RBC WEALTH MANAGEMENT
Global Insight Weekly

A closer look

Pass the baton

Kelly Bogdanov – San Francisco

While we still like the prospects for the long-term U.S. bull market, we think it's time investors expand their worldview. European equities are getting their groove back, so we're throttling back a bit on U.S. equities in favor of more attractive opportunities elsewhere.

We are curbing our enthusiasm for the U.S. market by shifting our rating down to Market Weight (benchmark) from Overweight.

This would mean rebalancing investment portfolios by moderately trimming exposure of U.S. equities, particularly in positions that have grown to above-normal levels, and passing the baton to other markets.

World of opportunity

Our primary consideration involves improved opportunities elsewhere, balanced with the fantastic run in U.S. stocks since last summer.

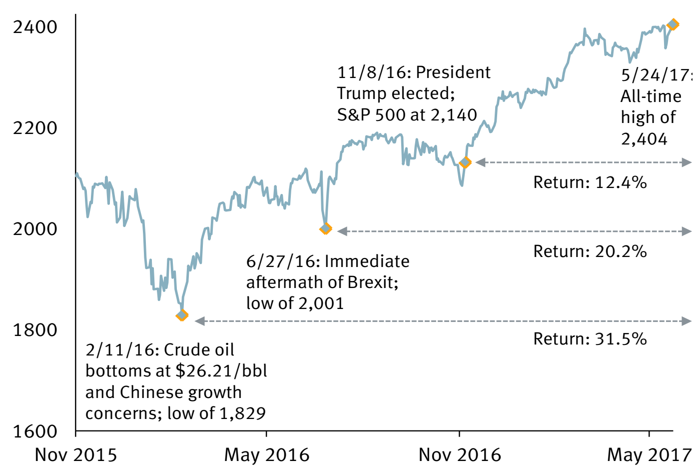
As the global economy showed initial signs of improvement, the S&P 500 began to take off. Following the election, it pushed even higher. It has rallied 20% since last June—two years of gains in less than one year—and even more since last February (see chart).

We anticipate returns for the S&P 500 and Dow Jones Industrial Average will be more muted in the next year and these indexes could even experience normal 5%–10% pullbacks—par for the course.

At the same time, we see attractive opportunities in other markets, particularly in Europe.

We recently upgraded European equities to Overweight from Market Weight as political risks have receded and fundamentals have improved. Europe's prospects look brighter to us than they have for quite some time. We think it has the potential to reverse years of underperformance.

The S&P 500 has moved rapidly off recent lows, assisting in the downgrade



Source - RBC Wealth Management, Bloomberg; daily data through 5/24/17

Market pulse

Escape velocity elusive

Another important motivation for our downgrade relates to U.S. economic momentum.

Stubbornly low Treasury yields combined with a flatter yield curve and further declines in the U.S. dollar may be telling investors that something is lacking.

It now seems more likely U.S. GDP growth could persist at a subpar rate of about 2.2% in the next 6–12 months rather than accelerate because pro-growth legislative catalysts have dimmed amid ongoing controversies related to President Trump and his campaign.

Thus far, the equity market has ignored the five formal congressional inquiries into the Trump team, aside from the one-day "Comey memo" dip roughly a week ago. However, the Department of Justice's special counsel appointment and its broad investigative mandate ensure these issues will not go away anytime soon. As the investigations intensify, there is a risk consumer and/or business confidence could weaken and congressional motivation to support the president's pro-growth agenda could wane further, especially in the Senate.

Subpar GDP growth of around 2% is not necessarily "bad" for the U.S. market. After all, the S&P 500 has surged more than 250% since 2009 during such a muddle-through phase. In 2018, the continuation of the subpar trend would likely mean "good" high single-digit S&P 500 earnings growth rather than "great" double-digit growth and a slow-moving Fed—that's not so bad and would support the continuation of the bull market.

But with other major developed economies finally gaining momentum and showing potential to improve, we believe there are attractive investment opportunities elsewhere that should not be ignored.

