January 23, 2020

RBC WEALTH MANAGEMENT

Global Insight
Weekly

All quiet on the trade front?

Frédérique Carrier – London

Markets breathed a collective sigh of relief as long-hoped-for trade deals have been hammered out. But we think the recent developments are no panacea. The shifting trade winds have not completely blown away the fog of uncertainty, and we look at how this all shapes the investment landscape.

With the MSCI World Index reaching new all-time highs in the last three months, one can be forgiven for concluding that recent trade agreements will usher in a much improved environment over their predecessors. In fact, global trade volumes are unlikely to revert to their previous heights and the deals could even hinder economic growth.

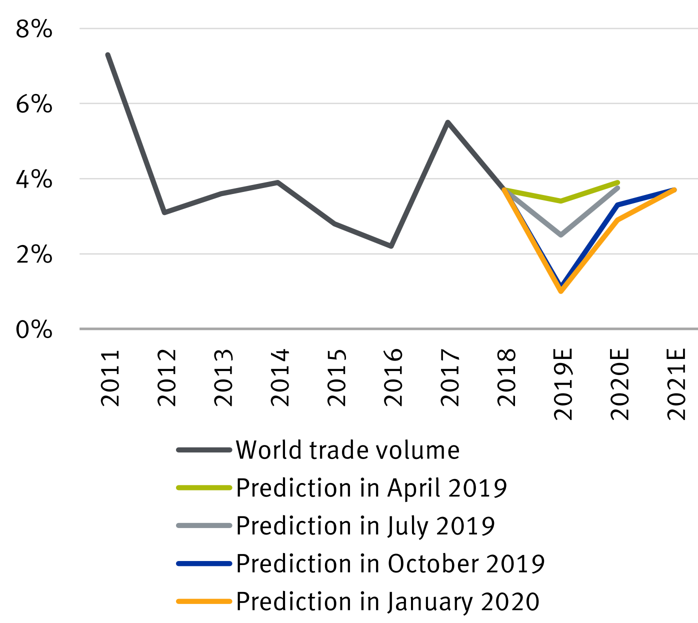
But markets have been relieved that the risk of a full-blown trade war has receded, and they have been driven by the hope that the lifting of trade uncertainty will help generate modest, if not significant growth. We look at the real economic impact four trade situations may have, and the implications for equities.

U.S.-China Phase 1: Lower—but not rolled back—tariffs

The recently signed Phase 1 trade agreement seems to bring a truce in the trade war which rattled financial markets over the past 18 months. It is undoubtedly good news, with China pledging to purchase an extra $200 billion of American goods, including agricultural products and services, over the next two years relative to 2017 levels. China also promised to change its intellectual property rules and not to manipulate its currency. In return, the U.S. will halve existing tariffs to 7.5 percent on $120 billion of Chinese imports and refrain from applying further levies.

But look closer and you can see that the benefits of the deal are limited. Duties of 25 percent on another $250 billion of Chinese goods remain in place. In fact, RBC Global Asset Management Inc.'s Chief Economist Eric Lascelles points out that the average U.S. tariff will decline only marginally from a high of 4.5 percent, much higher than the average of 1.5 percent that prevailed before the start of the trade spat.

IMF expectations for global trade growth revised down



Source - International Monetary Fund (IMF), RBC Wealth Management

Market pulse

3 A natural consolidation would be healthy for U.S. equities
3 A sign Canadian consumers will add to their debt loads?
4 ECB launches strategic review
4 Asian equities: Revisiting 2003's SARS outbreak

Click here for authors' contact information. Priced (in USD) as of 1/23/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6**
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Moreover, it is not clear how China will reach its aggressive purchase target, which requires it to buy roughly 50 percent more than it did in 2017. Failure to comply could lead to U.S. disgruntlement, and a renewed risk of escalating tensions cannot be ruled out.

Finally, Phase 2 negotiations, which may well be pushed back until after the U.S. presidential election in November 2020, may prove much trickier given China is unlikely to bend to U.S. demands to significantly reduce its support of state-owned enterprises.

Overall, while the worst-case scenario, a full-blown trade war with the imposition of new tariffs, has been avoided, the moderate tariffs in place are likely to crimp growth over the course of a few years by up to 0.65 percent in the U.S. and up to 0.8 percent in China, according to Lascelles, both of which are non-negligible impacts.

