RBC WEALTH MANAGEMENT

Global Insight Weekly

Separate the wheat from the chaff

Kelly Bogdanova – San Francisco

With a full slate of uncertainties to make sense of, it can be easy to get distracted. We think investors need to focus on the things that matter most to equity markets and not let the political storm in Washington rain on investment strategies.

A one-two punch brought U.S. and global recession risks back to the fore, pushing the S&P 500 down a total of three percent in two sessions and weighing on equity markets worldwide.

First, weak manufacturing and employment data poured cold water on the notion that the U.S. economy is in the clear. Second, the Trump administration formally opened up a new, Western front in the trade war by slapping tariffs on the EU.

Equity markets are also anxious about the forthcoming U.S.-China trade negotiations and Q3 earnings season. And … the impeachment investigation of President Donald Trump by the U.S. House of Representatives has generated uncertainty.

In other words, markets have a lot to juggle.

The recent selloff is reminiscent of many uncomfortable, topsy-turvy Octobers in previous years—a month notorious for volatility episodes. But the slide merely brought the S&P 500 down from the top end of the range, and it remains in the zone that it's been in for two years.

We think it's time to separate the wheat from the chaff.

Economic and earnings trends—the wheat—should drive portfolio decisions, in our view, as they matter most for equity markets. Trade disputes can certainly impact these trends.

Rancorous impeachment rhetoric is the chaff. We would not incorporate the impeachment process into asset allocation decisions unless it starts to meaningfully weigh on the economy and corporate profits—we see no signs of this so far.

Tune in the fundamentals

The trade war is at the heart of the challenges facing the global and U.S. economies. The existing tariffs and non-tariff barriers between the U.S. and China, the risk of more tariffs, and fears that the dispute could linger are weighing on U.S. manufacturing, and have helped knock the European economy flat on its back and have weakened Asia.

The new Western front in the trade war doesn't help. The World Trade Organization's ruling this week allowing retaliatory tariffs for past illegal subsidies of Airbus opens the door for up to $7.5 billion in U.S. tariffs on EU goods. This raises the risk that additional barriers could be erected by both sides.

If the trade disputes persist, the global and U.S. economies could weaken further. We will continue to monitor our U.S. recession indicators for signals.

At this stage, U.S. recession risks are more elevated than they were six or even three months ago, but they have not budged

Market pulse

Click here for authors' contact information. Priced (in USD) as of 10/3/19 market close, EST (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6**
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lately, according to our indicators. Four of six indicators are in expansionary territory, one based on manufacturing subcomponents is flashing a yellow caution sign, and one (the yield curve) is in the red. The disappointing manufacturing and employment data this week do not change these signals.

On the earnings front, we expect U.S. trends to be soft, but not recessionary. RBC Capital Markets recently lowered its S&P 500 annual earnings estimates a bit more for this year and next to $165 and $174 per share, respectively, signaling modest year-over-year growth.

The Q3 S&P 500 consensus estimate has slid to negative 2.4 percent, according to Refinitiv I/B/E/S. We think the growth rate will creep into positive territory by the end of reporting season, as most companies are likely to beat expectations. However, there are bound to be high-profile misses and warnings that could generate volatility. Also, the Q4 consensus of four percent year-over-year growth seems too high. We expect a number of companies to cut Q4 and 2020 estimates.

Tune out the political soap opera

If the economy and earnings are the wheat, impeachment rancor is the chaff.

The impeachment process in the House, and possibly a trial thereafter in the Senate, is certainly important to the country. But it may not necessarily impact the economy or corporate profits by a meaningful degree.

During the impeachment and trial of President Bill Clinton that spanned from mid-1998 to early 1999, the economy boomed. Real GDP growth averaged 5.2 percent quarter-over-quarter annualized, core inflation was tame, consumer confidence was high, and S&P 500 profits rose modestly.

At the time, the market was *much* more impacted by the Russian financial crisis and the related collapse of a large U.S. hedge fund, Long-Term Capital Management, than it was by the Clinton saga.

During President Richard Nixon's Watergate scandal and resignation in the 1970s, the economy and stock market were caught up in a host of problems, including the Yom Kippur War and Arab oil embargo. While Watergate developments caused selloffs at times, the market's overall slump was heavily influenced by the oil embargo's negative impact on gasoline prices, inflation, and the broader economy.

