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RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Shadows of doubt

Tom Garretson – Minneapolis; Frédérique Carrier – London

That uncertain feeling continues to gnaw at markets, with equities see-sawing. But we think there's more to the pullback than trade fears, and conditions for a rebound should be emerging. And we explain why the latest wrinkle for the fixed income market—China's threat to dump Treasuries—is much ado about nothing.

You wouldn't know it by looking at the one-week change in the Dow Jones Industrial Average Index, which is essentially flat, but volatility showed no signs of abating during the week as, you guessed it, trade war fears and uncertainty continue to hang over global markets. The Dow traded in a range of nearly 800 points for the week, amid a range of nearly 1,500 points thus far in May, some of the largest market swings since January.

In response to the U.S. tariff increase on $200B in Chinese goods to 25%, China took the relatively measured step of imposing 10%–25% tariffs on another $60B worth of U.S. imports, but China's response isn't scheduled to go into place until June. Regardless, both sides appear to be at loggerheads, with uncertainty likely to remain.

As a result, RBC Global Asset Management Chief Economist Eric Lascelles shifted his stance on the outlook for trade scenarios, now seeing "substantial tariffs" as the most likely scenario. But as we note in the table at right, even with a deal there is little upside to the growth outlook, the fact remains that tariffs only pose downside risks for both countries.

On the bright side, the Trump administration did announce that it would delay for six months any levies on auto imports from Europe and Japan while trade talks continue. This largely sparked the rally that fueled the rebound in most global stock markets—a clear sign that markets would like nothing more than to see an agreement, no matter how superficial, and to move on.

Markets were understandably shaky after the tone of the trade negotiations abruptly changed. After all, equities had

U.S. trade scenarios looking worse again

Scenario	Likelihood	Detail	Economic impact
Worst case	15%	Trade war	U.S.: -0.7% to -4.0% China: -0.8% to -1.8%
Negative	**35%**	**Substantial tariffs**	**U.S.: -0.4% to -0.8%** **China: -0.4% to -0.8%**
Slightly negative	30%	Small tariffs	U.S.: -0.3% China: -0.2%
Neutral	10%	Trump tariffs unwind	U.S.: 0% China: 0%
Best case	10%	Foreign barriers fall to pressure	U.S.: Positive China: ?

Source - RBC Global Asset Management; economic impact is the estimated effect on future growth

Market pulse

3 How equity volatility has been a boon for U.S. housing

3 The Canadian provincial GDP picture

4 Event risk is returning to the U.K. and Europe

4 Highlights of results out of Asia

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Priced (in USD) as of 5/16/19 market close, EST (unless otherwise stated).

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Wealth Management

rebounded from the December 2018 lows thanks not only to a pause in monetary policy plans from the Federal Reserve, but also from a stabilization in global economic growth and fading protectionist threats.

Is it really all about trade fears?

RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina points out that complacency had set in after the strong rally and with Q1 corporate earnings proving better than expected. This left the stock market somewhat complacent, with signs of crowding and vulnerable to some profit-taking.

Volatility has been capped by the hope that cooler heads will prevail. The U.S. is anxious to sustain economic growth ahead of the 2020 presidential election, as is China, given its recent fiscal stimulus to stabilize growth.

Calvasina also points out that after rebounds in 2010, 2011, and 2016, i.e., similar to the rebound in Q1 2019, pullbacks of 4%–10% were common. Since April 30, the Hang Seng has retreated 4.7%, the STOXX Europe 600 ex UK 1.7%, the Shanghai Stock Exchange 3.9%, the S&P 500 2.3%, the TOPIX 3.6%, and the FTSE All-Share 3.2%. Most major indexes are now at, or approaching, oversold territory while valuations are back to more attractive levels.

As such, we think the conditions will soon be in place for markets to eventually rebound, barring a deterioration in trade rhetoric. After all, monetary policy is accommodative in most regions, and underlying economic conditions remain good. The dent from protectionism to economic growth in both the U.S. and China would not be enough by itself to drive either country into recession, in our view. We are comfortable with our Market Weight position in global equities.

Sell in May and go away?

