September 6, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

NAFTA: A genuine breakthrough?

Patrick McAllister, CFA – Toronto

Following weeks of bilateral negotiations, the U.S. and Mexico have bridged their key differences and announced a revised trade accord. With both seemingly content to forge ahead with or without their northern neighbour, the pressure is on Canada to ensure NAFTA 2.0 remains a trilateral agreement.

Trade policy and tariffs continue to dominate government, corporate, and investor mindshare. While olive branches have been extended between the EU and the U.S., the latter could look to escalate its trade showdown with China by imposing tariffs on an additional $200B worth of Chinese goods as early as September 7. The U.S. and Mexico have announced a trade agreement, but whether this is a harbinger of a revised NAFTA that includes Canada or leaves much work to be done remains subject to considerable uncertainty.

What appears to have been settled?

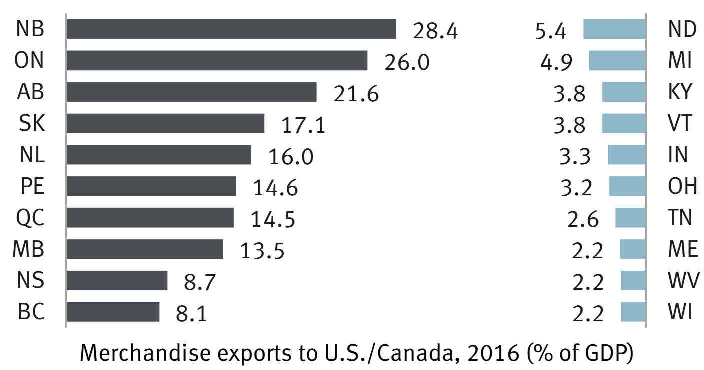
The rules governing tariff-free trade in automobiles and auto parts among NAFTA partners had been the largest wedge separating the U.S. and Mexico. With the deal announced on August 27, Mexico largely acquiesced to key U.S. demands and the issue of auto trade appears to have been settled.

A definitive account of what has been agreed will remain elusive until the legal text is released later this month, but the new rules have been widely reported to raise the minimum NAFTA-zone content requirements for duty-free trade to 75% (from 62.5%) and stipulate that at least 40% of content must come from plants at which workers earn $16 per hour or more. While details remain scant (e.g., what is the implementation timeline and how is content measured?), we believe that Canada is broadly aligned with the U.S. on the rules governing auto trade in a renegotiated NAFTA.

Where Canada may not be aligned with the U.S.-Mexico trade deal is the inclusion of a "sunset clause." The initial U.S. negotiating position called for the inclusion of a clause that would require all three countries to agree on extending NAFTA

Trade war would be more detrimental to Canada than U.S.

Top 10 Canadian provinces/U.S. states by merchandise exports to U.S./Canada as % of provincial/state GDP



Legend: NB - New Brunswick, ON - Ontario, AB - Alberta, SK - Saskatchewan, NL - Newfoundland and Labrador, PE - Prince Edward Island, QC - Québec, MB - Manitoba, NS - Nova Scotia, BC - British Columbia, ND - North Dakota, MI - Michigan, KY - Kentucky, VT - Vermont, IN - Indiana, OH - Ohio, TN - Tennessee, ME - Maine, WV - West Virginia, WI - Wisconsin

Source - Haver Analytics, RBC Global Asset Management

Market pulse

every five years, otherwise the deal would be terminated. The U.S. and Mexico struck a compromise whereby a six-year review would be followed by a 10-year sunset in the event the review did not result in an agreement to extend the pact. While we presume the Canadian negotiating team prefers an accord without such a clause, we believe the compromise will ultimately prove acceptable.

What issues remain outstanding?

Several sticking points remain as U.S. and Canadian negotiators reconvene talks in Washington.

Headlining these issues is NAFTA's existing Chapter 19 that allows companies that believe they have been unfairly targeted by duties to request arbitration via a bilateral trade panel. U.S. Trade Representative Robert Lighthizer views this provision as an infringement on U.S. sovereignty, but the Canadian government has been strident in calling for its preservation. A dispute settlement mechanism outside of the U.S. court system was a make-or-break issue for Canada in negotiating NAFTA's precursor, the Canada-United States Free Trade Agreement, which prompted the Canadian delegation to briefly walk out of the 1987 talks during the debate over its inclusion. We believe a creative solution may be required that satisfies both sides and provides cover against being seen as caving on a key issue.

