January 10, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Keep calm and (cautiously) carry on

Laura Cooper – London

The challenges swirling around financial markets have ratcheted up investor tension. And while markets will have to navigate uncertainty in 2019 and investors should prepare for the challenges ahead, we explain why cautious optimism is warranted.

Investors had to digest more than holiday meals around the dinner table in late December, as financial markets were whipsawed by a confluence of developments. The typically quiet period was anything but, with volatility surging to levels last seen when market nerves were frayed in the February 2018 selloff. The S&P 500 recorded its worst December since 1931 to round out what proved to be a tumultuous year, with the index down 6.2% over the 12-month period and ending 14.5% below its record high seen in September.

The bumpy ride for investors since late September came about on growing fears of a global growth slowdown and uncertainty persisting around U.S.-China trade developments. A flattening of U.S. Treasury yield curves—the difference between long-term and short-term Treasury rates—including a brief inversion of the 3- to 5-year curve, along with widening credit spreads further increased recessionary concerns. The added headache of the U.S. government shutdown that began on December 22 only aggravated the nervous investor sentiment.

But the catalyst for the late December capitulation across equity markets appeared to be the Fed ostensibly veering off the course of market expectations at its December confab. An apparent disconnect between Fed Chair Jerome Powell's moderately hawkish commentary and market fragilities triggered a selloff in equities and other risky assets while U.S. Treasury yields plunged and market pricing increasingly implied a Fed policy mistake.

Breathing a sigh of relief

Financial markets are receiving a boost to start the year, bouncing off of the December lows with the S&P 500 posting

A holiday selloff saw the S&P 500 record its worst December since 1931

S&P 500 Index

Source - RBC Wealth Management, Bloomberg; data through 1/9/19

Market pulse

3 The silver lining to the selloff

3 Little relief for Canadian housing affordability

4 A delay of Brexit is emerging as a possibility

4 China continues to look for ways to support its economy

its longest rally since November. Renewed U.S.-China trade optimism is supporting risk appetite, while an expressed willingness of central banks to be flexible to market conditions is providing further relief. Notably, the Fed dialing back its earlier hawkish tone is helping to assuage market fears of an aggressive path of policy tightening out of tune with financial market conditions.

Cautious optimism that the long-term bull market will remain intact appears warranted, in our view. For one, the year-end corrections produced much more attractive valuations in the U.S., with even greater value being unlocked in Canada, Europe, the U.K., and Japan. On the growth front, U.S. recessionary indicators appear largely contained and we believe the global economic expansion looks poised to persist despite momentum easing.

Navigating uncertainty in 2019

A sanguine outlook for 2019 is still tempered somewhat given the number of risks that lie ahead. Ongoing growth headwinds emanating from the lingering U.S.-China trade spat, political standoffs in Europe, a growth slowdown in China, and the looming of Brexit are contributing to a cloudy outlook for financial markets.

In the U.S., the risk of a prolonged government shutdown remains, although the knock-on effects to economic activity are likely to be limited. Instead, it could be a harbinger of the political frictions to come, which, in turn, could further soften domestic sentiment.

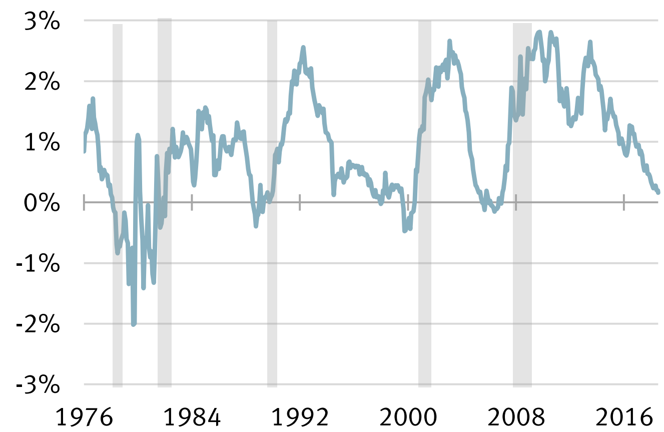
Meanwhile, the fading of fiscal stimulus tees up moderating U.S. growth this year; yet a plunge in the ISM Purchasing Managers' Index (a gauge of manufacturing activity) in December, albeit from elevated levels, sparked fears of a more imminent downturn. While a further deterioration of economic data against a backdrop of tightening financial conditions could aggravate the growth scare, the economic expansion appears intact despite slowing momentum.

