

# Global Insight

## Weekly



A closer look

## Baffling Brexit

Frédérique Carrier – London

The Brexit story saw another plot twist as Prime Minister May had to beat back a challenge from her own party. With the Brexit deadline looming, we look at how the drama's conflict, climax, and resolution may unfold, and what it all means for financial markets.

U.K. Prime Minister Theresa May survived a no-confidence vote on her leadership, which makes her immune to another challenge by her Conservative Party over the next 12 months. With more than one-third of Conservatives having voted against her, she is weakened, but unlikely to resign in the short term.

May will press on with attempting to get the Withdrawal Agreement that she negotiated with the EU approved by the U.K. Parliament. With the Brexit clock ticking, and critics of her deal no more likely to back the deal in its current form, high drama and extreme market volatility in U.K. financial assets—particularly in the pound—will continue to test investors' nerves. The issue will also likely keep global financial markets on edge.

### Path of least resistance to prevail?

May's deal includes both the detailed and legally binding Withdrawal Agreement—which sets the terms of the U.K.'s exit from the obligations of EU membership—as well as the political declaration, the non-legally binding, loosely defined statement of intent of the post-Brexit economic relationship between the U.K. and the EU.

The deal faced strong opposition from various fronts. Ardent Brexiters fear the relationship with the EU will remain too close for too long. Most other Members of Parliament (MPs) feel that leaving the EU without much certainty as to what the future relationship might be is worse than the status quo.

The prime minister will now attempt to extract some concessions or clarifications from the EU so as to make her deal more attractive. The EU is unlikely to offer more than reassurances and perhaps non-binding statements regarding the political declaration—that will probably not be enough to sway the passionate Brexiters.

A House of Commons vote on the Withdrawal Agreement is likely to occur in January, and we believe the deal is likely to be rejected. Visibility as to how the events may unfold is very low. There remains a low probability of a general election, a second referendum, an extension of Article 50 (the procedure for taking the U.K. out of the EU), or a hard Brexit, though the prospect of the latter has receded after a recent European Court of Justice ruling giving the U.K. the right to revoke its Article 50 notification unilaterally.

Our base case remains that MPs will eventually opt for a soft Brexit as the difficulties and impracticalities of other options become more and more apparent in the face of the March 29 deadline.

### Market pulse

- 3 S&P 500 primed to rally into year-end?
- 3 Bank of Canada proceeding with caution
- 3 Europe's political smorgasbord
- 4 U.S.-China tone on trade somewhat improved, but ...

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Priced (in USD) as of 12/13/18 market close, EST (unless otherwise stated).

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Wealth  
Management

## Brexit bites

For now, the absence of a Withdrawal Agreement acceptable to Parliament will continue to weigh on U.K. economic activity through the beginning of 2019. In November, the U.K.'s composite Purchasing Managers' Index reached its lowest level since the aftermath of the 2016 Brexit referendum as firms have started to postpone or cancel spending and investment decisions in the face of uncertainty. Business investment has also contracted in each of the first three quarters of the year.

The slowing economy is not yet reflected in the labour market, with unemployment stable at 4.1% and wages growing by an average of 3.3% for the past three months compared to the same period last year.

A weakening economy and wage pressure make for an uncomfortable environment for the Bank of England. The Brexit uncertainty means interest rate hikes are likely to be pushed out.

## Taking it all in

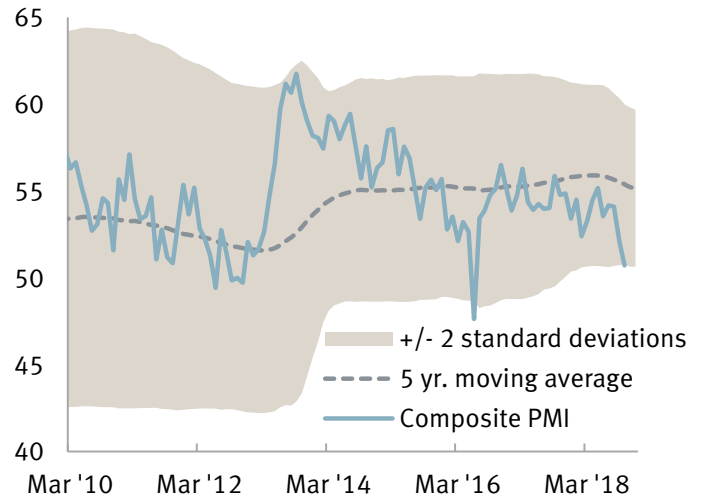
The pound is the barometer of this uncertainty and now hovers at an 18-month low. We would expect some—but limited—upside should a deal be eventually agreed to by Parliament, given the weak economy and a rising current-account deficit. The currency could weaken even further should a general election be called or in the event of a no-deal Brexit, given the heightened uncertainty around these outcomes. Conversely, an increasing probability of a second referendum would likely lift the pound.

