RBC WEALTH MANAGEMENT

Global Insight

Focus Article

2018 investment stance

Synchronized and durable economic growth underpin a supportive investment climate for 2018.

For important and required non-U.S. analyst disclosures, see page 7

All values in U.S. dollars and priced as of November 13, 2017, market close, unless otherwise noted.

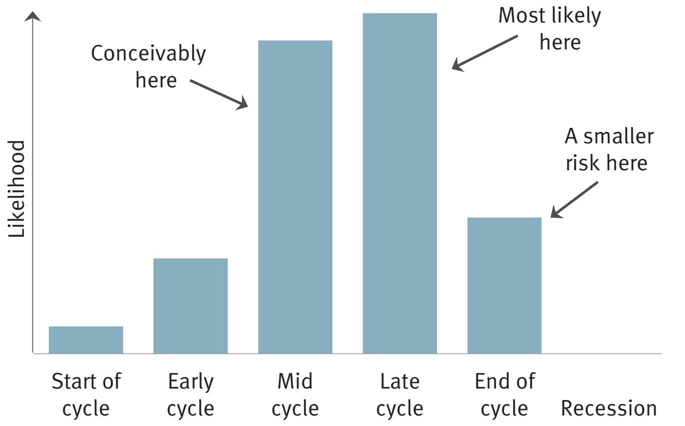
Wealth Management

2018 investment stance

A synchronized, durable upswing in most major economies leaves us optimistic, invested, but still vigilant toward global equities for 2018. And as central banks slowly ease off the gas, ending the era of "peak money," we look at how fixed income markets will likely react. We also provide our 2018 outlook on commodities and currencies.

For years, our investment stance has flowed from the premise that the global economy would gradually return to something approaching normal, led by the U.S. This has finally occurred, as major regions are in sync for the first time during the eight-year recovery cycle, providing a firmer footing for the global economy. We believe the U.S., Europe, China, and Japan have the potential to grow GDP at trend rates or better in 2018. Assuming U.S. recession risks remain low (we think they will), the stage seems set for worthwhile gains in developed equity markets and select opportunities in the credit segment of fixed income. Following are our thoughts on how to position portfolios in 2018.

U.S. most likely at late point of cycle



Note: Calculated via scorecard technique by RBC GAM
Source - RBC Global Asset Management (RBC GAM)

2018 view

Equity

We remain constructive on global equities given the synchronized upswing occurring in most major economies accompanied by low recession risks and relatively tame monetary policies. Corporate revenues, earnings, and estimates should continue to rise. While a consolidation period or pullback would be normal following the strong rally in 2017, we believe a moderate Overweight position in global equities is warranted as our positive long-term thesis remains intact. Valuations of major markets have pushed higher, but are not high enough to foreclose further gains and remain attractive compared to bond prices.

United States

- Continued GDP growth and profit gains should extend the long-term U.S. bull market for another year, at least. None of our domestic recession indicators are flashing red or even yellow. We forecast S&P 500 earnings of $141 per share in 2018, which would represent 7.5% y/y growth, roughly an average rate. The passage of corporate tax reform could add another $7–$15 per share.
- We favor the economically-sensitive Financials and Industrials sectors, and continue to like secular growers in the Technology sector. Health Care and Energy are our preferred value plays. Small-capitalization stocks are on our radar screen for a potential upgrade in 2018, particularly if earnings momentum accelerates.

Canada

- We recommend a Market Weight allocation to Canadian equities. Valuations appear attractive relative to the U.S. but are elevated on an absolute basis. We are monitoring uncertainties including the future of NAFTA and the impact of higher rates on consumers.
- We are constructive on banks in light of reasonable valuations and conservative earnings expectations. We believe mortgage growth will slow but that the housing market remains supported by solid fundamentals.
- We expect crude prices to remain range-bound as support from OPEC-led production curtailments is tempered by short-cycle U.S. shale production. We are cautious that further strength in oil prices could prove self-defeating should it prompt U.S. producers to increase output.

