

Global Insight

Weekly

Change in the air

Frédérique Carrier – London

The past several years had seen the grand European experiment put to the test. And then when COVID-19 swept in, it faced a fresh threat. But three recent positive developments could prove to be a game changer for the continent, leading us to be more bullish on European equities.

We are upgrading our stance on European equities to Market Weight from Underweight as several key developments appear to be afoot on the continent.

Two events in particular mark a departure from the status quo. First, the EU's joint response proposal to lend a hand to those countries most affected by the COVID-19 crisis suggests a step towards greater fiscal union. Second, Germany has shed its parsimonious past and is embracing fiscal spending. What's more, both of these are happening amid a backdrop of very accommodative monetary policy from the European Central Bank (ECB).

A crisis focuses minds

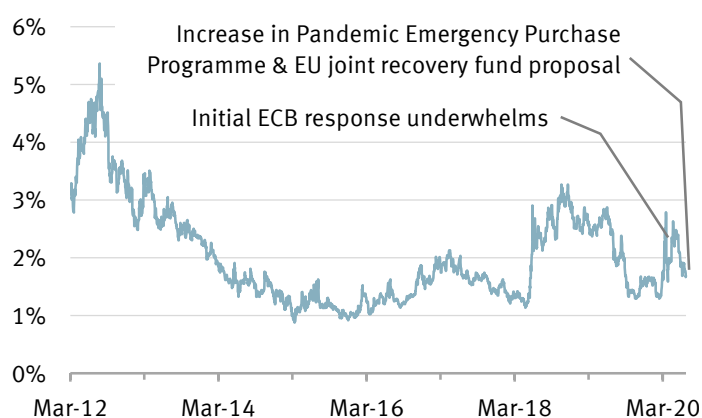
According to an old adage, crises tend to focus minds. This has certainly been borne out across Europe. In March, Northern Italy became the initial epicentre of the COVID-19 crisis, with new daily cases spiralling out of control. Lockdowns were imposed as the virus swept across the continent.

National governments responded swiftly by announcing spending programmes, some of them particularly ambitious, to support their respective economies. The ECB announced a new quantitative easing programme.

But financial markets were underwhelmed. The risk was that without a collective EU-wide response, the lack of apparent solidarity for those countries most affected by the crisis could fuel anti-EU sentiment. After all, why give up control of your domestic currency and abide by EU rules if you're going to be abandoned in a time of distress?

Signs of distress wane

Spread between Italian & German 10-year sovereign bond yields



Source - RBC Wealth Management, Bloomberg; data through 6/24/20

Market pulse

- 3 Volatility spikes bode well for future S&P 500 returns
- 3 Canada stripped of AAA credit rating
- 3 Encouraging signs of economic activity in the UK & EU
- 4 South Korea battling fresh virus clusters

Click [here](#) for authors' contact information. Priced (in USD) as of 6/25/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see [page 6](#).**
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Management

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European leaders seem to have heeded those calls to action and understood the precariousness of the situation. The confluence of three recent decisions may well prove to be a game changer for the region.

A substantial *joint* recovery fund

After much dithering, the European Commission proposed a €750 billion fund (or more than six percent of EU GDP) to bolster the recovery in the hardest-hit regions. The proposal, backed by the considerable clout of France and Germany, marks a pronounced change in attitude for Germany, which so far had been reluctant to use its savings for the benefit of the wider EU.

As proposed, the fund would boost the seven-year 2021–2027 EU budget, offering some €500 billion in grants and €250 billion in loans. This joint response comes on top of the significant stimulus that national governments already injected into their economies early in the crisis and the substantial monetary stimulus of the ECB.

The proposal is a step towards risk sharing and a deeper fiscal union as the European Commission aims to issue bonds at the pan-European level. These would be repaid over the long term by revenues generated from new taxes and levies targeting carbon emissions, single-use plastics, and digital firms.

However, the proposal remains very much a starting point, in our view. While it has been agreed in principle, there are many points of contention, including the fund's size, the split of loans and grants, and how to tie grants to requests for economic reforms.

Negotiations among all EU members are taking place over the next few weeks. With Germany assuming the six-month rotating presidency of the EU, German Chancellor Angela Merkel seems intent on pushing the proposal through. That she is enjoying high popularity at home and has earned much respect on the continent for successfully containing the health crisis, given Germany's particularly low death toll, should also help her cause. Ultimately, we expect a slightly watered-down version of the proposal to be adopted.

A German U-turn

The event which has most surprised financial markets is Germany's volte-face on its austere fiscal stance. The country's steadfastness at maintaining fiscal austerity has long been considered by the market as being one of the root causes of Europe's meagre economic growth.