We upgraded U.K. fixed income to Market Weight in September, as we expected investors to seek safe-haven assets in the U.K. We may review this position once uncertainty settles, but suggest investors should reduce duration to 3–5 years as 10-year U.K. Gilt yields have fallen below 1.30%. Yields may end up materially higher from current levels under several scenarios, i.e., should May's plans succeed, Brexit be overturned, or the Labour Party take the reins of power.

For U.K. equities, we maintain a Market Weight stance that is predicated on the market's attractive valuations and defensive nature, with a higher proportion of the Consumer Staples, Health Care, and Utilities sectors than other equity markets. Should a deal be secured, we would expect domestic stocks to enjoy a relief rally.

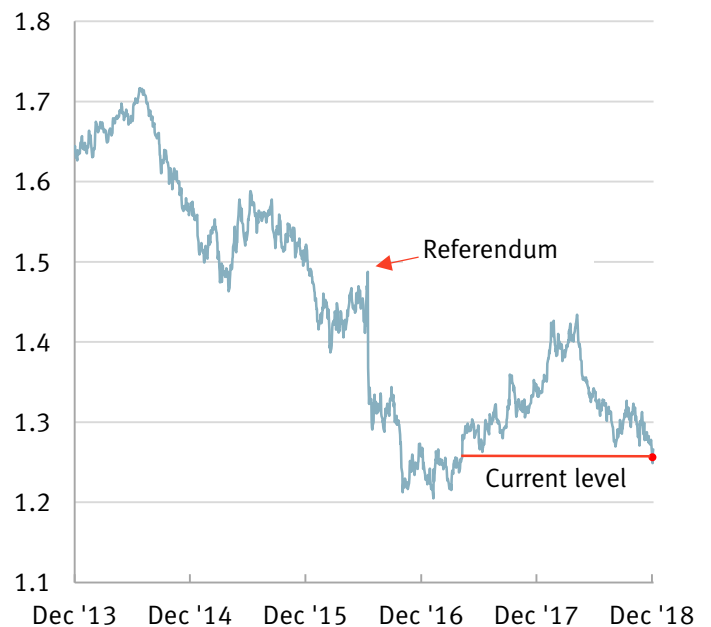
The political situation in the U.K. remains extremely complex and events are still in motion. Resolve in Parliament to avoid the harshest form of Brexit gives us slightly more confidence that our base-case scenario will prevail, though many hurdles remain.

## U.K. composite PMI tumbles



Source - IHS Markit, Haver, RBC Capital Markets estimates

## GBPUSD is at an 18-month low



Source - Bloomberg, RBC Wealth Management; data through 12/13/18



## United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets have steadied in recent days** after declining 5% to begin the month. **Easing tensions between the U.S. and China** have been reflected in the stability seen during the week on news that Chinese policy advisers are drafting a replacement for their “Made in China 2025” blueprint that will be more open and accessible to foreign investors. The changes mark an effort to aid negotiations as the two sides attempt to make further progress on reaching an agreeable conclusion to the trade dispute.
- Growth stocks were granted a reprieve from recent pressures, with Tech appreciating 2.5% so far for the week and Communication Services gaining 1.5%. Further highlighting the respite is the relative underperformance in value stocks, including Financials. **RBC Capital Markets bank analysts released their 2019 outlook in which they are constructive on the economy and U.S. bank stocks**, despite the 9.4% decline the group has seen thus far in December as the Treasury yield curve has come under renewed pressure. Our view is that, **barring recession, banks present an attractive risk/reward proposition**. Since 1994, when bank industry price-to-earnings ratios have been near current levels, the stocks have seen returns greater than 30% in the ensuing 12 months, on average, excluding the Great Recession.
- RBC Capital Markets, LLC Technical Strategist Bob Dickey believes **the market is set up to rally into year-end**. He anticipates the S&P 500 will climb from the bottom of its months-long range to the top of this range in a similar fashion to what has been repeated several times in recent months. He continues to believe we’re **in the midst of a consolidation period that is part of a broader secular bull market**.



