RBC WEALTH MANAGEMENT

U.S. ELECTIONS & MARKET MATTERS

What's in it for Europe and the UK?

Frédérique Carrier – London

The world can't take its eyes off the U.S. election—and not only because it looks like a Netflix show. The outcome will impact U.S. trade, foreign, and regulatory policies. We look at the repercussions for the EU and UK as well as portfolio strategy.

U.S. and EU: Close ties

Historical, cultural, and political ties between the U.S. and EU forged, in the words of the European Commission, "the largest, most bilateral trade and investment relationship in the world." The importance of this transatlantic relationship cannot be underestimated.

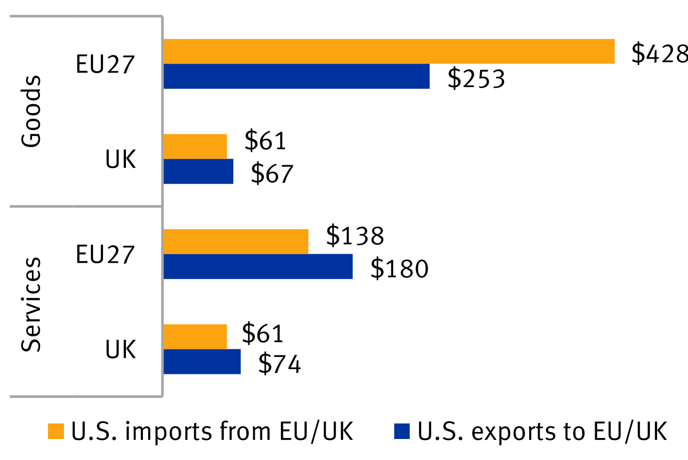
The U.S. and the EU have long been each other's largest trading partners, and this will remain the case now that the UK has ditched the EU. According to the Congressional Research Service, the EU27 (i.e., the EU excluding the UK) sent $566 billion of goods and services to the U.S. in 2018, accounting for some 20 percent of its total exports and close to four percent of EU27 GDP. Meanwhile, the U.S. exported $433 billion worth of goods and services to the EU27 that year, accounting for close to two percent of U.S. GDP.

But the relationship goes far beyond trade. Transatlantic foreign direct investment is significant. Even with the UK out of the EU, the U.S. and EU will remain each other's largest sources and destinations of foreign direct investment.

Hence, with the EU corporate sector so exposed to such an important partner, with large companies generating some 20 percent of sales from the U.S., the future direction of Uncle Sam's foreign, trade, and regulatory policies will hold sway with the Continent. The American economy's growth prospects and potential changes to U.S. policies will be key, in our view, as they feed through to European corporate earnings.

U.S.-EU and U.S.-UK goods and services trade in 2018

$ billion



Note: EU27 refers to the EU excluding the UK
Source - Congressional Research Service, Bureau of Economic Analysis

Market pulse

3 U.S. Treasury yields move higher on fiscal policy
3 Canadian consumer losses unlikely to exceed bank reserves
4 UK/European Consumer Staples beats, Luxury recovers
4 China's economic recovery remains intact

Click here for authors' contact information. Priced (in USD) as of 10/22/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6.**
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Outcome 1: Status quo

The U.S.-Europe relationship has been strained over the past four years as President Donald Trump, who is no fan of the EU, believed the bloc was taking advantage of the U.S. through unfair trade practices. He imposed 25 percent tariffs on European steel and aluminium exports and threatened to slap further tariffs on other goods worth more than $20 billion. However, a potential full-blown trade war with the EU does not share the same bipartisan support in the U.S. Congress as does one with China.

Should the status quo prevail and Trump remain in the White House for another four years, the rhetoric against the EU could very well escalate. No longer worrying about a second term, the president's trade policy could become more aggressive. Should the EU be on the receiving end of further tariffs, it has already said it would retaliate. Given that it takes in some 20 percent of U.S. exports, Europe is in a position to throw its weight around and could strike back effectively, in our view. If U.S. tariffs re-emerge, EU export-oriented sectors most at risk include manufacturers such as automakers and luxury goods.

Outside of the tariff issue, other sectors would likely fare better. With the fear of greater regulation receding, we would expect companies in the Energy and Financials sectors to enjoy a relief rally.

