RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

# Time for Financials to step up to the plate

Kelly Bogdanova – San Francisco

**Equities' partial recovery from the rout was welcomed, but this kind of ebb and flow is normal. It's the disconnect between economic trends and banks' performance that's perplexing, and we believe the sector needs to show some leadership for the U.S. market to mount a sustainable move higher.**

Global equities teetered up and down, gaining back roughly one-third of what was lost during the recent shakeout. Markets responded favorably to solid Q3 earnings reports, strong U.S. economic data, and somewhat tamer Treasury market action, although concerns about Federal Reserve policy still linger. However, they gave back much of the gains.

This is the normal ebb and flow that usually occurs during pullbacks and corrections—a sharp downturn is often followed by a bounce and then typically back-and-forth, choppy trading as the market attempts to find its footing. Quite often, major equity indexes retest their lows, sometimes weeks or months later. In other words, the global correction could take more time to play out.

Equity and crude oil markets dealt calmly with the disappearance and alleged murder of Jamal Khashoggi, Saudi journalist and *Washington Post* opinion writer. While the Trump administration has handled this matter cautiously thus far, Congress may respond more aggressively, according to Helima Croft, RBC Capital Markets, LLC's global head of commodity strategy and life member of the Council on Foreign Relations. In her commentary, *Saudi Arabia: Rogue One*, Croft said the crisis seems far from finished.

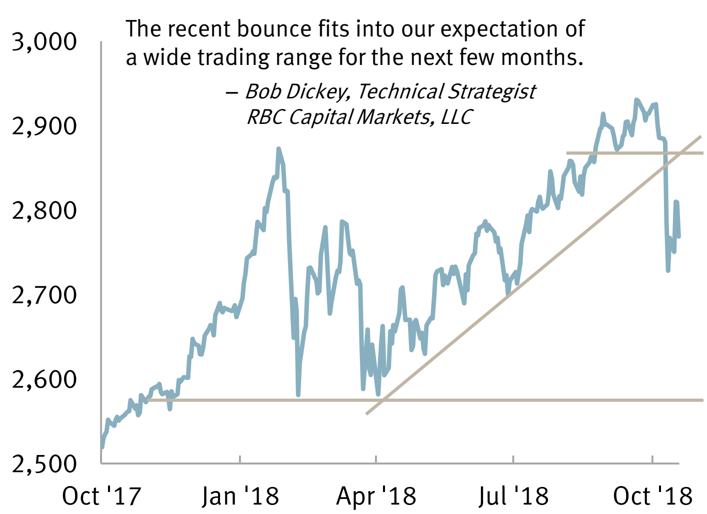
## Disconnected

In order for an "all clear" signal to flash for equities, one area of the U.S. market needs to step up to the plate: the Financials sector, more specifically, bank stocks. For months, there has been a disconnect between the sluggish trading in Financials and positive economic trends.

Banks have declined 3.4% since April, lagging the broader market by 820 basis points (8.2%). At the same time, a range

### Normal ebb and flow

S&P 500 Index (light blue) with technical support lines (beige)




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

## Market pulse



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Priced (in USD) as of 10/18/18 market close, EST (unless otherwise stated).

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Wealth Management

of economic data has picked up and forward indicators point toward solid activity over the next year, at least. This, combined with a relatively tame, methodical Fed rate hike cycle, normally would be positive for bank stocks and the Financials sector overall.

**Key issues have held back banks:**

- **The flat Treasury yield curve:** The narrow gap between short- and long-term yields constrains bank margins because banks tend to borrow at short-term rates and lend to customers at longer-term rates. Even though the yield curve has steepened a bit, this headwind remains.
- **Mediocre loan growth:** This has been surprising in light of above-trend economic activity. When all is said and done, RBC Capital Markets expects Q3 loan growth to rise 4.0% q/q and 1.6% y/y.
- **Rising deposit rates:** The percentage of Fed rate increases that is passed on to depositors, especially to commercial and high-net-worth depositors, has outpaced the benefit of rate hikes recently. Silver lining: this could ultimately hasten merger and acquisition activity.
- **Light net interest margins:** This key profitability measure has bounced off of its 2015 low, but RBC Capital Markets believes it will peak in Q4 2018 or Q1 2019 as banks come under more pressure to pay higher rates on deposits and amid the flat yield curve environment.
- **Heightened non-bank competition:** Traditional banks are increasingly facing competition from new, technology-driven upstarts that operate fully online, without brick-and-mortar locations. "Non-bank competition" is a recurring theme for banks this earnings reporting season. We believe the largest, most tech-savvy traditional banks are best positioned to compete with digital upstarts, as they have the balance sheet power to invest in digital initiatives and are already showing progress.
- **Concerns about hawkish Fed policy:** These jitters have increased as some Fed officials, including Chair Jerome Powell, have signaled openness to a more hawkish approach to rate hikes if warranted.

