October 19, 2017

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

The "X factor"

Kelly Bogdanov – San Francisco

With NAFTA's future insecure, the multi-decade trend toward greater global integration may seem at risk. But we think sweeping technological innovations just may be the "X factor" that holds things together, to the benefit of investors.

With tensions flaring up at the NAFTA renegotiations during the week, globalization and long-standing trade practices are once again on the defensive. The fate of North America's nearly 24-year-old trade framework remains uncertain even though negotiators pushed the deadline beyond the initial year-end target.

RBC Global Asset Management's chief economist believes there is a 40% likelihood NAFTA could be terminated—a non-trivial risk. If that plays out, previous trade agreements and/or WTO rules could come into force, and there would likely be considerable legal challenges. If NAFTA is "torn up," so to speak, it could slice roughly 0.8 percentage points from Canada's annual GDP growth and 0.4 points from U.S. growth, the chief economist estimates. For example, instead of annual U.S. GDP growth of 2.0%, it could be 1.6%.

Regardless of NAFTA's path, we think globalization, trade ties, and shared interests across borders are much more entrenched than critics of multilateral trade deals acknowledge, as we pointed out in our recent commentary.

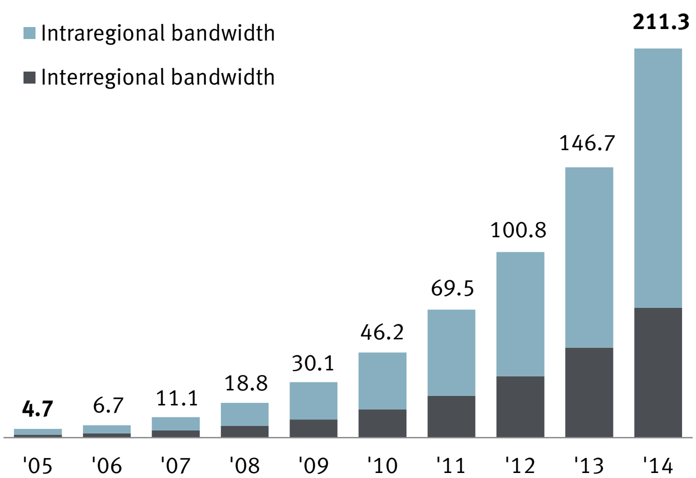
Additionally, technology is one pillar of globalization and trade that is often overlooked. It just may be the "X factor" that will hold things together at a time when relations are fraying around the edges.

No turning back

Technology is integrating commerce and peoples like never before. The industry's innovations are transforming how we do business and conduct our personal lives. They have no boundaries or borders, and they continue to shrink the globe.

Cross-border bandwidth multiplied almost 50-fold

Total used cross-border bandwidth in thousands of gigabits per second



Source - TeleGeography, McKinsey Global Institute analysis; February 2016 report

Market pulse

3 Finding value in Canadian preferred shares

4 U.S. corporate earnings off to a slow start

5 U.K./EU discussions appear stalled

5 19th National Congress commences in Beijing

Take just one example: the use of cross-border bandwidth multiplied almost 50-fold from 2005 to 2014. It has never been easier for companies—large or small—to buy components, sell products or services, build factories, and serve customers thousands of miles and an ocean away.

Tech has permeated global business to such a degree that nearly all cross-border transactions have a digital component. Roughly 12% of global goods transactions are conducted via international e-commerce, according to McKinsey Global Institute.

In the last 10 years, all types of cross-border flows raised worldwide GDP by an additional 10.1%, McKinsey estimates.

Technology's linkages to trade provide employment opportunities, cheaper goods, higher revenue and earnings for multinational companies, and by extension, higher stock prices. As we see it, tech innovations help create a bigger economic pie and benefit investors.

Not standing still

Tech is also democratizing globalization and trade for millions, if not billions, of people.