In June, Merkel announced a second stimulus package worth close to four percent of GDP, this one aimed at kick-starting Germany's recovery. This comes after a first package of a similar amount was announced in March. These cash injections were accompanied by other measures including loan guarantees amounting to more than 30 percent of GDP.

Such a 180-degree change in Germany's fiscal culture was unimaginable at the start of the year.

The ECB as a backstop to the economy

All of this is occurring as the ECB is ensuring liquidity flows in the European financial system. After an initially timid, insufficient, and disappointing response to the crisis, as well as clumsy communication that caused spreads between 10-year sovereign bond yields in the periphery and Germany to balloon, the ECB upped its Pandemic Emergency Purchase Programme (PEPP) by €600 billion in June, bringing it to €1.35 trillion or some 10 percent of euro area GDP.

The ECB's latest move was more aggressive than widely expected, not only by its size but also by extending the duration of the PEPP purchases through at least mid-2021. Moreover, ECB President Christine Lagarde stressed that the central bank will conduct net asset purchases until it "judges that the coronavirus crisis phase is over," thus promising that the ECB will be there should a second wave hit the economy.

Structural issues being addressed

Investors have long been critical of the euro area's lack of common fiscal policy to accompany its common monetary policy. They have also pointed fingers at Germany's fiscal rectitude. But the relevant authorities now seem to have addressed both issues. Accordingly, we are upgrading our stance on European equities to Market Weight.

These recent developments are indeed promising, in our view. As a result, spreads between 10-year sovereign bond yields in the periphery and Germany have narrowed while the euro has strengthened to a 12-week high against the U.S. dollar. Yet the region still faces a very deep recession, with GDP likely to contract by over 10 percent this year, according to RBC Global Asset Management Inc. Chief Economist Eric Lascelles. Economic activity indicators such as Purchasing Managers' Indexes have recently bounced back forcefully, but it is still too early to declare the region will enjoy a "V-shaped" recovery. Lascelles foresees growth of 3.6 percent in 2021.

Nevertheless, prospects are now looking brighter as these developments should buttress the recovery. Within European equities, we continue to favour the Health Care sector, whose outlook should be underpinned by ageing demographics and rising global health care expenditures, as well as renewables-focused utilities as governments look to stimulate their post-COVID-19 economies with an increasing focus on green and sustainable investments.

We are also mindful that Europe offers rich hunting grounds for "quality cyclicals." We believe select companies in the Industrials sector that benefit from secular trends are attractive. Meanwhile, the long-term fundamentals of the luxury and sporting goods categories within the Consumer Discretionary sector also appear structurally attractive, although near-term risks exist.



United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets have been generally lower this week**, largely as a function of the more than 2% selloff on June 24. **The NASDAQ is providing leadership as the only major index with gains for the week.** It's about 1.2 percentage points better than the S&P 500 and Russell 2000. The economically sensitive Dow Jones Industrial Average has been the worst of these four indexes. Sector leadership has been most evident in Tech and Consumer Discretionary; these are the only two sectors higher thus far this week. Laggards include cyclically-oriented sectors like Industrials and Energy.
- **The CBOE Volatility Index (VIX) remains elevated** relative to the post-Great Recession era despite declining from the March highs. After climbing all the way to 85 on March 18, the index then fell to a post-COVID-19 trough of 24 on June 5, before staging a bit of a resurgence since then with the current levels being higher than 30. **However, future S&P 500 returns are much better than average when looking 12 months out from periods of volatility similar to those levels being seen today.** Specifically, the average return in the 12 months after a reading of at least 30 on the VIX is 20.6%. This compares favorably to the S&P 500's average 12-month return of 9.1%. However, over shorter time horizons, e.g., one- and three-month periods, future returns have a much smaller lead over their averages. Put differently, and in a way that fits well with the COVID-19 and election year narratives, 12 months from now equity markets should be higher than they are today, but it's less clear what the path to get there looks like in the near term.
- Economically speaking, **initial jobless claims continued their recent pattern of being slightly higher than expected**; the 1.48 million reported was above consensus expectations looking for 1.33 million. The one silver lining to continuing claims is that they were much lower than expected despite the eye-popping headline number of 19.5 million.



Canada

Ryan Harder – Toronto

- **Canada lost its unanimous AAA rating** this week with Fitch downgrading Canadian sovereign debt to AA+, reflecting the “deterioration of Canada’s public finances in 2020 resulting from the coronavirus pandemic.” Although federal debt levels are low relative to developed peers, **provincial debt is in many cases quite substantial** and ultimately places an indirect burden on federal finances. Fitch estimates that Canada’s consolidated gross general government debt

Volatility spikes are historically good for future returns

S&P 500 returns in the ensuing months after the VIX hits 30

		Forward return			
		6M	12M	18M	24M
When VIX > 30	Average	12.1%	20.6%	25.8%	34.4%
	High	50.2%	69.3%	63.3%	95.1%
	Low	-36.3%	-40.8%	-41.4%	-32.3%
	% positive	83.1%	88.4%	88.7%	89.0%
Avg. all periods		4.29%	9.06%	13.78%	19.10%

Source - RBC Wealth Management, FactSet, Bloomberg; data from 1990 through 6/25/20

will reach 115% of GDP in 2020, a major increase from the 88% level in 2019. All this is in addition to heavily leveraged Canadian consumers, who are among the most indebted in the world relative to their disposable income. Nonetheless, **market reaction to the downgrade** in both government yields and the Canadian dollar **was muted**, as an eventual downgrade was largely expected at some point given the enormity of fiscal stimulus measures being introduced at the federal level.

