April 4, 2019

RBC WEALTH MANAGEMENT

Global Insight

Weekly

A closer look

Dollar drivers shifting to neutral gear

Laura Cooper – London

U.S. recessionary fears faded with signs of economic life reinvigorating investor sentiment. Progress toward a U.S.-China trade truce and green shoots emerging in Chinese economic data underpinned the enthusiasm, sending risky assets higher. While the Fed's pivot to patience shouldn't put the dollar in reverse, it will likely remove a key tailwind for the greenback.

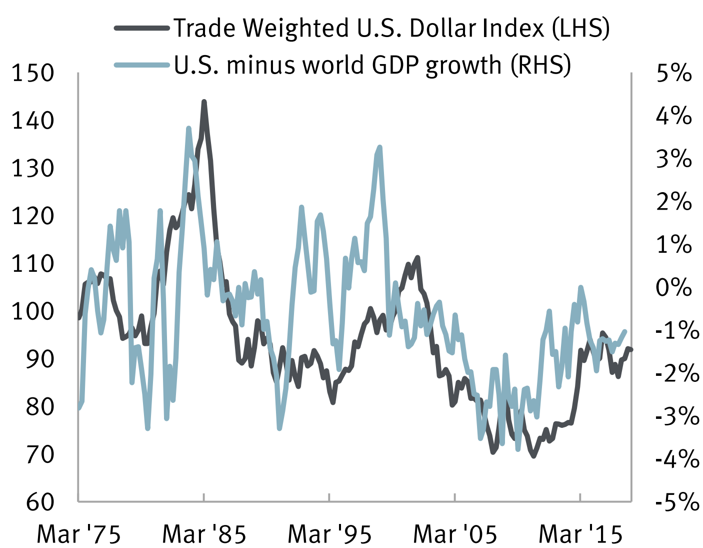
The U.S. dollar has been buffeted by numerous developments thus far in 2019. Progress on a trade deal with China, easing domestic growth momentum, and ongoing global risks have underpinned swings in the currency. The Fed's pivot to patience has not deterred continued range-bound performance beneath the fluctuations. But an extended rate hike pause and eventual signs of improving growth conditions abroad could limit the dollar's attractiveness later in 2019.

Driving in neutral after a strong rally

Economic momentum is slowing in the U.S., yet conditions remain favorable relative to abroad where economic growth remains subdued. Fading fiscal stimulus sets up the U.S. economy to churn out a slower pace of expansion in 2019 than last year. However, ongoing trade tensions and Brexit uncertainty are contributing to keeping activity abroad depressed for now, and, in turn, supporting capital flows to the U.S.

The greenback's appeal is further bolstered given an attractive interest rate environment. Global bond yields came under pressure in March on the back of intensifying global growth fears and growing caution from central banks, further pushing U.S. Treasury yields down from 2018 highs. U.S. rates are low historically, but when compared to negative yields offered in Germany, Switzerland, and Japan, the U.S. remains an appealing destination. Add inflation into the mix, and the U.S. bond market shows the highest real yields amongst advanced economies.

Global growth dynamics have been supportive of the dollar



Source - Bloomberg, Federal Reserve, International Monetary Fund, RBC Wealth Management; data through 4/3/19

Market pulse

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Wealth Management

Tapping the brakes but not going in reverse

The dollar does not appear to be at extreme valuations after its eight-year bull run. Even so, the Fed's signal that no further interest rate increases are likely in the pipeline this year removes a key tailwind going forward, in our view. While future policy moves are dependent on how economic data unfolds, and upward inflation pressures remain a risk, we see bond yields being capped by an extended Fed policy pause. Accordingly, a divergence in real rates favoring the dollar appears poised to ease.

