March 15, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

The shifting trade winds

Kelly Bogdanova – San Francisco

While the U.S. administration is embracing protectionism, fixing the one-sided trade relationship with China is easier said than done. If tit-for-tat trade barriers are erected, we see blowback for select sectors and explain how investors should position portfolios amid the rise of protectionism.

President Trump's protectionist policies are not merely targeted at steel and aluminum and driving a harder bargain on NAFTA with Canada and Mexico. China is viewed as the greatest longer-term trade threat in the administration's eyes.

The U.S. trade balance with China—exports minus imports—plunged to a $375B deficit in 2017, 65% lower than when the global financial crisis ended (see chart). The president's aim is to meaningfully reduce this deficit.

Public policy analysts across the political spectrum, including those at our national research correspondent, indicate tariffs on Chinese goods could be on the way.

The administration's current investigation into China's compulsory technology transfer policies for U.S. companies could result in tariffs on select Chinese imports and add more restrictions on Chinese investments in the U.S. The investigation falls under Section 301 of the 1974 Trade Act, which gives the president broad authority to impose tariffs but has rarely been used since the World Trade Organization (WTO) was formed in 1995. China could challenge any unilateral U.S. tariffs in the WTO.

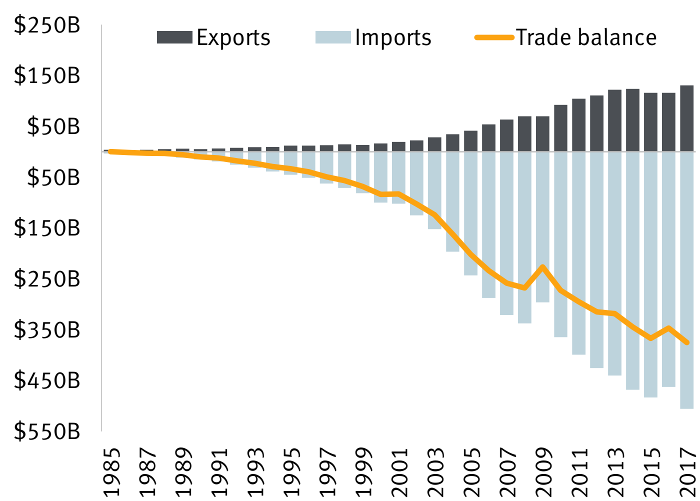
Also, Congress is in the process of changing the rules for Chinese investments in U.S. companies so that more merger and acquisition (M&A) transactions come under review, thereby making it more difficult for deals to take place.

Clash of the titans?

Our concern is that an initial burst of tariffs on Chinese goods could lead to a tit-for-tat building up of trade barriers over time.

Trade with China has become more one-sided over the years

U.S. trade with China



Source - RBC Wealth Management, U.S. Census Bureau; annual data through 2017

Market pulse

3 U.S. market's valuation is reasonable, any way we slice it
3 BoC chief sees untapped potential for Canada's economy
4 Portent for post-Brexit corporate legal bases?
4 Bank of Japan stands pat on policy

While targeted tariffs, such as those announced recently on steel and aluminum, won't have much economic impact on their own, a tit-for-tat layering of additional tariffs certainly could have a discernable negative impact, particularly if the disputes are between two economic powerhouses like the U.S. and China.

Even if tariffs are imposed, reducing the trade deficit with China by any meaningful amount will be tough to achieve given the U.S. consumer market is the largest in the world and thirsts for products from China and elsewhere. When a country is a net debtor—uses resources from other nations to fund domestic consumption and investment—trade deficits are unavoidable.

Furthermore, a nontrivial share of U.S./China trade is business-to-business and involves complex global supply chains with interdependencies that are often misunderstood in Washington. What might look like a straightforward industry tariff on the surface could end up tying global supply chains in knots.

Tech caught in the crossfire

The technology, industrial, communications, and consumer staples industries seem most vulnerable to trade-related headline risks and pressure. U.S./China trade risks have already contributed to equity market volatility and pressured semiconductor stocks and shares of aerospace giant Boeing recently.

The S&P 500 Technology sector has the highest share of international exposure among all sectors, by far (see upper chart). 18 semiconductor firms within the S&P 500 reap 20% to 85% of their revenues from China.

