October 11, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Don’t be shaken by the shakeout

Kelly Bogdanova – San Francisco; Tom Garretson, CFA & Ben Graham, CFA – Minneapolis

A number of factors reached critical mass, driving U.S. equities and other markets sharply lower. But investors shouldn’t overreact to this overdue pullback. We don’t think there is an existential threat to the U.S. bull market, and we look at how the Fed and bond markets fit into all of this.

Pullbacks and corrections are routine when it comes to investing, but they rarely feel that way when they arrive.

The U.S. equity market sold off on Wednesday and Thursday, marking six straight declines for the S&P 500. The NASDAQ stumbled more than the broader indexes. As Technology shares corrected sharply, the NASDAQ posted its second-biggest single-session selloff in seven years, falling 4.1% on October 10, behind only the Brexit-induced selloff in mid-2016. All total, the Dow Jones Industrial Average, S&P 500, and NASDAQ have declined 6.6%, 6.9%, and 9.6%, respectively, from their recent all-time highs.

Equity markets worldwide followed the U.S. lower, adding to their previous losses. Asian and emerging markets have borne the brunt of the global correction.

The U.S. fixed income market hasn’t been immune to the selling. Treasury prices fell and the 10-year Treasury yield climbed to 3.23% at one point, the highest level since 2011. The spike in yields spooked global equities.

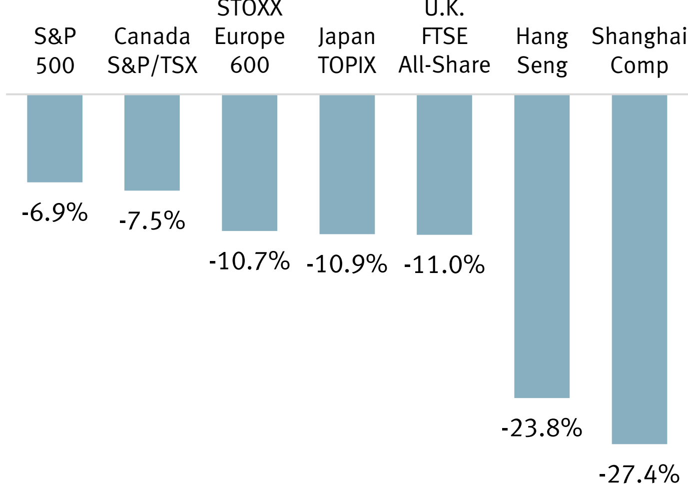
Pointing the finger

Corrections typically have multiple culprits, and this episode is no exception. Equity markets are primarily being held back by:

- the run-up in Treasury yields and related concerns about a higher interest rate regime;
- perceptions by some that the Federal Reserve may shift to an unnecessarily aggressive rate hike pace (we disagree);
- a fierce decline in global Tech stocks primarily due to tariff risks, regulatory threats, above-average valuations, and signs of peak activity in bellwether semiconductors;

The correction is weighing more heavily on Asia ex-Japan

Percentage decline of select equity indexes from 2018 highs*



*Four of the seven indexes reached all-time highs in 2018: S&P 500, S&P/TSX, FTSE All-Share (U.K.), and Hang Seng
Source - RBC Wealth Management, Bloomberg; data through 10/11/18; data in local currencies

Market pulse

4 Discount on Canadian equities offsets domestic risks
4 European stocks hit their lowest levels in nearly two years
5 The Hang Seng’s line in the sand

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Priced (in USD) as of 10/11/18 market close, EST (unless otherwise stated).
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- the increasing likelihood the U.S.-China trade dispute will intensify, and the ratcheting up of overall tensions between the two countries;
- concerns about China's slowing economic momentum;
- potential wrinkles in the U.S. Q3 earnings season related to margin pressure, tariff angst, and the strong dollar; and,
- the coming transition to a slower, more normal U.S. corporate earnings growth rate in 2019.

Data from RBC Capital Markets indicates global investors had crowded into the U.S. over the summer as tariff risks were hitting other markets with greater force. Technology and Communication Services have become particularly over-owned, and have underperformed during the market pullback. Another growth sector, Consumer Discretionary, has lagged as well.

There are also signs that computer-driven algorithmic trading may have exacerbated the equity selloffs. This is becoming par for the course during episodes of volatility.

