April 9, 2020

RBC WEALTH MANAGEMENT

Global Insight Weekly

Driven to distraction?

Frédérique Carrier – London

With the unrelenting speed and sway of newsflow over the past few weeks, market moves that would have normally attracted attention have largely passed with nary a glance. We zero in on the action in emerging markets, size up the challenges facing this asset class, and suggest how to position portfolios.

Under the radar

Chinese equities are a case in point. Their recent outperformance has been more abrupt than most think. As put by RBC Global Asset Management Inc. Chief Economist Eric Lascelles, early in 2020 "recriminations were flying against China given its status as the point of origin for the disease" and its heavy-handed approach to confinement measures. The renminbi floundered in response to the weaker growth outlook and as the epidemic was at that time considered purely a Chinese event.

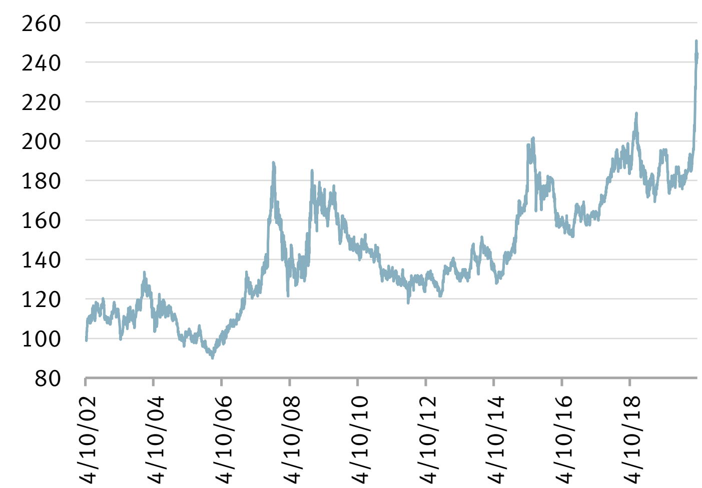
Fast forward a few months, and we're seeing a reversal of China's misfortunes, and prior criticism of a draconian lockdown has flipped to praise. It helps that COVID-19 is no longer seen as a Chinese-centric issue. Moreover, as Lascelles notes, the original epicenter in China "remains nicely under control" and the country's "economic rebound appears to be vigorous" as China slowly reactivates its economy.

This sea change is best illustrated by the outperformance of Chinese equities relative to other emerging markets, the most dramatic in more than 15 years. In fact, whereas the MSCI Emerging Markets ex China Index has retraced all its gains since 2009, the MSCI China Index has only retraced its advance since 2019.

China's outperformance may also reflect investors' concerns regarding other emerging economies. The MSCI India Index suffered its worst single-day drop ever in March despite India being a beneficiary of lower oil prices. Apprehension about several generations living in the same house making for fertile

Chinese equities abruptly outperform

MSCI China Index relative to MSCI Emerging Markets ex China Index (Apr. 10, 2002 = 100)



Source - Bloomberg, RBC Wealth Management; data through 4/3/20

Market pulse

ground for the virus to spread combined with containment measures that crimp economic growth spooked investors.

But it is the MSCI Emerging Markets Latin America Index that has suffered the most as all the gains made relative to the MSCI World Index since 2003 have been wiped out. Most Latin American countries heavily rely on commodities, and the collapse in their prices has robbed governments of an important source of revenue.

Emerging is difficult

Other than a few Asian nations such as South Korea and Taiwan, most emerging countries lack adequate resources to deal with the health care crisis spawned by the COVID-19 epidemic.

Health care systems in emerging nations are more precarious than in developed countries, with the number of hospital beds per 1,000 inhabitants much lower than in Europe or the U.S. According to the World Bank, India, for instance, has 0.7 beds per 1,000 people, Mexico 1.5, and Brazil 2.2, compared to 2.9 in the U.S. and 8.2 in Germany, a country with an admittedly well-endowed health care system.

