August 2018

RBC WEALTH MANAGEMENT

Global Insight

Perspectives from the Global Portfolio Advisory Committee

Thorny trade routes

While the tariff skirmishes may involve more fireworks, we think the trade standoffs will ultimately be manageable for economies and markets

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RBC Wealth Management

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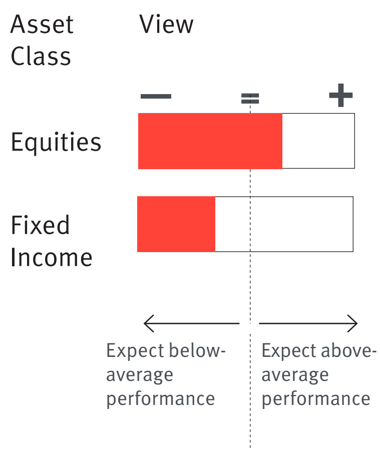

See "Views explanation" below for details

Source - RBC Wealth Management

Equities

- We maintain our modest Overweight in equities. Issues that have preoccupied markets recently such as trade disputes, the flattening yield curve, or Chinese indebtedness continue to hang over markets and will likely cause bouts of volatility should they come into focus.
- Yet despite the business cycle being increasingly mature in the U.S., there are no signs of an imminent recession on the horizon. Reassured, we continue to give equities the benefit of the doubt but remain vigilant for developments that would signal an economic "sea change." Corporate earnings in the U.S. and Canada as well as in the U.K., Europe, and Japan are beating expectations so far, while valuations are not overly demanding, further reinforcing our view.

Fixed income

- Trade developments continue to cast a long shadow over the rates market, but the economic impact has been minimal to date, allowing central banks to move forward with policy normalization plans. Despite the strong Q2 GDP print in the U.S., growth and inflation remain contained in most geographies. Furthermore, continued yield curve flattening could place limits on future central bank activity, suggesting to us that tightening cycles could be shorter than anticipated.
- Even though we maintain our Underweight to fixed income, we continue to see the best opportunities in credit. Investors should be selective and maintain their focus on quality, and broadly speaking we currently favor the A-rated space. Optimal curve positioning is an important consideration as well; here, however, regional preferences vary, so please consult the "Fixed income views" table on page 18 for our current recommendations.

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

Thorny trade routes

The U.S. and China are continuing to turn up the heat in their game of brinkmanship. And while the U.S. has made some progress on some fronts with other major trading partners, thorny issues remain, particularly on a NAFTA reboot. Investors should be vigilant about potential volatility, but unless the skirmishes metastasize into a full-blown trade war we think economies and markets will weather this uncertainty.

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Months of heated rhetoric and threats of hundreds of billions of dollars in tariffs have given way to constructive dialogue between the U.S. and two of its major trading partners, the EU and Mexico.

Meanwhile, trade relations between the U.S. and China are closer to reaching a boiling point, and more give-and-take is required to achieve a NAFTA reboot.

Our economists believe the global and U.S. economies are strong enough to withstand trade challenges, especially given the worst-case scenario of a full-on global trade war seems unlikely.

But financial markets may be confronted with tougher and more provocative rhetoric and perhaps additional tariffs before the bulk of trade issues are resolved.

A bull in a China shop?

The U.S.-China trade relationship is the most complicated and has the highest stakes, in our view.

This conflict could crystallize in coming weeks as the U.S. determines whether to make good on its threat to slap tariffs on another $200B in Chinese imports. The Trump administration turned the heat up recently by raising the possibility this

U.S. trade scenarios, from worst to best case

Scenario	Worst case	Negative	Slightly negative	Neutral	Best case
Likelihood	20%	25%	30%	15%	10%
Detail	Trade war	Substantial increase in tariffs	Several smallish tariffs	Reversal of Trump tariffs	Foreign barriers fall due to pressure

- Most trade models say protectionism damage would be fairly small.
- In the meantime, trade uncertainty is likely to drag on the economy.
- Integrated supply chains increase potential damage for multinationals.

Source - RBC Global Asset Management

could be a 25% tariff, rather than 10% as it had previously signaled. A formal review of this policy is ongoing and a decision is possible after September 5.

China's response to any U.S. actions—whether it decides to counter or negotiate—may be even more important in determining the near-term direction of this trade dispute. After learning Washington may up its tariff to 25%, the foreign ministry spokesman said, "… pressure and blackmail from the U.S. won't work." China has repeatedly warned it will retaliate if additional tariffs are imposed.

Select industries in both countries are showing signs of strain from the modest tariffs already in place, but neither economy is showing lasting scars. Should the tariffs keep mounting, we view the Chinese economy as more vulnerable due to its already well-entrenched path toward a slower growth rate.

For more about the root causes of the U.S.-China trade dispute, see "In the trenches of the trade dispute" on page 9.

U.S.-EU ceasefire

We never viewed an all-out trade war between the U.S. and EU as a credible risk. Consider the "deal" low-hanging fruit.

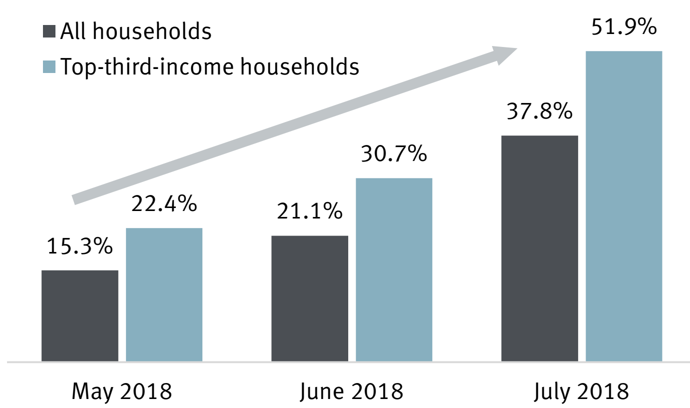
The U.S. and EU are moving in the right direction—even if their initial "deal" to negotiate a formal trade agreement was skinny on details and, in some respects, seemed like a solution in search of a problem. We never viewed an all-out trade war between the U.S. and EU as a credible risk. Consider the "deal" low-hanging fruit.

The U.S.-EU framework lays the groundwork for broad, constructive trade talks with the goal of reaching zero tariffs on most industrial goods, and tackles some thorny issues that have concerned markets.

It unwound the Trump administration's auto tariff threat, which was highly unpopular with manufacturers and parts companies on both sides of the Atlantic, many market participants, and even some U.S. administration trade officials. The two sides will refrain from levying tariffs against each other on autos and other goods, as long as formal trade negotiations are ongoing. But U.S. tariffs on non-EU automakers and auto parts companies, such as in Mexico, Canada, and Asia, are still a risk.

Trade tariffs worry U.S. consumers

% of respondents who made negative references to potential impact of tariffs



Tariff concerns have risen among all consumers, and especially the top third of households.

Source - RBC Global Asset Management, University of Michigan Surveys of Consumers

The U.S. and EU also committed to "resolve" the steel and aluminum tariffs and counter-tariffs that came into effect recently. This would be positive for the industrial sector as high raw materials prices have squeezed profits. But once again, it doesn't address the existing steel and aluminum tariffs on non-EU countries, including on Canada, the biggest steel importer into the U.S.