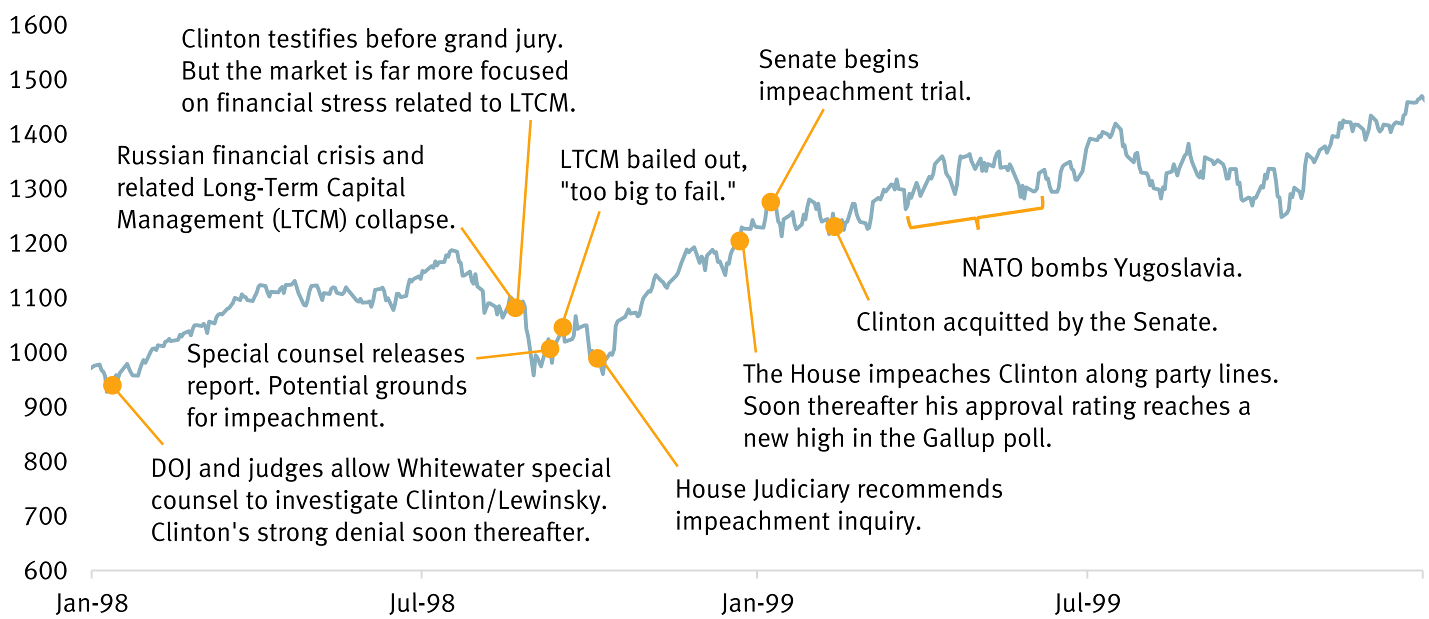
We think the Trump saga will generate periodic volatility for the market. If the impeachment process plays out and then moves to the Senate for a trial, history indicates there will be a massive amount of political and legal wrangling along the way.

We do not advise changing asset allocations in portfolios based solely on the D.C. drama. Stay focused on the economic indicators. If the impeachment and/or trial process becomes problematic for the economy by any meaningful degree, it will show up in the data.

Cautious but comfortable

As long as the trajectories of the global and domestic economies and corporate earnings remain at least in slow-growth modes rather than flash red recession warnings, we are comfortable holding U.S. and global equities at the Market Weight level in portfolios.