At this point, most of the world's population, regardless of income or social status, now interacts in the global marketplace. This is largely due to the tech infrastructure buildout of the 1990s, the far reach of mobile technologies, and warp-speed digital innovations of the past 5-10 years.

Progress isn't standing still. Technologies of tomorrow are already here. Robotics, automation, machine learning, and augmented reality could usher in new industrial and information revolutions. As artificial intelligence (AI) reshapes multiple industries, AI revenues could more than quadruple by 2020 and surge almost 25-fold by 2025 (see upper chart).

In addition to those state-of-the-art technologies, consider a less complex, yet ground-breaking gadget as just one example of what will further bind people together: Google Pixel Buds introduced a few weeks ago. While the gadget looks like normal smartphone ear buds or headphones, it is much more. Pixel Buds can function as a nearly real-time language translation system. With some simple commands, it enables users to converse in a foreign tongue, breaking down language barriers.

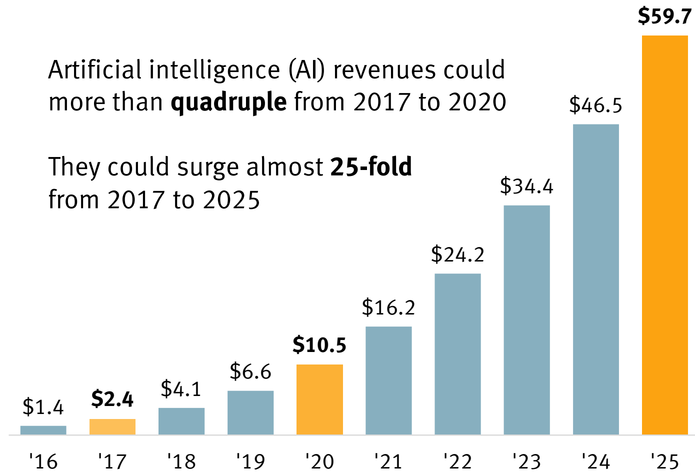
As these newer technologies and others such as blockchain and the integration of tech and health care take root, we think the natural trend toward globalization will solidify.

Binding us together

Certainly the pushback against globalization could linger or become more intense in the near term, as tensions during the NAFTA renegotiations are illustrating. Protectionist threats could rise, and there could be setbacks.

AI revenues are expected to surge in coming years

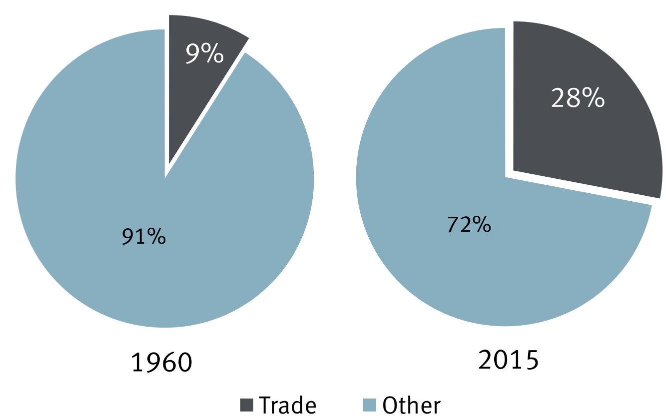
Projected revenues from worldwide artificial intelligence market (in U.S. $ billions)



Source - Statista, May 2017

Trade is a bigger share now, with plenty of room to increase

Trade as a % of U.S. economic activity



Source - World Bank, FedEx Chairman and CEO Frederick W. Smith's speech at the National Competitiveness Forum, December 9, 2016

But over time, globalization is resilient. It has staying power, as it stands on thousands of years of world history and is now being fueled by technological advancements that are binding companies, economies, and peoples more closely together.

Globalization has already benefitted investors, especially in the last 10–15 years, and we believe it has the potential to do so in the future, especially with tech as the "X factor."

