

Global Insight

Weekly



A closer look

Three sore spots for equities

Kelly Bogdanova – San Francisco; Frédérique Carrier – London

With equity markets hit by a fresh surge of volatility, vigilance is the watchword for the late-cycle period. We look at several inflamed pressure points and the appropriate posture to take toward equities as the market works through these challenges.

It's par for the course that volatility can jump and then swing in both directions on a moment's notice in the midst of a global equity correction.

On Monday, equities rallied on initial optimism about U.S. and China trade progress at the G20 meeting, only to see the major U.S. indexes sell off sharply in subsequent sessions and lead the rest of the world lower as fears about the U.S.-China relationship came back to the fore.

While there have been a number of issues fueling the correction since early October, concerns about U.S.-China tensions have been toward the top of the list lately. Equity markets, especially in the U.S., have also been preoccupied with the further flattening (and partial inversion) of the Treasury yield curve. Ongoing Brexit uncertainties have also been a factor.

Underpinning each of these issues is the potential impact on the U.S. and global economies and related recession risks. While our key forward-looking indicators continue to flash green, it is late enough in the business cycle for these risks to warrant investors' attention.

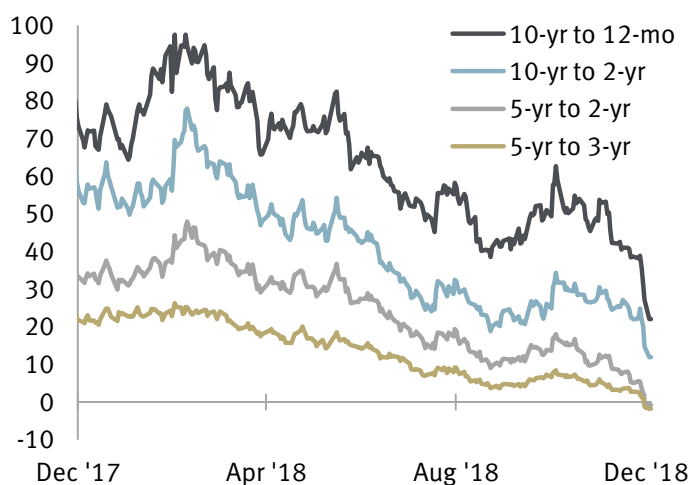
This trade war is about more than trade

Headlines about the U.S.-China trade discussions shifted from positive, to conflicting, to negative, and then back to positive, and then once again back to negative—all in less than a week.

From our perspective, the official government statements and press reports should be taken with a grain of salt. The U.S. and China may very well cobble together a trade pact within

Yield curve limbo: How low can it go?

Yield difference between various spots on the U.S. Treasury yield curve in basis points (bps)



Source - RBC Wealth Management, Bloomberg; daily data through 12/5/18

Market pulse

- 4 S&P 500 valuations have rapidly declined
- 4 Alberta's oil production cut to dent Canada's GDP
- 5 U.K. economic activity is faltering
- 5 No easy fix to strained U.S.-China relations

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Priced (in USD) as of 12/6/18 market close, EST (unless otherwise stated).

For important disclosures and required non-U.S. analyst disclosures, see [page 7](#)



Wealth
Management

the 90-day window, but other issues could complicate the relationship over the mid- and longer term.

Underscoring this point are multiple press reports of the arrest and request for extradition of a senior executive of China-based Huawei, the world's largest telecommunications equipment firm, for allegedly violating U.S. sanctions against Iran. The U.S. is confronting China on a number of levels, and that is unlikely to end in 90 days, in our view. For more on this topic, see the analysis on [page 5](#) and our recent article, [China and U.S. relations are heading into uncharted territory](#).

The yield sign

When the Treasury yield curve inverts (when short-term yields are higher than long-term yields) we have two rules of thumb.

First, don't react too quickly. Portions of the Treasury yield curve inverted in recent sessions—5-year to 3-year and 5-year to 2-year—spooking equity markets. However, this does not mean the other, more commonly monitored parts of the curve—10-year to 2-year and 10-year to 12-month—will fall like dominoes.