A tough task for central banks

Amidst the uncertainty, investors will be closely tuned in to guidance from central banks. Policymakers' flexibility in order to navigate the risks points to sustained support for an ongoing, albeit slower, economic expansion in 2019. The most notable example of this was a dovish pivot from Fed Chair Powell, who struck a fresh conciliatory tone with the markets on January 4 and again on January 10. An emphasis on patience and the readiness to shift the stance of policy significantly, if needed, ostensibly eased growth fears and provided some buoyancy to risk assets.

A flattening of U.S. Treasury yield curves increased recessionary concerns

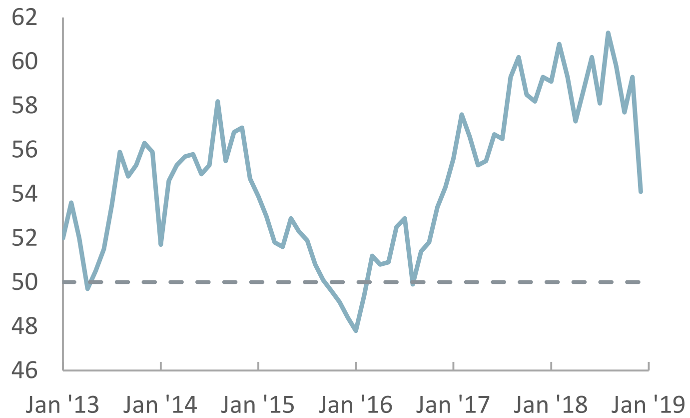
Yield differential of 10-year and 2-year U.S. Treasuries



Source - RBC Wealth Management, Bloomberg; data through 1/9/19

A December plunge in a gauge of U.S. manufacturing activity sparked a growth scare

ISM Purchasing Managers' Index



Source - RBC Wealth Management, Bloomberg; data through 1/9/19

Cautious optimism

Economic growth sufficient to allay investor fears of a downturn, the emergence of compelling valuations, and data-dependent monetary policy should provide conditions to support equity market performance in 2019, in our view. At the same time, as the U.S. business cycle marches towards its later stages, preparation for the market challenges that lie ahead will likely emerge as a dominant theme for investors in 2019; much like the Christmas selloff will likely mark 2018.

United States

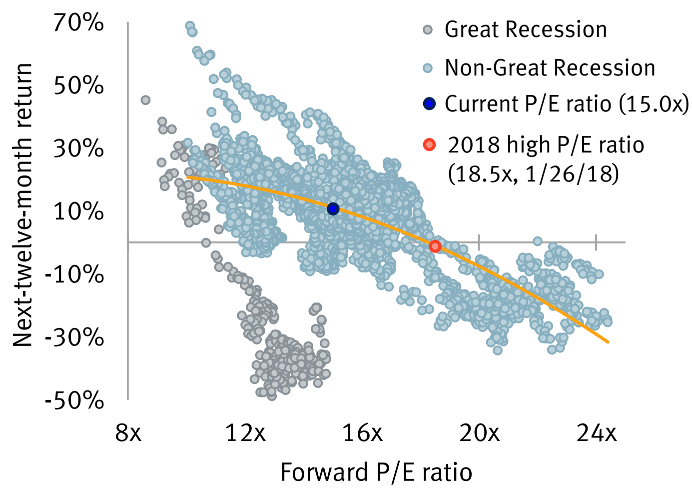
Ben Graham, CFA – Minneapolis

- **U.S. equities have climbed more than 10% from their Christmas Eve lows.** During that time, economically sensitive exposures have provided the best returns, evidenced by the **small-cap Russell 2000 gaining 7.2%** so far this month and outpacing the large-cap S&P 500 by more than 3.5 percentage points. Other strong-performing sectors include Energy—climbing on crude oil's 20%+ gains from Christmas Eve lows—Consumer Discretionary, and Industrials.