Canada in focus

Finding value in Canadian preferred shares

Joseph Wu & Mikhial Pasic – Toronto

Rising interest rates, stable commodity prices, and tighter credit spreads have propelled Canadian preferred shares to double-digit gains year to date. Despite the solid performance, we believe preferred shares remain well-positioned to deliver worthwhile returns on a 12-month time horizon, as valuations are reasonable, fundamentals remain constructive, and the development of a hybrid market will likely limit $25 preferred share issuance. Over the past decade, preferred shares have produced an annualized return equivalent to less than half the average dividend over that period, suggesting the market may still have potential to deliver moderate price appreciation.

Fundamentals remain constructive

Preferred shares have shined in an otherwise lacklustre year for the Canadian bond market, outperforming even U.S. high-yield bonds on a Canadian dollar-hedged basis as of October 13. Whereas a rising rate environment tends to dampen the performance of bonds, it has been a decidedly favourable tailwind for preferred shares with "rate reset" or "floating rate" features, which comprise around 80% of the Canadian preferred share market.

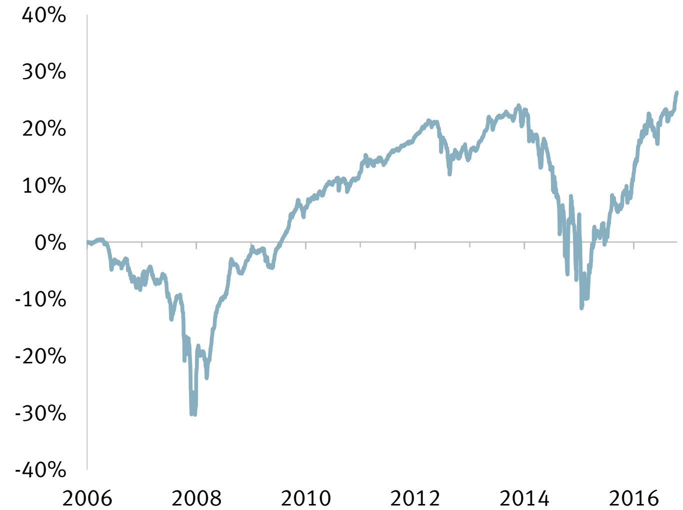
Although elevated household debt could limit the Bank of Canada's ability to meaningfully raise short-term rates in a traditional rate-hiking cycle, we believe the Canadian economy is likely to maintain enough momentum to allow the central bank to continue to nudge rates modestly higher through 2018. Higher short-term rates improve the cash flow profile of rate-reset and floating-rate issues beyond the reset date.

Beyond higher rates, preferred shares are one of the few remaining markets where credit spreads remain slightly above the long-term average, suggesting investors are still receiving adequate compensation for taking on additional credit risk. Meanwhile, the recent trend of "hybrid" issuance (interest-bearing $1,000 par issues that trade on the over-the-counter market) could be an underappreciated catalyst that may further bolster sentiment towards preferred shares.

We believe hybrid issuance is good news for preferred shares for two reasons. Based on current pricing, hybrids represent a lower (after-tax) funding option for issuers, and this will likely mean less preferred share issuance (i.e., less supply) and a greater chance of redemption for existing rate reset issues (i.e., potential for capital gains for issues trading at discount to call price). A hybrid market developed in the U.S. market in 2014 and preceded a strong period of performance for U.S. preferred shares that came against a backdrop of minimal new issue supply in the $25 par market.

TSX preferred share index total returns since 2007

S&P/TSX Preferred Total Return Index



Source - Bloomberg, RBC Wealth Management; data through 10/16/17

More room to run

Preferred shares have lagged the move higher in the 5-year Government of Canada bond yield over the past few months. This is partly a result of lower-priced issues having already grinded higher and the most recent round of new issues now trading well above $25. However, we continue to believe higher rates are a net positive for preferred shares. The preferred share market has only generated an approximate 2%–3% annualized return over the past decade, well below the approximate 5% average dividend the market has provided over that same period (see chart). In our view, this suggests there is still room for that market to deliver moderate capital appreciation from the current level to complement a mid-4% yield.

