RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Down the Brexit rabbit hole

Frédérique Carrier – London

The U.K.'s long and difficult road to Brexit continues, with Prime Minister Theresa May resigning. We shed light on the political upheaval and look at what this all means for the U.K.'s outlook and financial market strategy.

The outcome of the recent elections for the European Parliament is having far-reaching consequences on the U.K.'s political landscape and is resetting the debate about Brexit, with the U.K. still insisting on improving the terms of its exit from the EU scheduled for October 31.

The results

The Brexit Party, which campaigned on a "no-deal" platform (to leave the EU even if there is no formal agreement on terms), was the clear winner with 31.6% of the votes in the U.K. It benefitted from the support of disgruntled Conservative voters annoyed that Brexit has not yet been delivered. The Liberal Democrats, which campaigned on a clear platform of "Remain," did much better than the polls had predicted, claiming second place. They benefitted from disillusioned Labour voters put off by the party's ambiguous stance on Brexit and a second referendum. The big losers were the U.K.'s two traditional parties, Conservatives and Labour, both suffering from bitter in-fighting over Brexit. The former, in particular, languished with a mere 9% of the vote, its worst performance in any election in its history.

The fallout

The elections are having a profound effect on the Conservative Party. Even before the results were out, Prime Minister Theresa May succumbed to party pressure and announced she would resign as Conservative leader on June 7, though she will stay on as prime minister until her successor is chosen. Leadership candidates are adopting a more aggressive tone towards the EU, including a willingness to pursue a no-deal Brexit if necessary in order to reverse the exodus of voters to the Brexit Party.

Traditional parties lose significant support

Breakdown of U.K. seats in the European Parliament

	2014	2019	Difference
The Brexit Party	–	29	
UKIP	24	–	
No deal Brexit Parties	**24**	**29**	**+5**
Change U.K.	–	0	
Lib Dems	1	16	
Greens	3	7	
SNP	2	3	
Plaid Cymru	1	1	
Anti Brexit Parties	**7**	**27**	**+20**
Labour	20	10	
Conservative	19	4	
Mixed/Ambiguous Brexit Views	**39**	**14**	**-25**
Others	3	3	0

Source - European Parliament, BBC, RBC Wealth Management

Market pulse

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Priced (in USD) as of 5/30/19 market close, EST (unless otherwise stated).

For important disclosures and required non-U.S. analyst disclosures, see **page 6**

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Labour, aware its ambiguity cost it dearly, is shifting its stance towards supporting a second referendum, though with some conditions attached, for now.

What happens now?

The Conservatives hope to install a new leader—who will inherit the role of prime minister—before September. The process will see the 313 Conservative Members of Parliament select two candidates (among the 11 who have declared their candidacies so far) to stand in a run-off to be decided by some 120,000 Conservative party members. Polls currently favour former Foreign Secretary Boris Johnson, but it is too early to predict whether he will emerge as the winner. Over the past 50 years, only once did the early favorite clinch the top role. His closest challenger is Dominic Raab, the former Secretary of State for Exiting the European Union, though he trails Johnson by a wide margin at present.

Given hardening attitudes towards Brexit in Conservative circles, it is highly likely an ardent Brexiter will become party leader on the platform of pushing for no deal if necessary. In April, a ConservativeHome survey found that 75% of party members supported no deal.

But the same complex political environment—a minority government, a bitterly divided party, and a polarized Parliament—will greet the next prime minister. Moreover, a prime minister who is a hard Brexit proponent is likely to have even less political capital than May had in Europe, particularly as the EU Parliament will receive 29 potentially highly disruptive members from the Brexit Party.

Probability set

For financial markets, the question is whether a more ardent Brexiter as prime minister increases the probability of a no-deal Brexit, which would likely lead to a substantial loss in economic output, or of a general election, with the prospect of a far-left, possibly fiscally excessive Labour government with a nationalization agenda.

