June 28, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Trade tensions heat up: What investors need to know

Kelly Bogdanova – San Francisco

As trade tensions escalate on several fronts, investors are rightly concerned—and confused—about the vulnerability of the economy and markets. Here's what investors should know to help navigate the uncertainty ahead.

Risks associated with trade and tariffs are the top concern of institutional investors, according to a recent survey by RBC Capital Markets. They far outweigh worries about inflation, interest rates, Fed policy, and the economy overall, among many other issues.

Amid the uncertainties, there is a lot of confusion about the trade disputes, especially after a myriad of tariff threats and counter-threats have been lobbed back and forth in recent weeks. Neither the U.S. nor its major trading partners seem willing to back down anytime soon.

In an attempt to cut through the noise, we answer some frequently asked questions:

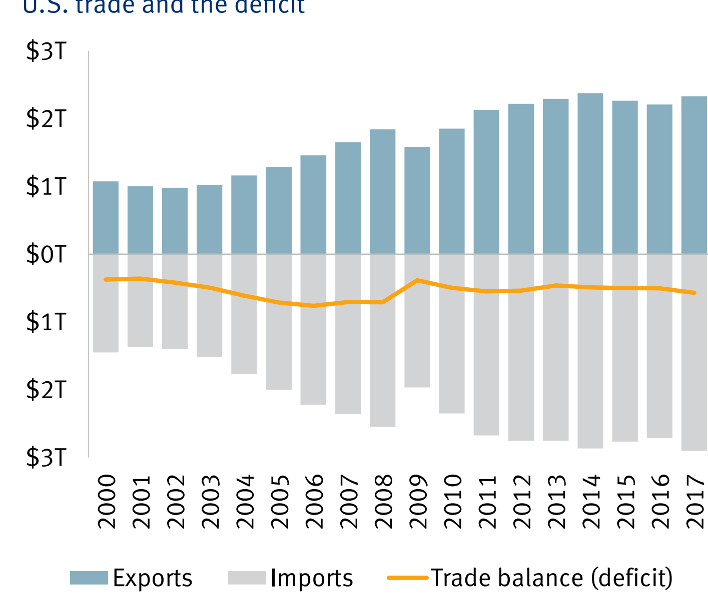
Q: Markets largely ignored trade tensions for months. Why have they reacted recently?

A: Perhaps this has to do with President Trump's unorthodox communications style. For much of his presidency markets have been in "show me" mode—less focused on rhetoric and more focused on actual outcomes.

For example, markets were slow to price in the historic U.S. tax cuts and associated increase in earnings estimates. The reaction to tariff rhetoric has been similar—most markets were mostly unaffected by the war of words until the prospects of multiple tit-for-tat tariffs became nearly assured. This is unusual behavior for equity markets, which normally price in events well in advance.

It's now clear the U.S. administration isn't completely bluffing and there is more to this than just tough rhetoric. What were trade "threats" months ago have begun to turn into actual

U.S. trade and the deficit



Source - RBC Wealth Management, U.S. Census Bureau; annual data through 2017

Market pulse

4 Oil prices continue to outpace U.S. Energy stocks

4 Impressions from the BoC governor's recent speech

5 Sterling slides on BoE's dovish tone

5 China stocks feel the sting of trade tensions

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Priced (in USD) as of 6/28/18 market close, EST (unless otherwise stated).

For important disclosures and required non-U.S. analyst disclosures, see page 7.

policies. Steel and aluminum tariffs have been implemented by the U.S. and counter-tariffs are forthcoming from many trading partners. Also, the first round of U.S.-China tariffs is nearing the implementation phase. We think the additional tariff threats lobbed in the past few weeks by all sides now seem more credible in the eyes of markets.

Q: What is the potential economic impact of tariffs?

A: The trade disputes are being fought on four different fronts: (1) steel and aluminum, which impact many countries; (2) automobiles, which impact auto-producing nations; (3) the U.S. versus China; and (4) the U.S. versus NAFTA partners Canada and Mexico.

Our economists believe there is a very low probability that all of these fronts will ignite at once into an all-out global trade war. They anticipate the parties will ultimately negotiate trade deals for most if not all of these because it is in the economic interests of all countries involved, including the U.S. If a full-on trade war is avoided, the economic damage should be manageable.

