

Global Insight

Weekly



A closer look

Equity market obstacle course

Kelly Bogdanova – San Francisco

While the U.S. stock market remains in the vicinity of its all-time high, several lurking uncertainties beg the question: Is the rally for real? We shed light on these issues and look at why we continue to believe the U.S. equity market deserves the benefit of the doubt.

The U.S. equity market is lingering near its recent all-time high following signals from the Federal Reserve that it could soon cut interest rates and after the U.S. and China stepped back from some of their adversarial trade rhetoric.

The market has not yet reached what we would classify as a strong, clear breakout. Bellwether transportation and small-cap stocks lag the S&P 500 and other broad indexes by substantial magnitudes. This means it could take more time to bust through the 18-month trading range.

As long as the domestic economy avoids slipping into recession, we think the bull market can persist. The health of the economy is a key uncertainty facing the market, and we provide some clarity on this and other questions that investors should consider.

Is the economy skating on thin ice?

There's little doubt momentum in key trade-oriented sectors, such as manufacturing, has weakened. Business confidence has pulled back for the same reason. And recently consumer confidence began to retreat. There is a wide gap between how consumers feel about their "current" situation compared to what they "expect" in the future, with the latter measure much lower—not a good sign.

However, due to other data the Atlanta Fed's Q2 GDP forecast has risen since May and now stands at 1.9%. We think the economy is vulnerable to further slowing in the months ahead, but only one of our six key recession indicators is signaling caution at this stage.

A new U.S. high but range-bound trading could persist

S&P 500 Index (blue) with technical guide lines (tan)



Source - RBC Wealth Management, Bloomberg; data through 6/26/19

Market pulse

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Priced (in USD) as of 6/27/19 market close, EST (unless otherwise stated).

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Wealth
Management

Are interest rate cuts always in stocks' best interest?

Stocks tend to respond positively to Fed rate cuts when they are used as “insurance” to keep the expansion going rather than as an attempt to put out a fire from a looming recession. For example, in the mid-to-late 1990s when growth was at risk, the Fed’s “insurance” rate cuts helped prolong the recovery and the market rallied.

However, when the Fed overstepped by raising rates too much during two periods from 1999 to 2006, and then subsequently shifted into rate cutting cycles in an attempt to undo the damage, it was too late. The economy contracted and bear markets materialized on both occasions.

Currently our economic indicators are pointing toward the former “insurance” scenario rather than the latter. **Therefore, we think the old “don’t fight the Fed” mantra still applies.**

Trade dispute whack-a-mole?

Trade disputes and sanctions are about more than the U.S. trade deficit and manufacturing jobs. The Trump administration is also attempting to hold back geopolitical rivals, address domestic challenges, and contain or suppress foreign corporate competition, in our view.

In addition to the high-profile dispute with China, U.S. tariff and sanctions threats are hanging over the European and Japanese auto industries (which would have knock-on effects for North American producers), a consortium of leading European natural gas infrastructure companies (Nord Stream 2), and allies Turkey and India for purchasing missile defense technology from a U.S. rival. The U.S. also initiated a separate tit-for-tat tariff spat with India, and recently threatened Vietnam as companies have shifted production there from China.

To us, this means once a trade or sanctions dispute is “resolved” another one may pop up somewhere else. And even when a trade deal is supposedly sewn up, tariff threats can come right back to bite countries that seem to be in the clear. Mexico knows this all too well.

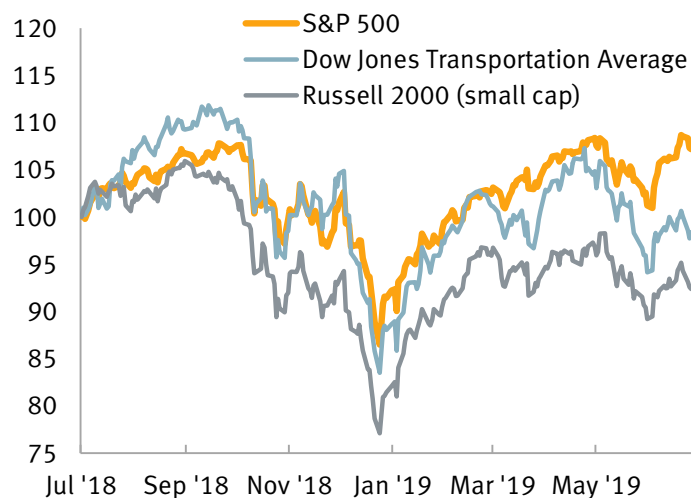
While we think some of this has been factored into the U.S. market already, persistent tariff and sanctions risks could continue to generate volatility episodes and weigh on industries and companies in the crosshairs. This is a headwind for **global growth.**

