

# Global Insight

## Weekly



A closer look

## A healthy choice

Kelly Bogdanov – San Francisco

As we take the pulse of the investment environment, we think the Health Care sector is back in shape and showing momentum. With appealing valuations and potential catalysts on the horizon, we explain why the sector is a healthy choice to boost portfolio performance.

Given the U.S. stock market's strong run of late and especially since last summer, it's become more challenging to identify attractive investment ideas as valuations have expanded and stocks have priced in more and more good news.

But one sector, Health Care, stands out as an area of the market that is worth accumulating.

We believe Health Care is attractive for three primary reasons:

- On a technical basis, the sector recently broke out of a two-year trading range.
- Developments in Washington indicate drug prices are unlikely to face tough regulations.
- The sector's valuation is inexpensive compared to historical norms and the broader stock market.

### Not stuck in the waiting room

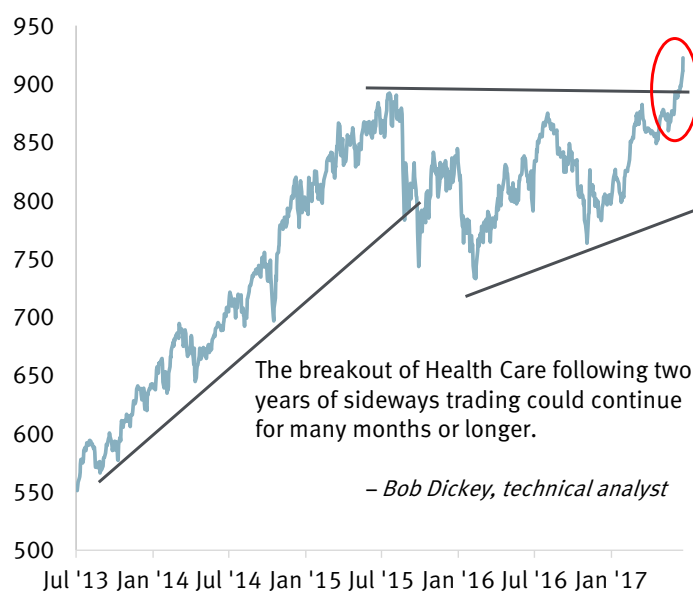
For the past two years the Health Care sector has been stuck in a wide trading range as investors' concerns about drug price restrictions mounted during the presidential campaign and persisted after the inauguration.

Furthermore, earnings and revenue growth rates of some of the largest biotech companies went through a difficult deceleration process as these companies matured. Meanwhile, biotech drug catalysts were few and far between, depriving Health Care of an important source of growth.

However, recently the S&P 500 Health Care Index, including the biotech and pharmaceuticals groups, gained meaningful momentum. Health Care busted out of its painful two-year trading range (see chart).

RBC Capital Markets, LLC Technical Analyst Bob Dickey believes this portends additional gains, potentially with some

S&P 500 Health Care sector technical trends have improved



Source - RBC Wealth Management, Bloomberg; data through 6/21/17

### Market pulse

- 3 China stocks hit the mainstream
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- 4 Where to look for quality in Canadian fixed income
- 5 U.K. draped in a veil of uncertainty

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Priced (in USD) as of 6/22/17 market close, EST (unless otherwise stated).

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Wealth  
Management

backing and filling along the way. He sees the breakout as a potential shift in market leadership that could continue for months or longer. At the same time, other areas of the market that have been strong could take a breather.

### The Washington Rx

This story is not solely about the technicals. Typically when a sector breaks out, there are other factors involved.

Increasingly, it's looking like the Trump administration will be much more friendly to the pharma and biotech industries than candidate Trump's tough rhetoric on the campaign trail and his firm comments in the early days of his presidency about restrictions on high drug prices.

The draft of a forthcoming executive order on drug pricing is favorable for the pharma and biotech industries, according to Kaiser Health News, which reviewed the documents and released its assessment on June 16. Instead of rolling out tough restrictions on drug pricing, some regulations would actually ease. Kaiser believes ideas from the industry's main lobbying group, the Pharmaceutical Research and Manufacturers Association (PhRMA), were incorporated into the draft.

