GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee June 24, 2021

China equities: Beyond the recovery

Frédérique Carrier – London & Jasmine Duan – Hong Kong

The recent correction in Chinese equity markets highlighted the uncertainties of the global pandemic recovery. But amid the ongoing transformation of the world's second-largest economy, we see a long-term story that should support investment opportunities.

The only major economy to achieve growth in 2020, China was also the first to withdraw its pandemic stimulus and tighten monetary policy. This led to a sharp equity market correction; higher commodity prices and antitrust investigations further dampened sentiment. In the wake of the correction, we see the risk-reward balance of some quality stocks is becoming more appealing, and retain our favourable long-term outlook.

A changing approach to economic development

The second-largest economy in the world, China now makes up a hefty 17% of global GDP and could contribute up to one-fifth of the total increase in world GDP in the next five years, according to the IMF. China is also the largest trading partner of more than 130 countries and regions. Its ability to sustain stable growth is key to the global economy.

China has gradually transformed itself from a manufacturing economy to a service-based economy. Services now account for 54.5 percent of GDP, up from 44.2 percent 10 years ago. Wealth accumulation has created the largest middle class in the world, increasing demand across many sectors including branded goods, health care services, and financial products.

China's 14th Five-Year Plan (FYP) aims for the country to reach "high-income" status, defined by the World Bank as an annual Gross National Income (GNI) per capita of more than US$12,700 (it is currently US$10,500). To this end, China set its 2021 GDP target to an easily achievable "over six percent." RBC Global Asset Management forecasts year-over-year growth of nine percent in 2021, given the low base effect, and 5.5% in 2022.

The FYP also introduces a new approach to economic development. Under a "dual-circulation" strategy, China will aim to expand domestic demand and foster innovation but reduce dependence on foreign markets, especially in the areas of technology and trade, while remaining open to the outside world and welcoming foreign investment.

Accordingly, China has pledged to accelerate the development of 5G, semiconductor manufacturing, and other technologies seen as critical to its economic future, and has increased investment in research and development.

Finally, China aims to move towards a green economy. Its FYP calls for reducing dependence on coal and boosting renewables capacity by 40 percent by 2025. Electric vehicles are targeted to constitute 20 percent of new car sales by 2025, from just five percent now.

For perspectives on the week from our regional analysts, please see pages 3–4.

Priced (in USD) as of 6/24/21 market close, ET (unless otherwise stated). Produced: June 24, 2021 3:44 pm ET; Disseminated: June 24, 2021 4:45 pm ET
For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

We believe the shift towards a high-tech, service-based, and greener economy will generate investment opportunities in the next decade in industries including internet technologies, biotech, domestic consumer goods and services, and electric vehicles.

In the near term, we believe earnings growth for Chinese companies should remain solid and underpin equities. Rising commodity prices could start to squeeze profit margins, but we note that historical upcycles in China's producer price index (PPI) have coincided with business cycle expansions and strong corporate earnings growth. We expect the MSCI China Index to post 20 percent earnings growth this year, and 17 percent in 2022.

Investment outlook: Breezy, then clear

Headwinds to Chinese equity performance have emerged this year; however, we think they are temporary or will be pushed aside by other forces.

Tighter credit: After the country's economy returned to its pre-pandemic level in Q4 2020, Chinese regulators became concerned about asset bubbles given the scale of the global effort to inject liquidity, and started to rein in credit growth. We expect further credit tightening measures to be dependent on economic growth and inflation data, with China's central bank likely to keep rates unchanged until the second half of next year. For now, the producer price inflation pass-through to consumers is still limited, consumption growth remains relatively weak, and the sporadic resurgence of COVID-19 adds uncertainty.

Antitrust investigations: In December 2020, following a dramatic suspension of Fintech giant Ant Group's planned $37 billion IPO, China launched an investigation into its affiliate company Alibaba Group, China's biggest online commerce company. Since then, regulators have told more than two dozen technology companies to resolve issues of unfair competition and alleged monopolistic practices, including Tencent, Baidu, and Meituan. After years of loose regulation of Chinese internet firms, we believe the more stringent approach to antitrust rules could ultimately promote a healthier competitive environment. We expect Chinese tech stocks to resume their uptrend only once regulators call an end to their investigations.

U.S.-China relations: Rising tensions with the U.S. will continue to be a major risk for China's equity market. Recently, the Biden administration ordered a further investigation into the origins of COVID-19, opening a new rift in the already tense relationship. This could add volatility, but should ultimately be outweighed by the strong prospects for the Chinese economy.