Outcome 2: Biden presidency

A Joe Biden presidency would probably herald an era of less tense international relations between the U.S. and the EU, in particular as Biden has vowed the U.S. would rejoin the Paris Climate Accord, an international agreement that attempts to mitigate greenhouse gas emissions and allows members to set carbon emission targets and restrictions for their economies. With a backdrop likely to be more conciliatory, longstanding contentious issues ranging from data protection to taxation of U.S. tech giants could be tackled. It is also more likely these disagreements could be settled within the framework of existing institutions and processes.

Moreover, we believe Biden's green agenda would be positive for European sectors exposed to energy efficiency, smart mobility, and renewables, areas where Europe is a leader. By contrast, should the new president focus on reforming health care policy and drug pricing, the European (and UK for that matter) Pharmaceuticals sector could be negatively affected. European pharma companies generate as much as 35 percent to 50 percent of sales from the U.S.

UK: Out in the cold?

A new U.S. administration could deprive the UK government of an important source of support. Trump has been a backer of the UK leaving the EU, a position that emboldened the Brexit movement, in our view.

For Britain, the key issue is whether a Biden presidency would diminish the prospect of reaching a trade deal with the U.S. to offset its loss of access to the EU single market. Securing a U.S. trade deal was central to the Brexit strategy, seen by many Brexiters as the ultimate prize that would more than make up for the cost of leaving the EU's economic structure and institutions. Recently, the UK government admitted that a trade deal with the U.S. would only add $4.3 billion to the post-Brexit UK economy over the next 15 years, or a paltry economic boost of some 0.2 percent.

Biden's position is less well known, though when he was vice president the Obama administration opposed preferential trade terms for a UK "out of Europe." A Biden administration would also be unlikely to prioritise Britain, with its 60 million inhabitants, over the EU, which has a population of some 450 million. Already, the U.S. views the UK as a less valuable ally, having lost much of its role as a lever of influence with the EU.

Talks for a U.S.-UK free trade deal are currently on hold until the spring of 2021 due to the COVID-19 pandemic. A new president could pause all negotiations while re-examining U.S. trade policy, causing further delays.

Portfolio strategy

For Europe and the UK, we believe domestic factors including monetary and fiscal policies will clearly be the main drivers of financial markets. Yet changes in the U.S. trade and regulatory frameworks could also influence prospects for certain sectors. Investors who want to mitigate uncertainty could focus on sectors with upside potential regardless of the election's outcome, such as infrastructure, or those that stand to benefit from structural growth and megatrends.

