September 3, 2020

The market's makeover

Kelly Bogdanova – San Francisco

The Dow Jones Industrial Average, viewed by many as the barometer of the broader stock market, executed its biggest shake-up in years. We check out the Dow's fresh look and why this matters for investors, and explain what this says—or doesn't say—about the economy as a whole.

The Dow Jones Industrial Average (aka "the Dow"), out of habit and tradition, is still widely considered to represent "the market" by individual investors in the U.S.

It's no wonder. The Dow is by far the oldest major equity benchmark in the world, stretching back to 1896—it's the "granddaddy" of them all. And it has a storied past. In good times and bad it has been the most-cited equity index. Even in recent decades, investors associate key events such as "Black Monday" in 1987 or major milestones like the first trip to "Dow 10,000" in 1999 with this blue-chip benchmark.

Changes in the Dow, especially as consequential as the ones that were recently implemented, can impact how this part of the market trades and how the U.S. economy is perceived.

Before and after

Today the Dow looks quite different than it did before the changes took place on August 31 when three stocks were added (salesforce.com, Amgen, and Honeywell) and three were removed (Pfizer, Exxon Mobil, and Raytheon). Last but certainly not least, the simultaneous four-for-one stock split of Apple shares also altered the Dow's structure.

The Apple stock split actually had a big impact. The stock went from representing a whopping 11.9 percent of the Dow's total value to just 2.9 percent after the split, as the table shows. This is due to the unique method by which individual stocks influence the overall value of the benchmark. The Dow is price-weighted, so stocks with the highest price per share have the greatest influence on the Dow's overall value and trajectory.

A major reshuffling of Dow stocks

Changes implemented to the 30-member Dow Jones Industrial Average (DJIA), effective Aug. 31, 2020

	Proportion of DJIA (weight in %)		
Company (ticker symbol)	Old	New	Difference
Added to benchmark			
salesforce.com (CRM)	0.0	6.2	6.2
Amgen (AMGN)	0.0	5.8	5.8
Honeywell (HON)	0.0	3.9	3.9
Removed from benchmark			
Pfizer (PFE)	0.9	0.0	-0.9
Exxon Mobil (XOM)	1.0	0.0	-1.0
Raytheon (RTX)	1.5	0.0	-1.5
Adjusted for stock split			
Apple (AAPL)	11.9	2.9	-9.1*

*Any discrepancies in calculations are due to rounding
Source - National research correspondent, Standard & Poor's, FactSet, RBC Wealth Management; data as of 8/31/20

Market pulse

3 U.S. equity market swings toward value stocks
3 Firmer rebound ahead for Canadian GDP?
4 Why UK equity performance has been disappointing
4 China's bank sector results feel COVID-19 sting

Click here for authors' contact information. Priced (in USD) as of 9/3/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see** **page 6.**
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When Apple was first added to the Dow in 2015 at almost $120 per share ($32 split-adjusted), it represented 4.7 percent of the index. But since then, the stock's price per share surged to more than $500 per share ($120 split-adjusted), climbing 320 percent, and its impact on the Dow rose significantly along the way. While the four-for-one stock split doesn't change the total value or market capitalization of Apple's stock, its representation in the Dow declines with the lower split-adjusted stock price.

The Apple stock split, combined with the other Dow changes, had the net effect of:

- Removing the distortion that Apple had on the benchmark
- Broadening out Tech exposure by adding another stock in the sector, salesforce.com
- Meaningfully increasing Health Care exposure by adding Amgen and removing Pfizer (adding a stock with a high price and removing a stock with a lower price)
- Boosting the representation of the Health Care and Industrials sectors, and reducing the Tech sector, as the top chart illustrates

When comparing the Dow and S&P 500 benchmarks on a sector basis, the Dow now tilts more toward Industrials and Health Care, and has relatively less exposure to Tech and Communications Services than the S&P, as the lower chart shows.

The Dow ≠ the economy

We think the Dow is now more representative of "the market" than it was before, especially since Apple shares will no longer distort its trajectory.

However, we don't view the Dow (or the S&P 500, for that matter) as being particularly reflective of overall U.S. economic conditions, especially in this COVID-19 environment.

