

Global Insight

Weekly

Going out with a bang?

Frédérique Carrier – London

As the Brexit endgame begins to unfold, the UK government appears ready to break the Withdrawal Agreement it negotiated less than a year ago. We look at how the British strategy could influence the prospects for free trade agreements with the EU and the U.S., as well as considerations that could affect investors in the months ahead.

British Prime Minister Boris Johnson recently proposed contentious legislation in preparation for the UK's departure from the EU single market. The divorce will be final at the end of December 2020, when the clock runs out on the one-year transition period during which the UK remains tied to the EU's economic structures.

The Internal Market Bill would in effect negate much of the Withdrawal Agreement, the divorce settlement to which the UK and EU agreed late last year. The main point of contention is state aid: the British government has decided it now wants an unconstrained ability to subsidize companies and industries, something that would not be possible under the terms of the current agreement.

An important casualty of the demise of the Withdrawal Agreement would be the Northern Ireland protocol, which guarantees the Good Friday Agreement that prevents a hard border on the island of Ireland.

Should the prime minister's proposal be passed in Parliament, and the UK renege on the Withdrawal Agreement, Britain would in effect breach international law.

The proposal was strongly condemned not only by the EU, but also by former Prime Ministers who want to protect the UK's reputation as a staunch defender of the rule of law. Politicians in the U.S. soon joined in, with Speaker of the House of Representatives Nancy Pelosi and presidential candidate Joe Biden pointing out that the House of Representatives would be unlikely to approve a U.S.-UK free trade agreement (FTA)

if the Good Friday Agreement were breached—a sign of the power of the Irish lobby in the U.S. An FTA with the U.S. was always much coveted by Brexit proponents, who saw severing ties with the EU as an acceptable cost to obtain it. With the EU accounting for close to 50 percent of Britain's exports, a large alternative FTA is clearly needed.

Most observers expected negotiations to become increasingly acrimonious as the deadline to reach a trade deal with the EU approached. Few, however, could have predicted a move that could sully Britain's international reputation.

Brexit brinkmanship: Does he mean it?

Is this simply a negotiating tactic, aimed at sowing havoc and preparing the ground for Britain to orchestrate a U-turn and agree to a trade deal? Or does Johnson believe the cost of leaving without a trade deal is a fair price to pay for the freedom to pick and choose industrial winners? Opinions are divided.

Market pulse

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Management

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Brexit scenarios to year's end



Note: whether a trade deal is agreed or not, emergency negotiations are likely to take place as several issues will likely need to be ironed out.

Source - RBC Wealth Management

A deal, at least in the form of a rudimentary FTA covering goods, is still possible. After all, the EU would still prefer one, and many observers believe the UK authorities should not consider putting the country through an economic shock at a time when Britain is already weak due to the COVID-19 health crisis. The British economy has bounced back from its 22 percent year-over-year Q2 contraction, but the recent tightening of restrictions in response to a rising infection rate will likely hamper the recovery. For 2020, RBC Capital Markets expects UK GDP to contract by some nine percent year over year, a much deeper contraction than is expected in the U.S. (-3.5%) or Canada (-6%).

While a rudimentary FTA is still possible in theory, we continue to assign a probability of just over 50 percent to the UK leaving the EU without a significant economic arrangement on December 31. Time is quickly running out, and the prospect of a no-deal Brexit seems to inspire less fear in the EU than it did in the past, given the bloc's recent creation of its ambitious fiscal stimulus package.

Staying Underweight amid poor visibility

The Bank of England is on high alert. With some of the government's emergency support programmes becoming less generous, new COVID-19 restrictions taking effect, and the prospect of a no-trade-deal Brexit looming, the UK economy is likely to need more support in the months to come. To that end, the central bank has reiterated that negative interest rates are part of its toolkit, and is looking into how they could be implemented effectively. In the short term, we anticipate further quantitative easing focused on gilts (UK government bonds) before year's end, with the potential for interest rates to be cut to zero later if deemed necessary.

For now, with a 6- to 12-month view, we would be Underweight UK sovereign debt. We expect gilt yields to grind higher over time as the effects of much higher government spending and accommodative monetary policy play out. Sterling investment-grade corporate credit provides relatively more compelling valuations, though we would be very selective given the double challenge of the pandemic and Brexit.

The prospect of negative rates, the recent resurgence of COVID-19 infections, and news of the government's intention to negate the Withdrawal Agreement led the pound to retrace some of its recent gains against the U.S. dollar and the euro, falling five percent against the former so far in September. We believe trade negotiation headlines will be the most prominent driver of sterling in coming weeks. With risks asymmetric to the downside, we have a cautious outlook for the currency. The pound's buoyancy so far this year suggests it is pricing in a 60 percent likelihood of a trade deal being signed, so it would likely retreat should this not materialise.