## Leadership skills

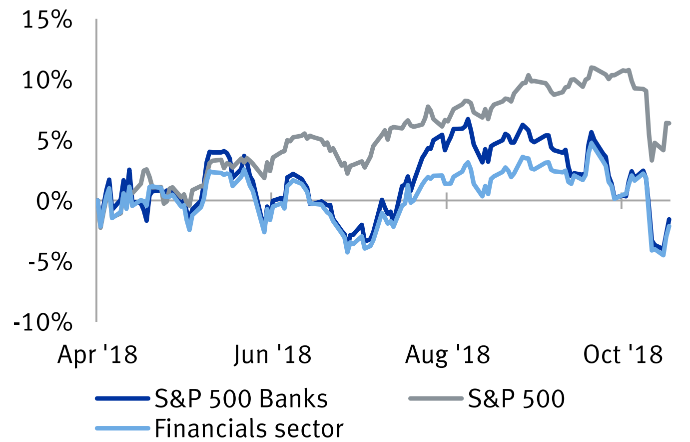
Despite the challenges, we still believe banks are attractive and have the potential to outperform over the long term.

Banks' Q3 earnings and forward guidance have been positive on balance. JPMorgan Chase, Bank of America, US Bancorp, and even Wells Fargo were strong. PNC Financial Services Group, normally a good operator, stumbled with loan growth.

Bank stocks are still reasonably valued compared to the broader market and versus the historical average based on our assessment of multiple valuation measures, including price-to-book (see lower chart). Banks' balance sheets haven't been this strong in many decades.

### Banks and the broader Financials sector have lagged

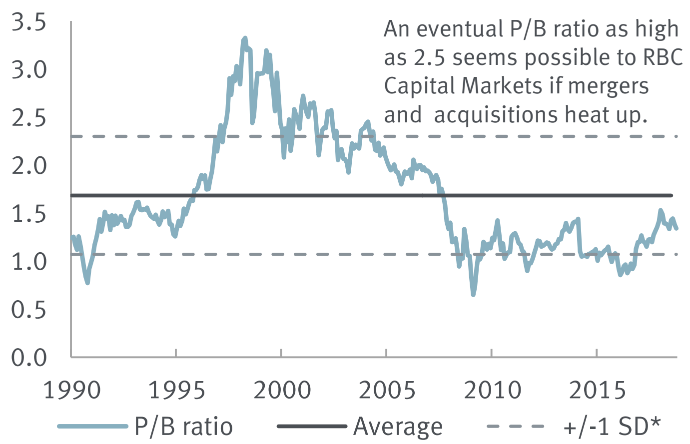
Index performance since April 2018




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

### U.S. banks still below the historical average valuation

S&P 500 Banks Index price-to-book (P/B) ratio




*SD: standard deviation. Source - RBC Wealth Management, Bloomberg; monthly data through 10/17/18

Historically, the Financials sector has been positively correlated with changes in inflation expectations, and expectations seem likely to rise.

We think banks have the potential to lead as long as the Fed doesn't overstep and the economy doesn't buckle. The economic expansion should persist and bank fundamentals should improve if the Fed refrains from raising rates too high, too fast, so as to unnecessarily choke off economic growth. Even with all of the subtle changes in Fed language recently, officials continue to signal a "gradual" approach to rate hikes.

To us, banks are a barometer of stock market health at this stage of the cycle. We believe the Financials sector needs to step into a leadership position for the market to mount a sustainable move higher.