That being said, our economists have evaluated some harsh scenarios. For example, if the U.S. and China were to levy 25% tariffs on all imports from each country and China were to include additional non-tariff barriers so as to match the total U.S. tariffs, RBC Capital Markets estimates it would subtract a little more than one-half of a percentage point from annual U.S. GDP growth (the economy would grow 2.4% rather than 2.9%, for example). Keep in mind, the U.S. and China tariff threats currently on the table are much lower than this (25% on the first $50B in goods, followed by a 10% tariff on the equivalent of $400B more in goods).

In another scenario, if the U.S. were to levy a hefty 20% tariff on imports from China, Mexico, and Canada, and each country countered, RBC Global Asset Management's economist estimates it would subtract 4.8% from Mexico's GDP growth (admittedly, a big number), 2.4% from Canada, 1.9% from the U.S., and 0.9% from China. The probability of this occurring is very low, in our view.

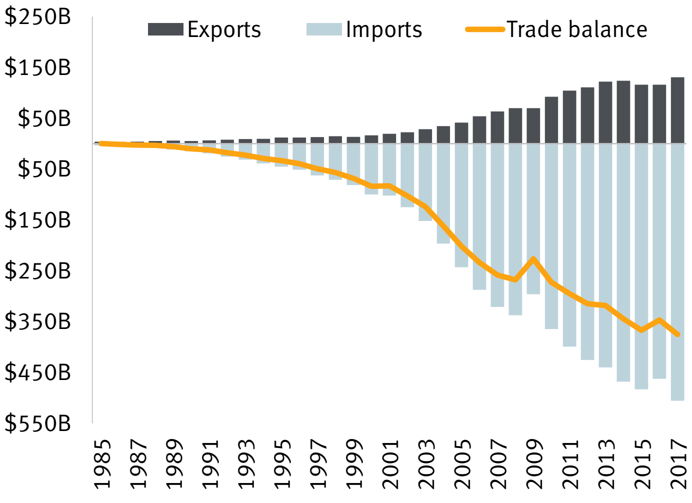
Q: Which U.S. sectors are most vulnerable to tariffs?

A: Theoretically, the U.S. sectors with the highest levels of international revenues—Technology, Materials, Energy, and Industrials—would have the most to lose in a global trade war on goods *and* services, as the bottom chart illustrates. But that's not what is being threatened and this issue is not cut and dried.

Thus far, the tariff threats have focused on goods, not services. The distinction matters because many Tech firms, including internet and some software companies, are services providers.

Trade with China has become more one-sided over the years

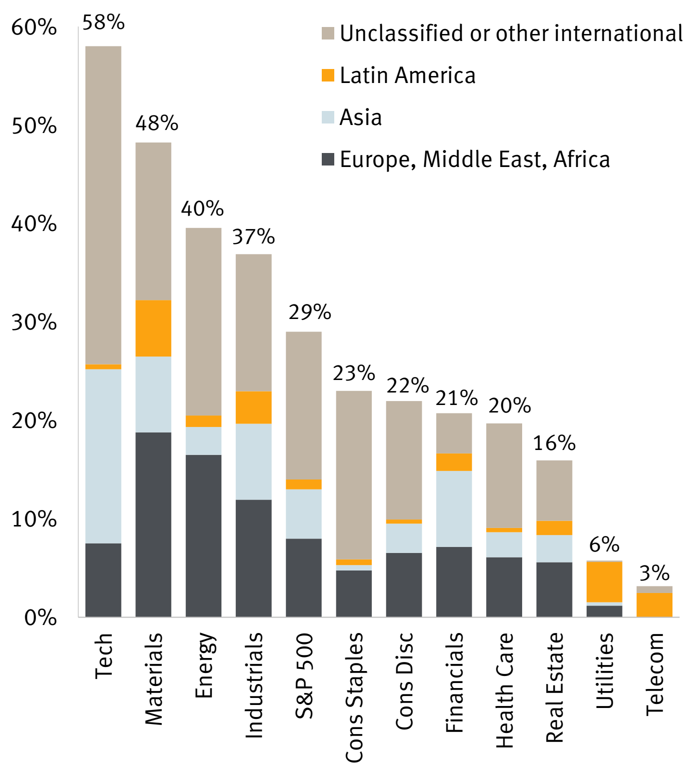
U.S. trade with China



Source - RBC Wealth Management, U.S. Census Bureau; annual data through 2017

Cyclical sectors are the most internationally exposed

S&P 500 percentage of international revenues by sector



Source - RBC Capital Markets U.S. Equity Strategy, Capital IQ, Standard & Poor's

They manufacture nothing so their risk is low. Within Tech, semiconductor and hardware companies are manufacturers and have significant revenues from overseas, so they are much more exposed to tariff risks.

