May 21, 2020

RBC WEALTH MANAGEMENT

Global Insight Weekly

Style guide

Kelly Bogdanova – San Francisco

Growth vs. value, it's an age-old debate. Given the COVID-19 dynamics of today's equity market, which style is more apropos? While some tempting cases can be made for value, we think it's too soon to go big into value stocks at the expense of growth stocks.

Growth stocks have powered ahead of value stocks since the Mar. 23 low and are outperforming significantly for the year, whether in the U.S. or globally.

The performance difference in the U.S. is a meaningful 22.5 percentage points, as the chart shows. The gap in performance between other developed and emerging country growth and value stocks is also wide, at a non-trivial 16.2 percentage point difference year to date.

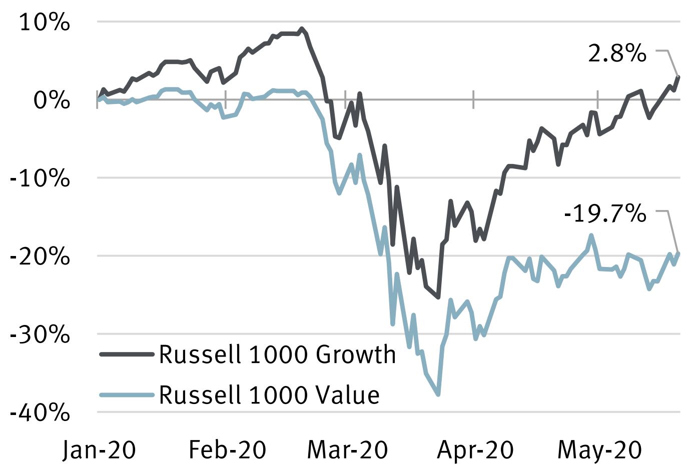
The reality is, value has lagged for a long time. It has had a few periods of brief outperformance in the U.S. and elsewhere since the Great Recession ended a little more than a decade ago, but overall it has trailed growth badly. Since the beginning of 2010, the U.S. Russell 1000 Growth Index has risen 264 percent, while the companion Value Index has risen only 91 percent.

This is largely due to the significant outperformance of technology-related and Consumer Discretionary stocks, which are in the growth category, and the significant underperformance of Energy and Financials, which are key components of the value category.

But there have been prior periods in history when value meaningfully outperformed growth. Might the style trade shift back to value soon? While there are reasons to pay closer attention to value stocks and we would caution against being outright bearish on them, we doubt value will grab the leadership mantle on a sustained basis over the medium term.

U.S. growth stocks have led value by a wide margin

Year-to-date performance of Russell 1000 Growth and Value Indexes



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

Market pulse

Click here for authors' contact information. Priced (in USD) as of 5/21/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6.**
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The values of value

Value has the valuation advantage over growth—the category is cheaper, the degree to which depends on the measure.

Based on RBC Capital Markets' valuation model that incorporates 34 different metrics—this method goes well beyond typical price-to-earnings (P/E) comparisons—growth no longer has the valuation appeal that it did throughout most of the post-financial crisis period. But the value category's valuation discount compared to growth isn't nearly as deep as it was during the peak of the tech bubble in 2000 when growth was severely overvalued. This is also the case on a straight P/E basis.

A contrarian argument can be made for value. Given the 10-year+ stretch of underperformance, including the extreme underperformance that has occurred since late 2019 as shown in the top chart, that streak seems bound to change at some point. Value is the out-of-favor style category, and the market can reward an out-of-favor, contrarian view when it is least expected.

The baton should remain with growth

While we think a case can be made for a brief snapback for value, it's difficult to envision value totally upending growth over the medium term.

Value needs some economic indicators to shift in order to regain solid footing, particularly inflation expectations.

Since 2014, value has drifted lower as inflation expectations measured by the U.S. Treasury market have declined, as shown in the bottom chart. Until inflation expectations stabilize and then begin to turn higher on a sustained basis, we think this will be a headwind for value.

Periods of sluggish or uneven economic output tend to favor growth over value. When economic and corporate earnings growth are scarce, inconsistent, or in doubt, institutional investors tend to reach for secular growth stocks. These are companies that can grow consistently due to long-term positive industry tailwinds, regardless of swings in economic output.