- The silver lining to the painful selloff that concluded 2018 is that 2019 is a fresh start with a better outlook for equity performance over the next 12 months. Today, as evidenced in the chart below, valuations are much lower and indicative of potential positive future returns while sentiment is less euphoric. Additionally and historically speaking, volatility spikes have seen positive outcomes in the market after the episodic challenges abate. Our view is that **double-digit returns from year-end levels would not be surprising** given this backdrop, although we expect volatility along the way.

S&P 500 valuations indicate low double-digit returns in 2019

S&P 500 forward price-to-earnings (P/E) ratio and subsequent returns



Note: In the chart above, the small blue and gray dots represent historical weekly S&P 500 P/E ratios since 2000 and the returns the market experienced in the subsequent 12 months at those particular P/E levels. Collectively, the dots show that lower P/E ratios typically result in higher returns 12 months later, and higher P/E ratios typically result in lower returns. The orange trend line represents forecasted returns at a given P/E level based on this historical data. The trend line is normalized by excluding the data from the Great Recession. With the forward P/E at 15.0x currently (represented by the larger dark blue dot), this model predicts a 12% return in the next 12 months.

Source - RBC Wealth Management, FactSet; data through 1/9/19

- Economic data in recent days has been intermittent. Given the government shutdown, certain trade and other data dissemination has been suspended. **The data that has been published shows mixed results with a slight positive bias.** The ISM Purchasing Managers' Index (PMI), which is an important sentiment gauge of manufacturing activity, indicated the economy was still expanding in December, but at a slower rate than recent months. The PMI reading of 54.1 was well below consensus estimates and November's reading of 59.3. Furthermore, the New Orders component, which is indicative of future output, registered an expansionary but lower-than-trend reading of 51.1 and the steepest one-month plunge in almost five years. However, the other side of this coin is that the U.S. economy added 312,000 jobs in December, 75% higher than the consensus forecast and the strongest reading in 10 months. These data points **align with our view that the U.S. is not headed into a recession, but economic growth in 2019 is likely to be slower than 2018.**

Canada

Arete Zafiriou & Richard Tan, CFA – Toronto

- The Bank of Canada maintained its overnight rate at 1.75%, consistent with the consensus view. **Despite a more dovish tone from the central bank, potential homebuyers are still struggling to find suitable housing.** According to RBC Economics, housing affordability in Canada has deteriorated to its worst level since 1990. An average Canadian home purchased in Q3 2018 would have required approximately 54% of household income to service the ownerships costs. In comparison, ownership costs in Vancouver and Toronto would have consumed about 87% and 75% of household income, respectively. **The combination of rising rates, stringent stress tests, and lower supply has prompted buyers towards condos,** which resulted in strong demand in Canada's largest markets in 2018. RBC Economics is projecting two additional rate hikes in 2019, thereby sustaining upward pressure on ownership costs. However, the market is pricing in close to zero rate hikes in 2019.

- In December of last year, the Alberta government announced an initial 8.7% cut to production of crude oil and bitumen effective January 1. This amounts to around 325,000 barrels per day in Q1 2019 and is expected by RBC Capital Markets to fall to an average of 95,000 barrels per day through the remainder of 2019 once storage levels have returned to normal. **On December**

31, 2018, the Alberta government amended the initial mandated curtailment guidelines. Among other changes, the government will use an operator's highest month of production in the year ending October 2018 as a baseline for production allocation, as opposed to using an average of the highest six months. A clause was added to accommodate an exemption in the case that more production is needed to ensure viable operation. The Alberta government has also changed its cut-off date regarding the exemption threshold from November to October 2018. **Since the curtailment was announced in December, the Western Canadian Select-West Texas Intermediate differential has tightened considerably.** RBC Capital Markets is forecasting a West Texas Intermediate price of $56 per barrel in 2019.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Recent economic data in Continental Europe was mixed.** German industrial production contracted by 1.9% y/y in November, while October data was downgraded. The weakness was not confined to the auto sector, which continues to struggle due to a change in emissions regulation. This and the recent weakening of the services sector are disappointing. Also, **euro area economic sentiment slipped** to 107.3 in December from 109.5 in November. However, euro area **unemployment unexpectedly decreased** to 7.9%, its lowest level since October 2008.