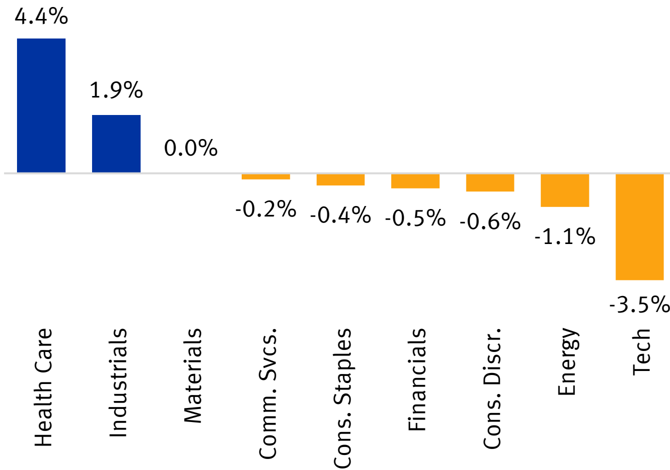
Both of these benchmarks are made up exclusively of large, publicly traded corporations, many of which are multinationals. The sphere of mom-and-pop businesses, which make up so much of the fabric of the broader U.S. economy are not represented in these benchmarks—nor are they intended to be.

While there are loose sector representations—meaning, a favorite local restaurant or hardware store would technically fall under the Consumer Discretionary sector—small and medium-sized businesses face far different challenges and opportunities than large corporations. The COVID-19 shutdowns and restrictions have borne this out.

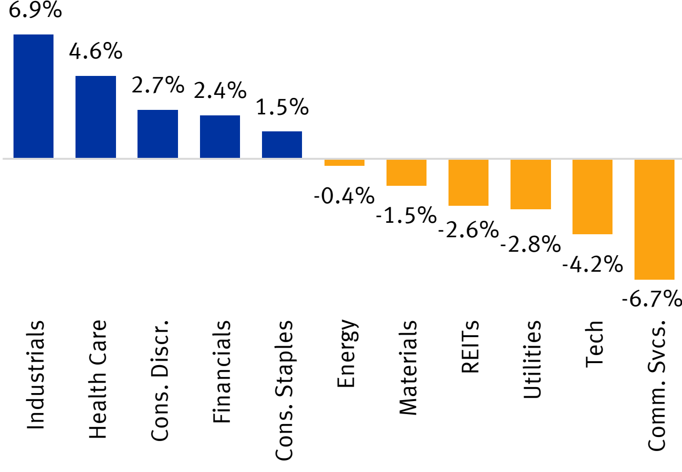
This is a key reason there is currently a disconnect between "the market" and the broader economy. Both of the major U.S. benchmarks have roared to record highs since the brutal

How the Dow changes impact sectors

Changes in Dow Jones Industrial Average sector weightings*



Differences in sector weightings:
Dow Jones Industrial Average vs. S&P 500 (Dow minus S&P)*



* Sector abbreviations: Cons. Discr. = Consumer Discretionary; Cons. Staples = Consumer Staples; Comm. Svcs. = Communication Services; REITs = Real Estate Investment Trusts; Tech = Information Technology.

Source - National research correspondent, Standard & Poor's, FactSet; data as of 8/31/20

COVID-19 selloff in February and March, while many small and medium-sized businesses are still struggling and some are at risk of closing their doors.

So when considering how "the market" is trading—whether via the Dow or S&P 500—it's best to think of the major benchmarks as reflecting how the largest segment of corporate America is faring rather than the economy as a whole.

United States

Ben Graham, CFA – Minneapolis

- **Another rotation trade to Value from Growth appears to be underway**, with the only question being whether the current movement is a temporary head-fake or indicative of a longer-lived shift to value-oriented equities. For the week, major indexes are trading generally in line with each other, but that's largely due to the fact that growth-oriented stocks and the Nasdaq Composite surged through Wednesday, Sept. 2 before the rotation away from these early-week leaders began the following day. In fact, **Thursday saw the greatest outperformance of Value relative to Growth of any single day this year**. The level of outperformance was 1.5x the size of the next closest day, May 26. Specifically, the Nasdaq fell 5.0% on Sept. 3 while the S&P 500 and Dow Jones Industrial Average "only" fell 3.5% and 2.8%, respectively. Further highlighting this split in performance is the fact that the S&P 500 Value Index traded 1.8% lower on the day while the S&P 500 Growth Index fell 4.6%.
- What's interesting is that **while Growth has significantly outperformed Value in 2020, there have been several rotational periods in which Value outperformed Growth**. These periods have typically lasted between one week and one month, with the most recent bout of Value outperformance seen in early August. However, **after each of these episodic rotations, Growth has resumed its torrid pace of outperformance**. It remains to be seen what will happen throughout the remainder of the year, but the one thing that is clear at this time is that investors will be weighing the better earnings growth of growth stocks against the valuation appeal of value stocks.

