August 30, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Better with age

Kelly Bogdanova – San Francisco

Strong consumer spending and corporate earnings growth underpin the current bull market. We see plenty of reasons for consumers to remain confident, while earnings growth appears likely to continue at a slower but healthy pace going forward. We look toward 2019 with a constructive view on U.S. equities.

With leading indicators signaling continued economic growth and corporate profits likely to rise at an average or above-average pace in 2019, it's no wonder the S&P 500 and other major U.S. indexes have climbed to all-time highs recently.

Consumers in control

In some respects the U.S. economy is getting better with age.

After shooting up by 4.2% in Q2, the highest in almost four years, RBC Capital Markets anticipates above-average GDP growth for the balance of this year and forecasts it will expand by 3.0% in 2019.

Business capital spending has gained momentum. It surged at a 10% annual rate during the first half of 2018, the strongest back-to-back quarters in six years. This is notable because it was stagnant in 2015 and 2016.

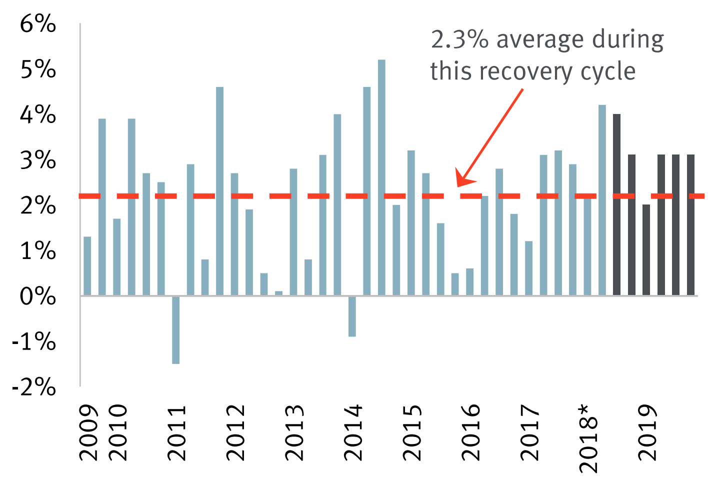
Consumer spending holds the key to future expansion, as it represents roughly 70% of total domestic economic activity. RBC Global Asset Management believes consumer spending has the capacity to remain buoyant. Strong job growth, ultralow unemployment, higher wages, and tax cuts are the primary reasons spending should stay elevated, with relatively tame inflation playing a supporting role. Additionally, wealth gains generated from the equity market and higher home prices should undergird the mid- to higher-income household segments.

Earnings aging gracefully

Corporate profits—the other major component of equity market performance over the long term—should remain in growth mode as well, albeit at a slower but healthy pace.

U.S. economy stable and firming

GDP growth quarter-over-quarter annualized rate (Actual: Light blue; Estimates: Dark gray)



*Q2 2018 GDP growth of 4.2% is a preliminary figure subject to revision.
Source - RBC Wealth Management, Bloomberg, RBC Capital Markets (Q3 2018–Q4 2019 estimates). Data period is Q3 2009 through Q4 2019

Market pulse

Click here for authors' contact information.
Priced (in USD) as of 8/30/18 market close, EST (unless otherwise stated).
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Profit data from the GDP report, compiled from IRS tax filings, jumped 7.7% y/y for non-financial firms in Q2, the fastest pace in almost four years. This data tends to be a good signal of overall economic momentum, as well as prospects for equities and other risky assets, because profits reported to tax authorities usually dip when economic momentum begins to slow. Trends can change quickly, but the Q2 data confirms what our other indicators are saying: the expansion and bull market have further to go.

S&P 500 earnings data, which differs because it represents the largest companies rather than all companies and is governed by distinct accounting rules, is signaling a meaningful slowdown in profit growth in 2019.

Should this be a concern? If lower earnings growth rates were mainly driven by economic or outside factors, it would be an unwelcome development.

However, in this case, much of the phenomenon is just math.

The S&P 500 earnings growth rate likely peaked in Q1 or Q2, depending on the calculation methodology (there are subtle differences between even the best data providers). Growth surged 26.6% y/y in Q1 followed by 24.8% in Q2, according to Thomson Reuters I/B/E/S. The consensus forecast dips slightly for Q3 and Q4, but remains above 20%.