There are usually many fewer social safety nets in emerging countries than found in Europe or Canada. Also, authorities in emerging countries do not have the same latitude to inject large amounts of money into their economies as their U.S. counterparts do. Such action would cause emerging currencies to depreciate, an undesirable outcome for emerging market nations as a large proportion of their corporate debt is denominated in foreign currency, usually U.S. dollars.

If these structural challenges weren't enough, cyclical difficulties are also mounting. Global demand for manufactured goods and commodities, on which most of these countries heavily depend, have come to a stand-still. According to International Monetary Fund (IMF) chief Kristalina Georgieva, nearly $90 billion have left emerging markets and developing economies in a widespread flight to safety.

It is therefore not surprising that the IMF has received requests for help from more than 90 countries over the past few weeks. As Georgieva put it, "The same way the virus hits vulnerable people with medical preconditions hardest, the economic crisis hits vulnerable economies the hardest."

But it is not all bleak. The IMF has a war chest that exceeds $1 trillion, representing a high 25 percent of the total stock of emerging market debt, according to Polina Kurdyavko, head of emerging market debt at BlueBay (an RBC Group company). This is more than the IMF had at its disposal during the Asian financial crisis of 1998 and the global financial crisis in 2008.

Outperformance since 2003 now fully wiped out

MSCI Emerging Markets Latin America Index relative to MSCI World Index (Apr. 24, 1998 = 100)

Source - Bloomberg, RBC Wealth Management; data through 4/8/20

How hard the hit?

But it is undeniable that economies everywhere will be severely hit this year. To wit, Lascelles has lowered his 2020 forecast for U.S. GDP growth to -7.7 percent from -3.2 percent as COVID-19's impact on the depth and duration of the downturn are becoming clearer.

Economic contraction overall in emerging markets will likely be less severe thanks to the underlying structural "catch-up" potential they enjoy. Moreover, China, the largest component of the asset class, is reactivating its economy and pressing on with its strategy of redirecting its efforts from servicing global markets to focusing on domestic consumption and servicing its own market of 1.4 billion people.

Still, given the uncertainties, we believe investors would do well to focus on those countries best equipped to deal with the current challenges. We have a long-held Overweight position on Asia ex-Japan equities. The region, which includes China, is a key beneficiary of lower oil prices. Moreover, many countries in the region have been praised for their focused and disciplined handling of the COVID-19 outbreak and have actively supported their domestic economies during this ordeal.

United States

Tom Garretson, CFA – Minneapolis; Alan Robinson – Seattle

- **Another week, another massive Fed development** with $2.3 trillion in lending programs announced. Though the basic framework was known beforehand, the details—and numbers—lit a fire under risk assets, particularly corporate bonds. The Fed has $750 billion earmarked for bond purchases, and **unexpectedly announced that it will expand beyond investment-grade bonds and into high-yield bonds and related exchange-traded funds (ETFs)**. However, the expanded purchasing will only apply to firms that were investment-grade-rated on or after Mar. 22, as the Fed likely recognizes that potential downgrades amid historic economic challenges could limit access to the Fed's facilities just when quality companies need it most. The Fed may also be trying to get ahead of potential market stress from forced selling by funds due to downgrades, and the possibility that a glut of new supply in high-yield markets could create its own market dislocations.

- But as unbelievable as it may sound, the $2.3 trillion reflects the Fed lending against just $195 billion of the $454 billion appropriated to it by the CARES Act. Should the central bank need to utilize the full amount, **the war chest could expand beyond $5 trillion**.

- **Equities rallied during the holiday-shortened week on evidence social distancing measures are starting to control the spread of COVID-19**. The Institute for Health Metrics and Evaluation (IHME), a Seattle-based independent research center, provided a less pessimistic projection for daily new cases and now projects Apr. 12 as the national peak for daily deaths from COVID-19.

- State-by-state data indicate **regions that implemented lockdown measures early in the pandemic are already showing declining case trends**, but in states with fewer restrictions, caseloads and fatalities continue to rise.

- Investors cited progress in disease control as evidence of light at the end of the tunnel for the economy, although **the IHME cautioned these projections assume social distancing will remain in force until the end of May at the earliest**.

