

Global Insight

Weekly



A closer look

That was then, this is now

Kelly Bogdanov – San Francisco

The U.S. Tech sector's new record high has brought back memories of the dot-com bubble. But unlike then, today's Tech sector is not propped up by fanciful talk. It's led by companies that are truly transforming the economy and our lives, and we believe Tech should be a source of attractive long-term returns.

The S&P 500 Tech sector finally reached a new all-time high, 17 years after the bubble-era peak. Even though the sector could use a rest following a strong 11.7% run since mid-April, we still believe it can generate attractive long-term returns.

Tech support

A lot has changed for the Tech sector since the bubble days.

The hopes and dreams that seemed dashed as the bubble was bursting are now playing out. The internet has indeed transformed our lives. Roughly 85% of the U.S. workforce is constantly or often connected to the internet during a typical workday. We imagine the numbers are similar in other developed nations.

The software industry has largely transformed into the cloud computing industry. Computer chips are passé—now chips for the Internet of Things, artificial intelligence, and self-driving cars are all the rage.

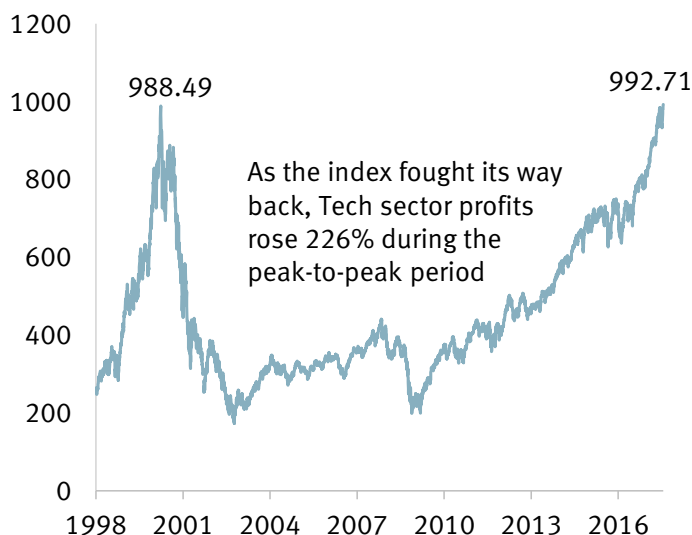
The sector is now led by real companies with real earnings and cash flows compared to the myriad of firms with hollow balance sheets and never-ending losses that used to capture imaginations.

Tech sector earnings per share have increased 226% since the previous bubble-era peak. The five S&P 500 companies with the biggest cash hoards are tech firms. They hold more than \$570B total in cash.

Companies that weren't even listed on public exchanges during the bubble era are now among the largest and most innovative tech firms, including Alphabet (Google), Facebook, PayPal, and Salesforce.com.

17 years later, U.S. Tech closes at an all-time high

S&P 500 Information Technology Sector Index



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

Market pulse

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- 4 Signs of steadiness in the Chinese economy

Click [here](#) for authors' contact information.

Priced (in USD) as of 7/20/17 market close, EST (unless otherwise stated).

For important disclosures and required non-U.S. analyst disclosures, see [page 6](#).



**Wealth
Management**

Leadership is also coming from companies that were public back then but have since reinvented their products and services, such as Adobe Systems, Analog Devices, Apple, Microsoft, and NVIDIA, just to name a handful.

The U.S. is the home of eight of the 10 largest tech firms worldwide by market capitalization. U.S.-based firms garnered 66% of the revenues in the past 12 months among the largest 100 tech companies globally.

Not over the top

While the industry's transformation has been nothing short of remarkable, ushering in a secular (long-term) growth phase that is impacting many segments of the global economy, there is another key difference between then and now that cannot be overlooked from an investment standpoint: valuation.

