RBC WEALTH MANAGEMENT

A week for the record books

Thomas Garretson, CFA – Minneapolis

The correction that seemed to hit stocks at warp speed has investors once again looking to central banks to save the day. But as markets increasingly expect a flurry of further Fed rate cuts, already low Treasury yields are only moving to new record lows.

What a difference a week makes. Since the S&P 500 peaked at 3,386 on Feb. 19, it has fallen by approximately 12 percent over the past seven trading sessions as the spread of the coronavirus picked up outside of China. While 10 percent-type corrections are a normal occurrence across any economic cycle, 10 percent corrections over the course of barely a week are less so. In the some 10,000 trading days since 1980, there have only been 14 such week-long periods of losses exceeding 12 percent.

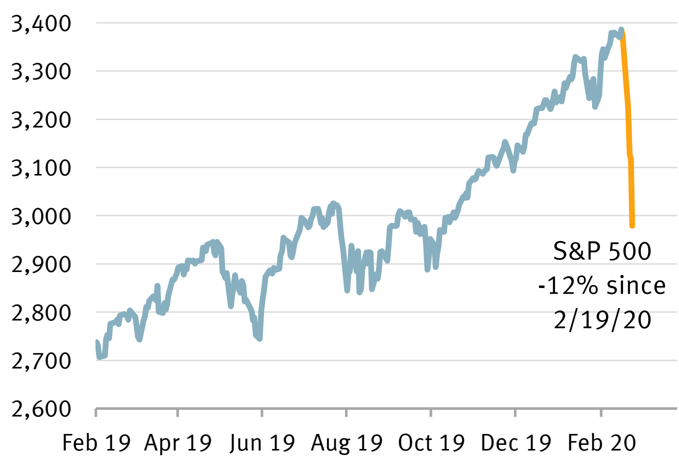
The impact of the coronavirus on corporate earnings and sales, whether among U.S. multinationals or companies headquartered elsewhere, will take a long time to sort out even if the contagion begins receding by early summer.

As companies begin to estimate the financial hit, this disease is proving far more difficult to assess than even the topsy-turvy trade risks between the U.S. and China were last year. The spread of the coronavirus carries with it many unknowns for multinational companies with complex global supply chains or meaningful sales in the hardest-hit countries.

After conducting a stress test based on coronavirus risks, RBC Capital Markets now estimates the downside risk to S&P 500 earnings in 2020 is at $170 per share, which is $2 lower than it estimated before the virus started spreading outside of China. Currently, RBC Capital Markets' official forecast remains at $174 per share and the consensus estimate is at $175. We think both of those estimates are vulnerable to moving down toward the $170 level over time.

Too far, too fast?

Stock pullback has been swift, but only to 4-month lows



Source - RBC Wealth Management, Bloomberg

Market pulse

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Click here for authors' contact information. Priced (in USD) as of 2/27/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 7.**
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Regardless, revenues and earnings of S&P 500 companies as a whole are actually more domestically-geared than a lot of major indexes outside of the U.S. So much of the impact on S&P 500 companies will come down to whether the spread of the virus is contained domestically, and how well U.S. economic fundamentals hold up.

Stock market developments significant, bond market developments historic

And if that's not enough for investors to process, the risk-off sentiment, the flight to safety, and the subsequent expectations for global central banks to take action in the form of interest rate cuts have taken U.S. Treasury yields to all-time record lows. The benchmark U.S. 10-year Treasury yield, off of which much of the financial universe is priced in some way, shape, or form, has traded as low as 1.24 percent, having opened the year at nearly 2.0 percent. Globally, the entire German government yield curve is back below zero percent, and the global stock of negative-yielding debt is once again on the rise, nearing $14 trillion.

