August 2017

RBC WEALTH MANAGEMENT

# Global Insight

Perspectives from the Global Portfolio Advisory Committee

## Implications of a peak dollar world

The greenback's day in the sun will eventually pass, so what does that mean for portfolio strategy?

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As usual the short-term movements of individual markets have been all over the map. But over the past year-and-a-half most broad averages have moved significantly higher. We see more to come. But risk management is always the right thing to do.

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While the market looks to be bracing for the end of the era of easy money, we don't think central banks will be tightening the screws too quickly as they still have to contend with lurking challenges. The Fed's glacial approach should set the tone for other central banks as they look to normalize policy.

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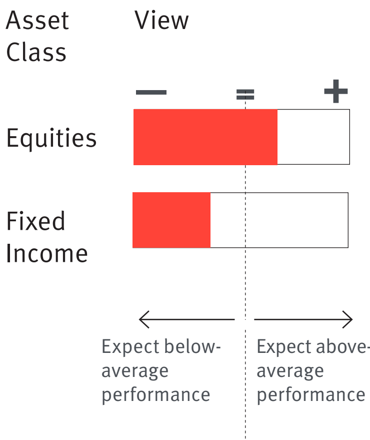
All values in U.S. dollars and priced as of market close, July 31, 2017, unless otherwise stated.

# RBC's investment stance

## Global asset views




See "Views explanation" below for details

Source - RBC Wealth Management

## Equities

- Equity markets continued to march higher in July and the global benchmark, the MSCI World Index, extended its winning streak to nine months, the longest of this bull market run. Relatively steady economic conditions and better-than-expected corporate earnings are fueling developed and emerging markets. U.S. and global recession risks remain low.
- Nevertheless, at some point, equity markets will take a breather—they always do. We think portfolio repositioning is warranted, particularly by trimming any sectors or securities that have ballooned during the rally, as there may be more attractive entry points in the coming months if a pullback materializes. While virtually all major equity markets have worthwhile long-term potential when viewed in isolation, a global equity portfolio can and should lean against risk at times like this.

## Fixed Income

- Major central banks have sounded more hawkish at times, but we believe they are unlikely to aggressively hike interest rates for the foreseeable future. Most, including the Federal Reserve and the European Central Bank, are still wrestling with low inflation, subpar economic growth, and productivity strains. There are no quick and easy solutions to these challenges.
- Central bank comments—hawkish or dovish—can indeed whip the global fixed income market around on a day-to-day basis, but we view this largely as noise. It's more important for investors to focus on economic trends as they will likely set the pace for the fixed income market in coming months. We continue to view the credit sector most favorably, but stretched valuations limit the pool of attractive securities so we would be patient and selective in adding new positions.

## Views explanation

(+/=/–) represents the Global Portfolio Advisory Committee's (GPAC) view over a 12-month investment time horizon.

+ Overweight implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

= Market Weight implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

– Underweight implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

Focus article

# Implications of a peak dollar world

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The cyclical bull market in the dollar has touched most aspects of global portfolio positioning this decade. We can't call an end to this cycle yet, but we know it's coming, and investors need to think about how this may change their investment decisions.

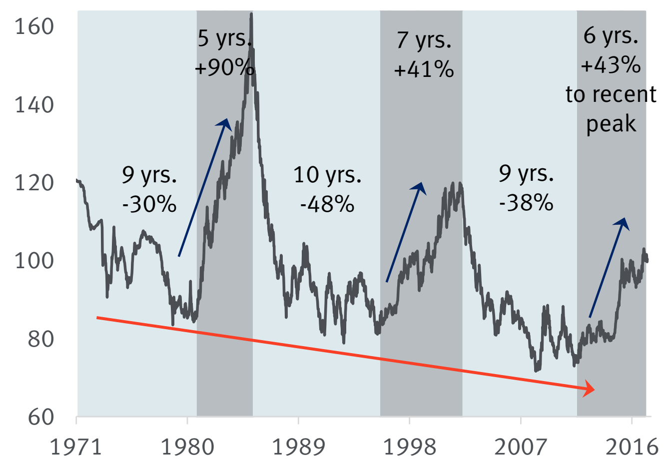
The dollar has been slowly falling in value since the era of free-floating exchange rates began in the 1970s. This declining trend is largely due to the law of large numbers—a huge economy like that of the U.S. can't grow as quickly as smaller, up-and-coming nations, so the U.S.'s share of the global economy has been slowly shrinking as others catch up. This creates incremental demand for foreign currencies, and puts pressure on the dollar.

However this gradual downtrend has been punctuated by three separate multiyear cycles of dollar strength. We believe we're close to the end of this third cycle, which, if confirmed, will require global investors to take a closer look at their portfolios.

## What does history tell us?

We believe the current dollar bull cycle started in May 2011 as several broad measures of the currency and sentiment bottomed out at that time. The most recent peak in the dollar in January 2017 marked a 43% move up from the start of the cycle over nearly six years. This compares to the two previous up-cycles of 90% in five years and 41% in seven years, which ended in 1985 and 2002, respectively. We're cautious about reading too much into a small sample size, but the recent bull market seems similar in scale and duration to the previous up-cycles.

### U.S. Dollar Index in the era of floating exchange rates




The dollar's latest cyclical rally may be fading.

Source - RBC Wealth Management, Bloomberg; weekly data through 7/20/17

## What causes dollar bulls to lose steam?

There are several explanations for cyclical turning points in the dollar; most relate to factors specific to individual currency pairs, and many are only apparent after the fact. We believe the following will be cited in this dollar cycle's eventual post-mortem.

Since the U.S. was the first to start raising rates, the market might think it will be the first to stop too, and this might be enough to cap the dollar's rise.