The Tech sector was wildly overvalued at 83x trailing and 60x forward earnings during the bubble era. Today, while its valuations are elevated, they are nowhere near those levels, registering at 24.6x trailing and 19.4x forward estimates (see upper chart). From our vantage point, the current price-to-earnings (P/E) ratios are reasonable considering the economy remains locked in an ultralow interest rate environment, which can accommodate moderately elevated valuations, and given we view the quality of earnings and balance sheets as high.

The ratio between the forward P/Es of the Tech sector and the S&P 500 currently stands at 1.02, below the average level since 2004. Meanwhile, Tech is forecast to moderately outgrow the S&P 500 in 2017 and 2018, according to the Thomson Reuters I/B/E/S consensus data.

Despite its strong year-to-date rally, Tech's free cash flow yield—a measure of expected return—exceeds the S&P 500 and seven of 10 other sectors.

Furthermore, Tech is now on the dividend radar screen. The sector's dividend yield has risen to 1.29% from only 0.09% at the bubble's peak.

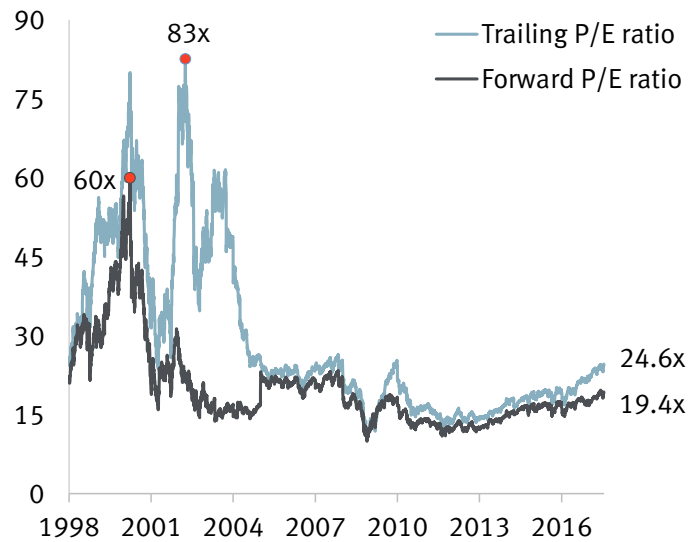
We think the sector's dividend yield expansion has much further to go, as some of the more mature companies with sizeable cash holdings have capacity to increase dividends, especially if overseas cash is repatriated as a part of a tax reform package. Among the five tech firms with the biggest cash holdings, roughly 85% of the cash is held overseas.

Tech solution

Despite the potential near-term headwinds following Tech's strong run, innovation trends combined with reasonable valuations and attractive secular growth prospects are compelling reasons to own the U.S. Tech sector in equity portfolios. We believe the innovation wave has the sector well positioned to help lead the S&P 500 in the next year or longer.

Tech valuations have drifted up but are nowhere near peak levels

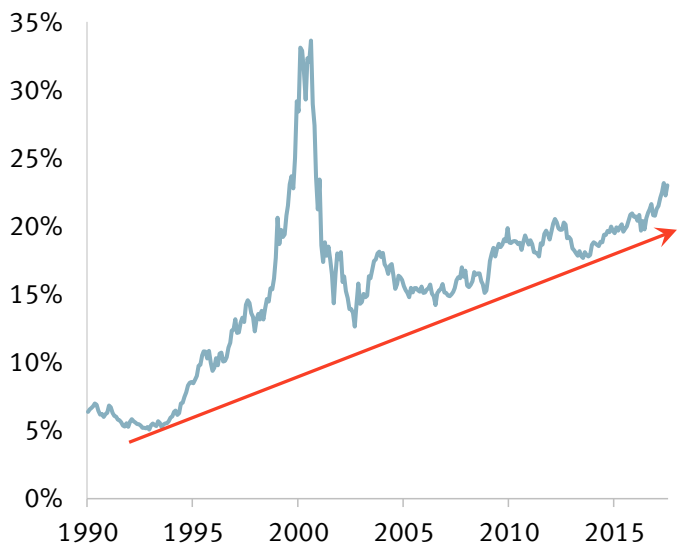
Tech sector price-to-earnings (P/E) ratios