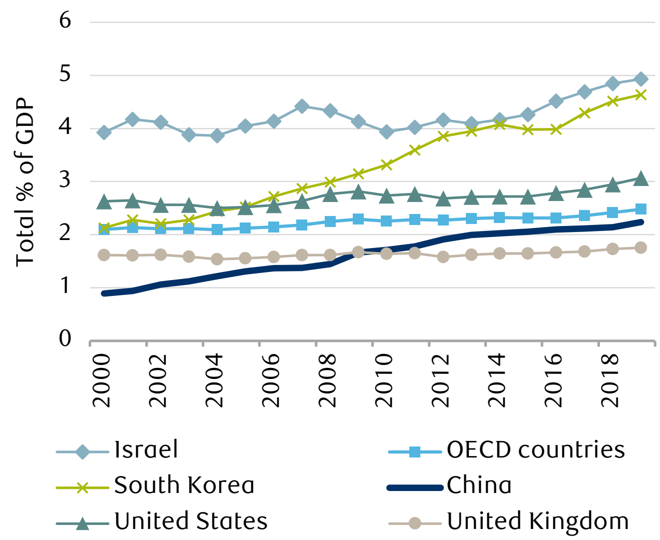
Investing in China's economic transition

We remain constructive on China as we see attractive secular opportunities coming from the country's economic transition. Currently, for jurisdictions that have more direct access to the Chinese equity markets, we prefer the onshore CSI 300 Index to the MSCI China Index. The former's valuation is more attractive, in our view, and it has lower exposure to internet stocks, which could remain under pressure in the short term.

We see opportunities in quality value stocks such as leading banks and industrial companies, which should benefit from the recovery. In the medium to long term, we expect some domestic Consumer Staples companies to emerge as the largest beneficiaries of the dual-circulation strategy. Moreover, we believe the risk-reward balance of some quality tech companies has become appealing after the recent correction.

China's investment in R&D continues to grow

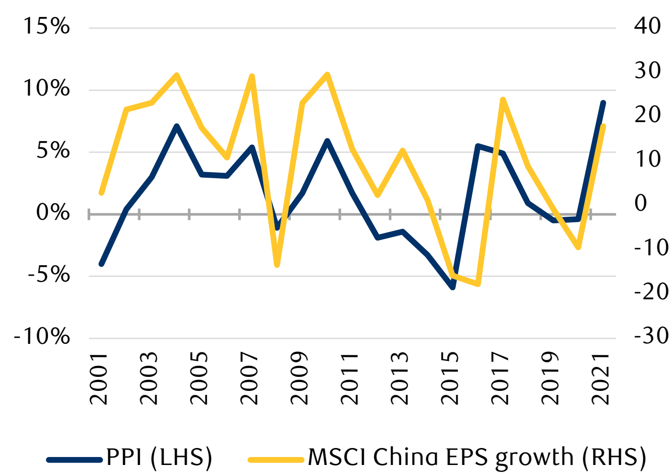
Research and development spending as percentage of GDP



Source - RBC Wealth Management, The Organisation for Economic Co-operation and Development (OECD)

Rising producer prices usually coincide with earnings growth

MSCI China Index EPS and Chinese Producer Price Index (PPI)



Source - RBC Wealth Management, Bloomberg; yearly data

UNITED STATES

Alan Robinson – Seattle

- **U.S. stock indexes hit new highs during the week as the dust settled in the aftermath of the previous week's Fed meeting**. Equity investors had initially been spooked by hawkish commentary regarding the prospect of the first rate hike, but comments by Fed officials over the weekend soothed these concerns, and stocks bounced back sharply at the start of the week.

- On Tuesday, June 22, **Fed Chair Jerome Powell added to the sense of relief by signaling that the policymaking Federal Open Market Committee will not pre-emptively raise interest rates on inflation fears alone**. In an address to members of Congress, he acknowledged recent price increases had been larger than expected, but he suggested they are largely a function of reopening dynamics and that inflation should fall back to the Fed's long-term goal.