We give greater weight to the aforementioned longer curves. They are still slightly positive by 13 and 20 basis points, respectively, but are admittedly close to inversion. Yield curves can hover close to inversion for a long time, and did so for years in the 1990s.

Furthermore, inversions typically occur quite far in advance of a forthcoming recession rather than striking right before an economic contraction occurs. Since the 1950s, it took 14 months after inversion, on average, for a U.S. recession to begin. The S&P 500 peaked almost six months after inversion, on average, although there was a lot of variability around the mean (see tables).

Our second rule of thumb is, once the 10-year to 12-month yield curve does invert (it inevitably will), don't try to rationalize it away by saying "this time it's different." While there are usually a number of reasons for the situation to be "different" in each business cycle, in the end recessions normally follow yield curve inversions. In our view, it's prudent to take the yield curve's track record seriously.

Backing off the Brexit cliff edge?

Two Brexit risks could have a substantial negative impact on financial assets: a no-deal, cliff-edge Brexit and a far-left Labour government. Two recent political developments suggest that the probability of the former has receded somewhat.

First, Parliament reasserted itself by voting in favor of an amendment that would give it more say on the plan of action if Prime Minister Theresa May's Withdrawal Bill, due to be voted on in the House of Commons on December 11, were to

U.S. Treasury yield curve track record

10-year to 12-month yield curve

U.S. economy: The yield curve has typically inverted before a recession begins

| Month yield curve inverts | Month recession begins | Interval (in months) |
|---------------------------|------------------------|----------------------|
| Dec '56 | Sep '57 | 9 |
| Sep '59 | May '60 | 8 |
| Apr '68 | Jan '70 | 21 |
| Mar '73 | Dec '73 | 9 |
| Sep '78 | Jan '80 | 16 |
| Sep '80 | Jul '81 | 10 |
| Feb '89 | Jul '90 | 17 |
| Apr '00 | Mar '01 | 11 |
| Jan '06 | Dec '07 | 23 |
| Average | | 14 months |
| Median | | 11 months |

Stock market: The S&P 500 has typically peaked about six months after inversion, on average, but the timing has varied

| Month yield curve inverts | Month S&P 500 peaks | Interval (in months) |
|---------------------------|---------------------|----------------------|
| Dec '56 | Jul '57 | 7 |
| Sep '59 | Aug '59 | -1 |
| Apr '68 | Dec '68 | 8 |
| Mar '73 | Jan '73 | -2 |
| Sep '78 | Sep '78 | 0 |
| Sep '80 | Dec '80 | 3 |
| Feb '89 | Jul '90 | 17 |
| Apr '00 | Mar '00 | -1 |
| Jan '06 | Oct '07 | 21 |
| Average | | 5.8 months |
| Median | | 3 months |

Source - RBC Wealth Management, Bloomberg, U.S. Federal Reserve, National Bureau of Economic Research

fail to pass. Rejection of the bill is widely expected, given the widespread opposition to it in Parliament.

The second event is an opinion from an Advocate General of the European Court of Justice (ECJ) that the U.K. Parliament could unilaterally revoke Article 50, the two-year process of leaving the EU.

We stress that both events are non-legally binding, yet, combined, they could enable the largely pro-EU Parliament to revoke Article 50 if the U.K. was seen as heading toward a no-deal Brexit, if the opinion of the Advocate General were to be confirmed by the ruling of the ECJ. Precedents suggest this is likely to be the case.

Our base case remains that the Withdrawal Agreement will eventually be approved, and that the U.K. will exit the EU, but the uncertainty could drag on. With the probability of a no-deal scenario receding, the conviction in our Market Weight on U.K. equities has grown.