It's important to bear in mind that roughly 8% of the growth rate in 2018 represents the tax cut boost, as shown in light blue in the bottom chart. In 2019, the tax cut boost will drop out of the data because growth is calculated on a year-over-year basis. Of course, companies will continue to benefit from lower tax rates.

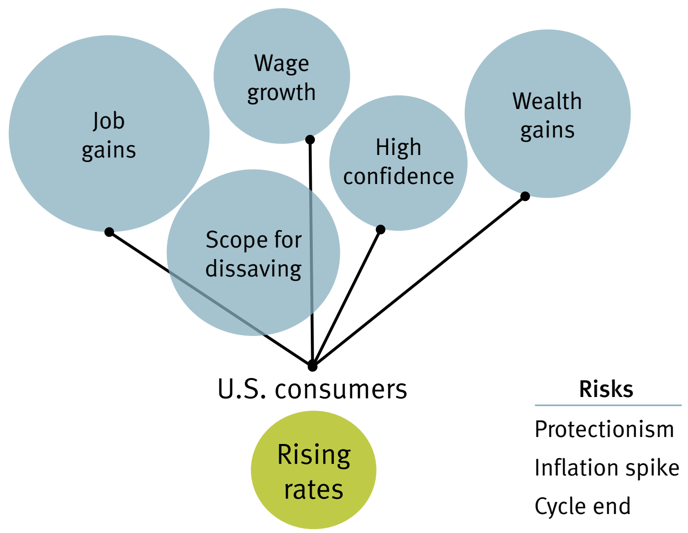
Furthermore, earnings growth will be tougher to come by next year following such a strong 2018. (The year-over-year calculation methods play a role again—the data is always competing against the same period in the previous year.)

We believe S&P 500 earnings will rise in the high single-digit to low double-digit range in 2019—an average or above-average rate—depending on the strength of the economy. A meaningful deceleration in growth, yes, but to a respectable level. It's actually normal for earnings growth rates to ebb and flow significantly throughout an expansion cycle.

Stay invested

With the economy getting better with age and corporate earnings aging gracefully, we think U.S. equities deserve the benefit of the doubt. Respectable earnings growth combined with above-trend economic momentum should support higher U.S. stock prices over the next year, at least. We remain constructive on U.S. equities and would hold a slightly Overweight position in equities overall.

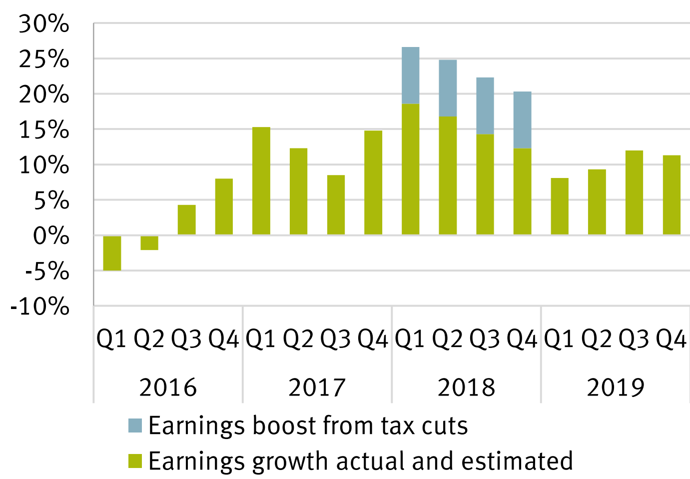
U.S. consumers can remain buoyant



Source - RBC Global Asset Management, RBC Wealth Management

U.S. earnings growth has likely peaked

S&P 500 earnings growth y/y (Q3 2018 and onward represents the consensus forecast)