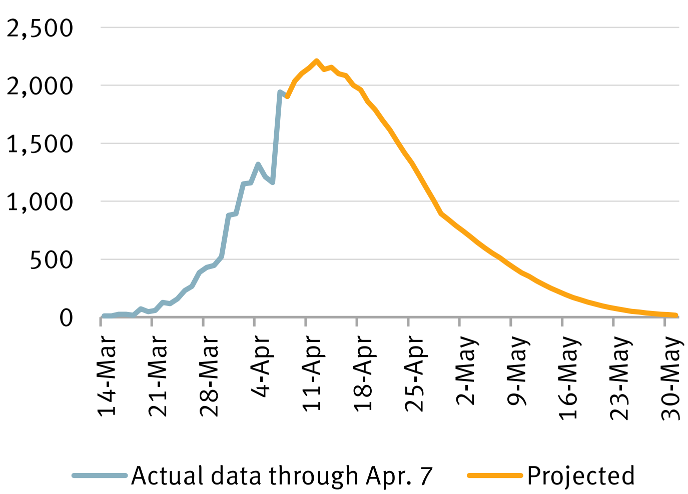
- Economists continued to revise projections of the extent of the economic hit caused by stay-at-home measures. **RBC Global Asset Management Chief Economist Eric Lascelles lowered his base-case forecast for 2020 U.S. GDP growth to -7.7%, from -3.2% previously**. He believes that although the origins of the shock are exogenous, the likely duration of the downturn will still cause real economic damage.

- **Media bellwether Walt Disney Co. (DIS)** appears to have benefited from some stay-at-home trends this year. It **announced Apr. 9 that paid subscriptions to its Disney+ streaming service had surpassed 50 million** as consumers increasingly seek home entertainment options. The pace of the increase surprised investors, as the developed-market subscriber count was up 50% since Feb. 4. The stock has underperformed the market this year due to theme park closures, but its media arm appears to provide welcome diversification.

- **Shares of package delivery companies FedEx Corp. (FDX) and United Parcel Service Inc. (UPS) were buoyed** during the week by reports Amazon.com Inc. (AMZN) was halting a delivery service known as Amazon Shipping that directly competes with these companies. However, we believe **the reprieve may be only temporary** as Amazon cited a need to focus its resources on warehouse fulfilment thanks to a surge in online shopping.

Social distancing measures are starting to impact disease projections

U.S. COVID-19 daily fatalities: Peak expected Apr. 12, 2020



Source - Institute for Health Metrics and Evaluation, University of Washington, RBC Wealth Management

Canada

Richard Tan, CFA & Meika McKelvey – Toronto

- While the S&P/TSX Composite Index has bounced off its Mar. 23 lows, **sentiment within the Energy landscape remains bleak**, and the sector continues to be one of the worst performers year to date. In an environment where

West Texas Intermediate and Western Canadian Select have collapsed below $30 and $10 per barrel, respectively, we believe **nothing is off the table as companies will have to make some tough financial decisions** in order to remain a going concern. In an attempt to shore up balance sheets, we've witnessed reductions in planned capital expenditures, dividend cuts, and suspensions of share buyback programs from the bulk of the sector. In some cases, companies have downsized their operations or have opted to shut-in production because economics at current prices simply do not make sense.

- On Apr. 9, Saudi Arabia and Russia agreed in principle for further production cuts in an effort to balance global demand-supply dynamics. However, we believe **valuations in the Energy sector will likely remain depressed** because of uncertainties related to implementation and softer demand as a result of COVID-19. All else equal, backing into Energy via the infrastructure assets such as pipelines and midstreams should provide portfolios with some relative ballast, in our view.

