September 10, 2020

RBC WEALTH MANAGEMENT

Global Insight Weekly

More to come?

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And just like that the script has flipped. As the tech giants recoiled, investors have been trying to figure out if this is a healthy correction, or is there more to it? We unpack the market's move and what it means for portfolio strategy.

The U.S. Technology sector selloff, which preceded the U.S. Labor Day holiday, spilled over into this week and tugged at other markets. The Tech sector corrected 11.4 percent over just four trading days, while the FANG+ Index—Facebook, Amazon, Apple, Netflix, and Alphabet's Google along with other tech-oriented stocks—dropped 13.6 percent. Crude oil had its worst one-day price contraction since June, dragging the U.S. and Canadian Energy sectors down roughly five percent over the four-day period.

There was no clear catalyst for this profit-taking. Seasonality, with institutional investors adjusting portfolio positions after the summer, probably played a role. Heightened options activity was widely cited as well. And it may be that jitters that COVID-19 social-distancing measures could be enforced for longer also contributed to the pullback.

An initial V-shaped economic rebound is being achieved and should be reflected in strong U.S. Q3 GDP data. However, the tail risks for growth—both to the upside and downside—in Q4 and beyond are "enormous," according to Tom Porcelli, chief U.S. economist at RBC Capital Markets, LLC.

While global economic data remains sound, with most countries' economic indicators consistent with an ongoing recovery, momentum seems to be plateauing in certain regions.

- The Caixin China General Composite Purchasing Managers' Index (PMI), which measures services and manufacturing activity, posted a solid reading of 55.1 in August, though the Caixin China Services PMI was at 54, down from a high of 58.4 in June.
- In Europe, after a sharp, three-month rebound, economic activity is slowing in most major countries as increases in COVID-19 infection rates have spurred the reintroduction of stricter social-distancing measures, which affect consumer-oriented sectors.
- Meanwhile, paradoxically, the U.S. labor market's recovery has lessened the urgency of a second fiscal rescue package, leaving unemployed workers with less support than before.

A "healthy" correction?

A longer-lasting correction cannot be ruled out. After all, the 10 percent fall in the Nasdaq in September barely dents its recent outperformance.

Market pulse

Click here for authors' contact information. Priced (in USD) as of 9/10/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6.**
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Moreover, we pointed out in the September issue of Global Insight that the increasingly narrow leadership of the S&P 500 could build distortions into the market if fund managers are forced to buy into stocks just to keep pace with the benchmark, or if others are reluctant to sell these stocks. We suggested it could be painful for market performance if the situation eventually unwinds.

As this correction has taken aim predominantly at Tech stocks, comparisons with 2001 are being drawn. Yet we think parallels to the bursting of the tech bubble are overstated. Back then, the U.S. Federal Reserve was actively withdrawing liquidity, having spent the previous year adding liquidity to buttress financial markets as they dealt with the fallout from the demise of the Long-Term Capital Management (LTCM) hedge fund and Y2K preparation. As the Fed stepped back, and at the same time many phantom dotcoms were exposed with unsustainable valuations, equity markets swooned.

Prospects for continued liquidity support are more encouraging today. The Fed's recent 2020 Economic Policy Symposium made clear that the Fed intends to keep interest rates low for a long time, abandoning its long-held policy of pre-emptive interest rate increases to fend off higher inflation. Other large central banks, such as the European Central Bank, the Bank of England, and the Bank of Japan, have very supportive monetary policies that should remain in place for a prolonged period of time.

Finally, the fundamental underpinnings of tech-oriented stocks within the various sectors of the U.S. market (Tech, Communication Services, and Consumer Discretionary) today are superior to those of the tech bubble era. Many stocks within these segments have sound business models, years of earnings growth behind them, and opportunities ahead, in our view. In contrast, numerous dotcoms that fueled the tech bubble had weak business models with little or no earnings prospects, and they exited the stage in short order.