## United States

Ben Graham, CFA – Minneapolis

- **Volatility has been the name of the game thus far in October** as major indexes are down multiple percentage points. In fact, the S&P 500 is down more than 4% from its September 2018 all-time high and the NASDAQ and small-cap Russell 2000 are approaching double-digit declines from their all-time highs. Interestingly, the volatility concerns were limited to global equity markets. Commodities, fixed income, and economic data have been largely uninterrupted in October action.
- **Evidence of the challenges to equity markets can be found in the VIX, a volatility index commonly referred to as the "fear gauge."** This measure represents the rapidity with which stock market insurance against market declines is being purchased, i.e., the index climbs when more investors are trying to protect against downside risk. The VIX reached a reading of 28.8 on October 11, its most elevated reading since the aftermath of the previous correction in February. The recent elevated levels demonstrate investors' fear that markets will move lower. The VIX has averaged 15.3 thus far in 2018. During the current economic expansion, volatility-related selloffs have proven to be timely opportunities for investors (as seen in the table at right), and a general rule of thumb in the past has been to buy stocks when the VIX exceeds 20, which fits with our view to remain modestly Overweight global equities at this time.
- **The minutes from the Fed's September meeting showed a more hawkish tone** as some participants voiced their opinion that rates may ultimately need to be modestly restrictive for a time. **On the economic front, it was business as usual** during the week, as Consumer Price Indexes demonstrated inflation was largely in line with consensus expectations, housing starts of 1.2 million were unsurprising, and September retail sales were slightly weaker than expected at the headline level but showed strength beneath the surface. All in all, the U.S. economy has remained relatively even-keeled despite the recent equity market volatility.

Volatility spikes have been buying opportunities

| | S&P 500 returns since 2010 | |
|---|---|---|
| Period | All times | VIX › 20 |
| Next 12 months | 13.7% | 16.2% |
| Next 6 months | 6.3% | 10.3% |
| Next 3 months | 3.4% | 7.0% |
| Next 1 month | 1.3% | 2.4% |

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

## Canada

Carolyn Schroeder & Richard Tan, CFA – Toronto

- **We believe few, if any, Canadian oil producers will escape the pricing dislocation that is being concentrated in Q4.** Regional fundamentals are weak and heavy crude oil is being marked against a West Texas Intermediate (WTI) benchmark that is pricing at multiyear highs. According to RBC Capital Markets, Canadian oil prices vis-à-vis Brent and WTI reflect a convergence of structural and cyclical factors including insufficient oil export pipeline capacity and a slow ramp-up of crude-by-rail. Western Canadian Select (WCS) crude appears the hardest hit with recent spreads spiking to $50 per barrel vs. WTI as per Bloomberg. RBC Capital Markets believes the process towards normalization entails two steps: first, refinery maintenance is peaking and will taper in mid-November; and second, Canadian stockpiles must be drawn down from near record-high levels. **RBC Capital Markets sees potential relief over the course of 2019, particularly when new pipeline capacity comes online.** The increased capacity is expected to add around 375,000 barrels of oil per day to the market, which should assist in narrowing the WCS-WTI spread. In isolation, the pipeline expansion is insufficient to bridge Canada's transportation constraints, but we believe it will alleviate pressure placed on crude-by-rail.
- On October 1, 2018, **LNG Canada announced a positive final investment decision for its proposed export facility** in Kitimat, British Columbia. The project is a **joint venture between five global leaders in liquefied natural gas** (LNG) and is expected to produce 14 million tonnes per annum once the first facility becomes operational in 2023. LNG Canada expects demand for LNG to double by 2035 driven by global commitments to address climate change and air pollution. As things stand today, increased inventories and a tight transportation environment have weighed on natural gas prices, thereby causing producers to struggle. Overall, the project should be a net positive for producers as it **provides an additional end-market opportunity which should allow for some price relief.** We note that the project is long-term in nature, and thus any potential exports will not take place for several years to come at a minimum.

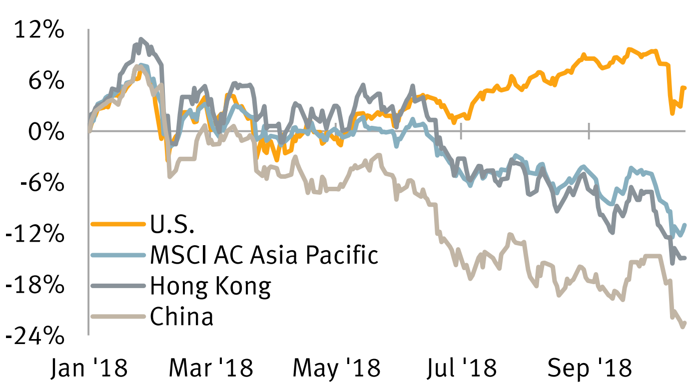
## Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Focus has remained firmly on Brexit development.** Hopes the EU would judge enough "decisive progress" had been made in the Brexit negotiations at this point to warrant arranging an additional mid-November EU summit to sign off on the final Withdrawal Agreement evaporated. **The sticking point remains the Irish backstop,** the legally binding default position the U.K. and EU would revert to if an agreement on trade arrangements between the two is not agreed upon after March 29, 2019.
- **A mid-November EU summit could still happen** if Michel Barnier, the EU chief negotiator, judges "sufficient progress" has been made to merit doing so.
- The **next European Council meeting** is scheduled for December 13–14, and is the time a deal is most likely to be signed off. That would leave just enough time to ratify and legislate for an end-of-March exit, though the timetable is becoming perilously challenging.
- Many newspapers, including the *Financial Times*, are reporting that **the U.K. is looking at the option of extending the transition period it is seeking by one year,** to the end of 2021. A transition period, a time during which the status quo applies so as to prepare the country for its future trading relationship with the EU, would only apply if the Withdrawal Agreement is sealed.
- Extending the transition period to just under three years is **likely to face much criticism** from the most passionate Brexiteers in parliament, who fear it is a back door to further extensions. After all, cobbling together the terms of a new trading relationship within that time frame will remain challenging. The U.K. hopes that with more time to negotiate, **the probability of needing the Irish backstop may be lower**. In the eyes of the EU, this lower probability doesn't make it any less necessary to ensure no hard border emerges in Ireland.
- **The FTSE All-Share** bounced back during the week, along with other stock markets worldwide, though to a lesser extent.