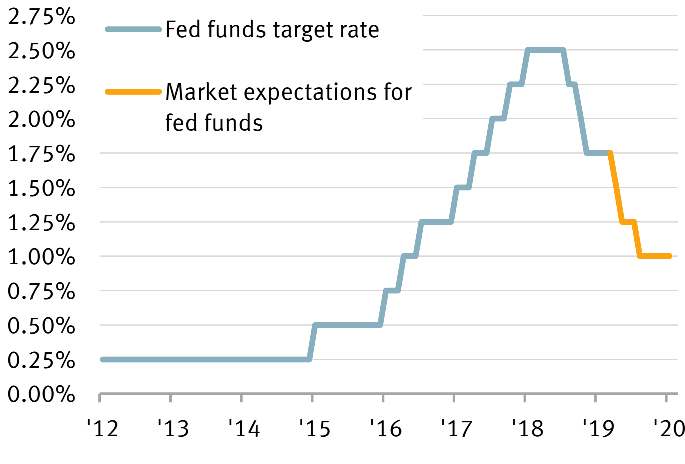
Global central bank easing in 2019 was supposed to set the stage for a steadier 2020. With that now off the table, what might the central bank response be to the economic risks from the coronavirus, and do they even have the right tools?

No half measures

Amidst a global crisis, investors are once again looking to global central banks to save the day. Unfortunately, they are likely to find that not only is monetary policy *not* the right tool in the face of potentially sharp declines in global demand and disruptions in global supply chains caused by the coronavirus, but most banks simply have limited room to act. Europe? The European Central Bank (ECB) policy rate is still -0.50 percent. The UK? Just 0.75 percent. China has been the most aggressive in boosting lending and adding stimulus for local businesses, but lacks the power to boost global demand.

Which leaves the Federal Reserve. Though historically low, the Fed's policy rate remains relatively high at 1.75 percent, and markets are pricing that the Fed will need to be the bank to provide the support. As the chart shows, markets are now expecting three full rate cuts this year to a range of 0.75 percent to 1.00 percent, with a 50 percent chance that the Fed cuts a total of four times. In terms of timing, the market now expects that the Fed will deliver at least one rate cut at the Mar. 18 meeting. However, the bigger issue, we fear, is that the Fed may be past the stage of policy "mid-cycle adjustments" and "insurance cuts." At this stage, a return to the zero percent to 0.25 percent range may be the only option to provide the necessary backstop and economic boost.

The market now expects three Fed rate cuts this year



Source - RBC Wealth Management, Bloomberg

Regardless, in the face of elevated uncertainty, cheaper money through the channel of lower rates likely isn't the answer to countering the negative economic impacts of the coronavirus; however, central bank policy can still serve to boost economies and markets via the sentiment channel. Though central banks may harbor doubts about the efficacy of lower interest rates, they will have little choice but to act if sentiment remains weak.

The answer, of course, is fiscal stimulus, and we look for some governments to move aggressively should the situation continue to deteriorate. China already is.

Low yield contagion

In the U.S., record low Treasury yields are an unwelcome sight for investors already struggling to find income, but the question is still, how low can they go? Despite the coronavirus being a global risk, U.S. yields are actually falling faster than their global counterparts. But this is actually not a new phenomenon, U.S. yields have been converging with global yields at a steady pace since the end of 2018.

And it's an easy story to tell. In 2011, the ECB began cutting rates, eventually moving into negative territory as the economy struggled. In the U.S., the Fed stayed patient, started raising rates only in 2015, and then only gradually as the economy continued to recover, allowing U.S. yields to open up a sizeable gap to the rest of the world, as shown in the chart on the following page.

Now at year 11 of the current business cycle, and as the fiscal stimulus of tax reform fades, perhaps it's no longer realistic to expect the U.S. economy to so handily outperform the rest of the world. It's not outside the realm of possibility that the

10-year Treasury yield joins much of the developed world below one percent, or even closer to zero percent, based simply on historical relationships.