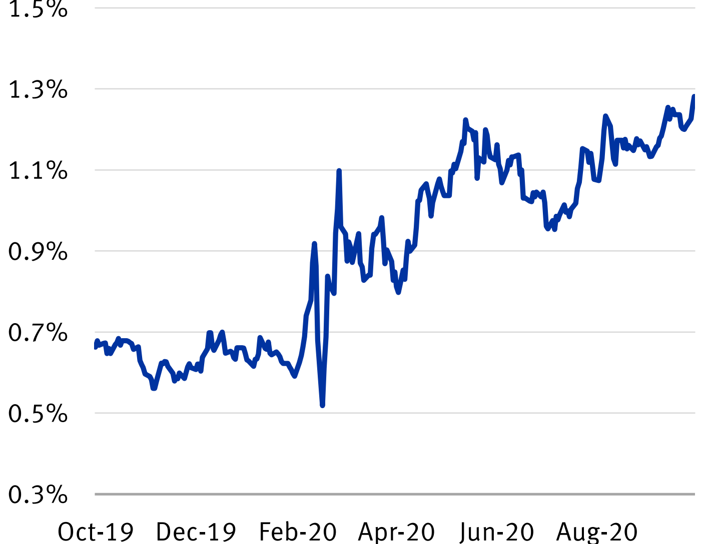
United States

Atul Bhatia, CFA – Minneapolis

- Treasury markets eschewed their traditional single-minded focus on monetary policy during the week, with **a rise of nearly nine basis points (bps) in 10-year yields instead closely linked to developments on potential pre-election stimulus**. The compromise bill—currently reported as roughly $2 trillion—is undeniably important, but rates markets are also considering the potential for a sustained pick-up in fiscal support under a unified government; such support could sustain higher rates even if the current round of stimulus legislation fails to advance.
- Complicating the consideration of additional spending is the U.S.'s growing debt burden. **The federal government posted a record $3.1 trillion shortfall** in the recently concluded 2020 fiscal year, bringing the total public debt burden to $21 trillion—over 100% of GDP. Despite the vast sums owed, the federal government's spending on interest payments in 2020 hit its lowest level in three years, thanks to the Fed's success in lowering rates.
- Even after this week's rise, **10-year government bond yields have traded in a tight range of 23 bps since Sept. 1**. If sustained, this would be one of the narrowest multi-month ranges in decades. One explanation for the relative lack of movement is the market's belief that the Fed will be quick to redirect its $80 billion in monthly Treasury purchases to any maturity with rising yields. Foreign investors are also drawn to rising U.S. rates, given the large percentage of global bonds with negative yields.

Fiscal vs. monetary focus leads to steeper curve

5Y yields kept low by Fed on hold; fiscal hopes drive 30Y yields higher



Source - Bloomberg, RBC Wealth Management; data through 10/21/20

- **The Fed's Beige Book**, a qualitative survey of economic conditions across the country, **showed mildly positive overall growth but atypically large differences between sectors**. Restaurants and travel-related businesses reported difficult conditions, while housing, auto sales, and other interest-rate-sensitive sectors saw stronger demand. Retail sales data showed similar trends, with a better-than-expected 1.9% increase in September compared to the previous month. The magnitude of the increase was a surprise given ongoing high unemployment, and was attributed in part to back-to-school shopping.

Canada

Richard Tan, CFA & Arete Zafiriou – Toronto

- The latest round of Canadian earnings reporting is underway and **arguably the most anticipated earnings releases will be the Canadian banks** (scheduled for the beginning of December) as they are often used to gauge the strength of the Canadian economy. The group has **underperformed the S&P/TSX Composite year to date**, driven by factors such as declining interest rates and uncertainty around loan losses. With respect to the latter, RBC Capital Markets believes that approximately 75%–90% of consumers with mortgage deferrals are still employed and have also increased their propensity to save. On the flip side, approximately 10%–15% of consumers with deferrals are unemployed, but government programs (e.g., the Canada Emergency Response Benefit) are believed to have more than offset the impact of lost wages. As a result, RBC Capital Markets believes **consumer loan losses are unlikely to exceed the reserves already built by the banks** because these estimates of loan loss provisions were originally constructed with the expectation of lower government support and a more severe economic backdrop.
- **Canadian retail sales increased 0.4% to CA$53.2 billion in August**, below Statistics Canada's preliminary 1.1% estimate. August was the fourth consecutive month of growth since COVID-19 and lockdown measures led to a record drop in April sales. Retail sales had already rebounded above 2019 levels by June, and were up 3.5% y/y in August. **Building material and garden equipment stores led the gains**, with spending up 4.5% m/m. Spending at gasoline stations was also relatively strong, up 1.2%. On the other side of the spectrum, **spending at sporting goods, hobby, book, and music stores declined** 3.7% m/m. As noted by RBC Economics, sales at clothing and accessories stores did not receive the usual boost from back-to-school shopping, and remain 11.8% below pre-pandemic levels. Based on a survey of retail companies, Statistics Canada estimates retail sales growth was relatively flat in September.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- The **Brexit** soap opera continues. **After having been called off late last week by the UK government, negotiations resumed and intensified**, with the UK and the EU introducing daily sessions and concurrent discussions of all pending issues. This new energy would suggest that both sides believe there is sufficient possibility of achieving a substantial result to warrant these negotiations. Nov. 15 is the key date by which an agreement needs to be reached for it to be ratified by EU member countries before the transition period ends on Dec. 31.
- Prime Minister Boris Johnson may claim that his recent manoeuvres have brought the EU back to the negotiating table, though the EU has not changed its negotiating position substantially. **If the prime minister really wants a trade deal, the UK will have to make important concessions**, particularly in the areas of support for businesses (the "level playing field") and governance. Whether these changes will be acceptable to ardent Brexiters remains to be seen.
- Avoiding the disruption and acrimony which would ensue if no trade deal were reached would be a desirable outcome, even if the trade deal is very basic. The renewal of negotiations sent **yields on 10-year Gilts higher** to 0.27% from 0.16% at the beginning of the week, while **the pound gained more than 1%** in the same period.
- Two trends are emerging from the Q3 results season thus far. First, **Consumer Staples companies have delivered strong beats to consensus estimates** thanks to firm demand. Reckitt Benckiser reported like-for-like sales growth of 13.3% for Q3 thanks to elevated demand for the company's disinfectant cleaning products. Nestlé and Unilever reported organic growth of 4.9% and 4.4%, respectively, in Q3 on increasing demand for at-home consumption. The sector's exposure to everyday small-ticket items is supportive of **sales remaining resilient in tough economic conditions**, in our view, even though some of the COVID-19 tailwinds will eventually wane.
- Second, **luxury goods demand has recovered**, suggesting the pandemic-induced slowdown was temporary. Hermès and LVMH reported Q3 organic growth of 7% and 12%, respectively, and flagged strong momentum in Asia as well as a significant improvement in all other geographical areas. This supports our view that the sector will benefit from structural growth in **demand arising from the growing wealth of emerging middle classes in Asia**.