USMCA: Sand in the gears

Despite three years in the making, the USMCA (United States-Mexico-Canada Agreement), to be signed imminently by U.S. President Donald Trump, is not substantially different than its precursor, NAFTA, one of the most successful trading arrangements in the world. But Lascelles points out that the USMCA is nevertheless less supportive of economic growth relative to NAFTA, mostly "because future growth of the auto supply chains is being hobbled."

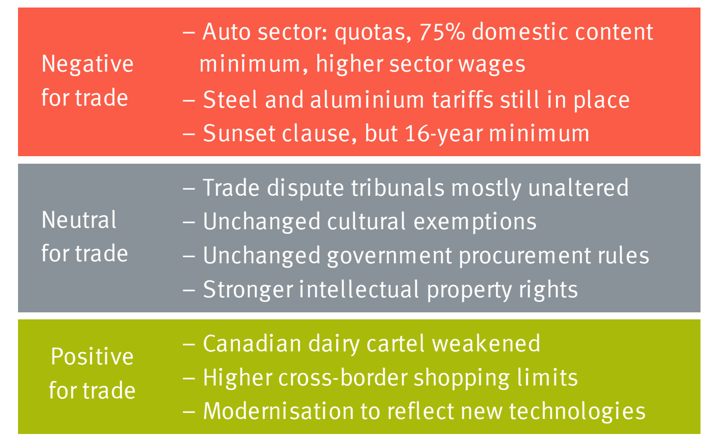
U.S.-EU trade tensions: On ... off ... on?

With the U.S.-China Phase 1 pact in the books, there are concerns that the mercurial Trump will train his sights on the Continent. U.S.-EU trade tensions have been simmering for some time. The Trump administration would like to access the well-protected European agricultural market to redress the large trade imbalance with Europe caused by imports to the U.S. of luxury goods, including wine and cheese.

Tensions seem to have abated recently as Trump and French President Emmanuel Macron declared a truce on the contentious digital services tax dispute, which threatened to mushroom into a transatlantic trade war. Macron has agreed to postpone until the end of 2020 a three percent tax that France imposed last year on the revenues of large tech companies, including Google, Apple, Facebook, and Amazon, that do business in Europe but escape the taxman's grip by shifting earnings to lower-tax jurisdictions.

Despite this detente, Europe may want to take heed of Trump's previous tactics of applying tariffs during negotiations with China, Canada, and Mexico to extract further concessions.

A worsening of trade conditions would be difficult for Europe at a time when its economy is not robust, particularly as it may suffer from China diverting some of its purchases from other trading partners to the U.S. in order to meet its commitments per the Phase 1 deal.



Main features of the USMCA

USMCA will have neutral to modestly negative economic effects

Negative for trade	– Auto sector: quotas, 75% domestic content minimum, higher sector wages – Steel and aluminium tariffs still in place – Sunset clause, but 16-year minimum
Neutral for trade	– Trade dispute tribunals mostly unaltered – Unchanged cultural exemptions – Unchanged government procurement rules – Stronger intellectual property rights
Positive for trade	– Canadian dairy cartel weakened – Higher cross-border shopping limits – Modernisation to reflect new technologies

Note: Canadian cultural exemptions remain largely in place, allowing preferential treatment of e.g., Canadian films, television shows, and music
Source - RBC Global Asset Management

"Get Brexit done"

Reelected on a slogan of "Get Brexit Done," UK Prime Minister Boris Johnson has his work cut out for him. Getting the UK to leave the EU on January 31 may have been fraught with difficulty, but that pales in comparison to the task of negotiating the future relationship with the bloc within the self-imposed deadline of December 31, 2020.

We expect only a bare-bones free trade agreement is feasible given this constraint. Moreover, we would not dismiss the possibility that the UK will have to trade on World Trade Organisation terms if the agreement is not achieved on time and the government refuses to ask for an extension to complete the negotiations. As this plays out, businesses will face lingering uncertainty that will likely constrain growth.

Trade: Good, but not as good

All these ongoing trade spats will likely conspire to put a lid on trade growth. The IMF's recently revised growth outlook for world trade volumes in 2020 looks for a rebound from 2019, but not back to the level of recent years as remaining duties will continue to drag on growth. The fall in the U.S. 10-year Treasury bond yield, a proxy for future economic growth expectations, to 1.74 percent seems to corroborate that no strong global recovery is expected in the wake of the recent positive trade outcomes.

