February 28, 2019

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Reality check

Jay Roberts, CFA – Hong Kong

As complex trade negotiations continue between the U.S. and China, investors should not be complacent with respect to outcomes. And while the current talks may yield some kind of deal, we believe it would be end of chapter, not end of story.

Blue sky

Markets have been buoyed recently by progress on trade talks between the U.S. and China. Indeed, talks have been going so well that President Donald Trump has pushed back the initial deadline for a deal to be made from the start of March to an unspecified date.

It's been widely reported that memorandums of understanding (MOU)—part of the process in some contract negotiations—are being drawn up across pain-points such as agriculture and technology. There may even be an MOU on the ever-thorny issue of China's currency, a long-time target of the Trump administration and an eternal scapegoat for the decline in American manufacturing might.

A presidential summit at Mar-a-Lago beckons. The Shanghai Composite increased by 12.8% in February. It's just all going swimmingly.

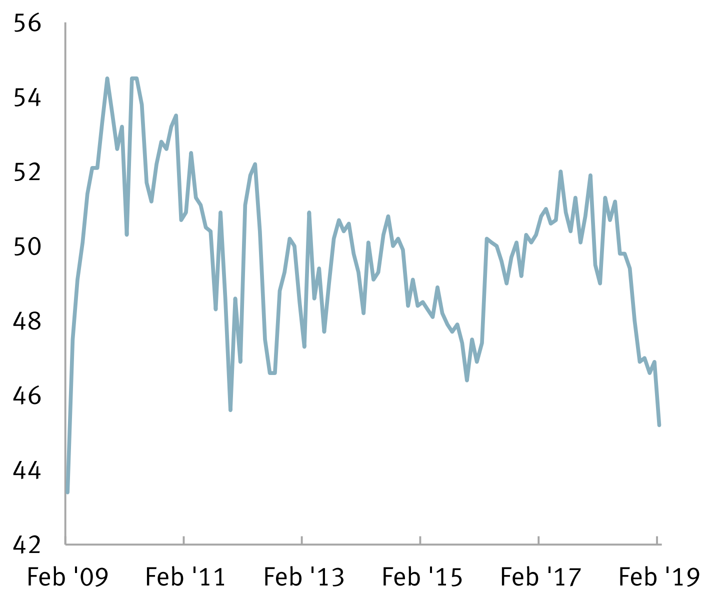
Grey sky

Except it isn't. Testimony on Capitol Hill by U.S. Trade Representative Robert Lighthizer brought things back to earth in pretty certain terms. Lighthizer, who is front and centre in the negotiation process, confirmed our views expressed in the February 21 edition of *Global Insight Weekly* and our *Global Insight 2019 Outlook* feature article "China and U.S. relations are heading into unchartered territory." While touting "real progress," he also emphasized that reaching an agreement remains a matter of "if," not "when." In short, the U.S. request for reform in China's laws, regulations, and behaviours in areas such as market access, technology transfer, and intellectual property protection remains at the core of any trade deal.

Lighthizer was clear that China increasing its purchases of U.S. goods is, by itself, not enough for the U.S. That $1.2T

China's trade momentum has stalled with tariff uncertainties

China New Export Orders Purchasing Managers' Index



Source - RBC Wealth Management, Bloomberg, China Federation of Logistics and Purchasing; data through 2/28/19

Market pulse

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Priced (in USD) as of 2/28/19 market close, EST (unless otherwise stated).

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in purchases over time would not suffice speaks volumes, in our view. Rather, structural changes will also be required for the U.S. to make an agreement. He also emphasized that measurable enforcement mechanisms at all levels of Chinese government would be necessary. Lighthizer's testimony was unambiguous: "Much still needs to be done both before an agreement is reached and, more importantly, after it is reached, if one is reached."

Red sky

Clearly, there are many moving parts to the negotiations. We think that there is a very low chance that an agreement is reached which fully meets U.S. demands. For one thing, China has been quite willing to promise to buy more U.S. goods, but is far less at ease with the idea of structural reform. And understandably so, from China's perspective.

