Global Insight Weekly

Good enough is good enough

Frédérique Carrier – London

The current earnings season isn't exactly setting the world on fire, and the coronavirus cloud of uncertainty is unlikely to dissipate anytime soon. But we sift through the clues that lead us to believe equities will see modest gains this year.

Q4 earnings wrap-up

The U.S. and Europe both have had a muted Q4 corporate earnings season. The former's is mostly behind us with some 82 percent of S&P 500 companies having reported so far, compared to about half of the Euro STOXX 600, an index of eurozone companies, having released their numbers.

In both cases, the majority of companies have posted earnings beats. Seventy-one percent of S&P 500 companies and some 60 percent of Euro STOXX 600 companies that have reported so far exceeded consensus expectations. The beat ratio is a little lower than usual in the U.S., while it's a bit higher than average in Europe. Both regions are generating earnings growth of three percent year-over-year. For the eurozone, this is the highest level achieved in the last five quarters.

In the U.S., the Utilities sector generated the strongest earnings growth, while Energy and Materials severely contracted. Technology and Health Care stood out with both a healthy surprise factor and earnings growth.

Earnings season in Japan, where 90 percent of TOPIX companies have reported, has been disappointing, with less than half overshooting earnings expectations. Moreover, earnings have declined by five percent year-over-year. Perhaps this shouldn't come as a surprise given that Japanese GDP contracted by 1.6 percent in Q4.

Notably, Japan's Consumer Discretionary sector has had a dismal showing as 60 percent of companies disappointed and

Muted U.S. and eurozone, disappointing Japan results

	S&P 500	Euro STOXX 600	TOPIX
Sales growth (y/y)	5%	4%	-4%
Companies beating sales estimates	65%	59%	35%
Magnitude of sales surprise	1%	0%	-7%
EPS growth (y/y)	3%	3%	-5%
Companies beating EPS estimates	71%	60%	49%
Magnitude of EPS surprise	5%	5%	-5%

Source - Refinitiv I/B/E/S, Bloomberg

Market pulse

Click here for authors' contact information. Priced (in USD) as of 2/20/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6.**
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Wealth Management

earnings contracted by a whopping 21 percent. In our view, this poor performance may stem from consumers bringing forward purchases into Q3 before the imposition of a sales tax hike in October took effect. Typhoon Hagibis, which swept across the country in October and packed a devastating punch, may have compounded the sector's pain.

We would expect the impact of these one-off effects to wane in time, and for earnings overall to improve in tandem with the global economic growth backdrop. If the yen weakens, the earnings environment of this exporting country would also likely benefit.

Look at guidance for clues

More than past earnings themselves, management guidance is particularly important in gauging companies' future prospects. RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina scrutinizes U.S. earnings announcements for common themes. This earnings season, she found that the majority of companies indicated the macroeconomic backdrop remains healthy, though the number that sees it as mixed or weak has increased steadily over the past three quarters.

Moreover, more than 40 percent of companies are emphasizing cost cutting. This proportion has grown steadily in the last five quarters, with the majority targeting general efficiency improvements, and a handful specifically mentioning either using technology to drive efficiencies or headcount reductions.

Lifting the veil on the coronavirus

The impact of the coronavirus is a key area of interest as it poses downside risk to 2020 earnings estimates if the virus is not contained soon. Companies can be impacted by a decline in their sales in China or through a disruption of their supply chains with parts or components becoming unavailable due to factory shutdowns.

At the time of the bulk of the U.S. Q4 earnings reporting, most management teams said it was simply too early to gauge the disease's future impact on their businesses. As such, there is much more uncertainty in the air regarding the coronavirus than what we've seen with other past issues, such as the U.S.-China trade conflict, where estimates were easier to assess and guidance more readily offered.

More recently, a few companies have captured some of the impact in their guidance. Apple warned it would likely miss its Q2 revenue guidance due to potential supply chain disruptions, while weaker demand from China was weighing on Q2 sales. It declined to give specific numbers altogether.

As the European earnings season typically lags the U.S. by two to three weeks, corporate guidance there may offer a clue as to U.S. exposure to the outbreak.

A relatively low proportion of companies in Europe have issued guidance. Those that have are generally positive about the prospects for 2020, but they are also sounding increasingly guarded about the impact of the coronavirus. The companies that have mentioned it the most operate in the Industrials, Consumer Staples, and Consumer Discretionary sectors. But few have been brave enough to quantify the impact.

Spirits company Pernod Ricard lowered its earnings growth range to two percent to four percent (from five percent to six percent), while its competitor Remy Cointreau withdrew its guidance due to the uncertainties, as has luxury brand apparel manufacturer Burberry. Michelin cut its operating income target by close to 20 percent; however, this is probably an extreme case as the Chinese motor authority recently estimated the coronavirus could reduce 2020 car sales in China by up to 10 percent in a worst-case scenario.