Source - RBC Wealth Management, Bloomberg; data through 7/19/17

Tech makes up 23% of the S&P 500, well below bubble levels

Tech sector as a percentage of S&P 500 market capitalization



Source - RBC Wealth Management, Bloomberg; monthly data through 7/18/17



United States

Kelly Bogdanov – San Francisco

- The equity market continued its winning ways with the **S&P 500, Dow, and NASDAQ** climbing to **new all-time highs** during the week. Solid corporate earnings reports helped boost the market.
- **One catalyst that has largely gone unnoticed is improved M&A activity** during the first half of this year, up 11% since last period and 30% y/y (see chart). We believe domestic M&A will remain healthy so long as U.S. GDP averages 2% or more and the global economy continues to firm. In our view, the **retail and packaged goods industries are candidates for consolidation** given the pricing and volume challenges caused by technological innovations and customers' changing purchasing patterns—i.e., the “Amazon effect.” Further out, RBC Capital Markets anticipates deals will transpire in the **banking industry**, potentially in late 2018 and into early 2019. Banks will likely seek to improve profitability and acquire deposit franchises as the Fed unwinds its balance sheet.



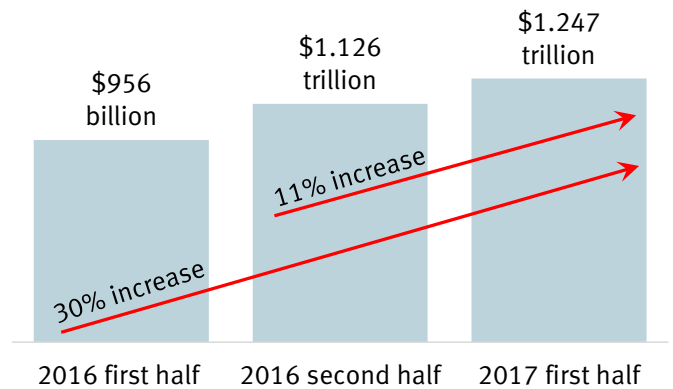
Canada

Alicia Buckiewicz & Farazeh Mahboob – Toronto

- Data released this month showed that the **Canadian housing market has cooled** since April. The Canadian Real Estate Association reported that **home sales fell 6.7% in June**, which is the **sharpest monthly decline since 2010**. Sales declined 11.4% y/y nationwide, with the decline most pronounced in Toronto. Nationally, price action was also negative, with prices down approximately 10% from the April peak. **Excluding Toronto and Vancouver, the picture is brighter**, with prices still up 5% y/y and monthly price gains recorded in Alberta, Manitoba, New Brunswick, and Prince Edward Island. The recent run of softer housing data comes against a backdrop of tighter policy on a number of fronts, including the newly introduced measures in Ontario designed to ease affordability pressures in the Greater Toronto Area.
- **RBC Capital Markets' energy team has cut its WTI crude forecasts** to annual average prices of \$48.47/barrel (bbl) in 2017 (from \$54.50/bbl) and \$50/bbl in 2018 (from \$60/bbl). U.S. oil supply growth forecasts, while down from previous expectations, remain robust while RBC Capital Markets expected shallower global inventory draws despite OPEC's agreement to cap production. RBC Capital Markets believes it is likely that OPEC will extend its existing agreement beyond March 31, 2018 with its next meeting slated for November 30. **The most important**

M&A has increased despite Washington uncertainties

U.S. merger and acquisition volume



Source - RBC Wealth Management, Bloomberg; data as of 7/18/17

factor underlying a sustained oil price recovery revolves around long cycle-time projects beginning to fade, which RBC Capital Markets anticipates in 2019.

