

Global Insight

Weekly

A bounce in their step

Kelly Bogdanova – San Francisco

Stock indexes around the world rebounded smartly from the losses stemming from fears over the coronavirus, with the U.S. market pushing to another record high. We look at four catalysts behind stock markets' resiliency, but point out that one of these makes us a bit uncomfortable.

The equity market rally has been sharp and swift since the Novel Coronavirus (2019-nCoV) became more acute, especially in the U.S. where the S&P 500 jumped 3.7 percent from its recent low and reached a new all-time high. Other markets have also bounced, although the recovery in Asia has lagged, understandably.

Why the optimism? There are four reasons markets have bounced, which we highlight below. However, the third reason gives us pause.

(1) Loosening the grip of coronavirus fears

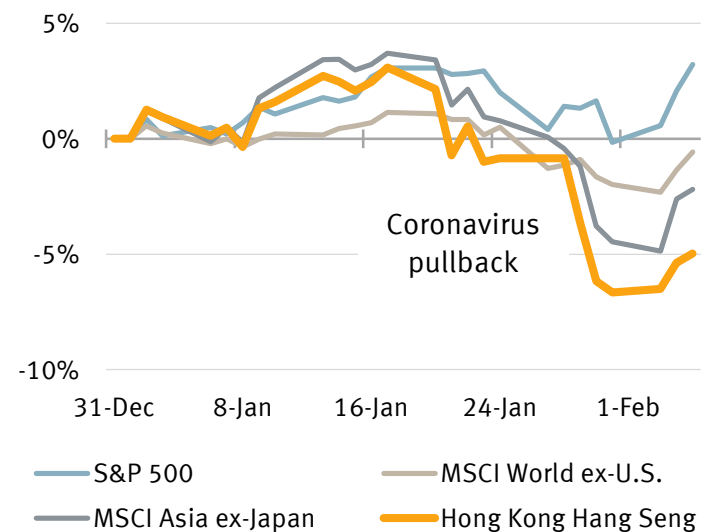
Thus far, markets seem to be taking cues from *official* coronavirus data. Even though the number of infections has jumped by almost 250 percent since last week, recently the increase in the daily rate of new cases has moderated, according to data from the Chinese and U.S. governments, and global health organizations. New infections have been mostly contained to China, predominantly in Wuhan and the surrounding Hubei province. Reported death rates remain low, and there has been progress on developing treatments and vaccines.

(2) Economies likely to ride out the outbreak

We think it's broadly accepted among institutional investors that coronavirus is likely to dent Chinese growth and constrain global growth. RBC Global Asset Management Inc. Chief Economist Eric Lascelles wrote, "The Wuhan epicenter is of considerable relevance to the Chinese economy, in its capacity as the country's seventh largest city, given its status

Asian markets have struggled more due to coronavirus

Year-to-date performance of select equity indexes (%)



Source - RBC Wealth Management, Bloomberg; data through 2/5/20

Market pulse

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- 3 Canada GDP data shouldn't move the needle for the BoC
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as a nationwide transportation hub, and given its large international manufacturing sector.”

However, we think equity markets are gravitating to our view that the economic impact should be manageable so long as the outbreak remains contained and because the Chinese government seems committed to supporting its economy. It just injected RMB 1.7 trillion into its banking system and officials have signaled a willingness to pull other levers.

At this stage, Lascelles expects China's Q1 GDP growth to be cut in half to three percent from its typical six percent rate, but he anticipates “unusually rapid” growth in Q2 if the outbreak subsides as others have in the past.

The net-net effect is that Lascelles reduced his 2020 GDP growth forecast for China to 5.6 percent from 5.9 percent. He noted, “This has less to do with mortality rates and more to do with absenteeism, temporarily closed businesses, supply chain issues and confidence effects.”

While the U.S. and Europe could experience coronavirus-related headwinds—particularly in Europe, which is more closely tied to China trade flows—we think this would also be short-lived. Economic trends in the U.S. and Europe have improved lately. In the U.S., the closely watched ISM Manufacturing Purchasing Managers' Index unexpectedly jumped back into expansion territory in January, rising to 50.9 from 47.2, and manufacturing sub-indicators were also strong.

(3) U.S. FOMO

The “fear of missing out,” or FOMO for short, is playing a bigger role in equity performance, in our view. This is the one catalyst that has propelled markets that we're least comfortable with.

