RBC WEALTH MANAGEMENT

Global Insight

Weekly

A closer look

Riding earnings momentum, but tuned in to tariff tiffs

Kelly Bogdanova – San Francisco

Earnings momentum should keep its mojo going, but we'll be listening closely to signals from management teams about what the trade crosscurrents mean to their earnings outlooks. We think the overall backdrop remains constructive and maintain our Market Weight stance on U.S. equities.

Amid angst about tariffs and following NATO meeting drama, the U.S. equity market is pivoting its attention toward a critical topic for stock prices—corporate profits.

Robust Q2 earnings growth is widely expected. But that doesn't mean there isn't room for companies to exceed estimates. The bigger question is: will some corporate executives constrain their enthusiasm about future quarters in light of the ongoing tariff tiffs?

Momentum mojo

The Q2 consensus forecast is for roughly 20% y/y earnings per share (EPS) growth, and we believe earnings beats could take that up another 3%–4%.

Tax cuts should boost profits substantially. But even when their impact is excluded, the consensus estimate is for sturdy 12.7% y/y EPS growth and could finish the reporting season modestly higher than that, in our assessment.

Revenue growth prospects—an even better barometer of corporate health—are also solid and could climb above 8% y/y for the third straight quarter. We think top-line growth has the potential to remain strong for the balance of the year as long as the domestic economy cooperates and trade disputes don't dent business and consumer confidence.

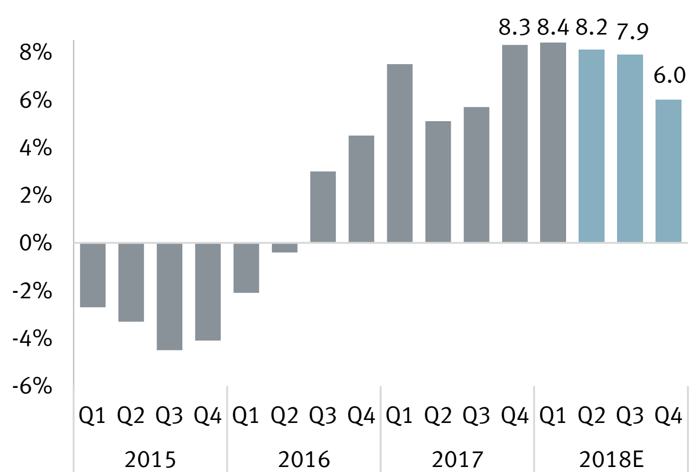
U.S. earnings and revenue growth should far exceed that of peer markets as shown in the lower chart on the next page.

A dollop of caution?

As reassuring as the Q2 prospects are, markets will be looking ahead—they always do. We view trade disputes as the biggest threat to the profit outlook.

U.S. corporate revenue growth outlook is sturdy

S&P 500 quarterly earnings growth (% y/y) – actual in gray, consensus estimates in blue



Source - RBC Wealth Management, Thomson Reuters I/B/E/S, national research correspondent, FactSet; 2018 consensus estimates as of 7/10/18

Market pulse

Click here for authors' contact information.

Priced (in USD) as of 7/12/18 market close, EST (unless otherwise stated).

For important disclosures and required non-U.S. analyst disclosures, see page 7.

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We expect Q3 and full-year guidance to be constructive overall given strong U.S. economic momentum and persistent growth in other developed economies.

But trade risks might encourage some management teams of U.S.-based multinationals to guide more cautiously about the future than they would otherwise. Executives in Europe and Asia could do the same.

Some U.S. executives involved in cross-border and overseas business are vocal free-trade advocates and generally opposed to tariffs. FedEx founder and CEO Frederick Smith comes to mind as an outspoken leader on the topic.

Management teams facing tariff headwinds have the opportunity to lay out the hazards of persistent trade disputes during their quarterly conference calls. But will they be willing to challenge President Trump's policies?

While we will pay close attention to any comments on trade, tariffs, and related supply chain disruptions, it's important to put this in perspective.

Not all U.S.-listed companies are directly vulnerable to trade risks. Twenty-one percent of S&P 500 firms and 46% of those included in the small-capitalization Russell 2000 are domestically focused and have no international exposure. Also, meaningful proportions of these indexes have only minimal international exposure.