We recommend investors pair high reset spread issues and perpetuals with discounted rate resets and floaters. The lower-priced issues offer upside potential if rates move higher which provides some interest rate diversification for fixed income portfolios that otherwise hold fixed coupon bonds, while issues with higher reset spread and high dividend perpetuals provide a bit of a downside buffer if market conditions worsen.

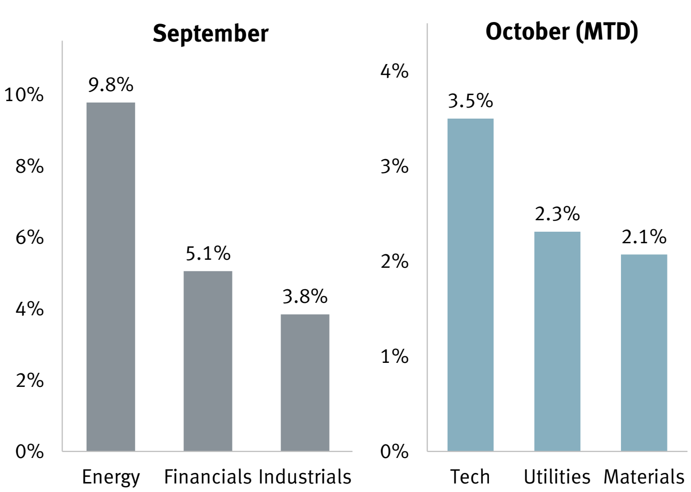
United States

Kelly Bogdanov – San Francisco

- **Sector rotation has been the hallmark of the eight-year U.S. equity bull market, and it persists**. Following blistering gains in September, economically-sensitive areas—Energy, small-cap stocks, Financials, Industrials, and Materials—have cooled off as the **enthusiasm for the reflation/growth trade has moderated** amid less buoyant economic data and uncertainties about tax cuts. Nevertheless, major indexes such as the S&P 500 and Dow Jones Industrial Average have reached successive new all-time highs as other areas of the market, such as Technology and Utilities, have taken up the slack.
- With the S&P 500 up 5.6% since mid-August and 19.7% since the presidential election, **our technical strategist cautions the market could lose steam near term**, which would be normal following such big moves. However, **the secular (long-term) bull market remains firmly intact**, based on our technical, fundamental, and economic indicators. We would continue to hold Market Weight exposure in U.S. equities—meaning invest at the strategic long-term allocation level in portfolios.
- **Corporate earnings season is off to a slow start for good reason**. With 15% of companies having reported so far, Q3 earnings growth is pacing at just 4.3% y/y, well below the 6.7% consensus estimate in mid-August before hurricanes hit Houston and Florida. Those **extreme weather events are distorting the overall trends**. S&P 500 growth would be tracking at 7.0% y/y if not for the hurricane losses from property and casualty insurance companies which could see a Q3 earnings decline of 64% y/y, on average, according to Thomson Reuters I/B/E/S. The pressure on that industry has also flipped the Financials sector's quarterly profit to a loss.
- Apart from the hurricanes' negative impact, **underlying earnings and revenue trends seem just fine**. Both beat rates are above the long-term and recent averages. S&P 500 revenue growth is pacing at 4.4% y/y, similar to nominal GDP growth. On balance, the banking industry has delivered positive results amid solid loan growth and lower-than-expected costs. Strong manufacturing activity is signaling earnings beats for other cyclical industries, in our view.