Source - RBC Wealth Management, Thomson Reuters I/B/E/S; data as of 8/29/18

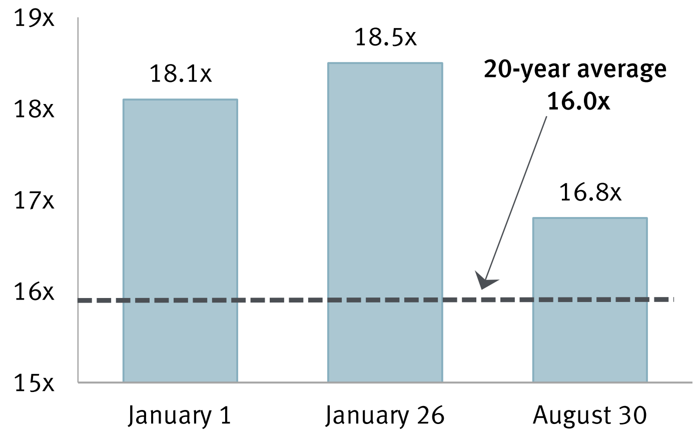
United States

Ben Graham, CFA – Minneapolis

- **Most major U.S. equity markets have been setting all-time highs in recent days** for the first time since late January with the Dow Jones Industrial Average being the most noticeable participant not quite at record levels. The S&P 500 has delivered an 8.5% gain in 2018, while the Russell 2000 is up 12.8% and the NASDAQ has climbed 17.2%. **Market leadership has also broadened in recent months**, as the big six of Facebook, Amazon, Apple, Netflix, Google (Alphabet Inc.), and Microsoft were, on average, 32.1% higher during the first six months of the year and accounted for more than 90% of the S&P 500's gains. Since June 30, the six are up just 6.7% on average and only responsible for 24% of the S&P 500 appreciation. Technology is the second-best performing sector in the quarter, with Health Care holding the top spot.
- January saw the S&P 500 forward P/E max out at 18.5x next-twelve-month (NTM) EPS estimates after starting the year at 18.1x. After the closing bell on Wednesday, August 29, the S&P 500 P/E ratio was 16.8x, much closer to the 20-year average of 16.0x. **Economic momentum has also persisted**, with 4.2% Q2 GDP growth materializing, a slightly higher level than previously reported. **2019 economic strength also appears poised to maintain momentum**, as seen in RBC Capital Markets, LLC Chief US Economist Tom Porcelli's GDP forecasts for H2 2018 and the full year of 2019 that are higher today than in January.
- **Trade headlines also helped equity markets hit all-time highs**, as the U.S. announced a preliminary trade agreement with Mexico and is working with Canada to include it in that deal or craft a separate arrangement.

S&P 500 valuations are much more reasonable today

Next twelve months P/E ratios in 2018



Note: January 26 was the previous market high until new records were hit this month
Source - RBC Wealth Management, FactSet; data through 8/30/18

Canada

Arete Zafiriou & Richard Tan – Toronto

- **The Canadian banks reported Q3 2018 results with the majority beating consensus expectations on the bottom line**. There were no surprises on the mortgages and personal loan front as growth continues to decelerate within Canada due to stricter mortgage rules and rising interest rates. **RBC Capital Markets believes revenue growth will slow**, but the banks should still be able to turn a profit by controlling expenses. International segments (particularly the U.S.) generally have a positive impact on earnings driven by lower taxes and growth in consumer spending. Contributions from capital markets were mixed among trading and investment banking activities. Capital positions were solid among the banks in RBC Capital Markets' coverage. Two of the big six banks increased their dividend as forecasted. Credit provisions were mixed, but remained relatively stable when viewed as a group. Overall results were generally healthy, but **RBC Capital Markets expects earnings to moderate going into 2019**. We reiterate our preference to own banks with greater international exposure.
- **The U.S. and Mexico have, at last, reached a trade deal after weeks of negotiations**. The agreement revised key aspects of NAFTA including issues regarding automobiles, agriculture, and labor laws. Notably, the agreement stipulates that 75% of auto parts be produced within North America compared to 62.5% previously. However, before anything can be finalized, **the deal must be approved by Congress, and any proposals involving Canada must be agreed upon**. Canada rejoined the negotiations on August 28, with U.S. President Donald Trump giving until August 31 to reach a deal. **One of the subjects up for discussion is Chapter 19**, a controversial dispute resolution provision that the U.S. and Mexico have left out of the current trade draft. Canadian officials suggested that access to Canada's protected dairy market would be compromised to save Chapter 19. RBC Global Asset Management assigns a 60% probability to a new NATFA deal: 45% probability of a compromise and 15% probability of the U.S. getting its way with additional protectionism measures.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- Much excitement was generated in the U.K. when **the EU's chief negotiator, Michel Barnier, commented that the EU was ready to offer the U.K. a partnership "like**

there has never been before with any third country." Currency markets reacted positively, reading into this a lower probability of a no-deal outcome which, according to RBC Global Asset Management's chief economist Eric Lascelles, would result in an 8% hit to GDP over the next several years. **The pound jumped to a three-week high of 1.30 against the dollar,** while Gilts sold off as markets interpreted the positive comment as increasing the odds that the next rate hike would happen earlier than August 2019.