Another key point: it's difficult to break down the risks by regions or countries. Many S&P 500 companies don't detail the sources of their international revenues, which is why the bulk of international exposure is in the "unclassified or other" category, as shown in the bottom chart on the previous page.

In general, internationally oriented semiconductor, tech hardware, materials, and industrial firms have the most exposure, and some consumer goods companies are vulnerable as well.

Q: What could hasten the end of the trade disputes?

A: A meaningful deterioration in U.S. and global economic indicators and a more pronounced selloff in equity markets could certainly grab the attention of elected officials and push sparring parties to resolve their trade differences. But we don't think it has to get that bad for deals to take place.

Corporate pressure could go a long way toward bringing an end to the trade disputes. A non-trivial share of major trade relationships—whether between the U.S. and China, the U.S. and the EU, or NAFTA members—is business-to-business and involves complex global supply chains with interdependencies that are often misunderstood or underappreciated by government officials. Some tariffs could tie global supply chains in knots. We don't doubt businesses of all sizes in all countries involved will warn governments about this, which could encourage positive movement toward trade deals.

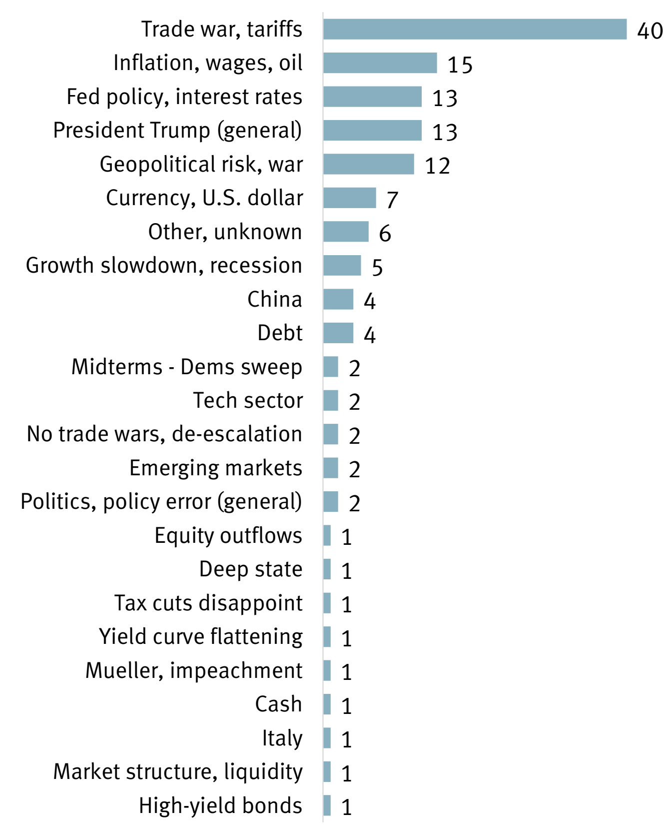
Two U.S. automotive industry groups have already sounded alarms about auto tariffs. ExxonMobil and Chevron warned of the damaging effects of tariffs on steel, which they use for infrastructure maintenance and expansion. High-profile European companies, Daimler and car lights supplier Osram, warned that rising trade tensions could weaken their profit outlooks. Any cautionary comments by U.S. companies during the upcoming Q2 earnings reporting season would likely catch the attention of the free trade advocates in the U.S. administration (Steven Mnuchin, Larry Kudlow). While additional warnings could rattle equity markets, they may also jolt trade negotiators into action.

Cooler heads should ultimately prevail

All sides of the trade disputes have economic incentives to resolve their differences, and we think this will eventually occur. In the meantime there could be more heated rhetoric and additional tariffs implemented that could keep equity markets off balance over the near term.

Survey of institutional investors: What is the biggest tail risk for the U.S. equity market?

