December 14, 2017

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Central vision

Tom Garretson – Minneapolis

It was a busy week for the major global central banks, with the Fed, the ECB, and the BoE all having met. While there were no surprises, investors received a number of new economic projections that may offer clues and insight as to how central banks are preparing to approach policy in 2018.

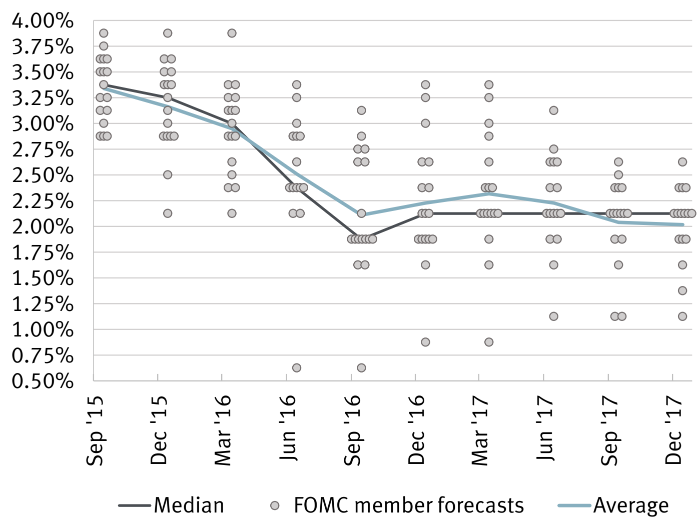
Eyes on the road

Beginning in the U.S., the Federal Reserve (Fed) delivered the widely anticipated third rate hike of the year that brought short-term rates to a range of 1.25%–1.50%, matching its beginning-of-year forecast for the first time this cycle and besting a market that was only priced for one this year. Now investors are looking to the road ahead and whether the Fed can offer up a repeat performance in 2018 given a market that is still only priced for two rate hikes, against the Fed's expectation for three further moves.

In our view, we're going to side once again with the market, and expect the Fed to struggle to hit its three rate hike forecast. While many point to the Fed's 2018 median forecast of three rate hikes, we have been watching the weighted average, which has been trending lower for the past nine months, as shown in the chart, and now sits just over 2%, or two rate hikes next year.

And this could be key for 2018 as we are perhaps arriving at the point where each rate hike could have greater implications for U.S. and global markets. To this point in the tightening cycle, rate hikes have largely been viewed by the market as simply a reflection of confidence in the underlying economic trajectory, having had little impact on risk assets—including stock markets which continue to reach new highs. But with yield curves flattening sharply in recent weeks, there has to be greater concern that the Fed is getting out over its skis in pushing for further increases absent inflationary pressures. We expect the yield curve to be one of the strongest headwinds that the Fed will have to fight in meeting its projected rate hike path next year.

Rate hikes in 2018:
Fed's median says three, but average slips toward two



Source - RBC Wealth Management, Federal Reserve Summary of Economic Projections

Market pulse

The next edition of the *Global Insight Weekly* will be published the first week of January.

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Priced (in USD) as of 12/14/17 market close, EST (unless otherwise stated).
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Wealth Management

So where has the Fed set the bar for rate hikes?

Elsewhere in the Fed's Summary of Economic Projections from the December 13 meeting, there was a somewhat curious development. While committee members now see further labor market strength taking the unemployment rate below 4% next year, and economic growth increasing to a range of 2.2%–2.6%, the inflation outlook actually edged lower, as shown in the top chart.

Some may argue that this actually lowers the bar for rate hikes, as the Fed is still forecasting that three rate hikes would be appropriate even if inflation only rises to a range of 1.7%–1.9%, from a latest print of just 1.4% y/y. But we would caution that a lower inflation outlook might simply be a reflection that the Fed is increasingly concerned that the low inflation it has labeled as "transitory" could be more persistent.

On the flip side, it may have raised the bar for rate hikes next year given the sharp upgrade in growth and expectations for labor market improvement. If the proposed tax cut package fails to deliver a short-term boost, or if the labor market strength begins to moderate, the Fed could easily see that as justification to tap the brakes on raising rates.

Regardless, we continue to believe that when attempting to read the Fed tea leaves next year, investors need only focus on inflation data, as that will dictate the Fed's plans, with economic growth being only a minor factor.