The valuation question

Our third main reason for the downgrade is there is less room for error with the S&P 500's elevated valuation at 21x trailing 12-month earnings and 17.9x the forward consensus estimate.

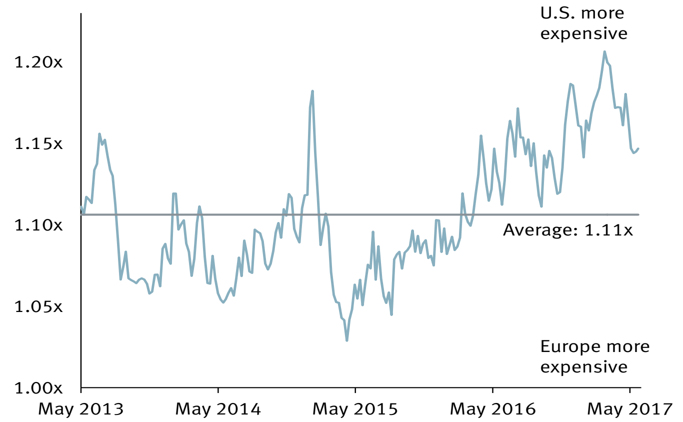
We concede price-to-earnings ratios could drift higher given the bull market can persist as long as the U.S. avoids a recession and the Fed doesn't hike rates too high, too fast—neither of which seem likely in the next 12–18 months, at least. RBC Capital Markets' work indicates multiples expand 60% of the time in the middle and late cycle periods. But the "easy" valuation expansion seems to be behind us.

Two bulls are better than one

By no means should the shift to Market Weight be construed as a negative call on U.S. equities. We remain constructive on the market's long-term prospects. Companies' potential earnings power and leadership positions in multiple industries still warrant meaningful investments at the benchmark level.

Valuations show U.S. equities are more richly valued against their European peers

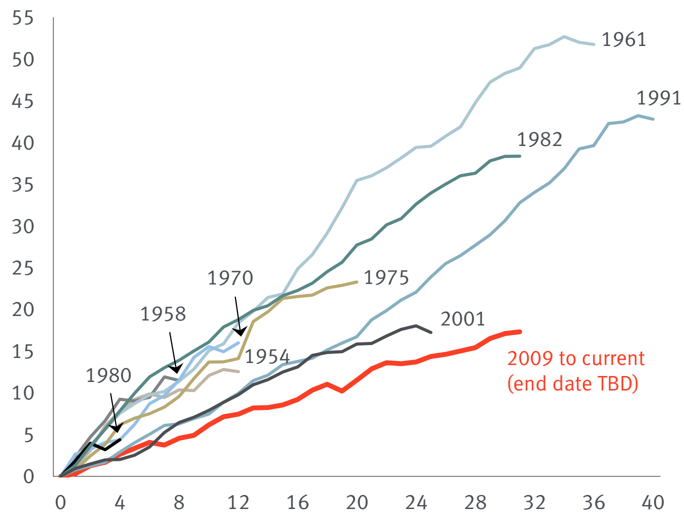
Forward P/E ratio of the S&P 500 against the STOXX Europe 600



Source - Bloomberg

This is a long-lasting, but slow-growing recovery

Percent U.S. cumulative GDP growth during each recovery cycle since WWII (dates represent beginning of recovery)



Source - RBC Wealth Management, St. Louis Federal Reserve; quarterly data through 4/28/17

We continue to believe the U.S. secular (long-term) bull market remains intact. None of our recession indicators are flashing red, or even yellow for that matter. This long period of GDP growth seems likely to persist, we just doubt it will accelerate to a normal 3% or so pace.

We think the U.S. market could cool off over the next 6–12 months rather than sprint at the fast pace of the past year, and more exposure to Europe is warranted.