Number of responses



Source - RBC Capital Markets U.S. Equity Strategy quarterly investor survey (June 2018), RBC Wealth Management

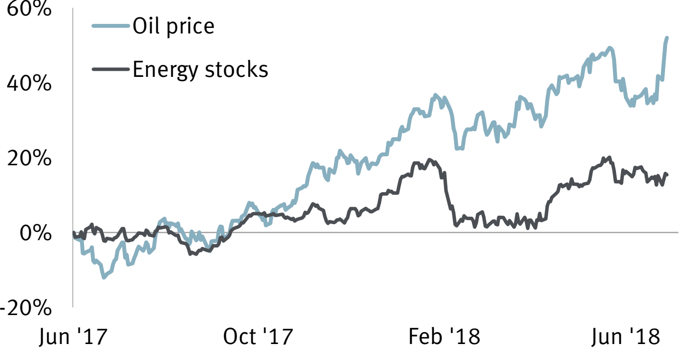
United States

Ben Graham – Minneapolis

- Volatility underscored by mixed trade headlines and constantly shifting tariff rhetoric caused most major U.S. indexes to trade lower during the week. **The Technology-heavy NASDAQ Composite experienced the worst decline of major U.S. indexes in recent days** while the trendy U.S. small-cap universe was narrowly behind. The tough sledding was driven by concerns about semiconductor and hardware industries as the White House revealed potentially stricter trade policy that could have negative implications for U.S. technology components manufacturers.
- **RBC Capital Markets' commodity strategists recently shifted their outlook on oil**, as they now see a **structurally bullish backdrop and the best fundamental setup in years**. As a result, their forecasts were lifted and show an expectation of WTI oil prices averaging $68/barrel (bbl) in 2018 and $76/bbl in 2019, up from $66/bbl and $64/bbl, respectively. However, while the commodity has rallied more than 60% in the last year, Energy stocks have only gained slightly more than 15%. Our view is that this differential will be narrowed by Energy stocks playing catch-up and we remain constructive on the sector.
- **The Financials sector experienced 13 straight days of losses heading into the Comprehensive Capital Analysis and Review (CCAR) results**, the longest such streak in nearly 30 years. CCAR is the decision-making process in which the Fed approves or rejects banks' intended capital distribution plans. The recent losing streak builds on the declines since the January 2018 highs in which more than $425B in sector market capitalization has been lost. We continue to be constructive on the sector, and banks specifically, due to what we view as reasonable valuations, loan growth that has started and should continue, and a normalization of Fed policy. **CCAR results should be a catalyst for a reversal of the recent trend**, in our view.
- **The yield curve has flattened further** as the U.S. 10-year Treasury declined to its lowest reading on June 27 since 2007. The spread between the 2-year and 10-year Treasury continued to decline and set post-Great Recession lows at 32 basis points. On the economic front, **final Q1 GDP was 2.0%**, lower than consensus estimates of 2.2%. Our view is that **equities should receive the benefit of the doubt** as long as the economic growth trajectory remains in place.

Oil prices continue to outpace Energy stocks

One-year price returns of oil (WTI) and the S&P 500 Energy sector



Source - RBC Wealth Management, Bloomberg; data as of 4:00 pm GMT 6/28/18

Canada

Diana Di Luca – Toronto

- **Bank of Canada (BoC) Governor Stephen Poloz spoke at the Greater Victoria Chamber of Commerce** on June 27, focusing on transparency and its role in promoting a more resilient economy. Those hoping that a speech about transparency from the central bank would include some element of forward guidance leading into the BoC's July 11 policy meeting were left disappointed. Rather, **Poloz focused heavily on the need for clarity in BoC communications** for a variety of audiences, including the general public. Regarding the upcoming meeting, Poloz indicated that the central bank is "working to incorporate in our projections the effects of the recently announced U.S. steel and aluminum tariffs, along with retaliatory measures, both in Canada and globally. We are also analyzing individual-level data to understand how the new lending guidelines in Canada are affecting the housing market and mortgage renewals. We expect these issues to figure prominently in our upcoming deliberations." The probability of a rate hike being priced in by the market edged up to around 59% following Poloz's speech, with markets still uncertain as to the outcome of the upcoming policy meeting.
- **Recent moves lower in government bond yields and moves tighter in BBB credit spreads diminish the appeal of BBB Canadian corporate bonds**. 5- to 10-year Government of Canada (GoC) bond yields have fallen 30–35 basis points (bps) over the last six weeks, while corporate bond spreads have hung in fairly well and remain near the narrowest level of the decade. This is unfortunate for investors looking to put cash to work, because credit spreads often widen when yields fall, which typically diminishes the extent to which corporate yields track government bond yields lower. But this has not been the case in the most recent move lower in government bond yields. This means investors are receiving fairly meager incremental compensation to take credit risk, which we believe enhances the appeal of government bonds and higher-quality corporate issues.