It's difficult for us to reconcile this U.S.-EU goal on steel tariffs with President Trump's enthusiastic appearance at a U.S. Steel plant in Illinois shortly after the EU deal. He told the crowd of steel workers, "After years of shutdowns and cutbacks, today the blast furnace here in Granite City is blazing bright, workers are back on the job and we are once again pouring new American steel into the spine of our country … Thanks to our tariffs, idle factories throughout our nation are roaring back to life." To us, this doesn't seem like a president who is ready to *fully* "resolve" the steel issue—with the EU maybe, but perhaps not with all countries.

This is the reality check when it comes to tariffs. Once they are put in place, they are difficult to unwind because real people and political constituencies benefit from them.

NAFTA: Reaching for a reboot

Patience still seems warranted when it comes to NAFTA.

We're encouraged the U.S. and Mexico are apparently making progress on auto and auto parts negotiations, as has been reported by multiple news agencies. These issues have been key sticking points.

It's also a positive sign that relations between President Trump and Mexico President-elect Andrés Manuel López Obrador are off to an amicable start.

But while López Obrador is broadly supportive of improving NAFTA, RBC Capital Markets notes that some of his goals and strategies differ from the current Nieto administration and that could take time to sort out. López Obrador doesn't take office until December 1.

It's unclear whether the U.S. prefers bilateral trade agreements with Canada and Mexico or if it's committed to the traditional three-country NAFTA framework.

At this stage it's also unclear whether the U.S. prefers bilateral trade agreements with Canada and Mexico or if it's committed to the traditional three-country NAFTA framework.

Regardless of the structure, there are a number of other thorny issues to sort out between the U.S., Mexico, and Canada aside from autos.

It would be difficult for a complete NAFTA reboot to take place this year, according to RBC Capital Markets' currency strategists, unless the U.S. abandons some of its key demands. They doubt this will occur in coming months. Therefore, NAFTA uncertainty could linger into next year.

RBC Global Asset Management's Chief Economist Eric Lascelles believes there is a 50% likelihood a new NAFTA deal will be struck at some point, a 25% likelihood the trade agreement will be terminated, and a 25% chance the current framework will stay in place.

Length matters

A key risk that is often missed in the wider trade debate is duration—the length of time tariffs and trade uncertainties remain in place.

The longer trade disputes simmer, the greater likelihood they will become a headwind for the economy.

Even if the trade disputes never reach a boiling point or a full-on global trade war, the longer they simmer, the greater likelihood they will become a headwind for the global and U.S. economies.

This can manifest in a variety of ways. At the most basic level, the longer tariffs linger, the more likely they will try business executives' patience.

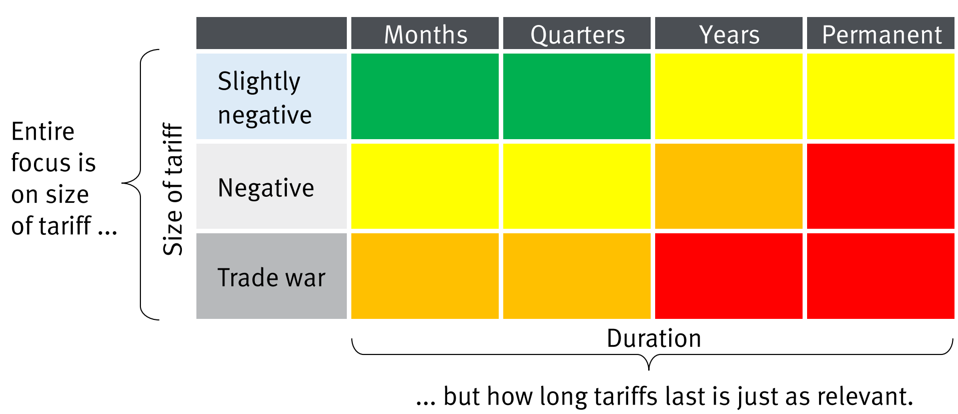
U.S. CEO confidence has pulled back slightly as trade challenges have mounted, but remains elevated. We believe it will retreat further if additional tariffs are implemented. And if corporate sentiment sours, capital spending decisions could be postponed or curtailed.

While long-duration trade disputes could put U.S. economic momentum moderately at risk, they could potentially impact trading partners more. We are already seeing anecdotal evidence that mid-size Canadian firms are becoming hesitant to spend, for example.

The heat map illustrates that relatively small tariffs that last for just months or quarters can be absorbed, as shown with the green boxes. But tariffs that last for years or are permanent, especially those that are larger in size, are more problematic, as shown by the orange and red boxes.

A second dimension to tariff math: Duration

Heat map of cumulative tariff pain



Source - RBC Global Asset Management

How this could end

We don't think the tariff risks have to become acute before meaningful trade deals can take place. Corporate pressure should go a long way toward bringing an end to the trade disputes.

A non-trivial share of major trade relationships—whether between the U.S. and China, the U.S. and the EU, or NAFTA members—is business-to-business and involves complex global supply chains with interdependencies that are often misunderstood or underappreciated by government officials. Some tariffs could tie global supply chains in knots. We don't doubt businesses of all sizes in all countries involved will continue to warn governments about this, which could encourage positive movement toward eventual deals.

Corporate lobbying has already changed the trajectory. We believe the U.S. and German auto industries played a major role in the tariff ceasefire that transpired between the U.S. and EU.

Furthermore, multiple challenges have already been filed against U.S. tariffs in the World Trade Organization (WTO) by major trading partners. Forthcoming rulings by the body or efforts to reform trade rules within the WTO by member countries could create pathways toward resolutions despite the institution's imperfections.

Navigating the trade winds

Some of the hot trade rhetoric and tariff moves seem like they are already priced into equity markets. After all, countries have been grappling with trade challenges for months, and markets are forward looking.

But we're cognizant that if stalemates between trading partners persist or tit-for-tat tariffs mount, the U.S. and other markets would be vulnerable to additional headwinds and volatility, at the least, and downside in more acute instances.

As long as trade rhetoric and tariffs don't put economic and earnings growth seriously at risk, equity markets should be able to navigate through this period.

The renewed U.S. sanctions on Iran also complicate matters, as President Trump wrote in a tweet, "Anyone doing business with Iran will NOT be doing business with the United States."

When there are uncertainties like these, which entail scenarios that could produce wide outcomes, we stay focused on the U.S. and global economies.

As long as trade rhetoric and tariffs don't put economic and earnings growth seriously at risk, equity markets should be able to navigate through this period. So far, the trade actions have not dampened conditions in the U.S., nor have they impacted other countries much, if at all.

While the dispute between the U.S. and China could get worse before it gets better and NAFTA may take more time to reboot, our economists believe the collective tariff tiffs should be manageable for major economies and could ultimately result in lower trade barriers overall. Getting to that point, however, may involve more fireworks.