S&P 500 during President Bill Clinton's impeachment and trial



Source - RBC Wealth Management, CUNY-Brooklyn College, Wikipedia (LTCM)

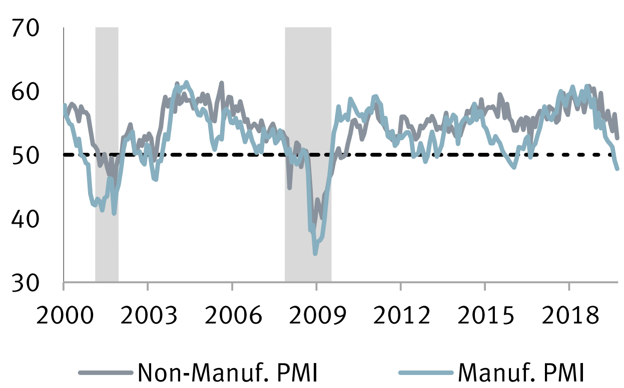
United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets have declined thus far during the week** as Institute for Supply Management Purchasing Managers' Index (ISM PMI) data showed a worsening economic picture in September that disappointed relative to expectations. **Economically sensitive indexes and sectors are the worst-performing** so far this week, as evidenced by the Dow Jones Industrial Average and Russell 2000 declining 2.8% and 2.2%, respectively. Both the NASDAQ and S&P 500 are better on a relative basis, with the NASDAQ the best major index at -0.9% so far.
- **All sectors are lower** during the first week of October, **with Tech, Real Estate and Consumer Staples** acting almost like a buoy with their **less than 1% declines**. On the other side of the coin, **Energy and Financials are down more than 4%** while Industrials are approaching that level largely because of the perception that deteriorating global economic data is starting to metastasize in the U.S.
- In fact, prior to announcing the September ISM Manufacturing PMI of 47.8, which missed the consensus expectation of 50.0, the head of the survey noted that "Global trade remains the most significant issue…" Furthermore, the new orders component registered 47.3 and highlighted ongoing deterioration in new activity while the non-Manufacturing (read: services) PMI reading of 52.6 sharply missed the consensus expectation of 55.1. Taken in combination, **the manufacturing and services data showed a possible slowing in the U.S. economy**.
- Interestingly, in tandem with ISM headline data being a poor recessionary indicator, **S&P 500 performance is typically best when PMIs are poor and then improve**, rather than when they are elevated and then decline. For example, in August 2018 the ISM Manufacturing PMI hit 60.8, which marked a post-Great-Recession high. However, as manufacturing data declined, the S&P 500 subsequently gained 0.9% in the next 12 months with a nearly 20% correction in the midst of that period. While markets may be rocky in the near term, **we continue to believe that a Market Weight position in high-quality U.S. stocks** is warranted in light of where the economic data has gone and where we think it will go from here.

Not the first time data has deteriorated since 2008

Institute for Supply Management PMI data



Note: Readings above 50 indicate an expansion, readings below 50 indicate a contraction; light gray bars indicate U.S. recession periods
Source - RBC Wealth Management, Bloomberg; data through 9/30/19

Canada

Christopher Girdler, CFA & Meika McKelvey – Toronto

- **Canada's July GDP came in slightly short of expectations** during the week, registering a flat print for the month compared to consensus expectations of a 0.1% gain. **The miss was attributed primarily to mining, oil, and gas**, with maintenance shutdowns in Newfoundland and a drop in rig counts. We believe expectations for Q3 GDP should remain intact, as this was a very marginal miss with underlying details appearing transitory in nature; **RBC Economics is still looking for 1.8% GDP growth in Q3**.
- **The Canadian economy has grown reliant on housing**, and the rebound in housing activity has helped support recent market optimism about the Bank of Canada's ability to remain neutral amidst trade and global economic risks. September housing data released during the week showed a **continued recovery in Toronto**, with sales increasing and prices up by the most in 21 months. **Vancouver sales rebounded as well**, suggesting that Canada's most expensive housing market may be finding a floor following its policy-driven downturn. Monthly sales in Vancouver are once again drawing near their historical 10-year average, although prices continued to dip.
- **Global oil prices have fallen more than 7% this week,** equivalent to $4 per barrel for WTI and $3 per barrel for Western Canada Select. **Concerns over a global slowdown** have worked their way back into financial markets, **sending bond yields and stock markets lower** during the week. Notably, inflation expectations have retreated from already low levels in Canada while Energy stocks have fallen out of favour. The S&P/TSX Capped Energy Index was approximately 6% lower during the week, with large diversified energy producers significantly outperforming smaller exploration and production (E&P) companies.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