- In light of the lower crude oil forecasts, **RBC Capital Markets' energy team lowered its cash flow per share estimates for its Canadian integrated and senior producer coverage universe** by 17% and 22% on average in 2017 and 2018, respectively. RBC Capital Markets' updated forecasts align with our more cautious outlook for crude oil. In the current environment, **we continue to favour well-capitalized producers with visible production growth and above-average execution capability.**



Europe

Frédérique Carrier & Thomas McGarrity – London

- As expected, the **European Central Bank (ECB)** kept its **policy unchanged** at its July meeting. The euro continued to strengthen versus the U.S. dollar (see chart on next page), crossing above \$1.16 for the first time since May 2016, as **ECB President Mario Draghi did not suggest the euro's recent strength was becoming uncomfortable** for policymakers. We expect the ECB to discuss some sort of changes to its monetary policy at its next meeting in September. RBC Capital Markets still sees the ECB extending its bond-buying program into the middle of next year but with purchases tapered to reflect the improvement in the euro area economy and the scarcity of government bonds available.
- There was a **surprise drop in U.K. inflation** in June. The Consumer Price Index eased to 2.6% y/y, from 2.9% y/y in May, and versus consensus expectations for it to remain flat. Key drivers of the decline were lower prices for fuel and the “recreation and culture” component of the inflation

basket. RBC Capital Markets believes June was a blip, and inflation in the U.K. will continue to head towards 3% y/y. We believe the dip in inflation has **diminished the chances of increasing hawkish sentiment** from the Bank of England's Monetary Policy Committee at its August meeting, with the **key focus shifting back to the downside risks to the U.K. economy**, rather than trying to counter a bout of above-target inflation.

- Swiss pharmaceutical group **Novartis beat consensus earnings estimates** by 3% for Q2. The company benefitted from **higher-than-expected sales from recently launched drugs**, which helped offset the impact of the ongoing decline of Gleevec, formerly Novartis' best-selling drug, which is now exposed to generic competition.
- **SAP**, the largest European software vendor, **nudged up its revenue guidance** for 2017 and announced a **€500M share buyback**. Operating profit was slightly below consensus expectations, however, as ongoing investments in its cloud business and increased hiring weighed on its operating margin.
- **Unilever's operating profit** for the first half of 2017 **beat consensus estimates** by 5%, as its **operating margin increased** 180 basis points to 17.8%, 100 basis points ahead of expectations. After rejecting Kraft Heinz's takeover bid earlier in 2017, Unilever set a target to achieve a 20% operating margin by 2020.