Continental Europe/ United Kingdom

- Despite an improving macro economy background, relatively loose monetary policy should remain in place until autumn 2018 in Europe. Equity valuations are now slightly above long-term averages, though this can be said of most regions. Relative to the U.S., the discount remains unduly high, in our view. We like sectors exposed to the domestic economy.
- The U.K. economy continues to be mired in uncertainty. The weak government is struggling with the mammoth task of redefining the country's business model after Brexit. The risk of the U.K. crashing out of the EU without a deal remains uncomfortably high, and we hold our long-held preference for companies that generate a large part of their revenues abroad. We would wait for more attractive valuations before changing this position.

Asia

- The Japanese equity market has reached levels not seen in 25 years. The earnings outlook and valuations are still somewhat supportive of equities. However, the chance of consolidation or a pullback in equities is moving higher. Inflation is modestly positive—arguably the key achievement of Abenomics. Key risks include currency appreciation and weakening global economic indicators.
- After an outsized performance in many Asia ex-Japan equity markets in 2017, we expect much more modest returns in 2018. We believe the risk of a correction is high, and the key risk factor is an end to the steady Chinese economic data. We also think mainland Chinese stocks are overvalued. Meanwhile, a number of large-cap stocks in Hong Kong are close to fully valued, although opportunities in new economy stocks still exist.

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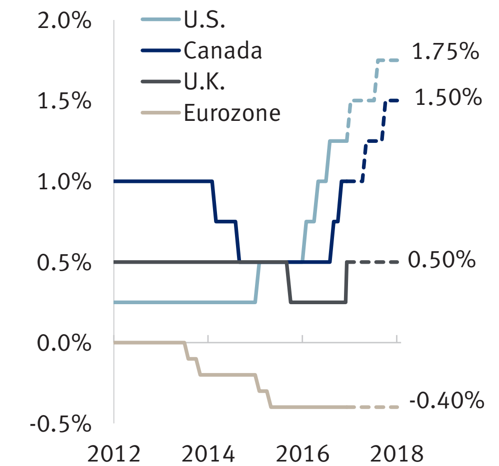
Fixed Income

In 2018, global central banks will be in focus as they gradually follow the Fed in deliberately normalizing monetary policy. Slow growth, low inflation, and shifting demographics should ensure this is a gradual process and, as a result, interest rates should remain contained. We expect Jerome Powell to be confirmed to lead the Fed, and foresee no major monetary policy shifts, although he could promote a lessening of financial regulations. Credit will continue to provide selective opportunities, but investors will be challenged by rich valuations.

Market expectations for bank policy rates



Source - RBC Wealth Management, Bloomberg; implied rates based on Overnight Index Swaps; data as of 11/9/17

United States

- The Fed is forecasting three rate hikes in 2018. In our view, the Fed's belief that inflation will move toward its target shouldn't sidetrack its "gradualist" rate hike plans.
- We expect the U.S. economy to maintain its steady-growth path as key indicators show few recession risks on the horizon. A wild card that could result in stronger growth would be the Trump administration delivering on its fiscal stimulus plans.
- 10Y Treasury yields inched higher late in 2017, but we don't anticipate significant additional upside largely due to patient central banks. We think the Fed's forecast for a 2.75% terminal fed funds rate should be viewed as a cap on 10Y Treasury yields.
- Credit spreads have little room to tighten further, but we don't foresee significant spread widening amid solid economic fundamentals. We recommend a focus on quality and feel slightly higher Treasury yields could provide an opportunity to extend duration. Preferred shares and munis will continue to provide selective opportunities.