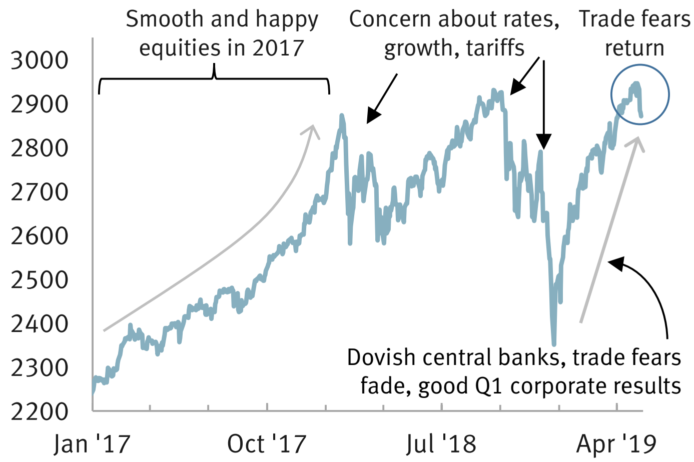
Treasuries, that is. Shifting to the U.S. fixed income market, the latest wrinkle in this trade war spat came amid stories that scholars in China are exploring selling Treasuries as a potential rebuttal to any further escalation in either tariff rates or their scope, the idea being that dumping Treasuries could drive up borrowing costs for U.S. businesses and consumers.

Of course, this has long been a threat—and fear for investors—given that China is the largest foreign holder of U.S. Treasuries, though Japan's holdings are essentially equal, at around $1.1T. But as the lower chart at right shows, China's holdings have been in a state of steady decline for years, both in terms of its absolute holdings and as a percentage of all outstanding Treasuries, the latter perhaps limiting its influence.

But that might be a moot point anyway. The simple truth is that dumping Treasuries simply isn't likely to be a realistic option for China. First, there are few, if any, global substitutes for the depth and liquidity that the Treasury market provides—a key factor that China has cited in the past. And second, doing so would likely only serve to exacerbate the ill effects of the trade spat on China's economy, as it would drive up the value of the Chinese yuan, making its exports more expensive and thus reducing global demand.

All told, while China may attempt to use the threat as a bargaining chip, we don't see it as realistic and recommend that investors focus their worries elsewhere. We continue to see little risk that Treasury yields move markedly higher from current levels, maintaining our view that the 10-year Treasury will remain below roughly 2.75% for the foreseeable future. We reiterate our Market Weight stance in U.S. fixed income.

The S&P 500 was ripe for a correction



Source - RBC Wealth Management, RBC Global Asset Management, *Wall Street Journal*, Haver Analytics; data through 5/9/19

China's influence in the U.S. Treasury market has been waning for years

Source - RBC Wealth Management, Bloomberg

United States

Bill Kuehn, CFA – Minneapolis

- **Housing remains one of the few sectors benefiting from current equity market volatility and the resultant flight to high-quality bonds that continues to push interest rates lower.** The thirty-year mortgage rate has fallen 84 basis points, from 4.82% in November to below 4% currently, increasing affordability and fueling demand for housing. The increase in affordability is beginning to show in housing data, with both housing starts and building permits beating estimates in April and accelerating to three-month highs. A May 15 National Association of Home Builders report showed **homebuilder sentiment rose to a seven-month high in May**, with optimism rising for both the present landscape and the six-month sales outlook—although the industry still faces shortages of qualified workers and buildable lots.
- Rising mortgage rates along with a lack of affordable homes for sale caused a stall in home-selling activity in 2018 that detracted from economic growth in all four quarters. However, **housing is finally expected to make positive contributions to economic growth in Q2 2019, with current estimates pointing toward 2% growth in residential investment**. A decline in the rate of home price appreciation, lower mortgage rates, and a labor market that continues to produce annual wage growth over 3% indicate continued strength in housing. We remain bullish on homebuilder equities as a trade, and believe the fundamentals remain intact for outperformance. RBC Capital Markets data suggest the arrival of a more stable pricing environment and fewer price cuts by homebuilders to increase sales, which should drive higher margins and produce earnings above the current estimates of homebuilders and Wall Street analysts alike.
- Although overshadowed by U.S.-China tariff developments, **the release of retail sales data was the week's big economic news**. A key indicator given consumer spending is responsible for roughly 70% of U.S. economic growth, **retail sales unexpectedly retraced in April following an exceptionally strong print in March**. We note the decline resulted from a large drop in auto sales, and **Wall Street economists still project an improvement in consumer spending in the current quarter**.

