RBC WEALTH MANAGEMENT

Global Insight Weekly

Rolling with the punches

Kelly Bogdanova – San Francisco

Geopolitics came roaring back to center stage as the U.S.-Iran conflict threatened to become an all-out war. But markets were not overly rattled by the saber-rattling. We look at why this sense of calm isn't too surprising and why we're comfortable with the setup for equities.

Following a stellar 2019, with the S&P 500 delivering its second-best annual return of this bull market cycle, equity markets have received a geopolitical wake-up call to begin 2020.

The U.S. drone strike that targeted and killed Iran's top general, and Iran's retaliatory ballistic missile strikes on U.S. military bases in Iraq, put equity markets on edge at times—that is, until details about Iran's strikes emerged and both sides attempted to de-escalate.

Overall, financial markets have not reacted much to the U.S.-Iran conflict despite the serious nature of the developments and meaningful risks that linger. Are they too complacent?

We've seen this story before

The equity market's relatively restrained response to a geopolitical clash is actually the norm rather than the exception.

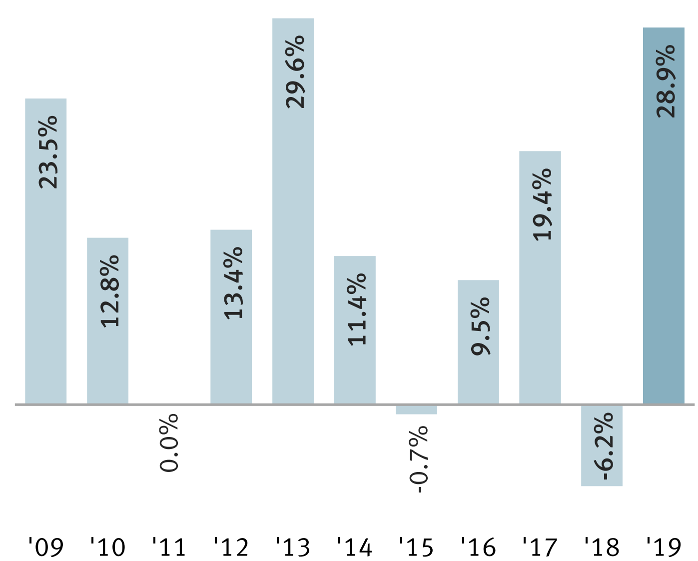
The S&P 500 fell 6.2%, on average, in 18 major post-WWII military conflicts or hostilities that we evaluated. While that level of decline is nothing to dismiss, it's well within the bounds of a typical, modest pullback in many scenarios that often confront markets, including scenarios that have nothing to do with military clashes.

Our study of previous geopolitical conflicts indicates the market's reaction lasted an average of only 30 days, even though many of the actual events lasted longer—sometimes much, much longer.

At times equities weakened during the run-up to a geopolitical conflict as tensions mounted, and recovered soon thereafter.

2019 was the second-best return of this bull market cycle

S&P 500 annual performance (not including dividends)



Source - RBC Wealth Management, Bloomberg

Market pulse

Click here for authors' contact information. Priced (in USD) as of 1/9/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6**
Produced: Jan 9, 2020 16:50ET; Disseminated: Jan 9, 2020 17:15ET

As the table shows, a handful of prior events were more difficult for the market to absorb, with the S&P 500 declining in the low-to-mid-double digits. In these instances, which are highlighted in red, two of the four acts of war were in the Middle East: in 1990 when Iraq invaded Kuwait and seized its oilfields, and back in 1973 during the Yom Kippur War and Arab oil embargo.

Expect the unexpected

It's too early to tell if the U.S.-Iran conflict has sufficiently de-escalated to the degree that market risks have largely lifted.

According to RBC Capital Markets' commodity team, which has a focus on Middle Eastern oil, "The Iran standoff remains far from over. As long as Iran remains under crippling sanctions—with no realistic prospect of relief—the diplomatic track seems closed off. The killing of General Soleimani will also likely bolster hardline aversion to making significant concessions to Washington on curbing Iran's nuclear activities, ending support for armed proxy groups, and halting its ballistic missile program … pay particular attention to Iran's nuclear restart as this remains another key redline for President Trump and his Israeli counterpart Benjamin Netanyahu."

When it comes to geopolitical risks, our longstanding advice is that investors should assume that such events can crop up occasionally and push the equity market into a temporary 5%–10% pullback or, in rarer cases, into a longer-lasting correction of greater magnitude.

It's fundamental

Ultimately, however, we believe it's the economic and earnings trajectories that set the pace for the global and U.S. equity markets. Federal Reserve policy also plays an important role because it can help or hinder economic expansions.