Additionally, congressional Republicans have never had an appetite to restrict drug pricing. Given that Congress is behind in driving the administration's legislative agenda due to distractions from all of the investigations, we believe they would have even less appetite to change the status quo at this stage.

### Cheap antidote

Another factor supporting additional gains in Health Care is inexpensive valuations amid stabilizing or improving earnings and revenue growth for most of its subsectors.

At a forward price-to-earnings (P/E) ratio of 17.3x, the Health Care sector is trading below its 18.3x long-term average since 1990.

The valuation is even more favorable when compared to the broader market. Health Care's P/E trades at a discount to the S&P 500 whereas it has historically traded at a premium.

Furthermore, the relative valuations between the two are near the lowest level in years, and are trading close to the two previous periods when Health Care valuations were depressed (see top chart, left side).

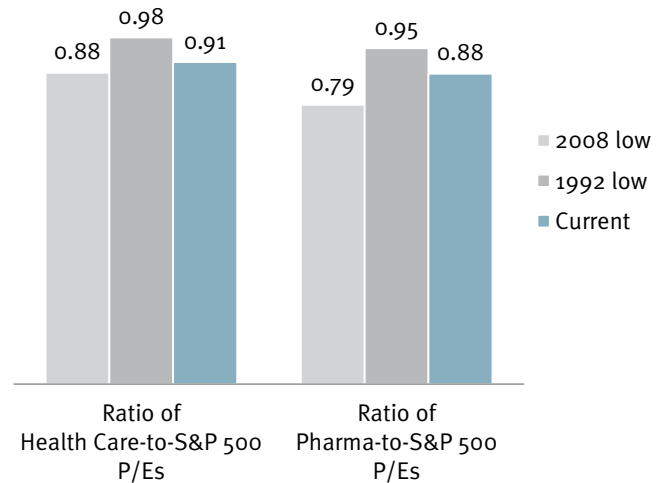
The forward P/E ratios of biotech and pharma are also trading below the S&P 500, as the bottom chart shows.

### Tonic for portfolios

Now that a technical breakout has occurred, risks in Washington have diminished, and fundamentals have stabilized or improved amid inexpensive valuations, we believe the Health Care sector is a healthy choice for investors in U.S. equities.

### Health Care valuations are reasonable compared to prior lows

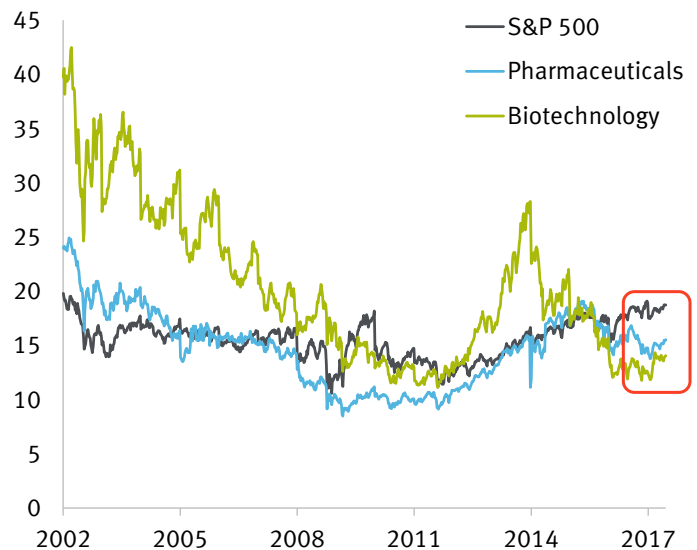
Current price-to-earnings (P/E) comparisons versus the two previous periods when Health Care valuations were depressed



Source - RBC Wealth Management, Bloomberg; current data reflects 6/20/17; P/E data based on forward earnings estimates

### Biotech is cheap on an absolute and relative basis

P/E ratios based on forward consensus earnings estimates



Source - RBC Wealth Management, Bloomberg; weekly data through 6/16/17



# China stocks hit the mainstream

Yufei Yang – Hong Kong

MSCI announced that it will include a limited number of mainland Chinese shares, known as A-shares, in its Emerging Markets Index; this was the fourth straight year MSCI considered adding mainland-traded stocks. Initially, 222 China A large-cap stocks will be included, giving mainland China a weighting of 0.73% in the index. Among these, the Financials sector is the largest chunk with 50 stocks accounting for a total weight of 36%, followed by the Industrials sector with a 16% weighting.