Canada

Arete Zafiriou & Richard Tan, CFA – Toronto

- **Escalation in U.S.-China trade rhetoric has weighed on global sentiment** and has led to a decline of approximately 0.2% in the S&P/TSX Composite (the index remains up 16.1% YTD) since U.S. President Donald Trump expressed frustration with negotiations between the world's two largest economies on May 6. Consumer Staples, Utilities, Real Estate, and Communication Services have remained in positive territory during this period as **investors have flocked to traditionally defensive industries**. Companies in those sectors tend to exhibit more stable earnings profiles and pay dividends that are typically viewed as attractive attributes during times of market volatility. Health Care and Consumer Discretionary were the worst-performing sectors on a relative basis. Financials, which makes up about 32% of the Canadian market, declined around 1.9%. In our view, **investors should opportunistically upgrade their portfolios along the quality curve** as we get deeper into the economic cycle. We would look to reduce exposure to cyclical businesses in favour of companies with less sensitivity to economic growth.
- Canadian provincial GDP data are only released on an annual basis with a significant time lag. Therefore, RBC Global Asset Management combines a number of high-frequency economic signals as a proxy for provincial GDP. Based on the resulting model, **Manitoba's GDP is likely the fastest-growing at 2.4% y/y** ending March 2019, with British Columbia (B.C.) and Quebec close behind at 2.1% y/y each. On the opposite end, **Alberta and New Brunswick are the laggards**, at 1.0% and 0.8% y/y, respectively. Ontario sits in the middle of the pack, at 1.7% y/y. Despite the percentages being in positive territory, six out of 10 provinces, including Canada's four largest (Ontario, Quebec, Alberta, and B.C.) have suffered decelerating GDP growth over the past year, suggesting to us the slowdowns are **more than an oil price story**—i.e., there are nationwide headwinds in play.

Decline of 84 basis points in the 30-year mortgage rate provides tailwind to housing activity

30-year fixed mortgage rate

Source - RBC Wealth Management, Bloomberg; data through 5/16/19

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Event risk is returning to the U.K. and Europe**, with currency and fixed income markets feeling the brunt of the risk-off sentiment. In the U.K., **the pressure to oust Prime Minister Theresa May is intensifying by the day**. She announced she would bring the Withdrawal Agreement back for a vote in early June, but it is likely to fail again, in our view. A rejection could trigger the fall of her government, and a leadership contest from which would likely emerge a more ardent Brexiter, given that Conservatives' attitudes towards Brexit, and a "hard Brexit" in particular, have been hardening over the past few months. The pound slid versus the U.S. dollar, extending recent losses to equal the mid-February low of 1.2803, while Gilts rallied, with the 10-year yield retreating to 1.059%. U.K. equities managed to remain stable, but only thanks to the Oil and Gas sector's response to higher oil prices.
- Ahead of the European Parliament elections on May 23, **Italian Deputy Prime Minister Matteo Salvini resumed using populist rhetoric, threatening to breach EU fiscal rules** to reduce the country's endemic unemployment rate. His coalition partner and fellow deputy prime minister, Luigi Di Maio, stressed that wider budget deficits are irresponsible. With growing disagreement among the coalition, there is an **increasing likelihood that the Italian government will fall after the upcoming European elections**, with recent polls pointing to Salvini emerging as prime minister. This would give Salvini the leeway to follow through on his plans. Italian-German bond spreads widened further, and the euro slid against the dollar to 1.1186. The STOXX Europe 600 ex UK Index was up slightly thanks to economic data, but markets are likely to focus on political risk in the short term.

Italian bond spreads widen as polls indicate Matteo Salvini could emerge as prime minister

German-Italian 10-year yield spread

Source - RBC Wealth Management, Bloomberg; data through 5/16/19

Asia Pacific

Nicholas Gwee, CFA – Singapore & Jasmine Duan – Hong Kong

- **Asian markets were volatile during the week** with U.S.-China trade developments remaining the key factor driving markets. China and Hong Kong stocks rebounded on May 15 and 16 after a sharp correction at the beginning of the week, though the Hang Seng Index was down 2.5% from May 9 to May 16.
- **Tencent** (700 HK), **one of the internet giants in China**, announced Q1 2019 revenue was up 16% y/y, the slowest pace since its IPO in 2004. **Online games, a key earnings contributor, recorded stable growth** (+18% y/y) as Chinese authorities have gradually resumed game approvals. Online advertising growth (+25% y/y) was a bit weak due to macro uncertainty. The company also began to separately disclose "FinTech and Business Services" this quarter, as the size and scale of these services warrant disclosure. Though the segment was negatively affected by the loss of interest income on "custodian cash balances" in Q1, margins beat estimates.
- **Nissan Motor** (7201 JP) **expects earnings for FY2019 to drop 46.7% y/y** to ¥170B. The company also issued profit guidance of ¥230B for FY2020, significantly lower than the average analyst projection of ¥453B. Moreover, the company cut its dividend for the first time in a decade. Nissan expects slowing revenue growth due to weak U.S. sales, aging vehicle models, and an out-of-sync product cycle. The stock was down more than 9% in recent trading sessions.
- **China's auto sales continued to slow in April**, after a slight recovery in March. Retail sales of sedans, SUVs, etc. were down 16.6% y/y, compared to a 12% decline in March. Besides macro uncertainties, buyers are delaying purchases as they wait for more government incentives and the launch of new models under the National VI emission standard.
- **U.S. President Donald Trump declared a national emergency over threats against American communications technology and services.** Following the order, the Department of Commerce put Huawei Technologies on its "Entity List," which means U.S. companies will need a special license to sell products to Huawei.