Focus article

In the trenches of the trade dispute

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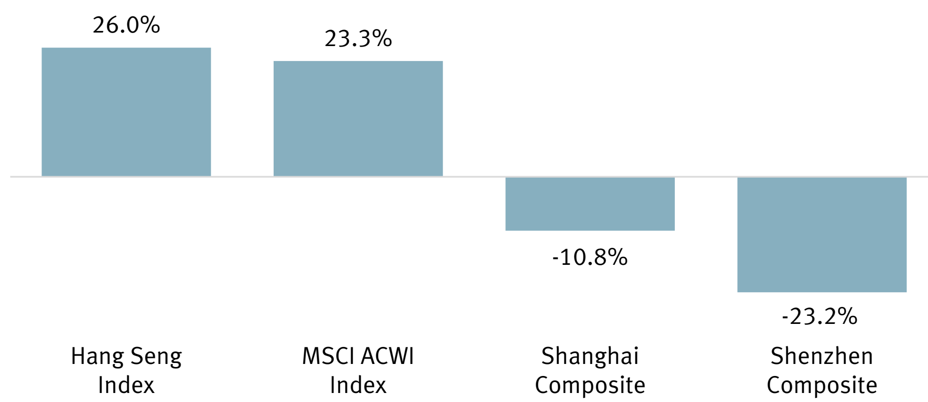
"There is no instance of a nation benefitting from prolonged warfare."
Sun Tzu, *The Art of War*

Chinese equities have been weak for several reasons, most prominently the U.S.-China trade dispute, although the tightening of domestic credit is an important factor. There is no easy fix to the trade dispute due to the nature of U.S. demands.

On the receiving end

It's been a rough ride for stocks in China and Hong Kong. Global equities have eked out a 1.2% gain in 2018, while Hong Kong's Hang Seng Index (dominated by Chinese companies) is down by 5.3%, the Shanghai Composite has fallen by 14.6%, and the Shenzhen Composite has declined by 18.4%. From the January peak, the latter two indexes are in bear market territory. Hong Kong is arguably correcting from a euphoric peak in January after a handsome 36% gain in 2017. The same cannot be said for China: Shanghai was only up by 6.6% while Shenzhen actually fell by 3.5%.

Index performance from 2017–August 2, 2018



Source - RBC Wealth Management, Bloomberg; data coverage from 1/2017

There are several reasons for the underperformance. China's process of deleveraging, or rather curtailing excessive growth in riskier areas of its credit markets, has been going on for a while. "Total social financing," a broad measure of credit growth in China, rose by 9.8% y/y in June, a sizeable number but actually its lowest level of growth on record (since 2003). Chinese bond yields have risen, with the rise in global corporate bond yields surely not helping. All in all, onshore borrowing conditions have tightened in 2018. To be clear, things aren't falling apart. Much of this is a deliberate result of policy as China finds answers to the common investor concern that its debt levels were growing too quickly. But the slowdown continues.

In the trenches of the trade dispute

Additionally, and much more prominently for global investors, there is the escalating trade dispute between the U.S. and China. As the punchy rhetoric has translated into actual policy and real-money tariffs over the past few months, losses for Chinese equities have accelerated. Most of the decline has occurred since May. Some fiscal stimulus measures from the government in July provided a short-lived hiatus for stocks. Renminbi weakness has raised the mercury further.

The crux of the problem is that the U.S. is demanding that China change its laws, regulations, and behaviours.

The real issue

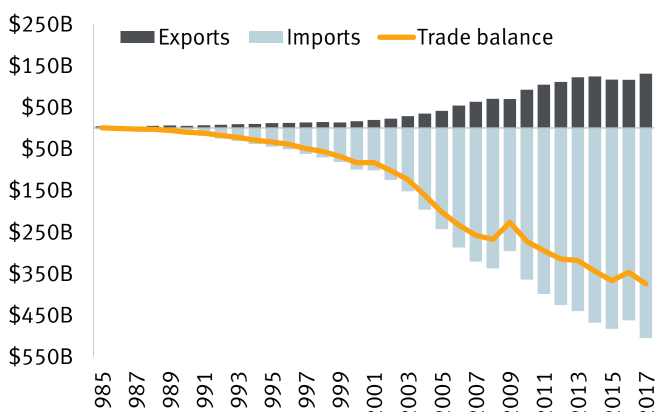
China ran a $375B trade surplus with the U.S. in 2017. It's easy to think that this is the focus of the U.S. It's also easy to think, therefore, that the answer is "simply" to reverse the trend, for example to get China to buy more oil and gas from the U.S. But the trade surplus is not the real issue. And the answers are far from simple. The crux of the problem is that the U.S. is demanding that China change its laws, regulations, and behaviours. That's a real challenge and why the dispute could easily evolve into a series of battles, or rather a trade war.

In our view, the trade surplus is largely a red herring, especially when one considers that a sizeable chunk of the goods coming from China are produced by multinational companies that effectively use China's scale for the assembly of products, often with key value-added components coming from other countries. Smartphones are perhaps the most obvious example.

The dispute properly began in March 2018 when the Office of the United States Trade Representative, headed by Robert Lighthizer, published a statement[1] outlining the administration's response—primarily tariffs and investment restrictions—to "China's unfair trade practices covered in the USTR Section 301[2] investigation of China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation."

The U.S. trade deficit with China is not the real issue driving the dispute

U.S. trade with China



Much of the trade deficit came from U.S.-based companies and other multinationals assembling goods in China and importing them into the U.S.

Source - RBC Wealth Management, U.S. Census Bureau; annual data through 2017

[1] https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/march/president-trump-announces-strong

[2] Section 301 is a key enforcement tool that allows the United States to address a wide variety of unfair acts, policies, and practices of U.S. trading partners.

The report concluded, inter alia, that China uses foreign ownership restrictions to pressure U.S. companies to transfer technology; that China restricts foreign technology licensing, resulting in terms that unfairly favour Chinese companies; that China systematically invests in U.S. companies to generate large-scale technology transfers; and that China conducts and supports cybercrime against U.S. companies.

Importantly, the short statement contains this stand-alone sentence: "The Chinese government's technology transfer and intellectual property policies are part of China's stated intention of seizing economic leadership in advanced technology as set forth in its industrial plans, such as 'Made in China 2025'." Effectively, the U.S. administration is accusing China of buying, coercing, or stealing its way to acquire U.S. technology in order to rapidly upgrade its economy. This is fueling nationalistic views that position China as a threat to U.S. hegemony, or "seizing economic leadership."

Made in China 2025

In fact, Made in China 2025 (MIC2025) is not a new plan. It was introduced by the Chinese government in 2015. Other countries such as Germany and Japan have similar national plans. The priorities of the plan include: promote innovation; improve the quality of goods and services; and promote renewable energy and environmentally friendly industry. In short, to move up the value chain and to

Amidst the trade dispute, Washington is pushing back against this "Made in China 2025" plan

10 categories by industry	Examples
Information technology	Integrated circuits & special equipment Information and communication equipment Operating systems and software
High-end machine tools and robots	High-speed, efficient machine tools Robots (multiple industries)
Advanced rail transportation equipment	Build the world's leading, modern rail transit industry system
Energy conservation and new energy vehicles	Technology for advanced combustion engines Support the development of electric vehicles
Biological pharmaceutical and high-performance medical apparatus and	Develop new products in chemical medicine, biotech drugs, and traditional Chinese medicine Develop high-performance medical devices such as imaging equipment, biological 3D printing
Aerospace equipment	Aviation equipment; form independent, complete aviation industry chain Space equipment
Marine engineering equipment and shipping technology	Develop deep-sea exploration
Electric power equipment	Promote the development of new energy and renewable energy equipment, smart grid transmission and transformation equipment, and advanced energy storage
Agricultural machinery and equipment	Develop advanced agricultural machinery
New materials	High-performance structural materials

Source - China's State Council, RBC Wealth Management become more self-sufficient. There are 10 categories in focus (see table on previous page). The plan comes with key performance indicators such as target ratios for research versus revenues, patents versus revenues, broadband penetration, CO2 emissions, water usage, and so on.