We think so, given the hardening of positions, and we assign a 30% probability to a no deal and the same for a general election, slightly higher than is currently discounted in markets. We also see a 30% chance of a Withdrawal Agreement being passed, leaving a 10% likelihood of Brexit not happening. Given our equal probabilities for these three scenarios, the visibility going forward is clearly murky:

No deal: This outcome remains the legal default on October 31. Parliament has some tools to prevent it, but whether they are deployed effectively and in a timely manner is questionable. Remember that the "Cooper" amendment that previously prevented a no deal from occurring was passed by only a single vote.

General elections: Encumbered by unhelpful parliamentary arithmetic, a new prime minster may seek a fresh mandate from the electorate. A general election under a new leader may be seen as the best alternative to seek this, as it would be less time consuming to legislate for an election and face less opposition from Brexiters than a second Brexit referendum would.

Withdrawal Agreement: An orderly exit is still possible should a new, pragmatic leader try and extract concessions from the EU, using a no-deal Brexit as a bargaining chip—a strategy May had eventually refused to use. While the EU may grant small concessions, we doubt it would substantially change the Withdrawal Agreement, particularly with respect to the Irish backstop—that would mean treating a departing member state more favorably than an existing one (Ireland). The new prime minster could try and sell the hardly altered Withdrawal Agreement to the House of Commons, as being presented by a fresher face may make it more amenable to Brexiters and improve its chance of passing.

Much to accomplish in very little time

Timeline to Brexit day

May 24	PM May announces she will step down
June 10–14	Nominations for Conservative leadership close
June 18	Conservative MPs start voting in secret ballot
June–July	2 remaining candidates put to a vote among 120,000 party members
3rd week July	Parliament summer recess starts
September 3	Parliament returns from summer recess with new PM
Sept 29–Oct 2	Annual Conservative Party Conference
October 31	Brexit day

Source - RBC Capital Markets

How to approach U.K. financial markets

With this hanging cloud of political uncertainty, market expectations for the Bank of England to increase rates are being firmly pushed out to 2020. The pound has come under pressure on the back of the flare-up in political frictions, falling from 1.318 versus the U.S. dollar just over a month ago to 1.2653. Greater volatility is likely, in our view, as Brexit uncertainty persists through the summer.

U.K. 10-year Gilt yields slipped below 0.9%, from a high of 1.2%, over the same period. We maintain a Market Weight stance on U.K. government bonds with a bias towards short-duration positioning. We also see the yield pickup for U.K. corporate credit as attractive and retain a Market Weight allocation, though we recommend a selective approach.

We are also Market Weight U.K. equities, which offer good value on a FY2020E price-to-earnings ratio of 11.6x. We think selectivity is prudent and continue to prefer globally diversified companies.