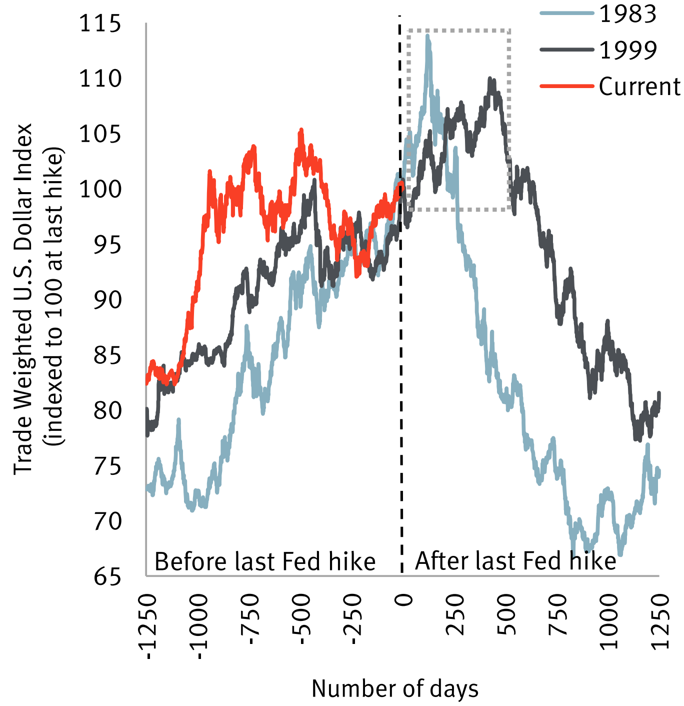
At the same time, the end of the tightening cycle does not necessarily point to an imminent dollar downturn. According to an analysis by RBC Global Asset Management, in previous rate hike cycles when conditions were similar to the current backdrop (modest dollar overvaluation and latter stages of a bullish dollar cycle), the dollar tended to remain buoyant over a 12-to-24-month period following the final Fed rate increase. The dollar's ability to retain its value in times when risky assets tumble on recessionary fears is one factor supporting this.

Green shoots to dampen greenback?

Supportive central bank policy shifts and earlier stimulus working to prop up the Chinese economy point to a steadying in the global growth slowdown, and further speed bumps for the dollar. The boost to risk appetite from an emergence of green shoots and investors' renewed search for yield outside of the U.S. should cause the attractiveness of the dollar to fade, in our view.

U.S. dollar performance before and after the final Fed hike

Trade Weighted U.S. Dollar Index; 100 at last rate increase in tightening cycle



Source - Bloomberg, Federal Reserve, RBC Global Asset Management, RBC Wealth Management; data through 4/3/19

While near-term European growth prospects remain subdued, as transitory factors dissipate and stimulus works through key export markets together with fiscal easing, economic momentum should reassert itself, and, in turn, lift the euro later this year. Unusual risks remain across the G10 countries, including Brexit in the U.K., and in Canada around the ratification of the USMCA trade agreement; although an anticipated cyclical rebound in these economies points to the broad-based dollar gains of 2018 unlikely being repeated in 2019.

Relief rally

For emerging markets (EM), the Fed's dovish pivot abated a headwind with the loosening in financial conditions helping to drive a modest recovery in EM currencies from 2018 declines. Idiosyncratic challenges emanating largely from political risks have capped broad-based gains, as has been most evident recently in Turkey, although contagion risks should remain contained, in our view.

The nascent EM outperformance could fade as the U.S. business cycle advances through its later stages, notably as EM currency indexes tend to pass their cycle peaks 18–24 months before the onset of a U.S. recession. But even so, we believe the backdrop for EM currencies remains constructive for now given diminished headwinds from central banks, relatively high interest rates in EMs, and a boost to risk appetite from progress on the U.S.-China trade front and easing in Chinese growth fears.

King Dollar downgraded but still reigns

Dollar support is likely to persist until there is evidence of improving growth conditions abroad. Yet with the Fed capitulating to financial markets and policy now poised to remain on hold, the main impetus to any further dollar strength has ebbed, in our view.

U.S. recession risks are ostensibly rising, and while the Fed committing to support the economic expansion should allay concerns of an imminent downturn, the Fed's apparent policy pause points to limited upside for the dollar from here, in our view. Instead, while the later stages of a U.S. business cycle do not likely portend an end to the dollar's bull run, a steady path forward appears more likely.