In general, large-capitalization semiconductor, tech hardware, materials, and industrial firms are most sensitive to trade risks, and some consumer goods companies are exposed as well. Their vulnerabilities have been at least partially priced into the market already, in our view.

Furthermore, not all tariffs are created equal. As Bloomberg points out, the U.S. and China have swapped tariffs on products that neither country exports to each other. For example, the U.S. now has a tariff on liquefied natural gas from China, but the U.S. doesn't purchase this from China. China slapped a tariff on U.S. piped natural gas, but the U.S. doesn't have pipelines to China. These are "tariffs" in name only.

Don't have tunnel vision

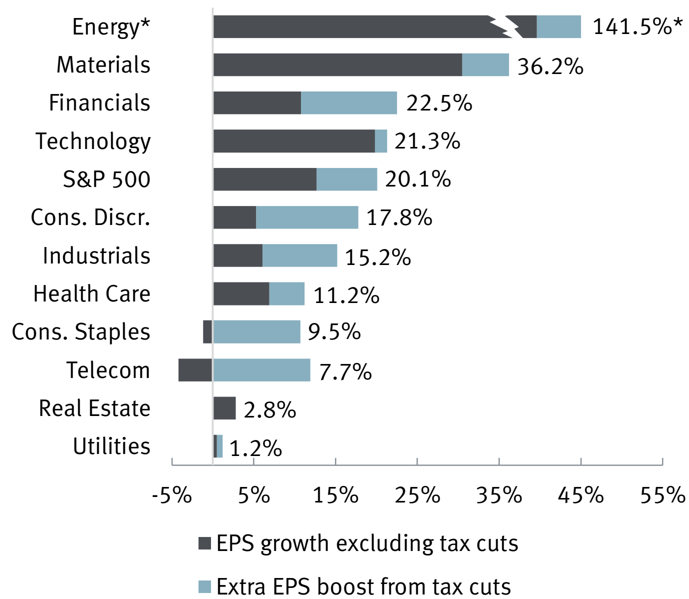
Despite the trade crosscurrents, investors shouldn't lose sight of why strong corporate momentum could persist.

U.S. companies are benefiting from generous tax cuts and the related boost in consumer spending. Business confidence is high, manufacturing activity is elevated, and employment growth is strong. Most companies cut the fat during the last downturn so operations are lean, and many industries are directly or indirectly benefiting from an innovation wave.

We expect robust Q2 results and constructive guidance overall even though comments about the trade tiffs could give the market pause from time to time. We maintain our Market Weight stance on U.S. equities.

Seven of 11 sectors and the S&P 500 projected to grow by double digits in Q2

Consensus forecast – growth rates include benefits from tax cuts (y/y)

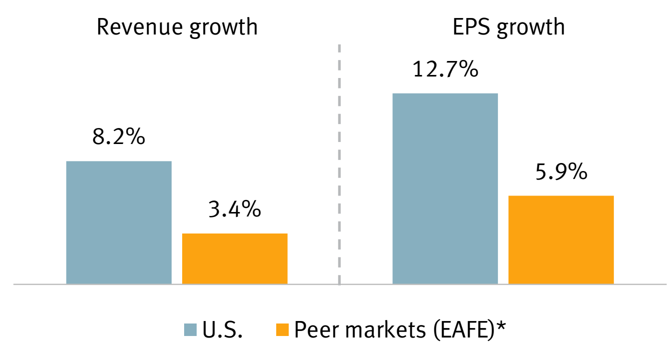


Source - RBC Wealth Management, national research correspondent, Thomson Financial, FactSet, company reports; data as of 7/10/18

* Energy data is truncated so as not to distort the other data. The sector's boost from tax cuts is proportionate to the total 141.5% growth estimate (88% of that is EPS growth excluding tax cuts).

Apples-to-apples growth comparisons favor the U.S.

Q2 consensus estimates for U.S. and peer markets (excluding tax cut benefits for U.S.)*



Source - National research correspondent, MSCI, Thomson Financial, FactSet; data as of 7/10/18

* "Peer markets" represents developed equity markets in Europe, Australasia, and the Far East (EAFE). Essentially, these are developed markets outside of the U.S. and Canada.