MSCI plans to add the shares in a two-step process during next year’s index review in May and August, but doesn’t rule out implementing in a single phase should the daily limit on Hong Kong Stock Connect trading be abolished or raised meaningfully.

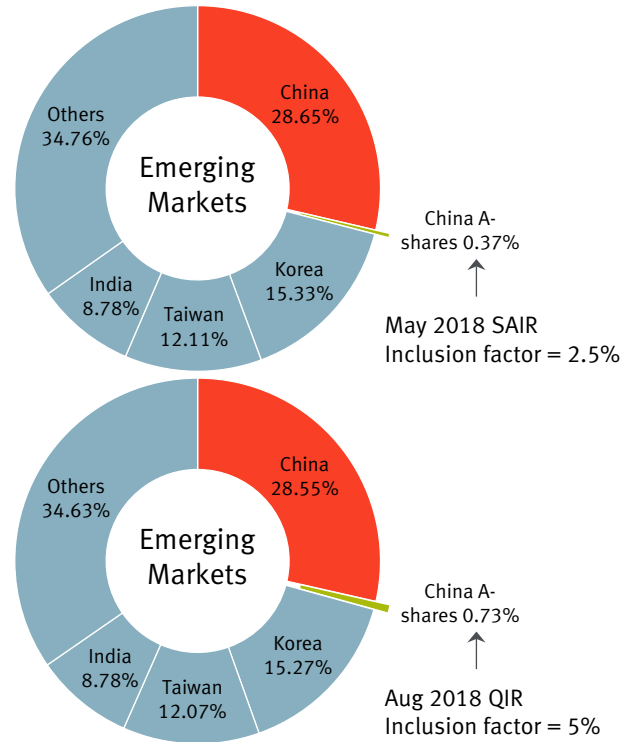
In the short term, the inclusion should be positive for sentiment, but the impact on funds flow will likely be quite limited. With a 5% inclusion factor, MSCI estimates about \$17–\$18B should flow into A-shares initially. That compares to the A-share market’s daily turnover of \$55B and total market cap over \$7T. Market reaction was muted following the announcement. The Shanghai Composite Index closed only 0.5% higher.

However, over the longer term, the inclusion represents a milestone in China’s capital market development.

Despite being the world’s second-largest equity market, A-shares have often been missing from global investors’ portfolios. Prior to the inclusion, China was already the largest component in the MSCI Emerging Markets Index at nearly 30%, but the index currently only includes Hong Kong stocks and U.S.-listed Chinese ADRs. Due to limited access to the mainland equity market, foreign investors own less than 1.5% of that market, according to MSCI, and the inclusion is likely to attract increasing attention from global investors. Under a full inclusion scenario, MSCI expects a \$340B inflow, although the process may take 7–10 years per the experience seen from other countries.

More importantly, the inclusion should compel Chinese policymakers to further improve the regulatory environment. Over the past few years, China has made positive changes that played a key role in MSCI’s consideration, such as the launch of the Stock Connect program linking the mainland and Hong Kong and the loosening of preapproval requirements for A-share-linked products.

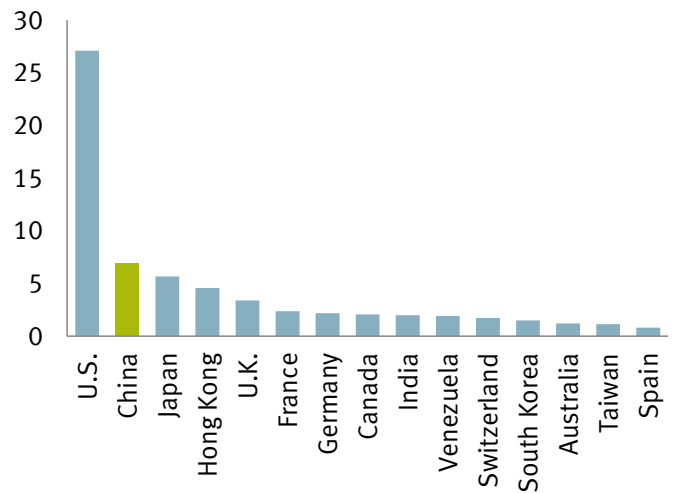
MSCI Emerging Markets weighting, by country



