

Global Insight

Weekly

An unshocking response to the Saudi oil supply shock?

Kelly Bogdanova – San Francisco

While markets often have a more measured response than the headlines do to geopolitical threats, an escalation of military tensions in the Middle East would likely grab the market's attention. We assess how geopolitical risks could impact portfolios and explain why we're comfortable with a Market Weight stance for equities.

One of the world's largest oil producers loses more than half of its output after drones and missiles penetrate its very expensive missile defense system, and just days later crude oil has retreated meaningfully from its spike and equities are nearly where they were before the attack. What gives?

Acts of war, terrorism, and the like don't always move markets, and there are key reasons they are responding calmly to the strikes on Saudi Arabia at this juncture. But if military tensions escalate, especially if the U.S. becomes involved, markets may take notice. RBC Capital Markets' commodity strategy team thinks "risks are high and that this conflict goes kinetic before year-end."

With geopolitical uncertainties on the rise and conflicts in the Middle East unlikely to disappear anytime soon, we think it's useful to gauge how military clashes have impacted the U.S. equity market previously, and to consider how such risks should be factored into portfolio positioning.

Rolling with the punches ...

Saudi Arabia, with the third-largest military budget in the world behind the U.S. and China, spent billions upon billions of dollars purchasing extensive missile defense systems to shield its key infrastructure, especially its Abqaiq crude oil processing facility, which was a well-known target, according to our commodity strategy team.

Nevertheless and for whatever reasons—there are various explanations by military hardware experts—the expensive

missile defense systems left the Kingdom's infrastructure extremely vulnerable. And it wasn't the first time.

The calm, measured market reaction to the Saudi energy infrastructure attack isn't unheard of compared to previous hostile acts. Some military and terrorism events move markets, others don't, and sometimes markets take a "wait-and-see" approach.

... but events can change

In this case, markets seem to be taking the risks in stride because Saudi Arabia believes it can fully restore oil production by month's end, and in the meantime it is releasing strategic reserves to fill the gaps.

Markets are laser-focused on the global economy, and crude oil's relatively tame reaction (as the initial shock to prices dissipated) means global consumer spending is unlikely to be impacted by this specific incident.

Market pulse

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Click [here](#) for authors' contact information. Priced (in USD) as of 9/19/19 market close, EST (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see [page 6](#)**
Disseminated: Sept 19, 2019 5:05ET; Produced: Sept 19, 2019 5:03ET



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Another reason for markets' restrained reaction is that so far President Trump seems to be doubling down on sanctions against Iran rather than prioritizing a military option.

But priorities and events can change, especially in the Middle East where war and terror is the norm rather than the exception. Tensions between Saudi Arabia and Iran, the war and humanitarian crisis in Yemen, and the related entanglements of the U.S. and other countries in the region are unlikely to flame out anytime soon. Not everyone in Washington seems intent on merely stopping at sanctions. Some are beating the war drums again.

Also, sanctions can be a slippery slope. Once a country has been sanctioned to the hilt with little prospect of relief, what incentive does it have to cooperate?

History lesson

If tensions in the region heat up further, we think the market's performance during previous military conflicts and hostile acts can serve as a guide to the potential range of outcomes.

The S&P 500 fell 6.3%, on average, in 17 major post-WWII military conflicts and security events that we evaluated. The market's reaction lasted an average of only 30 days. At times equities weakened during the run-up to the conflict as tensions were mounting, and recovered soon after it began. (See the full list along with terrorism events in the table.)

But like any small sample size, there were notable deviations, some of which are segmented in red in the table. In these cases, markets were not immune from volatility and meaningful losses. Some events sparked 10%+ corrections and negatively impacted the U.S. economy.

In our view, the state of market and economic fundamentals at the time, and the subsequent impact on economic momentum after the geopolitical shock occurs, go a long way in determining how acute and long-lasting the market's reaction will be following a clash.

Portfolio perspective

In determining equity allocations, we believe investors would be prudent to assume that geopolitical risks can crop up occasionally and push the equity market into a temporary 5%–10% pullback or, in rarer cases, an even longer-lasting correction of greater magnitude.