The latest rotation to Value is the sharpest single day of 2020

Relative performance of the S&P 500 Growth to Value, indexed to 100

Note: A rising line indicates outperformance of Growth, a falling line indicates outperformance of Value
Source - RBC Wealth Management, FactSet; data as of 9/3/20 at 11:20 EST

- **Economic data during the week have been largely indicative of an ongoing recovery**, although the surprise factor to the upside has been largely diminished. Specifically, the ISM Manufacturing Purchasing Managers' Index (PMI) was 56.0 while the Non-Manufacturing PMI was 56.9. Levels above 50 are indicative of an economic expansion, but only the manufacturing number beat expectations.
- Finally, while the formal jobs report for August will be released on Friday, Sept. 4, the **weekly payroll trends from the week of Aug. 24 were better than feared** with 881,000 initial claims and 13.3 million ongoing claims. On a combined basis, weekly claims were 1.16 million lower than feared.

Canada

Arete Zafiriou & Meika McKelvey – Toronto

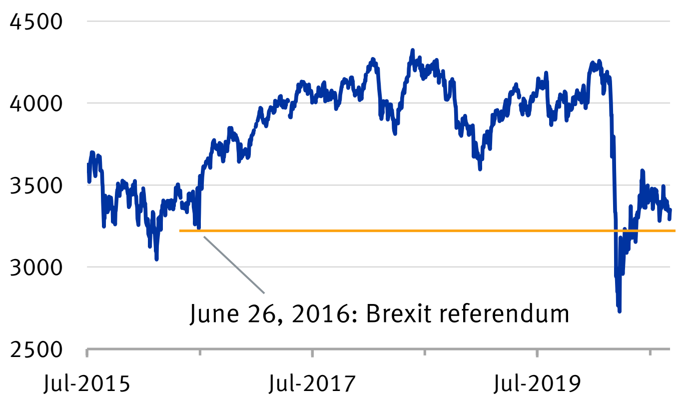
- **Canada's GDP contracted by a record 38.7% annualized in Q2**; the drop was approximately four times the size of the largest prior contraction, and came on the heels of an 8.2% decrease in Q1. Although the decline in economic growth was indeed eye-watering, it was actually **better than the Bank of Canada's forecasts**, which called for a 43% drop in the second quarter. GDP data for the month of June were released alongside the overall Q2 report and registered firmer than expected, up 6.5% month over month. Meanwhile, the forecast for July GDP came in better than anticipated as well, showing a 3% jump expected for the month. **The strong June result combined with the firmer July forecast leaves the expected Q3 GDP rebound looking firmer than before**, with RBC Economics now penciling in a 41% annualized GDP gain for the third quarter, up from 33% previously. However, it's important to note that although the initial bounceback is shaping up to be firmer than feared, RBC Economics warns that **the overall recovery will not be quick**, with the economy expected to operate below capacity well into next year—just not as far below capacity as it had estimated before the Q2 numbers were released.
- **The S&P/TSX Composite Index has yet to fully recover** from the sharp drawdown it experienced in the spring, with a total return of -6.5% since the market peaked on Feb. 19. The index is down 1.4% year to date on a total-return basis, weighed down by lackluster performance in the dominant Financials and Energy sectors. **Information Technology has been a standout performer**, gaining over 67.5% on a total return basis in 2020 through Sept. 3. Materials—the second-largest sector, and the second-best performer year to date—is far behind, with a total return of 28.3%. On the opposite side of the spectrum, **Health Care is the biggest laggard** year to date, down 36.7% as of Sept. 3.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- The FTSE All-Share Index was down marginally during the week, leaving it flat over the past month. The index has bounced back from its March 2020 lows, but while most equity markets, such as Europe and Japan, have consolidated the gains made since that point, and others, such as the U.S., have continued to build on them, **UK equities remain perilously close to their post 2016 Brexit referendum levels**.
- UK equities have faced several headwinds. They have a **large exposure to banking and Energy, two sectors which have suffered acutely from the COVID-19 crisis**, the former due to ultralow interest rates and an increase in nonperforming loans, and the latter from plummeting energy prices. UK equities also have a comparatively **low exposure to the Information Technology sector, the key driver for other markets' equity performance in recent months**. Moreover, as a high dividend yield market, UK equities have especially suffered from the significant cuts to dividend payouts year to date. Historically, dividends have been a larger component of the total shareholder return relative to other major equity markets.
- More recently, **the relative strength of the pound, courtesy of a weak dollar, has increased UK equities' woes** given the index is dominated by multinationals. Sterling has gained 16% relative to the dollar since the market plunge in March, and is now back to where it started 2020.
- **The performance of UK equities is disappointing as the UK economy has been recovering** thanks to the powerful mix of loose monetary policy and generous government support. The IHS Markit/CIPS UK Composite Purchasing Managers' Index reached a solid reading of 59 in August.