Source - MSCI, data as of 6/19/17

## China is the world’s second-largest equity market

Market cap, in USD trillions



Source - RBC Wealth Management, Bloomberg; data as of 12:28 pm GMT 6/22/17



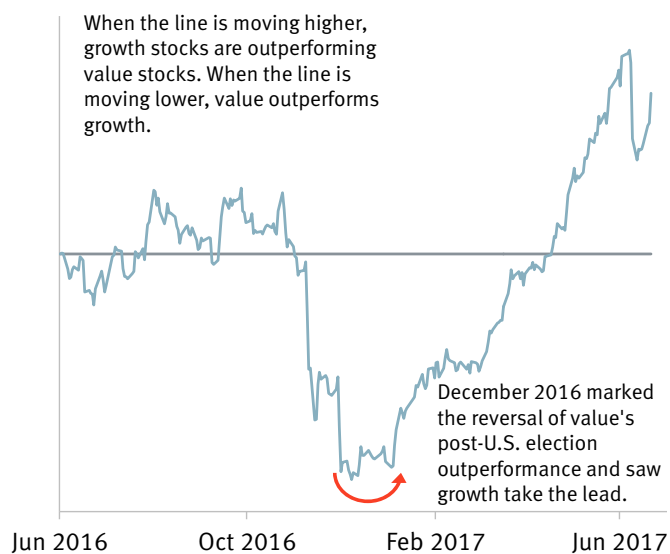
## United States

Kelly Bogdanov – San Francisco

- Major U.S. equity indexes continue to hover near all-time highs as short-term-oriented institutional investors debate whether the value or growth segments of the market will lead next. **We think style and sector rotation will persist** in an environment with subdued GDP growth and the Federal Reserve raising interest rates slowly. At times growth stocks will likely win out, while at other times value stocks should lead. Rather than attempting to pick the “flavor of the month” among sectors or styles, we think **it’s prudent to diversify equity portfolios while considering opportunities as they arise**—with Health Care being the current example, as discussed on page 1.
- **Energy** is one of only two sectors **that haven’t participated in the rally** (Telecom is the other). The sector has declined 3.6% so far this week and 15% year to date due to the relentless crude oil selloff. Despite the recommitment by OPEC and Russia to constrain supplies and indications they are largely adhering to production targets, WTI oil has retreated almost 21% year to date and closed near \$42/barrel recently, the worst level since last August. **Abundant U.S. supplies are the issue.** Technological advances have pushed the cost of production so low in select shale regions that some producers have increased supplies far more than analysts expected. U.S. oil production growth has been robust for the past seven months. Furthermore, even though domestic inventories

### Continued outperformance uncertain amid growth’s gains

Relative performance of the S&P 1500 growth and value indexes



Source - RBC Wealth Management, Bloomberg; data through 6/21/17

have retreated recently, they are still above normal for the peak summer driving season. While the Energy sector may be nearing a bottom, additional downside is not out of the question. **We put it in the “too late to sell, too early to buy” category.**

- For the broader equity market, we **think a consolidation period or a pullback could develop in the near term** given the S&P 500 has surged 3.3% since mid-May and 8.7% year to date. For the time being we would hold Market Weight positions in U.S. equities and would keep some cash on the sidelines in the event a pullback does materialize. **We continue to view the long-term outlook as bullish.**