A new world order

MIC2025 has done more than just ruffle a few feathers in Washington. In an interview with Fox News in March, Lighthizer called MIC2025 a "very, very serious challenge, not just to us, but to Europe, Japan and the global trading system."

Also in March, Peter Navarro, a big China bear on trade, advisor to the president, and author of the 2011 book *Death by China: Confronting the Dragon*, stated on Bloomberg Television that China "brazenly has released this China 2025 plan that basically told the rest of the world, 'We're going to dominate every single emerging industry of the future, and therefore your economies aren't going to have a future'."

Trump's own statement of June 15 announcing a possible tariff of 10% on $200B of Chinese goods stated right off the bat that "these tariffs are being imposed to encourage China to change the unfair trade practices … with respect to technology and innovation." Indeed, the majority of the products captured under the first round of tariffs are associated with the MIC2025 segments.

In response, China has said that criticisms from the U.S. and EU are hostile to the initiative as it moves China to become a direct, value-add competitor. Additionally, there is a desire in China to become more self-reliant. The recent story of ZTE Corp. (0763 HK) is an excellent example as to why.

A real threat?

Top-down initiatives have come and gone with varying degrees of success or failure during China's modern history.

MIC2025 sounds impressive, comprehensive, and even commercially threatening, depending on one's point of view. The reality may be somewhat different, however. MIC2025 was conceived at the top. Top-down initiatives have come and gone with varying degrees of success or failure during China's modern history. Implementation is via local governments and then via companies, who would apply for funds.

The National Manufacturing Advisory Committee, which advises the Chinese government, published a report outlining problems with the implementation of the plan. The report found that: many local governments simply rebranded existing policies to show adherence; development targets are set too low; local government policies are not market-oriented as they are reluctant to take risks; project approval is lengthy; and there is a lack of coordination among local governments with many choosing similar industries to support, perhaps leading to overcapacity.

Separately, the *South China Morning Post* reported that one city gave 10% of its MIC2025 budget to a company to set up a new "smart" liquid milk tea factory[3]—hardly global economic leadership.

[3] Is Beijing going back to the future with its much-hyped 'Made in China 2025' plan? *South China Morning Post*, July 10, 2018.

Going forward

The base case is that the U.S. will press on with further measures against China sometime soon, even though one might question the actual threat posed by MIC2025. That these developments come as the U.S. approaches the midterm elections in November is noteworthy. They are also in line with a U.S. administration that is increasingly turning away from the rest of the world under the auspices of getting a better deal.

Most recently, China has stated that it will respond to the second round of U.S. tariffs with another set of its own tariffs, ranging from taxes of 5% to 25%, on another $60B of U.S. goods. There are minimal negotiations at present between the two sides. The trade war could take shape. Consequently, we believe China and Hong Kong equities will remain under pressure, although we suspect that much of the damage has already been done to stock prices.

Global equity

Support system

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The second-quarter earnings season has been a good one—reported earnings so far have mostly exceeded analysts' estimates as has top-line revenue growth. Managements' upbeat guidance suggests there is more to come. For the most part, this has been true across the developed economies.

Of course, it's not yesterday's earnings an investor is paying for. Rather it's the present value of all future profits of which the two biggest "psychological" components are next year's expected earnings and the growth rate they represent. In turn, the two factors that boost (or diminish) confidence in those forward expectations are the latest quarter's results coupled with management guidance about the future.

On all those counts, most developed country stock markets are enjoying a constructive outlook. As noted, quarterly earnings are strong and management optimism suggests next year's robust earnings estimates are makeable.

Along the way, there have also been some notable reporting disappointments, prominently among the formerly high-flying social media stocks. Those below-expectation results produced eye-watering paper losses, measured from recent price peaks, which have made for sensational headlines. But the impact on the broad stock averages has been comparatively muted, while the consequences for the economy of Facebook, for example, experiencing a big earnings shortfall will be pretty close to zero.

Equity views

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

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

Other concerns are taking a great deal of investor attention and energy—trade disputes are foremost among them (see "Thorny trade routes" on page 4). We think the new global trade landscape won't be truly discernible before next year nor will its true impact on global growth. Meanwhile, what is much more certain is that there will continue to be considerable fiscal stimulus arriving in support of every major economy. In the U.S., the Congressional Budget Office estimates that will have totaled about $250B this year with another $450B arriving in 2019. In Europe, most countries have shifted from austerity to stimulus, while China is easing credit conditions and encouraging new infrastructure spending.

While all this largesse points to sustained global GDP growth next year, it also makes it likely central banks, led by the Federal Reserve, will go on gradually tightening credit conditions. Eventually credit will become expensive enough and scarce enough to produce an economic and earnings downturn. That time has not arrived. We continue to recommend a moderate Overweight commitment to equities in a global portfolio.

Global equity

Regional highlights

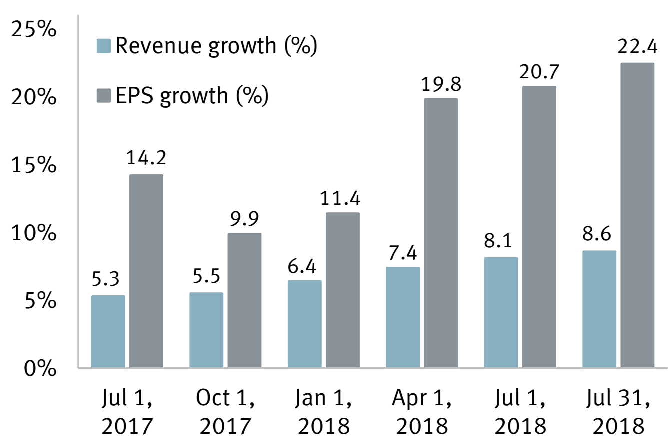
United States

- Amid ongoing tariff and foreign policy fireworks, U.S. equity investors seem focused on domestic economic and corporate profit trends—just as they should be. Strength in both has pushed the S&P 500 to the high end of its multi-month range.
- The U.S. economy grew at a 4.1% annualized rate in Q2 mainly due to strong consumer spending on the heels of tax cuts and robust job growth, and increased export activity generated by tariffs both real and threatened. That's the fastest growth rate in almost four years and brings the four-quarter average to just under 3.0%, ahead of the sluggish 2.3% pace since the recovery began in 2009. While economic momentum should cool in Q3, at this stage RBC Capital Markets anticipates economic growth could reach 3.8%.
- There are also signs that profits will remain strong in the second half of 2018, although consensus estimates have not increased. Q2 revenue growth is pacing above 8% y/y for the third straight quarter and could challenge that level in Q3. While some executives cautioned that tariff headwinds could constrain earnings if they blow harder, more seem focused on the slight drag that the strong dollar could create. Solid earnings and economic growth prospects support our constructive view on U.S. equities.