Canada's dairy supply management system has been in President Trump's crosshairs and is likely to require some movement on Canada's part. Trade pacts negotiated with the EU and the Trans-Pacific Partnership have seen Canada accept increased dairy import quotas, but it remains to be seen if this would be enough to satisfy the U.S.

Beyond this politically sensitive file, negotiators must tackle a host of other issues including intellectual property and cultural exemptions if they hope to strike a deal.

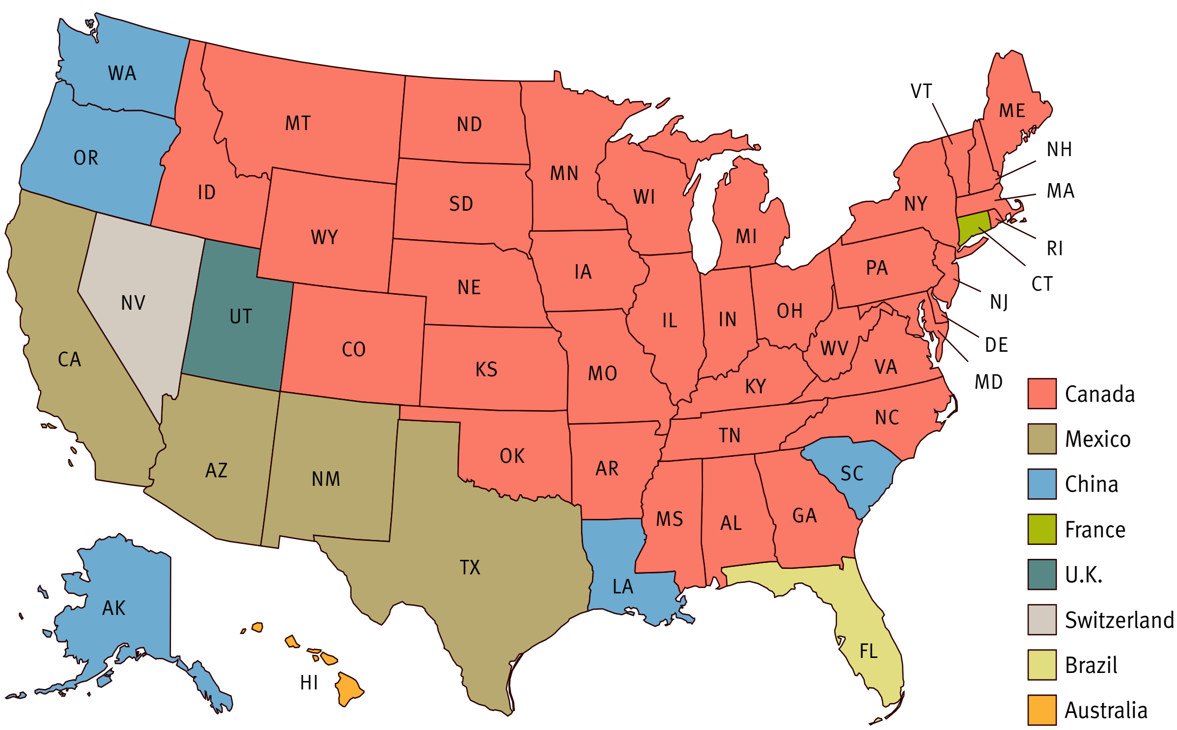
The path forward remains highly uncertain

After striking a deal with Mexico, Trump notified Congress on August 31 of his intention to sign a new trade agreement with or without Canada within 90 days. Whether Congress will entertain a bilateral deal is an open question as the original mandate bestowed on the administration called for negotiating a trilateral agreement. With notice of intent delivered, the administration must provide Congress with the legal text of the agreement by September 30, which provides a guidepost for progress in negotiations with Canada.

We believe a lack of tangible progress by that date could see the U.S. attempt to further its bilateral deal with Mexico and/or signal its intent to withdraw from NAFTA. Either option could meet considerable resistance from Congress, the ultimate arbiter of U.S. trade, and condemn NAFTA to prolonged uncertainty.

We continue to view trade policy uncertainty as a key risk that offsets the Canadian equity market's seemingly discounted valuation and underlines our Market Weight recommendation.