As for equities, valuations are undoubtedly attractive, with the FTSE All-Share Index close to where it stood following the 2016 Brexit referendum. But with the COVID-19 crisis far from being under control and a hard Brexit possible, we continue to believe there are better opportunities elsewhere and maintain our Underweight recommendation. We would focus on UK companies that are well positioned to benefit from long-term structural growth tailwinds or that have internal levers to grow, rather than on those whose prospects are tied to the macroeconomic environment.



United States

Ben Graham, CFA – Minneapolis

- **The S&P 500 officially entered correction territory this week**—defined as a minimum decline of 10% from recent highs—and on track for its worst September since 2008. To date, the S&P 500 has shed 9.3% from its Sept. 2 closing high. This trend is also evident and **even more exaggerated in the Nasdaq** (-11.5% since Sept. 2) while the **Dow Jones Industrial Average** (-8.0% since Sept. 2) **has held up slightly better** than these indexes and is yet to dip into correction territory. Granted, and it's not a small consideration, the Nasdaq is still the clear leader so far in 2020, up 18.9% year to date.
- **The divergence in index moves thus far in 2020**, both during the recovery and the current correction, **has seen a common amplifier: Growth and technology-oriented stocks**. In the aftermath of the March lows, growth and Tech stocks rallied on the heels of unprecedented fiscal stimulus and work-from-home trends. Several of the largest companies in the world more than doubled in value from their March lows, highlighted by Apple's climb of 160% and passing of the \$2 trillion milestone. Fast forward to today and the likelihood of further stimulus is fading, while the elevated valuations that are a result of this rally are coming to the forefront. As a result, these growth and Tech stocks are reversing course in what we believe is a **healthy, albeit fast, consolidation**.

U.S. equity market returns

Index or sector	2020 through 9/2/20	9/2/20 to date	Year to date
Nasdaq	34.4%	-11.5%	18.9%
S&P 500	10.8%	-9.3%	0.5%
Dow Jones	2.0%	-8.0%	-6.2%
Technology	38.6%	-12.3%	21.5%
Cons. Discretionary	30.1%	-9.2%	18.1%
Comm. Services	18.8%	-12.0%	4.6%
Materials	7.8%	-6.3%	1.0%
Health Care	5.9%	-5.8%	-0.3%
Cons. Staples	7.2%	-7.2%	-0.5%
Industrials	-2.1%	-5.4%	-7.4%
Utilities	-7.0%	-3.8%	-10.5%
Real Estate	-4.6%	-8.2%	-12.4%
Financials	-17.3%	-8.4%	-24.3%
Energy	-42.4%	-12.8%	-49.8%

Source - RBC Wealth Management, FactSet; data though 9/24/20

- As has frequently been the case with 2020, **the current correction is underway with a surprising amount of rapidity**. In fact, the Nasdaq fell 10.0% over the course of just three days ending Sept. 8. Excluding March of this year, when COVID-19 fears reached extremes, this was the worst three-day move for the tech-heavy index since the U.S. debt downgrade in August 2011. Furthermore, the CBOE Volatility Index (VIX) has seen an average reading of 30.5 in 2020, higher than every other year since the Great Recession, with a peak in March that was mere inches short of the October 2008 high.
- However, it's important to put this most recent correction into context. Despite the sharpest losses occurring in the stocks that were leaders throughout much of 2020, Tech remains the best-performing sector for the full year. It's followed by Consumer Discretionary and Communication Services, while the worst-performing sectors in 2020 include Energy and Financials. Surprisingly, the S&P 500 has actually climbed 0.5% in 2020, while the majority of sectors are lower for the year. Taken together, **we view this most recent Tech-led correction as part of the normal rhythms of markets** and it makes sense in the greater context of how 2020 has played out. Tech had run too far, too fast in recent months, in our view, and now it is correcting and bringing other parts of the market down with it, albeit to a lesser degree. Equity markets are essentially flat for the year, but they sure have been on an uncomfortably fast and rapidly shifting path for much of the ride.
- Finally, the economy continues to improve, despite the pace of the recovery being slower than the pace of the decline. Employment trends didn't deteriorate to the levels that many feared. Home buying activity remains elevated while manufacturing activity stabilizes. This **economic picture indicates incremental improvement that should provide a sturdy backstop for equity markets from here** and should prevent March-like losses for the foreseeable future, in our opinion.