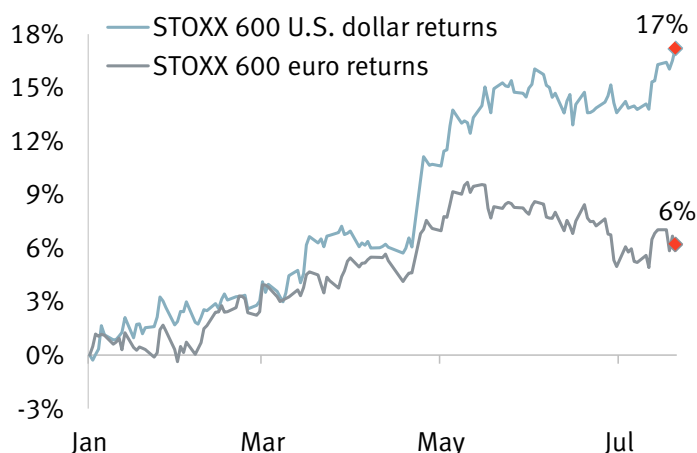
Asia Pacific

Jay Roberts – Hong Kong

- China's economy grew by 6.9% y/y in Q2, faster than forecast and the same pace as in Q1. **A broad range of economic indicators corroborate the steadiness at present in the Chinese economy**. Primarily, these include both official and unofficial leading indicators, which range from moderately positive in the manufacturing sector to robust in the larger services sector.
- At present, the **Chinese economy is performing above expectations**, in our view. A number of data points for the month of June, for example, show decent strength in the economy. These include: **industrial production, +8% y/y; retail sales, +11% y/y; commercial vehicle sales, +19% y/y**; and good data in the housing market.
- **E-commerce in China continues to grow at a far more rapid rate** than the broad economy. The National Bureau of Statistics stated that online retail sales in the first half of the year rose by 33% y/y. This growth is corroborated by strong revenue growth in China's largest internet companies, as well as by the number of packages delivered, heavily impacted by online sales. Deliveries rose by 31% y/y in June.

A strengthening euro is the key driver of diverging investor returns in Europe

STOXX Europe 600 returns, year to date



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

- At the same time, the **authorities in China continue to tighten leverage in the financial sector**. It appears that as a result of recent, tighter policies, causing a funding squeeze for banks, some banks had pushed up yields on popular wealth management products in order to attract funds. The regulator has responded by ordering certain banks to lower the rates on these products.
- The stabilizing renminbi, along with more stringent controls on capital flows, has caused **capital outflows** from China to **decline significantly** from the very high levels seen at the start of 2016. China's **FX reserves have been moving up again** over the past few months. In parallel, the country's **holdings of U.S. Treasuries have also been rising**, up for a fourth consecutive month in May, according to the U.S. Treasury Department.
- China now holds \$1.1T of U.S. government debt, slightly lower than Japan's holdings of \$1.11T. A total of \$6.1T of U.S. debt is held by foreigners, of which \$4T is held by governments. This means that **China and Japan hold approximately one-third of all foreign holdings of U.S. Treasuries** and over a half of foreign government holdings of Treasuries.
- **Ping An Insurance (2318 HK)**, the **second-largest insurance company in China**, is moving into **wealth and asset management outside Greater China for the first time**. Ping An's Lufax division will begin operating in Singapore with a focus on global clients rather than Singapore residents. Lufax manages \$65B of client assets in China. The stock has been particularly strong this year, rising by over 50% in Hong Kong. Other Chinese companies, such as Alibaba (BABA), have also been expanding into other parts of Asia.



MARKET SCORECARD

Data as of July 20, 2017

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,473.45	2.1%	10.5%	13.8%	16.2%
Dow Industrials (DJIA)	21,611.78	1.2%	9.4%	16.2%	19.4%
NASDAQ	6,390.00	4.1%	18.7%	25.5%	22.4%
Russell 2000	1,442.35	1.9%	6.3%	19.2%	14.5%
S&P/TSX Comp	15,264.64	0.5%	-0.2%	5.0%	5.8%
FTSE All-Share	4,095.07	2.3%	5.7%	12.4%	10.8%
STOXX Europe 600	384.07	1.2%	6.3%	12.7%	-5.6%
EURO STOXX 50	3,499.49	1.7%	6.4%	17.9%	-5.1%
Hang Seng	26,740.21	3.8%	21.5%	22.2%	5.3%
Shanghai Comp	3,244.87	1.6%	4.6%	7.2%	-18.7%
Nikkei 225	20,144.59	0.6%	5.4%	20.8%	-2.5%
India Sensex	31,904.40	3.2%	19.8%	14.3%	12.3%
Singapore Straits Times	3,293.13	2.1%	14.3%	11.8%	-2.4%
Brazil Ibovespa	64,938.02	3.2%	7.8%	14.8%	25.8%
Mexican Bolsa IPC	51,151.59	2.6%	12.1%	7.7%	12.3%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,243.91	0.2%	8.0%	-5.5%	13.4%
Silver (spot \$/oz)	16.33	-1.8%	2.6%	-15.9%	11.0%
Copper (\$/metric ton)	5,929.50	0.0%	7.4%	19.7%	8.6%
Oil (WTI spot/bbl)	46.79	1.6%	-12.9%	4.1%	-6.7%
Oil (Brent spot/bbl)	49.31	2.9%	-13.2%	4.5%	-13.0%
Natural Gas (\$/mmBtu)	3.03	-0.1%	-18.6%	14.0%	7.4%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.259%	-4.5	-18.5	67.9	-11.3
Canada 10-Yr	1.883%	12.1	16.2	76.0	30.5
U.K. 10-Yr	1.205%	-5.2	-3.4	37.0	-85.6
Germany 10-Yr	0.530%	6.4	32.2	54.1	-23.2