36 U.S. states count Canada as their No. 1 export destination



Source - RBC Capital Markets, U.S. Dept. of Commerce (2017 data)

United States

Ben Graham, CFA – Minneapolis

- **September has been challenging for U.S. equities so far, as all major indexes have traded lower, with the NASDAQ and Russell 2000 declining the most sharply.** Recent sector rotation trading days have caused the Technology and Consumer Discretionary sectors to trade lower, as they have retreated 2.6% and 1.2% during the week. Software has been the week's worst-performing industry within Tech, declining approximately 4%, while Internet Retail earned the same distinction in the Consumer Discretionary sector. On the other side of the coin are the bond proxies, which have seen Utilities and Consumer Staples climb 2.2% and 1.2%, respectively.
- **RBC Global Asset Management has released its quarterly outlook** that encompasses its views of global markets for the next 12 months. It's calling for an **S&P 500 price target of 3,000 one year from now** and recommending **Overweight positions in global Consumer Discretionary, Health Care, and Tech.** RBC Global Asset Management is least favorable on Industrials, Consumer Staples, Materials, and Financials. Additionally, one of our national research correspondents released a 2019 year-end price target of 3,350 for the S&P 500 based on an expectation of consensus earnings being realized and a re-acceleration in market multiples.
- **The yield curve has steepened from a low base in recent days,** with the spread between the 2- and 10-year Treasury rates expanding from a post-Great Recession low of 18 basis points (bps) in August to 25 bps on September 5. A flat curve is one of several components fueling our view that the Fed will only hike once more in 2018 and just twice in 2019. This contrasts with the Fed's previous communications that state two more hikes are coming in 2018 and three in 2019, while investor attention is squarely focused on how the language will be updated after the Fed meeting later this month.
- **The U.S. economy clearly accelerated in August,** as seen in the ISM Manufacturing and Non-Manufacturing Purchasing Managers' Indexes (PMIs) of 61.3 and 58.5, respectively. These strong readings soundly beat consensus expectations of 57.6 and 56.8, respectively. The acceleration in the ISM Manufacturing PMI brings the index to its highest level since 2004.

RBC Global Asset Management sector recommedations

Fall 2018 global sector recommendations

Sector	Recommended allocation	Benchmark weight	Difference
Consumer Discretionary	14.6%	12.6%	2.0%
Health Care	14.6%	12.6%	2.0%
Tech	20.9%	18.9%	2.0%
Energy	6.5%	6.5%	0.0%
Real Estate	3.0%	3.0%	0.0%
Telecom	2.6%	2.6%	0.0%
Utilities	2.9%	2.9%	0.0%
Financials	15.8%	16.8%	-1.0%
Materials	3.7%	4.7%	-1.0%
Industrials	9.2%	11.2%	-2.0%
Consumer Staples	6.2%	8.2%	-2.0%

Note: Benchmark is the MSCI World Index. Source - RBC Wealth Management, RBC Global Asset Management; data from Fall 2018 *Global Investment Outlook*

Canada

Arete Zafiriou, Diana Di Luca, & Richard Tan – Toronto

- **Q2 2018 results from the Canadian Mortgage and Housing Corporation** (CMHC) indicate there are **no early signs of a housing downturn,** according to RBC Capital Markets. CMHC's mortgage loss ratio increased year over year (as did the peer group) to 20% from 13%, supporting our thesis that the housing market should continue to slow. **Industry gross premiums have experienced a negative decline** over the past six quarters due to tightening regulations such as the implementation of the foreign home buyer tax and introduction of the B-20 rules. However, increased mortgage insurance prices have helped to partially offset the downtrend. Toronto and Vancouver continue to be important cities to monitor as they make up 50% of dollar value transactions within Canada.
- Using results data for **Canadian REITs and REOCs,** RBC Capital Markets produced a trend line that indicated **Q2 2018 earnings growth for the sector was 1%**, slightly below its 2% forecast and in line with Q1 2018 results. Looking forward, RBC Capital Markets expects the annual trend line earnings growth for 2018 to reach 3%, down from its prior 4% forecast. **Catalysts for growth** include GDP growth, healthy economic conditions in oil-producing provinces, and good property fundamentals in the Greater Montreal, Toronto, and Vancouver regions.
- As the market expected, the **Bank of Canada (BoC) maintained the overnight rate at 1.50%.** The BoC addressed the recent headline CPI reading of 3.0%—at the upper end of its target range—saying the reading was largely due to transitory factors and that it expects headline inflation to moderate to its 2% target in early 2019. The statement concluded with a sentence indicating that **downside risks from trade headlines are not going unnoticed** by the BoC: "[We] are monitoring closely the course of NAFTA negotiations and other trade policy developments, and their impact on the inflation outlook."