- Canada closed out the holiday-shortened week with the release of a labour force survey from Statistics Canada showing that the **Canadian economy shed more than one million jobs in March**. The result was worse than consensus expectations for around 500,000 jobs to be lost, which already would have been the worst month for job losses on record in Canada. The fall in employment was split relatively evenly between full-time (-474,000) and part-time (-537,000), and the **unemployment rate shot up to 7.8%** in March from 5.6% in February. The significant decline in Canadian jobs was not a surprise, with the survey taken over Mar. 15–21, when federal officials already reported that approximately one million employment insurance claims had been filed. While there remains significant uncertainty surrounding future job losses and increases in the unemployment rate (RBC Economics expects the rate to peak at approximately 15% in Q2), **the one thing that is clearly evident to us is that next month's figures will be worse**.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **In the UK, dividends are under unprecedented pressure**. More than 40% of UK companies have already cut dividend payouts, exceeding the number seen in 2008 amid the early stages of the financial crisis. **Current futures contracts are predicting UK companies will slash dividends by around 55% in 2020.** This is too pessimistic, in our view, as it implies that dividends from commodity-related sectors will almost entirely be lost in 2020, whereas in reality, they may only be reduced. We would argue a 35%–40% cut at the index level is more realistic. We believe the current prospective 5.3% dividend yield (source: Bloomberg) on the UK's FTSE All-Share Index overstates the yield that will likely be achieved on UK equities over the next 12 months given the widespread dividend cuts.

- **In Europe, only slow progress seems to have been made on a coordinated effort to help support the economy**. National governments overall have responded quickly and decisively to the crisis, announcing packages worth some 15% of GDP on average including loans and guarantees.

- **However, a burden-sharing solution at the EU level remains elusive**. Such a coordinated effort is important as European countries' fiscal solidarity could influence how the EU is perceived for years to come. Strong cooperation in the guise of a European Stability Mechanism (ESM) credit line with very light conditionality, jointly financed unemployment support, or common debt instruments would enhance support for the EU, in our opinion. Conversely, failure to act could undermine the long-term cohesion of the EU and the eurozone.

- At the time of writing, **the meetings of Eurogroup finance ministers are ongoing**. Very weak economic data out of France and Germany may focus minds on the issue at hand.

Asia Pacific

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

- **Asia equity markets have traded mostly higher** for the week, led by Japan and India. **Japan's government announced a $992 billion stimulus package** to cushion the economic impact of COVID-19. The package (approximately 20% of Japan's GDP) is one of the largest among advanced economies and twice the amount market observers were expecting. Japan also announced a **state of emergency for Tokyo and six other prefectures**, covering 44% of the population, which will last through May 6. Given the sharp increase of new cases in Tokyo, we believe the lockdown is necessary to stem the spread of COVID-19, but it **will likely drag Japan into a deeper recession** in 2020.

- **The months-long lockdown of Wuhan, China was lifted on Apr. 8**, one day after China reported no deaths for the first time since it began publishing figures. Anyone who has a "green" code on a smartphone health app is now allowed to travel. Elsewhere, IHS Markit now forecasts China's light vehicle production will drop 11.5% y/y in 2020 followed by a 7.5% expansion in 2021.

- **Hong Kong's government announced a new $17.7 billion stimulus package** to support the economy amid the COVID-19 outbreak with **a focus on job retention**. The government will provide a guaranteed employment plan and wage subsidies to qualified employers. In return, employers must not lay off employees during the subsidy period. Separately, **the Hong Kong Monetary Authority will "adjust regulatory parameters" to enable banks to lend more**, releasing a total lending capacity of HK$1 trillion, as well as other sector-specific measures to boost liquidity.

- **The Australian Prudential Regulation Authority has asked banks and insurers to limit discretionary capital distribution** so they have sufficient capacity to continue essential functions including lending and underwriting insurance. We believe the Big 4 Australian banks will likely adopt the new guidance and lower their dividend payouts accordingly. Analysts are now expecting dividend cuts of up to 40% in FY2020.