Invested and alert

Equities have been buoyed by central banks easing monetary policy, the search for yield, and hopes of global growth picking up as trade disputes wane. Disappointing economic growth or renewed tensions between the U.S. and its main trading partners would test investors' nerves and could spark volatility. So long as economic activity is sufficient for companies to eke out some earnings growth, as we expect will be the case, we think investors should maintain a Market Weight (benchmark) position in equities, though with heightened vigilance.

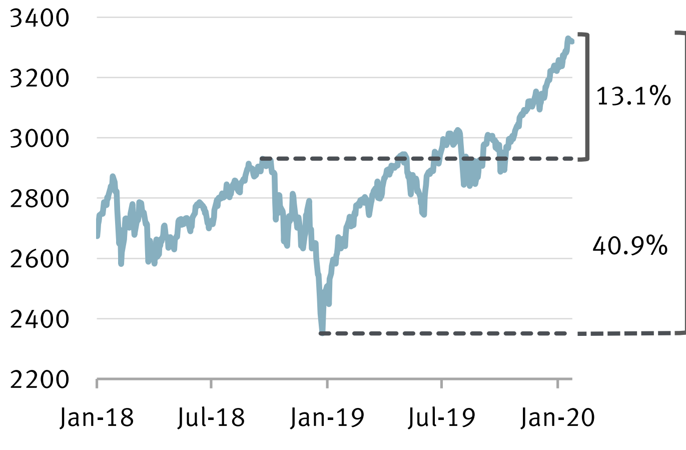
United States

Ben Graham, CFA – Minneapolis

- After setting six new all-time closing highs in the first three weeks of the year, **U.S. equity markets have muddled their way** through a week that saw the impeachment trial in the U.S. Senate kick off and several cities in China go into lockdown after a respiratory viral scare materialized. Thus far this week, **U.S. large caps are less than 0.5% lower while small caps declined 0.9%**. Growth has held up better than value, as evidenced by sector laggards including a sharp trade lower in Energy, Materials, and Financials. Slightly offsetting these declines are gains in Utilities, Real Estate, and Tech. Additionally, **U.S. interest rates have fallen in recent days**, bringing the yield on the S&P 500 (1.80%) back above the 10-year Treasury rate (1.74%).
- With the S&P 500 up 40.9% from its December 2018 lows and 13.1% from its September 2018 highs, **valuations have climbed accordingly**. On a forward-looking, next-twelve-month basis, the S&P 500 currently trades at 18.6x consensus EPS, per FactSet. This surpasses the January 2018 high of 18.5x. This backdrop of robust returns lasting longer than a year and slightly elevated valuations leads to our belief that **a natural consolidation would be healthy for U.S. equities**. Furthermore, the balance of these ideas supports our Market Weight recommendation for U.S. equities as we continue to hold a constructive view on underlying fundamentals while balancing this view against valuations that appear a bit rich.
- Economically speaking, **mixed to positive data was evident in home data and regional activity indexes**. Existing-home sales of 5.54 million in December and 3.6% m/m growth were much higher than consensus expectations. The Kansas City Fed Manufacturing Activity Index registered -1 for January, much higher than consensus expectations of -6. Meanwhile, the Chicago Fed National Activity Index reading for December registered -0.35, missing consensus expectations of 0.13.