- The EU may well be willing to come to an agreement on aerospace, security, and foreign policy, but its position regarding key issues such as customs arrangements, regulatory alignment, and market access does not seem to have changed. As such, the key issue for the U.K. remains that it needs to agree on a blueprint for its future relationship with the EU and pass this agreement through Parliament. **Prime Minister Theresa May's white paper proposal remains controversial,** though talks over the summer about stockpiling food and medicine in case no deal is reached and the U.K. exits the EU without a transition period highlight the issues at stake. The return of Parliament on September 5 may provide clues as to how the situation will unfold.

- Meanwhile, **euro area economic sentiment fell slightly to a one-year low, but remains at a high level compared to the long-term historical average**. Consumer confidence fell—particularly in France, Spain, and Italy—though business sentiment was mostly unchanged.

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **The MSCI Asia Pacific Index regained some ground** over the week but remains underwater for the year, down 4.2%. The underperformance of Chinese equities has been a key reason for the weakness.

- **China's largest banks reported reasonably stable earnings for Q2**. Earnings rose by approximately 5% y/y. Capital levels—and, importantly, asset quality—remain steady, although non-performing loan data has deteriorated somewhat across the sector as a whole. **The performance of the large banks is in contrast to the pressure that some smaller lenders are experiencing** as China continues to make progress on financial deleveraging, or rather reducing riskier kinds of lending.

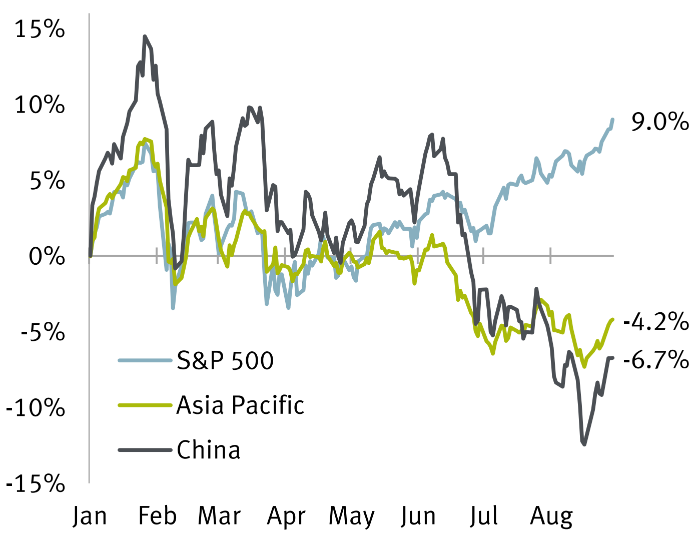
- **The Hong Kong Monetary Authority has been intervening again to support the Hong Kong dollar,** which is tightly pegged to the U.S. dollar. Thus far in August, the de facto central bank has purchased HK$25.3B ($3.2B). August is the first month since May in which the bank has spent money to defend the currency.

- **Short-term interest rates rose in Hong Kong**, mostly due to interest rate increases in the U.S. The three-month Hong Kong Interbank Offered Rate (HIBOR) has risen to 1.94% from a low of 1.02% early in the year.

- Despite rising borrowing costs, the Hong Kong housing market has continued to register price increases in 2018. **Prime real estate prices have risen by 160% over the past decade and are around 25% higher than prime real estate prices in central London,** for example. The rise in house prices has occurred in spite of various failed attempts by the authorities to rein in the market, with policies being overwhelmed by low lending rates, limited supply, and high demand.