All in together now

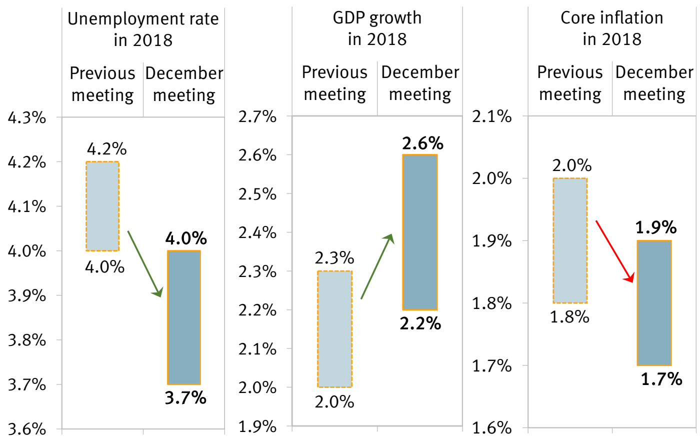
Turning to Europe, the European Central Bank (ECB) appears to be seeing the same things as the Fed as it too sharply upgraded its 2018 growth outlook by 0.50% to 2.3%—while only raising inflation expectations by 0.20% to 1.5%, still well short of the target of "below, but close to" 2%. The ECB also offered the first look at its 2020 forecasts, where most notably the bank only expects inflation to rise to 1.7% annually, which, in our view, is still likely to be seen as below its target—the implication being that investors should expect the ECB to continue to err on the side of caution.

Finally, the Bank of England (BoE) left rates and policy measures in place, but noted that further tightening may be needed in the face of a gradual buildup of inflationary pressure, but that any tightening would be "gradual, and limited" in coming years.

See you next year

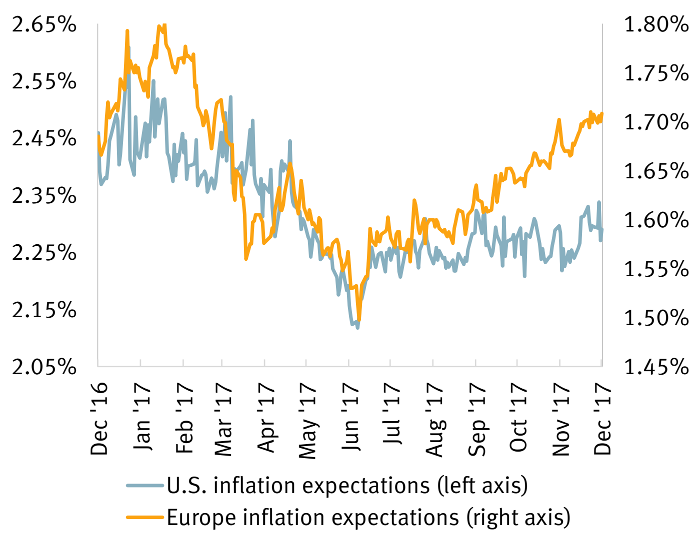
Central banks mostly bucked market expectations in 2017, forging ahead when the market believed they couldn't. But we still see the balance of risks the central banks weigh as being to the downside, which should keep policy tightening on a slow and gradual trajectory. We still see lower risk of upside data surprises that could cause banks to step on the accelerator. But at this stage of the economic cycle, particularly in the U.S., look for the Fed to remain front and center next year as markets debate whether monetary policy is becoming too restrictive.

2018: Fed sees lower unemployment, faster growth ... but lower inflation



Source - RBC Wealth Management, Federal Reserve Summary of Economic Projections (central tendency of forecasts, which excludes the three highest and three lowest projections for each variable in each year)

Market-based inflation outlook diverging for EU and U.S.