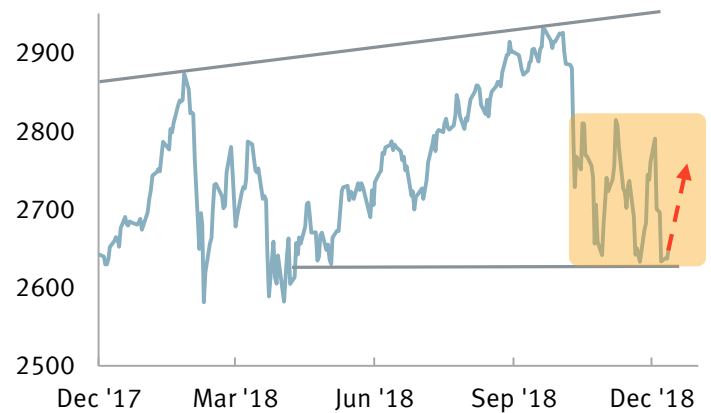
## Canada

Diana Di Luca – Toronto

- Following the **Bank of Canada’s (BoC) decision to hold the overnight rate at 1.75%** on December 5, **BoC Governor Stephen Poloz delivered an economic update speech in Toronto**. He noted that any future BoC rate hikes will be “decidedly data dependent.” The subsequent Canadian employment report was positive, with the economy adding a record 94,100 jobs in November, while the unemployment rate dropped to a new all-time low of 5.6%. However, wage growth will have to outpace inflation for households to better service the rising cost of record

Technically, the S&P 500 is primed to rally into year-end

S&P 500 since December 1, 2017



Source - RBC Wealth Management, FactSet; data through 12/12/18

- high debt, and the sixth consecutive month of slowing wage increases means the BoC should proceed with caution, in our view. **The market is now forecasting barely more than one hike through the end of 2019**, compared to the three rate hikes that were priced into expectations as recently as mid-October. This recent re-pricing has implications for both the bond and preferred share markets.
- Canadian corporate bond yields remain near recent highs, despite a 25–40 basis point move lower in government bond yields since early October. The result of this divergence is the **widest corporate bond spread** since mid-2016. In the investment-grade segment, liquidity is the worst in the BBB space. We **continue to recommend de-risking fixed income portfolios**. This means upgrading credit quality, as full valuations of lower-quality bonds leave this part of the market in the unappealing position of being vulnerable to both higher interest rates and a recession.
- **The preferred share market selloff has also continued against this risk-off backdrop**, with the TSX Preferred Share Index down 1.0% so far in December, reaching its lowest level since mid-2016. The recent selloff has presented some interesting value opportunities, in our opinion. Discounted rate resets, which can offer upside in a rising rate environment that is accompanied by tighter credit spreads, have been hit particularly hard during the selloff, and many of these issues offer yields on extension of over 6% based on the current 5-year Government of Canada bond yield.



## Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- In addition to the U.K., it was also a politically eventful week in Europe. **German Chancellor Angela Merkel’s party, the center-right Christian Democratic Union (CDU), chose**

**its new leader**, Annegret Kramp-Karrenbauer. A former state premier (akin to a state governor in the U.S.), she most recently served as general secretary of the CDU. The Merkel protégé is widely seen as a centrist within the CDU, and she **seems to support further EU integration**.

