May 24, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Bull market obstacle course

Kelly Bogdanova – San Francisco

While most have focused on the gauntlet of macro risks facing the bull market, there's an overarching—and overlooked—reason why the market has been wobbly, the midterm elections. But this is normal behavior for midterm election years and the market should maneuver past any potential pitfalls.

For months bulls and bears have faced off on a number of macro issues from the spike in Treasury yields, to inflation jitters, to protectionism and tariff risks, to geopolitical hazards, to Washington drama, and more (see table).

A handful of these issues sparked a 10% correction in the S&P 500 and pressured markets outside of the U.S. from late January through early February. While equities have bounced back somewhat since then, they are still wobbly and reactive to the macro risks du jour that tend to drift on and off the radar screen and then back on again.

But it's not only these legitimate macro risks that have been constraining equities in 2018. Importantly, we think an overarching—and overlooked—factor is also pressuring stock prices: the U.S. midterm elections looming in November.

The historical performance surrounding midterm House and Senate elections is among the strongest of the seasonal equity market cycles we track. The U.S. market typically corrects ahead of time and improves meaningfully after the midterm election year low has been established. Investors should keep this in mind as the market zigs and zags this year.

Pullback pattern

Corrections, pullbacks, and volatile market moves are par for the course in the 12-month period leading up to a U.S. midterm election.

The S&P 500 pulled back 5% or more ahead of 19 of 21 midterm elections since 1934. It declined 10% or more on 14 of those occasions, or 67% of the time. The S&P 500 corrected by an average of 20.6% over the 21 instances. (Performance

Bulls and bears have been facing off on ...

- Spike in Treasury yields
- Yield curve flattening
- Fed policy uncertainty
- Inflation jitters
- Geopolitical events
- Washington drama
- Protectionism, tariffs
- Economic growth
- Tech concerns
- "Peak earnings growth"

But is there an overarching issue at play?

Source - RBC Wealth Management

Market pulse

Click here for authors' contact information.

Priced (in USD) as of 5/24/18 market close, EST (unless otherwise stated).

For important disclosures and required non-U.S. analyst disclosures, see page 6.

RBC Wealth Management

is measured from the peak within 12 months prior to the midterm election year low, to that low.)

So it should be no surprise that the S&P 500 has already succumbed to a pullback in this midterm election year, falling 10% from the all-time high in late January through early February. The S&P 500 remains 5.1% below the January high.

Given the historical pattern, it seems at least part of the midterm election year correction has already been absorbed by the market, but we don't rule out additional turbulence in coming months.

Opening for opportunity

Importantly, the midterm election year low has historically been an inflection point for the U.S. market.

Turnabouts didn't always happen immediately after the election; sometimes more volatility occurred and the market rebounded weeks or months later. But once the market got going again, it really jumped.

The S&P 500 rallied 47.3%, on average, as measured from the low point reached during the midterm election year to the high in the following year. In 19 of 21 instances, the market surged 25% or more. It traded higher on all 21 occasions since 1934.

It seems history would argue to buy into any midterm election year turbulence.

Market maneuverability

In our assessment, there are no clear-cut reasons why the U.S. market tends to struggle at some point during the 12-month period that precedes a midterm election, and then rally smartly after the low has been reached.

Analysts often cite the uncertainty about party control of Congress as a factor, as that can impact the country's fiscal direction and the president's agenda. Markets don't like uncertainty, and a shift in control of the House away from the president's party is possible this year.

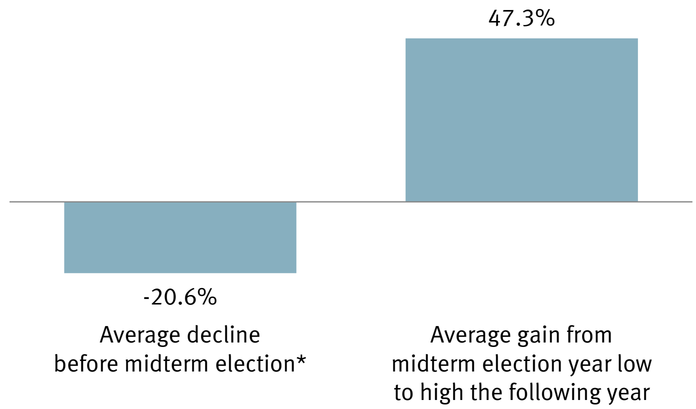
But even during the decades-long streak that the Democratic Party had a lock on the House, the midterm seasonal market pattern played out regardless of which party controlled the Senate or occupied the White House.

Perhaps the fear of the unknown is what grips the market, and then once the political landscape shakes out, those fears subside and market conditions improve. After all, earnings growth mainly drives stock prices over the long term, not shifts in party control in Washington.

