RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

In the trenches of the trade dispute

Jay Roberts, CFA – Hong Kong

"There is no instance of a nation benefitting from prolonged warfare." Sun Tzu, *The Art of War*

Chinese equities have been weak for several reasons, most prominently the U.S.-China trade dispute, although the tightening of domestic credit is an important factor. There is no easy fix to the trade dispute due to the nature of U.S. demands.

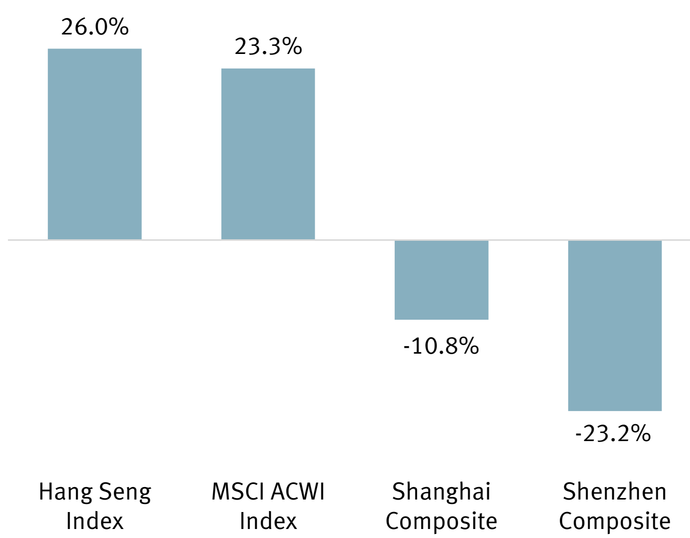
On the receiving end

It's been a rough ride for stocks in China and Hong Kong. Global equities have eked out a 1.2% gain in 2018, while Hong Kong's Hang Seng Index (dominated by Chinese companies) is down by 5.3%, the Shanghai Composite has fallen by 14.6%, and the Shenzhen Composite has declined by 18.4%. From the January peak, the latter two indexes are in bear market territory. Hong Kong is arguably correcting from a euphoric peak in January after a handsome 36% gain in 2017. The same cannot be said for China: Shanghai was only up by 6.6% while Shenzhen actually fell by 3.5%.

There are several reasons for the underperformance. China's process of deleveraging, or rather curtailing excessive growth in riskier areas of its credit markets, has been going on for a while. "Total social financing," a broad measure of credit growth in China, rose by 9.8% y/y in June, a sizeable number but actually its lowest level of growth on record (since 2003). Chinese bond yields have risen, with the rise in global corporate bond yields surely not helping. All in all, onshore borrowing conditions have tightened in 2018. To be clear, things aren't falling apart. Much of this is a deliberate result of policy as China finds answers to the common investor concern that its debt levels were growing too quickly. But the slowdown continues.

Additionally, and much more prominently for global investors, there is the escalating trade dispute between the U.S. and China. As the punchy rhetoric has translated into actual policy and real-money tariffs over the past few months, losses for Chinese equities have accelerated. Most of the decline has

Index performance from 2017–August 2, 2018



Source - RBC Wealth Management, Bloomberg; data coverage from 1/2017

Market pulse

Click here for authors' contact information.
Priced (in USD) as of 8/2/18 market close, EST (unless otherwise stated).
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Wealth Management

occurred since May. Some fiscal stimulus measures from the government in July provided a short-lived hiatus for stocks. Renminbi weakness has raised the mercury further.

The real issue

China ran a $375B trade surplus with the U.S. in 2017. It's easy to think that this is the focus of the U.S. It's also easy to think, therefore, that the answer is "simply" to reverse the trend, for example to get China to buy more oil and gas from the U.S. But the trade surplus is not the real issue. And the answers are far from simple. The crux of the problem is that the U.S. is demanding that China change its laws, regulations, and behaviours. That's a real challenge and why the dispute could easily evolve into a series of battles, or rather a trade war.