The full-year 2020 consensus earnings estimate for the S&P 500 has been trimmed to $176 per share from $178 as of early December 2019. The one percent reduction is in line with what we usually see at this time of year as prospects become clearer, suggesting any impact from the coronavirus has not yet been taken into account.

The way forward

While earnings releases have not been scintillating, they have been "good enough" in the U.S. and Europe, while in Japan, investors will likely look past the one-offs that hit companies in Q4, i.e., the sales tax hike and typhoon. We continue to expect that earnings growth will be sufficient to underpin modest equity gains this year, though coronavirus-led volatility may well come back to the fore. We stress the importance of vigilance, but any such volatility could also provide investors with better entry points in China-exposed stocks at some point.

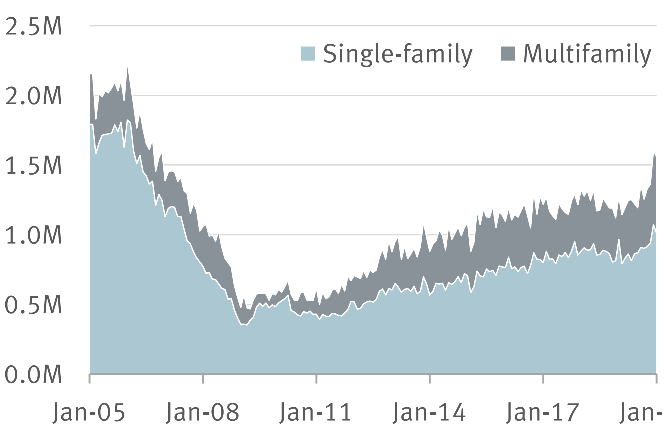
United States

Alan Robinson – Seattle

- **U.S. economic indicators released during the week were upbeat.** The **Empire State Manufacturing Index** climbed to 12 in February, beating the consensus estimate of 5. Similarly, the February **Philadelphia Fed manufacturing index** jumped to 37, the highest level in three years and up strongly from January's reading of 17. Both indicators suggest the U.S. manufacturing sector slowdown of 2019 is now in the rearview mirror.
- **U.S. housing market activity appears to be accelerating**, helped by 30-year mortgage rates falling to near-record lows around 3.4%. Total new housing starts of 1.57 million for January 2020 were up 22% y/y and printed well above consensus forecasts for 1.43 million. Approximately 65% of these projects were for single-family homes. **While this data was clearly positive for the homebuilder stocks, wood products companies also benefited**, as single-family housing starts typically consume 3x the amount of wood products compared to multifamily starts.
- **However, some U.S.-based globally exposed companies struck a cautious note.** Automotive component company **Aptiv plc** warned that analysts' forecasts for its current quarter were too high, citing coronavirus-related shutdowns in China. RBC Capital Markets, LLC U.S. Auto and Auto Parts Analyst Joseph Spak noted that **some Chinese facilities are not expected to come online until next month**, which may lead to issues even for global supply chains that operate outside of China. Regarding companies in the automotive segment, he wrote, "All guidance (and) consensus estimates are, in our view, invalid at this point." He believes that although the coronavirus impact is likely to be transient, a lack of visibility means investors are unlikely to add to auto exposure at this time.
- **The long-awaited merger of T-Mobile US Inc. & Sprint Corp. appeared to clear a final roadblock** after a New York judge dismissed a lawsuit by several U.S. states trying to block the deal. Tim Hoettges, the head of T-Mobile's main owner **Deutsche Telekom**, noted that the "new" T-Mobile would have a current market value of around $120 billion, compared to $274 billion for **AT&T** and $242 billion for **Verizon**, and suggested these valuations should converge given the three main U.S. wireless carriers would have similar customer numbers of between 140 million and 150 million each.

New home construction continues to build, still below pre-recession levels

U.S. housing starts, seasonally adjusted, annualized



Source - U.S. Census Bureau, FactSet, RBC Wealth Management; monthly data through January 2020