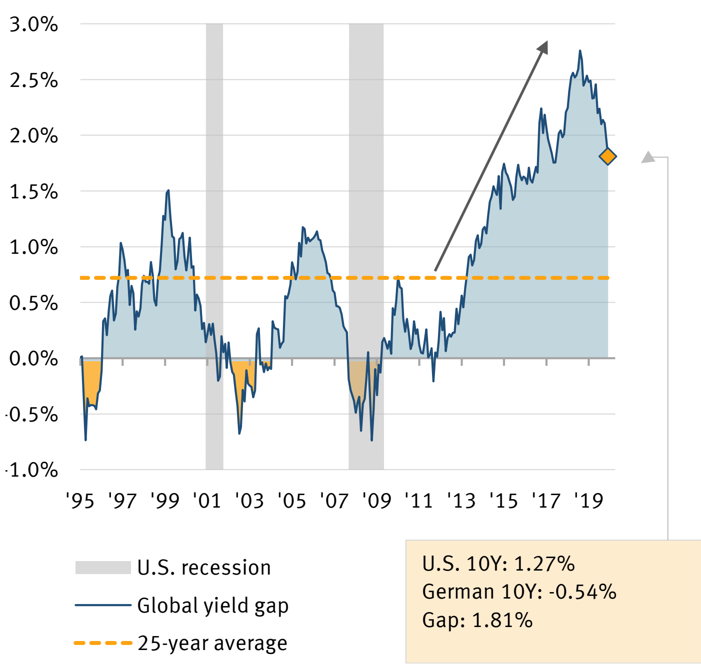
Gut check

There's simply little precedence for these types of events. The best case is that the coronavirus fears fade as quickly as they appeared. But as long as the underlying U.S. economic fundamentals remain intact, we still anticipate most equity markets will finish the year in positive territory. Staying invested is often the best strategy, and that is likely to remain the case. But more equity market volatility—in both directions—and a period of consolidation could be in store in the months ahead.

This disease outbreak illustrates the benefits of diversification. While U.S. stocks are down 10 percent over the past week and have erased year-to-date gains, aggregate U.S. bond indexes are up one percent. The classic 60/40 stock/bond portfolio is still flat for the year. Investors didn't really want to buy bonds with three percent yields, and they really didn't want to buy them at two percent yields, and they'll likely wonder why they should even bother at one percent yields, but bonds still provide portfolio ballast in times of turbulence, and low yields can move even lower.

What goes up, must come down

U.S. yields likely to close gap with global yields



Source - RBC Wealth Management, Bloomberg

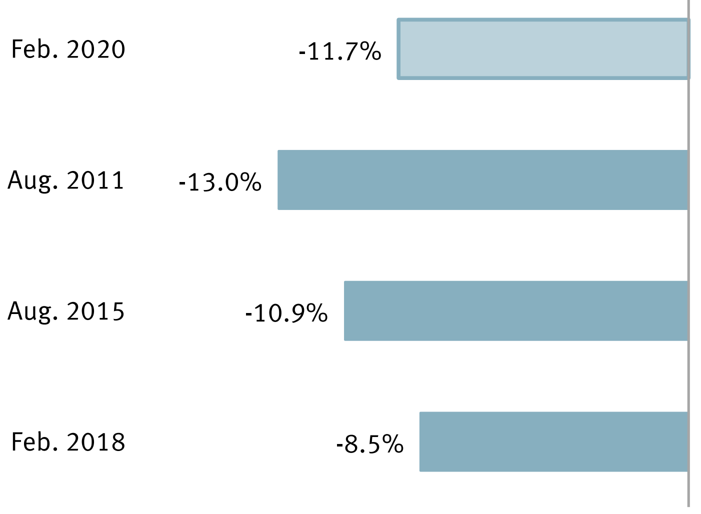
United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets are sharply lower in recent days as the one-two punch of an uncontained coronavirus and the recent evolution of the Democratic Party's presidential primaries act as a drag on stocks**. For the week, the S&P 500 has declined 10.8% and entered correction territory with the 12.2% retrenchment from intraday highs on Feb. 19. The NASDAQ is down a similar amount while the Dow Jones has held up "much better" with its 7.0% weekly decline. The Russell 2000 is down 10.5% thus far this week and 11.7% from its February high, while growth has held up better than value across the U.S. equity universe.
- From a sector perspective, **outperformance has only been evident on a relative basis as the best-performing sectors have merely declined less**. Bond proxies and defensively-oriented sectors have declined the least, with Consumer Staples (-8.5%) the best weekly performer, followed by Utilities (-8.7%) and Health Care (-9.3%). On the other end of the spectrum, sectors most exposed to cyclical end markets and the broader global growth narrative have seen the poorest performance. Energy is the worst of the worst for the week, down more than 16%, followed by Tech (-11.8%) and Materials (-11.7%).
- In an attempt to measure the rapidity of the most recent correction, we took a look at the worst 5-trading-day moves since the current recovery began in mid-2009. Since the close on Feb. 20, the S&P 500 is down 11.7%, and **there have only been three similar periods in the last 10 years—February 2018, August 2015, and August 2011**. The first was related to liquidity, derivative, and volatility fears; the second to fears of slowing global growth and rapidly falling oil prices as a result of a slowing in the Chinese economy; while the last was directly related to the European debt crisis and fears of a global double-dip recession. **The silver lining to these experiences is the average return in the ensuing six months was 11.7%, with all three periods delivering better-than-average gains**.
- While we view the coronavirus as modestly less material than these two other experiences, it is worth noting that the **backdrop behind U.S. equities was primed for a correction** in a way that neither of the other periods were. As of their recent highs, S&P 500 valuations—as measured by the next-twelve-month (NTM) price-to-earnings (P/E) ratio—had exceeded the January 2018 levels and reached highs for the current expansion. The S&P 500 was in fact trading at 19.0x NTM earnings per share, well ahead of the 10-year average P/E of 15.0x.
- **As long as the underlying U.S. economic fundamentals remain intact, we anticipate most equity markets will finish the year in positive territory**. But more equity market volatility—in both directions—and a period of consolidation could be in store in the months ahead. We would continue to hold a Market Weight position in U.S. equities for investors with a time horizon of 12 months or longer.