It's important to keep in mind the S&P 500 pullback follows the strongest quarterly performance in almost five years. U.S. equities are usually volatile in October and are often wobbly in midterm election years—typically pulling back within the 12-month period ahead of the election and then rallying after the dust settles.

Market maintenance

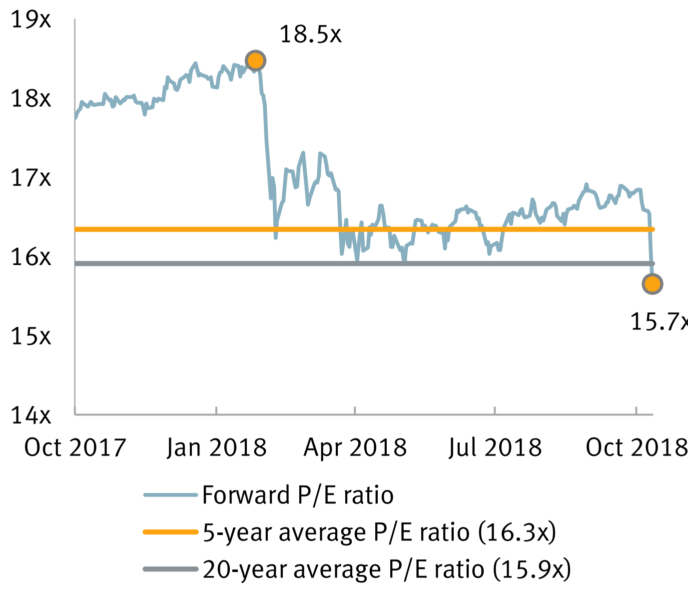
In our view, the entire laundry list of concerns above does not need to be resolved for equity markets to start to regain their sea legs. Our checklist of requirements for calmer conditions includes: Treasury yields settling down, Tech stocks stabilizing, and indications that Q3 U.S. earnings trends will be respectable overall despite some wrinkles by select companies. Some fear and loathing among investors would also help, in our assessment, as these attitudes are almost always contrary indicators. This process will likely take some time.

The immediate risks facing equities have not changed our constructive longer-term view because the two pillars for stocks—economic and earnings growth—are likely to continue to provide a sturdy foundation. We remain Market Weight U.S. equities and slightly Overweight the overall global equity asset class. Forward-looking indicators are still signaling the U.S. economic expansion will persist for the next 12 months, at least, and some of these data points have actually strengthened recently.

While we expect S&P 500 earnings growth to slow from its torrid 2018 pace of 20%+ y/y (including the boost from tax cuts), growth in 2019 should be average to slightly above average, in the high single-digit to low double-digit range.

The silver lining: Market valuations are easing

S&P 500 forward twelve-month price-to-earnings (P/E) ratio



Source - RBC Wealth Management, FactSet; data through 10/11/18

This should be enough to maintain the long-term bull market streak, in our view.

During market corrections, valuations typically ease when earnings forecasts do not deteriorate. At this stage, earnings growth is still materializing, sales growth is outpacing GDP growth, and valuations are easing. In fact, the S&P 500 forward price-to-earnings (P/E) ratio has declined. After reaching a peak of 18.5x in late January based on the twelve-month forward consensus forecast, the forward P/E has declined more than 15% to 15.7x to trade below longer-term averages. Additionally, measured against the 5- and 20-year averages, the chart shows that the current valuation appears to be relatively benign for a market forecast to grow earnings per share at 20%+ y/y for the second half of 2018 and at roughly 10% in the first half of 2019.

Passing the gut check

Over the near term, it's likely the issues weighing on U.S. and global equities will take some time for markets to sort through or adjust to, and could involve more downside.

RBC Capital Markets, LLC's Head of U.S. Equity Strategy Lori Calvasina is reluctant to buy the dip at this stage given the risks surrounding Q3 earnings season and the over-ownership of U.S. equities by global investors, and specifically crowding in Tech and Communication Services. We think earnings trends will be respectable overall with some select companies facing challenges related to margins, tariffs, or the dollar. But the process has to work through the system over the coming days and weeks.

RBC Capital Markets, LLC's Technical Strategist Bob Dickey anticipates that once the market finds its footing, perhaps at moderately lower levels, some backing and filling should occur within a trading range over the months ahead as the market consolidates the strong gains of the past two years.