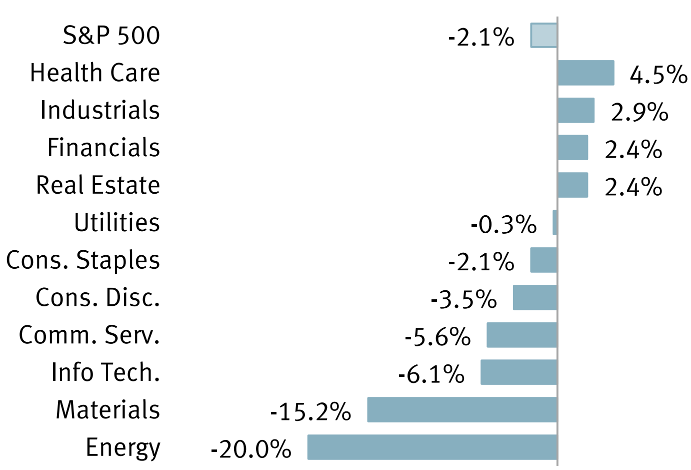
United States

Ben Graham, CFA – Minneapolis

- **U.S. equities kicked off April with broad gains**, evidenced by the S&P 500 climbing 1.6% in recent days. Small caps have been even better, gaining 1.8%, while the NASDAQ leads all major U.S. indexes. Returns so far this month have been characterized by a **modest dispersion along lines of economic sensitivity**. Financials and Materials have been the leaders, gaining more than 3.2% while other economically sensitive sectors are broadly higher. Bond proxies, highlighted by Consumer Staples and Utilities, have struggled as both sectors moved at least 1.2% lower.
- Quarterly earnings kick off in earnest in the coming days with JPMorgan Chase and other large banks are scheduled to report results on April 12. **Consensus expectations for S&P 500 quarterly earnings are actually indicating a slight contraction**, led lower by Energy, Materials, and Info Tech per Refinitiv I/B/E/S. The other side of the coin sees Health Care (+4.5%), Industrials (+2.9%), and Financials (+2.4%) with the best setup to deliver quarterly earnings growth. Despite the anticipated contraction in Q1 S&P 500 earnings, consensus indications show a resumption in earnings growth to the low- to mid-single digits for the remaining quarters of 2019. Also, **we think Q1 results could end up beating the current forecast**, which supports our view of holding a Market Weight position in U.S. equities with a tilt toward high-quality, defensive stocks.
- Recent Institute for Supply Management **manufacturing and services sector data indicated an ongoing economic expansion** after concerns were raised earlier this year about the slow deterioration in manufacturing. In a related report, the manufacturing Purchasing Managers' Index came in ahead of expectations as the headline reading of 55.3 beat last month's 54.2 and this month's estimate of 54.5. Furthermore, the new orders component showed a sharp reversal from February's data, indicative of an ongoing expansion to 57.9, while the prices paid component reaccelerated to 54.3.

Earnings to decline in Q1, before resuming their growth trend for the rest of the year

S&P 500 Q1 2019 EPS growth estimates



Source - RBC Wealth Management, Refinitiv I/B/E/S; data through 4/4/19

Canada

Arete Zafiriou & Carolyn Schroeder – Toronto

- Year-to-date, **the S&P/TSX Composite Index has outperformed the S&P 500 Index** in Canadian dollar terms. In the three-month period ending March 29, the S&P/TSX Composite gained 13.3% on a total-return basis compared to 11.5% for the S&P 500. **Canadian Health Care was the best-performing sector** over the period, up 49.1% on a total-return basis. The Info Tech sector was the second strongest, rising 25.9% on a total-return basis. Although they did not have the greatest absolute outperformance, the Financials and Energy sectors were the biggest contributors to the index's gains due to their large weightings in the benchmark. They added 3.4 and 2.8 percentage points, respectively, to the S&P/TSX Composite's 13.3% return. Finally, the Materials sector was the biggest laggard year-to-date, but was still in the green, up 8.5% on a total-return basis.
- **Canada's GDP increased by 0.3% in January, its best monthly gain in eight months**. Normalizing this on a quarterly basis, Canadian Q1 GDP is now tracking within the 1.0%–1.5% annualized range, slightly above the Bank of Canada's forecast. The advance was particularly impressive given that the mining and energy sector was down, in part due to Alberta's mandated oil production cuts, which took effect at the beginning of the year. Ultimately, January's solid gain can be attributed to an increase in construction and manufacturing. But according to RBC Global Asset Management, **it is worth putting this GDP increase into perspective**. Economic output declined in three of the prior four months, which argues that the Canadian economy is still in a tough position. Overall, RBC Global Asset Management's leading indicator aggregate for the economy remains weak and is trending downwards.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- In an attempt to break the political logjam, and in a blow to the ardent Brexiters in her Conservative Party, **Prime Minister Theresa May reached out to the opposition to**

find a mutually acceptable deal and announced she would seek another short extension of the Brexit deadline beyond April 12.