If an investor's current allocation to equities cannot be sustained through these types of declines then there may be a mismatch between the equity weighting and liquidity needs, risk tolerance, or time horizon that should be addressed. Funds earmarked for equities should be long-term allocations given the steep swings the equity market can (and usually does) have in a variety of circumstances.

S&P 500 responses to select acts of war and terrorism since World War II

Events	Start date	Trading days to trough	% change to trough	Trading days back to even
Acts of war				
U.S.				
U-2 shot down; cover unwound	May 7, 1960	2	-0.6%	4
Bay of Pigs invasion	Apr 15, 1961	6	-3.0%	14
Cuban Missile Crisis	Oct 16, 1962	6	-6.3%	13
Gulf of Tonkin Incident (Vietnam)	Aug 2, 1964	4	-2.2%	29
Tet Offensive (Vietnam)	Jan 29, 1968	25	-6.0%	46
Cambodian Campaign (Vietnam)	May 1, 1970	18	-14.9%	86
U.S. invades Grenada	Oct 25, 1983	11	-2.8%	15
Lead-up to U.S. Panama invasion	Dec 15, 1989	2	-2.2%	8
Lead-up to Gulf War (Desert Storm)	Jan 1, 1991	6	-5.7%	13
U.S. spy plane captured in China	Apr 1, 2001	3	-4.9%	7
War in Afghanistan	Oct 7, 2001	1	-0.8%	3
Lead-up to Iraq War	Feb 5, 2003	24	-5.6%	28
External				
N. Korea invades S. Korea	Jun 25, 1950	15	-12.9%	56
Lead-up to Six-Day War (June 6)	May 14, 1967	15	-5.6%	20
Yom Kippur War, Arab oil embargo	Oct 6, 1973	42	-16.1%	6 years*
Soviet-Afghan War	Dec 24, 1979	7	-2.3%	10
Iraq invades Kuwait, oilfields seized	Aug 2, 1990	50	-15.9%	131
Average		14	-6.3%	30
Terrorism				
U.S. Embassy in Iran seized	Nov 4, 1979	3	-1.0%	6
U.S. Marines killed in Lebanon	Oct 23, 1983	12	-2.5%	15
Oklahoma City bombing	Apr 19, 1995	1	-0.1%	3
U.S. Embassy bombings in Africa	Aug 7, 1998	5	-2.5%	7
WTC, Pentagon airplane attacks	Sep 11, 2001	5	-11.6%	19
Madrid train bombings	Mar 11, 2004	3	-1.7%	5
London Underground bombings	Jul 7, 2005	No S&P decline; FTSE -1.4%		
Paris Bataclan, restaurant attacks	Nov 13, 2015	1	-1.1%	2
Bastille Day attacks in Nice	Jul 14, 2016	1	-0.1%	2
Average		4	-2.6%	7

* Other economic and monetary policy factors negatively influenced the number of days it took the market to get back to even; this is not counted in the average number of trading days back to even.

Source - RBC Wealth Management, RBC Global Asset Management, Wikipedia, National Security Archive at George Washington University, U.S. Naval Institute; data attempts to capture any pre-event impact

As with any outside event, we focus on the potential economic and earnings impact, as these are the primary factors that drive equities over the medium-to-long term. As long as the trajectories of the global and U.S. economies and corporate profits are not materially threatened by the current geopolitical dispute in the Middle East, we are comfortable holding equities at the Market Weight or benchmark level in portfolios.

