GLOBAL
Insight
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RBC

Perspectives from the Global Portfolio Advisory Committee
January 7, 2021

Is the market defying logic?

Kelly Bogdanova – San Francisco

The chaos unleashed in Washington has shaken us all. And yet the stock market was largely unfazed, in much the same way it's shrugged off other challenges thrown its way of late. As the Democrats are about to gain full control of the reins of U.S. government, we explore what does and doesn't make sense about the market's behavior.

With the unprecedented storming of the U.S. Capitol building following one of the most controversial presidential elections in history, and the related violence and bloodshed, why is the U.S. equity market acting as if nothing much has transpired?

On Wednesday, the fulcrum day, the S&P 500 rose 0.6 percent. On Thursday, it tacked on another 1.5 percent. The Dow Jones Industrial Average fared well also, and small-capitalization indexes were even stronger.

The S&P 500 is hovering near its all-time high and its valuation is well above average following the biggest recovery rally since the 1960s.

Yet we've just experienced a tragic day in American history, and there are a multitude of challenges facing the country. In the past, the market has sold off time and time again on issues of much lesser importance. Is the market defying logic?

The straightforward answer is yes and no.

Tolerance limits

First off, we think it's naïve to assert that the massive ideological divisions that exist in the country—if left unchecked—won't ultimately lead to negative consequences for broader society and the economy and asset prices at some point in the future.

And we think it's equally naïve to assume the divisions will be mended anytime soon.

In this respect, the market could be rightly accused of defying logic with its sanguine response to the turmoil shaking the country.

The market isn't "political"

But the U.S. equity market is not currently and has never been a real-time barometer of the overall ideological and institutional health of the nation. As we've previously written, "the market" doesn't necessarily reflect Main Street or even American society as a whole.

Simply put, the major U.S. equity indexes represent the future prospects of corporate earnings for many of the largest and most successful companies in the world. When we own stocks, we own a portion of these profit streams.

The market is not blue, red, or even purple in its ideology. And to some degree, it's not even red, white, and blue, as a portion of the revenues comes from overseas via large and

For perspectives on the week from our regional analysts, please see pages 5–6.

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Priced (in USD) as of 1/7/21 market close, ET (unless otherwise stated). Produced: Jan. 7, 2021 18:33ET; Disseminated: Jan. 7, 2021 18:40ET
For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 8.

mega-sized multinationals that are domiciled in the U.S. and also have operations elsewhere.

In reality, the market is mostly about green—as in profits.

The reason the S&P 500 and other major indexes were not defying logic by rallying on Wednesday and then scooting higher on Thursday is because at this stage market participants perceive that Democratic control of the Senate, combined with the House of Representatives and White House, will lead to greater fiscal spending on COVID-19 relief and other federal initiatives, and would support economic growth.

The market has had a voracious appetite for fiscal stimulus since the pandemic began, and wants more—above and beyond the significant stimulus that has already been doled out. It seems hungry for clean energy infrastructure spending, too.

We think the market is also at ease with the party control scenario because this Democratic "blue wave" will be somewhat restrained, in our assessment. There is a big difference between a 5–10 foot wave (akin to narrow control of both chambers of Congress that Democrats will have) and the power of 30–40+ foot winter waves that break at Mavericks (akin to strong congressional majorities).

Thus far, risks of tax increases are not at the forefront. We think this is because razor-thin Democratic control in the Senate, combined with the party's narrow majority in the House, makes passing sweeping, substantial tax hikes difficult to achieve.

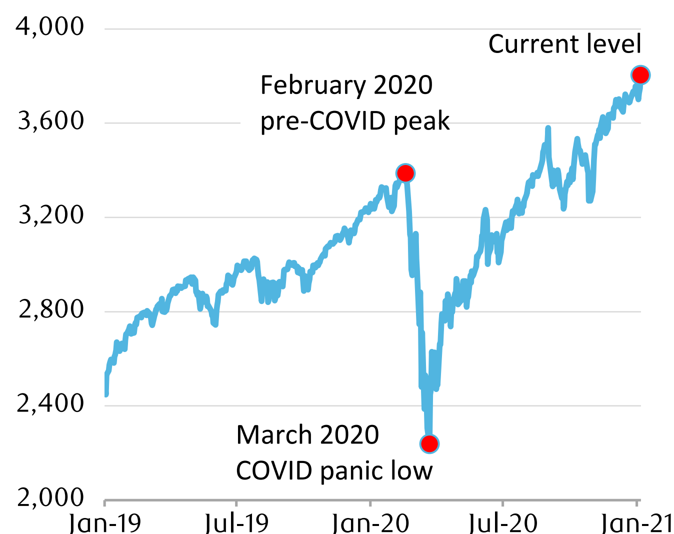
Also, in our view, politicians generally recognize that raising taxes in the early stages of an economic recovery and amid persistent COVID-19 economic challenges would be ill-advised, and this effectively reduces the risk of substantial tax increases—at least in 2021.