Sector rotation continues as markets move higher

Top 3 performing S&P 500 sectors in September and October to date



Source - RBC Wealth Management, Bloomberg; data through 10/18/17

Canada

Alicia Buckiewicz & Farazeh Mahboob – Toronto

- The Office of the Superintendent of Financial Institutions (OSFI) published the **final B-20 guidelines relating to residential mortgage underwriting practices**. The most prominent change is to impose stricter stress testing rules on borrowers with larger down payments, a move mirroring one previously imposed on borrowers with smaller down payments. This measure will pose a **headwind for the housing market**, but we expect a soft landing rather than a deep correction. The Bank of Canada will provide **additional guidance** on its growth outlook, including housing, within its Monetary Policy Report to be released on October 25.
- In light of the new guidelines, RBC Capital Markets believes that **sector valuations for the mortgage insurers are likely to remain constrained** in the near term because the new stricter mortgage underwriting guidelines and newly implemented foreign buyer taxes are likely to restrict mortgage loan growth. RBC Capital Markets sees the B-20 guidelines as having a **very minor negative effect on Canadian banks**, as the guidelines would only impact 10% of originations, but will likely have a more negative impact on the non-prime lenders.
- The decision earlier this week to extend NAFTA negotiation talks into 2018 **helped the Canadian dollar** break out to the upside from its flat three-week trading range. With the Fed expected to raise interest rates again this year, short-term interest rate differentials between the Canadian and U.S. market are back in favor of the U.S. dollar; however, **any data supporting crude prices**, like an end to the oil supply glut, **may be another positive** catalyst for the Canadian dollar.
- RBC Capital Markets expects **higher earnings for the Canadian base metal equities** in Q3 compared to Q2. Copper, zinc, nickel, and iron ore prices increased

mid-double-digits in the quarter, and price gains went alongside a strengthening global economy. However, for the Canadian miners, the higher earnings may be partially offset by a strengthening Canadian dollar, which was, on average, 7% higher in Q3.

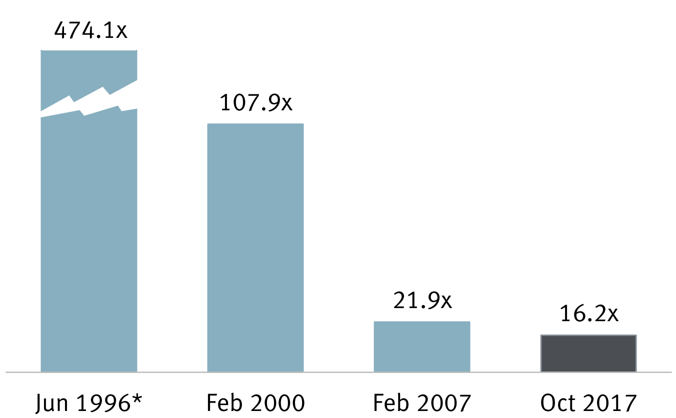
Europe

Frédérique Carrier & Thomas McGarrity – London

- The two-day **EU council meeting is underway** (October 19 and 20). It was supposed to be the event at which EU leaders would deem enough progress had been made on the "divorce bill," EU citizen rights, and the Irish border to **start formal discussions** regarding the future trade relationship between post-Brexit U.K. and the EU. This seems to be only **a remote possibility now**, in our view, as discussions seem to have stalled. **Financial discussions** in particular seem to have reached **an impasse**.
- Observers will be searching for any clues regarding discussions on a transition arrangement and when talks on a future relationship can begin in earnest. Without them, **the U.K. could crash out of the EU in March 2019**, a move we believe would be **detrimental to the economy**. We expect corporates will likely have to start making contingency plans for this eventuality over the next six months. The next EU council meeting is scheduled for December 14 and 15.
- Meanwhile, the **labour market remained steady** with the unemployment rate at 4.3%. The tight labour market is **starting to feed through to wages**, which are slowly creeping up. Inflation continues to crimp household disposable income, with CPI up 3% y/y in September vs. a 2.9% y/y increase a month earlier.

Japan's equities far less expensive than previous market highs

TOPIX Index trailing 12-month price-to-earnings ratio



*June 1996 data is truncated so as to not distort the other values
Source - RBC Wealth Management, Bloomberg; data through 10/19/17

- In Europe, the consensus expectation is for the **ECB** (at its October 26 meeting) **to outline how the QE programme will function** from January 2018 onwards. We expect the central bank to maintain a dovish stance and argue that the **length of time the QE programme runs matters more** than the size of the monthly bond purchases. RBC Capital Markets expects the **ECB to reduce net purchases** to around €30B per month from the current €60B and for the duration of the programme to remain open until at least September 2018.