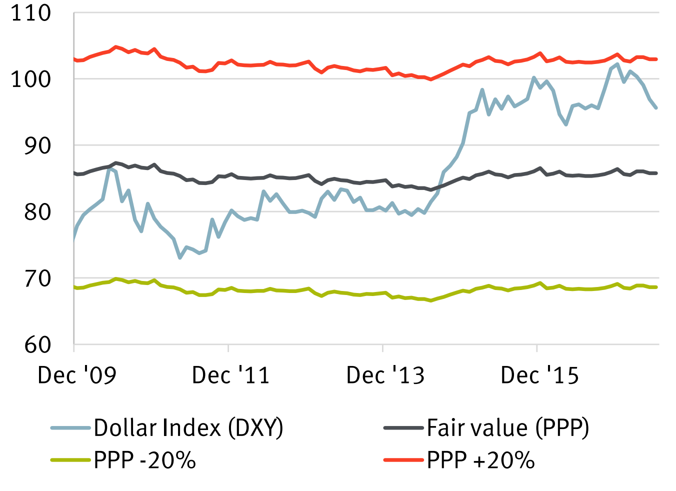
### Interest rate dynamics

The U.S. economy led those of its developed nation peers coming out of the global recession, and the U.S. Federal Reserve was the first central bank to consistently raise interest rates from record low levels. Capital flows toward the best, risk-adjusted return. This supported the dollar when all its neighbors' currencies were contending with near-zero interest rates in their home markets. But in recent months a number of other central banks from Europe, Canada, and Australia have hiked rates, or discussed unwinding quantitative easing programs. Since the U.S. was the first to start raising rates, the market might think it will be the first to stop too, and this might be enough to cap the dollar's rise.

### Valuation

It's hard to label a nation's currency overvalued just because certain items cost more there. But over the long term, fair-value measures such as purchasing power parity are useful in flagging instances where currencies are at extremes of valuation. In the modern era of globalization, it's unusual for major currencies to trade more than 20% above or below their fair value, and we note that these extremes tend to mark the turning points of dollar cycles. In May 2011, when the dollar rally began, it was 15% below fair value and in January 2017, when it most recently peaked, it was 18% above.

The dollar and its "fair value" bands




Extremes of valuation usually determine turning points in the dollar.

Notes: Purchasing power parity (PPP) measures a currency's fair value using a basket of common goods. The DXY is a weighted average of 6 major currencies. Source - RBC Wealth Management, RBC Capital Markets, Thomson Reuters; data through June 2017

### Political uncertainty

It may be a coincidence that the dollar peaked around the time of political transition within the U.S. But the markets crave certainty, and currencies often reflect sentiment toward economic and fiscal policies. Policy paralysis can weaken

a currency, and the current lack of political consensus and strains within the U.S. may act as a headwind to the dollar. Key near-term risks include delays to tax reform and to increases in the federal debt ceiling, as well as uncertainty around trade policies.

The current lack of political consensus and strains within the U.S. may act as a headwind to the dollar.

Importantly, we believe the dollar's reserve currency status is safe for the foreseeable future. There simply isn't an alternative vehicle that enjoys the liquidity and ease of convertibility of U.S. dollar-denominated assets.

## Positioning for a peak dollar world

History provides a few pointers toward investment themes that might work in a dollar bear market, some more reliably than others.

### Commodities

Products that are priced in dollars tend to be in more demand during a dollar bear cycle. On the surface, it would seem that the currency used for a transaction should have little bearing on aggregate demand for that product, but in the real world oil and hard industrial commodities enjoy a demand tailwind when the dollar is weak as those commodities appear cheaper to buyers outside of the U.S.

These tailwinds are most pronounced when industrial commodities are already in a bull market, as was the case during the last dollar bear cycle. Most commodities peaked by 2011–12 and have been under pressure since, but a weakening dollar may give commodity prices a boost over the next few years.

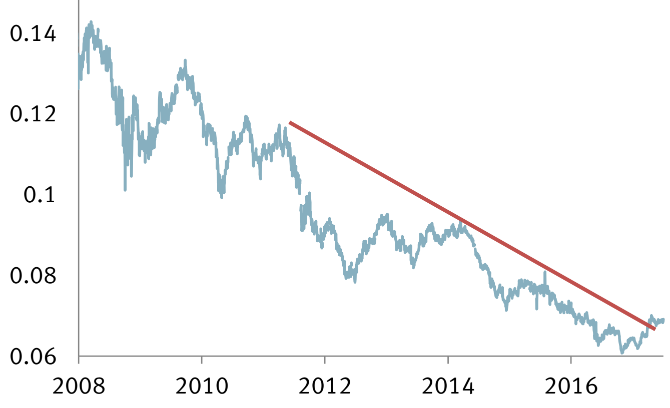
### International stocks

Similarly, equity markets outside of the U.S. tend to do well when the dollar is weak. In contrast to commodities, international stocks currently appear to be at the start of their own bull cycle, and we believe a weakening dollar will add to their outperformance.

On a global basis, money has scaled out of U.S. stocks this year and into international stocks. We believe this has been primarily driven by cheaper valuations and faster earnings growth outside of the U.S. as the global recovery finally picked up steam. But the pause in the dollar bull this year probably played its part too.

### Relative performance of European stocks to U.S. stocks

Ratio of MSCI Europe Index to S&P 500 Index




Will a weaker dollar add fuel to the recent bounce in international markets?

Source - RBC Wealth Management, Bloomberg; data through 7/27/17

In this weakening dollar environment, a U.S.-based investor with foreign holdings has captured the outperformance of overseas markets along with the benefit of stronger overseas currencies when their returns are translated back into dollars. For this reason, at this stage we tend to favor foreign equity vehicles in which the currency exposure is unhedged for long-term U.S.-based investors.

### U.S. equity sectors

The picture is a little less clear for U.S. stocks in a dollar bear market. Large caps and particularly multinational companies tend to perform relatively well as they have a higher proportion of profits generated from outside the U.S., most of which are denominated in appreciating foreign currencies.

We analyzed the five-year returns of each U.S. sector from the start of the most recent dollar bear and bull cycles, and the results of this admittedly small sample are mixed. We believe this is because the longer-term investment cycles of equities, coupled with rapid technological and business changes this century, tend to outweigh the effect of the dollar cycle.

We note that Energy and Materials companies tend to outperform when the dollar is weak.

However, we note that Energy and Materials companies tend to outperform when the dollar is weak, as one would expect, due to the currency tailwind enjoyed by commodities generally. These sectors also perform poorly in a dollar bull market, which suggests a consistent theme.

Outside of these two sectors it's been a mixed bag, although Health Care and Technology returns correlated positively with the dollar. However, most Tech companies have developed relatively high overseas revenue streams so the pattern of Tech sector weakness may not hold in the next cycle. Furthermore, Tech was working its way out of a post-bubble phase during the last dollar bear, a difficult and unique period for the sector that had little to do with the currency.