Regardless of how the political landscape shakes out this go around, once the market works past the midterm election period we think it will be more evident that the long-term secular bull market still has legs.

Corrections are common in midterm years, and so are follow-on rallies

S&P 500 returns surrounding midterm elections (1934–2014)



* Measured from the peak within 12 months before the midterm election year low, to that low
Source - RBC Wealth Management, Bloomberg; performance before and after 21 midterm election years

The historical pattern argues for buying the midterm dip

Notable S&P 500 factoids surrounding midterm election years
Correction periods ahead of midterm elections*
The average correction was 20.6% and the median correction was 19.9% over the 21 instances
Pullbacks of 5% or more occurred in 19 of the 21 instances
Corrections of 10% or more occurred in 14 of those occasions
Corrections of 20% or more occurred 10 times
Rally periods from midterm election year low to high the following year
The average rally was 47.3% and the median rally was 43.4% over the 21 instances
The S&P 500 traded higher on all 21 occasions
It rallied by 25% or more in 19 of the 21 instances

* Measured from the peak within 12 months before the midterm election year low, to that low
Source - RBC Wealth Management, Bloomberg; performance before and after 21 midterm election years (1934–2014)

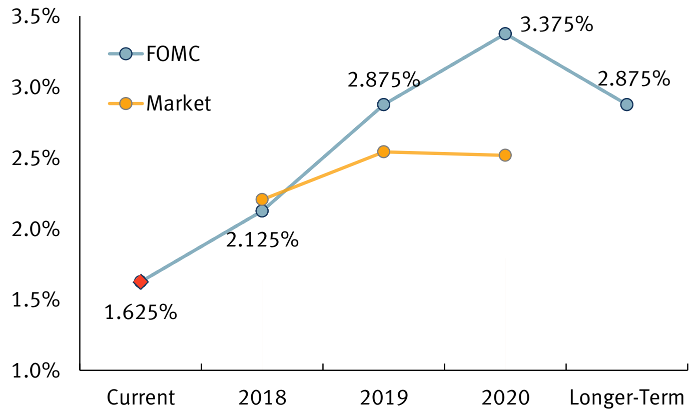
United States

Ben Graham – Minneapolis

- **The minutes from the Fed's May meeting confirmed the Fed's outlook on rate policy and the economy**. Policymakers clearly communicated a high degree of internal expectation that the next rate hike will occur at the June meeting with market expectations now at 100% for a 25 basis point hike in June. After peaking at 3.11% recently, the 10-year Treasury has since dipped below the 3% threshold. In terms of the flattening yield curve, the **difference (spread) between the 2-year and 10-year Treasury fell to post-Great Recession lows of 43 basis points**. Officials appear split on the meaning of this data point and we expect this discussion to be more prominent in the Fed's decision-making process in the back half of 2018 and into 2019. **Our U.S. Fixed Income Strategies Group continues to believe the flattening yield curve will be a headwind to rate hikes beyond the June meeting**, and believes that the market's view on future policy rates will prove more accurate than current Fed estimates.
- **In equities, geopolitics and interest rates have shaped recent movements**. U.S. indexes rallied in the beginning of the week on easing trade tensions between the U.S. and China after both sides agreed to put escalations on hold, before weakening into the back half of the week on a deterioration, and ultimate cancellation, of the proposed summit between President Trump and North Korean leadership. Given this backdrop and the action of Treasury yields, **bond proxies have been market leaders**. Utilities leads all sectors so far during the week, with Telecom and Real Estate following closely. As retail earnings—the only broad group still reporting earnings—continue, results have been mixed and share price moves largely dependent on guidance as opposed to results.
- On the economic front, data releases saw U.S. flash Purchasing Managers' Indexes come in slightly above consensus expectations, while housing data missed estimates. **Existing-home sales declined** 2.5% m/m in April to 5.46 million and undershot the consensus estimate of 5.55 million. **However, the bottleneck remains on the supply side**, as the average number of days a home is on the market declined, implying resilient demand despite the highest mortgage rates of the last seven years.

Market expectations for future rate hikes are lower than the FOMC's projections beyond 2018

Rate hike expectations after June meeting



Source - RBC Wealth Management, Bloomberg, Federal Reserve; data through 5/23/18; Note: Market data based on overnight indexed swap rates