First, the authorities posit that the current model, let's call it "authoritarian capitalism," has significantly benefitted China, lifting several hundred million people out of poverty over the past three decades and creating numerous corporate champions.

Second, to be seen as a superpower that can rub shoulders with the U.S. in contentious issues such as the militarization of the South China Sea, China surely cannot tolerate having the entire outcome of the trade war, which is conspicuous to say the least, dictated by the U.S.

Third, the Middle Kingdom has historically been sensitive to foreign interference in domestic affairs. This notion has come up repeatedly in recent years. Current U.S. demands likely smack of such interference to the authorities. Indeed, under President Xi Jinping, China has not only sought to entrench control at home (and, somewhat ironically, is using technology to do so), but is also pursuing a more overt, bolder, China-centric foreign policy.

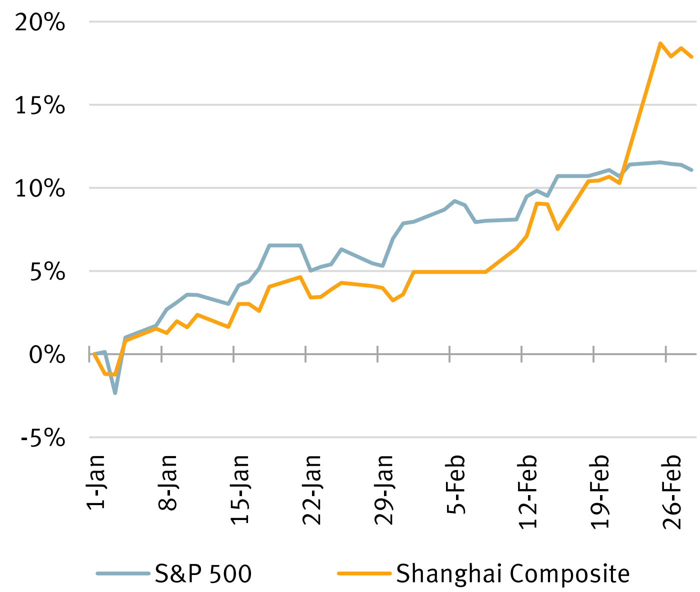
In short, we do not think that China will agree to everything. The big unknowns are how far along the road of structural reform it is willing to travel, if at all, and how far would it need to go in order to assuage the U.S.

Deal or no deal?

There is a reasonable chance that some kind of deal is done that meets some but not all of the U.S. requests. It seems clear to us that Trump is moving towards that conclusion. (That said, we think his voting base would be more than comfortable with an extension to, or increase of, existing tariffs, or the introduction of new tariffs. Indeed, we believe this would receive support outside of the base, including bipartisan support.) Obviously, the market response to such a deal would depend on its content, so frankly it could go either way. But

Both equity indexes have pushed higher on trade optimism, but China's spiked recently

Year-to-date percentage gains



Source - RBC Wealth Management, Bloomberg; data through 2/28/19

we do note that if the U.S. gets a deal that it's lukewarm on, it's entirely possible that current tariffs might stay in place. End of chapter, not end of story.

However, there is also some chance that no deal is made. Lighthizer's testimony was clear on this. China's official Xinhua news agency also noted that negotiations become more difficult towards the end. No deal might easily trigger a pullback in stocks and quite possibly another correction.

We believe that markets are perhaps complacent in this regard and have been pricing out a "no-deal" scenario as the presidential tweets have turned more positive and the initial deadline was delayed. The market impact of a no-deal scenario would spread beyond stocks. It would have implications for currencies and possibly for Treasuries, of which China is the largest holder.

Eventually, markets will find a way forward. But in the short term, it's no slam dunk.