## Canada

Diana Di Luca – Toronto

- **Government of Canada yields have continued to rise following comments from the Bank of Canada (BoC) early last week.** BoC Senior Deputy Governor Carolyn Wilkins noted that the “Governing Council will be assessing whether all of the considerable monetary policy stimulus presently in place is still required,” while BoC Governor Stephen Poloz added that “interest rate cuts have largely done their part.” Investors are now expecting the BoC to raise interest rates sooner and more frequently than they had previously anticipated. The **most dramatic yield moves have been seen in the 1–5 year part of the curve**, where rates have moved up 15–20 basis points.
- With the Canadian 10-year yield currently trading around 1.50%, we believe that **investors should look to add high-quality bonds in the 3–5 year part of the curve.** Our view on selecting shorter-duration bonds is based on recent flattening of the yield curve. The flatter curve makes extension trades from shorter maturities into 6–10 year bonds less compelling than earlier on in the year. If the 10-year yield falls below 1.50%, we would recommend shortened duration, but would recommend extended duration if the 10-year yields move higher towards the 2017 high of ~1.85%.
- The **TSX Preferred Share Index continues to climb higher** and sits just shy of the 700 level, its highest since early May. We believe the ~1.6% increase over the past 10 days has been **driven by a sharp rise in the Government of Canada yields** following the BoC comments. We have also seen a surge in demand from preferred share ETFs, which are looking to participate in the upside expected in the preferred share market fueled by the recent increase in rates. In this rate environment, **we recommend investors hold rate reset and floating rate preferred shares** trading well below their \$25 par values for upside potential.



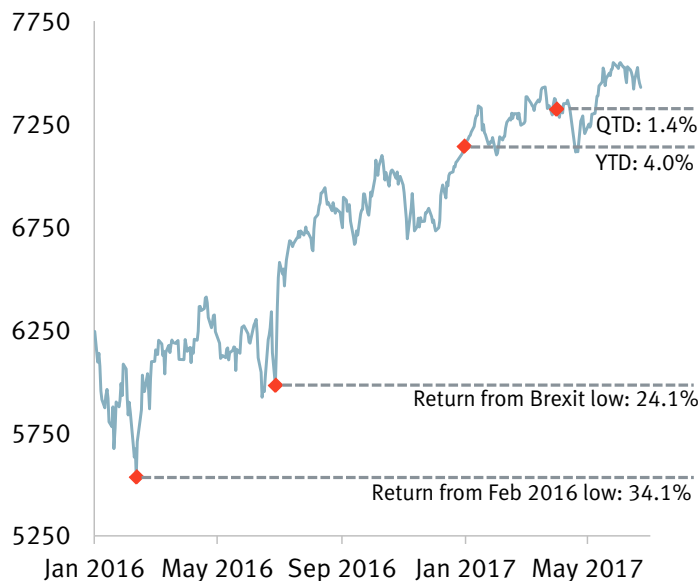
## Europe

Frédérique Carrier & Thomas McGarrity – London

- Despite an inconclusive U.K. election result and the uncertain future of Prime Minister Theresa May, **Brexit negotiations officially began** early in the week. **The U.K. gave up its stance to pursue negotiations for the divorce and new trade relationship simultaneously**, bowing to the EU's determined process requiring an agreement on the terms of the exit, before focusing on those of a new trading relationship. Perhaps political circles are recognising that the U.K.'s bargaining position is not stronger than that of the EU, as has often been asserted in previous months. **May's set negotiation strategy** of prioritising control of immigration and extracting the U.K. from the influence of the European Court of Justice **is being called into question** by some prominent politicians, including Chancellor of the Exchequer Philip Hammond, who want the priority to be the economy. While deliberations continue, the equity market continues to discount a hard Brexit scenario, in our view.
- While the U.K. remains draped in a veil of uncertainty, the newsflow out of Continental Europe has been encouraging. In France, **President Emmanuel Macron's party gained a majority in the National Assembly**. This is a notable achievement for a party which did not exist a year-and-a-half ago. With the centre-right

### U.K. stock appreciation is slowing as uncertainty builds and Brexit negotiations begin

FTSE 100 price levels and select returns



Source - RBC Wealth Management, Bloomberg; data through 6/22/17

- “Les Republicains” party, to which his prime minister is affiliated, forming the second-largest party, Macron has gathered the **necessary firepower to initiate largely business-friendly reforms**. He has signalled that decrees concerning labour reform could come through over the next few weeks, with the aim to foster job creation. We think decisive action on this front would be well received.
- Elsewhere, an agreement was reached on the next stages of the **Greek bailout programme**. An instalment of **€8.5B** is expected to be paid out shortly, **alleviating concerns regarding a heavy debt repayment schedule** this summer.