Our view remains that investors should give equities the benefit of the doubt as long as the economic, credit, and earnings cycles remain favorable for stocks. We would not overreact to the recent moves. Corrections usually take some time to play out. They rarely end quickly. We think investors have time to be patient and make portfolio decisions thoughtfully, in line with long-term goals.

Welcome to the policy error era

The bond markets are again receiving the bulk of the blame for equity market turbulence, and it may not be completely unwarranted. With the Federal Reserve having raised short-term rates to a 2.00%–2.25% range at its September meeting, we are nearing the level where policy rates begin to restrict economic activity—currently estimated by the Fed to be levels higher than 3.00%, or just three rate hikes away.

While the September rate hike had long been anticipated, markets have renewed worry on the back of recent historically strong economic indicators and rising wage pressures that might cause the Fed not only to raise rates toward that 3.00% level more quickly than expected, but to push well beyond it.

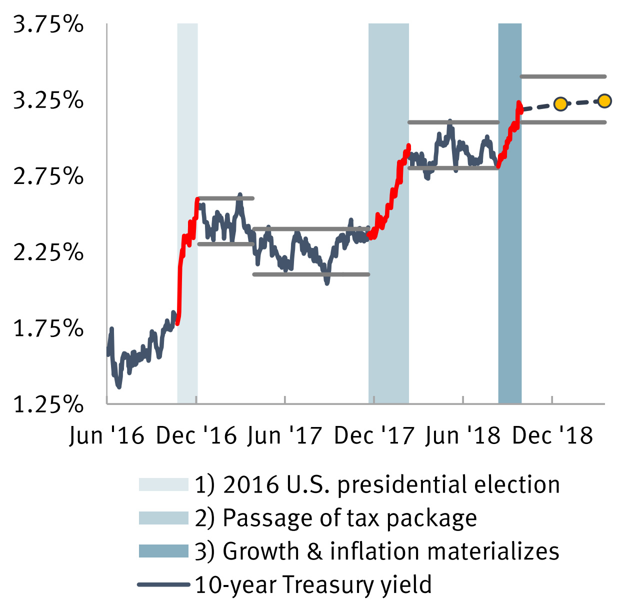
Those fears were sparked in part by Fed Chair Jerome Powell's October 3 comments. "Interest rates are still accommodative, but we're gradually moving to a place where they'll be neutral—not that they'll be restraining the economy," he said. "We may go past neutral. But we're a long way from neutral at this point, probably."

The bond market likely took issue with the Fed's decision, at its September meeting, to remove language characterizing policy as "accommodative" from its official statement as well as with Powell's suggestion that rates remain "a long way from neutral," which raised the possibility that the Fed chair thinks the neutral level could be higher than the Fed's current 3.00% consensus.

But the main problem is that while the Fed may think rates are a long way from neutral, markets continue to see policy rates peaking for the rest of this cycle at just 2.75%, or two rate hikes away.

Looking forward, we believe uncertainty around what each subsequent rate hike means for the economy, and the risk that the Fed will raise rates until something breaks, will keep markets on edge and is likely to keep volatility elevated—as is typical in a late-stage economic cycle environment.

We expect the 10-year Treasury yield to once again steady after latest selloff



Source - RBC Wealth Management, Bloomberg; 10-year Treasury yield forecasts based on futures market data

But it doesn't have to be this way

The chart shows the story of the benchmark 10-year U.S. Treasury yield over the last two years, and the three catalysts that have driven market selloffs. As in the past, we expect the 10-year yield to stabilize and find a new 30 basis points trading range, this time between 3.10% and 3.40%. However, we think this is the last hurrah for Treasury yields as we maintain our view that 3.40% is likely to be the speed limit for the 10-year in this economic cycle.

We also continue to see the Fed raising rates, likely twice more to 2.75%, before pausing. Despite recent strong data, RBC Global Asset Management expects economic growth to moderate next year, while the October 11 release of consumer price data showed inflation remains in check. That, combined with recent market action, should only serve to convince the Fed that caution is warranted.