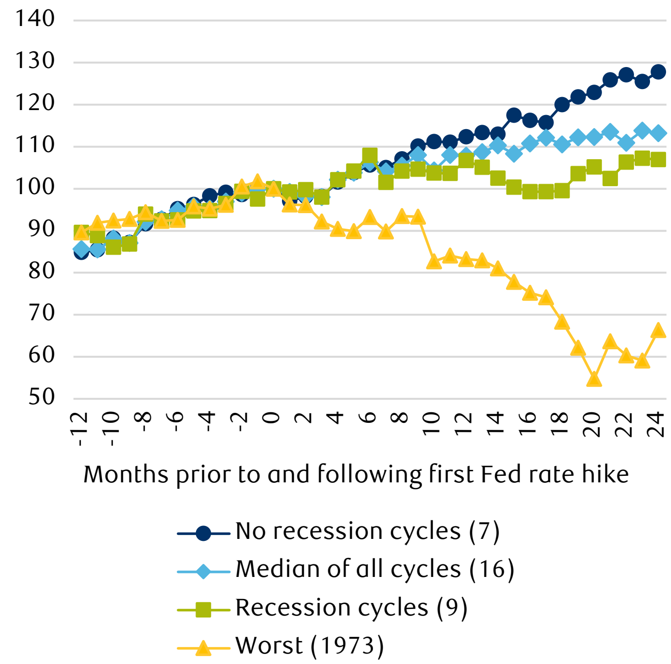
- The price action in some commodity markets appeared to back up this assertion. For example, **lumber futures were down 47% from their May peak** during the week as production ramped up to take advantage of high prices, even as consumers balked at the increased costs. This suggests to us that even though consumer balance sheets are strong, we are unlikely to witness runaway inflation of the kind seen in the 1970s.

- **But we also note that stocks have historically shrugged off the start of rate hike cycles**, as long as these hikes don't trigger recessions. RBC Global Asset Management studied the last 16 U.S. rate hike cycles since 1946 and found the broad stock market posted a median gain of 13% 24 months after the first rate hike of the cycle, with even stronger gains during non-recessionary cycles.

- **Investors started to look ahead to Q2 2021 earnings** season, with initial reporting expected the second week of July. According to Refinitiv, consensus forecasts expect S&P 500 earnings per share (EPS) to grow 64% y/y, up from a forecast of 54% at the start of the quarter. This builds on EPS growth of 58% y/y in Q1 2021. **We expect all eyes to be on profit margin pressures and forward guidance** during the upcoming reporting season.

Don't fear the rate hike; stocks can still rally as long as hikes don't trigger recessions

Median S&P 500 level before and after first rate hike; normalized, with level at first hike = 100



Source - RBC Global Asset Management, RBC Wealth Management, Bloomberg; data range: 1946-2018

CANADA

Luis Castillo & Simon Jones – Toronto

- **The Federal Reserve's shift in tone at its latest monetary policy meeting has sent ripples across financial markets** with the spotlight firmly fixed on Fed commentary regarding its outlook for inflation and interest rates. **The Government of Canada (GoC) yield curve flattened noticeably** following the announcement as central bank comments south of the border prove to be a major focus for rates markets globally. The GoC 30-year bond yield had peaked in early May before trending lower, with moves to the downside further accelerated by the Fed's newly acquired hawkish (or slightly less dovish) posturing towards inflation. More Fed members are seeing inflation risk to the upside with rate hikes penciled in sooner than the Fed previously expected. The market has started to price in a Fed that is less complacent in the face of inflation than previously, potentially giving the Bank of Canada more comfort in its own pursuit to remove monetary policy accommodation.

- **Canadian retail sales experienced their sharpest decline in 12 months**, falling 5.7% y/y in April, as reported by Statistics Canada. The decline coincides with the rise of the pandemic's third wave, which resulted in renewed public health restrictions across most of the country. Seven provinces reported declining retail sales, with Ontario (-13.4%) and Manitoba (-8.1%) experiencing the most severe drops. As most provinces limited "non-essential" retail, it is unsurprising to see losses concentrated in clothing and clothing accessory retailers (-28.6%) and sporting goods, hobby, book, and music stores (-26.2%). However, **the declines were broad-based with nine of the 11 subsectors reporting a decrease** in sales from March to April. Only food and beverage (+0.6%) and miscellaneous retail (+0.9%) were able to eke out modest gains during the period. **We believe the decline in retail sales is unlikely to correct in the May data** as pandemic-related restrictions remained in place throughout the month. Statistics Canada's preliminary estimate suggests that May's retail sales declined 3.2%.