We think U.S. GDP and corporate profits will grow at least modestly in 2020. We anticipate the Fed will stand pat with interest rates for the time being, maintaining its accommodative stance. All of this should set the table for moderate equity returns in 2020—albeit with periods of consolidation and volatility along the way.

The S&P 500 is trading at 18.8x RBC Capital Markets' 2020 earnings forecast of $174 per share versus a five-year average of 16.7x. While the valuation is elevated and has less room to expand, it is not unreasonable considering the ultralow interest rate environment. Lori Calvasina, RBC Capital Markets, LLC's Head of U.S. Equity Strategy, has a year-end S&P 500 target of 3,460, which would represent a 7.1% annual gain.

We are comfortable holding equities at the Market Weight or benchmark level in portfolios as long as most of our recession indicators continue to signal that the U.S. economic expansion will persist, and that the trajectories of the global and U.S. economies as well as corporate profits are not materially threatened by the conflict between the U.S. and Iran.

S&P 500 responses to select acts of war and terrorism since World War II

Events	Start date	Trading days to trough	% change to trough	Trading days back to even
Acts of war or hostilities				
U.S.				
U.S. spy plane shot down in USSR	May 7, 1960	2	-0.6%	4
Bay of Pigs invasion	Apr 15, 1961	6	-3.0%	14
Cuban Missile Crisis	Oct 16, 1962	6	-6.3%	13
Gulf of Tonkin Incident (Vietnam)	Aug 2, 1964	4	-2.2%	29
Tet Offensive (Vietnam)	Jan 29, 1968	25	-6.0%	46
Cambodian Campaign (Vietnam)	May 1, 1970	18	-14.9%	86
U.S. invades Grenada	Oct 25, 1983	11	-2.8%	15
Lead-up to U.S. Panama invasion	Dec 15, 1989	2	-2.2%	8
Lead-up to Gulf War (Desert Storm)	Jan 1, 1991	6	-5.7%	13
U.S.-led NATO bombs Yugoslavia	Mar 24, 1999	3	-4.1%	11
U.S. spy plane captured in China	Apr 1, 2001	3	-4.9%	7
War in Afghanistan	Oct 7, 2001	1	-0.8%	3
Lead-up to Iraq War	Feb 5, 2003	24	-5.6%	28
External				
N. Korea invades S. Korea	Jun 25, 1950	15	-12.9%	56
Lead-up to Six-Day War (June 6)	May 14, 1967	15	-5.6%	20
Yom Kippur War, Arab oil embargo	Oct 6, 1973	42	-16.1%	6 years*
Soviet-Afghan War	Dec 24, 1979	7	-2.3%	10
Iraq invades Kuwait, oilfields seized	Aug 2, 1990	50	-15.9%	131
Average		**13**	**-6.2%**	**30**
Terrorism				
U.S. Embassy in Iran seized	Nov 4, 1979	3	-1.0%	6
U.S. Marines killed in Lebanon	Oct 23, 1983	12	-2.5%	15
Oklahoma City bombing	Apr 19, 1995	1	-0.1%	3
U.S. Embassy bombings in Africa	Aug 7, 1998	5	-2.5%	7
WTC, Pentagon airplane attacks	Sep 11, 2001	5	-11.6%	19
Madrid train bombings	Mar 11, 2004	3	-1.7%	5
London Underground bombings	Jul 7, 2005	No S&P decline; FTSE -1.4%		
Paris Bataclan, restaurant attacks	Nov 13, 2015	1	-1.1%	2
Bastille Day attacks in Nice	Jul 14, 2016	1	-0.1%	2
Average		4	-2.6%	7

* Other economic and monetary policy factors negatively influenced the number of days it took the market to get back to even; this is not counted in the average number of trading days back to even.

Source - RBC Wealth Management, RBC Global Asset Management, Wikipedia, National Security Archive at George Washington University, U.S. Naval Institute; data attempts to capture any pre-event impact