Balancing act

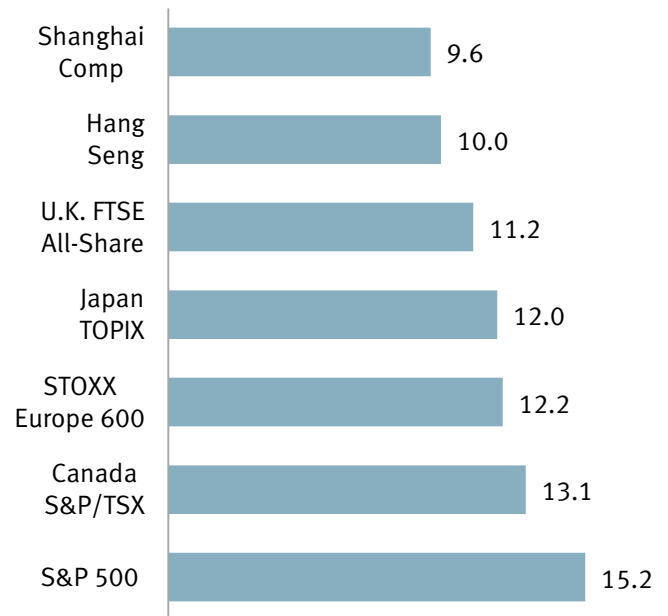
The risks related to U.S.-China relations, the Treasury yield curve, and Brexit will likely remain on equity markets' radar screen over the near term, and other uncertainties could also resurface as markets work through this correction period. These risks should be balanced against reliable leading economic indicators, in our view.

Thus far, our indicators are not signaling an elevated threat of recession, and therefore we maintain a Market Weight recommendation on overall, global equity exposure in portfolios, and for U.S. exposure as well.

We are closely monitoring leading indicators and other data because when they ultimately shift, it will be time to position equity portfolios more cautiously and defensively. At this stage, dramatic portfolio changes are not yet called for, in our view.

All valuations are below their long-term averages

Forward price-to-earnings ratios based on the consensus earnings forecast for the next 12 months



Source - RBC Wealth Management, Bloomberg consensus forecasts; data through 12/6/18

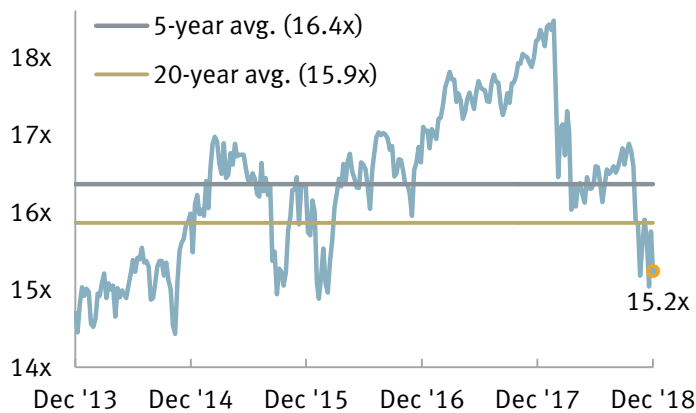


United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets have given back much of their late November gains** as the two-day losses that bookended the national day of mourning for former President George H.W. Bush approach the 5% threshold on major U.S. indexes. Small caps are even worse, surpassing the 5% mark. **Fears of increased tensions with China and other trade partners were heightened** after multiple press reports announced the CFO of China-based Huawei had been arrested in Canada at the behest of the U.S. This fuels the larger concern that the two sides will be unable to continue moving the trade ball down the proverbial field after tensions had actually eased on news of a 90-day tariff ceasefire.
- **Financials have taken the brunt of investor angst**, largely related to the flattening (and partial inversion) of the yield curve. The sector has declined almost 8% in recent sessions. Other economically sensitive sectors have performed poorly as well, notably Industrials and Materials. Interestingly, **the selloff has pushed market valuations to levels below average in advance of 2019 earnings that we forecast to grow at an approximately average rate.** The current next twelve month (NTM) P/E ratio on the S&P 500 is 15.2x, based on FactSet consensus estimates, clearly below both the 5- and 20-year averages. This valuation backdrop in light of 2019 earnings growth potential and the current sentiment reinforces our belief that a Market Weight position in U.S. equities in combination with a tilt toward value remains appropriate.