Canada

Arete Zafiriou & Sayada Nabi – Toronto

- On February 18, the Department of Finance announced it will be making **changes to the insured mortgage stress test**. Currently, the stress test is based on the large banks' posted mortgage rates. However, on April 6, 2020, the **benchmark rate will be revised** to the median five-year fixed insured mortgage rate plus 2.0%. As a result, **households may see qualifying rates fall around 30 basis points** from the current 5.19% rate. The change was introduced in an effort to make the minimum qualifying rate more reflective of evolving market conditions, since posted rates are not as responsive to changes in the mortgage market. The revision only applies to insured mortgages for now, but the Office of the Superintendent of Financial Institutions is discussing making a similar change for uninsured mortgages as well.
- **Rail disruptions are shaping the Canadian news cycle again**, with one large operator shutting down services in Eastern Canada in response to protests and blockades that began blocking certain rail lines on February 6. **The topic under contention is the CA$6.6 billion Coastal GasLink natural gas pipeline in northern British Columbia.** While the development enjoys the support of elected First Nations leaders along the pipeline's planned route, it has been met with resistance by hereditary chiefs representing the Wet'suwet'en First Nations. Protests in sympathy with the Wet'suwet'en position have led to the blockade of railway tracks in Belleville, Ontario. As the protests continued into week two, **Canadian National Railway** (CN) shut down its eastern rail network. The week-long CN rail strike in November contributed to a 4% decline in November's rail transportation GDP, and RBC Economics believes we may see history repeat itself this month.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The newly appointed Chancellor of the Exchequer, Rishi Sunak, confirmed he will deliver his first budget on March 11**, a date which had been reserved by his predecessor, Sajid Javid. This leaves him less than three weeks to draw up his plans.
- **Most observers suspect his appointment heralds a period of greater fiscal largesse.** After all, Javid resigned as he rejected attempts by the prime minister's office to exert greater control over fiscal policy.
- We have pointed out before that UK fiscal policy is already expansionary. RBC Capital Markets estimates that **spending announcements over the past six months imply £40 billion of extra borrowing** in fiscal year 2020–21.
- Faithful to fiscal discipline, Javid had committed to balancing the budget within three years and limiting public sector net investment to 3% of GDP. Abiding by these rules would give the new chancellor very little leeway. In fact, **achieving a balanced budget would require a mix of tax increases and/or spending cuts**—not what an economy bracing itself for an important transition requires.
- **A substantial re-writing of fiscal rules is likely coming.** The government has already shown its penchant for infrastructure spending by approving the completion of the ambitious £100 billion High Speed 2 (HS2) project to connect London with the Midlands and northern England and approving £5 billion of spending on bus and cycling infrastructure.
- Meanwhile, **trade negotiations with the EU are about to start**. The government is rejecting EU demands of following its regulations to secure access and seems reconciled to the tradeoff this would entail—i.e., tariffs, quotas, and customs checks. Its attitude seems to be that while a free trade agreement with the EU is desirable, falling back on unfavourable World Trade Organization terms is acceptable. For now, **we estimate the probability of a no-trade-deal Brexit at 25%**, though this could increase should positions not be softened.

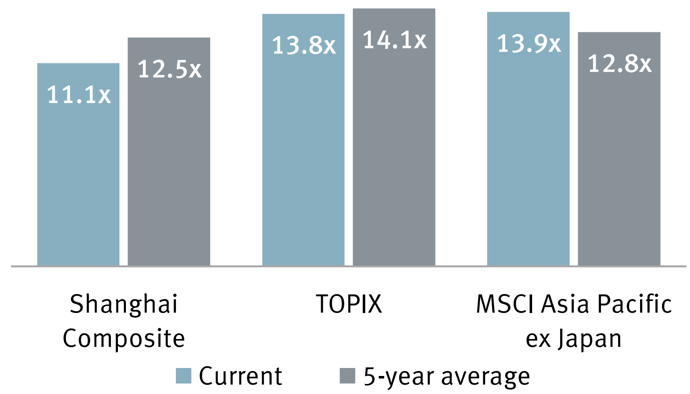
Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- **Market sentiment continues to improve in China and Hong Kong** as new virus cases are dropping and investors believe the government will ensure sufficient liquidity of the market.

Improving sentiment in China is coupled with reasonable valuations

Forward price-to-earnings ratios (next-twelve-month EPS)



Source - RBC Wealth Management, Bloomberg; data through 2/19/20

- **China lowered the one-year loan prime rate** (LPR) to 4.05% from 4.15% today, and the five-year rate to 4.75% from 4.80%. The LPR is considered China's de facto benchmark funding cost. **Lower LPR will help support the real economy** as the coronavirus outbreak has hit small and medium-sized firms, which are suffering a severe cash crunch due to a temporary closure of business, hard.
- **Chinese local governments have started to loosen curbs on the movement of people and traffic.** Many coastal cities announced that companies no longer need to seek prior approval before resuming operations. The government said around 50% of large companies in Guangdong, Shanghai, and Suzhou have resumed production. To boost consumption, Foshan, in Guangdong Province, announced **stimulus measures for its auto market**, the first in China to do so amid the outbreak.
- **Macau casinos reopened today** after being closed for two weeks. However, **only half the tables on a casino floor are permitted to be open** to ensure adequate distance between people. Galaxy Entertainment (27 HK), Sands China (1928 HK), Wynn Macau (1128 HK), and MGM China (2282 HK) said they will reopen in phases. They have 30 days to open fully according to a government mandate.
- China's e-commerce giant **Alibaba announced better-than-expected Q3 FY2020 results**. Total revenue was RMB 161.5 billion, up 38% y/y. Non-GAAP EBITDA of RMB 50.7 billion grew 39% y/y. The company's core commerce growth was healthy, up 38% y/y. However, Alibaba **expects a significant impact from the coronavirus in Q4 FY2020** due to supply chain and logistic interruptions.