Asia Pacific

Jay Roberts – Hong Kong

- The **MSCI AC Asia Pacific Index rose** and is a **short distance beneath its all-time high**.
- **Japanese indices have held on to strong gains**. Japan's TOPIX is approximately 5% below its 2007 high of just over 1,800. If the index breaks that level, it would be at its highest since the early 1990s. Given the strength in Japanese corporate earnings, **it would not be a stretch for the TOPIX to break through 1,800** in the next few months. However, investors should acknowledge the year-to-date strength of various Asian equity markets, including Japan. **A period of consolidation is increasingly likely**.
- The **Japanese election** will take place on **October 22**. We think it is likely Shinzo Abe will win, although it is less certain if his Liberal Democratic Party will gain a two-thirds majority. **An Abe win would be viewed positively** by Japanese equity investors.
- **The 19th National Congress of the Communist Party of China** kicked off in Beijing with **General Secretory Xi Jinping** giving a three-and-half hour **opening speech**. In it, Xi pointed out that the principal contradiction of China is between unbalanced and inadequate development versus the people's ever-growing needs for a better life. This **may indicate that China will place a higher priority on social fairness** than before, perhaps, for example, by trying to tackle the growing disparity between rich and poor.
- Xi's 30,000-word report outlined a **blueprint of the ruling party's objectives** at a very high level and covered a wide range of areas, including society, economy, law, military, diplomacy, party building, and so on. Lacking in detailed policies, the report **should have little imminent impact on the equity market**. The Congress ends on October 24, and **a new party leadership will be announced**. We expect five of the seven members of the powerful Standing Committee to retire. For more on this, please see our publication *China: The long march to reform*.

MARKET SCORECARD

Data as of October 19, 2017

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,562.10	1.7%	14.4%	19.5%	26.0%
Dow Industrials (DJIA)	23,163.04	3.4%	17.2%	27.3%	34.4%
NASDAQ	6,605.07	1.7%	22.7%	25.9%	34.6%
Russell 2000	1,502.04	0.8%	10.7%	22.9%	29.0%
S&P/TSX Comp	15,818.00	1.2%	3.5%	6.6%	15.0%
FTSE All-Share	4,127.21	1.9%	6.6%	8.2%	18.8%
STOXX Europe 600	389.11	0.2%	7.7%	13.2%	6.8%
EURO STOXX 50	3,602.08	0.2%	9.5%	17.9%	10.1%
Hang Seng	28,159.09	2.2%	28.0%	20.8%	22.0%
Shanghai Comp	3,370.17	0.6%	8.6%	9.3%	-0.5%
Nikkei 225	21,448.52	5.4%	12.2%	26.2%	18.3%
India Sensex	32,389.96	3.5%	21.6%	15.7%	18.4%
Singapore Straits Times	3,334.91	3.6%	15.8%	17.2%	10.3%
Brazil Ibovespa	76,283.16	2.7%	26.7%	20.1%	60.8%
Mexican Bolsa IPC	50,000.25	-0.7%	9.5%	3.1%	12.3%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,289.59	0.7%	11.9%	1.6%	10.2%
Silver (spot $/oz)	17.26	3.6%	8.4%	-2.3%	8.9%
Copper ($/metric ton)	6,949.00	8.0%	25.8%	49.4%	33.4%
Oil (WTI spot/bbl)	51.29	-0.7%	-4.5%	-0.6%	11.8%
Oil (Brent spot/bbl)	57.24	-0.5%	0.7%	8.7%	17.8%
Natural Gas ($/mmBtu)	2.90	-3.7%	-22.3%	-8.7%	18.6%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.316%	-1.8	-12.8	57.3	29.3
Canada 10-Yr	2.015%	-8.4	29.4	82.0	55.9
U.K. 10-Yr	1.279%	-8.6	4.0	19.7	-54.3
Germany 10-Yr	0.395%	-6.9	18.7	36.5	-17.0
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.59%	0.0%	3.2%	0.5%	4.9%
U.S. Invest Grade Corp	3.16%	0.3%	5.5%	2.6%	10.5%
U.S. High Yield Corp	5.41%	0.4%	7.4%	8.2%	20.4%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	93.1100	0.0%	-8.9%	-4.9%	-1.9%
CAD/USD	0.8013	-0.1%	7.7%	5.1%	4.3%
USD/CAD	1.2480	0.1%	-7.1%	-4.8%	-4.1%
EUR/USD	1.1852	0.3%	12.7%	8.0%	4.6%
GBP/USD	1.3161	-1.8%	6.7%	7.1%	-14.9%
AUD/USD	0.7879	0.6%	9.3%	2.0%	8.7%
USD/JPY	112.5300	0.0%	-3.8%	8.8%	-5.8%
EUR/JPY	133.3700	0.3%	8.5%	17.5%	-1.5%
EUR/GBP	0.9005	2.1%	5.5%	0.8%	22.9%
EUR/CHF	1.1570	1.1%	7.9%	6.6%	6.8%
USD/SGD	1.3565	-0.1%	-6.2%	-2.2%	-2.3%
USD/CNY	6.6138	-0.6%	-4.8%	-1.8%	4.0%
USD/MXN	18.8003	3.0%	-9.3%	1.5%	14.0%
USD/BRL	3.1708	0.3%	-2.6%	0.1%	-18.4%