Silver lining: Markets have averaged 11.7% gains in the six months after similar pullbacks

Worst 5-day returns for the S&P 500 since 2010



Source - RBC Wealth Management, FactSet; data through 2/27/20

Canada

Meika McKelvey – Toronto

- After blowing past initial coronavirus concerns, **Canadian risk assets, including equities and corporate credit, followed global markets lower** this week as the virus began to spread more meaningfully outside of China and concerns surrounding the global economic impact of the virus escalated. **The S&P/TSX Composite has fallen more than 6% over the last four trading days**, while Canadian credit spreads have widened out alongside U.S. spreads to their highest levels of the year (albeit they remain near all-time narrow levels).
- Continued weakness in activity indicators, combined with other current "home grown" problems (notably the ongoing rail blockades) as well as escalating coronavirus fears have pushed **rate expectations significantly lower** from pre-January Bank of Canada (BoC) meeting levels. Odds for a rate cut at next week's BoC meeting have risen to approximately 40%, while a 25 basis point cut is now fully priced in by April and a second full cut is expected by September.

- **The Canadian dollar has come under some significant pressure** this week as the broader coronavirus-induced risk-off move has impacted both commodities and commodity currencies. The Canadian dollar has fallen around 1.2% against the U.S. dollar since the start of the week, while **WTI crude oil has fallen more than 10%** over the same period to a 12-month low of approximately US$46.8/barrel. Although the full economic impact of the Covid-19 outbreak remains unknown, it continues to resemble **a giant pothole for the energy market as curtailed demand conditions weigh heavily**.
- On Feb. 21, Canada closed out a relatively busy week for data with the **December retail sales release**. With its most recent dovish tone centered on the domestic growth slowdown during the final weeks of 2019, the BoC's focus of late has been on activity statistics. Retail sales volumes fell 2.1% from Q3 2019, sitting close to flat on the month, as well as on a year-over-year basis (up around 0.4%). This reading caps off a poor year for the sector, and **continues the story of sluggish consumer spending** despite labour income strength and elevated consumer confidence.

