November 14, 2019

RBC WEALTH MANAGEMENT

Global Insight

Weekly

Breaking the Brexit impasse?

Frédérique Carrier – London

The Brexit saga has dragged on and on … and on. It has constrained global growth by holding back the UK and European economies, casting a shadow over equity markets. While there is light at the end of the long tunnel, there are various outcomes from next month's UK general election for global investors to consider.

What is the Withdrawal Agreement deal?

The first part of Prime Minister Boris Johnson's Withdrawal Agreement (WA) defines the legally binding terms of the UK's exit from the EU: leave the bloc on Jan. 31, 2020, with a one-year transition period which maintains the status quo. The two sides could agree to a one-off extension lasting two years if requested before July 1, 2020.

The second, non-legally binding part, suggests what the trading relationship could look like beyond Dec. 2020: a very loose free trade agreement (FTA) that includes limited regulatory harmonization and zero tariffs on goods (the deal does not cover services).

The UK government aims to finalize the FTA quickly and to start trading under these new terms from Jan. 2021. If the FTA is not in place by then, trade would commence under WTO rules. The estimated impact of Johnson's deal on the economy varies (see table).

General election scenarios

The outcome of the general election may yet alter Brexit's course. Given current polls, we see three viable scenarios: a Conservative majority, a Conservative-led minority, or a Labour-led minority.

Conservative majority government

If the Conservatives maintain their current 10% lead in the polls they would likely win a majority in the House of Commons.

Long-term impact of various Brexit outcomes on UK GDP

Johnson's Withdrawal Agreement is a harder form of Brexit than Theresa May's

	Johnson's Withdrawal Agreement	May's Withdrawal Agreement	Hard Brexit (WTO terms)
London School of Economics	-6.4%	-4.9%	-8.2%
UK in a Changing Europe	-5.8% to -7.0%	-5.5%	-8.7%

Source - National research correspondent

Market pulse

3 U.S. inflation tame, even with a strong consumer backdrop
3 Labor market is a pillar of strength for Canada's economy
3 Upgrading European equities (ex UK) to Market Weight
4 Japan's economic growth slumps

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RBC Wealth Management

Brexit Party leader Nigel Farage agreeing not to field candidates in constituencies won by the Conservatives in 2017 could help them retain seats. But Farage's help comes at a price: assurances an extension to the transition period beyond 2020 will not be sought.

With a Conservative majority, we would expect the WA to pass swiftly, perhaps in time for the UK to exit the EU on Jan. 31, 2020 in an orderly fashion (with a one-year transition period). We would expect the pound to initially react positively to this, as it would give clarity to an immediate exit. Gains may be limited given the currency's recent rally and attention soon turning to the extension request and life after the transition period.

If an amendment were to pass eliminating a transition, or if the government were to decline to request an extension, it would be crucial to finalize the FTA with the EU before the end of 2020, a colossal task, to avoid trading on WTO terms (i.e., a no-deal Brexit) from 2021.

Conservative minority government (hung Parliament)

But if the Conservatives are unable to win a majority, more Brexit gridlock is likely.

We would expect more attempts at amending the WA, with a view to effect a softer Brexit (including a longer transition period, Parliament's involvement in an extension request, or more regulatory harmonization). A second referendum would be seen as another way to break the impasse, and would be possible. The pound would probably fall in the near term given this uncertainty and investors adopting a wait-and-see attitude.

Labour minority government

We would expect the Scottish National Party (SNP) and the Liberal Democrats to enter into "confidence and supply" arrangements with the Labour Party. These are more flexible than coalitions, allowing votes against the government on certain issues.

Labour has stated it would seek to renegotiate the WA to soften it, and then put it to a referendum. The price for the SNP's support would likely be a second referendum on Scottish independence.

Although sterling could rise in the short term on hopes of a second Brexit referendum or softer exit from the EU, the move could be short-lived as the complexities of reshaping Brexit and fears of Labour's left-wing policies weigh on the outlook. We note that in a minority government, Labour's most extreme policies are unlikely to be enacted.