### U.S. sector performance during the first five years of the last dollar bear and bull markets

| Period | | | | |
|---|---|---|---|---|
| **Dollar bear market** January 2002 to January 2007 (S&P 500: 4.9%) | Winners | Energy 16.6% | Materials 10.8% | Financials 7.4% |
| | Losers | Technology 0.2% | Telecom 0.7% | Health Care 1.0% |
| **Dollar bull market** May 2011 to May 2016 (S&P 500: 9.3%) | Losers | Energy -2.7% | Materials 3.5% | Telecom 4.1% |
| | Winners | Health Care 14.6% | Discretionary 14.5% | Technology 11.7% |

Source - RBC Wealth Management, Thomson Reuters, FactSet; returns are compound average price returns, annualized; data through 7/20/17

## Endgame approaching

We can't say that the dollar bull cycle is over yet, and the rally that started in 2011 may still have several quarters to run. RBC Capital Markets analysts currently project a dollar peak in March 2018, while consensus forecasts imply we've already seen the high-water mark. We won't know for sure until after the fact, but if history is a guide we're probably close to the end of the dollar bull cycle. We think it's worth considering how to position portfolios in anticipation of a sea change in the dollar.

# Risk check

Major stock markets appeared to be uncoordinated over the past several months—some up, some down.

Technical and valuation differences between markets have become apparent. For example, the S&P 500 and Japan's TOPIX, which have been moving higher for some time, look stretched and overbought, and therefore vulnerable to correction. By comparison the European and Canadian indexes which have moved lower over the past few months look oversold and potentially ready to begin moving higher.

In terms of valuation the European and Canadian markets, both now at 17x latest earnings, have been getting cheaper as share prices have backed off. Meanwhile the S&P 500, verging on 20x current earnings, needs the economy and profits to keep growing as forecast.

But when one looks at the past year-and-a-half rather than just a few months, a more useful picture emerges. All major stock markets in developed countries are substantially higher than at last year's February lows. Mostly that reflects a steady improvement in the global economic outlook—Europe is growing at about 2%; China has stabilised for now at 6.5%–7%; the U.K. is hanging in; Canada's GDP growth is at 3%; and the U.S. looks solid at 2%+. Emerging economies such as Brazil, Russia, and India seem to be on a firmer footing.

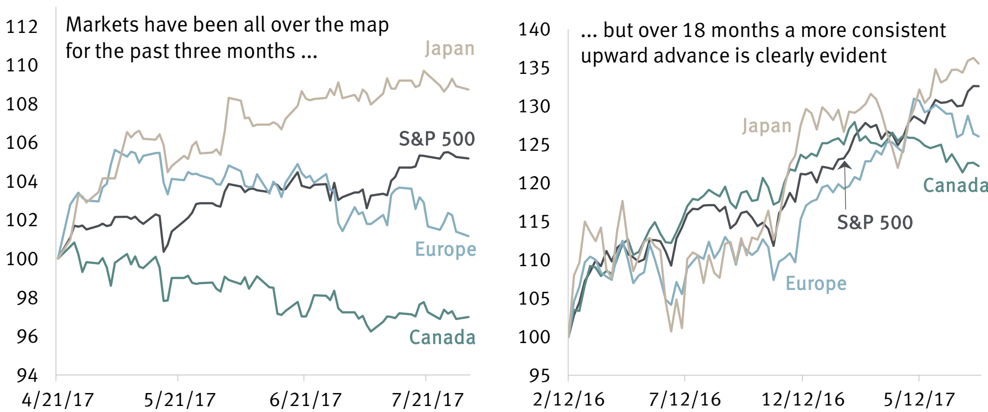
As economic growth has gathered momentum, earnings estimates have been revised higher and companies have more often than not been beating those estimates rather than failing to make them. So, share prices have been leading earnings higher, as they usually do. Forecasting markets to appreciate meaningfully over the

### Equity views

| Region | Current |
|---|---|
| Global | + |
| United States | = |
| Canada | = |
| Continental Europe | + |
| United Kingdom | – |
| Asia (ex-Japan) | = |
| Japan | = |

+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

### Short-term variability masks a powerful uptrend




Source - RBC Wealth Management, Bloomberg; data through 7/31/17

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coming 12 months requires the major economies to go on growing over the same time span and corporate earnings to continue to thrive.

That is what we expect to see unfold. Importantly, the next U.S. recession probably lies beyond 2018 as does any associated global economic downturn.

We continue to recommend a global portfolio carry a modest Overweight for equities. We are not recommending a more enthusiastic commitment because, while both GDP and corporate profits are likely to go on growing in the advanced economies, we find it hard to make a case that growth will accelerate. Average share prices should appreciate but probably more slowly than the 17% clip posted by the MSCI global index over the past 12 months, or the 14% delivered by the S&P 500.

And there is still plenty of room for policy mistakes. The opening of NAFTA renegotiations has large potential ramifications for Canada and Mexico but will also reveal the tenor of U.S. trade positioning in advance of discussions with China and other trading partners. Meanwhile, it's hard to see an easy path to a new debt ceiling agreement by early October for the U.S. Congress.

There is almost always a mismatch between the long-term return potential of high-quality equities and the short-term risks that can arrive from almost any quarter. Good portfolio practice is designed to marry those two disparate conditions. The following are always appropriate to think about:

**Rebalance away from excessive risk**. If strong markets have pushed portfolio equity exposure beyond what an investor regarded as the right commitment back in less-heady times, then now might be a good time to bring that exposure back into closer alignment with long-term risk appetite.

**Sell losers**. Better to deal now, in an elevated market, with stocks that are not working and where the conviction level has faded, than to be forced out at the bottom of a correction as the tax loss selling deadline looms.

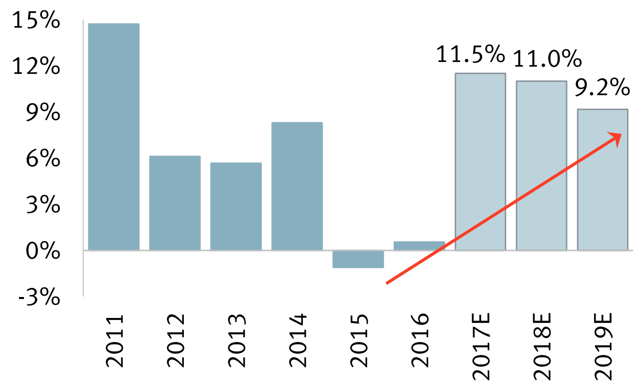
**Keep winners**. Stocks that are working, and where the conviction level is high, very often suffer the least in any market pullback and recover the fastest.

## Regional highlights

United States

- We remain constructive on the long-term potential for U.S. equities as economic stability should persist and

S&P 500 earnings growth rates




2017 to 2019 earnings estimates show growth expectations not seen since the immediate aftermath of the recovery from the Great Recession.