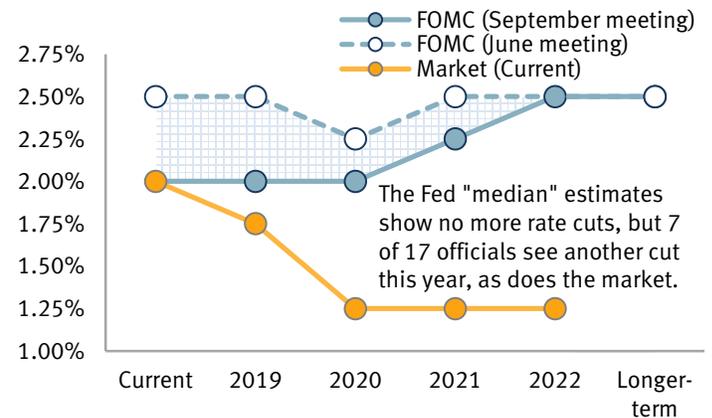


United States

Ben Graham, CFA & Bill Kuehn, CFA – Minneapolis

- For the second consecutive meeting Fed policymakers cut the federal funds rate by 25 basis points (bps)** to a target range of 1.75%–2.00%. There were three dissenting votes to the cut; noted hawks Esther George and Eric Rosengren favored no cut, arguing the U.S. economy remains on solid footing, and noted dove James Bullard favored a more aggressive cut of 50 bps. **There were few changes to the official statement’s language pertaining to the U.S. economy.** The changes mainly centered on gains in household spending, which were cited as “strong,” as well as a new mention of “weakened” business investment and exports, which would be in line with the warnings of trade tensions weighing on growth.
- The Federal Open Market Committee (FOMC) also released updated interest rate projections (aka, the dot plot) for the first time since June, and **the FOMC remains divided on the future outlook for interest rates.** Seven Fed officials estimated one additional 25 bps cut, five officials estimated no changes are needed, and five officials estimated one rate hike from here. In our opinion, the latter five officials aren’t signaling the need for a hike, but rather expressing their view that cutting interest rates from current levels was wrong. **We continue to expect at least one more 25 bps cut before year-end** as the Fed keeps a wary eye on trade-related issues and their potential impact upon global growth as it strives to keep the current expansion alive.
- U.S. equity markets have reversed a small portion of the rotation to value that kicked off the month.** Thus far this week, the NASDAQ and S&P 500 have delivered gains while the Russell 2000 and Dow Jones are slightly lower. For the month, the small-cap Russell 2000 has outperformed the S&P 500 by more than 170 basis points, 4.5% to 2.7%. With this recent shift from small to large and from growth to value as the backdrop, RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina has changed her sector recommendations. Calvasina has upgraded the more cyclical Industrials sector to Overweight from Market Weight and downgraded the more defensive Consumer Staples sector from Overweight to Market Weight. Economic data from recent days supports her opinion that the **economic backdrop has improved in recent months**, with trends in inflation moving ahead of the Fed’s 2% target, ISM services data surprising to the upside with its 56.4 reading, industrial production and retail sales higher than expected, and U.S. housing starts delivering their strongest month since 2007. These changes in sector allocations and economic

Markets continue to anticipate more rate cuts than Fed officials



Source - RBC Wealth Management, Bloomberg; data through 9/18/19

data points **support our recommendation of Market Weight positioning in U.S. equities.**



Canada

Arete Zafiriou & Sayada Nabi – Toronto

- Canadian banks have underperformed the broader market year to date;** the S&P/TSX Composite Index Banks (Industry Group) is up 12.2% vs. 17.7% for the S&P/TSX Composite Index. The group is trading at a forward P/E multiple of 10.9x, below its long-term average of 11.4x, and around 4% below its historical average discount to the broader market. Following the Q3 earnings season, RBC Capital Markets reduced its 2020 earnings estimates for the Canadian banks in its coverage universe. All of these banks reported Q3 2019 EPS below RBC Capital Markets’ expectations, primarily due to higher provisions for credit losses (PCLs), which were up 29% since Q4 2018. The U.S. segments also weighed on earnings, with several banks posting significant net interest margin compression. **RBC Capital Markets expects credit quality to continue to normalize through 2020, and forecasts U.S. and international earnings growth will slow to approximately 4% next year,** below this year’s estimated growth of approximately 19%.
- International trade can boost provincial economies, but that hasn’t been the case this year, according to RBC Economics.** Canadian provincial exports have been limited by tariffs and agricultural commodity bans, resulting in downward revisions to 2019 growth forecasts. RBC Economics has identified **Saskatchewan as the province with the highest exposure to international trade.** China’s decision to ban Canadian agricultural products including soybeans, meat, and canola caused the province’s exports to decline 6% in the first half of the year, trimming Saskatchewan’s 2019 growth outlook to

0.6% from 1.1%. **Trade concerns are echoed in British Columbia and Manitoba**, where falling exports reduced 2019 GDP estimates to 2.2% (from 2.4%), and 1.3% (from 1.5%), respectively. **Alberta's GDP was also revised lower** as economic growth continues to be curtailed by pipeline bottlenecks that have limited the Energy sector's reach. Not all revisions have been negative, however, as **strong consumer spending put the Atlantic provinces on track to meet their growth forecasts while also boosting the outlook for Quebec and Ontario**.