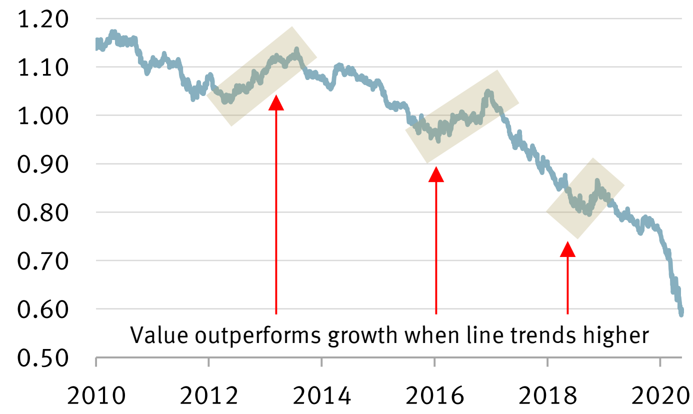
COVID-19 has absolutely ushered in a period of heightened economic and earnings uncertainty. RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina wrote, "We suspect that once the U.S. moves past an initial economic inflection that sluggish economic growth will become the norm for a while. And that's a backdrop that favors Growth leadership."

Recent U.S. earnings revision trends—the proportion of upside revisions—slightly favor growth over value, according to Calvasina. Profit margins have remained elevated for growth, while they have slipped for value.

Furthermore, money flows are a consideration. Bloomberg Intelligence analysts estimate that $5.8 billion has flowed into value exchange-traded funds (ETFs) globally in the past two

Value outperformance has been fleeting

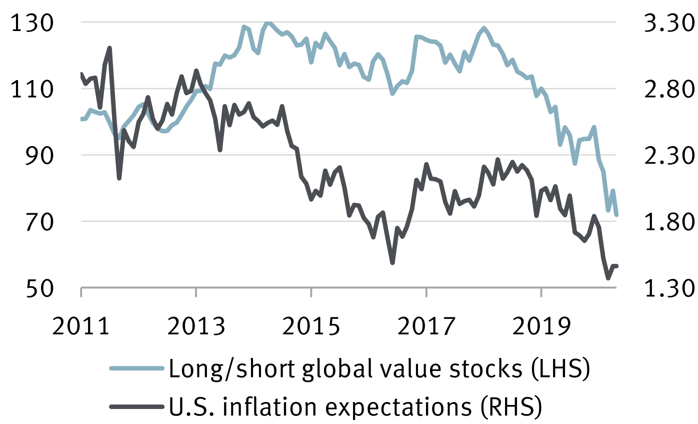
Performance of U.S. Russell 1000 Value Index versus Growth Index



Ratio of large-cap value divided by growth
Source - RBC Wealth Management, Bloomberg; data through 5/20/20

Value stocks have drifted lower with inflation expectations

Global value stocks versus inflation expectations



U.S. 5-year/5-year forward breakeven inflation expectation rate.
Source - Bloomberg Intelligence, RBC Wealth Management; monthly data through 5/20/20

months. That's a meaningful amount, but nearly $8 billion flowed into growth ETFs on a global basis during the same period. Roughly $5.8 billion of that occurred in just the past month, the most in history, when equity markets rallied forcefully across regions. Bloomberg Intelligence views this as a signal that investors may expect growth to continue to outperform value.

Not at a pivot point

As tempting as the valuation and performance differences are, which make the case for at least a brief snapback in value, we think it's too soon to go big into value at the expense of growth.

Calvasina remains neutral when it comes to this style debate. Each category has positives and negatives and, therefore, she would not meaningfully overweight one at the expense of the other in equity portfolios.

United States

Atul Bhatia, CFA – Minneapolis

- Fixed income markets last week reinforced two trends we expect to continue. First, **we believe rates are going to be driven largely by medical news**. The dominant move in Treasuries was Monday's vaccine-related sell-off. We expect most investors to look past weak April data and focus on economic reopening and medical trends. Second, **bond investors appear receptive to high-grade corporate issuance**. Investment-grade debt issued this year totals $943 billion, compared with only $497 billion at this point in 2019. All-in yield to issuers is also well below last year's levels.