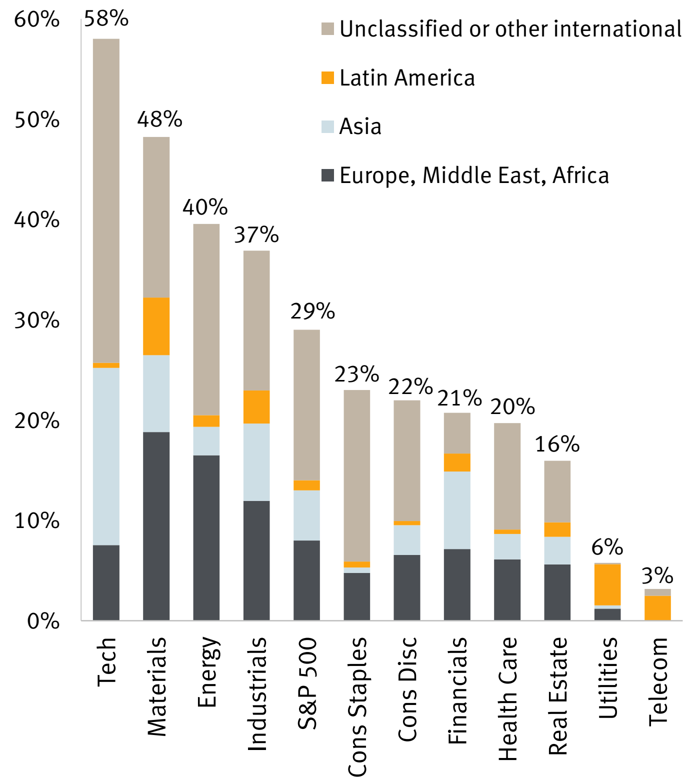
The Tech sector is also vulnerable to additional limitations that may be placed on M&A, as illustrated by the administration's recent decision to block Singapore-based Broadcom from buying U.S.-based Qualcomm on national security grounds due to Broadcom's China ties.

While we still favor Tech from a fundamental standpoint and believe the long-term secular growth drivers remain intact, at this stage we would be wary of holding an aggressive, super-sized position in the sector. It could enter a period of underperformance if Chinese trade and cross-border deal risks escalate. Tech valuations are by no means as high as they were during the bubble era, but they are at the top of the post-bubble range and have not priced in protectionist risks, in our view (see lower chart).

For U.S. equities overall, we believe the protectionist threats argue for tilting portfolios toward domestically oriented sectors. The Financials sector is the most attractive among those with high domestic revenues, in our assessment. Health Care also has some attractive characteristics.

Tech is the most internationally exposed sector

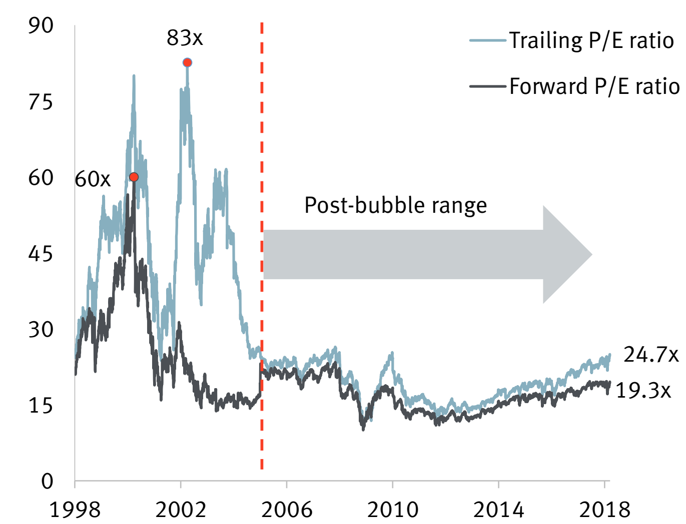
S&P 500 percentage of international revenues by sector



Source - RBC Capital Markets U.S. Equity Strategy, Capital IQ, Standard & Poor's

Tech valuations are nowhere near peak levels, but are toward the top end of the post-bubble range