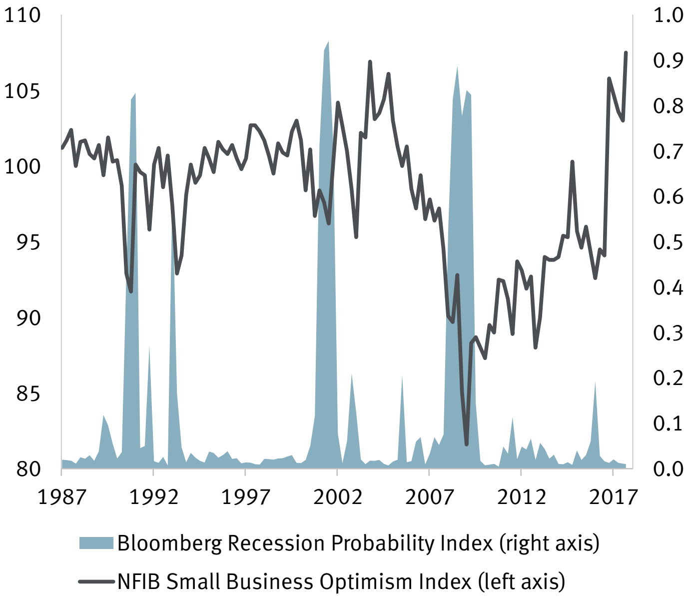
Source - RBC Wealth Management, Bloomberg; market expectations based on 5-year, 5-year forward inflation swaps (market measure of average expected inflation from year 5 to 10)

United States

Bill Kuehn & Sam Renikoff – Minneapolis

- **The NFIB small business optimism survey expanded to the highest level since 1983** as business owners became more upbeat about future economic conditions and sales prospects. According to the survey, taxes are the single biggest problem for small business, so **the prospect of tax reform is welcome news for business owners**. Digging into the details, a **record high of 24% of business owners plan to hire additional workers**, with notable increases in the construction and manufacturing sectors, confirming the recent strength in regional Fed manufacturing surveys is merited. However, plans to raise wages for existing workers remain muted, which is a concern for the consumption outlook. RBC Capital Markets' economists note that high confidence in the small business sector tends to be a mid-economic cycle development and points to the current recovery as still having many quarters to run.
- **Consumers were swiping the plastic to start the holiday shopping season**, with November's retail sales data crushing expectations, expanding by 0.8% m/m. **The spending gains were broad-based, with 11 out of 13 categories seeing gains**, with sales of appliances and electronics leading the way. Given that consumer spending makes up the vast majority of U.S. economic growth, the retail sales release gives us confidence that Q4 growth will continue to remain robust. The Atlanta Fed GDP Now model for Q4 economic growth sits at 3.3%.
- So far this month **we have seen municipalities flood the market with $36.5B in debt, as a result of tax proposals that would eliminate the tax-exempt status of a variety of categories**, such as advanced refunding and private activity bonds—which have totaled nearly 40% of issuance in the last three years. Should this pace continue through the end of the month, we could see issuance break the record of $56B set in 1985, which preceded the Reagan tax cuts.
- **The core consumer price index** (CPI), which is a measure of price inflation of consumer goods that excludes gasoline and food, **fell more than expected in November, further away from the Fed's 2.0% inflation goal**. The weak reading was weighed on by goods prices once again, which remain in a deflationary state, as well as declines in the cost of "lodging away from home." The deceleration of shelter costs is one we see as being fairly consistent due to disruptive factors like Airbnb and Couchsurfing, as well as historically low mortgage rates which keep the costs of servicing debt down. **The tepid inflation data is likely to keep the Fed on a gradual path**, and confirms that we will need to see wages rise above the 2.5% pace in order to drive demand-pull inflation and force companies to pass costs on to customers.

Small business optimism suggests this cycle has room to run



Source - RBC Wealth Management, Bloomberg; data as of 6:00 pm GMT 12/14/17

- However, we have already seen the **tax plan undergo numerous facelifts as the House and Senate iron out the final details**, and the exempt status of private activity bonds may actually be saved. During the week **House Ways and Means Chairman Kevin Brady stated, "I think there's agreement that private activity bonds can play an important role,"** while narrowing the scope to bonds related to "activities that must be subsidized by every taxpayer." That being said, much of next year's supply has already been pulled forward, with 2017 issuance possibly topping $420B, leading to a decrease in next year's projection toward $275B from the base case of $350B, which should be supportive of investors already in the muni bond market.