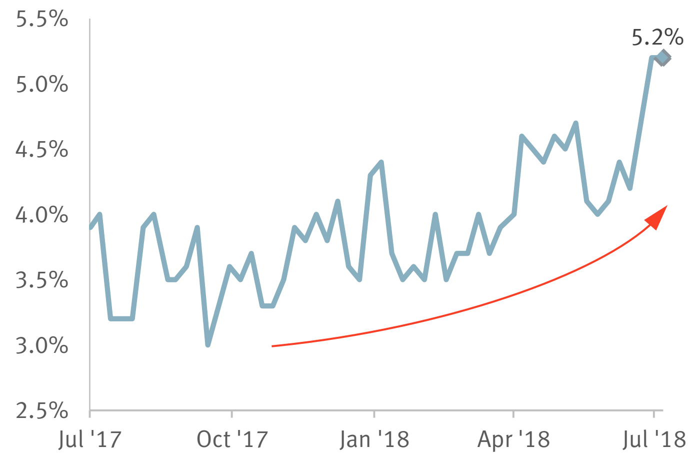
United States

Ben Graham – Minneapolis

- **Financials kick off earnings season** on July 13 as JPMorgan Chase, Citigroup, Wells Fargo, and PNC Financial are scheduled to release Q2 results. **Consensus estimates show clear double-digit organic earnings growth for the sector, with total earnings growth surpassing 20% y/y when taxes are taken into account**. Furthermore, we see large-cap banks' loan growth materializing with an expectation of 4.0% or modestly higher y/y median growth. Net interest margins should also expand on the back of the Fed's recent rate hikes and the group's greater relative sensitivity to short-term rates as opposed to long-term ones. With the S&P 500 Banks industry trading at 11.3x next 12-month earnings per share and just 1.3x book value, **we remain constructive on the Financials sector with the Banks our preferred sector exposure**.
- **The U.S. is preparing for additional tariffs** of 10% on another $200B in Chinese imports after implementing the first round on $34B of Chinese goods recently. **This latest round has China attempting to clarify its response because its imports of U.S. goods don't allow a same-sized retaliation** as in previous rounds. Additionally, President Donald Trump floated the idea that NATO should implement a new target of defense spending as a percentage of GDP at 4%, higher than the 2024 target of 2%. While drama at the NATO meeting captured headlines, it didn't impact U.S. markets.
- On the economic front, **inflation continues to tick higher** as the Consumer Price Index accelerated in June and the Producer Price Index, which measures wholesale inputs, jumped 3.4% y/y, the highest reading since November 2011. **NFIB Small Business Optimism surprised to the upside** with the 107.2 reading ahead of consensus estimates coming on the heels of a 35-year high in May of 107.8.

Loan growth for all U.S. banks, y/y

U.S. loan growth appears to be accelerating, to banks' benefit



Source - RBC Wealth Management, RBC Capital Markets; Weekly data through 7/6/18

Canada

Diana Di Luca – Toronto

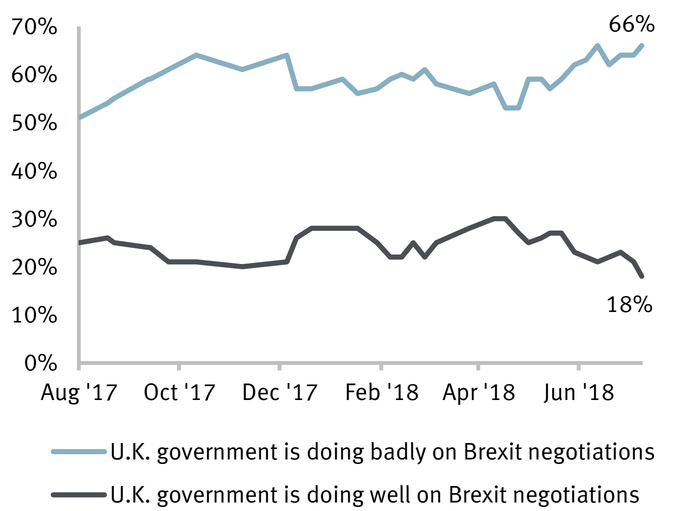
- As expected by the market, **the Bank of Canada (BoC) raised its overnight lending rate 25 basis points to 1.5% on July 11.** The BoC's press release and *Monetary Policy Report* (*MPR*) produced a balanced assessment of the risks that are playing out against economic growth that is humming along around potential. On the trend of global growth, the BoC noted it is tracking along as it previously expected (2018 growth of 3.75%) but highlighted that "more trade protectionism is the most important threat to global prospects." With respect to the Canadian economy, the BoC continues to expect growth between 2018 and 2020 to average 2%, but there were some interesting adjustments to its composition.
- What is most clear from the *MPR* is that the Governing Council is hanging its hat on business investment (2018) and exports (2019–20) to carry GDP forward as households adjust spending in light of higher interest rates. In our view, **this poses a risk to the achievable growth rate, especially as trade policy uncertainty should persist for some time.** Our concern can be somewhat offset by the fact that the BoC is already incorporating a negative effect towards exports and business investment within its current forecasts, which may not occur, but with GDP forecast to average 2% over the next three years this does not provide much comfort, in our view.
- The inflation forecasts were increased this year and next with the BoC expecting the headline Consumer Price Index to reach 2.5% before edging down towards its 2.0% target by the second half of 2019. With the BoC's preferred measure of wage growth running around 2.3%, the Governing Council noted that this is a little lower than it should be for a labour market with no slack. The BoC ended the press release by summarizing that the **"Governing Council expects that higher interest rates will be warranted to keep inflation near target and will continue to take a gradual approach, guided by incoming data."**