Constructive footing

The strong rally in the major U.S. equity indexes in the past couple months, combined with the significant surge since the March 2020 lows, raises questions about the sustainability of the moves. Technical indicators point to an increased risk of a near-term pullback, in our view. That said, most broad averages are not far above where they were back in February 2020 before the COVID-19-related retreat began. Nor are the typical harbingers of a bigger, more prolonged retreat in share prices anywhere in evidence—e.g., a breakdown in market breadth or a sustained, multi-month decline in small caps. In fact, the opposite is true: advance/decline lines have been making new highs ahead of the indexes and small caps are leading the charge.

The market has rallied substantially since the March 2020 low, but isn't much higher than the pre-COVID peak

S&P 500 Index level over two years



Source - RBC Wealth Management, Bloomberg; daily data through 1/7/21

But even if the market takes a much-needed rest or retreats somewhat, we think it has the potential to deliver worthwhile all-in returns for the year. We expect corporate profits to gain more ground as the economic foundation becomes sturdier with the help of ongoing ultraloose monetary policies, another round of fiscal stimulus, and the ultimate taming of COVID-19 headwinds.

To start the year, we would Overweight U.S. equities. We would position portfolios with a mix of cyclical (economically sensitive) and defensive dividend-paying sectors, with a tilt toward the value side of the fence. (See the U.S. section on page 5 for additional thoughts on investment styles and sectors.)

UK 2021—The next chapter

Frédérique Carrier – London

The free trade agreement between the EU and UK brings relief, but some challenges are in tow. We take a closer look at the agreement and its potential impact for investors.

Finally, a deal

After more than four years of negotiations, the EU and UK agreed to the terms of a free trade agreement (FTA). Though it is a barebones deal, this is undeniably good news—a deal avoids the acrimony and upheaval a dreaded "no deal" scenario would have wrought. For goods, it means no tariffs and no quotas, and the deal is a base to potentially build on, if desired.

However, we think a barebones deal is a large step back from EU membership. The Treasury has estimated that a limited free-trade deal such as this one would result in the UK economy being at least five percent smaller over a 15-year period. The agreement ends frictionless trade in goods by creating new non-tariff barriers such as cumbersome documentation and customs declaration, a new, costly, burden for exporters.

Moreover, the deal does not offer much for services. This is important as they account for 80 percent of the UK economy and 50 percent of its exports. When the UK was a member of the EU's single market, the EU used to recognise the UK's regulatory systems as "equivalent" to its own, allowing the UK to sell its services to the EU. That is no longer the case. For financial services, a key industry for the UK, where it enjoys a competitive advantage versus the EU, regulatory equivalence has been granted only in some limited areas, such as derivatives and clearing, but it is temporary and needs to be renegotiated.

Thus, while some issues such as those regarding goods have been settled, many more still have to be dealt with. We expect more negotiations to take place, particularly because the deal can be reviewed every five years by both parties. For the UK, the next revision is due after the 2024 national elections. The nature of the trade relationship with the EU may well reappear as a hot political issue.

Beyond agreeing to trade terms with the EU, its largest trading partner, the UK has also rolled over 60 FTAs the EU has with other countries—a notable achievement. The rollovers are usually on identical terms or sometimes slightly less attractive terms than those enjoyed by the EU. Thus, while avoiding a negative impact, the rolling over of these FTAs is not an incremental uplift to trade.

Over the next few years, the UK economy will adjust itself to these new circumstances. The UK already has a number of industries where it has a very strong competitive advantage—finance, technology, and medicine—and it will be important to ensure they continue to thrive in the new environment.