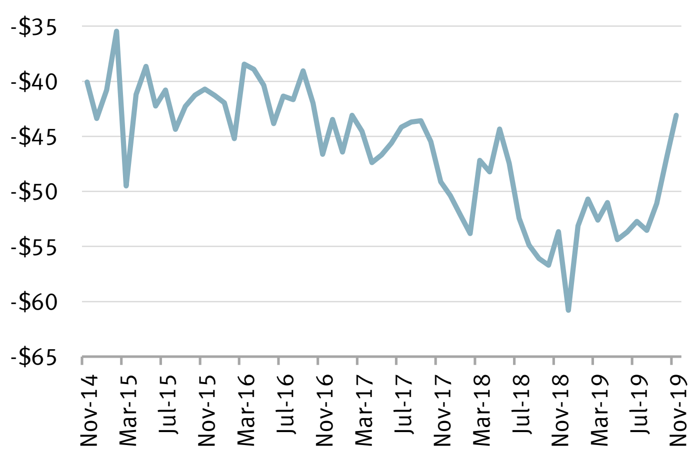
United States

Alan Robinson – Seattle

- Markets navigated a difficult geopolitical landscape during the first full week of the year, as year-end optimism over a U.S.-China trade deal briefly gave way to a risk-averse tone due to U.S.-Iran tensions. However, traders appeared more fearful of missing out on the stock rally, and pushed stocks to new highs again during the week. As a note of caution, **over 80% of S&P 500 stocks now trade above their 200-day moving averages**—a condition that often presages a short-term correction.
- In the 24 hours following the Iranian missile attack on U.S. interests in Iraq, **crude oil futures traded in a historically wide 11% range, but eventually settled $6 per barrel below the daily high**. RBC Capital Markets, LLC commodity strategist Michael Tran stated that although supply is tight and global economies are on a stronger footing, oil prices "are approaching the upper band of where we anticipate [they] could average for the year." If oil trades consistently higher this year, it could pose a risk to the global economic recovery.
- **The U.S. trade deficit improved for the fourth successive month**, and is now at a three-year low according to data released during the week. The November deficit fell by 8.2% m/m to $43.1 billion as imports decreased and exports increased. The drop in imports was driven by declines in cellphones and toys, but we expect that **the recent sharp decline in Chinese imports may reverse early this year** after the U.S. and China sign their Phase 1 trade deal.

Trade standoff has cut U.S. imports, reduced the trade deficit

Monthly U.S. trade deficit (billions of dollars)



Source - U.S. Bureau of Economic Analysis, RBC Wealth Management; monthly data through November 2019

- **In advance of the monthly U.S. employment data, payroll processor ADP released its own jobs report** showing the largest monthly rise in the number of available jobs since April 2019. A total of 202,000 new jobs were created in December, up 78,000 from November's upwardly revised total and beating the consensus forecast for 165,000 new jobs. However, we note ADP's figures rarely line up with the headline government-produced figures, and **seasonal issues with the late Thanksgiving holiday could bias the final payrolls number lower.**

Canada

Sayada Nabi – Toronto

- As **RBC Capital Markets hosted its annual Canadian Bank CEO Conference this week**, several key takeaways emerged regarding the 2020 outlook. Overall, **the tone was somewhat subdued** and the CEOs broadly **reiterated modest 2020 EPS growth expectations**; however, RBC Dominion Securities Inc. Bank analyst, Darko Mihelic believes **revenue headwinds will be the key focus** this year. In terms of credit, many of the banks noted they're seeing slightly looser terms and larger balances when it comes to corporate or commercial lending, but RBC Capital Markets believes this is not overly concerning or widespread in the commercial lending space. **Banks expect their personal and commercial loans to rise during 2020**, although RBC Capital Markets does not expect that growth to be on a straightforward path, but one that contains some lumpiness quarter to quarter. RBC Capital Markets forecasts **EPS growth of 4.7%** in 2020 for the large-cap Canadian banks under its coverage. The outlook on net interest margins (NIMs) is flat to slightly improving in the Canadian personal and commercial landscape, under the assumption of one rate cut by the Bank of Canada. Overall, RBC Capital Markets expects earnings growth to remain on the lower side of banks' historical range while noting potentially increased sensitivity to economic shocks.
- **The Canadian trade deficit declined**, but the improvement was driven by different reasons than what might have been expected, according to RBC Economics. The international trade deficit narrowed to $1.1 billion in November as the drop in imports exceeded the decline in exports. **Imports fell 2.4% m/m, whereas exports sagged 1.4% m/m.** RBC Economics highlighted **two key transitory factors behind the slump in exports**, namely the **11% plunge in energy exports** due to a major pipeline shutdown and the **week-long CN Rail strike**. This data comes on the heels of softer GDP in October (-0.1%), which was followed by a weaker-than-expected November labour market report. Looking ahead, **the external trade backdrop appears poised to improve** as trade tensions between the U.S. and China recede in the near term.