Canada

Farazeh Mahboob & Richard Tan – Toronto

- RBC Capital Markets held its annual Canadian Automotive, Industrials, and Transportation Conference earlier this month. **As the economic landscape continues to evolve within the automotive sector, firms are adapting** by increasing their investments into electrification and autonomous driving. RBC Capital Markets believes the **Canadian auto suppliers are undervalued** relative to global peers. On the other hand, the recent rebound in commodity prices combined with an increase in government spend has been **contributing positively to the growth profiles of engineering & construction firms** in RBC Capital Markets' coverage universe. Finally, despite the capacity issues among the transports, firms are **showcasing their ability to win over investors' confidence** as they are rectifying issues ahead of expectations.
- The Bank of Canada and the Office of the Superintendent of Financial Institutions have indicated that **domestic real loan growth has slowed modestly** (down 5.3% y/y) among the large Canadian banks as of February. RBC Capital Markets found that **sales activity picked up modestly in Toronto during April**, but housing activity and prices continue to be down year to date. Traditionally, sales have picked up in April and, as a result, RBC Capital Markets believes it would be wise to wait a few more months to digest the impact of the new mortgage rules on loan growth and the broader economy. RBC Capital Markets assumes that mortgage growth for larger banks will slow by 2% on an annualized basis.
- Following a review of Q1 earnings results, **RBC Capital Markets continues to favor the regional wireless operators** under its coverage universe and expects the group to outperform the broader Telecom sector this year. A **key theme** that emerged from this earnings cycle was a **deceleration in average revenue per user (ARPU) growth among the wireless incumbents**, consistent with company managements' view for ARPU growth to moderate into the +1%–2% range this year. Factors

contributing to this deceleration include the lapping of Premium Plus plans, larger data buckets, device proliferation, WiFi offload, bring your own device, and increased competition, offset by core price increases, growth in data consumption, and mix.

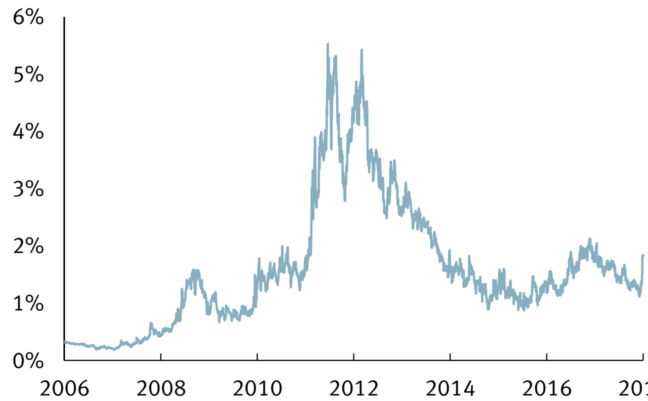
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Investors were concerned about weaker-than-expected economic indicators and Italian politics**. The impact was most felt in the foreign exchange market, with the **euro continuing to slide, bringing losses since the February peak to 6.5% against the dollar**. The yield on Italian 10-year bonds touched 2.395%, up from a low of 1.712% in April, bringing the spread compared to the German Bund to more than 1.8% from 1.1% a month ago.
- **Italy confirmed a technocrat as head of state**. Italy's president asked the new prime minister, law professor Giuseppe Conte, to form a new government which he says will be based on the agreement recently struck by the populist parties Five Star Movement and the Northern League. **The coalition is anti-establishment and likely to challenge the constraints of the eurozone's rules**. Investors will need to closely follow the developments of this government of unlikely partners. We expect a higher fiscal deficit, and thus indebtedness for the country which is already highly indebted, as well as a rollback of recent labour market reforms.
- **The euro area composite Purchasing Managers' Index (PMI) weakened** to 54.1 in April, from 55.1 the previous month, with **both the manufacturing and the services PMIs waning**. While some weakness was expected, the **extent of the fall came as a surprise**. Activity slowed in both France and Germany. Strikes and holidays may have had an impact and next month's data will be important to gauge the effect of these one-off events.
- The PMIs continue to point to Q2 economic growth of 0.5%–0.6% for the eurozone, but this **loss of momentum combined with the clouds starting to build in Italy make for a less encouraging picture** for the region. We maintain our Overweight position on European equities, with a preference for core economies over the periphery.

Weakening economic factors and politics drive Italian yields higher relative to peers

Italian 10-yr. government bond spread vs. 10-yr. Bund



Source - RBC Wealth Management, Bloomberg; data through 5/24/18

Asia Pacific

Jay Roberts, CFA – Hong Kong

- **Asian markets continue to tread water**. The uncertainty around the U.S.-China trade negotiations is weighing on stocks. Asian equities have also been consolidating after strong gains in 2017 and the correction in February.
- Asian markets were **initially buoyed by the agreement between the U.S. and China to suspend plans to impose tariffs** after talks in Washington. The joint statement said that the two countries would "substantially reduce" the U.S. trade deficit with China. **However, details were scant**, aside from mentioning an increase in U.S. exports of agricultural products and energy. More recently, President Trump tweeted that a detailed agreement "will be too hard to get done" and that a "different structure" would be needed, without elaborating on what that meant.
- With respect to the trade negotiations, a key issue is the **lack of clarity on what the U.S. is trying to achieve and how aggressive it wishes to be with China**. Those who are more critical of the trade situation with China, such as Peter Navarro, Robert Lighthizer, and John Bolton, would be more aggressive in their approach compared to more moderate figures such as Steve Mnuchin.
- Most importantly, it is not clear what Trump's views and goals are in this area. For example, he has often talked about the U.S. losing jobs to China, but recently offered **support for Chinese technology firm ZTE (763 HK) because ZTE has effectively shut down, impacting Chinese jobs**. ZTE, a large state-owned enterprise that employs around 80,000 people and is a major producer of smartphones and telecom equipment, was recently banned from buying U.S. products, necessary components in its own products, due to its business dealings with Iran and North Korea.