- Her election **reduces the risk that Merkel's coalition with the Social Democratic Party (SPD) splinters** in the near term and may lengthen the time Merkel remains as chancellor. Regardless, any change in the coalition is unlikely to result in a material change in German domestic and EU policies, in our view. The next important political event will be the European Parliament elections in May. How well the coalition partners CDU and SPD fare will likely determine the coalition's longevity.
- **French President Emmanuel Macron addressed the nation following violent street protests against a fuel tax.** Points of contention also included abolishing a wealth tax and what some critics perceive to be an aloof style. Adopting a more humble tone, Macron suggested a €100 per month supplement for minimum wage earners, abolition of taxes on overtime pay, and forgoing a planned tax hike for pensions below a certain threshold. These measures, along with the previously announced delay of the fuel tax, would slightly increase the fiscal deficit by some 0.4%, according to government estimates. Helped by his solid majority in parliament, Macron's resolve to reform France may remain unaltered, but the risk is **this recent episode could well make his reform plans less bold**.
- In a **significant concession** to the European Commission, **Italian Prime Minister Giuseppe Conte proposed to cut the deficit target to 2.04% of GDP for 2019.** This confirms our long-held view that the government's confrontational attitude towards the Commission would eventually give way to a more pragmatic approach.



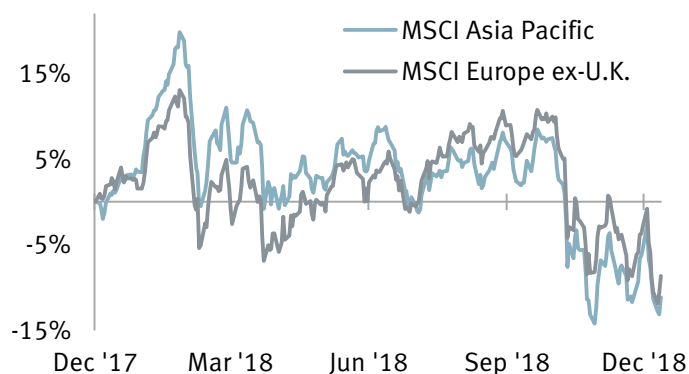
## Asia Pacific

Jay Roberts, CFA – Hong Kong

- **Asian equities dipped earlier in the week to their lowest level since October 29**, the bottom of the global equity market correction. However, **the trading range since then has been fairly narrow.** The MSCI Asia Pacific Index has traded between 147.9 and 154.1 since the start of November.
- **The Hong Kong equity market remains sensitive to the news flow** concerning the talks between the U.S. and China on trade and other issues, such as market access. **The tone on trade has improved somewhat**, with the two countries involved in dialogue accompanied by certain

## After January, 2018 has been challenging for international stocks

Performance relative to the S&P 500



Note: Positive/negative percentages indicate the amount of outperformance/underperformance relative to the S&P 500.

Source - RBC Wealth Management, Bloomberg; data through 12/12/18

concrete moves such as China's reduction of tariffs on U.S. autos to 15% from 45% (tariffs were increased to 45% earlier in the year as part of the dispute).

- From his comments, **it would appear that U.S. President Donald Trump would like to do a "deal,"** even to the extent that he suggested he might get involved in the Huawei case involving the company's Chief Financial Officer, Meng Wanzhou, who was arrested in Canada under U.S. allegations of breaking sanctions against Iran. Whether the legal process would allow for such involvement is another matter. However, even if a deal is done—and markets would react positively, in our view—**we still believe that relations will be strained and rivalry will continue to grow.** See last week's [Global Insight Weekly](#).
- **Mortgage lending at Australian banks fell meaningfully in Q3** by 7.4% y/y. This was the biggest quarterly decline since 2010. Australia has introduced regulations over the past several years to tame the housing market, including restrictions on interest-only loans that may be preferred by some investors. Interest-only loans were just 16% of mortgage loans in Q3. They were close to 50% just three years ago.
- **The average house price in Sydney, Australia's largest city, is down by 10.1% since the peak** in 2017, according to CoreLogic. This is larger than the 9.6% decline at the end of the 1980s shortly before the country's last recession. (Australia has not had a recession, or two quarters of negative GDP growth, since 1991!) The decline should be set in context of the very strong appreciation that occurred in house prices. Consequently, **house prices remain around 60% higher than in 2012.** A number of forecasters believe that the decline in prices will continue.