In our view, the trade surplus is largely a red herring, especially when one considers that a sizeable chunk of the goods coming from China are produced by multinational companies that effectively use China's scale for the assembly of products, often with key value-added components coming from other countries. Smartphones are perhaps the most obvious example.

The dispute properly began in March 2018 when the Office of the United States Trade Representative, headed by Robert Lighthizer, published a statement[1] outlining the administration's response—primarily tariffs and investment restrictions—to "China's unfair trade practices covered in the USTR Section 301[2] investigation of China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation."

The report concluded, inter alia, that China uses foreign ownership restrictions to pressure U.S. companies to transfer technology; that China restricts foreign technology licensing, resulting in terms that unfairly favour Chinese companies; that China systematically invests in U.S. companies to generate large-scale technology transfers; and that China conducts and supports cybercrime against U.S. companies.

Importantly, the short statement contains this stand-alone sentence: "The Chinese government's technology transfer and intellectual property policies are part of China's stated intention of seizing economic leadership in advanced technology as set forth in its industrial plans, such as 'Made in China 2025'." Effectively, the U.S. administration is accusing China of buying, coercing, or stealing its way to acquire U.S. technology in order to rapidly upgrade its economy. This is fueling nationalistic views that position China as a threat to U.S. hegemony, or "seizing economic leadership."

Amidst the trade dispute, Washington is pushing back against this "Made in China 2025" plan

10 categories by industry	Examples
Information technology	Integrated circuits & special equipment Information and communication equipment Operating systems and software
High-end machine tools and robots	High-speed, efficient machine tools Robots (multiple industries)
Advanced rail transportation equipment	Build the world's leading, modern rail transit industry system
Energy conservation and new energy vehicles	Technology for advanced combustion engines Support the development of electric vehicles
Biological pharmaceutical and high-performance medical apparatus and instruments	Develop new products in chemical medicine, biotech drugs, and traditional Chinese medicine Develop high-performance medical devices such as imaging equipment, biological 3D printing
Aerospace equipment	Aviation equipment; form independent, complete aviation industry chain Space equipment
Marine engineering equipment and shipping technology	Develop deep-sea exploration
Electric power equipment	Promote the development of new energy and renewable energy equipment, smart grid transmission and transformation equipment, and advanced energy storage
Agricultural machinery and equipment	Develop advanced agricultural machinery
New materials	High-performance structural materials

Source - China's State Council, RBC Wealth Management

1 https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/march/president-trump-announces-strong
2 Section 301 is a key enforcement tool that allows the United States to address a wide variety of unfair acts, policies, and practices of U.S. trading partners.

Made in China 2025

In fact, Made in China 2025 (MIC2025) is not a new plan. It was introduced by the Chinese government in 2015. Other countries such as Germany and Japan have similar national plans. The priorities of the plan include: promote innovation; improve the quality of goods and services; and promote renewable energy and environmentally friendly industry. In short, to move up the value chain and to become more self-sufficient. There are 10 categories in focus (see table on previous page). The plan comes with key performance indicators such as target ratios for research versus revenues, patents versus revenues, broadband penetration, CO2 emissions, water usage, and so on.

A new world order

MIC2025 has done more than just ruffle a few feathers in Washington. In an interview with Fox News in March, Lighthizer called MIC2025 a "very, very serious challenge, not just to us, but to Europe, Japan and the global trading system."

Also in March, Peter Navarro, a big China bear on trade, advisor to the president, and author of the 2011 book *Death by China: Confronting the Dragon*, stated on Bloomberg Television that China "brazenly has released this China 2025 plan that basically told the rest of the world, 'We're going to dominate every single emerging industry of the future, and therefore your economies aren't going to have a future'."

Trump's own statement of June 15 announcing a possible tariff of 10% on $200B of Chinese goods stated right off the bat that "these tariffs are being imposed to encourage China to change the unfair trade practices … with respect to technology and innovation." Indeed, the majority of the products captured under the first round of tariffs are associated with the MIC2025 segments.

In response, China has said that criticisms from the U.S. and EU are hostile to the initiative as it moves China to become a direct, value-add competitor. Additionally, there is a desire in China to become more self-reliant. The recent story of ZTE Corp. (0763 HK) is an excellent example as to why.