What if simmering Iran tensions boil over?

The difficulty of budgeting for geopolitical risks is that they are often unquantifiable and include multiple, complex scenarios that can be outside of the market’s ability to recognize or grasp. If we view events through a historical lens, the market has generally reacted calmly except for select situations. In 17 acts of war that we measured since WWII, the S&P 500 fell 6.3%, on

Bellwether indexes have yet to confirm the S&P 500’s all-time high

Relative performance of major indexes (normalized at 100)



Source - RBC Wealth Management, Bloomberg; data through 6/26/19

average, surrounding the event. In nine high-profile terrorist attacks it fell 2.6% on average. But if we segment out the market’s five worst reactions from the combined 26 episodes, the S&P 500 fell by an average of 14.3%, with a 16.1% decline being the most extreme reaction surrounding the Yom Kippur War and related Arab oil embargo in 1973.

While we think the market would view any serious conflict between the U.S. and Iran as quite problematic, perhaps it has refrained from reacting so far because it is in both countries’ interests to avoid this scenario.

What about the 2020 election?

Even though political headlines abound, we think it’s too early to start factoring the presidential race into equity portfolio positioning. We’re still months away from the Iowa Democratic caucuses in February 2020, which will mark the unofficial campaign kickoff.

In our view, economic momentum—specifically, whether the economy is expanding or contracting—is the main driver of corporate earnings and stock prices. There have been expansions and contractions and bull and bear markets regardless of which party wielded power in Washington. Given that emotions are likely to run high this presidential election cycle, it’s prudent for investors to focus on the economy.

Stay invested

Until recession risks escalate, we believe the U.S. equity market deserves the benefit of the doubt and recommend holding a Market Weight position in portfolios. While we think it’s too soon to become overtly defensive by cutting exposure below that level, we would upgrade the quality of holdings.



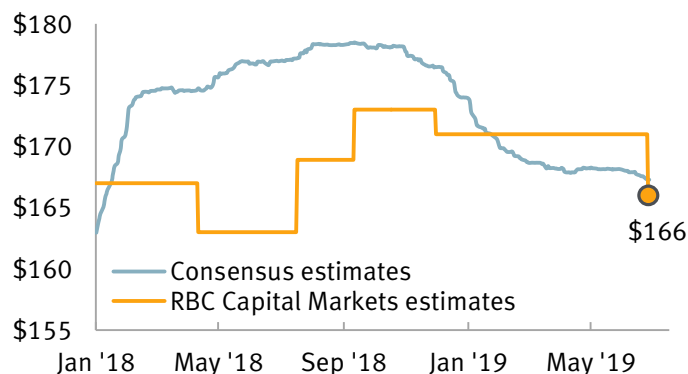
United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets lost a bit of steam**, trading lower for four consecutive days spanning Friday, June 21 through Wednesday, June 26. Despite this moderation, the S&P 500 has climbed 5.9% thus far this month and **remains on track for its best June since the 8.2% gain in 1955**. Weekly leadership could be found in large caps and economically sensitive stocks, resulting in the Dow Jones Industrial Average leading U.S. headline indexes and the small-cap Russell 2000 lagging its large-cap peers. Further highlighting this trend are the sector gains evident in Materials, while Energy, Tech, and Industrials held up better than average. More notably, the hyper-cyclical **Philadelphia Semiconductor Index surged 3.3%** on Micron's better-than-feared quarter and the broad takeaway the company provided showing the Huawei restrictions proved to be less onerous for semiconductor manufacturers than originally believed.
- In her latest *Macroscope*, RBC Capital Markets, LLC Head of U.S. Equity Strategy **Lori Calvasina modestly shifted her views on the U.S. equity market** by balancing her assumptions on underlying growth against the changing interest rate backdrop. Slight tweaks to her models included a **reduction in the 2019 S&P 500 EPS estimate to \$166** from \$171, which marks a slight reduction in the **2019 S&P 500 EPS growth forecast to 2% from 5%**. She sees incremental moderation in revenue growth and slightly higher interest and tax expense. Calvasina also **initiated a 2020 S&P 500 EPS estimate at \$175**, marking 5% growth from her 2019 forecast.
- **However, RBC Capital Markets' 2019 S&P 500 year-end price target of 2,950 remains intact**, as the interest rate backdrop should be more supportive of higher market

