

Global Insight

Weekly

When Wall Street bypasses Main Street

Kelly Bogdanova – San Francisco

The U.S. equity market continues to race ahead, even as businesses struggle with the economic gridlock created by COVID-19 shutdowns and society grapples with the effects of racial injustice. We look at why it's not unusual for Wall Street and Main Street to diverge from time to time, and we remain modestly Underweight U.S. equities.

Normally, equity markets face a wall of worry—and lately, there has been a mountain of worry. Yet following the initial steep COVID-19 selloff, markets have climbed the mountain successfully. U.S. and Canadian indexes are up almost 40 percent since the March lows, and major European markets are up about 30 percent.

With equity markets so buoyant during the economic crisis induced by COVID-19 lockdowns, and even drifting higher as the racial justice crisis has re-emerged, why does America's Main Street seem so disconnected from Wall Street?

Investor optimism, policy pragmatism

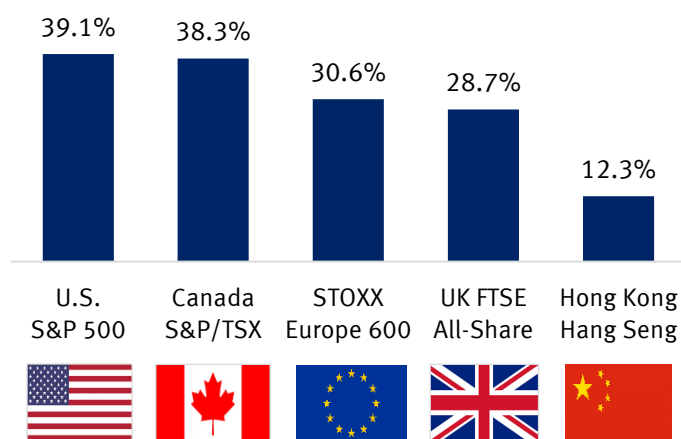
Of course, there are practical reasons why equity markets are moving at a faster pace:

- Markets look forward, not backward, and they're concluding that the current economic challenges will be temporary.
- The U.S. market seems to be assuming that the domestic economy and corporate profits will be back to 2019 levels sometime next year (we think it will be a little later).
- The Federal Reserve has thrown more than the kitchen sink at the severe economic crisis, backstopping the credit market for the first time in history. In hindsight, this has been a boon for the stock market and has supported valuations.
- Fiscal stimulus has also helped boost the market, in our view.

But this still begs the question, why aren't difficulties on Main Street reflected on Wall Street during this period of severe economic and social distress?

Big rallies off the low despite a mountain of bad news

Equity index performance since the MSCI World and S&P 500 bottomed on Mar. 23, 2020



Source - RBC Wealth Management, Bloomberg; data through 6/4/20

Market pulse

- 3 Value stocks continue to lead U.S. markets higher
- 3 New BoC governor to maintain bank's present course
- 4 Stimulus measures expand in Europe
- 4 Asian markets rally despite U.S.-China tensions

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Management

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Multinationals (often) move markets more

In reality, Wall Street and Main Street don't always move at the same pace, especially when major non-market-related events occur. This has been the case throughout history. The profit trends and future prospects of companies within "the market" can diverge at times from wider problems in society, especially during unique challenges such as pandemic lockdowns, social justice struggles, or crises in government.

They can even diverge when segments of the economy come apart. One example is the savings and loan (S&L) crisis, which began in the 1980s and stretched into the 1990s. It took down more than 1,000 of these small financial institutions, or roughly one-third of the total, across the country. The crisis contributed to the 1990 recession and hit the U.S. equity market at that time (and some would argue that its nascent phase contributed to the 1987 bear market), but the S&P 500 began a sharp recovery rally in 1991. However, the S&L crisis had a much longer aftermath in the communities where many of these institutions were located, and continued to impact local small businesses for years.

Furthermore, "the market" is actually a narrower slice of private enterprise than it is often perceived to be. When the business press refers to "the market," it is normally referring to the S&P 500, which represents roughly 500 large-cap (and mega-large-cap) companies at any given time, many of which are multinationals. This index includes big companies like Microsoft, Citigroup, Walmart, Honeywell, Chevron, etc. This isn't Main Street.