Source - RBC Wealth Management, Thomson Reuters I/B/E/S; data through 7/31/17

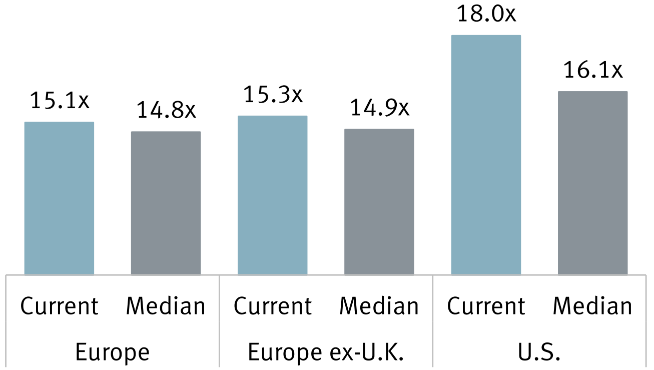
the Federal Reserve seems likely to maintain its prudent approach to normalizing interest rates.

- The market is building on a solid foundation. Thus far, Q2 corporate reports are exceeding expectations in terms of earnings growth, revenue growth, and beat rates. S&P 500 earnings growth is pacing at 10.8% y/y versus the initial 8.0% consensus forecast, and should finish the reporting period even higher. Solid results from banks and select industrial firms boost our confidence that 2017 earnings growth can meet or exceed the 11.5% consensus forecast. 2018 also looks bright.
- We do, however, recognize the market's pace of gains is unlikely to continue unabated. The S&P 500 has rallied 10.3% year to date and has recorded a string of new all-time highs. Temporary pullbacks are often the natural consequence of such moves. We recommend holding a Market Weight position in U.S. equities for the time being as technical indicators suggest the market is due for a rest and Washington seems unlikely to deliver pro-growth stimulus in the near term. We would focus on the Health Care sector due to attractive valuations and diminishing pharmaceutical pricing risks.

### Canada

- We are Market Weight Canadian equities. Among potential downside risks are the ability of Canadian households to absorb potentially higher interest rates and uncertainty around North American trade negotiations.
- RBC Economics expects a soft landing for the Canadian housing market. Ontario resales were down 12% m/m in June after a 15% fall in May. The extent of the plunge should be viewed against an exceptionally high level of resales earlier this year with recent activity only modestly below the long-term average. RBC Economics believes the slowdown is supportive of long-term stability.
- The Canadian dollar's rally has presented a share price headwind for domestically listed companies that derive a significant portion of their earnings from the U.S. With the currency nearing both purchasing power parity and its long-term average level, we believe probabilities favour some retracement of the past three months' surge higher. Investors can take advantage by buying high-quality Canadian companies with significant U.S. operations on weakness.

## Forward P/E ratios of various geographies




Continental Europe remains attractive, based on valuation and the reduced political risk.

Source - RBC Wealth Management, Bloomberg; data through 7/26/17; Europe including U.K. is the MSCI Europe index, Europe ex-U.K. is the MSCI Europe ex UK Index, U.S. is the S&P 500

- RBC Capital Markets' energy analysts moderated their oil outlook with a forecast for North American annual average benchmark prices of $48.47 per barrel in 2017 (from $54.50) and $50 in 2018 (from $60). This aligns with our cautious medium-term outlook against a backdrop of rising U.S. supply. We continue to advocate that Energy allocations be biased towards well-capitalized companies with visible production growth.

### Continental Europe & U.K.

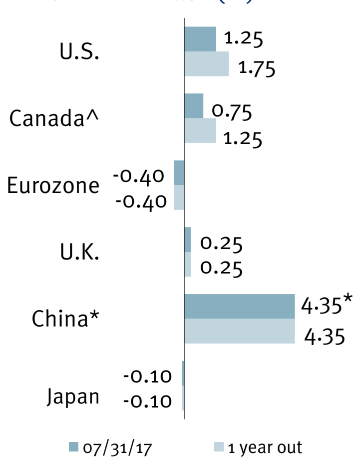
- We are Overweight European equities as economic momentum in the region remains strong, while valuations are less demanding than for other developed markets even as political risk has receded. Although consensus earnings expectations have increased, the current period of synchronized global growth should bode well for European profitability. We prefer well-capitalised banks and domestic-oriented sectors.
- We are Underweight the U.K. due to uncertain economic and political outlooks; risks to the economy remain skewed to the downside. We are cautious about U.K. consumer prospects given inflation looks likely to go on outstripping wage increases. Recent manufacturing, construction, and industrial production data has been gloomy, and seems unlikely to offset any consumer weakness, in our view.
- The surprise June election outcome has dramatically increased political uncertainty at a time when the U.K. is beginning to negotiate its Brexit withdrawal. The uncertainty of outcomes has increased as a result.
- While visibility for the U.K. is murky, there remain opportunities in select equities. Valuations are reasonable, while dividend yields are attractive. We maintain our bias towards U.K. companies with international exposure.

### Asia

- Asian equities registered another solid performance in July. The MSCI AC Asia Pacific Index is up 18% for the year. A number of Asian indices are at all-time highs. A period of consolidation is quite possible. Price-to-book value levels are modestly higher for most Asian equity markets than the 5-year average.
- China's economy grew by 6.9% y/y in Q2, faster than consensus forecasts and the same pace as in Q1. A stable currency and tougher controls have resulted in a significant deceleration of capital outflows. Foreign exchange reserves have been moving higher. A range of economic indicators, both official and unofficial, is corroborating the steady pace of expansion evident in the Chinese economy at present. E-commerce continues to show rapid growth, as online retail sales rose by 33% in H1 2017.
- We have a Market Weight view on Greater China stocks. Earnings growth may moderate and equity valuations, especially for A-shares, are not attractive. On the other hand, the government will not want to see excessive volatility in the equity market during the current period of financial deleveraging and heading into the 19th National Congress this autumn.
- We remain constructive on Japanese equities, although there has been a long run of strong performance. Prime Minister Shinzo Abe's popularity ratings have moved notably lower due to several domestic events.