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



Source - RBC Wealth Management, Bloomberg; data through 3/14/18

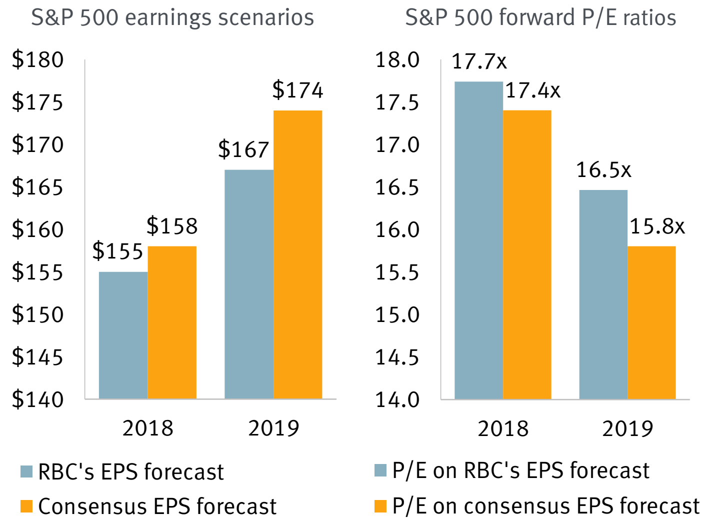
Furthermore, we believe a position in small caps is warranted, as it has higher domestic exposure than large caps at 81% to 71%, respectively.

United States

Kelly Bogdanova – San Francisco

- **A slew of headlines have been thrown at the U.S. equity market lately** related to trade tensions, soft economic data, geopolitics, and the Mueller investigation. The S&P 500 has slipped 1.4% so far during the week.
- Since the February correction low, the **rebound has been rather lopsided** from a sector perspective. **The Tech sector has led by a mile**, up 13.2%. Real Estate is the only other sector that has outperformed the S&P 500. The biggest laggards have been Consumer Staples and Energy. **We think the market has more churning to do** and could end up trading in a wide sideways pattern in the coming weeks and months as the outsized gains since mid-2016 are digested.
- Once the equity market gets through this choppy period, we believe the major indexes will work toward new highs. **Earnings growth prospects are favorable and valuations seem reasonable**, especially given the low interest rate environment. RBC Capital Markets forecasts S&P 500 earnings of $155 per share in 2018 and $167 in 2019. As long as GDP grows at a trend rate—between 2.0% and 2.5%—we think this can be achieved. While the consensus forecast began the year lower than RBC Capital Markets' estimates, optimism about corporate tax cuts has driven consensus forecasts higher than our estimates to $158 in 2018 and $174 in 2019. **But any way we slice it, we see the market's valuation as reasonable** whether it's based on our more conservative estimates or the more optimistic consensus forecasts. In all of these scenarios, the forward price-to-earnings ratios range from 15.8x to 17.7x (see chart).
- **The weak retail sales report raised some eyebrows**. Sales dropped 0.1% in February, the third straight monthly decline. That fell far shy of the consensus forecast, which called for a gain of 0.3%. **This prompted some economists to dial back their Q1 GDP forecasts**. It now seems less likely the economy will grow at a 3%+ clip in Q1 and there are some indications that even 2.5% is a tough hurdle. Nevertheless, our leading economic indicators are still signaling that the expansion should last another 12–18 months, at least.
- Equity and fixed income markets breathed a sigh of relief when **consumer inflation data came in tamer than feared**. The Core Consumer Price Index (excludes food and energy) rose 1.8% y/y, in line with the consensus forecast. **Overall, inflation data have been subdued following the "hot" wage increase in January** that sparked the equity correction. Even so, there is evidence the unusually low period of inflation could be coming to an end and that consumer prices could return to more normal levels in the next year or two as anomalies (low-priced cell phone service plans) roll out of the numbers.

The U.S. equity market appears reasonably valued



Source - RBC Wealth Management, RBC Capital Markets (RBC forecast), Thomson Reuters I/B/E/S (consensus forecast); data through 3/14/18

Canada

Diana Di Luca – Toronto

- In a speech at Queen's University in Kingston, Ontario, on March 13, Bank of Canada (BoC) Governor Stephen Poloz stated that the **Canadian economy has a number of sources of untapped potential growth**, which could increase capacity without fueling inflation. They include increasing labour force participation by targeted demographics such as youth and women, which aligns with the goals of the recently released 2018 federal budget. Poloz noted that the **BoC will be cautious in considering future rate moves**, highlighting uncertainty around issues including U.S. trade policies and the impact of interest rates on the economy given elevated household debt. The bond market is **pricing in two additional rate hikes in 2018**. We think this accurately reflects the risks on the horizon for the BoC and, as such, we continue to recommend short to intermediate maturity bonds. For bonds further along the (flat) curve, which are more heavily influenced by global factors, we continue to see the risk that yields will track materially higher over the course of the year and would be Underweight issues in the 8- to 10-year part of the ladder.
- **The TSX Preferred Share Index has been relatively flat** over the past month, following a drop from its February 1

high as global markets were gripped by a risk-off tone early last month. **The preferred share market has remained resilient** over the past month despite fluctuations in the 5-year yield, which now sits 12 basis points lower than a month ago, and CA$500M in new issuance starting to trade. **We continue to see value in high reset spread issues** as those issues offer stable income, limited interest rate risk, and downside protection.