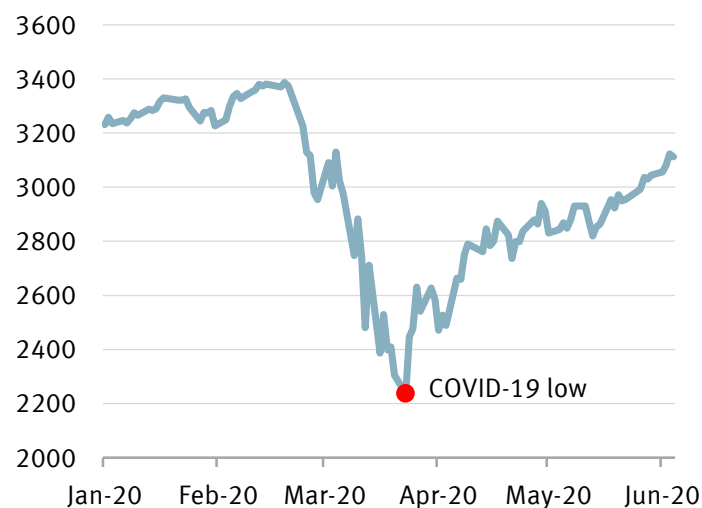
Another prominent large-cap index, the Dow Jones Industrial Average—which still has the reputation of being "the market" among a lot of North American investors—is even narrower: only 30 companies, including most of those household names listed above.

Both of these large-cap indexes attempt to reflect the broad composition of the U.S. economy, but they certainly don't capture the nuances of small and medium-sized business activity in cities and towns across North America.

Furthermore, while representation of mid- and small-cap companies is an important component of equity investing, the main U.S. indexes aren't very representative of the American small business community—and they are not designed to be. True, these indexes are a significant step below large caps in terms of the market value of the companies represented, so they are indeed much "smaller," but their constituents are in fact much larger than the small mom-and-pop businesses that are all over the country.

Ahead of itself?

S&P 500 Index year to date



Source - RBC Wealth Management, Bloomberg; data through 6/4/20

The road ahead to economic recovery

Even during economic expansion cycles, gaps can open up between Wall Street and Main Street.

S&P 500 gains can far outpace GDP growth. In seven of the 10 economic expansion cycles since 1949, the S&P 500 price return exceeded the expansion in nominal GDP, according to Bloomberg Intelligence. In four of those cases, the market overshot GDP by wide margins.

And while the S&P 500 and GDP tend to move together *directionally* over the longer term—rising, falling, or trading water—they can diverge in the shorter term.

Thus far, the stock prices of most publicly traded companies have been able to shake off the negative impacts of the COVID-19 lockdowns, with the exception of some at the epicenter of the lockdown recession, due to optimism about the prospects for economic and earnings recoveries. But mom-and-pop small businesses are just beginning to get back on their feet, and some have been knocked right back down due to widespread social unrest.

RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli believes the road ahead for the economy overall will be a slow one, and there could still be some pain ahead of us, as he stated in this recent [audio commentary](#). It could very well be that Wall Street has gotten ahead of itself. That is certainly the view of RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina. These are among the reasons we still think it's prudent to have some dry powder in equity portfolios.