Broad Asian equity recovery masks important country differences

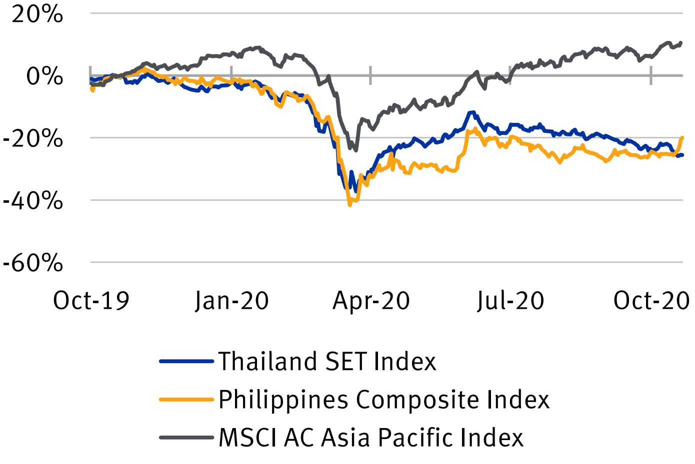


Chart data has been normalized to reflect the percentage change in index value since 10/2/19
Source - Bloomberg, RBC Wealth Management; data through 10/22/20

Asia Pacific

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

- **Asia Pacific equity markets have been mixed during the week** as major indexes gave up earlier gains on Thursday as hopes of a pre-election stimulus in the U.S. faded. **Thailand's SET Index fell to a six-month low** due in part to the escalating anti-government protests. On the other end of the spectrum, the **Philippines' PSEi Index is on track to post its best weekly gains since early June** as the easing of COVID-19 restrictions boosted risk appetite.
- **The International Monetary Fund (IMF) again lowered its 2020 GDP growth forecast for Asia to -2.2% y/y** on the back of sharper-than-expected contraction in countries such as India, the Philippines, and Malaysia. The IMF **upgraded its 2021 growth forecast to 6.9% y/y** but cautioned the recovery will be uneven with trade-oriented and tourism-dependent countries expected to lag the rest.
- **China's GDP grew by 4.9% y/y in Q3**, following a 3.2% expansion in the previous quarter, but missed the Reuters consensus expectation of 5.2% growth. Meanwhile, **industrial output rose** 6.9% y/y in September, its sixth consecutive expansion, and **retail sales growth accelerated** from August, rising 3.3% y/y. The latest set of economic data suggest to us that China's economic recovery from the COVID-19 shock remains intact. While the economic recovery continues to pick up pace, we believe authorities will remain on the lookout for pockets of weakness and introduce more targeted stimulus to support growth.
- We view last week's announcement that Hong Kong and Singapore have agreed to launch a "travel bubble" between the two locations as a landmark decision that could signal the gradual resumption of international passenger traffic in Asia. While encouraging, **we expect the recovery in traffic to be slow and bumpy** as the COVID-19 situation in and around the region remains very fluid.