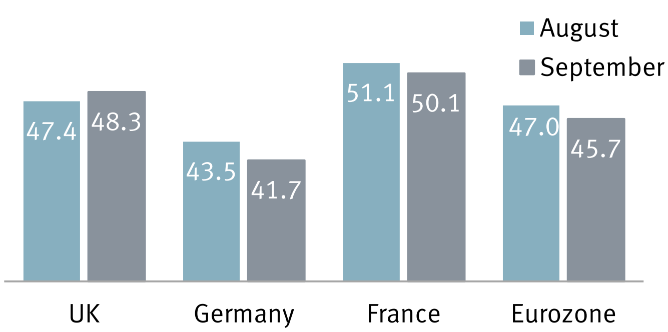
- **The UK government presented its much awaited alternative to the contentious Irish backstop**, the provision that would allow the border in Ireland to remain open until a permanent trade agreement is negotiated by keeping Britain in the EU customs union. That the proposal was not rejected outright by the EU was interpreted by markets as meaning it can be the basis for negotiations. **With less than two weeks until the next EU summit, it is unlikely contentious issues can be ironed out before the summit begins**, in our opinion. The situation remains very fluid, and an extension to the October 31 Brexit withdrawal date and a UK general election in late autumn remain our base-case scenario.

- Meanwhile, **the UK economy continued to slow. The composite Purchasing Managers' Index (PMI) fell into contractionary territory**, at 49.3, dragged down by the services PMI at 49.5, and the construction PMI at 43.3. All three were below consensus expectations. The manufacturing PMI bounced back a little, to 48.3, helped by inventory stockpiling and "catch-up" activity from auto plants that had taken an early summer break due to Brexit uncertainty. RBC Capital Markets believes the construction PMI is a better barometer of the economy given the distortions in the manufacturing PMI, and it estimates underlying GDP growth in the UK at a lackluster 0.1% q/q.

- **The Trump administration imposed retaliatory tariffs on EU goods after the World Trade Organization ruled that the EU's subsidies of Airbus were illegal**. This opened the U.S. to impose tariffs on as much as $7.5 billion of goods. However, the U.S. measures are not as widespread as many had feared. It slapped a 10% tariff on European-made Airbus planes and a 25% tariff on a range of goods, including UK and Irish whiskies, French wine, Spanish olives, certain pork products, and cheese. **The timing is unfortunate given the deepening economic slowdown in Europe**. Producers will likely have to implement a combination of price increases and cost cutting to offset the impact of these new duties. Concerns about U.S.-EU trade tensions led us to downgrade our stance on European equities to Underweight in July.

European slowdown

Select manufacturing PMIs



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Source - RBC Wealth Management, Bloomberg; data through 9/30/19

Asia Pacific

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

- **Asian markets mostly fell during the week** with China bourses closed for the Golden Week holiday. **Australia and Taiwan stock markets bucked the regional trend to trade higher**. The Australian stock market enjoyed a strong rally after the Reserve Bank of Australia (RBA) cut interest rates to a record low of 0.75%, the third cut in five months. The RBA also highlighted the potential for further cuts. The Taiwan stock market got a boost from Apple suppliers on the back of better-than-expected sales of the latest iPhones.
- **Retail sales growth in Hong Kong was the worst on record in August, down 23% year over year**, as clashes spread across shopping districts and took a heavy toll on malls. **The protests and a weak Chinese yuan that translates into lower spending are overshadowing the outlook for retail**. Notwithstanding the poor retail showing, the Hang Seng Index had a strong finish on October 3 following reports from TVB and Hong Kong Cable TV that Hong Kong is set to enact an emergency law to ban face masks at rallies. The news lifted hopes that officials could soon cool down the protests.
- **Japan finally rolled out a twice-delayed increase in the national sales tax to 10%** from 8% on October 1, which the government sees as critical to improve the country's finances. The government also introduced measures, including rebates for certain purchases made using electronic payments, in a bid to offset the impact of the increase. We believe these fiscal measures should cushion any blow to consumption following the tax hike.
- Share prices of Alibaba Group and JD.com had a rollercoaster ride after **Bloomberg reported that the Trump administration was considering** ways to limit U.S. investors' portfolio flows into China, including **delisting Chinese companies from U.S. stock exchanges**. White House trade adviser and China hawk **Peter Navarro later dismissed the reports as "fake news"** and the Treasury Department said there are currently no plans to delist Chinese stocks. The development came at a sensitive time when high-level officials are scheduled to meet in Washington on October 10–11 to resume trade negotiations.