United States

Ben Graham, CFA – Minneapolis

- **The S&P 500 is up more than 10% thus far in 2019, an impressive beginning to the year** and a surprisingly positive indicator for full-year 2019 returns. Since 1950, there have only been 20 previous instances in which the S&P 500 has gained 5% or more in the first two months of the year. Of those 20, 19 resulted in positive full-year gains, with the lone negative year being 2011 with a 0.002% decline. The average return over the 20 periods has been 21.7%. Suffice it to say that while we may have received a large share of 2019's full-year gains in the first two months of the year, this by no means implies the S&P 500 has delivered the entirety of its potential annual gains already. **Looking forward, the path may not be as smooth as January and February and a period of consolidation would not surprise us**. However, we continue to believe a Market Weight position in U.S. equities is warranted given the path of past returns and historical returns following similar starts to calendar years.

- **Recent equity market performance has been led by Technology and Financials stocks** while Materials, Health Care, and Energy have been the laggards. Small caps, as measured by the Russell 2000, have shed some of their 2019 lead. However, they remain comfortably higher, nearing 20% YTD gains. The Tech-heavy NASDAQ remains ahead of the S&P 500. **The yield curve has also widened in recent sessions**, as seen in the spread between the 2-Year and 10-Year Treasury widening to tie the 2019 high of 19 basis points (bps).

- **U.S. GDP grew at a 2.6% annualized clip in Q4 2018, a modestly positive surprise** compared to the consensus estimates of 2.2%. The consumer spending component was the most impactful contributor to the slowdown from Q3's reading of 3.4%, while **business investment and a rise in U.S. exports partially offset the consumer weakness**.

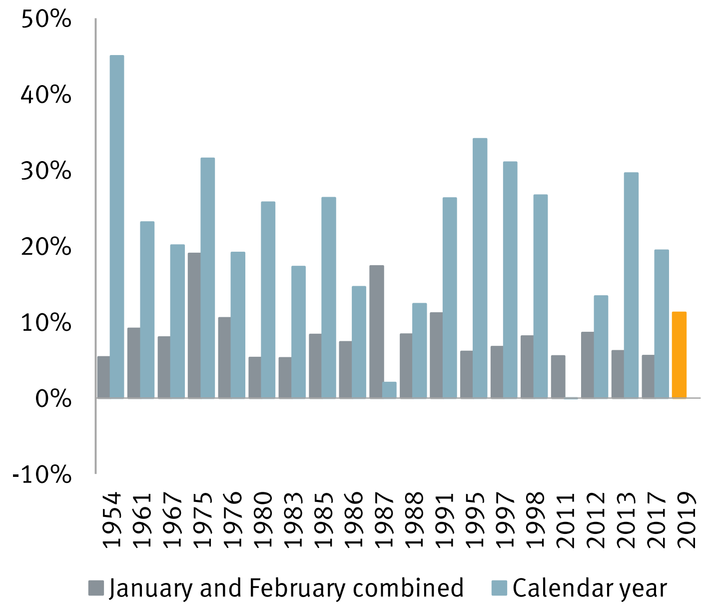
Canada

Diana Di Luca – Toronto

- **On February 21, Bank of Canada (BoC) Governor Stephen Poloz gave a speech on Canada's interest rate outlook**. The themes of the speech were Canada's need to move rates into a neutral range over time and the level of uncertainty Canadians face in the current day rates environment. There have been five rate hikes since mid-2017 but the BoC has been on hold since October 2018 as it takes all factors into account—specifically the

Strong starts indicate strong finishes

S&P 500 returns since 1954 when Jan./Feb. combined returns are greater than 5%



Source - RBC Wealth Management, Bloomberg; data as of 5:15 pm GMT 2/28/19

impact of higher rates on indebted consumers, and risk to the investment outlook. Poloz also acknowledged that the global growth outlook appears to have deteriorated slightly since the BoC Governing Council released its latest forecasts in January.

- Poloz claims the road to higher interest rates is "highly uncertain", which has left investors with lingering questions around housing and investment. **The next interest rate decision is scheduled for March 6**, and although major bank economists unanimously expect a rate hike this year, it is **unlikely the next decision will include a hike**, as the bond market is not pricing in any more hikes in Canada.