Canada

- Trade policy remains a source of considerable uncertainty for Canada. The U.S. administration has threatened to levy import tariffs of 25% on automobiles and 10% on auto parts in response to what it views as unfair trade practices. RBC Economics estimates the threatened tariffs would present a 0.5% hit to Canadian GDP. Given the concentrated nature of the Canadian automotive manufacturing industry in Southern Ontario, we believe any imposition of U.S. auto import tariffs would pose a high risk of spillover impacts to the local employment and housing markets.
- RBC Capital Markets adopted a more cautious outlook on the Canadian banks in light of its forecast for slowing asset growth, modestly rising credit provisions, and moderating

Q2 EPS and revenue growth estimates



Source - RBC Wealth Management, Thomson Reuters I/B/E/S

Second-quarter corporate profits and revenues are continuing their trends higher, a positive signal as we head farther into the second half of the year.

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efficiency gains. Because of this and the risks posed by housing and trade policy, RBC Capital Markets no longer expects valuation expansion from Canadian banks and has lowered its median target multiple by 0.5x to 11x forward earnings. This shift to a more cautious stance aligns with our recommendation for a modest Underweight allocation to the banks.

- Positive supply and demand fundamentals have led RBC Capital Markets' commodity strategists to increase their WTI crude oil forecast to an average of $68 per barrel in 2018 (from $63) and $76 in 2019 (from $65). Challenged producers, limited OPEC spare capacity, and a lack of new investment in long-cycle projects should keep supply in check while global economic growth continues to stoke demand. The forecast upside for Canadian heavy oil producers is blunted by the expectation that higher crude-by-rail transportation costs will drive deeper discounts for heavy barrels over the forecast horizon.

Continental Europe & U.K.

- Prime Minister Theresa May's new vision for post-Brexit Britain provoked acute political upheaval in the U.K. in July. She now seeks a much closer arrangement with the EU mostly in terms of trade for goods. The proponents of a "hard" Brexit, or clean break with the EU, were angered by such proposals and this reintroduced in markets the possibility May could face a party leadership challenge in the coming months. It also raised the question, again, of what kind of Brexit might be implemented as well as the prospect of a Labour government.
- Political risk is likely to culminate in the autumn when negotiations come to a head. October is the self-imposed deadline for a Brexit deal to be approved by the EU Council and signed off by the EU Parliament. While that deadline could slip, parliaments of the various EU countries would still need to vote on the proposal ahead of the U.K. exiting the EU on March 29, 2019. The risk of an uncoordinated Brexit that would hurt the economy remains, though the probability of a soft Brexit is probably higher and remains our base-case scenario.
- Against this backdrop, U.K. Equities moved within a tight range in July and the FTSE All-Share is roughly flat year to date. We are Market Weight the U.K. where relative value has emerged. We prefer international companies given Brexit risks to the economy, and we find good value in Energy and Financials.
- With evidence European economic growth is plateauing, we maintain our Market Weight for Europe given valuations that appear to be closer to fair value. We continue to prefer core markets to the periphery.

Asia

- Asian equities stabilized in July as the market continued to digest the ongoing trade dispute between the U.S. and China. The MSCI AC Asia Pacific Index is down 4.7% in 2018.
- While it is possible that trade negotiations resume and end well, this is an unlikely event in the short term, in our view. There is a good chance the U.S. will implement further tariffs on Chinese (and other countries') goods. The Chinese currency has weakened somewhat

Chinese yuan to U.S. dollar exchange rate

As trade tensions continue and further escalations become more likely, the Chinese yuan continues to weaken against the U.S. dollar.

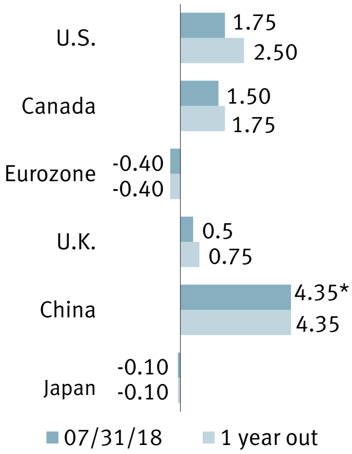
Source - RBC Wealth Management, Bloomberg

to over USDCNY6.83. RBC Capital Markets forecasts it to soften further into 2019 and go through 7.0.

- Equities in China and Hong Kong have been weak. In addition to trade issues, financial deleveraging has been gathering pace in China as the government has attempted to reduce riskier debts. This has created tighter financial conditions and, in turn, potential risks for the economy. However, the government has tried to diminish these headwinds by introducing a package of monetary and fiscal measures at the end of July.
- We continue to prefer Japanese equities among the major Asian markets. The popularity of Prime Minister Shinzo Abe has been on the rise again after taking a hit due to domestic scandals. This boosts Abe's chances of winning next month's Liberal Democratic Party leadership election that is held every three years. We believe his re-election would be viewed positively by investors.

This not so "silly season"

Central bank rate (%)



*1-yr base lending rate for working capital, PBoC
Note: U.K. interest rate shown does not reflect change by BoE on 8/2/18.
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management

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The "silly season," also known as the "dog days of summer," refers to late summer often typified by a slow news cycle and a preponderance of frivolous news stories. It can take on added meaning in an election year—U.S. midterm elections occur in November. With much of the electorate typically focused on summer activities, candidates are seemingly freer to rely on political posturing and hyperbole to garner media attention in the hopes of padding their election coffers.

Current events however are anything but silly and could continue roiling markets well into the fall. Central banks are becoming more attuned to the potential impact from a trade war on their respective economies, and this could ultimately impact how aggressive they can be with future policy actions. The longer trade issues simmer, though, the more likely this uncertainty leads to economic forecasts being reduced.

Recently, however, trade concerns haven't been enough to alter global monetary policy. The Bank of England raised rates last month, the Bank of Japan only introduced minor tweaks to its bond purchase program, and the Federal Reserve is still on track for another rate hike in September after holding steady earlier this month.

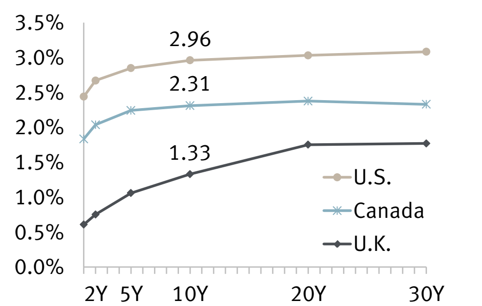
Fixed income investors, in our view, should continue to take advantage of selective opportunities; our regional experts provide their best thoughts below.

