March 29, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Growth vs. value: Trading places?

Kelly Bogdanova – San Francisco

Is the recent action in the Tech sector a sign of a sea change underway for U.S. equities and the start of a shift from growth to value? While it's premature to call a change in leadership, we explore why U.S. value stocks could be emerging, and why a key driver of that segment, Financials, looks attractive.

The global equity correction is persisting. U.S. protectionist policies and the potential responses of trading partners are still weighing on markets, but other factors have cropped up in recent sessions, particularly the weakness in Technology stocks.

As soon as it looks like new sector leaders could be emerging, the situation changes and becomes muddled again—typical behavior during correction periods. This back-and-forth action, much of which is being driven by the U.S. market, reinforces our view that investors should remain patient as global equities work through the volatility.

In the meantime, it's not too soon to contemplate the possibility that a shift could take place away from growth stocks toward value stocks.

Tech's troubles

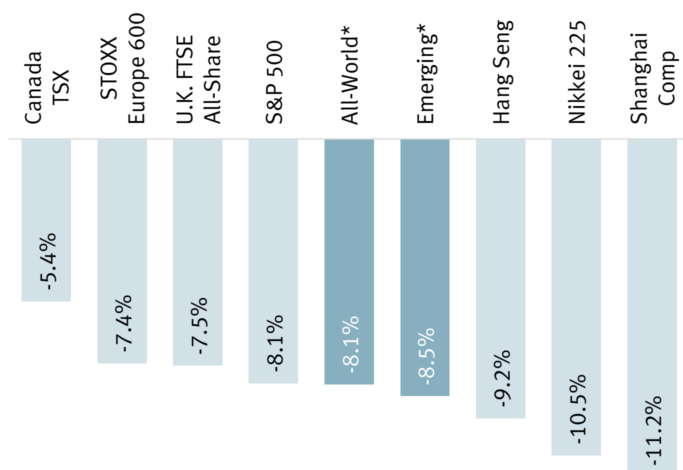
The global Tech sector has outperformed broad benchmarks since the correction began in January, but has lagged in the past couple weeks.

The trade spat between the U.S. and China has raised tariff uncertainties for semiconductor, hardware, and consumer tech companies. In our view, these industries are vulnerable if U.S./China trade dialogues break down and additional tit-for-tat tariff threats are announced.

The pedestrian death in the U.S. caused by Uber's experimental self-driving car also hit semiconductor stocks, particularly those leveraged toward artificial intelligence technologies in self-driving cars. These had been some of the hottest stocks of the past couple years.

The equity correction is a global phenomenon

Performance of major equity indexes since the January 26 all-time high



* The All-World and Emerging data are both FTSE indexes
Source - RBC Wealth Management, Bloomberg; data from the all-time high in global and S&P 500 indexes from 1/26/18 through 3/29/18

Market pulse

Click here for authors' contact information.

Priced (in USD) as of 3/29/18 market close, EST (unless otherwise stated).

For important disclosures and required non-U.S. analyst disclosures, see page 6.

Potential heightened regulatory oversight following Facebook's data privacy snafus raised concerns about how business models and revenue streams of social media and internet search firms could be impacted.

For the first time during this bull market cycle, widely embraced secular growth themes are under scrutiny. While we think the long-term innovation prospects remain bright for the Tech sector, these headwinds could linger over the near term.

Turn signal?

Amid the Tech weakness, there is a bigger issue to contemplate: Might the recent sector moves be signaling a shift from growth to value stocks?

Since the global financial crisis ended in 2009, growth has outperformed value for much of that time on a global basis, including in the U.S.

Given the trends so far during this correction and drivers of these style groups, RBC Capital Markets believes a shift toward value could unfold in the U.S. We think it is more difficult to make that call on a global basis because the moves in value stocks have been less pronounced in global indexes this cycle.

In the U.S., value tends to outperform growth when the 10-year Treasury yield rises, inflation expectations move up, and GDP growth strengthens, according to RBC Capital Markets' research. Conversely, when economic growth is harder to come by, like it was in prior years, growth stocks are favored because investors are willing to "pay up" for them. Value also tends to outperform growth during the latter stage of a bull market cycle.