- Perpetual preferred share prices remain near the lowest levels of the year, despite the fact that 10- and 30-year GoC bond yields are down approximately 40 bps since mid-May. This has resulted in credit spread widening of about 40 bps in recent months, and a number of issues have seen credit spreads widen 60–80 bps since early 2017. **We recommend taking advantage of the recent pullback in perpetual preferred shares by adding select positions**.

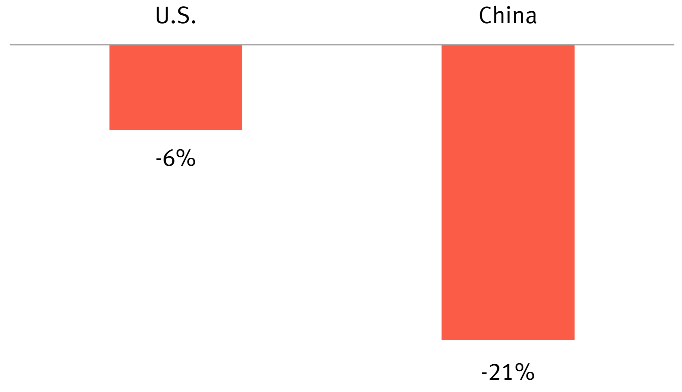
Europe

Frédérique Carrier & Laura Cooper – London

- **The British pound** slipped below 1.31 against the U.S. dollar, again reaching **post-Brexit referendum lows**.
- **Jonathan Haskel, the newly appointed member** of the Bank of England's (BoE) **Monetary Policy Committee**, struck a dovish tone, warning of the potential negative effects of Brexit uncertainty. He assessed that this will likely see him **err on the side of caution** when it comes to raising rates.
- **The downturn in the pound was further aggravated by BoE Governor Mark Carney's comments** following the release of the semiannual ***Financial Stability Report*** on June 27. Carney warned that the rise in protectionism and the potential spillover to business confidence is concerning as it could sap the strength of the global economy.
- Haskel's and Carney's comments raised **financial markets' doubts** that the BoE would be in a position to **raise interest rates at its upcoming meeting in August**, with the market-implied probability of a hike slipping to below 65% from more than 70% previously. The comments echo our view that **the pound is likely to stay weak this year**.
- Prime Minister Theresa May's cabinet is due to meet in the first week of July to draft a white paper on the future U.K.-EU trade relationship. With **several high-profile companies**, such as Airbus, Honda, and Siemens, **pointing to the "severe negative consequences" of Brexit**, many observers wonder whether May will make a U-turn and suggest that the U.K. should remain a member of a customs union. A House of Commons vote on this issue is expected later in July.
- The June European Commission Economic Sentiment Indicator for the eurozone came in marginally weaker than the previous month at 112.3 vs. 112.5. This is down from January's peak of 116.0 and corroborates our view that **while the European economy's momentum seems to have slowed down, economic activity remains healthy**, underpinning our Market Weight stance on European equities.

Chinese stocks are underperforming their U.S. counterparts on trade and economic slowdown concerns

Price returns of the S&P 500 and Shanghai Composite from January highs



Source - RBC Wealth Management, Bloomberg; data through 6/27/18

Asia Pacific

Jasmine Duan – Hong Kong

- **Asian equities are being hit by U.S.-China trade tension. The MSCI AC Asia Pacific Index is down 11.6%** from its high in January and down 4.5% YTD. China has been the worst performer in the region. **The Shanghai Composite Index is down 21%** from its high and has entered a bear market. The U.S. recently announced **plans to curb Chinese investments in sensitive areas**, such as technology. U.S. Treasury Secretary Steven Mnuchin later clarified that the move is not intended to target China, and President Donald Trump also softened his stance; however, the market did not respond positively to these statements, as Trump may change his decision at any time.
- **The renminbi (RMB) has depreciated around 3.7% against the U.S. dollar** (USD) in the past 11 days. In addition to trade tensions, the decision by the People's Bank of China to cut the required reserve ratio could also contribute to RMB weakness. RMB depreciation has raised concerns about higher debt burdens in some sectors (e.g., China Property and China Aviation) that carry a large amount of USD-denominated debt.
- **The response to the Xiaomi (1810 HK) IPO has turned out better than expected**. Xiaomi will be listed on Monday, July 9.
- **The Reserve Bank of New Zealand kept its benchmark interest rate unchanged** at 1.75%, but the bank said it **may consider a rate cut** if needed as economic growth slows and inflation remains below target.