FTSE All-share close to post 2016 Brexit referendum lows



Source - RBC Wealth Management, Bloomberg; data through 9/2/20

- **But government largesse is coming to an end, with several government schemes expiring**. Talks of higher taxes to finance the ballooning deficit have emerged, though such a move may eventually be deemed premature by the government. The autumn will see further negotiations with regards to Brexit—both the UK and the EU will need to be flexible if a rudimentary free trade agreement is to be cobbled together before year-end.
- **As we see more headwinds coming for UK equities, we maintain our Underweight stance**.

Asia Pacific

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

- Most MSCI Asia ex Japan companies have announced Q2 2020 results. Overall, earnings are largely in line with consensus expectations on a U.S. dollar basis. In terms of market, **Taiwan, Thailand, and China have reported the most earnings surprises (measured by number of companies) on the upside**. By sector, Health Care, software & services, and media & entertainment are seeing stronger earnings beats.
- **China's banking sector reported the worst quarterly results in more than a decade** as the banks significantly increased loan-loss provisions. However, the sharp earnings contraction had been expected by the market. After the COVID-19 outbreak, the Chinese government required banks to forgo RMB 1.5 trillion in profits by providing cheap funding, deferring loan payments, and increasing lending to small businesses. **Concerns over nonperforming loans and the opaque profit growth outlook are likely to cap share-price upside for the sector in the near term**, in our view.
- On Aug. 28, **Japanese Prime Minister Shinzo Abe announced he is stepping down for health reasons**, ahead of the end of his term as leader of the Liberal Democratic Party (LDP), which was set to expire in September 2021. So far, **there are no indications of major changes to the "Abenomics" framework and the Bank of Japan's monetary policy**, as most potential successors are Abe's political allies. The LDP will likely elect a candidate who will not significantly deviate from the government's current policies. Given the weak and fragmented opposition, the successor should be able to win a comfortable majority at the next general election.
- **India is considering extending its flagship jobs program in villages to unemployed workers in cities**. The program may be rolled out in smaller cities and initially cost about 350 billion rupees ($4.8 billion). The rural program involves employing people for local public-works projects such as road-building, well-digging, and reforestation. The market expects the city program would boost demand.