MARKET SCORECARD

Data as of May 16, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,876.32	-2.4%	14.7%	5.7%	19.8%
Dow Industrials (DJIA)	25,862.68	-2.7%	10.9%	4.4%	23.3%
NASDAQ	7,898.05	-2.4%	19.0%	6.8%	28.0%
Russell 2000	1,557.24	-2.1%	15.5%	-3.7%	11.7%
S&P/TSX Comp	16,443.86	-0.8%	14.8%	2.1%	5.8%
FTSE All-Share	4,028.33	-1.0%	9.6%	-5.2%	-2.1%
STOXX Europe 600	382.88	-2.2%	13.4%	-2.6%	-3.3%
EURO STOXX 50	3,438.56	-2.2%	14.6%	-3.5%	-5.6%
Hang Seng	28,275.07	-4.8%	9.4%	-9.1%	11.6%
Shanghai Comp	2,955.71	-4.0%	18.5%	-6.7%	-5.1%
Nikkei 225	21,062.98	-5.4%	5.2%	-7.3%	5.7%
India Sensex	37,393.48	-4.2%	3.7%	5.7%	22.3%
Singapore Straits Times	3,230.26	-5.0%	5.3%	-8.6%	0.1%
Brazil Ibovespa	90,024.47	-6.6%	2.4%	4.0%	31.1%
Mexican Bolsa IPC	43,442.49	-2.6%	4.3%	-6.4%	-12.2%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,286.48	0.2%	0.3%	-0.3%	4.0%
Silver (spot $/oz)	14.56	-2.6%	-6.1%	-11.1%	-13.6%
Copper ($/metric ton)	6,053.75	-5.8%	1.8%	-10.9%	8.2%
Oil (WTI spot/bbl)	62.87	-1.6%	38.4%	-12.1%	29.2%
Oil (Brent spot/bbl)	72.74	-0.1%	35.2%	-8.2%	40.8%
Natural Gas ($/mmBtu)	2.64	2.5%	-10.2%	-6.3%	-18.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.396%	-10.6	-28.8	-70.0	7.1
Canada 10-Yr	1.680%	-3.2	-28.7	-82.2	10.9
U.K. 10-Yr	1.074%	-11.1	-20.3	-42.9	-5.7
Germany 10-Yr	-0.095%	-10.8	-33.7	-70.1	-53.0

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.87%	0.6%	3.6%	6.7%	5.6%
U.S. Invest Grade Corp	3.56%	0.4%	6.1%	7.8%	7.3%
U.S. High Yield Corp	6.43%	-0.8%	8.0%	5.9%	8.9%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.8260	0.4%	1.7%	4.7%	-0.3%
CAD/USD	0.7428	-0.5%	1.3%	-5.0%	1.1%
USD/CAD	1.3463	0.6%	-1.3%	5.3%	-1.1%
EUR/USD	1.1173	-0.4%	-2.6%	-5.4%	0.8%
GBP/USD	1.2796	-1.8%	0.3%	-5.1%	-0.9%
AUD/USD	0.6890	-2.2%	-2.3%	-8.3%	-7.2%
USD/JPY	109.8400	-1.4%	0.1%	-0.5%	-2.9%
EUR/JPY	122.7300	-1.8%	-2.5%	-5.8%	-2.1%
EUR/GBP	0.8731	1.5%	-2.9%	-0.2%	1.8%
EUR/CHF	1.1285	-1.3%	0.3%	-4.5%	3.3%
USD/SGD	1.3726	0.9%	0.7%	2.4%	-1.6%
USD/CNY	6.8837	2.2%	0.1%	8.0%	0.0%
USD/MXN	19.1135	0.9%	-2.7%	-2.3%	2.5%
USD/BRL	4.0416	3.1%	4.1%	10.0%	30.5%

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 9:35 pm GMT 5/16/19.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 1.3% return means the Canadian dollar rose 1.3% vs. the U.S. dollar year to date. USD/JPY 109.84 means 1 U.S. dollar will buy 109.84 yen. USD/JPY 0.1% return means the U.S. dollar rose 0.1% vs. the yen year to date.

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As of March 31, 2019

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Hold [Sector Perform]	589	40.07	107	18.17
Sell [Underperform]	87	5.92	5	5.75

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