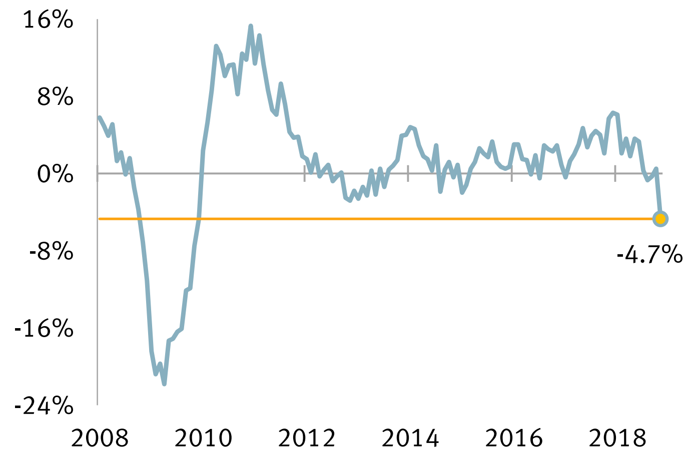
- Given the mixed data, weakness of the Italian economy as the uncertainty regarding budget negotiations took its toll, as well as the impact of Yellow Jackets protests in France that hindered economic growth, **RBC Capital Markets revised down its euro area Q4 GDP forecast** to 0.2% q/q from 0.4% q/q. This lowers its full-year 2018 growth estimate to 1.8% y/y from 1.9% y/y and 2019 forecast to 1.5% y/y from 1.6% y/y.

- **Brexit outcomes remain obscure and convoluted.** A vote on Prime Minister Theresa May's Withdrawal Agreement has been announced for January 15. Recent Parliament voting results on a number of amendments suggest to us that the agreement will be rejected. But while there seems to be a majority against the prime minister's deal and a "no deal" scenario, **no clear consensus on an alternative outcome has emerged.** Such a consensus is needed, in our view, to avoid the U.K. crashing out of the EU without a transition period, the so called "no deal" scenario.

- The Members of Parliament who oppose "no deal" or are unsatisfied with the agreement all want many different things, such as a second referendum, a "Norway Plus" agreement, or for the prime minister to enhance her deal. Unless they converge to one solution, **the risk of "no deal" remains.** Given the low visibility and complexity of the situation, **the possibility of Brexit being delayed is starting to emerge.** An extension to Article 50 would require unanimity from EU states.

German industrial production hits worst levels since 2009

Industrial production y/y, not seasonally adjusted



Source - RBC Wealth Management, Bloomberg; data through 11/30/18

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **The MSCI AC Asia Pacific Index hit its low for 2018 on December 25.** Asian equities have rebounded smartly since then, with the index gaining 6.3%.

- Japanese stocks, where we recommend an Overweight position, are the largest component in the index. **The TOPIX Index also hit bottom on December 25 and has since rallied by 7.6%** to 1,522. The TOPIX briefly topped 1,900 in January 2018. At that time, its price-to-earnings ratio was over 16x. Lower stock prices combined with earnings growth in 2018 have pushed this ratio to 12.0x. **This is a significant reduction in valuation over a 12-month period.**

- **The Chinese authorities continue to look for ways to support the economy.** The required reserve ratio (RRR), which determines the minimum amount of capital that Chinese banks must hold in reserves, will be reduced by 1% on January 15 and another 0.5% on January 25. This will free up over $100B in money that the banks can lend.

- However, this does not mean that the banks will actually lend the money. Perhaps with this in mind, **Chinese Premier Li Keqiang visited the country's largest banks**

in early January. A government statement said that Li wants banks to take advantage of such policy changes and support small businesses via lending.

- Li's comments tally with those of People's Bank of China Governor Yi Gang, who recently noted that **there would be increased focus from policymakers on supporting the economy in 2019.** This does not mean that Chinese authorities are ditching their efforts regarding financial deleveraging, or reducing growth in riskier areas of the domestic credit market. Rather, it reflects a nuanced change to policy. In our view, this will be a delicate balancing act for China. However, **the authorities have demonstrated an ability to successful execute when it comes to policy stimulus.**

- **Car sales in China fell in 2018 for the first time since 1992**. Sales of passenger vehicles declined by 5.8% y/y to 22.35 million units. Sales turned negative in June relative to the same period the previous year and have declined in every month since. Sales in November and December were particularly weak, declining by nearly 20% y/y. **The government has responded, stating that it will introduce measures to support the auto market.**

- **Geely Automobile** (175 HK), one of the most successful domestic Chinese car companies, noted that **sales fell by nearly 40% in December** to 93,000 units and forecast flat sales growth for 2019. The stock saw its largest one-day decline since 2015.