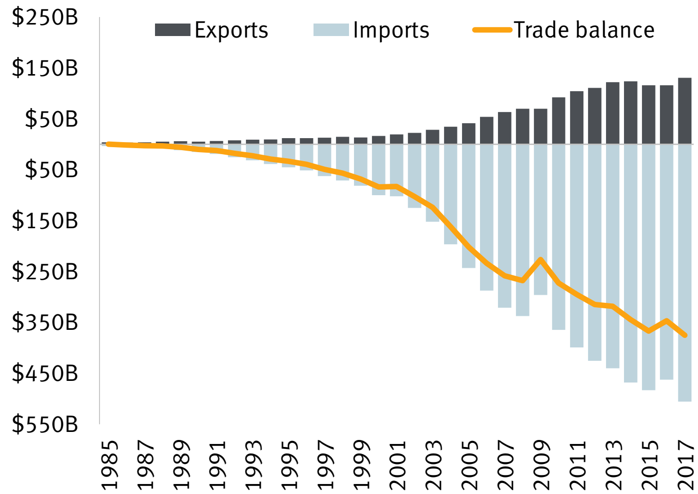
A real threat?

MIC2025 sounds impressive, comprehensive, and even commercially threatening, depending on one's point of view. The reality may be somewhat different, however. MIC2025 was conceived at the top. Top-down initiatives have come and gone with varying degrees of success or failure during China's modern history. Implementation is via local governments and then via companies, who would apply for funds.

The National Manufacturing Advisory Committee, which advises the Chinese government, published a report outlining

The U.S. trade deficit with China is not the real issue driving the dispute

U.S. trade with China



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

problems with the implementation of the plan. The report found that: many local governments simply rebranded existing policies to show adherence; development targets are set too low; local government policies are not market-oriented as they are reluctant to take risks; project approval is lengthy; and there is a lack of coordination among local governments with many choosing similar industries to support, perhaps leading to overcapacity.

Separately, the *South China Morning Post* reported that one city gave 10% of its MIC2025 budget to a company to set up a new "smart" liquid milk tea factory[3]—hardly global economic leadership.

Going forward

The base case is that the U.S. will press on with further measures against China sometime soon, even though one might question the actual threat posed by MIC2025. That these developments come as the U.S. approaches the midterm elections in November is noteworthy. They are also in line with a U.S. administration that is increasingly turning away from the rest of the world under the auspices of getting a better deal.

The key unknown is if China will continue to retaliate in round two. If so, the trade war could take shape. Thus far, there has been no sign that China will back down. Our view is that it will retaliate somehow. In the meantime, we believe China and Hong Kong equities will remain under pressure, although we suspect that much of the damage has already been done to stock prices.

[3] Is Beijing going back to the future with its much-hyped 'Made in China 2025' plan? *South China Morning Post*, July 10, 2018.