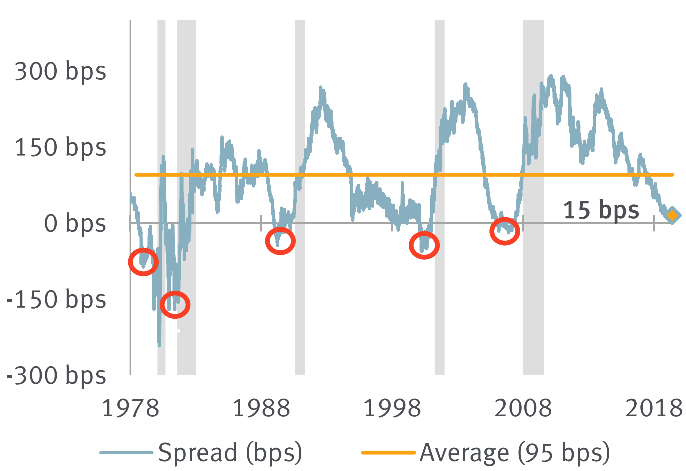
United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets are on track for their fourth straight week of declines** as major indexes have retreated between 0.9% and 1.9%. The Technology- and Health Care-heavy NASDAQ has held up better than the S&P 500 thus far during the week, but is lagging in May. As the month nears its end, it's clear to see that the **Energy sector (-10.3%) has disappointed** on declines of nearly 20% in the oilfield services industry, and the **Technology sector (-7.3%) has underperformed** on declines of greater than 15% for semiconductor shares due to global trade and tariff concerns. The other side of the coin saw defensive sectors perform well as interest rates fell. REITs has been the only sector to deliver positive returns thus far in May, while Utilities and Health Care delivered relatively good returns with the sectors' losses smaller than 2%.
- **The 10-year Treasury yield fell to its lowest level since the fall of 2017**, breaking below 2.30%. Additionally, on May 29, the spread between the 2-year and 10-year (2Y10Y) Treasury rates dipped below 14 basis points for the first time since late March. Remember that **there are several points along the short end of the yield curve that have inverted, but the 2Y10Y spread has yet to invert during this cycle**. That's important because the 2Y10Y spread is often used to gauge recession risks, and it hasn't given a false positive since the 2-year started being issued in 1976. This matters because the heightened risk at the short end of the yield curve supports our equity preference for high-quality, defensive stocks; the fact that the longer-dated end of the curve hasn't inverted continues to support our preference for a Market Weight position in U.S. equities.
- Finally, **economic trends continued a mixed trajectory** as disappointing pending home sales data saw a decline of 1.5% versus consensus expectations for a 0.5% gain, while the second reading of Q1 GDP showed economic growth of 3.1%, modestly ahead of expectations.

Narrowing, but not quite inverted

Difference between U.S. 2-year and 10-year Treasury rates



Note: Measured in basis points (bps), gray bars represent recessions
Source - RBC Wealth Management, Bloomberg; data through 5/29/19

Canada

Carolyn Schroeder – Toronto

- **The Bank of Canada (BoC) expectedly kept its policy rate on hold** during the week with its data-dependent stance reiterated throughout the released statement. As a result, **market reaction was muted** while global trade headlines remain the driving force of Canadian government bond yields. More specifically, the 10-year yields of many global economies have dipped below their respective policy rates with the U.S. 10-year reaching its lowest level since mid-2017 and the spread between the U.S. 10-year and 3-month rates venturing further into negative territory. The BoC's statement provided **minimal detail on any changes in the Governing Council's view** on where the economy is headed from here, with data developing largely in line with April staff projections. This **leaves us closely monitoring the data ahead** to see which direction the next move in monetary policy might be. The bond market thinks it's more likely to be lower, and bank strategists see the BoC on hold for the next two years, while the BoC itself suggests that if its forecasts are accurate, the next move is more likely higher.
- Statistics Canada announced that **Canadian headline retail sales were up 1.1% to CA$51.3B in March,** representing another month of growth. According to RBC Capital Markets, there was sales **growth in 7 of 11 subsectors and 9 of 10 provinces** on a sequential basis; the exception was Manitoba, which was down 0.7%. Total retail sales increased 2.4% for the second consecutive month in Alberta on the strength of higher sales in all subsectors. In Ontario, retail sales increased 0.8% on the strength of higher sales at gasoline stations. Across all provinces, retail sales growth in March was primarily attributed to building materials, up 4.3%, and increasing fuel prices at the pump accounting for a 6.0% increase. On a quarterly basis, retail sales increased 0.1% in Q1 2019, on the back of a 0.5% decrease in Q4 2019. Overall, that represents a **2.6% y/y increase in Canadian headline retail sales**.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Beyond the borders of the U.K., the European Parliament elections proved less eventful than expected**. Though the parliament is now more fragmented, **right-wing Eurosceptic parties** garnered less support than polls had suggested and **now hold less than 25% of the seats, up from 20% in the 2014 election**. Eurosceptics will likely find it difficult to exert meaningful influence as they remain deeply divided. Their advance was at the expense of the traditional centre, with liberal parties and the Greens also making gains, particularly in France and Germany.
- **Prominent right-wing Eurosceptic gainers were Italy's Lega Nord and Marine Le Pen's Rally National (RN)**, which edged French President Emmanuel Macron's party into second place by one percentage point. We note, however, that the RN gathered 3% less support than its predecessor, the Front National, had in 2014.
- **Conceivably, the aftermath of those elections will have a greater impact on national political landscapes than on regional governance**. We pointed out last week that if Italy's Lega were to do well, its leader might call snap elections in the autumn. **Two countries, Austria and Greece, have already announced fresh national elections**. Financial markets reacted favorably to the Greek announcement as polls suggest a swing to the business-friendly New Democracy party. Finally, **in the U.K., the European results have broad implications for the traditional parties** (see feature article). And in what will likely prove an additional headache for the next U.K. prime minister, the Scottish National Party—emboldened by its best-ever showing—published legislation enabling another Scottish independence vote before 2021.
- With parliamentary seats allocated, attention will turn to distributing the top jobs at the European Commission, the European Council, and the European Central Bank (ECB). **Appointing a German to the helm of the ECB would likely be seen as a hawkish move by the markets** given the country's commitment to fiscal and monetary rectitude.
- **Global auto manufacturers Renault and Fiat Chrysler announced they were in merger talks**, sending both companies' shares up around 12% on May 27. Increased consolidation among auto manufacturers has long been seen as necessary in light of the need for greater capital investment and the costs of shifting towards electrified powertrains and autonomous technologies. With trade-related risks added to the aforementioned structural challenges, **we remain cautious on the automotive subsector** despite low valuations.

Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- U.S.-China trade tensions are still an overhang for Asian markets. **President Donald Trump said the U.S. isn't ready to make a trade deal with China**. Afterwards, the *People's Daily* reported that **China may restrict the exports of rare earth minerals to the U.S. as retaliation**. We believe an agreement may not be reached anytime soon. The dispute could affect investors' risk appetite until the two parties meet again at the G20 meeting in late June, if not longer. The MSCI AC Asia ex Japan Index declined slightly for the week and has fallen roughly 10% since negotiations began to deteriorate in mid-April.
- Chinese telecom giant **Huawei**, one of the targets of the U.S. technology ban on China, **filed a motion in U.S. federal court** for a summary judgment in its challenge of the constitutionality of a section of the 2019 National Defense Authorization Act that bans U.S. government agencies from buying Huawei equipment. The move is meant to speed up the process to halt what Huawei calls the "illegal action" against the company.
- Trade tensions and related concerns about global growth are adding to **uncertainties about Japan's economic recovery**. A government report acknowledged ongoing weakness in exports and output but said the economy is recovering at a moderate pace. **Conflicting economic data fuel debate on a sales tax hike** set to come into effect in October, with some calling for another delay. While a tax hike could constrain growth, proponents argue it would help Japan achieve fiscal reform in the long run. A Reuters survey shows more than 60% of Japanese firms support the planned increase in the sales tax.
- **Alibaba** (BABA), the Chinese e-commerce giant, **is considering raising $20B via a second listing in Hong Kong** according to an unsubstantiated Bloomberg report. The firm could file a listing application as early as the second half of 2019. The move could diversify Alibaba's funding channels and boost liquidity.
- **FTSE Russell**, a global multi-asset index provider, said it **still plans to add Chinese A-shares to its global benchmark** despite the U.S.-China trade dispute. The inclusion will take effect after market close on June 24. According to Reuters, the first stage of the inclusion is expected to draw $10B into A-shares from passive investors. The second and third stages will occur in December and March 2020, respectively.