MARKET SCORECARD

Data as of January 10, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,596.64	3.6%	3.6%	-5.5%	14.4%
Dow Industrials (DJIA)	24,001.92	2.9%	2.9%	-5.4%	20.9%
NASDAQ	6,986.07	5.3%	5.3%	-2.3%	25.8%
Russell 2000	1,445.43	7.2%	7.2%	-7.3%	5.4%
S&P/TSX Comp	14,903.49	4.1%	4.1%	-8.3%	-3.4%
FTSE All-Share	3,804.40	3.5%	3.5%	-10.5%	-3.6%
STOXX Europe 600	348.88	3.3%	3.3%	-12.5%	-4.2%
EURO STOXX 50	3,075.73	2.5%	2.5%	-14.8%	-7.0%
Hang Seng	26,521.43	2.6%	2.6%	-14.6%	16.6%
Shanghai Comp	2,535.10	1.7%	1.7%	-25.9%	-19.8%
Nikkei 225	20,163.80	0.7%	0.7%	-15.2%	4.5%
India Sensex	36,106.50	0.1%	0.1%	4.9%	34.2%
Singapore Straits Times	3,183.51	3.7%	3.7%	-9.6%	5.9%
Brazil Ibovespa	93,805.93	6.7%	6.7%	20.0%	51.0%
Mexican Bolsa IPC	43,668.95	4.9%	4.9%	-10.5%	-4.8%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,286.33	0.3%	0.3%	-2.3%	8.3%
Silver (spot $/oz)	15.57	0.5%	0.5%	-8.3%	-7.3%
Copper ($/metric ton)	5,936.75	-0.2%	-0.2%	-16.5%	3.5%
Oil (WTI spot/bbl)	52.59	15.8%	15.8%	-17.3%	3.5%
Oil (Brent spot/bbl)	61.35	14.0%	14.0%	-11.3%	14.4%
Natural Gas ($/mmBtu)	2.98	1.5%	1.5%	2.6%	-9.0%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.742%	5.8	5.8	18.5	36.6
Canada 10-Yr	1.986%	1.9	1.9	-17.7	30.0
U.K. 10-Yr	1.274%	-0.3	-0.3	-1.2	-8.8
Germany 10-Yr	0.255%	1.3	1.3	-28.8	-3.0

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.31%	0.1%	0.1%	0.7%	3.2%
U.S. Invest Grade Corp	4.20%	0.4%	0.4%	-1.5%	3.6%
U.S. High Yield Corp	7.24%	3.0%	3.0%	0.3%	7.2%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	95.5580	-0.6%	-0.6%	3.5%	-6.3%
CAD/USD	0.7554	3.0%	3.0%	-5.2%	0.0%
USD/CAD	1.3238	-2.9%	-2.9%	5.5%	0.0%
EUR/USD	1.1500	0.3%	0.3%	-3.7%	9.0%
GBP/USD	1.2751	0.0%	0.0%	-5.6%	4.7%
AUD/USD	0.7187	2.0%	2.0%	-8.4%	-2.5%
USD/JPY	108.4500	-1.1%	-1.1%	-2.7%	-6.3%
EUR/JPY	124.7300	-0.9%	-0.9%	-6.3%	2.1%
EUR/GBP	0.9019	0.3%	0.3%	2.0%	4.1%
EUR/CHF	1.1324	0.6%	0.6%	-3.1%	5.5%
USD/SGD	1.3525	-0.8%	-0.8%	1.4%	-5.8%
USD/CNY	6.7885	-1.3%	-1.3%	4.3%	-1.9%
USD/MXN	19.1294	-2.7%	-2.7%	-0.9%	-12.3%
USD/BRL	3.7118	-4.2%	-4.2%	14.7%	16.2%

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 9:35 pm GMT 1/10/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 3.0% return means the Canadian dollar rose 3.0% vs. the U.S. dollar year to date. USD/JPY 108.45 means 1 U.S. dollar will buy 108.45 yen. USD/JPY -1.1% return means the U.S. dollar fell 1.1% vs. the yen year to date.

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