MARKET SCORECARD

Data as of October 3, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,910.63	-2.2%	16.1%	-0.5%	14.8%
Dow Industrials (DJIA)	26,201.04	-2.7%	12.3%	-2.3%	15.7%
NASDAQ	7,872.27	-1.6%	18.6%	-1.9%	20.5%
Russell 2000	1,486.35	-2.4%	10.2%	-11.1%	-1.7%
S&P/TSX Comp	16,369.03	-1.7%	14.3%	1.8%	4.1%
FTSE All-Share	3,893.78	-4.1%	6.0%	-5.7%	-5.0%
STOXX Europe 600	377.46	-4.0%	11.8%	-1.7%	-3.4%
EURO STOXX 50	3,417.37	-4.3%	13.9%	0.3%	-5.2%
Hang Seng	26,110.31	0.1%	1.0%	-3.6%	-7.3%
Shanghai Comp	2,905.19	0.0%	16.5%	3.0%	-13.3%
Nikkei 225	21,341.74	-1.9%	6.6%	-11.5%	3.5%
India Sensex	38,106.87	-1.4%	5.7%	5.9%	21.0%
Singapore Straits Times	3,087.97	-1.0%	0.6%	-5.5%	-4.9%
Brazil Ibovespa	101,516.00	-3.1%	15.5%	21.9%	32.2%
Mexican Bolsa IPC	42,443.31	-1.3%	1.9%	-13.4%	-16.1%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,505.07	2.2%	17.4%	25.7%	18.4%
Silver (spot $/oz)	17.57	3.4%	13.4%	20.0%	5.6%
Copper ($/metric ton)	5,643.00	-0.9%	-5.1%	-9.9%	-12.8%
Oil (WTI spot/bbl)	52.45	-3.0%	15.5%	-31.4%	4.0%
Oil (Brent spot/bbl)	57.61	-5.2%	7.1%	-33.2%	2.9%
Natural Gas ($/mmBtu)	2.33	0.2%	-20.6%	-27.7%	-19.4%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.532%	-13.2	-115.2	-164.9	-79.1
Canada 10-Yr	1.251%	-11.0	-71.6	-130.0	-86.1
U.K. 10-Yr	0.470%	-1.8	-80.7	-110.5	-88.3
Germany 10-Yr	-0.590%	-1.9	-83.2	-106.5	-105.3

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.19%	0.3%	8.9%	11.2%	9.3%
U.S. Invest Grade Corp	2.86%	0.3%	13.5%	14.0%	11.8%
U.S. High Yield Corp	5.89%	-0.5%	10.9%	5.6%	9.0%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	98.9000	-0.5%	2.8%	3.3%	5.7%
CAD/USD	0.7498	-0.7%	2.3%	-3.5%	-6.4%
USD/CAD	1.3338	0.7%	-2.2%	3.7%	6.8%
EUR/USD	1.0967	0.6%	-4.4%	-4.5%	-6.6%
GBP/USD	1.2340	0.4%	-3.2%	-4.6%	-6.8%
AUD/USD	0.6742	-0.1%	-4.4%	-5.1%	-14.0%
USD/JPY	106.8900	-1.1%	-2.6%	-6.7%	-5.3%
EUR/JPY	117.2300	-0.5%	-6.8%	-10.8%	-11.5%
EUR/GBP	0.8888	0.2%	-1.1%	0.2%	0.2%
EUR/CHF	1.0954	0.7%	-2.7%	-3.8%	-4.2%
USD/SGD	1.3808	-0.1%	1.3%	0.1%	1.4%
USD/CNY	7.1483	0.0%	3.9%	4.1%	7.4%
USD/MXN	19.6691	-0.3%	0.1%	3.3%	8.0%
USD/BRL	4.0879	-1.6%	5.5%	4.8%	30.1%

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 10/3/19.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 2.3% return means the Canadian dollar rose 2.3% vs. the U.S. dollar year to date. USD/JPY 106.89 means 1 U.S. dollar will buy 106.89 yen. USD/JPY -2.6% return means the U.S. dollar fell 2.6% vs. the yen year to date.

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Hold [Sector Perform]	618	42.74	126	20.39
Sell [Underperform]	80	5.53	3	3.75

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