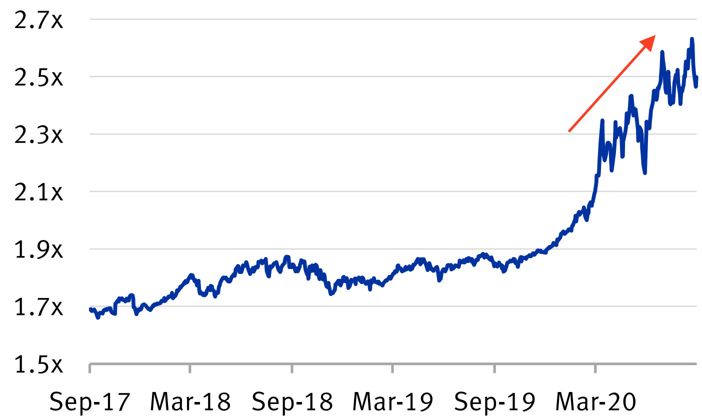
Things had become stretched …

Many, including us, had pointed to the diverging fortunes of Wall Street and Main Street, with the stock market roaring alongside key segments of the economy struggling to make a comeback—small and medium-sized businesses in the U.S. are still hobbled, for example.

But as the seemingly unstoppable U.S. stock market had been driven by the tech stocks that prospered in the new COVID-19 digitized world, the peculiarity of stock market gains were rationalized away—as is usually the case during periods of outsized gains. The FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google parent Alphabet) thrived in this environment thanks to their market dominance. Their earnings growth beat already demanding market expectations as other sectors floundered. General enthusiasm for these growth stocks soon settled in. Thought to be in short supply, investors were willing to pay a growing premium for them.

Tech outperformance took off as COVID-19 crisis began

Value of Nasdaq Composite Index relative to S&P 500 Equal Weight Index



Source - RBC Wealth Management, Bloomberg; data range: 9/11/17–9/9/20

Euphoria was not confined to the FAANG group. Our national research correspondent points out that the fondness for growth stocks extended to the broad Technology sector and Health Care stocks—two sectors whose prospects could be boosted by the COVID-19 environment. More than 30 stocks in the mid/large-cap S&P universe returned more than 100 percent in 2020 through September 2, the market's all-time high, while more than 90 stocks returned over 40 percent in the same period. This far outstrips the S&P 500's 11 percent gain and the S&P MidCap 400's five percent loss.

The fundamentals of the 30 biggest leaders, those whose share prices more than doubled in the period, are certainly firm. These companies generated rapid and impressive sales (some 30 percent on average) and earnings growth (some 50 percent on average). They enjoyed stronger balance sheets with net cash close to twice as large as their operating cash flows on average; and they reinvested more in capital expenditures and research and development—the equivalent of some 25 percent of revenues. While these companies clearly possess superior earnings quality, their year-to-date share price returns seem somewhat stretched nevertheless.

Portfolio checkup

Investors should brace for more choppiness in the months ahead, with COVID-19 infection rates remaining in the headlines, U.S. elections approaching, U.S.-China tensions ratcheting up, and Brexit challenges lingering. Valuation levels, with the S&P 500 trading at 20.1x the 2021 consensus forecast of $166 per share, suggest that complacency had set in during the summer. We doubt it has been fully flushed out. Pullbacks are a good opportunity to review portfolio positioning and holdings, in our view, and to tweak allocations if necessary.