# Borrowing the Fed's playbook

## Central bank rate (%)




^under review
*1-yr base lending rate for working capital, PBoC
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, Consensus Economics

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Concerns in the fixed income market have arisen that the days of easy money may be over. In June, bond yields backed up after a chorus of global central bank officials suggested the time for reduced accommodation was approaching. In July, the Bank of Canada (BoC) raised rates 25 basis points and BoC officials left markets guessing as to future plans. Despite these developments, our view is it will be months before global central banks can truly begin to move away from current policies. Prior to the Fed's first rate hike in late 2015, expectations were high that we would soon witness a tightening cycle similar to 2004–2006 with rates hiked at regular intervals. Needless to say, the Fed's glacial pace of policy normalization has been a surprise to some (see top chart on next page). But we suggest it sets the tone for what investors should expect from other central banks as all of them grapple with a cocktail of challenges, such as low inflation, slow growth, low productivity, and/or changing demographics. In our opinion, none of those issues lend themselves to quick, easy fixes. We think accommodation will be lifted slowly and gradually across central banks.

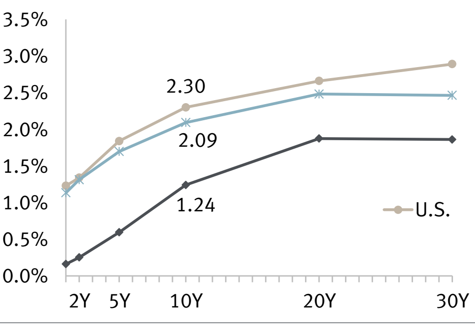
In order to determine what direction central banks, interest rates, and yield curves might take in coming months, it will be important for markets to focus more on current economic fundamentals rather than monetary policy models or past tightening cycles. We believe central banks will likely take pages from the Fed's playbook so rather than facing imminent tightening moves, markets

## Fixed income views

| Region | Gov't Bonds | Corp. Credit | Duration |
|---|---|---|---|
| Global | – | + | 5–7 yr |
| United States | – | + | 5–7 yr |
| Canada | – | = | 3–5 yr |
| Continental Europe | = | + | 5–7 yr |
| United Kingdom | – | = | 5–7 yr |

+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

## Sovereign yield curves




Source - Bloomberg

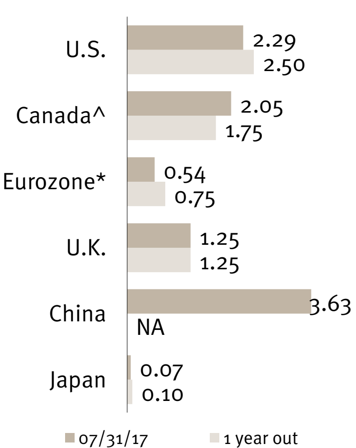
should get used to a steady diet of gradual policy tweaks. Volatility associated with central bank activities should keep investors on their toes in order to take advantage of selective opportunities to adjust their fixed income holdings.

## Regional highlights

### United States

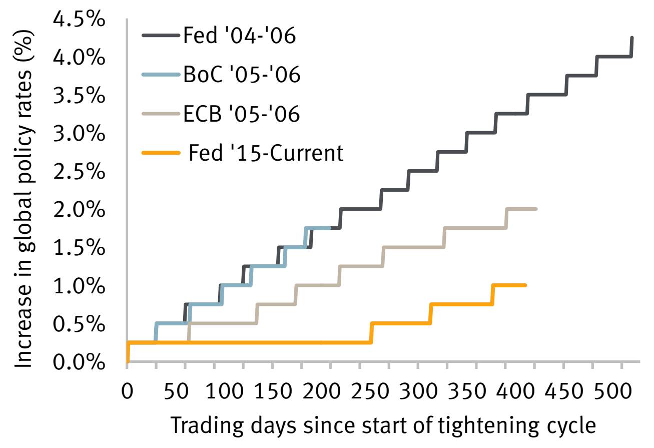
- July's Federal Open Market Committee meeting proved to be relatively uneventful, with the decision to hold rates between 1% and 1.25%. The Committee continues to reiterate that the string of weak inflation data is transitory, while

10-year rate (%)




^ under review
* Eurozone utilizes German Bunds
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee

Central bank tightening slower than past cycles



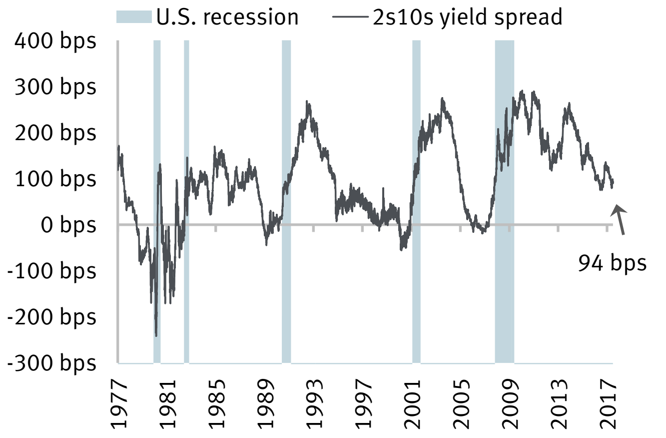

Source - RBC Wealth Management, Bloomberg; data through 7/31/17

Global challenges force central banks to gradual approach to tightening.

also maintaining its bias toward one additional rate hike in 2017. The 10-year Treasury yield backed up as high as 2.39% during the month, steepening the yield curve and calming investors' fears that a flat curve might be foreshadowing a recession.

- Despite weak oil prices, investor demand for risk assets continues to drive value out of high-yield bonds with credit spreads now just 12 basis points away from a year-to-date low that was the tightest since 2014. We continue to carry a slight Underweight recommendation on high yield as we believe investors are better suited to move up the credit spectrum, where high BBB and low A-rated credits with yields in the 3% range offer the most attractive risk/reward profile.
- Summer municipal bond issuance remains low despite falling yields as states have been reluctant to issue debt amid reports of declining tax revenue, while muni investors continue to be buyers. Strong demand has been isolated to the shorter end of the yield curve 10 years and below. In our view, this leaves value in the 15Y–20Y section of the yield curve, where muni/Treasury ratios still exceed 100%.

Yield curve flattened through spring




Source - RBC Wealth Management, Bloomberg; data through 7/31/17

Yield curve flattened to 94 basis points, but still indicates continued economic expansion.