EUROPE

Thomas McGarrity, CFA – London

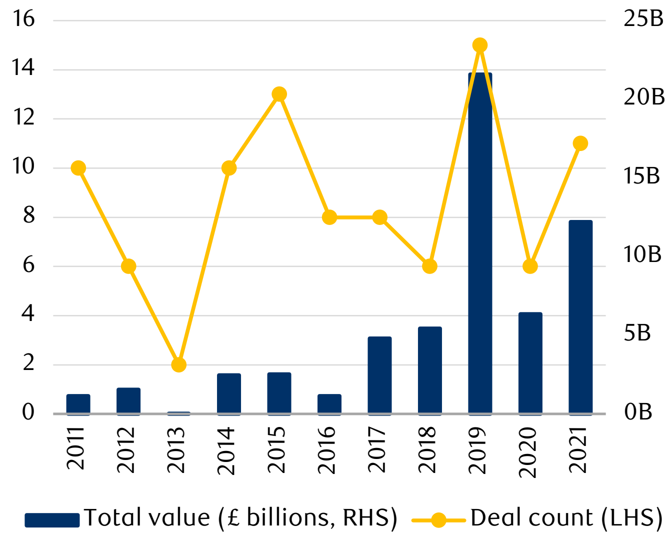
- **The board of UK-listed grocer WM Morrison Supermarkets (Morrisons) rejected an unsolicited £8.7 billion takeover bid** from U.S. private equity firm Clayton, Dubilier & Rice (CD&R), stating it had unanimously concluded the offer of 230p per share “significantly undervalued” the company. Morrisons’ share price is up 31% from its close on Friday, June 18 to around 234p, above the level of the rejected bid. Bloomberg and Financial Times articles highlighted **sector analysts’ expectation of further bids** from CD&R as well as potentially elsewhere; a successful private equity deal would represent one of the biggest leveraged buyouts in the UK since the 2007–2008 financial crisis.

- **The bid for Morrisons is the latest in a wave of takeover bids and deal activity in the UK this year across a range of sectors, from both corporate buyers and private equity**. With respect to the latter, according to the Financial Times, private equity firms have announced bids for UK-listed companies at the fastest pace in more than two decades. With UK equities continuing to trade near record low valuations relative to other developed markets, and global private equity firms sitting on record levels of dry powder—up to $1.4 trillion in money raised but not yet deployed, according to Bloomberg—we expect the UK to remain a rich hunting ground for private equity funds looking to put capital to work.

- While the increase in **buyout activity has been centered on the small-cap and midcap space** of the UK equity market covered by the FTSE Small Cap and FTSE 250 Indexes, respectively, **the large-cap arena of the FTSE 100 has seen a recent surge in activist investors taking stakes in UK-listed companies**. Again, this is likely a reflection of the relatively inexpensive valuations on offer, in our view. One of the companies targeted by activists, global health care group **GlaxoSmithKline (GSK)**, laid out at an investor update how its core pharmaceuticals and vaccines division, dubbed “New GSK”, will deliver a “step-change in growth and performance” over the next decade; the company plans to spin off its Consumer Healthcare business in mid-2022.

Private equity targets UK midcaps

Number and value of UK-listed companies taken private



Source - RBC Wealth Management, Bloomberg; data through 6/23/21

- **The Biden Administration ordered a ban on imports of a key solar panel material from China-based Hoshine Silicon Industry Co (603260 SH)**, according to a Reuters report. Separately, the U.S. Commerce Department added Hoshine and four other companies to its “entity list,” which requires U.S. companies to obtain a license before doing business with them. Some of these companies are major manufacturers of monocrystalline silicon and polysilicon that are used in solar panel production. Currently, about 45% of all polysilicon used in solar module production is produced in Xinjiang and about 35% is produced in other parts of China. The ban may affect the solar supply chain and could force U.S. companies to find materials elsewhere.

ASIA PACIFIC

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

- **Asian stocks were mixed this week** as investors digested commentary from Federal Reserve officials on the outlook for monetary stimulus. The governor of the Bank of Korea said at a press conference on June 24 that policy normalization should start this year in Korea, but normalization should not be seen as tightening.

- **New York-traded Chinese electric vehicle maker Xpeng (XP) received approval from the Hong Kong Stock Exchange to carry out an IPO in Hong Kong**. Bloomberg reported the company could raise as much as US$2 billion as soon as this year. Xpeng has yet to report a profit and has pledged to break even by late 2023 or 2024. Its revenues rose to RMB 2.95 billion in Q1 2021 and its deliveries grew 483% y/y in May.