MARKET SCORECARD

Data as of October 22, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,453.49	2.7%	6.9%	15.3%	25.3%
Dow Industrials (DJIA)	28,363.66	2.1%	-0.6%	5.9%	12.0%
Nasdaq	11,506.01	3.0%	28.2%	42.0%	54.1%
Russell 2000	1,630.25	8.1%	-2.3%	5.1%	5.9%
S&P/TSX Comp	16,279.36	1.0%	-4.6%	-0.7%	5.6%
FTSE All-Share	3,268.54	-0.4%	-22.1%	-17.9%	-15.4%
STOXX Europe 600	360.27	-0.2%	-13.4%	-8.7%	0.1%
EURO STOXX 50	3,171.41	-0.7%	-15.3%	-12.0%	-0.6%
Hang Seng	24,786.13	5.7%	-12.1%	-7.5%	-5.2%
Shanghai Comp	3,312.50	2.9%	8.6%	12.1%	24.8%
Nikkei 225	23,474.27	1.2%	-0.8%	4.1%	3.8%
India Sensex	40,558.49	6.5%	-1.7%	4.1%	18.8%
Singapore Straits Times	2,528.41	2.5%	-21.5%	-20.0%	-17.9%
Brazil Ibovespa	101,917.70	7.7%	-11.9%	-5.1%	19.1%
Mexican Bolsa IPC	38,652.19	3.2%	-11.2%	-10.9%	-17.7%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,904.47	1.0%	25.5%	28.0%	55.8%
Silver (spot $/oz)	24.70	6.3%	38.4%	41.0%	69.6%
Copper ($/metric ton)	6,977.75	4.6%	13.5%	20.5%	11.8%
Oil (WTI spot/bbl)	40.47	0.6%	-33.7%	-25.3%	-41.5%
Oil (Brent spot/bbl)	42.49	3.8%	-35.6%	-28.8%	-46.8%
Natural Gas ($/mmBtu)	2.99	18.4%	36.7%	31.7%	-4.7%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.861%	17.7	-105.6	-89.9	-233.7
Canada 10-Yr	0.664%	10.3	-103.8	-85.7	-182.2
U.K. 10-Yr	0.284%	5.5	-53.8	-42.7	-124.3
Germany 10-Yr	-0.566%	-4.4	-38.1	-19.8	-101.4

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.23%	-0.3%	6.4%	6.8%	18.7%
U.S. Invest Grade Corp	2.00%	0.1%	6.7%	8.0%	23.4%
U.S. High Yield Corp	5.31%	1.5%	2.1%	4.5%	12.0%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	92.9400	-1.0%	-3.6%	-4.7%	-3.2%
CAD/USD	0.7614	1.4%	-1.1%	-0.3%	-0.2%
USD/CAD	1.3134	-1.4%	1.1%	0.3%	0.3%
EUR/USD	1.1820	0.8%	5.4%	6.2%	3.1%
GBP/USD	1.3081	1.2%	-1.3%	1.6%	0.9%
AUD/USD	0.7117	-0.6%	1.4%	3.8%	0.5%
USD/JPY	104.9000	-0.5%	-3.4%	-3.3%	-7.0%
EUR/JPY	123.9900	0.3%	1.8%	2.7%	-4.1%
EUR/GBP	0.9035	-0.4%	6.8%	4.5%	2.2%
EUR/CHF	1.0724	-0.7%	-1.2%	-2.6%	-6.1%
USD/SGD	1.3569	-0.6%	0.8%	-0.4%	-1.7%
USD/CNY	6.6851	-1.6%	-4.0%	-5.5%	-3.8%
USD/MXN	20.9647	-5.2%	10.8%	9.5%	8.0%
USD/BRL	5.5958	-0.2%	38.8%	48.1%	51.8%

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 10/22/20.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -1.1% return means the Canadian dollar fell 1.1% vs. the U.S. dollar year to date. USD/JPY 104.90 means 1 U.S. dollar will buy 104.90 yen. USD/JPY -3.4% return means the U.S. dollar fell 3.4% vs. the yen year to date.

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Sell [Underperform]	81	5.44	11	13.58

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