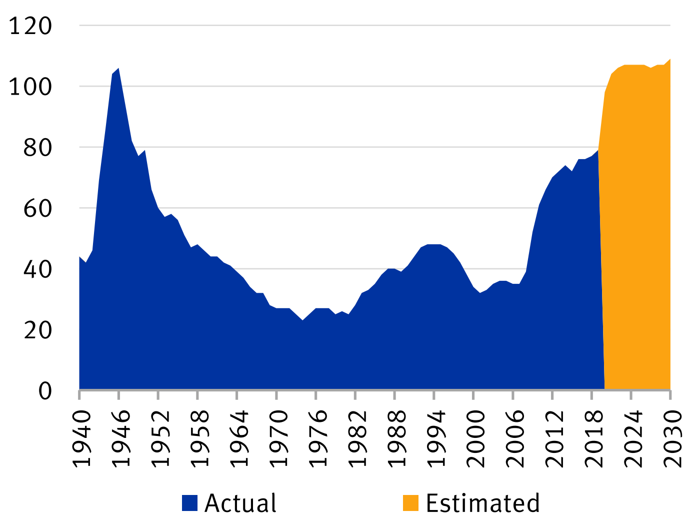
United States

Atul Bhatia, CFA – Minneapolis

- **Expectations for next week's Federal Reserve Board meeting are muted** following Chair Jerome Powell's recent announcement of a **new average inflation targeting regime**. Under the updated policy, the Fed may choose to tolerate above-target inflation for an extended period if it follows a period of below-target inflation. Details on the new plan are scant and we do not expect them to be fleshed out at this meeting, but the practical implication is clear: **the Fed is unlikely to tighten monetary policy for years**.
- **While monetary policy takes center stage, fiscal policy has remained largely absent** since the early-August lapse of unemployment provisions. Senate Republicans tried to advance a so-called "skinny" stimulus bill with a $300 billion price tag and a significantly reduced set of fiscal measures; the bill failed to make it out of the Senate and can be considered dead for now. Time is running out for new fiscal measures before the election, as policy makers are shifting their focus to funding the government beyond the start of the new fiscal year on Oct. 1.
- Complicating the conversation on additional stimulus is the federal government's existing debt burden. Updated economic projections from the Congressional Budget Office (CBO) indicate **federal debt will top 100% of GDP next year**; this would be the first time since World War II the U.S. has crossed that mark. The true amount is higher because the CBO estimates exclude debt to Social Security and other federal agencies. **Institutional investors seem unconcerned with the mounting U.S. burden**, as the Treasury has routinely been able to sell new bonds at or near historic low yields.
- **High-yield bonds proved relatively resilient during the recent bout of equity market selling**. One reason is that while ultralow Treasury yields have dragged down corporate bond yields, credit spreads—or the compensation for individual corporate bond risk—are still high by historical standards. This gives high-yield bonds some valuation cushion to absorb selling pressure.

Federal debt set to top U.S. annual production

Publicly held federal debt as % of U.S. GDP



Source - RBC Wealth Management, Congressional Budget Office; data through 9/9/20

Canada

Ryan Harder & Sayada Nabi – Toronto

- This week saw the first meeting of the Bank of Canada (BoC) since it released its most recent Monetary Policy Report in July. **No changes to the overnight rate, forward guidance, or quantitative easing program** were announced; however, the language of the post-meeting statement did show **some cautious optimism** starting to take hold at the central bank, with "stronger-than-expected goods consumption and housing activity largely reflecting pent-up demand." Nonetheless, the BoC reiterated that the path of the recovery is dependent on the progress of the COVID-19 pandemic, and that **the strong reopening we've seen so far is likely to be followed by a "protracted and uneven recuperation phase."**
- Economic recovery is a key concern as the world works to climb out of the pandemic-induced recession. **RBC Economics does not expect the Canadian economy to return to its pre-pandemic level of output in 2020**, and projects a 4.4% GDP gap relative to the pre-pandemic level at year's end. Since the spring lows, more than two-thirds of the workers who lost their jobs have returned to work, and RBC Economics believes many of the growth strains are in the rear-view mirror. Improving labour market conditions, coupled with government assistance, have reverberated into various sectors of the economy, pushing consumer spending to surpass pre-COVID-19 levels. **Housing sales rose strongly in July**, and manufacturing and trade activity also bounced back as governments eased restrictions. Adding up the positives in the economy, **RBC Economics has revised its Q3 growth forecast upward to 40% at an annualized rate, with expectations for growth to extend another 6% in Q4**.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The tedious Brexit saga took an unexpected turn during the week** when the UK government presented a draft bill setting out rules for the country's internal market once it leaves the EU single market at the end of 2020. **The draft bill effectively overturns key commitments made in the Withdrawal Agreement**, including how the UK would implement a customs arrangement between Ireland and Northern Ireland, which is key to maintaining the Good Friday Agreement for peace. Competition and state aid are also points of contention. In effect, the UK government is proposing to renege on an international agreement it negotiated and voted for.
- Is this a negotiating tactic? Perhaps. But it calls into question whether the UK government is looking for a deal at all. **We have tentatively estimated the risk of the UK failing to secure a trade deal by the end of the year at somewhat over 50%**. With negotiations on a free trade agreement with the U.S. on ice, this would be a further headwind to the already weakened UK economy. The pound has lost close to 4% against the U.S. dollar since the beginning of the month and we believe it could weaken further unless negotiations with the EU become more productive.
- **French luxury goods conglomerate LVMH**, the largest constituent of France's CAC 40 Index, **announced that it would not complete the acquisition of U.S.-listed Tiffany & Co.**, causing the shares of the latter to fall more than 6% on Sept. 9. A statement from LVMH's board noted a succession of events that undermined the acquisition, including the threat of tariffs on French products by the U.S., though ultimately it appears to be **the result of the French government asking LVMH to postpone the deal due to the ongoing U.S.-France trade dispute**. As originally proposed, the €16.7 billion deal was set to be the largest ever in the luxury sector.