# Global fixed income

## Canada

- The Bank of Canada (BoC) increased the overnight lending rate by 25 basis points to 0.75% in July, the first interest rate hike in seven years. While this was fully priced in, what unsettled the market was Governor Stephen Poloz and Senior Deputy Governor Carolyn Wilkins stopping short of saying that this will be a two-and-done hiking process to remove the emergency interest rate cuts that were put in place to deal with the oil price shock in 2015.
- We believe the BoC will be challenged to follow a traditional rate hike path in the face of the record high consumer debt levels and an economy heavily reliant on residential real estate. Inflation data points to a lack of core price pressure. We are comfortable taking on interest rate risk with a focus on adding exposure to the intermediate portion of a 10-year bond ladder.
- Investment-grade credit spreads are back to their tightest levels in three years. In our view, this gives investors a timely opportunity to upgrade quality within portfolios as well as use Maple bonds which capture the recent move higher in the Canadian yield curve.
- Preferred share prices moved marginally higher in July after a particularly strong prior month. We continue to Overweight preferred shares compared to corporate bonds but recommend investors use the market's recent strength to moderately pare positions.

## Continental Europe & U.K.

- The European Central Bank's (ECB) bond-purchasing programme is largely anchoring the region's government bond yields, and we expect the bank to continue to use it to manage financial stability across the eurozone. We await further insight, perhaps at the September meeting, into how the ECB intends to bring an end to the programme. It is scheduled to buy €60B of bonds per month until the end of 2017, and we expect bond buying to persist throughout 2018, but at a reduced rate. There are relatively few sources of political risk for the next 12 months in Europe and compared to North America, Europe is at an early stage in its credit cycle. Whilst growth and economic indicators continue to improve, we favour European corporate credit and see value in high-quality bank issues and peripheral government debt.
- In the U.K., the Bank of England faces a difficult trade-off between rapidly accelerating inflation (0.5% to 2.6% in a year) amid slowing economic growth. So far it has opted to hold rates steady. We remain sceptical that the consumer-led slowdown will be offset by other parts of the economy. Therefore, we continue to anticipate the rate-setting Monetary Policy Committee will focus on downside risks to economic activity rather than on inflation overshooting expectations, leaving tighter monetary policy off the agenda for the time being. We prefer sterling issues from international corporates whose revenue sources are geographically diverse and bonds with maturities between five and seven years, issuer-dependent.

# Too much pessimism?

## Commodity forecasts

| | 2017E | 2018E |
|---|---|---|
| Oil (WTI $/bbl) | 48.47 | 50.00 |
| Natural Gas ($/mmBtu) | 3.01 | 3.00 |
| Gold ($/oz) | 1,269 | 1,300 |
| Copper ($/lb) | 2.60 | 2.75 |
| Corn ($/bu) | 3.73 | 4.00 |
| Wheat ($/bu) | 4.55 | 4.90 |

Source - RBC Capital Markets forecasts (oil, natural gas, gold, and copper), Bloomberg consensus forecasts (corn and wheat)

## Commodities have retraced some of their 2016 gains

| Bloomberg Index | 2011-15 | 2016 | 2017 YTD |
|---|---|---|---|
| Commodity Index | -51.6% | 11.4% | -5.5% |
| Energy Subindex | -70.4% | 15.9% | -20.1% |
| Industrial Metals Subindex | -55.3% | 19.5% | 6.1% |
| Precious Metals Subindex | -36.7% | 9.1% | 3.8% |
| Agriculture Subindex | -41.7% | 1.8% | -2.4% |

Source - RBC Wealth Management, Bloomberg; data through 7/14/17

Renewed weakness in oil prices has been a major drag in the commodities pit in 2017. The Bloomberg Energy Subindex, which makes up nearly one-third of the broad Commodity Index, is down around 20% so far this year. However, recent developments give us cause for guarded optimism.

Stubbornly high oil inventories, particularly in the U.S., are showing some signs of ebbing. The U.S. Energy Information Administration reported domestic crude stockpiles dipped below 500 million barrels for the first time since January. Resurgent shale oil output and OPEC member production cut compliance remain two key risks to monitor. RBC Capital Markets continues to expect OPEC's production cuts and firming demand growth to push the global oil market into a modest deficit in Q3 or Q4. In July, the International Energy Agency raised its estimates for 2017 global demand growth to the highest level in two years, driven by a healthy world economy and increased consumption in China and India.

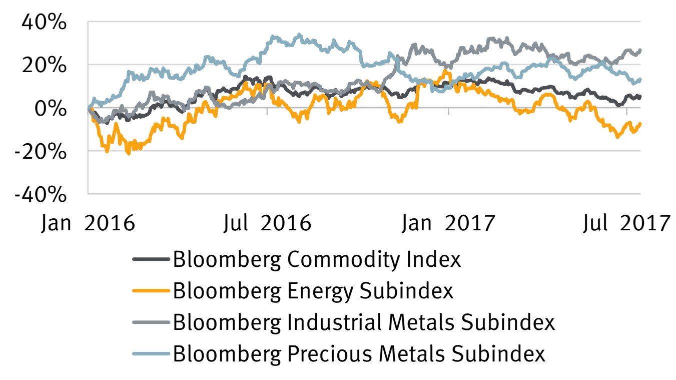
For base metals, improving global industrial output and a better tone to Chinese growth should be supportive at least near term. Global manufacturing and services activity indexes are at levels consistent with world GDP growth of just above 3%. In China, policymakers are keen to maintain economic momentum ahead of the National Communist Party Congress this autumn. Any withdrawal of stimulus beyond that date could pose challenges for industrial commodities.

We view the precious metals outlook as mixed. A softer U.S. dollar and somewhat elevated geopolitical risks (i.e., North Korea, Middle East) are bullish factors for gold. Yet subdued inflation and the potential for bond yields to grind higher due to the "hawkish" shift in tone from central banks could keep a lid on prices.

Grains have treaded water so far in 2017, albeit well above their deep lows of last year. This trend should persist through the second half. Concerns over the risk of adverse weather depressing crop yields and expectations for stocks-to-use ratios to improve heading into 2018 could help corn and wheat sustain their outperformance relative to other agricultural commodities.

Overall, we believe the outlook for commodities has improved for the coming months. We expect a modest rebound in oil (WTI) toward the low-$50s range and sustained strength for select metals and grains.

## Bloomberg commodity indexes




Receding drag from oil would go a long way to improve the performance of the commodities complex.