S&P 500 2019 EPS estimates continue their decline

Consensus estimates are bottom-up



Source - RBC Wealth Management, FactSet; data through 6/27/19

valuations—equities appear relatively more attractive when yields are lower. These changes to Calvasina's views **support our Market Weight recommendation in U.S. equities** and our preference for high-quality, slightly defensive companies.

- **In economic data, housing continued to disappoint as May's new home sales declined 7.8% against a consensus expectation of a 1.6% gain.** Fortunately, **pending home sales blunted the new home sales challenges slightly** as growth of 1.1% m/m was in line with expectations. Interestingly, research from our Fixed Income Strategies team may help explain this disconnect as the current interest rate backdrop, which should be favorable to all home financing, is primarily being taken advantage of by consumers looking to refinance their current homes as opposed to those looking to buy new ones.



Canada

Arete Zafiriou & Richard Tan, CFA – Toronto

- Canada, like much of the world, has been caught in the crossfire of the **U.S.-China trade dispute**. China accounts for approximately 5% of Canadian exports, thus we think the **direct impact to Canada's economy should be manageable** if a significant deceleration in China's economic growth materializes. **RBC Economics believes a further slowdown in the U.S. industrial sector is a greater threat to the Canadian economy.** Output from the sector and capacity utilization rates have declined by roughly 10% each, according to RBC Economics, since U.S. President Donald Trump's administration imposed tariffs on \$200B worth of Chinese imports in September 2018. While it's true that China exports about three times as many goods to the U.S. as the U.S. exports to China, it is also true that import tariffs are borne by domestic producers and consumers. RBC Economics states that the U.S. accounts for approximately 70% of Canada's exports; therefore, a slowdown in the U.S. economy driven by higher input costs from the **impact of tariffs could trickle down to the Canadian economy indirectly.**
- RBC Global Asset Management (GAM) recently observed that **Canada may be more vulnerable than the U.S. in the event of a recession in North America.** Shocks to U.S. GDP often hit Canadian GDP at a 1:1 rate, so a global or U.S. recession would have an equivalent adverse effect on Canada, all else equal. However, because Canada is a resource-rich region, it **could be hit harder by changes in commodity prices** which tend to fall during recessions. The main reason RBC GAM believes Canada **would be worse off is due to the housing market.** It estimates that almost 22% of Canadian GDP is linked to housing-

related activities, compared to the 19% historical average. Furthermore, household debt-to-income is much higher in Canada than in the U.S., and debt servicing costs continue to rise. Canadian home prices, home resales, and housing starts unwinding at the same time could weigh heavily on the Canadian economy.



Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Market participants in the U.K. spent a lot of energy trying to understand Conservative leadership frontrunner Boris Johnson's plan of action.** He initially stated on June 25 that “we are getting ready to come out on October the 31st ... do or die,” leading the nation to believe he would pursue a hard Brexit. But two days later, he seemed to change tack, declaring that the chances of a no-deal Brexit are “a million to one,” which suggests he would try to renegotiate the ill-fated Withdrawal Agreement. Overall, market participants are perplexed.
- RBC Capital Markets points out that **the pound has been the worst-performing G10 currency during the week**, due to the increase in the political risk premium. The perceived risk of an early general election has now risen to 40%, while the implied probability of the current Parliament running until the end of its term in 2022 is at an 18-month low.
- **The European Commission Economic Sentiment Indicator for the eurozone fell to 103.3 in June, close to a three-year low. We recently downgraded European equities to Underweight as we feared the potential for an economic recovery in the second half of 2019 would be jeopardized by the ongoing trade dispute.**
- German auto manufacturer **Daimler announced its third profit warning in a year** due to an increase of provisions for various ongoing governmental measures related to the company's diesel vehicles.
- **Shares in Hennes & Mauritz**, the Swedish fashion retailer, **jumped almost 14% on June 27** as sales significantly beat expectations, up 12% y/y in June, versus the consensus estimate for a 7% rise for the current quarter.
- Q3 results for **Chr. Hansen**, the Danish bioscience company, missed consensus expectations. The company **downgraded its organic sales growth outlook for 2019** to 7%–8%, from 9%–11% previously, sending the shares down by almost 14% on June 27.
- The shares of litigation-embroiled health care and agriculture group **Bayer** received a boost from the news that a **prominent activist investor had taken a stake worth over \$1B**. The shares jumped almost 9% on the announcement.



Asia Pacific

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

- Asian equity markets were mostly flat after a strong rebound in the week starting June 17. **Investors remain cautious ahead of the G20 summit**, where the leaders of the U.S. and China are scheduled to discuss the current trade disputes. Top-level negotiators for both sides have held discussions on economic and trade issues ahead of the meeting. Talks aside, **the latest tit-for-tat moves suggest a long road ahead**. The U.S. Commerce Department added several Chinese tech companies and a government-owned institute involved in supercomputing to its “entity list.” According to Bloomberg, China is considering adding FedEx to its list of “unreliable entities.” **While we do not expect significant compromises at the upcoming meeting, we believe there will be some form of progress.** In the event of a failure, consequences could be serious. In a televised interview with Fox Business, U.S. President Donald Trump warned of additional U.S. tariffs to be placed on Chinese goods if there is no progress on a trade deal.
- **A U.S. federal judge found three large Chinese banks in contempt for refusing to comply with subpoenas in an investigation into violations of North Korean sanctions.** The three banks were not named in the contempt order but are believed by *The Washington Post* to be China Merchants Bank (3968 HK), Bank of Communications (3328 HK), and Shanghai Pudong Development Bank (600000 CH) because of a related investigation by the U.S. Department of Justice. Share prices of the three banks declined. While the developments were related to old news (the subpoenas were issued in December 2017), the report came during a sensitive time, just days ahead of the G20 summit.
- **Japanese manufacturing activity deteriorated in June** with new orders registering the lowest level since June 2016. Japan's Manufacturing Purchasing Managers' Index fell to 49.5 from 49.8 in May. Japan's retail sales rose 1.2% y/y in May, in line with market expectations and rising at its quickest pace in six months.
- **Tokio Marine** (8766 JP) will be **seeking acquisition opportunities in Asian emerging markets and elsewhere** as it seeks to double profits from those regions, according to the new chief of Japan's largest property and casualty insurer.