Europe

Frédérique Carrier & Alastair Whitfield – London

- **In the U.K., Consumer Prices Index (CPI) inflation fell abruptly and more sharply than consensus expectations**, with headline inflation dropping from 2.1% y/y in July to 1.7% y/y in August. **Low inflation numbers have not yet influenced the Bank of England (BoE)**, which decided to maintain its policy rate at 0.75%.
- However, against a backdrop of continuing Brexit uncertainty, **the BoE made a slight dovish shift at its September meeting** given the prospect of a further weakening of growth due to a prolonged departure from the EU. This provides the basis for the BoE to potentially downgrade its forecasts at the November meeting, and allows flexibility for a shift in forward guidance if warranted. The bank can keep its powder dry for now, given the current low probability that the U.K. will exit the EU without a deal at the end of October. **But in the case of a no-deal Brexit, we believe both an emergency interest rate cut and the resumption of an asset purchase programme are possible**. The BoE has now positioned itself to be able to act depending on how the coming weeks play out.
- **European Central Bank (ECB) President Mario Draghi's message following the ECB's meeting suggests to us that it is unlikely the bank will need to act further in the near term** given the extensive measures that have already been set out, including €20B per month of quantitative easing from the beginning of November. Another reason the ECB may see no need for a rate cut at present is that **Draghi indicated fiscal policy should take precedence over monetary policy going forward. We are also seeing this change in tone amongst government authorities**. France and Italy have already loosened their purse strings somewhat, the former following the Yellow Vests protests and the latter in its recent budget negotiations. Germany is exploring ways to accelerate the release of previous commitments, while the Netherlands has drawn up plans for an investment fund of some €50B. The new European Commission has also stated it will be more flexible in the

interpretation of fiscal rules. This should help sustain growth, and lightens the responsibility of the ECB to further stimulate the economy for now.



Asia Pacific

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

- Asian markets mostly fell during the week, led by Hong Kong and India. **The Hang Seng Index posted four straight days of losses**. Risk appetite in Hong Kong markets remained subdued as demonstrators continued to clash with police. The NIFTY 50 Index dropped to a multiweek low on concerns over the brief surge in crude oil prices and related lingering geopolitical risks, and slowing regional economic growth.
- **Deputy trade negotiators from the U.S. and China are set to resume face-to-face talks in Washington** on September 19. The two-day talks are intended to lay the groundwork for high-level negotiations in early October. Investors have welcomed the recent de-escalation in the trade dispute. U.S. President Donald Trump hinted that a trade deal could be struck prior to the U.S. election in November 2020, or that an agreement could be reached “one day” after the vote. According to Trump, if the deal comes after the election, it would be on terms “far worse” for Beijing than it could achieve right now. The protracted dispute has dragged on for 14 months and the two sides remain at odds. **We do not expect a breakthrough at the upcoming negotiations**, but we also do not rule out a limited, piecemeal deal to ease the economic pain.
- **China's industrial production grew 4.4% y/y in August, the slowest pace in over 17 years**, missing market expectations of 5.2% growth. Fixed-asset investment and retail sales growth in August also slightly undershot forecasts. We believe the latest data **signal further weakness in an economy hit by the trade war and slowing domestic demand**.
- The Bank of Japan (BoJ) kept monetary policy steady at its September meeting. We believe the weaker yen may have taken some pressure off the BoJ to immediately follow other major central banks in lowering interest rates. In our opinion, **the BoJ is walking a fine line between conserving its limited ammunition and having to expand stimulus to defend Japan's fragile economic recovery**.
- **Three listed real estate investment trusts (REITs) in Singapore conducted equity fundraising to help finance new acquisitions**. The offerings were met with strong demand from investors. Going forward, we believe more REITs may take advantage of the keen interest and look to raise funds as well.