Fixed income views

Region	Gov't Bonds	Corp. Credit	Duration
Global	–	+	5–7 yr
United States	–	+	7–10 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

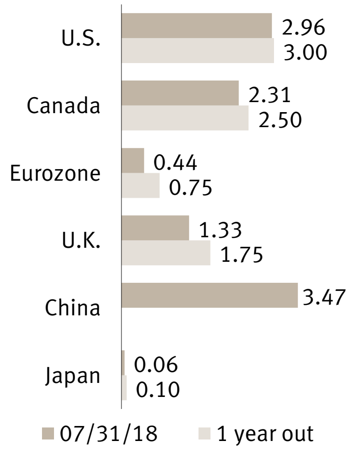
Regional highlights

United States

- As expected, the Federal Reserve left rates unchanged at 1.75%–2.00% during its August meeting, though we believe a September rate hike was all but confirmed. The meeting statement itself was uneventful, but the minutes that will be released later this month could attract more interest than usual as the market looks for language similar to Fed Chair Jerome Powell's "For now" comments from his congressional testimony that indicated the Fed may

Global fixed income

10-year rate (%)



Note: Eurozone utilizes German Bunds
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management

take a pause from hiking rates in the near future. Markets have yet to fully price in a fourth hike in 2018 despite the Fed's current forecasts, and in our view the Fed will hike just once more this year, with the spread between 2- and 10-year yields acting as a headwind at just 32 basis points.

- Investment-grade corporate bonds snapped their losing streak against Treasuries in July, outperforming government bonds by 1.35%. That produced tighter credit spreads (i.e., the yield compensation for credit risk) over Treasuries. The yield differential had reached a two-year high of 1.24% in June, but rallied back strongly to 1.09% as investors put money back to work into the corporate sector following significant fund outflows at the start the year. We expect corporate bond prices to continue to chip away at first-half losses over the remainder of the year.

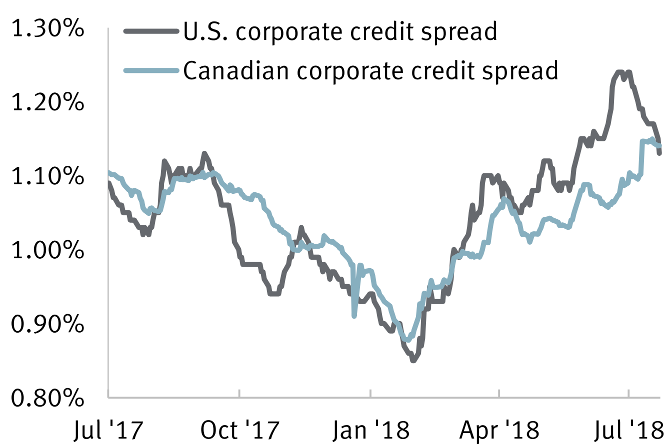
- Value left the muni market in July as the ratio of muni bond yields to comparable Treasury yields fell across the curve. At the front end, the ratio of 2-year munis to Treasuries is now just 61%, the lowest since 2014. At the long end, the 30-year ratio is now 98.7%, still below average, but north of the 2016 low of 90%. While value has mostly disappeared in muni markets, the curve is getting particularly richer at the front end.

Canada

- The Bank of Canada lifted the overnight lending rate 25 basis points in July, to 1.50%, which was largely expected after the release of its *Business Outlook Survey*. According to the survey, businesses continue to have confidence in the outlook for sales, investment and the labour market. Expectations for inflation have increased, reflecting businesses bumping up against capacity constraints as well as increasing trade policy uncertainty.

- Our focus remains squarely on short to intermediate maturities for two reasons. First, there is minimal compensation for investors in the longer end of the curve, in our view. Second, we believe that the BoC will continue its slow and incremental approach to removing monetary stimulus even though inflation is at target. This could lead to upward pressure in longer-dated yields.

Credit spreads converge as Canadian corporates underperform



U.S. investment-grade bonds broke their losing streak against Treasuries while Canadian credit extended losses.

Source - RBC Wealth Management, Bloomberg; data through 7/24/18

- Canadian corporate credit underperformed in July as spreads widened while U.S. equivalents experienced the opposite. Despite the spreads widening in Canada, they remain close to historical lows, and we think upgrading credit quality should be at the top of investors' priorities as we edge closer towards the end of the cycle.
- Preferred share prices moved modestly higher as a higher GoC 5-year yield helped boost the heavyweight rate-reset segment of the market. Our long-standing view of recommending an active approach to investing in preferred shares remains, and we are positive with a slightly defensive tilt.

Continental Europe & U.K.

Europe

- It remains our view that even when the European Central Bank's purchases of new bonds are completed at the end of 2018, its continued reinvestment of maturing bonds will provide support to the market. Unlike in the U.S., where the Federal Reserve is actively selling assets acquired under its quantitative easing programme, the ECB does not intend to make such sales for the foreseeable future. This should give European bond investors some level of comfort that yields should remain range-bound.
- European corporate credit has sold off in recent months; however, we think spreads against government yields should narrow unless the political backdrop comes under increased and sustained pressure.

U.K.

- With respect to U.K. fixed income, we prefer to focus on the macroeconomic backdrop rather than second-guess where volatile political currents will head next and what the eventual Brexit outcome will be.
- Headline inflation has stalled at 2.4%, short of market expectations, suggesting the inflation impulse from post-referendum currency weakness is abating. This did not deter the Bank of England from unanimously raising rates another 0.25% to 0.75% and providing a slightly more hawkish tone of ongoing monetary tightening over the Bank's forecast period to bring inflation back towards its 2% target.
- Our expectation is for the 10Y Gilt to trade closer to 1.75% by the year end, up from 1.33% currently. We are Underweight Gilts. We prefer U.K. corporate issuers to Gilts, especially those less impacted by the U.K.'s trading relationship with the EU. Industrials currently offer improved value having repriced, and we like subordinated bonds from non-U.K. banks. We prefer A-rated credits which currently offer a decent yield pick-up from AA paper.

Gasoline prices: More than meets the eye

In April, the average gallon of gasoline (all grades) in the U.S. crossed the $3.00 mark. It has been long thought that consumer sentiment towards gas consumption begins to shift around these levels, a view shared by RBC Capital Markets. By the end of June, gas had risen to $3.14 per gallon, a 26% y/y increase. Prices stayed at that level through most of July.

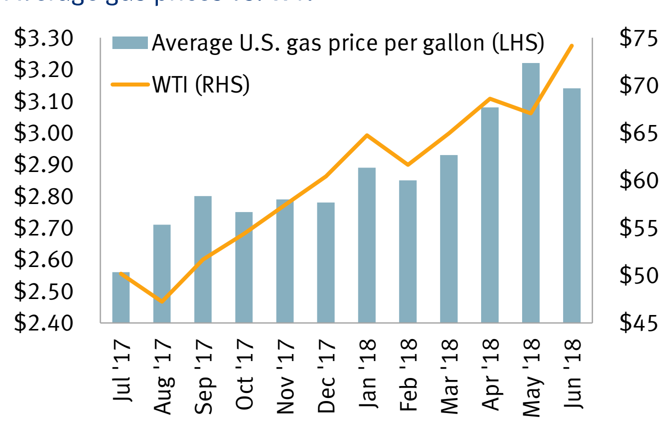
Consumers are often considered to be "price takers" when it comes to gas consumption due to their relatively inelastic demand—meaning in the short run, demand doesn't change much regardless of whether prices move up or down; consumers are generally willing to pay the market price. In that sense, changes in gasoline prices act like a tax increase when they rise, reducing a household's income available to spend on other goods, or leaving them flush with available cash when they fall.