S&P 500 gains have been strong whether measuring from previous highs or lows

S&P 500 Index levels and price returns



Source - RBC Wealth Management, FactSet; data as of 7:00 pm GMT 1/23/20

Canada

Carolyn Schroeder & Sayada Nabi – Toronto

- **The Canadian Survey of Consumer Expectations** (CSCE) focuses on respondents' views on the labour market, inflation, and household finances. The Q4 results indicated **consumers' views on the labour market were largely unchanged** compared to the previous quarter, underpinned by stable wage growth expectations. Meanwhile, households' interest rate expectations have been falling and the recent survey numbers reaffirm that inflation expectations remain well-anchored within the Bank of Canada's (BoC) 1%–3% target range. **Like their expectations for wage growth, consumers' expectations for growth in household income were largely steady** in Q4 2019. Expectations for spending growth edged up in 2019 and continued to surpass expectations for income growth, suggesting that consumers may reduce savings or increase debt to fund expenditures. On balance, we believe these survey results will not do much to ease concerns at the BoC that household debt growth, and the financial market vulnerabilities that come with it, are starting to pick up again.
- This week saw the BoC's first rate meeting of the new year, at which **the central bank decided to hold the overnight lending rate at 1.75%**. Although this marks the fifteenth consecutive month the rate has been kept unchanged, **the policy statement implied a more dovish tone**, according to RBC Economics. In the policy statement, economic data over the past three months were characterized as "mixed," and the central bank's outlook highlighted signs of weakness in exports, business expenditures, job creation, and consumer spending. Although the BoC initially attributed the slowdown in Canada's GDP growth at the end of 2019 to temporary factors, the policy statement acknowledged that **the domestic economy has been more negatively impacted by global headwinds** than the central bank had anticipated and "a high degree of uncertainty" remains. With all that said, the BoC still anticipates **growth will pick up as we move through 2020**, but cautions **the economy will not be operating at full capacity**.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The corporate earnings season started in Europe**, and close to 40% of companies on the STOXX Europe 600 will have reported by the end of January. Q4 2019 earnings expectations are still very subdued. Consensus is calling for **a 0.8% y/y earnings contraction** in Q4 for the UK and Europe combined, mostly due to the Energy and Materials sectors that are dependent on commodities prices. Such a low threshold should be achievable, in our view, given signs the global economy stabilized in the period. Consensus earnings expectations for 2020, at 8% y/y growth, are more demanding and rely on the global economy recovering somewhat.
- At its January Governing Council meeting, the European Central Bank (ECB) announced, as widely expected, that interest **rates would be at current or lower levels until inflation converged toward the mandated goal over the medium term**. There were no changes to the quantitative easing programme nor to forward guidance. Consensus is pricing in no change to rates in 2020, a view shared by RBC Capital Markets.
- **ECB President Christine Lagarde reiterated the importance of fiscal policy and formally launched a strategic review of ECB operations**, the second such review in the central bank's 20-year existence. The review will focus on topics such as the inflation target, including the numerical reference to 2%, a possible range around the target, and the measurement of inflation. It is also to include discussion on the tools used by the bank, including the impact of negative rates on the economy.

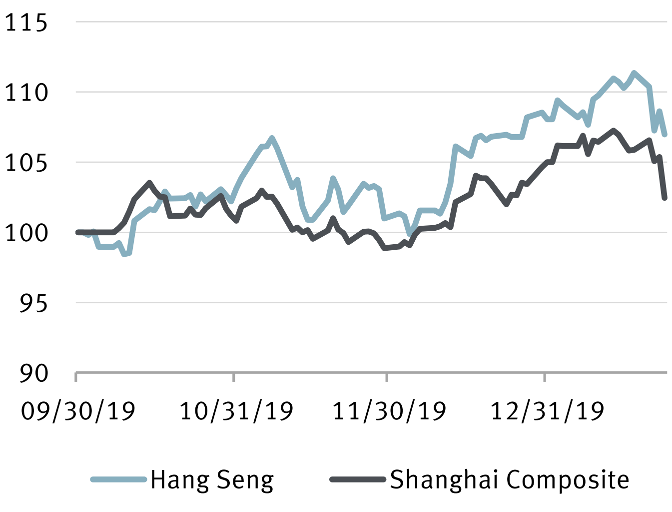
Asia Pacific

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

- **The coronavirus outbreak has interrupted the Asian equities rally**. While the outbreak currently does not appear to be as severe as SARS in 2003 and authorities are more prepared and alert this time, we may not have seen the worst of the pullback. Past results suggest **markets tend to bottom with the peak in new cases and news flow**. The number of new cases is still on the rise.
- If we refer back, the first SARS case was officially reported in December 2002, but China didn't start mass disease control until April 2003. From data collected afterward, reported cases dropped significantly after April 2003. The disease was largely under control in July 2003.

Asian equity indexes lose some Q4 gains on coronavirus concerns

Hang Seng and Shanghai Composite returns since 9/30/19, indexed to 100



Source - RBC Wealth Management, Bloomberg; data through 1/23/20

- **China's economy was negatively affected by SARS, notably in Q2 2003**, but recovered soon afterward. China's GDP growth slowed to 9.1% y/y in Q2 2003 from 11.1% y/y in Q1 2003, mainly due to the hit taken by sectors including tourism, transportation, hotels, and catering. GDP growth picked up to 10.0% y/y in Q3 2003. Overall, retail sales slumped to 6.8% y/y in Q2 2003 from 9.2% y/y in Q1 2003 before picking up to 9.7% y/y in Q3 2003. On the other hand, **fixed asset investment and industrial production were more resilient** as the government announced accommodative policies.
- **The Hang Seng corrected by about 19%** in the first five months of the SARS outbreak and **took four months to recover**. By the end of 2003, the index was up by approximately 55% from the bottom in April 2003.
- **China equities reacted differently**. The Shanghai Composite went up by 18% from December 2002 through April 2003. Afterward, it trended down by 20% until it found a bottom in November 2003.
- **We think tourism- and retail-related sectors** (airlines, hotels, gaming, retail, entertainment, etc.) **would be more negatively impacted by the coronavirus outbreak**, while there would be a positive bias for pharmaceutical stocks and makers of diagnostic kits and protective equipment (e.g., glove makers).