There have been two periods of U.S. value leadership during this bull market; perhaps there is another one in store (see upper chart).

Favorable fairway for Financials

Just as the Tech sector is a major part of the growth segment, the Financials sector is a heavyweight in the value category. We continue to believe Financials, and specifically bank stocks, have the potential to perform well in 2018.

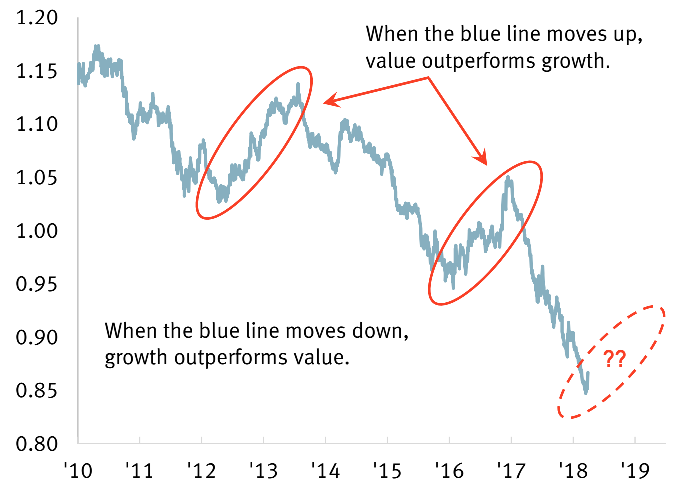
Historically, the Financials sector has been positively correlated with changes in inflation expectations. It also tends to outperform when Treasury yields rise, and should benefit from additional Federal Reserve rate hikes as long as economic growth stays intact.

Bank stocks are still reasonably valued compared to the broader market and versus the historical average based on our assessment of multiple valuation measures, including price-to-book (see lower chart). Earnings growth and revisions have been strong lately, and the loan growth outlook is bright, according to RBC Capital Markets' bank analysts. The Financials sector is among the biggest beneficiaries of corporate tax cuts. Furthermore, the bank regulatory environment is improving, especially for small and medium-sized firms.

While we believe it's too soon to make a definitive call that U.S. value will reign over growth, this trend could emerge in coming months. Regardless, we continue to view the value category's main constituent, Financials, as attractive.

Might value stocks take the lead soon?

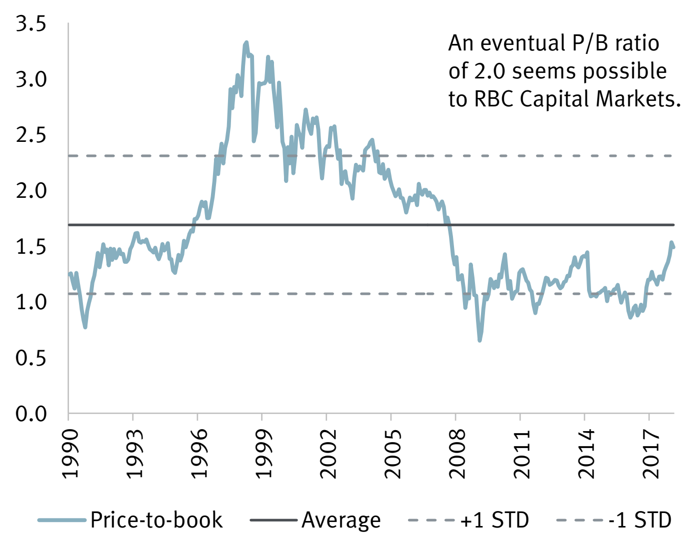
Performance of U.S. Russell 1000 Value Index vs. Growth Index (ratio of large-cap value divided by growth)