S&P 500 valuations have rapidly declined from January highs
Next twelve month (NTM) price-to-earnings (P/E) ratio



Source - RBC Wealth Management, FactSet; data as of 2:30 PM CST on 12/6/18

- **As the oil selloff continues** and with WTI down by more than 30% since early October, RBC Capital Markets, LLC Commodity Strategist Helima Croft believes it's **"gut check" time**. The combination of the oil price retreat and lack of constructive data points in recent weeks underlies outflows of recent months. Market participants' attention remains fixed on the outcome of potential production cuts from OPEC and its affiliates that should be announced on Friday. The concern is that the proposed production cut will not be large enough and supply will continue to outpace demand and further pressure prices from current levels.



Canada

Carolyn Schroeder & Arete Zafiriou – Toronto

- **The Bank of Canada (BoC) maintained its target overnight rate at 1.75%** on Wednesday as the market expected. The Canadian economy as a whole grew in line with the BoC's expectations in Q3, but data suggests decreasing momentum going forward, particularly due to weakness in the energy sector. According to the BoC, business investment outside the energy sector should strengthen with the signing of the United States-Mexico-Canada Agreement (USMCA) and the new federal government tax measures. **RBC Global Asset Management believes Canada's central bank may be inclined toward fewer rate hikes rather than more** in a world of slowing growth and above-consensus inflation. Following the BoC's statement, the market is now pricing in fewer than two rate hikes for 2019.
- On Sunday, **the Alberta government announced a crude oil and bitumen production cut** will come into effect on January 1, 2019. The cut will reduce output to 325,000 barrels per day until inventories return to seasonally normal levels, at which time the reduction will be scaled back to 95,000 barrels per day on average until 2020. For reference, the Alberta government suggested that inventories normally sit around 19 million barrels—16 million barrels less than the current level. Following the announcement, Western Canada Select surged over 65% to \$32.91. Although the Alberta government's aim is for this reduction in output to lower discounts on Canadian oil relative to U.S. benchmark prices, it will likely have a negative impact on Canadian real GDP. **RBC Global Asset Management estimates the approximate 9% cut in production will hurt Canadian real GDP growth by around 0.2% in 2019.**



Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- U.K. economic activity is faltering.** The services Purchasing Managers' Index (PMI) dropped heavily in November for the second month in a row to 50.4 and is now hovering just above the expansionary point of 50. Despite an improvement in the manufacturing PMI, which economists have largely attributed to inventory stockpiling ahead of Brexit in March 2019, the composite PMI retreated further to 50.7 from 54.1 in September as investment and consumer decisions are being postponed due to the uncertainty. According to RBC Capital Markets, such levels of activity would suggest **GDP may grow by a meagre 0.1% q/q in Q4**. The risk to its forecast of 1.3% y/y growth for 2018 is skewed to the downside. **We believe the weakness may well force the Bank of England to postpone the normalisation of interest rates.** Markets are currently discounting one rate hike next year.
- U.K. health care giant GlaxoSmithKline (GSK) was active on the M&A front** to support one of the group's strategic priorities of strengthening its pharmaceutical business. The group **bolstered its pipeline and commercial capability in oncology with the £4B acquisition of Tesaro**, a U.S. commercial-stage biopharmaceutical company. Tesaro's key major marketed product, Zejula, is a poly ADP-ribose polymerase (PARP) inhibitor, which GSK believes are "important medicines that have been underappreciated in terms of the impact they can have on cancer patients." Meanwhile on the divestment side, **GSK disposed Horlicks and other consumer health care nutrition products in India to Unilever** for £3.1B.