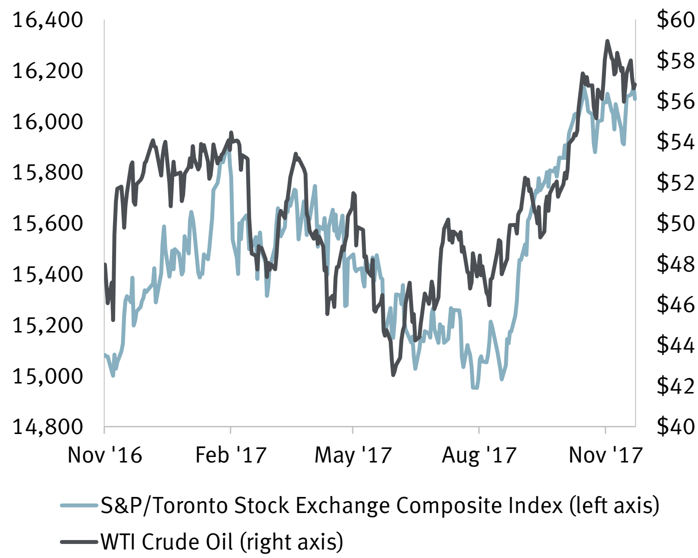
Canada

Alicia Buckiewicz & Farazeh Mahboob – Toronto

- **RBC Capital Markets recently lowered its recommended weighting on the S&P/TSX to Market Weight** from Overweight, with the expectation that **mid-single-digit earnings per share growth for the S&P/TSX in 2018 is a probable scenario**. The roughly 70% of the index that is not directly exposed to commodities is trading modestly above its 15-year median forward price-to-earnings ratio. Yet, the other 30% is directly exposed to commodities, predominantly oil, which may represent a source of downside risk. RBC Capital Markets believes that central banks' shift from quantitative easing to quantitative tightening in the year ahead may present headwinds for risk assets, such as equities, on both a Canadian and international scale.

- **Since November, oil prices have surged out of the listless 2017 trading range** towards $60/barrel (bbl). Unlike several premature price rallies, **RBC Capital Markets sees this recovery as more sustainable** given the improved fundamental backdrop. As such, it has increased its 2018 WTI average price forecast to $58/bbl (from $53/bbl), slightly above the current price. Therefore, while RBC Capital Markets expects oil prices to ebb and flow over the coming months, **prices seem to have found a rising price floor**, which should limit potential downside risk. But there are several key variables that present asymmetric risks in 2018. The U.S. shale production boom, for instance, has redrawn the global crude flow map, with U.S. exports now threatening the OPEC domination of Asian market share.
- RBC Capital Markets believes there is an **emerging rebound in both the U.S. and Canadian trucking market**. While improving demand and tightening capacity have been evident for several months now, **several Canadian trucking companies increased dividends** during the week. This signals that management teams also remain confident that conditions will continue to improve throughout 2018.

Exposure to oil may present downside risk to stocks



Source - RBC Wealth Management, Bloomberg; data as of 6:00 pm GMT 12/14/17

Europe

Frédérique Carrier & Thomas McGarrity – London

- The European corporate sector was particularly active with **two high-profile takeover bids**. Paris-based **Unibail-Rodamco has offered just under $25B to acquire Westfield**, the Australian shopping centre developer. The combined entity **would form the world's second-biggest mall owner** with properties worth a total of $72B. The hope is that as a consolidator in the industry, the entity will be better placed to face the stiff competition from online retailers. This transaction is not only the largest one in real estate made by a European acquirer, but it is also the largest-ever acquisition of an Asian-Pacific company by a European corporate.
- In the Technology industry, **Atos, the French IT services group, made a €46 per share cash offer for Gemalto**, the security software maker and manufacturer of chip payment cards, whose shares rose more than 33% on the news. **Gemalto rejected the bid**, describing it as "opportunistic" and that it "significantly undervalues" the company.
- **We expect buoyant corporate activity to continue in Europe**. The improving macroeconomic situation, relatively healthy balance sheets, and availability of cheap credit all bode well for a surge in activity. We would expect the volumes of European M&A, which have lagged those in the U.S., to start to close the gap.
- Elsewhere, the **final proposals of the Basel regulatory framework for European banks**, labelled "Basel IV" by the industry, **appear less harsh** than the market had feared. In our view, the upshot is that the proposals **will not lead to a significant increase in overall capital requirements**, while banks have a **very long phase-in period** to implement the reforms (until 2027), giving them ample opportunity to mitigate impacts and adjust business models accordingly.
- U.K. Prime Minister Theresa May suffered a defeat after **pro-EU members of her Conservative Party backed a move to give Parliament a full vote on any Brexit deal** at the end of the negotiations in 2019. This may decrease the possibility of a hard Brexit and potentially makes the negotiations with the EU more difficult, in our view. It also underscores the difficulties facing May given her slender parliamentary majority.