Scenario analysis

MORE LIKELY

CONSERVATIVE MAJORITY

Brexit: No delay; UK exits Jan. 31, 2020; amendments to bar extending transition possible

Economic policy: Fiscal stimulus: GBP 30B (1.5% GDP)

GBP impact: Stable/up near term on greater clarity; attention turns to trade relationship after transition period

CONSERVATIVE MINORITY

Brexit: Lengthy delays; impasse continues; 2nd referendum possible

Economic policy: Delays in delivery of fiscal stimulus

GBP impact: Down near term on uncertainty; amendments to WA could be positive

LABOUR MINORITY

Brexit: Lengthy delays; 2nd referendum most likely

Economic policy: Fiscal stimulus

GBP impact: Near term positive on 2nd referendum & possible softer Brexit could be outweighed by fears of left-wing policies

LABOUR MAJORITY

Brexit: Delays; attempts to renegotiate (political declaration); 2nd referendum possible

Economic policy: Fiscal stimulus; nationalisations

GBP impact: Down on fears of extreme Labour policies

LESS LIKELY

Source - RBC Wealth Management

Bank of England: It depends …

The Bank of England (BoE) recently struck a dovish tone and lowered its growth and inflation forecasts. Future moves clearly depend on how the election plays out. Under a majority Conservative government endorsing a quick Brexit, the BoE may stay on hold as long as the economy does not weaken further. It could readopt a tightening bias if large fiscal stimulus fosters inflationary pressures and the economy proves resilient. In the case of a hung Parliament or Labour minority government and more Brexit delays, with uncertainty remaining entrenched, a rate cut would be more likely.

Portfolio strategy

We remain Market Weight on UK equities as valuations appear attractive. We recently changed our bias from internationally focused companies to a more balanced approach between those and domestic-centric firms. We like banks and consumer stocks in particular. Investors will need to continue to be nimble.

We are Market Weight on UK Gilts, reflecting the BoE's dovish tone, and on sterling-denominated investment-grade corporate bonds, which offer attractive yield pickup, though investors should continue to be selective.

United States

Alan Robinson – Seattle

- The resiliency of the consumer space was in focus during the week. **Walt Disney Co. (DIS) stock hit a record high on Nov. 13 on news its Disney+ channel gained 10 million subscribers one day after its debut across five launch countries**. The 7.3% gain in the stock increased the value of the company by an eye-watering $1,700 per new subscriber, and refocused investor attention on the disruptive nature and profit potential behind the ongoing streaming wars. **The strength of the U.S. consumer was underlined by a robust report from retail stalwart Walmart Inc. (WMT)**. The company reported same-store sales growth of 3.2% y/y for Q3, with healthy growth in both foot traffic and ticket size.

- **In Fed Chair Jerome Powell's testimony to Congress, he reiterated his view that interest rates will remain on hold after three straight reductions**. He signaled that the U.S. central bank could resume cutting if the growth outlook falters, but that the bar for a change in either direction was unusually high. The market is now on the same page as the Fed in terms of keeping rates on hold for the time being, but only until June of next year, when the market is first pricing a greater than 50% chance of another cut.

- **As if to underscore Powell's views, U.S. inflation data for October provided a mixed message**. The headline Consumer Price Index (CPI) increased faster than expected at 0.4% m/m and 1.8% y/y, but this was explained by higher fuel costs. Core CPI barely eked out a 0.2% m/m gain, or up 2.3% y/y, a slight drop from the previous month. We believe the U.S. consumer remains in good shape due to the strong jobs market but has been conditioned to resist paying higher prices for goods and services. This suggests a "Goldilocks" situation for the economy in which spending power is not too cold and inflation is not too hot.

Canada

Ryan Harder & Meika McKelvey – Toronto

- **Higher Canadian yields this month are reflecting a noteworthy shift in the narrative of bond markets**: alongside some positive trade headlines out of the U.S., inflation expectations have moved higher amid an apparent shift from interest rate cuts to asset purchases by the Federal Reserve. Government of Canada bond yields have stalled at this point three times in the past three months, with the 5-year yield settling near the 1.55% mark this week. With essentially no cuts from the Bank of Canada priced in at these levels, **it's difficult to see intermediate yields climbing significantly higher** absent a material improvement to the economic outlook.

Inflation remains tame, even against a strong consumer backdrop

U.S. Consumer Price Index

Note: Monthly data series shows annual change in headline inflation
Source - RBC Wealth Management, Bureau of Labor and Statistics

- After adding 135,000 jobs in August and September combined, **Canadian employment showed some natural give-back in October**, with the number of jobs in the economy declining by a marginal 1,800 on the month. Apart from the employment decline, other details of the October report were quite constructive. The unemployment rate held steady at 5.5%, and average hourly earnings growth for permanent workers remained elevated, ticking up to 4.4% y/y. With roughly 440,000 jobs being added over the past year, the unemployment rate sitting just above multi-decade lows, and the wage picture continuing to improve, **the labour market remains a pillar of strength for the Canadian economy**.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **We are upgrading European equities (ex UK) to Market Weight from Underweight for investments with a time horizon of 12 months or longer.** Political headwinds such as a populist government in Italy and a hard Brexit have not materialized, and the regional economy is showing signs of bottoming. If U.S.-China trade tensions abate and global economic momentum picks up, Europe, as an open economy, is poised to benefit.