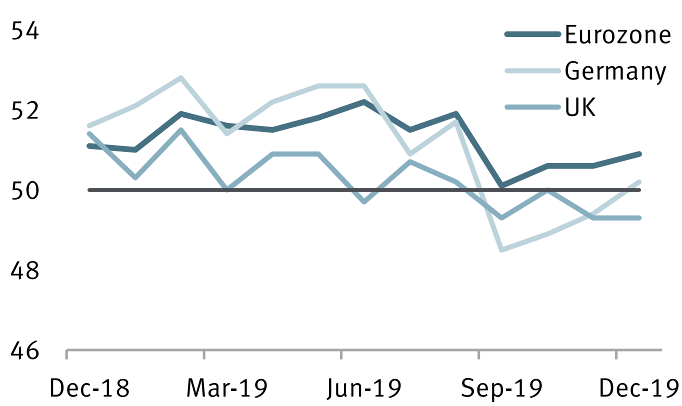
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **There was encouraging news out of Europe to start 2020**, though the weak spot remains German manufacturing.
- The Q4 Markit Eurozone Composite Purchasing Managers' Index (PMI) bounced off the September lows of 50.1 to reach 50.9 thanks to a notable improvement in the services PMI. **Business optimism about the year ahead (2020) also rose** to the highest level since May 2019, suggesting to us a bottoming of the economic slowdown in the absence of major shocks.
- In particular, the **Spanish services PMI rose to 54.9 in December**, the highest level since March 2019. According to RBC Capital Markets, this points to GDP growth of 0.4% q/q in Q4 for the country, a pace similar to that of Q3 and Q2. The German services PMI, in turn, was revised up to 52.9 from its earlier flash estimate of 52.0.
- **German manufacturing, however, continues to struggle** due to factors both cyclical (trade tensions and weaker global growth) and structural (the ill-fated focus on diesel cars and the general disruption in the auto industry with ride sharing gathering pace in many regions). According to the German Association of the Automotive Industry, **the number of vehicles produced in German factories in 2019 dropped to the lowest level in more than 20 years**. We believe German industrial activity is likely to remain subdued in the months ahead given high inventory levels and weak order books. Despite these difficulties, **consumption and construction are keeping the economy out of recession**.

After slowing for much of 2019, European PMIs perked up in the fourth quarter

Markit composite PMIs, by country and region



Note: Readings above 50 (solid black line) are considered expansionary while readings below are contractionary
Source - RBC Wealth Management, Bloomberg; data through 12/31/19

- Overall, **RBC Capital Markets expects euro area growth to reach 1% in 2020**, following an estimated 1.2% in 2019.
- **We have a Market Weight view on European equities** where valuations are not demanding. The regional economy is showing signs of stabilizing while global economic momentum seems to be gaining pace somewhat. European Central Bank President Christine Lagarde continues to assert that **concerted euro area fiscal stimulus would help growth** and political rumblings in this regard are becoming more persistent.

Asia Pacific

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

- **Asian equities have had a relatively good start to 2020** despite some market fluctuation in the wake of the flare-up of tensions in the Middle East. **Progress on U.S.-China trade talks has boosted market sentiment and risk appetite** since the end of 2019. China's Ministry of Commerce confirmed that a delegation led by Vice Premier Liu He will travel to the U.S. January 13–15 to sign the Phase 1 trade deal. We think the impact on markets of the current U.S.-Iran conflict will be short-lived. Trade progress and company fundamentals will play more important roles in the medium to long term, in our view.
- On the first day of the new year, **China announced a 50 basis point cut in the reserve requirement ratio** for banks, effective January 8. The cut will inject around RMB 800 billion into the market, helping to **reduce financing costs for small companies and micro-businesses**.
- China's Consumer Price Index rose 4.5% y/y in December, the same as November's reading. Pork prices were up 97% y/y, below the 110% surge in November. **Cooling pork prices bring less pressure to consumer inflation and provide more policy room for the People's Bank of China**, which we expect to use interest rate and liquidity tools to loosen monetary conditions in 2020.
- According to China's annual Central Economic Work Conference, which took place in December, ensuring **economic stability is the government's top priority for 2020**. We believe the country will continue to use policy stimulus to support the real economy.
- **Hong Kong equities had a recovery rally at the end of 2019, and the positive sentiment has been sustained into 2020**. China appointed Luo Huining as the new director of Beijing's Liaison Office in Hong Kong, a sign the country is trying to restore stability. Hong Kong's government recently estimated that the city's budget deficit, the first in 15 years, will not exceed 3% of GDP this year. Despite the tough economic situation, **we believe the Hong Kong equity market could see a strong boost if political uncertainty dissipates**.