MARKET SCORECARD

Data as of September 19, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,006.79	2.7%	19.9%	3.4%	20.0%
Dow Industrials (DJIA)	27,094.79	2.6%	16.1%	2.6%	21.1%
NASDAQ	8,182.88	2.8%	23.3%	2.9%	26.6%
Russell 2000	1,561.47	4.5%	15.8%	-8.3%	8.4%
S&P/TSX Comp	16,858.35	2.5%	17.7%	4.4%	10.2%
FTSE All-Share	4,044.88	2.3%	10.1%	-0.2%	1.3%
STOXX Europe 600	391.80	3.2%	16.0%	3.1%	2.5%
EURO STOXX 50	3,552.65	3.7%	18.4%	5.5%	0.6%
Hang Seng	26,468.95	2.9%	2.4%	-3.4%	-5.6%
Shanghai Comp	2,999.28	3.9%	20.3%	9.8%	-10.7%
Nikkei 225	22,044.45	6.5%	10.1%	-6.9%	8.6%
India Sensex	36,093.47	-3.3%	0.1%	-2.8%	11.4%
Singapore Straits Times	3,158.80	1.7%	2.9%	-0.6%	-2.1%
Brazil Ibovespa	104,339.20	3.2%	18.7%	33.5%	37.3%
Mexican Bolsa IPC	43,017.46	0.9%	3.3%	-13.3%	-14.4%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,498.74	-1.4%	16.9%	24.5%	14.3%
Silver (spot \$/oz)	17.78	-3.2%	14.7%	24.8%	2.7%
Copper (\$/metric ton)	5,779.75	2.2%	-2.8%	-5.2%	-10.9%
Oil (WTI spot/bbl)	58.13	5.5%	28.0%	-18.3%	17.5%
Oil (Brent spot/bbl)	64.62	6.9%	20.1%	-18.6%	17.2%
Natural Gas (\$/mmBtu)	2.55	11.6%	-13.3%	-12.3%	-18.4%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.784%	28.8	-90.0	-127.9	-46.1
Canada 10-Yr	1.430%	26.6	-53.7	-99.0	-66.2
U.K. 10-Yr	0.637%	15.8	-64.0	-97.1	-69.2
Germany 10-Yr	-0.507%	19.3	-74.9	-99.4	-95.9
Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	2.37%	-1.2%	7.8%	9.9%	8.1%
U.S. Invest Grade Corp	3.02%	-1.6%	12.1%	12.5%	10.7%
U.S. High Yield Corp	5.58%	0.7%	11.7%	6.8%	10.3%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	98.3520	-0.6%	2.3%	4.0%	7.1%
CAD/USD	0.7540	0.4%	2.8%	-2.6%	-7.3%
USD/CAD	1.3263	-0.4%	-2.7%	2.6%	7.9%
EUR/USD	1.1045	0.6%	-3.7%	-5.4%	-7.9%
GBP/USD	1.2528	3.1%	-1.8%	-4.7%	-7.2%
AUD/USD	0.6795	0.9%	-3.6%	-6.4%	-15.2%
USD/JPY	108.0300	1.6%	-1.5%	-3.8%	-3.2%
EUR/JPY	119.3200	2.1%	-5.2%	-9.0%	-10.9%
EUR/GBP	0.8816	-2.5%	-1.9%	-0.7%	-0.7%
EUR/CHF	1.0964	0.7%	-2.6%	-2.9%	-5.1%
USD/SGD	1.3791	-0.6%	1.2%	0.7%	2.4%
USD/CNY	7.0965	-0.8%	3.2%	3.6%	7.8%
USD/MXN	19.4397	-3.1%	-1.1%	3.5%	9.2%
USD/BRL	4.1617	0.4%	7.4%	0.8%	32.7%

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 9:35 pm GMT 9/19/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 2.8% return means the Canadian dollar rose 2.8% vs. the U.S. dollar year to date. USD/JPY 108.03 means 1 U.S. dollar will buy 108.03 yen. USD/JPY -1.5% return means the U.S. dollar fell 1.5% vs. the yen year to date.

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			Count	Percent
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Hold [Sector Perform]	588	40.80	114	19.39
Sell [Underperform]	81	5.62	2	2.47

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