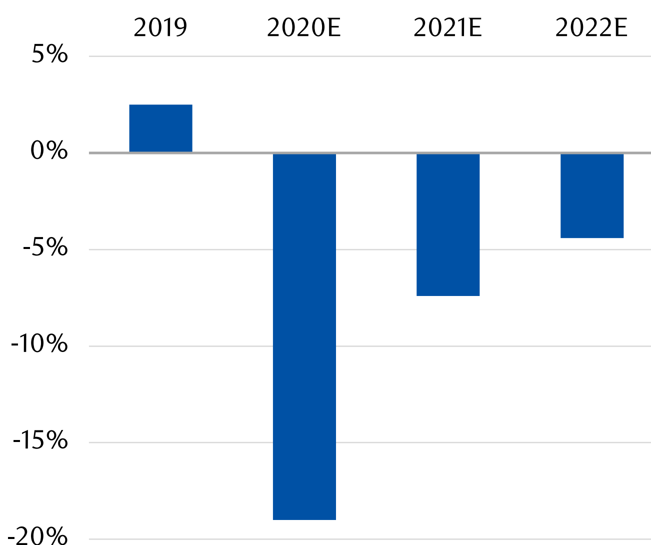
Short-term prospects

With these ongoing adjustments and a newly imposed national lockdown, we believe the economy will take a hit in Q1 2021. The Treasury is incurring large fiscal deficits to support the economy, and government debt could easily come close to 110 percent of GDP by the end of 2021 according to RBC Capital Markets. The Bank of England will continue to be on high alert—it extended its asset purchase programme late last year. RBC Capital Markets thinks there is a "decent chance" short-term interest rates could go in negative territory.

We expect a recovery to take hold midyear onwards thanks to this support and as mass inoculation against COVID-19 allows a gradual relaxation of restrictions put in place to curb its spread. The recovery will likely be led by consumer spending. RBC Capital Markets points out that UK households are sitting on £75–£80 billion of savings, or approximately four percent of UK GDP, they built up during the first lockdown. It expects private investment to respond once the recovery is more firmly established.

Pandemic elicits fiscal response from UK government

Surplus/deficit as a percentage of UK's GDP



Source - Haver Analytics, Office of Budget Responsibility, RBC Capital Markets estimates, RBC Wealth Management

After UK GDP contracted close to 10 percent year over year in 2020, RBC Capital Markets expects it to go up by about five percent in 2021.

Portfolio implications

We are cautious on the British pound through 2021 given the expected economic and trade disruption in the short term, combined with the UK's weak financial position, and the possibility of negative interest rates.

For fixed income investors, we continue to favour corporate credit over government bonds given the backdrop of low yields and flat yield curves. We see cyclical sectors benefiting from the recovery as it slowly starts to gain momentum during H1 2021, in our view. Conversely, the more defensive sectors that have performed well throughout the pandemic may start to lag.

We would hold a Market Weight (benchmark) position in UK equities. Given their underperformance since the referendum to leave the EU in 2016, we believe valuations have become very attractive. The UK signing the EU trade agreement and the reopening of the economy thanks to the vaccine rollouts should be supportive of their continued recovery in 2021.

According to our national research correspondent, using a blended valuation of price-to-earnings (P/E), price-to-book value, and dividend yields suggests UK equities are trading near a 30-year low. On a sector-adjusted basis, UK equities trade on a 20 percent P/E discount to global markets.

Now that an agreement with the EU has been reached, we would expect the "Brexit discount" attached to UK stocks to narrow. A growing number of recent bids for UK-listed companies across a range of different sectors in recent months highlights that global corporates and private equity are finding attractively valued assets in the UK. We would expect investment flows to return now that a "no-trade deal" scenario has been avoided and as the UK is one of global fund managers' biggest regional Underweights due to the relentless outflows since the referendum to leave the EU.

This, coupled with a cyclical rebound, should underpin UK equities. Consensus expects corporate earnings to bounce back by about a third in 2021, though this would leave them below 2019 levels.

We recommend taking a balanced approach to UK equities. We would maintain our long-standing exposure to quality international companies that can deliver resilient growth across the economic cycle. Consumer Staples and Health Care offer such opportunities. We would also hold UK-domestically exposed stocks, such as select Industrials, Consumer Discretionary, and banks that should benefit from an eventual cyclical upturn once the pandemic subsides and where valuations remain particularly low.