MARKET SCORECARD

Data as of May 24, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,727.76	3.0%	2.0%	13.4%	31.4%
Dow Industrials (DJIA)	24,811.76	2.7%	0.4%	18.1%	40.1%
NASDAQ	7,424.43	5.1%	7.5%	20.5%	52.7%
Russell 2000	1,628.22	5.6%	6.0%	17.8%	43.4%
S&P/TSX Comp	16,113.62	3.2%	-0.6%	4.5%	15.5%
FTSE All-Share	4,244.71	2.8%	0.5%	3.2%	24.0%
STOXX Europe 600	390.54	1.4%	0.3%	-0.5%	13.5%
EURO STOXX 50	3,521.76	-0.4%	0.5%	-1.8%	17.0%
Hang Seng	30,760.41	-0.2%	2.8%	21.0%	55.1%
Shanghai Comp	3,154.65	2.3%	-4.6%	3.0%	11.8%
Nikkei 225	22,437.01	-0.1%	-1.4%	13.6%	36.0%
India Sensex	34,663.11	-1.4%	1.8%	14.4%	37.0%
Singapore Straits Times	3,528.92	-2.4%	3.7%	9.2%	28.3%
Brazil Ibovespa	80,122.31	-7.0%	4.9%	26.7%	62.4%
Mexican Bolsa IPC	45,433.09	-6.0%	-7.9%	-8.2%	-0.1%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,305.10	-0.8%	0.2%	3.7%	6.3%
Silver (spot $/oz)	16.67	2.1%	-1.6%	-3.3%	2.8%
Copper ($/metric ton)	6,841.50	1.1%	-5.1%	20.8%	48.0%
Oil (WTI spot/bbl)	70.68	3.1%	17.0%	38.3%	46.7%
Oil (Brent spot/bbl)	78.80	4.8%	17.8%	46.0%	62.1%
Natural Gas ($/mmBtu)	2.93	6.0%	-0.8%	-8.8%	47.9%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.975%	2.2	57.0	72.5	111.2
Canada 10-Yr	2.410%	10.3	36.5	93.2	104.4
U.K. 10-Yr	1.401%	-1.7	21.1	32.9	-7.1
Germany 10-Yr	0.472%	-8.7	4.5	6.9	29.5
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.34%	-0.2%	-2.4%	-0.9%	0.5%
U.S. Invest Grade Corp	3.99%	-0.4%	-3.6%	-0.3%	3.9%
U.S. High Yield Corp	6.38%	0.0%	-0.2%	2.6%	16.9%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	93.7760	2.1%	1.8%	-3.6%	-1.9%
CAD/USD	0.7760	-0.3%	-2.5%	4.0%	1.8%
USD/CAD	1.2887	0.3%	2.5%	-3.9%	-1.8%
EUR/USD	1.1725	-2.9%	-2.3%	4.5%	5.2%
GBP/USD	1.3386	-2.7%	-0.9%	3.2%	-8.5%
AUD/USD	0.7579	0.7%	-2.9%	1.0%	5.5%
USD/JPY	109.2700	-0.1%	-3.0%	-2.0%	-0.7%
EUR/JPY	128.1200	-3.0%	-5.3%	2.4%	4.6%
EUR/GBP	0.8760	-0.2%	-1.4%	1.3%	15.1%
EUR/CHF	1.1621	-2.9%	-0.7%	6.4%	5.0%
USD/SGD	1.3393	1.0%	0.2%	-3.3%	-3.1%
USD/CNY	6.3784	0.7%	-2.0%	-7.4%	-2.7%
USD/MXN	19.5548	4.5%	-0.5%	6.0%	5.8%
USD/BRL	3.6451	4.0%	10.0%	11.2%	2.1%

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 5/24/18.

Examples of how to interpret currency data: CAD/USD 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD -2.5% return means the Canadian dollar fell 2.5% vs. the U.S. dollar year to date. USD/JPY 109.27 means 1 U.S. dollar will buy 109.27 yen. USD/JPY -3.0% return means the U.S. dollar fell 3.0% vs. the yen year to date.

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Sell [Underperform]	85	5.26	7	8.24

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