MARKET SCORECARD

Data as of January 9, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,274.70	1.4%	1.4%	26.7%	19.0%
Dow Industrials (DJIA)	28,956.90	1.5%	1.5%	21.3%	14.1%
NASDAQ	9,203.43	2.6%	2.6%	32.3%	28.5%
Russell 2000	1,664.99	-0.2%	-0.2%	15.7%	6.7%
S&P/TSX Comp	17,235.57	1.0%	1.0%	16.4%	5.6%
FTSE All-Share	4,213.77	0.4%	0.4%	11.3%	-0.8%
STOXX Europe 600	419.64	0.9%	0.9%	20.7%	4.9%
EURO STOXX 50	3,795.88	1.4%	1.4%	23.6%	4.8%
Hang Seng	28,561.00	1.3%	1.3%	7.9%	-7.9%
Shanghai Comp	3,094.88	1.5%	1.5%	21.6%	-9.3%
Nikkei 225	23,739.87	0.4%	0.4%	16.2%	-0.5%
India Sensex	41,452.35	0.5%	0.5%	14.5%	20.3%
Singapore Straits Times	3,247.48	0.8%	0.8%	2.8%	-7.9%
Brazil Ibovespa	115,947.10	0.3%	0.3%	23.9%	47.0%
Mexican Bolsa IPC	44,572.17	2.4%	2.4%	2.1%	-10.3%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,552.26	2.3%	2.3%	20.0%	18.2%
Silver (spot $/oz)	17.90	0.3%	0.3%	13.6%	5.5%
Copper ($/metric ton)	6,152.35	0.1%	0.1%	3.6%	-12.9%
Oil (WTI spot/bbl)	59.56	-2.5%	-2.5%	13.8%	-5.4%
Oil (Brent spot/bbl)	65.43	-0.9%	-0.9%	6.5%	-4.9%
Natural Gas ($/mmBtu)	2.17	-1.0%	-1.0%	-27.4%	-25.9%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.856%	-6.1	-6.1	-85.4	-69.7
Canada 10-Yr	1.607%	-9.5	-9.5	-37.1	-59.6
U.K. 10-Yr	0.820%	-0.2	-0.2	-44.1	-46.3
Germany 10-Yr	-0.179%	0.6	0.6	-45.8	-64.5

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.30%	0.1%	0.1%	8.7%	9.5%
U.S. Invest Grade Corp	2.86%	-0.1%	-0.1%	13.9%	12.3%
U.S. High Yield Corp	5.10%	0.3%	0.3%	11.3%	11.4%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.4330	1.1%	1.1%	2.3%	5.3%
CAD/USD	0.7660	-0.5%	-0.5%	1.2%	-4.5%
USD/CAD	1.3055	0.5%	0.5%	-1.2%	4.7%
EUR/USD	1.1105	-1.0%	-1.0%	-3.8%	-7.0%
GBP/USD	1.3066	-1.4%	-1.4%	2.2%	-3.5%
AUD/USD	0.6858	-2.3%	-2.3%	-4.4%	-12.3%
USD/JPY	109.5300	0.8%	0.8%	1.3%	-2.8%
EUR/JPY	121.6400	-0.1%	-0.1%	-2.6%	-9.5%
EUR/GBP	0.8500	0.5%	0.5%	-5.8%	-3.6%
EUR/CHF	1.0808	-0.4%	-0.4%	-3.9%	-7.9%
USD/SGD	1.3513	0.4%	0.4%	-0.1%	1.2%
USD/CNY	6.9318	-0.5%	-0.5%	1.7%	6.2%
USD/MXN	18.8429	-0.4%	-0.4%	-2.0%	-2.1%
USD/BRL	4.0898	1.5%	1.5%	11.1%	25.9%

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 8:58 pm GMT 1/9/20.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -0.5% return means the Canadian dollar fell 0.5% vs. the U.S. dollar year to date. USD/JPY 109.53 means 1 U.S. dollar will buy 109.53 yen. USD/JPY 0.8% return means the U.S. dollar rose 0.8% vs. the yen year to date.

Authors

Kelly Bogdanova – San Francisco, United States
kelly.bogdanova@rbc.com; RBC Capital Markets, LLC

Alan Robinson – Seattle, United States
alan.robinson@rbc.com; RBC Capital Markets, LLC

Sayada Nabi – Toronto, Canada
sayada.nabi@rbc.com; RBC Dominion Securities Inc.

Frédérique Carrier – London, United Kingdom
frederique.carrier@rbc.com; RBC Europe Limited

Thomas McGarrity, CFA – London, United Kingdom
thomas.mcgarrity@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

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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

Ratings:

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