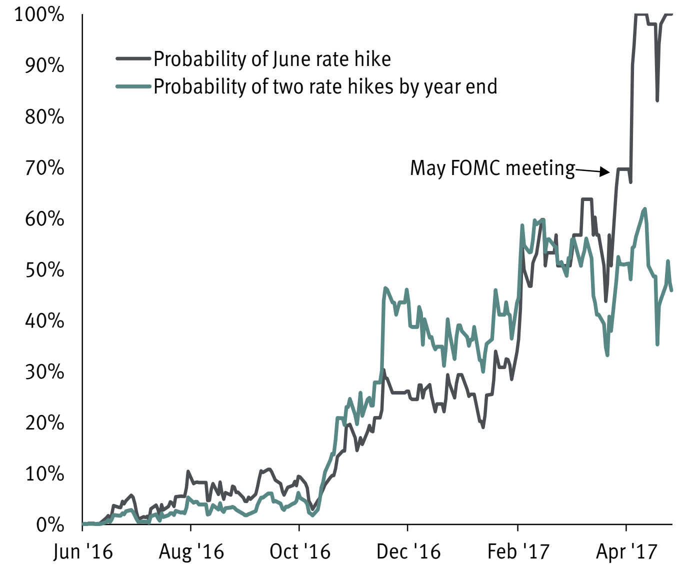
It's time to pass the baton.

United States

Bill Kuehn & Sam Renikoff – Minneapolis

- The Federal Open Market Committee's May meeting minutes showed that the **Fed is willing to look past the soft Q1 GDP** reading and weak inflation data, which officials deemed "transitory," leaving a **June rate hike firmly on the table**. Although some officials expressed concerns over easing core inflation pressures, others pointed to a weaker dollar as a potential driver of price growth going forward.
- The Fed **laid the groundwork for unwinding its $4.5T balance sheet**, proposing an implementation of caps on the amount of securities that would be allowed to mature without reinvestment on a monthly basis. The cap would carry a 3-month time horizon and would gradually rise toward the Fed's estimated "fully phased-in" level, until the balance sheet is reduced to its desired target, which Fed officials have estimated to be in the range of $2.5–$2.7T.
- **Compensation for credit risk continues to dissipate**, with yields on BB-rated credits just 69 basis points (bps) higher than BBB-rated credits, and yields on BBB credits just 57 bps higher than A-rated credits—which are 3- and 6-year lows, respectively. **The upside to riskier corporate credit appears to be fully priced into valuations**, as strong underpinnings of the U.S. economy and rising corporate earnings are represented in falling bond yields, but rising corporate leverage is not. In our view, investors should take a safer approach when putting money to work, and **we favor interest rate risk** over credit risk in the form of investment-grade corporate credits, where yields are currently above their 5-year averages.
- **The pace of both new and existing-home sales fell** in April, with new home sales falling a staggering 11.4% m/m in April despite declining mortgage rates during the month. The issue continues to be a **lack of available supply**. The current level of available inventory would be depleted in 4.2 months at the current pace—with less than five months of supply considered to be a **tight home market** by realtors.

Market sees June hike, less convinced for later this year



Source - RBC Wealth Management, Bloomberg; data through 5/25/17

Canada

Alicia Buckiewicz & Farazeh Mahboob – Toronto

- **The Bank of Canada** (BoC) kept its **rates on hold and reiterated uncertainties** outlined in the April Monetary Policy Report, namely U.S. tax and trade policy as well as high household debt levels, which continue to "cloud the global and Canadian outlooks." This statement was in line with our expectations and **reinforces our view that the BoC is likely to keep interest rates unchanged this year**. The press release accompanying the decision noted "ongoing excess capacity" in the economy upon review of the current inflation rate and subdued wage growth. While this comment remains cautionary, it is less so than previous releases.
- **OPEC extended oil production cuts** of roughly 1.8 million barrels per day for nine more months through March 2018. The agreement was struck after last year's arrangement failed to eliminate the global oversupply or achieve a sustained price recovery. **However, the S&P/TSX Energy Index and crude oil prices fell approximately 3%** in the wake of the announcement, which suggests the extension was already anticipated by the market.
- **Q2 Canadian bank earnings** have so far been generally positive. **Credit quality remains strong** with provisions for credit losses at most banks coming in below consensus expectations. The banks remain **well capitalized**, although a few reported lower CET1 ratios, which was partially due to higher stock repurchases. There have been **no signs of a slowdown in domestic mortgage growth**, but recent developments in the Canadian housing market could be a headwind going forward.
- Despite a moderate slowdown expected in North American auto sales and production this year, the **Canadian auto suppliers still anticipate positive earnings growth**. There has been a market shift towards more trucks and SUVs, which typically carry more content than cars. The global push towards fuel efficiency could also have a positive impact on margin levels, while operations in Europe and Asia provide some level of diversification. RBC Capital Markets sees the Canadian auto suppliers as **undervalued relative to global peers**.