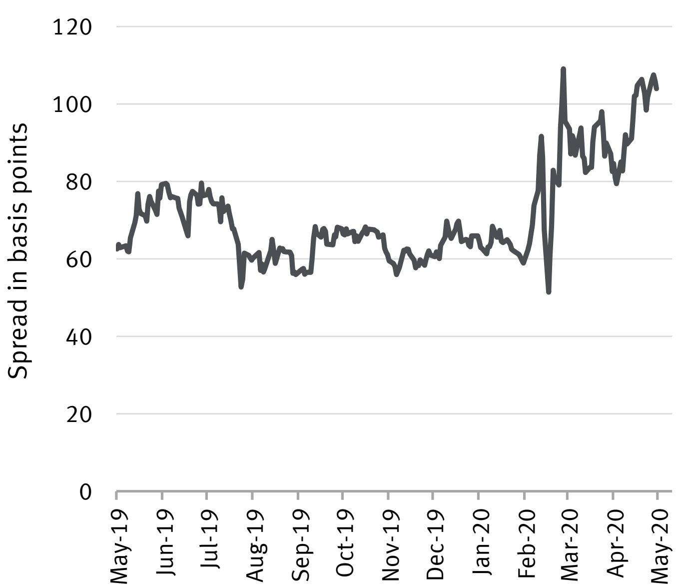
- **Although the financial press continues to discuss the possibility of negative policy rates in the U.S., we see this as an unlikely outcome**. Rate cuts work in part by spurring bank lending: they make it cheaper to borrow, while giving banks a profit incentive to lend. Cuts below zero upset that calculus, creating losses that banks cannot always pass on to depositors. Subzero rates could also have negative consequences for the dollar's reserve currency status. Balanced against these real and potential costs are extremely weak benefits; **demand uncertainty, not the base cost of funds, is the hold-up for economic activity**, in our view.

- **We see a greater likelihood of yield curve control**, where the Fed establishes a yield ceiling for longer-maturity Treasuries. Such a measure would help the Treasury sell new longer-term debt, help high-grade borrowers secure long-term funding at a lower cost, and help higher-risk borrowers gain short-term liquidity by making their debt's yield relatively more attractive. **Unlike negative rates, this is a policy tool the Fed has used previously**, and it is one we think it will consider seriously in the future.

- **The Fed launched its Secondary Market Corporate Credit Facility last week**. As expected, the Fed began with small purchases—only $305 million total—of fixed income ETFs. **We expect the Fed to be relatively inactive in this area**, purchasing just enough to demonstrate credibility and prove out the operational infrastructure; with bond issuance and trading functioning, the Fed has little reason for more active intervention.

Longer-term rates are high relative to shorter-term rates

U.S. Treasury 30-yr./5-yr. yield spread near its highest level in 12 months



Source - RBC Wealth Management, Bloomberg; data as of 11:44 am ET 5/21/20

Canada

Carolyn Schroeder & Ryan Harder – Toronto

- **Canada's Consumer Price Index (CPI) fell 0.2% y/y in April**, down from a 0.9% gain in March. This was **the first year-over-year decline in CPI since September 2009**. For a second straight month, a sizeable drop in gasoline prices was a significant driver of the easing in headline inflation. Providing some offset to lower core and energy prices, food prices increased sharply amid strong demand and, in some cases, supply chain disruptions. As the country continues to reopen and the economy enters recovery mode, **we believe the Bank of Canada (BoC) will shift its focus to supporting growth and returning inflation to its 2% target**. While there's no shortage of uncertainty regarding the future path for the economy and inflation, RBC Economics expects an ongoing shortfall in demand will keep inflation below 2% even as the effect of lower energy prices fades. That, in turn, should necessitate ongoing stimulus from the BoC, including an extended period of low interest rates and even more quantitative easing.

- **The BoC outlined eligibility criteria for the Corporate Bond Purchase Program** (CBPP) this week, paving the way for the central bank to begin purchasing corporate bonds directly on May 26. Only bonds rated BBB or higher by at least one agency will be eligible for purchase, unless they were downgraded after the initial program announcement on April 15, in which case they remain eligible for the program as long as their top rating stays at BBB- or higher. The program's stated goal is to "support the liquidity and proper functioning of the corporate debt market," suggesting **there may be some relief on the horizon for hard-to-sell bonds** that meet the eligibility requirements.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Bank of England (BoE) Governor Andrew Bailey expressed greater open-mindedness about negative interest rates** as part of a broader review of the BoE's toolkit, which is due out later this year. Given the adverse effect that negative rates can have on the banking sector in particular, we continue to believe that the BoE's next move will be to expand its asset purchase programme. Markets are currently pricing in a 10% probability of a cut in interest rates in February 2021, which would take them into negative territory.