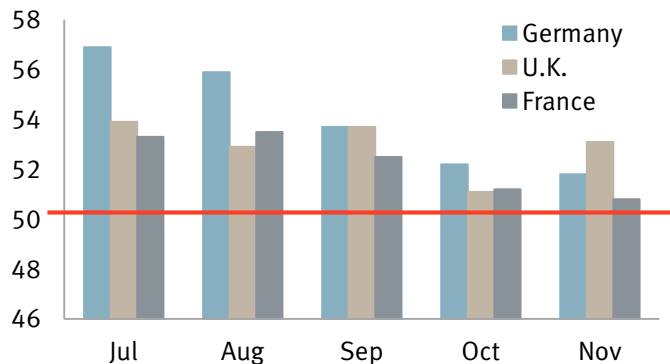
Asia Pacific

Jay Roberts, CFA – Hong Kong

- Asian markets remain volatile and directionless.** For example, Hong Kong's Hang Seng Index rallied strongly on Monday after the meeting between U.S. President Trump and Chinese President Xi at the G20 before selling off equally as strongly on Wednesday and Thursday. The weakness was likely a combination of uncertainty around the U.S.-China situation, the flattening yield curve in the U.S., and the arrest of the CFO of one of China's largest technology companies, Huawei, in Canada for possible extradition to the U.S. (the U.S. accuses Huawei of doing business with Iran in contravention of sanctions).
- The meeting between the U.S. and China**, headed by Trump and Xi, at the G20 in Argentina of course generated heightened interest among investors. Unsurprisingly, there was an agreement to try to work out some deal with

European PMI data has decelerated in the back half of 2018

Manufacturing Purchasing Managers Indexes (PMI)



Note: Red line indicates a reading of 50, which marks the boundary between expanding and contracting economic levels.

Source - RBC Wealth Management, Bloomberg; data through 11/30/18

respect to trade, with no additional tariffs to be imposed over a 90-day period. Also unsurprisingly, there are **mixed messages from both sides as to what is happening** and what the expected outcomes are. As the news ebbs and flows over the next several months, we would expect stocks in Hong Kong and China to remain range-bound and jittery.

- Let us suppose a deal is reached.** For example, China agrees to buy more goods from the U.S. as well as change some laws and regulations pertaining to technology transfer, protection of intellectual property, and market access. The markets would most likely welcome such a development.
- However, this would simply be a détente in the larger battle**, which is a much bigger one centered on national security and the U.S. attempts to contain a rising China amid a widening ideological gap, in our view.
- With respect to trade, note that the size of the trade surplus is so large—and still growing—that a “deal” is unlikely to make a major difference, in our opinion. Separately, **the litany of complaints that the U.S. has will be very difficult for China to address across the board in the allotted time**, even in the unlikely event that it wants to address them all.
- We believe **the big question is whether a piecemeal deal will be enough to stave off the China hawks in the U.S. administration.** Note also that there is a risk of no deal or an underwhelming agreement: the U.S. team is to be headed by Trade Representative Robert Lighthizer, a China hawk and certainly no pushover.
- In any event, **we continue to forecast strained relations over the long term** with implications for economies and markets. For more on this, please see our article [China and U.S. relations are heading into uncharted territory](#). Our views expressed therein have not changed.



MARKET SCORECARD

Data as of December 6, 2018

| Equities (local currency) | Level | MTD | YTD | 1 yr | 2 yr |
|---------------------------|-----------|-------|--------|--------|--------|
| S&P 500 | 2,695.95 | -2.3% | 0.8% | 2.5% | 21.9% |
| Dow Industrials (DJIA) | 24,947.67 | -2.3% | 0.9% | 3.3% | 29.6% |
| NASDAQ | 7,188.26 | -1.9% | 4.1% | 6.1% | 34.8% |
| Russell 2000 | 1,477.45 | -3.6% | -3.8% | -2.1% | 9.2% |
| S&P/TSX Comp | 14,937.00 | -1.7% | -7.8% | -6.1% | -1.2% |
| FTSE All-Share | 3,674.03 | -3.9% | -13.0% | -9.0% | -0.4% |
| STOXX Europe 600 | 343.31 | -4.0% | -11.8% | -11.1% | -0.4% |
| EURO STOXX 50 | 3,045.94 | -4.0% | -13.1% | -14.5% | -1.8% |
| Hang Seng | 26,156.38 | -1.3% | -12.6% | -7.3% | 15.4% |
| Shanghai Comp | 2,605.18 | 0.7% | -21.2% | -20.9% | -18.6% |
| Nikkei 225 | 21,501.62 | -3.8% | -5.5% | -3.0% | 17.1% |
| India Sensex | 35,312.13 | -2.4% | 3.7% | 8.3% | 33.8% |
| Singapore Straits Times | 3,115.52 | -0.1% | -8.4% | -8.3% | 5.6% |
| Brazil Ibovespa | 88,846.48 | -0.7% | 16.3% | 21.3% | 45.4% |
| Mexican Bolsa IPC | 41,987.00 | 0.6% | -14.9% | -10.6% | -6.9% |
| Commodities (USD) | Price | MTD | YTD | 1 yr | 2 yr |
| Gold (spot \$/oz) | 1,238.07 | 1.3% | -5.0% | -2.0% | 5.8% |
| Silver (spot \$/oz) | 14.48 | 2.1% | -14.5% | -9.3% | -13.4% |
| Copper (\$/metric ton) | 6,175.00 | -0.8% | -14.3% | -5.3% | 5.1% |
| Oil (WTI spot/bbl) | 51.49 | 1.1% | -14.8% | -8.0% | 1.1% |
| Oil (Brent spot/bbl) | 60.28 | 2.7% | -9.9% | -1.5% | 11.8% |
| Natural Gas (\$/mmBtu) | 4.37 | -5.2% | 48.0% | 49.6% | 20.2% |