### Asian equities continue to lag U.S. peers

YTD returns show impact of trade and economic concerns




Source - RBC Wealth Management, Bloomberg; data through 10/17/18; returns represented by the following indexes: Shanghai Composite Index (China), Hang Seng Index (Hong Kong), and S&P 500 (U.S.)

## Asia Pacific

Jay Roberts, CFA – Hong Kong

- **Sentiment in Asian equities remains weak,** especially in North Asia. The MSCI AC Asia Pacific Index is down 11% in 2018.
- Equity indexes in mainland China have been particularly weak and fell further during the week. **The Shanghai Composite is down 22.5% in 2018 while the Shenzhen Composite has lost 35%.** Most of these losses have occurred since May and coincide with the initial imposition of U.S. tariffs on Chinese goods. Both indexes hit a low for the year on Thursday.
- In recent weeks and months, the relationship between the U.S. and China has deteriorated further, in our view. While it is possible the unpredictable President Trump may do an about-face and try to strike a trade deal with China, we think that this is unlikely given the many different issues that the U.S. is tabling and the breadth of support in U.S. political circles for a tough stance towards China. And even if a deal were to happen, it would not solve the litany of issues that the U.S. has begun to raise publicly. That is, **a deal might only provide a temporary reprieve to the Chinese markets.**
- **One headwind for Chinese and Hong Kong equities has been the downtrend in China's currency.** The renminbi has declined against the dollar to over 6.93 and is **closing in on the psychologically important level of 7.00.** However, the U.S. Treasury Department decided not to label China a "currency manipulator" in its semiannual report on foreign exchange rates. That said, Treasury Secretary Steven Mnuchin did say that both China's "lack of currency transparency" and the "recent weakness in its currency" were of "particular concern."
- **Hong Kong equities failed to respond to the strong bounce in U.S. stocks that took place on Tuesday.** Wednesday was a public holiday. When the market reopened on Thursday, the Hang Seng Index barely moved. As we noted in last week's special *Global Insight Weekly*, equity valuations have largely been irrelevant during the downturn in 2018. However, history tells us that book value is an exceptionally strong support line for the Hang Seng Index, while 1.1x book value has also represented a compelling buying opportunity historically. Book value is 21,200; 1.1x book value is 23,320. The index is currently at 25,454. For the time being though, the **downward pressure remains.**