MARKET SCORECARD

Data as of May 30, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,788.86	-5.3%	11.2%	2.0%	16.3%
Dow Industrials (DJIA)	25,169.88	-5.4%	7.9%	1.1%	20.2%
NASDAQ	7,567.72	-6.5%	14.1%	1.9%	23.3%
Russell 2000	1,485.53	-6.6%	10.2%	-8.7%	7.6%
S&P/TSX Comp	16,089.24	-3.0%	12.3%	-0.3%	4.0%
FTSE All-Share	3,954.18	-2.8%	7.6%	-7.6%	-3.5%
STOXX Europe 600	372.07	-4.9%	10.2%	-5.2%	-5.1%
EURO STOXX 50	3,318.15	-5.6%	10.6%	-6.3%	-7.7%
Hang Seng	27,114.88	-8.7%	4.9%	-11.6%	6.7%
Shanghai Comp	2,905.81	-5.6%	16.5%	-8.3%	-5.1%
Nikkei 225	20,942.53	-5.9%	4.6%	-7.7%	6.8%
India Sensex	39,831.97	2.1%	10.4%	16.0%	31.2%
Singapore Straits Times	3,143.00	-7.6%	2.4%	-10.1%	-2.5%
Brazil Ibovespa	97,457.36	1.1%	10.9%	20.5%	55.5%
Mexican Bolsa IPC	43,345.82	-2.8%	4.1%	-5.3%	-11.6%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,288.58	0.4%	0.5%	-0.4%	3.0%
Silver (spot $/oz)	14.52	-2.9%	-6.3%	-11.8%	-14.9%
Copper ($/metric ton)	5,854.00	-8.9%	-1.6%	-14.4%	2.8%
Oil (WTI spot/bbl)	56.59	-11.5%	24.6%	-21.2%	10.6%
Oil (Brent spot/bbl)	66.49	-8.7%	23.6%	-16.7%	22.8%
Natural Gas ($/mmBtu)	2.56	-0.6%	-13.0%	-12.2%	-20.5%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.215%	-28.7	-46.9	-77.9	-6.5
Canada 10-Yr	1.554%	-15.8	-41.3	-88.8	4.4
U.K. 10-Yr	0.897%	-28.8	-38.0	-54.2	-18.5
Germany 10-Yr	-0.175%	-18.8	-41.7	-68.2	-58.5

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.79%	1.2%	4.3%	6.8%	6.0%
U.S. Invest Grade Corp	3.53%	0.8%	6.6%	7.7%	7.5%
U.S. High Yield Corp	6.50%	-1.0%	7.7%	5.7%	8.5%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	98.1570	0.7%	2.1%	4.4%	0.8%
CAD/USD	0.7405	-0.8%	1.0%	-4.9%	0.1%
USD/CAD	1.3504	0.9%	-1.0%	5.2%	-0.1%
EUR/USD	1.1131	-0.7%	-2.9%	-4.8%	-0.5%
GBP/USD	1.2614	-3.2%	-1.1%	-5.5%	-2.7%
AUD/USD	0.6911	-1.9%	-2.0%	-8.6%	-7.6%
USD/JPY	109.6100	-1.6%	-0.1%	-0.4%	-1.9%
EUR/JPY	122.0000	-2.4%	-3.0%	-5.3%	-2.4%
EUR/GBP	0.8824	2.6%	-1.8%	0.7%	2.3%
EUR/CHF	1.1219	-1.9%	-0.3%	-3.7%	2.8%
USD/SGD	1.3790	1.3%	1.2%	2.7%	-0.8%
USD/CNY	6.9019	2.5%	0.3%	8.0%	0.2%
USD/MXN	19.1467	1.1%	-2.6%	-2.5%	2.8%
USD/BRL	3.9763	1.4%	2.6%	9.6%	21.6%

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 5/30/19.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 1.0% return means the Canadian dollar rose 1.0% vs. the U.S. dollar year to date. USD/JPY 109.61 means 1 U.S. dollar will buy 109.61 yen. USD/JPY -0.1% return means the U.S. dollar fell 0.1% 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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