But crude oil's relationship to gasoline prices is not always that straightforward. For example, in July when oil prices weakened in response to Libya's plan to ramp up crude production, gasoline prices also retreated fractionally; however, the magnitude was less than proportional to the decline in crude. Why? Gasoline is a refined product—its production entails other costs than solely the price of crude. In particular, refining capacity can play a key role in determining gasoline prices, especially on a regional or country basis.

As it stands, U.S. refineries are running at near 94% of capacity, very close to their maximum practicable output according to RBC Capital Markets. In other words, even if additional barrels of oil were to come to market, it would not necessarily translate to cheaper prices at the pump because refineries are already running close to maximum throughput.

In our view, the sustainability of higher gas prices is more a question of refiners' ability to absorb incremental barrels of crude as opposed to the supply of crude itself. Until we see an uptick in net new refiners or an upgrade in production capabilities of existing refineries, we believe consumers will have to adjust to a higher-priced gas environment in the near to medium term.

Average gas prices vs. WTI



Gas prices tend to tick higher as crude prices rise, but there's more than meets the eye ...

Source - RBC Wealth Management, Bloomberg; data through 6/29/18

Commodity forecasts

	2018E	2019E
Oil (WTI $/bbl)	67.77	75.91
Natural Gas ($/mmBtu)	3.00	2.85
Gold ($/oz)	1,307	1,300
Copper ($/lb)	3.24	3.25
Corn ($/bu)	3.91	4.06
Wheat ($/bu)	4.90	5.00

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

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Currency forecasts

Currency pair	Current rate	Forecast Jun 2019	Change*
Major currencies			
USD Index	94.55	95.94	1%
CAD/USD	0.76	0.79	4%
USD/CAD	1.30	1.26	-3%
EUR/USD	1.16	1.16	0%
GBP/USD	1.31	1.25	-5%
USD/CHF	0.99	1.07	8%
USD/JPY	111.8	119.0	6%
AUD/USD	0.74	0.72	-3%
NZD/USD	0.68	0.71	4%
EUR/JPY	130.7	138.0	6%
EUR/GBP	0.89	0.93	4%
EUR/CHF	1.15	1.24	8%
Emerging currencies			
USD/CNY	6.81	7.20	6%
USD/INR	68.5	69.00	1%
USD/SGD	1.36	1.37	1%

* 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: Room to run – Rising price pressures prompted the Federal Reserve to raise its key interest rate in June. It also signaled it might raise rates twice more this year, one more than expected. This provides some scope for the dollar to gain modest upward traction through year end. However, as the growth thrust from tax cuts fades, the cautious normalization of U.S. rates against a backdrop of tighter policy in other advanced economies could see dollar strength dim through 2019.

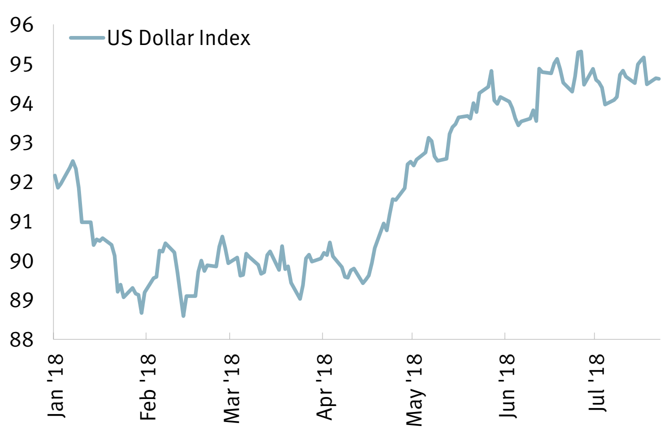
Euro: Low for longer – A reprieve from political flare-ups brought some relief to the euro downtrend seen since April, although renewed downward pressures could prevail, in our view. With the European Central Bank signaling that policy rates will likely remain at current levels at least through summer 2019, widening rate differentials with the U.S. could keep the euro under pressure through year end.

British pound: Political pressure – Signs that the U.K. economy is shaking off its earlier weather-led slump failed to bring relief to the British pound, with the currency sinking to a 10-month low against the dollar in July. Renewed political frictions or a breakdown in negotiations around finalizing the U.K.'s exit from the European Union could prompt a further decrease, in our view. Those risks underpin our expectation that the currency could slip below 1.30 against the U.S. dollar through year end.

Canadian dollar: Rates trump trade – The Canadian dollar found its footing against the U.S. dollar in July, although it remains close to the 12-month lows seen in June. Firm economic data teed up for a July interest rate hike from the Bank of Canada, with rising market optimism providing relief to the currency. Rising wages and an economy close to capacity could support another rate increase this year, although the potential for renewed bouts of trade tension could keep the currency on the defensive.

Japanese yen: A safe haven? – The Japanese yen fell by close to 8% against the dollar over April to July despite trade tensions escalating. Interest rate divergence with the U.S. can explain part of that move and with the Bank of Japan dampening expectations for a material shift in monetary policy, we remain cautious on the outlook for the yen.

U.S. dollar uptrend has slowed, although still see scope for gains



Rising rate differentials should be supportive of further dollar gains in 2018.

Source - RBC Wealth Management, Bloomberg; data through 7/24/18

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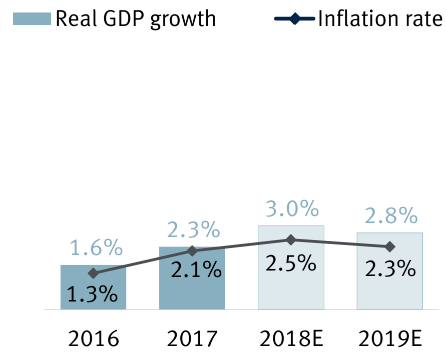
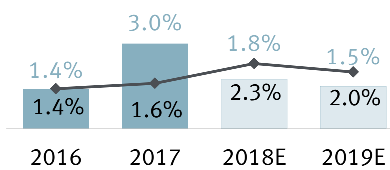
Key forecasts

United States — 4%+ GDP growth



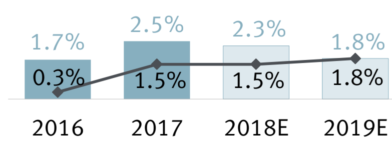
- Initial estimate of Q2 GDP at 4.1%, led by a 4% increase in consumer spending. H2 growth estimates not as robust. Housing data slowing as wage growth not enough to offset the effect of higher home prices and higher mortgage rates. The pace of hiring remains above 200K new monthly hires, unemployment rate jumped to 4% for June due to an increase in labor force participation. Both consumer and business sentiment have begun to slide amid trade worries, although still at historically elevated levels.

Canada — BoC raises rates



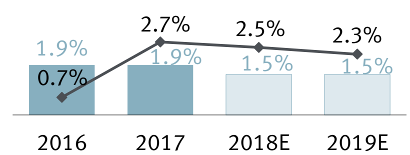
- GDP growth went from anemic 0.1% in March, to 0.3% in Apr., to robust 0.5% in May, led by increased mfg. activity and better-than-expected retail sales. The BoC raised overnight rate by 0.25% to 1.50% amidst resilient economy and core inflation at 2% target. Unemployment rate ticked up to 6.0% in June despite strong employment report. Wages continue to grow at above inflation rate of 3.5%. New homebuilding activity rebounding after slow start to 2018.