Source - RBC Wealth Management, Bloomberg; data through 3/28/18

U.S. banks still below the historical average valuation

S&P 500 Banks Index price-to-book (P/B) ratio



Source - RBC Wealth Management; Bloomberg; monthly data through 3/28/18

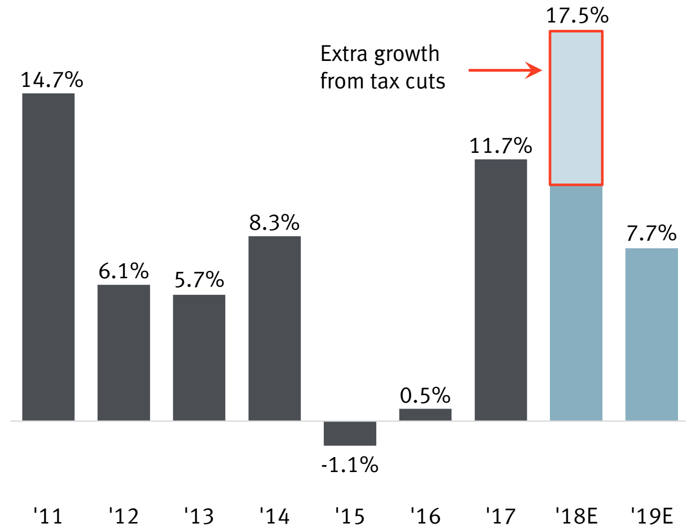
United States

Kelly Bogdanova – San Francisco

- **The S&P 500 finished Q1 down 1.2%**, ending a nine-quarter winning streak. Technology and Consumer Discretionary were the only positive sectors, while Telecom, Consumer Staples, and Energy underperformed the most. **The 10-year Treasury yield jumped 33 basis points** for the quarter, closing near 2.74%, well below the January peak of 2.95%. The move higher in yields initially sparked the equity selloff, although other factors came into play as the quarter progressed.
- **So far, transportation stocks**, often a key bellwether segment of the equity market, **have held together reasonably well during the correction**. In Q1, the Dow Jones Transportation Average moderately outperformed the Dow Industrials. In March, the performance gap widened, as the Transports inched up 0.1% whereas the Dow dropped 3.7%. The Transportation Average is much further above its previous low than the Dow is. **Investors and traders who adhere to the Dow Theory**, which asserts the predictive power of the Transports, **view these as positive signs for the broader market**. The Transports did not confirm the Dow's March weakness and did not flash a "sell" signal for the broader market.
- But that doesn't mean the market is out of the woods. RBC Capital Markets, LLC Technical Strategist Bob Dickey wrote, "**It's important to keep in mind that the volatility will probably remain high in both directions** for some time until the markets finally reach some kind of equilibrium, which could still take a few months. **We still think there is the potential for more downside risk** and would not be drawn into reacting to any single trading session in either direction."
- **Q4 2017 GDP growth was unexpectedly revised higher** to an annualized rate of 2.9% q/q from the previous reading of 2.5% and above the 2.7% consensus forecast. **Stronger-than-expected household spending and a more modest drag from inventories** helped push GDP up. Before-tax nationwide corporate profits (includes public and non-public companies of all sizes) came in much lower than the prior quarter. Perhaps some companies delayed recognizing profits due to the far more favorable tax rates that came into effect in Q1 2018. **There were healthy corporate trends beneath the surface**. Revenue growth has caught up with GDP growth and seems positioned to outpace it in coming quarters, according to RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli. He believes profitability will remain healthy, as strong revenue growth combined with tax cuts should enable companies to absorb any wage increases without sacrificing the bottom line. **RBC Capital Markets expects S&P 500 profits to surge 17.5% this year** with the help of tax cuts (see chart).

The U.S. earnings outlook is sturdy

S&P 500 y/y earnings growth: Actual in gray; RBC estimates in blue



Source - RBC Capital Markets U.S. Equity Strategy (estimates in blue), Thomson Reuters I/B/E/S (actual earnings in gray); data through 3/27/18

Canada

Richard Tan & Christopher Girdler, CFA – Toronto

- The Canadian Radio-television and Telecommunications Commission **(CRTC) upheld its original decision to restrict mobile WiFi operators from gaining access to incumbent wireless networks at regulated rates**. However, the CRTC is initiating a process through which it **hopes to ensure data-only plans will become more affordable** for Canadians. National wireless operators will be required to file proposals by April 23, 2018. RBC Capital Markets believes the **impact to national operators will be manageable** but could introduce a degree of repricing in the market, which could induce pressure on revenue growth.
- **As OPEC continues its attempt to curb the supply of oil**, there are some early indications that **there could be a shift in its objective**. For the past 15 months, it has been the oil bloc's objective to return inventories to their five-year average. Recent OPEC deliberations **considered the seven-year average as its new benchmark**, which could extend production cuts. RBC Capital Markets believes OPEC remains unwavering in its goal to balance the market

and prevent a scenario where U.S. production could overwhelm the demand from global participants.