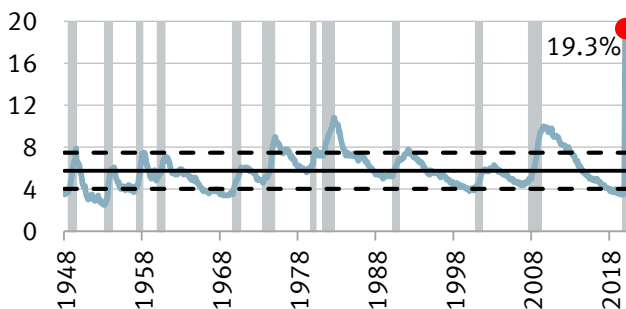
United States

Ben Graham, CFA – Minneapolis

- U.S. equity markets have been broadly higher this week with value stocks continuing their recent spate of outperformance relative to growth** after the S&P 500 Growth Index hit a 27-year peak relative to value on May 22. Since then, value has climbed 8% and growth 4%, with the former's relative strength continuing into this week. Following this trend, small caps are leading large thus far in June, and the NASDAQ is a relative underperformer to both the S&P 500 and Dow Jones Industrial Average. Furthermore, weekly and monthly leadership can be found in the Energy, Financials, and Industrials sectors, each of which is at least 5% higher. Health Care is the only sector lower thus far this week, but other bond proxies have gained less than the broader indexes.
- The 10-year Treasury rate has rallied in recent sessions**, climbing from 0.65% at last week's end to 0.82% currently. This move has helped facilitate the outperformance of value stocks in recent days and **may be linked to improving economic data and a slow reopening of the economy**. Furthermore, our Fixed Income Strategies team notes that total bankruptcy activity pales in comparison to what was seen in 2008–2009, and possibly even the Industrial Recession of 2015–2016.
- Economic data continues to trend in a modestly constructive manner** after ISM Purchasing Managers' Index (PMI) data this week showed Manufacturing and Non-Manufacturing readings that were both in contractionary territory, but better than consensus expectations. The

Elevated unemployment presents a silver lining of better-than-average returns

U.S. unemployment levels since 1948



S&P 500 average 12-month forward return

Unemployment higher than average: 11.9%

Unemployment greater than 9%: 14.2%

Note: May's 19.3% is a consensus estimate, all other data is actual. The solid line represents the average and the dotted lines represent +/- one standard deviation. The light gray bars represent U.S. recession periods. Source - RBC Wealth Management, St. Louis Fed; data through 6/1/20

Manufacturing PMI registered 43.1 while the Non-Manufacturing PMI came to 45.4. **May results for both indexes were better than the sub-42.0 readings from April, resulting in incremental improvement that also exceeded expectations.** Unemployment data will be reported on Friday, June 5 and consensus expectations currently reside at 19.8%. This is nearly double the previous highs of 10.8% and 10.0% seen in 1982 and 2009, respectively, and also represents the fastest growth in unemployment since at least 1948.

- However, the silver lining to elevated unemployment is that S&P 500 future 12-month returns are frequently better than average when unemployment is high** because that ensuing period typically encompasses an economic recovery. In fact, when unemployment is greater than 9%, usually a characterization of a period of economic strain if not outright recession, the S&P 500 has averaged 14.2% in the 12 months following such an elevated reading.



Canada

Ryan Harder & Sayada Nabi – Toronto

- Tiff Macklem officially took over as the Bank of Canada (BoC) governor** this week, which also saw his first rate decision on June 3. So far it seems the **existing policy direction from the BoC will remain intact**, with the overnight lending rate unchanged at 0.25% alongside a reiterated commitment to maintain large-scale asset purchases until the “economic recovery is well underway.” Overall, the **BoC's tone was cautiously optimistic**, saying the Canadian economy appears to be past the peak of disruption from COVID-19. Liquidity operations have also decelerated, reflecting continuing improvement in financial conditions. Regarding interest rates, Macklem has indicated his preference is to focus on asset purchases and other monetary policy tools before considering introducing potentially disruptive negative rates.
- Each year international students have accounted for CA\$6 billion in tuition for Canadian universities and colleges, and the pandemic puts those dollars at risk.** According to RBC Economics, 1.6 billion learners globally have been affected by school closures, and 91% of the world's students have been displaced from the classroom. In Canada this equates to 7 million students shifting their learning style to digital platforms. At the beginning of this year more than 640,000 foreign nationals held study permits, and 293,000 of those permits were issued just in 2019. According to RBC Economics, the international student population has doubled in the last five years, contributing about CA\$22 billion in GDP and 11,000 new permanent residences on an annual basis. Amid the lockdowns and ongoing travel restrictions, **new international student permits dropped**

by 45% y/y in March, with further declines expected down the road, according to RBC Economics. Considering the grim student immigration numbers, **the federal government is trying to find ways to curb the decline** by permitting new international students to begin their programs in their home countries, allowing completion of up to 50% of their program via distance learning, and assuring access to post-graduate work permits.



Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- Support and stimulus programmes continue to be announced in Europe. European Union member nations continued to discuss the **European Commission’s proposal for a joint response to the COVID-19 crisis**, which would total €750 billion (6% of EU GDP) in addition to the stimulus measures the various national governments have already announced for their countries.
- This week, **Germany announced an additional fiscal package for this year and next**, intended to help underpin the country’s ongoing economic recovery. **At €130 billion, it is equivalent to an additional 4% of national GDP** and roughly a third larger than suggested by earlier reports in the German media.
- The key features of the package include a temporary reduction in VAT (a sales tax) for the second half of 2020, incentives to buy electric cars, a cap on companies’ social security contributions for their employees, and extra support for small and medium-sized companies in sectors most affected by the crisis. **An investment programme of €50 billion to foster the transition to a greener economy** is also part of the package, underlining the importance of this issue for the country.
- Moreover, **the European Central Bank (ECB) increased the size of its Pandemic Emergency Purchase Programme (PEPP) to €1.3 trillion** from €750 billion at its June 4 meeting. This exceeded consensus expectations and, in our view, will be supportive of sentiment and contribute to rebuilding confidence going forward.
- **AstraZeneca**, the British-Swedish pharmaceutical company, **presented positive results from its ADAURA trial** at the American Society of Clinical Oncology conference last weekend. The trial showed the company’s Tagrisso demonstrated a statistically significant and clinically meaningful improvement in disease-free survival in the adjuvant (i.e. post-surgery) treatment of patients with early-stage non-small-cell lung cancer with a specific gene mutation. The trial’s principal investigator described the data as “transformative” and said the drug “has the potential to change the practice of medicine and improve

outcomes for patients” in this lung cancer setting. Share price outperformance in recent months has resulted in **AstraZeneca becoming the largest constituent of the FTSE 100 and FTSE All-Share indexes.**



Asia Pacific

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

- **Asian equities have had a strong run this week**, with the MSCI AC Asia ex Japan Index up 6.1% through June 4. Last week, the U.S. decided it could revoke special privileges granted to Hong Kong, but few details were announced. **Hong Kong equities have experienced a relief rally** this week, with the Hang Seng Index up 6.01% through June 4.
- **A reescalation of U.S.-China tensions is adding uncertainty to Asian equities** and will continue to be a short-term overhang, in our view. The Trump administration seems to view the U.S. stance on Hong Kong as an element in its ongoing trade negotiations with China and as election rhetoric. As details of China’s national security law for Hong Kong may not be drafted until August, we think both sides may leave some room for further negotiations/other developments.
- Despite these intensifying tensions, **some stocks in particular industries in China/Hong Kong markets have reached new highs** in the past few weeks, e.g., e-commerce, online gaming, health care, and leading consumer staples, as well as stocks of companies that derive the bulk of their revenue domestically.
- **NetEase (NTES), China’s second-largest mobile games company behind Tencent (700 HK), plans to list its shares in Hong Kong via a secondary offering.** According to Bloomberg, the company expects to raise HK\$21.3 billion through the IPO offering, which started on Jun. 2, while **JD.com’s (JD) Hong Kong IPO offering is scheduled to start next week.** Hong Kong Exchanges and Clearing (388 HK) is a clear beneficiary of the U.S.-listed Chinese companies returning for a secondary listing, in our view, with its share price reaching a 52-week high this week.
- **China’s Caixin Services Purchasing Managers’ Index**, a private gauge of China’s service sector activity, **improved to 55.0 in May from 44.4 in April**, well ahead of the 47.3 consensus expectation. This marked the **biggest sequential increase on record**, the first expansionary reading since January, and the highest level since October 2010. The main driver was new orders, while respondents highlighted an easing of COVID-19 restrictions and a pickup of domestic demand. We continue to favor Chinese equities as the country is further along in controlling COVID-19 than other nations, and thus its economy may recover ahead of other regions.