## Asia Pacific

Jay Roberts – Hong Kong

- **MSCI** decided to include a **limited number of mainland Chinese equities**, or A-shares, in its **Emerging Markets Index** (for details see [page 3](#)). Inclusion will not take place until mid-2018. Additionally, the weighting will be less than 1% of the index. This decision may be psychologically important and marks **another step along the road for China's capital market development**. However, in terms of funds flow, the impact should be quite limited.
- **New Zealand** kept its benchmark interest rate at a record low of 1.75%. Reserve Bank Governor Graeme Wheeler stated that **“monetary policy will remain accommodative for a considerable period.”** Growth has been weaker than forecast recently. In May, Wheeler noted that the bank's current expectation for when it will raise rates is in late 2019.
- **Japan's largest bank, Mitsubishi UFJ Financial Group** (8306 JP), **may eliminate approximately 10,000 jobs**, or 7% of the workforce, over the next decade. If so, this would be far more than the bank previously announced in 2016. Japan's persistently low interest rate environment is an ongoing headwind for the banking sector, although some banks have countered this by expanding more overseas.
- **Hong Kong's richest man** and best-known business person, Li Ka-shing, **may step down as chairman of CK Hutchison Holdings** (0001 HK), a major conglomerate with global business interests, in the summer of 2018 when he turns 90 years old, according to reports. His son, Victor, would take over. While such a move would be of little surprise to the market—it does remind investors that a **handful of Hong Kong's famous tycoons**, whose businesses dominate Hong Kong, are **reaching an age when they will pass on the baton** to others. Mr. Li is the second-richest man in Asia behind Alibaba's Jack Ma.





## MARKET SCORECARD

## Data as of June 22, 2017

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,434.50	0.9%	8.7%	16.7%	14.7%
Dow Industrials (DJIA)	21,397.29	1.8%	8.3%	20.3%	18.1%
NASDAQ	6,236.69	0.6%	15.9%	29.0%	21.0%
Russell 2000	1,404.54	2.5%	3.5%	22.2%	8.7%
S&P/TSX Comp	15,219.90	-0.8%	-0.4%	8.7%	2.9%
FTSE All-Share	4,069.07	-1.1%	5.1%	18.4%	9.4%
STOXX Europe 600	388.53	-0.4%	7.5%	13.8%	-1.5%
German DAX	12,794.00	1.4%	11.4%	27.0%	11.6%
Hang Seng	25,674.53	0.1%	16.7%	23.5%	-5.2%
Shanghai Comp	3,147.45	1.0%	1.4%	8.3%	-29.7%
Nikkei 225	20,110.51	2.3%	5.2%	25.2%	-1.6%
India Sensex	31,290.74	0.5%	17.5%	16.9%	12.8%
Singapore Straits Times	3,215.55	0.1%	11.6%	15.4%	-3.0%
Brazil Ibovespa	61,272.21	-2.3%	1.7%	22.2%	13.8%
Mexican Bolsa IPC	49,017.43	0.5%	7.4%	7.0%	8.4%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,250.08	-1.5%	8.5%	-1.3%	5.4%
Silver (spot \$/oz)	16.58	-4.4%	4.1%	-4.0%	2.2%
Copper (\$/metric ton)	5,717.50	1.1%	3.5%	21.8%	1.4%
Oil (WTI spot/bbl)	42.54	-12.0%	-20.8%	-12.2%	-28.7%
Oil (Brent spot/bbl)	45.22	-10.1%	-20.4%	-9.3%	-28.6%
Natural Gas (\$/mmBtu)	2.90	-5.6%	-22.2%	8.3%	6.1%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.146%	-5.7	-29.8	46.1	-22.7
Canada 10-Yr	1.498%	8.2	-22.3	26.7	-30.7
U.K. 10-Yr	1.015%	-3.1	-22.4	-29.8	-108.3
Germany 10-Yr	0.252%	-5.2	4.4	19.1	-63.2