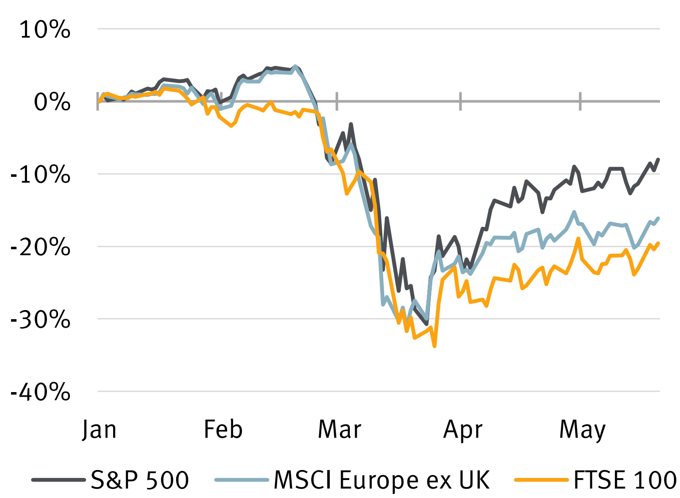
- After two months of hesitation, a joint EU fiscal response to the pandemic is finally taking shape with **France and Germany proposing to turbo boost the EU budget with an ambitious Europe-wide recovery fund of €500 billion**, or over 3.5% of the region's GDP. It would pay for reconstruction efforts across the region and offer grants to sectors and regions most weakened by the outbreak.

- A joint EU response is a critical addition to the swift and substantial responses to the crisis taken by various national governments. **Without such a show of solidarity at a time of great distress, we believe anti-EU sentiment would be inflamed** in the countries most affected by the crisis such as Italy and Spain.

- **The proposal is far from being a done deal** as it must still be agreed to by all member states and the European Parliament. Germany, which made an important concession by loosening its tight purse strings, may be able to convince other like-minded frugal states to follow its lead. For now, this bold proposal has shifted the tone of the joint response debate, enabling Italian borrowing costs to decline somewhat.

European equities lag on slower pandemic responses

Year-to-date performance



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

Asia Pacific

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

- A re-escalation of U.S.-China tensions is adding uncertainty to Asian markets this week. On May 15, **the U.S. changed the Foreign Direct Product Rule so that it will now bar Chinese tech giant Huawei and its suppliers from using U.S. technology and software as components for its products sourced from non-U.S. manufacturers**. Previously, the ban had only applied to U.S. companies. The policy may affect the global semiconductor and smartphone supply chain, and share prices of companies in these industries in Hong Kong and Taiwan have come under pressure. As Huawei has built up inventory and can continue to get chips through mid-September, the actual impact of the rule may only emerge in the second half of 2020.

- In addition, on May 20 the **U.S. Senate approved legislation that could lead to Chinese companies being delisted on U.S. stock exchanges**. Stricter U.S. oversight could potentially affect the future listing plans of Chinese corporations.

- Hang Seng Indexes Company announced that **companies with weighted voting rights and secondary-listed companies from Hong Kong, mainland China, Macau, and Taiwan will be eligible for inclusion in the Hang Seng Index and the Hang Seng China Enterprises Index**, with a weighting cap of 5%. Hang Seng Indexes will implement these changes at the time of the August 2020 index review. The changes pave the way for Alibaba (9988 HK), Xiaomi (1810 HK), and Meituan Dianping (3690 HK) to be included in the Hang Seng Index. Hong Kong Exchanges and Clearing (388 HK) may also benefit with more U.S.-listed Chinese companies returning for a secondary listing.

- **China's National People's Congress (NPC) will kick off on May 22** after a delay of over two months. A key issue to watch will be the annual growth target. Before the COVID-19 outbreak, the market expected that China would achieve GDP growth of 6%–6.5% in 2020. However, this target doesn't seem practical, in our view. We think **the official growth target to be announced during the NPC will signal how confident China is in a rebound** and the degree to which achieving rapid growth will be a priority. In addition, the NPC may announce more fiscal policies and further stimulus packages.