MARKET SCORECARD

Data as of June 4, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,112.35	2.2%	-3.7%	11.0%	13.3%
Dow Industrials (DJIA)	26,281.82	3.5%	-7.9%	3.7%	5.9%
NASDAQ	9,615.81	1.3%	7.2%	27.7%	26.4%
Russell 2000	1,452.06	4.2%	-13.0%	-3.7%	-12.2%
S&P/TSX Comp	15,527.87	2.2%	-9.0%	-3.9%	-3.3%
FTSE All-Share	3,509.99	4.4%	-16.4%	-11.1%	-17.6%
STOXX Europe 600	366.25	4.5%	-11.9%	-1.7%	-5.6%
EURO STOXX 50	3,261.67	6.9%	-12.9%	-2.2%	-6.0%
Hang Seng	24,366.30	6.1%	-13.6%	-9.0%	-21.4%
Shanghai Comp	2,919.25	2.3%	-4.3%	2.0%	-5.6%
Nikkei 225	22,695.74	3.7%	-4.1%	11.2%	1.0%
India Sensex	33,980.70	4.8%	-17.6%	-15.2%	-2.9%
Singapore Straits Times	2,707.20	7.8%	-16.0%	-13.8%	-21.9%
Brazil Ibovespa	93,828.60	7.4%	-18.9%	-3.6%	19.4%
Mexican Bolsa IPC	37,872.89	4.8%	-13.0%	-12.4%	-16.3%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,714.86	-0.9%	13.0%	29.4%	32.7%
Silver (spot \$/oz)	17.74	-0.7%	-0.6%	19.7%	8.1%
Copper (\$/metric ton)	5,499.25	2.7%	-10.6%	-6.1%	-21.1%
Oil (WTI spot/bbl)	37.41	5.4%	-38.7%	-30.0%	-42.2%
Oil (Brent spot/bbl)	39.99	13.2%	-39.4%	-35.5%	-46.9%
Natural Gas (\$/mmBtu)	1.82	-1.7%	-16.9%	-24.8%	-38.0%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.820%	16.8	-109.7	-131.0	-212.2
Canada 10-Yr	0.676%	14.2	-102.6	-79.9	-160.1
U.K. 10-Yr	0.306%	12.2	-51.6	-59.6	-99.1
Germany 10-Yr	-0.320%	12.7	-13.5	-11.4	-73.8

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.38%	-0.2%	5.2%	9.0%	16.8%
U.S. Invest Grade Corp	2.35%	0.2%	3.2%	10.2%	19.2%
U.S. High Yield Corp	6.27%	1.9%	-2.9%	3.0%	8.7%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	96.8230	-1.5%	0.5%	-0.3%	3.0%
CAD/USD	0.7403	2.0%	-3.8%	-0.8%	-4.3%
USD/CAD	1.3507	-2.0%	4.0%	0.8%	4.5%
EUR/USD	1.1328	2.0%	1.0%	0.7%	-3.2%
GBP/USD	1.2588	2.0%	-5.0%	-0.9%	-5.4%
AUD/USD	0.6940	4.1%	-1.2%	-0.7%	-9.3%
USD/JPY	109.1800	1.3%	0.5%	1.0%	-0.6%
EUR/JPY	123.6800	3.3%	1.6%	1.6%	-3.7%
EUR/GBP	0.8999	0.0%	6.4%	1.6%	2.4%
EUR/CHF	1.0831	1.5%	-0.2%	-3.0%	-6.3%
USD/SGD	1.3983	-1.1%	3.9%	2.3%	4.6%
USD/CNY	7.1112	-0.4%	2.1%	2.9%	11.0%
USD/MXN	21.9400	-1.1%	15.9%	12.1%	9.3%
USD/BRL	5.1370	-3.7%	27.5%	35.9%	37.2%

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 8:35 pm GMT 6/4/20.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -3.8% return means the Canadian dollar fell 3.8% vs. the U.S. dollar year to date. USD/JPY 109.18 means 1 U.S. dollar will buy 109.18 yen. USD/JPY 0.5% return means the U.S. dollar rose 0.5% vs. the yen year to date.

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