Canada

Ryan Harder & Luis Castillo – Toronto

- **Prime Minister Justin Trudeau's plan for the expansion of new fiscal spending measures into 2021 and beyond was outlined** in this year's Speech from the Throne. Given on Wednesday afternoon by Governor General Julie Payette, the speech marked the resumption of parliament, which was suspended in August. Among the **notable items announced** were the extension of the Canada Emergency Wage Subsidy, an investment in a nationwide childcare program, a promise to accelerate a national pharmacare strategy, and various incentives designed to meet a greenhouse gas emission

target by 2030. Although the full scope and execution of these programs are still unclear, the breadth of new spending items announced indicates that the FY2021 federal deficit is likely to be considerably larger than pre-COVID-19 levels. With interest rates already near zero and long-term yields having fallen significantly this year, we believe **the addition of ongoing fiscal stimulus should provide a tailwind for inflation going forward.**

- **Canada retail sales rose 0.6% in July to CA\$52.9 billion**, with sales up in six of 11 subsectors according to Statistics Canada. While a number of other activity measures remain well below the pre-COVID-19 levels, retail sales activity sits above the pre-lockdown level. Some of this consumer resilience stems from **household incomes increasing by over CA\$30 billion in the second quarter**, despite a nearly CA\$20 billion decrease in wages, as government transfers more than filled this gap. We note that the pace of retail sales growth has slowed considerably after a strong May (+21%) and June (+23%). Early August estimates suggest retail sales increased 1.1%.



Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Markets in Europe followed the lead of the U.S. and retraced some of their gains in the week.** In Europe and the UK, the Financials sector was hit worse not only due to concerns about rising infection rates affecting the economic cycle, but also as **banks were highlighted in a FinCEN report as having been implicated in money laundering operations.** The FTSE All-Share is now 24% below its starting point at the beginning of 2020, and the STOXX Europe 600 ex UK is down 10%.
- **Economic momentum in Europe started to slow down.** Both the French and German September flash PMI (Purchasing Managers' Index) for the services sector entered contraction territory, as the resurgence of infection cases weighed on business activity. Given only mild restrictions are in place compared to those used in March, this decline highlights **the sensitivity of economic activity to consumer behaviour.** By contrast, the manufacturing sector's readings remain in expansion territory, and were slightly above consensus expectations, albeit lower than the previous month's levels. Overall, while we think it is too early to worry about a double-dip recession, national authorities and the European Central Bank will be on the alert.
- For the UK, whose recovery trailed that of the euro area as the economy was reopened comparatively later, PMIs for both services and manufacturing were firmly in expansion territory in September, but below consensus expectations. Here as well, the risk is that as government restriction

measures become ever more severe in the winter months, economic activity could slow further. **Despite freshly announced stimulus**, including a wage-subsidy scheme designed to help out employees working reduced hours, **a decline in economic activity as soon as October cannot be ruled out.**



Asia Pacific

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

- **The correction in U.S. equities spilled over to Asian stocks during the week.** Sentiment for Asian equities remained somewhat weak, with the MSCI Asia ex Japan Index down by 2.3% as of Sept. 23.
- **In China, retail sales returned to growth for the first time since the COVID-19 pandemic**, up 0.5% y/y in August. Further data shows that sales of luxury goods, cars, and electronics are leading, ahead of the growth of food, clothing, and other essentials. According to Boston Consulting Group, luxury spending in China should grow 20%–30% this year.
- According to an unsubstantiated report from Bloomberg, **Ant Group Co., the fintech giant owned by Alibaba (9988 HK), is seeking to raise about \$35 billion in a dual listing in Hong Kong and Shanghai at a valuation of about \$250 billion.** The deal, which could be completed in mid-to-end-October, would be one of the largest IPOs in the world ever. The article noted that the company won't seek "cornerstone" investors (more common in Hong Kong than in other markets, these are usually large institutions that agree to hold the shares for about six months in exchange for a sizable allocation) in its Hong Kong share sale, as it is confident there will be sufficient demand for the IPO.
- On Sept. 23, **ByteDance Ltd., the owner of video-sharing app TikTok, filed in U.S. federal court for a temporary block on the Trump administration's ban** that would remove the app from U.S. app stores. Bloomberg reported that ByteDance is pursuing approvals from the Trump administration for a sale of its U.S. operations to Oracle Corp. and Walmart Inc. The company asked the court to set a hearing before the rules take effect at 11:59 p.m. on Sept. 27 and proposed that both sides file additional briefs this week.
- **South Korea's central bank estimates the country is expected to see a record number of "zombie" companies this year.** The Bank of Korea (BOK) defines such firms as those that have been unable to make payments on interest from operating profit for three years. The ratio of companies deemed "marginal" by the BOK will reach 21.4% of local firms subject to independent audits by the end of 2020, or around 5,000. That would be a significant increase from 14.8% in 2019.