Europe

Thomas McGarrity, CFA & Blaine Karbonik, CFA – London

- **European equity indexes entered into correction territory** as fears surrounding the coronavirus outbreak continue to intensify. **All the gains made by the STOXX Europe 600 Index since the beginning of November 2019 have been wiped out**. Since its peak on Feb. 19, the aforementioned index has fallen just over 10%, led down by the travel & leisure (e.g., airlines), basic resources (e.g., miners), banks, autos, and oil and gas sub-sectors. Defensive sectors Utilities and Real Estate outperformed but still fell 6.6% and 8.0%, respectively. In the fixed income market, the yield on **German 10-year Bunds dropped below -50 basis points** on "safe-haven" demand, while credit spreads widened marginally.
- **Cyclical parts of the equity market**, particularly luxury goods and autos within the Consumer Discretionary sector, as well as the Energy and Materials sectors, **remain the biggest areas of risk to earnings estimates in the short term**, in our view. However, this is already starting to be reflected in share prices.
- **Companies are beginning to quantify the expected impact of the outbreak**. For example, global brewing giant **Anheuser-Busch InBev** is forecasting a 10% decline in group profit in Q1 2020, while spirits group **Diageo** estimates the negative impact on sales and operating profit to be £225 million–£325 million and £140 million–£200 million, respectively (approximately 3%–4% of total sales). Food and beverage group **Danone** estimates €100 million in lost sales in Q1 2020, mostly relating to its water business in China.
- **The euro remains highly exposed to negative spillover effects from the coronavirus**, putting the expected growth recovery for the euro area at risk, especially given the already fragile state of the region's manufacturing sector. Beyond virus concerns, other headwinds cloud the outlook for the currency, including trade deal negotiations with the UK, persistently negative interest rates, and overhanging political risks. In light of these challenges, **we believe a cautious outlook for the euro is prudent**.

Asia Pacific

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

- **Asian equity markets traded lower across the board** this week as investors are increasingly concerned about the **continuing spread of the Covid-19 virus outside of China**. The decline in Asia was led by Thailand, which suffered its biggest drop in six years on Feb. 26 as the rising number of confirmed coronavirus cases dimmed the outlook for a quick rebound in tourism.
- **China reported 29 deaths from the coronavirus epidemic on Feb. 27, the lowest daily figure in almost a month, and a slight uptick in fresh infections to 433**. Beijing has pledged further fiscal and monetary measures to help stimulate an economic growth rebound. Senior officials from the People's Bank of China have highlighted that the economy will likely pick up quickly after the coronavirus is contained and stage a "V-shaped" recovery. According to a Bloomberg report, (1) **the daily coal burn at China's six major coastal power plants began to increase** during Feb. 15–20, and the pace is accelerating, although it remains 40% below last year's level, and (2) **major manufacturing hubs reported work resumption rates exceeding 50%** over Feb. 15–17. We believe economic activity is beginning to recover after a very slow start to February, supported by various government initiatives, and we expect a jump in the operating rate as the 14-day self-quarantine for workers who traveled during the recent Chinese New Year holiday starts to lift.
- South Korea has the highest number of confirmed cases outside of China at 1,595 with 12 fatalities. Authorities identified a religious group in the southeastern city of Daegu as being at the heart of the outbreak. **Samsung Electronics (005930 KS) temporarily shut down a factory in South Korea that manufactures its new Galaxy Z Flip smartphone** after an employee tested positive for the coronavirus. The Bank of Korea downgraded its 2020 GDP growth forecast to 2.1% from 2.3% amid mounting evidence of an economic hit from the outbreak, but unexpectedly kept interest rates steady.