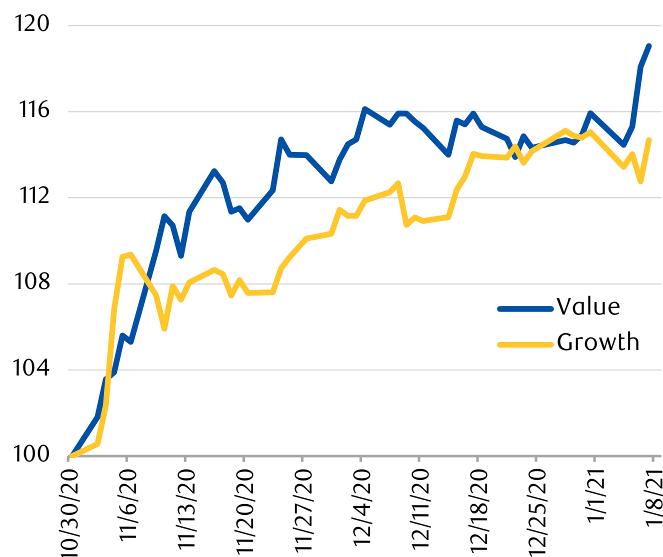
UNITED STATES

Alan Robinson – Seattle

- **U.S. stocks posted new highs** during the first trading week of the year, as an initial decline due to vaccine rollout concerns gave way to bullishness driven by reflation hopes. The market appeared to shrug off shocking headlines regarding riots in the U.S. Capitol and COVID-19 cases, but the forward-looking nature of the stock market suggests better times may be ahead for the economy.
- Digging deeper into the individual sectors that led these gains, it was clear that **"value" stocks**— those that trade at valuations below the overall market—**were key beneficiaries of the rally**. This was partly due to sentiment that Democratic control of the Senate would provide more stimulus to the economy, allowing value stocks to catch up with their pricier "growth" counterparts.
- **Among value stocks, banks were back in favor**. Besides the likelihood of a rebound in the economy, two other factors contributed. First, **long-term interest rates moved higher**, with the benchmark 10-year Treasury yield pushing above 1% for the first time since March 2020. This resulted in a steeper yield curve, which is good for banks' profit margins. Second, the Fed's somewhat unexpected decision to allow **a resumption of share repurchases in Q1 2021** prompted investors to buy in anticipation.
- **The Energy sector also caught a wave of upgrades** from strategists. Energy underperformed last year due to reduced demand for oil and increased environmental concerns. However, RBC Capital Markets, LLC energy strategist Michael Tran noted that the surprise move by Saudi Arabia during the week's OPEC+ meeting to cut oil production by one million barrels a day puts a price floor in the market. He expects this to trigger a **change in investing strategy** from "selling the news" to "buying the dips" in energy stocks.
- **U.S. employment data was also in focus** during the week, ahead of the monthly jobs report due Friday, Jan. 8. The private ADP report provided a harbinger, with private payrolls dropping by 123,000 in December versus November's 304,000 rise and the first monthly decline for the series since April 2020. This was mainly due to **job losses at large businesses concentrated in the leisure and hospitality sectors**.

Value stocks out-running their growth counterparts as reflation theme gains traction

Relative performance value and growth themes



Note: Daily close of Russell 3000 Value and Growth Indexes with 10/30/20 levels normalized to 100. Source - Thomson ONE Refinitiv, RBC Wealth Management

CANADA

Luis Castillo – Toronto

- Inflation expectations are on the move and Canada is catching up. **The Canada 10-year inflation breakeven, a measure of the market-implied inflation expectation, has broken above its pre-pandemic levels. It now sits just below the 1.5% mark** after a sharp reversal from its March lows as it attempts to catch up to its U.S. neighbor, which has seen its inflation expectation (U.S. 10-year breakeven) breach above 2% for the first time since 2018. This move higher accelerated in early November, gaining momentum on the back of positive vaccine developments and more recently on higher oil prices. While we have seen a sharp rebound in inflation expectations in Canada and the U.S., the cost of inflation protection remains relatively cheap in Canada as inflation compensation priced into federal bonds remains below historical averages.
- **Saudi Arabia surprised oil markets by announcing during the OPEC+ meeting on Jan. 5 a one million barrel per day production cut for February and March**. RBC Capital Markets, LLC Global Head of Commodity Strategy Helima Croft wrote in a recent Global Commodity Strategy report: "Prince Abdulaziz bin Salman [Saudi Arabia's energy minister] said that the cut was a clear signal of unwavering Saudi resolve and a gift to an oil market that is facing near-term demand uncertainty because of the emergence of the new COVID-19 strain and cascading government lockdown restrictions." This move sent oil prices soaring with West Texas Intermediate now hovering around the $50 level for the first time in almost a year. Canada's S&P/TSX Index reaped the benefits, climbing to near its highest level in almost a year. The Canadian dollar also saw big moves on the announcement, rising to its highest level since early 2018 against the U.S. dollar.