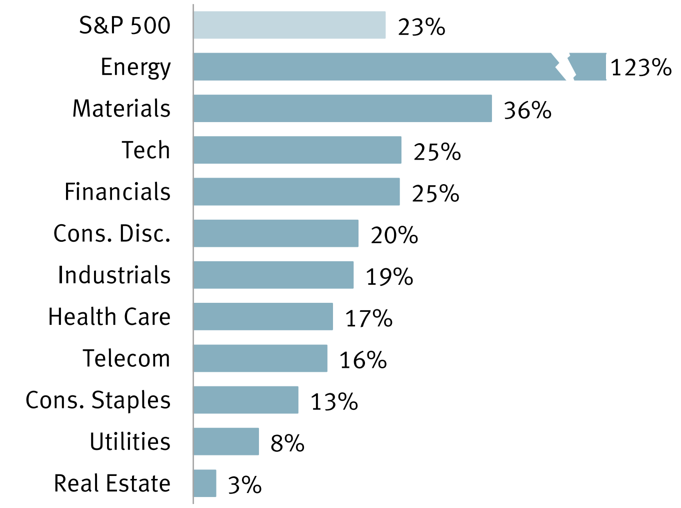
United States

Ben Graham, CFA – Minneapolis

- Investor concerns about the ongoing developments in the trade saga between the U.S. and China, as well as fears of inflation and rising input costs, have presented a **muted backdrop for U.S. equity markets** in recent days. Stocks have treaded water despite successful earnings data from the week as the S&P 500 inched 0.3% higher after gaining 3.6% in July. **Defensively oriented Real Estate and Health Care stocks have held up better than peers** as Health Care reported stronger-than-anticipated quarterly results and Real Estate delivered better-than-hoped-for distributions and cash flows.
- **Q2 earnings season is nearing completion, having demonstrated better-than-expected revenue and EPS growth so far.** With 79% of the S&P 500 market cap having reported, revenue growth expectations have surpassed 9.0% and current EPS growth estimates of 23.3% are well ahead of pre-earnings-season expectations of 20.7%, per Thomson Reuters I/B/E/S. The strongest growth trends are coming from economically sensitive sectors, meaning those most levered to Q2 GDP of 4.1%. However, the companies beating expectations most consistently are Health Care, Utilities, and Technology stocks (with the notable exceptions of Facebook, Intel, and Twitter).
- **Apple,** the world's largest publicly traded company, **surpassed the $1T market cap threshold** in intraday trading on Thursday, August 2 after reporting strong results on the back of its services and other business segment results in addition to capturing market share in China. The second- and third-largest companies by market cap are Google parent Alphabet and Amazon.com. Alphabet delivered its unprecedented 34th straight quarter of 23%+ y/y revenue growth and Amazon reported record margins and operating income.
- The U.S. 10-year Treasury rallied as an entirely uneventful Fed meeting came and went without a rate hike, as expected. Now, **interest is shifting to the Fed's September meeting** and the market's near-certain expectation that it will announce the third hike of 2018 at that time. Our view is that **the economy will have to continue at 3.0%+ growth through year end in order for the Fed to hike rates at both the September and December meetings**, which would meet the central bank's four-hike target for 2018. From our perspective, this is not necessarily a given. Recently, the 10-year yield has risen from its short-term bottom of 2.81% to flirt with 3.00% on the day of the Fed meeting.

Q2 earnings season delivering robust earnings

S&P 500 earnings growth, by sector



Source - RBC Wealth Management, Thomson Reuters I/B/E/S; Energy bar truncated due to extreme length; data through 8/2/18

- **U.S. housing readings continued their trend of weakening data**, with pending home sales down 4.0% y/y. This comes on the heels of housing starts, new-home sales, and existing-home sales all missing expectations in recent weeks. The ISM Manufacturing Purchasing Managers' Index decelerated from 60.2 in June to 58.1 in July but remains comfortably in expansionary territory.

Canada

Diana Di Luca – Toronto

- **Canadian GDP in May beat estimates** with growth of 0.5% m/m (0.3% expected) and 2.6% y/y (2.3% expected). The growth was the result of **gains in 19 of 20 industries**, making it the **broadest expansion since 2004.** The release follows a string of positive surprises for Canadian economic data. The employment report, CPI, housing starts, retail sales, manufacturing sales, wholesale trade, and now GDP all came in ahead of expectations, helping Government of Canada yields move higher in the past month.
- **Canadian corporates underperformed** after a large snap back in U.S. investment-grade spreads. Those spreads peaked in the U.S. at the end of June, while Canadian corporate spreads were resilient that month. Performance in July was the opposite, and spreads in the U.S. are now actually tighter than in Canada. As central banks slowly remove monetary stimulus and yields on government bonds lift (which we expect to continue), we

think this will likely put **pressure on credit** as it appears unlikely corporate bonds spreads can grind much tighter from these levels. Overall, this **fits into our narrative of upgrading credit quality** within portfolios as well as buying discounted bonds for improved after-tax yield and statement shock protection.