MARKET SCORECARD

Data as of April 9, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,789.82	7.9%	-13.6%	-3.1%	6.8%
Dow Industrials (DJIA)	23,719.37	8.2%	-16.9%	-9.3%	-1.1%
NASDAQ	8,153.58	5.9%	-9.1%	3.1%	17.3%
Russell 2000	1,246.73	8.1%	-25.3%	-20.1%	-17.7%
S&P/TSX Comp	14,166.63	5.9%	-17.0%	-13.3%	-7.0%
FTSE All-Share	3,233.24	4.0%	-23.0%	-20.3%	-18.3%
STOXX Europe 600	331.80	3.7%	-20.2%	-14.0%	-11.6%
EURO STOXX 50	2,892.79	3.8%	-22.8%	-15.3%	-15.3%
Hang Seng	24,300.33	3.0%	-13.8%	-19.4%	-19.6%
Shanghai Comp	2,825.90	2.7%	-7.4%	-12.8%	-10.0%
Nikkei 225	19,345.77	2.3%	-18.2%	-11.3%	-10.8%
India Sensex	31,159.62	5.7%	-24.5%	-20.0%	-7.8%
Singapore Straits Times	2,571.32	3.6%	-20.2%	-22.7%	-25.5%
Brazil Ibovespa	77,681.90	6.4%	-32.8%	-19.3%	-6.8%
Mexican Bolsa IPC	34,567.79	0.0%	-20.6%	-23.4%	-28.1%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,680.56	6.6%	10.8%	28.9%	25.8%
Silver (spot $/oz)	15.33	9.7%	-14.1%	0.7%	-7.1%
Copper ($/metric ton)	4,978.20	0.8%	-19.0%	-23.1%	-26.7%
Oil (WTI spot/bbl)	22.76	11.1%	-62.7%	-64.4%	-64.1%
Oil (Brent spot/bbl)	31.87	40.1%	-51.7%	-54.9%	-53.6%
Natural Gas ($/mmBtu)	1.74	6.3%	-20.4%	-35.4%	-35.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.719%	5.0	-119.8	-178.2	-206.0
Canada 10-Yr	0.763%	6.6	-93.9	-96.7	-137.6
U.K. 10-Yr	0.306%	-5.0	-51.6	-79.8	-110.1
Germany 10-Yr	-0.347%	12.4	-16.2	-33.7	-85.1
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.57%	0.2%	3.4%	9.5%	14.1%
U.S. Invest Grade Corp	3.30%	0.9%	-2.8%	6.0%	11.0%
U.S. High Yield Corp	9.39%	0.1%	-12.6%	-7.4%	-1.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	99.5160	0.5%	3.2%	2.6%	10.8%
CAD/USD	0.7155	0.6%	-7.1%	-4.6%	-9.2%
USD/CAD	1.3976	-0.6%	7.6%	4.8%	10.1%
EUR/USD	1.0925	-1.0%	-2.6%	-3.0%	-11.3%
GBP/USD	1.2462	0.3%	-6.0%	-4.5%	-11.8%
AUD/USD	0.6338	3.4%	-9.7%	-11.0%	-17.7%
USD/JPY	108.5000	0.9%	-0.1%	-2.4%	1.6%
EUR/JPY	118.5300	-0.1%	-2.7%	-5.3%	-9.9%
EUR/GBP	0.8767	-1.3%	3.6%	1.6%	0.5%
EUR/CHF	1.0559	-0.4%	-2.7%	-6.2%	-10.4%
USD/SGD	1.4167	-0.4%	5.3%	4.7%	8.0%
USD/CNY	7.0429	-0.6%	1.1%	4.9%	11.7%
USD/MXN	23.5328	-0.6%	24.3%	24.3%	28.2%
USD/BRL	5.1072	-1.9%	26.7%	35.2%	49.2%

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 4/9/20.

Examples of how to interpret currency data: CAD/USD 0.71 means 1 Canadian dollar will buy 0.71 U.S. dollar. CAD/USD -7.1% return means the Canadian dollar fell 7.1% vs. the U.S. dollar year to date. USD/JPY 108.50 means 1 U.S. dollar will buy 108.50 yen. USD/JPY -0.1% return means the U.S. dollar fell 0.1% vs. the yen year to date.

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As of March 31, 2020

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