- She thus seems to be **pivoting away from a hard Brexit towards a softer version**, which may find more support in Parliament. Her plan may still stumble. The Labour Party could insist on a confirmatory referendum, which would not be acceptable to Conservatives; or she may not have a credible plan to present to the EU when she requests another extension. As such, the risk of no deal, though low, remains for now.
- The U.K.'s composite Purchasing Managers' Index (PMI) dove to 50 in March from 51.5 in the previous month, as the services PMI dropped to 48.9, its worst level in two years. The drop in the composite index would have been more pronounced had it not been for Brexit-related stockpiling in manufacturing. **With stockpiling probably peaking, we believe the risk to the U.K. economy is likely to be on the downside**.
- **News in Europe was more positive. The IHS Markit Eurozone Composite PMI for March was better than expected** at 51.6 and stronger than the flash reading of 51.3. Services PMIs improved for the third consecutive month, marking 12-month highs in Spain and Italy (56.8 and 53.1, respectively), while French and German numbers were revised up (to 49.1 and 55.4, respectively). **The composite PMI continues to be held back by the manufacturing slowdown**. The risk, in our view, is that this malaise spreads to the services sector. With stronger Chinese economic data for March and increased optimism around U.S.-China trade talks, we believe European data may well bottom out over the next few months. RBC Capital Markets expects euro area GDP to expand 0.3% q/q in Q1.
- **European equities have clawed back most of their Q4 2018 losses** and are up 18% since their December lows.

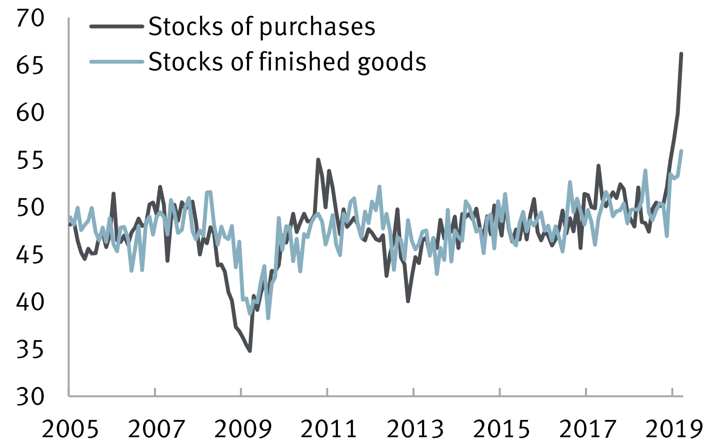
Asia Pacific

Jay Roberts, CFA – Hong Kong

- **The MSCI AC Asia Pacific Index** rose slightly in March after good gains in January and February. The index **has almost recovered the losses registered in the steep correction of Q4**. However, it remains well below its high point of 2018. Generally, Asian equity valuations are close to 5-year averages while the earnings outlook is nothing to write home about.
- On a more positive note, there was an **uptick in Chinese manufacturing data**. The official Purchasing Managers' Index, a leading economic indicator, unexpectedly rose to 50.5 from 49.2 in March. A number above 50 implies expansion in manufacturing activity. While at first glance this might not seem like a big move, it was in fact the largest increase since 2012. Another leading indicator, the Caixin China General Services Business Activity Index, rose to 54.4 from 51.1 (seasonally adjusted) in February. **While these data points do not indicate a trend, it is possible that the deceleration in the Chinese economy is easing at present**.
- Even so, the main driving force for the Chinese equity market in the short term remains the **trade talks** between the U.S. and China. While progress continues to be made, **key questions remain over enforcement mechanisms** for any deal and whether any, or all, existing tariffs will be kept in place irrespective of a deal being done.
- **ICBC** (1398 HK), China's largest bank and the largest in the world by assets, reported a **4.1% increase in earnings in 2018** to RMB297.7B ($44.3B). This was slightly below forecast. Results were stable with a moderate improvement in asset quality (which relates to bad loans). The bank noted increasing nonperforming loans in Northeastern China, which is an industrial heartland of China. **Bank of China** (3988 HK) **reported similar earnings growth** but cautioned that the banking sector will have to deal with a **complicated operating environment in 2019**.
- **Real estate stocks in Hong Kong climbed to a record high**. After months of weakness with an overall decline of 10% in prices, property prices reversed. We question, however, whether price increases in the physical market are sustainable given the extremely high levels of unaffordability, which are very stretched even by Hong Kong's standards. Hong Kong lays claim to the unfortunate title of the world's most expensive real estate market.