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Data as of February 20, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,373.23	4.6%	4.4%	22.5%	26.7%
Dow Industrials (DJIA)	29,219.98	3.4%	2.4%	14.4%	18.6%
NASDAQ	9,750.97	6.6%	8.7%	31.4%	39.0%
Russell 2000	1,696.07	5.1%	1.7%	9.9%	13.5%
S&P/TSX Comp	17,944.06	3.6%	5.2%	14.8%	17.9%
FTSE All-Share	4,150.19	2.3%	-1.1%	5.5%	5.3%
STOXX Europe 600	430.19	4.7%	3.5%	17.9%	16.1%
EURO STOXX 50	3,822.98	5.0%	2.1%	19.4%	14.4%
Hang Seng	27,609.16	4.9%	-2.1%	-3.1%	-7.5%
Shanghai Comp	3,030.15	1.8%	-0.7%	11.4%	-4.9%
Nikkei 225	23,479.15	-0.8%	-0.8%	11.0%	10.5%
India Sensex	41,170.12	1.1%	-0.2%	14.3%	20.0%
Singapore Straits Times	3,198.68	1.4%	-0.7%	-1.4%	-6.3%
Brazil Ibovespa	114,586.20	0.7%	-0.9%	19.6%	41.6%
Mexican Bolsa IPC	44,774.54	1.5%	2.8%	5.9%	-6.6%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,619.28	1.9%	6.7%	24.0%	21.8%
Silver (spot $/oz)	18.36	1.8%	2.9%	17.9%	10.7%
Copper ($/metric ton)	5,745.75	3.5%	-6.6%	-6.2%	-17.3%
Oil (WTI spot/bbl)	53.78	4.3%	-11.9%	-0.2%	-9.1%
Oil (Brent spot/bbl)	59.24	1.9%	-10.2%	-6.9%	-5.5%
Natural Gas ($/mmBtu)	1.92	4.1%	-12.4%	-25.6%	-26.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.517%	1.0	-40.1	-118.5	-131.3
Canada 10-Yr	1.308%	3.5	-39.4	-62.6	-101.8
U.K. 10-Yr	0.576%	5.2	-24.6	-60.6	-104.2
Germany 10-Yr	-0.444%	-1.0	-25.9	-56.7	-119.4

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.05%	0.1%	2.0%	9.9%	13.2%
U.S. Invest Grade Corp	2.57%	0.3%	2.7%	14.8%	17.6%
U.S. High Yield Corp	5.09%	1.2%	1.2%	10.0%	14.7%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	99.8900	2.6%	3.6%	2.8%	11.4%
CAD/USD	0.7541	-0.2%	-2.0%	-0.1%	-5.0%
USD/CAD	1.3260	0.2%	2.1%	0.0%	5.3%
EUR/USD	1.0786	-2.8%	-3.8%	-4.2%	-12.7%
GBP/USD	1.2877	-2.5%	-2.9%	0.2%	-7.3%
AUD/USD	0.6615	-1.2%	-5.8%	-6.7%	-15.8%
USD/JPY	112.1200	3.5%	3.2%	1.0%	4.0%
EUR/JPY	120.9400	0.6%	-0.7%	-3.2%	-9.2%
EUR/GBP	0.8377	-0.3%	-1.0%	-4.4%	-5.8%
EUR/CHF	1.0616	-0.7%	-2.2%	-6.6%	-8.1%
USD/SGD	1.4008	2.6%	4.1%	3.0%	5.9%
USD/CNY	7.0238	1.6%	0.9%	3.9%	10.8%
USD/MXN	18.8272	-0.1%	-0.5%	-3.1%	0.9%
USD/BRL	4.3904	2.5%	8.9%	16.8%	33.0%

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 9:35 pm GMT 2/20/20.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -2.0% return means the Canadian dollar fell 2.0% vs. the U.S. dollar year to date. USD/JPY 112.12 means 1 U.S. dollar will buy 112.12 yen. USD/JPY 3.2% return means the U.S. dollar rose 3.2% vs. the yen year to date.

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Hold [Sector Perform]	625	42.46	127	20.32
Sell [Underperform]	82	5.57	5	6.10

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