MARKET SCORECARD

Data as of September 24, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,246.59	-7.2%	0.5%	9.4%	11.2%
Dow Industrials (DJIA)	26,815.44	-5.7%	-6.0%	0.0%	1.0%
Nasdaq	10,672.27	-9.4%	18.9%	33.5%	33.5%
Russell 2000	1,451.82	-7.0%	-13.0%	-5.3%	-14.9%
S&P/TSX Comp	15,912.26	-3.6%	-6.7%	-5.3%	-1.8%
FTSE All-Share	3,245.12	-2.9%	-22.7%	-19.1%	-21.1%
STOXX Europe 600	355.85	-2.9%	-14.4%	-8.7%	-6.9%
EURO STOXX 50	3,159.64	-3.4%	-15.6%	-10.5%	-7.4%
Hang Seng	23,311.07	-7.4%	-17.3%	-11.3%	-15.2%
Shanghai Comp	3,223.18	-5.1%	5.7%	8.0%	15.2%
Nikkei 225	23,087.82	-0.2%	-2.4%	4.5%	-3.3%
India Sensex	36,553.60	-5.4%	-11.4%	-6.5%	0.7%
Singapore Straits Times	2,450.82	-3.2%	-24.0%	-22.3%	-23.9%
Brazil Ibovespa	97,012.10	-2.4%	-16.1%	-6.6%	24.4%
Mexican Bolsa IPC	36,217.49	-1.7%	-16.8%	-16.0%	-26.7%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.666%	-3.9	-125.2	-98.0	-242.3
Canada 10-Yr	0.557%	-6.5	-114.5	-75.0	-189.2
U.K. 10-Yr	0.219%	-9.2	-60.3	-30.9	-139.4
Germany 10-Yr	-0.501%	-10.4	-31.6	9.9	-101.1

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.18%	0.1%	6.9%	7.0%	18.4%
U.S. Invest Grade Corp	1.97%	0.2%	7.1%	8.1%	22.8%
U.S. High Yield Corp	5.83%	-1.2%	0.4%	2.7%	9.8%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	94.3170	2.4%	-2.1%	-4.1%	0.1%
CAD/USD	0.7489	-2.3%	-2.7%	-0.8%	-3.0%
USD/CAD	1.3354	2.4%	2.8%	0.8%	3.1%
EUR/USD	1.1672	-2.2%	4.1%	5.9%	-0.6%
GBP/USD	1.2738	-4.7%	-3.9%	2.0%	-2.9%
AUD/USD	0.7048	-4.4%	0.4%	3.6%	-2.8%
USD/JPY	105.4200	-0.5%	-2.9%	-1.5%	-6.5%
EUR/JPY	123.0400	-2.7%	1.0%	4.3%	-7.2%
EUR/GBP	0.9163	2.6%	8.3%	3.9%	2.3%
EUR/CHF	1.0816	0.3%	-0.4%	-0.4%	-4.5%
USD/SGD	1.3757	1.1%	2.2%	0.0%	0.7%
USD/CNY	6.8287	-0.3%	-1.9%	-4.0%	-0.4%
USD/MXN	22.1313	1.1%	16.9%	13.8%	16.7%
USD/BRL	5.5118	0.3%	36.8%	45.9%	34.8%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,869.90	-5.0%	23.2%	22.1%	56.0%
Silver (spot \$/oz)	23.21	-17.5%	30.0%	24.7%	62.8%
Copper (\$/metric ton)	6,617.10	-1.2%	7.6%	15.0%	4.1%
Oil (WTI spot/bbl)	40.16	-5.7%	-34.2%	-29.8%	-45.0%
Oil (Brent spot/bbl)	41.76	-7.8%	-36.7%	-33.8%	-48.6%
Natural Gas (\$/mmBtu)	2.19	-16.8%	0.0%	-12.6%	-28.0%

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 8:35 pm GMT 9/24/20.

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Authors

Frédérique Carrier – London, United Kingdom

frederique.carrier@rbc.com; RBC Europe Limited

Ryan Harder – Toronto, Canada

ryan.harder@rbccm.com; RBC Dominion Securities Inc.

Luis Castillo – Toronto, Canada

luis.castillo@rbccm.com; RBC Dominion Securities Inc.

Thomas McGarrity, CFA – London, United Kingdom

thomas.mcgarritty@rbccm.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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