| Govt bonds (bps chg) | Yield | MTD | YTD | 1 yr | 2 yr |
|------------------------|----------|-------|-------|-------|-------|
| U.S. 10-Yr Tsy | 2.892% | -9.6 | 48.7 | 55.3 | 50.3 |
| Canada 10-Yr | 2.084% | -18.4 | 3.9 | 22.8 | 44.8 |
| U.K. 10-Yr | 1.246% | -11.8 | 5.6 | 1.8 | -17.2 |
| Germany 10-Yr | 0.236% | -7.7 | -19.1 | -5.9 | -13.7 |
| Fixed Income (returns) | Yield | MTD | YTD | 1 yr | 2 yr |
| U.S. Aggregate | 3.50% | 0.5% | -1.3% | -1.3% | 2.4% |
| U.S. Invest Grade Corp | 4.33% | 0.6% | -3.3% | -3.1% | 3.6% |
| U.S. High Yield Corp | 7.19% | 0.3% | 0.3% | 0.6% | 9.2% |
| Currencies | Rate | MTD | YTD | 1 yr | 2 yr |
| U.S. Dollar Index | 96.7550 | -0.5% | 5.0% | 3.4% | -3.7% |
| CAD/USD | 0.7476 | -0.6% | -6.0% | -4.4% | -0.7% |
| USD/CAD | 1.3377 | 0.6% | 6.4% | 4.6% | 0.8% |
| EUR/USD | 1.1381 | 0.6% | -5.2% | -3.5% | 6.2% |
| GBP/USD | 1.2784 | 0.3% | -5.4% | -4.5% | 0.8% |
| AUD/USD | 0.7235 | -1.0% | -7.4% | -4.3% | -3.0% |
| USD/JPY | 112.7000 | -0.8% | 0.0% | 0.4% | -1.2% |
| EUR/JPY | 128.2600 | -0.1% | -5.2% | -3.2% | 5.0% |
| EUR/GBP | 0.8903 | 0.3% | 0.2% | 1.1% | 5.3% |
| EUR/CHF | 1.1302 | -0.1% | -3.4% | -3.2% | 4.4% |
| USD/SGD | 1.3692 | -0.2% | 2.5% | 1.5% | -3.6% |
| USD/CNY | 6.8827 | -1.1% | 5.8% | 4.0% | 0.0% |
| USD/MXN | 20.3546 | -0.1% | 3.5% | 7.9% | -0.2% |
| USD/BRL | 3.8821 | 0.4% | 17.3% | 20.0% | 13.8% |

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 12/6/18.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -6.0% return means the Canadian dollar fell 6.0% vs. the U.S. dollar year to date. USD/JPY 112.70 means 1 U.S. dollar will buy 112.70 yen. USD/JPY 0.0% return means the U.S. dollar is steady against the yen year to date.

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| Rating | Count | Percent | Investment Banking Services Provided During Past 12 Months | |
|-----------------------------|-------|---------|---|---------|
| | | | Count | Percent |
| Buy [Top Pick & Outperform] | 859 | 54.33 | 251 | 29.22 |
| Hold [Sector Perform] | 646 | 40.86 | 125 | 19.35 |
| Sell [Underperform] | 76 | 4.81 | 5 | 6.58 |

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