Eurozone — ECB holds rates



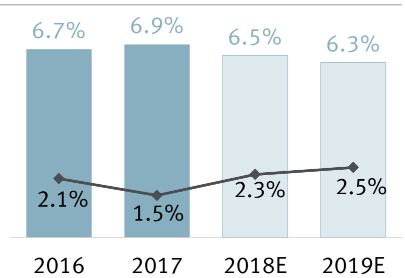
- Eurozone area PMIs halted the recent retreat as industrial production rose to 2.4% y/y in May from 1.7% y/y in Apr. The ECB held policy rates unchanged and is expected to stay at 0.0% until at least summer 2019. The ECB reiterated its guidance for asset purchases to be halved to €15B in Sept., the latest step towards taking quantitative easing to zero.

United Kingdom — Inflation easing



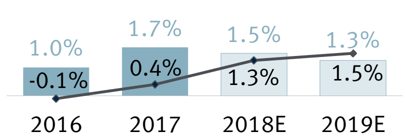
- The BoE hiked rates amidst labor market tightness, with unemployment at just 4.2% (3-month avg. ending May). Core inflation pressures eased more than expected, decelerating to 1.9% y/y in June from 2.1%, and no more rate hikes are likely in 2018. Retail sales growth slowed to -0.5% m/m from 1.4%, and industrial production declined again, -0.4% m/m.

China — Slowing down



- Economic growth slowed to 6.7% q/q annualized in Q2, the slowest pace since 2016, as government efforts to curb lending take hold. Fixed asset investment decelerated to 6.0% y/y in June from 6.1% and industrial production fell to a pace of just 6.0% y/y. The ongoing trade dispute with the U.S. clouds the growth outlook, with the trade surplus reaching $28.97B in June alone.

Japan — Easy policy



- The BoJ left rates unchanged and reaffirmed ultraloose monetary policy will continue well into the future, after core inflation disappointed at 0.7% y/y in June. Labor market remains strong despite uptick in the jobless rate to 2.4% from 2.3%, although wages have yet to fuel inflation. Retail sales recovered, rising 1.5% m/m as consumption improved late in Q2.

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

Market scorecard

Index (local currency)	Level	1 month	YTD	12 month
S&P 500	2,816.29	3.6%	5.3%	14.0%
Dow Industrials (DJIA)	25,415.19	4.7%	2.8%	16.1%
NASDAQ	7,671.79	2.2%	11.1%	20.9%
Russell 2000	1,670.81	1.7%	8.8%	17.2%
S&P/TSX Comp	16,434.01	1.0%	1.4%	8.5%
FTSE All-Share	4,253.31	1.2%	0.7%	5.1%
STOXX Europe 600	391.61	3.1%	0.6%	3.6%
EURO STOXX 50	3,525.49	3.8%	0.6%	2.2%
Hang Seng	28,583.01	-1.3%	-4.5%	4.6%
Shanghai Comp	2,876.40	1.0%	-13.0%	-12.1%
Nikkei 225	22,553.72	1.1%	-0.9%	13.2%
India Sensex	37,606.58	6.2%	10.4%	15.7%
Singapore Straits Times	3,319.85	1.6%	-2.4%	-0.3%
Brazil Ibovespa	79,220.43	8.9%	3.7%	20.2%
Mexican Bolsa IPC	49,698.01	4.3%	0.7%	-2.6%
Bond yields	**7/31/18**	**6/29/18**	**7/31/17**	**12 mo. Chg**
US 2-Yr Tsy	2.669%	2.528%	1.349%	1.32%
US 10-Yr Tsy	2.960%	2.860%	2.294%	0.67%
Canada 2-Yr	2.069%	1.914%	1.316%	0.75%
Canada 10-Yr	2.310%	2.168%	2.057%	0.25%
UK 2-Yr	0.772%	0.724%	0.269%	0.50%
UK 10-Yr	1.330%	1.278%	1.230%	0.10%
Germany 2-Yr	-0.570%	-0.665%	-0.680%	0.11%
Germany 10-Yr	0.443%	0.302%	0.543%	-0.10%
Commodities (USD)	**Price**	**1 month**	**YTD**	**12 month**
Gold (spot $/oz)	1,224.09	-2.3%	-6.1%	-3.6%
Silver (spot $/oz)	15.52	-3.7%	-8.4%	-7.8%
Copper ($/metric ton)	6,279.25	-5.2%	-12.9%	-0.9%
Uranium ($/lb)	25.85	13.9%	8.2%	28.9%
Oil (WTI spot/bbl)	68.76	-7.3%	13.8%	37.1%
Oil (Brent spot/bbl)	74.25	-6.5%	11.0%	41.0%
Natural Gas ($/mmBtu)	2.78	-4.9%	-5.8%	-0.4%
Agriculture Index	296.23	3.7%	5.0%	0.5%
Currencies	**Rate**	**1 month**	**YTD**	**12 month**
US Dollar Index	94.5540	0.1%	2.6%	1.8%
CAD/USD	0.7688	1.0%	-3.4%	-4.1%
USD/CAD	1.3006	-1.0%	3.5%	4.2%
EUR/USD	1.1691	0.1%	-2.6%	-1.3%
GBP/USD	1.3124	-0.6%	-2.9%	-0.7%
AUD/USD	0.7424	0.3%	-4.9%	-7.2%
USD/JPY	111.8600	1.0%	-0.7%	1.5%
EUR/JPY	130.7900	1.1%	-3.3%	0.2%
EUR/GBP	0.8909	0.7%	0.3%	-0.6%
EUR/CHF	1.1579	0.1%	-1.1%	1.1%
USD/SGD	1.3615	-0.1%	1.9%	0.5%
USD/CNY	6.8168	3.0%	4.8%	1.3%
USD/MXN	18.6469	-6.3%	-5.1%	4.8%
USD/BRL	3.7574	-3.1%	13.6%	20.2%

The Tech-heavy NASDAQ has underperformed following Facebook's earnings miss.

The yield curve continues to flatten as short-term Treasury issuance rises.

Crude oil fell as production from the Permian Basin in the U.S. surged.

The yen weakened after the Bank of Japan extended its ultraloose monetary policy.

Equity returns do not include dividends, except for the 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 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -4.1% return means the Canadian dollar has fallen 4.1% vs. the U.S. dollar during the past 12 months. USD/JPY 111.86 means 1 U.S. dollar will buy 111.86 yen. USD/JPY 1.5% return means the U.S. dollar has risen 1.5% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 7/31/18.

Research resources

This document is produced by the Global Portfolio Advisory Committee within RBC Wealth Management's Portfolio Advisory Group. The RBC Wealth Management Portfolio Advisory Group provides support related to asset allocation and portfolio construction for the firm's investment advisors / financial advisors who are engaged in assembling portfolios incorporating individual marketable securities. The Committee leverages the broad market outlook as developed by the RBC Investment Strategy Committee, providing additional tactical and thematic support utilizing research from the RBC Investment Strategy Committee, RBC Capital Markets, and third-party resources.

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