EUROPE

Frédérique Carrier & Thomas McGarrity, CFA – London

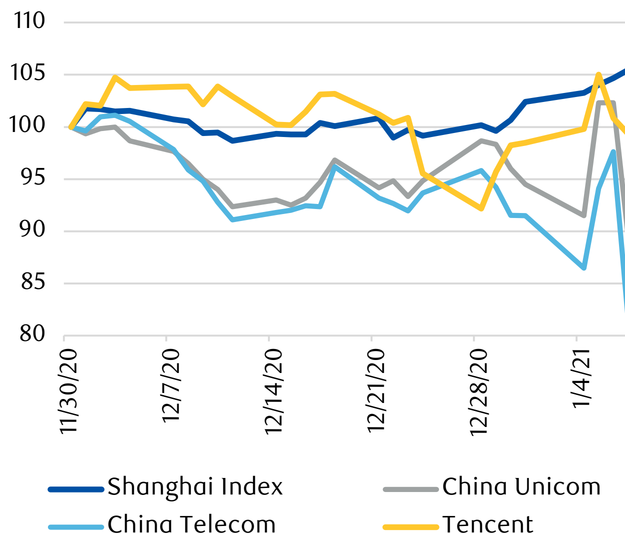
- While all eyes were on U.S. political developments during the week, **an important event likely to shape the EU political picture is scheduled for mid-January**. The first steps towards choosing German Chancellor Angela Merkel's successor will take place, with delegates from her party, the Christian Democratic Union, electing its new party chair. Merkel is leaving office in the autumn, after completing her fourth term. The next German federal election is scheduled for Sept. 26, 2021.
- **UK equities have started 2021 on good footing**, with the FTSE 100 Index turning in one of the strongest performances since the beginning of the year. This was, in part, helped by the index's higher proportion of mining and oil & gas companies compared to other markets. Upbeat manufacturing data, particularly in China; firm commodity prices; a weak U.S. dollar; increasing expectations for larger stimulus spending in the U.S.; and Saudi Arabia's pledge to slash crude oil output all supported the two sectors.
- **The iron ore market is extremely tight**, meaning demand is close to exceeding supply, and RBC Capital Markets believes this should continue through at least H1 2021. Accordingly, conditions could be in place to support mining equities as the higher cash flows could translate into higher dividends and share buybacks given the large miners' flexible payout policies.
- **European renewables focused companies**, including Ørsted, Siemens, Gamesa Renewable Energy, and EDP Renovaveis, **all gained more than 10% during the week**, buoyed by the Democrats securing control of the U.S. Senate, which raised hopes for higher "green spending." We believe decarbonisation will remain a key long-term investment theme, especially as governments target green and sustainable investments to support both their economic recoveries and carbon emission reduction goals.
- **Gambling company Entain became the latest UK-listed company subjected to a takeover approach**. The company rejected the £8.1 billion offer from U.S. company MGM Resorts International saying it undervalued the group.

ASIA PACIFIC

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

- **Asian stocks reached a record high during the week** with the expectation that more stimulus spending could be announced after the Democrats gained control of the U.S. Senate. **Infrastructure companies and the Materials sector led the rally**. Financials stocks were also among the top performers as the U.S. 10-year Treasury yield surged above 1% and the yield curve steepened. Clean energy stocks also outperformed, on hopes for more green energy spending under President-elect Joe Biden's administration.
- **The New York Stock Exchange is still proceeding with a plan to delist three major Chinese telecom operators**, its second reversal of course this week, after U.S. Treasury Secretary Steven Mnuchin disagreed with its decision to give the companies a reprieve. The conflicting moves have confused the market and led to share price volatility.
- **Chinese Internet giants Alibaba Group (BABA US/ 9988 HK) and Tencent (700 HK) led a selloff in Technology stocks on Jan. 7 as the Trump administration is weighing an investment ban on the two companies**, as reported by Bloomberg. With a combined market capitalization of more than US$1.3 trillion, the two companies are widely held by U.S. mutual funds and hedge funds. According to Bloomberg, about 30% of Alibaba's ADRs are held by U.S. institutions. It could take months for U.S. investors to unwind their positions. **We believe the impact to these two companies may be manifested more on a sentiment level**, while the impact on their fundamentals should be manageable due to limited exposure to U.S. operations. According to the South China Morning Post, HKEx (388 HK) may turn out to be a beneficiary as the threat of investment restrictions could encourage more Chinese companies to seek second listings in Hong Kong.
- According to Bloomberg, **Chinese search engine giant Baidu (BIDU) plans to list in Hong Kong** as soon as the first half of the year. The company could sell about 5%–9% of its share capital, which could raise at least US$3.5 billion based on its latest market capitalization.