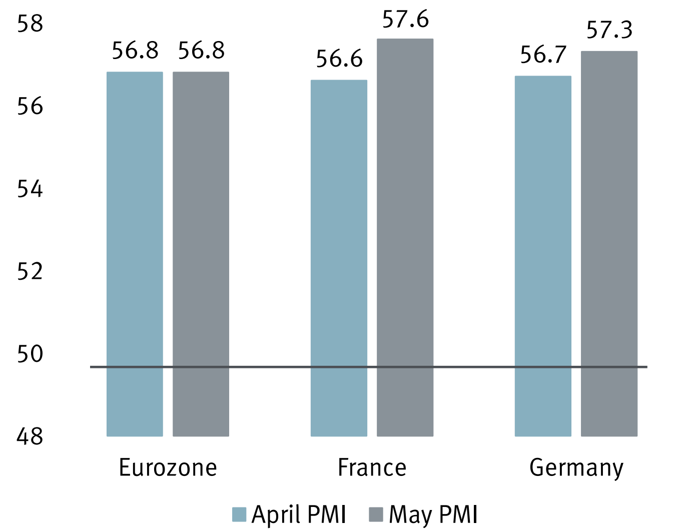
Europe

Frédérique Carrier & Thomas McGarrity – London

- **Economic news in Europe** continues to be **encouraging**. The May composite Purchasing Managers' Index (PMI) was unchanged, remaining at April's level of 56.8, the highest monthly reading in six years. This would **suggest that GDP growth in Q2 is strengthening** compared to the previous quarter's expansion of 0.4% q/q. Both French and German composite PMIs rose month over month to their highest levels since 2011. RBC Capital Markets' forecast of 1.6% growth this year is tilted to the upside.
- While many perceive the **European Central Bank** (ECB) has adopted a more hawkish tone, **RBC Capital Markets expects actual tightening to be far away**. It believes the ECB will maintain its quantitative easing programme in place until mid-2018 and does not expect a rate increase from the current -0.4% before 2019, and even when rates are eventually increased it does not believe they will move beyond zero. Core inflation is running around 1%, and unemployment remains uncomfortably high.
- Meanwhile in the **U.K., GDP growth was revised down** to 0.2% q/q from the previously published 0.3%, pointing to a sharper slowdown than expected. Both **net trade and consumer spending weakened**. This gives credence to our thesis that **disposable income will get squeezed by an increase in inflation**. RBC Capital Markets continues to see the risk that the slowdown in activity becomes more entrenched, eventually resulting in monetary policy being loosened in Q1 2018.
- **Cross-border M&A** continues abound. With some $171.8B of deals between U.S. and European companies announced in 2017 so far, activity levels are at a decade high, according to Thomson Reuters. It has been particularly prevalent in the chemicals sector, as industry players bid to boost growth and margins. Swiss specialty chemicals company **Clariant AG** and U.S. peer **Huntsman announced an all-share merger** on May 22 worth approximately $14B. Furthermore, the industrial gas duo **Linde** (Germany) and **Praxair** (U.S.) announced they have reached a **formal agreement on the terms of their merger**. With political risks diminishing in Continental Europe, and the British pound remaining weak, we expect **M&A to continue to remain a feature** in the region.