- **The October Markit Eurozone Composite Purchasing Managers' Index ticked up to 50.6**, better than consensus expectations, thanks to the downturn in manufacturing moderating and services strengthening. German exports, the largest sore point, were up 1.5% in September, and August numbers were revised upward.

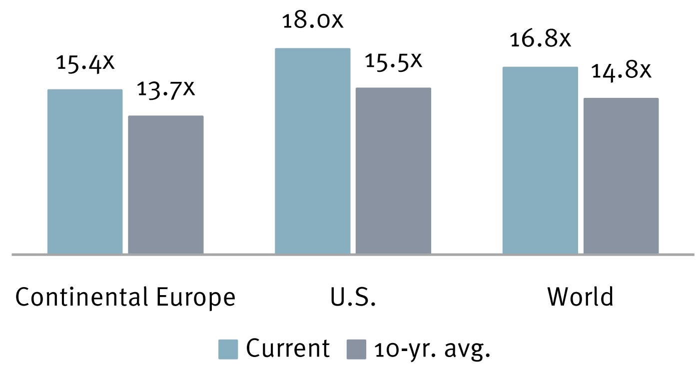
- Moreover, support for fiscal stimulus is becoming more persistent. With a primary fiscal balance of 1% of GDP, **the eurozone has the firepower to stimulate its economy. However, it is held back by stringent rules** which stipulate that a member country's deficit should not exceed 3% of its GDP and government debt should be less than 60% of its GDP. These rules were set when eurozone economies were growing at a nominal rate (real rate plus inflation) of 5%. With growth now hovering around 2%, **authorities are realizing that these rules would benefit from some modernization**.

- Former ECB President Mario Draghi's call for fiscal policy to enhance the work of monetary policy was reiterated by the new President, Christine Lagarde. The incoming EU Commission has also said it would adopt a "more lenient" approach to budgeting. In fact, France, Italy, and the Netherlands are already pushing those limits, though Germany still hesitates. **We don't expect game-changing fiscal stimulus, but we think this theme will become increasingly important going forward.** The current consensus forecast estimates fiscal stimulus of some 0.3% of GDP for 2020 may well inch up, which would underpin the recovery.

- We are mindful that European equities have had a good run over the past few months, along with other equity markets, but **valuations relative to the U.S. remain below long-term averages** when adjusting for sector differences.

Continental Europe upgrade comes with lower relative valuations

Price-to-earnings (P/E) ratios using next-twelve-month EPS estimates



Note: MSCI Europe Ex-UK Index, S&P 500, and MSCI World Index
Source - RBC Wealth Management, Bloomberg; data through 11/13/19

Asia Pacific

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

- **Asian markets traded mostly lower for the week** led by Hong Kong. The Hang Seng Index struggled as **anti-government protesters paralyzed parts of the Asian financial hub** for a fourth day. All schools in Hong Kong have suspended classes until Sunday due to transportation and safety reasons. Big banks on the island have been sending out safety memos with the latest edition expressing an even higher level of caution.

- **Trade talks between the U.S. and China may have hit a snag**. According to *The Wall Street Journal*, Beijing is hesitant to commit to a specific amount of agricultural product purchases in the text of a potential deal. U.S. President Donald Trump claimed last month that China had agreed to buy up to $50 billion in farm goods as part of the "phase one" trade deal.

- **Japan's economic growth slowed significantly in the third quarter**. GDP increased only 0.2% q/q, down from 1.8% in Q2 and missed economists' forecast of 0.9%. **A decline in exports amid ongoing global trade tensions outweighed growth in domestic demand**. Household spending and retail sales surged in September as consumers front-loaded purchases ahead of the value-added tax hike that was implemented on October 1, but the consumer activity was not enough to offset trade headwinds. Furthermore, **factory activity sank** to a three-year low and services sector activity shrank for the first time in three years. Market participants believe the latest Purchasing Managers' Index data may have increased the likelihood of further fiscal and monetary stimulus.