- **Japan’s au Jibun Bank flash Manufacturing Purchasing Managers’ Index fell to 51.5 in June** from 53.0 in the previous month, while the services reading rose to 47.2 from the previous month’s 46.5. **Strong exports have supported Japan’s manufacturers and helped the economy offset domestic weakness**. Services activity has been shrinking since February 2020, but it could start to improve as the most recent state of emergency has been lifted everywhere outside Okinawa and the country’s vaccination progress is accelerating.

MARKET Scorecard

Data as of June 24, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,266.49	1.5%	13.6%	39.9%	44.9%
Dow Industrials (DJIA)	34,196.82	-1.0%	11.7%	34.4%	27.9%
Nasdaq	14,369.71	4.5%	11.5%	45.0%	79.5%
Russell 2000	2,333.62	2.8%	18.2%	67.9%	52.5%
S&P/TSX Comp	20,215.12	2.5%	16.0%	32.2%	22.3%
FTSE All-Share	4,051.12	0.9%	10.3%	19.4%	0.1%
STOXX Europe 600	457.04	2.3%	14.5%	28.0%	19.1%
EURO STOXX 50	4,122.43	2.1%	16.0%	29.0%	19.3%
Hang Seng	28,882.46	-0.9%	6.1%	16.5%	1.3%
Shanghai Comp	3,566.65	-1.4%	2.7%	19.7%	18.6%
Nikkei 225	28,875.23	0.1%	5.2%	28.1%	35.7%
India Sensex	52,699.00	1.5%	10.4%	51.1%	34.7%
Singapore Straits Times	3,119.62	-1.4%	9.7%	18.7%	-5.8%
Brazil Ibovespa	129,513.20	2.6%	8.8%	37.2%	26.9%
Mexican Bolsa IPC	50,558.32	-0.6%	14.7%	33.4%	15.6%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.492%	-10.2	57.9	81.3	-52.2
Canada 10-Yr	1.416%	-7.0	73.9	87.0	-4.5
UK 10-Yr	0.741%	-5.4	54.4	55.2	-7.5
Germany 10-Yr	-0.188%	-0.1	38.1	25.2	11.9
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.52%	0.4%	-1.9%	-0.4%	17.7%
U.S. Investment-Grade Corp	2.08%	1.2%	-1.7%	3.1%	24.8%
U.S. High-Yield Corp	3.90%	0.9%	3.2%	13.7%	21.1%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,775.09	-6.9%	-6.5%	0.8%	25.0%
Silver (spot $/oz)	25.96	-7.4%	-1.7%	48.3%	68.1%
Copper ($/metric ton)	9,452.50	-7.8%	22.0%	61.4%	59.1%
Oil (WTI spot/bbl)	73.45	10.8%	51.4%	93.7%	27.3%
Oil (Brent spot/bbl)	75.59	9.0%	45.9%	87.5%	16.5%
Natural Gas ($/mmBtu)	3.42	14.4%	34.6%	114.0%	48.4%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	91.7970	2.2%	2.1%	-5.5%	-4.4%
CAD/USD	0.8116	-2.1%	3.3%	10.7%	7.0%
USD/CAD	1.2321	2.1%	-3.2%	-9.7%	-6.5%
EUR/USD	1.1933	-2.4%	-2.3%	6.1%	4.7%
GBP/USD	1.3926	-2.0%	1.9%	12.1%	9.3%
AUD/USD	0.7584	-1.9%	-1.4%	10.4%	8.9%
USD/JPY	110.8700	1.2%	7.4%	3.6%	3.3%
EUR/JPY	132.3000	-1.2%	4.9%	9.8%	8.2%
EUR/GBP	0.8569	-0.4%	-4.1%	-5.4%	-4.2%
EUR/CHF	1.0954	-0.3%	1.3%	2.7%	-1.1%
USD/SGD	1.3426	1.6%	1.6%	-3.6%	-0.8%
USD/CNY	6.4719	1.6%	-0.8%	-6.8%	-5.9%
USD/MXN	19.8258	-0.6%	-0.4%	-13.0%	3.2%
USD/BRL	4.9048	-6.0%	-5.6%	29.8%	28.2%

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 0.81 means 1 Canadian dollar will buy 0.81 U.S. dollar. CAD/USD 3.3% return means the Canadian dollar rose 3.3% vs. the U.S. dollar year to date. USD/JPY 110.87 means 1 U.S. dollar will buy 110.87 yen. USD/JPY 7.4% return means the U.S. dollar rose 7.4% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 6/24/21

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Hold [Sector Perform]	559	40.68	179	32.02
Sell [Underperform]	53	3.86	4	7.55

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