weeks, and while the rise of U.S. protectionist sentiment could see the trend persist in the near term, **we anticipate that a modest dollar recovery will prevail with the euro drifting lower through 2018**.

Asia Pacific

Jay Roberts – Hong Kong

- **Asian markets have begun 2018 with a bang**. Equities started the year strongly, benefitting from the re-rating of the outlook for U.S. earnings due to corporate tax cuts as well as generally positive sentiment towards equities due to robust, synchronized global growth.
- **The TOPIX Index in Japan broke through 1,900 to its highest level in over 25 years** but gave back some of the gains as the yen appreciated due to weakness in the dollar. **The Hang Seng Index in Hong Kong has risen by a remarkably strong 9.1% thus far in January**, surpassing the peak of 2007. We believe the pace of these gains is unsustainable.
- **Corrections in emerging market equities are common in both bull and bear markets**, yet investors were spared any such occurrence in 2017. While it is **difficult at present to identify a catalyst for a potential selloff** in stocks—although a **strong reversal in the weak dollar could be one**—in our view, Asian equities are susceptible to a move down after such a strong performance recently.
- **Taiwan Semiconductor Manufacturing** (2330 TT) **rose to a record high in Taiwan on strong quarterly earnings**. TSMC is the main chip supplier to Apple. The company also benefitted from demand for chips from cryptocurrency miners, who use an enormous amount of computing power (and energy) to support the technology behind cryptocurrencies. Morris Chang, the chairman and CEO of TSMC, the world's largest semiconductor foundry, said that revenue growth for the company in 2018 may be between 10% and 15%, powered by demand from high-performance computing, devices related to the "Internet of Things," and from the automotive industry.
- **HSBC** (0005.HK), the largest bank in Europe and Hong Kong and the second-largest component of the Hang Seng Index, **agreed to pay approximately $100M in penalties to resolve a U.S. Justice Department investigation with respect to rigging currency rates**.

MARKET SCORECARD

Data as of January 25, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,839.25	6.2%	6.2%	23.5%	51.3%
Dow Industrials (DJIA)	26,392.79	6.8%	6.8%	31.5%	66.1%
NASDAQ	7,411.16	7.4%	7.4%	31.0%	64.0%
Russell 2000	1,601.67	4.3%	4.3%	15.9%	60.6%
S&P/TSX Comp	16,204.01	0.0%	0.0%	3.6%	33.4%
FTSE All-Share	4,185.04	-0.9%	-0.9%	7.7%	29.5%
STOXX Europe 600	398.56	2.4%	2.4%	8.7%	18.5%
EURO STOXX 50	3,630.15	3.6%	3.6%	9.1%	20.9%
Hang Seng	32,654.45	9.1%	9.1%	41.7%	68.8%
Shanghai Comp	3,548.31	7.3%	7.3%	12.7%	20.8%
Nikkei 225	23,669.49	4.0%	4.0%	24.2%	38.3%
India Sensex	36,050.44	5.9%	5.9%	30.1%	47.2%
Singapore Straits Times	3,572.62	5.0%	5.0%	17.5%	38.3%
Brazil Ibovespa	83,680.00	9.5%	9.5%	27.1%	120.0%
Mexican Bolsa IPC	50,777.90	2.9%	2.9%	5.2%	22.4%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,347.19	3.4%	3.4%	12.2%	21.6%
Silver (spot $/oz)	17.28	2.0%	2.0%	1.7%	21.4%
Copper ($/metric ton)	7,111.00	-1.3%	-1.3%	20.1%	60.9%
Oil (WTI spot/bbl)	65.61	8.6%	8.6%	25.6%	131.1%
Oil (Brent spot/bbl)	70.06	4.8%	4.8%	27.2%	129.7%
Natural Gas ($/mmBtu)	3.45	16.8%	16.8%	3.5%	59.8%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.623%	21.7	21.7	11.1	62.1
Canada 10-Yr	2.244%	19.9	19.9	41.9	99.9
U.K. 10-Yr	1.412%	22.2	22.2	-5.9	-27.5
Germany 10-Yr	0.612%	18.5	18.5	14.8	14.1
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.92%	-1.0%	-1.0%	2.7%	4.3%
U.S. Invest Grade Corp	3.42%	-1.0%	-1.0%	5.5%	11.7%
U.S. High Yield Corp	5.61%	0.8%	0.8%	6.9%	30.2%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	89.2270	-3.1%	-3.1%	-10.8%	-10.2%
CAD/USD	0.8082	1.6%	1.6%	5.6%	15.5%
USD/CAD	1.2372	-1.6%	-1.6%	-5.3%	-13.4%
EUR/USD	1.2403	3.3%	3.3%	15.4%	14.3%
GBP/USD	1.4149	4.7%	4.7%	12.0%	-0.7%
AUD/USD	0.8032	2.9%	2.9%	6.1%	15.5%
USD/JPY	109.3700	-2.9%	-2.9%	-3.5%	-7.5%
EUR/JPY	135.6600	0.3%	0.3%	11.4%	5.7%
EUR/GBP	0.8766	-1.3%	-1.3%	3.0%	15.1%
EUR/CHF	1.1673	-0.3%	-0.3%	8.7%	6.2%
USD/SGD	1.3103	-1.9%	-1.9%	-7.3%	-8.4%
USD/CNY	6.3263	-2.8%	-2.8%	-8.1%	-3.8%
USD/MXN	18.5930	-5.4%	-5.4%	-11.8%	-0.1%
USD/BRL	3.1486	-4.9%	-4.9%	-0.7%	-23.0%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX and Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 9:35 pm GMT 1/25/18.

Examples of how to interpret currency data: CAD/USD 0.80 means 1 Canadian dollar will buy 0.80 U.S. dollar. CAD/USD 1.6% return means the Canadian dollar rose 1.6% vs. the U.S. dollar year to date. USD/JPY 109.37 means 1 U.S. dollar will buy 109.37 yen. USD/JPY -2.9% return means the U.S. dollar fell 2.9 vs. the yen year to date.

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Sell [Underperform]	105	6.34	8	7.62

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