- **The TSX Preferred Share Index ended July up 0.7%**, driven by higher rates across the curve, with the 5-year GoC yield up 18 basis points in the month. A lack of new issue supply was also supportive of the secondary market, with the last preferred share offering occurring nearly two months ago. With the Big Six Banks now in blackout until they report Q3 earnings in late August, we expect this **lull in new issue activity** to continue, although it could provide a window for non-financial issuers to come to market. The positive drivers were partly offset by wider credit spreads last month, as noted above. Overall, we **remain Overweight preferred shares**, but recommend a more defensive mix, shifting into higher reset spread and perpetual issues, which we believe provide stable income and downside protection.

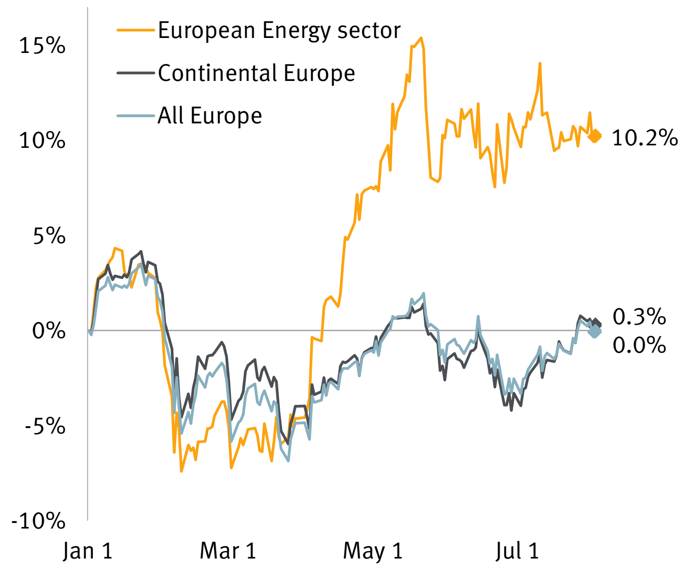
Europe

Thomas McGarrity, CFA & Alastair Whitfield – London

- **The Bank of England delivered on its much anticipated interest rate hike**, moving the deposit rate to 0.75% from 0.5%. The surprise came from the unanimous 9-0 vote vs. the consensus expectation of a 7-2 split, and a slightly more hawkish tone of ongoing monetary tightening over the BoE's forecast period to bring inflation back towards its 2% target. However, BoE Governor Mark Carney also noted that **Brexit is expected to have an impact on monetary policy going forward**. RBC Capital Markets expects two more rate hikes in 2019.
- **Europe's ongoing results season is confirming earlier trends**. With close to two-thirds of STOXX Europe 600 companies having reported, **Q2 earnings have grown a solid 12% y/y** so far, while revenues are up a pleasing 8% y/y, both slightly ahead of expectations. Much of this good performance, however, is thanks to the Energy sector. Stripping the sector out, EPS growth would not be much more than mid-single-digits.

European Energy sector earnings propel the sector into a leadership position

Year-to-date performance



Source - RBC Wealth Management, Bloomberg; indexes used are MSCI Europe, MSCI Europe Ex-UK, and MSCI Europe Energy; data as of 2:00 pm GMT 8/2/18

- **Notable results** include oil major **BP, which saw Q2 net income jump to $2.8B** compared to $684M a year earlier, demonstrating the **impact of higher oil prices**. To reflect management's confidence in the company's outlook, it **increased the quarterly dividend** for the first time in four years.
- In the banking sector, both **BNP**, the French bank, and **ING** in the Netherlands, reported **better-than-consensus earnings** thanks to robust loan growth and lower impairment charges than expected.
- **London Stock Exchange's** earnings per share increased 25% y/y in the first half of 2018, 5% ahead of consensus estimates, driven by growth from its Information Services unit (16% y/y) and LCH, its clearing division, (14% y/y).
- Semiconductor manufacturer **Infineon Technologies beat** both consensus expectations for sales and margins in its Q3 FY2018 results. The company also **increased its full year guidance** to reflect the stronger U.S. dollar relative to the euro than when it set its outlook.