- **Canadian credit has continued its impressive performance since the depths of the mid-March selloff.** Credit spreads—which represent the additional yield above government levels that investors receive for investing in bonds with credit risk—have been grinding tighter since the Bank of Canada and Federal Reserve first stepped in with unprecedented levels of asset purchases and other monetary policy support in March. This improved access to capital markets has enabled companies to fund their additional liquidity needs through the issuance of new debt, and those companies have done just that as record levels of corporate bond supply have hit new issue markets this year. Even in hard-hit sectors such as Energy, **many borrowers are now issuing debt with similar or lower coupons than would have been the case for new issues at the beginning of the year**, as lower government yields have more than offset the widening of credit spreads in that same time frame.



Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **European and UK equity markets succumbed to general risk-off sentiment**, retreating as much as 3%, before closing flat for the week (through June 25).

- **Economic activity indicators have been encouraging**, revealing a strong rebound, though with most economies still in contraction territory after a period of reopening (two months for Europe, one month for the UK).
- The IHS Markit Flash Eurozone Composite Purchasing Managers' Index (PMI) increased for the second month in a row in June, coming in at 47.5, up from 31.9 in May. Within that, the Services PMI surged to 47.3, while the Manufacturing PMI saw a more muted increase due to ongoing weakness in global demand. **France stood out with readings above 50 for both manufacturing and services, which are in expansionary territory**, as it drastically relaxed its lockdown measures in June.
- **In the UK, the Composite PMI was 47.6, up from 30 the prior month**, backing up the signal from the previous week's retail sales that indicated the initial rebound would be strong as the economy had begun reopening and life gets back to something approaching normal.
- **Sharp rebounds in these activity indicators are encouraging, but they are also to be expected in the initial phase of the recovery** as economies open up and improve from a very low base. RBC Capital Markets economists point out that it is likely the recovery in activity will slow considerably once the easing of lockdown measures plateaus.



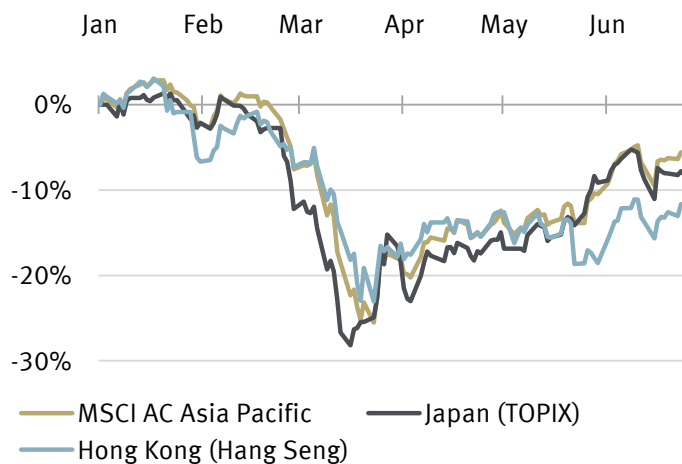
Asia Pacific

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

- The Asia Pacific equity market has traded broadly lower this week, weighed down by worries about a surge in COVID-19 cases around the globe. South Korea, Japan, and Australia

Asian equities rebound stalls on COVID-19 surge

Year-to-date performance



Source - RBC Wealth Management, FactSet; data through 6/24/20

reported higher numbers of daily new infection cases in certain cities. Meanwhile, China declared that a virus outbreak in Beijing was under control.

- **South Korea**, once the poster child in the battle against COVID-19, has declared that the country is **battling a second wave of infections** triggered by the May holiday. Officials re-imposed some social distancing measures following fresh clusters, and most cases reported in the past week have been domestic. Seoul's mayor warned on Monday that the capital **may have to go back to strict distancing measures** if the number of infections in the city remains high.
- Following the first deadly military border dispute in 45 years, **China and India have agreed to de-escalate tensions on their disputed border**. Historically, border clashes usually occur during the summer, do not last long, and have limited spillover effects from political or trade standpoints. **If the situation spirals into a trade conflict, we think India is at a disadvantage** given its heavier reliance on imports from China.
- **Singapore will hold a general election on July 10** as the government seeks a fresh mandate to govern amid the pandemic. The decision was made on the back of the stabilizing COVID-19 situation in the country and the constitutional requirement to conduct the election before April 2021. **Historically, general elections have little to no impact on domestic stock market performance**, and we do not expect this time to be different. Meanwhile, analysts mostly expect the ruling party to remain in power.
- **Shares of Japanese retailers gained on Wednesday** after furniture chain Nitori Holdings (9843 JP) and casual fashion retailer Shimamura Co. (8227 JP) reported double-digit year-over-year increases in June sales, **a potential indication of pent-up demand from local shoppers**.