- **Alibaba's Singles Day sales** (a shopping holiday in China akin to Black Friday in the U.S.) **hit a record high of $38.4 billion**, slightly ahead of market expectations. Sales growth of 26% y/y, however, was the lowest since the event started in 2009 and was held back by slowing e-commerce activity due to China's softer economic growth. Separately, according to an unconfirmed CNBC report on November 13, **Alibaba's secondary listing in Hong Kong is likely to take place in the last week of November** and could raise around $13 billion. Alibaba received the green light from the regulators on Tuesday to proceed with the share sales, according to the report.

MARKET SCORECARD

Data as of November 14, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,096.63	1.9%	23.5%	14.6%	20.1%
Dow Industrials (DJIA)	27,781.96	2.7%	19.1%	10.8%	18.7%
NASDAQ	8,479.02	2.3%	27.8%	18.8%	25.8%
Russell 2000	1,588.79	1.7%	17.8%	5.7%	8.0%
S&P/TSX Comp	16,972.18	3.0%	18.5%	12.2%	6.7%
FTSE All-Share	4,020.95	0.7%	9.4%	4.1%	-1.2%
STOXX Europe 600	404.41	1.9%	19.8%	11.6%	5.4%
EURO STOXX 50	3,688.81	2.3%	22.9%	15.1%	3.7%
Hang Seng	26,323.69	-2.2%	1.8%	2.6%	-9.7%
Shanghai Comp	2,909.87	-0.7%	16.7%	10.5%	-15.2%
Nikkei 225	23,141.55	0.9%	15.6%	5.9%	3.4%
India Sensex	40,286.48	0.4%	11.7%	14.6%	22.3%
Singapore Straits Times	3,231.85	0.1%	5.3%	6.2%	-4.9%
Brazil Ibovespa	106,556.90	-0.6%	21.2%	23.9%	50.4%
Mexican Bolsa IPC	43,188.69	-0.3%	3.7%	2.0%	-9.8%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,471.22	-2.8%	14.7%	21.5%	14.9%
Silver (spot $/oz)	17.03	-5.9%	9.9%	20.5%	0.1%
Copper ($/metric ton)	5,810.50	0.7%	-2.3%	-4.9%	-13.5%
Oil (WTI spot/bbl)	56.77	4.8%	25.0%	0.9%	1.9%
Oil (Brent spot/bbl)	62.38	3.6%	15.9%	-5.7%	0.3%
Natural Gas ($/mmBtu)	2.64	0.4%	-10.1%	-45.3%	-14.8%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.817%	12.6	-86.7	-130.8	-55.5
Canada 10-Yr	1.469%	5.7	-49.8	-96.5	-48.2
U.K. 10-Yr	0.709%	8.0	-56.8	-79.7	-61.2
Germany 10-Yr	-0.351%	5.6	-59.3	-74.9	-74.8

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.35%	-0.7%	8.1%	10.5%	8.6%
U.S. Invest Grade Corp	2.95%	-0.8%	13.0%	14.3%	11.5%
U.S. High Yield Corp	5.71%	0.1%	11.9%	9.0%	10.7%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	98.1820	0.9%	2.1%	1.4%	4.6%
CAD/USD	0.7548	-0.6%	2.9%	0.0%	-3.9%
USD/CAD	1.3248	0.6%	-2.9%	0.0%	4.1%
EUR/USD	1.1020	-1.2%	-3.9%	-2.6%	-6.6%
GBP/USD	1.2880	-0.5%	1.0%	-0.9%	-2.2%
AUD/USD	0.6786	-1.6%	-3.7%	-6.2%	-11.1%
USD/JPY	108.4300	0.4%	-1.1%	-4.6%	-4.4%
EUR/JPY	119.4800	-0.8%	-5.0%	-7.0%	-10.7%
EUR/GBP	0.8556	-0.7%	-4.8%	-1.7%	-4.5%
EUR/CHF	1.0895	-1.0%	-3.2%	-4.3%	-6.7%
USD/SGD	1.3617	0.1%	-0.1%	-1.3%	0.2%
USD/CNY	7.0208	-0.3%	2.1%	1.0%	5.8%
USD/MXN	19.3212	0.5%	-1.7%	-5.3%	0.8%
USD/BRL	4.1892	4.3%	8.1%	10.7%	26.4%

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 8:35 pm GMT 11/14/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 2.9% return means the Canadian dollar rose 2.9% vs. the U.S. dollar year to date. USD/JPY 108.43 means 1 U.S. dollar will buy 108.43 yen. USD/JPY -1.1% return means the U.S. dollar fell 1.1% vs. the yen year to date.

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Buy [Top Pick & Outperform]	748	51.73	208	27.81
Hold [Sector Perform]	618	42.74	126	20.39
Sell [Underperform]	80	5.53	3	3.75

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