Strengthening European PMIs point to stronger Q2 growth

Markit Flash Composite PMIs, values above 50 represent expansion



Source - RBC Wealth Management, Bloomberg; data through 5/23/17

Asia Pacific

Jay Roberts – Hong Kong

- **Moody's** surprised the market with a **downgrade of China's sovereign rating by one notch to A1** from Aa3. It expects that China's financial strength "will erode somewhat over the coming years" as debt levels rise. This was Moody's first such downgrade of China since 1989.
- The ratings agency also moved the **outlook up to stable**, opining that "the stable outlook reflects our assessment that, **at the A1 rating level, risks are balanced**." Moody's also noted that the erosion of China's credit profile will be gradual and "eventually contained as reforms deepen."
- China's level of debt relative to the size of its economy has grown quite rapidly for a number of years. This is no secret and has been widely discussed by market participants. The **biggest source of debt** growth, by far, has been in the **corporate sector**. While we believe the **overall level of debt is manageable, the rate of growth will have to moderate** at some point. The key question, in our view, is what impact a moderation in credit growth would have on overall Chinese economic growth. The impact will most likely drag on growth, but the extent is uncertain.
- **Mainland China stocks shrugged off the change** as the Shanghai Composite rose by 1.4% the following day, even though the credit ratings of many well-known state-owned enterprises (SOEs) were moved lower.
- However, the mainland equity market had already traded lower in recent weeks, reversing all of 2017's gains, and bond yields have risen, as the **regulators tackle leverage** in certain areas of financial services. The two areas in particular have been in focus: the **interbank lending market and wealth management products**, both of which have seen rapid growth in recent years.
- **Moody's also downgraded Hong Kong's debt rating to Aa2** from Aa1, citing its links to China. The outlook was raised to stable from negative in light of the lower rating.

MARKET SCORECARD

Data as of May 25, 2017

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,415.07	1.3%	7.9%	17.9%	13.4%
Dow Industrials (DJIA)	21,082.95	0.7%	6.7%	20.3%	15.2%
NASDAQ	6,205.26	2.6%	15.3%	30.9%	22.2%
Russell 2000	1,383.39	-1.2%	1.9%	25.4%	10.0%
S&P/TSX Comp	15,410.73	-1.1%	0.8%	11.5%	2.0%
FTSE All-Share	4,114.68	3.8%	6.2%	21.4%	8.7%
STOXX Europe 600	392.14	1.3%	8.5%	16.2%	-1.5%
German DAX	12,621.72	1.5%	9.9%	26.9%	8.9%
Hang Seng	25,630.78	4.1%	16.5%	29.3%	-7.1%
Shanghai Comp	3,107.83	-1.5%	0.1%	10.7%	-27.4%
Nikkei 225	19,813.13	3.2%	3.7%	19.0%	-0.4%
India Sensex	30,750.03	2.8%	15.5%	19.6%	11.1%
Singapore Straits Times	3,234.37	1.9%	12.3%	16.5%	-6.5%
Brazil Ibovespa	63,226.79	-3.3%	5.0%	25.0%	12.5%
Mexican Bolsa IPC	49,410.92	0.3%	8.3%	8.5%	8.8%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,255.26	-1.0%	8.9%	-0.3%	2.4%
Silver (spot $/oz)	17.16	-0.2%	7.8%	1.5%	-3.2%
Copper ($/metric ton)	5,662.50	-0.8%	2.5%	22.5%	-11.1%
Oil (WTI spot/bbl)	48.65	-1.4%	-9.4%	1.0%	-18.1%
Oil (Brent spot/bbl)	51.40	-0.6%	-9.5%	5.0%	-22.4%
Natural Gas ($/mmBtu)	3.19	-2.6%	-14.3%	59.5%	6.0%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.254%	-2.7	-19.1	40.0	2.0
Canada 10-Yr	1.462%	-8.5	-25.9	9.5	-25.2
U.K. 10-Yr	1.037%	-4.8	-20.2	-40.1	-91.4
Germany 10-Yr	0.362%	4.5	15.4	19.4	-28.7
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.51%	0.4%	2.0%	1.6%	4.7%
U.S. Invest Grade Corp	3.20%	0.6%	3.0%	4.4%	8.1%
U.S. High Yield Corp	5.51%	0.7%	4.6%	14.3%	12.7%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.2190	-1.8%	-4.9%	2.2%	3.2%
CAD/USD	0.7416	1.3%	-0.3%	-3.3%	-9.8%
USD/CAD	1.3484	-1.2%	0.3%	3.5%	10.9%
EUR/USD	1.1208	2.9%	6.6%	-0.1%	-0.9%
GBP/USD	1.2939	-0.1%	4.9%	-11.4%	-17.3%
AUD/USD	0.7454	-0.5%	3.4%	3.1%	-6.7%
USD/CHF	0.9733	-2.1%	-4.5%	-1.5%	5.1%
USD/JPY	111.8700	0.3%	-4.4%	1.5%	-6.8%
EUR/JPY	125.3800	3.2%	2.0%	1.4%	-7.6%
EUR/GBP	0.8662	3.0%	1.5%	12.7%	19.8%
EUR/CHF	1.0909	0.6%	1.8%	-1.5%	4.1%
USD/SGD	1.3867	-0.7%	-4.2%	0.3%	4.4%
USD/CNY	6.8685	-0.4%	-1.1%	5.0%	10.7%
USD/BRL	3.2788	3.2%	0.7%	-8.0%	9.1%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX and Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 8:35 pm GMT 5/25/17.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -0.3% return means the Canadian dollar fell 0.3% vs. the U.S. dollar year to date. USD/JPY 111.87 means 1 U.S. dollar will buy 111.87 yen. USD/JPY -4.4% return means the U.S. dollar fell 4.4% vs the yen year to date.