MARKET SCORECARD

Data as of May 21, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,948.51	1.2%	-8.7%	2.9%	7.9%
Dow Industrials (DJIA)	24,474.12	0.5%	-14.2%	-5.4%	-2.2%
NASDAQ	9,284.88	4.4%	3.5%	19.3%	25.6%
Russell 2000	1,347.56	2.8%	-19.2%	-12.8%	-17.7%
S&P/TSX Comp	14,884.85	0.7%	-12.8%	-9.4%	-7.9%
FTSE All-Share	3,311.40	1.5%	-21.1%	-17.5%	-23.3%
STOXX Europe 600	340.26	0.1%	-18.2%	-10.3%	-14.0%
EURO STOXX 50	2,904.98	-0.8%	-22.4%	-14.2%	-18.7%
Hang Seng	24,280.03	-1.5%	-13.9%	-12.2%	-22.3%
Shanghai Comp	2,867.92	0.3%	-6.0%	-1.3%	-10.8%
Nikkei 225	20,552.31	1.8%	-13.1%	-3.4%	-10.7%
India Sensex	30,932.90	-8.3%	-25.0%	-20.6%	-10.6%
Singapore Straits Times	2,555.34	-2.6%	-20.7%	-19.7%	-28.0%
Brazil Ibovespa	83,027.10	3.1%	-28.2%	-12.1%	1.5%
Mexican Bolsa IPC	35,560.76	-2.5%	-18.3%	-17.7%	-21.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,726.46	2.4%	13.8%	35.4%	33.6%
Silver (spot $/oz)	17.12	14.4%	-4.1%	18.4%	3.7%
Copper ($/metric ton)	5,417.50	5.0%	-11.9%	-9.2%	-20.8%
Oil (WTI spot/bbl)	34.17	81.4%	-44.0%	-45.8%	-52.7%
Oil (Brent spot/bbl)	36.10	42.9%	-45.3%	-50.0%	-54.4%
Natural Gas ($/mmBtu)	1.73	-11.4%	-21.1%	-33.9%	-38.5%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.675%	3.6	-124.2	-175.1	-238.4
Canada 10-Yr	0.550%	0.3	-115.2	-121.0	-193.6
U.K. 10-Yr	0.171%	-6.0	-65.1	-91.2	-130.5
Germany 10-Yr	-0.495%	9.1	-31.0	-43.2	-101.8
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.37%	0.1%	5.1%	10.5%	17.5%
U.S. Invest Grade Corp	2.54%	0.6%	2.0%	10.4%	18.5%
U.S. High Yield Corp	7.59%	2.0%	-6.9%	-1.8%	4.3%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	99.4460	0.4%	3.2%	1.4%	6.2%
CAD/USD	0.7167	-0.1%	-6.9%	-3.9%	-8.3%
USD/CAD	1.3952	0.1%	7.4%	4.1%	9.1%
EUR/USD	1.0948	-0.1%	-2.4%	-1.9%	-7.1%
GBP/USD	1.2219	-3.0%	-7.8%	-3.8%	-9.0%
AUD/USD	0.6564	0.8%	-6.5%	-4.6%	-13.4%
USD/JPY	107.6000	0.4%	-0.9%	-2.6%	-3.1%
EUR/JPY	117.7900	0.3%	-3.3%	-4.5%	-10.0%
EUR/GBP	0.8959	3.0%	5.9%	2.0%	2.0%
EUR/CHF	1.0628	0.5%	-2.1%	-5.8%	-9.6%
USD/SGD	1.4176	0.5%	5.3%	2.9%	5.8%
USD/CNY	7.1158	0.7%	2.2%	3.1%	11.5%
USD/MXN	22.8801	-5.4%	20.9%	20.3%	15.4%
USD/BRL	5.5671	1.5%	38.1%	47.3%	51.4%

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 5/21/20.

Examples of how to interpret currency data: CAD/USD 0.71 means 1 Canadian dollar will buy 0.71 U.S. dollar. CAD/USD -6.9% return means the Canadian dollar fell 6.9% vs. the U.S. dollar year to date. USD/JPY 107.60 means 1 U.S. dollar will buy 107.60 yen. USD/JPY -0.9% return means the U.S. dollar fell 0.9% vs. the yen year to date.

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As of March 31, 2020

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Buy [Outperform]	755	51.64	220	29.14
Hold [Sector Perform]	619	42.34	126	20.36
Sell [Underperform]	88	6.02	11	12.50

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