MARKET SCORECARD

Data as of June 28, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,716.31	0.4%	1.6%	11.3%	33.4%
Dow Industrials (DJIA)	24,216.05	-0.8%	-2.0%	12.9%	39.1%
NASDAQ	7,503.68	0.8%	8.7%	20.4%	59.9%
Russell 2000	1,645.02	0.7%	7.1%	15.4%	48.6%
S&P/TSX Comp	16,179.89	0.7%	-0.2%	5.4%	16.9%
FTSE All-Share	4,188.60	-0.8%	-0.8%	3.7%	25.9%
STOXX Europe 600	376.87	-1.6%	-3.2%	-2.3%	19.0%
EURO STOXX 50	3,365.52	-1.2%	-4.0%	-4.8%	22.0%
Hang Seng	28,497.32	-6.5%	-4.8%	11.0%	41.3%
Shanghai Comp	2,786.90	-10.0%	-15.7%	-12.2%	-4.3%
Nikkei 225	22,270.39	0.3%	-2.2%	10.6%	45.3%
India Sensex	35,037.64	-0.8%	2.9%	13.6%	32.1%
Singapore Straits Times	3,257.57	-5.0%	-4.3%	1.3%	18.2%
Brazil Ibovespa	71,766.52	-6.5%	-6.1%	15.7%	43.5%
Mexican Bolsa IPC	47,031.27	5.3%	-4.7%	-4.7%	5.2%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,248.02	-3.9%	-4.2%	-0.1%	-4.9%
Silver (spot $/oz)	16.00	-2.5%	-5.5%	-4.8%	-10.0%
Copper ($/metric ton)	6,693.50	-2.2%	-7.1%	14.1%	39.2%
Oil (WTI spot/bbl)	73.45	9.6%	21.6%	64.2%	53.5%
Oil (Brent spot/bbl)	77.68	0.1%	16.2%	64.2%	59.9%
Natural Gas ($/mmBtu)	2.95	-0.1%	-0.1%	-3.8%	1.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.837%	-2.2	43.1	60.9	137.0
Canada 10-Yr	2.134%	-11.0	8.9	51.2	105.2
U.K. 10-Yr	1.263%	3.3	7.3	10.9	30.2
Germany 10-Yr	0.319%	-2.2	-10.8	-4.9	43.1

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.28%	-0.1%	-1.6%	-0.7%	-0.7%
U.S. Invest Grade Corp	4.00%	-0.5%	-3.2%	-1.1%	1.6%
U.S. High Yield Corp	6.39%	0.6%	0.4%	2.9%	16.9%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	95.3130	1.4%	3.5%	-0.7%	-1.0%
CAD/USD	0.7536	-2.3%	-5.3%	-1.7%	-1.8%
USD/CAD	1.3270	2.4%	5.6%	1.8%	1.9%
EUR/USD	1.1562	-1.1%	-3.7%	1.6%	4.5%
GBP/USD	1.3075	-1.7%	-3.2%	1.2%	-2.0%
AUD/USD	0.7348	-2.9%	-5.9%	-3.8%	-0.5%
USD/JPY	110.5200	1.6%	-1.9%	-1.6%	7.6%
EUR/JPY	127.7800	0.4%	-5.5%	0.0%	12.4%
EUR/GBP	0.8843	0.6%	-0.4%	0.5%	6.6%
EUR/CHF	1.1536	0.1%	-1.4%	5.7%	6.2%
USD/SGD	1.3685	2.3%	2.4%	-1.0%	1.1%
USD/CNY	6.6270	3.4%	1.8%	-2.5%	-0.3%
USD/MXN	19.7193	-1.0%	0.3%	10.5%	4.7%
USD/BRL	3.8608	3.7%	16.6%	17.7%	16.9%

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 8:35 pm GMT 6/28/18.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -5.3% return means the Canadian dollar fell 5.3% vs. the U.S. dollar year to date. USD/JPY 110.52 means 1 U.S. dollar will buy 110.52 yen. USD/JPY -1.9% return means the U.S. dollar fell 1.9% vs. the yen year to date.

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As of March 31, 2018

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Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	865	53.49	275	31.79
Hold [Sector Perform]	667	41.25	147	22.04
Sell [Underperform]	85	5.26	7	8.24

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