NYSE delisting headlines adversely impact selected Chinese stocks



Note: Daily close from 11/30/20 – 1/7/21 with 10/30/20 prices normalized to 100.
Source - Thomson ONE Refinitiv, RBC Wealth Management

MARKET

Scorecard

Data as of January 7, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,803.79	1.3%	1.3%	17.5%	49.2%
Dow Industrials (DJIA)	31,041.13	1.4%	1.4%	8.6%	31.9%
Nasdaq	13,067.48	1.4%	1.4%	44.1%	91.5%
Russell 2000	2,096.89	6.2%	6.2%	26.4%	49.2%
S&P/TSX Comp	18,027.57	3.4%	3.4%	5.0%	24.3%
FTSE All-Share	3,870.45	5.4%	5.4%	-8.1%	3.8%
STOXX Europe 600	408.49	2.4%	2.4%	-2.2%	19.1%
EURO STOXX 50	3,622.42	2.0%	2.0%	-3.6%	19.4%
Hang Seng	27,548.52	1.2%	1.2%	-2.7%	6.6%
Shanghai Comp	3,576.21	3.0%	3.0%	15.2%	41.2%
Nikkei 225	27,490.13	0.2%	0.2%	16.6%	37.2%
India Sensex	48,093.32	0.7%	0.7%	17.7%	34.2%
Singapore Straits Times	2,906.97	2.2%	2.2%	-10.5%	-6.3%
Brazil Ibovespa	122,385.90	2.8%	2.8%	4.9%	33.5%
Mexican Bolsa IPC	46,188.66	4.8%	4.8%	4.6%	7.8%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.081%	16.8	16.8	-73.7	-161.5
Canada 10-Yr	0.794%	11.7	11.7	-78.6	-116.1
UK 10-Yr	0.284%	8.7	8.7	-50.8	-97.0
Germany 10-Yr	-0.522%	4.7	4.7	-23.7	-74.3
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.21%	-0.8%	-0.8%	6.3%	19.0%
U.S. Investment-Grade Corp	1.87%	-1.4%	-1.4%	8.1%	25.2%
U.S. High-Yield Corp	4.16%	0.1%	0.1%	6.9%	17.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,914.72	0.9%	0.9%	21.6%	48.5%
Silver (spot $/oz)	27.17	2.9%	2.9%	47.6%	73.6%
Copper ($/metric ton)	8,030.50	3.6%	3.6%	31.1%	36.0%
Oil (WTI spot/bbl)	50.83	4.8%	4.8%	-18.9%	4.8%
Oil (Brent spot/bbl)	54.48	5.2%	5.2%	-20.2%	-5.0%
Natural Gas ($/mmBtu)	2.67	5.2%	5.2%	23.5%	-9.3%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	89.7850	-0.2%	-0.2%	-7.4%	-6.1%
CAD/USD	0.7884	0.4%	0.4%	2.5%	4.9%
USD/CAD	1.2685	-0.3%	-0.3%	-2.5%	-4.6%
EUR/USD	1.2274	0.5%	0.5%	10.1%	7.0%
GBP/USD	1.3567	-0.8%	-0.8%	3.4%	6.2%
AUD/USD	0.7768	1.0%	1.0%	13.1%	8.7%
USD/JPY	103.8200	0.6%	0.6%	-4.3%	-4.5%
EUR/JPY	127.4200	1.0%	1.0%	5.4%	2.1%
EUR/GBP	0.9047	1.2%	1.2%	6.5%	0.8%
EUR/CHF	1.0864	0.5%	0.5%	0.4%	-3.4%
USD/SGD	1.3251	0.2%	0.2%	-1.8%	-2.3%
USD/CNY	6.4783	-0.7%	-0.7%	-6.7%	-5.4%
USD/MXN	20.0196	0.5%	0.5%	5.9%	3.4%
USD/BRL	5.4009	3.9%	3.9%	42.9%	44.7%

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.

Examples of how to interpret currency data: CAD/USD 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 0.4% return means the Canadian dollar rose 0.4% vs. the U.S. dollar year to date. USD/JPY 103.82 means 1 U.S. dollar will buy 103.82 yen. USD/JPY 0.6% return means the U.S. dollar rose 0.6% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 1/7/21.

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As of December 31, 2020

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Outperform]	828	54.83	299	36.11
Hold [Sector Perform]	615	40.73	166	26.99
Sell [Underperform]	67	4.44	12	17.91

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