We think investors will now turn their attention to the next meeting, in late October, when a 25 basis points hike is approximately 80% priced in by the market.

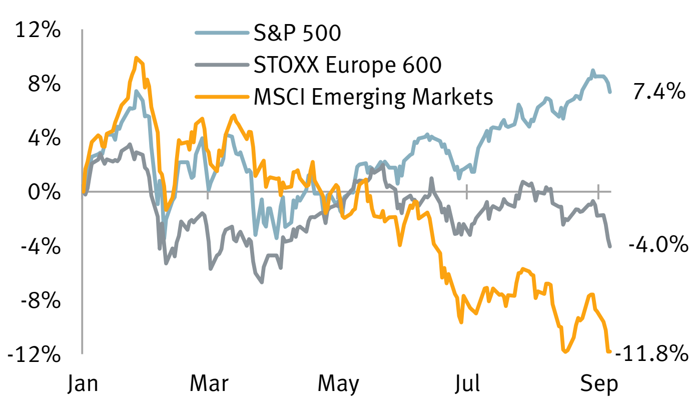
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The STOXX Europe 600 Index,** which encompasses both European and U.K. equities, **fell close to 3%** in the week as investors fled riskier areas of financial markets amid rising trade tensions and emerging market concerns. With some 27% and 24%, respectively, of U.K. and European companies' revenues generated from emerging markets, the **broad selloff in emerging market currencies spilled over into pan-European equities.**
- **The U.K. manufacturing Purchasing Managers' Index (PMI) dropped to a more than two-year low** of 52.8 in August. New export orders fell sharply from 53.0 the previous month to 47.4, thus showing signs of a contraction in manufacturing for the first time in two-and-a-half years. This could reflect businesses' **fears regarding protectionism, or EU-based companies moving their U.K. manufacturing operations abroad** given Brexit. The August services PMI came in above both the prior month's reading and market expectations at 54.3, pointing to the U.K. economy's increasing dependence on services, which is on track to grow by 0.3% q/q in Q3 or 1.3% y/y in 2018, according to RBC Capital Markets.
- **Bank of England (BoE) Governor Mark Carney expressed he would be willing to extend his tenure** beyond the current mandate of June 2019 so as to enable a smoother Brexit process. Given the wide-ranging uncertainties surrounding Brexit and the possibility of a "hard Brexit," which we believe would be a shock to investors' confidence in the U.K.'s economy, **retaining stability at the central bank is a welcome development.** Moreover, by staying until the second half of 2020, Carney will also help the BoE transition to a new governor.
- **One area that bucked the trend of losses was the Italian stock market,** which gained close to 1% in the week as newsflow from Italy grew increasingly positive. Prime Minister Giuseppe Conte suggested budget talks had been very productive and Deputy Prime Minister Matteo Salvini, head of the right-wing, anti-EU Northern League, **made conciliatory statements regarding honoring previous commitments.** Should these attitudes stand, a vociferous confrontation with the EU regarding Italy's budget may well be avoided.

Emerging markets' weakness spreads to Europe

YTD performance, local currency



Source - RBC Wealth Management, Bloomberg; data through 9/6/18, 12:15 CT

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **The Hang Seng Index finished under 27,000 for the first time in 2018.** The benchmark index in Hong Kong has been weighed down by a combination of the U.S. and China trade dispute, China's financial deleveraging, and a decline in the renminbi (the majority of the index's market capitalization is composed of companies from mainland China). The index **may remain under pressure, in our view, as investors worry about if and when the U.S. will announce its third round of tariffs against China.**
- Also, the Hang Seng Index's third-largest component, Chinese gaming and social networking company **Tencent, has been weak this year, declining by 33%**, although this must be put in the context of the exceptional rally in 2017 when the stock more than doubled in value. The most recent weakness in the stock has been due to **concerns that the government will introduce tighter regulations for online games** to improve public health, especially of children, and may introduce taxes. The company's largest revenue source is online gaming.
- **Japan's Prime Minister Shinzo Abe announced that he will seek a third term as head of Japan's Liberal Democratic Party.** The leadership election will be held on September 20. Opinion polls indicate that Abe currently enjoys a comfortable majority of support for re-election. Separately, Japanese capital spending by companies rose by 13% in Q2, the highest growth in over 10 years.
- **Australia kept its benchmark interest rate unchanged at 1.5%,** where it's been for over two years since a rate cut in August 2016. The last time the central bank raised interest rates was in 2010. Even though the economy grew by a better-than-expected 3.4% in Q2, **there is little expectation of any increase in the benchmark rate in the short-to-medium term due to a lack of inflationary pressures.** RBC Capital Markets forecasts the Australian dollar to decline modestly against the U.S. dollar.