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.51%	0.4%	2.7%	0.0%	6.2%
U.S. Invest Grade Corp	3.12%	0.7%	4.5%	2.2%	11.3%
U.S. High Yield Corp	5.48%	0.8%	5.7%	10.3%	15.6%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	94.2790	-1.4%	-7.8%	-3.0%	-3.8%
CAD/USD	0.7945	3.0%	6.8%	3.7%	3.2%
USD/CAD	1.2586	-2.9%	-6.4%	-3.6%	-3.1%
EUR/USD	1.1632	1.8%	10.6%	5.6%	7.5%
GBP/USD	1.2973	-0.4%	5.1%	-1.8%	-16.6%
AUD/USD	0.7959	3.5%	10.4%	6.4%	8.0%
USD/JPY	111.9000	-0.4%	-4.3%	4.7%	-10.0%
EUR/JPY	130.1600	1.4%	5.8%	10.6%	-3.2%
EUR/GBP	0.8966	2.2%	5.0%	7.5%	28.9%
EUR/CHF	1.1066	1.1%	3.2%	1.8%	6.0%
USD/SGD	1.3664	-0.7%	-5.6%	0.7%	-0.3%
USD/CNY	6.7597	-0.3%	-2.7%	1.2%	8.9%
USD/MXN	17.4969	-3.4%	-15.6%	-6.3%	9.3%
USD/BRL	3.1241	-5.6%	-4.0%	-4.2%	-2.2%

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 8:34 pm GMT 7/20/17.

Examples of how to interpret currency data: CAD/USD 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 5.6% return means the Canadian dollar rose 5.6% vs. the U.S. dollar year to date. USD/JPY 113.25 means 1 U.S. dollar will buy 113.25 yen. USD/JPY -3.2% return means the U.S. dollar fell 3.2% vs. the yen year to date.



UPCOMING EVENTS

Fri, Jul 21	Mon, Jul 24	Wed, Jul 26	Thu, Jul 27, cont.
ECB Survey of Prof. Forecasters	China Conf. Board Leading Eco. Index	China Swift Global Payments	Germany Consumer Confidence
U.S. Markit Manuf. PMI	Eurozone Markit Manuf. PMI	China Industrial Profits	Germany Retail Sales
U.S. Markit Serv./Comp. PMI	Eurozone Markit Serv./Comp. PMI	U.K. Q2 GDP (0.3% q/q, 1.7% y/y)	U.S. Durable and Capital Goods
U.S. Existing-Home Sales (5.5M, -1.4% m/m)	Germany Markit Manuf. PMI	U.K. Index of Services	U.S. Chicago Fed Nat'l Activity
Canada CPI (1.1% y/y)	Germany Markit Serv./Comp. PMI	Fed Meeting	Fri, Jul 28
Canada Retail Sales (0.3% m/m)	Tue, Jul 25	U.S. New Home Sales (616K)	U.S. Q2 GDP (2.6% q/q, ann'l'zd)
Sun, Jul 23	Germany IFO Surveys	Thu, Jul 27	U.S. Core PCE
Japan Nikkei Manuf. PMI (52.4)	U.S. Conf. Board Consumer Confidence	Japan CPI	Thu, Aug 3
		Japan Retail Sales	BoE Meeting

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

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As of June 30, 2017

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			Count	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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