MARKET SCORECARD

Data as of June 25, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,083.76	1.3%	-4.6%	5.7%	13.5%
Dow Industrials (DJIA)	25,745.60	1.4%	-9.8%	-3.0%	6.2%
NASDAQ	10,017.00	5.6%	11.6%	27.0%	33.0%
Russell 2000	1,413.32	1.4%	-15.3%	-7.1%	-14.7%
S&P/TSX Comp	15,446.14	1.7%	-9.5%	-5.7%	-4.6%
FTSE All-Share	3,401.43	1.1%	-18.9%	-16.0%	-18.0%
STOXX Europe 600	359.74	2.7%	-13.5%	-6.2%	-4.6%
EURO STOXX 50	3,218.91	5.5%	-14.1%	-6.5%	-4.5%
Hang Seng	24,781.58	7.9%	-12.1%	-12.1%	-14.4%
Shanghai Comp	2,979.55	4.5%	-2.3%	-0.1%	4.2%
Nikkei 225	22,259.79	1.7%	-5.9%	5.0%	-0.4%
India Sensex	34,842.10	7.5%	-15.5%	-11.6%	-1.8%
Singapore Straits Times	2,590.15	3.2%	-19.6%	-21.6%	-20.6%
Brazil Ibovespa	95,983.10	9.8%	-17.0%	-4.1%	35.3%
Mexican Bolsa IPC	37,734.52	4.5%	-13.3%	-13.8%	-19.3%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,762.71	1.9%	16.2%	23.8%	39.3%
Silver (spot \$/oz)	17.77	-0.5%	-0.5%	15.6%	8.8%
Copper (\$/metric ton)	5,856.50	9.4%	-4.8%	-2.8%	-13.2%
Oil (WTI spot/bbl)	38.67	9.0%	-36.7%	-32.9%	-46.0%
Oil (Brent spot/bbl)	41.57	17.7%	-37.0%	-36.1%	-44.4%
Natural Gas (\$/mmBtu)	1.45	-21.8%	-33.9%	-37.3%	-50.5%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.684%	3.1	-123.4	-130.1	-219.6
Canada 10-Yr	0.532%	-0.2	-117.0	-90.5	-156.1
U.K. 10-Yr	0.154%	-3.0	-66.8	-64.0	-114.0
Germany 10-Yr	-0.468%	-2.1	-28.3	-13.7	-79.5

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.30%	0.4%	5.9%	8.6%	17.3%
U.S. Invest Grade Corp	2.19%	1.6%	4.7%	9.4%	21.2%
U.S. High Yield Corp	6.57%	2.0%	-2.8%	1.2%	8.2%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.3750	-1.0%	1.0%	1.3%	3.3%
CAD/USD	0.7326	0.9%	-4.8%	-3.5%	-2.6%
USD/CAD	1.3650	-0.9%	5.1%	3.7%	2.7%
EUR/USD	1.1218	1.1%	0.0%	-1.3%	-4.2%
GBP/USD	1.2416	0.6%	-6.3%	-2.2%	-6.5%
AUD/USD	0.6882	3.2%	-2.0%	-1.1%	-7.2%
USD/JPY	107.1600	-0.6%	-1.3%	0.0%	-2.4%
EUR/JPY	120.2100	0.4%	-1.3%	-1.3%	-6.4%
EUR/GBP	0.9035	0.4%	6.8%	0.9%	2.5%
EUR/CHF	1.0640	-0.3%	-2.0%	-4.1%	-7.9%
USD/SGD	1.3913	-1.6%	3.4%	2.7%	2.1%
USD/CNY	7.0782	-0.8%	1.7%	2.9%	8.2%
USD/MXN	22.6834	2.3%	19.8%	18.0%	14.0%
USD/BRL	5.3613	0.5%	33.0%	41.9%	42.0%

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 6/25/20.

Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -4.8% return means the Canadian dollar fell 4.8% vs. the U.S. dollar year to date. USD/JPY 107.16 means 1 U.S. dollar will buy 107.16 yen. USD/JPY -1.3% return means the U.S. dollar fell 1.3% vs. the yen year to date.

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			Count	Percent
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