- **Corporate bond new issue activity in Canada has been muted in recent weeks** despite the fact that Canadian corporate bond yields have fallen to a seven-month low. A few new issues have filled the void in new issue supply over the past week, including the first pipeline offering in seven months and the third Canadian bail-in bank bond since the new structure was put in place in September.

- **U.S. Treasury Inflation-Protected Securities** (TIPS) are priced to offer investors a return of inflation plus a real yield of nearly 1%. Given that real yields are near the highest level in the post-Quantitative Easing era, we believe this is **a timely idea to re-visit**. We think the low breakeven inflation rate means there is a low hurdle for these bonds to outperform nominal U.S. Treasuries. Inflation-linked bonds tend to dampen volatility versus nominal bonds because inflation expectations tend to increase when yields rise and decrease when yields fall. This likely means a less volatile total-return path in fixed income holdings.

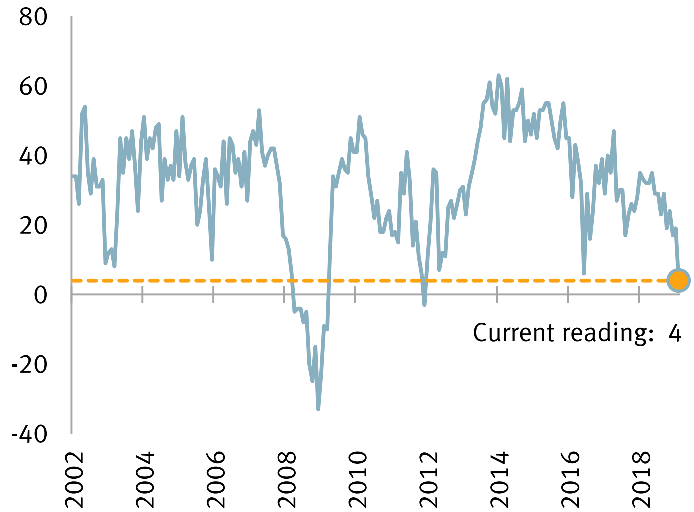
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Under pressure to give some clarity on the path forward for Brexit, U.K. Prime Minister Theresa May committed to giving the House of Commons a series of votes,** the first of which would be a vote on her tweaked Withdrawal Agreement deal on March 12. Should her deal be rejected, another vote would take place the following day on whether to proceed with a "no-deal" Brexit—i.e., crashing out of the EU with no transition period. In the likely event that the no-deal option is rejected, the House of Commons would vote on a motion calling for the government to request an extension to Article 50, the formal legal process by which the U.K. is leaving the EU.
- **The most likely scenario, in our view, is that an extension will be requested** and that May's deal will eventually pass, as no credible alternative has emerged as having enough support in the House of Commons.
- Three points are worth noting. **First, a no-deal scenario remains possible** if, at the end of the extension period, there is an impasse, with no agreement on any deal. No deal remains the default option. In fact, an amendment proposed by the Scottish National Party to rule out a no-deal Brexit under all circumstances was rejected by the House of Commons.
- **Second, a possible extension means that the uncertainty regarding a no-deal outcome that has been holding back the business sector is likely to continue beyond March.** A longer period of uncertainty would be bad news for the economy. The Lloyds Bank Business Barometer Summary Indicator, a reliable predictor of economic activity, has slid to its lowest level since June 2016, the month of the Brexit referendum. While the consumer is holding up for now, propped up by a healthy labour market, if this trend of business confidence continues on an extension of uncertainty beyond March, the current consensus U.K. GDP growth forecast of 1.4% may well prove to be too optimistic.