Canada

Arete Zafiriou & Richard Tan – Toronto

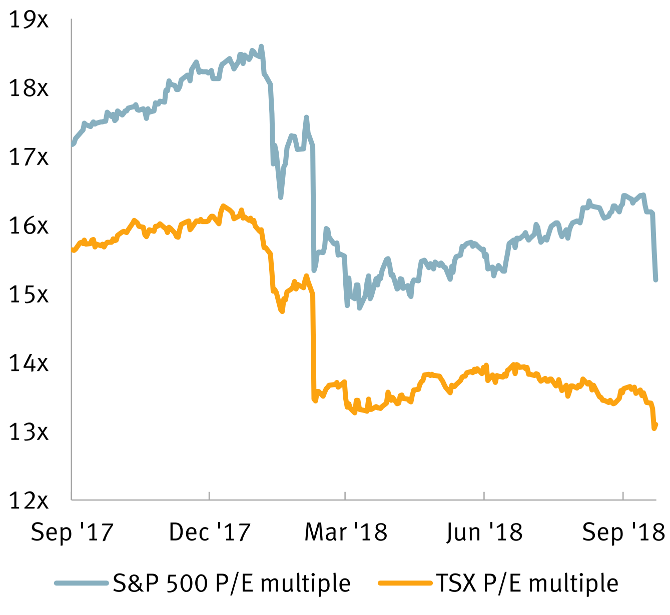
- **Thus far in 2018, the Canadian market has lagged the U.S.**, primarily due to pipeline constraints, reliance on commodity prices, trade uncertainties, a rising rate environment, and the outperformance of U.S. Technology stocks. As of market close on October 3, the S&P/TSX Composite was up 1.4% on a total-return basis compared with the S&P 500 at 11.0%. However, if we compare the performance of the S&P/TSX and the S&P 500 from the open on October 4 (the start of the selloff) through market close on October 10, the Canadian benchmark outperformed by approximately 97 basis points on a total-return basis.

- **Only four of the 11 S&P/TSX Composite sectors remain in positive territory on a year-to-date basis. Health Care is leading the pack** with returns north of 28% **followed by Technology** at approximately 12%. However, at 2% of the index, the Health Care sector's contribution to the benchmark is fairly muted. **Consumer names and Utilities have been lagging**, losing approximately 10% and 11%, respectively, as higher minimum wages, inflation concerns, and rising rates have caused multiples to contract.

- However, throughout the recent market selloff, **Utilities largely outperformed on a relative basis** as risk appetite diminished and investors rotated into defensive sectors. We remain **wary of the impact of higher interest rates** as sectors (such as Utilities) that are viewed as bond alternatives require high capital expenditures, carry a higher debt burden in their capital structure typically, and exhibit higher sensitivity to interest rates. **Yields on 10-year Government of Canada bonds have moved up** by approximately 46 basis points since the beginning of the year.

- **A number of factors reinforce our Market Weight stance on Canadian equities**. The economy remains healthy, with August employment data showing a net gain of 63,000 jobs, beating consensus expectations of 23,000. Furthermore, **the new USMCA trade pact was a net positive**, particularly in avoiding the threat of U.S. auto import tariffs on Canadian-made vehicles and parts. Canada also made fewer concessions than expected with respect to dairy. Housing has been sluggish for most of the year, but key pockets are now showing signs of stabilization. We have also become **more constructive on the outlook for crude oil prices** given the upcoming U.S. sanctions on Iran. The S&P/TSX now trades at a 2019 forward P/E of 13.1x compared with the S&P 500 at 15.2x. We believe that the discount on the Canadian market provides adequate compensation for domestic-specific risks (e.g., the impact of higher rates on leveraged households and housing, energy transportation constraints, and waning relative economic competitiveness) and leaves scope for an improved relative valuation in the event the Canadian outlook improves at the margin.

The discount of Canadian equities provides adequate compensation for domestic-specific risks



Source -RBC Wealth Management, Bloomberg; data through 10/11/18

Europe

Frédérique Carrier, Thomas McGarrity, CFA, & Alastair Whitfield – London

- **European stocks fell to their lowest levels since January 2017**. The STOXX Europe 600 fell 5.3% over the past five trading days in a broad-based selloff. Growth and cyclical sectors led the declines, including Technology (-8.6%), Financial Services (-7.9%), Industrial Goods and Services (-7.8%), and Basic Resources (-6.8%). **Defensive value (aka "bond proxy") sectors notably outperformed**, with Telecommunications (-0.9%), Real Estate (-1.9%), and Utilities (-2.5%) the best-performing sectors.

- **Among Tech stocks, Semiconductors were the worst hit** on continued trade war uncertainty and worries that the semiconductor cycle has peaked, with industry data pointing to rising inventories. The European Tech sector, especially Semiconductors, has had a strong run, and remains the best-performing sector in Europe since the start of 2017. **In the long term, we remain constructive**

on Semiconductors, given structural trends towards increased electrification, automation, and energy efficiency, which should underpin semiconductor content growth. However, performance could be held back in the short term until destocking concerns recede, and clarity emerges regarding trade wars.