Data and anecdotal evidence suggest that some institutional investors are chasing momentum—specifically, narrow pockets of the U.S. market in the Technology and Communication Services sectors that have been outperforming in recent weeks and months. As more investors have piled in, this has likely amplified gains in these segments, and has resulted in a narrower group of stocks leading the U.S. market.

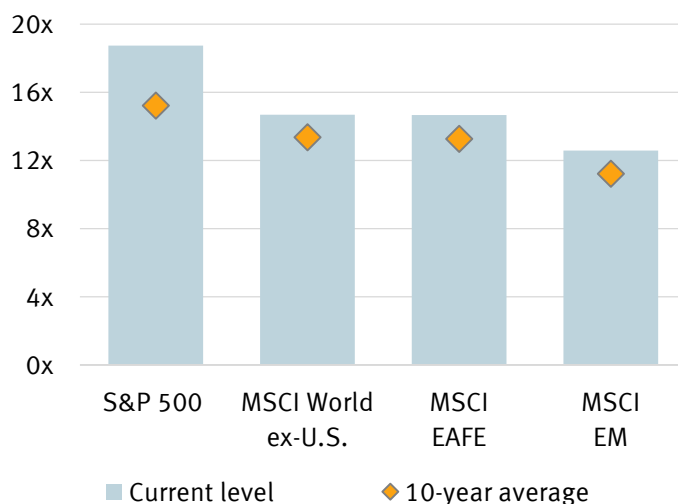
To us, a healthy rally is propelled over time by a broad group of stocks in a variety of sectors and industries leading, rather than just a narrow group.

RBC Capital Markets, LLC Technical Strategist Bob Dickey said there is reason to be circumspect. He wrote, “The higher volatility and big moves by some of the larger growth stocks in the market have often been signs of a market peak in the past, and the current market environment reminds us of those past periods where the volatile moves in some stocks did not make fundamental sense.”

He believes the U.S. market could pull back in the near term. He wrote, “We do not see the recent bounce as the start of a new up-leg for the indexes but as a more typical pattern of

U.S. valuation is more elevated above its long-term average than other major indexes

12-mo. forward price-to-earnings ratios based on consensus forecasts



Note: EAFE = European, Australasian, and Far Eastern markets; EM = Emerging markets

Source - RBC Wealth Management, Bloomberg; data through 2/5/20

higher volatility that often comes at turning points. We would expect this higher volatility will continue for several more weeks and lead into a pullback to the support levels of around 27,000 on the Dow Jones Industrial Average (DJIA) and 3,000 on the S&P 500 over the next two months.”

(4) Earnings trends “good enough”

Equity markets have also bounced lately because Q4 earnings and revenue trends have been largely as expected, with some bright spots. The U.S. earnings growth rate is likely to end the reporting season in positive territory.

Also, the rate of decline in forward earnings estimates has slowed or stabilized in a number of developed markets. For example, the consensus forecast for S&P 500 earnings has dipped just \$1 to \$176 per share since late December.

Stay on target

While equity markets have bounced due to these four factors, we don't rule out additional volatility as the economic implications of coronavirus are further discerned and digested. Any swings in U.S. momentum stocks could also impact the broader U.S. and global equity markets.

For long-term investors, we are still comfortable holding total equity exposure at the benchmark level in portfolios as long as most of our U.S. recession indicators continue to signal that the expansion will persist and the global economy is not meaningfully threatened by coronavirus or other extraneous factors. We do, however, recommend that investors double-check their equity allocations. If they have run ahead of target levels, now would be a good time to trim them back to normal, in our view.