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **U.K. Prime Minister Theresa May gained approval for a Brexit proposal** at a U.K. Cabinet meeting. A key element to the proposal includes **seeking to establish a free trade area with the EU for goods**, which would involve the U.K. essentially binding itself to EU regulation, while also limiting the U.K.'s capacity to negotiate trade deals elsewhere.
- May's efforts to propel a "soft Brexit" plan triggered a **backlash among some senior cabinet members**, with Foreign Secretary Boris Johnson and Secretary of State for Exiting the European Union David Davis **announcing their resignations**. Meanwhile, opposition to May's proposals continues to stir amongst the Eurosceptic backbench members of her Conservative Party.
- Following the publication of the long-awaited White Paper, a 98-page document that fleshes out the agreement reached by the U.K. Cabinet, **the next step in negotiations will be how the EU responds to the proposal**, with further concessions from the U.K. possibly required.
- The developments have **increased the probability for tail risk outcomes in the near term**. The chances for a market-friendly "soft Brexit"—with the U.K. in some form of a customs union—appear greater, yet the risk of further resignations teeing up for a leadership challenge or a snap election have also risen, adding pressure to the U.K. government.

Majority of U.K. citizens believe government is doing a poor job on Brexit negotiations



Source - RBC Wealth Management, YouGov EU Tracker; data through 7/9/18

- Having initially spiked on the news of plans for a softer Brexit approach, the **British pound soon unwound its gains** following the political turmoil.
- **U.K. gilts seemingly treaded through the political noise** with investors instead focused on the prospect for a rate hike by the Bank of England at its meeting on August 2. Signs that the U.K. economy is bouncing back after weather-related softness earlier this year have helped increase expectations for a 25 basis point rate hike increase to almost 80% from below 50% less than one month ago. Such improvement was evident with the release of **U.K. GDP data** on July 10 that showed **the economy grew by 0.2% over the three-month period ending in May**, compared with flat performance at the end of March.

Asia Pacific

Jay Roberts, CFA – Hong Kong

- The MSCI AC Asia Pacific Index rebounded from its low of the year after the U.S. and China implemented $34B in tariffs against each other. We think there is a good chance that the U.S. will explore and implement further trade measures against China. **Unless there is a positive result in the short term from negotiations**, which is unlikely, in our view, **we expect the Hang Seng Index to remain under pressure** for the rest of the summer.
- **The Bank of Korea kept South Korea's benchmark rate unchanged at 1.5%.** The central bank had raised rates in November for the first time in six years. However, there was one vote in the committee for a rate hike. **The employment situation in Korea is currently sluggish and inflation relatively tepid.** The Bank of Korea maintained its forecasts for consumer prices to rise by 1.6% this year (2017 actual: 1.9%) and modestly adjusted its growth forecast to 2.9% from 3.0%.
- **Xiaomi** (1810 HK), one of China's largest technology companies and best known for its Android-based smartphones, **raised $4.7B from its Hong Kong IPO** after pricing at the **low end of the marketed range**. The share price went down by as much as 6% on the first trading day on investor concerns around valuation. Afterwards, however, the stock rallied strongly. **FTSE Russell, the global index company, announced that it will add Xiaomi into six of its indexes**, for example the FTSE China 50 Index, from July 16. Xiaomi will also join the Hang Seng Composite Index on July 23. Xiaomi's market value is approximately $54B.