MARKET SCORECARD

Data as of December 14, 2017

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,652.01	0.2%	18.5%	17.7%	31.2%
Dow Industrials (DJIA)	24,508.66	1.0%	24.0%	23.8%	41.1%
NASDAQ	6,856.53	-0.3%	27.4%	26.1%	38.5%
Russell 2000	1,506.95	-2.4%	11.0%	11.1%	35.0%
S&P/TSX Comp	16,016.46	-0.3%	4.8%	5.4%	26.2%
FTSE All-Share	4,088.58	1.4%	5.6%	8.4%	25.6%
STOXX Europe 600	388.91	0.6%	7.6%	9.3%	11.3%
EURO STOXX 50	3,556.22	-0.4%	8.1%	10.7%	13.3%
Hang Seng	29,166.38	0.0%	32.6%	29.9%	36.9%
Shanghai Comp	3,292.44	-0.7%	6.1%	4.8%	-6.5%
Nikkei 225	22,694.45	-0.1%	18.7%	17.9%	20.2%
India Sensex	33,246.70	0.3%	24.9%	25.0%	32.2%
Singapore Straits Times	3,435.78	0.1%	19.3%	16.3%	22.1%
Brazil Ibovespa	72,428.93	0.6%	20.3%	24.4%	61.9%
Mexican Bolsa IPC	48,222.38	2.4%	5.7%	4.3%	15.1%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,253.06	-1.7%	8.7%	9.6%	18.2%
Silver (spot $/oz)	15.90	-3.2%	-0.1%	-5.5%	16.3%
Copper ($/metric ton)	6,691.75	-0.6%	21.2%	17.1%	43.5%
Oil (WTI spot/bbl)	57.04	-0.6%	6.2%	11.8%	57.1%
Oil (Brent spot/bbl)	63.45	-0.2%	11.7%	17.7%	67.3%
Natural Gas ($/mmBtu)	2.69	-11.1%	-27.8%	-24.1%	41.9%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.348%	-6.2	-9.7	-22.3	12.6
Canada 10-Yr	1.851%	-3.8	13.0	6.0	38.0
U.K. 10-Yr	1.174%	-15.6	-6.5	-21.2	-66.6
Germany 10-Yr	0.316%	-5.1	10.8	1.5	-25.8
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.67%	0.5%	3.6%	4.3%	6.2%
U.S. Invest Grade Corp	3.21%	0.8%	6.3%	7.4%	12.6%
U.S. High Yield Corp	5.72%	0.2%	7.3%	7.6%	27.5%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	93.6200	0.6%	-8.4%	-8.0%	-4.1%
CAD/USD	0.7815	0.8%	5.0%	3.8%	7.3%
USD/CAD	1.2797	-0.8%	-4.8%	-3.7%	-6.8%
EUR/USD	1.1778	-1.1%	12.0%	11.8%	7.2%
GBP/USD	1.3431	-0.7%	8.8%	6.9%	-11.3%
AUD/USD	0.7667	1.3%	6.4%	3.5%	5.9%
USD/JPY	112.3400	-0.2%	-4.0%	-4.0%	-7.2%
EUR/JPY	132.3000	-1.2%	7.6%	7.3%	-0.6%
EUR/GBP	0.8770	-0.4%	2.7%	4.6%	20.8%
EUR/CHF	1.1641	-0.6%	8.6%	8.3%	7.5%
USD/SGD	1.3459	-0.1%	-7.0%	-6.3%	-4.5%
USD/CNY	6.6093	0.0%	-4.8%	-4.3%	2.3%
USD/MXN	19.1451	2.8%	-7.6%	-6.5%	10.6%
USD/BRL	3.3353	2.1%	2.5%	-1.1%	-13.9%

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 9:35 pm GMT 12/14/17.

Examples of how to interpret currency data: CAD/USD 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 5.0% return means the Canadian dollar rose 5.0% vs. the U.S. dollar year to date. USD/JPY 112.34 means 1 U.S. dollar will buy 112.34 yen. USD/JPY -4.0% return means the U.S. dollar fell 4.0% vs. the yen year to date.

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As of September 30, 2017

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Hold [Sector Perform]	660	40.67	154	23.33
Sell [Underperform]	104	6.41	7	6.73

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