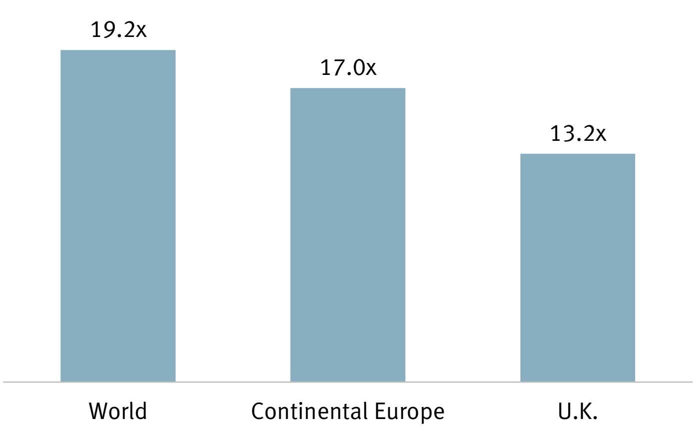
Europe

Frédérique Carrier & Thomas McGarrity – London

- The corporate earnings season is drawing to a close. **The corporate sector delivered healthy numbers in the eurozone** with sales growth of 5% and EPS growth of 14%. However, this **masks important differences among sectors** with Energy and Materials benefiting from stronger commodities prices and enjoying very strong growth. Technology and Discretionary enjoyed double digit, Financials high single digit, and Industrials and Health Care low single digit growth, respectively. Staples, Telecom, and Utilities earnings contracted.
- **Fifty-five percent of companies beat expectations**, in line with the historical average, with cyclicals positively surprising consensus the most. **The consensus expectation is for 2018 earnings growth of close to 11%**, only marginally higher than the expectation at the beginning of the year. Earnings revisions, much like economic momentum, appear to be peaking.
- **Euro area industrial production declined by 1% in January**, the first month on month contraction since last September. Much of the contraction can be explained by energy production which fell due to mild weather in January, though production of consumer durables also retreated. This data comes on the heels of **weakening Purchasing Managers' Indices in February**. All in all, RBC Capital Markets expects 0.6% q/q growth in Q1.
- In a potential sign of things to come, **Unilever announced it has chosen the Netherlands as its single legal base**, rather than the U.K. Its shares will continue to be listed in London (as well as Amsterdam and New York).
- The company, eager not to create political bad blood with the Brexit minded U.K. government, explained that a single legal base in the Netherlands reflects the fact that the shares in the Netherlands ("N.V.") **account for approximately 55% of the group's combined ordinary share capital, and trade with greater liquidity** than the U.K. ("PLC") shares. We believe the decision may also reflect that **Dutch law affords more protection against hostile takeovers** than the U.K. takeover code.

European valuations remain relatively attractive while delivering solid sales and earnings growth

Trailing P/E ratios



Source - RBC Wealth Management, Bloomberg; data through 3/15/18

Asia Pacific

Jay Roberts – Hong Kong

- **Asian equity markets greeted the high-profile departures of Gary Cohn and Rex Tillerson from the White House with a negative reception.** The departures have stoked fears of a change in direction for U.S. foreign policy and greater chances for trade tariffs, which Cohn, the president's top economic policy advisor, was against.
- **Bank of Japan** (BoJ) Governor Haruhiko Kuroda held his final policy meeting of this term. He will begin a new 5-year term in April. The BoJ **stood pat on policy**, as forecast. The BoJ runs the largest quantitative easing (QE) program in the world relative to the size of its economy (QE is typically when a central bank buys financial assets, usually government bonds, from its own country). The BoJ **continues to target a 10-year government bond yield of approximately 0%**.
- Even so, the **BoJ's unchanged policy** in the face of a moderate tightening bias elsewhere in the world **is not weakening the yen**. While Asian markets initially rallied and the yen weakened after the bumper jobs report in the U.S., the yen subsequently crept higher and remains a headwind for Japanese stocks.
- The third-largest bank in China, **Agricultural Bank of China (1288 HK), may raise as much as RMB100B ($15.8B)** in what would be the largest ever **follow-on (that is, post-IPO) share offering** by a Chinese company. The shares would be sold to a handful of state-related entities. **The stock rallied strongly** on the news, as did the other, large Chinese bank stocks trading in Hong Kong.