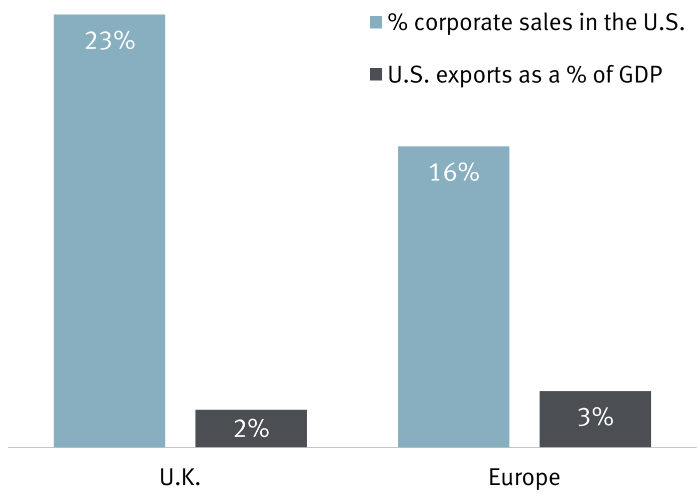
- **Government of Canada (GoC) bond yields were dragged lower** during the week as trade policy uncertainty persisted and there was a lack of economic data to provide support. **Longer-dated yields fell more than short-dated** and caused a further flattening of the GoC yield curve, a theme that has been consistent throughout March. **January GDP was released** late in the holiday-shortened trading week but offered no support, as **economic growth fell 0.1% over the month**, driven by lower contributions from the Real Estate and Energy sectors. December's GDP growth figure was revised 0.1% higher to 0.2%, but that did little to change the direction for yields.

Europe

Frédérique Carrier – London

- **Though fears of escalating protectionism may have abated somewhat**, **concerns linger**. We have looked at both the U.K. and the EU to gauge which areas of their corporate sectors may be most, or least, exposed to trade barriers being erected by the U.S.
- The U.K.'s corporate sector derives just under a quarter of its revenues from the U.S. Most of this, however, is thanks to plants and facilities that produce goods to be sold in the U.S. market, rather than through exports. Indeed, U.S. exports as a percentage of U.K. GDP is a relatively low 2%. As such, **the U.K. corporate sector would not seem particularly exposed to the protectionist threat**. The sectors deriving the highest percentage of revenues from the U.S. are pharmaceuticals (at just over 40%), closely followed by capital goods, Energy, and consumer services.
- **For the eurozone, the corporate sector derives a little less from the U.S.**, just over 15% of revenues, though U.S. exports are a marginally more important to the economy, representing 3% of eurozone GDP. In Europe, the **health care equipment sector** derives by far the **largest portion of revenues** from the U.S., with almost half of its sales arising there.
- At the other end of the spectrum, **sectors inherently domestically focused should emerge unscathed** from the protectionist trend. The U.K. sector least exposed to the U.S., with less than 5% of sales derived from the U.S., is Telecom. In the eurozone, it is Utilities.
- In both the U.K. and Europe, **banks have minimal exposure to the U.S.**, at around 10% of revenues. If protectionism starts to impact local economic growth, not our base-case scenario, banks would suffer too as they are intrinsically linked to their domestic economies.