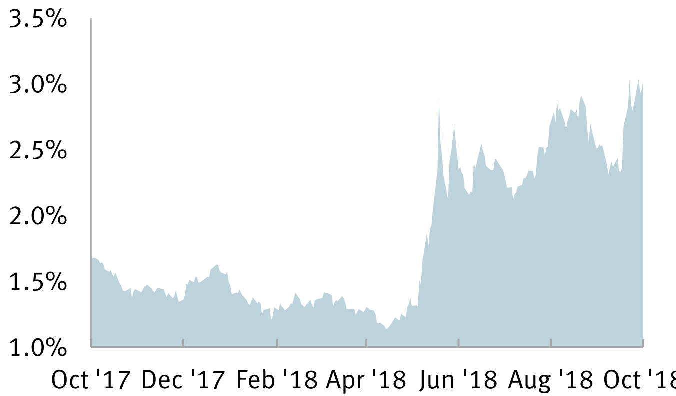
- **Luxury Goods stocks were also hit**. Bellwether LVMH Moët Hennessy Louis Vuitton confirmed that customs rules in China are being enforced more stringently on non-declared imports, adding to fears of a deceleration in Chinese consumer demand. Despite the Luxury Goods subsector having now given back all its 2018 gains, we believe its longer-term outperformance, the unwinding of positions, and profit-taking all suggest **further underperformance is possible in the short term**, especially amid mounting concerns of a slowdown in Chinese consumer spending and relatively rich valuations.

- **We maintain our Market Weight stance on both European and U.K. equities**. While both have undemanding valuations, in absolute and relative terms, risks around the Italian political situation and Brexit continue to cloud the outlook. We believe **the defensive qualities of Health Care are attractive** at this stage in the cycle and amid trade uncertainty, while valuations that are not overly demanding should shield the sector somewhat from rising bond yields. We also continue to see value in Energy and Insurance companies.

- In fixed income markets, **European and U.K. government bonds both broadly mirrored the move in U.S. Treasuries**, with yields falling from recent highs given the demand for sovereign assets in response to the fall in equities. German and U.K. government bonds have led the moves, being the risk-free assets for their respective markets.

Italian bonds look riskier as government plans larger deficit

Spread between Italian and German sovereign 10-year yields



Source - RBC Wealth Management, Bloomberg; data through 10/11/18

- Peripheral Europe has proved the exception, as **tensions continue around Italy's ongoing determination to deepen its deficit** as per the coalition government's manifesto earlier this year. This has seen **Italian 10-year yields continue to push above 3.5%**, with 2-year yield spreads relative to Germany widening by 78 basis points (bps) since late September and now exceeding 200 bps. Spanish and Portuguese 2-year yield spreads have followed this trend somewhat, but with much more modest moves (up by just 10 bps).

- We expect market concerns regarding Italy to persist while leaders of both the Five Star Movement and the Northern League, which make up **the Italian coalition government, continue to take a hard line against the EU Commission**. This could lead S&P and Moody's to potentially downgrade the country's outlook at the end of this month.

- Credit has seen limited moves and we remain constructive on the market overall. We maintain our stance on European credit (Overweight) and government bonds (Market Weight), as well as our Market Weight stance on U.K. government bonds and credit.

Asia Pacific

Jay Roberts, CFA & Calvin Ng – Hong Kong

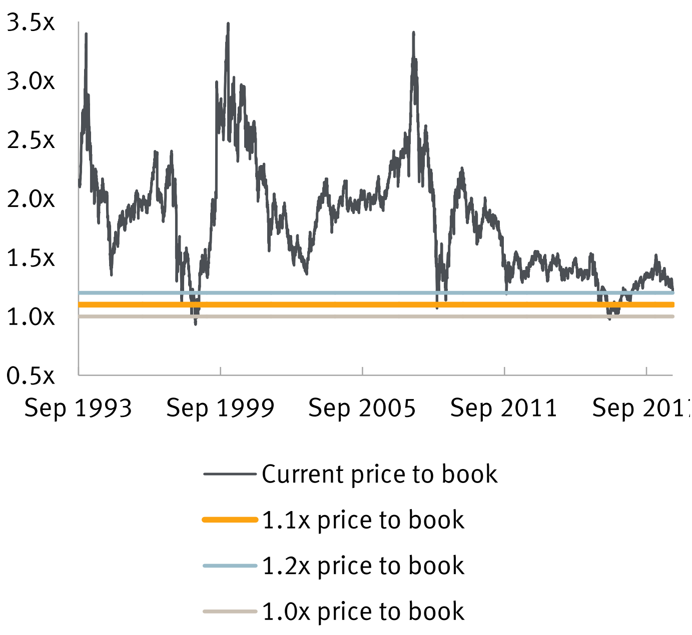
- **Asian equities saw red across the board, selling off sharply following the pullback in the U.S. equity market.**