UPCOMING EVENTS

Fri, May 26
- China Industrial Profits
- U.S. Q1 GDP Rev. (0.9% q/q annlzd.)
- U.S. Personal Consumption (0.4% q/q)
- U.S. Core PCE (2.0% q/q)
- U.S. Univ. of Mich. Sentiment (97.5)
- U.S. Durable Goods (-1.5% m/m)

Mon, May 29
- Japan Retail Sales
- U.S. Markets Closed (Memorial Day)

Tue, May 30
- China NBS Manuf. PMI (51.0)
- China NBS Non-Manuf. PMI
- Japan Industrial Prod.
- Eurozone Consumer Confidence
- Eurozone Economic Confidence
- Germany CPI
- U.K. GfK Consumer Confidence
- U.S. Personal Income (0.4% m/m)
- U.S. Personal Spending (0.4% m/m)

Tue, May 30, cont.
- U.S. Core PCE (0.1% m/m, 1.5% y/y)
- U.S. Conf. Board Consumer Confid.

Wed, May 31
- China Caixin Manuf. PMI (50.2)
- Japan Nikkei Manuf. PMI
- Eurozone Unemployment Rate
- Eurozone CPI
- U.S. Pending Home Sales (1.0% m/m)
- U.S. Fed Releases Beige Book

Wed, May 31, cont.
- Canada Q1 GDP

Thu, Jun 1
- Eurozone Markit Manuf. PMI
- Germany Markit Manuf. PMI
- U.K. Markit Manuf. PMI
- U.S. ADP Employment Change (175K)
- U.S. ISM Manuf. PMI (55.0)

Thu, Jun 8
- ECB Meeting

The dates reflect North American time zones. All data reflect Bloomberg consensus forecasts where available.

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As of March 31, 2017

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Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	843	51.94	285	33.81
Hold [Sector Perform]	679	41.84	149	21.94
Sell [Underperform]	101	6.22	8	7.92

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Ratings:

Top Pick (TP): Represents analyst's best idea in the sector; expected to provide significant absolute total return over 12 months with a favorable risk-reward ratio. Outperform (O): Expected to materially outperform sector average over 12 months. Sector Perform (SP): Returns expected to be in line with sector average over 12 months. Underperform (U): Returns expected to be materially below sector average over 12 months.

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