Asian equities bouncing on the rebound in China, but still lag U.S. peers

Performance year to date



Source - RBC Wealth Management, Bloomberg; data through 8/29/18

MARKET SCORECARD

Data as of August 30, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,901.13	3.0%	8.5%	18.0%	33.3%
Dow Industrials (DJIA)	25,986.92	2.2%	5.1%	18.7%	40.8%
NASDAQ	8,088.36	5.4%	17.2%	27.0%	54.9%
Russell 2000	1,732.35	3.7%	12.8%	24.5%	39.0%
S&P/TSX Comp	16,371.55	-0.4%	1.0%	8.2%	11.5%
FTSE All-Share	4,143.65	-2.6%	-1.9%	2.6%	11.4%
STOXX Europe 600	385.36	-1.6%	-1.0%	3.9%	11.8%
EURO STOXX 50	3,430.99	-2.7%	-2.1%	0.8%	13.2%
Hang Seng	28,164.05	-1.5%	-5.9%	0.2%	22.4%
Shanghai Comp	2,737.74	-4.8%	-17.2%	-18.6%	-11.0%
Nikkei 225	22,869.50	1.4%	0.5%	17.2%	36.7%
India Sensex	38,690.10	2.9%	13.6%	22.3%	36.5%
Singapore Straits Times	3,225.72	-2.8%	-5.2%	-1.2%	14.0%
Brazil Ibovespa	76,404.09	-3.6%	0.0%	7.8%	30.4%
Mexican Bolsa IPC	49,653.14	-0.1%	0.6%	-3.0%	4.2%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,200.06	-2.0%	-7.9%	-8.3%	-8.5%
Silver (spot $/oz)	14.56	-6.2%	-14.1%	-16.5%	-21.7%
Copper ($/metric ton)	6,073.00	-3.3%	-15.7%	-9.9%	32.2%
Oil (WTI spot/bbl)	70.25	2.2%	16.3%	52.9%	51.6%
Oil (Brent spot/bbl)	77.59	4.5%	16.0%	52.6%	60.4%
Natural Gas ($/mmBtu)	2.89	3.8%	-2.2%	-1.8%	2.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.859%	-10.1	45.3	72.8	129.2
Canada 10-Yr	2.276%	-3.4	23.1	44.1	125.5
U.K. 10-Yr	1.455%	12.5	26.5	42.5	81.7
Germany 10-Yr	0.346%	-9.7	-8.1	-1.3	43.7

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.32%	0.5%	-1.1%	-1.0%	-0.7%
U.S. Invest Grade Corp	3.96%	0.4%	-2.0%	-0.9%	1.0%
U.S. High Yield Corp	6.24%	0.8%	2.1%	3.6%	12.3%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	94.6790	0.1%	2.8%	1.9%	-1.4%
CAD/USD	0.7704	0.2%	-3.2%	-2.8%	0.9%
USD/CAD	1.2979	-0.2%	3.2%	2.8%	-0.9%
EUR/USD	1.1672	-0.2%	-2.8%	-1.8%	4.7%
GBP/USD	1.3014	-0.8%	-3.7%	0.7%	-0.5%
AUD/USD	0.7264	-2.2%	-7.0%	-8.1%	-3.3%
USD/JPY	110.9800	-0.8%	-1.5%	0.7%	7.8%
EUR/JPY	129.5300	-1.0%	-4.3%	-1.1%	12.9%
EUR/GBP	0.8968	0.7%	1.0%	-2.5%	5.3%
EUR/CHF	1.1313	-2.3%	-3.3%	-1.2%	3.2%
USD/SGD	1.3673	0.4%	2.3%	0.7%	0.2%
USD/CNY	6.8445	0.4%	5.2%	3.8%	2.5%
USD/MXN	19.1355	2.6%	-2.7%	8.0%	1.7%
USD/BRL	4.1499	10.5%	25.3%	31.3%	28.1%

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 8:35 pm GMT 8/30/18.

Examples of how to interpret currency data: CAD/USD 0.77 means 1 Canadian dollar will buy 0.77 U.S. dollar. CAD/USD -3.2% return means the Canadian dollar fell 3.2% vs. the U.S. dollar year to date. USD/JPY 110.98 means 1 U.S. dollar will buy 110.98 yen. USD/JPY -1.5% return means the U.S. dollar fell 1.5% 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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