- **The biggest losses were seen in Taiwan and mainland China stocks**. The Taiwanese benchmark declined by 6.3% on Thursday. That index is **heavily concentrated in Technology stocks**, which account for well over 50% of total market capitalization—further evidence, in our view, that Technology stocks are **at the heart of the current pullback**.

- **The Shenzhen and Shanghai Composites fell by 6.0% and 5.2%, respectively**, on Thursday. Those indices have been **under pressure through the year**. We think their underwhelming performance earlier in the year was primarily driven by the ongoing financial deleveraging process in China, which has been dampening growth. (Financial deleveraging refers to the Chinese authorities reducing areas of riskier credit growth in the Chinese economy.) However, most of the declines have come since May and are a direct result of the U.S.-China trade dispute, which has rocked investor sentiment.

- Both indices are in bear markets. In 2018, the Shanghai is down 21.9% and Shenzhen 31.9%. The **MSCI China Index**—which has a very different index composition

Price-to-book multiple for the Hang Seng Index over 25 years



Source - RBC Wealth Management, Bloomberg; data through 10/11/18

to Shanghai and Shenzhen, both of which have heavy weighting to state-owned enterprises—**has also been weak, but less so**.

- **In Hong Kong, stocks that combine both "China" and "Technology" generally proved toxic on Thursday**. Index heavyweight **Tencent** (0700 HK) declined by 6.8% and is down 34% in 2018 and 43% from its peak in January. **Sunny Optical Technology** (2382 HK) and AAC Technologies (2018 HK) were also among the biggest losers on the day at -6.2% and -7.3%, respectively. The Technology sector was the worst performer, down 6.7%. The best performers were Consumer Staples and Utilities, both down 1.4%.

- **The Hang Seng Index is also in a bear market**, down 23.8% from its all-time high, although this should be viewed in the context of the index's **particularly strong performance in 2017** and its sprint to a **euphoric peak in January**. The index has retreated 15.5% in 2018, again with losses accelerating since May.

- Going forward, if the U.S. pullback were to turn into **an official correction** (a decline of at least 10%; the S&P 500 is down 5% from its September high), we would **expect Asian equities to remain under pressure**. However, a further retreat might take them into oversold territory, in our view, because the Hang Seng has already retreated considerably. Equity valuations have been largely irrelevant in the course of the decline this year. However, history tells us that **book value is an exceptionally strong support line for the Hang Seng**, while 1.1x book value has also represented a compelling buying opportunity historically (see chart). The index is currently at 25,266; book value is 21,200. The index would need to retreat a further 7.7% to reach 1.1x book value of 23,320.

- **Japan's TOPIX declined by 3.5%** and is down 6.4% in 2018. **Japan remains one of our preferred equity markets in Asia**.

- In currencies, the **Chinese renminbi weakened to USDCNY6.929**. The threat of the currency weakening to over USDCNY7.00 is growing. Weakness in the currency may provide ammunition to those in the U.S. administration who seek to label China a currency manipulator. A report from the Department of the Treasury on the topic is due shortly. The yen also strengthened against the dollar, as is common in a risk-off environment.

- In fixed income, the **hawkish tone set by Federal Reserve Chair Jerome Powell has continued to cloud the Asian credit market** with longer-tenor bond yields picking up. Currencies such as the Indonesian rupiah and Indian rupee both tested new lows against the dollar, triggering rounds of selling in the sovereign and quasi-sovereign space.