United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets have largely shrugged off late January's weakness** thus far this week, as evidenced by the three major large-cap indexes hitting new all-time highs. With weekly gains approaching 5%, the NASDAQ and Russell 2000 are leading the S&P 500 and Dow Jones Industrial Average—whose gains are still north of 3%. **Value and growth stocks have alternated leadership** on a daily basis, but for the week, both are up similar amounts while the VIX, often referred to as the fear index, has declined to below 15 from its January 31 intraday high of 19.99. **Weekly sector leadership can be described as pro-growth and pro-cyclicality** as Tech, Materials, Health Care, and Industrials are the four leading sectors.
- Earnings season rolls on with 73% of the S&P 500 market cap having delivered results. At this time, **the S&P 500 is on track for earnings growth of 1.6% and revenue growth of 4.8% for the fourth quarter**. These growth metrics compare favorably to the respective -0.3% and 4.1% estimates from December 31, and highlight the overall surprise factors that have been positive thus far in earnings season. Specifically, Consumer Discretionary, Information Technology, and Communication Services have been delivering the best earnings **surprise factors** with each more than 8% higher than expected in aggregate. Meanwhile, Industrials (-3.1%) is the only sector surprising to the downside while Utilities and Real Estate have delivered positive surprise of less than 1%.
- After last week's weak economic data, headlined by the regional Purchasing Managers' Index (PMI) data from the Chicago Fed and Pending Home Sales, this week saw a reversal. **Both ISM PMIs hit expansionary levels** and came in higher than expected with the 50.9 reading on the Manufacturing Index and 55.5 on the Non-Manufacturing Index. These compare favorably to consensus expectations of 48.5 and 55.1, respectively. Finally, ADP employment data showed a **monthly gain of 291,000 jobs**. While there may be revisions to this initial print in coming months, it was the best monthly reading since May 2015's job growth of 295,000.



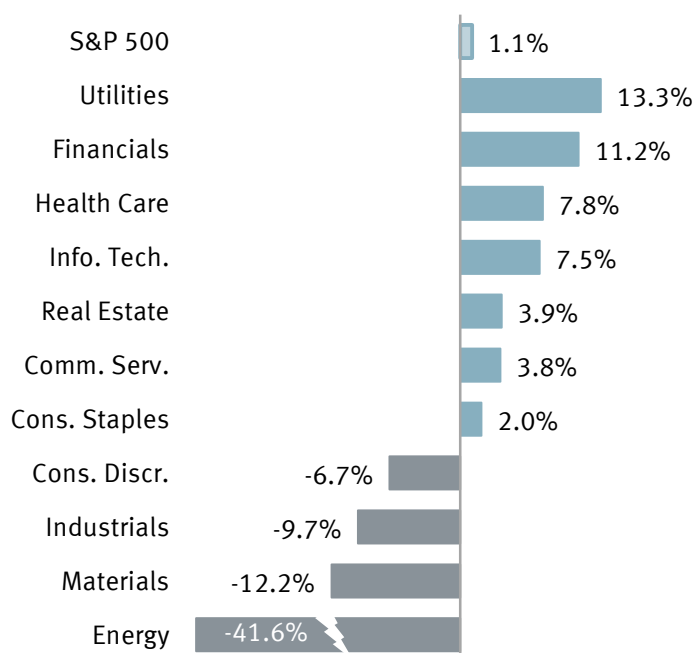
Canada

Meika McKelvey – Toronto

- All eyes were on the **November GDP release** last Friday after the Bank of Canada (BoC) emphasized the recent growth slowdown in Canada as one of the major factors behind the more cautious tone at its January meeting. The small **0.1% m/m gain beat expectations** for a flat reading, and **both**

S&P 500 earnings growth, by sector

Fourth quarter 2019, year over year



Note: Energy is truncated

Source - RBC Wealth Management, Refinitiv I/B/E/S; data as of 2/6/20

goods and services edged up 0.1% in the month. However, the headline gain was driven mainly by growth in utilities on the back of colder weather in many parts of the country. The underlying details of the report were slightly softer and revealed some positives and negatives that are both likely to unwind in the coming months. Ultimately, **the November print does not change the barely flat growth picture for Q4** (+0.3%) and should not move the needle for the BoC in terms of the possible need for easing.

- Another strong data print that wasn't as encouraging under the hood was the release of the **December Canadian trade deficit. It came in at a smaller-than-expected CA\$370 million**, with the headline improvement driven by energy exports after the completion of repairs on a major pipeline helped shipments of crude surge during the month. Non-energy exports showed almost no growth in December and although the Canadian National Railway and General Motors strikes likely weighed on results, **underlying trends remain soft**. On the import side, capital goods import volumes (an indicator for business investment) fell almost 3% to the lowest level in two years and combined with aircraft/other transport imports (which often feed into the non-residential investment category), **Q4 annualized growth saw its third straight quarterly decline**. Overall, like the November GDP beat, the better December trade print is unlikely to ease

growth concerns at the BoC, and the door to a potential rate cut should remain firmly open.



Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Economic data suggests the eurozone economy has bottomed.** The IHS Markit Eurozone Composite Purchasing Managers' Index (PMI) reached 51.3 in January, slightly more than the 50.9 registered in December, and better than economists' expectations. **The positive outcome came despite disappointing performance in France** where pension reform protests led to slightly weaker economic activity. Much like what we saw with the 2018 Yellow Vests protests, we would expect the impact of the current demonstrations to be temporary and for a rebound in the French economy to follow.
- **However, that is not to say that the region is out of the woods. Some areas, such as German manufacturing, are still struggling.** German new factory orders fell 2.1% m/m in December, the eighth monthly decline in 2019. Moreover, as European Central Bank President Christine Lagarde pointed out in a recent speech, the coronavirus is a new risk to sentiment. **RBC Capital Markets expects the outbreak will affect February economic activity data in Germany in particular**, as it is an exporting nation and given the importance of the automotive market to its economy. The Chinese motor authority recently estimated the coronavirus could reduce car sales in China by 2%–5% in 2020, and up to 10% in a worst-case scenario. The 10-year German Bund yield reached a low of -0.44%, down from a high of -0.15% in mid-January.
- Meanwhile, **the UK is enjoying an economic bounce** with the country's January composite PMI at a healthy 53.3, above the prior-month level, as businesses take heart in the strong Conservative majority in government. Yet **attention should soon turn to the trade negotiations with the EU** where UK Prime Minister Boris Johnson has opted to diverge from the EU on regulations so that **only a bare-bones free trade agreement looks possible**. This approach should be disruptive to the UK economy, though higher government spending should help see it through any disruptions.



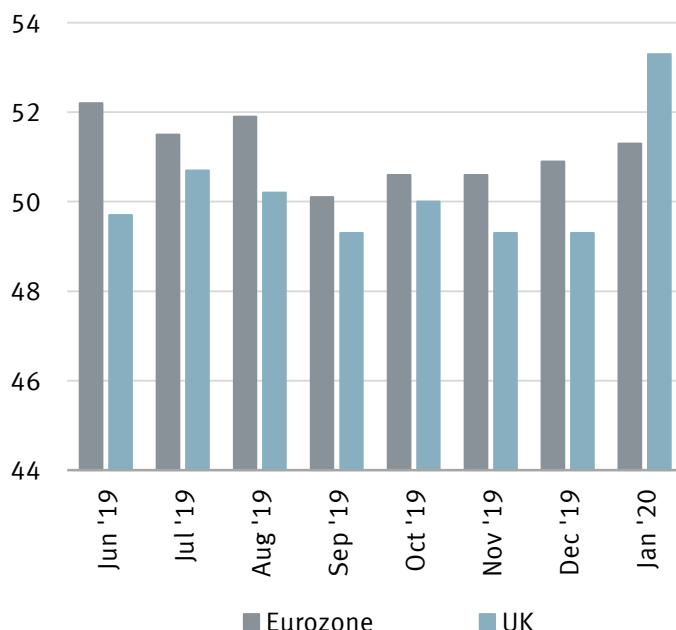
Asia Pacific

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

- **After plunging by 8% on February 3, the China A-share market recovered strongly** over the next few days. The Chinese government has taken various measures to support

European economic data firming

Markit Composite PMI



Source - RBC Wealth Management, Bloomberg; data through 1/31/20

the market, including: the People's Bank of China injected RMB 1.7 trillion of liquidity into the banking system on February 3–4; suspending securities lending from February 3 until further notice; and proprietary traders at brokerages and insurers are prohibited from being net sellers of equities this week. **We believe the government will have to further loosen monetary and fiscal policy to maintain economic stability.** Other potential measures include cutting banks' required-reserve ratio and higher fiscal spending (higher deficits).

- Positive tariff news also boosted market sentiment. On February 6, **China announced it will halve tariffs on some \$75 billion of imports from the U.S.** The cut will take effect from 1:01 p.m. on February 14 (Beijing time), the same time as when the U.S. is set to reduce tariffs on Chinese products. Chinese tariffs on American goods that were adopted from September 2019 will be lowered, with some rates dropping to 5% from 10%, and others to 2.5% from 5%.
- **Hong Kong closed more border crossings with China** on February 3. The city will also impose a mandatory 14-day quarantine on all visitors from mainland China starting from February 8. **Retail sales, which have been sliding for 11 months due to local protests, will likely suffer another hit.** Hong Kong's retail sales in December 2019 slumped by 19.4% y/y amid protests. For 2019, total retail sales decreased by 11.1% y/y in value and by 12.3% in volume terms. We remain cautious on the retail outlook for Q1 2020.