MARKET SCORECARD

Data as of January 23, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,325.54	2.9%	2.9%	26.0%	17.1%
Dow Industrials (DJIA)	29,160.09	2.2%	2.2%	18.7%	11.3%
NASDAQ	9,402.48	4.8%	4.8%	33.8%	26.0%
Russell 2000	1,685.01	1.0%	1.0%	15.9%	4.6%
S&P/TSX Comp	17,621.78	3.3%	3.3%	15.9%	7.7%
FTSE All-Share	4,170.34	-0.6%	-0.6%	10.8%	-1.7%
STOXX Europe 600	420.03	1.0%	1.0%	18.4%	4.3%
EURO STOXX 50	3,736.85	-0.2%	-0.2%	20.1%	1.8%
Hang Seng	27,909.12	-1.0%	-1.0%	3.3%	-15.2%
Shanghai Comp	2,976.53	-2.4%	-2.4%	15.3%	-16.1%
Nikkei 225	23,795.44	0.6%	0.6%	15.5%	-1.4%
India Sensex	41,386.40	0.3%	0.3%	14.6%	14.5%
Singapore Straits Times	3,234.56	0.4%	0.4%	2.0%	-10.0%
Brazil Ibovespa	119,527.60	3.4%	3.4%	23.8%	48.2%
Mexican Bolsa IPC	45,476.43	4.4%	4.4%	4.1%	-9.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,562.99	3.0%	3.0%	21.8%	16.5%
Silver (spot $/oz)	17.80	-0.3%	-0.3%	15.8%	4.4%
Copper ($/metric ton)	6,073.75	-1.2%	-1.2%	2.6%	-11.8%
Oil (WTI spot/bbl)	55.50	-9.1%	-9.1%	5.9%	-14.0%
Oil (Brent spot/bbl)	62.11	-5.9%	-5.9%	1.6%	-11.2%
Natural Gas ($/mmBtu)	1.94	-11.3%	-11.3%	-34.9%	-43.6%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.729%	-18.9	-18.9	-101.2	-88.4
Canada 10-Yr	1.415%	-28.7	-28.7	-55.5	-81.4
U.K. 10-Yr	0.591%	-23.1	-23.1	-73.5	-76.2
Germany 10-Yr	-0.308%	-12.3	-12.3	-53.3	-86.9
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.20%	0.9%	0.9%	9.6%	10.6%
U.S. Invest Grade Corp	2.71%	1.4%	1.4%	15.6%	14.2%
U.S. High Yield Corp	5.09%	0.7%	0.7%	11.7%	11.8%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.6710	1.3%	1.3%	1.6%	8.4%
CAD/USD	0.7618	-1.0%	-1.0%	1.6%	-5.4%
USD/CAD	1.3129	1.1%	1.1%	-1.6%	5.7%
EUR/USD	1.1057	-1.4%	-1.4%	-2.8%	-10.1%
GBP/USD	1.3124	-1.0%	-1.0%	0.4%	-6.3%
AUD/USD	0.6844	-2.5%	-2.5%	-4.2%	-14.5%
USD/JPY	109.4700	0.8%	0.8%	-0.1%	-0.8%
EUR/JPY	121.0500	-0.6%	-0.6%	-3.0%	-10.8%
EUR/GBP	0.8426	-0.4%	-0.4%	-3.2%	-4.1%
EUR/CHF	1.0717	-1.3%	-1.3%	-5.4%	-9.0%
USD/SGD	1.3516	0.4%	0.4%	-0.5%	2.6%
USD/CNY	6.9426	-0.3%	-0.3%	2.2%	8.4%
USD/MXN	18.7593	-0.9%	-0.9%	-1.4%	0.3%
USD/BRL	4.1700	3.5%	3.5%	10.9%	28.7%

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 1/23/20.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -0.4% return means the Canadian dollar fell 0.4% vs. the U.S. dollar year to date. USD/JPY 110.16 means 1 U.S. dollar will buy 110.16 yen. USD/JPY 1.4% return means the U.S. dollar rose 1.4% vs. the yen year to date.

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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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