- Meanwhile, the **People's Bank of China (PBoC) announced that it would cut the reserve requirement ratio (RRR) by 1%**, effective October 15, in an effort to prepare for liquidity in case the trade dispute starts to impact the funding market. Also, **China launched sovereign dollar bonds** (unrated), seen as an attempt to anchor the cost of borrowing at least for state-owned enterprises. This might have just spared the market from selling off more heavily amid the global stock rout. The issue of $3B was oversubscribed by five times. It marks the second time China has raised money via sovereign bonds denominated in dollars; the first was in 2017.

MARKET SCORECARD

Data as of October 11, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,728.37	-6.4%	2.0%	6.8%	27.7%
Dow Industrials (DJIA)	25,052.83	-5.3%	1.3%	9.5%	38.2%
NASDAQ	7,329.06	-8.9%	6.2%	11.0%	39.7%
Russell 2000	1,545.38	-8.9%	0.6%	2.6%	25.9%
S&P/TSX Comp	15,317.13	-4.7%	-5.5%	-3.1%	5.3%
FTSE All-Share	3,848.58	-6.8%	-8.8%	-6.9%	0.2%
STOXX Europe 600	359.65	-6.1%	-7.6%	-7.8%	5.7%
EURO STOXX 50	3,209.19	-5.6%	-8.4%	-11.0%	6.2%
Hang Seng	25,266.37	-9.1%	-15.6%	-11.0%	7.3%
Shanghai Comp	2,583.46	-8.4%	-21.9%	-23.8%	-15.7%
Nikkei 225	22,590.86	-6.3%	-0.8%	8.2%	32.7%
India Sensex	34,001.15	-6.1%	-0.2%	6.8%	21.1%
Singapore Straits Times	3,047.39	-6.4%	-10.4%	-7.1%	6.7%
Brazil Ibovespa	82,921.08	4.5%	8.5%	8.2%	35.9%
Mexican Bolsa IPC	47,558.23	-3.9%	-3.6%	-5.1%	-1.0%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,224.71	2.7%	-6.0%	-5.2%	-2.2%
Silver (spot $/oz)	14.60	-0.7%	-13.8%	-15.0%	-16.4%
Copper ($/metric ton)	6,251.00	-0.2%	-13.3%	-7.5%	30.5%
Oil (WTI spot/bbl)	70.97	-3.1%	17.5%	38.3%	39.7%
Oil (Brent spot/bbl)	80.19	-3.1%	19.9%	40.8%	53.0%
Natural Gas ($/mmBtu)	3.23	7.5%	9.5%	11.9%	-0.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	3.142%	8.1	73.7	79.4	137.9
Canada 10-Yr	2.499%	7.2	45.4	39.0	130.2
U.K. 10-Yr	1.674%	10.1	48.4	29.4	69.5
Germany 10-Yr	0.518%	4.8	9.1	5.5	49.3

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.60%	-0.9%	-2.5%	-2.1%	-1.4%
U.S. Invest Grade Corp	4.22%	-1.1%	-3.4%	-2.5%	0.4%
U.S. High Yield Corp	6.61%	-1.0%	1.5%	1.7%	10.5%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	94.9960	-0.1%	3.1%	2.1%	-2.8%
CAD/USD	0.7677	-0.9%	-3.5%	-4.3%	1.8%
USD/CAD	1.3026	0.9%	3.6%	4.6%	-1.8%
EUR/USD	1.1596	-0.1%	-3.4%	-2.2%	4.9%
GBP/USD	1.3237	1.6%	-2.0%	0.1%	9.2%
AUD/USD	0.7123	-1.4%	-8.8%	-8.5%	-5.5%
USD/JPY	112.0700	-1.4%	-0.6%	-0.4%	8.3%
EUR/JPY	129.9600	-1.5%	-3.9%	-2.6%	13.6%
EUR/GBP	0.8760	-1.6%	-1.4%	-2.3%	-3.9%
EUR/CHF	1.1473	0.7%	-2.0%	-0.6%	5.0%
USD/SGD	1.3764	0.7%	3.0%	1.6%	-0.2%
USD/CNY	6.8899	0.3%	5.9%	4.5%	2.5%
USD/MXN	18.9875	1.4%	-3.4%	1.5%	0.4%
USD/BRL	3.7785	-6.7%	14.1%	19.1%	18.2%

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 10/11/18.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -3.5% return means the Canadian dollar fell 3.5% vs. the U.S. dollar year to date. USD/JPY 112.07 means 1 U.S. dollar will buy 112.07 yen. USD/JPY -0.6% return means the U.S. dollar fell 0.6% vs. the yen year to date.

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