MARKET SCORECARD

Data as of August 2, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,827.22	0.4%	5.7%	14.1%	31.1%
Dow Industrials (DJIA)	25,326.16	-0.4%	2.5%	15.0%	38.3%
NASDAQ	7,802.69	1.7%	13.0%	22.6%	51.9%
Russell 2000	1,682.10	0.7%	9.5%	19.1%	39.9%
S&P/TSX Comp	16,409.16	-0.2%	1.2%	7.5%	13.3%
FTSE All-Share	4,165.55	-2.1%	-1.3%	2.5%	15.4%
STOXX Europe 600	386.64	-1.3%	-0.7%	2.1%	15.3%
EURO STOXX 50	3,469.21	-1.6%	-1.0%	0.3%	19.3%
Hang Seng	27,714.56	-3.0%	-7.4%	0.4%	25.2%
Shanghai Comp	2,768.02	-3.8%	-16.3%	-15.7%	-6.8%
Nikkei 225	22,512.53	-0.2%	-1.1%	12.1%	37.3%
India Sensex	37,165.16	-1.2%	9.1%	14.4%	32.8%
Singapore Straits Times	3,286.32	-1.0%	-3.4%	-1.9%	15.0%
Brazil Ibovespa	79,636.69	0.5%	4.2%	18.6%	41.8%
Mexican Bolsa IPC	49,056.04	-1.3%	-0.6%	-4.2%	5.4%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,207.85	-1.3%	-7.3%	-4.6%	-11.4%
Silver (spot $/oz)	15.31	-1.3%	-9.6%	-7.7%	-25.8%
Copper ($/metric ton)	6,147.00	-2.1%	-14.7%	-2.8%	25.9%
Oil (WTI spot/bbl)	68.96	0.3%	14.1%	39.1%	74.5%
Oil (Brent spot/bbl)	73.37	-1.2%	9.7%	40.1%	75.5%
Natural Gas ($/mmBtu)	2.82	1.3%	-4.5%	0.3%	3.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.984%	2.4	57.9	71.3	142.8
Canada 10-Yr	2.365%	5.5	32.0	42.5	128.7
U.K. 10-Yr	1.377%	4.7	18.7	14.1	56.9
Germany 10-Yr	0.460%	1.7	3.3	-2.6	49.6

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.39%	-0.2%	-1.8%	-1.2%	-1.1%
U.S. Invest Grade Corp	4.02%	-0.2%	-2.7%	-1.2%	1.3%
U.S. High Yield Corp	6.30%	0.0%	1.3%	2.5%	14.1%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	95.1730	0.7%	3.3%	2.5%	0.1%
CAD/USD	0.7678	-0.1%	-3.5%	-3.5%	0.7%
USD/CAD	1.3025	0.1%	3.6%	3.6%	-0.6%
EUR/USD	1.1586	-0.9%	-3.5%	-2.3%	3.2%
GBP/USD	1.3018	-0.8%	-3.7%	-1.6%	-2.5%
AUD/USD	0.7364	-0.8%	-5.7%	-7.6%	-3.2%
USD/JPY	111.6600	-0.2%	-0.9%	0.8%	10.7%
EUR/JPY	129.3600	-1.1%	-4.4%	-1.5%	14.2%
EUR/GBP	0.8900	-0.1%	0.2%	-0.7%	5.9%
EUR/CHF	1.1533	-0.4%	-1.5%	0.2%	6.6%
USD/SGD	1.3690	0.6%	2.5%	0.7%	2.2%
USD/CNY	6.8428	0.4%	5.2%	1.8%	3.3%
USD/MXN	18.6612	0.1%	-5.1%	4.7%	-1.4%
USD/BRL	3.7548	-0.1%	13.4%	20.6%	15.2%

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 8/2/18.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -3.5% return means the Canadian dollar fell 3.5% vs. the U.S. dollar year to date. USD/JPY 111.66 means 1 U.S. dollar will buy 111.66 yen. USD/JPY -0.9% return means the U.S. dollar fell 0.9% vs. the yen year to date.

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As of June 30, 2018

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Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	854	53.61	262	30.68
Hold [Sector Perform]	665	41.75	142	21.35
Sell [Underperform]	74	4.65	6	8.11

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