MARKET SCORECARD

Data as of March 15, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,747.33	1.2%	2.8%	15.2%	36.3%
Dow Industrials (DJIA)	24,873.66	-0.6%	0.6%	18.7%	44.2%
NASDAQ	7,481.74	2.9%	8.4%	26.8%	58.2%
Russell 2000	1,576.62	4.2%	2.7%	14.0%	47.8%
S&P/TSX Comp	15,670.62	1.5%	-3.3%	1.0%	16.9%
FTSE All-Share	3,947.16	-0.9%	-6.5%	-1.5%	17.2%
STOXX Europe 600	376.88	-0.7%	-3.2%	0.5%	10.6%
EURO STOXX 50	3,414.13	-0.7%	-2.6%	0.1%	11.3%
Hang Seng	31,541.10	2.3%	5.4%	32.6%	55.5%
Shanghai Comp	3,291.11	1.0%	-0.5%	1.5%	14.9%
Nikkei 225	21,803.95	-1.2%	-4.2%	11.4%	27.4%
India Sensex	33,685.54	-1.5%	-1.1%	14.6%	37.2%
Singapore Straits Times	3,517.73	0.0%	3.4%	12.1%	23.9%
Brazil Ibovespa	84,928.20	-0.5%	11.2%	28.2%	80.2%
Mexican Bolsa IPC	47,817.05	0.8%	-3.1%	0.7%	8.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,316.13	-0.2%	1.0%	7.9%	6.8%
Silver (spot $/oz)	16.40	-0.1%	-3.2%	-5.5%	7.3%
Copper ($/metric ton)	6,952.75	0.8%	-3.5%	19.0%	40.0%
Oil (WTI spot/bbl)	61.19	-0.7%	1.3%	25.2%	68.4%
Oil (Brent spot/bbl)	65.08	-1.1%	-2.7%	25.6%	68.0%
Natural Gas ($/mmBtu)	2.69	0.7%	-9.0%	-9.9%	45.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.826%	-3.4	42.1	33.3	85.6
Canada 10-Yr	2.141%	-9.4	9.6	37.6	81.1
U.K. 10-Yr	1.438%	-6.3	24.8	22.7	-9.9
Germany 10-Yr	0.576%	-8.0	14.9	16.1	26.0
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.15%	0.2%	-1.9%	1.5%	2.4%
U.S. Invest Grade Corp	3.76%	-0.1%	-2.7%	3.2%	7.6%
U.S. High Yield Corp	6.20%	-0.3%	-0.5%	5.3%	22.1%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	90.1620	-0.5%	-2.1%	-10.5%	-6.7%
CAD/USD	0.7657	-1.7%	-3.7%	1.9%	2.3%
USD/CAD	1.3059	1.8%	3.9%	-1.8%	-2.2%
EUR/USD	1.2303	0.9%	2.5%	14.6%	10.7%
GBP/USD	1.3934	1.3%	3.1%	13.4%	-1.5%
AUD/USD	0.7796	0.4%	-0.2%	1.1%	4.5%
USD/JPY	106.3500	-0.3%	-5.6%	-6.2%	-6.0%
EUR/JPY	130.8400	0.6%	-3.3%	7.5%	4.1%
EUR/GBP	0.8829	-0.4%	-0.6%	1.1%	12.5%
EUR/CHF	1.1711	1.7%	0.1%	9.1%	6.8%
USD/SGD	1.3144	-0.8%	-1.6%	-6.2%	-4.9%
USD/CNY	6.3221	-0.1%	-2.8%	-8.6%	-3.0%
USD/MXN	18.6969	-0.7%	-4.9%	-2.7%	4.5%
USD/BRL	3.2836	1.1%	-0.9%	5.8%	-12.8%

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 3/15/18.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -3.7% return means the Canadian dollar fell 3.7% vs. the U.S. dollar year to date. USD/JPY 106.35 means 1 U.S. dollar will buy 106.35 yen. USD/JPY -5.6% return means the U.S. dollar fell 5.6 vs. the yen year to date.

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Hold [Sector Perform]	683	41.24	155	22.69
Sell [Underperform]	105	6.34	8	7.62

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