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.47%	0.4%	2.8%	1.1%	6.3%
U.S. Invest Grade Corp	3.13%	0.8%	4.3%	3.9%	11.0%
U.S. High Yield Corp	5.64%	-0.1%	4.6%	12.3%	13.3%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.5390	0.6%	-4.6%	4.1%	3.4%
CAD/USD	0.7559	2.1%	1.6%	-2.9%	-7.0%
USD/CAD	1.3230	-2.0%	-1.6%	3.0%	7.5%
EUR/USD	1.1153	-0.8%	6.0%	-1.3%	-1.7%
GBP/USD	1.2686	-1.6%	2.8%	-13.7%	-19.8%
AUD/USD	0.7540	1.5%	4.6%	0.5%	-2.4%
USD/CHF	0.9717	0.4%	-4.6%	1.4%	5.5%
USD/JPY	111.3200	0.5%	-4.8%	6.6%	-9.8%
EUR/JPY	124.1500	-0.3%	1.0%	5.2%	-11.3%
EUR/GBP	0.8792	0.8%	3.0%	14.4%	22.7%
EUR/CHF	1.0837	-0.4%	1.1%	0.1%	3.7%
USD/SGD	1.3902	0.5%	-3.9%	3.9%	4.1%
USD/CNY	6.8348	0.2%	-1.6%	3.9%	10.1%
USD/BRL	3.3412	3.5%	2.6%	-1.1%	8.5%

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 8:37 pm GMT 6/22/17.

Examples of how to interpret currency data: CAD/USD 0.76 means 1 Canadian dollar will buy 0.76 U.S. dollar. CAD/USD 1.6% return means the Canadian dollar rose 1.6% vs. the U.S. dollar year to date. USD/JPY 111.32 means 1 U.S. dollar will buy 111.32 yen. USD/JPY -4.8% return means the U.S. dollar fell 4.8% vs. the yen year to date.



## UPCOMING EVENTS

Fri, Jun 23	Sun, Jun 25	Wed, Jun 28	Thu, Jun 29, cont.
Eurozone Markit Manuf. PMI (56.8)	NY Fed Pres. Dudley Speaks (Base)	China Swift Global Payments	Eurozone Consumer Confidence
Eurozone Markit Serv./Comp. PMI	<b>Mon, Jun 26</b>	Japan Retail Sales	Germany CPI
Germany Markit Manuf. PMI (59.0)	China Industrial Profits	U.S. Pending Home Sales	U.K. GfK Consumer Confidence
Germany Markit Serv./Comp. PMI	Germany IFO Expectations	<b>Thu, Jun 29</b>	U.S. Q1 GDP Revision (1.2% ann'l'zd)
U.S. Markit Manuf. PMI (53.0)	U.S. Chicago Fed Nat'l Activity	China NBS Manuf. PMI	U.S. Personal Consumption
U.S. Markit Serv./Comp. PMI	U.S. Durable Goods (-1.0% m/m)	China NBS Non-Manuf. PMI	U.S. Core PCE
U.S. New Home Sales (590K, 3.7% m/m)	<b>Tue, Jun 27</b>	Japan CPI	<b>Fri, Jun 30</b>
Canada CPI (0.2% m/m, 1.5% y/y)	U.S. Conf. Board Consumer Confidence	Japan Industrial Prod.	U.K. Q1 GDP Final Revision
Canada Core CPI		Eurozone Economic Confidence	U.S. Personal Income/Spending

The dates reflect North American time zones. All data reflect Bloomberg consensus forecasts where available.

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Rating	Count	Percent	Investment Banking Services Provided During Past 12 Months	
			Count	Percent
Buy [Top Pick & Outperform]	843	51.94	285	33.81
Hold [Sector Perform]	679	41.84	149	21.94
Sell [Underperform]	101	6.22	8	7.92

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**Top Pick (TP):** Represents analyst's best idea in the sector; expected to provide significant absolute total return over 12 months with a favorable risk-reward ratio. **Outperform (O):** Expected to materially outperform sector average over 12 months. **Sector Perform (SP):** Returns expected to be in line with sector average over 12 months. **Underperform (U):** Returns expected to be materially below sector average over 12 months.

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