## MARKET SCORECARD

### Data as of October 18, 2018

| Equities (local currency) | Level | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| S&P 500 | 2,768.78 | -5.0% | 3.6% | 8.1% | 29.4% |
| Dow Industrials (DJIA) | 25,379.45 | -4.1% | 2.7% | 9.6% | 39.7% |
| NASDAQ | 7,485.14 | -7.0% | 8.4% | 13.0% | 42.7% |
| Russell 2000 | 1,560.75 | -8.0% | 1.6% | 3.7% | 28.2% |
| S&P/TSX Comp | 15,404.13 | -4.2% | -5.0% | -2.4% | 4.4% |
| FTSE All-Share | 3,864.62 | -6.4% | -8.5% | -6.7% | 1.6% |
| STOXX Europe 600 | 361.67 | -5.6% | -7.1% | -7.6% | 5.6% |
| EURO STOXX 50 | 3,211.59 | -5.5% | -8.3% | -11.3% | 5.4% |
| Hang Seng | 25,454.55 | -8.4% | -14.9% | -11.3% | 8.8% |
| Shanghai Comp | 2,486.42 | -11.9% | -24.8% | -26.5% | -19.4% |
| Nikkei 225 | 22,658.16 | -6.1% | -0.5% | 6.1% | 33.6% |
| India Sensex | 34,779.58 | -4.0% | 2.1% | 6.7% | 24.0% |
| Singapore Straits Times | 3,069.67 | -5.8% | -9.8% | -7.8% | 8.4% |
| Brazil Ibovespa | 83,847.12 | 5.7% | 9.7% | 9.5% | 31.5% |
| Mexican Bolsa IPC | 47,024.46 | -5.0% | -4.7% | -5.8% | -2.2% |
| **Commodities (USD)** | **Price** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| Gold (spot $/oz) | 1,226.06 | 2.8% | -5.9% | -4.3% | -2.9% |
| Silver (spot $/oz) | 14.58 | -0.8% | -14.0% | -14.3% | -17.3% |
| Copper ($/metric ton) | 6,216.00 | -0.8% | -13.8% | -10.5% | 33.4% |
| Oil (WTI spot/bbl) | 68.65 | -6.3% | 13.6% | 31.9% | 36.5% |
| Oil (Brent spot/bbl) | 79.34 | -4.1% | 18.6% | 36.4% | 53.5% |
| Natural Gas ($/mmBtu) | 3.23 | 7.2% | 9.2% | 13.0% | -1.1% |

| Govt bonds (bps chg) | Yield | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| U.S. 10-Yr Tsy | 3.171% | 11.0 | 76.6 | 82.5 | 143.3 |
| Canada 10-Yr | 2.498% | 7.1 | 45.3 | 46.2 | 130.1 |
| U.K. 10-Yr | 1.538% | -3.5 | 34.8 | 22.3 | 45.8 |
| Germany 10-Yr | 0.416% | -5.4 | -1.1 | 2.0 | 38.1 |
| **Fixed Income (returns)** | **Yield** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Aggregate | 3.58% | -0.7% | -2.3% | -1.9% | -1.4% |
| U.S. Invest Grade Corp | 4.21% | -0.9% | -3.2% | -2.4% | 0.2% |
| U.S. High Yield Corp | 6.54% | -0.7% | 1.9% | 1.9% | 10.6% |
| **Currencies** | **Rate** | **MTD** | **YTD** | **1 yr** | **2 yr** |
| U.S. Dollar Index | 95.9500 | 0.9% | 4.2% | 2.8% | -2.0% |
| CAD/USD | 0.7647 | -1.3% | -3.9% | -4.7% | 0.2% |
| USD/CAD | 1.3077 | 1.3% | 4.0% | 4.9% | -0.2% |
| EUR/USD | 1.1458 | -1.3% | -4.6% | -2.8% | 4.3% |
| GBP/USD | 1.3020 | -0.1% | -3.6% | -1.4% | 5.9% |
| AUD/USD | 0.7103 | -1.7% | -9.0% | -9.5% | -7.3% |
| USD/JPY | 112.1200 | -1.4% | -0.5% | -0.7% | 7.9% |
| EUR/JPY | 128.4700 | -2.6% | -5.0% | -3.5% | 12.6% |
| EUR/GBP | 0.8800 | -1.2% | -0.9% | -1.4% | -1.4% |
| EUR/CHF | 1.1407 | 0.1% | -2.5% | -1.4% | 4.9% |
| USD/SGD | 1.3813 | 1.0% | 3.4% | 1.8% | -0.3% |
| USD/CNY | 6.9376 | 1.0% | 6.6% | 4.7% | 2.9% |
| USD/MXN | 19.1469 | 2.3% | -2.6% | 1.5% | 2.9% |
| USD/BRL | 3.7187 | -8.2% | 12.4% | 17.3% | 16.7% |

Source - Bloomberg. Note: Equity returns do not include dividends, except for the 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 10/18/18.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -3.9% return means the Canadian dollar fell 3.9% vs. the U.S. dollar year to date. USD/JPY 112.12 means 1 U.S. dollar will buy 112.12 yen. USD/JPY -0.5% return means the U.S. dollar fell 0.5% vs. the yen year to date.

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As of September 30, 2018

| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
| Buy [Top Pick & Outperform] | 859 | 54.33 | 251 | 29.22 |
| Hold [Sector Perform] | 646 | 40.86 | 125 | 19.35 |
| Sell [Underperform] | 76 | 4.81 | 5 | 6.58 |

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