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Data as of July 12, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,798.29	2.9%	4.7%	14.5%	30.0%
Dow Industrials (DJIA)	24,924.89	2.7%	0.8%	15.8%	35.8%
NASDAQ	7,823.92	4.2%	13.3%	25.0%	55.8%
Russell 2000	1,690.28	2.9%	10.1%	18.7%	40.2%
S&P/TSX Comp	16,567.42	1.8%	2.2%	9.4%	14.4%
FTSE All-Share	4,207.12	0.1%	-0.3%	4.0%	16.4%
STOXX Europe 600	384.37	1.2%	-1.2%	-0.1%	14.3%
EURO STOXX 50	3,445.49	1.5%	-1.7%	-2.0%	17.5%
Hang Seng	28,480.83	-1.6%	-4.8%	9.4%	34.2%
Shanghai Comp	2,837.66	-0.3%	-14.2%	-11.3%	-6.9%
Nikkei 225	22,187.96	-0.5%	-2.5%	10.4%	37.9%
India Sensex	36,548.41	3.2%	7.3%	14.9%	31.4%
Singapore Straits Times	3,253.01	-0.5%	-4.4%	1.4%	12.1%
Brazil Ibovespa	75,857.42	4.3%	-0.7%	17.0%	39.8%
Mexican Bolsa IPC	48,696.30	2.2%	-1.3%	-4.2%	4.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,247.03	-0.5%	-4.3%	2.2%	-6.5%
Silver (spot $/oz)	15.95	-1.0%	-5.8%	0.2%	-20.9%
Copper ($/metric ton)	6,130.00	-7.5%	-14.9%	4.3%	26.4%
Oil (WTI spot/bbl)	70.33	-5.2%	16.4%	54.6%	50.3%
Oil (Brent spot/bbl)	74.36	-6.4%	11.2%	55.8%	53.4%
Natural Gas ($/mmBtu)	2.80	-4.3%	-5.2%	-6.3%	2.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.847%	-1.3	44.2	53.0	133.7
Canada 10-Yr	2.156%	-1.2	11.1	28.1	109.8
U.K. 10-Yr	1.282%	0.4	9.2	2.1	45.4
Germany 10-Yr	0.357%	5.5	-7.0	-22.2	44.8
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	3.29%	0.3%	-1.3%	-0.2%	-0.8%
U.S. Invest Grade Corp	3.98%	0.7%	-2.6%	-0.3%	1.1%
U.S. High Yield Corp	6.45%	0.3%	0.5%	2.9%	13.1%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	94.8060	0.4%	2.9%	-1.0%	-1.7%
CAD/USD	0.7600	-0.2%	-4.5%	-3.1%	-0.9%
USD/CAD	1.3158	0.2%	4.7%	3.2%	0.9%
EUR/USD	1.1672	-0.1%	-2.8%	2.3%	5.5%
GBP/USD	1.3208	0.0%	-2.3%	2.5%	-0.3%
AUD/USD	0.7408	0.0%	-5.1%	-3.5%	-2.8%
USD/JPY	112.5300	1.6%	-0.1%	-0.6%	7.5%
EUR/JPY	131.3400	1.5%	-2.9%	1.7%	13.4%
EUR/GBP	0.8837	-0.1%	-0.5%	-0.2%	5.8%
EUR/CHF	1.1700	1.1%	0.0%	6.2%	7.0%
USD/SGD	1.3633	0.1%	2.0%	-1.0%	1.3%
USD/CNY	6.6678	0.7%	2.5%	-1.8%	-0.3%
USD/MXN	18.9511	-4.8%	-3.6%	6.6%	3.3%
USD/BRL	3.8797	0.1%	17.1%	20.9%	17.7%

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 7/12/18.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD -4.5% return means the Canadian dollar fell 4.5% vs. the U.S. dollar year to date. USD/JPY 112.53 means 1 U.S. dollar will buy 112.53 yen. USD/JPY -0.1% return means the U.S. dollar fell 0.1% vs. the yen year to date.

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Buy [Top Pick & Outperform]	854	53.61	262	30.68
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