MARKET SCORECARD

Data as of September 3, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,455.06	-1.3%	6.9%	18.9%	19.1%
Dow Industrials (DJIA)	28,292.73	-0.5%	-0.9%	8.3%	9.0%
Nasdaq	11,458.10	-2.7%	27.7%	45.5%	41.3%
Russell 2000	1,544.68	-1.1%	-7.4%	4.9%	-11.3%
S&P/TSX Comp	16,448.90	-0.4%	-3.6%	0.3%	1.1%
FTSE All-Share	3,281.39	-1.8%	-21.8%	-17.6%	-20.7%
STOXX Europe 600	366.08	-0.1%	-12.0%	-3.6%	-4.3%
EURO STOXX 50	3,304.22	1.0%	-11.8%	-3.4%	-2.7%
Hang Seng	25,007.60	-0.7%	-11.3%	-2.0%	-9.8%
Shanghai Comp	3,384.98	-0.3%	11.0%	15.5%	24.4%
Nikkei 225	23,465.53	1.4%	-0.8%	13.8%	3.3%
India Sensex	38,990.94	0.9%	-5.5%	6.6%	1.8%
Singapore Straits Times	2,531.79	0.0%	-21.4%	-18.1%	-21.1%
Brazil Ibovespa	100,721.40	1.4%	-12.9%	1.0%	32.2%
Mexican Bolsa IPC	36,429.66	-1.1%	-16.3%	-12.9%	-26.4%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,930.06	-1.9%	27.2%	24.8%	60.7%
Silver (spot $/oz)	26.57	-5.6%	48.8%	37.9%	83.0%
Copper ($/metric ton)	6,709.75	0.2%	9.1%	20.1%	12.9%
Oil (WTI spot/bbl)	41.37	-2.9%	-32.2%	-23.3%	-40.7%
Oil (Brent spot/bbl)	44.02	-2.8%	-33.3%	-24.4%	-43.7%
Natural Gas ($/mmBtu)	2.48	-5.6%	13.5%	5.3%	-14.8%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.635%	-7.0	-128.3	-82.3	-222.6
Canada 10-Yr	0.536%	-8.6	-116.6	-58.1	-169.2
U.K. 10-Yr	0.237%	-7.4	-58.5	-16.9	-116.7
Germany 10-Yr	-0.488%	-9.1	-30.3	21.8	-82.1
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.11%	0.4%	7.3%	6.7%	17.8%
U.S. Invest Grade Corp	1.90%	0.8%	7.8%	8.2%	22.8%
U.S. High Yield Corp	5.28%	0.2%	1.9%	5.1%	11.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	92.7450	0.7%	-3.8%	-6.3%	-2.5%
CAD/USD	0.7622	-0.5%	-1.0%	1.7%	-0.2%
USD/CAD	1.3121	0.6%	1.0%	-1.6%	0.2%
EUR/USD	1.1855	-0.7%	5.7%	8.0%	2.0%
GBP/USD	1.3280	-0.7%	0.2%	9.9%	3.2%
AUD/USD	0.7275	-1.4%	3.6%	7.6%	0.8%
USD/JPY	106.1700	0.2%	-2.2%	0.2%	-4.4%
EUR/JPY	125.8800	-0.4%	3.4%	8.3%	-2.4%
EUR/GBP	0.8927	0.0%	5.5%	-1.7%	-1.1%
EUR/CHF	1.0778	-0.1%	-0.7%	-0.5%	-4.3%
USD/SGD	1.3646	0.3%	1.4%	-1.9%	-0.5%
USD/CNY	6.8488	0.0%	-1.6%	-4.6%	0.4%
USD/MXN	21.6885	-0.9%	14.6%	8.6%	13.1%
USD/BRL	5.2907	-3.7%	31.3%	40.0%	27.2%

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 9/3/20.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -1.0% return means the Canadian dollar fell 1.0% vs. the U.S. dollar year to date. USD/JPY 106.17 means 1 U.S. dollar will buy 106.17 yen. USD/JPY -2.2% return means the U.S. dollar fell 2.2% vs. the yen year to date.

Authors

Kelly Bogdanova – San Francisco, United States
kelly.bogdanova@rbc.com; RBC Capital Markets, LLC

Ben Graham, CFA – Minneapolis, United States
benjamin.graham@rbc.com; RBC Capital Markets, LLC

Arete Zafiriou – Toronto, Canada
arete.zafiriou@rbc.com; RBC Dominion Securities Inc.

Meika McKelvey – Toronto, Canada
meika.mckelvey@rbccm.com; RBC Dominion Securities Inc.

Frédérique Carrier – London, United Kingdom
frederique.carrier@rbc.com; RBC Europe Limited

Thomas McGarrity, CFA – London, United Kingdom
thomas.mcgarrity@rbc.com; RBC Europe Limited

Jasmine Duan – Hong Kong, China
jasmine.duan@rbc.com; RBC Investment Services (Asia) Limited

Nicholas Gwee, CFA – Singapore
nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

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Rating	Count	Percent	Count	Percent
Buy [Outperform]	776	51.63	238	30.67
Hold [Sector Perform]	635	42.25	130	20.47
Sell [Underperform]	92	6.12	12	13.04

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