MARKET SCORECARD

Data as of February 6, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,345.78	3.7%	3.6%	22.5%	24.1%
Dow Industrials (DJIA)	29,379.77	4.0%	2.9%	15.7%	17.9%
NASDAQ	9,572.15	4.6%	6.7%	29.8%	34.5%
Russell 2000	1,677.46	3.9%	0.5%	10.5%	11.3%
S&P/TSX Comp	17,757.49	2.5%	4.1%	13.0%	15.6%
FTSE All-Share	4,170.89	2.8%	-0.6%	6.2%	6.3%
STOXX Europe 600	425.49	3.6%	2.3%	16.4%	14.1%
EURO STOXX 50	3,805.52	4.5%	1.6%	18.5%	12.1%
Hang Seng	27,493.70	4.5%	-2.5%	-1.8%	-10.1%
Shanghai Comp	2,866.51	-3.7%	-6.0%	9.5%	-15.0%
Nikkei 225	23,873.59	0.9%	0.9%	14.4%	10.5%
India Sensex	41,306.03	1.4%	0.1%	11.7%	20.8%
Singapore Straits Times	3,231.55	2.5%	0.3%	1.5%	-5.1%
Brazil Ibovespa	115,190.00	1.3%	-0.4%	21.7%	37.3%
Mexican Bolsa IPC	44,493.15	0.9%	2.2%	1.5%	-9.8%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,566.83	-1.4%	3.3%	19.9%	18.3%
Silver (spot \$/oz)	17.82	-1.2%	-0.2%	13.7%	7.1%
Copper (\$/metric ton)	5,703.50	2.7%	-7.2%	-8.9%	-18.9%
Oil (WTI spot/bbl)	50.95	-1.2%	-16.6%	-5.7%	-19.6%
Oil (Brent spot/bbl)	55.11	-5.2%	-16.5%	-12.1%	-17.6%
Natural Gas (\$/mmBtu)	1.87	1.2%	-14.8%	-29.9%	-32.4%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.642%	13.5	-27.5	-105.2	-115.9
Canada 10-Yr	1.369%	9.6	-33.3	-55.6	-99.6
U.K. 10-Yr	0.582%	5.8	-24.0	-63.4	-93.9
Germany 10-Yr	-0.370%	6.4	-18.5	-53.2	-106.2
Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.12%	-0.5%	1.4%	9.3%	11.9%
U.S. Invest Grade Corp	2.66%	-0.5%	1.8%	13.8%	15.4%
U.S. High Yield Corp	5.32%	0.5%	0.5%	9.1%	12.9%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	98.4680	1.1%	2.2%	2.2%	9.9%
CAD/USD	0.7526	-0.4%	-2.2%	-0.6%	-6.0%
USD/CAD	1.3287	0.4%	2.3%	0.6%	6.4%
EUR/USD	1.0980	-1.0%	-2.1%	-3.4%	-11.3%
GBP/USD	1.2926	-2.1%	-2.5%	0.0%	-7.3%
AUD/USD	0.6728	0.5%	-4.2%	-5.3%	-14.9%
USD/JPY	109.9700	1.5%	1.3%	0.0%	0.4%
EUR/JPY	120.7500	0.5%	-0.8%	-3.4%	-11.0%
EUR/GBP	0.8495	1.1%	0.4%	-3.3%	-4.3%
EUR/CHF	1.0703	0.1%	-1.4%	-6.0%	-7.6%
USD/SGD	1.3857	1.5%	3.0%	2.2%	5.1%
USD/CNY	6.9707	0.9%	0.1%	3.4%	10.8%
USD/MXN	18.6602	-1.0%	-1.4%	-2.4%	0.3%
USD/BRL	4.2825	0.0%	6.4%	15.7%	32.4%

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 2/6/20.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -2.2% return means the Canadian dollar fell 2.2% vs. the U.S. dollar year to date. USD/JPY 109.97 means 1 U.S. dollar will buy 109.97 yen. USD/JPY 1.3% return means the U.S. dollar rose 1.3% vs. the yen year to date.

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