The U.S. is an important market to the U.K. corporate sector though not necessarily through exports



Source - OECD, RBC Wealth Management, our national research correspondent; 2016 data

MARKET SCORECARD

Data as of March 29, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,640.87	-2.7%	-1.2%	11.8%	28.5%
Dow Industrials (DJIA)	24,103.11	-3.7%	-2.5%	16.7%	36.7%
NASDAQ	7,063.45	-2.9%	2.3%	19.8%	45.7%
Russell 2000	1,529.43	1.1%	-0.4%	11.5%	37.9%
S&P/TSX Comp	15,367.29	-0.5%	-5.2%	-1.9%	14.5%
FTSE All-Share	3,894.17	-2.2%	-7.8%	-2.9%	16.0%
STOXX Europe 600	370.87	-2.3%	-4.7%	-2.0%	10.1%
EURO STOXX 50	3,361.50	-2.3%	-4.1%	-3.3%	11.9%
Hang Seng	30,093.38	-2.4%	0.6%	23.4%	47.8%
Shanghai Comp	3,160.53	-3.0%	-4.4%	-2.5%	8.2%
Nikkei 225	21,159.08	-4.1%	-7.1%	10.1%	23.7%
India Sensex	32,968.68	-3.6%	-3.2%	11.6%	32.4%
Singapore Straits Times	3,427.97	-2.6%	0.7%	7.6%	21.6%
Brazil Ibovespa	85,365.56	0.0%	11.7%	30.3%	66.9%
Mexican Bolsa IPC	46,124.85	-2.8%	-6.5%	-5.9%	0.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,324.97	0.5%	1.7%	5.7%	6.7%
Silver (spot $/oz)	16.35	-0.4%	-3.5%	-10.4%	6.4%
Copper ($/metric ton)	6,633.50	-3.8%	-8.0%	12.7%	34.9%
Oil (WTI spot/bbl)	64.94	5.4%	7.5%	31.2%	69.6%
Oil (Brent spot/bbl)	70.27	6.8%	5.1%	34.1%	79.5%
Natural Gas ($/mmBtu)	2.74	2.6%	-7.3%	-13.8%	43.8%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.739%	-12.2	33.4	36.2	93.5
Canada 10-Yr	2.091%	-14.4	4.6	49.8	91.2
U.K. 10-Yr	1.350%	-15.1	16.0	20.0	-6.1
Germany 10-Yr	0.497%	-15.9	7.0	15.3	36.0
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.14%	0.4%	-1.7%	1.0%	1.6%
U.S. Invest Grade Corp	3.79%	-0.1%	-2.6%	2.3%	6.0%
U.S. High Yield Corp	6.20%	-0.7%	-0.9%	4.1%	21.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	90.0860	-0.6%	-2.2%	-9.9%	-5.3%
CAD/USD	0.7758	-0.4%	-2.5%	3.4%	1.4%
USD/CAD	1.2890	0.5%	2.5%	-3.3%	-1.4%
EUR/USD	1.2301	0.9%	2.5%	14.3%	8.9%
GBP/USD	1.4024	1.9%	3.8%	12.8%	-2.5%
AUD/USD	0.7676	-1.1%	-1.7%	0.1%	0.6%
USD/JPY	106.4400	-0.2%	-5.5%	-4.1%	-5.6%
EUR/JPY	130.9100	0.6%	-3.2%	9.5%	2.9%
EUR/GBP	0.8771	-1.0%	-1.2%	1.3%	11.7%
EUR/CHF	1.1766	2.2%	0.5%	9.7%	7.8%
USD/SGD	1.3115	-1.0%	-1.8%	-5.9%	-3.2%
USD/CNY	6.2898	-0.7%	-3.3%	-8.7%	-3.3%
USD/MXN	18.1840	-3.5%	-7.5%	-2.8%	4.8%
USD/BRL	3.3036	1.7%	-0.3%	5.9%	-9.2%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX and 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 8:36 pm GMT 3/29/18.

Examples of how to interpret currency data: CAD/USD 0.77 means 1 Canadian dollar will buy 0.77 U.S. dollar. CAD/USD -2.5% return means the Canadian dollar fell 2.5% vs. the U.S. dollar year to date. USD/JPY 106.44 means 1 U.S. dollar will buy 106.44 yen. USD/JPY -5.5% return means the U.S. dollar fell 5.5 vs. the yen year to date.

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Sell [Underperform]	105	6.34	8	7.62

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