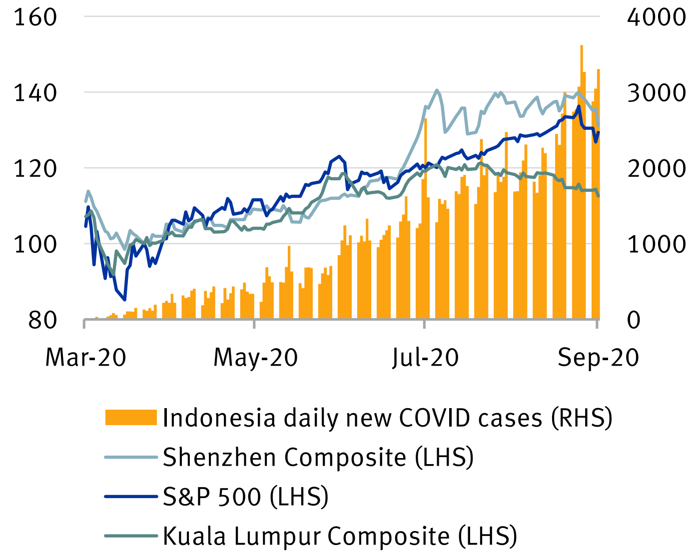
Asia Pacific

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

- **Asia Pacific equity markets traded broadly lower during the week, with the decline led by Indonesia and China**. Indonesia is reinstating a partial lockdown on its capital as new COVID-19 infections surge. Jakarta's regional governor stated the city's hospitals will reach maximum capacity by Sept. 17 if nothing is done to contain the spread. Analysts believe **the latest developments could delay the full recovery of Southeast Asia's largest economy**. Meanwhile in China, **the Tech-heavy Shenzhen Composite Index is on track to post its worst weekly decline since mid-March** as confidence in the sector has weakened following the Tech-led correction in the U.S.

Indonesia: COVID-19 cases spike, equities lag

Index levels normalized to March 30, 2020



Source - RBC Wealth Management, Bloomberg; data through 9/9/20

- The tit-for-tat between the U.S. and China continues. The U.S. Department of Defense is considering adding SMIC (981 HK), China's largest chipmaker, to the Entity List, which would make it difficult for the company to obtain parts made in the U.S. The Chinese Foreign Ministry accused Washington of "blatant hegemony," adding that Beijing was "firmly opposed" to such actions. **If such sanctions materialize, we think it would be negative for Chinese semiconductor companies** and would also place them at a disadvantage against their South Korean and Taiwanese competitors. China has been developing its own semiconductor manufacturing capabilities, but many Chinese companies still rely on American equipment in their production lines, and China is a major buyer of semiconductor equipment from the U.S. **Analysts believe sanctions would likely be a lose-lose situation for companies on both sides**.
- **SoftBank Group's (9984 JP) share price is down 8.4% week to date** (through Sept. 9). Investors were spooked by a Sept. 6 Bloomberg report that suggested SoftBank made "substantial bets" on U.S. technology stocks, using derivatives, which saw sharp corrections in recent days. On Sept. 8, Bloomberg also reported that **SoftBank's offer to sell a third of its stake** (valued at roughly $12 billion) **in its domestic wireless operation has been fully subscribed** and firms managing the transaction will likely offer additional shares in the form of an over-allotment. SoftBank will use the cash to buy back the company's shares.