## MARKET SCORECARD

Data as of December 13, 2018

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,650.54	-4.0%	-0.9%	-0.5%	16.7%
Dow Industrials (DJIA)	24,597.38	-3.7%	-0.5%	0.0%	23.5%
NASDAQ	7,070.33	-3.5%	2.4%	2.8%	29.4%
Russell 2000	1,432.70	-6.6%	-6.7%	-6.0%	4.3%
S&P/TSX Comp	14,750.35	-2.9%	-9.0%	-8.6%	-4.1%
FTSE All-Share	3,752.66	-1.8%	-11.1%	-8.7%	-0.8%
STOXX Europe 600	349.42	-2.3%	-10.2%	-10.6%	-2.3%
EURO STOXX 50	3,112.17	-1.9%	-11.2%	-13.1%	-3.8%
Hang Seng	26,524.35	0.1%	-11.3%	-9.2%	18.2%
Shanghai Comp	2,634.05	1.8%	-20.4%	-20.3%	-16.5%
Nikkei 225	21,816.19	-2.4%	-4.2%	-4.1%	13.3%
India Sensex	35,929.64	-0.7%	5.5%	8.7%	34.6%
Singapore Straits Times	3,111.08	-0.2%	-8.6%	-10.3%	5.3%
Brazil Ibovespa	87,837.59	-1.9%	15.0%	20.5%	48.2%
Mexican Bolsa IPC	41,512.51	-0.5%	-15.9%	-14.0%	-11.4%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,242.83	1.7%	-4.6%	-1.0%	7.3%
Silver (spot \$/oz)	14.77	4.1%	-12.8%	-8.1%	-12.7%
Copper (\$/metric ton)	6,144.75	-1.3%	-14.7%	-8.2%	8.2%
Oil (WTI spot/bbl)	52.58	3.2%	-13.0%	-7.1%	-0.8%
Oil (Brent spot/bbl)	61.86	5.4%	-7.5%	-0.9%	11.0%
Natural Gas (\$/mmBtu)	4.13	-10.5%	39.8%	52.0%	18.8%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.913%	-7.5	50.8	57.1	44.2
Canada 10-Yr	2.156%	-11.2	11.1	31.3	39.7
U.K. 10-Yr	1.289%	-7.5	9.9	7.3	-15.2
Germany 10-Yr	0.285%	-2.8	-14.2	-2.9	-7.5
Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.47%	0.8%	-1.0%	-1.1%	2.9%
U.S. Invest Grade Corp	4.32%	0.8%	-3.1%	-3.0%	4.0%
U.S. High Yield Corp	7.28%	0.1%	0.1%	0.3%	7.9%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.0830	-0.2%	5.4%	3.9%	-3.9%
CAD/USD	0.7487	-0.5%	-5.9%	-4.0%	-1.7%
USD/CAD	1.3357	0.5%	6.3%	4.2%	1.7%
EUR/USD	1.1362	0.4%	-5.4%	-3.9%	6.9%
GBP/USD	1.2660	-0.7%	-6.3%	-5.7%	0.0%
AUD/USD	0.7223	-1.1%	-7.5%	-5.4%	-3.7%
USD/JPY	113.6100	0.0%	0.8%	1.0%	-1.4%
EUR/JPY	129.0800	0.5%	-4.6%	-3.0%	5.5%
EUR/GBP	0.8975	1.1%	1.1%	1.9%	6.9%
EUR/CHF	1.1293	-0.1%	-3.5%	-3.1%	5.0%
USD/SGD	1.3716	-0.1%	2.7%	1.9%	-3.7%
USD/CNY	6.8816	-1.1%	5.8%	4.0%	-0.3%
USD/MXN	20.3008	-0.3%	3.3%	6.8%	0.1%
USD/BRL	3.8909	0.6%	17.6%	17.3%	16.7%

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 12/13/18.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -5.9% return means the Canadian dollar fell 5.9% vs. the U.S. dollar year to date. USD/JPY 113.61 means 1 U.S. dollar will buy 113.61 yen. USD/JPY 0.8% return means the U.S. dollar rose 0.8% vs. the yen year to date.



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			Count	Percent
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