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Canada

- With the Canadian economy likely to operate near full capacity and fiscal policy to remain expansionary, the anticipated speed of interest rate hikes is likely to dictate the direction of bond markets. A flatter curve keeps our focus on short to intermediate bond maturities.
- Despite an improving economic backdrop, credit spreads are at the tightest levels in nearly a decade, which keeps us wary of taking on too much credit risk. We continue to utilise the growing non-domestic issuer (maple) market as a source of diversification.
- Higher interest rates over the medium term provide a constructive backdrop for preferred shares, while the development of the hybrid market could divert supply and provide additional support. We believe investors are being adequately compensated for the subordination risk in preferred shares relative to corporate bonds.

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Continental Europe /United Kingdom

- Despite the European Central Bank deciding to taper its monthly bond purchase program from €60B to €30B from the beginning of 2018, we see yields within the region remaining well-underpinned given the central bank's ongoing accommodative approach and its focus on maintaining an extended period of stimulus. The current low level of inflation, at 0.9%, compared to its target of "close to but below 2%" provides support to its accommodative approach being maintained for the coming year.
- In the U.K., we do not see the recent 25 basis points hike from the Bank of England as the start of a tightening cycle. With ongoing uncertainty around Brexit negotiations and signs of a slowdown in economic momentum, we see rates in a holding pattern.

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2018 view

Currencies

United States dollar – On the right track

- The dollar is poised to gain ground in 2018 after broadly underperforming through 2017. The ongoing tightening cycle set against firm economic growth should underpin USD strength with the market underpricing the trajectory of rate hikes. Tax reform uncertainty is the chief source of downside risk.

Canada dollar – Caution for now

- The Bank of Canada adopted a more cautious tone in the face of elevated household debt with a pause in the tightening cycle likely to limit near-term CAD support. Tighter monetary policy through 2018 should provide scope for renewed strength, though risks around NAFTA renegotiations will be watched closely.

Euro – Potential weakness

- The long path towards normalisation of monetary policy signaled by the ECB surprised the market, and ostensibly ended the euro's rally. The continued adoption of a "lower for longer" stance will likely keep the euro under pressure over the coming year.

British pound – Under pressure

- Brexit uncertainty and a continued squeeze on U.K. consumers underpin our expectation for a weaker GBP next year. With no further rate hikes expected in 2018, as the Bank of England downplays inflation concerns, potential support for GBP is likely to be limited.

Japanese yen – Possible underperformance

- With monetary policy likely to remain highly accommodative in Japan, as others move gradually towards normalisation, we would envisage the yen underperforming. Continued sensitivity to exogenous factors, such as swings in risk appetite, is likely to make trends difficult to spot amongst heightened volatility.

Commodities

Oil – Eye on OPEC

- Global oil inventories fell for the third consecutive quarter in Q3 2017. The rebalancing effort will push into 2018, with OPEC contemplating a further extension of the current production cut agreement beyond March 2018.
- The International Energy Agency (IEA) revised oil demand growth higher to 1.6% in 2017 following a strong Q2, and expects 2018 growth to moderate slightly to 1.4%.
- A significant push of prices past $55 per barrel will likely be curbed by resurgent shale output.

Natural gas – Obstacles of oversupply

- The Industrials sector is expected to emerge as the main engine of natural gas demand growth, according to IEA, but power generation also continues to expand, albeit at a more modest rate.
- Oversupplied markets will likely keep pressure on prices and discourage new upstream investment in gas production.

Gold – Pricing limbo

- Geopolitical risks remain a supportive factor of spot prices, but the prospect of higher U.S. interest rates could keep a lid on price momentum.

Base metals – China's important impact

- We expect global economic growth to moderate slightly in 2018 as real estate investment slows in China and the impact of 2016–17 stimulus wanes. Infrastructure spending in China will remain key for base metals prices, and the "One Belt, One Road" initiative could provide potential upside depending on the scale and speed of execution.
- Near term, most base metals have ample supply, leaving them vulnerable to downside pressure if demand doesn't materialize.

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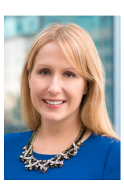

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