MARKET SCORECARD

Data as of September 10, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,339.19	-4.6%	3.4%	12.1%	16.1%
Dow Industrials (DJIA)	27,534.58	-3.1%	-3.5%	2.3%	6.5%
Nasdaq	10,919.59	-7.3%	21.7%	35.1%	37.8%
Russell 2000	1,507.75	-3.5%	-9.6%	-2.3%	-12.2%
S&P/TSX Comp	16,185.32	-2.0%	-5.1%	-2.1%	0.8%
FTSE All-Share	3,353.64	0.3%	-20.1%	-16.0%	-16.6%
STOXX Europe 600	367.48	0.3%	-11.6%	-4.9%	-2.1%
EURO STOXX 50	3,312.77	1.2%	-11.5%	-5.3%	0.1%
Hang Seng	24,313.54	-3.4%	-13.8%	-8.9%	-8.6%
Shanghai Comp	3,234.82	-4.7%	6.1%	7.1%	21.2%
Nikkei 225	23,235.47	0.4%	-1.8%	8.6%	3.9%
India Sensex	38,840.32	0.5%	-5.9%	4.6%	2.4%
Singapore Straits Times	2,492.09	-1.6%	-22.7%	-21.0%	-20.1%
Brazil Ibovespa	98,834.60	-0.5%	-14.5%	-4.1%	29.3%
Mexican Bolsa IPC	36,180.74	-1.8%	-16.9%	-15.0%	-25.9%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,944.79	-1.2%	28.2%	30.9%	62.6%
Silver (spot $/oz)	26.82	-4.7%	50.2%	49.0%	89.2%
Copper ($/metric ton)	6,758.50	0.9%	9.9%	16.6%	14.7%
Oil (WTI spot/bbl)	37.30	-12.5%	-38.9%	-35.0%	-44.8%
Oil (Brent spot/bbl)	39.77	-12.2%	-39.7%	-36.2%	-48.6%
Natural Gas ($/mmBtu)	2.31	-12.1%	5.6%	-10.4%	-17.5%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.680%	-2.4	-123.7	-105.1	-225.1
Canada 10-Yr	0.567%	-5.5	-113.5	-86.7	-171.9
U.K. 10-Yr	0.227%	-8.4	-59.5	-41.2	-124.2
Germany 10-Yr	-0.433%	-3.6	-24.8	11.4	-83.4

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.16%	0.0%	6.8%	7.4%	17.7%
U.S. Invest Grade Corp	1.97%	-0.1%	6.9%	8.9%	22.2%
U.S. High Yield Corp	5.56%	-0.3%	1.4%	3.9%	11.3%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	93.4010	1.4%	-3.1%	-5.0%	-1.8%
CAD/USD	0.7581	-1.1%	-1.5%	-0.3%	-0.2%
USD/CAD	1.3191	1.1%	1.5%	0.3%	0.2%
EUR/USD	1.1815	-1.0%	5.4%	7.0%	1.9%
GBP/USD	1.2805	-4.2%	-3.4%	3.7%	-1.7%
AUD/USD	0.7258	-1.6%	3.4%	5.8%	2.0%
USD/JPY	106.1300	0.2%	-2.3%	-1.3%	-4.5%
EUR/JPY	125.3900	-0.8%	3.0%	5.6%	-2.7%
EUR/GBP	0.9227	3.3%	9.1%	3.2%	3.7%
EUR/CHF	1.0758	-0.3%	-0.9%	-1.8%	-4.8%
USD/SGD	1.3698	0.7%	1.8%	-0.8%	-0.7%
USD/CNY	6.8343	-0.2%	-1.9%	-3.9%	-0.3%
USD/MXN	21.4703	-1.9%	13.4%	10.1%	11.4%
USD/BRL	5.3274	-3.0%	32.2%	41.0%	30.4%

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 9/10/20.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -1.5% return means the Canadian dollar fell 1.5% vs. the U.S. dollar year to date. USD/JPY 106.13 means 1 U.S. dollar will buy 106.13 yen. USD/JPY -2.3% return means the U.S. dollar fell 2.3% vs. the yen year to date.

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As of June 30, 2020

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Sell [Underperform]	92	6.12	12	13.04

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