MARKET SCORECARD

Data as of February 27, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,978.76	-7.7%	-7.8%	6.7%	8.5%
Dow Industrials (DJIA)	25,766.64	-8.8%	-9.7%	-0.8%	1.4%
NASDAQ	8,566.48	-6.4%	-4.5%	13.4%	16.9%
Russell 2000	1,497.87	-7.2%	-10.2%	-5.3%	-2.5%
S&P/TSX Comp	16,717.44	-3.5%	-2.0%	4.0%	6.7%
FTSE All-Share	3,787.97	-6.6%	-9.7%	-2.9%	-5.6%
STOXX Europe 600	389.45	-5.2%	-6.3%	4.5%	1.9%
EURO STOXX 50	3,455.92	-5.1%	-7.7%	5.3%	-0.1%
Hang Seng	26,778.62	1.8%	-5.0%	-6.9%	-14.4%
Shanghai Comp	2,991.33	0.5%	-1.9%	1.3%	-9.1%
Nikkei 225	21,948.23	-7.2%	-7.2%	1.8%	-2.0%
India Sensex	39,745.66	-2.4%	-3.7%	10.7%	15.7%
Singapore Straits Times	3,111.70	-1.3%	-3.4%	-4.3%	-12.1%
Brazil Ibovespa	102,983.50	-9.5%	-10.9%	5.8%	18.5%
Mexican Bolsa IPC	41,607.42	-5.7%	-4.4%	-3.9%	-13.3%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,639.78	3.2%	8.1%	24.2%	24.4%
Silver (spot $/oz)	17.68	-2.0%	-0.9%	12.4%	7.6%
Copper ($/metric ton)	5,645.25	1.7%	-8.2%	-13.8%	-19.2%
Oil (WTI spot/bbl)	47.09	-8.7%	-22.9%	-17.3%	-25.3%
Oil (Brent spot/bbl)	51.32	-11.8%	-22.2%	-22.7%	-23.0%
Natural Gas ($/mmBtu)	1.74	-5.8%	-20.7%	-38.0%	-35.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.271%	-23.6	-64.7	-141.2	-162.3
Canada 10-Yr	1.157%	-11.6	-54.5	-75.8	-111.8
U.K. 10-Yr	0.470%	-5.4	-35.2	-80.4	-109.1
Germany 10-Yr	-0.543%	-10.9	-35.8	-69.1	-122.2
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.85%	1.1%	3.1%	10.9%	14.7%
U.S. Invest Grade Corp	2.45%	1.1%	3.5%	15.6%	18.9%
U.S. High Yield Corp	5.67%	0.0%	0.1%	7.7%	12.3%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	98.4530	1.1%	2.1%	2.4%	9.0%
CAD/USD	0.7469	-1.1%	-3.0%	-1.7%	-4.6%
USD/CAD	1.3388	1.1%	3.1%	1.8%	4.8%
EUR/USD	1.0994	-0.9%	-2.0%	-3.3%	-10.1%
GBP/USD	1.2888	-2.4%	-2.8%	-3.2%	-7.3%
AUD/USD	0.6571	-1.8%	-6.4%	-7.9%	-15.6%
USD/JPY	109.6900	1.2%	1.0%	-1.2%	2.2%
EUR/JPY	120.5900	0.3%	-1.0%	-4.4%	-8.2%
EUR/GBP	0.8531	1.6%	0.8%	-0.1%	-3.0%
EUR/CHF	1.0654	-0.3%	-1.9%	-6.4%	-7.2%
USD/SGD	1.3952	2.2%	3.7%	3.5%	5.4%
USD/CNY	7.0044	1.4%	0.6%	4.7%	10.9%
USD/MXN	19.4686	3.3%	2.9%	1.6%	3.3%
USD/BRL	4.4911	4.9%	11.4%	20.4%	38.2%

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 2/27/20.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -3.0% return means the Canadian dollar fell 3.0% vs. the U.S. dollar year to date. USD/JPY 109.69 means 1 U.S. dollar will buy 109.69 yen. USD/JPY 1.0% return means the U.S. dollar rose 1.0% vs. the yen year to date.

Authors

Thomas Garretson, CFA – Minneapolis, United States
tom.garretson@rbc.com; RBC Capital Markets, LLC

Ben Graham, CFA – Minneapolis, United States
benjamin.graham@rbc.com; RBC Capital Markets, LLC

Meika McKelvey – Toronto, Canada
meika.mckelvey@rbccm.com; RBC Dominion Securities Inc.

Thomas McGarrity, CFA – London, United Kingdom
thomas.mcgarrity@rbc.com; RBC Europe Limited

Blaine Karbonik, CFA – London, United Kingdom
blaine.karbonik@rbc.com; RBC Europe Limited

Jasmine Duan – Hong Kong, China
jasmine.duan@rbc.com; RBC Investment Services (Asia) Limited

Nicholas Gwee, CFA – Singapore
nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

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As of December 31, 2019

			Investment Banking Services Provided During Past 12 Months	
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Buy [Top Pick & Outperform]	765	51.97	225	29.41
Hold [Sector Perform]	625	42.46	127	20.32
Sell [Underperform]	82	5.57	5	6.10

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