Source - Bloomberg, RBC Wealth Management; data through 7/14/17

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## Currency forecasts

| Currency pair | Current rate | Forecast Jun 2018 | Change* |
|---|---|---|---|
| **Major currencies** | | | |
| USD Index | 92.86 | 99.69 | 7% |
| CAD/USD | 0.80 | 0.76 | -5% |
| USD/CAD | 1.24 | 1.32 | 6% |
| EUR/USD | 1.18 | 1.06 | -10% |
| GBP/USD | 1.32 | 1.22 | -8% |
| USD/CHF | 0.96 | 1.05 | 9% |
| USD/JPY | 110.26 | 102.00 | -7% |
| AUD/USD | 0.80 | 0.74 | -8% |
| NZD/USD | 0.75 | 0.70 | -7% |
| EUR/JPY | 130.57 | 108.00 | -17% |
| EUR/GBP | 0.89 | 0.87 | -2% |
| EUR/CHF | 1.14 | 1.11 | -3% |
| **Emerging currencies** | | | |
| USD/CNY | 6.72 | 7.50 | 12% |
| USD/INR | 64.18 | 66.50 | 4% |
| USD/SGD | 1.35 | 1.45 | 7% |

* Defined as the implied appreciation or depreciation of the first currency in the pair quote.
Examples of how to interpret data found in the Market Scorecard.
Source - RBC Capital Markets, Bloomberg

### U.S. dollar: Bullish forecast under pressure

Recent data in the U.S. has been mixed, causing the market to pare back expectations of further rate hikes from the Federal Reserve. Marry this up with Congress' inability to pass new legislation and a so far unpredictable administration, and you get a continuation of dollar weakness. While risks to our bullish USD outlook are appearing, the labor market continues to tighten, albeit with the absence of wage growth for now. Ultimately this could carry inflation and the dollar higher once again.

### Euro: Monetary policy shift ahead

The euro breached its 2016 high against the USD in July, as expectations continued to build that the ECB would soon remove some of its support given economic improvements in the eurozone. However, this process is likely to be slow due to unacceptably high unemployment in most regional economies. While we are no longer bearish on the single currency, we would need to see further improvement before shifting outright bullish.

### British pound: Temporary strength

While a weaker dollar saw GBP breach \$1.31 for the first time this year, weaker-than-expected activity data and business surveys kept the pound subdued against other currencies—a trend we expect to continue. Inflation also came in below consensus, causing the market-implied probability of a hike from the Bank of England to be reined in. We remain bearish on sterling, targeting GBP to fall to \$1.15 and €1.08 by the end of the year.

### Canadian dollar: Policy-driven rally

The Bank of Canada hiked rates in July, with an indication that it intends to hike another 0.25% before the end of the year. As the market was positioned for further CAD weakness, this has caused a sharp 10% rally from the low in May. Further gains could be limited. High levels of consumer indebtedness, the impact of strong CAD on exports, risks to rate hike expectations, and NAFTA renegotiation trade concerns all drive our hesitance to predict further strength from current levels.

### Japanese yen: Volatile

The yen has increasingly been driven by external factors, namely broad risk appetite and short-term U.S. rate expectations. Speculative positioning around those two factors has been causing sharp swings within the ¥108–¥115 per USD range throughout 2017, keeping the yen undervalued for now. As those speculative positions unwind, we see the yen strengthening toward ¥100 per USD in early 2018.

CAD rallies on prospect of higher Canadian rates

CAD per USD (inverted)

Despite recent strength, a correction seems likely.

Source - Bloomberg, RBC Wealth Management; data through 7/21/17

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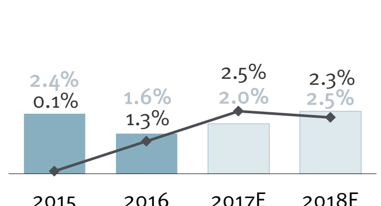
# Key forecasts

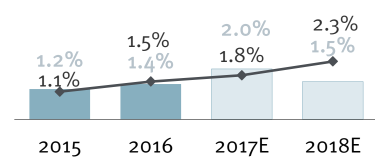
## United States — Fed confident in economy

- FOMC held rates in July, left the door open for 1 more hike in 2017. Q2 GDP first estimate solid at 2.6%, reaccelerating from 1.4% in Q1. Leading indicator points to similar Q3. CPI data holding at 1.7% y/y, pausing the downtrend. Import prices increasing due to weaker dollar. Hiring strong, but wage growth muted. Housing, permits reaccelerated after spring lull. Retail sales muted in June.



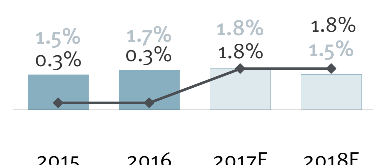

## Canada — Surge in growth

- May GDP growth surprised at 0.6%, fueled by energy and mining. Retail sales up 0.6% in the month. Housing starts reaccelerated back over 200K although cooling in Greater Toronto Area is evident. The Bank of Canada raised the overnight rate by 25 bps in July, expected to do so again in October. Hiring robust, the unemployment rate fell to 6.5%. Headline inflation dropped to 1.0% y/y, core steady at 1.3%.



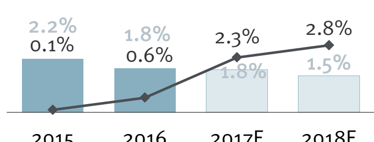

## Eurozone — Confidence improving

- Economic growth expanding and confidence improving, but inflation pressures non-existent. Policymakers expect strong labor market will lead to inflation, allowing for reduced stimulus. Industrial production reaccelerating after June lull. Unemployment rates falling across the eurozone. Retail sales remained strong at 2.6% y/y.



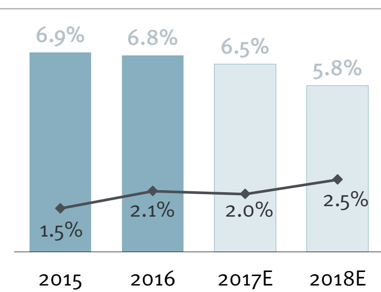

## United Kingdom — Tepid growth

- Second-quarter GDP dipped to 1.7%. Industrial production, manufacturing dragged on growth as Brexit uncertainty weighs. Consumers resilient as core retail sales surged 3% y/y. Wage growth at slowest pace since 2014, rising just 1.8% y/y. Inflation eased back to 2.6%, providing some shelter for the BoE to hold rates steady.



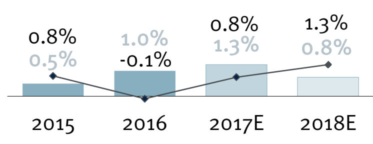

## China — Growth on target

- Economy expanded 6.9% in Q2 fueled by strong acceleration in retail sales and industrial production. Trade surged on a pickup in both global and domestic demand. Investment continued to ease amid de-risking measures from the People's Bank of China's deleveraging goals. Despite strong month, expectations are for the pace of growth to moderate in H2 2017.