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 10/19/17.

Examples of how to interpret currency data: CAD/USD 0.80 means 1 Canadian dollar will buy 0.80 U.S. dollar. CAD/USD 7.7% return means the Canadian dollar rose 7.7% vs. the U.S. dollar year to date. USD/JPY 112.53 means 1 U.S. dollar will buy 112.53 yen. USD/JPY -3.8% return means the U.S. dollar fell 3.8% vs. the yen year to date.

UPCOMING EVENTS

Fri, Oct 20
- U.S. Existing-Home Sales (-0.9% m/m)
- Fed President Yellen Speaks (DC)
- Canada CPI (0.3% m/m)

Sun, Oct 22
- China September Property Prices

Mon, Oct 23
- Japan Nikkei Manufacturing PMI
- Eurozone Consumer Confidence
- U.S. Chicago Fed National Activity

Tue, Oct 24
- Eurozone Markit Manufacturing PMI
- Eurozone Markit Services/Comp. PMI
- Eurozone Q2 Govt. Debt and Deficit
- Germany Markit Manufacturing PMI
- U.S. Markit Manufacturing PMI (53.0)
- U.S. Markit Services/Composite PMI

Wed, Oct 25
- Germany IFO Expectations
- BoC Meeting

Wed, Oct 25, cont.
- U.K. Q3 GDP (0.3% q/q, 1.5% y/y)
- U.K. Index of Services
- U.S. Durable/Capital Goods
- U.S. New Home Sales (-1.8% m/m)
- U.S. FHFA New House Price (0.4% m/m)

Thu, Oct 26
- China Industrial Profits
- Japan CPI
- ECB Meeting

Thu, Oct 26, cont.
- Germany Consumer Confidence
- U.S. Wholesale Inventories
- U.S. Pending Home Sales (0.3% m/m)

Fri, Oct 27
- U.S. Q3 GDP (2.6% q/q, annl'zd)

Week of Oct 30
- BoJ Meeting (10/31)
- Fed Meeting (11/1)
- BoE Meeting (11/2)

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

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As of September 30, 2017

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	859	52.92	294	34.23
Hold [Sector Perform]	660	40.67	154	23.33
Sell [Underperform]	104	6.41	7	6.73

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