Stockpiling probably peaking?

U.K. Manufacturing PMIs



Source - Haver Analytics, IHS/Markit, RBC Capital Markets

MARKET SCORECARD

Data as of April 4, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,879.39	1.6%	14.9%	8.9%	22.0%
Dow Industrials (DJIA)	26,384.63	1.8%	13.1%	8.7%	27.5%
NASDAQ	7,891.78	2.1%	18.9%	12.1%	33.8%
Russell 2000	1,567.49	1.8%	16.2%	2.3%	14.6%
S&P/TSX Comp	16,311.61	1.3%	13.9%	7.6%	4.1%
FTSE All-Share	4,046.62	1.7%	10.1%	4.4%	1.4%
STOXX Europe 600	387.87	2.3%	14.9%	5.6%	2.1%
EURO STOXX 50	3,441.93	2.7%	14.7%	3.0%	-1.1%
Hang Seng	29,936.32	3.0%	15.8%	1.4%	23.4%
Shanghai Comp	3,246.57	5.0%	30.2%	3.7%	0.7%
Nikkei 225	21,724.95	2.4%	8.5%	1.9%	15.5%
India Sensex	38,684.72	0.0%	7.3%	17.2%	29.3%
Singapore Straits Times	3,316.21	3.2%	8.1%	-0.7%	4.3%
Brazil Ibovespa	96,313.06	0.9%	9.6%	14.2%	46.4%
Mexican Bolsa IPC	43,937.39	1.5%	5.5%	-7.4%	-11.0%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,292.99	0.1%	0.8%	-3.0%	2.9%
Silver (spot $/oz)	15.15	0.2%	-2.2%	-7.1%	-17.3%
Copper ($/metric ton)	6,484.00	0.0%	9.0%	-3.1%	12.7%
Oil (WTI spot/bbl)	62.10	3.3%	36.8%	-2.0%	21.7%
Oil (Brent spot/bbl)	69.26	1.3%	28.7%	1.8%	27.9%
Natural Gas ($/mmBtu)	2.64	-0.8%	-10.1%	-2.8%	-19.8%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.508%	10.3	-17.6	-29.5	14.8
Canada 10-Yr	1.697%	8.0	-27.0	-47.8	11.3
U.K. 10-Yr	1.084%	8.4	-19.3	-28.4	1.7
Germany 10-Yr	-0.006%	6.4	-24.8	-50.6	-26.3

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.02%	-0.5%	2.5%	4.2%	5.0%
U.S. Invest Grade Corp	3.69%	-0.5%	4.7%	4.7%	7.0%
U.S. High Yield Corp	6.30%	0.3%	7.6%	6.3%	10.2%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.2790	0.0%	1.2%	7.9%	-3.2%
CAD/USD	0.7488	0.0%	2.1%	-4.4%	0.3%
USD/CAD	1.3356	0.1%	-2.1%	4.6%	-0.3%
EUR/USD	1.1222	0.0%	-2.1%	-8.6%	5.1%
GBP/USD	1.3080	0.3%	2.6%	-7.1%	5.1%
AUD/USD	0.7117	0.3%	1.0%	-7.8%	-5.9%
USD/JPY	111.6000	0.7%	1.7%	4.5%	0.8%
EUR/JPY	125.2400	0.7%	-0.5%	-4.5%	6.0%
EUR/GBP	0.8580	-0.3%	-4.6%	-1.6%	0.0%
EUR/CHF	1.1223	0.5%	-0.3%	-4.9%	4.9%
USD/SGD	1.3549	-0.1%	-0.6%	3.3%	-3.1%
USD/CNY	6.7170	0.1%	-2.3%	6.6%	-2.5%
USD/MXN	19.1482	-1.4%	-2.6%	5.8%	1.7%
USD/BRL	3.8589	-1.6%	-0.4%	15.9%	24.8%

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 4/4/19.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 2.1% return means the Canadian dollar rose 2.1% vs. the U.S. dollar year to date. USD/JPY 111.60 means 1 U.S. dollar will buy 111.60 yen. USD/JPY 1.7% return means the U.S. dollar rose 1.7% vs. the yen year to date.

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Hold [Sector Perform]	589	40.07	107	18.17
Sell [Underperform]	87	5.92	5	5.75

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