## Japan — Need for easy policy

- Core inflation rose 0.2%, the fastest pace since 2015, although far from the BoJ's 2% target. 1.51 jobs-to-applicants ratio is highest since 1970s, but has yet to impact wages. The bank held rates steady and pushed its 2% inflation forecast to 2020. Somewhat encouraging for economic growth, household spending rose 2.3%—the fastest pace in over a year as weak inflation boosts real income.




Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee

# Market scorecard

| Index (local currency) | Level | 1 Month | YTD | 12 Month |
|---|---|---|---|---|
| S&P 500 | 2,470.30 | 1.9% | 10.3% | 13.7% |
| Dow Industrials (DJIA) | 21,891.12 | 2.5% | 10.8% | 18.8% |
| NASDAQ | 6,348.12 | 3.4% | 17.9% | 23.0% |
| Russell 2000 | 1,425.14 | 0.7% | 5.0% | 16.8% |
| S&P/TSX Comp | 15,143.87 | -0.3% | -0.9% | 3.8% |
| FTSE All-Share | 4,046.20 | 1.1% | 4.5% | 10.7% |
| STOXX Europe 600 | 377.85 | -0.4% | 4.5% | 10.5% |
| EURO STOXX 50 | 3,449.36 | 0.2% | 4.8% | 15.3% |
| Hang Seng | 27,323.99 | 6.1% | 24.2% | 24.8% |
| Shanghai Comp | 3,273.03 | 2.5% | 5.5% | 9.9% |
| Nikkei 225 | 19,925.18 | -0.5% | 4.2% | 20.3% |
| India Sensex | 32,514.94 | 5.2% | 22.1% | 15.9% |
| Singapore Straits Times | 3,329.52 | 3.2% | 15.6% | 16.1% |
| Brazil Ibovespa | 65,920.36 | 4.8% | 9.5% | 15.0% |
| Mexican Bolsa IPC | 51,011.88 | 2.3% | 11.8% | 9.3% |
| **Bond yields** | **7/31/17** | **6/30/17** | **7/29/16** | **12 mo chg** |
| US 2-Yr Tsy | 1.349% | 1.382% | 0.655% | 0.69% |
| US 10-Yr Tsy | 2.294% | 2.304% | 1.453% | 0.84% |
| Canada 2-Yr | 1.316% | 1.103% | 0.540% | 0.78% |
| Canada 10-Yr | 2.057% | 1.762% | 1.027% | 1.03% |
| UK 2-Yr | 0.269% | 0.358% | 0.110% | 0.16% |
| UK 10-Yr | 1.230% | 1.257% | 0.685% | 0.55% |
| Germany 2-Yr | -0.680% | -0.572% | -0.625% | -0.06% |
| Germany 10-Yr | 0.543% | 0.466% | -0.119% | 0.66% |
| **Commodities (USD)** | **Price** | **1 Month** | **YTD** | **12 Month** |
| Gold (spot $/oz) | 1,269.44 | 2.2% | 10.2% | -6.0% |
| Silver (spot $/oz) | 16.83 | 1.2% | 5.7% | -17.3% |
| Copper ($/metric ton) | 6,336.25 | 6.9% | 14.7% | 28.9% |
| Uranium ($/lb) | 20.08 | -2.0% | -1.5% | -22.0% |
| Oil (WTI spot/bbl) | 50.17 | 9.0% | -6.6% | 20.6% |
| Oil (Brent spot/bbl) | 52.65 | 9.9% | -7.3% | 24.0% |
| Natural Gas ($/mmBtu) | 2.79 | -7.9% | -25.0% | -2.9% |
| Agriculture Index | 294.62 | -1.0% | 1.2% | 1.5% |
| **Currencies** | **Rate** | **1 Month** | **YTD** | **12 Month** |
| US Dollar Index | 92.8630 | -2.9% | -9.1% | -2.8% |
| CAD/USD | 0.8014 | 3.9% | 7.7% | 4.5% |
| USD/CAD | 1.2480 | -3.7% | -7.1% | -4.2% |
| EUR/USD | 1.1842 | 3.6% | 12.6% | 6.0% |
| GBP/USD | 1.3215 | 1.5% | 7.1% | -0.1% |
| AUD/USD | 0.8003 | 4.1% | 11.0% | 5.4% |
| USD/JPY | 110.2600 | -1.9% | -5.7% | 8.0% |
| EUR/JPY | 130.5700 | 1.7% | 6.2% | 14.5% |
| EUR/GBP | 0.8961 | 2.2% | 5.0% | 6.1% |
| EUR/CHF | 1.1449 | 4.6% | 6.8% | 5.7% |
| USD/SGD | 1.3553 | -1.5% | -6.3% | 1.2% |
| USD/CNY | 6.7266 | -0.8% | -3.1% | 1.4% |
| USD/MXN | 17.8005 | -1.8% | -14.1% | -5.1% |
| USD/BRL | 3.1266 | -5.5% | -3.8% | -3.8% |

Strong earnings continued to drive the technology-heavy NASDAQ higher.

Short-term Canadian yields rose after the Bank of Canada hiked rates for the first time in two years.

Crude oil surged to end the month on falling U.S. inventories and news of further OPEC production cuts.

The dollar fell over 2% in July on weaker growth prospects and strong currencies from key trading partners, giving a boost to corporate earnings.

Equity returns do not include dividends, except for the German DAX and Brazilian Ibovespa. Equity performance and bond yields in local currencies. U.S. 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. Examples of how to interpret currency data: CAD/USD 0.80 means 1 Canadian dollar will buy 0.80 U.S. dollar. CAD/USD 4.5% return means the Canadian dollar has risen 4.5% vs. the U.S. dollar during the past 12 months. USD/JPY 110.26 means 1 U.S. dollar will buy 110.26 yen. USD/JPY 8.0% return means the U.S. dollar has risen 8.0% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 7/31/17.

# Research resources

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As of June 30, 2017

| Rating | Count | Percent | Investment Banking Services Provided During Past 12 Months Count | Investment Banking Services Provided During Past 12 Months Percent |
|---|---|---|---|---|
| Buy [Top Pick & Outperform] | 826 | 52.01 | 293 | 35.47 |
| Hold [Sector Perform] | 657 | 41.37 | 144 | 21.92 |
| Sell [Underperform] | 105 | 6.61 | 7 | 6.67 |

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