MARKET SCORECARD

Data as of September 6, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,878.05	-0.8%	7.6%	16.7%	31.6%
Dow Industrials (DJIA)	25,995.87	0.1%	5.2%	19.2%	40.2%
NASDAQ	7,922.73	-2.3%	14.8%	23.9%	50.2%
Russell 2000	1,714.47	-1.5%	11.7%	22.3%	36.8%
S&P/TSX Comp	16,100.94	-1.0%	-0.7%	6.9%	8.7%
FTSE All-Share	4,042.34	-1.6%	-4.3%	0.2%	8.5%
STOXX Europe 600	373.47	-2.3%	-4.0%	-0.1%	6.9%
EURO STOXX 50	3,295.95	-2.9%	-5.9%	-4.0%	7.4%
Hang Seng	26,974.82	-3.3%	-9.8%	-2.3%	13.4%
Shanghai Comp	2,691.59	-1.2%	-18.6%	-20.5%	-12.9%
Nikkei 225	22,487.94	-1.6%	-1.2%	16.2%	31.6%
India Sensex	38,242.81	-1.0%	12.3%	20.8%	32.0%
Singapore Straits Times	3,147.69	-2.0%	-7.5%	-2.6%	8.7%
Brazil Ibovespa	76,416.01	-0.3%	0.0%	4.1%	27.1%
Mexican Bolsa IPC	48,711.85	-1.7%	-1.3%	-3.6%	2.3%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,200.08	-0.1%	-7.9%	-10.1%	-11.1%
Silver (spot $/oz)	14.16	-2.6%	-16.4%	-20.8%	-29.4%
Copper ($/metric ton)	5,854.25	-1.9%	-18.8%	-14.9%	27.2%
Oil (WTI spot/bbl)	67.77	-2.9%	12.2%	37.9%	51.2%
Oil (Brent spot/bbl)	76.72	-0.9%	14.7%	41.5%	62.3%
Natural Gas ($/mmBtu)	2.78	-4.7%	-5.9%	-7.4%	2.2%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.877%	1.6	47.1	77.2	134.3
Canada 10-Yr	2.232%	0.4	18.7	28.8	120.5
U.K. 10-Yr	1.416%	-1.1	22.6	41.1	75.5
Germany 10-Yr	0.355%	2.9	-7.2	0.8	46.6

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.34%	-0.3%	-1.2%	-1.4%	-1.0%
U.S. Invest Grade Corp	4.00%	-0.4%	-2.3%	-1.4%	0.6%
U.S. High Yield Corp	6.31%	-0.1%	1.9%	3.1%	12.0%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	95.0080	-0.1%	3.1%	2.9%	0.2%
CAD/USD	0.7611	-0.7%	-4.3%	-6.9%	-2.2%
USD/CAD	1.3139	0.8%	4.5%	7.5%	2.3%
EUR/USD	1.1625	0.2%	-3.2%	-2.5%	3.3%
GBP/USD	1.2929	-0.2%	-4.3%	-0.9%	-3.8%
AUD/USD	0.7197	0.1%	-7.8%	-10.0%	-6.4%
USD/JPY	110.7000	-0.3%	-1.8%	1.4%	8.5%
EUR/JPY	128.6800	-0.1%	-4.9%	-1.1%	12.1%
EUR/GBP	0.8991	0.4%	1.2%	-1.6%	7.4%
EUR/CHF	1.1222	-0.2%	-4.1%	-1.6%	2.8%
USD/SGD	1.3747	0.2%	2.9%	1.8%	2.1%
USD/CNY	6.8355	0.1%	5.1%	4.8%	2.5%
USD/MXN	19.2125	0.7%	-2.3%	8.0%	5.1%
USD/BRL	4.0592	0.1%	22.5%	30.9%	27.0%

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 9/6/18.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -4.3% return means the Canadian dollar fell 4.3% vs. the U.S. dollar year to date. USD/JPY 110.70 means 1 U.S. dollar will buy 110.70 yen. USD/JPY -1.8% return means the U.S. dollar fell 1.8% vs. the yen year to date.

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