MARKET SCORECARD

Data as of June 27, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,924.92	6.3%	16.7%	8.3%	20.9%
Dow Industrials (DJIA)	26,526.58	6.9%	13.7%	10.0%	24.5%
NASDAQ	7,967.76	6.9%	20.1%	7.0%	29.6%
Russell 2000	1,546.55	5.5%	14.7%	-5.7%	10.2%
S&P/TSX Comp	16,307.73	1.7%	13.9%	0.5%	6.7%
FTSE All-Share	4,041.72	3.0%	10.0%	-3.7%	-0.5%
STOXX Europe 600	382.21	3.6%	13.2%	0.6%	-1.0%
EURO STOXX 50	3,442.38	4.9%	14.7%	1.3%	-2.7%
Hang Seng	28,621.42	6.4%	10.7%	0.9%	10.8%
Shanghai Comp	2,996.79	3.4%	20.2%	6.5%	-6.1%
Nikkei 225	21,338.17	3.6%	6.6%	-4.2%	5.5%
India Sensex	39,586.41	-0.3%	9.8%	12.4%	27.9%
Singapore Straits Times	3,328.60	6.8%	8.5%	2.3%	3.4%
Brazil Ibovespa	100,724.00	3.8%	14.6%	42.7%	63.3%
Mexican Bolsa IPC	43,316.56	1.3%	4.0%	-7.6%	-11.8%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,408.32	7.9%	9.8%	12.5%	12.9%
Silver (spot \$/oz)	15.25	4.7%	-1.6%	-5.0%	-8.5%
Copper (\$/metric ton)	5,971.00	2.8%	0.4%	-10.8%	2.3%
Oil (WTI spot/bbl)	59.43	11.1%	30.9%	-18.3%	34.3%
Oil (Brent spot/bbl)	66.38	2.9%	23.4%	-14.5%	42.3%
Natural Gas (\$/mmBtu)	2.32	-5.4%	-21.0%	-22.5%	-23.5%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.012%	-11.2	-67.2	-81.3	-19.3
Canada 10-Yr	1.474%	-1.4	-49.3	-61.9	-9.5
U.K. 10-Yr	0.822%	-6.4	-45.5	-42.3	-26.8
Germany 10-Yr	-0.320%	-11.8	-56.2	-64.1	-69.0
Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.55%	0.9%	5.8%	7.5%	6.7%
U.S. Invest Grade Corp	3.22%	1.9%	9.3%	10.0%	8.7%
U.S. High Yield Corp	5.88%	2.2%	9.8%	7.1%	10.3%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	96.2180	-1.6%	0.0%	1.0%	-0.2%
CAD/USD	0.7633	3.2%	4.1%	1.8%	0.7%
USD/CAD	1.3102	-3.1%	-3.9%	-1.8%	-0.7%
EUR/USD	1.1369	1.8%	-0.9%	-1.6%	0.3%
GBP/USD	1.2670	0.3%	-0.7%	-3.4%	-1.1%
AUD/USD	0.7008	1.0%	-0.6%	-4.5%	-7.6%
USD/JPY	107.7900	-0.5%	-1.7%	-2.2%	-4.1%
EUR/JPY	122.5500	1.3%	-2.6%	-3.8%	-3.8%
EUR/GBP	0.8973	1.5%	-0.2%	1.9%	1.4%
EUR/CHF	1.1104	-0.7%	-1.3%	-3.6%	2.0%
USD/SGD	1.3535	-1.5%	-0.7%	-1.0%	-2.4%
USD/CNY	6.8771	-0.4%	0.0%	4.1%	0.9%
USD/MXN	19.1807	-2.2%	-2.4%	-4.9%	6.6%
USD/BRL	3.8242	-2.5%	-1.5%	-1.0%	15.4%

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 6/27/19.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD 3.2% return means the Canadian dollar rose 3.2% vs. the U.S. dollar year to date. USD/JPY 107.79 means 1 U.S. dollar will buy 107.79 yen. USD/JPY -1.7% return means the U.S. dollar fell 1.7% vs. the yen year to date.

Authors

Kelly Bogdanova – San Francisco, United States

kelly.bogdanova@rbc.com; RBC Capital Markets, LLC

Ben Graham, CFA – Minneapolis, United States

benjamin.graham@rbc.com; RBC Capital Markets, LLC

Richard Tan, CFA – Toronto, Canada

richard.tan@rbc.com; RBC Dominion Securities Inc.

Arete Zafiriou – Toronto, Canada

arete.zafiriou@rbc.com; RBC Dominion Securities Inc.

Frédérique Carrier – London, United Kingdom

frederique.carrier@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

Thomas McGarrity, CFA – London, United Kingdom

thomas.mcgarritty@rbc.com; Royal Bank of Canada Investment Management (U.K.) Ltd.

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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			Count	Percent
Buy [Top Pick & Outperform]	794	54.01	202	25.44
Hold [Sector Perform]	589	40.07	107	18.17
Sell [Underperform]	87	5.92	5	5.75

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