U.K. economic trends are the most challenging since 2011

Lloyds Bank Business Barometer Summary Indicator



Source - RBC Wealth Management, Bloomberg; data through 2/28/19

- **Third, any Article 50 extension would require unanimity of the 27 EU members and should therefore not be entirely taken for granted.** Should it be agreed to, we would expect the extension to be short in order to keep the U.K. from being involved in the European Parliamentary elections in May.
- To assess the chances of May's deal being passed, we would **monitor the attitude of the most ardent Brexiteers who seem to be softening up on the issue of the Irish backstop.**

MARKET SCORECARD

Data as of February 28, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,784.49	3.0%	11.1%	2.6%	17.8%
Dow Industrials (DJIA)	25,916.00	3.7%	11.1%	3.5%	24.5%
NASDAQ	7,532.53	3.4%	13.5%	3.6%	29.3%
Russell 2000	1,575.55	5.1%	16.8%	4.2%	13.6%
S&P/TSX Comp	15,999.01	2.9%	11.7%	3.6%	3.9%
FTSE All-Share	3,888.81	1.7%	5.8%	-2.3%	-1.6%
STOXX Europe 600	372.80	3.9%	10.4%	-1.8%	0.7%
EURO STOXX 50	3,298.26	4.4%	9.9%	-4.1%	-0.6%
Hang Seng	28,633.18	2.5%	10.8%	-7.2%	20.6%
Shanghai Comp	2,940.95	13.8%	17.9%	-9.8%	-9.3%
Nikkei 225	21,385.16	2.9%	6.8%	-3.1%	11.9%
India Sensex	35,867.44	-1.1%	-0.6%	4.9%	24.8%
Singapore Straits Times	3,212.69	0.7%	4.7%	-8.7%	3.7%
Brazil Ibovespa	95,584.35	-1.9%	8.8%	12.0%	43.4%
Mexican Bolsa IPC	42,823.81	-2.6%	2.8%	-9.7%	-8.6%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,313.09	-0.6%	2.4%	-0.4%	5.2%
Silver (spot $/oz)	15.61	-2.8%	0.7%	-4.9%	-14.8%
Copper ($/metric ton)	6,546.00	6.4%	10.0%	-5.1%	9.7%
Oil (WTI spot/bbl)	57.22	6.4%	26.0%	-7.2%	5.9%
Oil (Brent spot/bbl)	66.03	6.7%	22.7%	0.4%	18.8%
Natural Gas ($/mmBtu)	2.81	-0.3%	-4.6%	5.2%	1.2%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.719%	8.9	3.4	-14.2	32.9
Canada 10-Yr	1.944%	6.5	-2.3	-29.1	30.9
U.K. 10-Yr	1.302%	8.3	2.5	-19.9	15.1
Germany 10-Yr	0.183%	3.4	-5.9	-47.3	-2.5

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.19%	0.0%	1.1%	3.2%	3.8%
U.S. Invest Grade Corp	3.91%	0.2%	2.5%	2.6%	4.9%
U.S. High Yield Corp	6.56%	1.6%	6.2%	4.2%	8.6%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	96.2190	0.7%	0.0%	6.2%	-4.8%
CAD/USD	0.7598	-0.3%	3.6%	-2.5%	1.1%
USD/CAD	1.3162	0.3%	-3.5%	2.6%	-1.0%
EUR/USD	1.1371	-0.7%	-0.8%	-6.7%	7.5%
GBP/USD	1.3259	1.1%	4.0%	-3.6%	7.1%
AUD/USD	0.7095	-2.4%	0.7%	-8.6%	-7.3%
USD/JPY	111.4400	2.3%	1.6%	4.5%	-1.2%
EUR/JPY	126.7200	1.7%	0.7%	-2.6%	6.2%
EUR/GBP	0.8576	-1.8%	-4.6%	-3.2%	0.4%
EUR/CHF	1.1350	-0.3%	0.8%	-1.5%	6.7%
USD/SGD	1.3520	0.5%	-0.8%	2.1%	-3.6%
USD/CNY	6.6941	-0.1%	-2.7%	5.7%	-2.5%
USD/MXN	19.2758	0.9%	-1.9%	2.3%	-4.1%
USD/BRL	3.7568	3.0%	-3.0%	15.7%	20.8%

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 9:35 pm GMT 2/28/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 3.6% return means the Canadian dollar rose 3.6% vs. the U.S. dollar year to date. USD/JPY 111.44 means 1 U.S. dollar will buy 111.44 yen. USD/JPY 1.6% return means the U.S. dollar rose 1.6% vs. the yen year to date.

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